ESG Today: Implementing Change

Responsible investing can offer a more complete picture of business opportunities, as well as aligning values, helping to reduce risk and improving alpha

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Professional investors increasingly understand the importance of integrating environmental, social and governance factors into their investment process. But at the same time, ESG investing suffers from a confusion of definitions and terminology, and there are competing methods of implementation, some at the security level, some at the asset class level. Jackie VanderBrug, managing director and investment strategist at Bank of America Global Wealth & Investment Management Chief Investment Office; Bruno Bertocci, senior portfolio manager and managing director at UBS Asset Management; and Tim Barron, chief investment officer at Segal RogersCasey, discuss advances in ESG in terms of impact, measurement and building customized solutions, and explain how integrating ESG factors can improve returns and reduce risk.

P&I: Why the alphabet soup? ESG, SI, responsible investing, impact investing, etc.? What are we talking about? Is there a commonly accepted definition?

Bruno Bertocci: ESG integration is an evolution of fundamental investing that includes other material factors — environmental, social, governance — that might not be financial in nature but that are relevant to the investment process, which in my case is about stock selection. ESG factors give you a more complete picture of business opportunities, it can reduce risk and improve alpha.

Jackie VanderBrug: The alphabet soup is unhelpful. Instead, we often use the idea of a spectrum: Responsible investing is often associated with removing certain companies or even industries. Sustainable investing is saying, 'How can we positively use these environmental, social and governance factors to support selection?' Social impact investing is how you look at transforming our world and our economy. Many managers use all the criteria and the categories are blending.

Tim Barron: A bit of alphabet soup is necessary because in fact there are distinctions between ESG and, for example, impact investing. ESG tends to be more comprehensive and more widely understood, so we've adopted that as the general nomenclature we use when we talk to clients about the topic.

P&I: What's more important, E or S or G in terms of investing?

VanderBrug: It's akin to 'which child do you love the best?' Some clients do have a particular focus, though.

Historically, governance issues were the most understood and therefore the most utilized. Environmental factors, as the data improves, are now more defensible. The huge opportunity on the horizon is in the social space.

Barron: It's impossible to delink the three completely. At the end of the day, the E is likely to be the most transparent, the G second and the S is the place where the topic really can get extremely political and where you can have significant disagreements.

Bertocci: From the viewpoint of stock selection, governance is the broadest factor, because every company has governance. If you're thinking about the task of running an active portfolio, identifying a company that's well-governed should be your aim. But the E and S factors should also be viewed through the lens of a company's business model and their materiality to it.

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>
> ~ **Jackie VanderBrug,**
> Bank of America Global Wealth & Investment Management
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P&I: What is driving the growth of ESG generally? And what's driving that growth or interest among institutional investors specifically?

Barron: One is the recovery from the global finance crisis: Interest disappeared post-crisis but is increasing again. Also very important: Data from service providers is giving us more and more information about ESG factors.

Bertocci: Professional investors are realizing that these factors contain material information, while individual investors are realizing that these factors can align their personal philosophy with their portfolio.

There are some regional factors as well. If you go to South Asia or China, the environment is in focus simply because you can see the haze outside your window. In Japan, the government pension fund has focused on governance and engagement as a way to improve corporate returns to help the economy out of its doldrums.

These factors pretty much all take us to the same railway station in the end.

VanderBrug: I would add that academic and practitioner research demonstrates that these factors do enhance a manager's ability to make better decisions. Another driver is regulatory, such as the Department of Labor's 2015 Interpretive Bulletin clarifying that ESG issues are proper components of a fiduciary's primary analysis.

P&I: What led you and your firm to get involved with ESG investing?

Bertocci: We've been involved in this space for a very long time. Back in the late 1970s we were delivering portfolios with sustainable characteristics for high-net-worth clients in Europe. Over time we pivoted to a view that this is the future.

Our clients want these strategies. They're some of the fastest-growing products on our platform. The material, non-financial factors are helpful to the investment process, allowing us to better understand a company's value. We also think it's the right thing to do.

VanderBrug: A lot of this has been rooted in client demand. We did some client research, and they said it's not just an environmental lens but a broad ESG lens that's very compelling.

Our involvement has also increased as the availability of institutional-class products have increased. We have more and more third-party fund managers who are integrating ESG and delivering the kind of performance that we're looking for.

Barron: Segal Advisors and Rogerscasey were the second and third consulting firms to sign the [United Nations Principles for Responsible Investment]. We were early in because we believe that it's incumbent upon fiduciaries to consider all factors that can affect security prices.

P&I: How do you counter the argument that ESG is a fad or that in order to use ESG principles, investors need to give something up?

VanderBrug: Climate change and demographic shifts and preferences for transparency in corporate actions have become the standard. ESG factors have enabled investors — almost like the x-ray enabled the medical profession — to see things more clearly. The value of that information is only increasing. So no, it is not a fad.

Barron: I encountered the topic in the early 1980s when I was on the plan sponsor side. So if this is a fad, it certainly has 30-plus years of staying power.

Bertocci: Definitely not a fad. The high level of interest

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can be seen in the number of comments by asset owners and investment managers about ESG disclosures on the SEC's concept release [about modernizing disclosure requirements in Regulation S-K]. There's an understanding even among traditional fundamental analysts that these factors are material, they improve transparency and the analytical process, and you don't have to give up anything. Market makers and regulators understand that transparency improves pricing and capital allocation.

P&I: How should institutional clients or investment committees weigh the importance of financial returns against achieving a positive social impact?

Barron: The objective of assessing securities is to gain insight to add value to make money. Considering these factors is not inconsistent with that process in any way, shape or form. There isn't a mutually exclusive notion of having to balance financial returns against achieving a positive ESG impact. The intersection of those two motivations clearly is accomplishable.

Bertocci: You have to be clear what you're talking about. Social impact in a shared-value perspective — the way Professor Michael Porter[1] talks about it — is completely consistent with stewardship of the shareholder's capital. So a company that uses less energy not only improves the environment, it is more efficient.

You also have to be clear about what you're trying to measure and what you're trying to achieve. The notion of impact measurement in public securities is very leading edge. Our team has been very involved in that area. The data and the methodologies are in evolutionary mode.

VanderBrug: We are going to see an increased understanding of the theory of change of impact in public markets. It's going to allow for a different conversation,

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~ **Tim Barron,** Segal RogersCasey

building on Michael Porter's theory of shared value. But it will be even broader in terms of the role of investment analysis and capital allocation in creating impact in society.

P&I: What is your process to evaluate an investment for ESG?

Bertocci: We leverage internal data using a proprietary, comprehensive database. We have an internal scoring system that hinges on the materiality of the data to the business model. We score companies against each other, primarily at the sector level. The factors that we look at for industrial companies, for example, would be different than those for software companies.

We marry this data with traditional valuation, improving the stock selection process, with the goal of producing value for our clients.

Our approach is also well-suited to the way our firm is organized. We have a very large and deep platform of fundamental analysts. We want considerations of sustainability factors to be integrated in the whole discussion of why we should invest in a particular company. We are ready for the world when this becomes routine.

VanderBrug: Broadly, we have an internal strategy called socially innovative investing. It builds off of Michael Porter's concept of shared value. Corporations need vibrant communities and society needs healthy, competitive companies. We look for corporations that drive positive social impact through progressive policies and are creators of value. We also look at human capital engagement, environmental stewardship and the community engagement process.

In each of those areas we look at over 400 different data points, and we score companies against their sector peers, not just on their policies but their performance. We also look at trends and monitor momentum.

What is clear from some of the new academic research is that without an in-depth understanding of these factors, you're actually not going to be adding much value.

Barron: We don't evaluate individual securities, we evaluate asset managers. Our process is to assess whether the manager is appropriately considering all variables — ESG included — that may have an impact upon their ability to add excess return. So we do believe it's important to assess ESG variables, we just are doing it at a different level.

P&I: What is your due diligence process given the many moving parts to ESG rather than just simple returns?

VanderBrug: An ESG strategy undergoes the same investment due diligence process as all other strategies and is compared to peers when being considered for the platform. But we do have an additional review for ESG.

We have an eight-factor review process based on Bank of America's commitment to ESG, research sources, thought leadership, impact measurement and more.

Barron: We have a seven-factor model that deals with everything from firm stability to process, philosophy, operations, organization, fee structures, performance history, etc. We utilize that same process for evaluating all managers, ESG focused or others.

But with ESG, there are some considerations that are different. We want to absolutely know their source of data for ESG factors, but for that matter, we're going to look at the sources of data used by any manager.

Bertocci: We're not selecting managers, we are building portfolios. Our due diligence process for considering a stock for the portfolio includes traditional fundamental analysis. From a sustainability standpoint, we have a proprietary scoring system. The idea is to have the most complete assessment of the investment opportunity from every angle.

P&I: What are the risks and limitations institutional investors need to be aware of with ESG investing?

Barron: If there's a limitation with ESG, it may be the potential for a mismatch between the long-term horizon of some elements to ESG and the shorter time horizon of the asset manager. Many investors recognize they are permanent sources of capital and are concerned about being overwhelmed by short-termism. Bridging that time horizon gap is important.

Bertocci: There really aren't any limitations. You can make analytical errors, measurement mistakes and fundamental errors regarding ESG just as you might in any portfolio, but aside from that, it's as good as or even more informative than any other process.

VanderBrug: There is actually risk in not considering ESG factors.

To shift the question from risk to awareness that institutional investors need to have, one is that there may be a limited number of fund managers that have the track records and AUM that institutional investors require. That's going to be constraining.

P&I: How should institutions think of ESG vis-à-vis asset allocation?

Bertocci: There's no one-size-fits-all answer. Most large asset owners have fairly traditional asset allocation schemes. It makes more sense to fit managers and strategies within that rather than have a special ESG side pocket.

It's really about broad integration across the portfolio wherever possible on an incremental basis.

As we've heard, there's a limited number of managers. So that's going to keep an asset owner from moving at 100 miles an hour. But still you can see an awful lot of progress.

VanderBrug: We see ESG as additional inputs into the investment process. It's not an asset class. The trend is very strongly toward understanding ESG as part of investment beliefs early on in a conversation with a board and then moving to say, 'OK, given our investment beliefs and the role that we see ESG playing, where is it in asset allocation that we see the greatest opportunities?'

Barron: There are investors who have a percentage allocation to ESG managers specifically within certain asset classes. In addition, there are now a whole host of asset managers with ESG-oriented capabilities and one of the approaches they take in trying to raise assets is to say you need to have an explicit allocation to ESG. This toe in the water approach may be helpful for many asset owners to gain a deeper understanding of the space.

P&I: Are there certain asset classes that better lend themselves to ESG strategies than others?

VanderBrug: Historically, the availability of data led to U.S. large caps being the most developed asset

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class. There are some really strong managers and great opportunities in large caps.

But better is in the eye of the beholder. What's very interesting is the emergence of ESG on the fixed-income side. Whether we're talking about municipal water bonds or conservation bonds or corporate green bonds, investors are finding that intersection of impact and traditional risk-return. There are also opportunities in real assets.

On the private equity side, what's fascinating is this convergence of impact managers and traditional managers who are looking for financial return and social return, and are actively monitoring and measuring both. So lots of opportunities across asset classes.

Barron: It's a bit of a barbell. There's lots of data about the traditional asset classes, but the private end of the asset class spectrum has shown an increasing number of opportunities, particularly in things like renewable energy.

Bertocci: I'm in the equity area. That's where most of this started, and I would say that fixed income is right behind us, as are private equity and infrastructure. Real estate has also been very much in the forefront, it's just been easier to do ESG with stocks.

P&I: In today's difficult investment environment, where do you see the biggest opportunities for investors pursuing an ESG strategy?

Barron: We seek the intersection of making money for clients and positive contributions to the general well-being of the world's collective future.

We can't continue to kill our planet by spewing pollutants into the air. Water is a precious commodity. As the emerging world develops, it is going to require a different mix of sustenance and other basic needs.

Those are all areas where we can invest in solutions and make money and make a positive contribution.

Bertocci: There's opportunity across the entire spectrum of equities. Large asset owners are also interested in moving their passive portfolios in the sustainable or carbon-aware direction. These are very large pools of assets. Coming up with an innovative solution in that space is an interesting opportunity. Eventually, being able to deliver the proper quantifiable impact measurement score on an equity portfolio will have tremendous impact.

VanderBrug: We would absolutely agree on this thematic focus, whether it's water, emerging-market middle class, climate mitigation, food security, gender inclusion, etc. In addition, some of the leading innovators on our platform are doing research on the social side, around workforce engagement: How do we effectively use and leverage and empower workforces? So that's very interesting.

P&I: What steps do institutional clients and investment committees need to take to implement an ESG strategy?

VanderBrug: There is an initial conversation about investment beliefs and the role that ESG factors play, followed by a taking stock. It's a matter of setting the strategy and identifying the best managers. It's asking what are we going to measure and what we think ESG is adding from a risk-return profile.

Barron: Education, education, education.

Bertocci: ESG isn't really a separate asset class. This is about executing good processes for manager selection. You wouldn't consider a manager that integrates ESG if they don't also have a sound analytical platform and process and governance and team and resources.

P&I: Where do you see ESG investing going in the near and distant future?

Barron: The next phase of ESG is going to be one of heightened awareness. The availability of data allows sponsors and asset managers to really communicate, to talk an ESG language. Investors should not confuse this conversation about ESG with some kind of political agenda. It's simply sound investment practice.

Bertocci: ESG is going to evolve into something that's commonplace. The data's going to become easier to get and will be integrated into more processes. It won't be a curiosity or an annex to a main room where regular investment people are. This will be something that everybody does.

This is just an evolution of traditional fundamental process, adding inputs that people didn't consider in 1934 when Graham [and] Dodd's book ['Security Analysis'] was written, but that are available today. So they're on the table. Why wouldn't you think about them?

VanderBrug: I agree with this idea of a shift to a more mainstream approach, and it will be driven by the improved ability to clearly price social and environmental risk. As more research comes out and the data gets better, we will get more interesting and focused strategies using different ESG factors as alpha generators.

It's evolutionary, yet there's an opportunity here that is also revolutionary. We're undergoing one of the larger shifts in investing as we start to understand that these non-financial factors are material. ❖

[1] *Michael Porter, head of the Institute for Strategy and Competitiveness at Harvard Business School, is a leading authority on competitive strategy and the application of competitive principles to social problems such as the environment and corporate responsibility. He is co-author, with Mark. R. Kramer of the Kennedy School at Harvard University, of Creating Shared Value, a business concept that suggests the competitiveness of a company and the health of the communities around it are mutually dependent.*

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