

## ESG Indexes Through the Slump and Rally of 2020

Yuliya Plyakha Ferenc | March 2021

The year 2020 was a rollercoaster ride for individuals' personal lives as well as the financial markets. In fact, during 2020 we witnessed two stock market regimes: a slump – from Jan. 1, 2020 to March 23, 2020 and a rally – between March 24, 2020 and the end of the second week of 2021.<sup>1</sup> The slump and rally provided a unique window to examine the performance of different ESG strategies, which have proliferated in recent years but have endured fewer market cycles than more traditional strategies.

During the worst of the pandemic's impact on equities, ESG indexes tended to outperform particularly due to positive contribution of stocks with high MSCI ESG ratings.<sup>2</sup> But how did these indexes fare for all of 2020, when one considers all the ups and downs? When we looked back at the whole 2020, we found that despite important differences in how MSCI's flagship ESG Indexes have been constructed, all had performed in line or better than their parent MSCI ACWI Index (Exhibit 1; the Appendix provides key index performance metrics). We took a deep dive into the common factors that were driving MSCI ACWI ESG indexes performance and found:

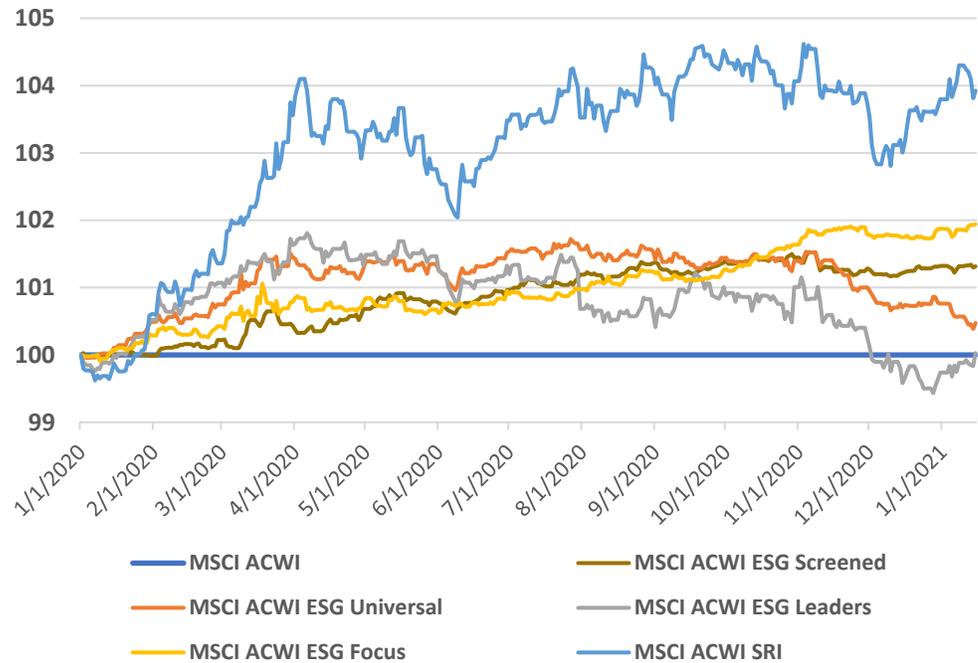
- While all MSCI ACWI ESG indexes finished the year 2020 at least as well as their parent, most of them outperformed during both the slump and rally of 2020. ESG characteristics played a leading role in outperformance during the slump, rally, and the whole year.
- Higher index concentration together with the higher average ESG index scores ('ESG scores') led to higher performance. The two most concentrated indexes with the highest index-level ESG scores, the MSCI ACWI SRI and MSCI ACWI Focus Indexes, outperformed other ESG indexes. Lower concentration led to less pronounced ESG effect and a reduction in active returns.

<sup>1</sup> We examine both the level of CBOE VIX® Index, which is an indicator of market uncertainty and the level of MSCI ACWI IMI Index. After a rapid increase, which started on March 3, 2020, CBOE VIX® Index experienced the new high of 82.69 on March 18, 2020, followed by the global market's slump on March 24, 2020. The highest GFC VIX® level was documented on Oct. 24 in 2008 and reached the mark of 89.53. We end the sample on Jan. 10, 2021.

<sup>2</sup> See [MSCI ESG Indexes during the coronavirus crises](#).

- The negative correlation between ESG and volatility that has been found across studies provided a ‘protective’ effect during the slump, as expected, but impaired performance during the rally.<sup>3</sup>

**Exhibit 1. Relative Performance of Select MSCI ESG Indexes vs MSCI ACWI Index**



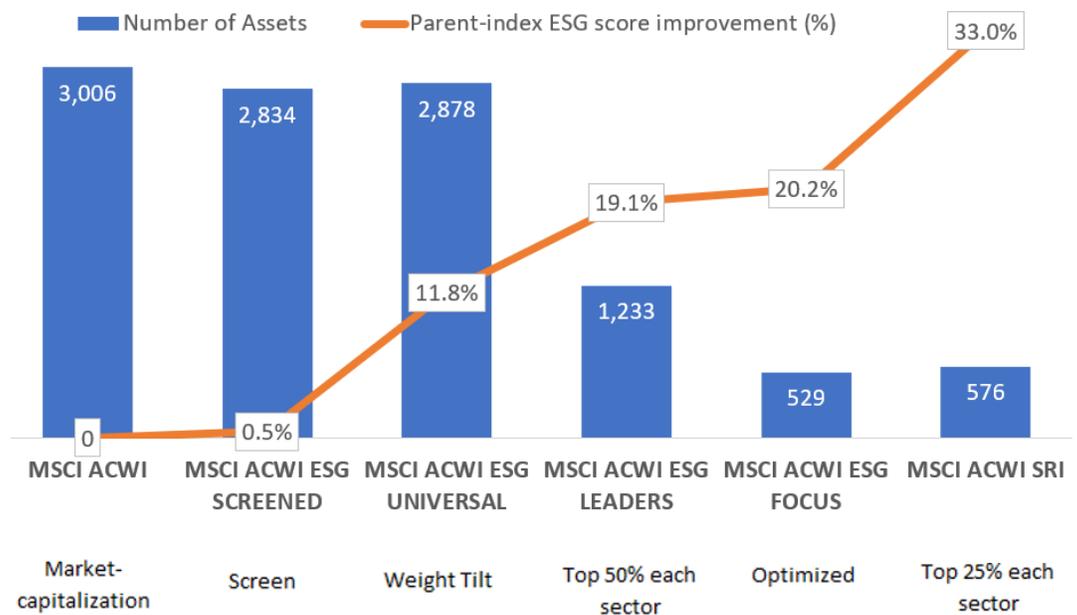
Data from Dec. 31, 2019 to Jan. 15, 2021

The five flagship MSCI ACWI ESG indexes have been constructed to help investors achieve a range of ESG and financial objectives. Some are better suited to meeting values-based objectives while others preserve a broad investment universe with minimal deviation from the benchmark. The diverse level of exclusions and asset weighting schemes are summarized in Exhibit 2. We sorted the indexes according to the improvement of their ESG scores over the parent index during 2020. The level of improvement was the smallest for MSCI ACWI ESG Screened Index, while it was the highest for MSCI ACWI SRI Index.

<sup>3</sup> See, for example, Giese, G., Lee, L.-E., Melas, D., Nagy, Z., and Nishikawa, L. 2019. “Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance.” *The Journal of Portfolio Management*.

Exhibit 3 reveals that ESG was a main performance driver of the ESG indexes during 2020.<sup>4</sup> In fact, it was the largest positive contributor for three of the five indexes, with the Industry factor being a larger contributor for the broadest indexes. The ESG indexes with greater concentration and greater ESG score improvement enjoyed both strongest performance and higher active performance contribution from the ESG factor. The performance contribution from other equity style factors appears to be negligible, except for the MSCI ACWI SRI Index, where the contribution was sizable.

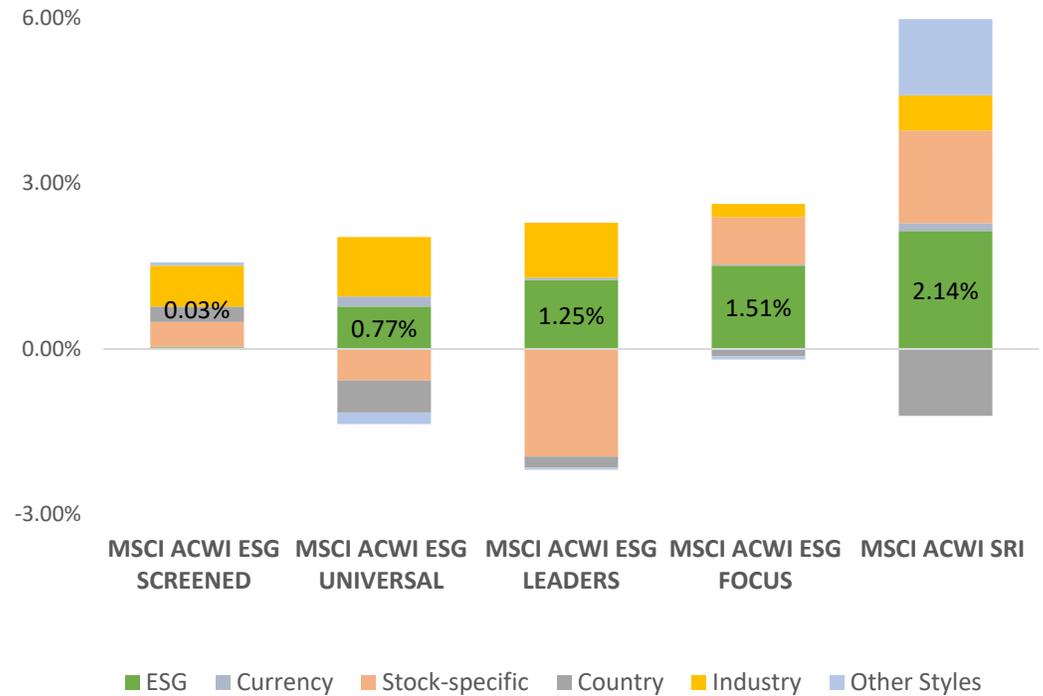
**Exhibit 2. Methodology, Concentration and ESG Score Improvement During 2020**



Data from Dec. 31, 2019 to Jan. 15, 2021

<sup>4</sup> For this study we leverage [MSCI Barra Global Equity Total Market Model with ESG factor](#), which builds on top of the MSCI Barra Global Equity Total Market Model methodology and allows us to measure portfolio exposure to ESG factor. This factor is based on the [MSCI ESG Ratings](#) and assigns higher ESG exposure to stocks with higher MSCI ESG Ratings.

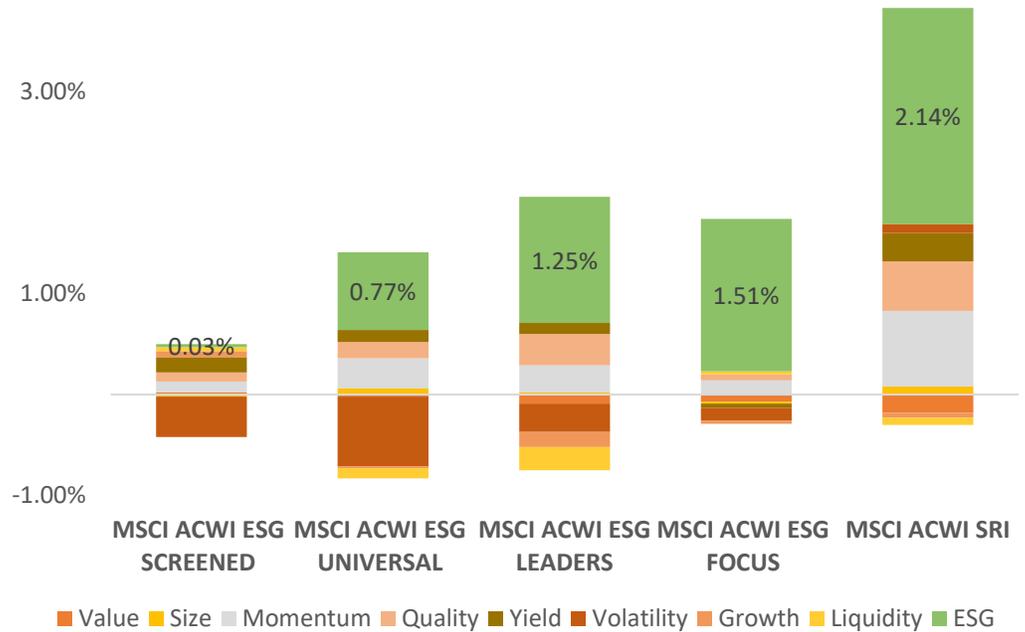
**Exhibit 3. Active Factor Attribution During 2020**



Data from Dec. 31, 2019 to Jan. 15, 2021

What role did style factors play throughout the highly volatile year? During the period between November 2013 and January 2021 ESG Indexes shared several commonalities with respect to their fundamental characteristics, which became paramount during 2020. Compared to the MSCI ACWI Index they had on average lower exposure to Value and Residual Volatility, and higher exposure to Momentum, Quality, and ESG factors.

Exhibit 4. Style Factors Active Performance Attribution During 2020



Data from Dec. 31, 2019 to Jan. 15, 2021

Exhibit 4 shows that on top of the **ESG factor, Quality and Momentum** characteristics played a positive role during the whole year. Interestingly, **Residual Volatility’s** contribution to active return was negative for most Indexes. This might be surprising, as in the long run low residual volatility stocks have tended to outperform high residual volatility stocks<sup>5</sup> and, as we mentioned above, all Indexes in this study have had negative active exposure to residual volatility factor. To probe further, we examined the active return contribution of the Residual Volatility factor (and all style factors) during the slump and the rally. Exhibit 5 shows that, in fact, the role of Residual Volatility throughout the two periods was reversed: it played a protective role for four out of five indexes during the slump, but negatively impact performance for all five indexes during the rally.

<sup>5</sup> See, for example, Ang, A., Hodrick, R. Xing, Y., and Zhang, X. 2006. “The Cross-Section of Volatility and Expected Returns.” *Journal of Finance*, and references therein.

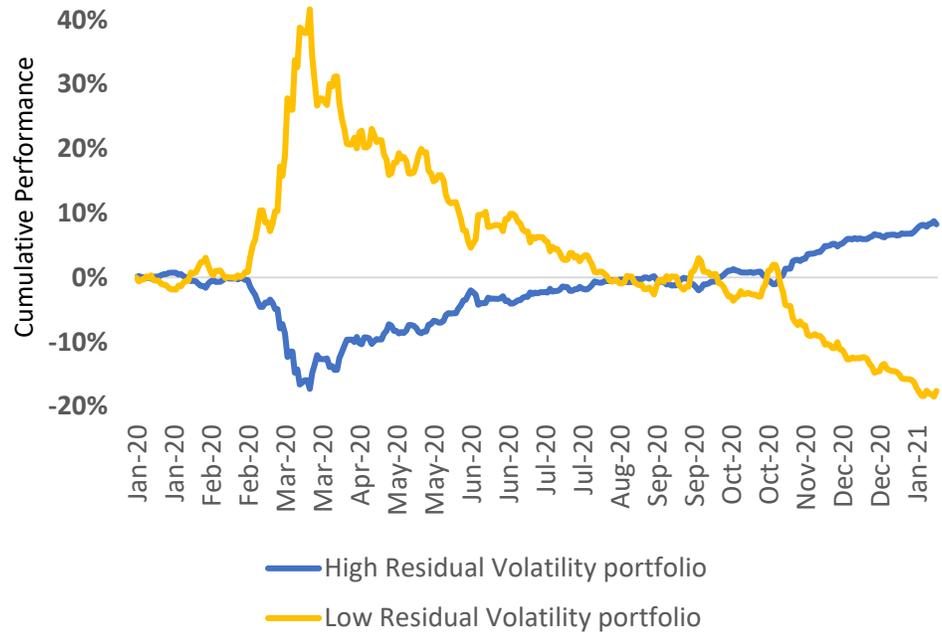
**Exhibit 5. Style Factors Active Performance Attribution**



Data from Dec. 31, 2019 to Jan. 15, 2021

Further, to isolate the reason for a reverse contribution from Residual Volatility factor we formed two portfolios from MSCI ACWI Index stocks, one with low residual volatility stocks, another with high residual volatility stocks. The insights of the reverse contribution from Residual Volatility factor during slump and rally are demonstrated by the performance of the two portfolios in Exhibit 6: Low residual volatility stocks underperformed high residual volatility stocks during rally.

Exhibit 6. Performance of High and Low Residual Volatility Stocks Constituents



Data from Dec. 31, 2019 to Jan. 15, 2021

Though MSCI ACWI ESG indexes are different in terms of asset weighting rules and concentration, they have several features in common that helped them to stand the slump and rally of 2020. They enjoyed positive and somehow expected contribution from Industries, ESG, Quality, and, less expected from Momentum factors. An unexpected appeared small negative or weak contribution from Residual Volatility factor because during the rally low volatility stocks underperformed high volatility stocks making all low volatility strategies vulnerable during this period. And ESG stayed resilient through trough and rally of 2020.

## Appendix: Key Index Performance Metrics

	MSCI ACWI Index	MSCI ACWI ESG Screened Index	MSCI ACWI ESG Universal Index	MSCI ACWI ESG Leaders Index	MSCI ACWI ESG Focus Index	MSCI ACWI SRI Index
<b>Total return* (%)</b>	11.1	11.6	11.6	11.6	12.1	12.6
<b>Total risk (%)</b>	13.5	13.6	13.3	13.1	13.6	13.0
<b>Return / risk</b>	0.82	0.85	0.87	0.89	0.89	0.97
<b>Sharpe ratio</b>	0.77	0.80	0.82	0.83	0.84	0.91
<b>Active return (%)</b>	0.0	0.4	0.5	0.5	0.9	1.4
<b>Tracking error (%)</b>	0.0	0.5	0.7	1.1	0.5	1.6
<b>Information Ratio</b>		0.95	0.77	0.41	1.78	0.91

*Data from Nov. 30, 2012, to Jan. 31, 2021. All metrics annualized for periods longer than a year. ACWI ESG Universal since Feb. 8, 2017; MSCI ACWI ESG Focus since June 25, 2018; and MSCI ESG Screened since Dec. 14, 2018. \*Gross returns annualized in USD.*

## Contact us

esgclientservice@msci.com

### AMERICAS

Americas	1 888 588 4567 *
Atlanta	+ 1 404 551 3212
Boston	+ 1 617 532 0920
Chicago	+ 1 312 675 0545
Monterrey	+ 52 81 1253 4020
New York	+ 1 212 804 3901
San Francisco	+ 1 415 836 8800
São Paulo	+ 55 11 3706 1360
Toronto	+ 1 416 628 1007

### EUROPE, MIDDLE EAST & AFRICA

Cape Town	+ 27 21 673 0100
Frankfurt	+ 49 69 133 859 00
Geneva	+ 41 22 817 9777
London	+ 44 20 7618 2222
Milan	+ 39 02 5849 0415
Paris	0800 91 59 17 *

### ASIA PACIFIC

China North	10800 852 1032 *
China South	10800 152 1032 *
Hong Kong	+ 852 2844 9333
Mumbai	+ 91 22 6784 9160
Seoul	00798 8521 3392 *
Singapore	800 852 3749 *
Sydney	+ 61 2 9033 9333
Taipei	008 0112 7513 *
Thailand	0018 0015 6207 7181 *
Tokyo	+ 81 3 5290 1555

\* = toll free

## About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

## About MSCI ESG Research Products and Services

MSCI ESG Research products and services are provided by MSCI ESG Research LLC, and are designed to provide in-depth research, ratings and analysis of environmental, social and governance-related business practices to companies worldwide. ESG ratings, data and analysis from MSCI ESG Research LLC. are also used in the construction of the MSCI ESG Indexes. MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc.

To learn more, please visit [www.msci.com](http://www.msci.com)

## Notice and disclaimer

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. or its subsidiaries (collectively, "MSCI"), or MSCI's licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the "Information Providers") and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or disseminated in whole or in part without prior written permission from MSCI. All rights in the Information are reserved by MSCI and/or its Information Providers.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not be applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, "Index Linked Investments"). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investable assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on [www.msci.com](http://www.msci.com).

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.'s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.'s company filings on the Investor Relations section of [www.msci.com](http://www.msci.com).

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Except with respect to any applicable products or services from MSCI ESG Research, neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI's products or services are not intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Issuers mentioned or included in any MSCI ESG Research materials may include MSCI Inc., clients of MSCI or suppliers to MSCI, and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and Standard & Poor's. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and Standard & Poor's.

MIFID2/MIFIR notice: MSCI ESG Research LLC does not distribute or act as an intermediary for financial instruments or structured deposits, nor does it deal on its own account, provide execution services for others or manage client accounts. No MSCI ESG Research product or service supports, promotes or is intended to support or promote any such activity. MSCI ESG Research is an independent provider of ESG data, reports and ratings based on published methodologies and available to clients on a subscription basis. We do not provide custom or one-off ratings or recommendations of securities or other financial instruments upon request.

For information about how MSCI collects and uses personal data, please refer to our Privacy Notice at <https://www.msci.com/privacy-pledge>.