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Why Are Investors Integrating ESG Into Their Investment Process?

ESG & Sustainability Transformation

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With the rapid evolution of ESG investing in the context of the ESG globalisation megatrend, this is a frequently asked question in the investment community, at least in emerging economies. It must be said that the development of ESG investing has never been more strongly supported by both academic research and investment practice, especially technological breakthroughs.

Multiple approaches to ESG analysis are used and a myriad of tools and techniques are available to integrate ESG across the investment value chain. These include company analysis, asset valuation, portfolio decision-making and asset management (stewardship).

ESG analysis methods use a variety of data sources, from commercially available databases to primary analytical research.

In previous articles, we have answered the question of the benefits of integrating ESG factors in businesses. In this article, we will answer the same question from an investor's perspective, regardless of the market, size, strategy or investment product.

Why do investors integrate ESG?

An investment firm may have a variety of goals and objectives for integrating ESG into its investment process.

These may include:

- Meeting legal or fiduciary duty requirements,
- Meeting the needs of clients and beneficiaries,
- Reducing investment risk,
- Increasing investment returns,
- Providing investment professionals with more tools and techniques to use in their analysis,
- Improving the quality of engagement and stewardship, and
- Reducing reputational risk at the firm and investment levels.

We will consider each of these goals in the following sections. The goals may vary depending on the nature of the firm. Some firms are pure asset managers, some are asset owners (e.g. pension funds), and some have mixed characteristics of both asset managers and asset owners (e.g. some large insurance companies or endowments, which use both in-house asset managers and third-party firms).

Meeting Fiduciary Legal or Regulatory Requirements or Meeting Client and Beneficiary Requirements:

A significant number of investment professionals have yet to integrate ESG. According to the 2017 CFA Institute Global ESG Survey, 24% of equity investors, 55% of fixed income investors (e.g., bonds or loans), and between 79% and 92% of alternative asset class investors (across private equity, real estate, infrastructure, and hedge funds) do not integrate ESG into their processes. More recent research continues to show that ESG integration is still not widely accepted. The Royal Bank of Canada's 2020 Responsible Investment Survey noted that 25% of respondents and, on a regional basis, 36% of U.S. respondents do not integrate ESG.

However, these investors or their asset-owning clients may be subject to certain national regulations, such as the EU Shareholder Rights Directive, the UK Department for Work and Pensions' regulations, or the UK Stewardship Code. In these cases, the regulations or clients may require a certain level of ESG integration, even though the investor may not believe that ESG integration will enhance returns or reduce risk. The aim is to meet minimum legal obligations or to meet client needs.

The debate has developed over the past two decades. Historically, legal questions have arisen as to whether certain aspects of exclusionary strategies (e.g., excluding tobacco companies) are consistent with fiduciary duties (modeled after what a prudent person would do). Today, a number of legal and regulatory standards suggest that failure to incorporate ESG aspects may be inconsistent with fiduciary duty. The United Nations Environment Programme Finance Initiative (UNEP FI), together with law firm Freshfields and the United Nations Principles for Responsible Investment (PRI), has been examining these questions over the past decade. Their analysis (across jurisdictions/countries) argues that investors' fiduciary duties require them to do the following:

• Incorporate ESG issues into their investment analysis and decision-making, consistent with their investment time horizon

• Encourage high standards of ESG performance in companies or other entities in which they invest

• Understand and incorporate the sustainability-related priorities of beneficiaries (in pension or insurance funds) and savers (in banks), regardless of whether these priorities are financially material.

As of 2021, regulatory updates include the EU Shareholder Rights Directive II, the UK Stewardship Code, and guidance from the US Department of Labor (DoL).

Notably, over the past decade, the tone of US DoL guidance has fluctuated but regardless, the point is that investors must be mindful of the legal requirements surrounding ESG integration.

Reducing Investment Risk and Increasing Investment Returns:

Many investors seek to integrate ESG into their investment process to better understand and reduce investment risk. Some also seek to enhance returns through ESG by seeking higher alpha. Recent surveys show that more companies do so to reduce risk than to increase returns, but some do so for both reasons.

Other tools and techniques to use in analyzing and improving the quality of investment and asset management engagement activities:

Judging by ESG surveys conducted by both academics and investors, not all companies believe that ESG integration leads to better risk-adjusted returns. However, many ESG integration tools, such as scorecards, can be used to engage with corporate management teams and support asset management activities. These same tools can also enhance the clarity of an investee company's business model.

Reputational Risk at the Corporate Level:

Investment firms may view ESG integration as necessary to ensure a strong reputation and limit reputational risk to stakeholders. Evidence of the differing perspectives in the corporate world can be found in the Business Roundtable's "Statement on the Purpose of a Corporation" (August 2019), signed by 181 CEOs (including CEOs of major investment banks and asset managers) who pledged to lead their companies to achieve the goals of benefiting all stakeholders—customers, employees, suppliers, communities, and shareholders.

These CEOs wrote:

While each individual company serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- *Delivering value to our customers. We will continue the tradition of American companies leading the way in meeting or exceeding customer expectations.*

- *Investing in our employees. This starts with compensating them fairly and providing significant benefits. It also includes supporting them through education and training to help them develop new skills for a rapidly changing world. We promote diversity and inclusion, dignity and respect.*

- *Dealing fairly and ethically with our suppliers. We are dedicated to serving as a good partner to other companies, large and small, that help us fulfill our mission.*

- *Supporting the communities where we work. We respect the people in our communities and protect the environment by implementing sustainable practices throughout our business.*

- *Create long-term value for shareholders, who provide the capital that enables companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.*

Each of our stakeholders is essential. We are committed to delivering value to all of them, for the future success of our companies, our communities and our country.

A core component of consumer brand surveys is attitudes towards sustainability and climate, as well as perceptions of diversity and inclusion. Managing ESG risks and opportunities therefore becomes a critical part of managing any business's brand value and reputation.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!