



# Integrating ESG Factors in the Investment Process

By Jeroen Bos, CFA

The importance of responsible investing (RI) has increased substantially in recent years and is gradually entering the mainstream investment arena. I believe this trend is irreversible and for good reasons. Recent events—such as the BP oil spill, the accounting scandal at Olympus, the collapse of an apparel factory in Bangladesh, and ongoing global concerns about the environment (water scarcity, climate change, and depletion of natural resources in general)—illustrate that environmental, social, and governance (ESG) factors can have a significant impact on a company's share price performance and hence on investment portfolios. Therefore, integrating ESG factors into the mainstream investment process is essential for optimizing the risk–return characteristics of one's portfolio.

**RISK–RETURN IMPACT.** One of the reasons that RI took years to be accepted is the misperception that investing in a responsible way (which in the past mainly meant excluding certain investments from an ethical perspective) would actually reduce the investable universe and thus have a negative impact on investment performance. For this reason, some argued that considering

ESG factors in the investment decision-making process would be in violation of the asset manager's fiduciary duty to maximize investment returns. But many studies have shown that incorporating ESG factors improves the downside protection while potentially improving the upside as well, and in any event, it should improve the risk–return characteristics of an investment portfolio. Other studies have shown positive correlation between ESG-score improvements and share price outperformance. All these findings make perfect sense because the goal of investing in a responsible way is to look for sustainable business models, which often result in a company having a competitive edge and being able to achieve superior returns. Consequently, inclusion of ESG factors should be perfectly in line with an asset manager's fiduciary duty as well.

Furthermore, integrating ESG factors can—and should—be seen as simply being a more complete approach to investing. This realization is gradually leading to an increasing focus on the analysis of ESG factors in the overall investment process.

**IMPACT ON SOCIETY AND REPUTATION.** Today, the rise of social media has made

reputational risks for asset managers potentially greater. Integrating ESG factors in the investment process can help asset managers guard against reputational risk in several ways. RI should drive asset allocation toward more sustainable business models, which should have a positive effect on society and the environment. The positive impact on society can be further strengthened if investors engage with the companies on ESG aspects to encourage improvements. When investment decisions are guided by ESG considerations, the reputational risk of chosen investments should be lower relative to investments that are perceived as having a negative impact on society and the environment. Finally, RI provides an opportunity for investors to reflect their own beliefs and values in their investment portfolios. Note that RI should not be only about excluding certain companies but rather about finding out which companies do well (or are improving) when ESG factors are analyzed. As this realization is gradually growing, the market is slowly moving away from an approach driven by exclusion only.

**IMPACT ON ASSET-GATHERING CAPABILITIES.** For asset managers, the topic of ESG

integration is also becoming increasingly important from an asset-gathering perspective. Large asset owners (e.g., pension funds) increasingly demand proper ESG integration into the investment process or view ESG integration as one of the important factors when deciding which asset manager will receive their business. This trend is likely the result of pension funds becoming more aware of their reputational risks, more responsible and eager to reflect their values and beliefs, and more aware of the risk-return optimization that ESG integration brings to their investments. I expect this trend to continue in the coming decade, giving asset managers that do a good job on this front an attractive opportunity to outperform the market in terms of asset gathering.

**MATERIALITY OF ESG FACTORS.** The way investors integrate ESG factors in one's investment process has also been gradually evolving. Traditionally, analyzing

ESG factors was often not fully included in the investment process or was considered external to it. A proper analysis should always include a view on ESG factors because omitting material ESG items will likely make for an incomplete assessment of the fair value of a company. Key when integrating ESG factors into an investment analysis is to focus on materiality (i.e., factors that are likely to have a material impact on the longer-term sustainability of a company's business model and its share price performance). Examples of material factors include safety standards, environmental impact, and resource access in the mining industry, social and labor issues in the consumer sector, product liability and bribery in the health-care sector, and governance and alignment between management and shareholders for companies in general. In addition, asset managers/owners could decide to bring in stricter measures,

including non-material factors, that provide protection against reputational risk or reflect their values and beliefs.

Today, there is an emerging trend in which separate ESG teams provide an ESG overlay to the "mainstream" analyst's research or the portfolio manager's investment process. To accomplish true ESG integration, however, one should make ESG an integral part of the investment analysis performed by the mainstream analysts and an integral part of the overall investment process. The industry likely will move toward an integrated approach over the next decade. This transition will require the mainstream analysts and portfolio managers to expand their skill set and adjust the way they analyze potential investments.

Jeroen Bos, CFA, is the head of global equity research at ING Investment Management and a member of the board of directors of CFA Society Netherlands.

## LETTERS

### DEMOGRAPHICS AND GROWTH

The article "Welcome to the Age Era" by Susan Trammell, CFA (November/December 2013), which was based on a study by Denis Chaves and me, explored in depth how demographics affect GDP and capital markets. I can only hope that her article will draw more attention to this important area of research because this whole subject is entirely underappreciated.

For instance, the US Congressional Budget Office (CBO) bases its projections on a reversion to 3% real GDP growth after one year of slower growth and three years of even faster catch up. No one seems to object. Folks who suggest 2% growth as a norm are seen as alarmists; 1%-ers are branded as lunatics.

So what? Well, what's the 40-year average for real GDP growth? It's 2.1%. So, how realistic is the 1% slow-down? For starters, the U.S. working-age population is projected to grow 0.8% per year slower in the coming 20 years than in the past 60 years. And the workforce is older. Older workers are more productive than

younger workers (though younger workers would be loath to admit it!), but their productivity growth is obviously slower—they already have honed their skills.

There goes another chunk of growth.

So, yes, slowing the 2.1% growth of the last 40 years by 1% is totally realistic!

Rob Arnott  
Newport Beach, California

### RESULT-DRIVEN MANAGEMENT

Prompted by the interview with economist Robert Pozen about time management and boosting productivity ("Secret Juice," November/December 2013), one reader writes:

Thirty-odd years ago, when I was a "rising star" among buy-side analysts, our human resources (HR) department told us all to practice time management.

When my direct boss (I was very lucky to be working for a guy four grades higher: an above-average actuary with an honours degree in mathematics from Cambridge who possibly had more brains than the whole of HR Department) asked

why I wasn't doing so, I pointed out that it meant getting everyone else to do things at times that suited myself. It took him nearly one second to think about it and realise that I was right (I could see it in his face). No one raised the question with me again. It wasn't that he was concerned about me manipulating him—he would have considered it "fair game" if either of us imagined that I could—but that our firm would have lost the goodwill of stockbrokers and investment banks if I had tried to do it to them.

Robert Pozen is quite correct in saying, "The central idea of the book is that what counts is not the time that you put in but the results you achieve." That does not—repeat, not—require you to keep umpteen people hanging around for half an hour because it is "better" to keep them waiting than to waste a couple of minutes of your own time.

John Borgars, FSIP  
United Kingdom