Sustainable Finance Group

ESG Integration

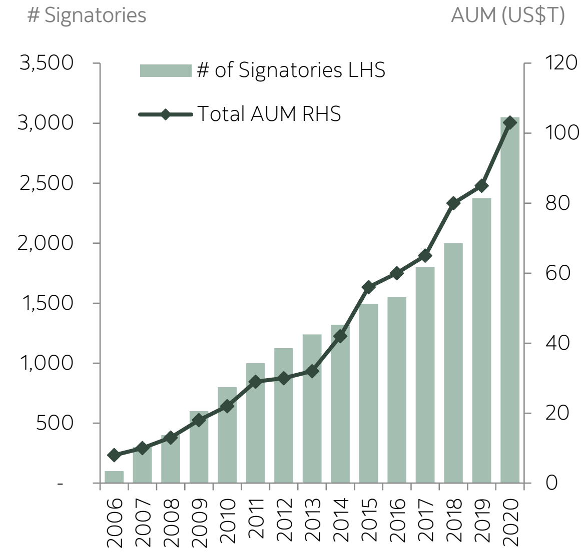
JUNE 2020

Integrating ESG & Thematic Investments

The UN Principles for Responsible Investing (PRI) defines ESG Integration as the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions. The academic literature around the case for ESG integration in investment strategies has steadily grown since the Hamburg University/Deutsche Asset Management Meta Study was published in 2015. The list of benefits continues to expand beyond the surface opportunity for enhanced risk-adjusted returns. ESG investing can lead to better alignment of investment values, the reduction of large drawdowns, a higher level of social/environmental impact, and potential for Scope 3 emissions reporting improvement to name a few. While the opportunity is appealing, it should be noted that ESG integration is still largely dependent on the strength and quality of the investment process.

ESG Integration - Potential Benefits		
Risk-Adjusted Returns	Minimize Drawdowns	Increase Impact
Mission Alignment	Mitigate Reputational Risk	Reduce Volatility

UN PRI SIGNATORY GROWTH



In addition to ESG integration, the market is witnessing the emergence of an increasing number of thematic funds (green, social, or impact), as the investment characteristics become better understood. Thematic investments can include green bonds, social bonds, sustainability bonds, transition and sustainability-linked bonds. While the impact reporting benefits provided by thematic instruments are certainly compelling, it should be acknowledged that the green premium or 'greenium' will behave differently based on currency, region, and issuer type.

Thematic Investing - Considerations		
Primary Market 'Greeniums'	Secondary Market 'Greeniums'	Impact Reporting
Liquidity	Greenwashing Risk	Volatility

PROCESS

Investment Policy Statement: Requisite analysis and approvals required internally before the strategy can be rolled out. Often, this involves a cost-benefit analysis using recognized academic literature outlining the various considerations of the decision.

- Basic elements include: active vs. passive ESG/thematic, style, engagement, exclusions, proxy voting, reporting.

Fiduciary Duty: Clarifying the scope and definition of the fiduciary duty definition at the outset will be an integral pillar for the successful implementation of the strategy.

- "As institutional Investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, corporate governance (ESG) issues can affect performance of investment portfolios." (UN PRI, 2019)

Megatrends: Identifying global megatrends can help to tilt the portfolio to emerging long-term trends and opportunities.

- Globalization, Automation/IA, Inequality & Wealth Creation, Digital Disruption, Human Rights, Urbanisation, Longevity.

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UN Principles Responsible Investing (‘PRI’) Signatory: The PRI signatory signals to stakeholders (trustees, beneficiaries, service providers) an enterprise-wide commitment to sustainability objectives. The PRI also offers comprehensive tools and support to help signatories implement a robust ESG policy across assets. It should be noted there is an annual assessment undertaken by PRI to determine the level and progress of integration occurring.

Exclusions: Formalize asset or norms-based (i.e., UN Global Compact) exclusions into Investment Policy Statement.

- Examples: tobacco, gaming, weapons, child labor, etc.

Proxy Voting: Establish a proxy voting policy. Depending on the size of the investment team, it may be advantageous to assign the process to an external service provider who is better able to effectively research and make decisions.

Engagement: There is a growing body of literature that points to the correlation between effective engagement and long-term performance. Given the labor intensity of the activity, it may also be effective to outsource (collective engagement) the process to an external service provider.

ESG Style: ESG strategies have been categorized into a variety of styles each with their unique risk-return and impact profiles, and offer various compelling trade-offs that should be carefully weighed.

- Negative/Exclusionary Screening, ESG integration, Corporate Engagement, Norms-Based Screening, Positive/Best-In-Class Screening, Sustainability-Themed Investing, Impact Investing.

Thematic Allocation: Dedicate a portion of AUM to thematic holdings (green, social, sustainability, transition, KPI-Linked) can be an effective way to improve the impact per dollar of invested capital through the investees requirement to publish annual impact reports. A formal thematic allocation can lead to higher primary market new issuance fills (‘dark green’ investor category’).

Reporting: Reporting on the progress and impact of the portfolio can be an effective way of building trust with beneficiaries. Implementing carbon accounting into the portfolio can facilitate a transition to a more formal carbon budget down the line, which would directly feed into the Scope 3 GHG emissions reduction of the entity. Comply with various jurisdictional reporting and ESG declaration requirements.

- Sources: PRI rating, Mercer rating, Morningstar ESG Fund Ratings, Thematic impact, avg. ESG score of portfolio.

Education: Ongoing education of investment team, executive, board, and beneficiaries to facilitate an informed and transparent decision-making process.

- Sources: CFA ESG certificate, Foundations of Sustainability Accounting (SASB), education consultants.

Outreach: Strategic outreach can yield two benefits: 1) can leverage the influence of a collective engagement platform, and 2) can provide a strong education experience for investors.

- Organizations: United Nations Global Compact (UNGC), UN Sustainable Development Goals (SDG), UN PRI, Carbon Disclosure Project (CDP), International Corporate Governance Network (ICGN), United Nations Framework Convention on Climate Change (UNFCCC).

Culture & Incentives: The quality of the implementation, targeting enhanced risk-adjusted returns, while raising the societal impact of the portfolio allocation process is largely dependant on the established culture and incentive program. A portion of the investment team’s compensation can be tied to an ESG composite metric comprised of the average ESG score of the portfolio, PRI assessment score, and the Mercer rating where accessible.

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ACADEMIC LITERATURE

ESG and financial performance: aggregated evidence from more than 2000 empirical studies. Friede, Busch & Bassen. Journal of Sustainable Finance & Investment (2015). Link.

Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices. Alex Edmans, Journal of Financial Economics (2010). Link

The Impact of Corporate Sustainability on Organizational Processes and Performance. Eccles, Ioannou & Serafeim (2014). Link

Corporate Sustainability: First Evidence on Materiality," Khan, Seafeim, & Yoon, The Accounting Review (2015). Link

The link between ESG, alpha, and the cost of capital: Implications for investors and CFOs. Kolbel & Busch (2017). Link

ICMA SUSTAINABLE FINANCE DEFINITIONS Link

Climate Finance	Supports the transition to a climate resilient economy by enabling mitigation actions, especially the reduction of greenhouse gas emissions, and adaptation initiatives promoting the climate resilience of infrastructure.
Climate Transition	Pathway supported by targeted policies and initiatives in line with the Paris Agreement.
Green Finance	Broader than Climate Finance in that it also addresses other environmental objectives such as natural resource conservation, biodiversity conservation, and pollution prevention and control.
Impact Finance	Produces verifiable and direct positive impact on the society and/or environment, based on agreed metrics and benchmarking while also seeking market-aligned or better financial returns.
Responsible or ESG Investing	Refers to strategies and practices that incorporate material ESG factors in investment decisions and active ownership with a view to minimize risks and maximize returns. Can be pursued by all investors, as part of their fiduciary duty on the basis ESG factors are considered as having a material impact on returns.
Social Finance	Supports addressing a specific social issue and/or seeking to achieve positive social outcomes, especially, but not exclusively, for a target population(s).
Socially Responsible Investment	Refers to investing with the aim of achieving financial returns while respecting specific ethical, environmental and social criteria.
Sustainable Finance	Incorporates climate, green and social finance while also adding wider considerations concerning the longer-term economic sustainability of the organizations that are being funded, as well as the role and stability of the overall financial system in which they operate.

SUSTAINABILITY ADVOCACY GROUPS

Principles for Responsible Investing
Link

CFA ESG Integration Framework
Link

Sustainable Accounting Standards Board – Materiality Map
Link

Carbon Disclosure Project
Link

Task Force Climate Finance Disclosures
Link

Sustainable Development Goals
Link

Climate Action 100+
Link

Mercer ESG Fund Ratings
Link

Morningstar ESG Fund Ratings
Link

United Nations Global Compact
Link

International Corporate Governance Network
Link

United Nations Framework Convention on Climate Change
Link

International Capital Markets Association
Link

Climate Bond Initiative
Link

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