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Environmental, Social, and Governance Investing: Myths versus Reality

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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTING

Myths versus Reality

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The term "ESG" (environmental, social, and governance) was first used in a 2005 study entitled "Who Cares Wins."[1] In the decade and half since then, ESG investing has had a profound influence on asset managers that focus primarily on the institutional marketplace. Yet most wealth managers and financial advisors have been reluctant to fully incorporate ESG factors within their investment processes. For example, a recent financial industry publication references two studies that quantify the low adoption rate of ESG investment strategies among U.S.-based financial advisors.[2] It notes the results of a 2018 survey of financial advisors in which only 36 percent of those surveyed offered ESG investment options to their clients.

Why should wealth managers care about ESG investing? One important reason is that sustainable investing is growing rapidly.[3] Thus, those that embrace it early in the cycle can hold a competitive advantage over those that fail to do so. To help financial advisors better understand the benefits of ESG investing, this article demystifies ESG investing by exploring four common misperceptions many financial advisors hold regarding ESG investing.[4]

ESG MYTH #1: CLIENTS DON'T CARE ABOUT ESG INVESTING

As a portfolio manager at a large financial institution managing a global equity ESG offering for internal distribution, I interacted directly with financial advisors and their clients. When discussing the benefits of offering an ESG strategy to the firm's clients, I heard the common refrain: "Clients don't care about ESG investing." In fact, numerous surveys show that in general, three-fourths of all investors are interested in sustainable investments. For example, at least 84 percent—and as many as 90 percent—of millennial investors and nearly three-fourths of women investors are interested in engaging in ESG investing.[5]

Ironically, even though three-quarters of individual investors worldwide, and 71 percent in the United States, say it is important to align their investments with their values and ethics, only 17 percent of financial advisors say that they need to "[i]mprove their ability to understand ESG and explain it to their clients."[6] In this author's opinion, it is time for a reality check among the remaining 83 percent of financial advisors to assess the true desires of their clients.

Perhaps, you might say, financial advisors are merely responding to client interest—or lack thereof. For example, in a recent industry survey, only 14 percent of investors polled had discussed ESG investing with their wealth managers. However, amazingly, of these 14 percent of investors, a meaningful 61 percent had initiated the conversation, rather than the advisor bringing it up.[7] Further, studies show that for impact investors—and women in particular—who want to incorporate ESG value-centric investing within the investment process, finding a knowledgeable and qualified advisor can be a problem.[8]

How can financial advisors remedy this situation? The fact that no universal standard of ESG investing yet exists should not hold you back. ESG is not a style of investing but an incorporation of non-financial factors—or drivers of return—within the investment process. Thus, ESG investing fits within all styles of investing. In fact, many predict that within the next 10 years, we will not use the term ESG investing at all. Instead, financial advisors and their clients will consider it an integral part of the investment process, not an add-on or optional.

A recent industry report offers the following suggestions to facilitate advisors' integration of ESG strategies within their investment processes:[9]

- Acquire additional education and training on ESG strategies, and truly listen to how clients express their preferences for incorporating ESG values as part of the investment process.
- Make ESG part of the investment discussion. For example, in addition to discussing investment performance, include a section on how well portfolio holdings have contributed to clients' ESG goals.
- Provide clear definitions of what is meant by "ESG" investing. The lexicon of values-based investing is dynamic and confusing and includes "ESG," "sustainable," "responsible," "SRI," and "impact" investing (see table 1).[10]

Table 1

DEFINITIONS

Term	Definition
Environmental, social, and governance (ESG)	• Typically refers to the factors and issues investors consider regarding a firm's sustainable business practices. • Environmental: A responsible investing factor dealing with climate impact, energy consumption, biodiversity, waste management, and natural resource use. • Social: A responsible investing factor dealing with employee engagement and development, labor relations, human rights practice, product safety, and consumer protection. • Governance: A responsible investing factor dealing with management structure, board accountability and independence, executive compensation, audits and internal controls, and shareholder rights.
Impact investing	• Intentionally seeking positive environmental and social outcomes alongside financial returns through investing practices across asset classes. See responsible investing.
Responsible investing	• An investment philosophy that incorporates ESG factors into investment analysis, portfolio construction, and ongoing monitoring across asset classes with the objective of enhancing long-term performance, managing risk, and aligning client values.
Socially responsible investing	• Originally, a term used interchangeably with ESG investing. Typically, legacy SRI approaches have emphasized exclusionary screening.
Sustainable investing	• An umbrella term often used interchangeably with responsible investing. See responsible investing.

Source: Nuveen, "Responsible Investing: ABCs of Responsible Investing," https://www.nuveen.com/en-us/thinking/responsible-investing/glossary-responsible-investing

Once advisors acknowledge that clients are interested in ESG investing, how do they start the discussion? In a recent survey of financial advisors, researchers took a closer look at investors' ESG motives and obstacles, with an aim of understanding where advisors could fit into the process.[11] They concluded that, in spite of the growth of robo-advisors and online investment platforms, ESG is an area where clients may prefer a wealth manager's guidance and insights.[12]

ESG MYTH #2: ESG IS JUST THE LATEST FAD; IT WILL NOT LAST

In my discussions with financial advisors, I often hear the comment: "ESG is just a passing fad. I am adopting a wait and see stance until I know that it is real." If this conversation took place five years ago, I might consider it a valid remark. However, at this point we know that ESG investing is here to stay. Many recent developments confirm that ESG investing is a trend and not a fad. For example:

- The Global Sustainable Investment Alliance estimates that global ESG assets totaled $30.6 million in 2018,[13] representing a 38-percent growth rate since 2016. As a basis of comparison, the S&P 500, which represents 80 percent of the U.S. stock market's valuation, was approximately $22 million at the end of 2018.[14]
- During the first six months of 2019, sustainable funds in the United States saw an asset flow of $8.9 billion, contrasted with an asset flow of $5.5 billion in all of 2018.
- A recent study reported that most U.S. asset managers (83 percent) integrate ESG data within their fundamental analysis process.[15]
- From a product development perspective, the top five ESG themes for asset managers are:[16]
  - Climate change/carbon
  - Fossil fuel divestment
  - Sustainable natural resources/agriculture
  - Gender equality
  - Clean water/water scarcity

Further evidence of ESG investing durability is the fact that one out of four dollars in the United States, or 26 percent, is invested in ESG strategies.

What has led ESG investing to this tipping point? Several factors are contributing to its growth. First, society is looking to companies—both public and private—to recognize and address urgent social and economic issues. We are witnessing a redefinition of corporate purpose and profit. Instead of corporations acting solely to maximize profits for shareholders, corporate leaders such as Larry Fink of BlackRock are making the linkage between purpose and profit: "Purpose is not the sole pursuit of profits but the animating force for achieving them. Profits are in no way inconsistent with purpose—in fact, profits and purpose are inextricably linked."[17] In his letter to chief executive officers, Fink references a recent study by Deloitte in which it asked corporate leaders to identify the primary purpose of public corporations. Their response? Approximately 63 percent more respondents said "improving society" is the primary purpose than said "generating profit" is the primary purpose.

Secondly, the millennial investors are demanding a change in corporate behavior based on their radically different definition of what constitutes "fiduciary behavior." Studies estimate that approximately $68 trillion in wealth will transfer from older generations to younger generations. If we are truly witnessing an investor revolution to combine purpose with profit, corporate leaders soon will be held accountable for ESG performance—in addition to stock performance. And, in the future, ESG-centric corporations most likely will adopt a longer time horizon when defining corporate strategy. If this happens, financial advisors that integrate ESG factors within their investment processes could substantially outperform those that do not.

ESG MYTH #3: ESG INVESTING RESULTS IN LOWER RETURNS FOR CLIENTS

In my conversations with financial advisors, I often hear the concern that integrating ESG factors within the investment process will result in lower returns for clients. Historically this was the case, but this is emphatically not the case today.

WHAT IS AN EXTERNALITY?

An externality is an economic term referring to a cost or benefit incurred or received by a third party. However, the third party has no control over the creation of that cost or benefit. An externality can be both positive or negative and can stem from either the production or consumption of a good or service.

Important: An externality may not affect the entity that causes the externality.

Numerous studies now confirm that overall ESG investing does not compromise return expectations and potentially may lead to superior risk-adjusted returns in the long run.[18] Rather than an "either or scenario," astute investors have discovered that combining ESG metrics (such as good governance practices) with traditional fundamental metrics (such as strong balance sheets) enhances the overall investment process. Although ESG investing will not outperform in every market environment, research conducted by one of the largest asset managers suggests that "ESG-friendly" portfolios could potentially underperform in "risk-on" market periods, with the expectation that ESG portfolios will demonstrate greater resiliency in market downturns.[19]

In addition, researchers now have confirmed a linkage between material positive ESG practices and superior performance. For example, researchers analyzing companies that demonstrate positive ESG attributes found ESG-centric companies enjoy:[20]

- Lower cost of capital
- Higher valuations
- Fewer bankruptcies
- Higher productivity
- Higher return on assets
- Higher return on equity
- Stock market outperformance

Another study, conducted by analysts at a major financial institution, found that ESG metrics have been strong indicators of future volatility, earnings risk, price declines, and bankruptcies.[21] In addition, researchers assert that using ESG metrics to analyze companies in emerging markets may prove to be a very effective investment strategy.

Given the discussion above, it is now obvious that a trade-off no longer exists between ESG investing and higher returns. What has changed in how investors value companies? Traditionally, local communities and society in general bore the cost of negative externalities, e.g., communities adjacent to a coal operation might experience damaging pollution of waterways as a result of mining activity. Thus, even though the coal company operations produced negative externalities, investors did not incorporate these negative externalites into their valuation of the company.

However, today many investors now recognize that to adequately value a company requires incorporating the full costs and benefits of externalities—both positive and negative—within the investment process. In effect, company valuation is shifting to produce a more comprehensive assessment of corporations' total costs of operations and production, which can result in investors applying a discount or premium to the valuation process, depending on if the externality is negative or positive.[22]

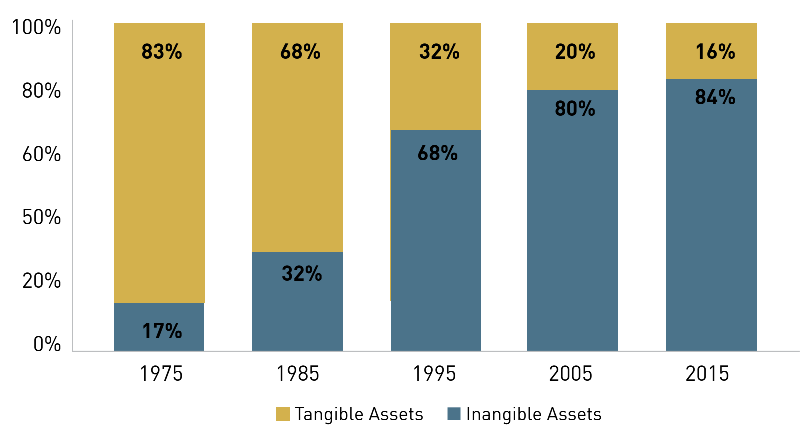
What we are experiencing today is investors' willingness to incorporate ESG sustainable performance—or lack thereof—into a company's market price and cost of capital.

ESG MYTH #4: ESG FACTORS ARE 'FEEL GOOD' FACTORS—NOT DRIVERS OF RETURN

Traditionally, investors relied on fundamental analysis, using financial metrics such as return on equity or earnings growth, to determine the fair market value of a security. And in fact, 20 years ago, accounting metrics in the form of key performance indicators (KPIs)

Figure 1

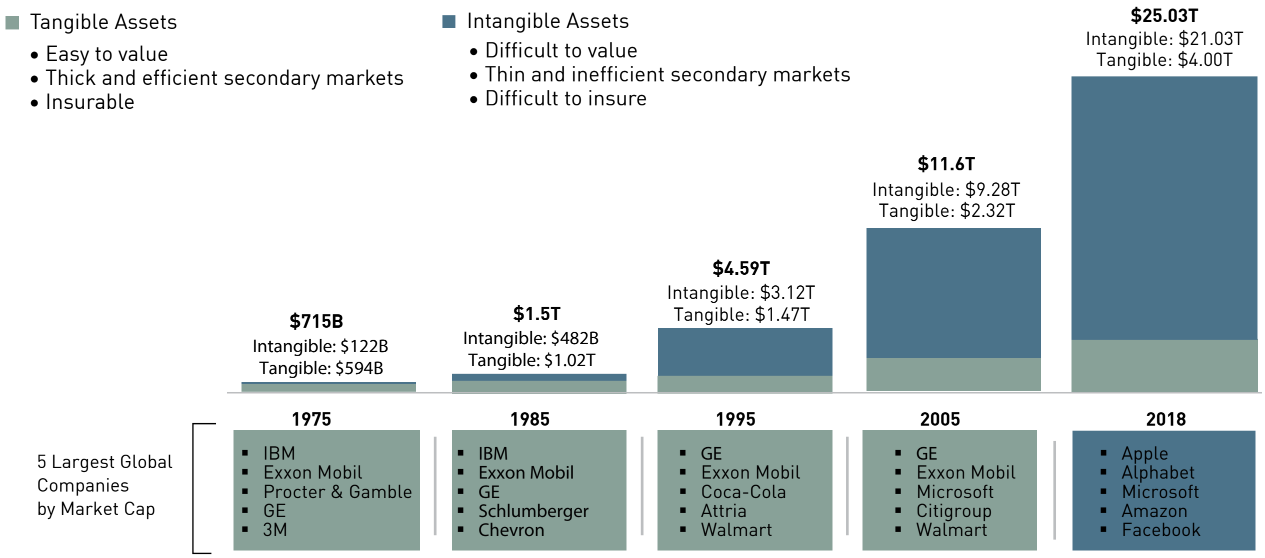
COMPONENTS OF S&P 500 MARKET VALUE



Source: © 2019 Ocean Tomo, Intangible Asset Market Value Study, Components of S&P Market Value; https://www.oceantomo.com/intangible-asset-market-value-study/

Figure 2

TANGIBLE VS. INTANGIBLE ASSETS FOR S&P COMPANIES, 1975–2018



Source: "2019 Intangible Assets Financial Statement Comparison Report," Aon's Intellectual Property Solutions sponsored Ponemon Institute Study and Report (April 2019), Figure A, page 1, https://www.aon .com/thought-leadership/ponemoninstitutereport.jsp; Bruce Berman, "$21 Trillion in U.S. Intangible Assets is 84% of S&P 500 Value—IP Rights and Reputation Included" (June 4, 2019), https://ipcloseup.com/2019/06/04/21-trillion-in-u-s-intangible-asset-value-is-84-of-sp-500-value-ip-rights-and-reputation-included/

made sense as a measurement of a firm's fair market value, because tangible assets made up the majority of a firm's worth. Times have changed, because today intangible assets, such as reputation, intellectual property, and good governance, are important considerations in determining a company's fair market value. According to a recent intangible asset market value study, within the past quarter century "intellectual capital" has emerged as the leading asset class (see figure 1).[23]

In 1975, tangible assets such as real estate and equipment represented 83 percent of the value of the S&P 500, and intangible assets represented only 17 percent of the value of the S&P 500 (figure 2). Today, the situation is reversed, with intangible assets representing 84 percent of the value of the S&P 500 and tangible assets representing only 16 percent of the value of the S&P 500. In fact, the value of intangible assets is five times greater than tangible assets for most industries. The explosion in corporate intangible assets goes together with the emergence of the digital economy. Using ESG, KPIs allow investors to accurately value a firm's non-financial (intangible) assets.

ESG factors may have started out as "feel good" factors 20 years ago when socially responsible investing emerged on the scene. However, today positive ESG attributes are both "feel good" factors as well as material (non-financial) KPIs that are relevant and predictive indicators of fair market value.

Thus, to assess the true value of companies, savvy investors integrate ESG analysis within the traditional fundamental analysis process. Further, these investors are recognizing that ESG factors can help in determining fair market value and in managing long-term investment risks. Is ESG analysis perfect? Undoubtedly not. However, although we still have a way to go, several organizations and asset managers are quantifying material KPIs on an industry-by-industry basis.[24]

CONCLUSION

At a recent United Nations gathering of financial industry ESG cognoscenti, the message throughout the sessions was that the biggest risk for ESG investing may be ignoring it.[25] For the following reasons, the time has come for wealth managers to embrace ESG investing wholeheartedly:

- Clients do care about ESG investing and want their advisors to help them invest in a sustainable and responsible manner. This requires wealth managers to incorporate ESG issues within the financial planning process, and to integrate ESG metrics within the investment process.
- ESG investing is not a fad; it is a growing trend and is here to stay. Like any new enhancement to the investment landscape, those advisors who embrace ESG investing—and demonstrate their knowledge of the issues and strategies—will hold a competitive advantage over those who ignore it and hope that it will fade away.[26] My advice to advisors? Get on board with ESG investing or risk losing clients.
- Although historically it may not have been the case, today ESG investing offers an opportunity to capture market inefficiencies, which can potentially enhance returns, lower

volatility, and mitigate negative risk exposures such as controversy risk. As data sources become more robust and companies incorporate sustainable practices throughout their operations, investors will become more adept at identifying market winners and losers.

- Yes, ESG investing is a "feel good" factor that is highly desirable to most investors. However, potentially superior performance and enhanced risk management also can feel good to investors. But most importantly, ESG investing reflects the changing nature of capital markets in which non-financial factors, such as good governance and sustainable supply chain management, are quantifiable drivers of return.

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ENDNOTES

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7. Allianz "ESG Clarity Survey" (October 17, 2017), https://us.allianzgi.com/en-us/our-firm/newsroom/press-releases/results-of-2017-esg-survey.
8. See Ellen Remmer, "How to Find a Financial Advisor Who Shares Your Interest in Impact," *Barron's* (April 7, 2019), https://www.barrons.com/articles/how-to-find-a-financial-advisor-who-shares-your-interest-in-impact-51554642026. As an ESG portfolio manager, I spoke at several client events. Without exception, existing clients would come up to me after my talk and voice their frustration with their advisors' lack of interest in, or understanding of, ESG investing.
9. See endnote 6.
10. An excellent resource for advisors interested in mastering ESG terminology is the glossary contained in Nuveen's "Responsible Investing: ABCs of Responsible Investing," https://www.nuveen.com/en-us/thinking/responsible-investing/glossary-responsible-investing. In addition, see: https://www.investopedia.com/financial-advisor/esg-sri-impact-investing-explaining-difference-clients/.
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22. Historically, investors considered only internal direct costs in their assessments of companies. Indirect external costs, such as degradation of the environment, were not included in the valuation process. A good example of investors incorporating negative externalities within the valuation process of an industry found among coal companies. The "S&P Global Market Intelligence" report, published in January 2019, notes that market capitalization of the sector is down significantly from 2011. Specifically, the 12 largest publicly traded U.S. coal producers lost 16 percent of their total market value from September 2018 to January 2019, with several companies filing for Chapter 11 bankruptcy protection.
23. See "Intangible Asset Market Value Study," Ocean Tomo, https://www.oceantomo.com/intangible-asset-market-value-study/. Traditionally, the term "intellectual capital" refers to intellectual property assets, such as patents, trademarks, and copyrights. The Ocean Tomo study expands this definition to "special client intangible assets," such as corporate and governance preference rights.
24. One such organization is the Sustainability Accounting Standards Board (SASB), a nonprofit organization that has developed a set of sustainability standards specific to its unique classification system of industries. SASB standards differ by industry, enabling investors and companies to compare performance from company to company within an industry. See: https://www.sasb.org/standards-overview/.
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26. A recent Allianz survey found that, within the general population, only 15 percent of Americans know what the letters "ESG" in ESG investing mean. See "Allianz ESG Investor Sentiment Study Report" (2019), https://www.allianzlife.com/-/media/files/allianz/pdfs/esg-white-paper.pdf.

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