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MOVING ESG INTO THE MAINSTREAM: DRIVERS AND ACTIONS

By Mike Scott

There was a time when environmental, social and governance (ESG) issues were the niche concern of a select group of ethical, or socially responsible investors. That time has long gone and it is not hard to see why.

From the wildfires that have engulfed Australia to the Dieselgate scandal that continues to reverberate in the boardroom of VW and concerns about conditions in workplaces ranging from cobalt mines to iPhone factories and textiles producers; ESG issues have become increasingly central to economic performance and it is now widely acknowledged that they can have a material impact on company earnings and therefore investor returns.

At the turn of the century, ESG factors were thought to be so irrelevant to company performance that they were referred to as "non-financial issues" by City analysts. If they were considered at all, they were seen as an ethical issue and it was generally accepted that investors would sacrifice financial returns in order to invest according to their beliefs.

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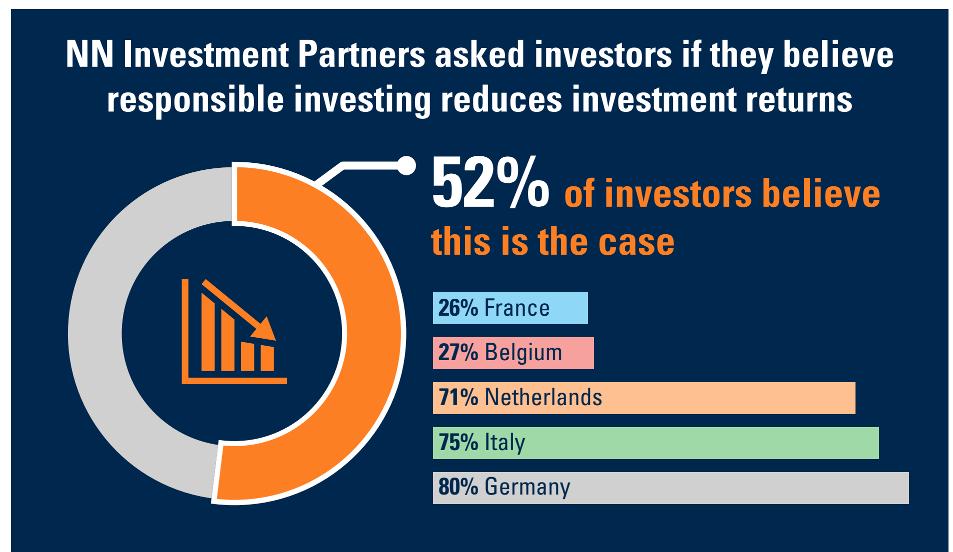
Indeed, a study by NN Investment Partners[1] showed that more than half of professional investors still think that incorporating ESG into their investment strategy will reduce their returns, with more than 70% thinking this in Italy and the Netherlands, along with 80% of German investors.



https://www.ipe.com/chart-of-the-week-investors-still-believe-esg-investing-limits-returns/10033473.article

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The value of ESG analysis

However, time and again this school of thought has been shown to be wrong – company valuations and profits have been hit by the impact of individual incidents such as BP's 2009 Deepwater Horizon disaster, which cost the company $70 billion in the decade after it occurred and saw its market capitalisation fall by more than half (55%).[2] Companies also face longer-term threats ranging from resource scarcity, which has affected industries from agriculture (water shortages) to automotive (metals such as palladium for catalytic converters).

Considering ESG factors is "a way to measure externalities," says Christian Heller, CEO of the Value Balancing Alliance, whose members aim to create a standardized model for measuring and disclosing the environmental, human, social and financial value companies provide to society. "It's a way to extend risk management because at some point the externalities will be internalised, for example through carbon taxes."

The Harvard Business Review[3] says a number of studies have shown a positive relationship between ESG and returns. "A 2017 study by Nordea Equity Research (the largest financial services group in the Nordic region) reported that from 2012 to 2015, the companies with the highest ESG ratings outperformed the lowest-rated firms by as much as 40%," the HBR says. In 2018, Bank of America Merrill Lynch found that firms with a better ESG record than their peers produced higher three-year returns, were more likely to become high-quality stocks, were less likely to have large price declines, and were less likely to go bankrupt, it adds.[4]

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"A growing body of academic and industry research has indicated that companies with better-managed ESG risks tended to enjoy lower cost of capital — typically an indication that the market saw them as less risky," reports MSCI, the index provider. "Among companies in the MSCI World Index, those with the highest MSCI ESG Ratings experienced three times fewer incidents of dramatically sharp falls in share price than companies with the lowest ESG ratings (between January 2007 and May 2017).[5]

Asset owners drive change

Asset owners are integrating ESG across their portfolios

Nearly a quarter (21%) of asset owners surveyed said that ESG is fully integrated across their portfolio while an additional 24% said they have significant allocations to ESG (representing at least half the portfolio). More than a quarter (29%) said that they have no specific allocations to ESG within their portfolios.

21% Fully intergrated
24% Significant allocations
29% No specific allocations

Asset Owners Plan on Increasing Knowledge Base

Asset owners picked education as their top priority over the next 12 months, with 42% planning to educate their supervisory board on the importance of ESG and sustainability issues, and 36% planning to train existing staff on how to use ESG data. Other immediate priorities for asset owners included more formally integrating ESG into their investment processes by updating existing policies or adopting new ones (39%) and hiring additional ESG specialists (24%).

42% Seek to educate their supervisory board
36% Plan to train exisitng staff
39% Plan to update existing policies and impliment new initiatives
24% Plan to recruit additional ESG specialists

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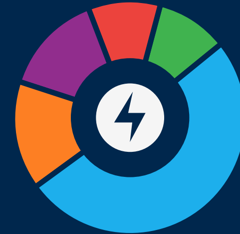
Key Challenges for Asset Owners

More than half (51%) said that the "lack of quality ESG data" was their biggest challenge in allocating to ESG-oriented investments. This easily topped the other survey choices, which included: "skepticism over the viability of ESG" (15%), "political or regulatory uncertainty" (14%), "confusion over industry terminology" (10%) and "lack of quality fund managers" (10%).

51% Lack of Quality ESG Data
15% Viability of ESG
14% Political/Regulatory Confusion
10% Industry Terminology Confusion
10% Lack of Quality Fund Managers



Key Drivers of ESG Adoption and Growth

A combined 59% of asset owners cited "evidence of the materiality of ESG issues" (35%) and "opportunities to generate alpha" (24%) as their biggest motivators in allocating to ESG- or impact-oriented investments. More than a third (38%) pointed to "growing investor or beneficiary demand" while virtually nobody cited "regulatory or political pressure" (3%).

59% Growing evidence of Materiality
38% Growing investor/beneficiary demand
3% Regulatory or political pressure

Opinions on Industry Standards

While 33% of asset owners use internally developed ESG metrics to build and monitor their portfolios, the industry standards with the most widespread support include: the PRI (42%), UN SDGs (25%), SASB (22%) and TCFD (20%). Only 24% said they do not use any measurement or reporting metrics or standards.

42% look to PRI
25% UN SDGs
22% SASB
20% TCFD

Pressure to incorporate ESG is Increasing from asset owners – the CFA Society New York reports that "institutional asset owners are aggressively embracing ESG, with 45% reporting that ESG is fully or significantly integrated across their portfolios and 39% planning to more formally integrate ESG into their investment processes". [6]

"Asset owners have a tremendous amount of power and influence when it comes to shaping the future direction of the global capital markets," says Daniel Dagen, CEO of CFANY. "As the world's sustainability challenges become more severe and urgent, these asset owners are sending a clear message to the financial services industry: ESG and sustainability must become the new normal."

Pension funds are acting "not because they are trying to save the world, particularly, but because it is their job to look after their beneficiaries' money and taking into account ESG risks is a crucial part of that," says Charlene Cranny, communications and campaigns director at the UK Sustainable Investment and Finance Association.

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One recent example of this new assertiveness on ESG came from the £30bn Brunel Pension Partnership, a UK local government pension fund pool, which recently challenged its 130+ asset managers and the wider sector to step up on climate or risk being excluded from its investments.

Brunel says the finance sector is currently "unfit for purpose for addressing climate change" and if companies do not show "significant progress" on managing their climate risks by 2022, it will vote against their board members and could sell its shares. If asset managers don't reduce exposure to climate risk, their mandates will be reviewed and potentially removed.

"Climate change is a rapidly escalating investment issue," said chief investment officer Mark Mansley. "The finance sector is part of the problem when it could and should be part of the solution for addressing climate change. How the sector prices assets, manages risk, and benchmarks performance all need to be challenged."

Pressure grows, from government and citizens

Asset owners themselves are under increasing pressure to ensure that their allocations fully incorporate ESG considerations, adds Therese Niklasson, global head of ESG at Investec. "The focus on issues such as climate change, active ownership, transparency and reporting, and sustainability-related regulation is intensifying. That's putting asset owners under more pressure to ensure that their allocations properly integrate ESG considerations, and that engagement with companies and other entities is conducted in an effective and coordinated way."

The pressure is coming from the top down in the form of increased government and regulatory action and from the bottom up in the form of pressure and protests from concerned citizens.

UK pensions minister Guy Opperman last year called on the country's 50 largest pension schemes to provide evidence of what they are doing to tackle climate change and other ESG issues.

The top-down pressure is driven by the Paris Agreement on Climate Change, under which 197 countries signed up to a commitment to keep average temperature rises to "well below 2°C". This has prompted governments to introduce stricter rules, such as the UK's commitment to have net zero emissions by 2050, while a number of cities and states have their own targets. C40 Cities says 30 of the world's largest cities, from Barcelona to Boston and Stockholm to Sydney, representing more than 58 million people, have already peaked their greenhouse gas (GHG) emissions.[7]

This is translating into increasing calls for investors to take such issues into account, and a growing number of tools that enable them to do so.

UK pensions minister Guy Opperman last year called on the country's 50 largest pension schemes to provide evidence of what they are doing to tackle climate change and other ESG issues, for example. "Pension funds are a powerful weapon in the fight against climate change. We need urgency on this vital issue from trustees and investment managers," he said.[8]

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Addressing risks

Caroline Escott, policy lead for investment and stewardship at the Pensions and Lifetime Savings Association, said: "Ultimately pension funds have a duty to invest their assets in line with the best interests of their members. Increasingly, research has shown that companies that are more environmentally aware and have strong social and governance policies in place, tend to outperform those that do not. It is also widely acknowledged that climate change poses a severe risk to investment portfolios and it is firmly in schemes' and savers' interests to seek to address it."

At the same time as the number of rules and regulations that companies and investors face is on the rise, there has been a marked change in the public discourse as well. High profile protests by activists such as Extinction Rebellion and the Greta Thunberg-inspired school strikes are just the most visible manifestation of increasing knowledge and concern about climate change that translates into new expectations of companies and investors when it comes to tackling the problem.

The same development can be seen in relation to other ESG issues, such as ocean plastic, child labour and unsafe working conditions. Companies are starting to see the impacts, not just in direct disruption to their operations but in protests against sponsorship by oil companies of the National Theatre and the Royal Shakespeare Company in the UK. In the US, there have been protests against sponsorships by members of the family that owns Purdue Pharma, a company facing lawsuits related to the opioids crisis.

New tools

As a result, it has become ever-more important for companies and investors to be able to demonstrate their ESG credentials. There are a number of tools to help them do this, including the Taskforce on Climate-related Financial Disclosures (TCFD), an initiative set up by Michael Bloomberg and outgoing Bank of England governor Mark Carney. The TCFD recommends that companies disclose their climate risks, both physical risks such as the impact of floods, droughts and wildfires and 'transition' risks such as increasing legislation and other restrictions on high carbon companies.[9]

Others include the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI).

Companies and investors often moan about the amount of time and resources required to answer all the requests for sustainability information, but recent technological advances in areas such as artificial intelligence, big data analysis and machine learning mean that it is becoming easier to gather and interpret the necessary information.

The pressures on investors to act are clear, and the pioneers of the ethical investing movement have been joined by a growing band of asset managers that have incorporated ESG into their investment strategies, particularly in the active investment field. One of the most successful initiatives of recent years has been Climate Action 100+, which focuses on engagement with the biggest emitters and is backed by more than 370 investors with $35 trillion of assets under management.

The initiative has persuaded oil companies such as BP, Shell and Norway's Equinor to adopt emissions reduction targets and its engagements have led a number of other companies to agree net zero targets.[10]

But the biggest passive investors – Blackrock, State Street Global Advisors and Vanguard – have always lagged behind, meaning that investor engagement efforts always lacked critical mass.

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The Blackrock effect

However, Blackrock, the biggest investor in the world, may have just changed all that. CEO Larry Fink, in his annual letter to clients, announced that the firm had joined Climate Action 100+ and that "we believe that sustainability should be our new standard for investing".[11]

The company said it would "place sustainability at the centre of our investment approach, including: making sustainability integral to portfolio construction and risk management; exiting investments that present a high sustainability-related risk, such as thermal coal producers; launching new investment products that screen fossil fuels; and strengthening our commitment to sustainability and transparency in our investment stewardship activities".

"Climate change has become a defining factor in companies' long-term prospects. I believe we are on the edge of a fundamental reshaping of finance," he told CEOs in a separate letter. "Climate risk is investment risk. In the near future – and sooner than most anticipate – there will be a significant reallocation of capital."[12]

Blackrock's move put pressure on the other big passive investors – Vanguard and SSGA – to respond with similar moves and has been welcomed by other investors. SSGA has since announced that it will vote against companies that don't integrate ESG into their strategies. "I think it will make a big difference," said Simon Smiles, chief investment officer for UHNW at UBS. "Putting concrete commitments on paper as the world's largest investment manager – that's a profound statement."

One of the major barriers to further integration of ESG factors into investing is that there is still a lack of data, and the data that exists is not standardised. There is only around a 30% correlation between the ratings of the two main ESG ratings providers, Sustainalytics and MSCI, said Smiles. "They're very different ratings, so how do you work out how sustainable a company really is?"

Blackrock's call for companies to report according to SASB and TCFD guidelines should help to drive standardisation. Bank of America CEO Brian Moynihan adds that "what we seek is a general framework for companies to demonstrate their long-term sustainability".[13]

And with everyone from Greta Thunberg to Prince Charles calling for a more sustainable financial system, 2020 is the year, according to MSCI, that "ESG storms the CFO's office, elbowing its way onto the bottom line as financiers get creative with ways to bind ESG criteria to their terms of capital, introducing a plethora of corporate borrowers into the wide world of ESG".[14]

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