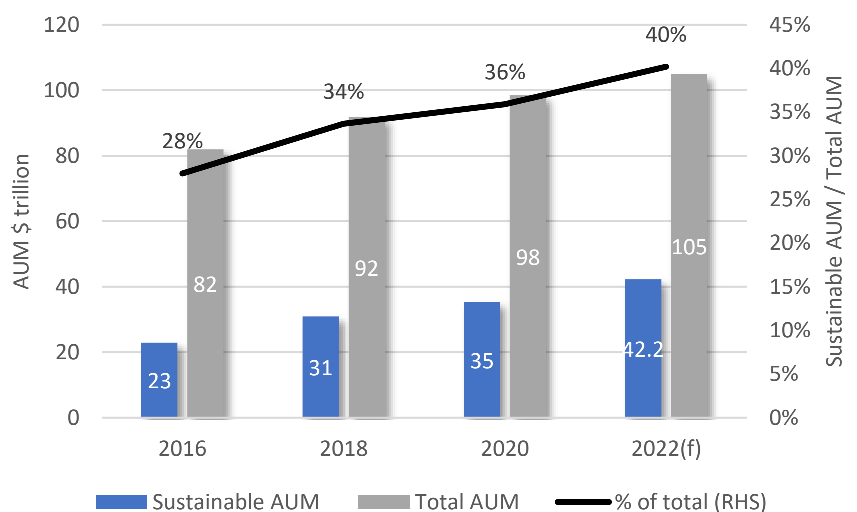
ESG Research

ESG & Investment

A Primer

- Over the last 20 years **E**nvironmental, **S**ocial and Corporate **G**overnance (ESG) has moved from the side-lines to the mainstream of the investment management industry
- Almost all new mutual funds recently launched in the EU and UK have been marketed as ESG funds or as funds with an ESG aspect
- Recent estimates indicate that over $42 trillion of assets, some 40% of total global AUM were classified or self-identified as ESG focussed funds
- Environmental factors have moved from concerns about environmental pollution to focus on carbon emissions and climate change
- Social issues include issues of equality and discrimination in the workforce and have much more impact in a knowledge-based economy
- Corporate Governance has become codified over time, but most corporate failures have aspects of poor governance at their root
- Investors have become significantly more engaged with corporates on ESG issues which are now a core aspect of their investment philosophy
- Public opinion is generally leading regulation so corporates need to do more than 'mere compliance' as a strategy to preserve their reputation
- Public awareness of corporate attempts to 'green wash' activities through over-promising is already causing Gen Z to react adversely both as customers and employees
- ESG is now a major force in the investment management industry has become enshrined in the investment process

Global AUM in ESG investments



Source: Statista, GSIA, Bloomberg Intelligence, SEAL Advisors

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The ESG Revolution

Profound impact

In the last 20 years a revolution has taken place in society that has had a profound impact on the world of investment. A widespread recognition has arisen that environmental, social and corporate governance issues (ESG) can have a material impact on a company's financial performance and on investment returns. As individuals have become more sensitised to ESG issues, so they have taken a closer interest in where their pension fund or mutual fund savings are being invested. There has also been a dramatic shift among employees to greater understand what their employers are doing about ESG issues.

Need to adapt

At the same time consumers are now expressing far greater interest in more sustainable products and businesses. As a result, companies, and their providers of capital (shareholders, banks, bond investors) and to an increasing extent their suppliers, landlords, and customers, have had to adapt to a rapidly evolving environment.

New standards & regulations

The world of ESG is awash with a new and fluid vocabulary which can be a difficult journey for many corporates and their advisers to negotiate. The growth in ESG as a mainstream component of investment management has led to an array of new reporting standards, new regulations and a new audience for financial communications.

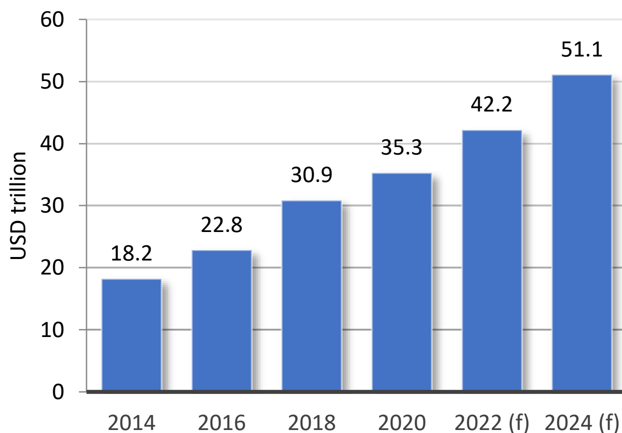
Significant part of total AUM

ESG investing has become a vast part of the investment universe, across equities, fixed income, and real estate, within both public and private markets. A recent report by Bloomberg Intelligence estimates that globally ESG assets under management reached $35 trillion in 2020, up from $22.8 trillion in 2016. In 2022 Global ESG assets are estimated to have reached $41 trillion and are forecast to grow to over $50 trillion by 2025. This would amount to over 40% of the projected total assets under management globally.

Flows into ESG ETFs

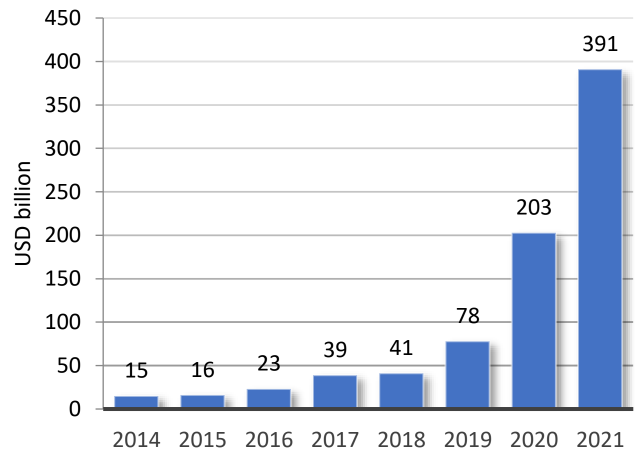
Flows into ESG related exchange traded funds (ETFs) have experienced explosive growth rising from $15 billion in 2014 to almost $400 billion by the end of 2021.

Figure 1Global AUM in SG investments ($ trillion)



Source: GSIA, Bloomberg, SEAL Advisors

Figure 2: Global ESG ETF Assets ($ billion)



Source: Statista, SEAL Advisors

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Cannot ignore ESG

Within the UK the Investment Association ("IA"), a trade body representing the institutional investment community managing approximately £9.4 trillion of assets, estimated that in 2021 49% of AUM integrated ESG factors into investment policy. This was an increase from around 37% in 2019. Given the continual launch of new ESG investment products, the growth in green bond issuance and rebranding of existing active and passive investment funds means this growth is very likely to continue. In short, ESG is a highly significant and rapidly expanding investment methodology which companies, both public and private cannot ignore.

The ESG Basics

ESG issues

There is no 'one-size fits all' to ESG investment and as the acronym indicates, environmental, social and governance issues cover a multitude of areas. Table 1 below lists some the main concerns that investors focus on when assessing companies and their management with regard to ESG concerns.

Table 1: Investor Issues relating to ESG

Environmental	Social	Governance
Climate risk/GHG	Human Rights	Board Structure
Air pollution	Community relations	Board diversity
Resource management	Labour relations	Remuneration policies
Hazardous waste	Health & Safety	Performance management
Biodiversity impact	Diversity & inclusion	Shareholder rights
	Customer welfare	Regulatory compliance
	Product quality/safety	Supply chain management
	Selling practices	Risk management
	Data security/privacy	Accounting policies
		Competitive Behaviour

Source: SEAL Advisors

Need for disclosure

Historically, data available to investors to allow good evaluation of these issues has been inconsistent, incomplete, or only disclosed voluntarily. Companies often claimed (rightly or wrongly) that their systems were not designed to deliver such information in a timely or comprehensive fashion. Many investor and regulator initiatives have been attempting to improve matters in the UK and elsewhere and a great deal of progress has been achieved, albeit much remains to be done.

ESG factors used to value assets

The challenge to investors is to incorporate this data more fully into their analysis in order to improve the process of valuing investments. It is hoped that more effective analysis will in turn drive more efficient markets and theoretically better resource allocation across the economy. Since these are the among the key objectives of the most important financial regulator in the UK (the Financial Conduct Authority), readers should expect continued regulatory interest and initiatives to improve the scope and quality of ESG reporting.

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ESG background

ESG were seen as "externalities"

Historically, investors saw ESG factors as *non-financial* sources of risk for companies. Economic theory refers to non-financial factors as '*externalities*' in that they are meaningful but not incorporated into decision making. This is partly because they are difficult to quantify through a pricing mechanism. Examples would include companies not accounting for the costs they impose on society from the products or processes they use-such as the health costs of pollution or smoking. Companies have also evolved into a world where intangibles such as company's brands and reputation, regulatory compliance, employee morale and grievance, or customer expectations and reactions can all be analysed in social media forums instantly and have an impact on corporate financial performance and share prices.

Changing attitudes towards ESG

As a result of changing attitudes and a rising tide of research that has focused on quantifying ESG risks, what investors have typically assumed to be *non-financial* are increasingly incorporated directly into financial analysis. Many rating agencies such as Sustainalytics, MSCI and Refinitiv exist to provide ESG rating scores for a large number of public listed companies which investors can directly incorporate into their analysis. Currently they use different methodologies and place different emphasis on different factors, leading to not only different, but in some cases, wildly different scores for the same company.

How do investors think about ESG?

Investor attitudes to ESG

As in any process of major change, investors adapt to new thinking in various ways, with different degrees of open mindedness and different adoption rates. We see investors of all kinds adopting a variety of attitudes towards ESG based on levels of understanding. As in many fields there are die hard naysayers, idealists, single interest groups, and evangelists reflecting the legitimate but competitive interests seeking accommodation within various political and regulatory frameworks.

Reduce scepticism

Over time the evidence would suggest investors tend to move from scepticism towards pragmatism as they develop greater understanding of the nuances of the subject. This is certainly borne out by the significant growth of inflows into ESG focused investment funds which has coincided with a substantial increase in the media time focused to ESG related issues. Moreover, research conducted by PwC[1] in September 2021 revealed that 79% of investors believed that ESG risks are an important factor in investment decisions-making and 75% of respondents believe that companies should address ESG issues, even if doing so reduces short-term profitability.

Corporates need to pay attention

From an investor viewpoint there are several reasons why corporates must pay increasing attention to ESG issues given the growth in consumer and institutional money following ESG strategies. This includes:

- To comply with or anticipate developing regulations at corporate, product, employee, or customer levels reducing risks and potential liabilities
- To attract capital or remove risk of higher cost of capital supplied by ESG driven investors-this applies to both listed and unlisted companies, and to debt as well as equity investors.

[1] Chalmers, J, Cox, E and Nadja Picard (2021), "The economic realities of ESG", Strategy & Business, October 28, 2021

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- ESG issues are important for their own sake and to enhance and maintain their reputation

Historical development of ESG

Social responsibility is not new

Corporates' willingness to do good and/or operate in a socially responsible manner is by no means a new concept. Wealthy philanthropists channelling funds and resources "to do good while doing well" dates back to the industrial revolution with the likes of Robert Owen and George Cadbury. In more recent times, corporates making explicit statements on their approach to integrating social and environmental concerns in the business strategy has come under the umbrella of corporate social responsibility or CSR. The United Nations Industrial Development Organization (UNIDO) defines CSR as *"being the way through which a company achieves a balance of economic, environmental, and social imperatives ("Triple-Bottom-Line- Approach"), while at the same time addressing the expectations of shareholders and stakeholders".* UNIDO also highlight that it is important to draw a distinction between CSR, which can be a strategic business management concept, and charity, sponsorships or philanthropy.

> ***Defining CSR***
> *…..being the way through which a company achieves a balance of economic, environmental, and social imperatives ("Triple-Bottom-Line- Approach"), while at the same time addressing the expectations of shareholders and stakeholders (Source: UNIDO)*

CSR differs from ESG

It is the latter concepts of charity, sponsorships and philanthropy that have become the main focus of many companies' approaches to CSR and the contents of their CSR reports. While there is an overlap with ESG, CSR has become more about how corporates are giving back to the community and how they are better engaging with their employees. This is distinct to ESG which seeks to characterise specific issues that impact the operational and financial performance of a company. Unlike CSR, ESG focuses on risk and the impact of non-compliance and where disclosure is a requirement rather than an option. In recent years there has been a gradual de-emphasis of the term CSR with most of the key elements now incorporated in to the ESG disclosures.

ESG has a long history in investment

It is important to note however, that ESG was not born out of CSR. The inclusion of ESG into investment strategies started life as "ethical" or "values-driven" investing adopted by various faith-based and charitable organisations. As Figure 4 shows this can be traced back to the Quakers and Methodists of the 1700s who excluded slave labour from their investment practices. These organisations had both moral and financial reasons to disinvest or exclude certain companies or sectors. This gathered pace politically in the anti-apartheid movement in the 1960's and 1970's when sanctions were imposed against international companies with South African interests. The rise of ethical investing also led to exclusions of gambling, tobacco and firearms related companies, as the costs to society of legal but potentially harmful products or activities became more appreciated.

Ethics and the enviroment

As ethical investing gathered pace, more attention began to be focused on corporate environmental pollution, which, in the early 2000s led to a focus on carbon dioxide and other 'greenhouse gas' (GHG) emissions and their implications for climate change. As regards governance, a variety of corporate failures linked to poor corporate governance in the late 1980s and 1990s reinforced the minority opinion that ESG matters warranted closer attention, at

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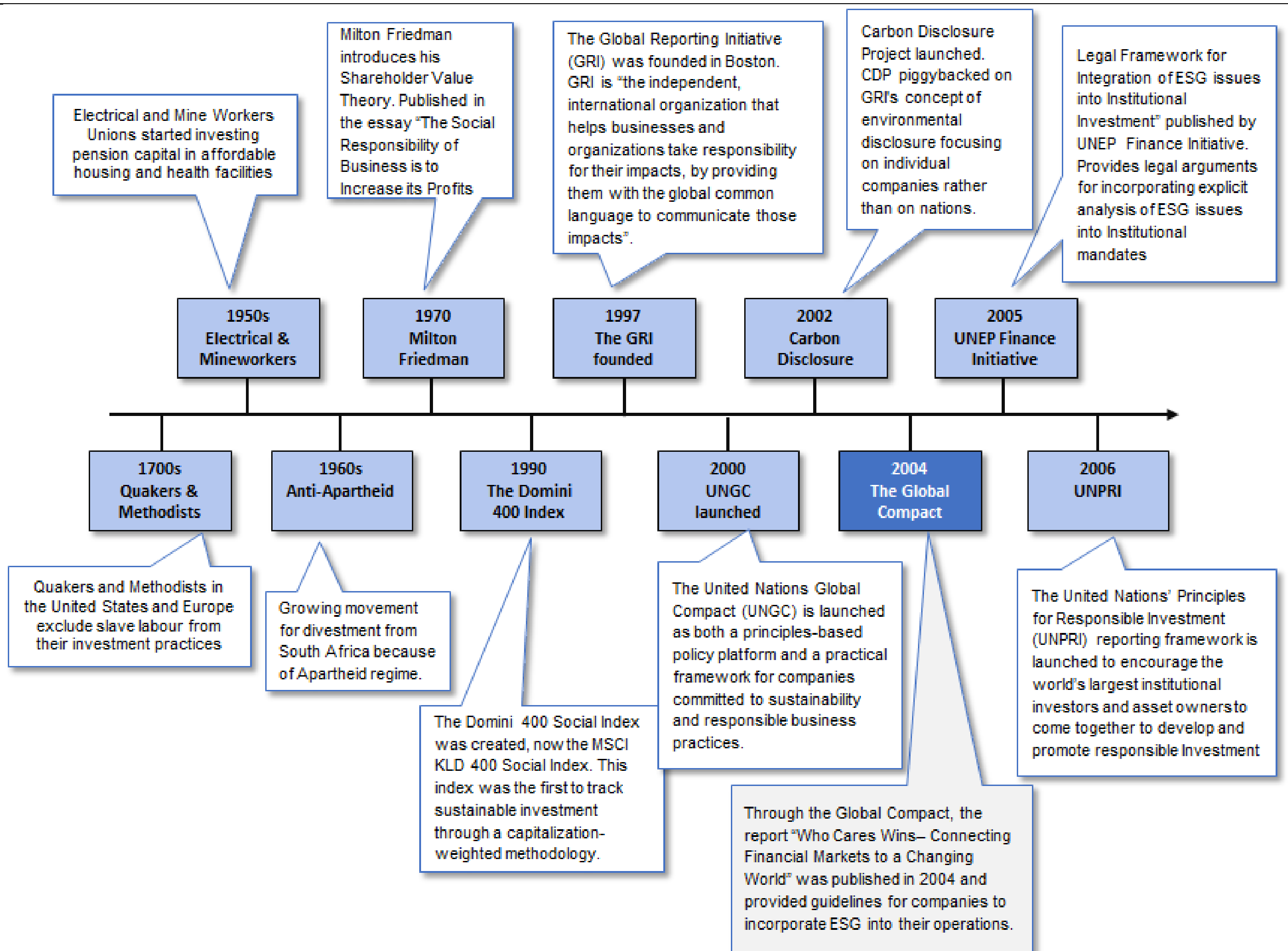
least for improved shareholder risk management. This led to greater regulatory activity, which in the UK led to the present UK Corporate Governance Code.

Important milestone for ESG investment

Modern ESG in institutional investment can perhaps be dated back to 2004 and the publication by the United Nations Environment program (UNEP) of a document entitled "Who Cares, Wins – Connecting Financial Markets to A changing World[2]". In this report a group of financial institutions argued strongly for greater inclusion of ESG factors into investment analysis, asset management and securities brokerage. The executive summary states that "*The institutions endorsing this report are convinced that in a more globalised, interconnected and competitive world the way that environmental, social and corporate governance issues are managed is part of companies' overall management quality needed to compete successfully.*"

Figure 4: Milestones in ESG Investor events



Source: HM Government, SEAL Advisors

In 2006 the United Nations' Principles for Responsible Investment (UNPRI) reporting framework was launched to encourage the world's largest institutional investors and asset owners to come together to develop and promote responsible Investment. Each signatory was required to adhere to the six

[2] International Finance Corporate (2004), "Who Cares Wins — Connecting Financial Markets to a Changing World, June 2004

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Principles for Responsible Investment. Examples include "*the incorporation of ESG issues into investment analysis and decision-making processes*", being "*active owners and incorporate ESG issues*" into ownership policies and practices, and the establishment of "*appropriate disclosure on ESG issues by the entities" in which signatories invest*.

Standardisation of accounting standards

Since the establishment of the PRI in 2006 a number of notable developments have taken place relevant to ESG investing. Some of these are listed in Figure 5 above and includes the launch of the Sustainability Accounting Standards Board (SASB) in 2011. This was created to standardize sustainability accounting and measurements across 77 industries with the mission "*to establish and improve industry specific disclosure standards across financially material environmental, social, and governance topics that facilitate communication between companies and investors about decision-useful information*".

Task Force on Climate-Related Financial Disclosures

This was followed by the launch of the Task Force on Climate-Related Financial Disclosures (TCFD) in 2015, formed by the Financial Stability Board (FSB), to develop a set of voluntary climate-related financial risk disclosures which can be adopted by companies.

Figure 5: Recent Developments in ESG Investing

Source: SEAL Advisors

Lunch of the UN Sustainable Development Goals

In the same year the UN General Assembly established the Sustainable Development Goals (SDGs) with the stated aim of achieving all of them by 2023. The SDGs are 17 goals, with a holistic approach to addressing five pillars: Basic Needs (Nutrition, Affordable Housing), Empowerment (Decent job, Education), Climate Change (Alternative Energy, Green Buildings), Natural Capital

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(Sustainable Water, Sustainable Agriculture), Governance (Bribery & Ethics, Governance Structure). Companies can report to show alignment with these objectives.

SFDR and ESG values

In 2021 the Sustainable Finance Disclosure Regulation (SFDR) covering financial market participants within the EU was launched. The legislation looks to promote strong ESG values and mandates fund managers to actively disclose whether their fund falls under Article 6 (no ESG incorporation), Article 8 (ESG Fund), or Article 9 (Impact Fund).

Also in 2021, Larry Fink, CEO of BlackRock, the world's largest asset manager famously published his annual letter to shareholders in which the ESG theme was prominent throughout.

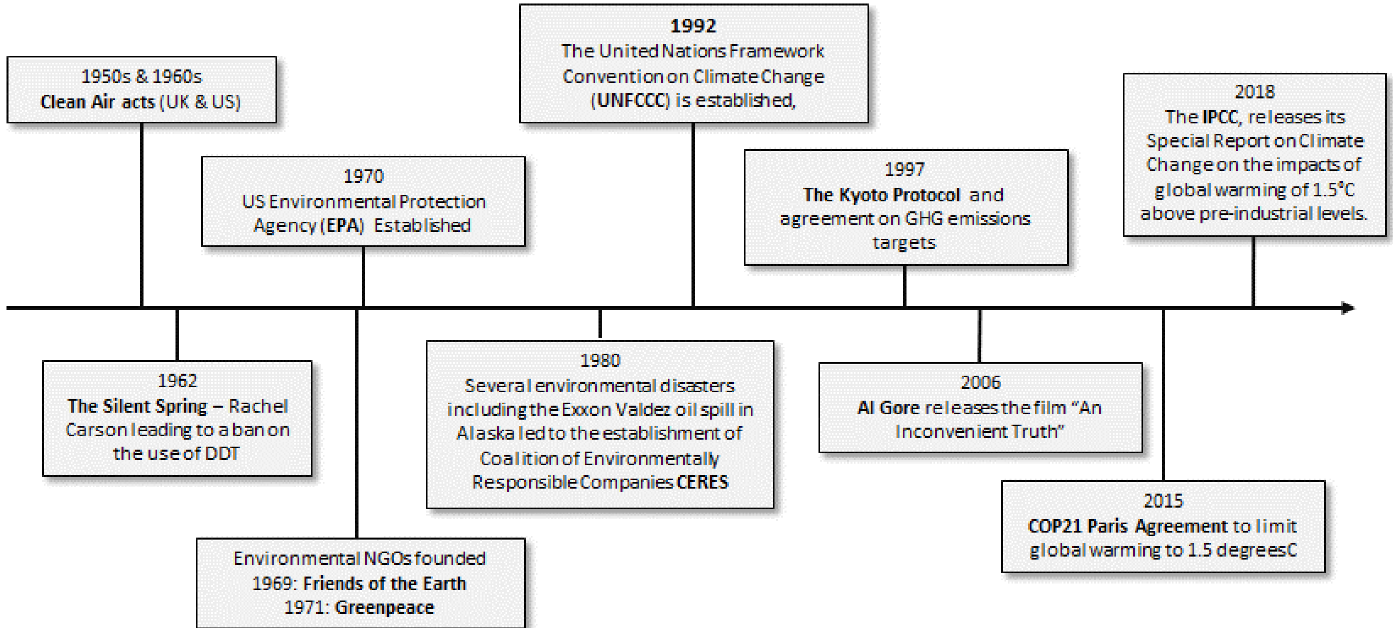
In 2022 the FCA began a consultation on sustainability disclosure requirements aimed at tackling 'greenwashing'.

ISSB standards launching in 2023

In the second half of 2023 the International Sustainability Standards Board (ISSB), created by the IFRS foundation, will launch a comprehensive ESG reporting standard for companies reporting under IFRS. This will be a major step forward for the provision of a globally accepted template for corporate ESG reporting.

While ESG is used as the catch-all for issues relating to the environment, society and corporate governance, their historical development has been quite distinct. In the following section we take a look at the history of the individual elements.

Figure 6: Significant developments in environmental issues and events



Source: SEAL Advisors

Environmental

Environmental issues become recognised

Historically, environmental concerns focussed on air, water and ground pollution, with seminal works published in the 1960's (for example, Rachel Carson's Silent Spring) leading to US pesticide reforms. Further environmental incidents in the 1970s and 1980s attracted activist and wider public concerns including specific toxic waste and hazardous waste incidents such as the 1978 US Love Canal

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landfill disaster, Union Carbide's gas leak at Bhopal in India (1984), and the Exxon Valdez oil spill in 1989. The hole in the ozone layer discovered in 1985 was linked to aerosol propellants which after much campaigning and government intervention led to CFCs being universally banned.

The RIO Earth Summit 1992

The rise of environmental interest for institutional investors can be traced back to the Rio Earth Summit in 1992 which led to the first UN sponsored intergovernmental efforts to manage environmental issues. Since the early 2000s greenhouse gas emissions and their impact on climate change have been at the top of the environmental agenda. This has led to a revolution in data gathering via the likes of the Carbon Disclosure Project to manage risks and as governments have acted to sponsor the creation of renewable energy generation via subsidies, green investment opportunities have emerged.

Social

Gradual change codified into law

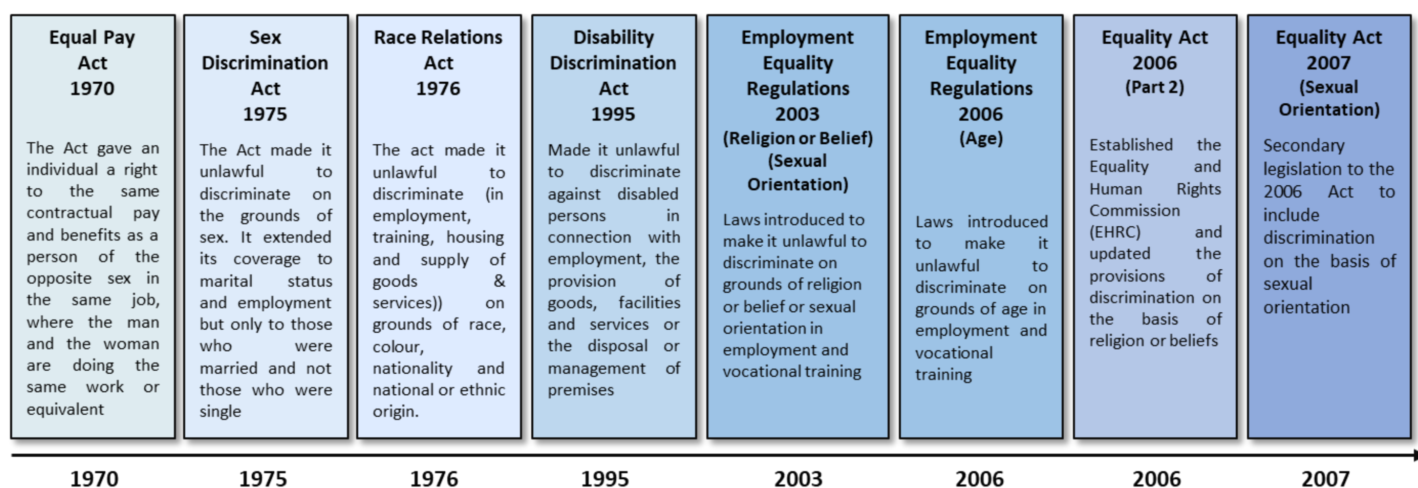
Social factors affecting investment have tended to focus on the treatment of customers and employees and reflect changes in attitudes within society. While change has been gradual and has involved multiple pressure groups it has, in most cases eventually found its way into law or regulation. An illustration of this is the Equality Act 2010 which came into force on 1 October 2010. It brought together over 116 separate pieces of legislation into one single Act.

The UK Equality Act

As Figure 7 shows, the journey of the Equality Act of 2010 began with the Equal Pay Act in 1970. This was followed by various acts dealing with discrimination and equality. While much of the 2010 Act had already been incorporated into law in some form in the previous Acts, the 2010 Act differed in that explicitly identified protected characteristics such as age, disability, race, religion and sexual orientation as well prohibiting certain behaviours such as harassment and discrimination.

With anti-discrimination and equality though legislation now a fundamental aspect of law in most development nations, investors are increasingly aware of the need to allocate capital to those companies that respect and uphold these laws.

Figure 7: Precursor UK legislation to 2010 Equality Act



Source: HM Government, SEAL Advisors

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Labour relations have changed

For companies and their employees, modern labour relations issues have grown from social concerns and financial negotiations based on collective interests in an economy dominated by large scale manual labour. The advent of the more knowledge-based and flexible working (the 'gig economy') and to some extent the recent growth in "working from home" have undermined the power of organised labour. Although union membership has remained at depressed levels, especially in the private sector, individual workplace grievances, determined by the view of the victim, have replaced mass walkouts and strikes. In some sectors this is compounded by comparison websites for comparing workplace experiences such as Glassdoor and facilitated by the use of social media.

Table 2: 2010 Equality Act, Protections and prohibited behaviours

Protected Characteristics	Prohibited Behaviours
Age	Discrimination
Disability	Harassment
Gender re-assignment	Victimisation
Marriage & civil partnership	
Race	
Religion or belief	
Sex	
Sexual Orientation	

Source: HM Government, SEAL Advisors

The influence of Gen-Z

Regulation may be taking time to catch up, but as Gen Z enters the workplace, their attitudes as employees and consumers towards ethical behaviour and transparency by employers is making itself felt. Three-quarters of Gen Z consumers state that sustainability is more important to them than brand names. According to Nielsen[3], 75% of Millennials are eco-conscious to the point of changing their buying habits to favour environmentally friendly products.

Social concerns have an international outlook

Social concerns are also increasingly international in outlook given the framing of regulation and in certain areas such as the UK's Bribery Act 2010 no distinction is made to the location of the potential corruption being attempted. The Anti Money Laundering rules are also being applied more widely across the world under the purview of the supra-national Financial Action Task Force.

Rights of indigenous peoples

EU reporting requirements under the Corporate Sustainability Reporting Directive cover non-EU firms with subsidiaries in the EU. This covers some 49,000 companies. Newer issues face international companies in response to continuing concerns in specific industries such as the rights of indigenous peoples affected by mining companies particularly in Australia and Africa.

Selling practices in focus

Selling practices aimed at vulnerable or easily exploited customers are under scrutiny where 'informational asymmetry' between buyer and seller do not create a 'level playing field'. Investor attention is also focussed on cross-border product supply chains, especially in less developed countries, and in specific industries such as fast fashion retail close attention has had to be given to supply chains

[3] "Was 2018 the year of the influential sustainable consumer?", NIQ Analysis, 17th December 2018

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both home and abroad. Companies that have failed to undertake supply-chain checks and failed to identify exploitation of workers have faced serious backlashes from customers and investors alike.

Corporate Governance

The rise of corporate governance

A succession of corporate failures in the 1980s and subsequent corporate scandals such as Enron in the USA gradually drove the expansion of investor focus on governance to supplement existing legislation which prescribed duties of directors. The 'comply or explain' approach to questioning from investors has now (informally) been replaced in many instances by a 'comply or else' approach to the various aspects of the UK Corporate Governance Code.

UK Corporate Governance Code

As Table 3 shows, the development of today's UK Corporate Governance code began in 1992 with the publication of the Cadbury Report and the Code of Best Practice. This was followed by various reports and review of UK corporate governance as well the introduction of statutory duties for company directors which was enshrined in the 2006 Companies Act. The latest iteration of the code was published in 2018 which included a far greater emphasis on stakeholders such as employees as well as shareholders.

Table 3: Landmarks in UK Corporate Governance regulations

Date	Event	Summary
1992	Cadbury Report	Code of Best Practice (the Cadbury Code). A requirement was added to the London Stock Exchange Listing Rules which required companies to "comply or explain".
1998	The Hampel Committee & The Combined Code	The Hampel Committee reviewed the recommendations made by the Cadbury and Greenbury Committees. Hampel recommended a single code of corporate governance, and this led to the Combined Code which applied to all UK listed companies
2003	Corporate Governance Code	The Financial Reporting Council became responsible for the Corporate Governance Code
2003	The Smith Report	The Smith Report was published in the wake of the collapse of Arthur Andersen and the Enron scandal. The report concerned auditor independence and provided guidance for audit committees. The Higgs Independent Review considered the role and effectiveness of non-executive directors
2006	Companies Act	The Companies Act introduced a statutory duty for directors to "have regard to" stakeholders, and strategic reports were introduced
2010	UK Stewardship Code	The Institute of Directors published a corporate governance code and guidance for unlisted companies. The first version of the UK Stewardship Code was published. It aimed to enhance the quality of engagement between institutional investors and companies, so that institutional investors contribute positively to the governance of the companies in which they invest
2010	UK Corporate Governance Code	The Combined Code was revised and renamed the UK Corporate Governance Code.
2018	Wates Corporate Governance Principles	The FRC published the Wates Corporate Governance Principles for large private companies. Following a major review, the FRC published a revised UK Corporate Governance Code. Changes included far greater emphasis on stakeholders
2020	UK Stewardship Code	The FRC published the UK Stewardship Code which set far higher standards for asset owners and managers.

Source: ICAEW, SEAL Advisors

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Need for full disclosure

As a result of the various iterations of the codes relating to corporate governance it is now incumbent on corporates to make very full disclosure of the performance of the extensive system of their board committees and this now occupies a significant part of public company report and accounts.

The recent bull market in US stocks, (and in particular those dominated by founders) has been accompanied by a significant transfer of wealth from shareholders to executives via generous stock-based compensation schemes without sensible performance criteria or alignment of interests[4]. This took place seemingly without much scrutiny, or any scope for redress. There continues to be a process of improvement in efforts to avoid conduct risk through fostering a culture of diversity and challenge, though generally it is a failure of governance which is associated with corporate failures and significant shareholder losses.

The advent of ESG collaboration

Role of collaboration

The increasing trend towards accepting that climate change poses physical risks (flood, famine, fire, hurricane, sea level rise) as well as financial ones (through insurance or rebuilding) spawned a number of collaborative investor groups amongst institutions which formerly would have been fierce rivals. This development in the early 2000s was supported by consideration of the fatalities and economic losses, especially insured losses, created by hurricanes in Florida such as Katrina in 2005. Several considerations aimed at improving corporate disclosures and management of (universal) climate related risks such as GHG emissions. These included the UN PRI (Principles for Responsible Investment) to which asset owners, managers and companies can sign up.

Under the management of the United Nations Environment Program (UNEP) Finance Initiative, and the UN Global Compact, the PRI aims to harness the global finance industry to pursue the UN's Millennium development goals, now Sustainable Development Goals or SDGs.

Multiple groups

Other regional investor groups also formed to promote action by companies and lobby governments to combat climate change leading to a slew of new acronyms: These include The Institutional Investor Group on Climate Change in the UK/Europe (IIGCC), The Investor Group on Climate Change in Australasia (IGCC), and The Asia Investor Group on Climate change (AIGC).More recently these four groups have begun to coordinate action under the 'Global Investor Coalition on Climate Change' or 'Paris Aligned Investment Initiative'.

ESG and Policy Change

Embracing greener issues

Issues that became tentatively identified as possible non-financial issues creating financial risk have now been enshrined in legislation. In the UK, successive governments since 2010 have moved to embrace a greener agenda culminating in the UK's Net Zero emissions by 2050 target. This is intended to meet commitments under the multilateral government initiative now codified in the Paris Agreement of 2016. The EU is moving more slowly in the same direction although recent events (i.e. Russia's invasion of Ukraine) has pushed climate change initiatives further down the EU political agenda.

As governments have embraced the need for a more sustainable approach to finance and investment, this has been accompanied by a significant increase in policies focused on the ESG agenda. The United Nations Principles for

[4] Famously called out by Warren Buffet in his [1998 letter to shareholders of Berkshire Hathaway] pp13-16

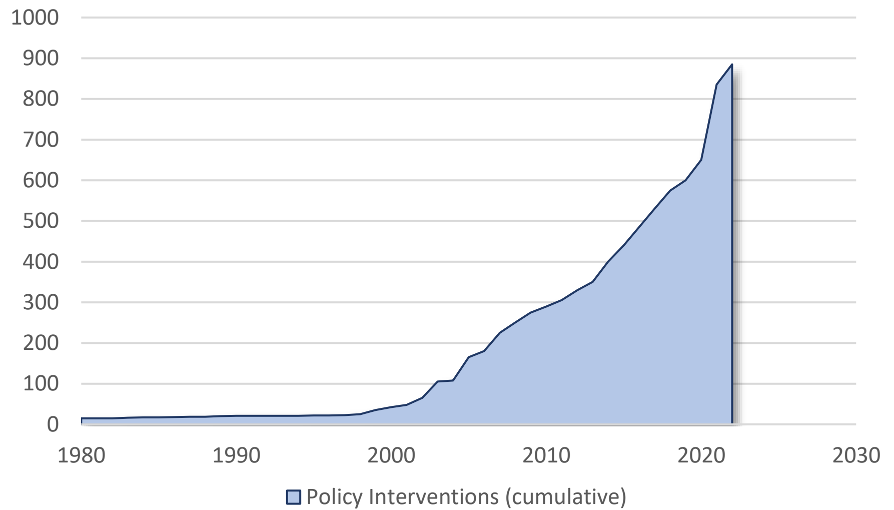
Responsible Investment provides a detailed history of regulations since the 1960s and conclude;

"Greater Government and policy maker interest in sustainable finance and investment has grown dramatically since the start of the century. Of the policies identified by PRI, 96% have been developed since the year 2000. The pace continues to increase – the PRI identified 225 new or revised policy instruments in 2021, more than double the number in any previous year. This continues the trend identified when the PRI first published its database of global sustainable finance policy in 2016".

Rapid expansion in policy interventions

The extent of the rapid expansion in policy interventions relating to sustainable investment can be seen in Figure 8 below which shows that the vast majority of policies have been launched within the last 10 years.

Figure 8: Cumulative number of policy interventions in sustainable investment



Source: UN PRI

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Has ESG helped or harmed investors?

Does ESG increase investor returns?

With the rise in investor interest in incorporating ESG issues into financial analysis and promoting the virtue of ESG friendly investment portfolios, the natural question is whether corporate financial performance has been materially affected, and if so, have returns to investors increased? A more sophisticated and nuanced question would be whether in developed markets - where information is rapidly incorporated into share prices - any new form of analysis can improve risk adjusted returns or can ESG provide a persistent tool to 'beat the market'.

Inconclusive evidence

Intuitively, the case for improving ESG behaviour leading to better performance should be based on the idea that better corporate management of risk (including ESG risks) leads to less volatile corporate financial performance and a higher valuation (ie a lower cost of capital). To date there has been limited success in isolating these effects in a robust statistical way by academics. In the sense that there has always been a disconnect between corporate financial performance and share prices it is also no surprise to see that links between good or improving ESG scores do not necessarily coincide or lead to better investment returns.

Complicating factors

While there may be intuitive investment implications from ESG, a difficulty lies with the following factors which complicate statistical academic and financial analysis:

- Inconsistent/incomplete data
- the conflicts between issues within one company (environmentally positive companies may also have poor corporate governance)
- highly subjective views on social issues
- the difficulty in quantifying many variables for ease of statistical analysis
- the difficulty in forecasting conduct risk/fraud ex ante
- the traditional issue of correlation vs causation

Materiality

Materiality is important

A significant issue for investors and incorporation of ESG into their investment strategies is that of materiality. Investors often diverge on this issue as while what constitutes material financial information has a clear meaning (see box) in investment, there may be many and conflicting factors which are synthesised into a decision to invest (or divest).

If an issue is not material, it will not be included. But different observers and investors with different mandates will tend to have differences of option on what is or is not material. Values driven investors (often using exclusionary methods) may have a more absolutist approach.

> ***Materiality***
> *Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence decisions that primary users of financial statements (hereafter, investors) make on the basis of those financial statements, which provide financial information about a specific company. (Source: IFRS)*

As an example, consider a major food retailer that sells cigarettes. A generalist investor may argue that its turnover in tobacco products as a share of its total sales is immaterial. A cancer charity might take a different view and exclude the retailer on principle.

In order for institutional fund managers to operate with their fiduciary responsibility to their client they must - if challenged - be able to support a thesis

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that taking ESG issues into account does not result in worse outcomes for clients.

Fiduciary duty and ESG

Current thinking on the legal basis of fiduciary duty (largely derived from report published by UNEP in 2005[5]) is that a belief (ex-ante) in the chain of logic outlined above, rather than the (ex-post) lack of robust and unimpeachable statistical evidence of enhanced (risk adjusted) returns allows investors to deploy assets behind ESG strategies without breaching a general fiduciary duty.

Changing views on fiduciary duty

A more recent updated view[6] suggests that failure to consider ESG issues (or opportunities) might now constitute a breach of fiduciary responsibility. This means it changes the burden of proof from allowing ESG into mandates to mitigate risk to punishing failure to do so for ignoring the issues (or opportunities).

The report asserts that:

Empirical and academic evidence demonstrates that incorporating ESG issues is a source of investment value. ESG analysis assists investors to identify value-relevant issues. Neglecting ESG analysis may cause the mispricing of risk and poor asset allocation decisions and is therefore a failure of fiduciary duty. (Source: UN PRI)

ESG and Share Prices

Some elements of E, S and/or G have influenced share prices….

Some research suggests that of the individual elements within ESG there is limited influence on performance in either positive or negative direction from 'E' or 'S' behaviour, but that poor corporate governance has a statistically significant link to bad outcomes[7]. One of major issues in all studies that attempt to look at the impact that ESG has on share prices is isolating general or sector issues from stock specific issues. ESG influences can be very often confused with sector effects notably when looking at defence, tobacco, energy or mining stocks. These tend to perform well or badly for reasons unconnected with individual company behaviour.

Returning to the question of whether ESG helps or harms investors, in his analysis of ESG and financial performance, Guillaume Coqueret (2022) looks at the relationship between the iShares MSCI USA ESG Select ETF relative S&P500 index[8] . The latter is based on sustainability screens that are based on sectors, as well as on ESG scores. The series are normalized so that their initial value is one. The author concludes that at first sight, there is not much difference between the two series. In the first half of the sample, the lines are hardly distinguishable. Between 2012 and 2019, the S&P 500 seems to outperform marginally, but 2020 has eroded part of this superiority.

….but limited statistical significance

He also computed some basic performance measures including average return, volatility and VaR. While return was slightly higher for the S&P 500 vs the MSCI ESG index (9.1% vs 8.7%) volatility (i.e. a measure of risk) was higher for the market index compared to the ESG index. On a risk-adjusted basis the ESG index return was slightly higher than that of the S&P 500. However, he also notes that none of the metrics would pass a test of statistical significance and

[5] A legal Framework for the integration of environmental,social,and governance issues into institutional investment,UNEP Finance Initiative ,October 2005
[6] Fiduciary Duty in the 21st century UNEP FI/UN PRI 2020
[7] Giroud, Xavier, and Holger M Mueller. 2011. "Corporate Governance, Product Market Competition, and Equity Prices." Journal of Finance 66 (2): 563–600.
[8] Guillaume Coqueret (2022), ESG investing and financial performance, chapter 4, Perspectives in Sustainable Equity Investing.

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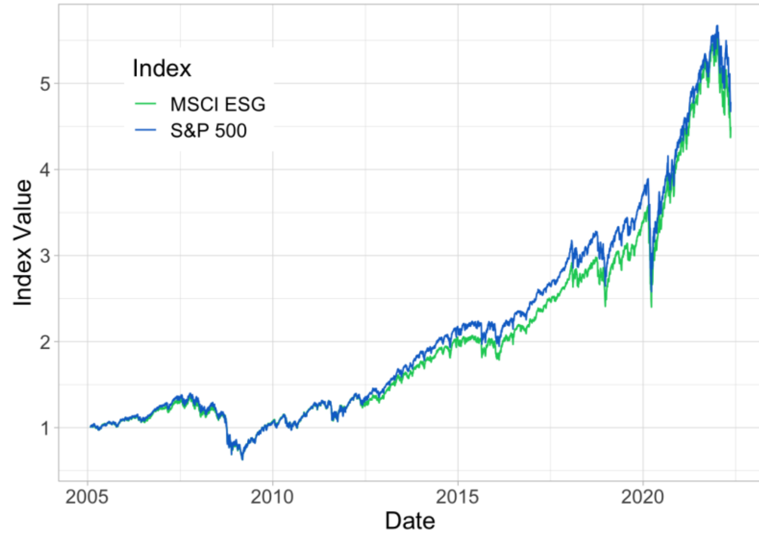
concludes there is no measurable difference between the two, which is line with the majority of academic research on the subject.

Figure 9: S&P 500 vs MSCI ESG index



Source: Coqueret (2022), ESG investing and financial performance

Two steps forward, one step back?

Most funds use an ESG marketing angle

The widespread incorporation of ESG analysis into mainstream investment thinking has progressed to such an extent that that almost all new mutual funds being launched in the EU and UK are being marketed as ESG funds. With this growth in ESG labelled funds regulators have begun to express some concerns, showing a sense of scepticism that marketing of ESG investment products has progressed faster than the achievement of tangible progress towards societal goals.

More rigour being introduced

Amundi, BlackRock, Axa, Invesco, NN Investment Partners (Goldman Sachs), Pimco, Neuberger Berman, Robeco and Deka are among investment companies that have decided to reclassify some of their Article 9 funds (the highest sustainability designation under Europe's Sustainable Finance Disclosure Regulation) to the broader, and less demanding, Article 8 category. This followed clarification that all investments in an article 9 fund must be sustainable, i.e. none involved in transition to a more sustainable path are allowed.

Green Washing
ESG investing has grown significantly in recent years as investors look for sustainable and ethical opportunities. This has generated issues such as financial 'greenwashing', whereby products are mis-sold as being more sustainable than they truly are. (Source: Oxera)

Along with the growth in ESG, over-emphasizing sustainability credentials has become a significant issue for investment funds. The "greenwashing" agenda is now being acted upon and FCA are consulting on a new regime of consumer protection. The likelihood is that as greater understanding of the nuances of ESG investing percolate through to retail investors the rules on fund marketing will also become better understood and more nuanced.

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Summary

Hard to quantify variables

ESG Investing seeks to incorporate a variety of potentially hard to quantify variables into financial analysis. Here we have traced the history of ESG back to faith-based roots and exclusionary policies and seen that as socially responsible investing has evolved into ESG, so new opportunities and risk reduction from tilting portfolios towards better scoring or improving ESG companies has taken over.

ESG plays a pivotal role in investment decisions

Institutional investors are collaborating and integrating ESG into their processes to mitigate risk and seek return, though while there is no overwhelming evidence that there is a strong positive impact on risk adjusted returns, neither it is detrimental. Thus from 2005 it has been possible for asset owners to justify that it is not a breach of any fiduciary duty to mandate their managers to incorporate ESG risks and opportunities into their processes. As a result, ESG investing has grown to an enormous extent and seems likely to continue to do so.

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