ESG – a finance-first approach to investing

Jon Cunliffe explores the balance between investing socially and maximising risk-adjusted returns

Numbers may be dwindling, but even today, a group of investors still subscribe to the Milton Friedman doctrine that corporations have no duty to be socially responsible. This doctrine argues that a firm's only responsibility is to legally maximise its stakeholder profits, leaving individual investors, consumers, and employees – rather than corporations – as the leaders of social causes.

While in the past, this approach was viewed to be rationally compelling, there are obvious problems with it. For example, a firm that takes its corporate social responsibility seriously may benefit from a greater community allegiance, which will ultimately benefit shareholders. Furthermore, and perhaps more damaging, is evidence that this approach can lead to an excessive focus on short-term profit delivery at the expense of longer-term investment and innovation.

However, when integrating environmental, social and governance (ESG) factors and acting as responsible investors, care needs to be exercised to not constrain investments too narrowly, because it will begin to reduce prospective risk-adjusted returns. More broadly, the more the focus shifts away from a finance-first approach towards giving social and economic considerations precedence, the greater the risk that future investment returns will be compromised.

Against this background, a pragmatic approach to ESG should always be part of any good investment manager's toolkit and is consistent with a finance-first approach to investing. For example, if a company is involved in polluting the environment, exploiting its workers or incentivising its managers to focus on short-term profit delivery, then these issues are likely to reduce the sustainability of its business model and therefore its attractiveness as an investment.

ESG considerations are therefore not a 'bolt on' to a pre-existing approach to asset allocation but must sit at the heart of how members' retirement savings should be deployed. While it cannot be conclusively proven, there is considerable academic evidence in support of the view that companies with higher-than-average ESG ratings tend to be rewarded with higher market valuations than their peers.

A key reason for this seems to be that these companies are better at managing the non-financial risks of their business models, thereby making them relatively more sustainable and less prone to a damaging de-rating by the market. For example, investors don't need to be reminded of the impact of the Deepwater Horizon oil spill or the emissions scandal on the respective share prices of BP and Volkswagen.

At The People's Pension, we have successfully integrated ESG into the stewardship of our members' retirement savings and, using Morgan Stanley Capital International (MSCI) ESG ratings, our default proposition has been rated AA, making it a 'leader' in managing ESG risks. However, this is only part of the broader remit we have as responsible investors.

Rather than adopting the best in class (the 'how') approach to ESG investing, responsible investing involves taking the active decision to remove (or choose) investments based upon the 'what'. Exclusions typically involve controversial weapons, addictive substances, gambling, and activities damaging to the environment. Therefore, in addition to ESG integration, we have used negative screens to help us divest £226 million from 147 companies involved in controversial weapons or linked to controversies involving human rights, labour, the environment, and corruption.

Given that responsible investment increasingly informs investor preferences, this approach should not necessarily entail sacrificing returns and, for example, can be used to reduce the likelihood of holding assets which may become stranded by climate transition. On this basis, an exclusionary approach can, in theory, augment the improved risk-adjusted returns delivered by ESG integration. We have taken this approach even further by implementing tilts to reduce the carbon emissions of the assets we hold on behalf of our members.

We want to be engaged asset owners, and we therefore expect our external managers to engage on behalf of our members to ensure good governance and the appropriate mitigation of non-financial risks. In so doing, we would expect this activity to positively impact our members' returns over the long term.

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