Responsible Investing

Overcoming hurdles

2019

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HIGHLIGHTED IN THIS PUBLICATION:

- GLOBAL STRATEGIC ASSET ALLOCATION
- GLOBAL SECURITY SELECTION
- REGIONAL ASSET ALLOCATION
- REGIONAL PORTFOLIO CONSTRUCTION

Jason Jay, who is the Director of the Sustainability Initiative at MIT Sloan and one of EFGAM's Future Leaders panellists, sees three hurdles which need to be overcome for a more widespread adoption of sustainable and responsible investing. This is a summary of a presentation he gave at our annual EFGAM Knowledge Exchange in January 2019.

Hurdle 1. Mental models

The mental models of participants in the investment industry are generally built on quantitative factors such as risk and return, portfolio optimisation and fees. ESG criteria cover a wide range of factors: from air pollution to audit committee structures; from biodiversity to bribery; from child labour to climate change. These criteria are often seen as in conflict with the standard financial criteria.

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This makes many of the conversations about adopting ESG overtly challenging and political. One approach is to say that some investment performance may have to be sacrificed to meet ESG requirements. However, a body of evidence suggests that performance need not be compromised. Perhaps the most comprehensive assessment of the link between ESG criteria and corporate financial performance (CFP) found that "the business case for ESG investing is empirically very well founded. Roughly 90% of studies find a nonnegative ESG–CFP relation."[1]

Furthermore, a recent study mapping sustainability characteristics on a firm-specific basis showed that firms with good ratings on material sustainability issues significantly outperformed firms with poor ratings.[2]

Hurdle 2: Data

The second hurdle is the issue of whether the data can be trusted. The general approach taken is to collect ESG data, do a rating of companies based on this and then an analysis of performance in relation to it. Data availability is growing: the proportion of S&P 500 companies reporting such data was 85% in 2017, up from 20% in 2011. Even so, there are 45,000 listed companies in the world and we have ESG data for only 7,000 of these.

Another major concern is that there is little correlation between different agency rankings: less than 50% between two major ones, for example. For credit ratings, the correlation between the major agencies is typically 90-95%. The explanation of the weak correlation lies in: measurement error; the use of different indicators; and different processes for aggregation.[3] In this environment, analysts can take a very simple view – such as "I like company X for these reasons" – and not make a proper assessment of each of the many ESG criteria.

Hurdle 3: impact

Many people want to behave responsibly and also want to feel good about their investments. But if we want, for example, less gun crime, what can we do? One approach would be to provide capital to firms that actively seek to reduce this. Another approach would be to buy into gun companies and put pressure on them to deal with gun crime themselves through, for example, tighter checks, providing information about how the guns they sell are used, and so on. Jason gave an example of that approach – "nuns with guns" – where a nuns' pension fund invested in gun companies to seek a change in their behaviour.

Jason Jay

[1] Friede, Busch & Bassen, 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', *Journal of Sustainable Finance & Investment*, 2015. http://dx.doi.org/10.1080/20430795.2015.1118917
[2] Khan, Serafeim and Yoon, 'Corporate Sustainability: First Evidence on Materiality', *The Accounting Review*, Vol. 91, No. 6 http://dx.doi.org/10.2139/ssrn.2575912
[3] See the work of Berg, Koelbel and Rigobon. http://mitsloan.mit.edu/sustainability/aggregateconfusion

Research in this area has shown that investors can affect companies through such shareholder engagement, especially when the costs of demanded reforms are low, investors wield influence, and companies have prior experience with engagement.[4]

Conclusion

Overcoming the hurdles to sustainable investing is no easy task, yet there is an important and growing demand for investing in a sustainable manner. Improvements in data gathering and analysis may well be one of the most important practical ways in which this can be advanced in the coming years.

[4] Kölbel, Heeb, Paetzold and Busch, *Beyond Returns: Investigating the Social and Environmental Impact of Sustainable Investing* (November 23, 2018). http://dx.doi.org/10.2139/ssrn.3289544

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