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"It takes time to connect the dots, I know that. But I also know that there can be a day of reckoning when you wish you had connected the dots more quickly."

AL GORE
FORMER AMERICAN POLITICIAN AND ENVIRONMENTALIST

Can an eye to ESG enhance long-term portfolio performance?

Responsible investing, call it ESG, has come a long way since Al Gore sharply raised the world's awareness about climate change in his 2006 documentary—*An inconvenient truth*.

While investing with an eye on environmental concerns remains integral (the 'E'), responsible investing increasingly incorporates a company's social behaviour (the 'S') and its governance (the 'G'). Adding momentum to this style is the realisation that there is a growing cohort of investors led by millennials (which we used to call Generation Y) that is increasingly likely to make their investment decisions by taking into account such environmental, social and governance issues. Indeed, USD 30 trillion of capital is expected to come their way to invest (inherited from baby boomers) over the next couple of decades [1].

As we highlight on the following pages, a number of trends are emerging within ESG. Firstly, it is no longer an 'all-or-nothing' space, with investors increasingly seeking to progressively shift their portfolios onto a more 'responsible' footing, rather than making a potentially more complicated across-the-board leap. Secondly, a growing body of research is showing that an eye to ESG investing doesn't negatively impact client returns and instead may enhance long-term portfolio performance. Indeed, as reflected in some recent corporate controversies, "seeing the world through an ESG lens helps throw light on systemic risk", as UBS ESG Analyst Julie Hudson notes in relation to events surrounding Volkswagen. Finally, awareness of responsible investing, and demand for ESG funds, is broadening beyond thinking only about equity investments, to also considering fixed income as well as credit investments.

Ultimately, wealth managers will increasingly need to be able to offer value-based investment options to their clients. And ensure they can align their investments with their values (both ethical and political) in a way that also delivers competitive returns.

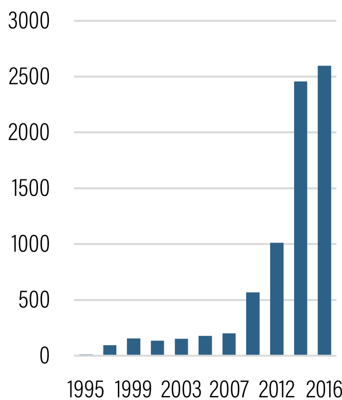
What is ESG investing?

Responsible investing, or ESG, is an approach to investment decision-making that takes environment, social and governance (ESG) issues into account.

- **Environmental issues** include climate change, carbon emissions, water stress, waste, biodiversity, renewable energy and clean technology.
- **Social issues** include human capital, labour standards, product and chemical safety, privacy and data security, as well as controversial sourcing.
- **Governance issues** include board and leadership structure, pay equality, ownership, ethics, corruption, taxation transparency and anti-competitive behaviour.

[1] Accenture. *The "Greater" wealth transfer—Capitalizing on the intergenerational shift in wealth, 2012:*
http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture-CM-AWAMS-Wealth-Transfer-Final-June2012-Web-Version.pdf

Investment funds incorporating ESG factors, US



Source: *Report on US sustainable, responsible and impact investing trends, 2016.*

Ethical assets under management have grown significantly in the current decade. According to Allianz, assets invested with money managers that incorporate ESG criteria grew from USD 1.4 trillion in 2012 to USD 8 trillion in 2016. In Australia, according to the latest *Responsible Investment Benchmark Report* [2], core responsible investment funds grew by 26% to AUD 65 billion in 2016.

Why is ESG investing growing in importance?

There are a number of driving forces behind the rise of responsible investing. The world is clearly confronting sustainability challenges, as the global population grows, and resource availability is stressed. There is also underway a significant shift in investor preference, led by millennials, toward more socially and environmentally-responsible investing. According to the latest Factset research, 70% of millennial high-net-worth investors expect their wealth managers to screen for ESG factors, while MSCI highlights US Trust research showing 67% of millennials believe investments "are a way to express social, political or environmental values" versus 36% of baby boomers [3].

For corporates, there is also increasing pressure to lift standards of operation. This is no longer confined to manufacturing and industrial sectors. In financial services, companies are being asked to do more to incorporate climate change scenarios in their own risk assessments. For example, the latest guidelines from the *Financial Stability Board's Task Force on Climate-Related Financial Disclosure* include a recommendation that companies, asset owners and investment managers, banks and insurance companies incorporate climate scenarios into their risk assessment.

Investors and corporates alike also face a rapid rise in complexity around sustainability, with the accelerating pace of change potentially making it difficult to stay on top of developments. Together, these are increasing the demand for specialist organisations and fund managers with the expertise in these areas to advise both corporates and investors.

Trend 1—ESG is no longer an 'all-or-nothing' space

Some time ago, responsible investing focused particularly on 'the product' and the environment, by excluding companies and funds investing in those sectors deemed non-ESG, such as tobacco, arms, gambling and the like (negative screening). Today, the space is becoming less black and white, with a more holistic focus on 'company behaviour'. Positive screening is largely taking over from negative screening, with companies being assessed for ESG factors that allow a modern 'best-in-class' approach to investment choice. This can extend from environmental behaviour, through to board diversity, staff turnover and other management controls.

70% of millennial high-net-worth investors expect their wealth managers to screen for ESG factors

FACTSET

Moreover, along the lines of a quote controversially ascribed to a 1907 sermon by William Watkinson, "It is better to light a candle than curse at the darkness", investors are increasingly seeking to progressively shift their portfolios year-by-year onto a more responsible footing. In so doing, they can avoid the more challenging task of an across-the-board re-allocation, often without the breadth of investment options that reflect their risk appetitive and investment horizon.

In the past, negative screening could lead to the complete exclusion of some sectors, providing investors less options to diversify risk. Similarly, a shift toward a fully-ESG portfolio was often challenged by a lack of available investment vehicles, also raising the cost to investors attempting to align their values. However, the move to positive screening and the growth of ESG-available investments means that this is now much less of an impediment.

Trend 2—ESG investing need not come at the expense of returns, and may enhance them

A growing body of research suggests a positive contribution of ESG characteristics to financial performance. According to a recent report drawing together 2,000 separate empirical studies, "roughly 90% of studies find a non-negative" relationship between ESG alignment and corporate financial performance. More importantly, "the large majority of studies report positive

[2] https://responsibleinvestment.org/wp-content/uploads/2016/07/RIA413_Benchmark_Report_A4_OZ_v4.pdf
[3] US Trust *Insights on wealth and worth, 2014.*

“investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments “

MORGAN STANLEY

findings” [4]. Similarly, a recent study by Morgan Stanley [5], which evaluated more than 10,000 funds and managed accounts, shows that “investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments.”

So, while there can be a perception bias by investors about ESG investing, this suggests an eye to ESG signals can positively enhance a portfolio’s performance. More evidence of this has emerged recently, given an onslaught of major adverse corporate events, including Volkswagen in 2015 and Wells Fargo in 2016, which highlighted the value of ESG signals in evaluating portfolio risk.

It may also be the case that companies striving for ESG excellence also possess a natural drive toward more innovative behaviour, both in their internal efficiency, leadership diversity as well as their infrastructure (energy and water use). This natural drive often aligns with sustained strong financial performance.

Finally, a focus for a growing group of investors is how they can achieve positive social outcomes that are measurable, along with competitive returns (ie, ‘impact investing’), with availability of investment options in this space also continuing to grow strongly.

Trend 3—ESG is increasingly a focus in fixed income and credit investing

ESG is no longer just about equity investments. Increasingly, high-net-worth investors, family offices and not-for-profit investors are seeking responsible managers across their fixed income portfolios, as well as turning to how ESG factors can be used more fully in credit analysis.

MSCI in its 2018 *ESG trends to watch* [6] report noted that “historically, the uptake for ESG integration by fixed income investors has lagged equities”. However, there had been a rapid growth in fixed income assets being managed against ESG principles, reflecting client demand and competition among asset managers to meet that demand. A 2016 report by Eurosif [7] also highlighted increasing demand for ethical fixed income investments.

We expect ESG signals will also be increasingly applied to credit risk research. This transition is likely to be facilitated relatively rapidly by the growth of ESG expertise in equity investing. It is also plausible that in the future, deteriorating credit risk may, as it has for single securities, reflect ESG events. MSCI recently noted that in a study of the ESG ratings of 60 countries between 2011-2014, that higher ESG-rated sovereigns “on average saw their CDS spreads narrow by more, or widen by less, than their lower-rated counterparts” over the following three years [8].

In summary

In a constantly shifting global environment, where global trends can impact significantly on markets, incorporating ESG criteria into a portfolio is increasingly being shown to reduce long-term risk and potentially enhance long-term returns. As evidenced over the past couple of years, ESG signals can identify future risks that are not yet otherwise evident, such as in the case of Volkswagen and Wells Fargo. The expertise that has grown in ESG equity investing has also allowed the rapid expansion of ESG factors across fixed income portfolios. This has facilitated investors being able to progressively shift their portfolios onto a more responsible footing, with a broader array of positively-screened investments that no longer see a desire to align values complicated by a lack of diversity. It is likely that ESG criteria will increasingly prove an important signal for enhancing portfolio performance, while the number of investors who focus on ascertaining measurable positive social and environmental benefits from ESG-aware portfolios is only likely to increase in the years ahead.

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[4] Friede, G., Busch, T. and Bassen, A., 2015: *ESG and financial performance: aggregated evidence from more than 2,000 empirical studies*. Journal of Sustainable Finance and Investment, 5(4), pp. 210-233.

[5] https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf

[6] https://www.msci.com/documents/10199/6faa4e4e-c3d3-4baf-ba82-d7cc4647d95d

[7] http://www.eurosif.org/wp-content/uploads/2016/11/SRI-study-2016-HR.pdf

[8] MSCI ESG research, 2017: *Did ESG ratings help to explain changes in sovereign CDS spreads?*

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