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Successful ESG integration: moving from why to how

Guillaume Mascotto

Recent regulatory developments suggest that environmental, social and governance (ESG) investing is neither a fad nor a subjective enterprise. Rather, it has become a critical part of day-to-day investment management. Global investor commitment to ESG and impact-themed investing has evolved from a question about why ESG is important to how it can be most effectively implemented.

ESG investing is an evolving concept that currently lacks standardised definitions, consistency and a solid baseline for analysis and measurement.

Despite recent progress at the regulatory level and higher levels of issuer ESG disclosure, investors are increasingly relying on ESG information about companies, which can differ per third-party ratings, scores and other beta-type filters.

Much of that data hasn't been audited or contextualised around financial materiality and company fundamentals.

A growing body of research supports a positive relationship between high ESG characteristics and investment outcomes. However, as an investment factor, ESG continues to lack uniform definitions and a solid methodological baseline for security analysis. There continues to be no generally accepted accounting principles (GAAP) for ESG. The explanatory effect of ESG on returns in the context of stock market crises also remains subject to debate.

As a result, overreliance on popular guidance based on ESG overlays (such as ESG analysis separated from fundamental analysis) or inserts (top-down SRI screens) runs the risk of obscuring which ESG issues are financially material and under which valuation technique or scenario would they alter a company's solvency and growth trajectory over a given time-horizon.

The following represents a ten-step process which can be used for an ESG integration strategy:

1. Be flexible and investment-led

ESG factors can be integrated in multiple ways. An ESG integration framework should therefore be flexible and align with the particulars of a given investment strategy. For example, ESG teams may want to consider the following:

- Providing investment teams with the right tools and in-house ESG expertise to implement an integrated approach or combination of approaches best suited to their investment processes
- Allowing investment teams to tailor the ESG integration process according to asset class, style, time horizon, opportunity set and client objectives
- Tying business planning to specific, measurable, achievable, relevant and time-based (SMART) goals to help incentivise the

investment organisation to commercialise ESG solutions the market demands.

2. Build strong partnerships with fundamental analysts

The number of ESG specialists aside, systematic ESG integration cannot be achieved unless fundamental analysts and ESG specialists work together. This should not be to substitute fundamental analysis but rather to augment it.

Financial and ESG information must be considered concurrently. The objective is to ensure investment analysts and portfolio managers participate in the ESG assessment by allowing them to provide input regarding the financial materiality of ESG issues to which their issuers are or could be exposed.

3. Focus on industry and macroeconomic context

Identifying ESG issues should consider, and be corroborated by, the macroeconomic context and any relevant industry-specific competitive forces.

Asset managers should assess ESG materiality first at the macro and sector levels before assessing at the issuer level. Macro assessments should consider ESG issues that could potentially affect long-term global market dynamics and regulatory developments.

Given that not all sectors are exposed to the same macro ESG issues, ESG teams should work with in-house sector leads to isolate the issues that could potentially alter long-term, sector-specific competitive forces.

4. Identify downside risk and upside potential

Although many investors think of ESG primarily as a risk input, it can also represent upside opportunities. Therefore, analysts should focus on both the ability of the issuer to manage potential ESG-related costs and/or liabilities and its aptitude for setting the firm's strategic direction to capture growth opportunities flowing from ESG issues. It is also important to consider time horizon, as exposure to an ESG risk or opportunity may not materialise for five, ten or even 15 years.

5. Achieve an equilibrium between ESG quality and returns; avoid unintentional biases

As ESG demand grows, investors should be aware of the potential risk of a crowded ESG trade. Once a good ESG trade becomes public, its success may attract other investors, eventually leading to concentration and overpricing.

Thus, investors should redouble efforts to be creative in unearthing ESG rising stars (such as issuers in earlier stages of business inflection or on the verge of improvement following a business misconduct controversy).

6. Remain data intensive while considering variant ESG views

Investment teams should consider third-party ESG ratings and artificial intelligence and understand the drivers underpinning these opinions and signals. This is similar to how they consider credit ratings, sell-side research and quantitative analysis.

However, they should do so while generating variant views to exploit any potential disconnects in external ESG research or quantitatively driven data.

7. Build your own ESG framework

The financial materiality of ESG analysis should be supported by proprietary research based on combined ESG and financial variables with a focus on investment implications. Proprietary ESG assessments should also apply to various asset classes and be dynamic, capturing whether an issuer's risk management practices are improving or worsening over time.

To effectively scale ESG integration efforts, proprietary ESG research should ideally be centralised and made accessible to all investment teams.

8. Embrace long-term stewardship

Engagement with issuers that have weaker ESG performance relative to their peers but show room for improvement is essential. This helps portfolio managers gain a more thorough understanding of the company's approach to ESG risk management, including controversies and remedial actions.

Engagement also encourages an issuer to increase transparency on material ESG issues. If engagement fails to yield positive outcomes, portfolio managers could escalate their concerns by supporting ESG proxy resolutions, reducing the holding's weight, or divesting from the issuer, among other methods.

9. Take a solutions-driven approach

There is no one-size-fits-all approach to ESG. As client needs and regulatory developments continue to evolve, so should the capabilities of investment managers.

A manager's ESG program should therefore be flexible and regularly reviewed against industry best practices and market trends. This may help managers to provide multiple ESG solutions in all investment disciplines, subject to client needs.

10. Be passionate

Any new enterprise, regardless of the field, requires passion to succeed. Passion is the cornerstone of ESG 'grit'.

The millennial generation has fully embraced, with passion, the importance of ESG issues. They are likely to expect genuine passion on the part of their asset managers as they seek investment solutions in an effort to secure their long-term financial viability.

Case studies in robust ESG integration

Two highly ESG-exposed sectors offering insightful case studies of ESG integration are the energy and pharmaceutical sectors.

The decarbonisation of global energy use patterns presents risks and opportunities for energy companies.

The quote

A growing body of research supports a positive relationship between high ESG characteristics and investment outcomes.

The quote

Although many investors think of ESG primarily as a risk input, it can also represent upside opportunities.

Investors can gauge a company's potential to capture opportunities either in the form of compliance/operational risk reduction or growth inflection in new business lines by analysing several important characteristics, including stranded asset coverage and investments in renewable energy, negative emissions technologies and solutions that accelerate the transition to a circular economy.

In this sense, while ESG integration may help evaluate potential risks at the macro (climate change) and sector (regulation, market conditions, negative externalities) levels, it should also seek to identify those companies likely to succeed in the transition to a lower-carbon economy..

Pharmaceuticals is another sector of note in this scenario. Key areas for pharma companies include their approach to supply chain custody issues, international quality standard certifications and regulatory compliance.

A significant product recall can become an expensive ordeal between lost sales, replacement costs, government fines, and litigation expenses. If a company has recorded major product recalls and/or received regulatory warnings, investors should assess whether such actions could result in material costs. If so, they should also determine if the company can absorb litigation costs, withstand brand reputation damage and deploy the proper remediation steps to replace and fix defective products.

In short, if a company endured a significant public flogging as a result of gaps in product quality and safety controls, an integrated process would allow for a deeper assessment into whether the company is taking proper steps to prevent another damaging event. If this assessment revealed positive results, an asset manager would then look for risk management upside potential in the form of spread-tightening or growth inflection, based on this new course of behaviour.

While investors would undoubtedly benefit from additional and standardized disclosure about companies' ESG-related risks and opportunities, it's essential to distinguish between the quantity and quality of disclosure.

Active ESG integration can fill in the gaps. Accomplishing more with integration beyond reliance on ESG disclosures and third-party ratings, focusing on bottom-up analysis in tandem with integrated financial and ESG variables constitutes a more substantive understanding of an issuer's financial risk exposure to given ESG issues. Additionally, an integrated approach may help investors to evaluate how these issues can influence companies to react positively by innovating in net-positive impact business lines or de-risking balance sheets.

The investment community's conceptual understanding of ESG and its role in investment decision-making is continually unfolding. Accounting for ESG risks and opportunities is in line with fiduciary duty—it is not disconnected from financial returns.

To successfully achieve this alignment, we believe investors should take an investment-led approach focused on materiality and fundamental analysis. They must also remain flexible to evolving client-specific values and guidelines. **FS**