Effective ESG investing requires materiality and intentionality

The rationale and usefulness of investing in ESG are increasingly being questioned. Was its remarkable rise in popularity just a fad? Certainly not, as is made clear when we examine what makes ESG necessary and effective.

ILLUSTRATION: SHUTTERSTOCK

By *Habib Moudachirou* and *Mamadou-Abou Sarr*

ESG investing has dramatically grown over the last few years, driven by regulation, market demand, investors' and stakeholders' requests. Financial firms have been expanding their sustainability efforts as part of their long-term strategies.

This popularity came with great scrutiny, exemplified by criticisms pointing to a lack of standardization, greenwashing concerns and doubts on links between ESG and financial performance. These legitimate concerns called for answers, not only to increase the effectiveness of ESG investing, but also to safeguard its credibility with investors.

ESG backlash? The green elephant in the room

'ESG investing is ineffective', 'not practically measurable', 'the acronym is outdated', 'it detracts from the financial performance', summarize some of the objections to ESG. In recent months, in the US, these whispers led to law proposals by a few states, including Florida, Texas and Indiana. The proposed laws seek to bar investment firms from managing state pensions, citing either that 'ESG investing is a breach of fiduciary duty' or that 'ESG investing shuns companies in sectors that are vital for the economy' of said states.

We believe that ESG investing cannot be viewed as a homogenous field. There has been a tremendous evolution from the early years of basic exclusionary approaches to ESG. Investment firms today employ approaches that are essentially iterations of three primary approaches: SRI, Impact Investing and ESG Integration. In our organisation, we break down ESG evolution into three 'I' areas: Information, Impact and Integration. Typically, SRI investing involves exclusions to an investment universe based on moral or religious criteria which relies on good corporate disclosure (Information). Conversely, Impact Investing often focuses on combining the financial objective (profit) with a desired social, economic or environmental outcome (purpose). Lastly, ESG Integration takes a holistic approach by combining both financial and non-financial objectives to mitigate risks and improve returns.

Though compelling, abundant research on the fiduciary duty argument finds that companies that incorporate material sustainability issues add long-run value to their profitability. Arguably, the current societal transition makes it untenable for businesses to continue opposing shareholder primacy and stakeholder capitalism. Shareholder primacy is a shareholder-centric form of corporate governance focused on maximizing shareholder value, while stakeholder capitalism is a system in which corporations are oriented to serve the interests of all stakeholders. In the long-term, stakeholder capitalism and shareholder primacy can be said to have a symbiotic relationship: absent of that realisation, value created at the expense of the non-investor stakeholders may be short-lived.

ESG materiality, the key to financial performance?

ESG is not a separate asset class, nor does it make portfolios immune to macro crises. Both ESG and non-ESG strategies with the same investable universe have performed similarly this year. The first eight months of 2022 have seen most asset classes experience a tumultuous and downward trend, amid inflationary pressures caused by widespread supply-chain disruption and an energy and commodity crisis intensified by the war in Ukraine.

To draw conclusions on ESG financial performance, a long-term view must be considered. The year 2020 saw many ESG strategies outperform for the same reasons as they are underperforming in 2022: an information technology sector overweight and an energy sector underweight.

Portfolio construction is critical. Investors recognise that material ESG matters may have a direct financial impact on companies' balance sheets and investment portfolios as vectors of risks and opportunities. That said, not all ESG issues are financially material. One must identify and integrate the relevant metrics in the investment process, following a recognized standard.

The Sustainability Accounting Standards Board (SASB) materiality map has been increasingly adopted by asset owners as their reporting framework, following SASB's suite of industry-specific ESG focused standards that have a financial impact. This idea stems from the realisation that every sub-industry has its own ESG issues that matter. An investment solution that focuses on ESG materiality may be well positioned to deliver added long-term value.

Intentionality as a remedy to greenwashing

As greenwashing continues to make headlines, pressure is mounting for fund managers to prove their truthfulness to investors about their ESG-labeled products. Recently, Morningstar removed over 1,200 funds, worth $ 1 trillion, from its ESG funds list. The SEC has begun to levy fines over ESG claims, putting all managers on notice. Last year, the German regulator BaFin initiated a probe into allegations of ESG misstatements by the asset management arm of a global firm.

Regulation continues to play a key role in protecting investors. In Europe, the EU taxonomy sets a general framework for a unified classification system, while the Sustainable Finance Disclosure Regulation (SFDR) requires that fund managers evaluate and disclose their financial products' ESG features. Meanwhile, the SEC calls for disclosure and justifications for ESG-labelled on products. ESG considerations must be core to the investment process, rather than an overlay: the integration of material sustainability factors into investment portfolios should be intentional rather than incidental.

ESG is not stopping, rather will keep evolving

Corporations are finding themselves at the confluence of a climate and a societal transition. Tomorrow's winners – and survivors – will likely be the ones who will recognize and adeptly manage changes. ESG is here to stay, although the field will keep fast evolving. ■

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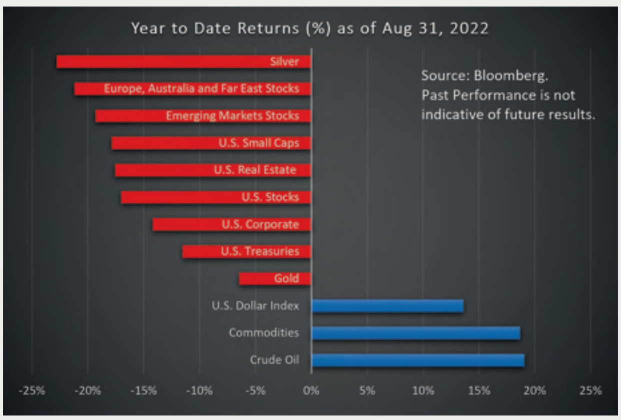
FIGURE 1: YTD RETURNS – ESG PERFORMANCE SECTION



Source: Bloomberg (31 august 2022).

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SUMMARY

The rise of ESG investing is attracting scrutiny, often citing financial performance and greenwashing.

Materiality is to drive financial performance: investors recognize that material ESG issues may directly impact companies' balance sheets.

Intentionality to mitigate greenwashing: the integration of material sustainability factors into portfolios should be intentional – not accidental – to effectively deliver.

Ultimately, climate and societal transitions only reinforce the need for ESG, which will keep evolving.

PHOTOS: ARCHIVE V-SQUARE QUANTITATIVE MANAGEMENT