ESG Integration in Investment Management: Myths and Realities

By Sakis Kotsantonis, Chris Pinney, and George Serafeim

From JACF Issue 282 | Date???
Executive Summary

Sustainability in business refers to the integration of social and environmental considerations, such as climate change and income inequality, into business strategy and practices. Defined in this way, sustainability is a subject of growing interest to investors and companies alike, who are asking themselves: Is this business approach finance-worthy—that is, capable of earning high enough rates of return to continue to attract capital from private investors? If so, how can investors (and the companies themselves) evaluate corporate sustainability programs and investments?

The number of public companies reporting ESG information grew from fewer than 20 in the early 1990s to 8,500 by 2014. Moreover, by the end of 2014, over 1,400 institutional investors that manage $60 trillion in assets had signed the UN Principles for Responsible Investment (UNPRI). Nevertheless, companies with high ESG “scores” have continued to be viewed by mainstream investors as unlikely to produce competitive shareholder returns, in part because of the findings of older studies showing low returns from the social responsibility investing of the 1990s. But studies of more recent periods suggest that companies with significant ESG programs have actually outperformed their competitors in a number of important ways.

The authors’ aim in this article is to set the record straight on the financial performance of sustainable investing while also correcting a number of other widespread misconceptions about this rapidly growing set of principles and methods:

*Myth Number 1: ESG programs reduce returns on capital and long-run shareholder value.*

Reality: Companies committed to ESG are finding competitive advantages in product, labor, and capital markets; and portfolios that have integrated “material” ESG metrics have provided average returns to their investors that are superior to those of conventional portfolios, while exhibiting lower risk.

*Myth Number 2: ESG is already well integrated into mainstream investment management.*

Reality: The UNPRI signatories have committed themselves only to adhering to a set of principles for responsible investment, a standard that falls well short of integrating ESG considerations into their investment decisions.
**Myth Number 3: Companies cannot influence the kind of shareholders who buy their shares, and corporate managers must often sacrifice sustainability goals to meet the quarterly earnings targets of increasingly short-term-oriented investors.**

Reality: Companies that pursue major sustainability initiatives, and publicize them in integrated reports and other communications with investors, have also generally succeeded in attracting disproportionate numbers of longer-term shareholders.

**Myth Number 4: ESG data for fundamental analysis is scarce and unreliable.**

Reality: Thanks to the efforts of reporting and investor organizations such as SASB and Ceres, and of CDP data providers like Bloomberg and MSCI, much more “value-relevant” ESG data on companies has become available in the past ten years.

**Myth Number 5: ESG adds value almost entirely by limiting risks.**

Reality: Along with lower risk and a lower cost of capital, companies with high ESG scores have also experienced increases in operating efficiency and expansions into new markets.

**Myth Number 6: Consideration of ESG factors might create a conflict with fiduciary duty for some investors.**

Reality: Contrary to the myth, many ESG factors have been shown to have positive correlations with corporate financial performance and value, prompting ERISA in 2015 to reverse its earlier instructions to pension funds about the legitimacy of taking account of “non-financial” considerations when investing in companies.

Further, over the last fifteen years research has shown that many ESG factors like environmental practices can have a direct or indirect material impact on the financial performance of companies and should be considered by investment managers. These factors can no longer be dismissed as simply social or ethical issues. The challenge for investment managers is to identify and take account of the relevant ESG factors for the industries and companies they are investing in. While this may be complicated by the lack of industry standards to guide ESG reporting and the increasingly “noisy” ESG reporting environment, this is a task they must now take on if they are truly to act in the fiduciary interest of the beneficiaries they serve.

The importance of developing such standards has also been increasingly recognized by policymakers and multi-stakeholder initiatives, which are now working to promote reforms in the legal interpretation of fiduciary duty. In October 2015, the Department of Labor issued a new
interpretation, noting that its 2008 bulletin had “unduly discouraged fiduciaries from considering ETIs and ESG factors.” In this more recent statement, the Department of Labor also acknowledged that ESG issues might have a direct bearing on the economic value of a plan’s investments, and that such issues are accordingly not only a legitimate, but—at least in some cases—even a necessary focus of the fiduciary’s primary analysis of the economic merits of competing investment choices.