# THE OBSTACLES ESG NEEDS TO OVERCOME

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**A recent survey from Royal Bank of Canada (RBC) Global Asset Management found that the use of environmental, social and governance (ESG) principles when investing is on the rise, but misconceptions remained. The survey found, among other things, that Europe led the way in ESG investing and an increasing number of investment managers were looking to increase their ESG exposure next year.**

This is good news for a space that has been slow to establish itself as part of the investment landscape. And the data also supports it; the MSCI ACWI ESG Leaders Index was up 15.3% YTD at the end of July 2017, which compares to an uplift of 3.37% in the same period last year.

Data from Eurekahedge also corroborates this trend, with the Eurekahedge ESG Fund Index, which tracks the performance of 33 fund managers incorporating an ESG framework in their investment process, rising 8.36% YTD to July 2017. It contrasts with the Eurekahedge Equity ex ESG Fund Index which returned 7.93% over the same period and the average global hedge fund posting gains of 4.34%.

Part of this uplift is likely a result of ESG being put under the spotlight in the last couple of years as a result of the 'COP23' - or the Conference of Parties to the UN Convention on Climate Change (UNFCCC) and Sustainable Development Goals.

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Camilla Ritchie, investment manager at 7IM, says: "While there are 17 of these goals, and many are not easily invested in, there are some such as clean energy that are. This has helped to raise the profile of ESG."

MSCI is one data provider that supplies ESG reports on companies where all three pillars of ESG are separated and considered. The MSCI ESG Ratings calculate each company's exposure to key ESG risks based on a granular breakdown of a company's business: its core product or business segments, the locations of its assets or revenues, and other relevant measures such as outsourced production. The aim is to give the company a high or low rating and therefore judge whether it's investable or not. This work is helpful, but it's not cheap.

Ritchie explains: "There is a premium to be paid for investing sustainably but the hope is that if a company follows good environmental, social and governance policies it will be less likely to be impacted by future taxes on carbon emissions suggesting a better long-term return with lower volatility. VW used to be the poster boy of low carbon emissions from diesel cars then the emissions scandal broke when it was revealed that VW had cheated and that the emissions when driving normally were much higher than had been warranted during testing. If only environmental factors were taken into consideration VW would have been viewed as a good environmentalist before but had governance been taken into account which MSCI failed them on before the scandal they would not have made it into the MSCI SRI Europe list."

## The Long Road

However, there is still a way to go for ESG investing. One of the biggest issues the sector comes up against is whether considering ESG factors means giving up potential returns.  According to RBC's survey, the most common ESG-related question or concern from investment consultant clients was whether returns will suffer.

**Jeremy Richardson, Senior Global Equities Portfolio Manager at RBC GAM explains: "There is a perception that ESG could reduce investment returns, but the perception is not true."**

There are also misunderstandings on what ESG includes; it is not just investing in ethical or environmental factors. Other factors can include, among other things, environmental water stress – how much water a company uses; carbon intensity – what the company's $CO_2$ emissions are; social factors - how well employees are treated; and governance - whether a company has changed its directors or not, the shareholders.

Arleta Majoch, COO at Auriel Capital explains that ESG is still paying a dear price for its roots in ethical investing.

*"It grew out of it, yes, but the contemporary ESG investor is unlikely to have much in common with the original church investors who first decided to put their money where their mouth is. Purely ethical exclusions can still be a drag on returns today but ESG and ethical investing/exclusions are two different things. ESG is incorporating ESG criteria in investment decision making as and when it is relevant. And relevant it is, as we keep being taught by the Volkswagens and BHP Billingtons of this world."*

## Resistance

Investing in ESG can be conflicting for investors who must weigh up non-financial data with the view that factors such as bad governance or environmental issues might impact company performance over the long term.

Richardson explains that ESG issues are qualitative, judgemental and can take time to have an impact. This conflicts with the short-term nature of some investment strategies, including hedge funds.

> **"If the investment horizon is short term, as is often found in the hedge fund community, then there is less reason to care about such qualitative long-term issues. They can be ignored as being irrelevant to the investment case," Richardson says.**

As a result of this, demand for hedge funds using ESG principles is often low.

Ritchie explains that ESG hedge funds have difficulty attracting enough money; *"I can think of two that have closed down in the last few years. In these instances, they became UCITS funds which meant that more portfolios managers could invest in them. The reason hedge funds have difficulty with ESG is the short term view they have, which conflicts with the long term returns of ESG. It's difficult to rationalise the two."*

Data availability is also in short supply and, as Majoch explains, the good ESG data still costs money to buy externally or requires some in-house skill and effort to scrub and fill in with sensible estimates. However, the availability and quality of data is rapidly improving.

## The Change

Change is happening, albeit slowly. RBC's survey showed that 25% of respondents planned to increase their allocation to managers incorporating ESG into their investment management process or strategies next year, and a number of asset managers are already starting to change their way of thinking by including considering long term horizons and mandating managers to evidence ESG values.

Changing regulations are also helping to shift the mind-set. These include discussions around carbon emissions in France and in the US including ESG factors in the investment appraisal, which is no longer considered to be contrary to the investment manager's fiduciary duty of care.

Regulatory incentives are also being used. The Japanese government has supported the use of indices only open to companies achieving a minimum return on equity. If you're not included in the indices then it says a lot. Younger investors are also more understanding of ESG and want their investment actions to be aligned with their personal values.

In the passive space the use of indices is helping change investor behaviour and there is a real opportunity to change how ESG is viewed if the passive and active sectors work together.

Richardson explains that the passive sector, by its very nature, has a small voice – most companies see very little engagement from passive shareholders.

> **"So active shareholders have a responsibility to make their voices heard and agitate in favour of long-term stewardship. If they don't pipe up, then company managers will only hear the vocal demands of short-term holders," he says.**

> **"ESG is about risks and opportunities, opportunities that are typically not included in traditional financial reporting…there is a widespread opportunity for ESG, but we need to challenge the old-school thinking that prioritises short-term profit maximisation above all else,".**