Investments

Responsible Investing Is Not a Preference

How the use of ESG factors is changing the investment process for good.

By Robert E. Pike for PSCA's Investment Committee

The PSCA Investment Committee has been carefully tracking the burgeoning growth of responsible investing (RI) and its primary use of environmental, social, and governance (ESG) factors to analyze investments. While asset owners, managers, and investors globally have incorporated the additional rigor and differentiated analysis provided by ESG, the defined contribution market has been reticent to consider these methods, for a variety of good reasons. However, the market has now reached a tipping point and it will be incumbent upon plan sponsors and their fiduciaries to become more familiar with RI as it will inevitably impact their plan investments.

The Purpose of a Corporation

Shareholders in corporations throughout history have always had profit as the primary objective for forming and operating a business. Beginning in 1602 with the founding of the Dutch East India Company, and continuing through to our own Standard Oil Company in the 19th century, shareholders in "joint stock companies" have always pursued the monetary reward on invested capital as the most important benchmark by which to judge the success or failure of an enterprise. Even today, in business schools across the country, students are taught that the goal of the corporation (and its financial managers) is to increase the value (share price) of the stock.

The experience of history has taught us, however, that profit can come with high costs. Abuse of people and natural resources by operators focused on short-term rewards and an unequal distribution of wealth are frequently cited. This early unbridled laissez-faire style of capitalism resulted in various forms of state intervention (regulations, welfare benefits, etc.) such that commercial and political/social interests have vied for primacy in a constant ebb and flow of change in the modern era. Today, capitalism is under attack as never before.

Recognizing this growing tension, in August of 2019 the Business Roundtable (BR) released a new *Statement on the Purpose of a Corporation* signed by 181 CEOs of America's largest companies, who committed to lead their companies for the benefit of all stakeholders — customers, employees, suppliers, communities, and shareholders. This extraordinary pivot demoted the principle of shareholder primacy, refuting the notion that corporations exist principally to serve shareholders. As BR stated: "With today's announcement, the new Statement…outlines a modern standard for corporate responsibility." Traditional methods of investment analysis must and will change to encompass the broader scope of considerations being developed through the use of ESG factors. It is no longer a choice (preference).

Background and Development of Responsible Investing

Not all investors succumbed to a "profit-first" motive. Early efforts by religious orders to invest their money only in enterprises that did not conflict with their values (i.e., exclusionary investing that prohibited investments in alcohol, tobacco, etc.) were the genesis of the movement toward RI. Throughout the twentieth century, investors widened their viewpoint to include the social and economic impact of diverse issues like racial discrimination, gender pay gaps and corruption, as well as environmental challenges like carbon emissions and clean water.

These differing approaches to investing all sought to better understand the wider impact of economic activity and its effect on financial performance. In response, the United Nations established the Principles for Responsible Investing (UNPRI) in 2006 to provide a unified set of global guidelines for investors to positively impact the world through their investment policies. These principles have become the de-facto global standard against which companies are being measured. Every major asset manager and asset owner in the world has become a signatory, pledging to observe the principles and bring about fundamental change to their investment policies to better align with the PRI goals.

Exhibit 1: Environmental, Social, and Governance Factors

Environmental Issues	Social Issues	Governance Issues
Climate Change and Carbon Emissions	Customer Satisfaction	Board Composition
Air and Water Pollution	Data Protection and Privacy	Audit Committee Structure
Biodiversity	Gender and Diversity	Bribery and Corruption
Deforestation	Employee Engagement	Executive Compensation
Energy Efficiency	Community Relations	Lobbying
Waste Management	Human Rights	Political Contributions
Water Scarcity	Labor Standards	Whistleblower Schemes

Source: CFA Institute

Today, the term "responsible investing" (RI) has become the globally recognized umbrella term for the most common approaches in use today: sustainable; sustainable, responsible, and impact (SRI); socially responsible investing (also SRI); impact; social impact; mission-based; value-driven; green; and ethical. Each of these approaches consider some or all of the issues listed in Exhibit 1 using specialized investment analysis (ESG factors) to select companies and build portfolios that best meet a desired objective.

Benefits of RI

Consistent with Fiduciary Duty

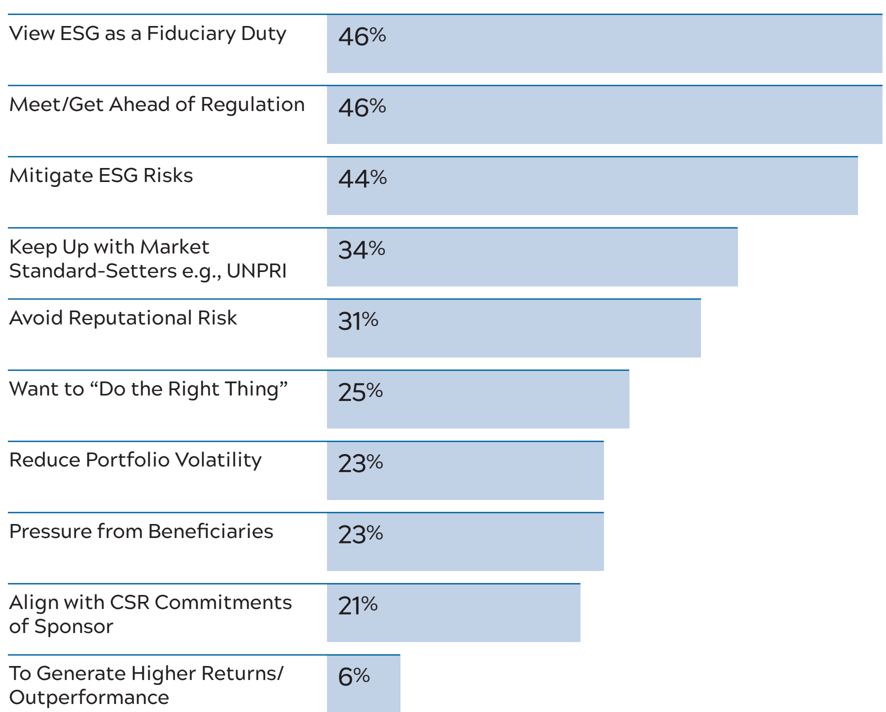
The world's leading investment professionals and largest institutional investors all view ESG as a fiduciary duty. In February of 2019, the CFA Institute (the world's leading organization of investment professionals) issued a statement of "Positions on Environmental, Social, and Governance Integration." It concluded that "ESG factoring is consistent with a manager's fiduciary duty to consider all relevant information and material risks in investment analysis and decision making." Similarly, in a global survey of institutional investors and asset owners conducted by State Street Global Advisors in mid-2019[1] (SsGA study), this same reason was listed as the primary driver behind the decision to adopt ESG. See Exhibit 2.

Ability to Lower Portfolio Risk without Sacrificing Return

Investors increasingly are choosing ESG primarily for its ability to lower risk. Academic meta-studies of ESG data find that higher-scoring companies have lower earnings volatility. A recent Morgan Stanley study[2] examined Morningstar data back to 2004 and found a dramatic 20 percent lower downside deviation (risk) in sustainable funds versus their traditional counterparts, while both demonstrated similar return profiles. In a recent Nuveen survey among high net worth investors, 34 percent agreed that "responsible investing can add alpha and reduce risks. Companies are likely to perform better when they adhere to ESG principles."[3]

A significant emerging risk may be a coming global re-allocation of capital

Exhibit 2: What Are the Most Significant Factors in Driving Your Institution to Adopt ESG Principles?



away from poorly-performing companies. In his most recent letter to CEO's *(A Fundamental Re-Shaping of Finance)*, Blackrock's Chairman Larry Fink, citing climate change, stated: "These questions are driving a profound reassessment of risk and asset values. And because capital markets pull future risk forward, we will see changes in capital allocation more quickly than we see changes to the climate itself. In the near future — and sooner than most anticipate — there will be a significant reallocation of capital."

At the same time, many believe that returns are reduced (sacrificed) when using RI, citing outdated studies which utilized exclusionary (narrow) screening. Very comprehensive and timely academic and industry meta-studies have shown that companies with robust RI practices have better operational performance and cash flows, and better access to capital (lower funding costs), all of which lead to better (or at worst, neutral) investment performance.[4]

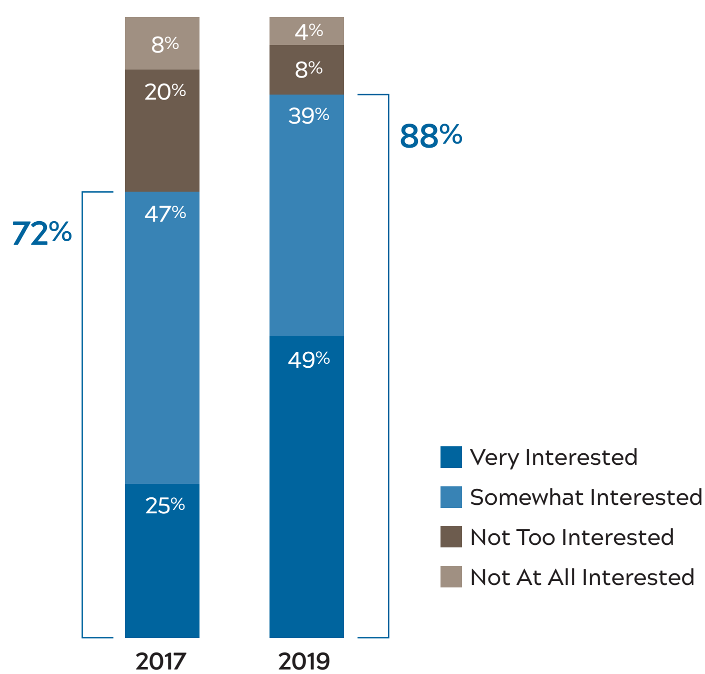
Strong Demand for RI

Study after study indicates that investors have interest in RI funds. Nuveen's recent fourth annual RI survey demonstrated that 78 percent of the general population (and 93 percent of millennials) want an RI option. For plan sponsors, Morgan Stanley's recent survey[5] shows keen interest in adding an RI option to plan investment options. See Exhibit 3.

ESG Integration Broadens the Investment Opportunity Set

The key change over the past 20 years has been the integration of ESG data into consideration of all investible markets and securities. As the CFA Institute states: "ESG investing grew out of investment philosophies such as Socially Responsible Investing (SRI), but there are key differences. Earlier models typically use value judgements and negative screening to decide which companies to invest in. ESG investing and analysis, on the other hand, looks at finding value in companies — not simply at supporting a set of values." For plan sponsors, it means no longer having to exclude companies (i.e., choose what DOL/EBSA call "economically targeted investments") and bear this perceived risk.

Exhibit 3: Interest — If There Were a 401(k) Option



A Robust and Growing Fund Marketplace

The growth of funds that embrace ESG investing has grown significantly over the past decade. See Exhibit 4.

The marketplace is responding as never before with new ESG products. Some of this is due to externalities (increasing demand whether from social choice/investor preference, new rules and regulations, etc.). However, investment managers world-wide now must meet "minimum requirements" should they wish to remain a signatory to the UNPRI, or face delisting. Having more than 50 percent of a firm's assets under management (AUM) meet responsible investing guidelines is a key requirement that is forcing all organizations to boost their RI AUM. RI product growth will therefore meaningfully increase over time, whether by new products or the re-launch of old products with a "new" RI label (sometimes called "greenwashing").

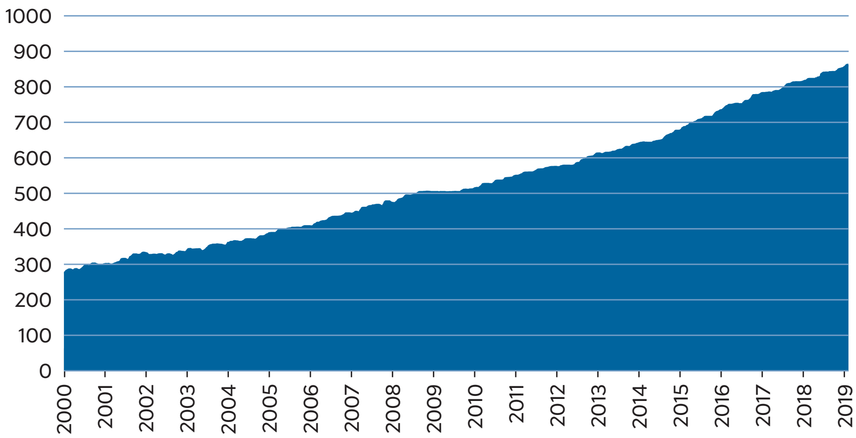
Challenges for Investors

Lack of Comparability of ESG Data

The broad and complex issues that make up the ESG landscape are growing, often interlinked, and frequently not measurable using traditional metrics (i.e., what is the return on investment for having a more diverse workforce?). Moreover, different countries have different financial reporting requirements. As a result, data measurement and ESG reporting lacks consistency, comparability, and reliability (quality). This is cited consistently as the #1 challenge to further adoption of ESG.

Fortunately, governments and stakeholder groups recognize the need for more uniform global standards. In November 2018, the Sustainability Accounting Standards Board (SASB) published the first ever globally applicable industry standards (77 in total) to assist companies in disclosing financially material, actionable

Exhibit 4: Number of U.S. ESG Funds (1/01/00–9/30/19)



Source: DWS/Morningstar

sustainability information (see https://materiality.sasb.org/ for SASB Materiality Map®). In January 2020, the Big Four accounting firms launched the most comprehensive proposal to date to account for ESG related activities on corporate financial statements. While continuing to evolve, much has been accomplished and the movement to adopt standards is growing globally.

Complexity and Lack of Transparency Across Data Providers

The methods used by leading ESG data providers to analyze, score, and rank companies vary greatly, are typically proprietary, and can produce different scores for the same company.

A key challenge for investors, therefore, is to understand as clearly as possible the particular methodology of the data provider and how that data can be utilized to help achieve specific goals and objectives. For instance, an investor who is primarily interested in lowering global carbon emissions may prefer an investment product or data provider that explicitly eliminates or severely penalizes companies with high carbon emissions in their ranking process.

Regulations are Forcing Change

As of October 2019, new pension fund regulations in the United Kingdom require that ESG factors be considered; otherwise funds must justify how their disregard will not hurt investment returns. In December of 2019, the European Union adopted a landmark agreement that codifies the criteria (taxonomy) for permitted carbon emissions of investment portfolios. Because it also requires companies and investment managers to disclose these levels, significant divestment of non-conforming or poorly-scoring companies is expected. While the US has not enacted such laws, many other countries are considering these types of changes, and global capital markets do not discriminate or hesitate to adjust security prices accordingly, so all investors need to prepare for further regulatory catalysts.

Takeaways for Plan Sponsors

Guidance from the Department of Labor's (DOL) Employee Benefits Security Administration (EBSA) on this topic has been confusing and is frequently cited as a reason by plan sponsors to avoid consideration of RI. This will change as the (accelerating) global adoption of RI reaches an inflection point and becomes the standard and best practice in what is already being called today's most important investing megatrend. It is a critical (and evolving) body of knowledge that deserves greater focus.

One thing remains the same: prudent fiduciary oversight. The shift to RI means that existing fund line-ups will increasingly be at risk as investors reject non-RI aligned funds and companies, even as more choices become available. Whether explicitly stated in investment policies or not, ESG considerations are widely considered to be a risk reduction tool that plan fiduciaries ignore at their own peril.

The mainstreaming of RI is inevitable. The combination of burgeoning investor preference and product availability, as well statutory mandates, ensure that these changes will fundamentally change investing in the future — for good.

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Note: The author and fellow ESG Sub-Committee member Matthew Luksa of Dimensional Fund Advisors are editing the second edition of the PSCA Resource Guide for Responsible Investing, which will be published in April 2020.

[1] "Into the Mainstream: ESG At the Tipping Point", State Street Global Advisors, November 2019

[2] Morgan Stanley Institute for Sustainable Investing, "Sustainable Realty: Analyzing Risk and Returns of Sustainable Funds", 2019

[3] Nuveen / TIAA-CREF, Fourth Annual Responsible Investing Survey, 2019

[4] University of Hamburg "ESG and Corporate Financial Performance" (December 2015), Savita Subramanian, ESG Part II, A Deeper Dive, Equity Strategy Focus Point, June. 2017

[5] Morgan Stanley Institute for Sustainable Investing, "Sustainable Signals", 2019