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The Case for ESG Investing

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In the past, investors worried about underperformance when investing responsibly. These days, though, they should expect positive performance. My view is that environmental, social and governance (ESG) data by itself is not enough for security selection; but when coupled with other valuation measures, ESG has proven effective in the post-2008 environment.

As the aphorism goes, "a rising tide lifts all ships." That works in a bull market, but after the 2008 credit crisis, the stormy markets sank quite a few boats, leaving afloat only those better equipped to navigate the more uncertain waters. Among the investment themes that did well is one based on ESG characteristics. Organized by the United Nations in 2006 under the Principles for Responsible Investing guidelines, which were designed to help asset owners be more responsible and aware investors, ESG has evolved into a roadmap for asset managers looking for sustainable investments.

The definition of "sustainable," as I see it, is based on two parts: risk and opportunities. The type of risk involved cannot be insured against nor diversified away from, since it deals with reputational damage and loss of investor confidence. This can include environmental spills, industrial accidents, regulatory changes and other events for which company management should have a response plan and preventive guidelines in place. ESG characteristics try to measure the extent and implementation of company policies when determining exposure to such risk and, hence, the sustainability of the business model.

The second part, based on opportunities, is easier to understand in principle but harder to implement in practice. Here, ESG characteristics include a host of components that try to measure how a company is positioned to maintain its competitive advantage. These components include reduction of resource consumption and greenhouse gas emissions; product innovation; employment quality, diversity and opportunity; board structure and shareholder rights, among other things.

ESG data has unique characteristics that investors should take note of:

• Infrequent reporting: ESG data is mostly updated on an annual basis or whenever a company voluntarily releases information.

• Consistent performance: Well-performing ESG companies tend to be keep performing well, while bad ESG companies tend to remain bad.

• Size matters: While it is difficult to generalize, larger companies tend to have better ESG coverage than smaller companies.

From the viewpoint of an institutional investor, it is important to differentiate ESG from focused themes, such as renewable energy, water management and shareholder activism, where the concept is to address single-issue investments. ESG, instead, is meant to look broadly across the market with the goal of using a structured approach to evaluating companies on important non-financial performance and using that information in stock selection.

Full integration of ESG into an investment process is difficult because there is currently no valuation framework that can directly link stock prices with ESG characteristics. For example, how should board diversity, employee training or carbon dioxide emissions be discounted or factored into the present stock price? Some approaches include ESG as a component of risk in determining a cash flow discount rate. However, methods that focus solely on risk can cause investors to miss out on any opportunities that ESG investments may offer.

We took a different approach, looking to answer the following question: “If a company has a good ESG profile, does its stock perform better than others that do not have the same level of ESG?” This approach involved a structured analysis that compared ESG ranks over time and identified correlations with stock price returns. In addition, we compared stocks within the same sector in a best-of-breed approach, rather than trying to reconcile business operations across sectors. Once we identified the return properties of ESG, we combined ESG ranks with other valuation measures, such as value, growth and momentum, to arrive at a fully integrated valuation of a stock.

Considering ESG as a potential source of returns is very interesting for investors, since these characteristics provide additional insights into companies and complement traditional valuation measures. And from where we sit, ESG characteristics provide another benefit that became apparent in the post-2008 environment: Investments based on ESG appear to be holding their own by providing a diversifying return stream and being well positioned to navigate the volatility in the market.