The Next Step for ESG Investing: Moving from What and Why to How

By Daniel T. Allen

The implementation of Environmental, Social and Governance (ESG) factors has evolved to a point where it may be possible to begin to develop standardized principles and methodologies that quantify ESG results. These results are the manifestations of efforts by companies to improve performance long term by becoming increasingly sustainable. This development would represent the critical "how" component of the process.

To date, a great deal has been made of "what" needs to be done and "why" it needs to be done but the difficulty of addressing how to quantify ESG criteria has largely been ignored. The United Nations Principles for Responsible Investing[1] has become perhaps the most visible framework intended to describe the general recognition that ESG factors represent risk factors that must be adequately addressed and provide an overarching framework to address what needs to be done. As evidence of the importance that the market places on ESG,

ESG Overview

Globally, there has been an accelerating public consciousness that simply using traditional financial metrics are not adequate investment criterion and institutions and individuals have become increasingly interested in the behavior and values that are manifested by business entities. According to BSR, "*The global financial crisis of late 2008 has led to intense scrutiny of the foundational beliefs and basic structures that underpin current global markets and investment models*."[2] This trend is confirmed through the broad calls for greater disclosure and accountability, and the market's growing recognition that there is a significant demand for ESG products and services. The demand is particularly high in Europe, but growing rapidly in the United States.

ESG Investing has been primarily the provenance of institutional investors where ESG criteria are often considered a metric to illustrate quality management and a commitment to long-term sustainability. Socially Responsible Investing (SRI) is a subset of ESG investing that is typically

[1] (UNEP FI, 2006)
[2] (Laura Gitman, 2009)

retail oriented and takes a narrower, more exclusionary approach focused on the “rights and wrongs” of various actions.

This institutional orientation is borne out through examination of ESG/SRI invested assets. According to the Social Investment Forum, in 2007, $2.7 trillion in Assets Under Management (“AUM“) was managed in the United States using some aspect of ESG/SRI principles. Of that less than $200 Billion was mutual funds, closed end funds and ETFs and less than $3 Billion in separately managed accounts.[3] The remainder was in institutional accounts.

Institutional investors tend to take a longer term view of investing and are interested in the sustainability of companies. Effectively dealing with ESG issues is fundamental to a company being sustainable. The classic definition of sustainability as, “development that meets the needs of the present without compromising the ability of future generations to meet their own needs”[4] is accurate but may be insufficient as it does not clearly address the financial or economical imperative of a business’s operation. George P. Nassos, Director - Environmental Management and Sustainability Program & Center for Sustainable Enterprise at IIT Stuart Graduate School of Business summarizes it like this, “"*For long-term investors, it is imperative to look for companies that are truly sustainable -- environmentally, socially and economically… these companies will provide the best long term return for their shareholders and, at the same time, will be able to sustain their competitive position.*” It is the marriage of strong ESG fundamentals with strong financial fundamentals that truly makes a company sustainable.

Background of ESG

The roots of ESG Investing can be traced back to early efforts at Socially Responsible Investing (SRI) started by religious organizations such as the Quakers which established restrictions on investing. In the early to mid-1700s, Quaker church members were prohibited from participating or investing in the slave trade or providing any support for the ability to wage war. John Wesley (1703-1791), founder of the Methodist Church, preached in his famous Sermon 50, “The Use of Money,” that we must be moral in all dealings with money so that we might “*gain all we can*

[3] (SIF, 2007)
[4] (Brundtland, 1987)

without hurting our neighbour."[5] Wesley recognized that there was a component to an investment's value that went beyond the financial metrics. He defined it in moralistic terms.

Throughout the 1800s and early 1900s, religious investors were encouraged to avoid what was considered to be "sinful" investments in guns, liquor, and tobacco. This continued to be the main thrust until the 1960s when, during the Civil Rights Movement, Dr. Martin Luther King, Jr. in his August 1967 sermon, Where do we go from here?, began to call for the use of economic power as a means to create pressure for social change.[6] The idea expanded into the anti-war movement of the day, and investors who opposed the Vietnam War began to avoid investing in companies that were supporting the war effort.

In 1971, PAX World launched the PAX World Fund (now called the PAX World Balanced Fund) which is widely regarded as the first publicly available SRI mutual fund. The fund primarily screened out companies profiting from war efforts. Throughout the 1970s and 1980s, investor avoidance of South Africa is believed to have reduced international investments in South Africa by as much as 75% and added to the political pressure that eventually forced that system to change. Through this period funds were also created to advance such causes as women's rights, labor equity and the environment and a growing acceptance of what we now call ESG became routinely included as a consideration in public pension funds.

Current Status of ESG

In the last three years according to the UNPRI, "*the number of signatories to the Principles for Responsible Investment has soared from 50 to 500, representing US$18 trillion of assets and 36 countries.*"[7] This represents an enormous growth of interest in the subject and is an indication that ESG Investing is no longer a niche approach but now represents a fundamental shift in the way asset managers view investing. This growth accelerated last year during the financial crisis. The crisis *"catalyzed additional investor interest in responsible investment, with 160 new signatories – holding assets of over US$5 trillion– signing up to the PRI between October 2008 and May 2009."*[8]

[5] (Wesley, 1872)
[6] (Clayborne Carson, 2001)
[7] (UNEP FI, 2009)
[8] (UNEP FI, 2009)

Unlike the original SRI movement which is primarily values driven and is sometimes criticized for being based on non-financial criteria, ESG is based on assessing the financial risk of ESG factors and strives to evaluate the way in which companies address and mitigate their ESG risk factors. Michael Muyot of CRD Analytics describes it this way, "*As companies look to raise profitability and enhance long-term shareholder value by focusing increasing attention on transparency and environmental, social and corporate governance (ESG) matters, they simultaneously boost their appeal to the expanding sustainability investor community*."[9] In other words, the risk-based approach of ESG provides the opportunity to take a quantitative approach to evaluating ESG factors with an eye to improving the investment selection process in a meaningful financial way.

The question of "why" we should consider ESG issues has been widely debated and discussed. War, apartheid, sweat shops and their social and political consequences have made it clear that social issues have financial consequences. The Exxon Valdez incident, superfund sites and the climate change[10] debate makes it clear that environmental issues have financial consequences. Enron, Global Crossing, WorldCom, Lehman Brothers, AIG, Citi have all brought awareness of the financial importance of corporate governance.

The impact on markets and the investors who have been hurt or helped by the good or bad application of these issues makes it clear "who" should be interested. In fact, according to the CFA Institute "*There is an increasing recognition of the need to include the analysis of ESG factors*"[11] in order to fulfill the duty of financial professionals to act in the best interests of clients.

The UNPRI and other initiatives have worked to address "what" should be considered. Conferences have been held throughout the world to discuss environmental, social and governance concerns and identify what should be included as an evaluated criterion.

The open question still being broadly struggled with is "how" ESG issues can and should be best incorporated into the investment process. SRI takes a values based approach but the approach is controversial, binary in that each issue is typically applied as a yes or no criterion and is highly subjective based solely on the particular values used. For ESG Investing to truly become a

[9] (Muyot, 2009)
[10] (GS Sustain Research, 2009)
[11] (CFA Institute: Centre for Financial Market Integrity, 2008)

component of mainstream investing, thoughtful financial metrics need to be developed that provide investment managers the tools that they require for quantifying the financial impact of a company's ability to manage ESG risks. Investors and financial managers need a variety of tools to measure the financial premium of those risks, their impact on long term Cost of Capital, and on a company's likelihood for lasting sustainability.

Recommendation to the Community

The issue of "how" cannot be resolved by any one group and will require the combined efforts of academic institutions, asset management firms, institutional investors and others but it is an issue that is clearly timely. I recommend that an effort be made to bring thought leaders on the various aspects of ESG Investing together with the purpose of addressing the fundamental question of how ESG criterion may best be quantitatively applied into the investing process.

I recommend that a conference be planned for Early to Mid October that would bring these individuals together for the purpose of creating such quantitative methodologies. In the mean time, I further recommend that a working group be established to begin to narrow down the working issues and plan the upcoming conference.

About the Author

Daniel T. Allen is the Director - Business Development for Ativo Capital Management LLC, an SEC-registered investment advisor. Mr. Allen is a graduate of the J. Mack Robinson College of Business, Georgia State University and is a former U.S. Military officer. He has been quoted in national publications such as USA Today, frequently writes about Environmental, Social and Governance (ESG) Investing and is a public speaker on the topic. He is the group leader of the LinkedIn group, ESG Investing, one of the largest international professional groups of its kind. His security licenses include the Series 7 and Series 66.

Citations

Brundtland, G. H. (1987). *Report of the World Commission on Environment and Development: Our Common Future.* New York, NY: United Nations.

CFA Institute: Centre for Financial Market Integrity. (2008). *Environmental, Social, and Governance Factors at Listed Companies.* London: CFA Institute.

Clayborne Carson, E. (2001). *A Call to Conscience: The Landmark Speeches of Martin Luther King, Jr.* New York: IPM/Warner Books.

GS Sustain Research. (2009). *Change is coming: A framework for climate change – a defining issue of the 21st century.* New York: Goldman Sachs Global Investment Research.

Laura Gitman, D. B. (2009). *ESG in the Mainstream: The Role for Companies and Investors in ESG Integration.* San Francisco: BSR.

Muyot, M. (2009). *INDEXING SUSTAINABLE PERFORMANCE.* New York: CRD Analytics.

SIF. (2007). *2007 Report on Socially Responsible Investing Trends in the United States.* Washington D.C.: Social Investing Forum Foundation.

UNEP FI. (2009). *Annual Report of the PRI Initative 2009.* New York: United Nations.

UNEP FI. (2006). *United Nations Principles for Responsible Investing.* New York, NY: United Nations.

Wesley, J. (1872). *Sermon 50: The Use of Money - Delivered 1744.* Thomas Jackson, Editor.

Disclaimer