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ESG Investing: From Niche to Norm

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Individuals have long invested according to their conscience, from abolitionists who avoided businesses involved in the slave trade two centuries ago and more, to those who shunned chemical companies manufacturing Agent Orange during the Vietnam War. Driven by investors' ethical values, such socially responsible approaches prohibit investing in certain companies or industries.

But investing sustainably with environmental, social and governance (ESG) criteria in mind is a newer concept that has become almost a standard among institutional investors in recent years. This is partly down to increasing concern among institutions and their clients about achieving competitive financial returns alongside positive social and/or environmental impact and partly because governments and regulators are now placing ESG much higher on the agenda of institutional investors.

Initiatives from various tentacles of the state are coming thick and fast these days. In late 2018, the California Senate passed an act ordering two mammoth pension funds, CalPERS and CalSTRS, to identify climate risk in their portfolios and report on it every three years. In early 2019, the UK's auditing watchdog proposed revamping its stewardship code to require fund-manager signatories to take "material ESG factors" into account. Interest in ESG in Asia is also on the rise, even though it is not yet as widespread as in Europe. For example, Shinzo Abe's administration in Japan has used the country's own stewardship code, devised in 2014 and since updated, to exhort institutional investors to consider ESG seriously. The country's largest public fund investor and the world's largest asset owner, the Government Pension Investment Fund, has since become a major proponent of ESG integration by allocating 3% of its domestic equity portfolio (approximately ¥1 trillion or US$9 billion) to ESG-focused index investments.

In any case, governments and regulators are pushing on an open door. Institutional investors increasingly understand that prudent ESG practices such as good governance, strong shareholder rights and transparency are positives for investors in any company. Among individual investors, women and millennials are two groups most likely to regard ESG integration as important in investing, according to research conducted by the Morgan Stanley Institute for Sustainable Investing and Bloomberg. Both groups of investors will see their share of the world's wealth rise in the long term: women's share of global wealth has already reached 40% after huge strides over the past century, according to Credit Suisse. As for millennials, they will grow richer as they get older and their careers progress, and the working generations that come after them will probably be, if anything, even more ESG-focused.

There are many ways of measuring the increase of investor interest in ESG, but here is one interesting fact: interest in ESG topics, as measured by Google search volume, has increased tenfold during the past three years.

Tens of trillions

Driven by all these forces, assets under management in portfolios that use 'sustainable investing' – a loosely used catchall term that may include socially responsible investing, mission-related investing, impact investing, and investing according to ESG principles – grew more than 600% to US$23 trillion in the 10 years to the end of 2016, according to a report from the Global Sustainable Investment Alliance.

In 2018, Aberdeen Standard Investments, Sustainalytics and the University of Oxford's Smith School of Enterprise and the Environment published a research report entitled *Smart Beta and ESG: Promoting Sustainability in Smart Beta Investment Strategies*. This report suggests that institutional investors who do not consider ESG are now in a minority. Over three-quarters of asset owners surveyed said they took account of ESG when awarding mandates or outsourcing asset-management activities, whether for smart beta or for other strategies. It may be that some of this is only skin-deep – almost half of investors said they were unable to identify the contribution of ESG to their overall manager-selection process. But it still represents progress.

ESG and investment – what do the numbers show?

The evidence suggests that investing with ESG in mind will not hurt returns. There is also some evidence – though this is not quite as strong – that ESG-integrated investing is, on balance, slightly good for returns.

For example, Calvert Investment Management has compared the performance of its own Calvert Social Index (CSI), a benchmark for US companies based on its responsible investment criteria, with the Russell 1000[1]. It found that between 2000 and 2014, picking individual stocks with good ESG practices added an average of 7 basis points a year, after stripping out the effects of differing allocations to industries and styles, when compared with the Russell 1000. But 7 basis points is not very much, and the evidence that ESG consistently adds alpha to returns is not yet compelling.

Aberdeen Standard Investments

The evidence that ESG might actually boost returns grows weaker still when it comes to measuring the performance of portfolios rather than individual stocks. After trawling through previous studies, a 2018 paper from DWS and Hamburg University found quite a strong positive correlation between a company's ESG quality and accounting items such as profit and loss. But it found a much weaker correlation – at least by one measure – between the ESG quality of companies held in a mutual fund and the performance of that fund. The authors speculated that this might reflect construction constraints and implementation costs, among other things[2].

But we shouldn't be too negative: to reiterate, at worst, recent studies suggest that ESG-integrated investing doesn't hurt returns; at best it is mildly positive. As the DWS/Hamburg University paper put it: "In the worst case, ESG-focused mutual funds may exhibit similar risk/ return profiles when compared to conventional mutual fund investments".

Why ESG doesn't hobble investors

The notion that ESG integration does not harm portfolio returns, and may in fact aid returns, is intuitive since companies with good ESG practices make for safer investments. Conversely, companies with poor ESG tend to be riskier.

The credit crunch revealed this in spectacular style. Until it struck, the Royal Bank of Scotland (RBS) rivalled whisky and shortbread as Scotland's most recognisable export, with a string of acquisitions and a policy of aggressive expansion that briefly made it the biggest bank in the world by assets during 2008. Sir Fred Goodwin, the CEO at the time, was lauded as a talented leader. But investors paid little heed to governance issues. One problem was a remuneration structure for the CEO that rewarded him for increasing revenue, profit, assets and leverage, rather than for looking after capital, liquidity and asset quality. In 2011, Adair Turner, chairman of the Financial Services Authority at the time, blamed the bank's collapse partly on the "underlying deficiencies in RBS management, governance and culture which made it prone to make poor decisions". Had investors in RBS spotted these ESG issues early, they would have saved themselves a lot of trouble and money.

The experience of RBS is echoed by a recent study of US companies which shows that in the run-up to the credit crunch, executive remuneration that rewarded higher risk-taking from the CEO was positively associated with ESG controversies and socially irresponsible activities. These issues increase the risk to the firm[3].

There is another, more direct risk from poor ESG: the risk of sledgehammer sanctions by government and regulator. The banks, in particular, are these days facing swingeing fines for poor or alleged poor behaviour – usually in governance. Consider one of the biggest cases: in 2013, JPMorgan agreed to pay US$13 billion to settle a complaint from the US government about its alleged role in underwriting fraudulent securities. Consider, too, one of the most catastrophic cases – for the company involved, though of a private rather than listed business. In the same year that JPMorgan settled its case, Wegelin & Co, Switzerland's oldest private bank, closed its doors for the final time after admitting to the US authorities that it had helped Americans evade taxes. It was an ignominious end to 272 years of history.

Poor ESG a growing danger in a digitised world

Poor ESG is becoming an even greater risk to companies' share prices than before. As well as spreading information to a much greater degree than even five years ago, let again ten, social media also spreads outrage more effectively. This can turn consumers away from companies and force politicians to take action against businesses extremely quickly.

Shares in Irish air carrier Ryanair used to fly high. But they plunged in value between mid-2017 and late 2018. This was in part because of poor labour relations and working conditions inside the company, which began to affect the service provided to customers. These are the sort of issues that could be identified by assessments of social considerations by investors and their partners. But Ryanair became even more beleaguered when an elderly woman was racially abused on a flight by another customer, and the offending customer was not removed. The incident flew around the world faster than a Ryanair plane after a passenger filmed the incident and posted it. The result: a #boycottryanair hashtag on Twitter.

It's not just about the environment

These examples of failures show how important social and governance policies are. But these two areas are often ignored by ESG investors in their determination to look at environmental factors.

This is a mistake. Another earlier piece of research from Deutsche Asset & Wealth Management and Hamburg University, published in 2015, analysed hundreds of studies. It looked at what proportion of them found a positive association between each of these three aspects of ESG on the one hand, and various measures of financial performance, such as profits and growth, on the other. Governance came highest of all three categories, in 62% of studies. Environment and social factors were not far behind, at 59% and 55%. For all three categories, under 10% of papers found a negative correlation[4].

Kicking the tyres

If investing with ESG in mind causes no harm to returns and may do a bit of good for them, this opens the way for mainstream investors anxious to apply it to their own portfolios. If a thing's worth doing, it's worth doing well. But how to do it well?

The *Smart Beta and ESG: Promoting Sustainability in Smart Beta Investment Strategies* research report from Aberdeen Standard Investments, Sustainalytics and the University of Oxford's Smith School of Enterprise investigated these issues. It found that many investors were not kicking the tyres of ESG investment hard enough or often enough.

Failure to be rigorous about ESG is often understandable. In the report, several small asset owners said they lacked the resources to support manager visits to external fund managers to discuss ESG. They opted instead for the relatively time-efficient methods of ESG questionnaires and ad hoc conversations. As the respondent for a small private North American pension fund put it: "I'm an investment team of one, so I have to take the managers at their ESG word".

But this less-than-comprehensive approach to ESG integration wasn't restricted to small investors. A mere 28% of all investors in the survey said they had conducted in-house quantitative analysis of the risk/ return implications for their portfolios of ESG integration. In fact, none of the North American 'mega-investors' – institutions with at least US$100 billion in assets – had done it. Overall, more small institutional investors – one third – said they had undertaken it, compared with 24% of mega-investors worldwide. Since they had not conducted this research, it is unlikely that they had thought enough about what kind of ESG strategy provides the best risk-adjusted return.

Choosing the right strategy

If investors are time-poor, the solution is to seek strategies from external managers that provide strong evidence about the likely boost in investment returns and a high level of detail about how to achieve this boost. Well-researched and differentiated quantitative investment strategies, such as those tracking Aberdeen Standard Investments' proprietary SMARTER Beta™ ESG Multifactor equity indices*, may provide this reassurance. By excluding companies engaged in producing controversial weapons and those companies facing severe ESG threats (in effect, negative screening), and by harvesting multiple 'risk premia' – value, quality, momentum, small size and low volatility – a higher level of risk-adjusted returns and ESG scores (based on third-party ESG ratings) than equivalent market-capitalisation-weighted indices can be achieved over the medium to long term.

However, it would be even smarter for such quantitative investment strategies to be combined with an active approach to voting and engagement, often described as 'stewardship'. Few quantitative strategies engage in stewardship, though all investment strategies – both fundamental and quantitative – managed by Aberdeen Standard Investments do so. Investors get much more 'bang for their buck' by remaining highly engaged shareholders: coaching, coaxing and cajoling companies into improving their business strategies and execution, as well as their ESG practices and reporting. Only the largest asset owners have the time and resources to do this themselves. This means that other asset owners need external fund managers or other parties to do it for them.

Conclusion

To sum up, the boost from ESG-integrated investing is uncertain, but institutional investors should not think of it as a burden that hits returns. Intuitively, companies with good ESG practices make for safer investments. However, investors searching for a way of beating conventional market-capitalisation-weighted indices need to keep looking for another solution. Well-researched and differentiated quantitative ESG investment strategies, such as those tracking Aberdeen Standard Investments' proprietary SMARTER Beta™ ESG Multifactor equity indices, or customised variants thereof, may provide such a solution.

Responsible investing terminology

Responsible investing: a loosely used catchall term describing investments intended to generate both social and financial returns and may include socially responsible investing, mission-related investing, impact investing and investing according to environmental, and social and governance principles.

Negative screening: also often referred to as socially responsible investing, incorporates an investor's ethical or moral principles by excluding companies involved in certain activities or industries (e.g. alcohol, gaming and adult entertainment).

Mission-related investing: investments directly aligned with the specific mission and social beliefs of the investing organisation. Alignment can be expected to be identifiable before initiating the investment and to have measurable social benefits.

Impact investing: investments made into companies, organisations and funds with the intention to generate measurable social and environmental impact alongside a financial return. The impact sought via these investments is usually specifically targeted to a thematic strategy e.g. health care, clean water, alternative energy, microfinance or to a geographical sector.

ESG integration: considers investment decision-making in a wider context than traditional financial analysis and explicitly analyses a range of risks and opportunities related to ESG drivers.

Stewardship: entails actively engaging with the managers and boards of directors of investee companies on business strategy and execution, including specific sustainability issues and policies, and exercising shareholder rights through proxy voting at shareholder meetings.

* Aberdeen Standard Investments' SMARTER Beta™ ESG Multifactor equity index series includes: Global (in USD, GBP, EUR), Developed Markets (in USD, GBP, EUR), International (in USD), Europe ex-UK (in USD and EUR) and US (in USD).

[1] Perspectives on ESG Integration in Equity Investing: An opportunity to enhance long-term, risk-adjusted investment performance, Calvert Investment Management.

[2] Digging Deeper into the ESG-Corporate Financial-Performance-Relationship, DWS and University of Hamburg, 2018.

[3] CEO risk-taking incentives and socially irresponsible activities, British Accounting Review 50, Kais Bouslah and others, 2018.

[4] ESG & Corporate Financial Performance: Mapping The Global Landscape, Deutsche Asset & Wealth Management and University of Hamburg, 2015.

About the Author

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