INFORMATION FOR INVESTMENT PROFESSIONALS

Shifting trustee mindsets: why ESG integration and risk management are two sides of the same coin

Responsible Investment | September 2019

Chris Wagstaff
Head of Pensions and Investment Education

Chris Anker
Lead Responsible Investment Analyst

Trustees should not treat the management of environmental, social and governance factors as a box-ticking or 'set-and-forget' exercise

As all trustees of UK occupational pension schemes are aware, from 1 October they will have to set out in their scheme's Statement of Investment Principles (SIP), and publish on a publicly available website, how they take account of financially material risks. Additionally, DC trustees must update their default investment strategy to take account of financial considerations. Crucially, financially material risks include environmental, social and governance (ESG) factors, with the Department for Work and Pensions' forthcoming regulations making explicit reference to managing what is prospectively the most material and systemic ESG risk – climate change.

Not that this should come as any great surprise, given the Bank of England has recently highlighted climate change as posing significant risks to the global economy and financial stability. Indeed, investment consultancy Mercer recently modelled the potential financial impacts of climate change under different scenarios and found that sudden sizeable return impacts are likely to dominate pension portfolios that fail to build in sustainability themes.

Indeed, policymakers, financial regulators, NGOs and professional bodies all have the management of financially material ESG factors firmly in their sights, given the recent plethora of recommendations, directives and guidance issued to strengthen ESG integration by almost all asset owners, whether pension schemes or other institutional investors.

And for good reason. A company that is not managing financially material ESG risks may well maximise short-term profits, but in so doing could severely compromise its ability to successfully compete in the future.

By contrast, better governed companies with strong ESG risk management credentials should deliver more sustainable returns by not being so materially exposed to operational, regulatory and reputational risk.

Ultimately, then, ESG analytics are an integral and increasingly mainstream component of a trustee's ever-expanding risk management toolbox.

Confusion still reigns

However, while the consideration of ESG factors is increasingly seen as a way to proactively assess portfolio risk and return characteristics, many trustees still lack an understanding of the extent to which their portfolios have ESG-related vulnerabilities, which ESG factors are financially relevant and material, and how ESG risk manifestly affects different asset classes and strategies. This isn't necessarily surprising given that ESG comprises myriad factors from resource depletion and climate change to diversity, employee relations and compensation, and executive pay, with no universally accepted overarching definition of ESG, what each category comprises and the degree of overlap between the three. Needless to say, ESG isn't a single factor and ESG risks take on a variety of forms.

Also, the terms responsible investment, sustainable investment and ESG are used interchangeably, despite the subtle nuances that differentiate each. Moreover, there is no one-size-fits-all approach to integrating ESG factors into an investment process, with techniques ranging from negative screening, or exclusion, to more sophisticated engagement and social impact approaches.

In short, trustees are being tasked with taking a position on ESG, but don't always have the available information, or the information framed in such a way, to make an informed decision about what constitutes a coherent ESG policy or responsible investment framework. Indeed, most trustees are wholly reliant on their asset managers and investment consultant to inform their approach – which often results in little constructive challenge. Indeed, some trustees are still tempted to see this merely as a box-ticking exercise, despite the ever-increasing risks of doing so.

Moreover, while most investment consultants and asset managers are very close to the topic, understand the issues and largely present the suggested policy in a risk management frame, not all do. This means trustees must keep asking questions until they are satisfied they fully understand the proposed framework and what it implies for investment decision making and risk management.[1]

Exclusion or engagement?

Central to trustees formulating a coherent responsible investment policy is the need to take a position on the exclusion versus engagement debate. Crucially, and perhaps counter-intuitively given that the direction of travel is to reduce man-made greenhouse gas emissions, totally excluding higher carbon emitters from pension portfolios isn't a sustainable strategy. Exclusion, after all, precludes engagement, which is instrumental in effecting positive change and ultimately moving the dial on climate change. Why is this so important? As Lucy Thomas, Head of Investment Stewardship at the New South Wales Treasury Corporation, recently said, "If we don't take care of our impact on the economy, society and the environment … we inhibit our ability to generate returns from these systems."[2]

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[1] For guidance on how trustees might address the requirement to consider ESG issues, the PLSA has issued a note entitled "ESG & Stewardship: A practical guide to trustee duties". This can be found online at: https://www.plsa.co.uk/Policy-and-Research/Document-library/Responsible-Investment-Guide-2019.

[2] Framing the Big Issues in Sustainability. WTW Sustainability Beliefs to Action series - Part 1. August 2019.

Indeed, high carbon emitters are both the problem and the solution. For instance, engaging with leading – ideally best of breed – automotive manufacturers that produce vehicles with internal combustion engines may well result in these giants becoming the driving force behind scalable electric vehicle production. Engagement also typically improves corporate ESG scores, compiled by an increasing number of asset managers (ourselves included), investment consultants and index providers, which help differentiate the businesses most effectively managing ESG risk, and those which are improving, from their worse performing and backtracking peers.

Columbia Threadneedle Proprietary Responsible Investment Ratings

Our own ratings combine two models – one focused on assessing performance with respect to **financial stewardship**, and the other on performance in managing material **ESG risk** factors. Through cloud-based analytics and data science, the tool draws on a large amount of published data for each constituent of our universe of 5,500 companies. The outputs of the two models are combined to produce an overall, forward-looking responsible investment rating from 1 to 5. Companies rated 1 are regarded as having the strongest prospects for delivering future outperformance, while companies rated 5 are regarded as displaying the weakest prospects.

We determine ESG materiality through reference to the Sustainability Accounting Standards Board (SASB®) materiality framework, which identifies the most material ESG risk factors for 77 distinct industries. For each company, between two and 16 such factors are identified as material and thus form part of our risk management assessment. This ensures that at the industry level there is a focus only on those sustainability topics that would likely affect the financial condition and operating performance of any given business.

Financial stewardship, meanwhile, is assessed by looking at the composite of various academic models which, taken together, help us to characterise companies in terms of their financial resilience, enduring financial quality and the strength of their financial governance.

Our RI ratings give our analysts and portfolio managers improved insight into how sustainably a business is managing its balance sheet and how effectively it is managing material ESG risks, helping to underpin ESG integration across our business.

Does sustainability command a valuation premium?

For many trustees, however, the elephant in the room is the somewhat misplaced perception that responsible investment means compromising on financial return and diversification. This isn't helped by its ethical investing origins and association with narrowing the investment universe and lower investment returns, or the inconclusive evidence on the value generated by integrating ESG factors into investment decision making. As intimated earlier, this is a consequence of there not being a universally accepted definition of what E, S and G each comprise, in addition to the limited timeframe over which data is available and qualitative evidence not always being quantifiable. Moreover, one needs to objectively disentangle and isolate the effects of ESG factors on performance from a multiplicity of other financial and non-financial risk factors.

Turning this on its head, the challenge is demonstrating to trustees that a failure to incorporate ESG considerations into investment strategies could be materially detrimental to outcomes, and therefore a failure of fiduciary duty to the scheme's beneficiaries. After all, the view that financial markets do not reward sustainable behaviour has long been held.

This is principally a result of market inefficiency (a failure to internalise the costs of "unsustainable" development in security pricing) and market failure (companies not disclosing adequate information on the sustainable development risks and opportunities of their activities).

However, a degree of comfort can be derived from a considerable number of meta studies that provide evidence of firms with best-in-class ESG credentials exhibiting strong financial performance, given their lower cost of capital and better operational performance.

One recent study that demonstrates the value of integrating ESG factors into investment decision making is that published by George Serafeim at Harvard Business School.[3] Serafeim found that the valuation premium paid for companies with strong sustainability performance has increased over time. In other words, the market rewards such companies with a higher valuation multiple relative to peers after adjusting for factors such as profitability, size, leverage, past returns and other firm characteristics. Moreover, this higher multiple is even greater in the presence of positive public sentiment about a company's sustainability performance. However, when this performance is largely discounted as a result of ambivalent public sentiment, the valuation premium disappears, effectively giving trustees a free lunch in the form of a discounted share price. Indeed, Serafeim finds that when this is the case, significant outperformance results.

And finally …

Of course, establishing a coherent ESG policy, or responsible investment framework, is not a set-and-forget exercise. Far from it. Trustees must monitor and develop their ESG policies and statements as the materiality of different aspects of ESG become more apparent and analytics improve. Additionally, trustees must soon embrace a revised UK Stewardship Code and address various aspects of their asset manager mandates in their scheme SIP by 1 October 2020, while DC trustees will be required to publish an implementation statement setting out how they have acted on their policies in relation to financially material factors.

Ultimately, trustees want to be able to confidently state investment beliefs such as "markets efficiently price in long-term ESG risks, especially climate risks" and "ESG is a collection of identifiable risk factors which prospectively attract a positive return in the long run". Proof points of these statements are contingent on measures requiring companies to make the necessary disclosures on the ESG risks relating to their activities and regulatory mechanisms to internalise ESG externalities in security market pricing. Trustees can, however, now confidently state that "ESG factors are a collection of material risks and opportunities integral to investment decision making that should be managed in the same way as any other material risk".

In the meantime, they should keep asking questions of their investment consultant and asset managers until they are satisfied that financially material ESG risks, which might otherwise compromise the ability to generate long-run sustainable returns, are being properly managed. In short, ESG analytics need to become an integral component of the trustee risk management toolbox.

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[3] George Serafeim. Public Sentiment and the Price of Corporate Sustainability. Harvard Business School. Working paper 19-044. November 2018. This paper analyses data for the years 2009-2018 provided by MSCI for ESG performance ratings and TruValue Labs for measuring public sentiment about a company's sustainability performance.