Summary

• Active managers are increasingly integrating ESG factors into their investment decision-making processes.
• The key challenges that remain are the lack of standardisation and definitions.
• There is no one-size solution and many active managers have their own models and tools.
• Engagement is also seen as an important part of the process and a way to change corporate behaviour.

The caring touch

Lynn Strongin Dodds explores how active managers are increasingly integrating ESG factors into decision-making processes

Environmental, social and governance (ESG) issues have become increasingly significant considerations in an active manager's portfolio construction. It not only helps them identify the risks but also the opportunities to generate strong risk-adjusted returns. However, there is no template in terms of integration or engagement in how to change corporate behaviour.

A report by Russell Investments last year highlighted the trend by showing that more than half of the 300 active management firms polled allowed ESG analysis to drive investment decisions, compared to 30 per cent who were surveyed in 2018. Although the environment has grabbed the headlines, governance continues to remain the most important ESG component for 86 per cent of the respondents.

Comparisons

"It is clear that ESG considerations impact asset valuations," says Aviva Investors global head of ESG research, Paul LaCoursiere. "It is no longer a question as to whether you should, but it is a must to include them if you do not want to leave value on the table. One of the biggest challenges though is the lack of standardisation because companies do not have to disclose all ESG-related information, which means we do not have access to consistent data for the full opportunity set."

NN Investment Partners (NN IP) head of specialised equity and responsible investing, Jeroen Bos, agrees that collecting high-quality, comprehensive data is still a challenge because "although companies may well volunteer ESG information, this often lacks consistency because regulators do not stipulate standards to the same degree that they demand in financial data".

The European Union recently initiated a review of the EU Non-Financial Reporting Directive (NFRD), because of its failure to deliver comparable or reliable sustainability reporting data. Currently, companies are allowed to apply different reporting frameworks. Meanwhile, the US government last year rejected proposed legislation that would require companies to report more ESG information, as well as specific disclosures for risks associated with climate change.

Given the backdrop, active managers are forging their own path, although the endgame is to give sustainability and financials the same weighting. The theory is that incorporating ESG factors into mainstream fundamental analysis would improve portfolio returns. However, many are not just conducting in-depth analysis but also engaging in proxy voting at annual general meetings and having conversations with senior executives to ensure that companies are heading in the right direction.

Looking under the bonnet

In the meantime, pension funds are advised to look carefully under the proverbial investment bonnet to see what exact metrics and tools are being used. Schroders head of sustainability strategy, Hannah Simons, notes that firms are at different points of the sustainability journey. "Although everyone says they are doing integration, it means different things to different fund managers," she adds. "For instance, some managers will simply look at third-party data but the approach taken by the different providers is inconsistent, which is why we have a dedicated specialist team and have developed proprietary tools to understand what are the most material factors and emerging trends that will have an impact on companies."

Materiality

Overall, the focus has sharpened on materiality and the impact ESG issues can have on the bottom line, as well as the risk-adjusted returns that can be generated. For example, NN IP developed a framework where "we also use data from a variety of sources such as Sustainalytics and TrueValue Labs, and we also build our own material framework for each sector," says Bos. "We look at the material ESG topics per sector and company. This can be, for example, safety for mining companies or product pricing and selling practises in healthcare. We then incorporate these material insights into our investment analysis."

MFS also conducts its own proprietary ESG analysis but takes "the full gamut of ESG data that we hotly debate to reach our own conclusions," according to its managing director of UK institutional sales, James Lindsay. "Data around sustainability is unstructured and contains many nuances," he adds. "As such, the industry has been unable to come up with a universal taxonomy or a universal single score for ESG factors. There are many different providers with many different scoring methodologies and this is a gift for firms like MFS that conduct deep fundamental research. As Albert Einstein said: 'Not everything that counts can be counted, and not everything that can be counted counts.'"

Lindsay says that as long-term investors, MFS aims to create long-term value, which means understanding all the material risks. "We assess the traditional financial valuations of a stock such as earnings, cashflow, return on equity as well as ESG metrics," he adds. "These non-financial risks include climate change on the environment side, as well as board diversity and supply chain management on the social front and fraud and bribery for governance."

Pragmatism

Whatever path chosen, Columbia Threadneedle head of responsible investment, EMEA, Iain Richards, advises adopting a more multi-dimensional and not dogmatic approach. He notes that a few years ago, investors had put a lot of capital into Sun Edison, a wind and solar company that seemed unstoppable until falling silicon prices put its revenue under pressure causing it to eventually file for bankruptcy in 2016 (shareholders lost around $10 billion). On the other hand, oil and gas companies tend to be excluded although they are also big investors in renewable energies.

"It is important to be pragmatic," he says. "It is not just about looking at a company's carbon footprint but at whether and how it is able to adapt its business for energy transition and the move away from fossil fuels. It is also about the opportunities this creates. It takes thought, but analytics need to be fit for purpose and support actionable intelligence to identify the winners and losers."

Engagement can also help steer companies in the right ESG direction. Although oil and gas are often targeted under the E banner, other sectors such as utilities, chemicals and airlines are also increasingly deemed inappropriate investments. However, as Richards and many of his peers point out, they are still needed for the modern economy to function and transformation will take time. Active managers who integrate ESG and engage believe they will be able to better identify those companies that hold the most promise for the future, as well as those that have the potential to catch up.

"It would be easy to divest the laggards but then you give up a seat at the table and a voice to help them improve," says LaCoursiere. "Engagement has been a long-standing practice at Aviva and we think it should be an ongoing process with senior executives alongside AGM proxy voting. We do it on a thematic basis and, although we have been pushing for more disclosure on the environment, we are also looking at improving transparency in the social such as labour standards and supply chain management."

Robeco also has a well-established engagement and voting programme with a 13-member dedicated active ownership team who cover specific themes. In 2019, these included ESG issues around artificial intelligence, digital healthcare, single-use plastics, corporate governance in emerging markets, and biodiversity. This year, biodiversity is still on the list, as well as improving mining safety, governance in emerging markets, decarbonising companies and portfolios as well as executive pay.

Fund managers have also joined forces to apply pressure. For example, Aviva Investors co-sponsored with Hermes and L&G a resolution that requires BP to describe how it evaluates the consistency of each new material capital investment with the Paris Agreement goals. It aims to keep the rise in global temperature this century well below two degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. The three are part of the Climate Action 100+, an investor initiative to engage with major greenhouse gas emitters.

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