Enhancing ESG portfolio returns

Could Currency Alpha be the answer?

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Over the past decade, socially responsible investing has become a key objective of pension funds globally. Environmental, social and governance (ESG) risk ratings have enabled investors to incorporate non-tangible information about a company, such as environmental and employee welfare policies, into their investment decisions.

As the demand for ESG rated equity and bond funds increase, portfolio managers are consistently searching for ways to enhance the return to risk ratios of their funds versus those of their competitor's. Although this is not always a straightforward task given that investing in non-ESG assets usually impacts the overall fund's ESG rating in a detrimental manner. However, one possible solution could be an investment in currency alpha given its ESG neutral effect on the overall portfolio rating.

Currency Alpha

Whilst most portfolio managers are aware of the risks created by leaving the currency exposures of their international assets unhedged, far fewer are aware of the potential for returns that can be generated by investing in a currency alpha product.

In addition, making an allocation to currency alpha has neither a positive nor negative impact on the ESG rating a credit agency gives to a fund, its impact is "ESG rating neutral" in that respect. This is an important point as many ESG managers seek ways to enhance the returns of their portfolios, and therefore distinguish themselves from their competitors, without the additional investment changing the ESG score of their fund.

An additional benefit of allocating to currency alpha is that such an investment does not necessarily require to be funded as managed accounts can be used. Therefore, an allocation to currency would not involve having to raise additional capital and/or liquidating part of the underlying investment in the ESG equities or bonds.[1]

The purpose of this white paper is to assess the impact on the risk and return of a typical ESG equity and ESG bond portfolio when an allocation to currency alpha is made.

Methodology

To conduct the analysis, two popular ESG indices have been used as proxies for ESG equity and bond portfolio returns. For the equities, we use the MSCI World ESG Leaders Index;[2] this is a capitalisation-weighted index that provides exposures to companies with high ESG performance relative to their sector peers. For the bonds, we use the Bloomberg Barclays MSCI US High Yield Liquid Corporate Sustainability SRI Index;[3] this is a high-yield, US dollar-denominated benchmark that negatively screens out issuers with substantial revenue derived from sources such as alcohol, adult entertainment and tobacco. The analysis also uses a proxy for currency alpha—the Barclays Currency Traders Index;[4] this is an equally-weighted composite of managed programs trading solely in currency.

The data used in the study is monthly and commences from October 2007 for the equity analysis and January 2007 for the bond analysis, these dates coincide with the start dates of each of the indices. All analysis runs to the end of December 2020.

Analysis

ESG EQUITIES

In column 1 of Figure 1 we show the annualized performance of the ESG equity portfolio for the period end of September 2007 to end of December 2020. In addition, we also show the performance of the currency alpha. From a return-to-risk perspective, that currency alpha outperformed the ESG equity portfolio mainly due to significantly lower annualized standard deviation, 2.44% versus 16.74%. In addition, the currency alpha also had substantially lower maximum drawdown over the period, -2.98% versus -55.65%.

The returns of the ESG equity portfolio and the currency alpha were negatively correlated over the period of study, -0.24. This suggests that adding an allocation of currency alpha to the ESG equity portfolio would result in diversification benefits. To assess the impact of this, we calculated the performance of the ESG equity portfolio with a 20% allocation to currency alpha in column 3 of Figure 1. Over the period in question, adding currency alpha to the portfolio increase performance by 53bps and also reduced the overall risk of the portfolio.

Figure 1 shows performance data for the overall period, however, in order to provide more granularity, in Figure 2 we have broken down the performance of the ESG equity portfolio, currency alpha and the combined portfolio (ESG equity + 20% currency alpha) on a year-by-year basis together with the excess returns generated by adding the allocation to currency in each year.

Column 4 of Figure 2 shows that in 13 of the 14 years studied, an allocation to currency alpha would have generated positive returns. In total over the period, it could have added about7% to the ESG equity portfolio. Figure 2 also highlights the diversification benefits of adding currency alpha, as it shows that in each of the 5 years that the ESG equity portfolio suffered losses, the returns from currency alpha were positive and hence would have helped the overall portfolio return.

FIGURE 1. ESG EQUITY PORTFOLIO AND CURRENCY ALPHA PERFORMANCE

	ESG Equities	Currency Alpha	ESG Equity + 20% Currency Alpha
Annualized Risk	3.70%	2.60%	4.23%
Annualized Stdev	16.84%	2.44%	16.72%
Ret/Risk	0.22	1.07	0.25
Max Drawdown	-55.65%	-2.98%	-55.36%
Correl (ccy, equities)			-0.24

Source: Mesirow, Bloomberg. Proxy for equities is the MSCI World ESG Leaders Index; proxy for currency is the Barclays Currency Traders Index. Period under study is from September 2007 to December 2020.

FIGURE 2. ESG EQUITY PORTFOLIO AND CURRENCY ALPHA YEAR-ON-YEAR PERFORMANCE (%)

	ESG Equities	Currency Alpha	ESG Equity + 20% Currency Alpha	Excess Returns
2020	12.62	4.77	13.57	0.95
2019	22.91	2.28	23.37	0.46
2018	-10.04	4.50	-9.14	0.90
2017	17.11	-0.05	17.10	-0.01
2016	4.87	1.44	5.16	0.29
2015	-3.04	4.58	-2.13	0.92
2014	2.81	3.31	3.47	0.66
2013	22.28	0.88	22.46	0.18
2012	11.12	1.71	11.46	0.34
2011	-7.85	2.28	-7.40	0.46
2010	8.03	3.42	8.72	0.68
2009	25.64	0.94	25.83	0.19
2008	-54.53	3.46	-53.83	0.69
2007	-2.85	0.95	-2.66	0.19
			Total	**6.89**

Source: Mesirow, Bloomberg. Proxy for equities is the MSCI World ESG Leaders Index; proxy for currency is the Barclays Currency Traders Index. Period under study is from September 2007 to December 2020.

1. Daily margin will be required if the currency alpha programme trades via futures or non-deliverable forward (NDFs) contracts. | 2. Bloomberg ticker GAIN Index | 3. Bloomberg ticker SUCMTRUU Index | 4. For more information, please see: https://portal.barclayhedge.com/cgi-bin/indices/displayCtaIndex.cgi?indexCat=Barclay-CTA-Indices&indexName=Currency-Traders-Index

ESG BONDS

In Figure 3 we show the annualized performance of the ESG bond portfolio and currency alpha, alongside the performance of the ESG bond portfolio with a 20% allocation to currency alpha. Again, we see the benefit of such an allocation to currency with the combined portfolio's return improving by 52bps and risk reducing slightly. This is further highlighted in Figure 4, in which we break down the performance of each of the portfolios on a year-on-year basis. The ESG bond portfolio suffered losses in 4 out of the 14 years in the study and, in each of those years, having an allocation to currency generated positive returns and therefore would have helped in terms of improving overall performance.

FIGURE 3. ESG BOND PORTFOLIO AND CURRENCY ALPHA PERFORMANCE

	ESG Bonds	Currency Alpha	ESG Bonds + 20% Currency Alpha
Annualized Risk	5.58%	2.58%	6.10%
Annualized Stdev	6.04%	2.40%	6.02%
Ret/Risk	0.92	1.07	1.01
Max Drawdown	-16.07%	-2.98%	-15.76%
Correl (ccy, equities)			-0.09

Source: Mesirow, Bloomberg. Proxy for bonds is the Bloomberg Barclays MSCI US High Yield Liquid Corporate Sustainability SRI Index; proxy for currency is the Barclays Currency Traders Index. Period under study is from December 2006 to December 2020.

FIGURE 4. ESG BOND PORTFOLIO AND CURRENCY ALPHA YEAR-ON-YEAR PERFORMANCE (%)

	ESG Bonds	Currency Alpha	ESG Bonds + 20% Currency Alpha	Excess Returns
2020	9.65	4.77	10.60	0.95
2019	13.42	2.28	13.87	0.46
2018	-2.58	4.50	-1.68	0.90
2017	6.03	-0.05	6.02	-0.01
2016	5.24	1.44	5.53	0.29
2015	-0.15	4.58	0.77	0.92
2014	7.33	3.31	7.99	0.66
2013	-1.87	0.88	-1.69	0.18
2012	7.70	1.71	8.04	0.34
2011	8.72	2.28	9.17	0.46
2010	8.25	3.42	8.94	0.68
2009	16.91	0.94	17.10	0.19
2008	-5.36	3.46	-4.67	0.69
2007	4.88	2.58	5.39	0.52
			Total	**7.22**

Source: Mesirow, Bloomberg. Proxy for bonds is the Bloomberg Barclays MSCI US High Yield Liquid Corporate Sustainability SRI Index; proxy for currency is the Barclays Currency Traders Index. Period under study is from December 2006 to December 2020.

ESG EQUITIES AND ESG BONDS

So far, we have considered the impact of an allocation of currency alpha to an ESG equity portfolio and an ESG bond portfolio separately. In this final section, we look at the impact of adding currency to a portfolio consisting of 50% ESG equities and 50% ESG bonds.

Figure 5 illustrates the overall annualized performance of each portfolio over the period studied and Figure 6 shows the year-on-year breakdown of performance of each. The diversification benefits generated by allocating to currency are again highlighted via the improvement to the overall return/risk statistic and also in the year-by-year excess returns.

FIGURE 5. ESG EQUITY/ESG BOND PORTFOLIO AND CURRENCY ALPHA PERFORMANCE

	60% ESG Equities & 60% ESG Bonds	Currency Alpha	60% ESG Equities & 60% ESG Bonds + 20% Currency Alpha
Annualized Risk	4.70%	2.60%	5.22%
Annualized Stdev	10.16%	2.44%	10.06%
Ret/Risk	0.46	1.07	0.52
Max Drawdown	-35.15%	-2.98%	-34.73%
Correl (ccy, equities)		-0.23	

Source: Mesirow, Bloomberg. Proxy for equities is the MSCI World ESG Leaders Index; proxy for bonds is the Bloomberg Barclays MSCI US High Yield Liquid Corporate Sustainability SRI Index; proxy for currency is the Barclays Currency Traders Index. Period under study is from September 2007 to December 2020.

FIGURE 6. ESG EQUITY/ESG BOND PORTFOLIO AND CURRENCY ALPHA YEAR-ON-YEAR PERFORMANCE (%)

	60% ESG Equities & 60% ESG Bonds	Currency Alpha	60% ESG Equities & 60% ESG Bonds + 20% Currency Alpha	Excess Returns
2020	11.13	4.77	12.09	0.95
2019	18.17	2.28	18.62	0.46
2018	-6.31	4.50	-5.41	0.90
2017	11.57	-0.05	11.56	-0.01
2016	5.05	1.44	5.34	0.29
2015	-1.60	4.58	-0.68	0.92
2014	5.07	3.31	5.73	0.66
2013	10.21	0.88	10.38	0.18
2012	9.41	1.71	9.75	0.34
2011	0.43	2.28	0.89	0.46
2010	8.14	3.42	8.83	0.68
2009	21.28	0.94	21.47	0.19
2008	-29.94	3.46	-29.25	0.69
2007	-0.35	0.95	-0.16	0.19
			Total	**6.89**

Source: Mesirow, Bloomberg. Proxy for equities is the MSCI World ESG Leaders Index; proxy for bonds is the Bloomberg Barclays MSCI US High Yield Liquid Corporate Sustainability SRI Index; proxy for currency is the Barclays Currency Traders Index. Period under study is from September 2007 to December 2020.

ESG and Currency Alpha

CAN ESG BE USED WITHIN CURRENCY ALPHA?

Prior to concluding the paper, in this next section we briefly discuss how ESG ratings can be used to generate signals within the currency alpha programs themselves.

Up until recently, ESG ratings have only been published at a corporate-level. However, with ESG ratings at a country-by-country level now becoming more readily available, the scope for potential use within the currency making decision itself has now increased.

For example, Middleton (2020) found that MSCI country level ESG ratings could be of use in predicting G10 currency prices. Middleton also found that the ESG currency factor, developed as part of this research, exhibited low or negative correlation with other more 'traditional' currency trading strategies such as carry and trend. Thus, highlighting how incorporating ESG country-level ratings as part of the decision process within a currency strategy could offer benefits from a diversification stand point also.

Using the same MSCI ESG data, Baker, Braga-Alves and Morey (2021) looked at 42 currencies and also found significant relationships between a country's ESG rating and the future path of its exchange rate. Specifically, they found that countries with higher ESG ratings had substantially better performing currencies compared with the currencies of countries with lower ESG ratings.

INCORPORATING ESG INTO CURRENCY ALPHA AT MESIROW

Mesirow has four systematic currency alpha programs and, as part of the ongoing effort to ensure the efficacy of models underpinning the strategies, an ESG indicator was recently introduced within the fundamental model suite.

The indicator is based on bespoke in-house created ESG country ratings and is applied to 30 currency pairs ranging from G10 to emerging market economies. The ESG indicator, alongside other economic data, is then used to rank currencies to create a long/short portfolio. What has been noted thus far is that the signals generated by the ESG indicator exhibit low correlation with those produced from other economic data, thus making the ESG indicator a complimentary addition to Mesirow's current currency alpha model suite.[5]

Closing remarks

As ESG equity and bond investing becomes ever more popular, many managers are seeking ways to enhance the returns of their portfolio without impacting their ESG rating. Unfortunately, the majority of investment choices open to such managers will not be "ESG rating neutral" and may have a detrimental impact on the ESG rating a credit agency awards the fund. However, an allocation to currency alpha has neither a positive or a negative effect on the overall fund's ESG score and therefore may offer a solution to this problem.

Using empirical analysis, we have demonstrated how currency alpha can help enhance an ESG equity and bond portfolio's return-to-risk ratio and therefore offer a way for ESG managers to distinguish themselves from their competitors whilst simultaneously maintaining their ESG standings.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

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