Does investing according to ESG principles mean sacrificing returns?

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Contents

This paper summarises research on how ESG factors can influence companies, their fundamental and share price performance, and portfolios. By doing so, it helps to address some misunderstandings about ESG, risk and return.
The relationship between ESG and risk/return has been a fertile ground of enquiry for researchers in past decades. In writing this paper, our aim was to give investors real evidence of how ESG may affect their investments. While this is not an exhaustive review, we have tried to include analyses that are rigorous and robust, with an emphasis on peer-reviewed academic research. We recognise that there are potential biases in the research included in this paper, and that there are a number of drivers of share prices and financial returns that may not be related to ESG. One common concern in any research of this type is the distinction between correlation and causality. A given company might have good ESG credentials, good share-price performance and good fundamental performance. In terms of our research, however, we have been careful not to assume that the former quality is automatically the main driver of the latter two.
There are a number of outside factors that may affect company financial or share-price performance. We should also be aware that larger and more successful companies may have more resources to spend on ESG activities. Such conditions could suggest causality between fundamental performance and ESG quality, but that is the inverse of the hypothesis we present in this paper. While we have tried to cover a wide range of research in this paper, including a number of meta-studies, we recognise that the area remains an interesting one for further study.

Executive summary

The benefits of incorporating environmental, social and governance (ESG) factors in the investment process are still being debated by some in the investment community. There are those that believe that an ESG strategy involves accepting a trade-off, receiving lower returns in exchange for 'doing good'. Such thinking does not fit with our view. Instead, we strongly believe that ESG can have a very positive effect on both corporate financial performance (CFP) and on portfolios. We believe that companies that are well-managed, and which consider long-term risks and opportunities around ESG issues, should outperform over the long term.

In this paper, we summarise research on how ESG really influences companies and portfolios. Our aim in writing it was to address some of the misunderstandings about ESG, risk and return. We gathered evidence that ESG integration can be beneficial for investors. The following are some of the most notable findings that we made.

- ESG factors can have a positive effect on corporate financial performance – with evidence showing that higher-quality companies tend to make better profits. They can also influence single-stock returns – with evidence showing that shares of better quality companies can perform better than inferior peers. Finally, they can benefit portfolio risk and return. There is evidence across many time periods and regions (especially in emerging markets) that integrating ESG into the investment process, and investing in companies with better ESG scores, can add to performance.
- ESG integration can lead to lower risk. Given the relationship between risk and return, maintaining a similar return whilst lowering risk is an attractive outcome.

Introduction

ESG investing had its origins in values-based investing, in many cases reflecting ethical or religious views. Over time, it has evolved to include a wider range of strategies and investment products. These vary from strategies that seek to minimise the negative impact of companies or portfolios, to those that seek to maximise positive impact.

At the same time, ESG investing has moved from a niche part of capital markets to the mainstream. The growth of organisations including PRI[1], CDP[2], the Sustainability Accounting Standards Board (SASB)[3], and the Global Reporting Initiative (GRI)[4], to name but a few, demonstrates this well. Reinforcing this move to the mainstream, the Global Sustainable Investment Review 2018, published by the Global Sustainable Investment Alliance, found that sustainable investing assets in Europe, US, Japan, Canada, and Australia / New Zealand stood at USD 30.7 trillion at the start of 2018. This figure is more than a third (34%) higher than that of two years[5] previously.

The need to invest responsibly, in a way that integrates ESG into the investment process, is clear. For the third year in a row, the World Economic Forum's "Global Risks Report"[6] places Extreme Weather and Climate Action Failure as the leading two of the top global risks, measured by likelihood. Extreme Weather has been number one for five years running. The top seven risks are all, arguably, ESG risks.

"The need to invest responsibly, in a way that integrates ESG into the investment process, is clear."

Top Global Risks by Likelihood

	1st	2nd	3rd	4th	5th	6th	7th
2021	Extreme Weather	Climate action failure	Human environmental damage	Infectious diseases	Biodiversity loss	Digital power concentration	Digital inequality
2020	Extreme Weather	Climate action failure	Natural disasters	Biodiversity loss	Human-made environmental disasters		
2019	Extreme Weather	Climate action failure	Natural disasters	Data fraud or theft	Cyberattacks		
2018	Extreme Weather	Natural disasters	Cyberattacks	Data fraud or theft	Climate action failure		
2017	Extreme Weather	Involuntary migration	Natural disasters	Terrorist attacks	Data fraud or theft		

[1] See: https://www.unpri.org/
[2] See: https://www.cdp.net/en
[3] See: https://www.sasb.org/
[4] See: https://www.globalreporting.org/
[5] See: http://www.gsi-alliance.org/trends-report-2018/. Note that the report defines Sustainable Investing as including the following Sustainable investment encompasses the following activities and strategies: Negative/exclusionary screening, Positive/best-in-class screening, Norms-based screening, ESG integration, Sustainability themed investing, Impact/community investing, and Corporate engagement and shareholder action.
[6] See: https://www.weforum.org/reports/the-global-risks-report-2021

With these risks as the backdrop to conversations about ESG, investors are keener than ever to incorporate it into their investment process, whether as asset owners or asset managers. Yet there remains considerable debate as to the risk or return implications of doing so. These concerns often centre on the belief that investors must "give up" performance when integrating ESG, that somehow by considering a wider array of data and information, investments and outcomes will be less attractive. This uncertainty is especially concerning given the magnitude and urgency of the challenges society currently faces. Among these are the effects of climate change, rising inequalities[7], and the need to reduce the environmental impact of our consumption patterns.

We believe that ESG integration leads to better risk-adjusted returns for our clients, and better outcomes. The ESG issues that we consider as part of our investment process are financially material. It follows, therefore, that having a better understanding of financially material issues allows us to make better investments for our clients.

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ESG refers to the consideration of Environmental, Social, and Governance factors in the investment process. Specifically:

- Environmental factors relate to how a company affects its environment. For example, they could include its energy consumption, waste disposal, land development and carbon footprint, among others. They also concern how the environment might affect the company (for example, the effect of climate change).
- Social factors involve a company's relationship with its employees, its approach to issues like diversity and inclusion, labour standards (including along the company's supply chain) and its approach to human rights. They also cover data protection and security.
- Corporate governance factors can include a company's corporate decision-making structure, independence of board members, treatment of minority shareholders, executive compensation and political contributions, among others.

[7] The World Social Report 2020, published by the published by the UN Department of Economic and Social Affairs (DESA), found that "...countries where inequality has grown are home to more than two thirds (71 per cent) of the world population". See: https://www.un.org/development/desa/dspd/world-social-report/2020-2.html.

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Does investing according to ESG principles mean sacrificing returns?

To answer this, we must first address several related questions. First, how does ESG affect corporate financial performance – do high quality companies do better? Second, how does it influence single-stock returns – do better-quality companies outperform inferior peers? Finally, what about portfolio risk and return – does including ESG in stock selection improve either one?

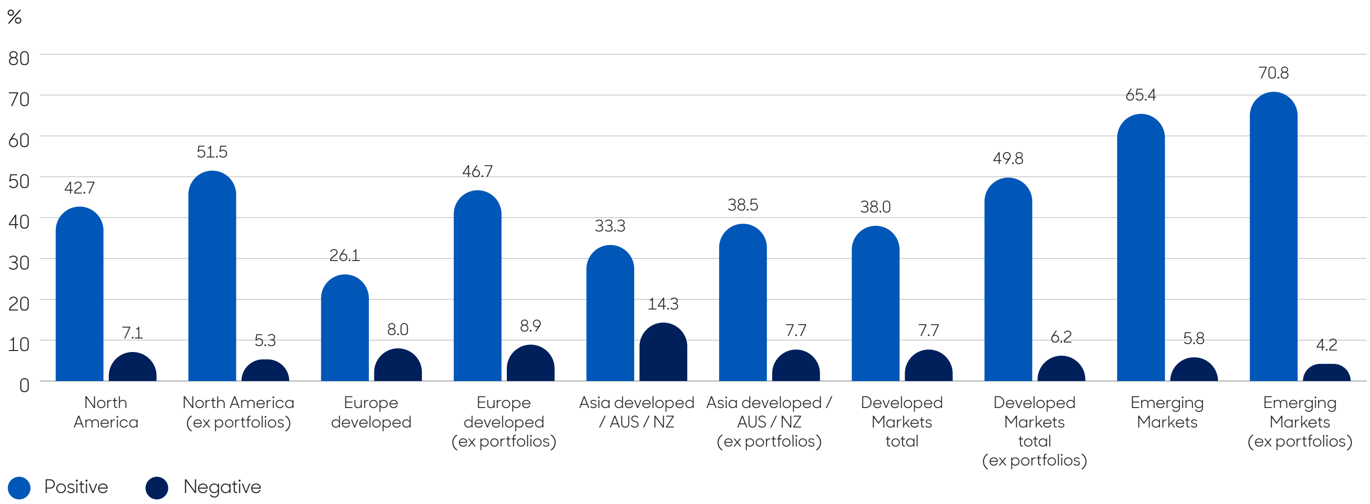
These are all distinct fields of research, but they are clearly inter-related. It seems to follow that companies with good financials might well have better stock returns. Surely, therefore, selecting a number of these stocks and constructing a portfolio from this universe of higher quality companies might lead to better risk-adjusted returns? In this section we consider each of these questions.

ESG and corporate financial performance

Here, we consider evidence that higher-quality companies, defined as those with better ESG ratings or scores, perform better on a fundamental basis, i.e. in terms of corporate financial performance (CFP). This fundamental performance could relate to broad-based profitability, return on equity (ROE), return on assets (ROA), or dividend payments, for example. These are distinct from share-price performance – they relate to the financial performance of the company itself.

One of the broader pieces of research on this topic is a recent and comprehensive meta-analysis[8] of over 2,200 unique research papers on ESG integration. Authors writing in the Journal of Sustainable Finance & Investment found that around 90% of the 2,200 studies reviewed showed"...a nonnegative ESG–CFP relation". A large majority revealed a positive relationship between ESG and corporate financial performance, with the authors concluding that "...the business case for ESG investing is empirically very well founded". The emerging markets sample is particularly interesting, showing, "...with 65.4%, a considerable higher share of positive outcomes over developed markets. Excluding the proportion of portfolio studies, the ratio increases further to 70.8%":

Chart 1: Relationship between ESG and corporate financial performance



Source: Journal of Sustainable Finance & Investment, 2015.

[8] Alexander Bassen, Timo Busch, and Gunnar Friede, "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies," Journal of Sustainable Finance & Investment, 2015, Volume 5, Number 4, pp. 210–33. See: https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917

A more recent meta-study[9] looked at newer research than previous meta-studies. Its authors reviewed more than 1,000 research papers from 2015 to2020, examining the relationship between ESG and financial performance. The study assessed both research relating to corporate financial performance, and research relating to investment performance. It found "…a positive relationship between ESG and financial performance for 58% of the "corporate" studies focused on operational metrics such as ROE, ROA, or stock price". Meanwhile, 59% of "investment" studies "…showed similar or better performance relative to conventional investment approaches." These investment studies typically focused on risk-adjusted attributes such as alpha or the Sharpe ratio. Broad takeaways from the research included:

The paper concludes that the "… analysis of more than 1,000 research papers exploring the linkage between ESG and financial performance since 2015 points to a growing consensus that good corporate management of ESG issues typically results in improved operational metrics such as ROE, ROA, or stock price … [and that] for investors seeking to construct portfolios that generate alpha, some ESG strategies seem to generate market rate or excess returns when compared to conventional investment strategies, especially for long-term investors, and provide downside protection during economic or social crisis".

Separately, MSCI analysed over 1,600 companies (part of the MSCI World Index universe) over the period from January 2007 to May 2017. In doing so, it divided companies into five ESG score quintiles, with Q1 indicating the lowest ESG rating and Q5 the highest. The research[10] provided some useful insights, including that:

- highly rated firms (those in Q5) were more profitable and paid higher dividends than lowly rated firms (those in Q1);
- highly rated firms demonstrate both lower earnings volatility and lower systematic volatility;
- highly rated firms have lower levels of beta and hence lower costs of capital; and
- ESG score momentum is an important factor, with an improvement in ESG characteristics leading to increasing valuations over time.

Improved financial performance due to ESG becomes more noticeable over longer time horizons.

ESG integration as an investment strategy performs better than negative screening approaches.

ESG investing provides downside protection, especially during a social or economic crisis.

Sustainability initiatives at corporates appear to drive better financial performance due to mediating factors such as improved risk management and more innovation.

Studies indicate that managing for a low carbon future improves financial performance.

ESG disclosure on its own does not drive financial performance.

[9] See: https://www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/esg-and-financial-performance

[10] Guido Giese, Linda-Eling Lee, Dimitris Melas, Zoltan Nagy, and Laura Nishikawa, "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance.", Journal of portfolio Management, Vol. 45, No. 5, 2019. See: https://www.msci.com/documents/10199/03d6faef-2394-44e9-a119-4ca130909226

Company stock returns

Below, we go on to look at the relationship between ESG quality and stock returns. Do shares of better quality companies perform better than inferior peers? Are they less volatile than these peers? Compelling research[11] on that relationship comes from Kempf and Osthoff (2007). They used SRI ratings from KLD Research and Analytics, Inc. to construct a long-short portfolio, going long companies with high SRI ratings and going short those with low SRI ratings. The authors analysed this portfolio's performance, drawn from members of the S&P 500 and the DS 400 indexes[12], between 1992 and 2004. They found that the long-short portfolio generated a positive four-factor alpha of up to 8.7% per year.[13] While the time series is historical, the length of study provides some comfort that these insights may be able to add value on a forward looking basis.

Research in the Journal of Sustainable Finance & Investment[14] examined the correlation between ESG performance and volatility of stock returns. This study considered a sample of 157 stocks that are members of the Dow Jones Sustainability Index (DJSI) against 809 companies that are not members of the DJSI. The research found that, across all the industries examined, DJSI member companies displayed lower stock-return volatility versus the reference / non-DJSI companies. The members had an average of 28.67% less volatility, with particularly strong impact in the materials, banking, energy and technology industries.

The research also found that two-thirds of the industries studied demonstrated better returns for DJSI members companies versus the reference / non-DJSI companies, with an annualised outperformance ranging from 2.25% to 31.84%. The conclusion is that "ESG factors bring lower volatility and therefore lower risk, and consequently higher risk-adjusted returns".

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Salama, Anderson and Toms (2011) made similar observations using a dataset of UK companies. They found that a firm's environmental performance is inversely related to its systematic financial risk[15]. The findings are consistent with those of Dunn et al (2018), whose research[16] concluded that high-scoring ESG stocks have lower volatility and betas than lower scoring ESG stocks. Making use of a global sample of stocks and the MSCI ESG scoring database, the authors find that: "Stocks in the worst ESG quintile have total volatility and stock specific volatility that is higher by 10-15%, and betas that are higher by 3%, than the corresponding measures for stocks in the best ESG quintile".

Perhaps more interestingly, the authors of this study also note the informational benefit of ESG scores. They found that "…ESG exposures may inform investors about the riskiness of the securities in a way that is complementary to what is captured by traditional statistical risk models." The findings that higher-scoring firms have lower beta should suggest a lower cost of capital. This has indeed been a part of ESG investing, the notion being that better-managed firms with a more sustainable business model should – all things remaining equal – enjoy a lower cost of capital.

[11] [5] Kempf, Alexander; Osthoff, Peer (2007), "The effect of socially responsible investing on portfolio performance", CFR Working Paper, No. 06-10, University of Cologne, Centre for Financial Research (CFR). See: https://www.econstor.eu/bitstream/10419/57725/1/702962686.pdf

[12] KLD use SRI ratings data to construct the Domini 400 Social Index (DS 400), a "a capitalization weighted index of 400 US securities that provides exposure to companies with outstanding Environmental, Social and Governance (ESG) ratings and excludes companies whose products have negative social or environmental impacts". For more see here: https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6

[13] A four-factor model "…controls for the impact of the market risk, the size factor, the book-to-market factor, and the momentum factor on returns".

[14] N. C. Ashwin Kumar, Camille Smith, Leïla Badis, Nan Wang, Paz Ambrosy and Rodrigo Tavares, "ESG factors and risk-adjusted performance: a new quantitative model", Journal of Sustainable Finance & Investment, 2016, vol. 6, issue 4, 292-300. See: https://econpapers.repec.org/article/tafjsustf/v_3a6_3ay_3a2016_3ai_3a4_3ap_3a292-300.htm and https://bus.lmu.edu/media/bus/responsibleinvestingprogram/ESG%20Performance.pdf

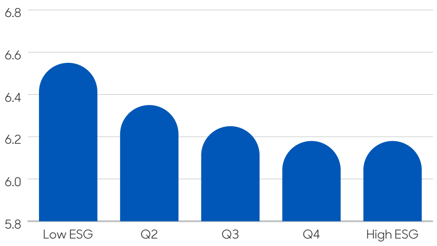
[15] Salama, Anderson and Toms (2011), "Does Community and Environmental Responsibility Affect Firm Risk? Evidence from UK Panel Data 1994-2006", Business Ethics A European Review 20(2):192 – 204. See: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1457146

[16] Dunn, J., Fitzgibbons, S. & Pomorski, L., 2018, "Assessing Risk Through Environmental, Social and Governance Exposures", Journal of Investment Management, 16(1).See: https://www.aqr.com/Insights/Research/Journal-Article/Assessing-Risk-through-Environmental-Social-and-Governance-Exposures

Sharfman and Fernando (2008)[17] focused on environmental risk management at 267 US firms. In their study, they found that better environmental risk management at firms is correlated with a lower cost of equity stemming from lower systematic risk (ie beta). These findings are consistent with research from MSCI[18] that showed that companies with higher ESG scores generally experienced lower costs of capital when compared to companies with poorer ESG scores. This was the case in both developed and emerging markets, during a four-year study period. As with other research mentioned in this paper, the MSCI study found that the cost of capital differential was greater in emerging markets:

Chart 2: World – cost of capital

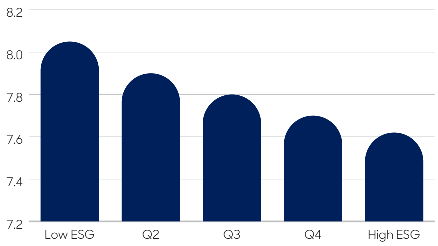
%



Source: MSCI, February 2020.

Chart 3: World – cost of equity

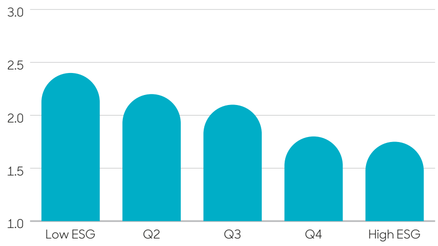
%



Source: MSCI, February 2020.

Chart 4: World – cost of debt

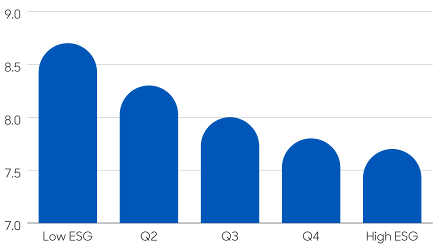
%



Source: MSCI, February 2020.

Chart 5: EM – cost of capital

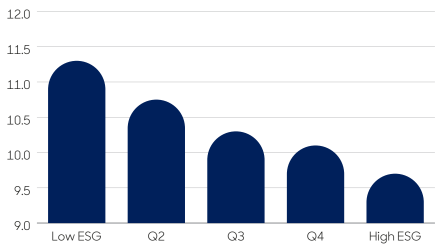
%



Source: MSCI, February 2020.

Chart 6: EM – cost of equity

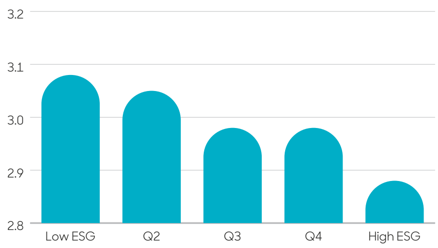
%



Source: MSCI, February 2020.

Chart 7: EM – cost of debt

%



Source: MSCI, February 2020.

Staying with emerging markets, recent research[19] examined the relationship between ESG scores and stock and portfolio performance in China with a focus on members of the country's CSI300 index. The research found that ESG integration can aid investors in China, with high-scoring ESG portfolios outperforming low-scoring ESG portfolios in normal circumstances. Interestingly, the research also found that the impact of ESG is more pronounced during periods of market turbulence and crisis; companies with higher ESG ratings proved to be more resilient during the COVID-19 crisis in 2020.

[17] Sharfman, M. P., and Fernando, C. S. (2008), "Environmental risk management and the cost of capital", Strategic Management Journal 29(6), 569–592. See: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1129032

[18] See: https://www.msci.com/www/blog-posts/esg-and-the-cost-of-capital/01726513589

[19] David C. Broadstock, Kalok Chan, Louis T.W. Cheng, Xiaowei Wang, "The role of ESG performance during times of financial crisis: Evidence from COVID-19 in China", Finance Research Letters, 2020, 101716. See: https://www.sciencedirect.com/science/article/pii/S1544612320309983

Portfolio research and implications

Next, we move on to consider whether ESG integration can benefit portfolio performance. This is a pertinent topic for us. While single-stock performance is helpful, as active managers we seek to construct portfolios of high quality companies, and so the relationship between ESG quality and portfolio outcomes is interesting.

There are two components to this – risk and return. Naturally, it is tempting to focus on what ESG can add to portfolio performance. However, equally important to us as portfolio constructors is the impact of ESG on the risk of a portfolio. We think in terms of risk-adjusted returns, that is the performance of a portfolio considering the degree of risk that the portfolio takes. Put simply, the more that we can lower the risk needed in order to enjoy a return, the better. Consider two portfolios – both have the same portfolio return, but one has lower risk (as measured by volatility). Here, the portfolio with lower volatility would have higher risk-adjusted returns, returning more per unit of risk. So it is interesting to us to understand whether ESG lowers portfolio volatility. So, can ESG lower portfolio volatility?

"The research also found that the impact of ESG is more pronounced during periods of market turbulence and crisis; companies with higher ESG ratings proved to be more resilient during the COVID-19 crisis in 2020."

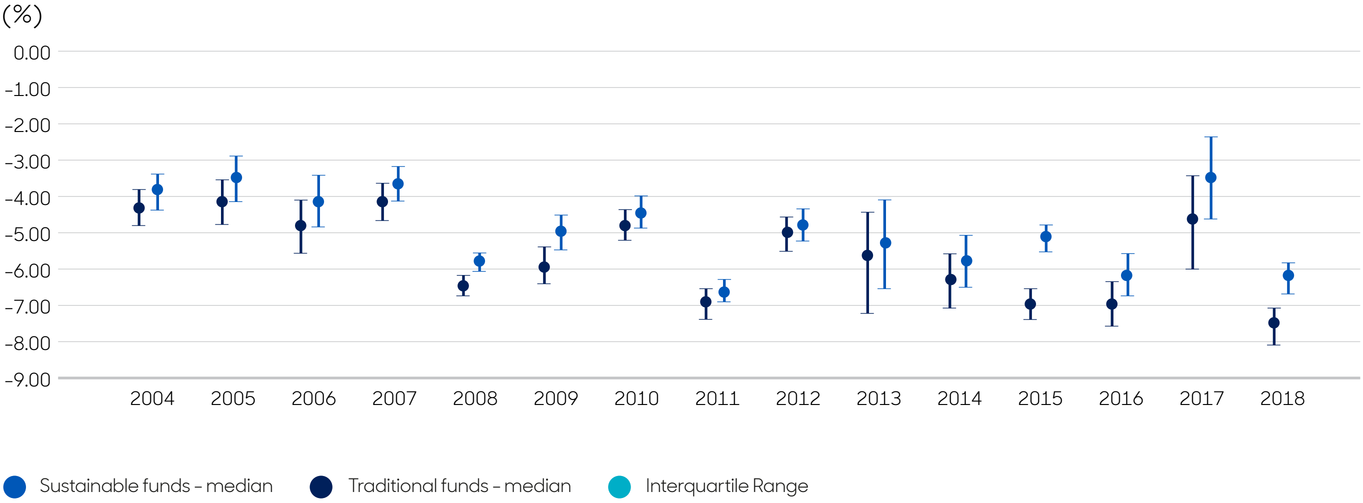
Indeed, research[20] in 2020 published in the Journal of Asset Management examined the benefit of integrating ESG into portfolios. Its authors sampled 1,010 European and 1,651 U.S. firms and assessed performance between January 2002 and December 2015. The study measured ESG scores across 15 key ESG indicators as per by Thomson Reuters Asset4. Among other things, the author found that "ESG integration reduces portfolio risk across the full spectrum of markets and investment styles".

In a similar vein, a recent analysis[21] by Morgan Stanley examined the risk and return performance of ESG-focused[22] mutual a nd exchange-traded funds, and compared them to their 'traditional' counterparts, over the period from 2004-2018. The research used Morningstar data, and examined 10,723 separate funds. It showed that while performance of sustainable funds was similar in terms of returns to their traditional counterparts:

"Incorporating environmental, social, and governance (ESG) criteria may help to limit market risk". Of note, the research found that "...sustainable funds were less risky investments between 2004 and 2018". It measured this by downside deviation (up to 20% less downside deviation), with downside deviation notably smaller in turbulent markets (i.e. 2008, 2009, and 2015).

[20] Kaiser, L. "ESG Integration: Value, Growth and Momentum" Journal of Asset Management (2020), 21, 32-51. https://doi.org/10.1057/s41260-019-00148-y
[21] Morgan Stanley, "Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds", (August 2019) . Link to the full whitepaper: https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf
[22] The ESG Focus Fund label is a Morningstar label; Funds tagged by Morningstar with the ESG Focus attribute are defined as those that prioritize investments based on multiple screens for numerous ESG factors and a variety of strategies, ranging from ESG integration to exclusion.

Chart 8: Medium Downside Deviation of Sustainable and Traditional Funds, 2004 - 2018



Source: Morgan Stanley, August 2019.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Sustainable Funds	-3.86	-3.52	-4.14	-3.66	-5.83	-5.03	-4.44	-6.66	-4.80	-5.32	-5.80	-5.14	-6.15	-3.47	-6.24
Traditional Funds	-4.29	-4.16	-4.82	-4.12	-6.43	-5.87	-4.79	-6.88	-5.02	-5.66	-6.30	-6.96	-6.96	-4.59	-7.56
Difference (Sustainable - Tradition	0.43 **	0.64 *	0.68 **	0.46 **	0.60 *	0.84 **	0.35 **	0.22	0.22 ***	0.34 **	0.51 ***	1.82 ***	0.80 ***	1.11 ***	1.32 ***
Statistical Significance	99%+	***		95%+	**			90%+	*						

What is ESG Quality / Significance of Materiality

The research we have discussed so far supports our view as to the benefit of integrating ESG, but there is a risk in simply looking at ESG scores and inferring ESG quality. Elsewhere in this paper, we have used ESG quality as shorthand for companies that score well in ESG scoring, but our experience teaches us that it is risky to consider ESG scores as a definitive view of the quality of a company.

Companies may score well for issues that are not material to operations, and less well on topics that could really affect value. Simple ESG scores and ratings alone are not sufficient. Investors need to understand the materiality of issues that face the firm, and interpret the ways in which a company is addressing material risks and opportunities. Indeed, we spend a lot of time understanding the materiality of a range ESG issues for firms.

Some issues will be more pronounced, and present greater risks and opportunities, for firms depending on where, and in which industry, they operate. Consider an oil and gas company – the range of topics we might discuss with it will differ from those we would talk about with a telecoms company. For each one, we think about whether an issue will likely materially impact the company's financial performance. We also discuss the ways in which it is managing this risk (or opportunity). For an oil and gas business the discussions might typically be around climate change and the transition to renewable energy, the company's health and safety record, and approach to environmental management. For a telecoms company we might typically discuss cyber-security, human capital management, and energy intensity.
Part of the challenge of ESG is determining what is material for a company. It is here that we draw on the expertise of analysts, fund managers, ESG specialists, and macro-economic research to pull together a view of materiality for different sectors and countries. Focusing on 'strong' performance by a company on a non-material issue can give a misleading view.

This focus on materiality was the topic of research[23] by Khan, Serafeim and Yoon from Harvard Business School (2015). The authors found that firms that perform well on the ESG issues most material for their firm can out-perform those who don't, with an estimated alpha for firms that score well on material ESG issues of 6.01%. At the same time, the authors find that "...firms with strong performance on immaterial sustainability topics do not outperform firms with poor performance on immaterial topics". This suggests that misplaced focus (or, at worst, greenwashing) does not lead to additional alpha.[24] The research reinforces the importance of focusing on material ESG issues, a key part of our own investment process.

"Investors need to understand the materiality of issues that face the firm, and interpret the ways in which a company is addressing material risks and opportunities."

[23] Khan, Mozaffar N., George Serafeim, and Aaron Yoon. "Corporate Sustainability: First Evidence on Materiality." Harvard Business School Working Paper, No. 15-073, March 2015. See: http://nrs.harvard.edu/urn-3:HUL.InstRepos:14369106
[24] Laying claim to undeserved environmental, social & governance (ESG) credentials in an attempt to profit from the associated publicity.

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Implications for active management

Our brief review of some of the research on ESG investing found that:

- ESG factors can have a positive effect on corporate financial performance – with evidence showing that higher-quality companies tend to make better profits. They can also influence single-stock returns –with evidence showing that better quality companies can perform better than inferior peers. Finally, they can benefit portfolio risk and return. There is evidence across many time periods and regions (especially in emerging markets)that integrating ESG into the investment process, and investing in companies with better ESG scores, can add to performance.
- ESG integration can lead to lower risk. Given the relationship between risk and return, maintaining a similar return whilst lowering risk is an attractive outcome.

These results are positive, and support our view that ESG can have a very positive effect on both corporate financial performance (CFP) and on portfolios. While we concede that shorter-term dislocations can occur, over a longer timeframe for the case for ESG integration is compelling.

What does that mean for us in practice? As long-term investors, we place great emphasis on understanding ESG issues, with a focus on the most material ESG issues for companies and sectors. As active managers, we want to invest in well-managed companies with sustainable business models, and make a considerable effort to identify such companies. There are two interconnected components to our ESG analysis:

Macro / thematic level ESG research

Here, we look to understand major themes and trends in ESG, and understand how they might affect firms, drawing on the expertise of analysts, fund managers, ESG specialists, and macro-economic research to pull together a view of materiality for different sectors and countries. Our views on ESG build on the four inter-connected meta-themes we have identified – or what we have called the 4Ps, including People (including demographics), Policy (including governance and engagement), Planet (including environment and climate change), and Progress (including technology and infrastructure).

Specific topics we research might include any of the following:

- climate change and decarbonisation
- changing consumer preferences (specifically for more sustainable products)
- supply-chain management
- financial inclusion

Firm-level ESG research

Here, we look to identify the ESG issues and risk factors facing each company, building on our research of the macro issues discussed above, our deep understanding of sectors and countries, and our knowledge of companies derived from extensive due diligence. We want to understand the ways in which management are addressing and managing these issues, and embed this research into our core research process to help us build a view of the quality of a company.

In turn, there are the two ways in which we as active managers look to add to returns by integrating ESG.

First, we want to understand firm-level ESG better than the market. While we consider ESG scores from third-party providers, we do our own due diligence and research. This means we have as full a picture as possible. ESG quality is an area characterised by high levels of information asymmetry, particularly in emerging markets where information disclosure is less fulsome than developed markets. What do we mean by this? Simply that behaviour and practises can be better than disclosures might suggest. By extension, relying only on company disclosure when assessing ESG does not provide the whole picture. As active managers, we use our local presence around the world to find companies with ESG quality that are not yet fully appreciated by the market, leveraging our local presence to meet companies, along with other stakeholders. This is not a simple task – it requires deep understandings of business models, supply chains, jurisdictions and geographies, regulations, and environmental issues, and draws on multiple areas of expertise across the firm to build a comprehensive picture of quality.

Second, we want to help companies improve and enhance their ESG through active engagement. We are not activist investors, but we do look to draw on our experiences across industries and regions to constructively challenge management to do better. We believe it is not just our right to do so, but our responsibility.

If there is a link between ESG scores and performance, then improving ESG scores (either through influencing behaviour or simply improving disclosure) may, we believe, help stock and hence portfolio performance. Indeed, there is evidence[25] that engaging on ESG factors is associated with "subsequent significant reductions in the portfolio firms' downside risk" where engagements have been deemed successful. Similar research found a positive link between successful ESG engagements and abnormal returns; researchers writing in The Review of Financial Studies[26] found positive market reactions to engagements at U.S. listed firms over 1999-2009, with an average one-year size adjusted abnormal return after initial engagement of +7.1% for successful engagements.

[25] Hoepner, Andreas G. F. and Oikonomou, Ioannis and Sautner, Zacharias and Starks, Laura T. and Zhou, Xiaoyan, (2018), "ESG Shareholder Engagement and Downside Risk", AFA 2018 paper, European Corporate Governance Institute – Finance Working Paper No. 671/2020, Available at SSRN: https://ssrn.com/abstract=2874252 or http://dx.doi.org/10.2139/ssrn.2874252

[26] Dimson, E., Karakaş, O. & Li, X. (2015), "Active Ownership", Review of Financial Studies, 28(12), 3225-3268. See: https://academic.oup.com/rfs/article/28/12/3225/1573572

Final thoughts

This paper attempted to summarise research on how ESG really influences companies and portfolios. We wanted to address some of the misunderstandings about ESG, risk, and return. While we recognise that the research we discussed is not exhaustive, we have provided a wide range of data, with a particular focus on peer-reviewed academic studies. Our finding is that there is evidence that ESG integration can be beneficial for investors. This supports our view that ESG can have a very positive effect on both corporate financial performance (CFP) and on portfolios. As such, the outcome reinforces the importance of our focus on ESG as part of our core research process.

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