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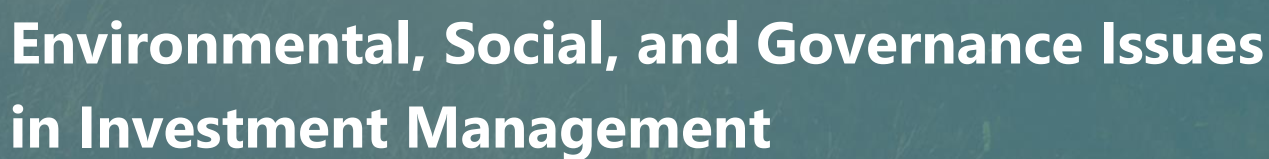


Environmental, Social, and Governance Issues in Investment Management

HIGHLIGHTS

- Traditional approaches to investment management, where strictly financial factors affecting risks and returns are considered, are giving way to broader, more inclusive methodologies that consider multiple Environmental, Social, and Governance (ESG) factors.
- ESG is the group of Environmental, Social, and Governance factors that are increasingly being considered as an integral part of the decision-making process in organizational management and more generally in the investment management process.
- Unlike negative screening ethical investment approaches, that exclude or include investments based on ethical and “values” related factors, ESG issues are being increasingly employed as complementary to traditional risk and return approaches to investment management. ESG issues are viewed as risk and opportunity factors that would help maximize risk-adjusted returns over the long-term.
- ESG awareness and adoption is growing fast. Signatories of the United Nations-supported Principles of Responsible Investment (PRI) Initiative topped 2,372 with total Asset Under Management in excess of USD 86 trillion in 2019. The list of signatories includes 432 Asset Owners and around 1,660 Investment Managers globally.
- Despite the significant advances in ESG awareness and adoption over the past few years, a lot remains to be done. The list of challenges is long but the most prominent include short-term biases of individual investors and short-termism of institutional investors that is driven by the structure of management incentives, culture, and market pressure and expectations that are built around quarterly results.

INTRODUCTION

Traditional approaches to investment management, where strictly financial factors affecting risks and returns are considered, are giving way to broader more inclusive methodologies that consider multiple factors thought to impact the long-term well-being of investment portfolios as well as our planet.

These factors include elements that were previously considered immaterial, their effect is too long-term to matter, and are very difficult to quantify and measure. The group of these factors is now referred to as Environmental, Social and Governance issues, or ESG.

Even though ESG investing has its roots in ethical investing, it is no longer pursued based solely on ethical values. Unlike traditional ethically driven investment approaches, which don't always pursue the maximization of risk adjusted returns as their prime targets, ESG strategies put less emphasis on ethical concerns. ESG strategies aim at achieving a traditional investment target of maximizing risk-adjusted return on investment, but unlike most mainstream strategies, their targets usually have a longer time horizon.

FROM VALUE INVESTING TO "VALUES" INVESTING AND BACK

"Values" investing comes in many forms and has evolved and changed considerably over the past few decades. One of its earlier forms is negative screening ethical investing. This is where investors require that companies that do not comply with certain pre-set criteria be excluded from the investment universe under consideration. Basically, this boils down to actively eliminating or selecting investments based on specific ethical guidelines that are motivated by religious and personal values or political beliefs. Islamic or Sharia compliant investing is a prime example; Islamic sharia, for example, forbids investing in companies that derive their revenues from alcohol, pork, or gambling, among others. Other criteria could include factors such as being involved in trading, manufacturing, or distribution of tobacco and firearms, or political affiliation.

Other forms of values-based investing include Impact Investing and Socially Responsible Investing (SRI). Socially Responsible Investing uses screening techniques to screen companies in or out. A mutual fund, for example, could use filters to screen in companies involved in renewable energy generation, recycling, and electric vehicles, while screening out companies that are known to be polluters or generators of high levels of greenhouse gases (GHG). In this sense, SRIs are still considered specialty investments that may prioritize a socially responsible investment approach over short-term financial profits.

Impact investing, on the other hand, has been traditionally limited to private direct investment but is starting to find appetite among individual investors. Impact investing is a specialty investment that could be in the form of either debt or equity, and that is targeted

at supporting a cause or a specific economic sector. Examples include investment vehicles that are working to support affordable housing, clean energy, solar power projects, wind farms, and other initiatives that are thought to have a direct impact on the wellbeing of society.

The values-based investment approaches discussed so far predominately use screening technics to select or eliminate an investment and this is how ESG is emerging as a systematically different investment approach to sustainable and socially responsible investing.

HOW IS ESG DIFFERENT

ESG is the group of Environmental, Social, and Governance factors that are increasingly being considered as an integral part of the decision-making process in organizational management and more generally in the investment management process.

Traditional investment approaches use factors such as projected profitability and revenues, indicators of balance sheet quality and other technical valuation metrics to estimate the expected risk and return of an investment. There is, however, a group of factors that is not straightforward to measure in monetary terms and that is not part of the traditional investment analysis framework, and that sometimes, plays a crucial role in determining the long-term risk and return of an investment. These factors are grouped together under the Environmental, Social and Governance framework. ESG factors are slowly being integrated across the investment management process.

Unlike ethically driven investment themes, such as Socially Responsible Investing and Impact Investing, that essentially use screening tools to include or exclude investments, ESG investing uses a completely different approach. Much like traditional financial analysis, ESG investing analyses specific performance indicators within each of its three vectors, Environmental, Social and Governance, to try to determine their potential long-term impact on the investment in question. Moreover, ESG issues could be considered by investors for both economic and moral reasons. Economically driven investors would use an ESG framework to identify long-term sources of risk and opportunity in an investment, while morally driven investors would use the framework to identify issues that they believe to be morally objectionable.

RELEVANCE AND MATERIALITY

Of course, not all ESG factors are as relevant across industries and certainly not all that are relevant are material. For companies that operate in the fossil fuel industry such as oil and coal exploration and mining, environmental factors are much more relevant than for companies that are in education or in retail. For the latter, relevant factors would include customer welfare and employee relations and rights, for example. Water scarcity and climate change are prime issues to consider in the financial analysis of food, farming, and agribusiness companies. Governance issues, such as board independence, management quality,

transparency and disclosure, however, are very much relevant in every sector. They have been relevant and material across companies and sectors and have been covered by analysts for many years before the broader ESG framework started to become mainstream.

Even though some ESG issues might seem like low probability high impact events that could greatly affect the future of a company, they should not be regarded as such. What happened to Enron was not the result of unexpected outside factors. It was rather the result of years of deliberate accounting fraud that might have been prevented had stricter governance standards been implemented at the time. Similarly, investigations blamed BP, among others, for inadequate safety systems that led to the huge oil spill in the Gulf of Mexico in 2010 and caused major environmental damage and significant losses for investors in BP.

Major social trends could equally affect the prospects of some sectors and their perception by the general public. Increased awareness of the dangers of obesity and the drive to lead healthier lifestyles is forcing major industries to change and adapt. Fast-food and soft drinks companies are trying to reposition their product offerings to appeal to new consumer preferences.

While the consideration of environmental social and governance issues is not new to financial analysis, the systematic consideration of such issues is. Financial analysts have always considered factors such as reputational risks, potential for regulatory framework changes and megatrends like demographic changes as part of the overall financial evaluation of investments. What's meant by a complete ESG factor analysis today, however, is the systematic integration of all relevant and material issues into the larger framework of a traditional financial analysis.

Although there can't be one exhaustive list of ESG issues, below is a list of some of the most common examples of issues to consider within each of the three ESG vectors.

Table 1. Common ESG factors

Environmental	Social	Governance
Energy Consumption/ Efficiency	Human Rights	Management Quality
Air and Water Pollution	Data Protection & Privacy	Audit Committee Structure
Carbon Emissions	Community Engagement	Political Contributions
Climate Change	Health & Safety	Board Independence
Waste Production	Gender & Diversity	Conflicts of Interest
Waste Management	Employee Relations/ Engagement	Executive Compensation
Water Scarcity	Employee Rights	Transparency and Disclosure
		Shareholder Rights

Source: NBK Capital

Obviously, the number of ESG issues that analysts could potentially consider is quite large. It is very important, therefore, that analysts focus on those factors that are the most material and relevant and set their analysis "budget" accordingly. Relevance and materiality will vary significantly across sectors and industries, and in some instances two companies in the same industry could have different sets of factors to consider. Carbon emissions is a more material environmental factor to consider for a power generation company for example than it is for

a manufacturer, even though it could be relevant for both. Therefore, successfully and systematically integrating ESG issues into the financial analysis framework requires a thorough understanding of the ESG issues that would affect an industry or investment, and, at the same time, it requires that data on such issues be available. Moreover, and in addition to data availability, another challenge facing practitioners is having this data standardized so that an apples-to-apples comparison can be reliably conducted.

Table 2: SASB Materiality Map for the Financial Sector and its Industries

Dimension	General Issue Category	Sector	Industries						
		Financials	Asset Management & Custody	Commercial Banks	Consumer Finance	Insurance	Investment Banking & Brokerage	Mortgage Finance	Security & Commodity Exchanges
Environment	GHG Emissions								
	Air Quality								
	Energy Management								
	Water & Wastewater Management								
	Waste & Hazardous Materials Management								
	Ecological Impacts								
Social Capital	Human Rights & Community Relations								
	Customer Privacy								
	Data Security								
	Access & Affordability								
	Product Quality & Safety								
	Customer Welfare								
	Selling Practices & Product Labeling								
Human Capital	Labor Practices								
	Employee Health & Safety								
	Employee Engagement, Diversity & Inclusion								
Business Model & Innovation	Product Design & Lifecycle Management								
	Business Model Resilience								
	Supply Chain Management								
	Materials Sourcing & Efficiency								
	Physical Impacts of Climate Change								
Leadership & Governance	Business Ethics								
	Competitive Behavior								
	Management of the Legal & Regulatory Environment								
	Critical Incident Risk Management								
	Systemic Risk Management								

Source: Sustainability Accounting Standards Board (SASB)

Trying to tackle this particularly important concern, the Sustainability Accounting Standard Board (SASB) has drawn from the "materiality" concept as applied in financial accounting to create a standard matrix for material issues for every industry and sector. The SASB has developed a set of 77 industry standards that were published in November 2018, "providing a set of globally applicable industry-specific standards which identify the minimal set of financially material sustainability topics and their associated metrics for the typical company in an industry".

The standards are illustrated graphically on the SASB website in the SASB Materiality Map® which we have reproduced parts of here to illustrate and compare the material factors for the Financial sector (table 2) to those of the Health Care sector (table 3).

As seen in table 2 above, for the Financials sector the most material factors are the "Selling Practices & Product labeling" and "Product Design & Lifecycle Management", in addition to "Business Ethics" and "Systemic Risk Management". Factors that are labeled in red in the table are likely to be material for more than 50% of industries in the sector. Other factors such "Physical Impact of Climate Change" are labeled in grey as they are material for the fewer than 50% of industries in the sector, specifically for they are more material for the Insurance and Mortgage Finance sectors.

While Social factors, such as consumer protection and employee engagement, and Governance factors, such as Business Ethics and Systemic Risk Management, seem to be obviously material for the Financials sector, Environmental issues, which could be nonetheless relevant, seem to take the back seat as far as materiality is concerned.

Looking at the SASB Materiality Map for the Health Care sector, a very different picture emerges. Most of the Material factors are concentrated in the middle part of the matrix and are related to Social issues, which is expected given the nature of the Health Care sector, its stakeholders and its social impact.

Social issues such as "Product Quality & Safety", "Customer Welfare", and "Access & Affordability" take central stage across all industries in the sector, while Environmental issues are mostly material to industries such Health Care Delivery with "Energy Management" and "Waste & Hazardous Materials Management" being especially important.

The second most important group of issues to consider in the Health Care sector is that related to Human Capital and Business Model and Innovation. Within those two dimensions, all factors are deemed likely to be material for fewer than 50% of industries within the Health Care Sector.

Table 3: SASB Materiality Map for The Health Care Sector and its Industries

Dimension	General Issue Category	Sector	Industries					
		Health Care	Biotechnology & Pharmaceuticals	Drug Retailers	Health Care Delivery	Health Care Distributors	Managed Care	Medical Equipment & Supplies
Environment	GHG Emissions							
	Air Quality							
	Energy Management							
	Water & Wastewater Management							
	Waste & Hazardous Materials Management							
	Ecological Impacts							
Social Capital	Human Rights & Community Relations							
	Customer Privacy							
	Data Security							
	Access & Affordability							
	Product Quality & Safety							
	Customer Welfare							
	Selling Practices & Product Labeling							
Human Capital	Labor Practices							
	Employee Health & Safety							
	Employee Engagement, Diversity & Inclusion							
Business Model & Innovation	Product Design & Lifecycle Management							
	Business Model Resilience							
	Supply Chain Management							
	Materials Sourcing & Efficiency							
	Physical Impacts of Climate Change							
Leadership & Governance	Business Ethics							
	Competitive Behavior							
	Management of the Legal & Regulatory Environment							
	Critical Incident Risk Management							
	Systemic Risk Management							

Source: Sustainability Accounting Standards Board (SASB)

Governance issues for Health Care, on the other hand, are concentrated on Business Ethics. The rest of the factors, although very much relevant for all corporate practices across all industries, are largely deemed immaterial. It is important to note here, that the materiality concept should be looked at in relative terms. While all governance factors are important in any business sector, some other social or environmental issues could be more important and

have a potentially larger impact on the future viability of a business and are therefore given more consideration.

ESG AWARENESS IS GROWING FAST

A good indication of how fast ESG awareness is growing is the list of signatories of the Principles for Responsible Investment (PRI) initiative. The PRI is a United Nations-supported initiative that is the world's proponent of responsible investing. It has two United Nations partners; the UN Environment Programme Finance Initiative and the UN Global Compact. According to their website, the PRI "*works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions…*"

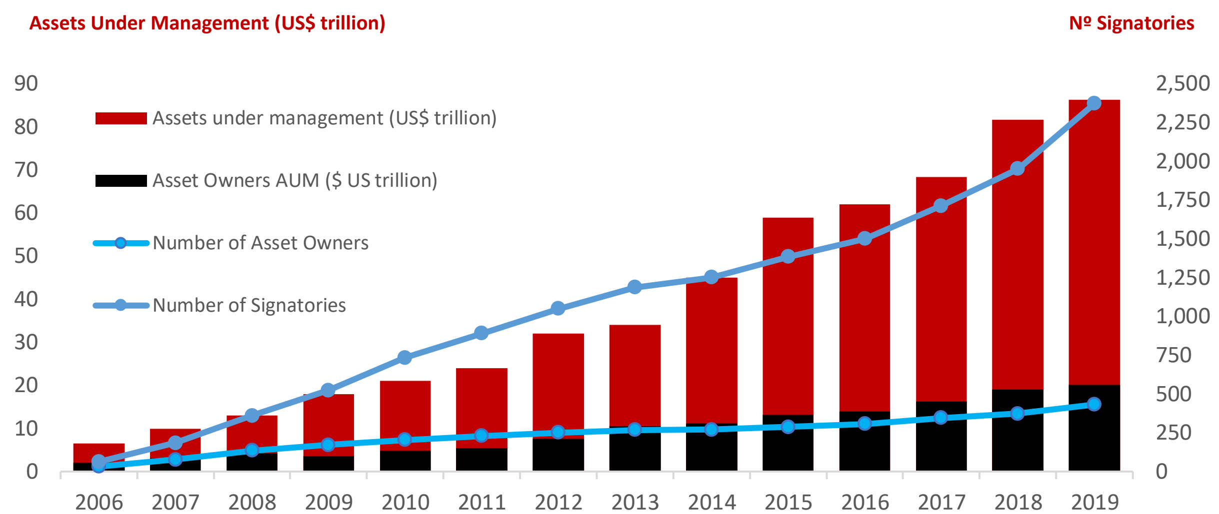
The PRI encourages investors to use responsible investment within an ESG framework to enhance return and better manage risks. It promotes a set of six high level principles of responsible investing that offer action points for incorporating ESG issues into investment practice. The Six principles are highlighted in chart 1 below.

Chart 1. The Six United Nations Principles for Responsible Investment

Source: UN Principles for Responsible Investing PRI

The number of signatories of the PRI principles has grown consistently since its launch in April 2006. Today it includes 2,372 signatories, including 432 Asset Owners and around 1,660 Investment Managers, with a total Assets Under Management of the signatories of a little over USD86 trillion.

Chart 2. PRI Signatories and AUMs Growth



Source: Principles for Responsible Investing (PRI)

DRIVERS AND CHALLENGES TO ESG ADOPTION

One major driver that is helping the growth of ESG awareness and adoption is the increasingly heated debate on climate change and its long-term effects on people and ecosystems. The effects of this debate on policy issues and the regulatory framework of energy intensive industries are just starting to take shape.

Many countries are putting deadlines on the use of internal combustion engines, the renewable energy industry is attracting more and more investments, and the drive to move away from carbon-intensive energy sources is accelerating. Over the long-term, this poses a risk of increased taxation and regulations on the conventional energy sector which has the potential to radically change its dynamics. As the current energy transition gains momentum, it will inevitably have significant transformative effects on other sectors that are directly and indirectly related to energy such as transportation, manufacturing, and financials.

Other drivers of ESG adoption have also been noticeably gathering steam. Client demand, for instance, is proving to be a significant factor as a new generation of clients is emerging. Millennials are becoming an increasingly important source of funds in the asset management industry. According to a report by MSCI, Millennials could put between $15 trillion and $20 trillion into US domiciled ESG investments over the next two to three decades. Moreover, a wealth transfer from baby boomers to the next generation of around $30 trillion is expected to happen over the same period. Multiple studies and surveys are showing that millennials, women, and a younger generation of investors in general, have a different kind of return requirements. In addition to positive returns, this new generation of investors are more socially conscious and want their investments to make a social and environmental impact.

Data is also a significant driver. Availability of data and more advanced analytical tools are slowly making it easier for companies to report on ESG issues and for data and analytics providers to make such tools available for investors. Data providers such as Reuters, Bloomberg, and MSCI have started to provide ESG data and are reporting rising usage rates from clients. In August 2016, Morningstar introduced the Morningstar Sustainability Rating which classifies funds on a scale of 1 to 5 according to their position in industry group in terms of sustainability.

Another important factor is the fact that large investors and asset owners have become global and too big to afford ignoring material risks derived from ESG issues. The size of the asset management industry has increased so much that investment portfolios are becoming more and more spread across continents and have therefore become increasingly exposed to risks related to governance issues and natural disasters like wildfires and floods well beyond the frontier of their domicile. Pension funds, endowments, sovereign wealth funds and other large investors are integrating ESG issues into their investment processes and RFPs forcing investment managers to comply.

Despite the sizable advances in ESG awareness and rate of adoption, significant challenges remain for it to become mainstream. One particularly important challenge is that, by nature, individual investors tend to have a short-term bias. Short-termism also affects institutional investors and is driven by the structure of management incentives (which is a major governance issue), culture, and even pressure from financial investors and analysts. ESG factors are more likely to affect performance over the long-term than in the next quarter.

Even as surveys have shown that top management in most large investment management firms are well aware of the significance and importance of ESG and the risks of ignoring them, the challenge is to push this awareness down. There is a significant cultural change involved in trying to spread ESG awareness down and across the organizational structure.

Moreover, despite the improvement in data availability, more needs to be done in terms of data quality and timeliness and in standardizing the reporting requirements by companies so that investors and analysts could make meaningful comparisons across companies and time periods.

Just like any other major transition, the transition to sustainable investing practices will ultimately happen. There will be some difficulties along the way but the change is already underway and the transition is accelerated by multiple drivers. It is driven by a new type of clients who are more socially aware, by major industry players that are pushed by large investors and asset owners, by independent bodies and organizations that are helping setting standards of implementation, and by regulators that will ultimately catch up with the private sector.

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