A darker shade of green

Summary
- Regulation is driving DB schemes to incorporate ESG into their investment decision-making process.
- Creating a well-balanced portfolio is being hampered by the lack of consistent and poor quality of data.
- Investors still favour negative screening, which creates concentrated portfolios.
- Larger asset managers have their own intrinsic models and proprietary data to create more diversified ESG-friendly portfolios.

Lynn Strongin Dodds explores how ESG integration into pension fund portfolios is evolving

At first glance, environmental, social and governance investment (ESG) strategies seem to be at odds with building a well-diversified portfolio. Excluding large swathes of companies could tip the balance, for example, in favour of cleaner energy companies and against old-school manufacturing. However, a closer look reveals that increasingly defined benefit (DB) schemes are being more thoughtful in their portfolio construction. There is still work to be done but they are mining data, metrics and in some cases holding meaningful dialogues with management to create a more balanced investment strategy.

Regulation

One driver is a stronger regulatory impetus. As Legal & General Investment Management head of institutional clients, Mark Johnson, notes that under new disclosure rules in the UK, pension scheme trustees must bear the responsibility to weigh ESG and climate change risks more explicitly. They are obliged, as part of a scheme's Statements of Investment Principles (SIPs), to outline their approach to engagement and voting of their shares in companies. The schemes also have to explain how they incorporate financially material factors, including ESG and climate change considerations, in investment decision making. The rules are in line with the European Union Shareholder Directive II, which has the same aims of disclosure and engagement.

Challenges

However, despite the legislative push, the industry is still facing a number of challenges in terms of portfolio construction. The most notable is the lack of quality and reliable data available. There may be a treasure trove of information but it is still difficult to discern whether companies that claim to have strong ESG credentials actually deliver the goods. One problem is the various measurements being used. This can lead to one company reporting the carbon emissions of its entire business, while another may only disclose the carbon emissions for its headquarters but not for its other locations or operations.

This helps explains why the majority, three-quarters, of investors surveyed in a recent McKinsey study wanted more standardised sustainability reports and information that can be compared as easily as their financial disclosures. The theory is that greater uniformity would help investors streamline their research processes and enable them to allocate capital in a more efficient manner.

Complicating matters is the multiple iterations of ESG. "Everyone has their own definition of ESG and there is often a low correlation between the ratings of the same company," says Schroders head of systematic investments, Ashley Lester. "The scores are different because of the criteria that is being applied. For example, some may believe that nuclear waste is a more significant issue than carbon emissions. It is not a right or wrong way, but investors have to be clear how their fund managers define ESG."

While there is a plethora of external data providers and rating houses, the larger players typically have their own intrinsic models, frameworks and analysis. However, Lazard Asset Management co-head of sustainable investment and ESG, Jennifer Anderson, believes that the proverbial buck stops with the portfolio manager. "In order to build a well- balanced portfolio, the portfolio manager needs to be forward thinking and to have proprietary research. They cannot rely exclusively on third-party providers."

Negative screening

Another issue impacting portfolio construction is that investors are still wedded to negative screening. According to the McKinsey study, exclusion applies to two-thirds of sustainable investment across the global sustainable spectrum. This method not only creates concentrated portfolios but also neglects corporates that may not be up to ESG scratch today but have the potential to be better corporate citizens in the future.

Take BP. It would not be a natural constituent in many pure ESG funds or those that incorporate ESG metrics. However, the oil and gas giant is part of the portfolio at Majedie Asset Management because like its peers, it has and is planning to allocate greater resources to renewable energy projects "We do not separate ESG from financial performance and have a top-down and bottom-up approach based on our proprietary research that identifies the risks and opportunities for companies," says Majedie's head of responsible capitalism, Cindy Rose. "We also actively engage with companies such as BP to push them forward. For example, the transition to a more friendly carbon environment that meets the Paris accord will take time and as a result, we still need BP to provide energy."

She adds: "However, there is a big opportunity because they have a massive amount of capex that they can use for renewable projects. We look at things such as what their strategy is, where they expect to be in 25 years and what green tech will be developed."

Engagement is also a critical plank for LGIM, according to head of sustainability solutions, Caroline Ramscar. She points to the fund manager's climate impact pledge, which was introduced two years ago. The fund manager assesses, as well as scores, over 80 of the world's largest companies across six sectors identified as key to meeting global climate change goals. If, after working with the companies, they fail to deliver the goods and improve minimum standards, LGIM divests the stock from its Future World Range and, across its entire book, votes against the chair. "We look to use active ownership and if they do not improve their behaviour, we will divest them from our Future World funds," she adds.

In general, LGIM has developed its own proprietary scoring model for the different ESG components. Ramscar notes there are 28 indicators, which for environment would for instance include a company's carbon footprint, while for social issues, it could cover workforce and board diversity as well as investor rights and floating shares percentages.

UBS Asset Management, which has its own set of metrics, also adopts a more holistic view. "There needs to be a solid integration process starting from the financial analysts to the portfolio manager if you want to have strategies that are well diversified and aligned with traditional investments versus simply relying on third-party data," says UBS Asset Management head of sustainable investment research and stewardship, Christopher Greenwald. "Third-party ratings are a starting point but not the answer. Our analysts will interpret the information and apply it to their investment cases to explain any sustainability risk they encounter."

Greenwald also does not believe in excluding whole sectors. "Instead we reweight our holdings and encourage companies to go on the right path and change their behaviour," he adds. "One of our most successful investment strategies (Long-Term Themes Fund) invests according to long-term themes such as energy efficiency, demographics and infrastructure and look for those that are addressing these issues in terms of clean energy and healthcare on a long-term basis."

Factors

Another path taken by some fund managers is to treat ESG as another factor that sits alongside value, momentum, quality, size and low volatility. Schroders, for example, has created a sustainability factor that aims to translate social and environmental impacts into financial costs or benefits across investment strategies in a systematic and quantitative manner. "In a world of trade-offs, the question is how can I develop a more constructive and diversified portfolio," says Lester. "By emphasising sustainability as a factor, rather than a set of exclusions, we can cram in as much factor exposure as possible, subject to the overall tracking error budget, and ensure that we have the right quantities and ratios of factor exposures in the portfolio."

For now, creating more diversified portfolios is easier for some asset classes than others. Not surprisingly, as Anderson points out, ESG integration is the most straightforward but there is an increasing interest in ESG as it relates to fixed income. "Similar ESG criteria to those used in equities research can be applied to corporate bonds but the data may be not be available for the range of issuers in fixed income and or course there is no proxy voting," she adds.

As with any investment, investors who want a diversified sustainable approach need to do their homework and look carefully under the proverbial portfolio bonnet to see how ESG is integrated, the methodology being applied and whether the holdings are evenly spread out across different sector.

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