

## Intentional Endowments Network

*An initiative of [www.CraneSustainability.org](http://www.CraneSustainability.org)*

# The Business Case for ESG

**A**DDRESSING KEY MATERIAL FACTORS that have often not been considered investment decisions can help investors maximize a portfolio's risk and return profile. In addition to addressing constituent concerns, incorporating material environmental, social, and governance – or “ESG” – factors into an investment decision value chain can enhance long-term returns, decrease risk by providing downside protection, and deliver portfolio benefits such as diversification and reduced volatility. As recommended by the CFA Institute, trustees should “consider all relevant risk and value factors deemed appropriate when designing the scheme's investment strategy. In addition to typical financial measures, these factors may include environmental, social, and corporate governance issues.”<sup>1</sup>

## What is ESG Investing?

ESG investing is the systematic consideration of environmental, social, and governance criteria in investment decision-making and portfolio construction to identify risks and opportunities. Investors use ESG strategies as an enhancement to traditional analysis that can underappreciate the business relevance of ESG factors. At times when these factors are not easily quantifiable in conventional analyses, they may still translate into real financial risks or rewards.

Megatrends in global, inter-related social and ecological factors can impact financial markets and companies' financial performance. Drivers of these impacts include environmental liabilities, resource scarcity, climate change, modern slave labor, and gender equality. These issues pose real risks to businesses, investors, and society as a whole, both in the immediate and longer term.

ESG investing does not dictate the exclusion of any one investment or economic benefit; consideration of ESG factors does not imply avoiding 'sin stocks' or implementing negative screens for ethical, moral, or political reasons. It is not a values-based investment strategy. It does call for the inclusion of data and relevant considerations traditionally excluded by strategies focused solely on quarterly returns which may in turn lead some investors to include or exclude specific investments.

## Spectrum of Approaches

There is a spectrum of ESG analysis and investing methods. ESG analysis provides investors with additional insights into potential risks and can help to inform asset allocation, portfolio construction, proxy voting, and on-going investment management. ESG risk/return decisions can be made at the company, industry and portfolio level. Products include ESG funds and span most existing financial strategies, including passive, active, growth, value, core, domestic, international, global, and thematic funds. Financial data providers such as Bloomberg, MSCI, Thompson Reuters, Morningstar and Sustainalytics offer resources to inform ESG analysis.

### Top takeaways about ESG investing:

- » Performs comparably with non-ESG investing
- » Growth: from 2012-2014 sustainable investment strategies in the US grew 75% to \$6.57 trillion;<sup>2</sup> globally, they rose 61% to \$21.4 trillion.<sup>3</sup>

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Consistent metrics and standards for the field are emerging. The Sustainability Accounting Standards Board (SASB), which includes two former SEC commissioners on its board of directors,<sup>4</sup> is in the process of identifying sector-specific reporting standards to improve corporate disclosure on material ESG factors.<sup>5</sup>

This initiative will essentially aggregate ESG factors with others that are already material under SEC securities law.

## Elements of fundamental equity valuation that can be impacted by ESG factors to a material degree:

- » Supply chain risks
- » Reputational and brand impact
- » Operational or product delays and lost productivity
- » Potential for impaired assets
- » Human capital: recruiting necessary talent
- » Winning bids/license to operate
- » Regulatory and legislative risks
- » Operating costs

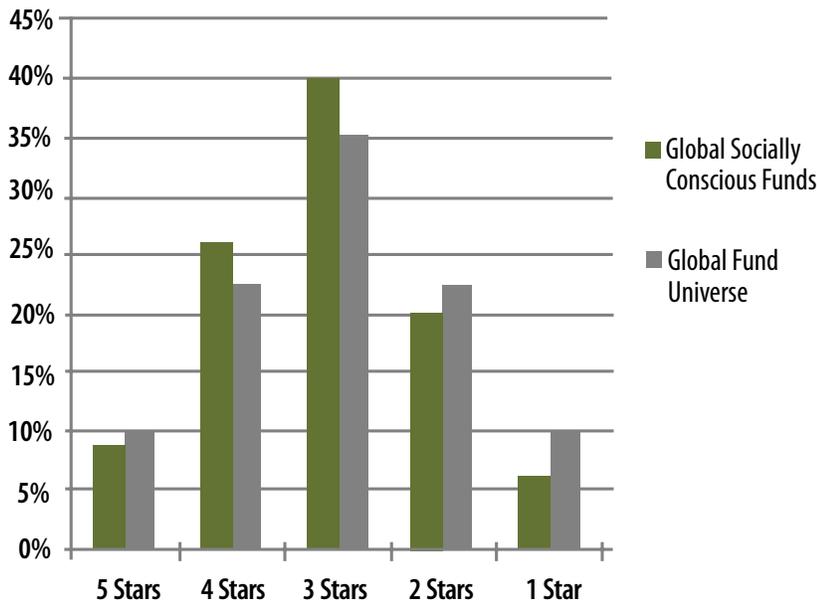
## How do ESG investing strategies perform financially?

As with any investment product, some ESG strategies perform better than others, and some perform better than benchmarks and comparable non-ESG managers. Specific measurement periods matter as start and end dates frequently impact strategies differently.

In recent years the amount of data on ESG investing has grown significantly, providing evidence that ESG investment often outperforms traditional strategies. *One recent meta-study found that 89% of research studies showed that companies with high ESG ratings exhibit market-based outperformance compared to industry peers; another showed that 90 companies with strong sustainability policies outperformed a similar group with low sustainability standards, with a 4.8% higher annual above-market average return between 1993 and 2011.* At a minimum, recent papers from Morgan Stanley, UBS, TIAA-CREF, Allianz Global, Cornerstone Capital and MSCI and Generation Foundation have all concluded that ESG investing generally performs comparably to non-ESG strategies.<sup>6</sup> Contrary to some traditionally held views, there is no performance penalty associated with pursuing such strategies (see Appendix for references).

A 2016 analysis of Morningstar Analyst Rating for funds found that those funds tagged as “socially conscious” have better ‘star ratings’ than the overall universe, as shown in the bar chart below.<sup>7</sup>

Exhibit 1 Morningstar Ratings Distribution of Global Socially Conscious Funds (Date as of 1/16)



Source: Morningstar Direct

This analysis found that “fully 75% of the socially conscious funds have 3, 4 or 5 stars, rather than the two thirds that would be expected based on the normal distribution of the Morningstar Analyst Rating,” and concluded that: “The evidence from the star rating is pretty clear: Investors interested in incorporating sustainability into their portfolios can do so without worrying about an intrinsic performance penalty.

The evidence from the star rating is that socially conscious funds tend to either outperform (globally) or perform in line with (U.S.) their conventional peers on a risk-adjusted basis.”<sup>7</sup>

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## When Applying *Material* ESG Factors to Stock Selection

Evolution of \$1 Invested in March 1993



George Serafeim and colleagues at Harvard Business School applied guidance from the Sustainability Accounting Standards Board (SASB) to explore how materiality matters to ESG data. Industry by Industry, they mapped recommended reporting topics to data points that reflected company investments in material sustainability areas.

Controlling for systematic risk factors and opportunity sets, they analyzed stock prizes for each decile of “ESG improvers”

on material factors— that is, focusing on only those ESG factors deemed material for each company’s industry. The chart shows the best 10% and worst 10%.

The divergence shown in the chart expresses the potential for alpha generation. That is, to the extent investors can identify material factors and apply them to sock selection, they may gain an edge by separating stocks more likely to perform better (blue line) and worse (red line) over time.

*Text and image excerpt from: "The Financial and Societal Benefits of ESG Integration: Focus on Materiality," Calvert Investments, <http://www.calvert.com/perspective/research/calvert-serafeim-series-report-materiality>*

*Source: Mozaffar Khan, George Serafeim, and Aaron Yoon, "Corporate Sustainability: First Evidence on Materiality" (2015), <https://ssrn.com/abstract=2575912>*

## What would we do differently if we were to pursue ESG investing?

Broadly speaking, the process of ESG investing for endowments might include the following steps:

- » Educate the Board, investment committee, administrators, investment consultants, and stakeholders on ESG investing and what it means for managing the endowment.
- » Develop an ESG framework to integrate into the investment philosophy.
- » Develop an investment policy statement that reflects this framework and includes directives for external managers to consider ESG factors.
- » Communicate to investment managers and consultants the institution’s position on ESG investing, and request responses on if and how managers consider ESG criteria.
- » Evaluate current portfolios – both direct holdings and manager strategies – to identify limited ESG interests, and then engage with those managers to request better conformity with client expectations.
- » Endowments with limited ability or resources for shareholder engagement can consider requesting investment manager reporting on the ESG characteristics of portfolio constituents, engagement and proxy voting.
- » Include ESG integration metrics during the course of normal monitoring of the performance of managers and the endowment portfolio as a whole. ■

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## Appendix

### Material ESG Factors in the S&P 500: Examples from 2014 corporate 10-K filings

**Coca Cola:** “Water is a limited resource in many parts of the world, facing unprecedented challenges from overexploitation, increasing demand for food and other consumer and industrial products whose manufacturing processes require water, increasing pollution, poor management and the effects of climate change.”

**Progressive:** “Moreover, changing climate conditions, whether due to an increase in average temperatures (global climate change) or other causes, may increase how often severe weather events and other natural disasters occur and how much insured damage they cause. The extent of insured losses from a catastrophe is a function of both our total net insured exposure in the area affected by the event and the nature and severity of the event. We use catastrophe modeling tools and third-party experts to help estimate our exposures to such events. Those tools and expert opinions are based on historical data and other assumptions that limit their reliability, and they may become even less reliable as climatic conditions change.”

**Traveler’s Insurance:** Severe weather events over the last several years have underscored the unpredictability of future climate trends and created uncertainty regarding insurers’ exposures to financial loss as a result of catastrophes and other weather-related events. For example, over the last decade hurricane activity has impacted areas further inland than previously experienced by the Company, thus expanding the Company’s potential for losses from hurricanes. Additionally, both the frequency and severity of tornado and hail storms in the United States have been more volatile in recent years, while any further reductions in arctic sea ice may contribute to rising sea levels that could impact flooding in coastal areas. Accordingly, the Company may be subject to increased losses from catastrophes and other weather-related events.

Additionally, the Company’s catastrophe models may be less reliable due to the increased unpredictability, frequency and severity of severe weather events or a delay in the recognition of recent changes in climate conditions.”

Moving toward ESG for endowments need not be done all at once. In any long-term investment management enterprise, there is normal portfolio turnover and asset manager transition. Establishing the rationale and criteria for ESG-guided investing can be done thoughtfully and methodically over time. This allows asset owners the option to move into ESG investing as part of normal operations and manager turnover.

### Reports and guides on trends and practical application of ESG investment strategies:

- » **“The 21st Century Investor: Ceres Blueprint for Sustainable Investing”**<sup>8</sup> | Ceres, 2013 – *Practical guide for asset owners and managers outlining ten steps for implementing a sustainable investment strategy that considers risks posed by issues such as water and resource scarcity, climate change, human and labor rights, population growth, that influence financial performance and are often not considered in traditional investment analysis.*
- » **“2014 Report on Sustainable and Responsible Investing Trends in the United States”**<sup>9</sup> | US SIF, 2014 – *The latest report in a bi-annual survey of trends in sustainable, responsible, and impact investing showing the number of managers engaged and dollars invested in such practices, as well as other key trends in the space.*
- » **“Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies”**<sup>10</sup> | Morgan Stanley Institute for Sustainable Investing, March 2015. *Found that investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments. This is true on both an absolute and a risk-adjusted basis, across asset classes and over time.*
- » **“Can ESG Add Alpha? An Analysis of ESG Tilt and Momentum Strategies”**<sup>11</sup> | Zoltán Nagy, Altaf Kassam and Linda-Eling Lee, MSCI, June 2015. *Both ESG Tilt and ESG Momentum strategies outperformed a global benchmark over an eight-year period. A significant portion of this outperformance was not explained by style factors, and may have been attributable to ESG factors.*
- » **“ESG in Equities”**<sup>12</sup> | AllianzGI Global Solutions, December 2015. *The majority of studies analyzed report a positive relationship between corporate sustainability and stock price behavior. Much of the newer research in particular show that superior ESG strength also appears to lower volatility risk.*
- » **“Sustainable Investing: Addressing the Myth of Underperformance”**<sup>13</sup> | Sebastian Vanderzeil, Craig Metrick and Andy Zheng, Cornerstone Capital, September 24, 2015. *Evidence shows that aligning investments with ESG*

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factors can create financial value, and there is no reduction in investor returns for investment strategies that appropriately and consistently apply ESG factors.

- » **“Sustainable Investing: To integrate or exclude”**<sup>14</sup>  
UBS, Third quarter 2015. *Empirical evidence from research conducted over the past three decades failed to document any consistent difference in the performance between sustainable investment and conventional strategies.*
- » **“Corporate Sustainability: First Evidence on Materiality”**<sup>15</sup> | Mozaffar Khan, George Serafeim, Aaron Yoon, March 9, 2015. *Found that firms with strong ratings on material sustainability issues significantly outperform firms the poor ratings on these issues.*
- » **“From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance”**<sup>16</sup>  
Gordon L. Clark, Andreas Feiner, Michael Viehs, March 5, 2015. *Meta-study of more than 200 sources, 88% of which found that companies with strong sustainability performance had better operational performance and cashflows, and 80% of which found strong sustainability performance had positive effects on investment performance.*
- » **“Sustainable Investing: Establishing Long-Term Value and Performance”**<sup>17</sup> | DB Climate Change Advisors, June 2012. *Found that 89% of research studies showed that companies with high ESG ratings exhibit market-based outperformance compared to industry peers.*

- » **“The Impact of Corporate Sustainability on Organizational Processes and Performance”**<sup>18</sup>  
Robert G. Eccles, Ioannis Ioannou, George Serafeim, Harvard Business School, July 2013. *18-year study (1993-2011) showing that 90 companies with strong sustainability policies outperformed a similar group of 90 companies with low sustainability standards, with a 4.8 percent higher annual above-market average return.*

To access additional reports, please visit:

[http://www.intentionalendowments.org/financial\\_performance](http://www.intentionalendowments.org/financial_performance).

## *Note on fossil fuel divestment*

Much of the conversation related to sustainable investing recently has focused on fossil fuel divestment, particularly in higher education where student calls for divestment are strong. Divestment is an example of a negative screen, and different from ESG investing. While ESG investing may result in managers deciding not to invest in certain companies or sectors, this is true of nearly all investment strategies. ESG investing holds the premise that fiduciaries should integrate the broadest perspective when considering risks and opportunities that can affect the long-term health and performance of the endowment. While not mutually exclusive of divestment, ESG investing does not require divesting, and the two are often driven by different motivations.

For reports focused specifically on performance of fossil fuel divestment and carbon risk, please visit:

[http://www.intentionalendowments.org/carbon\\_risk](http://www.intentionalendowments.org/carbon_risk).

<sup>1</sup> CFA Institute, Code of Conduct for Members of a Pension Scheme Governing Body, 2008.

<sup>2</sup> Reclaiming Fiduciary Duty Balance, Rotman International Journal of Pension Management, Vol. 4, No. 2, p. 4, Fall 2011

<sup>3</sup> <http://www.ussif.org/trends>

<sup>4</sup> [http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA\\_Review\\_download.pdf](http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf)

<sup>5</sup> Mary Schapiro is Vice Chair of the Board and Elise Walter is on Board of Directors Sustainability Accounting Standards Board 2014 Annual Report

<sup>6</sup> Socially Responsible Investing: Delivering competitive performance, Lei Liao and Jim Campagna, TIAA CREF, September 2014.

Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies, Morgan Stanley Institute for Sustainable Investing, March 2015

To integrate or to exclude: Approaches to sustainable investing, UBS, Third Quarter 2015

How and Why SRI Performance Differs from Conventional Strategies: Executive Summary, Jianan Du, Brandon Thomas and Janis Zvingelis, Envestnet, July 2014

Can ESG Add Alpha? Zoltán Nagy, Altaf Kassam and Linda-Eling Lee, MSCI, June 2015

Sustainable Investing: Addressing the Myth of Underperformance, Cornerstone Capital Group

Allocating Capital for Long-Term Returns, Generation Foundation, May 2015

<sup>7</sup> “You Don’t Have to Sacrifice Returns for Sustainability” Jon Hale, Ph.D., CFA, Morningstar, August 2016

<sup>8</sup> <http://www.ceres.org/resources/reports/the-21st-century-investor-ceres-blueprint-for-sustainable-investing/view>

<sup>9</sup> <http://www.ussif.org/content.asp?contentid=82>

<sup>10</sup> <https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf>

<sup>11</sup> <https://www.msci.com/documents/10199/4a05d4d3-b424-40e5-ab01-adf68e99a169>

<sup>12</sup> [http://www.allianzgi.com/en/Risk-Management/Documents/ESG-in-Equities\\_Nov2015.pdf](http://www.allianzgi.com/en/Risk-Management/Documents/ESG-in-Equities_Nov2015.pdf)

<sup>13</sup> <http://cornerstonecapinc.com/2015/09/sustainable-investing-addressing-the-myth-of-underperformance-2/>

<sup>14</sup> [https://www.ubs.com/global/en/about\\_ubs/follow\\_ubs/highlights.html](https://www.ubs.com/global/en/about_ubs/follow_ubs/highlights.html)

<sup>15</sup> [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2575912](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912)

<sup>16</sup> [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2508281](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281)

<sup>17</sup> [https://www.dbadvisors.com/content/\\_media/Sustainable\\_Investing\\_2012.pdf](https://www.dbadvisors.com/content/_media/Sustainable_Investing_2012.pdf)

<sup>18</sup> [http://www.hbs.edu/faculty/Publication\\_Files/SSRN-id1964011\\_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf](http://www.hbs.edu/faculty/Publication_Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf)