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ESG Investing Becomes Mainstream

Forum Spotlights

The subject of ESG, or investing in accord with environmental, social and governance principles, arose in several sessions at Commonfund Forum 2018. One session, in particular, was devoted to the ongoing evolution of responsible investing, with a focus on ESG. The following article highlights key takeaways from the session, with thanks to the leaders of the discussion: the moderator, Commonfund Managing Director Deborah Spalding, and featured speakers Chris Fowle, Head of Americas, Principles for Responsible Investment (PRI), and Cary Krosinsky, Lecturer at Yale University and a teacher of theory and practice of sustainable investing at Brown University.

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ESG AND SRI ARE NOT SYNONYMOUS

ESG is distinct from traditional socially responsible investing, or SRI. Historically, responsible investing was dominated by SRI, which largely focused on screening out certain investments deemed counter to an organization's mission. Over time, however, investors became concerned that negative screening could limit potential returns by narrowing one's investable universe through security or sector exclusions. ESG evolved as a distinct approach to SRI and one that looked at both the downside risks and the upside opportunities, and allowed for greater potential impact through active strategies such as public company proxy voting.

DATA COLLECTION IS IMPROVING

Some asset owners will say, "I'd like to get started, but I don't trust the data that's out there." While there is certainly room for improvement, there are service providers, such as MSCI, Carbon Tracker and Sustainalytics, which can be accessed and downloaded from the Bloomberg terminals used by many analysts. Traditional data and research corporations are beginning to see the benefit of having ESG capabilities, as evidenced by S&P Dow Jones Indices' recent purchase of Trucost. As an investor considering ESG, there are two important things to keep in mind. First, while there is work to be done in data collection, don't dismiss reasonably good data in a quest for perfect data. Second, since the cost of sourcing data can be high, be strategic about what data you actually need and focus on that. As more investors demand ESG disclosure, it will encourage greater transparency and the cost of data acquisition will likely decline as disclosure becomes more mainstream. Organizations such as the Principles of Responsible Investment have been pushing for greater disclosure by requiring signatories to report on responsible investments through a standardized reporting framework. Signatories failing to do so risk delisting, a discipline that has helped to foster an increased commitment to reporting.

STANDARDS DEVELOPMENT IS STILL EARLY ON THE CURVE

Similar to a lack of data, there is still no standardized ESG reporting comparable to industry-accepted standards such as FASB[1] and IFRS[2]. While there are many emerging standards, they are still largely voluntary at this point. But as mentioned earlier, PRI includes a core principle devoted to reporting, and as reporting evolves so will standards. Some members of the G20 are developing standards, like Article 173 in France, which in 2015 became the first-ever mandatory institutional investor climate reporting law. There is a growing feeling among ESG-aware investors that they do not want to wait for markets or regulators to tell them what to do, but instead wish to seize the initiative themselves.

> *"ESG is many things that, taken together, offer a menu of approaches or options that allow decision-makers to select what makes sense for their organization.*
>
> *– Cary Krosinsky*

1 Financial Accounting Standards Board
2 International Financial Reporting Standards

ACCEPT THAT STANDARDS ARE STILL EVOLVING

While laudable, standards are somewhat of a double-edged sword. Proliferating standards in various stages of development can often complicate the exercise, rather than move the discussion forward. Materiality thresholds are a key component of what can and should be included. The question is: What data are really needed? And, can a sustainability strategy be tied to better financial outcomes? Once standards are better accepted, the overall system can become self-perpetuating. Today, however, ESG standards are in a kind of chaotic middle phase—neither nascent nor mature.

IT'S A MISCONCEPTION THAT ESG RISKS UNDERPERFORMANCE

Some believe that an increment of returns is left on the table when investing in a sustainable manner. This is more of a values-first approach, and there are plenty of studies showing that divestment from certain industries or countries can lead to underperformance. First, asset owners should look at their current investment holdings, and then define what it means for them to be a responsible owner.

Cary Krosinsky

Divestment may ultimately be the most appropriate decision, but it should be at the end of a thoughtful process.

ESG AS A RISK MITIGATOR

ESG is a complex topic. Taken together, ESG criteria offer a menu of approaches or options that allow decision-makers to create customized approaches for their portfolio and organization. Some asset owners use ESG for risk mitigation. While traditional SRI strategies may introduce unintended risks from greater portfolio concentration as a result of sector and/or security exclusions, ESG approaches can be implemented via engagement versus divestment. Whether an investor is focused on board governance, lower exposure to environmental hazards, fair labor practices or equal opportunity policies, the use of ESG factors can help uncover objectionable or avoidable practices and manage company-specific risks, while also creating a platform for an asset owner to promote change.

MANAGERS AND CONSULTANTS ARE A POTENTIAL RESOURCE

Investment consultants play a critical role in the design of investment policies and asset allocation. Many are signatories to PRI, and can be a valuable resource to institutions wanting to learn more. But, among endowments and the consultant communities, there is a bit of a chicken-and-egg problem. Many consultants have fairly robust offerings around ESG and can provide strong input in structuring ESG programs. But they aren't proactively bringing it to clients because, in many cases, the clients aren't asking. And, in the same vein, clients aren't asking because the consultants aren't discussing it. Alternatively, institutions that have an internal investment office or work with an outsourced provider may have more ability to proactively and collaboratively consider and incorporate ESG into their custom portfolios. This, of course, depends on the capabilities and willingness of the investors and the resources they have aligned behind that effort, which can vary widely.

WHAT POSTURE SHOULD INVESTMENT COMMITTEES TAKE?

Traditionally, there have been two polar positions: On one end of the spectrum, the committee might say, "Let's focus on maximizing returns and not look at ESG." Another committee might say, "We are mission oriented, and for us not to align our capital with our mission is inconsistent with our fiduciary responsibility." Some of these philosophical positions have arisen from experience-based assumptions that have built up over time, such as student protests that have colored the thinking of investment committee members when it comes to responsible investing. It's important for investment committees to look broadly at the field and see the new directions ESG has taken over the last few years. There are many ways to tackle ESG issues that can resonate with all stakeholders, whether done on a large scale or a more pointed, issue-specific approach.

Today, ESG is challenging the traditional interpretation of fiduciary duty. While ERISA regulations do not apply to endowments, they are an example of how the landscape is changing. The Department of Labor has issued guidelines very clearly stating that ESG factors can and should be incorporated into investment decision-making. Increasingly, there is a feeling that ESG is not only consistent with fiduciary duty, it should actually be part of one's fiduciary duty.

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– Chris Fowle

Chris Fowle

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