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Navigating the Myths of ESG Investing: A Road Map to Success

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INVESTMENTS & WEALTH INSTITUTE®

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A ROAD MAP TO SUCCESS

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Two years ago, *Investments & Wealth Monitor* (*IWM*) published an article about the myths of environmental, social, and governance (ESG) investing.[1] When Anthony Davidow, chair of the *IWM* editorial board, recently asked me to write an update on this topic, I was doubtful. I wondered if the need still existed to further educate advisors about the myths surrounding ESG investing. To my surprise I discovered that, although select advisors have embraced ESG investing, fewer than half of financial advisors have fully integrated it within their advisory practices.

This will soon change. The CFA Institute "now encourages all investment professionals to consider ESG factors," viewing the integration of these factors as "consistent with a manager's fiduciary duty to consider all relevant information and material risks in investment analysis and decision-making."[2]

If you are one of ESG's early adopters, this article offers additional ESG insights to help you better educate your staff, clients, and prospects. For those advisors who are still on the sidelines regarding ESG, the following discussion will help demystify unrelenting ESG falsehoods still held by skeptical advisors.

This article explores four persistent myths around ESG investing to enhance advisors' understanding of the ESG space:

Myth #1: ESG represents an investment philosophy.

Myth #2: ESG factors are "feel good" factors, not drivers of return.

Myth #3: Using ESG metrics does little to help mitigate portfolio risk.

Myth #4: All ESG database vendors provide robust and consistent data.

In addition, this information arms advisors with new insights regarding how to develop a holistic investment process that adds value for existing clients and provides advisors with a differential advantage vis-à-vis other financial advisors.

INTEGRATING ESG AS PART OF YOUR ADVISORY OFFERING

The most important reason to include or enhance an ESG offering is that it satisfies a need to better serve your clients, because a dissatisfied client can soon become a former client.

- As discussed in *FT Advisor*, a recent Oxford Risk survey points out that "63 per cent of retail investors have or would consider moving investments to new advisors because they are unhappy about their wealth manager's ESG focus."[3]
- *FT Advisor* also highlights a survey conducted by Consumer Intelligence showing that 20 percent of investors already have switched advisors for this reason.

Secondly, interest in ESG investing continues to grow. What started as a niche, moralistic offering for socially conscious investors has morphed into a robust analytical framework for measuring nonfinancial key performance indicators (KPIs) on an industry-by-industry basis. Numerous studies now demonstrate that nonfinancial measures—both positive and negative—drive returns. Thus, employing metrics to uncover material nonfinancial ESG issues gives investors the opportunity to capture positive inefficiencies and avoid negative externalities, both of which can positively influence returns.[4]

ESG MYTH #1: ESG REPRESENTS AN INVESTMENT PHILOSOPHY

ESG does not represent an investment philosophy, just as a dividend discount model does not represent an investment philosophy. ESG defines an analytical framework that incorporates nonfinancial metrics within the investment process. Because it focuses on nonfinancial ESG metrics, it is additive and complementary to existing investment approaches across a broad landscape of different investment philosophies, such as value, growth, growth-at-a-reasonable price, contrarian, passive, and others.

Investopedia defines investment philosophy as a set of beliefs and principles that guide an investor's decision-making process. It goes on to say:

> *Investment philosophies are one of the defining characteristics of people or firms that manage money. Most investors who achieve*

long-term success develop and refine their investment philosophies over time and don't abandon it as market conditions change.[5]

Simply mention Warren Buffet (Berkshire Hathaway), George Soros (Soros Fund Management), or Cathie Wood (Ark Investment) and astute investors immediately will understand the beliefs and principles that guide their investment processes.

Using MSCI Research as the source, I examined the investment philosophies of four of the top 10 largest ESG equity funds by assets under management (see sidebar).[6] Consistent with the idea that an investment philosophy identifies a set of beliefs rather than an investment strategy or screening process, none of the firms used "ESG" to describe their investment philosophies.

Even though ESG does not exemplify an investment philosophy, it does provide a robust framework to help advisors identify nonfinancial risks that can materially impact a client's portfolio, both positively and negatively.

ESG MYTH #2: ESG FACTORS ARE 'FEEL GOOD' FACTORS, NOT DRIVERS OF RETURN

A recent Callan survey on ESG investing found that—despite the growing trend toward ESG adoption—more than 50 percent of institutional investors do not incorporate ESG as part of the investment decision-making process, saying "its benefits are unproven or unclear."[7]

In the previous *IWM* article about the myths of ESG investing, I discussed this same misperception regarding ESG not being a driver of return. Ironically this myth persists, despite numerous studies refuting the claim.

FOUR OF THE TOP 10 LARGEST ESG EQUITY FUNDS BY ASSETS UNDER MANAGEMENT

Parnassus: "Parnassus Investments believes that high-quality companies with solid fundamentals offer compelling long-term investment opportunities."*

Vanguard: "Successful investment management companies base their business on a core investment philosophy, and Vanguard is no different. Although we offer many specific strategies through both internally and externally managed funds, an overarching theme runs through the investment guidance we provide to clients—focus on those things in your control."†

Northern Trust: "At Northern Trust Asset Management, we understand that investing ultimately serves a greater purpose. That is why our philosophy is rooted in the fundamental belief that investors should get compensated for the risks they take—in all market environments and in any investment strategy. At the heart of our philosophy is how we think about, view, and analyze risk. As risk-aware investors, we take risk intentionally, to achieve investors' desired outcomes and minimize unintended consequences."‡

Aberdeen: "We believe that deep fundamental research into companies, combined with team debate and rigorous stock selection, is the key to driving better investment returns for clients. Our stock-picking process is truly bottom-up."§

* *https://www.parnassus.com/about-us/philosophy-and-process*

† *https://corporate.vanguard.com/content/dam/corp/research/pdf/Vanguards-Principles-for-Investing-Success-US-ISGPRINC_062020_Online-1%20(1).pdf*

‡ *https://www.northerntrust.com/united-states/what-we-do/investment-management*

§ *https://www.abrdn.com/docs?editionId=eba4d6af-d736-452e-8096-e1212378c2ca*

Arabesque Partners and University of Oxford conducted a meta-study of more than 190 of the highest-quality academic studies, assessing the link between stock prices and ESG. Overall, they found a significant positive correlation between sound ESG standards and lower cost of capital as well as better operational performance.[8] Empirical studies also show international evidence of the positive relationship between employee satisfaction and stock returns. Regarding the "E" factor, recent research demonstrates that companies' positive environmental news triggers positive stock prices. Similarly, firms behaving environmentally irresponsibly demonstrate significant stock decreases.[9]

In its publication "10 Reasons to Care about Environmental, Social and Governance (ESG) Investing,"[10] Bank of America provides compelling evidence that ESG investing drives superior portfolio performance:

1. Beating the benchmark: Top ESG-ranked companies recorded better performance than the average S&P 500 company.
2. Rising investor interest: New investments in ESG could total an estimated $20 trillion in the next two decades. Demographic groups taking the lead are women, high-net-worth individuals, and millennials.
3. Financial metrics alone no longer tell the story: Percentage of companies' total value attributed to intangible assets such as brand reputation have now surpassed tangible assets.
4. Happy employees = successful companies: Companies that employees rated as "best places to work" outperformed those rated "worst places to work" by 41 percent.
5. The best signal of bottom-line risk: S&P 500 companies in the top 25 percent by ESG ratings experienced lower future earnings-per-share volatility than those in the bottom 25 percent.
6. Bankruptcy risks avoided: Investors could have avoided 90 percent of

S&P 500 bankruptcies over a five-year period if they had screened out firms with below average environmental and social rankings five years earlier.

7. "Good" companies enjoy lower funding costs: The lower the ESG score, the higher the cost of debt.
8. ESG controversies can cost a lot: When a company faces problems related to ESG issues, the stock price tends to suffer for a year or even longer.
9. ESG investing opportunities: Trillions of dollars managed by U.S. portfolio managers incorporate ESG issues to address global challenges.
10. Chances are you already do care about ESG: Stocks have been bought and sold on ESG concern for decades. Today, investors use ESG metrics with financial metrics to assess a company's potential.

Lastly, as discussed in a Northwestern Kellogg "Insight" piece, Aaron Yoon (Kellogg) and George Serafeim (Harvard) analyzed data about more than 3,000 companies. They found that the "stock value did tend to rise after positive ESG news about a firm emerged, but only if the news was financially material—that is, related to the company's sector."[11] (I'll discuss the importance of materiality below.)

ESG MYTH #3: USING ESG METRICS DOES LITTLE TO HELP MITIGATE PORTFOLIO RISK

Research now definitively shows that nonfinancial events, in the form of ESG-related issues, pose financial risks to companies. ESG risk is multi-faceted, covering broad categories of nonfinancial risk such as climate change, data fraud, stakeholder activism, human rights, diversity, supply chain management, and externalities.

ESG risks are the environmental, social, and governance risk issues that potentially impact a company and its stock or bond price either positively or negatively. Can paying attention to ESG issues add value when it comes to risk management? Until quite recently, investors ignored employing ESG metrics as a risk management tool. However, today more investors are using ESG metrics to complement traditional portfolio risk management measures such as statistical analysis.[12]

The evidence is clear, at both the macro level as well as the individual company or stock level, that material ESG KPIs can help predict a wide array of potential risk exposures, including climate change effects, reputation risk, and controversy risk. In addition, ESG metrics may help identify drawdown risk, portfolio volatility, earnings risks, price declines, and bankruptcies.

For example, research conducted by Bank of America Global Research found that stocks with minimal peak-to-trough declines, or drawdowns, had an average ESG score of close to the 70th percentile ahead of the period analyzed. Conversely, those with extreme declines (more than 90 percentage points) had an average in the 47th percentile ahead of the decline.[13]

As Morningstar points out, portfolios often contain hidden ESG risks. For example, a dividend portfolio carries 20 percent more ESG risk than the overall market and a renewable energy portfolio is 10 times as carbon-intensive as the global equity market. Derived from Morningstar research, the list below provides a sample of hidden risk exposures often found in investors' portfolios[14]:

- Value and size may possess long-term performance advantages, but they carry higher ESG risk and carbon intensity than growth and large caps.
- Strategies that tend to overweight utilities or industrials, such as high dividend yield, minimum volatility, and infrastructure, can lead investors to carbon-intensive, high-ESG-risk sections of the market.
- Dividend growth strategies are designed differently than dividend yield strategies, so they do not have the same levels of ESG risk.
- High-quality companies tend to carry lower ESG risk and less carbon intensity, as do many thematic strategies focused on transformative technologies.
- Renewable energy investing is not the same as low carbon or low ESG risk. Companies that are involved with both clean energy and fossil fuels can have carbon-intensive operations or carry other ESG risks.

Because a growing proportion of corporate value is intangible, investors are supplementing risk screens of traditional company-reported data with output from unstructured data using 4IR technologies[15] such as neuro-linguistic programming and machine learning. Social media now provides stakeholders, including employees, consumers, and communities, a platform with which to broadcast their messages.[16] Gauging stakeholder sentiment across a wide variety of issues historically represented a Herculean task, given the enormous amount of data mining required. With the advent of these innovative technologies, investors can now detect stakeholder sentiment quickly and efficiently across a wide range of risk issues. These technologies provide investors with an "outside view" of nonfinancial risks related to reputation, brand, ESG controversies, and other risks.[17]

In addition, ESG risk metrics can detect "greenwashing,"[18] which is a growing concern among investors and regulators.

Relative to the debt market, investors are using ESG metrics to determine the potential credit risk of a borrower. As it pertains to sovereign debt, researchers see an inverse relationship between countries' ESG risk scores and their credit default swaps or bond spreads.[19] Most agree that corporate governance—the "G" factor—plays the most key role in credit analysis.

The bottom line suggests that ESG is a vital component of any risk management process. Not only can it add value, but it also helps to mitigate a wide variety of ESG nonfinancial risks. Currently no uniform ESG risk standards exist. Thus, it seems obvious that those that pay attention to these types of risks hold an advantage over industry peers that do not.

ESG MYTH #4: ALL ESG DATABASE VENDORS PROVIDE ROBUST AND CONSISTENT DATA

ESG databases and corresponding ranking systems have come a long way since the early days of ESG investing. More companies are providing useful information to rating agencies voluntarily, and organizations are developing robust standards around ESG issues.[20] Yet problems persist, as demonstrated by the low correlations across ESG ranking vendors shown in table 1.

A recent KPMG insight report highlights the following:

> *The problem is that ESG data—generally speaking—is inconsistent, poorly verified and non-standardized. As yet, there are no international accounting standards for ESG data; verification and audit approaches remain inconsistent; fewer smaller companies report any ESG metrics at all."* [21]

Investors agree, evidenced by the results of an EY survey of global investors in which 56 percent of respondents found ESG disclosures inadequate.[22]

Unlike analyst forecasts, it is difficult to develop a quality database and ranking methodology due to the multidimensionality of the data and the varying time periods of the issue outcomes. The result? ESG data are not comparable across various vendors. Data vary along the following dimensions:

- scope
- criteria
- measurement
- weights

Many believe that creating standards may solve many of the problems of data inconsistency. However, standards will not necessarily address the issue of materiality adequately. As a user of ESG data, it is important to understand a vendor's approach to the dimensions mentioned above as well as the user's lens or view. A corporate social responsibility manager will consider ESG data in a different manner than an investment professional or a community activist. Consequently, investors are forming their own conclusions based on the underlying ESG data. Rather than using an inadequate materiality framework, some are creating their own materiality frameworks.

A recent United Nations Principles for Responsible Investment (UNPRI) blog quotes Sebastien Thevoux-Chabuel, portfolio manager at Comgest, as saying that "the issue with materiality is most of the time people do not ask, 'which ESG issues are material and to whom?'"[23]

For me, a good starting point begins with the Sustainability Accounting Standards Board (SASB) Materiality Map. The Map visually reveals how 26 general sustainability issues manifest across 77 industries.[24]

Given the rising cost of ESG data, firms such as Arabesque recommend that ESG data users consider making ESG data a public good. They argue that more accessible ESG data can serve the needs of market participants as they move toward making better-informed and sustainability-driven decisions.[25]

Engine No.1, an asset management firm, provides a comprehensive analysis of ESG data issues in its September 2021 thought piece, "A New Way of Seeing Value."[26] It explores the flaws in ESG metrics, data, and analysis. As a solution to the data dilemma, it suggests that investors move from a "pure portfolio" materiality question to that of actual impact. In doing so, Engine No. 1 approaches ESG investing from a new direction in which analysis is integrated, ESG metrics and ratings focus on change rather than materiality, and investors become active owners. (Whether or not you agree with the conceptual framework and recommendations, a reading of the analysis of the ESG data dilemma is well worth your time.)

Table 1

CORRELATIONS BETWEEN ESG RATINGS

Correlations between ESG ratings at the aggregate rating level (ESG) and at the level of the environmental dimension (E), the social dimension (S), and the governance dimension (G) using the common sample. The results are similar using pairwise common samples based on the full sample. SA, SP, MO, RE, KL, and MS are short for Sustainalytics, S&P Global, Moody's ESG, Refinitiv, KLD, and MSCI, respectively.

	KL SA	KL MO	KL SP	KL RE	KL MS	SA MO	SA SP	SA RE	SA MS	MO SP	MO RE	MO MS	SP RE	SP MS	RE MS	Average
ESG	.53	.49	.44	.42	.53	.71	.67	.67	.46	.70	.69	.42	.62	.38	.38	.54
E	.59	.55	.54	.54	.37	.68	.66	.64	.37	.73	.66	.35	.70	.29	.23	.53
S	.31	.33	.21	.22	.41	.58	.55	.55	.27	.68	.66	.28	.65	.26	.27	.42
G	.02	.01	-.01	-.05	.16	.54	.51	.49	.16	.76	.76	.14	.79	.11	.07	.30

Note: The colors represent a correlation matrix heat map. Green indicates positive correlation, red indicates negative correlation. The stronger the color, the larger the correlation magnitude, e.g., dark green versus light green or yellow.

Source: "Aggregate Confusion: The Divergence of ESG Ratings," by Florian Berg, Julian F. Koelbel, and Roberto Rigobon, MIT Sloan and University of Zurich (this version: January 14, 2022; original version: August 15, 2019, https://ssrn.com/abstract=3438533).

UKRAINE AND ESG INVESTING

Not surprisingly, you might wonder how ESG investing relates to Russia's military invasion of Ukraine. In this case, an ESG assessment requires applying material ESG metrics to the Russian securities market, at both the country and company level. From an economic perspective, ESG investors price in the cost of material ESG risks and negative ESG externalities in their current assessment of the Russian market. However, it is important to remember that even though ESG investing considers a plethora of nonfinancial factors, moral or political issues are not among them.

COUNTRY ESG ASSESSMENT

From an ESG perspective, investors are focusing greater attention on Russia and how its actions could affect its potential as an emerging market investment opportunity. The greatest interest in assessing investment in Russia at the country level exists among sovereign bond holders. In addition, pension funds and index providers keep a close watch on country factors. For example, the policies of select European pension funds require a pension fund administrator to follow its government's lead when that government imposes sanctions on another country.[27]

At the end of February 2022, as it relates to sovereign debt, MSCI downgraded Russia's country rating from BBB to CCC, which is the lowest rating possible.[28] Multiple reasons exist for a downgrade. For example, as it pertains to the "S" factor in Russia, it could relate to Russia's diversion of social spending to military expenditures or potential war crimes committed against the citizens of Ukraine.

Around the same time, both MSCI and FTSE Russell removed Russia from their emerging market indexes.[29] As figure 1 shows, Russia's country weight in the MSCI Emerging Market Index has eroded steadily over the past several years.

The emerging market of Russia has long traded at a discount due to ESG concerns. Investors and rating agencies now are fully pricing in past and present ESG issues.

COMPANY ASSESSMENT

As discussed previously, the aggregate ESG score of a company represents how well or poorly a company manages its ESG risks—both positive and negative—relative to its industry peers. In recent years, we note an increasing trend of corporate leaders such as BlackRock's Larry Fink recognizing the need to identify and mitigate ESG risks that are material to their companies. Thus, not surprisingly as it pertains to the crisis in Ukraine, we are observing numerous global companies taking a public stance against Russia. For example, a recent Yale School of Management study identifies more than 750 companies globally that have announced their departure from Russia.[30]

EXCLUSION AS A STRATEGY

Given the apparent human rights violations committed by Russia in Ukraine, investors are advocating complete divestiture of all investment in Russia. For example, State Street Global Advisors recently suspended the purchase of Russian securities in all its portfolios.[31] As it pertains to the crisis in Ukraine, this "all-or-none" approach is especially relevant to passive index providers. However, as discussed above, using material ESG KPIs instead of excluding entire countries or sectors can provide investors with a more nuanced and granular approach to investing.

CONCLUSION

To recap, these are the takeaways:

- ESG is not an investment philosophy. It is a robust conceptual framework, useful for identifying material KPIs and potential risk exposures.
- Overall, investment strategies that employ material ESG metrics at the industry and sector level outperform investment strategies that exclude ESG metrics.
- ESG provides a useful analytical tool to identify and manage portfolio risk exposures; it is especially effective at providing both an inside and an outside view of potential nonfinancial risks.
- Many ESG data issues remain unresolved. Going forward, expect to see greater standardization of ESG metrics and exciting developments around applying 4IR technologies that offer the potential to convert ESG data into ESG information.

Interest in ESG will continue to grow. To fully take advantage of this wave of interest, advisors must act now to begin the process of fully integrating an ESG framework within their practices. A Natixis survey of 8,550 investors among 24 countries found that 41 percent of respondents said that they did not know enough about ESG investing.[32] This gap between investors' desire to incorporate ESG and the knowledge of how to do so opens the door for enterprising advisors to develop and enhance their ESG offerings. In my estimation, fully integrating an ESG framework rather than approaching it in a piecemeal fashion best fits the needs of both advisor and client.

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ENDNOTES

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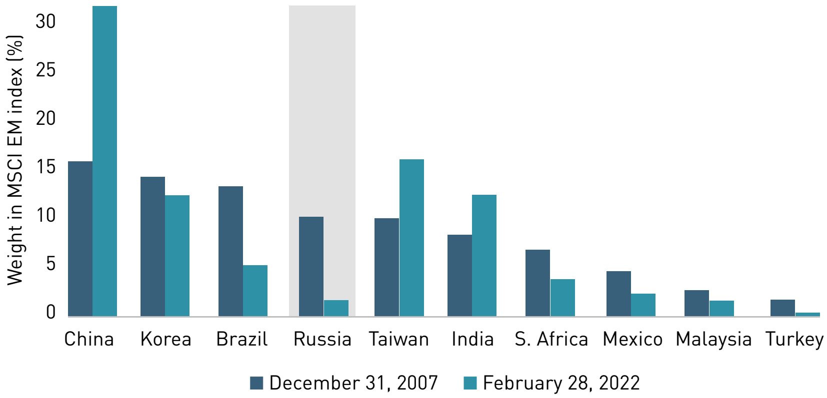
Figure 1

RUSSIA'S WEIGHT IN THE MSCI EMERGING MARKETS INDEX (%)



Source: MSCI

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16. See Jeremy Heimans and Henry Timms, *New Power: How Power Works in Our Hyperconnected World and How to Make it Work for You* (Doubleday, 2018).
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26. See: https://engine1.com/. The thought piece is available only by request.
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