

# ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING

A Guide for Investment Professionals



CFA Institute



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# **ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING**

A Guide for Investment Professionals

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CFA Institute is the global association of investment professionals that sets the standards for professional excellence. We are a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community.

Our mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

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# Abstract

*The practice of considering environmental, social, and governance (ESG) issues in investing has evolved significantly from its origins in the exclusionary screening of listed equities on the basis of moral values. A variety of methods are now being used by both value-motivated and values-motivated investors in considering ESG issues across asset classes. There is, however, a lingering misperception that the body of empirical evidence shows that ESG considerations adversely affect financial performance. For investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete investment analyses and better-informed investment decisions.*

## Introduction

A critical factor in the financial performance of investments is the investor's ability to identify drivers of the expected risk and return of investments. Financial analysts and portfolio managers are expected to be familiar with the financial factors that drive the value of an investment. However, issues that are difficult to measure in monetary terms and that do not form part of traditional financial metrics also affect the risk and return of investments—at times, decisively. In general, they are referred to as *environmental, social, and governance* (ESG) issues.

ESG issues are often highlighted by news media when investors suffer sudden and substantial losses on listed equities—losses that are attributed to poor management of risks posed by one or more of these ESG issues. For example, at a number of companies—including Petrobras, Enron, Banco Espírito Santo, Parmalat, and Toshiba—governance risk has proved costly for investors.

Regarding environmental risks, the health and safety record of BP in the run-up to the Gulf of Mexico oil spill in 2010 was worse than that of its peer group. When this fact was brought to the fore after BP's share price had fallen, it reinforced the need to analyze ESG performance indicators. The ongoing drought in California has also re-emphasized the need to consider water stress, a prominent ESG issue, in investment analyses for the businesses concerned, from agricultural farming to semiconductor manufacturing. Concerns about climate change and fossil fuel assets becoming stranded are finding expression in shareholder resolutions at the annual meetings of large oil companies, such as Shell.

In addition, social issues (e.g., labor relations) can have a significant and direct impact on a company's financial performance—for instance, the South African mining company Lonmin experienced a breakdown in its relationship with its workforce in 2012. For other companies, labor relations may have an indirect impact through reputation—for example, Walmart is frequently criticized for its labor practices.

In the past, the governance issues were seen as relevant mainly for *value*-motivated investors and the environmental and social issues as relevant mainly for *values*-motivated investors. Not anymore. There is a growing realization that whether motivated by economic value or moral values, ESG issues are relevant for all long-term investors.

Although ESG issues often receive attention owing to extreme events that cause sharp drops in the stock prices of relatively large listed companies, they are *not* confined to equities, extreme events, or large companies. The ESG issues and related megatrends, such as scarcity of a natural resource (e.g., potable water) and changing demographics (e.g., the economic rise of pro-sustainability millennials), are relevant to investment risk and return across asset classes.

*For investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions.*

This guide is divided into three chapters. Chapter 1 provides background information needed to understand ESG considerations in investing, Chapter 2 explains the application of different methods of considering ESG issues, and Chapter 3 explores salient issues in the debate on ESG considerations.

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# 1. Background: ESG Issues in Investing

This chapter provides the context for this guide as well as shares information needed to understand the discussion on ESG issues in investing.

## 1.1. Context and Objectives of This Guide

CFA Institute has been educating investment professionals on governance issues in investing for many years. In 2005, CFA Institute published “The Corporate Governance of Listed Companies: A Manual for Investors,” which was followed by a second edition in 2009.

In 2008, with the growth in the body of knowledge on social and environmental issues, CFA Institute published “Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors.” The focus of the publication was how to integrate ESG risk and opportunity issues into a fundamental analysis of listed equities. Since then, CFA Institute has continued to produce educational content on ESG issues in investing in a variety of forms (e.g., short books, articles, conference proceedings, video, and audio). A number of CFA Institute members in different parts of the world who are on the cutting edge of the practice of considering ESG issues in investing have been keen to work with CFA Institute to produce more educational content in this area. There is also interest in knowing the perspective of members regarding ESG considerations in investments. Since 2013, CFA Institute has been pursuing its Future of Finance initiative,<sup>1</sup> a global effort to shape a more trustworthy, forward-thinking financial industry that better serves society. These developments, together with a perceived need for a brief guide for investment professionals on the state of ESG considerations in investing, have led to the publication of this guide. As stated by Paul Smith, CFA, president and CEO of CFA Institute:

CFA Institute believes that every investment analyst should be able to identify and properly evaluate investment risks, and ESG issues are a part of this evaluation, our exam curriculum emphasizes risk management, and our members are increasingly interested in continuing education materials on ESG.

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<sup>1</sup>See [www.cfainstitute.org/FutureFinance](http://www.cfainstitute.org/FutureFinance).

In this context, the objectives of this guide are to (1) serve as a primer for investment professionals on ESG considerations in investments across asset classes, (2) inform the reader of the state of the discussion and practices regarding ESG considerations in investments, and (3) share the views of CFA Institute members regarding ESG considerations in investments.

Throughout this publication, we refer to the results of a survey of CFA Institute members on ESG issues. On 26 May 2015, 44,131 members who are portfolio managers and research analysts were invited via email to participate in an online survey. The survey closed on 5 June 2015; 1,325 valid responses were received, for a response rate of 3% and a margin of error of  $\pm 2.7\%$ .

This guide was written in collaboration with practitioners who specialize in ESG issues. Some case studies included in this guide were contributed by these professionals and are duly sourced to them.

## 1.2. Examples of ESG Issues

There is no one exhaustive list of ESG issues. ESG issues are often interlinked, and it can be challenging to classify an ESG issue as only an environmental, social, or governance issue, as **Table 1** shows.

These ESG issues can often be measured (e.g., what is the employee turnover for a company?), but it can be difficult to assign them a monetary value (e.g., what is the cost of employee turnover for a company?).

| Table 1. Examples of ESG Issues       |                               |                             |
|---------------------------------------|-------------------------------|-----------------------------|
| Environmental Issues                  | Social Issues                 | Governance Issues           |
| ■ Climate change and carbon emissions | ■ Customer satisfaction       | ■ Board composition         |
| ■ Air and water pollution             | ■ Data protection and privacy | ■ Audit committee structure |
| ■ Biodiversity                        | ■ Gender and diversity        | ■ Bribery and corruption    |
| ■ Deforestation                       | ■ Employee engagement         | ■ Executive compensation    |
| ■ Energy efficiency                   | ■ Community relations         | ■ Lobbying                  |
| ■ Waste management                    | ■ Human rights                | ■ Political contributions   |
| ■ Water scarcity                      | ■ Labor standards             | ■ Whistleblower schemes     |

### 1.3. ESG Considerations Are Not New

The consideration of ESG issues in investing for economic value is not a new phenomenon. Many investors have long considered such issues in fundamental investment analysis by including an assessment of reputational risk, regulatory developments, or such megatrends as an aging population. Some ESG analysis is also built into traditional analytical frameworks, such as Porter's Five Forces. The modern references to ESG analysis, however, refer to a systematic consideration of relevant and material ESG issues rather than to a cursory inclusion of one or more of them. The consideration of ESG issues is a complement to (not a substitute for) traditional fundamental analysis, and ESG issues remain relevant throughout the investment process—from the initial analysis to the buy/sell/hold decision to ongoing ownership practices.

Because of the prominence of large corporations in the global economy and the large proportion of corporate securities held by fiduciary investors, as well as the challenge of trust in finance,<sup>2</sup> there is also a sustained interest in ESG issues in investing by civil society, policymakers, and, of course, news media.

### 1.4. Various Labels, Same Issues

Various labels are used to describe investments that consider ESG issues, from the relatively traditional *socially responsible investing* to the more recent *responsible investing* and *sustainable investing*. Traditional socially responsible investing is most closely associated with avoiding morally questionable businesses, whereas sustainable investing is usually characterized by identifying investment risks and opportunities with the help of ESG analysis. There is, however, a lack of consistency in the use of such labels, and different labels can be used to mean overlapping ideas. Today, those who say they practice socially responsible investing describe it in much the same way as those who say they practice sustainable investing. The common theme underlying the various labels is an emphasis on ESG issues. Therefore, in this guide, we use the relatively neutral term ESG issues to remain focused on how these issues need to be considered for a more complete investment analysis and better-informed investment decisions regardless of how the investment may be labeled.

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<sup>2</sup>See [www.cfainstitute.org/learning/future/getinvolved/Pages/investor\\_trust\\_study.aspx](http://www.cfainstitute.org/learning/future/getinvolved/Pages/investor_trust_study.aspx).

## 1.5. Moral Values vs. Economic Value

Investors consider ESG issues for various reasons. Some may see them solely as economic risks and opportunities—a source of economic value. Others may see ESG issues not just as risks and opportunities but also as a matter of moral values. Those motivated by moral values may not wish to become complicit in actions they find objectionable or may actively attempt to make a positive impact on society or the environment. For instance, regardless of the economics of investing in the tobacco industry, an individual investor or a health-related charity may find investing in tobacco unacceptable because smoking is harmful to one's health. But other investors may not share the same concerns. They may invest in the tobacco industry if they believe it is an economically attractive investment, and they may look at ESG issues simply to complement their traditional financial analysis. A fundamental point in the “value versus values” debate is that all investors pursue the same *economic value* (even if with different investment objectives and time horizons), but they inevitably have different *moral values*. The different exclusionary screens used in traditional socially responsible investing help explain the different values being implemented in investing.

Both the values-based and the value-based ESG approaches co-exist in investment management. Values-based investing has also shown growth and evolution. For example, consider that in faith-based finance, the global Islamic finance industry is widely reported as one of the fastest-growing segments in finance. Similarly, there is much interest among both investors and policymakers in modern impact investing, which blends value and values. That said, value-based investing is clearly larger than values-based investing.

## 1.6. Short-Termism

A major and recurring theme regarding ESG issues is that they do not fit well with short-termism in investing—that is, the excessive focus of some corporate leaders, investors, and analysts on quarterly earnings and a lack of attention to long-term value creation. There are structural reasons and practices that cause short-termism in financial markets, most notably, financial incentives and culture. ESG issues do not fit well with short-termism because they tend to affect financial performance over longer periods. For instance, the poor governance of a large company is more likely to affect the company over the long term than in the next quarter. CFA Institute has been covering the issues of short-termism and corporate culture in its publications, and in the interest of brevity, we do not discuss those issues here.<sup>3</sup>

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<sup>3</sup>To see our work on short-termism, see [www.cfainstitute.org/ethics/topics/Pages/explore\\_short\\_termism.aspx](http://www.cfainstitute.org/ethics/topics/Pages/explore_short_termism.aspx).

## 1.7. Externalities

Whose responsibility are the externalities linked to ESG issues, such as climate change? More specifically, can the burden of externalities be left to governments and regulators to bear alone?

One view is that confronting climate change through government policy, such as the EU's emissions-trading system, has yet to generate the desired results. Investors should not knowingly leave something to governments that governments have yet to deal with effectively and that will inevitably affect the lives of beneficiaries of the investments. Another view is that fiduciary investors cannot be expected to take responsibility for what is beyond their control, and it is unrealistic to bring externalities within the ambit of fiduciary responsibility.

Perhaps a middle ground between these two views on externalities and investment management is the pursuit of “stewardship” along the lines of the UK Stewardship Code, with a “comply or explain” requirement, which “aims to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders.”<sup>4</sup> Another case in point is the Code for Responsible Investing in South Africa, which “gives guidance on how the institutional investor should execute investment analysis and investment activities and exercise rights so as to promote sound governance.”<sup>5</sup>

An interesting case in this debate on externalities is the very large investment funds with global portfolios—“universal owners”—that are exposed to the risk that some investments in the portfolio may affect the returns of other investments. For example, some companies might benefit by externalizing environmental costs through pollution, which, in turn, affects other companies, thus affecting the returns of the universal owner's portfolio. Externalities are an economic reason why universal owners should engage with investee companies and policymakers, but the wider debate on externalities and institutional investors is far from settled.

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<sup>4</sup>See [www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx](http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx).

<sup>5</sup>See [www.iodsa.co.za/?page=CRISACode](http://www.iodsa.co.za/?page=CRISACode).

## 1.8. Majority Consider ESG Issues

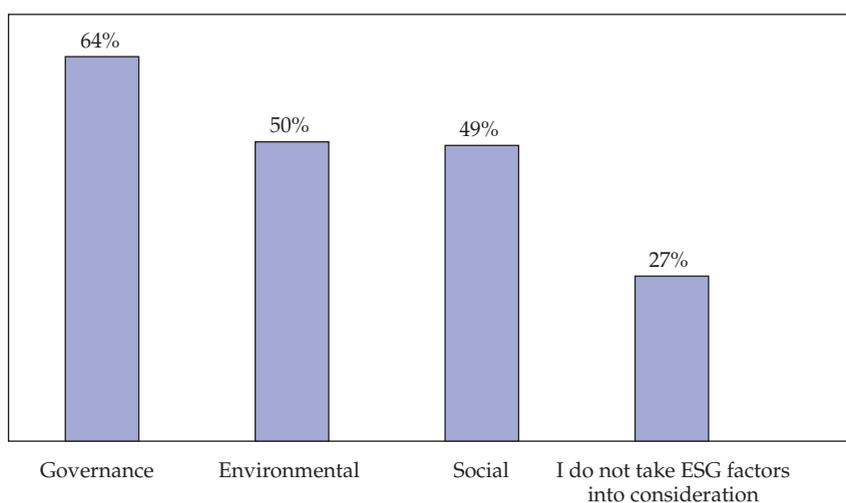
The discourse on ESG issues is based on the premise that these issues, particularly the environmental and social issues, do not receive sufficient consideration in investment decision making. A number of reasons are offered to explain why this is the case. Three stand out:

- It is difficult to assign a monetary value to ESG issues and to integrate them into quantitative models.
- ESG-related disclosure by companies may be limited, unverified, and nonstandardized.
- ESG issues tend to influence financial performance in the long term whereas many investors, as suggested earlier, have relatively short-term horizons.

Despite these challenges, consideration of ESG factors is becoming more common. Evidence points to a growing awareness of ESG issues in investing. In our survey, only 27% of respondents said that they do not consider ESG issues. Thus, 73% consider at least environmental, social, or governance issues, or combinations thereof, in investment decisions (**Figure 1**).

**Figure 1. ESG Issues Considered**

*Which, if any, of the following ESG issues do you take into account in your investment analysis or decisions?*

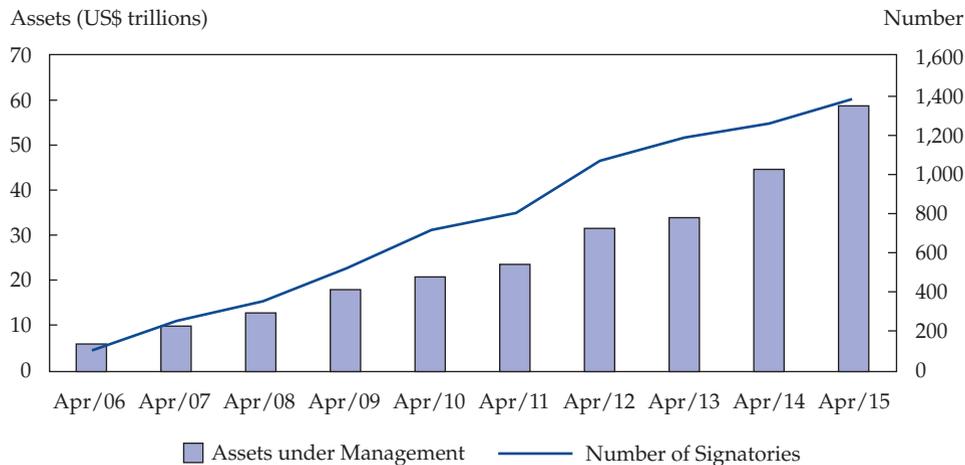


## 1.9. Awareness Has Been Growing

A well-known indicator of the increasing awareness of ESG issues is the rapidly growing list of signatories to the United Nations–supported Principles for Responsible Investment (PRI), the principal framework for investors who wish to integrate the consideration of ESG issues into their investment decision making. According to PRI, the assets under management (AUM) of its signatories have grown from less than \$6 trillion at PRI’s launch in 2006 to nearly \$60 trillion as of April 2015 (**Figure 2**).

Critics argue that such voluntary consideration of ESG issues results in a reclassification of AUM without a substantive change in how investment decisions are made. Their point is not without merit, and we discuss this criticism later in the guide. But the sheer size of these assets supports the view that many asset owners, investment firms, and professional service providers are giving important consideration to ESG issues in making their investment decisions.

**Figure 2. PRI Signatories and Assets under Management**

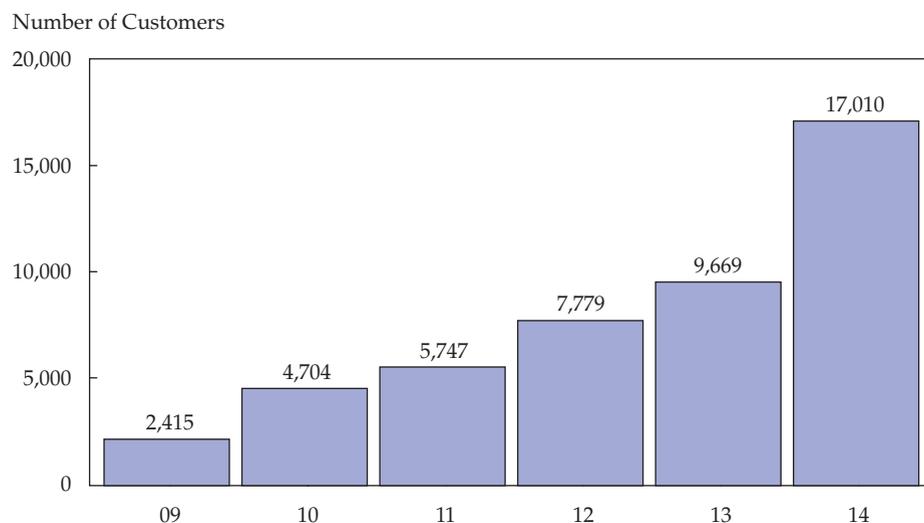


## 1.10. ESG Data Usage Rising

Another indicator of the growing awareness and consideration of ESG issues is the availability and usage of ESG data and professional services. According to Bloomberg, the number of its customers using ESG data grew by 76% during 2013–2014 (**Figure 3**).

There is a growing number of ESG data and research providers as well as rankings and ratings from both mainstream and specialized providers, such as Reuters, MSCI, and Sustainalytics. Morningstar, a well-known provider of investment research, has announced that it will start offering ESG scores for funds in 2015.

**Figure 3. Bloomberg ESG Data Unique Users, FY2009–FY2014**



## 1.11. ESG Issues: To Consider or Not to Consider

Responding to the question, “Why do you take ESG issues into consideration in your investment analysis/decisions?,” the highest proportion of survey respondents selected “to help manage investment risks.” This response is consistent with the literature on ESG issues, which tends to describe them primarily as risk factors. The fact that clients/investors demand it came in second, which makes intuitive sense. When asset owners demand that investment managers pay attention to ESG issues, managers must take notice. The asset owners could be motivated by value and/or values. Interestingly, “regulation requires it” was selected by only 7% of respondents, supporting the view that the consideration of ESG issues in investing is not led by regulation (see **Table 2**).

We asked those who responded that they do not consider ESG issues to share their reasons why. The top two reasons were lack of demand from investors and the immateriality of ESG issues. Not surprisingly, when these respondents were asked what would make them consider ESG issues, the top two reasons were demand from clients/investors and the materiality of ESG issues with respect to financial performance (see **Figure 4**).

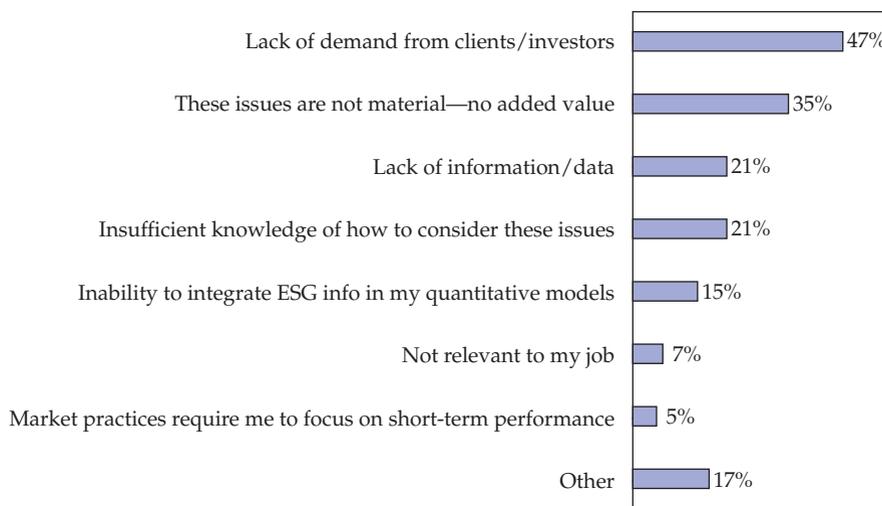
We return to the critical issue of financial performance and ESG issues later in the guide.

**Table 2. Why Consider ESG Issues?**

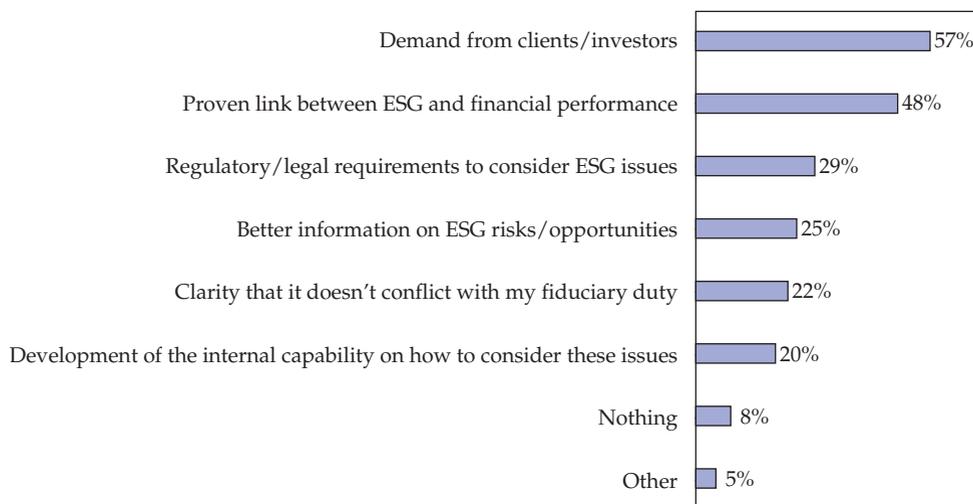
| Survey Response                                   | Respondents (%) |
|---|-----------------|
| To help manage investment risks                   | 63              |
| Clients/investors demand it                       | 44              |
| ESG performance is a proxy for management quality | 38              |
| It’s my fiduciary duty                            | 37              |
| To help identify investment opportunities         | 37              |
| My firm derives reputational benefit              | 30              |
| Regulation requires it                            | 7               |
| Other   | 5               |

**Figure 4. Reasons for Not Considering/Considering ESG Issues**

*A. Why do you not take any ESG issues into consideration in your investment analysis/decisions?*



*B. What, if anything, would cause you to begin considering ESG issues in your investment analysis/decisions?*



## 1.12. Focusing on the Relevant and the Material

There are numerous ESG issues, and an investment analyst must narrow them down to a set of issues that are most relevant and material. This process requires reasoning and empirical work and will vary by sector. For example, utilities face greater exposure to environmental risks than do software providers, just as clothing manufacturers face supply chain challenges concerning labor standards that do not seem to affect the financial services industry. A company that incorporates ESG exposures into its long-term strategic planning and adequately communicates that fact to investors will provide a more complete picture of its prospective value.

Complementing traditional financial analysis with a consideration of ESG issues faces the challenge of the changing relative importance of these issues over time. In spite of this challenge, some industry- and sector-specific ESG performance indicator standards have been developed by such entities as the European Federation of Financial Analysts Societies and the Sustainability Accounting Standards Board.

## 1.13. Climate Change and Other Environmental Issues

According to the Intergovernmental Panel on Climate Change (2014), the continued emission of greenhouse gases is “increasing the likelihood of severe, pervasive and irreversible impacts for people and ecosystems” and risks posed by climate change would require “substantial and sustained reductions in greenhouse gas emissions.” The World Economic Forum’s “Global Risks 2015 Report” lists “failure of climate-change adaptation” as number 5 of the “top 10 risks in terms of impact” (World Economic Forum 2015, p. 3).

The risks posed by climate change mean that carbon-intensive energy sources face more regulation and taxation. Future climate change regulations will likely touch many sectors, including those outside carbon-intensive industries—most prominently, insurance.

Although climate change may be the most prominent environmental issue facing investors, it is clearly not the only one. In the CFA Institute survey, respondents rated environmental degradation and resource scarcity above climate change (see **Figure 5**).

## 1.14. Social Issues Affect More Than Reputation

Social issues play an increasingly important role in the public’s perception of investments. News of a poor health and safety record or oppressive labor practices can damage a company’s reputation and thus its profitability. Similarly, social trends, such as a growing concern about obesity, are likely to affect the long-term prospects of such sectors as food.

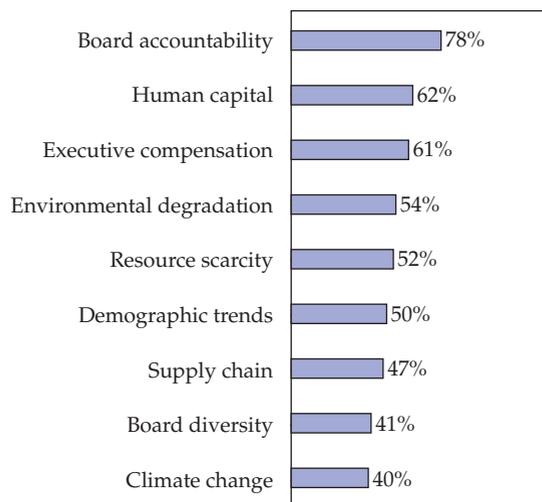
The effects of social issues, however, are not confined to reputation. A breakdown in a company’s relationship with labor or the communities it operates in can hurt its profitability. But the effects need not be permanent. Companies can change their practices and convince their stakeholders and investors that they have done so. A case in point is Nike: In the 1990s, Nike was associated with sweatshops in its supply chain in developing countries but took corrective measures to address the issue.

## 1.15. Governance Issues Widely Considered

Governance issues tend to remain relevant and material across companies and sectors. Historically, among the ESG issues, corporate governance has been covered the most in business and finance curricula and in investment research and analysis. In our ESG survey, respondents also cited a governance issue—board accountability—first when asked which set of issues they consider. Nevertheless, social issues (e.g., human capital) and environmental issues (e.g., environmental degradation) also appear among the issues rated highest by respondents (see Figure 5).

**Figure 5. Relative Importance of ESG Issues**

*Please rate the following ESG issues in terms of importance to your investment analysis/decisions on a scale of 1 to 5, where 1 is not important at all and 5 is very important.*



The top rating given by these investment professionals to board accountability, followed by a mix of social and environmental issues, differs from the impression generated by some of the ESG news flows, which often center on climate change.

## 1.16. Principles, Standards, and Advocacy

A number of principles, standards, and conventions—and associated advocacy organizations—serve as a common reference point for investors considering ESG issues, including PRI (mentioned earlier), UN Global Compact, Equator Principles, OECD Guidelines for Multinational Enterprises, International Labor Organization Declaration on Fundamental Principles and Rights at Work, SA 8000 (auditable social certification standards for decent workplaces), and ISO 26000 (guidance on how businesses and organizations can operate in a socially responsible way). Some investors use these frameworks in applying ESG methods, such as exclusionary screening and active ownership. Others are likely to refer to them in ESG integration.

There are also organizations in different parts of the world that are working to promote ESG considerations in investing. These include the Global Sustainable Investment Alliance (including USSIF and Eurosif), Global Reporting Initiative, Sustainability Accounting Standards Board, World Resources Institute, International Integrated Reporting Council, CDP (formerly, Carbon Disclosure Project), Accounting for Sustainability, Global Impact Investing Network (GIIN), and International Corporate Governance Network, among many others.<sup>6</sup>

## 1.17. Law and Regulation

A range of laws and regulations pertaining to ESG issues are already in place—and more keep coming. A 2013 study by KPMG, the Centre for Corporate Governance in Africa, the Global Reporting Initiative, and UNEP states that there are 180 laws and regulatory standards in 45 countries pertaining to corporate sustainability reporting; of those, 72% are mandatory (p. 8). A prominent example is the codes of corporate governance used in different parts of the world. Other examples include the exclusion of controversial weapons (Belgium), a stewardship code for institutional investors (United Kingdom), and disclosure of CSR (corporate social responsibility) activities of listed companies (Malaysia). A recurring development, in various parts of the world, is a requirement that investors

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<sup>6</sup>For more information about some of these organizations, see <http://bit.ly/ESG-orgs>.

disclose to what extent they consider environmental and social issues in investment decisions and shareholder rights.

## 1.18. Relevance across Asset Classes

Most of the discourse on ESG issues has been focused on listed equities, but the practice of considering ESG issues with respect to other asset classes, most notably fixed income, is growing.

In fixed income, ESG issues are mostly about risk. ESG analysis in fixed income considers how such issues as carbon emissions, labor relations, and corruption might affect issuers' creditworthiness. A useful reminder is the case of the mining company Lonmin. After violent labor conflicts in Marikana, South Africa, in 2012, the company was forced to issue a warning regarding the servicing of its debt. Thus, risk pertaining to social issues, which could easily be overlooked in a traditional financial analysis, could also prove costly for fixed-income investors.

As in equities, governance in fixed income is the most analyzed of the ESG issues. For example, in an emerging-market high-yield corporate debt issue, fixed-income investors need to understand the full corporate structure and governance of the issuing entity and related entities before making any investment decision.

In recent years, such organizations as PRI and INSEAD have put together some case studies on ESG considerations in other asset classes, including private equity, but more needs to be done to clarify how to consider ESG issues across asset classes.

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## 2. Application: The Six Methods for Considering ESG Issues

In Chapter 1, we discussed background information on ESG considerations in investing. In Chapter 2, we explain how ESG considerations in investing are being implemented. Investors use six methods for bringing ESG considerations into their decision making: exclusionary screening, best-in-class selection, thematic investing, active ownership, impact investing, and ESG integration. These methods are not mutually exclusive and are often used in combinations. They are used by both value- and values-motivated investors.

### 2.1. Exclusionary Screening

Exclusionary screening refers to avoiding securities of companies or countries on the basis of traditional moral values (e.g., products or services involving alcohol, tobacco, or gambling) and standards and norms (e.g., those pertaining to human rights and environmental protection). In values-based exclusions, the focus is on the business of the company, and entire sectors are excluded. In norms-based screening, the focus is on the company's behavior regarding internationally accepted norms in such areas as human rights and labor standards. Where such values-based avoidance is built into the governing legislation (e.g., a ban on financing controversial weapons), exclusionary screening can also become a legal obligation.

Exclusionary screening is the oldest ESG method. An important point to note regarding exclusionary screening based on values and norms is that the particular security will not be invested in regardless of how economically attractive it may become. The remainder of this section is derived from the descriptions provided by MSCI in 2014 in explaining the values-based and norms-based exclusions for its ACWI Select Global Norms and Criteria Index.

#### ***Exclusions for the ACWI Select Global Norms and Criteria Index***

Companies involved in (1) serious violations of widely accepted international norms of responsible corporate behavior and (2) certain controversial business activities are excluded. The norms-based exclusions are defined as violations of standards related to human rights, working conditions, the environment, anti-corruption, and control of weapons. The business activities exclusions are for involvement in alcohol, gambling, tobacco, military weapons, and adult entertainment.

## Examples of Violations of International Norms

*Human rights:* Companies involved in serious violations of internationally accepted norms concerning fundamental human rights, as defined in Principles 1 and 2 of the UN Global Compact, are excluded. Such violations include involvement in abuses concerning civil and political liberties, the deleterious impact of a firm’s operations on freedom of expression and free speech, and infractions concerning the rights of indigenous peoples. Companies assessed as being involved in “very severe” controversies concerning the following key performance issues are excluded: human rights abuses, support for controversial regimes, freedom of expression and censorship, and impact on local communities.

*Working conditions:* Companies involved in serious violations of internationally accepted norms concerning fundamental labor rights, as defined in Principles 3, 4, 5, and 6 of the UN Global Compact, are excluded from the index. Such violations include involvement in forced labor, child labor, employment discrimination, and failure to respect employee rights of freedom of association and collective bargaining.

## Examples of Involvement in Controversial Businesses

*Alcohol:* Companies earning greater than 5% of revenues from the manufacture, distribution, or sale of alcoholic beverages are excluded.

*Gambling:* Companies earning greater than 5% of revenues from (1) owning and/or operating gambling establishments and/or (2) the manufacture or sale of products necessary for the gambling industry are excluded.

## 2.2. Best-in-Class Selection

Best-in-class selection refers to preferring companies with better or improving ESG performance relative to sector peers. It could be implemented on either the level or the change in ESG performance—that is, investing more in companies with better ESG performance levels or momentum relative to sector peers. Best-in-class methodology is sometimes referred to as positive selection or positive alignment. In the remainder of this section, we discuss the application of best-in-class selection by NN Investment Partners.<sup>7</sup>

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<sup>7</sup>Formerly, ING Investment Management; our thanks to Nina Hodzic and Jeroen Bos for contributing information for this section.

## ***Approach to Best-in-Class Selection***

NN Investment Partners determines the relative position of companies in their respective industry by using ESG scores, which are based on both the opportunities and the risks that companies face. ESG criteria comprise around 150 factors, partly depending on the industry. Analysts look at whether a company has ESG policies and management systems in place, whether it has signed up for international initiatives, and what the actual conduct of the company is. For each industry, analysts at NN Investment Partners initially focus on the top 50% of companies in terms of ESG scores in each sector. Selection of companies that are close to the sector average depends on overall portfolio construction features, such as sector and regional risk characteristics and restrictions.

## ***Belief regarding Best in Class***

NN Investment Partners believes that the best-in-class method can improve the risk and/or return characteristics of a portfolio. A strong ESG policy makes companies more aware of the various risks they face and increases overall transparency. Companies that score well on ESG issues are often more efficient with lower environmental costs—for example, a lower electricity or water bill. In addition, these companies are expected to have empowered human capital, resulting in higher productivity and a stronger reputation among clients, other stakeholders, and society itself. A strong governance framework secures the legal position of a (minority) shareholder in many ways, which starts to matter in difficult times. A best-in-class methodology needs to be combined with a check on ESG controversies in order to avoid potentially misleading claims, or “greenwashing.” Also, momentum in ESG performance is a strong signal of a change in the market’s perception of a company. Therefore, both the level of ESG scores and the change in ESG scores over time need to be considered. Two examples of best-in-class companies, included in NN Investment Partners’ sustainable equity strategies, follow.

## ***Best in Class: ASICS***

ASICS, together with its subsidiaries, manufactures and sells sporting goods. The company is headquartered in Japan. Through constant research and innovation, the company creates products and services that help people enjoy the physical and mental benefits of sports, contributing to a healthy society. ASICS seeks to integrate sustainability as a basic consideration in the design of its processes and products and to improve sustainability throughout the entire value chain. ASICS regularly checks working conditions in its supply chain. ASICS’ rating system scores each factory on a range of criteria, such as working hours and health and safety. ASICS’ ESG score, as determined by NN Investment Partners on the basis of data from Sustainalytics, is 68.4 versus the industry average of

57.2. The company scores well above average in all three areas (environmental, social, and governance) and shows positive momentum over the years. The company exhibits strong ESG policies, reflecting a commitment to mitigate related risks and impacts. There is significant evidence that corporate behavior at ASICS is in line with its strong ESG policies.

### **Best in Class: Linde**

Linde is a global gas and engineering company headquartered in Germany. The company offers a wide range of compressed and liquefied gases as well as chemicals. Linde develops new applications in close collaboration with its customers, taking into account their specific needs. The company pays particular attention to the environmental impact of its production processes and focuses on making its technical processes and plants more energy efficient. In this way, the company can reduce carbon emissions of its own operations as well as those of its customers. The company has clear targets in the energy efficiency area. An improvement of 0.8% was reached between 2008 and 2012, and a further 0.86% a year is required to meet the 2017 target. The company's water intensity is well below the industry average. Linde's ESG score is 74.7 versus the industry average of 63.3 and shows positive momentum. The company scores well above average in all three areas (environmental, social, and governance). Linde has strong ESG policies and management systems and systematically identifies and controls risks along the product value chain. There is significant evidence that Linde is "walking the talk" with its strong ESG policies.

## **2.3. Active Ownership**

Active ownership refers to the practice of entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change. Engagement with a company could be for monitoring or influencing outcomes and practices regarding ESG issues. Active ownership is in sharp contrast to the idea that investors should vote with their feet—that is, simply sell off the investments with questionable practices.

Activism varies in terms of aggressiveness of the approach. Some investors may use publicized and confrontational measures, whereas others may prefer a more discreet approach. Note that "active ownership" is not necessarily the same as "activist investing," which may rely more on aggressive measures commonly associated with hedge funds.

The following actions are part of active ownership:

- Vote in shareholder general meetings.
- Write a letter to the company.

- Meet with company representatives.
- Raise a question at a general meeting of the shareholders.
- File a shareholder resolution.
- Attempt to gain a seat on the board.
- Call for an extraordinary/special meeting of the shareholders.
- File a complaint with the regulator/authority.
- Issue a statement to the news media.

Achieving the desired results of active ownership takes time and is not without cost—most notably, staff time—thus, some investors prefer to pool resources and outsource some of the activities related to engagement. Next, we look at case examples of active ownership directly relevant to ESG issues.

### ***JP Morgan Chase's Say-on-Pay Vote***

In the United States, say-on-pay votes are mandated by the Dodd–Frank Act. Under the statute, shareholders can endorse or object to executive compensation. Most companies can get majority support for proposed executive compensation. In 2014, according to Towers Watson, the average support for company pay practices was 91%, and only 2% of companies failed to get majority support. In 2015, in the say-on-pay vote at JP Morgan Chase, a record low percentage of shareholders approved the company's pay packages for its executives. This compensation proposal also faced criticism from proxy adviser Institutional Shareholder Services. In total, 61% voted in favor of the measure at the annual meeting—down from 79% in 2014 and 94% in 2013. After the vote, it was reported that JP Morgan's board would consider changes to compensation policies for top executives.

### ***The Church of England and Environmental Standards***

In 2013, the Church Investors Group (of the Church of England) continued its engagement program of encouraging companies that operate in carbon-intensive sectors, or that could be considered laggards in comparison with their peers, to report their greenhouse gas emissions to the CDP (formerly, Carbon Disclosure Project) and to adopt emissions-reduction measures. To enable engagement across the whole market, the initiative was based on sending tailored letters to the targeted companies. The program resulted in a

72% improvement in the environmental performance of the 53 companies targeted. An academic assessment of the initiative showed, with 90% confidence, that Church Investors Group members were responsible for the most improvement among the FTSE 250 companies.<sup>8</sup>

## **Mitigating Governance Risk through Engagement**

During 2013–2015, Sparinvest, an asset management firm in Denmark, held a dialogue with the management of a telecom company headquartered in Japan to improve both the substance and the transparency of the latter’s anti-corruption strategies, policies, and systems. This engagement between Sparinvest and the telecom company was part of a wider engagement coordinated by PRI. Through meetings and regular communications with management, Sparinvest encouraged the company to improve in a number of indicators, including greater disclosure around whistleblower policies and incidents; the application of anti-corruption policies to contractors, subcontractors, and suppliers; and internal risk assessments and regular monitoring of the internal anti-corruption program. During the period of engagement, the company issued its first annual report with information on the integration of its sustainability and corporate social responsibility practices as well as its first anti-bribery handbook for its increasingly global workforce, covering such risks as facilitation payments. Most significantly, the company issued a clear statement of zero tolerance of corruption. At the beginning of the engagement, in 2013, a third-party provider scored the company—on the basis of public disclosure and a binary scoring method—25% against a series of 18 governance-related indicators. After the engagement with Sparinvest, the company’s score rose to 81%.<sup>9</sup>

## **2.4. Thematic Investing**

Thematic investing refers to investing that is based on trends, such as social, industrial, and demographic trends. A number of investment themes are based on ESG issues, including clean tech, green real estate, sustainable forestry, agriculture, education, and health. Although thematic investing is not confined to ESG issues, here we focus on examples of thematic investing that pertain to ESG issues.

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<sup>8</sup>Church Investors Group, “Being Good Stewards: Church Investors and Corporate Engagement” ([www.churchinvestorsgroup.org.uk/system/files/documents/JamesCorah/CIG-GoodStewards.pdf](http://www.churchinvestorsgroup.org.uk/system/files/documents/JamesCorah/CIG-GoodStewards.pdf)).

<sup>9</sup>Olivia Mooney, Principles for Responsible Investment; information courtesy of David Orr, Sparinvest.

## ***Profile of a Water- and Air-Themed Fund***

This fund is for investors who (1) wish to invest in the shares of companies focused on the water-related sector worldwide, (2) are willing to bear significant variations in market value and thus have a low aversion to risk, and (3) have a long-term investment horizon (at least seven years). It aims to invest in equities issued by companies operating in the water and air sectors worldwide. The companies targeted in the water sector include water production companies; water conditioning and desalination companies; water suppliers; water bottling, transport, and dispatching companies; companies specializing in the treatment of waste water, sewage, and solid, liquid, and chemical waste; companies operating sewage treatment plants; and companies providing equipment, consulting, and engineering services in connection with these activities. The companies targeted in the air sector include those responsible for inspecting air quality, suppliers of air-filtration equipment, and manufacturers of catalytic converters for vehicles. The fund invests at least two-thirds of its total assets in equities issued by companies operating in the water sector.

## ***Profile of an Alternative Energy-Themed Fund***

The investment objective of this fund is to provide investors with long-term capital. To achieve this objective, the fund intends to invest at least 80% of its net assets in equity securities of globally based companies involved in the alternative energy or energy technology sectors. Alternative energy includes energy derived from such sources as solar and wind power, hydro-electricity, tidal flow, wave movements, geothermal heat, and biomass/biofuels. Energy technology includes technologies that enable these sources to be harnessed; various kinds of storage and transportation of energy, including hydrogen and other types of fuel cells, batteries, and flywheels; and technologies that conserve energy or enable more efficient use of energy. Fund managers believe that over the next 20 years, the alternative energy sector will benefit from the combined effects of higher energy prices driven by population growth, developing world industrialization, and diminishing fossil fuel supplies; falling costs of alternative energy assets as the technology improves; energy security concerns; and climate change and environmental issues. The fund is a long-only equity portfolio of 30 equally weighted positions.

## ***Profile of a Food- and Agriculture-Themed Fund***

This fund seeks to achieve capital appreciation. To achieve this investment objective, it invests in a global and diversified portfolio of investments that provide exposure to the food and agriculture sectors. The fund is permitted to invest in a broad range of instruments, including transferable securities, units in collective investment schemes, exchange-traded funds, and exchange-traded commodities. It intends to take full advantage of the

ability to invest directly in derivatives in order to achieve the objective. In particular, the fund is expected to combine core conventional long-only holdings with synthetic equity swaps, contracts for differences for long and short equity positions, stock indexes or stock index options, and equity derivatives and equity derivatives baskets.

## 2.5. Impact Investing

Impact investing refers to investing with the disclosed intention to generate and measure social and environmental benefits alongside a financial return. According to Global Impact Investing Network, the practice of impact investing has four core characteristics: (1) investors intend to have a social and/or an environmental impact, (2) investments are expected to generate a financial return on capital and, at a minimum, a return of capital, (3) investments are to generate returns that range from below market to risk-adjusted market rate, and (4) investors are committed to measuring and reporting the social and environmental impacts.

The following examples concern Bridges Ventures, an impact investing specialist firm founded in 2002 in the United Kingdom.

### *Investment Strategy*

According to the firm, its

investment strategy is to focus on opportunities where investments can generate investor returns through helping meet pressing social or environmental challenges—be it backing businesses that generate jobs in underserved markets, or building environmentally friendly care homes for the elderly to sustain an ageing population, or providing flexible financing for innovative community transport models.

### *The Gym*

The Gym pioneered the concept of low-cost gyms in the United Kingdom, opening its first site in 2008. It provides fitness facilities in purpose-built gyms that are open 24 hours and located mainly in underserved areas. The transaction represents a 50% internal rate of return (IRR) and a 3.7× multiple for investors in Bridges funds, of which a minority were rolled over to retain a 25% stake going forward, enabling these investors to benefit from the future growth in the business.

## The Hoxton

The investment in the hotel The Hoxton produced employment for one of the bottom 3% of deprived wards in England. More than 70% of The Hoxton staff live in underserved areas. The hotel has won praise and awards from different publications, including *GQ*, the *Guardian*, and Observer Travel Awards. It has consistently achieved 90% or greater occupancy rates for its 208 rooms. The exit delivered a return of £13.3 million to Sustainable Growth Fund I, representing an IRR of 47% and 8.8× the total investment, and £1.9 million to Sustainable Growth Fund II, representing an IRR of 35% and 3.4× the total investment.

## SimplySwitch

SimplySwitch is an independent and free online and telephone-based price comparison and switching service that offers consumers immediate, impartial information on the most economical and appropriate gas, electricity, home phone, broadband, and mobile phone suppliers. It was also the first service of its kind to be accessible by telephone as well as the web, making it easier for those who lack the resources or know-how to go online to save money on their household bills. SimplySwitch was sold for £22 million. The exit returned £7.5 million, which represented a money multiple of 22× for investors.<sup>10</sup>

## 2.6. ESG Integration

ESG integration refers to systematic and explicit inclusion of ESG risks and opportunities in investment analysis. Unlike the best-in-class method, ESG integration does not necessarily require peer group benchmarking or overweighting (underweighting) the leaders (laggards). Similarly, ESG integration does not require any *ex ante* criteria for inclusion or exclusion. The integration of ESG risks and opportunities into investment analysis is relevant for most, if not all, investors. The following are examples of ESG integration.

### *Valuation of Mining Companies and ESG Risks*

When valuing stocks in the mining sector, analysts at Citi Research analyze the management of the relevant ESG issues by the mining companies. In particular, analysts carry out environmental and social impact assessments and closure planning to gauge the quality of the process that mining companies use to assess and manage the environmental and social impacts of a mine throughout its life and beyond. As part of these assessments,

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<sup>10</sup>See [www.bridgesventures.com/exits](http://www.bridgesventures.com/exits).

analysts use environmental indicators (e.g., the ISO 14001, a family of standards that provide practical tools to manage environmental responsibilities) as well as health and safety indicators (e.g., lost production time due to labor injury frequency), along with an analysis of government relations and local economic and community engagement. These analysts are of the view that effective management of ESG risks can significantly reduce mine development lead times, which they see as critical to future earnings capacity. Exercising their judgment, the analysts appropriately adjust the discount rate for mining companies that have lower ESG risks. For example, in one case, the discount rate of a mining company with better ESG management was adjusted from 10.7% to 7.5%, which increased the estimated intrinsic value of its stock by 29%.<sup>11</sup>

## ***Valuation of a Mining Stock and ESG Issues***

Anglo American, a mining company with operations spread across a number of countries, has received mixed assessments of its ESG performance. Although some analysts have taken a favorable view of the company's ESG performance for such reasons as its risk mitigation processes and track record on environmental management, others have taken a different view. In 2015, analysts at Robeco, an asset management company, stated that Anglo American scores low on some of its most material ESG issues, such as occupational health and safety and management of local stakeholders. These analysts believe that in platinum mining, Anglo American's profitability is affected by wage inflation and labor strikes. Accordingly, these analysts revised their forecasts of costs upward by 400 bps, which reduced margins by 80 bps and the target price by -7%. In addition, reflecting several ESG factors, analysts at Robeco adjusted the weighted average cost of capital upward by 50 bps, which reduced the target price by -12%. The total impact of integrating ESG risk analysis into the Robeco analysts' estimate of Anglo American's target price is -19%.<sup>12</sup>

## ***Valuation of Utilities and ESG Risks and Opportunities***

In the United States, the Environmental Protection Agency's emission and carbon regulations are expected to have a material impact on valuing the power sector. Analysts at ClearBridge Investments believe that these regulations will increase the operational costs of the power plants with higher emission levels (e.g., older, less efficient coal plants) and require additional environmental spending. According to these analysts, incremental expenditures on environmental retrofits should make smaller, older coal plants uncompetitive and lead to their retirement. Implementation of mercury regulations alone could

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<sup>11</sup>Justin Sloggett, Principles for Responsible Investment, email message to one of the authors.

<sup>12</sup>Justin Sloggett, Principles for Responsible Investment, email message to one of the authors; our thanks to Willem Schramade, Robeco Asset Management, for permission to use the Robeco information.

lead to retirement of an estimated 17% of the country's coal-fired capacity by 2017. Thus, the companies owning newer plants with lower emissions (consisting of renewables, efficient coal, combined cycle gas plants, and nuclear plants) will be relative winners. The increasing penetration of distributed solar power generation and utility-scale energy storage will have a disruptive effect on utilities over the longer term. For example, NextEra Energy (NEE), the largest wind and solar energy producer in the United States, will see a higher output growth and a more efficient cost structure than some of its peers as it drives earnings growth with these low-carbon energy sources. ClearBridge analysts believe that NEE has an attractive above-average earnings growth rate of 6%–8% and an attractive relative valuation.<sup>13</sup>

## Deepwater Horizon and BP Credit Default Swap Spreads

Poor management of ESG factors can contribute to corporate default, price volatility of credit securities, credit rating downgrades, and widening credit default swap (CDS) spreads. Consider the example of BP. On 20 April 2010, the *Deepwater Horizon* oil-drilling platform exploded, killing 11 workers and resulting in a large oil spill, the results of which cost BP several billion dollars. Prior to the catastrophe, some of the ESG research on BP had shown that the company had significant safety and environmental violations at its US operations, including fines. For example, in March 2005, 15 people died and 180 were injured in an explosion at BP's Texas City refinery; in March 2006, there was a massive spill from a BP pipeline at Prudhoe Bay, Alaska. Most investors were not paying attention to the concerns that some ESG research reports had raised. In 2010, as news of the oil spill hit the markets, the BP five-year CDS spread jumped from under 100 bps to as high as 600 bps. Only then did market participants start to pay attention to BP's unenviable record on health and safety. Not only BP's shareowners but also its creditors were affected. Had investors paid attention to ESG research, they could have taken a number of actions to manage BP's higher-risk profile—for example, by underweighting BP in their portfolios or by engaging with BP to improve its health and safety standards.<sup>14</sup>

## ESG in Private Equity: Apax Partners

Apax Partners adopted the Private Equity Council's guidelines for responsible investment in 2009 and became a signatory to the Principles for Responsible Investment in 2011. According to Apax Partners, it considers sustainability issues in the early stages of

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<sup>13</sup>According to Tatiana Thibodeau, senior analyst at ClearBridge Investments (<http://www.clearbridge.com>).

<sup>14</sup>Presentation by Christoph Klein on ESG integration in fixed income at the 2015 CFA Institute Annual Conference.

any potential investment opportunity and monitors them throughout its stewardship of the investee company. Apax Partners has a number of initiatives in place in its portfolio companies to reduce complexity, waste, and energy consumption. Two examples, the first pertaining to energy and the second to waste management, follow.

*Plantasjen:* This company has improved its energy performance by increasing insulation in all newly built stores and by installing heat pumps in six stores in the last 12 months. The increased insulation has reduced the energy consumption of the newly built stores by approximately one-third compared with older stores, and the newly installed heat pumps have reduced energy consumption by approximately 20%.

*KCI:* This company offers a recycling program for facilities and patients that allows the safe disposal of certain single-patient negative pressure wound therapy (NPWT) devices. KCI provides this recycling program free of charge to the customer. KCI has partnered with Sharps Compliance Inc. to convert customer-recycled KCI single-patient NPWT devices into PELLA-DRX, an industrial resource with a BTU content greater than or equal to that of coal. Therefore, none of the Sharps Compliance-processed medical waste ends up in a landfill; instead, it is repurposed into an industrial resource capable of powering homes and businesses.<sup>15</sup>

## 2.7. ESG Integration Used More Widely

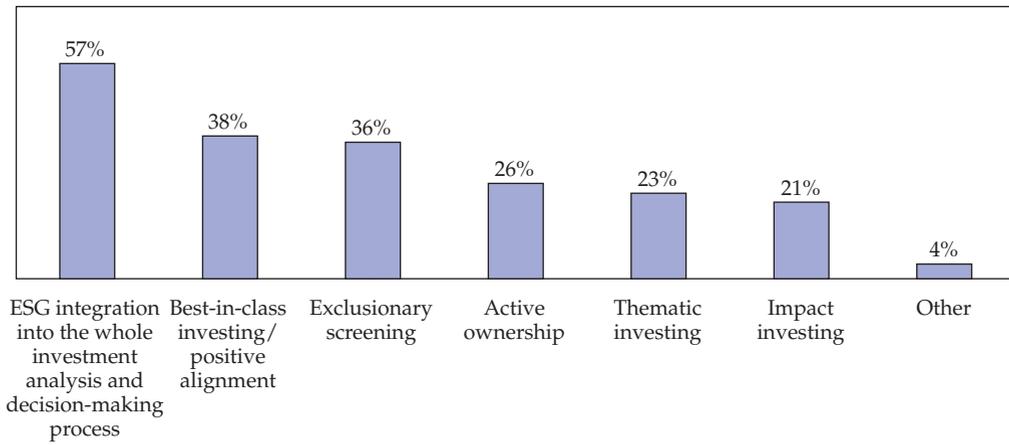
Our survey responses indicate that ESG integration is the most used (57%) of the six methods available. This finding contrasts sharply with the perception that ESG issues are only about the exclusionary screening of “sin stocks” (alcohol, tobacco, and gambling). With the signatories of PRI, which emphasizes ESG integration, having nearly \$60 trillion (as of April 2015) in AUM, it makes intuitive sense that ESG integration is becoming more common among investment professionals (**Figure 6**).

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<sup>15</sup>The case study on Apax Partners was adapted from INSEAD, “ESG in Private Equity: A Fast-Evolving Standard” (2014): <http://centres.insead.edu/global-private-equity-initiative/research-publications/documents/ESG-in-private-equity.pdf>.

**Figure 6. Methods of Considering ESG Issues**

*A. How do you take ESG issues into consideration in your investment analysis/decisions?*



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## 3. Debate: Issues regarding ESG Considerations

In this third and final chapter, we cover a range of issues that come up in the debate on ESG considerations in investing.

### 3.1. Disclosure Remains a Challenge

Investors can consider ESG issues in their investment decisions only if they have relevant and timely information to do so. At present, mandatory corporate disclosure provides limited information on ESG-related risks and opportunities. The ESG-related disclosure may be released at a different time than the regular financial statements, making integration harder.

It is worth noting, however, that disclosure and data have improved. Some initiatives—such as the Sustainable Stock Exchanges Initiative,<sup>16</sup> which shows how exchanges can work together with investors, regulators, and companies to enhance corporate ESG transparency—are seeking to improve ESG disclosure. Similarly, availability of data is on the rise, even if better quality and greater quantity are needed. For instance, the number of large global companies that disclose their greenhouse gas emissions and water management and climate change strategies to CDP, an environmental nongovernmental organization, rose from 295 in 2004 to 5,003 in 2014.

Our survey shows that for the majority of respondents, public information, third-party research, and company reports are the main sources of ESG information. As many as 61% of respondents agree that public companies should be required to report at least annually on a cohesive set of sustainability indicators in accordance with the most up-to-date reporting framework (**Figure 7**).

The challenge with voluntary disclosure is that companies may disclose and exaggerate only what reflects well on them and downplay or not disclose what does not. This behavior could both limit ESG analysis and bias it in favor of disclosure rather than performance.

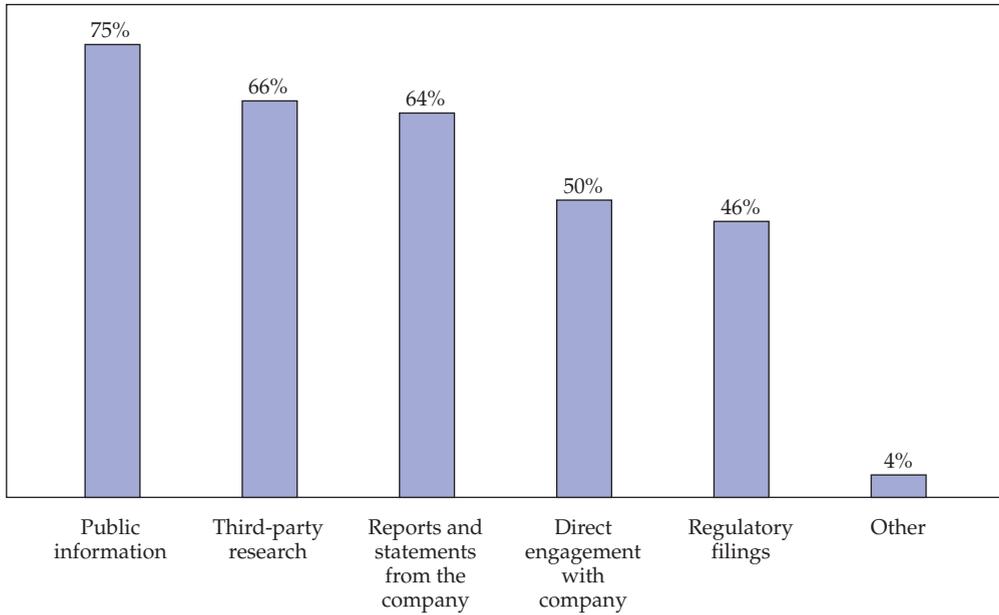
A clear majority (69%) of these respondents agree that ESG disclosures by listed companies should be subject to some level of independent verification. Respondents were divided on whether ESG disclosures should be subject to limited verification or similar to an audit and whether ESG professional services firms or public accounting firms should carry out the independent verification (**Figure 8**).

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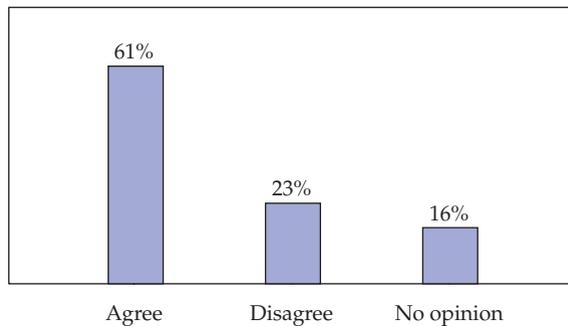
<sup>16</sup>See [www.sseinitiative.org](http://www.sseinitiative.org).

**Figure 7. ESG Information Sources and Mandatory Reporting**

*A. How do you get ESG information/data?*

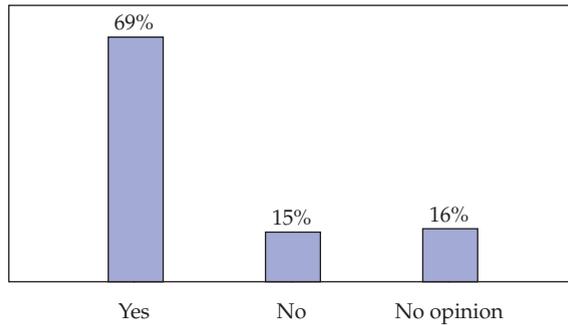


*B. Do you agree or disagree that public companies should be required to report at least annually on a cohesive set of sustainability indicators in accordance with the most up-to-date reporting framework?*

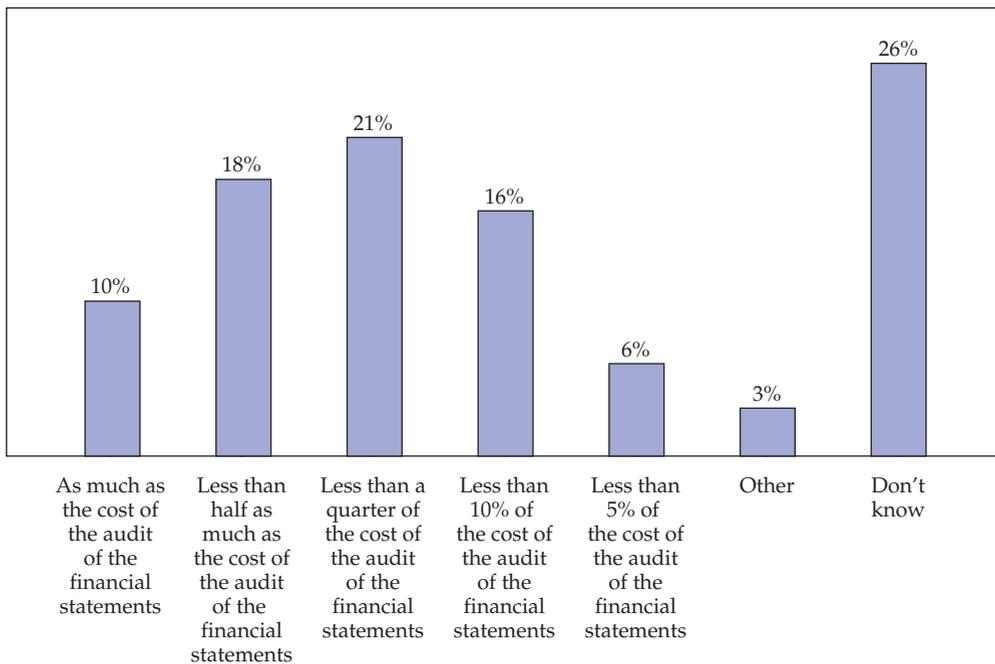


**Figure 8. Verification of ESG Disclosures and Its Cost**

*A. Do you think it is important that ESG disclosures be subject to some level of independent verification of ESG disclosures?*



*B. Which best represents your view on how much should be spent to obtain independent verification?*



Disclosure and independent verification come with a cost. Only 10% of respondents said that listed companies should spend on an ESG audit as much as they spend on an accounting audit.

## 3.2. Fiduciary Responsibility

The law regarding fiduciary duty varies from country to country and is thus difficult to generalize. Two reports—“A Legal Framework for Integrating Environmental, Social, and Governance Issues into Institutional Investment,” also known as the Freshfields Report (2005),<sup>17</sup> and the Fiduciary II Report (2009)<sup>18</sup>—found that considering ESG issues in pursuing economic value is permitted, if not required, by legal interpretations of fiduciary duty. However, there remains some ambivalence on the subject. For instance, in our member survey, when asked why they consider ESG issues, 37% of respondents indicated that they do so because it is their fiduciary duty. Among those who do not consider ESG issues, 22% suggested that they would consider ESG issues if they had clarity that doing so does not conflict with their fiduciary duty.

Based on an analysis of eight countries, including both common law and civil law jurisdictions, in the context of ESG integration, the report “Fiduciary Duty in the 21st Century” contends that “failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty” (Sullivan, Martindale, Feller, and Bordon 2015, p. 9).

The case for the consideration of ESG issues by fiduciary investors is strengthened when the law governing fiduciary duty facilitates it. For example, in South Africa, the updated Regulation 28 of Pension Funds Act 24/1956, effective 1 January 2012, explicitly includes references to ESG considerations:

A fund has a fiduciary duty to act in the best interest of its members whose benefits depend on the responsible management of fund assets. . . . Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance character.

The reasoning underlying fiduciary responsibility is inevitably linked to what effect ESG considerations have on the financial performance of investments. There is a lingering misperception that the principal ESG method is exclusionary screening, to be used by only values-motivated investors.

<sup>17</sup>See [www.unepfi.org/fileadmin/documents/freshfields\\_legal\\_resp\\_20051123.pdf](http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf).

<sup>18</sup>See [www.unepfi.org/fileadmin/documents/fiduciaryII.pdf](http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf).

### 3.3. Financial Performance

Financial performance is one area that has received substantial, if not the most, attention in research on ESG issues. The Sustainable Investment Research Initiative Library,<sup>19</sup> a searchable database of academic studies, lists hundreds of research papers regarding ESG issues, many of which are on performance.

In 2014, a report by the University of Oxford and Arabesque Partners analyzed about 200 studies to assess how sustainable corporate practices can affect investment returns. It concluded that “88% of the research shows that solid ESG practices result in better operational performance of firms and 80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices” (Clark, Feiner, and Viehs 2014).

There are other such literature reviews and metastudies. The metastudy on ESG issues and performance by Mercer (2009)—“Shedding Light on Responsible Investment: Approaches, Returns and Impact”—reached similar conclusions.

The key point is that, on the whole, the empirical evidence does not support the notion that ESG considerations necessarily adversely affect performance. In the case of ESG integration, this finding makes intuitive sense because, in principle, there should be no adverse impact on performance if it is simply about doing a more complete investment analysis.

### 3.4. Fossil Fuel Divestment and Stranded Assets

Divestment campaigns have been part of the evolution of ESG considerations in investing. A prominent divestment campaign concerned South Africa’s apartheid regime in the 1980s. Such campaigns tend to make their impact by influencing the public discourse, which could result in stigmatization of the companies and sectors involved and, more importantly, changes in legislation affecting them. The latest divestment campaign pertains to fossil fuels in the context of climate change and touches on a range of sectors, from coal mining to steel. Many educational endowments face pressure from students and other stakeholders to divest from fossil fuel. Some endowments have announced decisions to divest, whereas others have announced decisions not to divest. A key point made by divestment campaigners is that one should not be able to profit from injustice. But investment firms’ divestment based on moral values raises concerns about fiduciary duty and financial performance.

One area in which the debate on fossil fuel divestment becomes an economic consideration for fiduciary investors is *stranded assets*. There is a risk that some climate-sensitive assets, most notably fossil fuel reserves, could suffer from write-offs or downward revaluations, or

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<sup>19</sup>See [www.calpers.ca.gov/page/investments/governance/sustainable-investing/siri-library](http://www.calpers.ca.gov/page/investments/governance/sustainable-investing/siri-library).

conversion to liabilities largely because of regulation. If financial markets do not price the risks of stranded assets, investment performance could be affected.

### 3.5. Regional Differences

There are perceived differences across (and within) regions on how willing and able investment firms are to address ESG issues in investing. The results of our survey seem to confirm such differences. Some of the responses most favorable to ESG issues tended to come from the Europe, Middle East, and Africa (EMEA) region and the Asia-Pacific region and the least favorable from North America. A relatively high proportion of survey respondents in the Asia-Pacific region consider ESG issues (78%), followed closely by members in the EMEA region (74%). Respondents in the Americas region are the least likely to use ESG information in their decision-making process, but even there, a solid majority (59%) do consider ESG issues. The proportions of respondents who do not take ESG issues into consideration (33%) and do not think ESG training is necessary (30%) are highest in North America. There is a perception that, on the whole, Western Europe is leading the ESG practice. These regional differences could obviously change over time, and the reasons behind these differences are not well understood. For instance, in developed markets with relatively strong regulation, investors could arguably be assuming that some of the ESG issues are being taken care of through regulation.

### 3.6. Innovations in Impact Investing: Green Bonds and Social Impact Bonds

The green bonds market came into being in 2007 with the help of multilateral banks. Green bonds enable capital raising and investment for new and existing projects with environmental benefits—but they are a process rather than a product. That’s because the Green Bond Principles,<sup>20</sup> their chief framework, are a set of voluntary guidelines about process. Although this market segment has grown quickly, a key question facing green bonds concerns *additionality*—that is, whether green bonds finance projects that would not be funded otherwise. With estimated issues below \$100 million a year in 2015, green bonds remain a small niche in the overall fixed-income market.

Another innovation in impact investing is social impact bonds, the first of which was launched in 2010. A social impact bond is a contract between a special purpose vehicle and the government in which the government commits to pay for improved social outcomes,

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<sup>20</sup>See [www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/green-bond-principles](http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/green-bond-principles).

such as reduced recidivism rates for prisoners. Social impact bonds give investors a chance to address social problems through investing. They strike a balance between giving money away altruistically and seeking a financial return solely for one's own benefit—an economic return plus a social return. The market for social impact bonds is estimated to be much smaller than the market for green bonds.

### 3.7. ESG Issues and Passive Investing

Although ESG issues have historically been associated with active investing, they are also relevant to passive investing or, more generally, rules-based investing. Investors can benefit from ESG considerations when they are integrated into the benchmark index. A number of such indexes are being offered. In addition, passive investors can use active ownership to manage their ESG risks. However, they need a policy and systems to ensure that different investment managers do not take opposing positions while exercising active ownership on behalf of the same asset owner.

### 3.8. Modern Applications: Smart Beta

ESG methods are being used with such techniques as smart beta. In the context of equity indexes, smart beta generally refers to weighting schemes that do not use market capitalization. There have been attempts to apply smart beta together with ESG criteria. One way to construct a smart beta ESG index is to use an alternative weighting to stocks already selected for higher ESG ratings. One such low-volatility smart beta ESG index was launched in 2015,<sup>21</sup> which measures the performance of the 50 least volatile from within a selection of sustainable stocks and excludes alcohol, tobacco, gambling, armaments and firearms, and adult entertainment. Another way to build it is to first filter stocks using such criteria as low volatility and then apply ESG criteria for the alternative weighting scheme.

### 3.9. Obstacles to Practical Implementation

There is some criticism of how ESG issues are taken into consideration. Some of the criticism echoes the arguments that environmentalist and entrepreneur Paul Hawken made against socially responsible investing in 2004. Hawken said that “the cumulative investment portfolio of the combined SRI [socially responsible investing] mutual funds is

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<sup>21</sup>“S&P Dow Jones Launches Smart Beta ESG Index,” *Global Investor* (30 March 2015): [www.globalinvestormagazine.com/Article/3441004/S-P-Dow-Jones-launches-smart-beta-ESG-index.html](http://www.globalinvestormagazine.com/Article/3441004/S-P-Dow-Jones-launches-smart-beta-ESG-index.html).

virtually no different than the combined portfolio of conventional mutual funds” (Hawken 2004, p. 16). The implication is that if every company can be deemed investable using one method or another, the credibility of “responsibility” suffers.

There is no denying the inherent subjectivity of ESG consideration, just as there is no denying the inherent subjectivity of active investing in general. However, the degree of subjectivity regarding both process and outcome remains an ongoing challenge for ESG integration. Two analysts applying discounted cash flow analysis may reach very different valuations, but there is reasonable clarity on what process they follow, and there are long-standing textbooks that explain this process. The same is not true of ESG integration. If “responsible” portfolios include investments with contested ESG performance, the greater subjectivity exacerbates the concerns about credibility.

The practice of considering ESG issues needs more clarity on how to apply ESG methods—most notably, ESG integration. Of course, it can be understandably difficult to use evidence-based cause-and-effect attribution for ESG methods. Demonstrating how values-based exclusionary screening leads to avoiding certain businesses is relatively straightforward, but demonstrating how value-based ESG integration leads to better-informed investment decisions is more complex. Without understating this difficulty, not attempting to document how ESG integration informs investment decisions will not help its cause.

It is important not to exaggerate the benefits of ESG analysis. It faces some of the same limitations as traditional analysis and may not necessarily lead to investment insights. For example, BP scored high in some ESG ratings before the *Deepwater Horizon* catastrophe in 2010. Similarly, Volkswagen scored high in some ESG ratings before its emissions scandal came to light in 2015.

Although more disclosure on ESG issues by companies remains a demand by some investors, it is not without debate. One issue is that, although some investors seem favorably disposed to demand more disclosure from listed companies, the disclosure practices of investment management firms and asset owners regarding ESG issues are not known to be much better. One argument suggests that for investors to make the case for greater disclosure more convincing, they need to demonstrate that they are willing to walk the talk themselves.

There is an expectation among those interested in ESG issues that as more and more investors consider ESG issues, more pressure is placed on the companies they invest in to improve their ESG performance—which should both reduce risk for investors and make the world a better place. There is, however, an ongoing tension between authenticity

and mainstreaming. If an increasing proportion of global AUM claims to consider ESG issues without attributable difference in investment decision making or in the behavior of investee companies, it will not help build the credibility of ESG considerations.

### 3.10. The Challenge of ESG Education

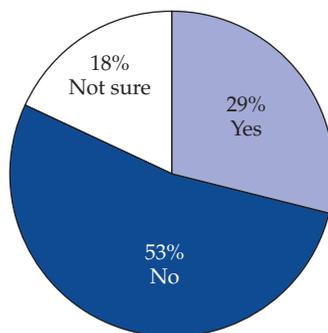
Those who might consider ESG issues in investing remain in need of more education and training. A little over half (53%) of respondents indicated that employees at their firm do not receive training on ESG issues (**Figure 9**).

Of those who do, the most common ways are miscellaneous sources (e.g., conferences and publications) and learning by doing (**Figure 10**). A low level of training and formal education does not breed confidence in how rigorously ESG issues are being considered in investment analysis.

Although the literature on ESG issues covers their effect on financial performance extensively, there remains a gap regarding how to consider ESG issues in practice. Perhaps expanding on the “how to” should now rank higher on the ESG research agenda.

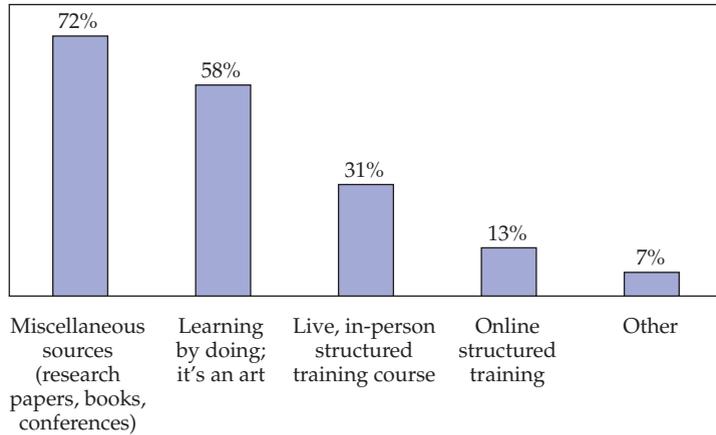
**Figure 9. Employee Training on ESG Issues**

*Do any employees at your firm receive training on how to consider ESG issues in investment analysis/decisions?*

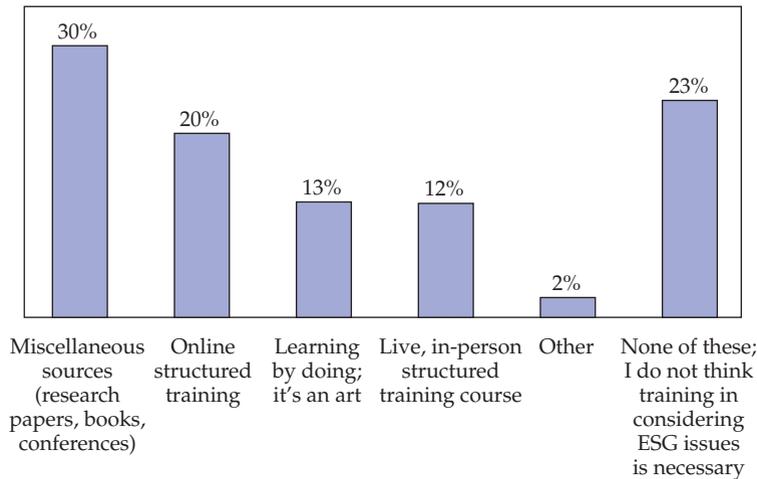


**Figure 10. Modes of Training on ESG Issues**

*A. How do employees at your firm receive training on how to consider ESG issues in investment analysis/decisions?*



*B. If you would like employees at your firm to receive training in considering ESG issues, what would be your preferred mode?*



## 3.11. ESG Education and CFA Institute

CFA Institute believes that every investment analyst should know about the investment risks and opportunities posed by ESG issues. CFA Institute helps investment professionals better understand ESG issues in investing through its educational programs—most notably, the CFA® Program—and learning opportunities for continuing professional development (CPD).

### *ESG Content in the CFA Program Curriculum*

Like any other topic, the ESG content in the CFA Program is determined by the practice analysis process,<sup>22</sup> whereby CFA Institute determines what should be included in the CFA Program through a survey of investment practitioners. Although the CFA Program curriculum changes from year to year, the 2015 curriculum has the following readings that directly address ESG issues/responsible investing:

- **Level I:** Volume 4—Corporate Finance and Portfolio Management, Corporate Finance, Study Session 11, Reading 40, The Corporate Governance of Listed Companies: A Manual for Investors (Note: The reading is devoted to corporate governance.)
- **Level II:** Volume 3—Corporate Finance, Reading 26, Corporate Governance (Note: The reading includes a section specific to ESG risks.)
- **Level III:** Volume 4—Fixed Income and Equity Portfolio Management, Reading 24, Equity Portfolio Management (Note: Socially responsible investing is explained at some length.)

Given the increasing interest in ESG considerations in investing, the Education Advisory Committee of CFA Institute initiated a reassessment of the coverage of ESG issues in the Candidate Body of Knowledge,<sup>23</sup> with the goal of identifying the scope and practical implications of ESG investing appropriate for the CFA Program. In 2014, as part of this initiative, four practice analysis sessions were held in London, New York City, Amsterdam, and Hong Kong with ESG experts. The participants at these meetings had considerable expertise in ESG issues and were a rather diverse group in terms of designation (both CFA charterholders and noncharterholders), perspective (buy side, sell side, investor relations, industry associations, and vendors), and market sector (equity, fixed income, and

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<sup>22</sup>See [www.cfainstitute.org/programs/cfaprogram/courseofstudy/Pages/practice\\_analysis.aspx](http://www.cfainstitute.org/programs/cfaprogram/courseofstudy/Pages/practice_analysis.aspx).

<sup>23</sup>See [www.cfainstitute.org/programs/cfaprogram/courseofstudy/Pages/cbok.aspx](http://www.cfainstitute.org/programs/cfaprogram/courseofstudy/Pages/cbok.aspx).

private equity). Having conducted these practice analysis sessions, we are in the process of updating the ESG-related content in the CFA Program, and we will continue to evaluate the volume and emphasis of ESG issues in the CFA Program curriculum.

### CFA Institute CPD ESG Content

CFA Institute has been producing educational content on ESG issues in investing for many years, which is now too extensive to be listed here. We have also been covering some of the key topics that underlie ESG issues, such as short-termism and gender and diversity, without necessarily labeling them ESG content. The CPD methods consist of events, including online events, and a variety of print and digital publications, with both shorter and longer reads. In 2014, we added an online course, ESG-100,<sup>24</sup> to our growing list of ESG-related offerings. The ESG-100 provides questions and answers in a self-quiz format, so you can gain and/or test your understanding of ESG issues in investing. To our knowledge, this course is the only free online course regarding ESG issues. To assist investment professionals in accessing our CPD ESG content, we provide a one-page list.<sup>25</sup>

## 3.12. Conclusion

Both value-motivated and values-motivated investors consider ESG issues in investment decisions. The practice of considering ESG issues in investing has evolved significantly from its origins in exclusionary screening of listed equities on the basis of moral values. There are, however, some lingering myths about ESG considerations, and the results of our survey have debunked three, as shown in **Table 3**.

| Table 3. Myth vs. Reality  |  |
|--|--|
| Myth   | Reality  |
| Investment firms consider ESG issues primarily for reputational reasons. | The top reason investment professionals consider ESG issues is to manage risks.                        |
| ESG issues are mostly about climate change.                              | The top ESG issue investment professionals consider is board accountability.                           |
| ESG methods are confined to exclusionary screening.                      | There are six major methods, of which ESG integration is used most widely by investment professionals. |

<sup>24</sup>See [www.cfainstitute.org/learning/products/onlinelearning/Pages/103978.aspx](http://www.cfainstitute.org/learning/products/onlinelearning/Pages/103978.aspx).

<sup>25</sup>See [www.cfainstitute.org/learning/future/knowledge/pages/esg.aspx](http://www.cfainstitute.org/learning/future/knowledge/pages/esg.aspx).

Important challenges face the evolving practice of considering ESG issues in investing. An obvious and structural challenge, which is not unique to ESG considerations, is short-termism in financial markets. But there are others. For instance, the case for “what” and “why” for ESG considerations has been made with sufficient clarity, but there is a need to clarify “how to” apply ESG methods—most notably, ESG integration—across asset classes.

One objective of this guide is to explain the state of ESG discourse to investment professionals. Although a number of topics are part of the ESG discourse, for investment professionals a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions.

*If you are a member of CFA Institute and you would like to participate in our educational initiatives regarding ESG issues, we invite you to join the CFA Institute members LinkedIn subgroup on ESG issues in investing. To see the continuing professional development resources regarding ESG issues in investing provided by CFA Institute, which are available to both members and nonmembers, please visit <http://bit.ly/ESG-learn>.*

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