Global Asset Management

MASSIVE SPREADSHEETS AND A DOSE OF COMMON SENSE:

Implementing and Measuring ESG Investments

In 2015 the global pool of capital dedicated toward responsible investing reached $77.4 billion—up from just $25 billion in 2014, according to the Global Impact Investing Network. And as the volume of funds pursuing environmental, social and governance (ESG) goals has swelled, investors have been increasingly confronted with questions not only about how to allocate funds for ESG but also about how to pick managers, how to best achieve their goals and how to measure their progress.

These issues were at the forefront of a panel discussion on implementing and measuring ESG investment hosted by RBC Global Asset Management in June 2016 titled Responsible Investing: A Shifting Paradigm. Moderated by Bloomberg equity market specialist Lee O'Dwyer, the event brought together a quartet of ESG experts in implementing ESG into an investment strategy, and measuring its impact. Each gained his expertise on the front lines, helping investors devise strategies and deploy capital in pursuit of the double returns—both social and financial—that ESG investing can deliver.

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:

- **Eyal Bilgrai**, Director of Investments, Sonen Capital
- **Garrett Wilson**, Investment Officer & ESG Investment Specialist, Hirtle Callaghan
- **Ben Yeoh**, Senior Portfolio Manager, Global Equities, RBC Global Asset Management (UK) Ltd
- **Max Zehrt**, Director, Institutional Relations, Canada, Sustainalytics

Lee O'Dwyer: Max, when you are speaking with potential and existing clients about the growth in this space, what are you hearing? What is driving this tremendous growth?

Max Zehrt: I would say there's no one single driver. We speak about the UN Principles for Responsible Investment, and that's certainly a driver broadly. I think the regulatory framework is changing; I know we all heard about the announcements from the Department of Labor and ERISA. North of the border where I am, there's also been a big regulatory shift; Ontario introduced legislation this year that says pension plans have to disclose how they are thinking about these issues, how they are integrating ESG overall and if they're not, why aren't they doing so?

Secondly I think there's been a shift toward materiality in the last decade. When I started in this industry about a decade ago, it was really, 'let's pick every ESG factor under the sun and let's integrate, let's think about this for every single company.' Now we are really focusing on what matters and what's really contributing or detracting from the bottom line. Water probably doesn't matter as much for financial stocks, but utilities, materials, energy, probably more so.

Third, I would say client demand overall is coming from different channels. So institutional managers of course they've been on board with ESG, but foundations, endowments, high net worth individuals, we're even seeing retail advisors and just people on the street thinking about this more broadly.

Lee O'Dwyer: Garrett, how does responsible investing fit into a diversified portfolio, and particularly through the lens of allocation?

Garrett Wilson: Hirtle Callaghan is an outsourced CIO. We take full discretion on our assets, so for us, it's really important to develop a framework, to develop a sense of how we think about the issue of investing and how went want to implement from our perspective alongside our clients.

When I think about the implementation, it really comes down to interaction with the client, to figuring out what's the allocation, what's the dynamic, what are the goals you want to obtain and achieve in the portfolio?

Lee O'Dwyer: Eyal, can you speak to the distinction between public and private markets. Is there some disagreement about whether private markets have more impact?

Eyal Bilgrai: I think we've all heard the view that impact investing is more prevalent in private markets because it's hard to generate the same type of impact in public markets. But we actually believe that investing in the public markets can generate a lot of impact, especially when you think about scalability. If you think about the type of impact that a large-scale public company can generate, it's a lot.

We think about impact investing in the public markets in two ways: sustainable companies and thematic companies. When you think about sustainable companies we look at every type of company in the universe and we look at how they operate, looking at the underlying processes and operations, whether they fit with the sustainable future. On the thematic side, we're looking at companies that specifically are in the business of products or services that address a more sustainable future. For example companies that are operating in the areas of renewable energy, water scarcity, water pollution, sustainable agriculture and so on.

On the sustainable side, any type of company can fit. Think about a company like say Microsoft, with great internal processes in terms of gender diversification, in terms of LGBT rights. Or a company like Nike, whose shoes themselves do not contribute to sustainability, but Nike produces zero waste in their processes.

Ben Yeoh: For my team at RBC Global Asset Management, we are very much bottom-up stock pickers but the companies we own often play into a theme. I think one of the difficulties about some of the thematic investing is that a lot of people feel that there are no themes that are undiscovered. People may say, "Well, everyone knows there's a diabetes epidemic, surely that's should be discounted by an efficient market." You go slowly round in circles explaining, well no, it's still is a major problem, in which there are still opportunities to be found for creative, active investors.

Lee O'Dwyer: Max, maybe you can talk a little more about the actual motivations of these institutions. When you're educating those smaller foundations that are brand new to this, what are they interested in?

Max Zehrt: I think you nailed it – the first thing is education. When I deal with foundations, typically small boards or a couple members, we really have to lay down the framework: what is ESG integration and, more importantly, what isn't ESG it? Second, I think it really depends on the level of ambition and where they are on the spectrum of. Some foundations we work with, they just want a broad approach to ESG.

Then on the other end of the spectrum, there are foundations and endowments and even pensions that are better communicating the themes they're looking at, let's say climate change or gender diversity. Then we can narrow down that focus and provide analytics.

Ultimately what we do for them is provide information they can use to engage with their managers. We try to educate them, provide them with metrics, provide them with a narrative, but we understand that every manager is different, every manager approaches this differently.

Lee O'Dwyer: Ben, let's move the conversation towards the measuring side. As you implement a strategy, you've got performance return, which traditionally we equate with a percentage sign. Then, there is this ESG factor. How you articulate performance, monetarily and non-monetarily?

Ben Yeoh: Performance is the easy part. You get that in percentages and we decompose factor returns, stock-specific risk returns. We know whether our returns might be coming from a factor bet like a beta or volatility or things like that and we keep that low and very diversified so that we know our returns from what we call idiosyncratic alpha, or stock-specific risk due to our company stock peaks. Then we triangulate a lot of this ESG-type data to track what's happening in our portfolio. This is where we're still a bit more in the early days, but we can track what's happening in terms of what's an E score, what's an S score, what's a G score across the portfolio.

We look at MSCI data and also Sustainalytics data, which don't agree but together can give you a pattern of directionality. Then I would lay that back into our qualitative and engagement scenario. We're meeting with management often on very specific issues, and we're saying, "Are they having a reasonable response?" So we look at how our engagement and how our active ownership is working. We find that companies which don't engage but that we think have very reasonable and sound business practices might actually end up in a divest bucket, because the fundamental analysis didn't align with our original thesis. Maybe we saw it as having great management, with really good scores, but their response was not reasonable when we challenged on some of these topics.

Lee O'Dwyer: I think you just described particularly well how you are triangulating across data, measuring those factors. Garrett, how does a manager articulate that in an elevator pitch to the client?

Garrett Wilson: I think it's anecdotes – you want to hear real tangible stories, you want to hear how its worked in the portfolio, how an environmental or social decision that you have made has benefited the portfolio. And you want to know when it hasn't worked and what did you learn from that. You want to understand, when they've made a certain decision, what got them to that decision and then what was the outcome?

Once again I think you want to meet a manger that truly believes that this is part of the process. You don't want to have the discussion where it just sounds like we have some data we run through and it's a reference point. If you're going to pick an active manager to think about any strategy, you want them to be embedded in their process, and you want to have outcomes that show up.

Ben Yeoh: So the anecdotes definitely point us home, and actually my elevator pitch to the trustees is actually a common sense investing framework. You have two companies, one has happy and productive employees and low employee turnover. That's not a metric which is in their reporting, and you don't see it in the P&L or cash flow. You've got a similar company with very high employee turnover, the employees are very unhappy. Which company do you think is going to be stronger in 3-5 years?

Proving that link to return may be hard; you can take any one single metric in isolation and it's very hard to prove. But there is common sense investing, particularly when you get to the trustee level and particularly if some of them have been business owners, they know these things are important to running strong businesses and so it makes intrinsic sense that your fundamental manager should be looking at them. That's the essence of the elevator pitch.

Eyal Bilgrai: We spend a lot of time, in terms of impact measurement, building massive spreadsheets. We think about it in two ways. For global equity strategy, we compare performance to a global benchmark. For example we benchmark ourselves to the MSCI All Country World Index and we will compare various key performance indicators of our strategy relative to that benchmark.

We can also show how a strategy compares in terms of greenhouse-gas emissions, carbon intensity, water intensity, women on boards and various other measurements. You can actually see that one portfolio is better on various environmental and social issues than another.

Lee O'Dwyer: Ben, do you have to have a conversation with clients about time horizons, around what is appropriate when they consider your portfolio and their investment with you as opposed to other places they have allocated their money?

Ben Yeoh: Something that is important to know about ESG is that KPIs don't change that fast. They change maybe on an annual basis for a specific company and if you think about it for a whole portfolio with a relatively low turnover, the characteristics of the portfolio don't move that much. This is important because I think if you are only holding an asset for a month or a week or even up to a year, a lot of these risks and opportunities don't crystallize over this type of time period.

It's about asking, are we going to be part owners of something or are we just renting a share certificate? It's a little bit like the difference between renting a student apartment, where you're just worried about getting your deposit back in six months, not worried about the neighbors or cracks in your window – versus owning a house where you are worried about the structure, what your neighbors think and your community.

That's also probably a source of some of the market inefficiency in ESG. A lot of studies have been done on time horizon, because there's a big portion of the market which is not prepared to hold over the longer term, they are only interested in short-term trades. So I do think that time horizon question is important and that the client has to understand that.

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