



ESG INVESTING

ISSUES AND CHALLENGES

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Environmental, Social and Governance (ESG) criteria and sustainable finance

What is ESG?

- A risk management approach to integrate long-term risks and opportunities relative to environmental, social and governance factors into investment decision-making.
- Also, can include a general alignment with societal values related to environment and corporate social responsibility, and principles of good governance, i.e. the broader concept of sustainable finance.

Environmental

- climate change – including physical risk and transition risk
- Biodiversity loss and other resource depletion (e.g. water)
- waste and pollution

Source: Adapted from UN-PRI

Social

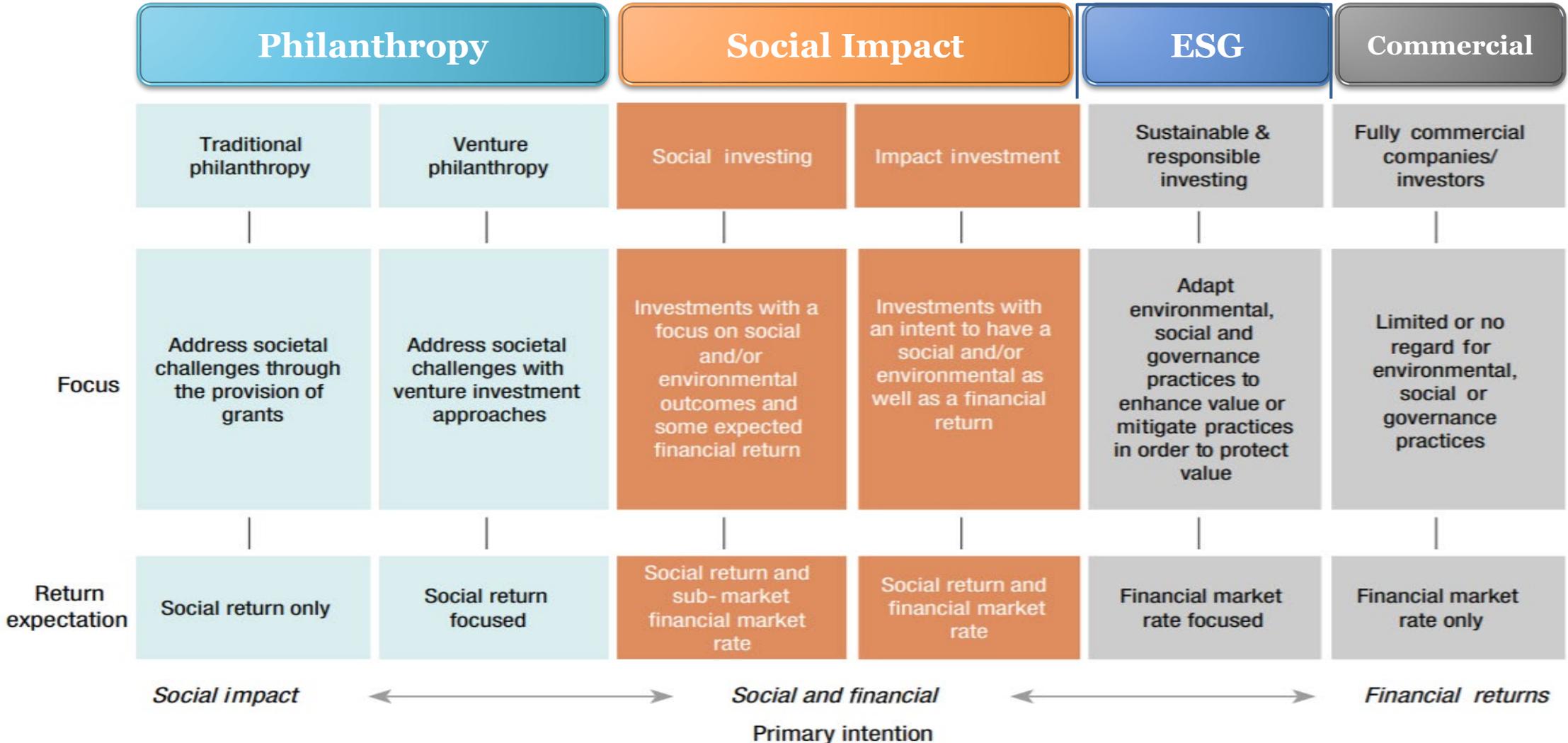
- working conditions, including slavery and child labour
- local communities (e.g. indigenous)
- conflict
- health and safety
- employee relations and diversity

Governance

- executive pay
- bribery and corruption
- political lobbying and donations
- board diversity and structure
- tax strategy



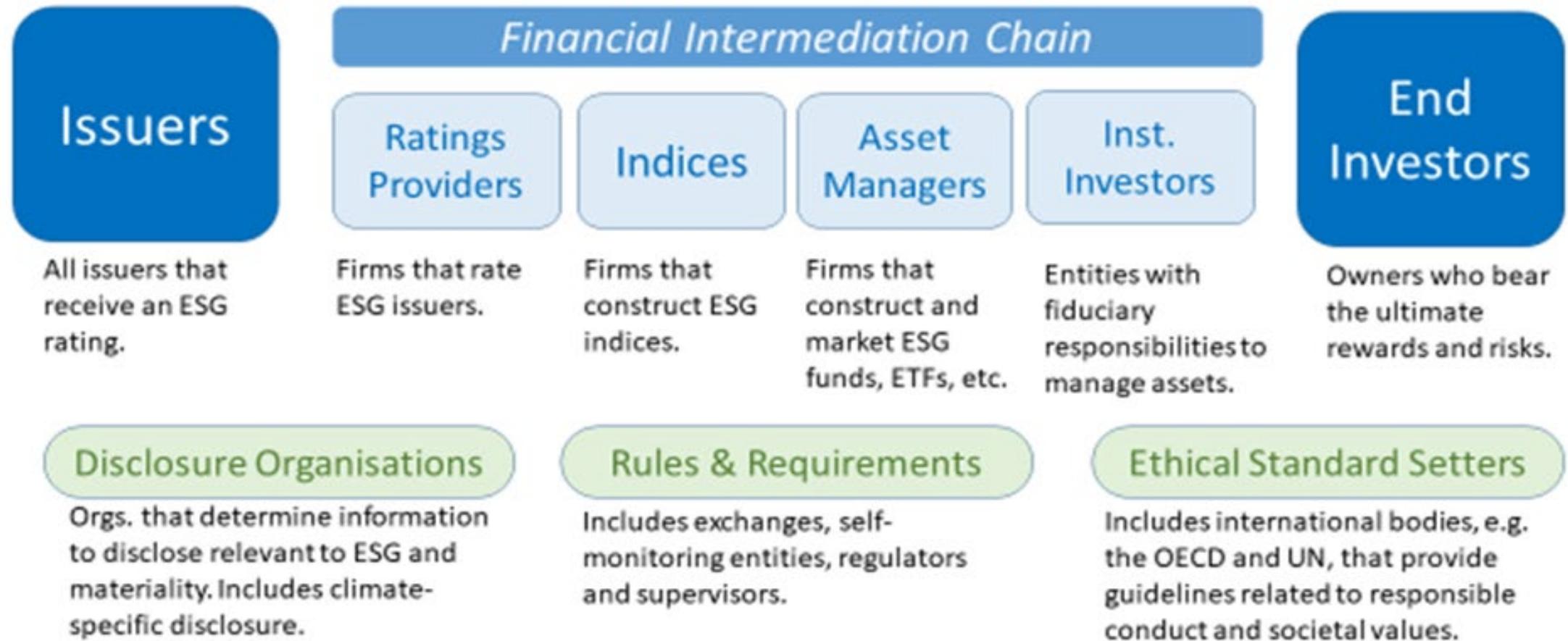
ESG within the investment spectrum



Adapted from OECD (2017)



ESG investing ecosystem



Source: OECD staff illustration.



ESG scoring methodology

Across various ESG rating firms, the methodologies for scoring vary widely by:

- Use of *metrics* (#, choice, can be over 300 metrics)
- Assessing long-term *risks*, *mitigants* and “*opportunities*”
- Assessing *controversies**
- Determining “*materiality*” *factors* by industry, which affects score.
- Determining importance of *time horizon* of +/- effect
- *Weighting* metrics within and across ESG factors based in part on judgement.

While data-drive, ESG scoring methodologies are often highly qualitative in judging importance, financial materiality, and weighing factors to derive final ESG scores.

*defined as (ongoing) situation in which company operations or products allegedly have a negative environmental, social, or governance impact.



ESG ratings considerations

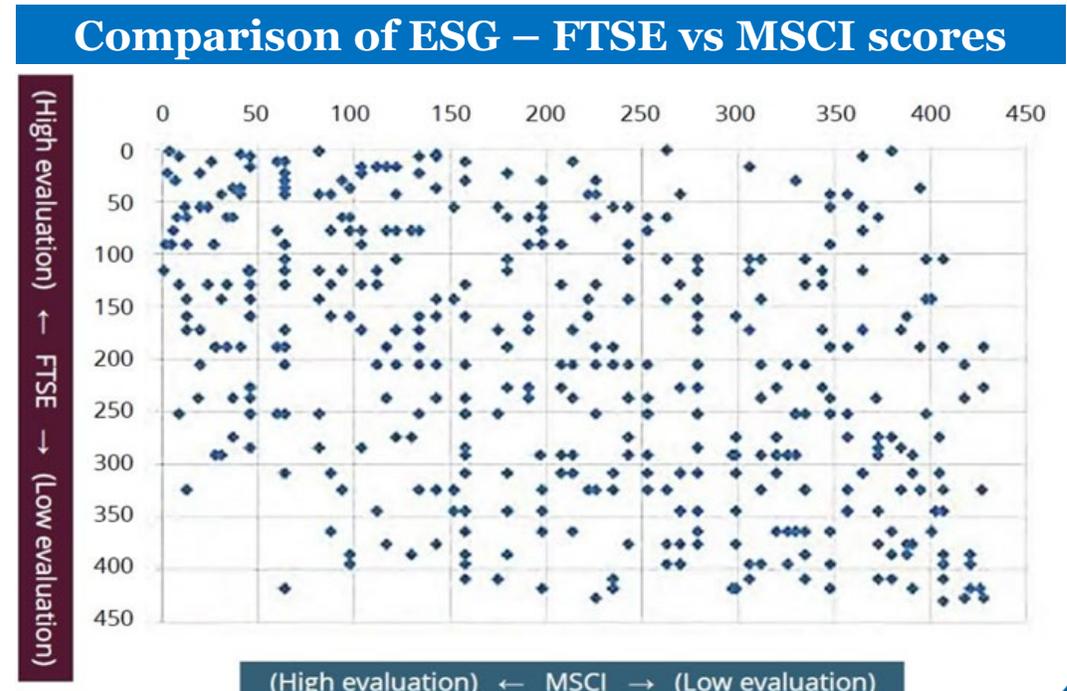
- Some concerns that ratings vary *considerably* across ratings providers.
- Therefore, constituent weights in a high-ESG scoring index likely vary considerably across providers.

SSGA Assessment of R² of ESG ratings among major score providers

	Sustainalytics	MSCI	RobecoSAM	Bloomberg ESG
Sustainalytics	1	.53	.76	.66
MSCI		1	.48	.47
RobecoSAM			1	.68
Bloomberg ESG				1

Source: State Street Global Advisors (2019)

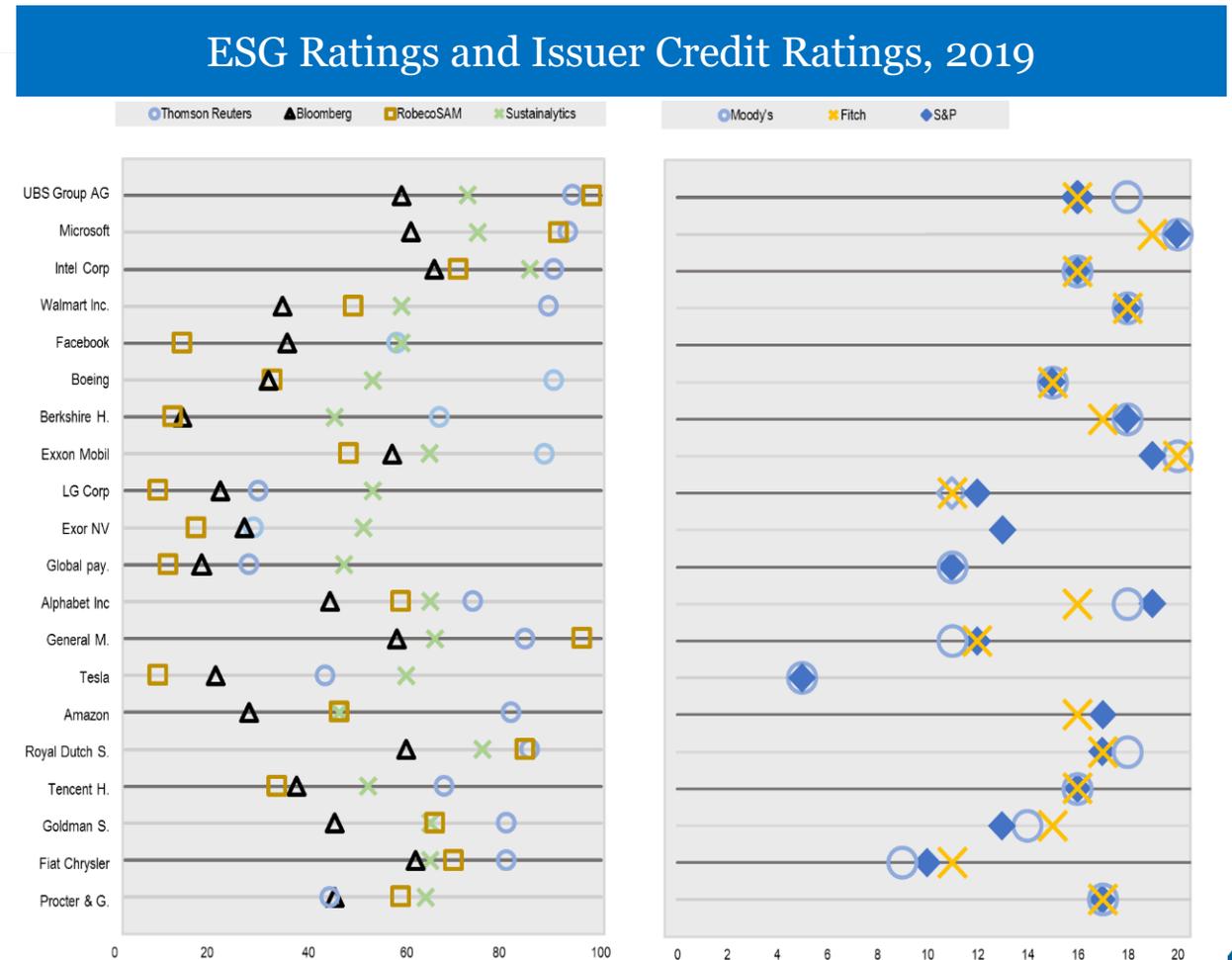
Source: SSGA (2019)





ESG ratings differences

- **ESG ratings differ considerably** among the prominent ESG raters.
- This is in sharp contrast to a **low deviation of the credit ratings** of these same firms.
- **Differences in ratings approaches and definitions** are key drivers of return differentials.



Source: OECD Secretariat calculations from ESG and credit ratings



ESG investment approaches

Approaches

High ESG intent

Exclusion

- Removing issuers that do not meet ethical standards or those aligned with societal values.

Tilt (Best in Class)

- Rebalancing to increase exposure to companies with better ESG scores, *within industries*.

Thematic

- Aligning with one of the E/S or G for focused approach.

Impact

- May include active engagement with issuers where improvements in ESG can be made.

ESG Integration

- Fully incorporating ESG considerations into key aspects of investment process.

- ***Given these approaches, the quality of and trust in ESG scopes is critical to the process and outcomes.***



ESG investment strategies

Strategies

Both high and low ESG

Momentum

Alpha /
shorting

Carbon
transition

Value in
EMEs

SDGs

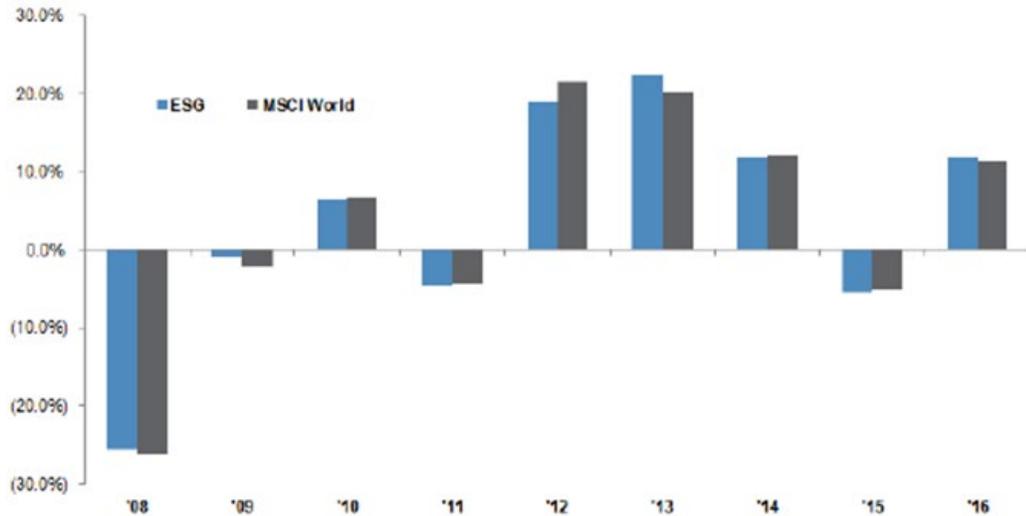
- “ESG Fund” can include ESG approaches but also a wide range of strategies, including multiple strategies.
- Goal is not necessarily to invest in issuers with higher ESG scores, but rather to achieve superior returns based on ESG information.
- In some cases, funds could also use ESG information to align with societal values such as SDGs.



Attributes of ESG performance

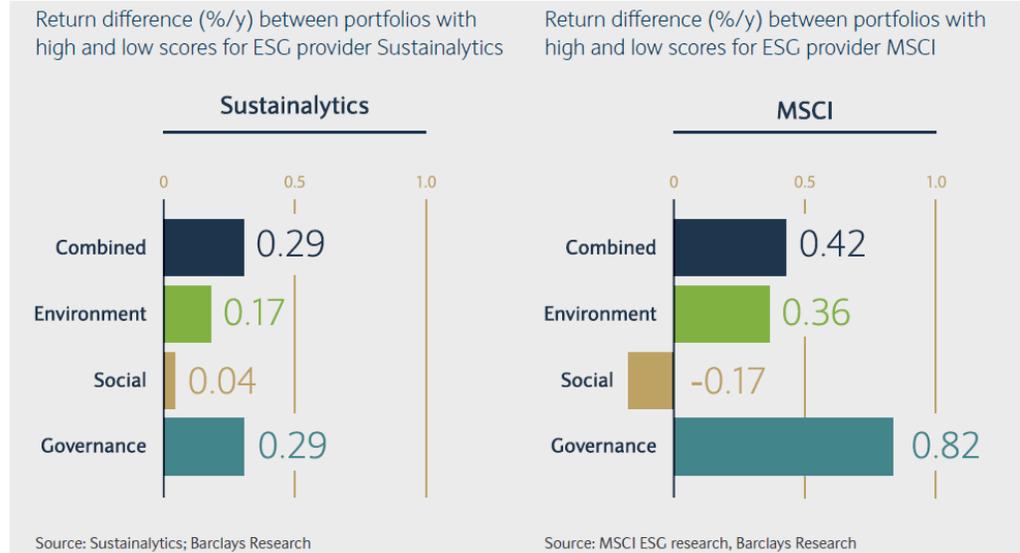
- Some research indicates that ESG-tilted portfolios can outperform traditional indices.
- However, studies are mixed as to whether there are biases associated with asset or market size, higher ROE, or even P/E expansion due to greater demand.
- There is some evidence from industry assessments that governance and environmental scores are contributing to or correlated with improved returns in high ESG portfolios relative to low-scoring portfolios.

Performance - ESG vs traditional benchmarks



Source: JPMorgan (2016), ESG Investing

Performance - ESG factors



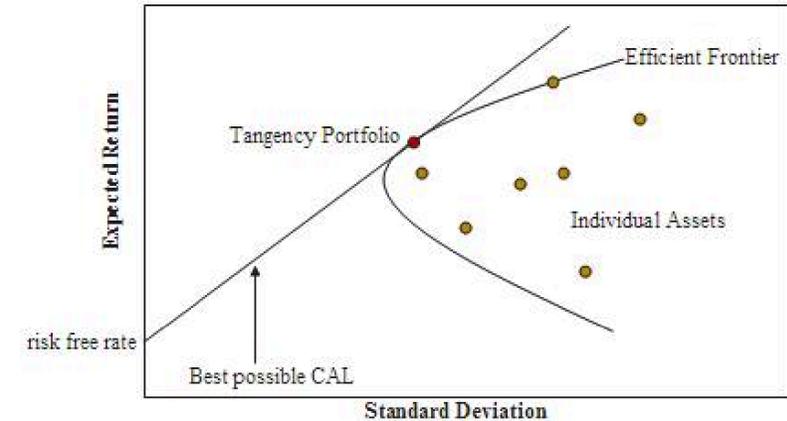
Source: Barclays Research



Methodology

Modern Portfolio Theory Markowitz

- The frontier represents the lowest variance for a set of stocks.
- Assets/portfolios inside the frontier are inefficient and provide a lower Sharpe ratio.
- Diversification is the sole way of reducing risk.



Morningstar Funds analysis

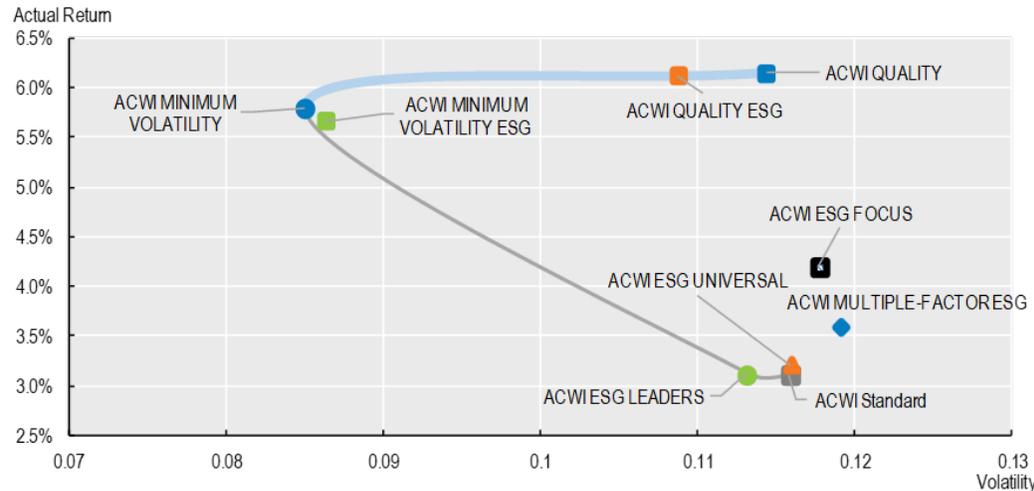
- The funds will be analysed using a sample of funds' annualized returns over 2, 5 10 year periods across Morningstar fund sustainability ratings.
- This does not compare ESG funds to traditional indices, but rather compares funds based on a range of ESG ratings.



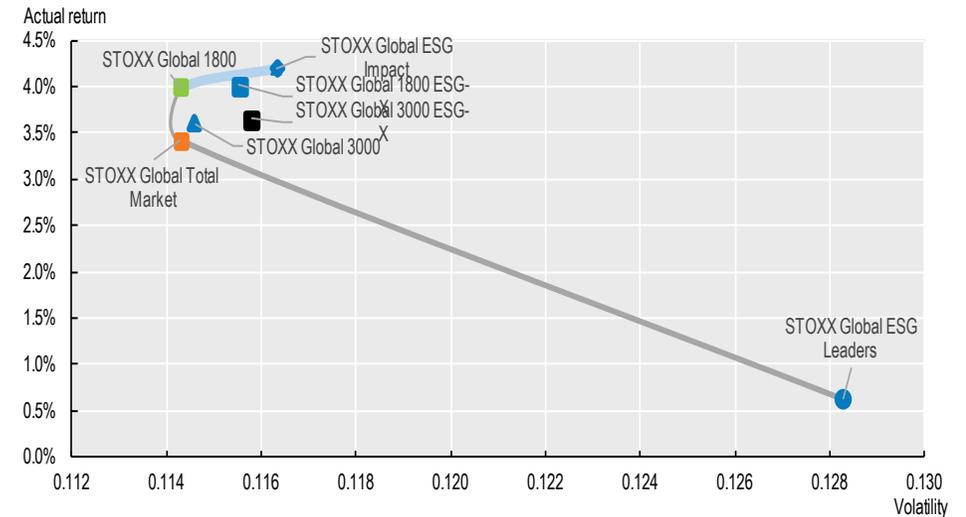
Empirical results - Modern Portfolio Theory

- We applied Markowitz MPT to understand the effect of the ESG constraint on the concentration risk.
- Investing in ESG indices suggest an increase in volatility, due to a lower number and concentrated weighting of constituents.

MSCI Minimum variance frontier and price index with base value 100, 2014-2019



STOXX Minimum variance frontier and price index with base value 100, 2014-2019



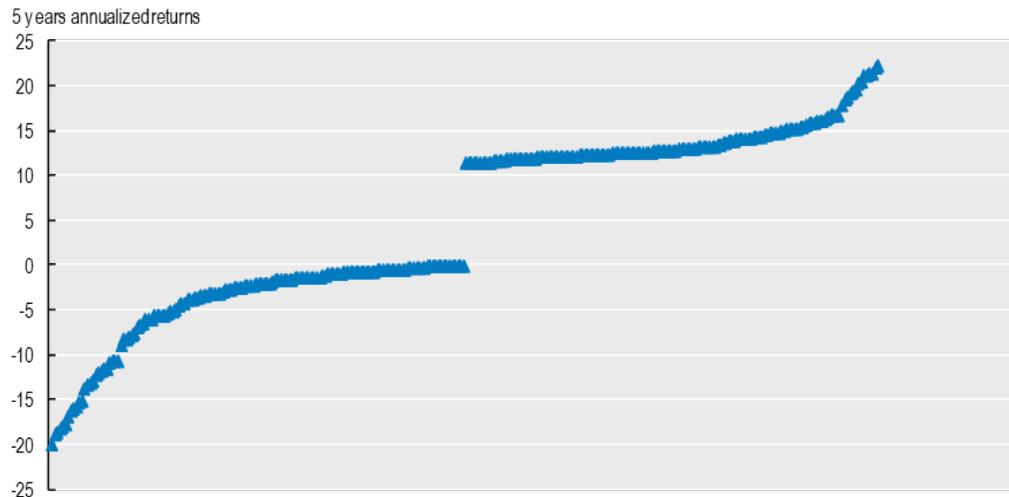
Based on preliminary assessment by Boffo and Patalano (2020, forthcoming)



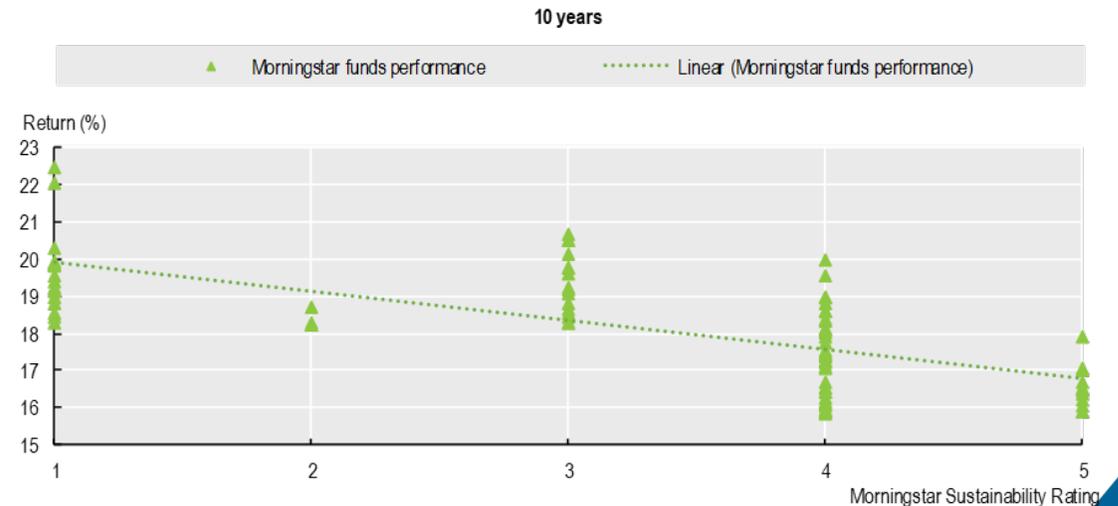
Funds performance – sample analysis

- The results suggest little correlation between ESG ratings and fund performances, as rated by Morningstar, using a specific sample of funds.
- This result indicates that investors should not generalise about the potential financial returns of funds based on ESG scores.

Distribution of 300 sustainable funds performances (5 sustainability stars*), 2019



10 years annualized funds' performance to Morningstar sustainability rating, 2019*



*Signifies funds that have portfolios with highest avg. ESG rating of underlying issuers. 5-year annualized returns.

*best performing funds



Issues for consideration

Taxonomy and classification

- Various terms are used in different ways across the industry → difficult to know what actions/decisions are associated with various terms, and implication for risks and returns.

Ratings and data comparability

- There is insufficient consensus on the appropriate metrics to be used for ESG for issuer disclosure and ratings assessment, and ratings approaches and scores vary widely.
- Also, lack of transparency over detailed methodologies and judgment results in different ESG ratings, which can in turn influence index weights and portfolio tilting based on ESG scores.

Performance & benchmarking

- Range of fund styles and index benchmarks makes it difficult to understand (a) performance on a relative basis, and (b) the extent to which goals other than financial risk-adjusted returns are pursued by the funds.

Promising developments → but need for policy engagement to ensure comparability, integrity, and trust.