NEAR-TERM UNCERTAINTY
LONG-TERM OPPORTUNITY

2016 RBC Global Asset Management Responsible Investing Survey Report
ESG investing, or the consideration of corporate environmental, social and governance (ESG) factors and how they may impact an investment, has been gaining traction with investors over the last few years. Even as capital pours in to ESG investing, data and understanding in this area remains incomplete and opaque — and that’s good news for investors seeking competitive market returns.

Those are the key conclusions drawn from RBC Global Asset Management’s new survey of ESG asset owners, wealth managers and consultants. The survey reveals lingering uncertainty over responsible investing’s ability to drive financial performance and mitigate portfolio risk. It also indicates frustration with the lack of corporate ESG disclosures, and points to evolving expectations for both investing strategies and portfolio managers.
Alpha Uncertainties and Data Dissatisfaction

In perhaps the survey’s most surprising revelation, less than a third (30%) of respondents said they considered ESG investing a source of alpha. This is despite a growing body of research concluding that various responsible-investing factors do in fact improve financial returns. In a 2015 study, MSCI found that portfolios with an ESG bias outperformed a world stock index, made up of over 1,500 large-cap equities, over an eight-year period. Specific factors valued by ESG investors have also been proven to correlate with higher long-term returns.

Investors’ uncertainty about ESG as an alpha source may derive from their dissatisfaction with the amount of relevant data companies are providing. Just 17% of survey participants responded that they were satisfied with the quality and quantity of ESG-related data companies are making available. Conversely, 43% of participants indicated that they were somewhat or completely dissatisfied.

While multiple efforts are being made to close this information gap, the divergence between the empirical data and the perception in the marketplace represents an opportunity that can be exploited for enhanced returns. It points to the need for thorough fundamental analysis in ESG investment decisions, especially for investors seeking both alpha and impact in the long term. Because ESG factors are not yet fully incorporated into valuations, we believe that investors who understand how to identify and properly consider those factors will have an advantage.

From Divestment to Engagement

Qualitative, buy-and-hold investing remains a relatively new development in ESG, which a few decades ago consisted almost exclusively of negative screens deployed to weed out companies with particularly objectionable social or environmental practices. Today a majority (52%) of ESG investors and professionals consider negative screens a niche tactic, to be used only by mission-specific investors.

This represents more than a change in investing style — it is a recognition that engagement is more powerful than divestment. Many of today’s ESG investors believe they can encourage and enact greater positive change — and increase shareholder value — by engaging with companies than by divesting. An asset manager that is a significant shareholder gains access to company senior management and boards of directors and a voice to advocate for positive change. These investors view change as a powerful driver of shareholder value.

To be sure, negative screens remain in widespread use and divestiture campaigns can still generate enormous momentum. In recent years the Fossil Fuel Free movement has not only captured headlines but prompted commitments to divest totaling in the trillions of dollars, largely driven by institutional titans including the world’s largest sovereign-investment fund.

According to our survey, investors are taking the Fossil Fuel Free movement seriously. Only 26% of respondents consider Fossil Fuel Free to be a fad, and a full 62% consider it a lasting investment issue. Whether this is driven from true philosophical alignment, or merely reflects investors following a popular trend remains to be seen.

Conclusion

Taken as a whole, this survey portrays an investment approach only beginning to come into its own. On the one hand it’s striking — and, perhaps, encouraging — to see so much capital pouring into ESG-related investing even as asset owners and financial professionals alike remain broadly uncertain about those investments’ ability to provide alpha and mitigate risk.

On the other hand, the value proposition inherent in ESG investing is becoming more apparent all the time. Even as data remains imperfect, investors can see and feel the impact on their portfolio values. There are plenty of examples of value being spectacularly destroyed by companies with poor ESG standards. But to see value created by ESG investing requires a commitment to an ESG approach, and also to skilled, knowledgeable analysis and long-term ownership. As ESG integration grows in prevalence as an investment theme, those commitments will continue to spread across the industry — and asset owners will be the better for it.

The full results of the survey follow.

1Source: MSCI Research Insight - Can ESG Add Alpha?
**Key Findings**

Q1. Do you think of ESG as an alpha source?

Less than a third of respondents, 30%, believe ESG factors drive alpha, which may indicate an inefficient market.

- Given that there is increasing evidence in support of the idea that ESG is a powerful alpha driver, it is expected that over time more investors will become convinced of its merits.
- Until that conviction is fully incorporated into valuations, ESG investing will present an opportunity to produce competitive returns.

Q2. Please indicate which of the following statements you agree with.

The majority of respondents, 52%, believe that negative screening tactics do not apply to a broad spectrum of investors.

- Fortunately, there are several options available to investors seeking to incorporate ESG factors in their investment portfolios; negative screening is just one of those.
- Screens are more prevalent among mission-driven investors, which may not be surprising. Fewer than a third of respondents agree that negative screening impacts alpha.

Q3. Do you believe the Fossil Fuel Free movement is an investment fad or a lasting investment issue?

Nearly two thirds of survey respondents, 62%, believe the Fossil Fuel Free movement is a lasting investment issue.

- The movement, which is a type of negative screen, has amassed much popular support and immense firepower in the form of trillions of dollars’ worth of commitments to divest.
- While the movement’s strength and arguments have not been accepted by all respondents, investors cannot afford to ignore the issue.
- When this much capital aligns behind any investing thesis it may potentially impact valuation over the long term.
The majority of respondents, 40%, do not think of ESG as a risk mitigator.

- Once again, respondents reflect a broader uncertainty about ESG’s ability to mitigate risk. And once again, this reveals an opportunity for investors.
- Perhaps investors are unconvinced by anecdotal evidence, including the value depletion that has occurred at companies engulfed by high-profile scandals or environmental catastrophes.
- But for the one respondent out of three who does see ESG as a risk mitigator, it will be crucial to ensure they engage with fund managers who share that belief.

The majority of respondents, 43%, indicate some level of dissatisfaction regarding the amount and quality of ESG-related information made available by companies.

- This broad dissatisfaction is likely to alleviate in the coming years, based on the progress being made by organizations like Sustainalytics, MSCI and the Carbon Disclosure Project (CDP).
- As long as data remains deficient, however, asset managers will have an important role to play in identifying and understanding ESG opportunities and risks.
- Even as data quality and availability improve, thorough research and shrewd analysis will endure as key drivers of ESG investing.
- Because many ESG factors ultimately stem from human behavior, understanding how those factors predict performance will remain heavily reliant on the experience and judgment of human asset managers.
Q6. How integral are executing voting rights to active ownership?

<table>
<thead>
<tr>
<th>Statement</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executing voting rights are a part of the portfolio manager’s role.</td>
<td>60%</td>
</tr>
<tr>
<td>Proxy advisory firms play an important role in executing our ESG strategy.</td>
<td>22%</td>
</tr>
<tr>
<td>Asset owners must execute voting rights directly.</td>
<td>18%</td>
</tr>
</tbody>
</table>

60% of respondents view proxy voting as the portfolio manager’s job.

- While proxy-advisory firms can play important roles in voting, many feel portfolio managers should be reading proxies themselves, even when they use advisory firms.
- Disagreement among the advisory firms is routine and, as noted in the previous question, ESG investing often involves a high level of human judgment that should not be left in the hands of objective outside analysts.
- It is good practice for ESG-motivated asset owners to ask their portfolio managers whether they read proxy statements.

Q7. What are the largest stumbling blocks for more serious consideration of ESG by fund managers or asset owners?

Most respondents chose research and returns as the top stumbling blocks to increased focus on ESG by asset owners.

- Here again there is an opportunity to exploit a market that remains inefficient.
- This may not be the case for long, however, as growing realization that ESG can in fact drive compelling returns will undoubtedly draw more interest and more capital, driving out some or most inefficiencies.
- One day the opportunities will be harder to come by.

Methodology

RBC Global Asset Management conducted an online survey around responsible investing. The survey was distributed to 1,000 institutional asset owners, wealth managers and pension plan consultants. Ninety individuals completed the online survey. Percentages in certain questions exceed 100% because respondents were asked to check all that apply. Due to rounding, percentages used in all questions may not add up to 100%.