

ESG and Institutional Investors

Can environmental, social, and governance factors help managers add value and meet risk–return targets?

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Since the United Nations Principles for Responsible Investment guidelines were issued in 2006, many institutional investors have had a growing interest in putting their funds to work toward meeting environmental, social, and governance (ESG) goals. But asset owners wishing to increase their exposure to sustainable investing face a challenge when considering their public equity portfolios: either passively target ESG characteristics and risk underperformance or seek alpha with traditional equity strategies and leave sustainable investments for smaller, specialized mandates.

Institutional investors face an additional challenge when considering ESG. Individuals can access many mutual funds that adhere to personal values but may not have the performance of other funds. Institutions, however, have a duty to their plan's beneficiaries that requires meeting certain return and risk targets.

A good alternative for institutions is to invest in a fund that provides ESG exposure, excess return versus a broad market index, and risk control. This approach would be the “best of all choices” because institutions can have a target return, keep the benchmarks used in asset allocations, and provide the ESG exposure sought by the fund's investment boards. This model presents a challenge for asset managers, however, because their current investment approach needs to fully integrate ESG data in a way that adds value.

ESG Data

Companies are not required to report all components of their ESG expo-

sure, and much of what is available depends on voluntary disclosures. The trend so far has been for larger companies to provide fuller reports than mid- or small-cap companies, so coverage for large-cap indices is better than for small cap. As a service to the investment community, several market information firms collect ESG data from company annual reports, 10Ks, websites, government publications, non-government organizations, media, news, litigation reports, and management interviews, among



other sources. These data, collectively known as “nonfinancial data,” are organized into many categories, and each is given a rank or score. Each of these data providers starts with a host of basic measures, called “key performance indicators,” and aggregates them into several factors, which are combined to form top-level categories.

The type of information collected and the frequency of company disclosure result in data updates that typically occur on a one-year cycle. Some data entries have shorter update periods, perhaps monthly or quarterly, but the bulk of the ESG data change once a year.

The data offer many useful features but also have a few drawbacks. On the positive side, the data provide an integrated, normalized measure that can be compared across ESG areas. For each investor to compile a similar set of data would be very difficult and time consuming. Also, the data allow investors to track changes over time and give an in-depth look at risk areas of a company that are not contained in stan-

dard financial reports. Finally, because the data provide a basis for comparison across an industry, companies can be ranked against their peers based on ESG performance.

The drawbacks stem from the lack of generally accepted principles for measuring ESG components. For instance, scores from one ESG data supplier may not be comparable to the scores from another because the methodologies used to derive the scores are different. Another difficulty is that scores from one industry are not comparable to scores from another industry because the components for the scores can be quite different. The environmental score for, say, an energy company may not be comparable with that from an internet company.

Perhaps the biggest challenge for active managers is the lack of a valuation framework that relates ESG to stock prices. How should energy conservation policies, board diversity, or community engagement be priced in a stock? With market and fundamental data, managers have well-established models, such as the capital asset pricing model or the dividend discount model, but no such model exists for ESG data. The connection between ESG and company performance can be very intuitive. For example, good ESG policies may serve as a proxy for quality management (e.g., management that

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tries to anticipate regulatory requirements and consumer preferences). Also, ESG can be a gauge for company risk because legal threats and activist investor challenges can drag down a company's performance.

Common Applications

Several approaches have been used to help institutions invest with an ESG focus, but each has a characteristic that may not appeal to all investors. One approach has been the development of ESG indices to facilitate passive management. These indices, however, have risk–return properties that are different from common country indices because many companies are excluded and sector weightings can be different. Another approach is negative screening—a manager simply removes the “worst offenders” from a buy list and then applies the usual stock-selection process. This approach may not provide the desired level of ESG exposure. With positive screening, a manager develops a buy list from highly ranked ESG stocks and then applies the usual stock-selection process. Given the limited number of stocks available, this approach may result in incomplete sector exposures or large-cap bias in the portfolio.

The challenge for institutional investors and asset managers is to develop funds that incorporate ESG principles and provide the needed risk–return targets. An effective solution will require full integration of ESG characteristics into the stock-selection process, likely by combining ESG data with other stock-valuation measures to arrive at a thorough assessment of stock prices. To play a role in active management, ESG data must give insights into stock price movements so managers can provide the ESG exposure and enhanced returns sought by investors.

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Adding Value with ESG

Can ESG data be used to generate “alpha”? Prior studies on the effectiveness of ESG to pick stocks have shown mixed results. In particular, a 2007 Russell Research survey of 45 research papers on ESG found a similar number of positive and negative results, with the bulk of the papers falling in the neutral category. One indication from these efforts is that applying ESG as a single factor across the whole market may not be an effective way to find alpha. A better insight may be gained by looking at smaller subcomponents to see how ESG and stock prices are related.

Several approaches can be considered. For example, environmental, social, and governance scores can be analyzed individually across the market to come up with three distinct factors, each of which can be evaluated separately. Each score could be recombined into a final score or used individually in stock selection.

Alternatively, ESG can be evaluated across market sectors to see how investors have responded to industry

trends. This approach would facilitate peer comparisons between companies in the same sector and would identify the leading and lagging ESG companies. It would also match the relative comparison approach used by ESG data providers.

In all cases, the analysis of ESG scores requires a relative comparison between companies because no measure exists for labeling a company “good” and another “bad.” The best that can be done for stock valuation is to say that one company is better at implementing ESG than another company, even though both companies can be “good” or “bad” in the eyes of some investors.

A promising area for ESG implementation is to combine ESG data with other valuation sources. Because ESG data are fairly static in terms of stock price movements, they may not give enough information for actively managing return and risk in a portfolio. Still, the data give new insights by providing measures of company performance that are taken outside of the common financial statements or earnings estimates that are analyzed by managers.

The goal of many institutional CIOs is to “operationalize” a plan's commitment to sustainable investing. Full integration of ESG characteristics into active equity portfolios can be one approach to meeting such a commitment. By fully integrating ESG into active management, it may be possible to “do well while doing good”—that is, to meet the risk–return guidelines of the Prudent Investor Rule and gain exposure to the desired ESG characteristics. **■**

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