ESG Investing: Plus ça change, plus c'est la même chose…!

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At most institutional investor meetings on environmental, social, and governance (ESG) issues these days, the issue of investing for returns (value) versus outcomes (values) is usually front and centre.

Typically, investors position their approach squarely in the data-driven camp (value) with an accompanying disclaimer going something like this: "We are not trying to change the world" (values). Whether or not there is any validity in making this distinction underlies much of the confusion associated with ESG investing. Compounding this lack of clarity is the fact that many investors have only recently begun to apply ESG criteria and tend to be relatively unaware of its intellectual basis and biases. In fact, in some regions, nearly 80%[i] of asset managers now claim they integrate ESG criteria into their investment decisions—an adoption rate that would have seemed fantastical several years ago. And yet, few seem aware of the inherent tension of using ESG criteria as a risk-return-tool versus a means to an end.

Bedrock

Socially responsible research and investment options have been available for a number of years, but it was around 2000 that things really got interesting, primarily because the breadth and size of the actors changed dramatically. Several initiatives launched within the World Economic Forum and the United Nations (UN), and looked to engage corporates on the one hand, and investors on the other, to push the inclusion of environmental and social considerations into business planning and investment decision-making. Disclosure of these issues also received attention from a host of actors, including non-governmental organizations (NGOs), insurers, pension funds, as well as labour interests.

The World Economic Forum has long been engaged with the corporate sector on the question of "corporate citizenship," beginning with the 2004 publication of the "Value and Values" report, which highlighted for the first time the gap between Corporate Social Responsibility (CSR) and investor interest:

> "Our investors don't care' has become a common refrain both from leading companies who have been frustrated by the lack of investor support for their efforts to improve social and environmental performance, and from the corporate laggards, happy to have a ready-made excuse for their lack of investment and vision in this area.[ii]"

Ironically, perhaps, several initiatives were just getting underway, which would ultimately place a great deal more interest on corporate action in these very areas.

While the World Economic Forum conducted its consultations, for example, the UN was pulling together a group of asset managers under the auspices of the UN Environment Program (UNEP). The focus on asset managers was largely unintended because asset owners weren't all that interested in participating at the time. And those asset managers that did participate—including AGF Investments Inc. (formerly Acuity Investment Management Inc.)* —had a business interest in progressing socially responsible investing (SRI) as an investment approach. The group known as Asset Management Working Group (AMWG) produced a number of important studies on materiality and fiduciary responsibility. Through this research, it was able to enlist third-party actors who validated the potential materiality of some ESG factors to the investment process and therefore legitimized ESG inclusion in a fiduciary context. Again, the 'ethos' behind the initiative was obvious in the forward:

> Clearly, the unpaid environmental debt that exists at the heart of our markets is unsustainable. Increasingly, we are seeing more severe environmental and social impacts – at the global, regional and local level – stemming from the reluctance of markets to embrace sustainability, a concept so well captured by the "People, Planet, Prosperity" ethos.[iii]

In effect, the AMWG took a values-laden concept like "SRI" and de-stigmatized it in risk language by calling it "ESG" and stressed that explicit exclusions were not required in a context of materiality. Important, but hardly earth-shattering given that Canadian firms Jantzi Research Inc. (Sustainalytics) and Innovest (now MSCI ESG Research) had been ranking companies within all sectors on ESG criteria for some time—a move that wasn't surprising given the need to be more inclusive in the Canadian resource economy.

The case for thematics

It's not surprising that a recent survey of U.K. defined contribution investors found the vast majority would prefer responsible investment products to be clear that they "invest in companies that meet standards for doing environmental and social good." The term 'ESG' simply did not resonate (Invesco survey 2019). Acknowledging, if not embracing, the desire for social and environmental progress and placing this in a fiduciary context, is both the challenge and opportunity for ESG investors—as it has been for more than 20 years.

Ironically, all of this makes the case for using sustainability themes as a basis for an investment strategy even stronger. The thematic manager is inherently both outcome and data-driven given each investment directs capital at a company which stands to benefit from sustainability. By making values explicit—by default they will not be everyone's—and defining a market-based process to benefit, it is indeed possible to do both.

Adopting a thematic approach around sustainability issues entails defining those that are robust enough to represent long-term investable themes from those that don't. Investors using this approach do not need to agree with the desirability of the theme (that it should happen), just that it is happening and is investable. Think of the move to plant-based proteins or reduced plastics use.

The disruption occurring in the automotive industry is also a telling example. While many investors may have been caught owning one or several of the original equipment manufacturers (OEMs) during the emissions scandal, there was scant rationale for owning OEMs as a thematic investor. Tightening emissions regulations in all jurisdictions have been a long-term theme with the technical challenges of combustion engines and cost decline of electric growing more obvious each year. Seeking exposure to the emerging battery supply chain either as a hedge, or to reduce conventional exposure, is justifiable purely on financial grounds. Upping exposure to OEMs, who may now have credible electric vehicle (EV) plans, may also make sense for long-term investors. This is an opportunistic data-driven approach and is supported by the existing actions of regulators around the world. It doesn't require further policy action nor disclosures from corporates, though these may provide further justification for the exposure.

Overall, thematic investors will tend to focus more on capital allocation decisions and use engagement in support of this pursuit.

Founded in 2000, the high-profile United Nations Global Compact was an initiative designed to engage the private sector in the UN's broad social and environmental agenda. In 2004, the report, *"Who cares wins: Connecting Financial Markets to a Changing World,"* was published in partnership with the International Finance Corporation (IFC) and set a clear basis for the work:

> [We] are convinced that in a more globalised, interconnected and competitive world the way that environmental, social and corporate governance issues are managed is part of a companies' overall management quality needed to compete successfully. Companies that perform better with regard to these issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets [...][iv]

As per the work of the AMWG, previous pillars of SRI that included explicit screening (at least that would lead to exclusions) and community investment were quietly scrubbed from the agenda – essential to attracting a broader financial audience still faced with restrictive interpretations of fiduciary duty. The UN-supported Principles for Responsible Investment (PRI) launched shortly thereafter, initially signed by 20 asset owners and now encompassing over US$80 trillion in investments, according to its own 2018 data.

While this history is largely forgotten, what's undeniable is the global intentionality of this group of multinational actors to engage the financial sector in 'being a force for good.'

Purpose and data

Twenty years on and we have a curious situation where PRI signatories routinely screen out certain sectors (such as weapons and tobacco) and attempt to limit exposure to others (particularly fossil fuel) where an appropriate risk argument can be devised for doing so. That a pledge in the form of the Paris Accord is given as a justification for this risk argument is in itself instructive. From a pragmatist point of view, there is little evidence to suggest countries are taking the necessary steps to achieve the desired 1.5 to 2 degree cap on warming. Yet, detailed scenario-planning assuming this action is becoming a default for responsible investors. Corporates that push back often highlight this obvious lack of progress as a reason to continue with business as usual.

As advocates for progress engage with these recalcitrants, critics rightly point out that the heavy weight being placed on some ESG issues may be viewed as an 'end run' on the political process. After all, ESG investors are pushing corporates towards a desired outcome, despite a lack of political consensus (democracies set the rules, not the outcomes). While this approach is in line with the UN's initial intent, it's not one that everyone will agree with. Improving diversity or reducing mine tailing pond collapses are laudable goals in and of themselves that shareholders can have some influence upon. Demonstrating an explicit long-term link to returns will always be a matter of interpretation. Although this is uncomfortable territory, ESG investors should realize that screening, or even engaging with companies that do not meet minimum expectations is congruent with the values reviewed above, but not easily reconciled with a purely data-driven approach, as I will explain.[1]

All active investors believe in inefficient markets and therefore reduce or filter the investable universe using various data biases (market capitalization, region, cash flow, return on equity, earnings growth, themes, etc.). In all cases, corporate financial metrics tend to revert to mean. In other words, excess returns draw competition and are eventually arbitraged away resulting in portfolio turnover to identify a more protected opportunity. Expectations for 'ESG' factors are no different in a data-driven approach.

There should be no agreement on what criteria define a 'good' investment and there should be recognition that competitive advantage from good performance on an ESG metric is likely fleeting, albeit perhaps with a long tail. While there can be agreement on what issues might routinely be most material to a particular sector (as per the Sustainability Accounting Standards Board), there would be no agreement on how best to use this within a particular investment strategy.

Most importantly, the data-driven investor should be ambivalent to progress on social and environmental, or governance issues unless this directionality demonstrably improves returns. In this case these indicators would have

[1] This can be confusing. By way of example, at conferences in Canada, I have heard of the need to engage with carbon intensive sectors on issues relating to transition despite, in some cases, the poor relative financial performance. That this rationale was not historically applied to the 'clean tech' sector despite its central place in any 'transition' is telling. Being 'long-term' providers of capital can often be prefaced by 'where there is short-term cash flow.' That the 'transition' would be less daunting had these technologies benefited from lower cost of capital and engaged long-term holders should be obvious.

already been used or should have been captured within other measures and would obviously be closely guarded. To think otherwise is to assume that professional investors simply were not interested in possible sources of alpha prior to their designation as 'ESG' relevant.

Consider investments made specifically with a view to environmental mitigation. Whether for a pipeline or a mine, capital expenditure on mitigation beyond regulatory requirements generally cannot be justified on value alone. Exactly how much more should be spent is a judgement call which shareholders (not just management) have traditionally attempted to minimize, preferring instead higher cash returns in the form of dividends or share repurchase. These are certain while investments to avoid adverse future risks (insurance) are not—unless this investment is weighted higher due to a particular view of the future, beyond conventional risk/return parameters.

These other objectives are why a truly data-driven ESG approach is unlikely, or at least will be uncommon. At some point, reducing pollution or improving diversity is an end in and of itself which ESG investors naturally expect continual progress on. There is a social rationale for improvement, but not a financial one. If this dynamic weren't true, we would see more strategies willing to short companies with high ESG ratings—much of their success should be reflected in the share price while risks from downgrades would not be. On the contrary, hedge funds in the space have tended to short the laggards, which is entirely in line with a directional approach to ESG.

Those few approaches that have taken a decidedly less prescriptive approach to prioritizing investment criteria often can have a very different emphasis. Just Capital, a U.S.-based NGO, used survey data to define its emphasis in ranking the most "Just" companies in America. It's not surprising that issues related to workers and customers moved up the scale relative to shareholder-driven priorities such as climate change or corporate governance. Again, this highlights the challenge in separating a bias or agenda from a purely data-driven approach.

Perhaps the most obvious evidence that ESG investing is inherently purpose-driven is the rise of impact investing and the increasing adoption of the UN sustainable development goals (SDGs) within broad investor alliances such as the PRI. This framework proposes to direct capital at solutions to the issues of poverty, health and the environment, and is consistent with previous UN initiatives that engage the private sector and build on the UN Millennium Goals. Ultimately, the SDGs are much broader than the original (late 1980s) definition of sustainable development, which was skewed more to environmental concerns. That the increased focus on poverty and inequality dovetails nicely with the community investing pillar of the 'SRI' movement is not without some irony. In other words, Plus ça change, plus c'est la même chose...!' (the more things change, the more they stay the same).

For more information on sustainable investing please visit AGF.com.

i RI Research, "Almost 80% of responding asset owners to global Responsible Investor survey now integrating ESG into investment." June 11, 2019.

ii The World Economic Forum and the Prince of Wales International Business Leaders Forum. "Values and value: Communicating the Strategic Importance of Citizenship to Investors, 2004, Page 5.

iii The United Nations Environment Programme Finance Initiative (UNEP FI) Asset Management Working Group (AMWG). "The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing," 2004, page 3.

iv United Nations Global Compact Office and International Finance Corporation (IFC), "Who Cares Wins: Connecting Financial Markets to a Changing World," 2004, page V.

*Effective April 17, 2015, Acuity Investment Management Inc. was amalgamated into AGF Investments Inc.

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