ESG Part 3: Paradise City

Opportunities and challenges of incorporating ESG in investment management strategies

In the first two parts of our ESG series, we got into detail about why it is still unclear how to effectively measure sustainability and why this leads to varying ratings from different agencies. We went from the imponderable jungle of ESG ratings to the heavenly gates of recent studies, which confirm the hypothesis that sustainability has a positive impact on the financial performance of companies. In today's Part III, we want to show you the way to the streets of Paradise City, ergo the real life of how asset managers use multiple approaches to evaluate the chances and risks in the new era of ESG-focused investments and which set of data they consider to be qualified for doing so.

In 2020 climate change and sustainability became two of the most important boardroom opportunities and challenges facing businesses. The next decade will see climate change become a major focus for companies, as investor preferences change and pressure mounts from regulators for businesses to disclose more information on how they are impacting the climate agenda. These growing concerns about the urgent threats facing society has brought the asset management industry to a crossroad. The environmental, social and governance (ESG) investment trend is accelerating and simultaneously becoming more complex. Appetite to invest in these strategies is undoubtedly growing. The approach investors are taking to ESG is becoming more sophisticated as their understanding deepens. Asset managers worldwide are facing a major challenge: how to navigate a path through these issues and build a sustainable business model for a new era of ESG-focused investments? Achieving this will mean taking long-term, strategic decisions in the immediate future about their approach to ESG and their market positioning.

It has now become undeniable that the financial sector will play a pivotal role in transforming the economy to help support the goal to reduce the impact of climate change and asset managers could be at the forefront of a new standard for investing.

Two major trends can be identified as the driving force:

1. **Client demand**:
Investors are increasingly focused on the role that companies can and should play in tackling urgent threats to the environment and society, especially the issue of climate change. They are therefore seeking ways to ensure companies make a measurable contribution to addressing these threats. According to a recent report by Morgan Stanley, 84% of investors are pursuing or considering pursuing ESG integration in their investment process. Today, globally, more than $22.8 trillion is invested sustainably, representing more than $1 out of every $4 under professional management. This number alone shows that asset owners have embraced sustainability for good.

2. **Regulation**:
Besides other national and Europe-wide regulatory moves, the European Commission's sustainable finance work stream is bringing forward a series of regulatory initiatives feeding into the targets set by the European Green Deal. These initiatives are intended to make ESG themes more investable for institutional and retail investors, thereby unlocking huge additional investment flows into this area. The European Green Deal aims to make Europe the first climate-neutral continent by 2050. A central element of the Green Deal is its Investment Plan, which is intended to unlock at least €1 trillion of sustainable investments in the decade up to 2030, in order to support the transition to climate neutrality. The accompanying sustainable finance strategy will be implemented via a series of guidelines and regulations around ESG, most of which are due to come into force in 2021 and 2022. These rules have major implications for all participants in the financial system, especially in areas concerning the collection and reporting of data relating to ESG issues.

The "active nature" of ESG investing

Incorporating ESG factors in investment strategies has become a distinct service for many providers of investment services. ESG investing is an approach that focuses on several non-financial dimensions of a stock's performance, including the impact of the company on the environment, governance, and a social dimension. For each of these dimensions, substantial information on the firm's practices needs to be collected and analysed. The outcome of this analysis is then used by the portfolio manager to construct a diversified portfolio. In a sense ESG investing can be compared to "fundamental investing" where fundamental analysis and research is carried out on individual stocks or sectors by investment managers hoping to generate excessive risk adjusted returns on their portfolios compared to the market. In essence it can be compared to an active "stock-picking" strategy carried out by numerous active investment firms and even if the passive ETF wave has "washed" a lot of active managers to the shore, it is still a widely used technique which has billions under management worldwide. When comparing fundamental with ESG investing, we can observe several striking similarities: it seems very plausible to argue that the quality of management is strongly related to corporate governance. Furthermore, addressing the interests of the environmental and social interest groups requires substantial strategic planning efforts. However, the most convincing argument that ESG investing is highly similar to fundamental investing is that most ESG investors believe in beating passive portfolios with their strategy.

As investment managers gradually become more sophisticated about sustainable investing, they start using multiple approaches and overlapping strategies to design solutions that meet their specific objectives and constraints.

The following investment approaches can be identified:

> **ESG integration**
This means proactively considering ESG criteria alongside financial analysis with nearly all asset owners who are engaged in sustainable investing, using it at least opportunistically as part of their mix of approaches. In 2021 we can comfortably make the case that a majority is forced to do so by their Investment Policy Statement. This is in line with the role of risk and return as important drivers of the move toward sustainable investing, since integration tends to be focused on identifying long-term risks and capturing opportunities arising from sustainability trends.

> **Restriction screening**
This method intentionally avoids investments generating revenue from objectionable activities, sectors or geographies. Such strategies can provide downside protection and risk-mitigation benefits depending on the nature of the screen. If restriction screens lead to avoiding company-specific risk, they can play a positive role in maximizing risk-adjusted returns. Examples of restriction screening investment strategies are for example:

- **Negative screening**
  Excluding certain sectors, issuers or securities for poor ESG performance relative to industry peers, or based on specific ESG criteria, e.g. avoiding particular products/services, regions or business practices.
  Absolute avoidance of activities such as: alcohol, tobacco, gambling, adult entertainment, military weapons, fossil fuels, nuclear energy
- **Norms based screening**
  Screening issuers against minimum standards of business practice based on international norms. Useful frameworks include UN treaties, Security Council sanctions, UN Global Compact, UN Human Rights
- **Positive screening**

Investing in sectors, issuers or projects selected for positive ESG performance relative to industry peers. Active inclusion of companies within an investment universe because of the social or environmental benefits of their products, services and/or processes

> **Thematic investing**

Thematic investment strategies focus on themes and sectors dedicated to specific ESG issues. The more material the issue is to the valuation of each company, the more impactful the approach is likely to be on financial returns. The top thematic investments for the moment are those addressing climate change adaptation and mitigation. Thematic ESG investing involves two main approaches: multi-theme and single theme.

- **Multi-theme-approach**
  Various funds offer a multi-theme approach linked to the 17 UN Sustainable Development Goals, with mostly two objectives in mind – to deliver attractive long-term returns and to deliver positive change by contributing toward a more sustainable and inclusive world
- **Single-theme approach**
  Investors can also access more specialist strategies, which invest in a single theme, such as battery technology, cyber security and water. These are constructed on the types of companies who offer pure play exposure to the specific theme. Examples are 'smart cities' funds, which invest in the infrastructure, technology and logistics involved in making the world's most populous cities more environmentally friendly or funds investing in sustainable food production.

> **Shareholder Engagement**

Direct shareholder engagement on ESG issues gives investors additional opportunities to reduce risk and drive change in the direction they want, even within companies that may start off with poor ESG performance but can potentially improve over time. To get the full benefit of these implementation approaches, particularly in light of the challenges identified by asset owners in accessing adequate tools and data, manager selection matters. Whereas restriction screens can be theoretically achieved with a passive portfolio, approaches like direct engagement may require a manager who is active, able to engage company management and takes a structured approach to sustainable investing.

> **Impact investment**

Impact investing is the practice of allocating investments to enterprises or funds structured to deliver specific social or environmental impacts. The opportunistic nature of impact investing approaches is perhaps unsurprising given the bespoke nature of such strategies and potentially more limited availability of investment products. Examples of Impact investment vehicles are for example:

- Microfinance funds who promote financial inclusion by providing capital to the poorest via specialized institutions, thus creating opportunity for both the previously excluded and the business community as a whole.

- Specific green bonds or green infrastructure funds, whereby investors can contribute to mitigating industrial or other anthropogenic damage to the environment (e.g. green mobility solutions)
- Social impact bonds (SIB) which are a vehicle for mobilizing capital to tackle a specific societal problem (e.g. education, criminality)

Keys to the city: The need for an ESG "toolkit"

Increased adoption of sustainable investing practices ultimately depends on being able to identify clear benefits for investors. As with any investment process, it is important to have meaningful data and the right tools (see as well our 1st ESG post "Welcome to the Jungle" of ESG ratings). Among the top challenges facing asset managers are the availability of quality sustainability data and lack of knowledge about sustainable investing. The lack of quality ESG data stands out, with most asset managers listing it as one of their biggest challenges.

In a recent report[1] asset managers were asked specifically about tools used to inform sustainable investing strategies. Only 42% of respondents indicated that they felt they had access to adequate tools to assess the alignment of investments with sustainability goals. Among them, they rely most heavily on in-house research (75%) to support those investments, with third-party specialty research following close behind (73%). In short, those respondents who are satisfied by the information available to them have either built the capabilities themselves or turned to specialists over mainstream investment information. On the other hand, those not satisfied with ESG tools felt that reliable third-party data would be most helpful for assessing alignment of investments with sustainability goals, with 67% looking for mainstream third-party data providers; 57% looking for specialist third-party research; and 57% looking for third-party ratings, rankings and indexes. Only 35% felt that developing in-house research would be most helpful for their organizations. The lack of reliable data is a real challenge for asset owners but within that challenge lies opportunity for asset managers and third-party data providers. With better tools, information and training, interest in sustainable investing is poised for continued growth. In fact, although 16% of investors described a lack of knowledge as their biggest challenge to adopting ESG, they expressed interest in learning more about sustainable investing approaches. A whopping eighty-four percent of survey respondents want to learn more about at least one approach to sustainable investing.

Managerial concerns: Your route to paradise

How should asset managers react? In deciding their strategic response to the growing importance of ESG for both the institutional and retail client base, there is a crucial decision to be made by asset managers. Should they view this change in the landscape primarily as a matter of compliance and merely require adjustment to a new level of regulation, or should they view this as an opportunity to align the purpose and ambitions of their

[1] Morgan Stanley Sustainable Signals, 2019

organization with a major long-term industry trend and establish ESG as part of their DNA and value proposition? Either approach is feasible and depends in part on where they operate in the market. But whichever approach is chosen, asset managers will need to answer a number of key questions in three areas:

> **Strategy**
  What is your ESG ambition, what commitments are you willing to make, what actions will you take and what does this mean for your market positioning?

> **Customer offering**
  How effectively can you align your product offering with your chosen ESG strategy? In which product categories are you best positioned and how well do they address the options available in ESG? How will you segment and address customers with your new offering?

> **Risk and organization**
  How do you model ESG risks and adjust your ESG risk appetite? How do you attract the diverse talent you need? What do you have to adjust in your business model, your organizational structures and your governance framework in order to implement your chosen strategy? What ESG data, IT infrastructure and reporting do you need to accomplish this

Only when all these questions are thoroughly taken into account can asset managers consider themselves to be ready for the streets of Paradise City in the upcoming decade of ESG investing.

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