INVESTOR CHALLENGE

Integrating ESG While Pursuing Alternatives–Like Returns

CHALLENGE

Find a liquid alternatives strategy that meets the investor's socially responsible investing requirements.

SOLUTION

We capture the volatility risk premium by selling options while integrating ESG characteristics into the base stock portfolio.

RESULTS

The investor gains improved ESG exposure while accessing a liquid, uncorrelated return stream.

Challenge

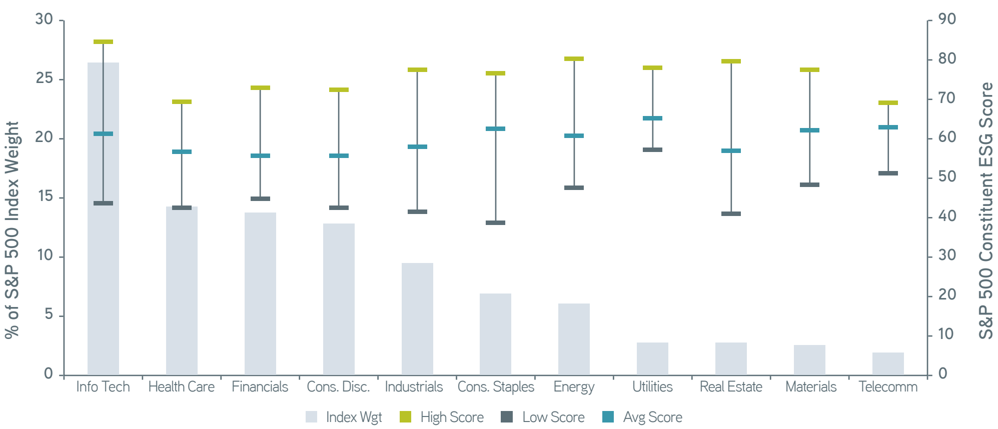
A longtime foundation client wanted to invest a portion of its endowment in a range of asset classes that reduce carbon emissions and promote sustainable growth. However, there were few liquid alternatives strategies that integrated companies' environmental, social, and governance (ESG) characteristics and provided sufficient transparency at an attractive cost.

How would we build a liquid alternatives strategy that also meets ESG requirements?

Solution

Parametric found that an embedded risk premium—the volatility risk premium (VRP)—creates an opportunity to enhance returns through option selling. Option sellers essentially provide financial insurance to buyers and are paid a premium for this service. What's more, the VRP has been found to be persistent over time. By providing this insurance for publicly traded large-cap stocks, investors can achieve a more liquid, transparent, and cost-effective return solution than other types of alternatives portfolios.

Furthermore, larger publicly traded stocks tend to be well evaluated from an ESG perspective. This makes it possible to consistently identify sustainable-growth characteristics, which often can't be done for privately held assets or thinly traded public securities. For example, all constituents of the S&P 500® Index receive comprehensive ESG scores, and higher-scoring companies can be found across all sectors.



Sources: Sustainalytics, S&P as of 6/30/2018.

ESG scores by sector

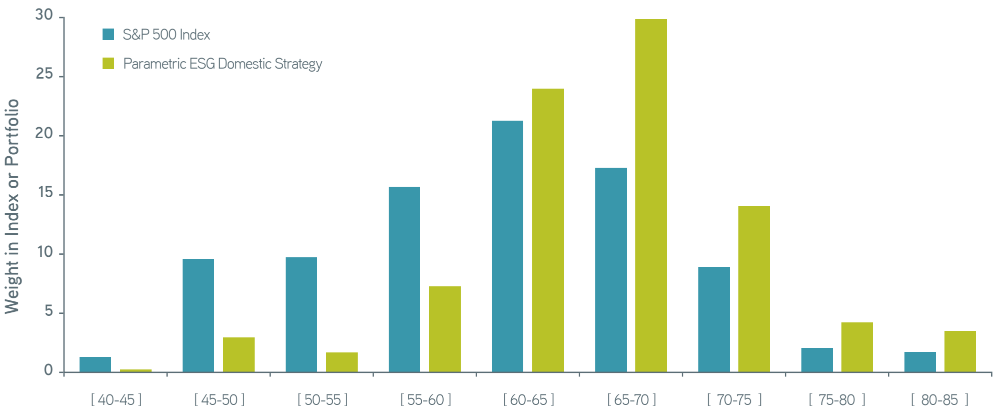
Parametric's VRP-based Defensive Equity Strategy sells out-of-the-money index put and call options against a base portfolio consisting of both US Treasury bills and stocks. The stock portion of the portfolio can be built integrating company-level ESG scores. For this foundation, we constructed a stock portfolio designed to increase exposure to companies that are proactively managing the ESG issues most material to their business. This helped build an investment strategy the foundation could use as a complement to—or replacement for—a hedged equity strategy, efficiently incorporating investor-specific ESG principles. Over the long run, Parametric's Defensive Equity Strategy aims to deliver more attractive risk-return characteristics than equities alone. The VRP-based strategy seeks to structurally reduce equity market risk while adding a relatively uncorrelated risk premium to enhance returns.

We captured the volatility risk premium by selling options while integrating ESG characteristics into the stock portion of the base portfolio.

Results

By using Parametric's ESG integration techniques to construct the stock portion of the base portfolio, the client increased its exposure to companies with strong ESG characteristics while still receiving the risk-return benefits of our Defensive Equity Strategy. Capturing the VRP using publicly traded large-cap stocks created an opportunity for the client to enhance return and simultaneously control holdings based on ESG requirements in one cost-effective solution.

We improved the client's ESG exposure while pursuing an uncorrelated return stream.



Sources: Parametric, Sustainalytics, S&P 500 Index as of 6/30/2018

Potential score improvement using ESG integration in an equity portfolio

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