EDISON

Edison Explains

ESG Investing

Today every issuer is being scrutinised on awareness and performance on a range of environmental, social and governance factors.

What is ESG investing?

ESG investing includes an explicit assessment of environmental, social and corporate governance (ESG) issues in the context of investment decisions. Integrating of ESG issues in the investment process is now common practice for asset managers in their assessment of risks and opportunities, as ESG issues include many non-financial risks.

ESG issues are divided into three different components. Environmental issues include anything to do with the natural world, such as climate change, pollution or waste management. Social issues affect our everyday lives, such as modern slavery, human rights or child labour. Finally, governance issues relate to the way in which a business operates and is managed; examples include bribery, corruption, diversity and political lobbying.

However, there is overlap between the three ESG components, and one issue will not normally solely define a company's ESG performance. Furthermore, these issues are not one dimensional and vary across industries, locations and the company's target investors. Finally, ESG issues are not static but dynamic, constantly changing with the social or environmental landscape.

Key to ESG investing is active engagement by investors. Active ownership drives change in companies towards more innovative and exciting sustainable products or services. Active ownership also drives shareholder returns, as it helps to reduce the risk of ESG issues and enhances opportunities driving value growth.

Edison Insight

'The shift from a shareholder capitalism model to a stakeholder capitalism model has accelerated in the last two years. Today every issuer is being scrutinised on awareness and performance on a range of environmental, social and governance factors. The societal response to poor responses to these factors now carries sufficient risk that they can lead to long-term impact on profitability and valuation ratings. The analysis of securities therefore must extend to include these factors in deriving an investment thesis.' Neil Shah, Managing Director, Content & Client Strategy

Change towards ESG investing

The idea of focusing capital on assets that align with the values of the investor is not new. Examples of socially responsible investing are the exclusion of companies involved in the tobacco or alcohol trades and companies operating within the South African apartheid regime. However, since the foundation of the UN Principles for Responsible Investment (PRI) in 2006, there has been a far greater focus on investing in companies that mitigate ESG risks or create opportunities.

The UN PRI is a voluntary set of investment principles that encourage investor signatories to integrate ESG into their portfolios. The first principle states that signatories 'will incorporate ESG issues into investment analysis and decision-making processes'. Today, the number of signatories has grown to more than 3,000, representing over $103.4tn assets under management.

There is a distinction to be made between ESG integration and impact investing. ESG integration incorporates ESG factors in the materiality risk and returns profile of an asset, a method which looks to enhance portfolio performance. ESG integration may also exclude companies that do not meet their ESG performance requirements (eg new oil exploration in the Arctic). On the other hand, impact investing is investment in companies that are searching for measurable solutions to environmental or social issues, in conjunction with a financial return. For impact investors, financial returns are not the biggest driver of investment and returns expectations are diverse.

15/12/20

There has been exponential growth in the ESG market in recent years. Global assets under management that apply to ESG data have doubled over the last four years to $40.5tn in 2020 (source: PIOnline). More recently, October 2020 marked the highest ESG monthly flows on record at $36bn, up 45% on September (source: Morgan Stanley). Deloitte predicts that ESG mandated assets could grow three times as fast as non-ESG mandated assets to comprise half of all professionally managed investments in the US by 2025.

Public discourse about environmental and social issues has changed dramatically over the last 10 years, with an increase in global climate catastrophes and greater media focus. This has also brought about a change in discussions about finance, with a shift away from Friedman's traditional shareholder capitalism model towards an increasingly stakeholder-focused capitalism.

Issues and resolutions regarding ESG metrics

ESG investors have had to contend with a lack of standardised metrics against which they can measure a company's ESG performance and the transparency of a company's ESG performance in its annual reporting. Although there are several boards and agencies that aim to assist in the reporting of ESG issues, they have not provided a consistent set of standards or a framework by which investors can measure a company's ESG performance.

In 2015, the UN's Sustainable Development Goals (SDGs) provided the first formal common framework for multiple stakeholders. They are targets that companies should aspire to meet, aiming to 'end poverty, protect the planet and ensure that all people enjoy peace and prosperity by 2030' (www.undp.org). Nevertheless, companies have often failed to disclose non-financial ESG issues in their annual reporting.

New frameworks such as the EU Taxonomy Regulation (July 2020) and the World Economic Forum's (WEF) new set of metrics released in September 2020 (developed by the Big Four accounting firms: Deloitte, Ernst & Young, KPMG and PwC), allow investors to measure ESG performance against economic activity. The WEF's new framework of metrics will allow companies to standardise ESG performance reporting in their annual reports, providing greater transparency for investors.

Both Sustainalytics and MSCI have attempted to provide ratings for companies based on their ESG and corporate governance performance, to allow investors to assess the non-financial risks associated with companies more easily. Sustainalytics derives its ESG risk rating by evaluating the degree to which a company's economic value is at risk from ESG factors. Its risk categories are divided into negligible, low, medium, high and severe. These categories are absolute and do not vary depending on the relevant issues or industry.

The MSCI ESG ratings measure the risks and opportunities presented by large-scale trends as well as the nature of the company's operations. Its assessment of material ESG risks and opportunities varies by industry and company, and the final MSCI ESG rating is derived from the weighted averages of key issue scores dependent on industry and company. Its final scores are therefore relative to the ESG performance of other companies within the same industry, ranging from best (AAA) to worst (CCC) rating.

What motivates investors to integrate ESG into their portfolios?

The popularity of ESG investing has grown primarily as evidence has shown that it provides safer and stronger returns to shareholders. Studies have demonstrated the outperformance of ESG funds over non-ESG funds over one-, three-, five- and 10-year time frames (source: Morningstar). Other studies have shown that companies with robust ESG targets often have lower costs of capital, lower volatility, and few instances of corruption, bribery or fraud. This demonstrates that highly rated ESG companies are good long-term, high-conviction, low-turnover investments, enabling investors to meet their fiduciary requirements while integrating ESG into their portfolios. Historical reluctance regarding ESG integration into portfolios citing short-term performance now seems outdated, with new studies demonstrating that ESG funds outperform over both the short and long term.

Fundamentally, asset managers should be concerned about the risks and opportunities that any business presents, and the long-term implications of environmental or social challenges should be included in their risk assessment. However, the shift has come with the opportunity to create financial returns, while also creating positive social or environmental impacts.

Overall, companies with solutions to ESG issues provide three motivations for investors to integrate them into their portfolios. The first is evidence suggesting that it improves long-term investment performance in the face of long-term structural headwinds and tailwinds. As Nick Henderson, director of Responsible Global Equities at BMO Global Asset Management, has stated, ESG integration is 'something that every manager should be doing'.

Secondly there is a push for investments to better align with personal values, which has come through demographic change. Studies have shown that millennials are twice as likely to be interested in investments dedicated to solving social and environmental problems. Estimates suggest that the millennial generation could put between $15tn and $20tn into US-domiciled ESG investments over the next 20–30 years, doubling the size of the current US equity market (source: MSCI).

Finally, with greater emphasis in public discourse about making sustainable choices in our everyday lives, clients want their investments to make a positive social and environmental impact. Now more than ever, whether through greater transparency of ESG issues from companies in their annual reporting or ESG rating systems, investors and clients can judge the ESG performance of their investments.