BEST PRACTICES FOR RESPONSIBLE INVESTING

Portfolio Management, Research, Ownership, and Collaboration

By Leola Ross, PhD, CFA®
BEST PRACTICES FOR RESPONSIBLE INVESTING

Portfolio Management, Research, Ownership, and Collaboration

By Leola Ross, PhD, CFA®

In the coming years, responsible investing will just be how we all invest. The understanding of how environmental, social, and governance (ESG) factors impact security prices and portfolio structure will be integrated into the entire industry. As we move toward this inevitable reality, it is vital to establish best practices for this process, our portfolios, and our clients. This article reviews the many ways we are developing this practice.

As many investors seek to express preferences for ESG factors in their investment portfolios, the industry has responded with qualitative analysis, data sources, metrics, products, and practices. We have embraced many of these efforts. Because our responsible investing policy and practice is driven by our beliefs, this article is structured according to those beliefs.

Our firm incorporates responsible investing in investment manager evaluation process, portfolio management, advisory services, and through implementing proprietary solutions as desired by clients. Our responsible investing practice is founded on the following four beliefs:

1. ESG factors impact security prices. These factors can vary by company, industry, and region and their importance can vary through time.
2. A deep understanding of how ESG factors impact security prices adds value to a skillful investment process.

We believe it’s vital for a firm to integrate responsible investing into the investment process from the ground up.

3. Embedding ESG considerations into a firm’s culture and processes improves the likelihood of prolonged and successful investing.
4. Active ownership of securities is an effective tool for improving investment outcomes (Forrest et al. 2016).

A responsible investing policy provides a strong basis for investing, advising, and building products that reflects our beliefs and helps to meet clients’ goals, preferences, and circumstances.

BEST PRACTICES FOR RESPONSIBLE INVESTING

We believe it’s vital for a firm to integrate responsible investing into the investment process from the ground up.

These practices work well together to help our clients achieve their goals with close attention to their preferences and the circumstances they face, now and in the future.

BELIEF 1: ESG Factors Impact Security Prices +
BELIEF 2: A Deep Understanding of How ESG Factors Impact Security Prices Adds Value to a Skillful Investment Process

In Belief 1, we acknowledge the impact of ESG on security prices. In Belief 2, we further describe that impact as being complicated to interpret and implement. We present Beliefs 1 and 2 together because key components of our practice stem from these two beliefs. Before delving into these components, let’s remind ourselves, specifically, what impacting and understanding prices means in the context of investing—both in the short run and in the long run.

INVESTMENT SUCCESS VERSUS PROFITABILITY

Given Beliefs 1 and 2, note how ESG factors are relevant to active security selection. Our first belief is that ESG factors impact prices. We do not assert that ESG factors have a positive or negative
impact on prices, only that there is an impact. In some cases, an ESG factor may be underpriced, and in others the ESG factor may be overpriced. It is the investor’s responsibility to identify where the current price lies by including ESG into the pricing assessment.

This brings us to Belief 2: This understanding will add value to a skillful investment process. The combination of these two beliefs is the cornerstone of our prioritization of qualitative manager assessments in our own responsible investing practices. Therefore, the investment merit of ESG integration is found not in portfolios with particular ESG factor exposures, but rather in the added value that comes from understanding how ESG factors may influence the risk of owning a security, i.e., the current price of a security and the trajectory of that price over time.

So how does this differ from profitability? Profitable firms are not always the best investments. Thinking back to Siegel (1994, 1998, 2002, 2008, 2014), recall that declining industries often are underpriced by a market that seeks shiny, new objects. Investing in these declining industries—what we often call value investing—may be a solid and value-adding strategy. Similarly, those ESG factors that improve firm profitability may be overpriced or underpriced by the market and can result in either value-adding or detracting investment choices. The task of an investment manager is to identify those securities that will outperform the market because they are underpriced, assess their risks in a holistic way, and construct portfolios with the full breadth of detailed research. The key to successful ESG integration is in combining the additional investment lens of ESG into an understanding of underpriced and overpriced securities.

There is an increasing acceptance in the marketplace that corporations will be more sustainable and, in the long run, more profitable if they have good ESG practices. We agree. In fact, we have built out a strong set of material ESG metrics in order to find these firms in a quantitative fashion (Steinbarth 2017). That said, active managers must recognize that not all ESG factors, even those that improve firm profitability, will lead to strong investment results for all securities. Identifying exactly how ESG factors influence current and future prices is essential for bringing clients the full value-add of ESG into their portfolios.

**ESG Ranks—a Qualitative Assessment of Our Managers**

Russell Investments is well-known for its manager research. In 2014 we added an analyst assessment of ESG integration into our evaluation of each active manager’s research rating. Our internal scale goes from one to five, where three indicates retain and four indicates hire.² Note that active managers exhibit a bell-like distribution of ratings as shown in figure 1. Almost half of the rated managers fall into the three bucket, close to 25 percent have ratings at four, and more than 5 percent earned a five (the highest rating). The fours and fives are noteworthy because these are not specialist ESG or thematic managers, but the managers we rank for all our products and services.

To understand how these ratings can be attained when a manager isn’t focusing specifically on ESG, or any particular theme, we review how the ratings are determined. Through a combination of investment manager interviews, survey responses, and a quantitative review of their portfolios, our manager research analysts determine how well the manager assesses and incorporates the risk and return impacts of ESG issues. Note that ESG awareness and integration is not about restricting securities, targeting ESG or climate-related metrics of any sort, or even intentionally investing in securities with better ESG practices. Rather, such awareness and integration are about understanding how E, S, and G impact a firm and will impact the future direction of a security’s price. It can be entirely legitimate that a manager with a high rating has a material allocation to, for example, firms with fossil fuels, labor issues, or governance issues.

The point is that the manager understands the following:

1. How these issues contribute to the future success (or not) of the firm
2. How well the current price reflects these factors
3. How the price is likely to change in the future based on these factors
4. What to monitor over time in managing the position size and sell decision for that security

In figure 2, we explain our qualitative criteria for rating managers on their performance.
Almost half of our respondents have incorporated ESG into their firm-wide processes (120 of 253).

Coupling the manager research with the survey information, about 75 percent of active managers are integrating ESG with information on firm-level policies, awareness, and processes. Fewer than 40 percent (98 of 253) offer custom ESG offerings to their clients.

The smaller role of custom offerings supports our position that ESG integration is not about improving a decision-making process rather than being a specialist.

ESG integration. Note that we are focused on awareness, demonstrated understanding of risks and returns, and perspective. This qualitative rating is not contingent upon restrictions, metrics, or themes. Also note that the middle ranking, a three, reflects adequate awareness and similar abilities to peers. Therefore, combining the information in figures 1 and 2, we can assert that roughly 75 percent of the active manager community is integrating ESG into portfolio decision-making processes.

SURVEYS AS A STARTING POINT

We rely most heavily on our qualitative assessments of active asset managers, but it can take quite a long time to reach each of them individually. To gauge the industry in a timelier fashion, we also have surveyed the investment firms represented in our equity and fixed income active manager universes about ESG awareness and integration. This survey is about the firms rather than individual products and focuses on policy and offerings in addition to process and awareness. Below we offer a brief comparison of the survey responses to our more in-depth research.

We surveyed 253 managers across 2016 and 2017, including both fixed income (109 responses) and equity (144 responses) investment firms. The survey contained some 20 questions and 13 sub-questions across a variety of ESG topics. We scored each firm across four categories: policy, process, offerings, and awareness. The range of scores is one to five with five being the highest possible score.

Figure 3 illustrates the following key survey findings:

- Similar to our manager-level ratings research, we find that the majority of managers have ESG policies in place (142 of 253) and are aware of ESG as investment factors (128 of 253).
- Almost half of our respondents have incorporated ESG into their firm-wide processes (120 of 253).
- Coupling the manager research with the survey information, about 75 percent of active managers are integrating ESG with information on firm-level policies, awareness, and processes. Fewer than 40 percent (98 of 253) offer custom ESG offerings to their clients.
- The smaller role of custom offerings supports our position that ESG integration is not about improving a decision-making process rather than being a specialist.

Figure 2

The manager demonstrates strong awareness of the potential risk and return of ESG issues on individual holdings and the portfolio structure.

The manager can clearly demonstrate how portfolio positioning reflects the management of relevant ESG risks and/or how ESG exposures can add value.

The breadth of perspective and analytical inputs on ESG issues are superior to peers.

Source: Russell Investments, April 2018

Figure 3

The manager demonstrates adequate awareness of the potential risk and return impacts of ESG issues on individual holdings and the portfolio structure.

The manager’s perspective and analytical inputs on ESG issues is undifferentiated from peers.

The manager either does or does not demonstrate awareness of the potential risk and return impacts of ESG issues on individual holdings/portfolio structure.

Meaningful discrepancies have been found between the target ESG guidelines and holdings in the portfolio.

The manager’s perspective and analytical inputs on the ESG issues lack rigor.

Source: Russell Investments, April 2018.

© 2019 Investments & Wealth Institute, formerly IMCA. Reprinted with permission. All rights reserved.
BELIEF 3: Embedding ESG Considerations into a Firm’s Culture and Processes Improves the Likelihood of Prolonged and Successful Investing

It should not be surprising that the impact of ESG factors extending to the financial success of companies (in general) also can impact the success of investment firms.4

In our assessment of an investment firm’s organizational environment, we look for organizational dynamics, cultural values, and actions that will support a strong investment process and lead to superior investment results. We believe organizations that do the following are more likely to achieve prolonged investment success:

- Attract and retain the right people
- Offer a supporting environment for their investment teams
- Provide fair remunerations and incentives
- Bestow a level of autonomy to make good investment decisions
- Provide adequate resources to perform the job

Likewise, a firm’s incorporation of ESG factors within its organization impacts its own organizational outcomes. For example, successful investment firms tend to have strong governance to protect the interests of the firm and its employees, as well as dedication to clients’ best interests. They are likely to have more transparency and accountability for decision-making and outcomes. They are more likely to place integrity front and center.

DIVERSITY AND INCLUSION DISAGGREGATED RANK

In addition to our sub-rank to research regarding ESG integration, we also have a sub-rank to investment staff. We believe that investment teams assessed by our manager research analysts to have strong diversity and inclusion will have more stable team structures and better decision-making outcomes.5

Several studies have shown that diverse and inclusive teams are more successful than non-diverse teams. Although these studies do not point specifically to the impact on investment performance, benefits can include better task performance and greater organizational stability.

1. Teams from diverse backgrounds encourage greater accuracy and sharper “cognitive resources” in an examination of facts (Rock and Grant 2016).
2. Other studies have demonstrated the value of diverse viewpoints to performance. For example, Jehn et al. (1999) found that “informational diversity”—the differences in knowledge bases and perspectives arising from education, experience, and expertise—is positively related to group performance. The study also found that lack of alignment on tasks can negate that benefit, so teams must also be inclusive and not just pay lip service to diversity.
3. Diverse organizations can be financially stronger. Hunt et al. (2015) found that “companies in the top quartile for racial and ethnic diversity” are 35 percent more likely to have financial returns above their respective national industry medians. Similarly, studies suggest that greater female representation in corporate leadership is associated with higher profitability. For example, Dawson et al. (2016) found clear evidence that “companies where women made up at least 15% of senior managers had more than 50% higher profitability than those where female representation was less than 10%.”
4. Diverse and inclusive organizations may have an edge in attracting and retaining top talent. For example, J.P. Morgan Chief Executive Officer Jamie Dimon has been a vocal proponent of that viewpoint (Weber and Ensign 2016).
5. Finally, women may trade differently than men. For example, several articles argue that women suffer less from overconfidence. Such articles cite the Barber and Odean (2001) brokerage data study that found men trade 45 percent more than women, indicating that women tend to hold on to their investment positions longer.

In figure 4, we illustrate how both the ESG and the diversity and inclusion (D&I) ranks place in our ranking system.

Figure 4

INCLUDING ESG AND D&I IN RUSSELL INVESTMENTS’ MANAGER RANKS

<table>
<thead>
<tr>
<th>DISAGGREGATED RANKS</th>
<th>SUB-CATEGORIES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INVESTMENT STAFF</strong></td>
<td>Category 1</td>
</tr>
<tr>
<td>Organizational Environment</td>
<td>Category 2</td>
</tr>
<tr>
<td>Security Selection</td>
<td>Diversity and Inclusion</td>
</tr>
<tr>
<td>Country Selection</td>
<td>Category 4</td>
</tr>
<tr>
<td></td>
<td>Category 5</td>
</tr>
<tr>
<td></td>
<td>Category 6</td>
</tr>
<tr>
<td><strong>RESEARCH</strong></td>
<td>Category 1</td>
</tr>
<tr>
<td>Asset Allocation</td>
<td>Category 2</td>
</tr>
<tr>
<td>Sell Decision</td>
<td>Category 3</td>
</tr>
<tr>
<td>Portfolio Construction</td>
<td>ESG Considerations</td>
</tr>
<tr>
<td>Currency Management</td>
<td>Category 5</td>
</tr>
<tr>
<td>Implementation</td>
<td>Category 6</td>
</tr>
</tbody>
</table>

Source: Russell Investments, April 2018
BELIEF 4: Active Ownership of Securities Is an Effective Tool for Improving Investment Outcomes

Being an active owner is an important component of investment responsibilities. Through active ownership, one can better understand both the risk factors and potential return associated with ownership of a company. Good stewardship practices are best implemented through proxy-voting activities, and being an engaged shareholder, with the underlying objective to protect and enhance shareholder value.

In the coming years, responsible investing will just be how we all invest. Understanding how ESG factors impact security prices and portfolio structure is vital, because that understanding will be integrated into the entire industry. As we move toward this inevitable reality, firms need to develop best practices for processes, for portfolios, and for investor clients.

This approach may include engaging with subadvisors and working with proxy vendors. It also requires working with other asset owners to obtain multiple opinions on a given shareholder issue, in addition to engaging directly with management teams of companies held in portfolios.

FROM POLICY AND BELIEFS TO PRACTICE—A SUMMARY

In the coming years, responsible investing will just be how we all invest. Understanding how ESG factors impact security prices and portfolio structure is vital, because that understanding will be integrated into the entire industry. As we move toward this inevitable reality, firms need to develop best practices for processes, for portfolios, and for investor clients. These practices must incorporate decisions from asset and manager selection, from direct investing to reporting formats, from asset allocations to dynamic tilts, from internal policies and practices to industry collaboration. We believe the best firms will lead the investment community in integrating investing best practices with responsible investing best practices. Ultimately, we expect these two to be one and the same.

Leola Ross, PhD, CFA®, is director, capital markets research, at Russell Investments. She earned a BS from Drew University and a PhD from Southern Methodist University. Contact her at webmast@russellinvestments.com.

ENDNOTES

2. As of the original writing of this paper on April 16, 2018, this count relates to our researched universes of active managers, which extends beyond the subadvisors we use in our funds.
5. Thanks to Kris Nelson for authoring this sub-section.
6. Thanks to Rob Kuharic and Sarah Alvarez for authoring this section.

REFERENCES


Important information

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Russell Investments’ ownership is composed of a majority stake held by funds managed by IA Associates with minority stakes held by funds managed by Reverence Capital Partners and Russell Investments’ management.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the “TSSE RUSSELL” brand.

Copyright © 2018, Russell Investments Group, LLC. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an “as is” basis without warranty.

First used: June 2018 AI-26605-06-21