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What Exactly Is ESG Investing?

Itâ??s not a new way to investâ??endowments, foundations, and large pension plans have been investing their consciences for decadesâ??but there has been a lot of buzz about environmental, social, and governance (ESG) investing in recent years. In fact, assets in ESG equity and fixed income strategies have ballooned over the past ten years. According to the US SIF Foundation, of the $40.3 trillion of assets under management in the U.S. in 2016, $8.1 trillion was invested in ESG portfolios. That growth represents a 30 percent increase from $6.57 trillion in 2014.

If you read ten articles on the topic, youâ??ll likely come away with at least seven descriptions of what it is. So what exactly is ESG investing? No uniform definition exists, but at its heart, ESG investing is an investment methodology that allows an investor to apply a set of criteria that aligns portfolio investments with the investorâ??s ethical considerations or values. Many investors use environmental, social, or governance factors to evaluate potential investments. And since ESG criteria are based upon corporate attributes, they apply to both stocks and bonds issued by a company.

Digging a Little Deeper

ESG investing originated in the 1960s and was then known as socially responsible investing. At the time, many institutional investors were looking to exclude specific companies or entire industriesâ??such as companies involved in cigarette production or doing business with the South African apartheid regimeâ??from their portfolios. Some investors use other terms, such as sustainable investing, impact investing, and mission-related investing, which are used either as synonyms or represent specific flavors of ESG investing. Regardless of the nomenclature, a common theme is their focus on generating both financial and nonfinancial returns.

Letâ??s take a closer look at environmental, social, and governance criteria:

Environmental. Environmental criteria examine how a company performs as a steward of natural resources and the environment. This may include, among others, the following factors:

- Carbon intensity
- Fossil fuel reserve ownership
- Water usage intensity
- Pollution
- Alternative energy utilization
- Green buildings
- Energy efficiency

Social. Social criteria screen based upon how a company manages its relationships with employees, suppliers, customers, and the communities where it operates. Examples include:

- Labor practices
- Human rights
- Animal welfare
- Data protection and privacy
- Diversity
- Business involvement in practices such as major disease treatment, education, firearms, and predatory lending

Governance. Governance deals with a companyâ??s leadership, executive pay, audits and internal controls, and shareholder rights. Examples of governance factors include:

- Board of directorsâ?? independence
- Frequency of director elections
- Common equity voter protections
- Compensation policies
- Accounting controls
- Risk oversight
- Shareholder engagement
- Management structure

What constitutes an acceptable set of ESG criteria for an investor varies and depends on that investorâ??s beliefs and ethicsâ??whether the investor is an organization, such as a nonprofit, or an individual. Some focus on a short list of specific issues like carbon emissions and energy efficiency, while others take a broader view that incorporates factors from all three sets of criteria.

Several organizations have created guidelines for what constitutes ESG best practices. One such organization is the Sustainability Accounting Standards Board (SASB). This nonprofit has developed accounting standards and disclosures for public corporations to release materially important ESG

information for investors. In addition, index and data providers like MSCI and Morningstar now provide investors with ESG portfolio scoring and benchmarks. And several service providers have created proprietary scoring systems that rate companies on their exposure or commitment to ESG-related factors.

If youâ??re comparing potential investments, itâ??s important to note that the specific factors vary from group to group, so understanding the underlying methodology is critical.

Implementing ESG Strategies

To the extent an investor wishes to incorporate ESG factors into his or her portfolio, it can be accomplished in several ways. Three of the most common methods can be used to address different goals.

Exclusionary screening is the predominant form of ESG investing and, as the name suggests, is an approach that excludes companies with undesirable ESG characteristics from an investment managerâ??s opportunity set. This approach is typically best suited for investors primarily concerned about not supporting companies with operations or values that are antithetical to their missions or priorities. For example, a church-linked nonprofit foundation may use exclusionary screening to avoid companies engaged in gambling, tobacco, or other activities against their values. Exclusionary screening can be used by investors that employ a zero-tolerance approach to specific factors such as coal extraction and weapons manufacturing.

Often, exclusionary mandates are implemented in separate accounts, where an investment manager builds a customized portfolio for an ESG investor. While separate accounts provide the flexibility and customization necessary, they can be relatively expensive at low asset levels and are primarily used by institutional investors.

Thematic investing strategies pool the assets of multiple, like-minded investors to create leverage that can be used to influence the corporate policy related to ESG issues. Thematic investing can be accomplished by mutual fund and exchange-traded fund asset managers. Common themes for ESG fund managers include specific factors like religious values, gender diversity, and low carbon emissions, as well as the three ESG themes more broadly. These funds can be cost-effective solutions for investors whose ethical considerations or missions align with these funds.

ESG integration includes ESG factors alongside traditional financial and risk management measures to create portfolios. ESG integration is a recent advancement and is causing many asset managers to build out research capabilities to support it. Investors should expect major investment firms to tout these capabilities as they are refined in the future.

Investment Challenges

Investors should always weigh the potential benefits of an investment strategy against the risks and considerations. And ESG investing carries with it a few additional considerations or challenges that require study. For example, investors should consider:

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- Performance. In addition to the risk that an investment manager will underperform, ESG investingâ??s focus on or aversion to specific companies or industries can create performance differentials relative to benchmarks or peer groups. For example, an ESG fund focused on low carbon emissions may underperform during a period of rising energy prices because of its lack of exposure to oil companies.
- Corporate behavior. Corporationsâ??especially large, global companiesâ??are complex organizations and may possess both positive and negative characteristics, so getting a clear read on corporate behavior can be challenging. And while corporations may create ESG-friendly policies, they may not follow through in practice, and shareholder advocacy may be ineffective.
- Fees. Research on ESG criteria can increase research costs, so investment management fees for ESG strategies tend to be higher than those for their non-ESG peers. According to Morningstar, the average expense ratio for an ESG equity mutual fund is 0.85 percent, compared to the average of 0.57 percent paid by investors in all equity mutual funds.
- Diversification. Because ESG criteria limit available investment options, some asset classes may lack diversification. That may mean they are not viable investment options for some investors or may be subject to an unacceptable level of tracking error, even relative to an ESG benchmark. For example, environmentally focused investors are hard pressed to adequately diversify a high yield bond portfolio with industrial and utility companies comprising 90.86 percent of the Bloomberg Barclays U.S. High Yield Index.
- ERISA compliance. Qualified retirement plan sponsors face the additional challenge of complying with the Department of Laborâ??s evolving guidance on use of ESG. Bottom line: the DOL no longer prohibits investment managers who use ESG criteria but suggests that plan sponsors not use ESG criteria to promote social, environmental, or other causes at the expense of plan participantsâ?? financial interestsâ??in the form of lower return expectations or greater risk.

The current state of the art for ESG investing provides a range of approaches for implementing strategies tailored to an investorâ??s very specific goals. Despite the inherent complexities and a number of practical challenges, ESG investing is growing dramatically as more institutional and individual investors look for ways to align their portfolios with their values. If youâ??re interested in learning more about ESG investing and how it can play a role for your organization, please contact your CAPTRUST financial advisor.

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