Institute for Sustainable Finance

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By **Sean Cleary, PhD**
Executive Director,
Institute for Sustainable Finance

By **Dustyn Lanz**
CEO of the Responsible
Investment Association (RIA)

This series explores the foundations of sustainable finance, one of the most important emerging fields of our time. Sustainable finance aligns financial systems and services to promote long-term environmental sustainability and economic prosperity.

SUSTAINABLE FINANCE PRIMER SERIES:

Environmental, Social and Governance (ESG) Factors in Investing

WHAT ARE ESG CONSIDERATIONS?

ESG refers to Environmental, Social and Governance factors. Already a mainstream finance issue, ESG integration requires that investors and businesses incorporate these considerations into their decision-making processes. As of September 30, 2019, more than 2,600 global investors responsible for over USD $89 trillion in assets were signatories of the UN Principles for Responsible Investment (PRI), up from less than USD $6 trillion in 2006. Being a PRI signatory means committing to integrating ESG factors into investment and ownership decisions.

WHAT IS DRIVING THE GROWTH IN ESG INTEGRATION?

Several factors are driving this dramatic growth including regulatory, reputational and ethical pressures. However, the main force has been strong demands from customers and investors. For example, a 2019 survey by the Responsible Investment Association (RIA) indicated that 72% of investors were interested in responsible investing that incorporated ESG considerations, up from 60% in 2018.

As global asset management firms urgently attempt to address these demands, they are faced with several constraints. These include the availability and consistency of ESG data, the internal capacity to deal with ESG issues, the establishment of adequate systems and processes, and the ability to attract and train qualified personnel.

WHAT ESG DATA IS AVAILABLE?

According to the Global Initiative for Sustainability Ratings, there were over 125 providers of ESG data by 2016. Four of the most commonly used providers include MSCI, Sustainalytics, Bloomberg and Refinitiv. While the categories and methods of establishing these ratings typically differ from one provider to another, they all strive to measure a company's performance along the three measures of environment, social and governance. For example, the MSCI ratings attempt to assess what the most significant ESG risks and opportunities are that face a particular company and its industry, how exposed the company is, how well it is managing these issues, and how it stacks up to its global industry peers.

While the availability and granularity of ESG data is still evolving, users of this data continue to express concerns over the consistency and reliability of such data. For example, a recent publication from State Street Global Advisors indicated a correlation coefficient of 0.53 between the MSCI and Sustainalytics ratings, with similar low correlations with other ESG provider ratings. As a result, many large investors have developed their own ESG rating systems.

HOW HAVE ESG-FOCUSED INVESTMENT STRATEGIES PERFORMED?

One of the common misperceptions regarding ESG integration is that it sacrifices returns. This view is outdated and is not consistent with a wide abundance of empirical evidence. Research shows that ESG-focused investments have produced similar returns and risk levels to those associated with traditional benchmarks and strategies. If anything, the evidence indicates slight improvements in terms of risk reduction, with no corresponding reduction in returns.

For example, in 2015 Deutsche Asset & Wealth Management and Hamburg University conducted a comprehensive review of over 2,000 empirical studies. They found that most of the studies show a positive correlation between ESG standards and corporate financial performance, and that on balance, ESG strategies clearly did not under-perform. Subsequent studies have supported these results with several indicating that strategies that incorporate "changes" in ESG ratings provide superior risk-adjusted returns.

WHAT ARE THE BENEFITS TO INTEGRATING ESG CONSIDERATIONS?

First, ESG integration can lead to an improved reputation and a higher level of stakeholder satisfaction, including customers, employees, creditors and investors. Second, as mentioned above, there are also opportunities to offer improvements in investment performance. Third, there are inherent benefits to taking a long-term strategic approach to systemic global issues in terms of identifying profitable opportunities, and in managing the associated risks. As noted by the CFA Institute, "systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions."

WHAT'S HAPPENING IN CANADA?

According to RBC's 2019 Responsible Investment Survey of close to 800 global institutional investors and investment consultants, 70% of those surveyed integrate ESG factors into their investment decisions.

Among the Canadians included in this survey:

- 57% integrated ESG factors because they believed it was a component of their fiduciary duty,
- 61% did because they believed it could lead to lower risk and/or higher returns,
- 41% did because it was mandated by investment guidelines,
- and 33% did because it was mandated by board/stakeholders.

Further, 90% of these investors believed the integration of ESG considerations would lead to as good or better returns, and 72% believed it would mitigate risk.

These survey results are consistent with the fact that there are currently over 120 Canadian asset owners and managers who are PRI signatories. A report from RIA Canada shows that CAD $2.1 trillion in assets are managed in alignment with a "responsible" investment strategy by the end of 2017, more than four times the 2006 figure of CAD $459.5 billion. The report notes that this represents 50.6% of Canada's investment industry, up from 37.8% two years prior.

Explore other primers in the sustainable finance series here.

Sean Cleary, PhD, CFA, is the Executive Director for the Institute for Sustainable Finance and the BMO Professor of Finance at Smith School of Business at Queen's University.

Dustyn Lanz is the CEO of the Responsible Investment Association.

Maya Saryyeva
Associate Director
Institute for Sustainable Finance
613.533.3067

maya.saryyeva@queensu.ca