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ESG Investing: Making Money While Doing Good

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Environmental, Social, and Governance (ESG) funds have grown dramatically. It is estimated that funds with ESG focus have assets under management USD37.8 trillion, which is likely to grow to over USD50 trillion by 2025 (Diab and Adams. 2021). ESG risks are now better understood than ever before. Internationally, large banks have well-capitalized programs with ESG and impact platforms, pay-for-success and green bonds, and toolkits for social capacity building. A study by the European multinational financial services company Allianz found that 64% of millennials were likely to make investment decisions based on societal problems that are important to them (Allianz. 2019) Till recently, many writers felt that ESG investing was a passing fad. That is no longer true. ESG investing has grown its roots firmly.

This article explores the areas of ESG investing. I discuss how incentives are created for ESG investing, financial models/approaches for achieving focus on ESG issues. Finally, I look at the roadblocks that inhibit ESG investing.

Two key issues in how ESG works

There are two key issues in how ESG works with companies and investors: Agency problem and Information asymmetry and signaling.

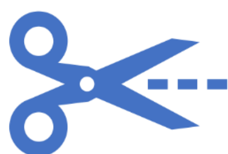
Agency problem: There is an inherent conflict between the principal and the agent. The agent often acts in her self-interest rather than in the interest of the principals. Thus, the CEO may often try to maximize her remuneration without ensuring that shareholders' needs are met. Such differences in views could be related to ESG risks. For example, shareholders/owners and CEOs might view ESG risks differently. To mitigate agency

problems, shareholders must draw proper contracts to ensure that the CEO acts in the best interest of the shareholders. Thus, from a company's perspective, focus on ESG actions is contingent upon how CEOs are incentivized to pay attention to the ESG risks that the shareholders are concerned about.

Information asymmetry and signaling: Managers/CEO know more about the company's operations relative to everyone else. ESG performance is particularly susceptible to information problems. Hence, companies need to signal that they are good (ESG positive) through communication. There is a risk that companies may signal wrongly that they are good when they are bad. Greenwashing is one such mechanism of signaling virtue. Misleading or wrong signals will eventually be caught out, and their credibility will weaken. This issue is truer today where active investors, whistle-blowers, and social society closely watch every action taken by a company, and information asymmetry is gradually reduced.

Models of achieving focus on ESG issues

Investment in equities is now increasingly including ESG considerations. There are many models of achieving focus on ESG issues. We discuss four: Exclusionary/Screened Investing, Best-in-class selection, Active Ownership, and ESG Integration.



Exclusionaly screening

Best in class selection

Active ownership

ESG integration

1. Exclusionary/Screened Investing

In screening, we use a set of filters to determine which companies, industries, sectors or activities are eligible or ineligible to be included in a portfolio or fund. The choice of the criteria depends on an investors preferences, values and ethics. There are two types of screens – negative screens and positive screens. For instance, the highest emitters of greenhouse gases may be excluded from the portfolio using a negative screen. Alternatively, only low emitters are included in the portfolio using a positive screen. A third approach is a norms-based screen that determines inclusion or exclusion based on international norms. These three approaches are detailed below (Principles for Responsible Investing. 2021):

Negative Screening*:* Negative screening requires excluding certain sectors, issuers, or securities for poor ESG performance relative to industry peers or based on specific ESG criteria, for example, avoiding particular products/services, regions, or business practices. Negative screening often requires one to avoid companies that

are in businesses like alcohol, tobacco, fur, gambling, pornography, military weapons, fossil fuels, and nuclear energy. Sometimes one does not want to completely avoid business especially for conglomerates. In such cases a materiality threshold (e.g., 10%) is set. The materiality threshold may be based on revenue or profits. A company engaged in a business where tobacco contributes less than 10% of the revenues is investible. Beyond 10% it is not investible. An example of negative screening is Shariah screening. Based on Islamic principles, it excludes investment in gambling, usury, alcohol, etc.

Norms-based Screening*:* Here issues are screened against minimum standards of business practice based on international norms. Useful frameworks include UN treaties, Security Council sanctions, UN Global Compact, UN Human Rights Declaration, and OECD guidelines. A category of norms-based screen is the "controversy screen." Here companies that engage in unethical behaviour are excluded.

Positive Screening*:* Positive screening is the process of finding companies that score high on ESG factors relative to their peer companies for the sustainable investment portfolios. Active inclusion of companies is done within an investment universe because of the social or environmental benefits of their products, services and/or processes. These investments are made in companies that are transitioning from brown to green, renewable/cleantech companies, and enterprises in social business.

There are three modes of screening/exclusion. In *absolute exclusion*, no investment is made when exclusionary criteria are fulfilled. For instance, an investment manager will not invest in companies involved in fossil fuels or a company found to be violating human rights. In *threshold exclusion,* partial investment is made within a tolerance level. Here ,say, if up to 10% of revenues derived from indirect exposure to fossil fuels one can invest in the company. Beyond 10% investments are not permissible. In *relative exclusion* an investment is made if the company is performing relatively better -- where energy transition has occurred or board diversity has improved, not determined through revenue exposures.

Exclusionary investment has achieved significant success, and its ease of use makes it an ideal candidate for ESG investing.

2. Best-in-class selection

Here one looks for companies that are leaders in their sector in terms of ESG factors. There are two ways of evaluating for best in class: on an absolute basis and on a relative basis. When doing selection based *on an absolute basis*, investors compare the company's ESG ratings with companies across the ESG universe. By contrast, when using the best-in-class selection *on a relative basis*, investors compare ESG ratings/scores with companies with other companies in the same industry.

Investors seek to achieve return and risk profiles similar to traditional investments while integrating material ESG factors in evaluation. This involves applying a higher weight to companies with favorable ESG scores and lower weights to companies with unfavorable ESG scores. While evaluating for the best-in-class, investors often look at ESG quality, distribution of ESG ratings, and ESG ratings momentum. We assess *ESG quality* from the management's ability to manage key risks and opportunities from ESG factors. We assess the *distribution of ESG ratings* by classifying companies into leaders, average or laggards. The distribution of companies in these categories is then considered for decision-making. We assess *ESG rating momentum* by considering the percentage of holdings in the portfolio that has recorded a recent ESG ratings upgrade or downgrade.

Implementation of a best-in-class selection can be done through either of two approaches -- Active or passive. In the *active approach*, managers integrate ESG research into the investment process. Material financial as well as non-financial (ESG) information is identified and goes into the investment decision process. The portfolio managers then choose companies to invest in. This involves selecting companies with the desired ESG factors to reduce long-term risk while generating a sustainable alpha. The primary objective is to earn strong risk-adjusted returns with ESG characteristics being somewhat in the background. This approach is popular in Europe but is gaining ground in North America. Alternatively, investors can use a *passive approach* by investing in several available ESG integrated indices (for example, MSCI ACWI ESG leaders). These indices tend to have static methodologies that adjust the weights of the traditional index constituents based on their underlying ESG ratings. For this strategy, performance has varied in different time periods.

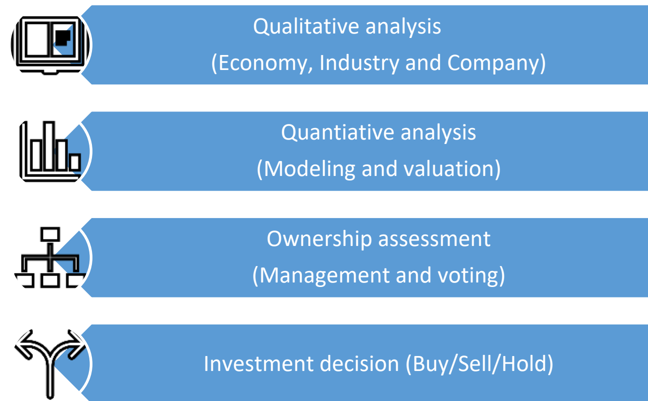
3. Active Ownership

Active owners frequently communicate with companies with ESG issues. They exercise their ownership rights and voice their concerns to bring about a change. They engage with companies to monitor their ESG performance. They may also influence outcomes and ESG practices through their intervention.

An example of active ownership is the recent push by activist investors that have goaded oil companies like Exxon Mobil and Chevron to pay greater attention to their emissions by having resolutions passed in the shareholders meeting and even gained seats on the board.

4. ESG Integration

Unfortunately, the traditional equity research process doesn't take note of the ESG risks discussed earlier. Let us take a look at the traditional equity research process and try and understand where ESG elements can be brought in.



During the qualitative analysis phase, ESG issues impacting the industry and the company can be identified. During the modeling and valuation analysis, ESG risks can be captured in either the discount rate or the cashflows. However, one should be careful not to account for the same risk in both cash flows and the discount rate. While evaluating the management, careful attention should be paid to both management's views on ESG as well as their past track record on dealing with those issues. There are several techniques of integrating ESG in investment decisions.

Quantitative strategies: Quantitative (or quant, as they are popularly called) strategies aim to outperform the benchmarks by utilizing data, mathematical models, and statistical techniques. Integration of ESG factors into quantitative models can be achieved through two approaches. In the first approach securities that rank poorly on ESG are assigned a weight of zero. This is based research that links ESG factors to investment risk and/or risk-adjusted returns. In the second approach weights of each constituent of the portfolio is adjusted according to the statistical relationship between an ESG dataset and other factors.

Smart-beta Strategies: Both active and passive investment are used in some combination while undertaking smart-beta investing. Here constituents are assigned weights by factors other market capitalisation. Typically there are three objectives – outperform the index, lower the down side risk or increase the dividend yield. Smart beta strategies utilise mathematical weighting models in portfolio construction to generate excess market returns. Alternatively, they can be used to reduce the downside risk and enhance the portfolio's ESG risk profile.

Passive and enhanced Passive strategies: Passive investment strategies try to track the returns of a market index, typically a market capitalization index. It could also track a section of the market. To replicate the market many methods are used.

- Full replication methodology requires buying all the constituents of an index.

- Partial replication methodology requires the investment manager to create a subset of stocks within the index. The weights of the selected stocks are adjusted in a manner that the portfolio matches returns from the overall index. This approach reduces transaction costs. However, it also increases the tracking error.
- In another approach derivatives are used to track an index.

Passive strategies can incorporate ESG factors. The exposure to a particular risk factor can be reduced by adjusting weights of the constituents of the parent index. So, stocks with a high ESG risk factor can be given a lower weight and weights of other stocks adjusted accordingly.

Then there are funds that use partial replication approach. These funds have the flexibility of excluding companies with high ESG risk or low ESG ratings. Portfolio optimisation techniques are often used to help minimise the tracking errors of the replicated portfolio.

Additionally, integration techniques can be applied to enhanced passive strategies. As enhanced passive strategies can make active investment decisions such as adjusting index constituent weights and excluding certain stocks altogether to lower downside risk or outperform the benchmark, managers can integrate ESG factors into these strategies.

Roadblocks to ESG Investing

While ESG finance has been growing there are a number of roadblocks that are slowing down the pace of growth. These include behavioral issues of investors, multiplicity of ESG reporting, risks to ESG investing, repurposed ESG branding, and limited corporate resources for ESG.

Behavioral Issues: Bankers are a conservative lot and don't like change. Consequently, they are risk-averse. Unwilling to experiment with newer financing modes, they often take refuge in exclusionary screening. This approach is simple and makes them look good too. Besides, there is a behavioral tendency amongst human beings to focus on the present and discount the future. Furthermore, there is an intent-action gap between what new investors say they want and how they actually invest. This gap can be explained by inertia because sustainability/ESG funds usually require investors to choose them.

Multiple reporting documents: ESG reporting is a mess. Multiple documents report on ESG issues are available in annual reports, sustainability reports, integrated reports, and corporate websites. Thus, making an informed decision about the ESG actions of a company is extremely difficult. There are multiple documents, and often different documents report the same statistic differently making analysis a headache.

Risks: There are risks involved that inhibit the growth of ESG finance. First is the risk of stranded assets. Large loans are outstanding against current investment in non-sustainable technologies. Should companies be allowed

to keep these "bad" assets in their portfolio, or should they be asked to divest are questions that most bankers grapple with. With ESG growing, these assets could become stranded and bankers would have to worry about writing them off. At the same time, new investments would require funding from the same banks, which would also be risky. This issue is exacerbated by the fact that pandemic has resulted in significant cash flow disruptions for companies making banks wary about the repayment capability of their customers. The pandemic gets over in a year or two, but bankers would be on their guard for unforeseen events in the future – quite like focusing on the present and discounting the future described earlier.

Repurposed branding: Many existing funds are being renamed into "ESG funds." While it helps the fund manager creating a portfolio of funds in the sustainability segment, there is increasing worry that these rebranding are being undertaken without any substantive change in their composition. Some are calling this practice "green washing" or "impact washing." Such practices create a false impression about their ESG credentials causing confusion in the minds of investors.

Limited Corporate resources for ESG: Large companies tend to have significant resources to manage their ESG issues. However, small- and-medium sized firms have neither the resources nor the capabilities to deal with ESG issues. This makes it difficult to bring these companies into the ESG fold.

The juggernaut of ESG investing rolls on creating a momentum that will help make the world a better place. As knowledge grows and information gaps reduce ESG investing will become better and meet society requirements. The competitive advantage that early movers are reaping today will gradually disappear with the differentiation between ESG funds and non-ESG funds disappearing. That may take many decades. Till then ESG investing will rule the roost.

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