

Effective integration of ESG issues into investment decision-making

August 2009



Introduction

In July 2009, we released a report 'ESG Integration: Facing the Challenges' which describes how we integrate environmental, social and governance (ESG) issues into our investment process. It presents a series of examples showing how we analyse ESG issues across the major asset classes in which we invest and offers some reflections from our analysts and fund managers on the relevance of ESG issues to their particular asset classes and investment strategies. Five major lessons have emerged from our work to integrate ESG issues.

Lesson 1: Effective integration begins with the investment process

In our view, ESG integration must begin the investment process for the asset class or funds in question. The central question is whether and how ESG factors can be built into the particular investment process (or how the investment process can be refined to accommodate these factors),

rather than seeking to impose ESG factors on the investment process.¹ Thus, attention must be paid to understanding:

- The investment process, in particular where and how ESG issues are – or may be – relevant to investment research and decision-making.
- The needs/interests of the particular fund manager and analyst. Our experience is that different fund managers and analysts have quite different views on the relative importance of thematic versus fundamental analysis, and assign different weights to quantitative and qualitative information.
- Which issues are already well understood by the market and which are not. While there may be limited investment value to be derived from focusing research resource on topics such as tobacco litigation, themes such as innovation or human capital management may provide fertile areas for research and analysis.
- The investment time horizons of a fund. If fund performance is evaluated over relatively short time horizons, fund managers may be less interested in how longer-term issues such as climate change adaptation are likely to affect the companies in which they invest.

Lesson 2: People are key

Investment management – and, by extension ESG integration – is about people as much as it is about process. We have invested significant time and resources in establishing a research team (our Responsible Investment team) with a dedicated focus on ESG issues. However, simply establishing an expert team is nowhere near enough. To maximise the value of their research we need to harness both the right people and the research platform so as to add real value to investment research.

Our starting point has been the acknowledgement that analysts following different asset classes may have quite different views on whether the securities issued by the same company are good investments or not. Our objective is to ensure that these different views are recognised and understood. We have actively developed the links between our equity, credit and Responsible Investment team, and have encouraged analysts and fund managers to interact with each other, including encouraging joint meetings with companies. In addition, research meetings (e.g. daily morning review meetings, stock and sector research meetings) are open

¹ We recognise that this is very much a mainstream investment view. Clearly, investors with an ethical objective or mandate will take a different approach and may modify their investment process to explicitly accommodate these ethical objectives.

to all, we have weekly updates on forthcoming research and company meetings across the three research teams, and the heads of the equity research, credit research and Responsible Investment teams meet monthly to review research priorities and ensure effective coordination of the research process.

We also have an open access research system where all research from the different teams is stored and can be accessed and reviewed by everyone. Our aim is to ensure that views on specific securities – shares, bonds issued against different parts of a company's capital structure – take account of the full range of analysis we have done of the company.

Lesson 3: ESG issues can be material... but not all the time

The starting point for our work on integration is that ESG issues can be important drivers of investment value.

Over the past few years, we have seen many cases where these issues have significantly impacted on company cashflows, balance sheets, reputations and, hence, on value. Examples include government legislation in areas such as waste and water management, economic incentives such as the European Union's Emissions Trading Scheme for greenhouse gas emissions and tobacco litigation.

However, these examples should not be interpreted as an argument that all ESG issues are, or will be, material. While there is no universally agreed definition, financial analysts frequently use numerical thresholds – five percent of a company's revenue or five percent moves in a company's share price are common rules of thumb – to assess the financial materiality of a particular issue.

Using these metrics, the vast majority of social or environmental issues – notwithstanding examples such as tobacco litigation and climate change – are simply not material. Moreover, time horizons are critical. While climate change adaptation, for example, is clearly a huge issue for society, with potentially enormous financial implications for companies and their

investors, the time horizons over which it will play out is beyond conventional investment time horizons.

Lesson 4: ESG performance may not be a good proxy for corporate risk

There has been extensive discussion about whether ESG performance (as measured in terms such as total pollutant emissions) is a good proxy for wider corporate risk. We have some sympathy with the view that it can be. We agree that the quality of management of ESG issues can provide important insights into overall quality of management of a company, in terms of its ability to identify and assess the significance of wider business risks and its ability to effectively respond to and engage with stakeholders. In addition, we believe that companies that manage these issues effectively are likely to be better investments over the longer term.

However, ESG performance is only part of a complex picture. It is just one of a whole series of factors – for example, the nature of the company's activities, the quality of the company's management, cash flows and balance sheet strength – that investors consider when making investment decisions. In addition, where ESG issues are or may be material, investors do not consider a company's ESG performance in isolation but rather how it may impact on cash flows, revenues, profits and balance sheets. For example, in relation to greenhouse gas emissions, while some commentators have argued that investors should preferentially invest in companies with lower greenhouse gas emissions, prudent investors will consider not only total greenhouse gas emissions but also:

- The likelihood that the company will be required to reduce some or all of its greenhouse gas emissions.
- The emissions reductions that are or will be required.
- The timeframe over which the emissions reductions are required.
- The cost to the company of reducing or offsetting its emissions.

Lesson 5: Responsible investment is not just about enhanced analysis

Integrating ESG issues into investment analysis is widely presented as the holy grail of investment, allowing investors to generate better returns while also delivering on their wider social obligations. The logic is that integration sends a clear signal to companies that ESG issues are an important factor in investment decisions, thereby providing an additional incentive for companies to manage them effectively.

While this argument is attractive in theory, it presupposes that companies recognise whether and how investors take account of these issues. In fact, many companies have been sceptical of the assertion that investors do take account of ESG issues in their investment decisions. It is therefore essential that investors actively engage with companies to set out their expectations of how issues such as climate change should be managed and to explain exactly how these issues are taken into account in their investment analysis. Unless investors provide this feedback, companies will not understand the reasons informing the buy/sell or overweight/underweight decision, or whether or not these decisions were influenced by consideration of specific ESG issues.

Conclusion

ESG integration should not be a stand-alone activity but rather one element of a holistic approach to responsible investment that encompasses actively promoting high standards of corporate governance and corporate responsibility, explaining to companies how ESG issues are built into investment processes and decisions, and playing a supportive role in public policy and wider debates on corporate governance and corporate responsibility.

Produced by the Insight Responsible Investment Team

Web: <http://www.insightinvestment.com/uk/responsibleinvestment/>

Tel: 020 7321 1162

Issued by Insight Investment Management (Global) Limited. Registered office 33 Old Broad Street, London EC2N 1HZ. Registered in England and Wales. Registered number 827982. Authorised and regulated by the Financial Services Authority.

More insight. Not more of the same.

Insight
INVESTMENT

06855-08-09