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# Applying ESG Factors may not be straight-forward – March 2019

## INTRODUCTION

Many families want responsible investing to play an increased role in their portfolio design. The goal is greater alignment between their investments and their personal values, promoting outcomes that are financially rewarding while supporting positive social and environmental change.

Investment managers increasingly understand the need to accommodate *sustainable investing*, once considered a fetish.

However, obstacles to adoption include confusion surrounding, terminology, rationale and implementation.

Investors in the U.S. and Asia have been generally slower to embrace ESG factors or other approaches to responsible investing than have Europeans, because they appear less convinced that it will be impactful and would like clearer evidence of a positive impact on financial performance. But evidence suggests that when a client does decide that ESG investing is important, they do not just nibble, they seek significant ESG allocations.

While not all managers expressly state that they apply ESG factors, good investment analysis necessarily identifies sound corporate behavior and objectives to protect the company and its stakeholders. It would seem unwise to ignore key sustainability issues when assessing a company's ability to generate long-term financial returns.

### *Implementing Within the Investment Processes*

JPMorgan estimates $23 trillion of assets are now managed applying ESG factors as a part of the investment criteria, with over $100 billion invested in *ESG Funds*. According to Barrons, US assets managed under ESG mandates grew 23% (CAGR) between 2014 and 2016 (compared to an average of 5% for the industry as a whole). Approximately half of US financial advisors now have portfolios dedicated to ESG investing.

Applying ESG factors to portfolios, funds and sector indices take a range of approaches including: (i) exclusionary approaches, applying broad principles, or screens or sector bans; (ii) "positive" approaches that include companies with certain performance or improvement scores; and (iii) thematic, or impact, investment approaches.

### *Measurement Issues*

However, ESG classifications can be problematic. It is difficult to manage and report on that which is hard to measure.

ESG data are a means to assist an investor to evaluate a company's strategy, institutional purpose and management execution and understanding how the company is adapting to transformational change (e.g., changing consumer preferences, evolving policies addressing climate change).

Morningstar (via Sustainalytics) and MSCI have created sustainability ratings to assist in evaluating or scoring mutual funds. Moody's and S&P now incorporate ESG data into their credit ratings. But some managers, such as GMO warn against a broad application of third-party scoring systems. It is also important to identify those factors that are truly material for any particular industry and company.

## IMPLEMENTATION ISSUES

A consensus is lacking as to what ESG or sustainable investing involves, whether the integration of such in the investment decision is based on seeking improved financial performance or reduced risks (or both), or is simply an attempt to align portfolio construction with personal values.

Like any new trend, responsible investing has its critics. Some question whether it even is appropriate. However, more often critics point to difficult implementation and measurement issues.

1) ***Definitional issues***.

Even though integrating ESG factors within investment decisions has clearly accelerated since 2012, definitional issues appear to be holding back adoption.

The UN's Sustainable Development Goals created a framework in 2015, but the 17 goals are rather general and difficult to translate into portfolio design.

It is hard to monitor compliance with the *Principles of Responsible Investing*, even ignoring that many signatories have done little to implement the spirit of the goals.

2) ***Not effective in changing corporate behaviour***.

Many critics argue that it would be more effective to engage with managements on broad issues such as climate change, diversity or governance, rather than simply divest.

Some have argued that if too many fund managers exclude certain sectors, then the cost of capital will increase for those sectors and while there might be supply constraints later, it could positively impact the sector's future returns, perversely.

3) ***Limiting choice necessarily results in worst outcomes***.

The argument is, the larger the asset class you want to exclude, the greater potential underperformance (vis-à-vis a benchmark).

There remains debate on whether ESG has demonstrated itself as a useful style factor.

4) ***Is a fad – asset managers owe a duty to focus on the traditional, widely-accepted analytical approaches***.

Some have questioned whether asset managers owe a fiduciary duty to their clients to take ESG issues into account. In the US, there has been arguments that the manager's fiduciary duty is focused on financial performance, and that applying ESG factors constitutes activism which may not be part of the manager's mandate.

For example, when aligning "core" values, are those the values of the manager or of the clients or as prescribed by activist or independent groups. Clients necessarily have a broad range of values. Communities sensitive to "political correctness" may see this as a liberal intrusion into an otherwise allegedly scientific process.

5) ***Primarily a marketing ploy, since quality investment managers already apply these principles.***

Others argue that applying ESG factors is redundant because the best companies and best asset managers are already incorporating these factors within strategic and investment decisions. The sustainability of their business model has always been relevant. It is suggested that developing these new frameworks and reporting systems is more likely to confuse and increase costs without a commensurate benefit.

In addition, commentators point out that fund managers often trumpet ESG credentials and commitments and yet have changed their investment approach very little. Companies lay claim to integrate ESG factors into their strategic planning, but it is very resource intensive and time consuming to collect, catalogue and present performance or compliance confirmation.

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We think it unlikely that there will ever be a consensus on specific frameworks for responsible investing, its role in asset manager deliberations and how best to implement, but so long as research continues to support a connection between sustainable business models and financial performance, and certain demographics increasingly champion the goals, asset managers will be offering a range of approaches to integrate ESG factors and responsible investing. Borrowing from Voltaire - waiting for the perfect approach should not prevent asset managers from improving on current approaches.

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