A Special Report from

SAVVY INVESTOR

Effective ESG: Strategies for doing well by doing good

Discussing ESG strategies that lead to positive outcomes with leading industry professionals

Authored by Savvy Investor

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Special Report

Effective ESG: Strategies for doing well by doing good

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Effective ESG: Strategies for doing well by doing good

MATTHEW KIMBROUGH
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Matthew Kimbrough is a former Fixed Income Portfolio Manager and MBA graduate from HEC Paris, having previously worked for Argent Financial Group and JP Morgan in both the U.S. and UK.

"THE PAST YEAR AND A HALF HAS SERVED TO HIGHLIGHT THIS FUNDING GAP, ESPECIALLY GIVEN THE STRAIN EXERTED BY COVID-19 ON GLOBAL HEALTHCARE SYSTEMS."

Impactful ESG Investments and Optimal Portfolio Outcomes

The 2010s saw a notable decline of social infrastructure investments in many of the largest OECD countries. The past year and a half have served to highlight this funding gap, especially given the strain exerted by Covid-19 on global healthcare systems. In addition to healthcare, social infrastructure encompasses many other essential services provided to the community, including educational facilities, affordable housing, and other civic buildings.

But how can investment managers optimise the integration of ESG characteristics within their portfolios? One approach is bottom-up, examining only stock-specific ESG constraints versus a relevant benchmark. Another approach is top-down, placing a greater emphasis on portfolio-level exposures. In 'How to Boost Your ESG Scores and Preserve Your Risk-Reward Outcomes', Intech looks at four such methodologies (two bottom-up and two top-down), adjusting ESG constraints in an attempt to determine the optimal method with respect to both risk and reward.

Climate change also continues to be at the top of the agenda for investors and regulators alike. In the paper 'The Going Gets Tough: Can heavy industry decarbonise?', Aviva Investors outlines the issues that heavy industry and heavy transport are facing. They go on to underline the importance of companies, policymakers and investors collaborating to enable these companies to reach net-zero emissions by 2050.

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INTECH

Intech is a specialised, quantitative equity manager that pioneered the use of Stochastic Portfolio Theory in 1987. Over 30 years later, Intech remains distinctive in our approach – harnessing volatility to exploit diversification as an alpha source, not just risk reduction. Institutional investors around the world embrace The Intech Way across four investment platforms: Enhanced Equity, Active Equity, Defensive Equity, and Absolute Return.

Intech continues to innovate today, embedding a long-term sustainability focus across our areas of influence: ESG Investments, Active Stewardship, Corporate Responsibility, and Global Cooperation. Intech believes our sustainability efforts reinforce our principal responsibility: representing our clients' objectives, preferences, and best interests.

AVIVA INVESTORS

Aviva Investors is a global asset manager with integrated expertise across equities, credit, multi-asset and macro, solutions and real assets. Our investment intelligence spans major markets where we currently invest over £357 billion (as at 30 June 2021) on behalf of our customers. As part of the Aviva Group – the UK's largest insurance company – we are uniquely positioned to combine our insurance heritage with our investment capabilities to deliver the outcomes that matter most to today's investor.

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In partnership with Eden Reforestation Projects, we have committed to the planting of a tree for every new Savvy Investor member.

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Featured Paper from Intech:

How to Boost Your ESG Scores and Preserve Your Risk-Reward Outcomes

HOW TO BOOST YOUR ESG SCORES AND PRESERVE YOUR RISK-REWARD OUTCOMES

September 2021

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Key Ideas

- Investors tend to use one of two approaches to help enhance a portfolio's ESG scores: applying stock-driven exposures or optimizing portfolio-driven exposures.
- Developing or buying stock-level ESG ratings seems like a straightforward path to ESG implementation, but using stock ratings alone potentially invites steep trade-offs in return, risk, and ESG consistency at the portfolio level.
- Our research shows that targeting portfolio-level ESG results both by incorporating ESG constraints and concurrently adjusting non-ESG optimization constraints appears to offer a more practical way to pursue both stronger and more consistent ESG *and* risk-reward outcomes.
- We analyze the impact of applying four different ESG approaches — two focused on stock-driven exposures and two managing portfolio-driven ESG exposures — to a baseline non-ESG portfolio with an attractive long-term risk-reward profile.
- Both portfolio-driven approaches delivered meaningful and more consistent ESG enhancement while essentially preserving the level of excess return and tracking error of the baseline non-ESG portfolio.
- Both stock-driven approaches also offered favorable, though less consistent, ESG score improvements but with notably reduced returns.

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"MANY INVESTORS CONTINUE TO RELY ON STOCK-DRIVEN ESG EXPOSURES WHEN INTEGRATING ESG CONSIDERATIONS INTO PORTFOLIO CONSTRUCTION; HOWEVER, FOCUSING ON PORTFOLIO-LEVEL EXPOSURES APPEARS TO BE A MORE EFFICIENT APPROACH."

What's the most effective ESG investment approach?

As more investors embrace the importance of incorporating environmental, social, and governance (ESG) considerations into their portfolios, there has been growing interest in managing the potential performance trade-offs that can often be associated with capturing enhanced ESG characteristics. Investors tend to favour one of two typical approaches to implementing ESG investment strategies: stock-driven and portfolio-driven. Many investors continue to rely on stock-driven ESG exposures when integrating ESG considerations into portfolio construction; however, focusing on portfolio-level exposures appears to be a more efficient approach.

Stock-exclusions invite challenges

Focusing on stock-level ESG exposures may intuitively seem like the most straightforward way to improve a portfolio's ESG scores. Yet, our research shows that a stock-driven approach alone can come with steep trade-offs that may significantly limit a portfolio in several ways – especially when the approach relies on excluding a material number of low-rated stocks.

First, excluding stocks reduces the investment universe, which tends to restrict overall return potential. Fewer names to choose from generally translates into fewer ways to add alpha. Similarly, working with fewer names reduces diversification potential, and increases overall risk relative to the portfolio's benchmark. Third, and perhaps most importantly, stock-exclusion approaches may not consistently maintain a portfolio's ESG profile. This potentially introduces a level of unintended exposure variability, the degree of which may grow as the number of exclusions increase.

For example, the consistency of an ESG boost resulting only from stock exclusions may be lower and less consistent than expected, as the improvement of the desired ESG metrics relative to the benchmark is unmanaged and can be quite uneven.

Instead, a more practical approach begins by defining the investor's ESG investment goals and then focusing on how best to integrate the corresponding constraints based on the overall desired portfolio attributes. In other words, begin with the end in mind. We believe this method offers much greater portfolio control and helps better manage the trade-offs between ESG and risk-reward outcomes to pursue stronger outcomes for both.

Test case: comparing implementation approaches

In this paper, we expand on our earlier research to explore how a more sophisticated application of portfolio-driven ESG integration might capture ESG

"THE GOOD NEWS: THERE ARE MORE EFFICIENT WAYS TO IMPLEMENT ESG CONSIDERATIONS."

outcomes similar to those produced by a stock-driven exposure approach. Our goal is to understand how your ESG implementation choice – portfolio-driven exposures versus stock-driven exposures – could affect an active, non-ESG strategy with a history of generating alpha. We'll examine the results across just two dimensions: ESG outcomes and risk-return outcomes.

Conclusion

It's no surprise that incorporating ESG considerations into a portfolio usually comes with investment trade-offs. However, the types and magnitude of these potential concessions can often depend on how you integrate ESG into the portfolio-management process.

A conventional approach that focuses on stock-driven exposures, especially those that simply exclude stocks based on pre-determined ESG ratings, can be ham-fisted and quite disruptive to performance for many investment processes without necessarily guaranteeing a minimum level of ESG improvement. This can risk putting investors in the difficult position of trying to decide how much return they may be comfortable giving up in exchange for an enhanced ESG profile.

The good news: there are more efficient ways to implement ESG considerations. Our research shows that by focusing on managing overall portfolio characteristics and exposures rather than only restricting individual securities, it's possible for broadly diversified strategies to pursue a desired minimum level of ESG improvement without materially damaging long-term return or tracking error. The result can be a powerful win-win for investors, delivering effective ESG investment strategies without overly restricting outperformance potential.

To download the paper in full click here.


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Ask the Expert: Aviva Investors

Disclosures, Trade-offs and Green Premia: The Future of Sustainability in Real Assets

Laurence Monnier leads and coordinates quantitative research within the real asset research team, covering infrastructure, real estate and private debt investments. She joined Aviva in 2010 and has over 25 years' experience in real asset investing. Edward Dixon is Head of Environment, Social and Governance (ESG) for Aviva Investors' £52 billion Real Assets platform, encompassing Real Estate, Infrastructure and Private Debt.

Laurence Monnier
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Understanding the difference between what stakeholders say they are doing and what they are really doing is a complex business. This is particularly the case now, when governments and companies face mounting pressure to clean up their environmental act. Financiers, regulators, investors, lawyers, activists and pressure groups are all asking questions, wanting to know more about who is polluting, recycling, greenwashing and so on.

Investors in private markets, who are typically closer to the assets they hold than in public markets, have significant influence in shaping the sustainability agenda. However, this is not as straightforward as it might appear, with little standardisation on disclosures, challenges in turning brown assets green, and fierce competition causing risk-adjusted returns to dwindle in certain sectors.

To find out more, we talked to Laurence Monnier, head of quantitative research, and Ed Dixon, head of ESG, from Aviva Investors' Real Assets team.

Sebastian Culpan-Scott: How should we define sustainability in real assets? Is it in the eye of the beholder?

Laurence Monnier: For me, sustainability is a given. As a long-term investor, everything we do has to be sustainable. If we are looking to invest for the next 20 years or 30 years, if an asset is not sustainable, we should not be looking to participate. Quite separate to that is a debate about the environmental or social impact of one asset over another.

Ultimately, though, sustainability is about concentrating on assets aligned with the transition to the greener and fairer economy people want to see.

Sebastian: Is addressing it simply part of your fiduciary duty to clients?

Ed Dixon: It's unequivocal, and not only because it is included in the UK's Stewardship Code. We need an in-depth understanding of the risks and impacts of the assets we manage and ensure the long-term interests of clients and society are fairly represented in our investment process.

This is written into our responsible investment policy and strategy for real assets; we must understand the long-term impacts, and if the assets have impacts that undermine the stability of the industry, the economy and/or society, then they do not represent a good investment.

This runs from our investment policy and processes, to our real assets strategy, all the way to the Stewardship Code at the top of the tree.

Laurence: This has come to the forefront of many investors' minds in the last two years. Sustainability has always been there, but the intense focus on it is relatively recent, and there are more working groups than most people care to follow.

"A DEGREE OF THOUGHT HAS GONE INTO REAL ESTATE EQUITY, BUT VIRTUALLY NONE FOR PRIVATE EQUITY, PRIVATE DEBT OR INFRASTRUCTURE."

There is a fair amount of standardisation of disclosures around climate, and alignment is very much on the agenda for discussion by the regulators; everybody is mindful about the importance of moving towards a common view. But it is difficult because there are so many different aspects of sustainability. Different issues keep coming to the fore: biodiversity, climate risk, gender, race and ethnicity, and so on. It would be valuable to standardise, but there are so many aspects that are difficult to capture, and the landscape is changing all the time.

I don't think you will ever develop a single, all-encompassing standard that neatly encapsulates what sustainable is.

> **"Different issues keep coming to the fore: biodiversity, climate risk, gender, race and ethnicity, and so on. It would be valuable to standardise, but there are so many aspects that are difficult to capture, and the landscape is changing all the time."**

Sebastian: How easy is this area to navigate in private markets, bearing in mind some of the frameworks around sustainability disclosures were crafted with public markets in mind?

Ed: Some pieces of legislation, like the Sustainable Finance Disclosure Regulation (SFDR), were written for liquid markets. A degree of thought has gone into real estate equity, but virtually none for private equity, private debt or infrastructure. The same could be said for the guidelines from the Task Force on Climate-Related Financial Disclosures (TCFD). The guidelines are adequate for real estate, but somewhat lacking for other (illiquid) asset classes.

As an asset manager working in private markets, you hope you can get some commonality with your peers, but there is no private markets body that ties everything together. The Association of Real Estate Funds has looked at this from a real estate equity perspective and made an effective response to SFDR. But, broadly, there is nothing equivalent for private debt or infrastructure, so a lot of the larger private market managers – including Aviva Investors – have come together to try to develop some sort of commonality.

Asset management is not just about liquids; we need the regulatory and industry bodies to think this through in a lot more detail.

> **"As an industry, lenders have a lot of power. Lenders can also develop a sustainable loans strategy and influence borrowers, as we already do through real estate sustainable transition loans."**

Sebastian: At an asset class level, are there areas where it is particularly hard to shape the sustainability of the asset in which you are investing?

Laurence: The degree of influence you can have clearly depends on your role. So, if we are lender in a syndicate refinancing bank loans, we may have limited influence, but even there the influence of lenders is growing. Lenders are promoting changes to loan documentation standards, to alter disclosures around ESG issues and what borrowers will have to disclose. As an industry, lenders have a lot of power. Lenders can also develop a sustainable loans strategy and influence borrowers, as we already do through real estate sustainable transition loans.

"IN REAL ESTATE, WE'RE STARTING TO WORK WITH PEERS TO COME UP WITH A BETTER SET OF MINIMUM STANDARDS ON GREEN LEASING."

It is true that if you are a major investor who brings the equity cheque you will have more power than if you are a small equity participant or a lender in a syndicate, but lenders do still have a big voice in the debate.

Sebastian: We are hearing about more industry-led sustainability initiatives. Is the finance industry finally stepping up?

Ed: People on the ground appreciate the change that needs to happen and want to push it forward, but in some cases, it is being held back by how quickly their employers or industries are able to go.

Take infrastructure debt, for example. A consortium of lenders, initially led by us, has got together to produce a set of minimum standards, which would mean borrowers have to come forward and disclose certain information at the point a deal is made. We are close to agreement, but to achieve industry-wide buy-in, at some point an industry body will need to adopt and push it forward.

In real estate, we're starting to work with peers to come up with a better set of minimum standards on green leasing. Broadly, this involves a new concept where sustainability requirements are embedded into the lease to bring direct benefits to the occupier, so they are rewarded for reducing their environmental impact, but we face the same challenge regarding standardisation.

There has been progress in some areas. Take the Better Buildings Partnership (BBP), which established a climate change commitment we have signed up to alongside the majority of our peers. BBP said: 'We know where the industry needs to be, and we are going to put you on the hook to do this,' and it has really driven rapid change. It is also working on operational energy ratings and moving that agenda forward with the government. This is forward-thinking, but I am not sure we benefit from the same collectives or industry bodies driving change in private debt.

Overall, there is a groundswell of opinion among the larger players wanting to collaborate to raise standards, but I don't know how soon the representative bodies will be able to drive the changes through. There is no single private markets organisation that exists to tie everyone together; that is needed to make the change.

"There is no single private markets organisation that exists to tie everyone together; that is needed to make the change."

Laurence: I think the industry is stepping up, but maybe we should be asking if it is stepping up in the most effective way. That's another question. There are the issues we have already touched on – about potentially having too many standards, too many views. The EU has its guidelines, then we have the sustainable and green loan framework, the guidelines for climate disclosures and so on. In addition to BPP, infrastructure investors and private lenders have their own forum to discuss issues, then we have companies and lawyers as well. We also have the Asset Owners Alliance, bringing together all the net-zero owners and the insurance industry, as well as the Net Zero Alliance for asset managers. How will they mesh to create the sustainability standard of tomorrow?

Will it mean aligning with the EU taxonomy, or any other standards? That taxonomy is fine, but how relevant is it for a road project in Benin? The level of interest has led to complications and some overlaps, but it does at least suggest we are going in the right direction. Ultimately, I suspect a smaller number of dominant standards will emerge.

"THERE IS A MISUNDERSTANDING THAT PRIVATELY LISTED COMPANIES DO NOT HAVE ESG DISCLOSURE REQUIREMENTS. DISCLOSURE MAY BE LESS ADVANCED IN THE PRIVATE SPHERE, BUT THERE ARE REQUIREMENTS FOR INSTITUTIONS."

Sebastian: **There have been suggestions recently that as disclosure requirements in the public space intensify, the temptation is to move dirtier assets off balance sheet. Is this any cause for concern?**

Laurence: There is a misunderstanding that privately listed companies do not have ESG disclosure requirements. Disclosure may be less advanced in the private sphere, but there are requirements for institutions through the Asset Owners Alliance, through the guidelines set out by the TCFD and now the obligation for UK pension funds to disclose their net-zero alignment. This has been compulsory for insurers in France for a long time. The need to disclose is getting more attention, whether you are public or private, and therefore taking assets private is not necessarily the way to avoid this.

If you think about investors in real assets that manage assets day-to-day, we need to stay close to what is going on. It is not just about making a small disclosure in a footnote; it is about what we may or may not be embedding in a building or piece of infrastructure. It's real.

The other thing to consider is the implications of that choice between retaining an asset and improving it or selling it on to somebody else. This is a real question for us in infrastructure and real estate. If we sell an asset, it is off our balance sheet and improves our own carbon credentials, but it does nothing to improve the planet.

All things being equal, it may be better to keep some of the assets that are not aligned with the net-zero transition today but improve them, so they are much cleaner for everybody's benefit. But as an asset manager, we also have responsibilities to our investors. We manage assets; we are not there to lose money. We need to be mindful of this as we look at which assets to improve and how to do it. If we think the cost of improving the asset is uneconomical, we may be forced to sell on.

> **"All things being equal, it may be better to keep some of the assets that are not aligned with the net-zero transition today but improve them, so they are much cleaner for everybody's benefit."**

Sebastian: **Can we return to questions of scale and the importance of disclosure thresholds? Is it not the case that some smaller bodies are exempt from some of the tougher requirements?**

Laurence: Scale is an issue. For example, some smaller infrastructure projects may not have to disclose, but of course larger professional investors in those projects do. The fact the smaller body is exempt does not take away responsibilities from the larger bodies, which are not.

There are concerns that the disclosure requirements are too heavy for some of these smaller bodies. For example, if your asset turnover is less than £1 million a year, you may not be able to afford the consultants or staffing costs required to make your ESG disclosures.

Sebastian: **What is your view on the idea expressed by Professor Richard Murphy that countries with net zero established in law have experienced a crystallising event, which should force companies to reveal the costs of transitioning on the balance sheet?**

Laurence: It is a logical proposal, but if you drill into the detail, the question is hard to answer. Take a software company, for example. How will it disclose how much it will cost to be net zero? It depends how it intends to get there! How will it deliver goods? What vehicles will be used? Will they be electric? Will the power come from renewables?

"IF WE WANT TO GET TO NET ZERO, THERE ARE STILL A LOT OF UNKNOWNS, AND A LOT OF TECHNOLOGICAL CHANGE NEEDS TO HAPPEN."

If we want to get to net zero, there are still a lot of unknowns, and a lot of technological change needs to happen. We need to be able to reduce emissions drastically but also capture carbon dioxide from the air, and it is not clear how much that will cost. No-one really understands the cost side now: not the government, not big companies and certainly not small software companies concentrating on their own product lines.

Pushing for disclosure is helpful, but it sometimes distracts from the real issue, which is everyone thinking about what they have within their immediate control to help us achieve net zero. The more time we spend on disclosing things that we don't know very much about, the less time we are likely to spend on doing things that have an impact. That said, the move to make climate disclosure mandatory has contributed positively to the finance industry stepping up to the plate.

Sebastian: **Have we got to the point where changing 'brown' assets to green ones makes sense, but clients may be concerned about the reputational risk of retaining these assets?**

Laurence: Not in the assets we own personally. As we have been focused on sustainability for a long time, the sectors we invest in are generally green – renewables, full fibre broadband and so on. There are investors with blacklists that prohibit them from investing in certain kinds of assets, like roads, because of the pollution. Should we be doing it? That's a live debate.

In my view, it is disingenuous to say: 'We won't invest in roads anymore', and then expect an Amazon delivery to come to your door. If we choose not to invest in roads and do not maintain them, what happens then? I think the bigger question is: which roads do we wish to invest in, and what are the conditions that allow us to be comfortable with that? How will the trade-offs between environmental costs and social benefits be made?

Another example of trade-offs is in district heating. On the lending side, there are cases where we lend to district heating, but we have specified we do not wish to see energy inputs from non-clean solutions.

The danger of a pure exclusion approach is that it could create significant moral hazard by leaving assets in the hands of people who are less focused on environmental issues, and that may be detrimental for the clients we serve. Ultimately, we need to make sure our investment strategies are aligned with the transition and we are working to ensure all the assets are aligned, rather than restricting the types of assets in which to invest.

"The danger of a pure exclusion approach is that it could create significant moral hazard by leaving assets in the hands of people who are less focused on environmental issues, and that may be detrimental for the clients we serve."

"THE ESTABLISHED RENEWABLE SECTORS SUCH AS WIND AND SOLAR ARGUABLY LOOK EXPENSIVE TODAY FOR INVESTORS FOCUSED PRIMARILY ON FINANCIAL RETURNS."

Sebastian: **You spoke about managers' responsibility to clients in terms of delivering returns. Where is the greatest evidence of green premia now?**

Laurence: The established renewable sectors such as wind and solar arguably look expensive today for investors focused primarily on financial returns. There has been a real rush to buy and that has driven returns down at a point when investment risks have been increasing as subsidies are removed.

"WHILE RENEWABLES HAVE A LOT OF BENEFITS, IF YOU OBTAIN YOUR ENERGY FROM 100% INTERMITTENT RENEWABLE SOURCES YOU ARE LIKELY TO HAVE BLACKOUTS IN JANUARY BECAUSE WE CURRENTLY HAVE NO WAY TO STORE VAST AMOUNTS OF ENERGY IN AN ECONOMIC AND ENVIRONMENTALLY FRIENDLY WAY."

While renewables have a lot of benefits, if you obtain your energy from 100% intermittent renewable sources you are likely to have blackouts in January because we currently have no way to store vast amounts of energy in an economic and environmentally friendly way. So, the more renewables you build out, the less each asset is likely to contribute. Take, for example, a solar asset in the UK; it only delivers power about 10% of the time to the grid, yet every time you build a new asset you use carbon building it, transporting it to the site, installing it and so on.

You must ask yourself if you can go beyond a sector view into an analysis of which assets are good or not good. It is not just a case of understanding if the sector is aligned with the transition, but also asking which specific assets are aligned within the broader asset class. This kind of analysis makes sense from both financial and transition standpoints. And if you own assets that are not aligned, what are you going to do about it?

These are much more nuanced questions than basic sector allocation decisions, but that is what truly sustainable investing is about.

Featured Paper from Aviva Investors:

AIQ: Cleaning up Capitalism


The going gets tough

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When the global pandemic took hold in early 2020, economists were quick to label it as an exogenous shock to the system. But this thinking was (and still is) wrong. Just as the global financial crisis did in 2007-09, the pandemic exposed serious flaws and limitations in standard economic modelling.

> **"Larger lessons about internalising externalities (or 'outside' factors) and sustainability can and should be learned."**

A more rounded, systems-thinking view of the world would better capture the interconnections between human activity and zoonotic diseases. Regardless of Covid-19's actual origins, it should not come as a surprise that unbridled encroachment onto the habitats of wildlife would cause the chances of viruses jumping from one species to another to increase. Larger lessons about internalising externalities (or 'outside' factors) and sustainability can and should be learned.

ESG, ESG, ESG. It is all clients want to talk about right now. Understandably so. For if we are to deal with some of the world's greatest challenges, capitalism needs a systems reboot. Many answers and solutions already exist, but with so much noise and complexity, the risk of confusion and unintended consequences looms large, as does the risk of greenwashing.

> **"ESG, ESG, ESG. It is all clients want to talk about right now. Understandably so. For if we are to deal with some of the world's greatest challenges, capitalism needs a systems reboot."**

Part of the issue is that ESG investing means different things to different people. It ranges from negative and positive screening to integration and stewardship, through to impact investing and market reform initiatives. That is an extremely broad church. However, it is increasingly clear that piecemeal and uncoordinated efforts will not be enough to correct massive market failures like inequality, climate change and environmental degradation. Micro changes require macro changes to be layered on top.

As always, we do not pretend to have all the answers. Instead, we have tried to craft, create and curate the best ideas and opinions on how to best 'clean up capitalism'. Fittingly, and to avoid the echo chamber issue, we blend both internal and external viewpoints to offer a more rounded view.

> **"It is increasingly clear that piecemeal and uncoordinated efforts will not be enough to correct massive market failures like inequality, climate change and environmental degradation."**

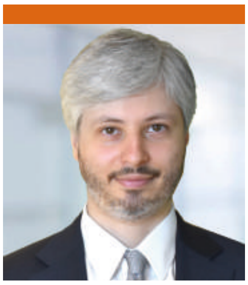
We look at how legal ('Law and climate disorder') and regulatory intervention ('Pricing carbon') are necessary. Beyond stick-based incentives, we explore how positive spillovers from key players can multiply through value chains ('Supply-chain ripples') and the challenges of decarbonising heavy industry ('The going gets tough'). This is complemented by wide-ranging interview with John Elkington.

To download the papers in full please click on the links above.

Ask the Expert: Intech

How Can Investors Utilise ESG Scores to Achieve Better Returns?

Vassilios Papathanakos, PhD, is jointly responsible, with Dr. Adrian Banner, CEO and CIO, for day-to-day implementation of the investment process and trading operations at Intech. He holds a PhD, Physics, from Princeton University. Richard Yasenchak serves as proxy for the Portfolio Management Team, providing in-depth insights into Intech's strategies' performance attribution and trends.



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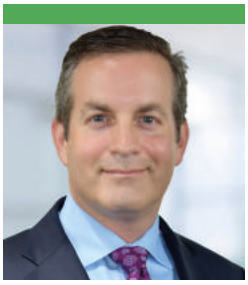

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Sebastian Culpan-Scott
Editorial Director, Savvy Investor

Sebastian Culpan-Scott: Do you believe ESG attributes are a source of excess return or risk?

Vassilios Papathanakos: It depends on the application and the investment process, but we feel that ESG attributes are more significant in the role they play as a risk factor that should be considered in portfolio construction. Still, integrating ESG into the investment process does not need to compromise the excess return, regardless of whether ESG is a compensated risk factor or not.

There is debate on defining ESG attributes, which translates to uncertainty on how to properly account for their contribution to portfolio risk. Still, ESG attributes constitute a risk factor that must be managed or controlled. We feel that a statistical approach to ESG that incorporates an assessment of ESG ratings in terms of non-ESG risk factors is the most promising approach.

> **"Still, integrating ESG into the investment process does not need to compromise the excess return, regardless of whether ESG is a compensated risk factor or not."**

Sebastian: How would you describe the differences between ESG integration of stock- vs portfolio-driven exposures?

Richard Yasenchak: There are two commonly used approaches in ESG integration: stock- and portfolio-driven. Many investors rely on a stock-driven approach to capturing ESG in portfolio construction, which generally relies on excluding companies with the least favourable ESG ratings or overweighting those with the most favourable ESG ratings to achieve a higher portfolio ESG profile. The stock-driven approach is often idiosyncratic and subjective, because which companies are at the bottom depends sensitively on the ratings methodology. Conversely, the portfolio-driven approach targets ESG outcomes at the portfolio level while allowing for the entire investable universe of stocks. This approach to ESG integration is more systematic and objective, because it focuses on more reliable ESG characteristics, which are more stable over time, and more consistent across ratings methodologies.

We believe the stock-exclusion approach generally incurs an unnecessary and steep trade-off between ESG and risk-reward outcomes, which grows as the number of exclusions increases. First, it introduces a greater

"WE BELIEVE THE STOCK-EXCLUSION APPROACH GENERALLY INCURS AN UNNECESSARY AND STEEP TRADE-OFF BETWEEN ESG AND RISK-REWARD OUTCOMES..."

potential of uncompensated risks during the short term, as the exclusion ignores the index weights and associated active risk. Second, it reduces the opportunity set available for finding alpha and the diversification required to manage risk. Third, and possibly worst, it may still not result in a consistent ESG profile over time, introducing a level of unintended ESG exposure variability, as shown in the paper. A more effective approach is to identify the ESG goals and then integrate ESG constraints into the portfolio construction without restricting the stock universe. This allows achieving the desired attributes and performance outcomes with greater flexibility and reliability.

"A more effective approach is to identify the ESG goals and then integrate ESG constraints into the portfolio construction without restricting the stock universe."

Sebastian: Do ESG attributes impact the risk and return characteristics of the strategy?

Vassilios: Yes, we observe a material negative impact on performance when integrating ESG without proper treatment. This is because unmanaged ESG exposures introduce risks that may be uncompensated, i.e., they tend to increase the tracking error without also increasing the excess return. Additionally, unnecessarily heavy-handed implementation of ESG tilts may interfere with seeking alpha opportunities that are not inherently contradicting, i.e., decreasing the long-term excess return without also decreasing the tracking error.

Sebastian: How do ESG attributes frame the investment universe of the strategy?

Richard: For many investment approaches, ESG integration starts by excluding stocks with low ESG ratings. This stock-driven approach to integration materially restricts the investment universe because of the exclusion of 'bad' stocks. Instead, our preference is to preserve the entire investment universe, while also incorporating the additional context on the ESG attributes. This portfolio-driven approach reframes the entire investment universe, instead of restricting it, which helps avoid lopsided risk exposures and unnecessarily reduced alpha opportunities.

"ESG data doesn't have to be limited. In a quantitative investing setting, the available historical ESG data can be extrapolated to the beginning of the benchmark indices' history."

Sebastian: How do you integrate ESG considerations effectively given historical limitations in the availability of ESG data?

Vassilios: ESG data doesn't have to be limited. In a quantitative investing setting, the available historical ESG data can be extrapolated to the beginning of the benchmark indices' history. This can be accomplished by relying on statistical analysis to identify the stable characteristics of ESG attributes; this is an essential advantage of quantitative managers.

This statistical analysis also facilitates the integration of ESG considerations by identifying the best approaches to complementing them with other risk constraints to balance the inherent exposures of ESG attributes. This preserves risk-managed diversification at the portfolio level and minimises the interference with the strategy's performance characteristics.

"EMPLOYING THE SYSTEMATIC CHARACTERISTICS OF ESG ATTRIBUTES FOR PORTFOLIO-DRIVEN APPROACHES RESULTS IN INCREASED STABILITY BY DESIGN."

Sebastian: **How stable are a portfolio's ESG scores, given the subjective and changing nature of ESG ratings?**

Richard: For stock-driven approaches, stability is low. Different ESG ratings systems generally have low correlation, and they disagree strongly on which companies have extreme ESG ratings. This means that a portfolio that excludes stocks using one particular ESG ratings system will have an unreliable ESG profile as measured by other approaches.

What's more, the ratings of the 'bad' ESG stocks are particularly sensitive to details of the methodology. They amplify subjective judgments, data errors, even minor changes in the methodology, and other sources of uncertainty. As the stock-driven approach primarily relies on achieving its ESG targets on exclusion, these effects are not balanced and generate a high degree of instability.

On the contrary, employing the systematic characteristics of ESG attributes for portfolio-driven approaches results in increased stability by design. By distilling the objective aspects of the ESG attributes, the portfolio-driven approach ensures that the resulting portfolio shows a clear improvement across multiple ESG ratings systems. Moreover, the focus on persistent characteristics provides stability over time, and robustness against changes in the methodology, data issues, and other sources of instability. Finally, the portfolio focus allows the investment process to accommodate abrupt changes in single-stock ESG ratings by spreading the effect across dozens of other stocks without significant disruption to the overall ESG level.

"The portfolio focus allows the investment process to accommodate abrupt changes in single-stock ESG ratings by spreading the effect across dozens of other stocks without significant disruption to the overall ESG level."

Sebastian: **Are there limits to boosting ESG scores?**

Vassilios: Yes, and they depend on how concentrated the portfolio must be to achieve the target ESG boost and how this interferes with excess return and diversification. The more diverse the investable universe, the greater the boost without sacrificing excess return or overly restricting diversification.

'Diversity' here must be understood both in terms of traditional portfolio management (i.e., how many relatively uncorrelated sources of excess return and diversification there are) as well as in ESG terms (i.e., the spread of good-vs-bad ESG ratings available to choose from). For example, in an investable universe composed only of stocks with ratings in the 4-to-6 range, it will not be possible to boost the portfolio ESG rating above 6, no matter the available risk budget.

"The more diverse the investable universe, the greater the boost without sacrificing excess return or overly restricting diversification."

In the paper 'How to Boost Your ESG Scores and Preserve Your Risk-Reward Outcomes', we discuss a case where the investable universe is quite diverse. This allows the portfolio-driven approach to achieve an average ESG boost equal to that achieved by excluding half of the investable universe. However, unlike the stock-driven approach, this ESG boost is reliable over time. It does not come at the cost of material degradation of either excess return or risk control.

"MARKETS RECOGNISE NEW GLOBAL ESG RISKS THAT IMPACT SECURITIES AND PRICE THEM ACCORDINGLY."

"The complexity of regulatory changes in the environmental, social, and governance pillars affects the ratings of companies in the investment universe and the responsibilities of investors implementing ESG policies."

Sebastian: Are the existing ESG approaches sufficient to handle future challenges in the evolving ESG landscape?

Richard: Yes, but only with ongoing research and development. The complexity of regulatory changes in the environmental, social, and governance pillars affects the ratings of companies in the investment universe and the responsibilities of investors implementing ESG policies. Furthermore, markets recognise new global ESG risks that impact securities and price them accordingly. This has potential implications for the risk exposures underlying ESG attributes, which are likely to shift materially but unpredictably. The approach employed to implement ESG objectives must be flexible enough to accommodate these shifts, and reliable enough to navigate them without compromising the performance characteristics of a strategy given a series of undesirable outcomes. In our view, the portfolio-driven approach is the only practical solution to these challenges.


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Savvy Investor's Top Recent ESG Papers

TOP RECENT ESG PAPERS

The following table features 30 of the top ESG papers uploaded to the Savvy Investor site.

ESG data and ratings continue to grow in importance, and the topic itself is continuously gaining momentum within the investment industry. CFA Institute and IOSCO provide an overview of ESG ratings, and discuss why these ratings can be beneficial to not just companies, but to the entire planet! They also highlight areas within ESG ratings where improvements can be made.

Bridgewater Associates and S&P Dow Jones Indices share their assessments of companies' net-zero targets, and outline the challenges of reaching them. They also discuss how they use this data in order to make investment decisions.

A number of papers also discuss the challenges facing ESG investors, global water risks, and ESG investing with emerging market debt.

SAVVY INVESTOR'S TOP RECENT ESG PAPERS (BY DATE)

PAPER TITLE	DATE
How to Boost ESG Scores & Preserve Risk Reward Outcomes (Intech, 2021)	27/09/21
What Covid-19 Revealed About Social Infrastructure (Franklin Templeton, 2021)	27/09/21
Exploring the Links Between ESG Supervision and Performance (NN IP, 2021)	07/09/21
FAQ: S&P Paris-aligned & climate transition indices (S&P Dow Jones Indices, Sep 2021)	07/09/21
Assessing the Viability and Value of ESG Investing in EM Debt (Invesco, Sep 2021)	02/09/21
Net Zero and Broad ESG in One Index (S&P Dow Jones Indices, Sep 2021)	01/09/21
What Will the Global Push to Net Zero Mean for Oil? (Bridgewater Associates, 2021)	31/08/21
How Asset Owners Can Go from Net Zero to Climate Leadership (BCG, 2021)	31/08/21
ESG Ratings and Data Products Providers (IOSCO, 2021)	31/08/21
ESG and Expected Returns on Equities: The case of environmental ratings (Wharton Pension Research Council)	31/08/21
Pricing Carbon: Taxing polluters is the only way forward (Aviva Investors, Aug 2021)	31/08/21
Deep Water Waves: Five long-term drivers that face investors (Franklin Templeton, Aug 2021)	31/08/21
The Going Gets Tough: Can heavy industry decarbonise? (Aviva Investors, Aug 2021)	26/08/21
Country Sustainability Visibly Harmed by Covid-19 (Robeco, 2021)	25/08/21
Climate-related Risks and Opportunities: An asset manager perspective (Norges Bank, 2021)	24/08/21
ESG Score Predictor: Applying a quantitative approach for expanding company coverage (Moody's, 2021)	24/08/21
Net Zero: Managing the wider impact of economic and capital displacement (Franklin Templeton, Aug 2021)	19/08/21
Webinar: Putting climate talk into action (PGIM & MSCI, Jul 2021)	18/08/21
Integrated ESG and the Role of Thematic Strategies in Asset-Owner Portfolios (Greenwich Associates, 2021)	17/08/21
Video: Challenges Facing ESG Investors – The risk & return challenge (QMA, Aug 2021)	11/08/21
ESG Ratings: Navigating through the haze (Enterprising Investor blog, Aug 2021)	10/08/21
Climate Change's Impact on Global Banks: A matter of degrees (Wells Fargo AM, Aug 2021)	09/08/21
Cryptocurrencies and ESG: A contradiction in terms? (Candriam, Jul 2021)	06/08/21
The Investment Case for Net Zero Buildings (LGIM, 2021)	04/08/21
Water Risks in South Asia Impact on Emerging Market Sovereign Debt (Wells Fargo AM, 2021)	04/08/21
ESG in Credit (Fitch Ratings, 2021)	03/08/21
Valuing Biodiversity: The tools at our disposal (Manulife IM, Jul 2021)	02/08/21
Sustainability in the UK (FTSE Russell, 2021)	02/08/21
Introduction to Net Zero (Amundi, 2021)	30/07/21
Emerging Markets and the Case for Sustainable Investing (Manulife IM, Jul 2021)	30/07/21

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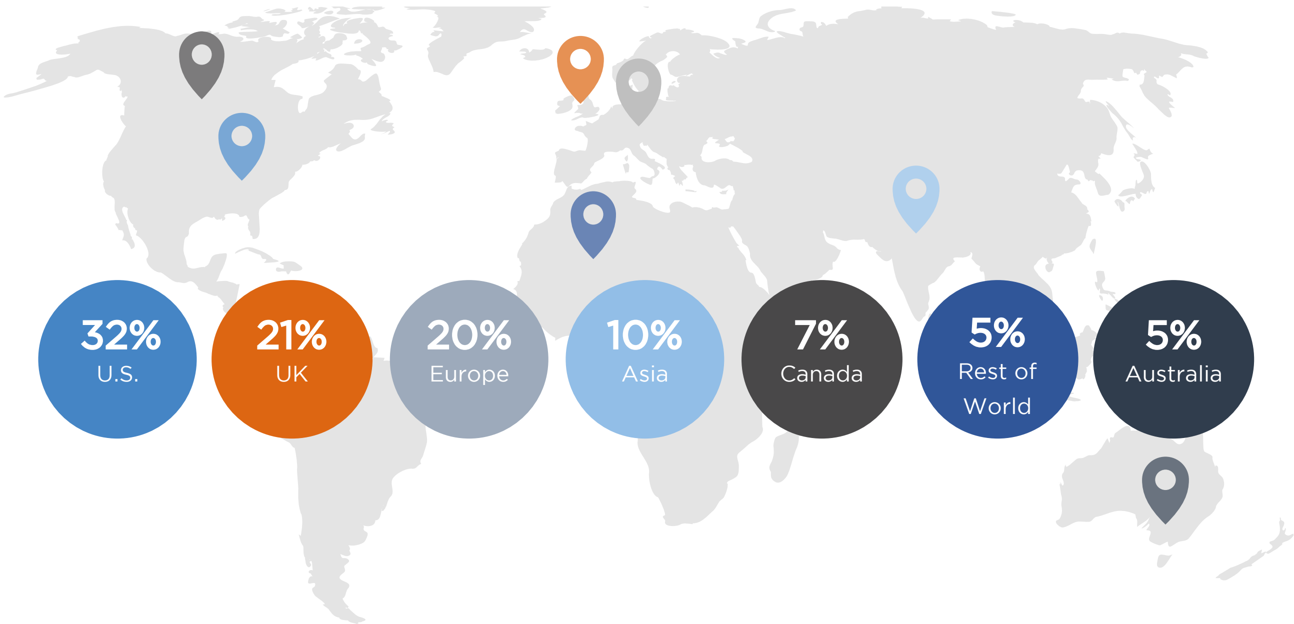

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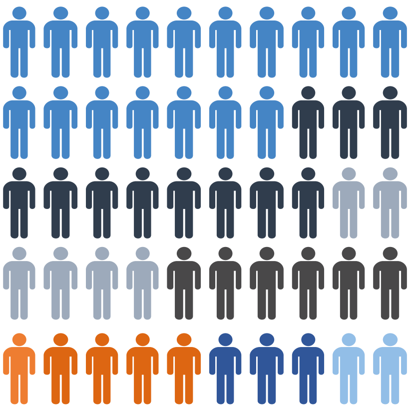

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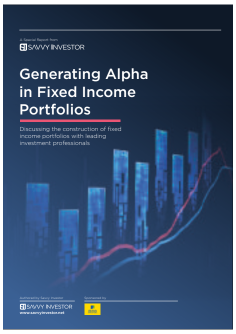

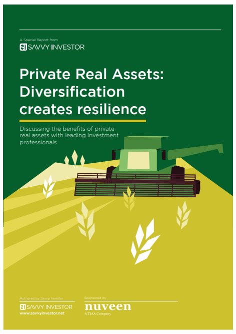

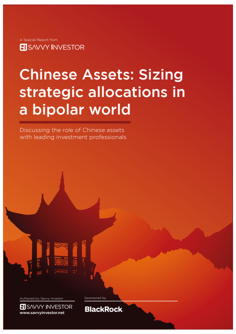

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