ESG INVESTING:

From Negative Screens to Positive Returns

The earliest attempts at socially responsible investing involved simply withholding or withdrawing investments from companies that engaged in behaviors the investor deemed disagreeable. Today, ESG investors—and their brethren, socially responsible investors and impact investors—often take the opposite approach: they direct their capital toward those companies they disapprove of most, and then use their ownership to influence the companies' behavior.

In either case, the core belief is the same: conscientious investors can wield their capital as a tool for positive change. Today, many of them are beginning to do so without sacrificing returns. These were a few of the consensus points achieved among a group of seasoned ESG professionals at a panel discussion on ESG strategy hosted by RBC Global Asset Management in June 2016, titled Responsible Investing: A Shifting Paradigm. Moderated by Bloomberg equity-markets specialist Lee O'Dwyer, the panel talked at length about how ESG has grown, where the challenges lie, and how smart investors are seeking both social and financial success in ESG investing.

Since 2014 RBC GAM has moved deliberately to more formally integrate ESG throughout its investment process. As part of this, RBC GAM has improved its proxy voting process and continued to work collaboratively with other like-minded investors to broaden its understanding and influence on ESG-related issues. RBC GAM will continue to create opportunities like this panel to engage with its clients and peers and share the best thinking about ESG in the marketplace.

The panelists:

- **Chris Fowle**, Vice President, Investor Initiatives, Carbon Disclosure Project
- **Karen Heifferon**, Senior Investment Consultant, Beacon Pointe Advisors
- **Jamie Nulph**, Senior Associate, MSCI
- **Ben Yeoh**, Senior Portfolio Manager, Global Equities, RBC Global Asset Management (UK) Ltd

Lee O'Dwyer: Karen, could you start by giving us an understanding of, when you're engaging with a client, how you define the difference between SRI, ESG and impact investing?

Karen Heifferon: We explain that, historically, it's been a negative screen. So you build a portfolio and if you're an organization that wants to exclude tobacco or weapons or fossil fuels, then you can have that opportunity with an SRI fund or an SRI focus. You build a portfolio and you exclude what you don't want.

In ESG integration, it's really part of the fundamental analysis, so a portfolio manager or analyst will look at a company and see how that company has adhered to certain environmental, social and governance standards, and then they'll compare those companies against their peers in selecting the best in class. Typically ESG integration and SRI are associated with public markets because large companies report the relevant data.

Impact investing is really intended to generate measurable social and environmental impact. Large companies don't necessarily have a single-minded social impact focus, and so typically with impact investing we focus on private companies, private investments and real estate. Examples of that would be private equity or real estate funds that focus on clean technologies and agricultural sustainability.

Lee O'Dwyer: Does anybody want to add to that definition?

Ben Yeoh: I concur, and I guess I'd also point out what strings the three together: there's an intentionality involved in looking at these areas.

Lee O'Dwyer: Right, that's the commonality between them. In terms of implementing, would it be fair to say that you are fully integrating ESG into a portfolio approach?

Ben Yeoh: Yes, definitely, and we would put a lot of emphasis on the fact these ESG or non-financial factors are a source of alpha for us. People are slowly coming around to the fact that if you view ESG as an alpha source, as an opportunity, it should lead to enhanced returns. I think that's a key component of the ESG integration story.

Lee O'Dwyer: Jamie, maybe you can give us an idea of the many different types of clients you're dealing with. And when you engage with those clients what are the type of approaches that you're seeing?

Jamie Nulph: Absolutely. At MSCI, within the ESG research group we have 900 clients globally and that ranges from the largest pension funds in the world to a small family I worked with last year in Colorado that wanted to align its investments with its values. It's a very broad spectrum of client types and approaches. You can classify them in terms of those who really want to align with values and are more on the socially responsible investing side, and those that are looking at ESG integration and at how these issues potentially add risk or how they potentially add alpha.

Even within the ESG integration approach, we have a number of different ways that clients are looking at this. Some may look at movements and improvements we call ESG momentum, focusing on engaging with companies on different issues to help them improve performance. Some take a best-in-class approach. Some will integrate directly into a discounted cash flow model.

We're also seeing a lot more on the quantitative side for ESG integration, leveraging different signals. Then of course you still have a lot of investors who are focused on screening out and aligning with their values, but at the same time they're also looking at other areas like impact investing and ESG integration. It's not really shifting away from anything, but really just more strategies coming to the fore.

Lee O'Dwyer: The idea of best-in-class is positive screening as opposed to negative screening – how is that evolving?

Jamie Nulph: When we think about best-in-class we take an industry-based approach. What are the most material risks and opportunities that could face an industry and how is a particular company mitigating or taking advantage of those? A best-in-class approach can be simply tilting towards those companies that are performing better within every industry. We also have a few clients who are actually taking what could be called a worst-in-class approach. They look at the companies that have a poor ESG profile and if they can engage with those companies and improve their ESG performance, then that could potentially improve the financial performance as well.

Ben Yeoh: I would concur with that, and I would say that the interesting thing about the data providers – you mention Sustainalytics, MSCI and there's also CDP, Bloomberg – is we find there's often quite a lot of disagreement about how they score companies, what they're scoring and how they're weighting it. From a practitioner point of view, this data can offer interesting flags for either risks or opportunities. But you still need a fund manager or someone who is actively sifting through it all to see what's relevant for their portfolio.

I think asset owners are beginning to understand that intentionality is important, going beyond just ticking the box and getting to the underlying questions. Is the company, whether you want to classify it as sustainable or as a good investment, heading in the right direction and do you want your capital there?

I think the other idea that is coming through, across the spectrum, is are you putting your capital to work in the way you want it to work? The phrases we're coming across are, 'active ownership' and 'stewardship.' You're not just renting a share certificate for a month or a week, just trying to get a return. You're investing in and being part of a business. Engaging with management to try and help and improve that company in a sustainable manner – that's something that is beginning to align with a lot of what trustees and asset owners are thinking about.

Lee O'Dwyer: Karen, as you're engaging with the institutions, foundations, endowments and such, are you hearing from more that are motivated to know what you own, how you are leveraging your balance sheet and building ESG infrastructure? And how do you answer them?

Karen Heifferon: A lot of our clients are asking more questions about what we own. With some of our clients we'll report quarterly on how much fossil-free exposure we have in a portfolio, how much coal exposure we have in a portfolio, and then you'll have some investment committee members that will look at individual securities and say, 'I'm against GMOs so why do we have this seed company in here?'

We view these questions as an opportunity to engage with them, to go back to their organization's mission and values and how we can incorporate them into a screenable process within their portfolio.

Lee O'Dwyer: Let's address the elephant in the room. RBC Global Asset Management conducted a survey of everyone invited here today, and one of the questions was "How satisfied are you with the amount and quality of ESG-related information being made available by companies?" And only 18 percent said they at least somewhat satisfied! Clearly, data is a problem. Ben, can you elaborate a little on the issues you confront as a portfolio manager when you have so many gaps in data? How much of a pain is that?

Ben Yeoh: It is a big pain. In terms of our process the first thing is to actually have multiple sources of ESG or non-financial data. So, Bloomberg, MSCI, Sustainalytics, CDP – and some of it is estimation, some of it is real data. Some of it is data which has got a different weighting. Then you have company-reported data. You have to try and triangulate the best you can.

I think that's why from our point of view as an active manager, we go directly to the company to get a qualitative view. You have intentionality of management, how are they managing things like employee satisfaction, R&D, productivity. Then you can back that up with your data. Even in terms of standard finance, a P/E ratio or a return on equity in isolation is kind of meaningless. It's the same for a lot of the ESG-related data. In isolation it doesn't mean an awful lot. You have to patch and triangulate.

Then I think there are questions around what asset managers report and what asset owners expect. We're now getting questions about what we own, but also how do we engage with companies. Why or what did we vote in the last proxy, when was the last time we met management? What did we discuss? Are you actually stewarding our capital the way we would like? So then how do you report on that, and there's a lot of issues about what you can report, what you should report and how to report it.

Lee O'Dwyer: Jamie, how is MSCI handling those gaps in data?

Jamie Nulph: Taking a specific example like carbon emissions, we benefit so much from the work that CDP is doing to encourage disclosure in the space and the work SASB is doing to push for more disclosure, and we're ecstatic about that. In the interim, we've really had to look at how we can model and proxy different items to really understand what risks companies are exposed to. For example, if we're looking at water stress, companies aren't reporting whether or not the regions they operate in are experiencing water stress; they're reporting the water intensity of their operations. We've had to mark that ourselves using other resources, then overlay that with things that companies do report, like where their operations are. Knowing where their operations are, we can overlay those two and at least get a picture of the risk exposure.

Lee O'Dwyer: Chris, could you talk about the data gaps from the perspective of CDP, which has been mentioned several times as one of the rare and important sources of high-quality data?

Chris Fowle: Sometimes in the back of my mind I think people almost use it as an excuse to avoid ESG; "I can't think about ESG or SRI because the data's not perfect yet." But in my mind, it's a journey. It's a journey for the companies as they start to figure out what to disclose, how to disclose it and how to get better at disclosing. And it's a journey for investors.

You need to start somewhere and there's never going to be a perfect Yes-No switch that you can go to and say, "this is good and that's bad." I wish everybody took a fundamental approach, and really rolled up their sleeves and got really deep into the data because that's the best way to capture in particular the qualitative data that Ben mentioned. We've definitely tried to move towards more of a sector focus with our research, and say, "for this sector, we see these as the critical issues." They could be on climate, water, policy, regulation, carbon pricing, emissions targets or science-based targets. There's a lot of data out there and I think investors are doing a better and better job, but it's definitely going to take diving deep into the details – whether you're an active or a passive investor.

Lee O'Dwyer: I'd also like to ask you to give us an idea about where the divestment movement is at right now, as it relates to things like alpha and misconceptions.

Chris Fowle: We would never advocate for divestment. Instead it's about engagement, it's about getting companies to disclose. We have more than 5,500 companies reporting to CDP, and more than 500 cities report to us as well, on many of these issues. And what we're seeing in the market, especially from the endowment space and from universities in particular, is a strong push towards ESG due to the students. We've had Cal State Northridge, University of California, the University of Toronto, Harvard and other universities come on board as signatories and members to CDP. Columbia's SRI committee just required that their endowment do the same, because they want to take an educational approach with the students, demonstrate that they're learning about these issues and starting to take them into account. I think for some investors, for whom divestment is not going to have a huge impact on financial returns, it may be an option. I think Stanford took that option with its coal stance, but for others, the trend from where I sit with the endowments that we speak to, it's definitely moving more towards the engagement and education side.

Lee O'Dwyer: Last question, around the idea of environmental alpha, and how do you feel you capture it. Does return have to have a percentage sign associated with it? How are you identifying and articulating alpha in an ESG product?

Ben Yeoh: With ESG integration in particular, you're getting better returns from it. There's actually a lot of academic studies, both causal, correlational and meta studies that demonstrate how looking at these types of factors adds to your performance. My analogy is to a robotic surgery tool. This ESG data set is a robotic surgery tool, but if you put it in the hands of a rubbish surgeon, he's just going to cut open the wrong artery faster, he's not going to save your life. Same for an ESG data set. If you take the qualitative and the quantitative and put it in the hands of someone who can understand what makes a good long-term sustainable company, you will definitely get alpha.

The irony about a lot of what we call non-financial or ESG investing is that, when issues are material, in three to five years – or sometimes even one year – they actually lead to a financial impact because they're key to the sustainability of that business model.

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