RI Interview: QMA CEO Andrew Dyson on ESG quant research and the danger of the bandwagon

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by **Hugh Wheelan** | July 23rd, 2018

In a recent letter to clients, Andrew Dyson, the Chairman and Chief Executive Officer of US fund manager QMA, said that on a trip a few weeks back to Europe virtually every other conversation was about "one facet or another of environmental, social and governance (ESG) investing", so much so that "it had gotten to feel a bit like the movie Groundhog Day".

Dyson, an expat Brit, is an old hand in asset management, so his perspective is worth listening to. He joined QMA from Affiliated Managers Group where he was an Executive Vice President, and he's a former Head of BlackRock's Global Institutional Client Business. Prior to that he had a long senior advisory career at Mercer in Europe and the US. QMA is a quant manager within the multi-manager model of PGIM, the large investment management business of US-based Prudential Financial. It runs about $130bn in assets via a dynamic multi-factor strategy and a quant multi-asset business; 95% of which is US money.

Dyson could be having a few more ESG Groundhog Days – maybe even Stateside this time – because QMA has published an interesting, detailed research paper that contributes to the data/performance/applicability debate of ESG in quant/factor investing that is likely to generate many more discussions, as all good research papers should do. It adds to a healthy flow of quant ESG research at the moment by fund managers.

In his client letter, Dyson posits 3 rules he believes are important to the ESG discussion.

The first, he says is that "Facts are the facts". What does he mean? Talking to RI, he says QMA already includes a couple of corporate governance attributes,

including audit independence, as part of its normal factor models because they meet its tests of large-scale data availability, clear underlying academic/economic thesis that can be tested over cycles and across markets, and they are investment 'additive'. He adds: "What we're not willing to do, and what our clients don't expect us to, is to include a factor of any sort which doesn't meet that high bar." To broaden its research into ESG factors, it carried out a meta-study analysing the conclusions of the overall body of related research. In his letter, Dyson gives the three-second version of its results: “Studies have conclusively shown that companies that score better on ESG enjoy lower costs of capital, both debt and equity, and higher valuations than companies that score poorly on ESG. However, as yet, no definitive evidence exists based on the past 30-some years of data that investing in such companies produces higher returns (or lower returns for that matter).”

A quant manager – certainly a multi-factor manager – has a different lens, of course, to a fundamental manager. As Dyson notes to RI: “We view an individual stock as a collection of attributes; it has a certain exposure to 14 or 15 signals such as value, quality and growth, which we’ll score in order to build the best portfolio. One of the things we’re not doing in that conversation is making a judgement about the business plan per se of a company.”

But again, as he points out, financially relevant quant data does not “preclude an argument that, for example, investing in companies that produce outsize carbon emissions will hurt future returns. It may well be that society imposes future taxes on such companies that change the nature of their business, or are not presently reflected in their valuations, so their emissions can definitely be argued to be an incremental risk they bear. He says he can personally see this as a reasonable risk for a fiduciary to consider. But, he notes: “This is demonstrably an opinion, not a fact, and should be debated as such before being accepted.”

Coming back to the data, QMA’s study is titled Integrating ESG in Portfolio Construction and was produced by a heavyweight quartet of finance professionals: Roy Henriksson, QMA Chief Investment Officer, Patrick Pfeifer, Vice President, Margaret Stumpp, Senior Advisor and former CIO at QMA, who is also on the Investor Advisory Group of SASB, and Joshua Livnat, a Professor Emeritus of Accounting at New York University Stern School of Business.

The research is extensive and merits a full read. It examines the potential integration of material ESG factors into quant portfolio construction, notably including companies where ESG data is thin, a significant problem currently. It does this by expanding the classification of non-ESG-reporting firms into good and bad ESG groups and then using a related ESG Good Minus Bad (GMB) factor to scale up the number of companies by over 200% while preserving the characteristics and return patterns of the original sample. Using its quant technique of taking large numbers of positions and small active exposures, QMA says it can incorporate the sparse ESG data into portfolio construction and tilt the aggregate portfolio towards good and away from bad ESG firms. The manager is proposing this to clients, but Dyson’s second qualification on ESG is to ‘remember whose money it is’, which is important, but something that should be difficult to overlook. He explains that the spectrum of client demand is “much more nuanced than the debate seems to acknowledge”.

“The great majority of people do believe in climate change and are interested in ways of ameliorating that. And there are a number of investors who believe that factoring in ESG criteria is the only way to invest for the long-term, which also goes beyond ESG into impact investing. At the other end of the spectrum, there are a lot of investors, particularly in the US, who are just after returns. But actually, there are a lot of investors in the middle as well, and I think that they are all too easy to miss. They say: “I can accept that there are risks that aren’t being captured so it is right to reflect those in some way, but not if that means missing out on returns.”

For QMA this means ‘four shades’ of quant ESG. The first is incorporating ESG factors into its current strategies that pass its evidential hurdle. The second shade is at the other end of the spectrum for mission-type investors who make their own values-based decisions on exclusions. In between sit two strategy shades. The first is a set of exclusions based on QMA’s good versus bad company research. The second is for investors who see the good versus bad signal as a risk factor, but don’t want to rule out investing in bad companies if they’re attractive on other factors: “We think there’s a lot of investors on the spectrum who would say that’s where they are.”

Dyson’s third rule is: “Be transparent”, which he says is vital: “Given the bandwagon-loving nature of our industry.” He notes: “It is no surprise to find that virtually all managers have hitched themselves to ESG in one way or another, if only as a defence mechanism in response to the volume of questions and interest we are all receiving.” Talking to RI, he adds: “There’s a reason people do it. By the time you have consultants rating every manager in sight on ESG, even if you weren’t a great believer in bandwagons it would be hard to not jump on it. But if I look at who is actually on the bandwagon, on one end you have evangelicals who deeply believe, and that’s great. But I also perceive that there are a lot of people who I think are paying lip service and saying: ‘Of course we view this as an integral part of our research agenda,’ but its very hard to know how, or why or what.”