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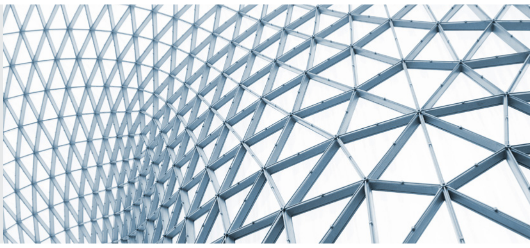

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How ESG supercharged a Shiller strategy

Combining smart beta with ESG filtering and carbon reduction techniques shown to enhance returns.

Key Takeaways:

- Ossiam's ESG Shiller strategy [1] takes a straightforward and proven methodology and adds to it a transparent, comprehensible ESG overlay.
- Ossiam combined its smart beta know-how and ESG expertise to create an ESG version of the high-performing Shiller Strategy[2], significantly reducing the carbon impact of the portfolio.
- Over the long-term, the Shiller Strategy has proved its worth, and over a shorter timeframe the ESG overlay has added considerable value. That value, given economic, social and investment trends around sustainability, could persist.

The CAPE® ratio, developed by the Yale economist professor Robert J. Shiller, has proved its effectiveness beyond all reasonable doubt.

US stocks returned a healthy 10.18% a year[3] on average from 2002 to 2019, but over the same period the Shiller strategy, implementing this ratio, outperformed US stocks by more than 3% a year.

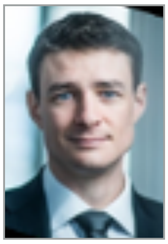
Given this sizeable outperformance, some investors might be willing to sacrifice a small part of the upside for an ESG-friendly version of the strategy. But they would not need to. The evidence to date shows that a low carbon version of the strategy has only increased the outperformance.

So what is the Shiller strategy and how does ESG integration impact its risk profile and returns?

Constructing a sector-rotation portfolio

Robert Shiller, who received the Nobel Prize in Economics for its empirical analysis of asset prices, is the architect of the CAPE® (cyclically-adjusted price to earnings) Ratio. This ratio, now widely known as the Shiller P/E, is calculated by dividing a market index price by the average of the index's earnings for the last ten years, adjusted for inflation.

(1) the Ossiam's ESG Shiller Barclays CAPE US Sector Value
(2) the Shiller Barclays CAPE US Sector Value
(3) as represented by the S&P 500 NTR

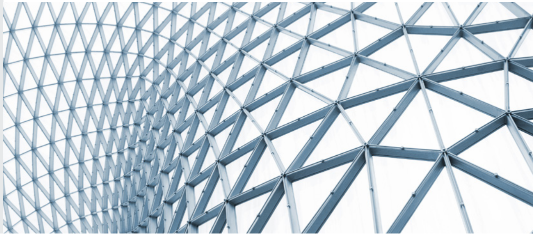


Tristan Perret, CFA
Co-Head of Investment Management and Research
Ossiam

The relationship between the CAPE® ratio and long-term returns from the stock market is robust. In essence, if CAPE® indicates that the market is expensive long-term returns will tend to fall, and vice-versa.

The Shiller Strategy, which serves as a starting point for the Ossiam's strategy, has adapted this ratio to identify the five most undervalued sectors in the S&P 500. Of these five, the one with the lowest momentum over the last twelve months is removed to avoid a potential value trap (whereby a cheap sector just keeps getting cheaper). The index then equally weights the four remaining undervalued sectors and rebalances them monthly.

The strategy is very easy to understand which is why investors like it," says Tristan Perret, co-head of investment management and research at Ossiam, the smart beta specialist affiliate of Natixis Investment Managers. "What you get is a sector rotation strategy based on a valuation metric, which is very different from traditional value strategies."



What you also get is returns of more than 13% a year on average over nearly two decades.

ESG overlay increases performance

Given investor demand for ESG investments, Ossiam decided to combine its smart beta know-how and its ESG expertise to create an ESG version of its successful Shiller Strategy. The aim was to significantly reduce the carbon footprint of the portfolio.

Two discrete components feed into the ESG version of the strategy. The first component takes the sector selections from the Shiller Strategy and removes stocks which are categorised as "controversial". Typical exclusions relate to controversial weapons, tobacco or thermal coal. It also removes stocks that are in breach of one of the Ten Principles of the UN Global Compact, which commits signatories to implement universal sustainability principles. In the utility sector, companies which derive more than 20% of their electricity production from thermal coal are also removed. Finally, it removes companies that undergo severe controversies (such as environmental incidents or governance incidents like corruption or money laundering).

So the first component excludes a number of companies and therefore reduces the size of each sector. The second component takes these reduced-sized sectors and optimises them to reduce carbon footprint. "We have set an ambitious goal of a 40% reduction in total greenhouse gas emissions, carbon intensity and potential emission from reserves," says Perret.

The two-step process has had a remarkable impact on the performance of the strategy. Whereas the US equity version of the Shiller Strategy already outperformed the S&P 500 by more than 1% last year, the ESG integration added a further 6% to returns. The first component, which excludes controversial companies, added around 2% of performance, while the optimisation to improve the carbon footprint of the portfolio explains the remaining 4% of outperformance.

Was ESG outperformance in 2020 an anomaly?

Let it be said that 2020 was an unusual year. Buoyed by stay-at-home-stocks, ESG themes surged and outperformance by the two components of Ossiam's ESG Shiller Strategy was continuous throughout the year.

The outperformance of the tech sector was accelerated in Ossiam's ESG Shiller Strategy by the exclusion policy, which removed stocks such as Alphabet and overweighted Netflix, Adobe and Twitter, all even more impressive performers.

The optimisation component came through strong too, by excluding high carbon emitting companies such as airlines, which suffered from the economic impact of the pandemic.

The big question is: will the ESG overlay continue to outperform in "normal" markets?

"The crisis made the outperformance of ESG more extreme," says Perret. "But there are longer-horizon trends that ESG strategies should continue to benefit from." These include excluding or underweighting oil stocks, as the oil industry starts to see significant write-downs of the value of reserves. "Those write-downs have long been predicted by low carbon approaches," says Perret.

Taking into consideration climate change will be a leading indicator of portfolio outperformance in the future, he believes. "You don't know when and you don't know how and exactly by how much, but the trend is entrenched and ESG will likely add substantial value."

And even if ESG is not always a source of alpha in every period, it will likely be a source of protection versus downside risk, protecting portfolios from drawdown as unsustainable corporate practices are punished by regulators and investors.

The value of simplicity

Just occasionally an investment strategy is simple to understand, simple to invest in and also outperforms. Ossiam's ESG Shiller Strategy takes a straightforward and proven methodology and adds to it a transparent, comprehensible ESG overlay.

Over the long-term, the Shiller Strategy has proved its worth, and over a shorter timeframe the ESG overlay has added considerable value. That value, given economic, social and investment trends around ESG, could persist.

Written in May 2021

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