ESG: A powerful risk tool for prudent investing

Julie Moret explains how ESG is different from ethical investing, offering a new lens for asset managers to analyse risks and opportunities

Interest in environmental, social and governance (ESG) has soared since the launch of the Principles for Responsible Investments (PRI) in 2006. At last count, nearly 1,400 signatories, representing $59 trillion in assets under management, had signed up, committing to integrate ESG considerations into investment decision making, ownership practices and reporting. Nevertheless, there remains variability of interpretation and implementation of ESG practices, compounded by a confusing and often interchangeable array of terms and acronyms.

At Franklin Templeton, we make a clear distinction that ESG is different from ethical investing or values-based investing. We do not think it should require a trade off in terms of performance but instead we see it as a component of risk-based investing, evaluating potential risks and drivers of long-term return, and assessing whether those risks are priced in, compatible with the principles of prudent investing.

We believe investors can benefit from using an ESG lens to understand the ESG-related business risks and opportunities companies face. This could include assessing the potential impact of ESG factors on a company's long-term business model and the resilience of companies to adapt to ESG changes. Over time, these considerations may reshape competitive advantages and ultimately the sustainability of business growth and long-term value creation for shareholders.

For example, in the wake of the 2015 UN Climate Change Conference, there is likely to be increased scrutiny on finding ways to reduce carbon emissions. Over the long term, this may have implications for businesses using and producing fossil fuels whom could find themselves structurally challenged by new rules or targets. Investors employing an ESG lens to examine metrics such as a company or country's carbon emissions, intensity, reserves or energy mix may find themselves better able to identify those that are more flexible and able to adapt.

ESG analysis is not just about risk; we believe it can also identify investment opportunities. For example, across the world, some significant demographic trends are apparent—such as growing populations—which put a strain on natural resources including water. In our view, companies that can capitalise on the growing demand for efficient water solutions as well as those that demonstrate sustained growth while reducing use appear well positioned to adapt their business models to changing ESG issues that can be material for their long-term success.

Investment managers need to be able to measure and understand risk in order to manage it. We want to ensure risks we take in our portfolios are understood, are known, are an intended part of the investment process, and that we have the potential to be compensated. We believe that analysing the more traditional quantitative-risk measures—such as tracking error or beta—alongside more qualitative ESG risk metrics that capture quality of management and reputational risk provide for a more rounded and multi-dimensional perspective.

As the quality and availability of ESG data and tools continues to develop, we believe there are benefits for asset managers who understand the data and how it can be used to further inform their investment evaluation. ESG data can provide that new perspective to uncover hidden risks that lie beneath the surface of balance sheets and financial ratios. Time invested on evolving investment research practice to incorporate ESG as part of the investment process will, we believe, distinguish those firms that are successful.

More information:
Jill Barber, head of institutional, UK & Ireland, Franklin Templeton Investments.
jill.barber@franklintempleton.co.uk
020 7073 8544
franklintempleton.co.uk

Written by Julie Moret, head of ESG, Franklin Templeton Investments

In association with

For Professional Investors Use Only. Not for Distribution to Retail Investors. Issued by Franklin Templeton Investment Management Limited, Cannon Place, 78 Cannon Street, London EC4N 6HL. Authorised and regulated by the Financial Conduct Authority. © 2016. Franklin Templeton Investments. All rights reserved.