Chapter 1: Introduction to ESG Investing

1.1. What is ESG Investing

- ❖ ESG investing is an approach to managing assets where investors explicitly incorporate environmental, social, and governance (ESG) factors in their investment decisions with the long-term return of an investment portfolio in mind.

- ❖ Short-termism covers a wide range of activities such as trading practices (based on short-term momentum and price movement), prioritize maximizing quarterly financials etc.

- ❖ The Shareholder Rights Directive (SRD) was issued by the European Union (EU) in September 2020, requiring investors to be active owners and to act with a more long-term focus.

The Definition and Scope of ESG Issues

	Environmental	Social	Governance
Definition	Factors pertaining to the natural world. These include the use of and interaction with renewable and non-renewable resources (e.g., water, minerals, ecosystems, and biodiversity).	Factors that affect the lives of humans. The category includes the management of human capital, non-human animals, local communities, and clients.	Factors that involve issues tied to countries and/or jurisdictions or are common practice in an industry, as well as the interests of broader stakeholder groups.
Examples	- Climate change - Resource depletion - Waste	- Human right - Child labor - Employee relation	- Bribery - Board structure - Tax strategy

1.2. Types of Responsible Investment

- ❖ Responsible investment: an approach to managing assets where you explicitly acknowledge ESG factors.

- ❖ Socially responsible investment (SRI) refers to approaches that apply social and environmental criteria in evaluating companies. Usually in conjunction with sector-specific weightings. A hurdle is established for qualification within the investment universe, based either on the full universe or sector by sector.

- ❖ Best-in-class investment (aka. "positive screening") involves selecting only the companies that overcome a defined ranking hurdle, established using ESG criteria within each sector or industry. Not all best-in-class are considered responsible investing.

  The tracking error for MSCI World SRI, which is designed to represent the performance of companies with high ESG ratings and employs a best-in-class selection approach to target the top 25% companies in each sector, is only 1.79%.

- ❖ Sustainable investment refers to the selection of assets that contribute in some way to a sustainable economy—that is, an asset that minimizes natural and social resource depletion. This may include best-in-class and/or ESG integration.

- ❖ Thematic investment is investment in themes or assets specifically related to ESG factors, such as clean energy, green technology, sustainable agriculture, gender diversity, or affordable housing. Not all thematic funds are considered to be responsible investments or best-in-class.

- ❖ Green investment refers to allocating capital to assets that mitigate climate change, biodiversity loss, resource inefficiency and other environmental challenges. Green investments can be considered a sub-category of thematic and/or impact investing.

The goal of mitigation is to:
- avoid dangerous interference with the climate system
- stabilize GHG levels in a time frame sufficient to allow ecosystems to adapt naturally to climate change
- ensure that food production is not threatened
- enable economic development to proceed in a sustainable manner

Examples of mitigation strategies:
- Energy: deploying renewable energy sources
- Buildings: retrofitting buildings (i.e. reduce building's carbon footprint)
- Transport: adopting more sustainable, low-carbon transportation and infrastructure
- Land use and forestry: improving forest management, reducing deforestation and growing more of our existing forest (aka. proforestation)
- Agriculture: improving crop and grazing land management
- Carbon pricing and other economic measures
- Industry and manufacturing

2. Climate change adaptation - adjusting to actual or expected future climate events, thereby increasing society's resilience to climate change and reducing vulnerabilities to its harmful effects.

   Examples of adaptation strategies:
   - protecting coastlines and adapting to sea-level rise
   - building flood defenses
   - managing land use and forestry practices
   - planning more efficiently for scarce water resources
   - developing drought-resilient crops
   - protecting energy and public infrastructure
   - developing clean cooling systems

   Climate change adaption and resilience measures require location-specific assessment of climate risks and suitable approaches to address them.

   States, provinces, cities and municipalities are at the frontline of adaption and resilience due to their high concentration of people, assets, and economic activity. Representing 80% of global gross domestic product (GDP) therefore are heavily exposed to climate risks in the forms of:
   - sea level rise
   - extreme weather events
   - increase in the spread of tropical diseases

Pressure on Natural Resources

❖ The relationship between businesses and natural resources is becoming increasingly important due to dramatically accelerating biodiversity loss and less secure access to natural resources.

❖ Governments and business are having to deal with greater pressures on resources, caused by:
  - population growth
  - health improvements leading to people living longer
  - economic growth
  - the accompanying increased consumption in developed and emerging economies

❖ Depletion of natural resources: over-consumption of natural resources - the planetary boundaries model sets out earth's limits on natural resources. 8.6 billion people in 2030, 9.8 billion people in 2050 and 11.2 billion people in 2100.

  The relative improvements in efficiency (using fewer resources per unit of production) may be offset by increased consumption of a given product—an effect known as the Jevons paradox.

❖ Water: water scarcity is the lack of FRESH water to meet water demand.

Chapter 5: Governance Factors

5.1. Corporate Governance: Accountability and Alignment

- Corporate governance is the process and structure for overseeing the business and management of a company. Governance is about people and processes.

- Assessment provides an insight into the decision-making process impacting allocation of investors' capital and the likely delivery of long-term value.

- Large companies need robust processes to deliver policies and investors will judge a company's governance based on the quality of its policies and processes and on the diligence and care with which the board oversees their implementation.

- The two A's of corporate governance:
  1. Accountability
     - People need to be given authority and responsibility for decision-making.
     - People need to be held accountable for the consequences of their decisions and the effectiveness of the work they deliver.
     - Corporate governance focuses on board structure, director independence and accurate accounts.
  2. Alignment
     - Arises from the agency problem, i.e. aligning interests of managers and owners, which is magnified for larger companies.
     - Require appropriate incentives and chains of accountability to ensure alignment.

  A codified set of guidelines for good governance has grown from the basic concepts of accountability and alignment.

5.2. Formalized Corporate Governance Frameworks

Corporate Governance Codes

- First formal corporate governance code emerged in the UK in 1992.

- The Cadbury Committee was created because of the perceived problems in accounting and governance. Its creation followed the Caparo and Polly Peck scandals.

- Key motivators have been from corporate failures and scandals. When companies fail, investors lose money, there is often pressure for an improved approach.

- UK model of 'comply or explain' is followed around the world.

- Codes develop in line with ongoing scandals/economic development:
  - UK Greenbury Report 1995 on remuneration following the shocks around pay levels at newly privatized utilities.
  - US Sarbanes-Oxley Act 2002 on financial reporting following the Enron, Tyco and WorldCom scandals. Creation of the Public Company Accounting Oversight Board (PCAOB) as the country's audit standard setter and inspector, establishing a standard for auditor independence and challenge.
  - Heightened standards of corporate governance (for board and auditor) across Europe following the failures at Ahold and Parmalat in the Netherlands and Italy in 2003.
  - Creation of stewardship codes in the UK and then around the world, the legislative changes (i.e. 2010 Dodd-Frank Act in US), tightened standards for the oversight of banks following the financial crisis of 2008.
  - Rapid advance of the Japanese governance standards following the Olympus scandal of 2011-12 and the overstatement of profit by Toshiba in 2015.

2. Breakdown issues into a number of indicators.
3. Determine a scoring system.
4. Assess a company and give it a score.
5. Calculate aggregated scores at issue level.
6. Benchmark the company's performance.

<u>Materiality Assessments and Risk Mapping</u>

- Determining which ESG issues are most material is not an exact science.

- Frameworks such as the materiality maps provided by the SASB are helpful in providing some guidance, but investment professionals often develop their own view on what is most material.

- As of 2019-2020, a trend has developed in company reporting to include more material ESG factors. However, various stakeholders do not agree on materiality and how to report, so developing proprietary materiality assessments could continue to be an important technique for investors to potentially develop their own analytical framework alongside standardized frameworks, such as those of the SASB or the Global Reporting Initiative (GRI).

- ESG risk mapping may be conducted at the research stage. A company has its risk mapped on to a specific theme or factor (e.g. carbon footprinting). Mapping can also be used for material opportunities, can be applied to Sector (most material), Sub-sector and Company.

7.4. Valuation and Company Integrated Assessment Stage and the Challenge of Company Disclosure on ESG Topics

<u>Model Adjustments based on ESG Assessment</u>

- Discounted cash flow (DCF) input adjustments e.g. a company's environmental management processes and policies are judged strong or weak. After this judgement, the cost of capital used to discount cash flows is adjusted down or up by 1% to account for this.

- Explicit profit and loss sales, balance sheet and margin adjustments from ESG assessment. Adjustments can be made direct to the balance sheet or capital expense lines.

- Valuation ratio adjustments with ESG integration. An investor may decide a company is worth a certain price/earnings (P/E) ratio premium/discount versus its peers due to ESG factors.

<u>The Challenge of Company Disclosure on ESG Topics</u>

- Most ESG data is not compulsory under typical reporting standards. Management has flexibility in what is chosen to be reported. In fact, there can be over-disclosure. Lack of disclosure could be an indicator of poor ESG management. Even when revealed, ESG disclosure may be UNAUDITED, not complete, or incomparable.

- While poor disclosure is a challenge to market efficiency, this relative inefficiency could arguably be a source of superior risk-adjusted return for the skilled investor.

7.5. Discussion of Private Markets, Real Estate and Infrastructure; Discussion of ESG in Fixed Income and Differences to Equity; and Challenges to ESG Integration

<u>Discussion of Private Markets, Real Estate and Infrastructure</u>

- Majority or full ownership stakes offer investors much greater control over the definition, application and reporting of ESG data alongside or outside existing reporting standards.

- For real estate, it depends heavily on companies participating in the Global Real Estate Sustainability Benchmark (GRESB) reporting assessment process. Before GRESB in 2009, the commercial and residential real estate sectors had little regard for ESG factors.

- ESG in private equity faces a number of challenges because they're smaller businesses (so do not have the reporting requirements).

- Exclusionary screening based approaches have evolved from values-based screening to increasingly sophisticated approaches that now negatively screen across a much larger set of ESG criteria.

- The degree of exclusions may carry significant implications from a portfolio management perspective, not just in terms of higher tracking error, but also unintended factor exposure. Investors (particularly asset managers) are generally more reluctant to adopt exclusions. With no beneficiaries directing a specific worldview and often a very diverse base of investors with exclusion preferences that may conflict, asset managers tend to default to as unconstrained an investment universe as possible.

- One of the most exiting areas in portfolio management focuses on quantitatively understanding the risk properties of ESG.

- Regarding challenges of ESG integrations at the security level, there is widespread disagreement about what an ESG factor represents. While single-security level, case studies often frame the investment process with a powerful engagement story, their anecdotal nature does not describe performance attribution from ESG exposure at a portfolio level. Describing ESG performance attribution at a portfolio level requires quantifying ESG as a factor on its own. The correlation to other factors such as value, quality, size and momentum undermines the effort to define ESG as uniquely singular enough to be included in risk factor attribution analysis.

- This represents a CAUSALITY PROBLEM for ESG. If ESG does not represent a mix of existing factors like quality and value, then how can academics and practitioners begin to define it.

8.7. <u>ESG Screening within Portfolios and Across Asset Classes: Fixed Income, Corporate Debt and ESG Bonds</u>

- Fixed Income (Government, Sovereign, Corporate and Other)
  - ESG integration has experienced a good deal of catch up relative to listed equities. However, there is differentiation across the sub-asset classes.
  - Lower levels of ESG integration in areas like sovereign debt and high yield credit often reflect a scarcity in ESG ratings and data sets, particularly in the unlisted credit markets.
  - Corporate debt is now enjoying greater levels of ESG integration. There is growing evidence of ESG-incorporated methodologies yielding meaningful performance differentials. The temporal dimension across multiple debt maturities and credit risk profiles arguably lends itself to a more granular comprehension of ESG issues and their materiality.
  - ESG bond types: ESG-oriented bonds are organised around sustainability themes. Distinguishable from normal bonds because of their underlying use of proceeds and the greater transparency they provide towards their use of proceeds. Despite the development of ESG in fixed income, the absence of universally recognised standards certification for sustainable bonds. Types of ESG-orientated bonds:
    - Green bonds (aka. climate bonds, provide a clear benefit to the environment etc)
    - Social Bonds (provide access to essential services, infrastructure and social programs to underserved communities)
    - Sustainability bonds (offer broadly defined bonds that create a positive social or environmental impact)
    - Sustainability-linked bonds (provide financing to issuers who commit to specific improvements in sustainability outcomes)
    - Transition bonds (provide financing to “brown” industries with high GHG emissions)
    - SDG-linked bonds (overlap with green/social bonds, specifically committing and advancing to SDG-related targets)
    - Blue bonds (for clear marine and ocean-based benefits)

Chapter 9: Investment Mandates, Portfolio Analytics and Client Reporting

9.1. Introduction: Accountability to Clients and Alignment with them

- Double-agency: asset owner delegates to the asset manager who then delegates to the board of directors.

- Alignment should be designed such that the time frames and structures of portfolio manager assessment and remuneration closely reflect both the performance experienced by the clients they serve and the time frames over which they need performance to be delivered.

- Accountability should mean that portfolio managers respond to the clearly expressed intentions of their clients and report as fully as required.

- 5 steps in mandate Design, Construction and Oversight:

  1. Clarifying client's needs: defining the ESG investment strategy
     - The investment philosophy is often shaped by the overall purpose of the organisation, set by its founding documents/mandates. For many asset owners now, it is vital that ESG is integrated within that purpose.

     - The Pensions and Lifetime Savings Association (PLSA) produces a Stewardship Checklist for its members, which encourages just such a development of a broader philosophical approach.

     - Since October 2019, U.K. occupational pension scheme regulations require pension schemes to set out in their statement of investment principles (SIP) their policies on how they consider financially material ESG factors. New reporting requirements, in line with Europe's Shareholder Rights Directive II, will reinforce the same.

     - How the purpose and investment beliefs and philosophy see ESG impacting investment performance - whether the risk factors or value creators – will shape how ESG is integrated into mandates and what the asset owner will expect of its fund managers.

     - McKinsey suggests that there are 2 fundamental questions that asset owners need to ask in developing ESG investment philosophy:
       i. Are ESG factors more important for risk management or value creation?
       ii. What ESG factors are material?

  2. Fully aligning investment with clients' ESG beliefs
     - Once the asset-owner client has developed investment philosophy and beliefs, this then needs to be translated into the specifics of the mandate that is awarded to the fund managers.

     - There are 2 key elements to this:
       i. Is ESG a risk management tool or a source of investment advantage?
       ii. Which aspects of ESG most matter from the perspective of the asset owner?

     - Determining the answers to these questions will be the starting points for shaping the mandates awarded.

     - These philosophical statements then need to be operationalized into ESG policies that cover a range of practical issues. Regardless of the investment strategy or asset class, such an ESG policy needs to address the manner in which the portfolio manager:
       - addresses ESG issues at portfolio reviews,
       - establishes the rationale and methodology for ESG portfolio-level assessment,
       - assesses exposure to ESG risk within the risk management function,
       - determines ESG impacts to the portfolio,
       - responds in the investment decision-making process to ESG implications, and