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MARKET insights

RETIREMENT SOLUTIONS DIVISION

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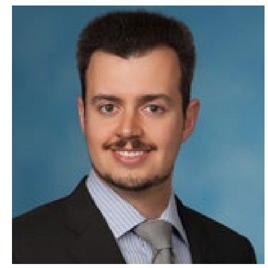
INSPIRED INVESTING: PART I

Everything You Always Wanted to Know About ESG but Were Afraid to Ask



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ESG (which stands for environmental, social, and governance), sustainability, and impact are terms most investors have heard often these days. The overarching concept seems simple enough: invest in companies that are making the world a better place so you can save for retirement while ensuring you have an Earth to retire in. Dig deeper, however, and many questions arise: How has ESG investing changed over time? How do I incorporate ESG into my portfolio? The information presented below aims to answer these questions so that you understand the current landscape of ESG investing and can make an informed decision on how to integrate it with your investment objectives.

Key Takeaways:

- ESG investing has been around since the 18th century but has rapidly evolved over last few decades. Modern ESG strategies invest inclusively across asset classes, regions, and industries while providing exposure to a broad range of sustainability factors.
- Demand for ESG strategies has likewise surged—rising to $17 trillion, or a third, of all professionally managed US assets.
- A standardized way of measuring various E, S, and G metrics remains elusive as all ESG raters have their own methodologies. Nonetheless, the industry's growth will likely support the emergence of a uniform standard.

ESG Evolution: From Exclusion to Inclusion to Cross-Asset Engagement

Ethical investing is not a novel concept. Its origins can be traced back to the 18th century when John Wesley, the founder of the Methodist faith, outlined values-based investing principles in his The Use of Money sermon. In it, he said that "to gain money we must not lose our souls" and thus should not engage with businesses that may directly or indirectly harm our neighbors, even as we should seek to "gain all we can". In today's language we would say that Wesley advocated for achieving the highest risk-adjusted level of return while limiting negative impacts to stakeholders.

This method of excluding, or screening out, companies that engage in practices not aligned with commonly held investor values is called SRI which stands for socially responsible investing. Since simply narrowing your investment universe can reduce diversification and lower risk-adjusted performance, most ESG detractors blame SRI for allegedly sapping returns. Yet, there are few modern ESG strategies that rely purely on negative screens. The figure below summarizes how ESG investing has evolved to offer comprehensive solutions for investors who want to generate competitive performance while producing a positive impact on the world.

ESG 1.0 (SRI)	ESG 2.0 (Inclusion)	ESG 3.0 (Diversified Engagement)
Avoid companies and industries seen as objectionable to a common set of values (for example tobacco, weapons, deforestation, lack of employee diversity).	Invest inclusively across all industries into companies that are implementing measures to create positive stakeholder outcomes and long-term shareholder value.	Invest across asset classes and provide exposure to a broad range of E, S, and G factors. Directly engage with companies to unlock positive impact for both stakeholders and shareholders.

Along with greater sophistication came a significant rise in demand. Morningstar reported a 30% increase in ESG retail funds during 2020 and $51 billion of inflows, which is a continuation of accelerating trends seen since 2015. Looking across all professionally managed U.S. assets, which includes the far larger institutional universe, ESG-linked investments stood at $17 trillion at the end of 2019 according to the U.S. Social Investment Forum (SIF) Foundation's "2020 Report on U.S. Sustainable and Impact Investing Trends." This represents roughly a third of all professionally managed U.S. assets and more than a fivefold increase since 2010 when "ESG 2.0" strategies began coming to the forefront. As sustainable investing continues evolving to meet investors' needs, its market share is likely to continue growing too.

Quantifying Impact: The Disparate State of ESG Ratings

As ESG investors became more sophisticated, they've demanded greater transparency into how their funds are invested across various E, S, and G factors. Environmental considerations include efforts to reduce carbon emissions, increase biodiversity, and cut waste. Social metrics include improving worker safety standards, supply-chain sustainability, and keeping customers' data secure. Governance measures include ethical business practices, board diversity, and exposure to controversy.

To address this need, several providers of ESG ratings, such as MSCI and Sustainalytics, have emerged. Much like credit rating agencies assess the health of companies' balance sheets, ESG raters seek to evaluate firms' and funds' exposure to environmental, social, and governance factors.

The challenge is that, unlike with accounting metrics for measuring credit risk, there is currently no common standard to measure ESG metrics such as the ones listed above. Thus, while the correlation between Moody's and S&P® credit ratings are 0.92, the correlation among ESG raters' scores is just 0.54 on average, according to an MIT Sloan Study.

While it's important to be aware of this discordance among rating agencies, it should not dissuade investment into ESG strategies. Rather, investors should ensure that their funds have a clear and thought-out policy for measuring and reporting ESG attribution whether it's based on third-party ratings or proprietary scores. As sustainable investing continues to grow, PLFA expects that a shared set of standards will emerge and make ESG attribution simpler. Until then, investors in multiple ESG funds should understand how to properly aggregate their exposure to key ESG metrics. Alternatively, a multi-asset ESG product may offer a turnkey solution for providing transparent exposure to a broad range of ESG factors, competitive performance, and straightforward integration with a portfolio of traditional asset classes.

To conclude, sustainable investing has come a long way from its theological beginnings more than two centuries ago. The ESG landscape continues to evolve at a rapid pace and ascertaining a fund's ESG attribution requires understanding the methodology of the rating process it employs. However, Inspired Investing has never been easier through educational initiatives, greater rating transparency by fund managers, and new ESG strategies designed to be turnkey solutions can help investors of all stripes integrate ESG into their portfolios.

Want to learn more? In the second part of this series, we dispel some commonly held misconceptions about ESG investing.
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