Lost in Translation
In Search of Authenticity in ESG Integration

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1. Executive summary

The term "ESG integration" was launched by the UN-backed Principles for Responsible Investment (PRI) in 2006. Since then more than 1,800 investors, asset managers and service providers have signed up to the PRI and committed to adhere to the six principles, of which the integration of ESG into investment analysis and decision-making processes is the first.

Today a large number of investors and asset managers use "ESG integration" to describe their overall approaches to responsible, sustainable or ethical investing. In tandem, all known services providers offer a variety of "ESG integration" products, tools and services. Companies, the media and civil society use the term. "ESG integration" has entered common investment parlance.

But what does ESG integration really mean? The widespread and varied use of the term is making this question ever harder to address. Add to this the number of reporting instruments, stock-exchange ESG practices, existing and proposed stewardship codes, corporate disclosure requirements and political initiatives – all of which underline the systemic challenge that the industry faces. We say that the only people who can deliver a genuine answer are the asset managers tasked with buying and selling securities.

We believe that incorporating environmental, social and corporate governance matters into an investment process is and should always be about investing. We say that ESG issues should be considered as factors alongside financial factors, that they should be treated holistically by an investment team and that they should be managed from a risk-and-return perspective to support better-informed investment decisions.

When "ESG integration" is disconnected from the investment process – when it is hijacked by screening, scoring, overlaying, filtering or any other form of framework or tool – something vital is lost in translation. We encourage a sincere search for authenticity in ESG integration and call for clarity in the approaches, strategies and methods used by investors and asset managers in the diverse space of responsible and sustainable investing.

Crucially, we make the case for active ownership and investment stewardship through fund-manager-driven dialogue and engagement. We argue that what has become an undue focus on outputs should be replaced by a renewed focus on outcomes to enable and support a substantial contribution to sustainable development.

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2. Introduction

“We advocate a process of ESG integration that is driven by fund managers and which prizes enhanced understanding and meaningful engagement.”

The concept of integrating environmental, social and governance (ESG) factors into investment decisions has grown enormously in recent years. So, too, has the proliferation of assessment instruments purportedly intended to help this trend flourish to best effect.

These instruments emerged from a fundamental desire to develop a more sustainable global financial system. Asset managers needed to better understand how companies were addressing ESG issues, and asset owners needed to better understand how asset managers were responding to the increasing attention to such matters in relation to portfolio management.

These needs have not changed today. There has been a strong appetite for a taxonomy around ESG considerations, for guiding principles of good stewardship and for a framework for holistically capturing risk.

Yet it could be argued that over time, as the process of trying to meet them has developed, these needs have somehow been lost in translation. With hundreds of different assessment instruments and initiatives in operation around the world, it is time to consider the possibility that many approaches to ESG integration might – or already have – become box-ticking exercises that contribute little genuine insight or worth to asset managers and asset owners alike. Ironically, it seems as if the very instruments and initiatives advocating transparency and clarity have essentially contributed to an opaque framework of bureaucracy.

In the following pages we explore whether the ever-distending superabundance of scorecards, ratings, screening tools and stewardship codes might serve to deter asset managers from engaging more proactively with portfolio companies on material ESG matters. We question whether we have reached the point at which too much is measured and not enough is understood, whether a one-size-fits-all approach is being forced on an industry whose strength lies in diversity and whether asset managers and the companies in which they invest are being penalised for failing to meet prescribed and sometimes confusing standards when they should instead be encouraged and rewarded to engage and change.

Our arguments stem from concern at the present trajectory of ESG integration. We argue that some current accountability measures fail to address financially material matters and that the demands of some assessment mechanisms may actually disenfranchise asset managers and investors from ESG integration. We suggest that the nascent culture of “naming and shaming” – with industry bodies and others assessing, scoring and rating managers that fail to meet any one predetermined standard – runs counter to the likes of the PRI’s core mission of providing “a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice”.

Ultimately, we call for a return to authenticity and a back-to-basics approach. In doing so we advocate a process of ESG integration that is driven by fund managers and which prizes enhanced understanding and meaningful engagement. ESG is not a numbers game or a shrine to bureaucracy: it is an opportunity to elevate the materiality and impact of environmental, social and governance considerations across society. We say that to get back to the origins of investing – and to seize the opportunities that it presents – we need to re-establish traditional priorities that are rooted in prudent fiduciary responsibility rather than in commercial and political imperatives.

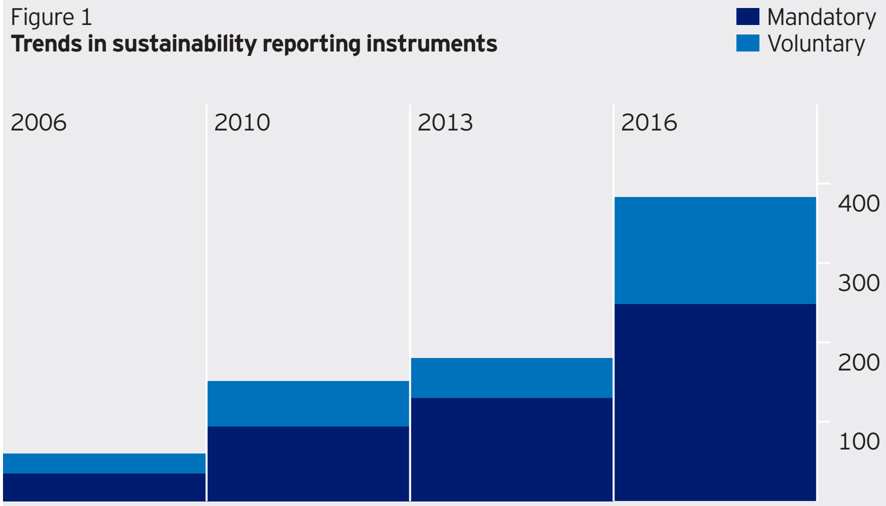
3. From principles to proliferation

The continued growth and success of an industry is usually accompanied by the gradual emergence of standards. It is highly unlikely that there will be only one set, but research has shown that there are frequently only a convenient and widely accepted few. Studies have demonstrated how this can enhance efficiency and reduce costs even when applied to products as obscure as concrete piles.[1]

In the allegedly sophisticated world of responsible and sustainable investing, however, the very opposite has happened. Here companies, asset managers and asset owners alike instead find themselves confronted by a bewildering and ever-expanding proliferation of competing demands.

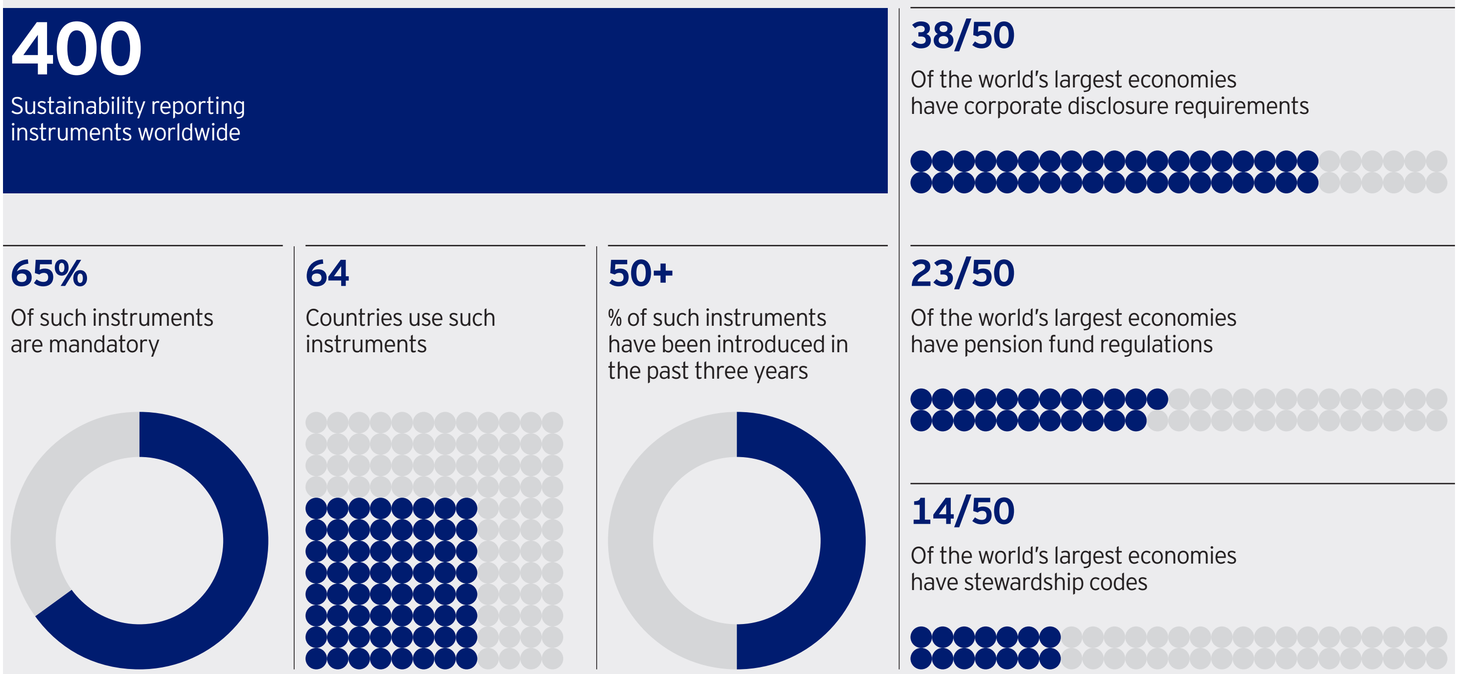
> "Mandatory requirements could reduce ESG integration to a box-ticking exercise...
>
> Longer-term benefits are more likely to stem from transparency and choice than from prescriptive legislation."

Figure 1
Trends in sustainability reporting instruments



Source: PRI/MSCI: Global Guide to Responsible Investment Regulation, 2016; KPMG: Carrots and Sticks: Global Trends in Sustainability Reporting, Regulation and Policy, 2016.

Figure 2
The numbers game in figures



Sources: PRI/MSCI: Global Guide to Responsible Investment Regulation, 2016; KPMG: Carrots and Sticks: Global Trends in Sustainability Reporting, Regulation and Policy, 2016

4. Metrics versus meaning

Since the launch of the Principles for Responsible Investment in 2006, as figures 1 and 2, more than 400 different sustainability reporting instruments have come into operation around the globe. This alone is staggering. In addition, there are so many stewardship codes and corporate disclosure requirements that it is difficult even to keep count of them, let alone to comply with them. Just a few examples of the resulting potential for confusion and intimidation are highlighted below:

- The competing reporting standards include the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC) and the Climate Disclosures Standard Board (CDSB) – each of which has its own distinct emphases.
- Forty stock exchanges around the world now require some kind of sustainability reporting. The 2017 Dow Jones Sustainability Index questionnaire, as one example, is more than a hundred pages long.
- New EU legislation requires companies with more than 500 employees to fulfil exhaustive ESG disclosure demands encompassing environmental matters, respect for human rights, board diversity and anti-corruption and anti-bribery policies.
- In 2017 the Task Force for Climate-Related Financial Disclosures issued a report offering a way for companies to disclose information on identifying and tackling climate-related risks and to outline the metrics and targets used to assess and manage them.
- The EU Commission Action Plan on Financing Sustainable Growth, unveiled in March 2018, features a commitment to strengthening sustainability disclosure. It also proposes an EU taxonomy in the form of a "common language for sustainable finance… to define what is sustainable".

Taken individually, many of these initiatives might be perfectly well intentioned and potentially useful. Taken together, they present an image of a sector whose practices have become fragmented and convoluted and which has somehow lost sight of what truly matters. Critics have pointed out that mandatory requirements could reduce ESG integration to a box-ticking exercise and that longer-term benefits are more likely to stem from transparency and choice than from prescriptive legislation.

Within the world of physics, the "observer effect" states that simply observing a situation is sufficient to alter it. In other words, holding something up to scrutiny will inevitably stimulate change. Relatedly, business management guru Peter Drucker once famously said: "If you can't measure it, you can't improve it."

It is perhaps not surprising that responsible and sustainable investing, having experienced so much change, has witnessed the growth of a huge industry to gather data and monitor actions. Yet the reality is that much of what is being done is of minor consequence to asset management firms focused on investment risk.

Values or valuation?

While we support the notion of disclosure, our contention is that nothing has true importance once everything allegedly becomes important. This is the situation we now seem to have reached. What do all of the reports, surveys and frameworks actually achieve? How many of the questions asked really need answering? Notwithstanding Drucker's assertion, the fact that you can measure something does not necessarily mean that you do improve it.

This is why we need to see ESG scores and ratings in a more nuanced and balanced way. They should not represent a would-be dividing line between companies that prosper and companies that are vilified. Instead they can serve as a tool to flag a need for further investigation. The wealth of ESG-related information currently available should help fund managers to understand companies, providing additional insights to better enable them to identify and assess risks when they take positions. They should be leveraged as an input to guide investment decisions.

And it is not just companies that are being measured, of course: asset managers themselves are also being judged. They are being assessed on how they respond to ESG scores and how they screen out companies that fail to make the grade; on how many votes they have cast at AGMs around the world; on how often they have voted down issues such as executive remuneration; even on how many letters they have sent to companies.

Much attention is given to these data points, yet there is little focus on the key performance indicators or meaningful metrics that can actually tell an investor that their asset manager is truly incorporating these factors. The fact that an asset manager "executed 350 engagements last year", for instance, is meaningless without details of the nature of the engagements or whether they were advocated or enacted by the fund managers making the buy/sell decisions.

The present fascination with headline data is influencing investment decisions. This risks harming investors. It is distracting fund managers from the important task of analysing the sustainability of business models and management teams as a factor alongside robust financials and valuation; and it is forcing them to give too much consideration to themselves and how they will be scored. Fund managers' priority should always be to meet the needs of clients.

With these assessments conducted in isolation and without knowledge about investments, the situation also calls for asset managers to take charge of their agenda and to be clear in their definition of responsible and sustainable investment and their interpretation of ESG integration.

> "The present fascination with headline data is distracting fund managers from the important task of analysing the sustainability of business models and management teams."

5. The power of active ownership and fund-manager-driven dialogue

The investment industry can be viewed as having been hijacked by a superfluity of questionnaires, initiatives and frameworks. We contend that many of these instruments masquerade as contributors to positive change but in reality encourage the inefficient diversion of resources. One corollary is that too many asset managers are forced to devote time and energy to polishing their ESG marketing veneer at the expense of their duty of meeting investors' needs.

This is not what responsible investing is about. Knee-jerk, blunt-instrument reactions and "greenwashing" do not promote sustainability. The goal should be to bring about change with a longer-term view while at the same time respecting a fundamental obligation to protect and grow investors' wealth.

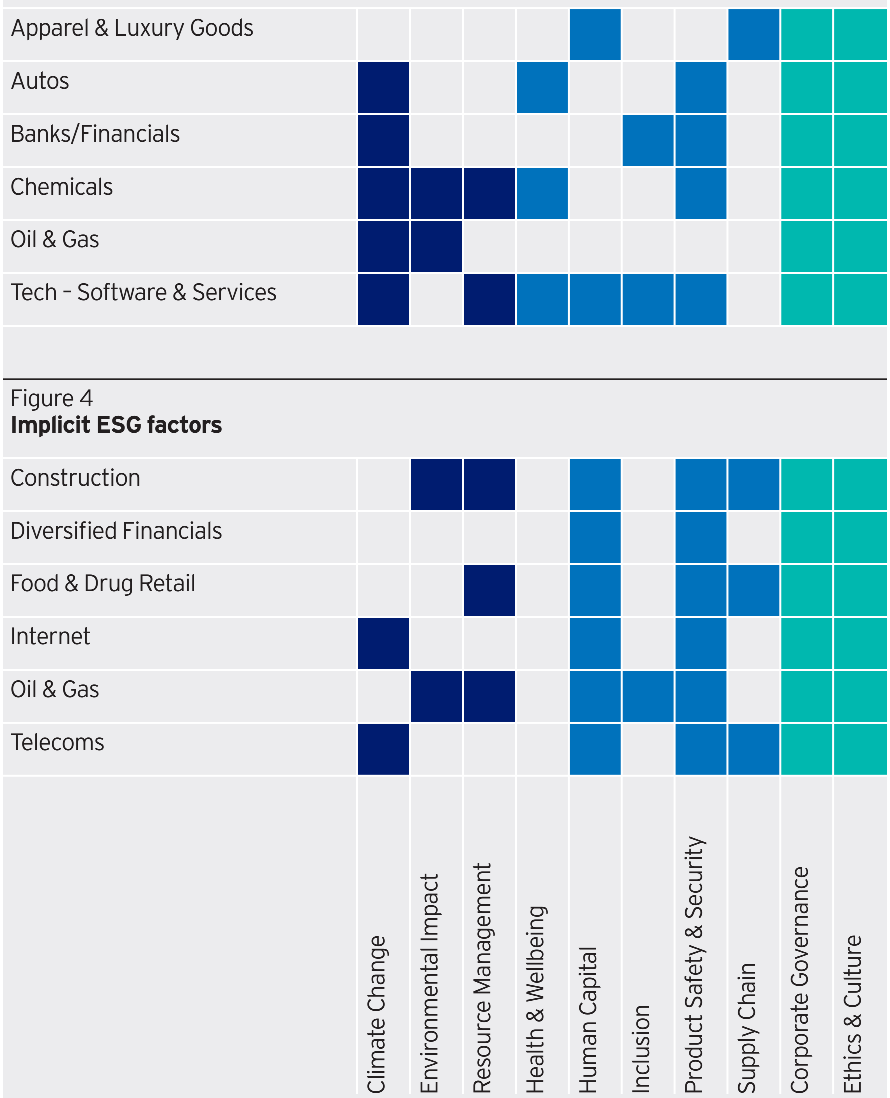
Governance, insight and forward thinking
The starting point for sustainable, long-term, effective investing is governance. Academic studies have shown that strong environmental and social standards stem from a good governance structure. It is governance that fund managers need to know about, and they cannot glean all the information they require from numbers alone.

To develop a good understanding of corporate efforts to achieve long-term relevance, fund managers should approach companies directly to understand their vision and ability to deal with the kinds of sustainability-related risks and opportunities that are truly material to their prospects and performance. Given that there are currently more than 2,000 identified ESG risks and that these vary from industry to industry, as figures 3 and 4 show, a focused view is essential.

> "We argue for a forward-looking approach & genuine integration rather than the penalising and casting aside of companies that cannot immediately meet the demands of myriad metrics."

Figure 3 & 4
Heat map: ESG factors to industries

Environmental
Social
Governance



Source: Copyright 2018 Morgan Stanley – Embedding Sustainability into Valuation: The Next Chapter, 15 January 2018.

Engaging through meaningful interaction and proactive dialogue should provide real insights. It is a long way removed from the practice of simply avoiding or excluding companies that do not come out on top when judged by output-focused ESG standards that are too often highly subjective in approach.

It is also a long way removed from the belief that divestment offers a quick-fix solution. Divestment rejects the possibility that meaningful change can be brought about through the power of active ownership. We argue for a forward-looking approach and genuine integration rather than the penalising and casting aside of companies that cannot immediately meet the demands of myriad metrics.

None of this means that ESG assessment tools have no use. As we remarked earlier, they can flag the need for further investigation and serve as an input to guide investment decisions. If viewed as the be-all and end-all, however, they will slide away from ESG integration into the investment process.

6. Conclusion

“We encourage asset managers to focus on what really matters, which is their fiduciary responsibility to investors and financially material ESG factors. Fund managers are the change agents.”

The investment industry has the power to effect enormous change through ESG integration. This power should be supported by meaningful information and data to enable better-informed investment decisions and constructive dialogue. Data and metrics should not be used in a fragmented and convoluted way that prevents asset managers and asset owners from thinking for the long term and seeking to bring about meaningful and lasting change within the corporate world.

We encourage asset managers to focus on what really matters, which is their fiduciary responsibility to investors and financially material ESG factors. Fund managers are the change agents.

This means engagement in the form of active ownership and investment stewardship. It means an in-depth grasp of governance. It means proactive dialogue. It means ESG integration into investment processes and decisions.

It also means the establishment of standardised, core, non-financial ESG ratios that relate to long-term systematic risk. If asset managers, asset owners and academia could collaborate to develop such metrics, thereby firmly cementing the significance of sustainability alongside financial factors, it would go a long way towards them reclaiming control of the responsible investing agenda.

Studies have shown that companies with strong ESG performance lower their cost of capital, improve their stock-price performance and operate more effectively. Research has also shown that such companies are more likely to generate higher risk-adjusted returns over the long term than those that pay little or no heed to such concerns.[2]

Responsible and sustainable investing is a journey, not a race, and the people best placed to lead that journey are those who ultimately make the buy and sell decisions.

Authenticity in ESG integration
Key takeaways

- Effective and material engagement should be fund-manager-driven. A positive outcome is more likely when dialogue takes place between a company and its actual investor.
- Corporate governance should be front and centre in understanding how companies manage environmental and social risks and opportunities. Such an approach recognises that governance issues are more likely to be exposed by fund manager interrogation than by ESG questionnaires and that governance should be the primary concern.
- Collaboration between investors, asset managers and academia should be promoted to develop meaningful metrics – for example, ESG ratios that relate to long-term systematic risk.
- There should be consolidation towards globally agreed standards on corporate reporting.

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[1] See, for example, Swann, GMP: The Economics of Standardisation (2000), and Bongers, C: Optimal Size Selection in Standardisation: A Case Study (1982).
[2] See, for example, Friede, G, Busch, T, and Bassen, A: ESG and Financial Performance: Aggregated Performance From More Than 2,000 Empirical Studies (2015).

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