Are ESG Stocks in a Bubble?

What a flows and valuation analysis of the most common ESG funds is telling us

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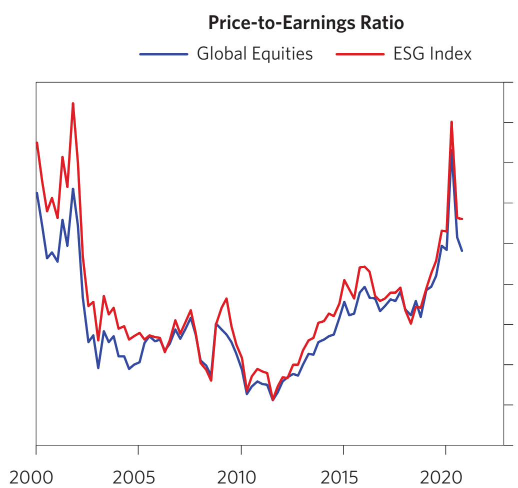
We increasingly see investors of all stripes prioritizing environmental and social impact goals in their investment portfolios. This raises the question: have investors already piled into companies that are most aligned with environmental and social goals, creating an "ESG bubble"?

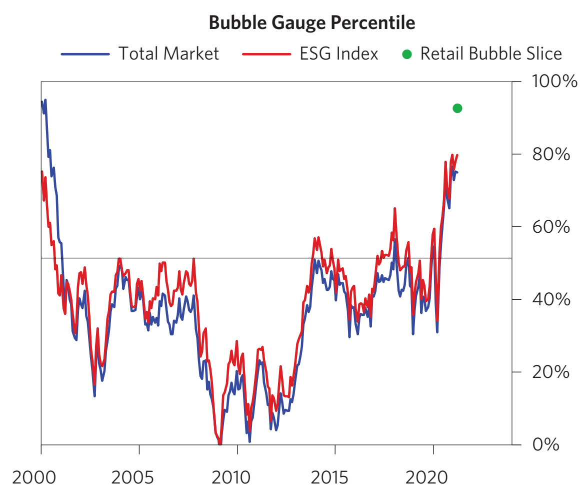
Here is what we see:

- **The valuation of common ESG indices continues to track the broader market**, and we see little overlap between the most popular ESG stocks and the stocks where we've seen a retail-fueled "bubble." The few sectors most significantly overweight by ESG indices, such as renewable electricity, have moderately higher valuations, but the valuations are well below what we see in the "bubble stocks" and constitute small weights in the index.
- **Positioning doesn't yet look overextended, and we suspect that the unfolding ESG story is still in early innings.** So far, only a small share of the money that could move has aligned with ESG goals: globally, 4-5% of the mutual fund and ETF universe is in ESG funds. Typically, transitions of this type take many years to complete. Examining the equity holdings of a group of institutional investors that has expressed significant interest in ESG, covering $1.5 trillion in public equity holdings, we see that they have been shifting out of industries like oil and defense for a decade or so and have room to shift further relative to common ESG indices.
- **Going forward, large ESG flows are likely still ahead of us.** If just 2.5% of all equity holdings shift to an ESG index (about the pace at which we've seen capital in the mutual fund universe make the transition), most sectors would receive inflows or outflows equal to 2-3% of market cap, leading to notable price moves. For sectors like water utilities and renewable electricity, inflows would be even larger. It is easy to imagine flows accelerating even faster, as European investors are already moving much more quickly. And while today's most common ESG indices make relatively modest changes in their holdings versus market cap, investors could push into ESG indices that require much larger changes to their equity portfolios. One such example of a sustainability-focused allocation is our BW Sustainable Equities portfolio.

Valuation of ESG Indices Is Very Similar to the Market

We looked at what is held by the most common ESG indices, aggregating the holdings of the largest global and local indices that are tracked by investors. As shown below, at the aggregate level, the common ESG indices have very similar valuation characteristics to the broad market. At the individual company level, only a handful of the stocks that ESG funds are most overweight relative to market cap flag as "bubble" stocks.



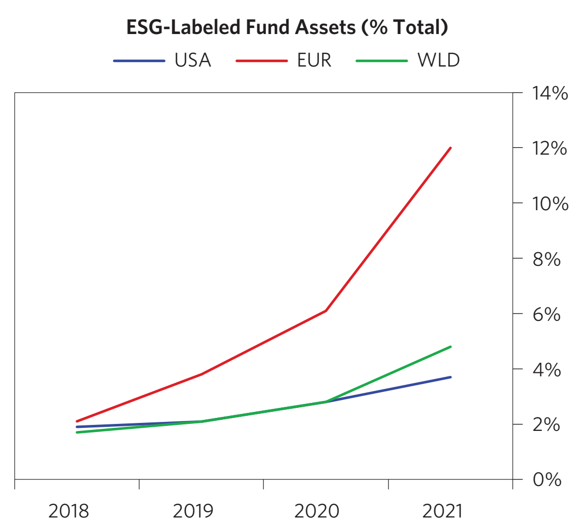


It is not surprising that valuation at the ESG index level would be similar to the valuation of the overall market, given that common ESG indices, as set out in their goals, track the market relatively closely and avoid making large deviations in exposure; they effectively cut out "the worst" companies and don't choose to hold only "the very best." As shown below, common ESG indices significantly divest from tobacco, defense, and oil; renewable electricity and water utilities get scaled up meaningfully, while a few sectors get scaled up to the tune of 1.5-2x market cap. **There is a small tail of sectors that are most significantly overweight by ESG indices and they do have moderately higher valuations than the overall market, but these sectors are quite tiny.** Of course, the valuation differences we see could be due to many other factors (e.g., a bias for growth), and these valuations are still moderate relative to the frothiest stocks (where the value measure is about twice as stretched).

Sector	Market Weight	ESG Index Weight	Weight Relative to Market	Value Measure
Tobacco	1%	0%	0.0	-0.9
Aerospace and Defense	1%	0%	0.2	-0.3
Oil	3%	2%	0.4	-0.5
IT Manufacturers	5%	2%	0.5	0.4
Broadcasting	1%	0%	0.5	-0.5
Hotels	1%	0%	0.6	-0.2
Mining and Metals	2%	1%	0.6	0.1
Biotechnology	3%	5%	1.6	0.4
Airlines	0%	0%	1.6	0.2
Utilities	3%	6%	2.1	0.4
Construction	2%	3%	2.1	-0.1
Engines and Machinery	3%	7%	2.1	0.0
Water Utilities	0%	1%	8.0	1.3
Renewable Electricity	0%	2%	10.0	1.2

So Far, Only a Small Share of the Money That Could Move Has Aligned with ESG Goals

Looking at the universe of mutual funds and ETFs around the world, only 4-5% of it is currently in ESG-labeled funds. Europe is furthest along, with ~12% of money in ESG funds. The shift is happening at 2-3% per year globally, but at a faster clip of 6-8% per year in Europe.

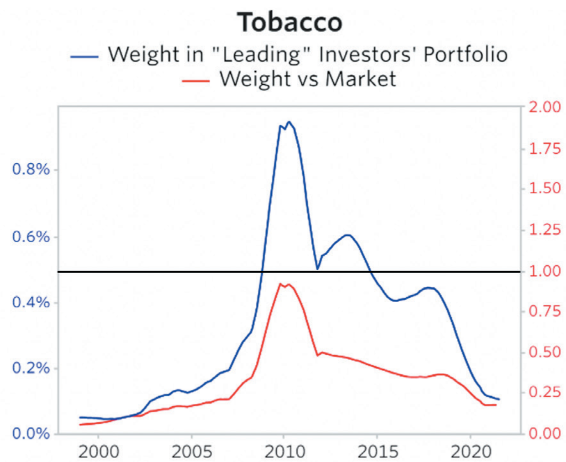


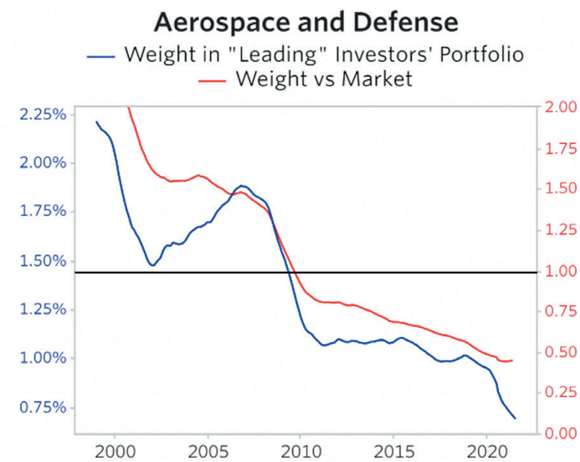
We also looked at the equity holdings of a group of institutional investors that has expressed significant interest in ESG, covering $1.5 trillion in public equity holdings. These entities have already made big moves in the direction of ESG indices, though not nearly as big as it would take to fully align with them. These investors hold about 2.5x the market weight of the most "over-owned" ESG sectors—renewable electricity, water utilities, and forestry and paper (recycling). **The over-allocation is well below the ESG index, and they have similar over-allocation to other non-ESG sectors, like household durables. They have fully divested from "bad" ESG sectors, like tobacco, but still hold more defense and oil than an ESG index.**

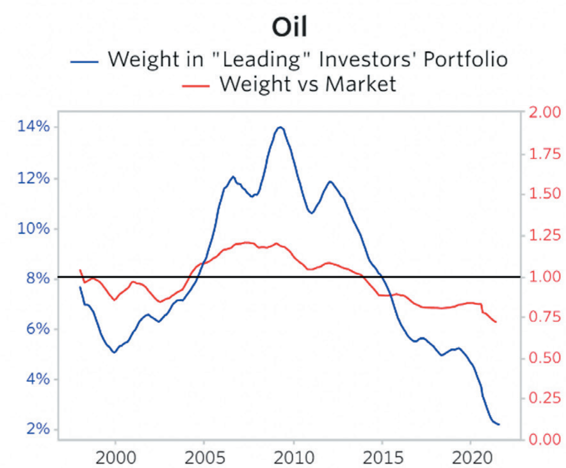
Sectoral Composition

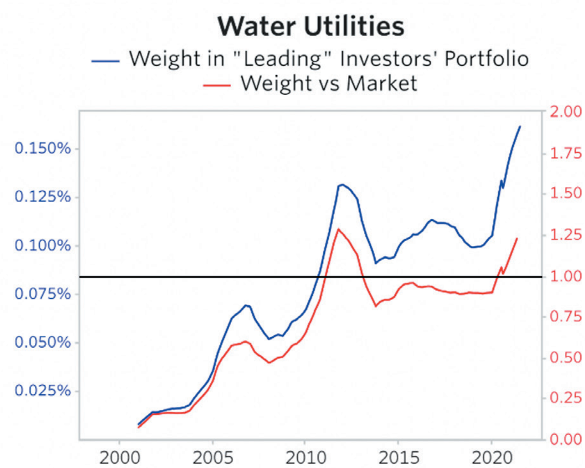
	Weight (%)			Diff to Market		Weight Relative to Market	
	Market	ESG Index	"Leading Investors"	ESG Index	"Leading Investors"	ESG Index	"Leading Investors"
Tobacco	1%	0%	0%	-1%	0%	0.0	0.2
Aerospace and Defense	1%	0%	1%	-1%	-1%	0.2	0.5
Oil	3%	2%	3%	-2%	-1%	0.4	0.8
IT Manufacturers	5%	2%	4%	-3%	-1%	0.5	0.8
Broadcasting	1%	0%	1%	0%	0%	0.5	0.9
Hotels	1%	0%	1%	0%	0%	0.6	1.2
Mining and Metals	2%	1%	2%	-1%	0%	0.6	0.9
Food and Drug Retailers	1%	0%	1%	0%	0%	0.7	1.2
Internet Services	4%	3%	3%	-1%	-1%	0.7	0.8
Beverages	2%	1%	2%	0%	0%	0.7	1.1
Restaurants	1%	1%	1%	0%	0%	0.8	1.0
Pharmaceuticals	4%	3%	4%	-1%	0%	0.8	1.0
Transportation	2%	2%	2%	0%	0%	0.8	1.0
Business Services	4%	3%	4%	-1%	0%	0.9	1.0
Telecom Services	7%	6%	6%	-1%	-1%	0.9	0.9
Diversified	1%	1%	1%	0%	0%	0.9	0.7
Computer Software	6%	6%	5%	-1%	-1%	0.9	0.8
Apparel	1%	1%	2%	0%	0%	0.9	1.2
Food Producers	2%	2%	2%	0%	0%	1.0	1.2
Computer Services	1%	1%	1%	0%	0%	1.0	1.0
Media	2%	2%	2%	0%	0%	1.0	1.0
IT Components	2%	2%	2%	0%	0%	1.0	1.2
Healthcare	4%	4%	3%	0%	0%	1.0	1.0
Forestry and Paper	0%	0%	1%	0%	0%	1.0	1.7
Retailers	3%	3%	3%	0%	0%	1.1	1.0
Hosehold Durables	0%	0%	0%	0%	0%	1.1	2.6
Chemicals	3%	3%	3%	0%	0%	1.1	1.1
Publishing	0%	0%	0%	0%	0%	1.3	1.4
Semiconductors	5%	8%	5%	2%	0%	1.4	0.9
Personal Care	2%	3%	2%	1%	0%	1.4	0.9
Biotechnology	3%	5%	3%	2%	0%	1.6	1.0
Airlines	0%	0%	0%	0%	0%	1.6	2.4
Utilities	3%	6%	3%	3%	0%	2.1	1.1
Construction	2%	3%	2%	2%	1%	2.1	1.5
Engines and Machinery	3%	7%	4%	4%	1%	2.1	1.3
Water Utilities	0%	1%	0%	1%	0%	8.0	2.3
Renewable Electricity	0%	2%	0%	1%	0%	10.0	2.4

Looking at these holdings through time, you can also see that these types of transitions tend to be in the works for many years. **The move to divest from "bad" ESG companies took years and occurred gradually, and the move into "good" ESG companies is still accelerating.** As shown below, moving out of tobacco is a very old story—in the 2000s, ESG-conscious institutions already had almost no investments there. They started moving out of oil 10 years ago, and their weight relative to the market has been stable for over 5 years. They have also moved out of defense for 20 years relatively steadily. In contrast, the move into "good" ESG sectors is still clearly accelerating.









Going Forward, There Is Substantial Room for ESG Flows to Run, with Implications for Relative Stock Prices

Below, we very roughly estimate the flows implications if the shift into ESG assets continues. We looked at two scenarios:

1. **If 2.5% per year of all equity holdings shifted to an ESG index:** This is roughly the pace at which we've seen mutual fund and ETF flows make the transition, and we assume that all equity holdings shift at this pace.

2. **If 7% per year of all equity holdings shifted to an ESG index:** This is roughly the pace at which we've seen mutual fund and ETF flows shift in Europe, which is further ahead—but keep in mind that European allocations to mutual funds were shifting at a pace of 2-3% in 2018-19, before accelerating more recently.

Under the first scenario, most affected sectors would receive inflows or outflows equal to 2-3% of market cap, which would lead to moderate but notable price moves. For sectors like water and renewable electricity, inflows would be more sizable, at 25-40% of market cap; of course, these sectors are also quite small in the context of the overall market. And if flows move faster, in line with our second scenario, impacts would be 2-3x larger.

Divergent Sectors' Flows

					Flow (% Market)		Flow (% Sector)	
Sector	Market Weight	ESG Index Weight	Diff	Weight Relative to Market	Current Growth	Europe-Like Growth	Current Growth	Europe-Like Growth
Tobacco	1%	0%	-1%	0.0	-0.02%	-0.03%	-3%	-6%
Aerospace and Defense	1%	0%	-1%	0.2	-0.03%	-0.06%	-3%	-5%
Oil	3%	2%	-2%	0.4	-0.06%	-0.11%	-2%	-3%
IT Manufacturers	5%	2%	-3%	0.5	-0.08%	-0.16%	-2%	-3%
Broadcasting	1%	0%	0%	0.5	-0.01%	-0.02%	-2%	-3%
Hotels	1%	0%	0%	0.6	-0.01%	-0.02%	-2%	-3%
Mining and Metals	2%	1%	-1%	0.6	-0.02%	-0.05%	-1%	-2%
Biotechnology	3%	5%	2%	1.6	0.05%	0.10%	2%	4%
Airlines	0%	0%	0%	1.6	0.00%	0.01%	3%	6%
Utilities	3%	6%	3%	2.1	0.09%	0.18%	3%	6%
Construction	2%	3%	2%	2.1	0.05%	0.10%	3%	6%
Engines and Machinery	3%	7%	4%	2.1	0.11%	0.22%	3%	7%
Water Utilities	0%	1%	1%	8.0	0.02%	0.05%	24%	48%
Renewable Electricity	0%	2%	1%	10.0	0.04%	0.08%	42%	84%

This analysis assumes that investors shift from a "traditional" market index to today's most common ESG indices. If investors shifted into other indices where deviations from market holdings were larger, implications on pricing could be even more significant. For example, we have shown that investors can make much larger changes to their equity portfolio than just by moving to these indices, significantly increasing their impact without materially changing the portfolio's financial characteristics; as described in our linked research from May 24, our BW Sustainable Equities portfolio allocates much more capital toward companies that are aligned with the UN's Sustainable Development Goals, like SDG 3, which is concerned with good health outcomes, and SDGs 7 and 13, which are focused on climate. This illustrates the potential for investors to adopt even larger shifts in their equity holdings than those contemplated here.

"Leading Investors" is constructed based on Bridgewater research into publicly available information for large investors and allocators that have shown significant focus in holding ESG-assets.

Where shown, BW Sustainable Equities portfolio represents an illustrative view of equity allocations that uses SDG ratings to select SDG-aligned assets. This index is constructed based on Bridgewater analysis and does not represent returns of any actual Bridgewater strategy.

Bridgewater research utilizes data and information from public, private and internal sources, including data from actual Bridgewater trades. Sources include, 4Cast Inc., the Australian Bureau of Statistics, Asset International, Inc., Barclays Capital Inc., Bloomberg Finance L.P., CBRE, Inc., CEIC Data Company Ltd., Consensus Economics Inc., Corelogic, Inc., CoStar Realty Information, Inc., CreditSights, Inc., Credit Market Analysis Ltd., Dealogic LLC, DTCC Data Repository (U.S.), LLC, Ecoanalitica, EPFR Global, Eurasia Group Ltd., European Money Markets Institute – EMMI, Factset Research Systems, Inc., The Financial Times Limited, GaveKal Research Ltd., Global Financial Data, Inc., Harvard Business Review, Haver Analytics, Inc., The Investment Funds Institute of Canada, Intercontinental Exchange (ICE), Investment Company Institute, International Energy Agency, Investment Management Association, Lombard Street Research, Markit Economics Limited, Mergent, Inc., Metals Focus Ltd, Moody's Analytics, Inc., MSCI, Inc., National Bureau of Economic Research, North Square Blue Oak, Ltd , Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, RealtyTrac, Inc., RP Data Ltd, Rystad Energy, Inc., S&P Global Market Intelligence Inc., Sentix Gmbh, Shanghai Wind Information Co., Ltd., Spears & Associates, Inc., State Street Bank and Trust Company, Thomson Reuters, Tokyo Stock Exchange, TrimTabs Investment Research, Inc., United Nations, US Department of Commerce, Wood Mackenzie Limited World Bureau of Metal Statistics, and World Economic Forum. While we consider information from external sources to be reliable, we do not assume responsibility for its accuracy.