VAR CAPITAL

ESG Investing – A short guide to implementation

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Introduction

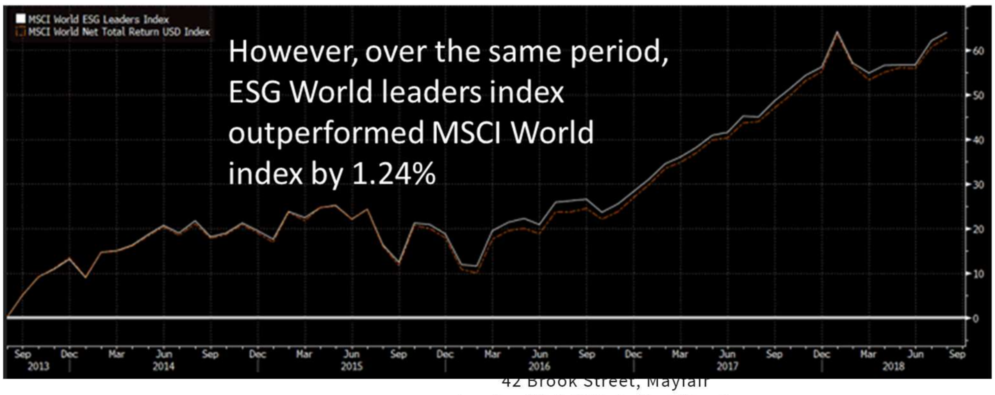
Environmental, Social and Governance (ESG) criteria refer to the main factors that investors consider with regards to a firm's ethical impact and sustainable practices. This paper shares the challenges of implementing ESG and methods of implementation in client portfolios.

Development of ESG based investing

Over the past 10 years, an increasing number of investors are considering ESG issues when constructing their investment portfolios. A study by the CFA Institute[1] has revealed that as of 2017, 73% of their survey respondents take ESG issues into account in their investment analysis and decisions. Amongst ESG risks, Governance is most commonly considered by investors, likely due to its connection to a company's management and stability.

A recent study done by MSCI Inc.[2], a provider of ESG evaluation scores, detailed that high ESG-rated companies displayed superior long-term financial performance. Their data detailed that high ESG-rated companies exhibited higher profitability, less systematic volatility, lower idiosyncratic tail risks and a higher dividend yield. Further research by MSCI Inc. showed that an improving ESG profile, otherwise known as ESG Momentum, could signal that a company is becoming less susceptible to systematic risks.

However, research from VAR Capital showed that the performance comparison yields mixed results.



Challenges with ESG Implementation

There are a few challenges in the adoption and application of ESG by investors. The CFA Institute[3] outlines the four main challenges as below:

1) Defining standards and terminology

   A survey conducted last year by State Street Global Advisors[4] found that over half of those institutional investors already implementing some form of ESG strategy in their portfolios were struggling with clarity around standards and terminology. Another criticism targets the ESG ratings firms themselves. Their ratings are inconsistent due to significant differences in data collection, analysis and reporting.

2) ESG understanding and adoption

   There is room for improvement with regards to awareness and understanding of ESG risks and its difference from SRI (Socially Responsible Investing) or Impact Investing. ESG is about financial performance but considers how environmental, social and governance factors drive or inhibit performance. SRI, on the other hand, integrates social and environmental factors in investment analysis to avoid investing in businesses potentially harmful to society or the environment. Impact investing, similarly to SRI, considers ESG factors but then makes investments only in companies whose goal it is to generate social and/or environmental impact, as well as financial returns.

3) Lack of data and the quality of ESG information

   Currently, ESG information is disclosed voluntarily by companies and is not officially audited, so there is no industry specific standard yet. However, organizations like the Task Force on Climate-Related Financial Disclosures (TCFD)[5] are beginning to provide the standards required for consistent, comparable and reliable ESG ratings.

4) ESG for small-cap companies and emerging markets

   ESG has a natural home in the public markets, for large companies in Europe and USA, which already have ongoing disclosure requirements. Smaller companies / private companies currently do not have the same transparency as large listed companies. Same applies to Emerging Market companies where data is hard to come by.

Measuring ESG scores across companies

Thanks to recent developments in ESG universe, there are strong guidelines on how to measure the environment, social and governance factors of a company. We have compiled a range of criteria to measure ESG using information from various ESG evaluation providers, such as RobecoSAM, ISS QualityScore, CDP Climate Score and MSCI Inc.

Environmental Metrics – The contribution a company or government makes to environmental issues, such as climate change and pollution, through:

- Waste Pollution and Management
- Greenhouse Gas Emissions
- Energy Efficiency
- Decarbonizing
- Resource Depletion
- Management of Environmental Risks and Opportunities

Social Metrics – The measure of diversity, human rights, consumer protection, and other social issues. A company with good social metrics is less likely to be involved in controversy, and more likely to have a stable customer base and work force.

- Human Rights
- Labour Standards
- Exposure to Illegal Child Labour
- Workplace Health and Safety
  Community Relations

Governance Metrics – A set of rules or principle defining rights, responsibilities and expectations between different stakeholders, with regards to the governance of corporations. A well-defined governance system can be used to balance or align interests between stakeholders and can work as a tool to support a company's long-term strategy. Factors that go into the governance metrics are:

- Board Structure and Independence
- Management Diversity
- Compensation/Remuneration
- Shareholder Rights and Takeover Defences
- Audit and Risk Oversight
- Anti-Crime/Anti-Money Laundering Policy
- Corruption & Bribery
- Tax Strategy

Implementing ESG in portfolios

There are several steps required in implementing ESG in portfolios. They are outlined below:

ESG strategy

It is important to understand the client's objectives and goals before designing an ESG portfolio. Key questions to ask for designing an ESG strategy include:

- Are the drivers for ESG return enhancement, risk reduction or societal benefit?
- Is the client willing to be a long-term investor and avoid short term performance lag?
- How strict should the ESG criteria be?
- What level of involvement would the client like to have in ongoing decision making?

ESG Based Portfolio Construction

The next step would be to construct portfolios based on ESG criteria. This could mean excluding sectors with high ESG risk such as the tobacco, alcohol and oil industries or excluding companies with low ESG scores.

Tools for implementation

VAR Capital uses a range of tools from ESG score data providers. We outline a set of tools and their descriptions below:

- RobecoSAM
  [Percentage rating score, 100% as the best]

  RobecoSAM focuses on Economic factors rather than the usual Governance factors of most ESG ratings, as well as the environmental and social factors that are relevant to the companies' success. They provide data for 3,400 listed companies internationally, considering between 80-120 industry-specific questions
- Sustainalytics
  [Percentage rating score, 100% as the best]
  Sustainalytics gives an overall ESG rating relative to industry peers and shows the Environment, Social, and Governance metrics used to get the overall score separately. They cover over 6,500 companies across 42 sectors internationally and looks at over 70 industry specific ESG indicators within each industry.
- ISS QualityScore (Institutional Shareholder Services)
  [Rating score from best to worst, 1 – 10]
  ISS QualityScore covers board structure, compensation/remuneration, shareholder rights and audit & risk oversight, which is all updated on an ongoing basis. ISS provides corporate governance reports on over 5,600 public companies internationally.

- CDP Climate Score (Carbon Disclosure Project)
  [Rating score from worst to best, 1 – 8]
  Reflects the level of company commitment to climate change mitigation, adaptation, and transparency. CDP scores companies that respond on-time to the questionnaire sent on behalf of an investor request.

Ongoing monitoring and reporting

ESG should form part of ongoing monitoring, reporting and client discussions. The performance should be benchmarked against wider market indices to ensure there is no long-term lag due to ESG implementation.

Conclusion

There can be significant long-term benefits by considering ESG data when creating investment portfolios and strategies, as high ESG rated companies can be more profitable and less volatile to invest in than low ESG rated companies. Despite there being significant challenges to ESG implementation across industries today, more companies and organizations are researching the benefits of ESG implementation than ever before, and investors are regularly adopting some form of ESG strategy in their investment decisions.

About VAR Capital

VAR Capital is an award-winning asset manager and family office based in London. We often assist our clients with ESG design and implementation when creating and reviewing investment portfolios and strategies. VAR has the capability, tools, resources and knowledge to implement ESG in client portfolios. For further information, please visit http://www.varcapital.co.uk

Please contact Vikash Gupta at vikash@varcapital.com for more information.

Sources

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5) https://www.fsb-tcfd.org/about/#
6) https://events.mergermarket.com/esg

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