

What Does ESG Success Look Like?

With ESG now firmly established, S&P Dow Jones Indices (S&P DJI) hosted its inaugural environmental, social and governance (ESG) seminar in London on 10 May 2017—“What Does ESG Success Look Like?” Acknowledging the fact that institutional mandates incorporating ESG are on the rise, a predominantly institutional audience participated in a lively debate during the event. The event began with a scene-setting session focusing on the rapidly changing global policy landscape. A recent survey by the Principles of Responsible Investment found that of the 300 regulations in 49 countries dealing with ESG integration in financial markets, over one-half had been introduced in only the past three years—a classic “hockey stick” increase.

While some of these, such as the EU’s Occupational Retirement Provision Directive and France’s energy transition law Article 173, were seen as promising frameworks that could encourage market participants along the investment chain to consider ESG issues, the effectiveness of some other regulations was called into question. A need was identified for collaborative thinking to create policy frameworks that better align the different roles of asset owners, asset managers, regulators and others. China’s green financial system was highlighted as “the one to watch”, having already achieved significant headway in its alignment of values, purpose, government, targets and institutional arrangements such as rules, incentives, education and market oversight.

Moment of Truth

Some concern was expressed regarding the direction of U.S. policy on ESG, especially over its lasting commitment to the Paris Agreement on climate change, on the shift to clean power, as well as the proxy rights of minority shareholders to challenge companies.

A “moment of truth” is coming in May 2017, with the U.S. decision on its support of the Paris Agreement, which, if negative, could test the resolve of other countries to reduce carbon emissions. However, it was noted that the significant momentum of state legislation, in particular California’s, was likely to persist.

The first panel—“ESG: From Policy to Practice”—discussed the merits of different policy approaches in achieving change, from regulations to relying on guidance and transparency. In some regions, such as the UK, it was argued that softer tools had been shown to be more pragmatic and effective. For instance, the UK’s Stewardship Code has been copied in other regions. There was a call for better data and benchmarking, so that market participants could better judge performance and encourage improvements.

The panel shared experience of their journeys, from defining a set of ESG investment beliefs to integrating ESG in investment decision-making: the resounding message being that one can reduce carbon and broaden ESG exposure significantly without foregoing returns. Unlocking the opportunity hinged on drawing together pertinent ESG data sources and having the courage to “get started”. The ultimate objective was to integrate ESG throughout multi-asset investment strategies, while focusing

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greatest attention on the most materially significant asset classes, such as emerging markets, forestry, agriculture and real assets.

In it for the Long Run

There was discussion around the importance of long-term value creation—something which many felt the financial industry had lost sight of in a rush to achieve better short-term returns. A leading industry figure said that no investor could claim they were following their fiduciary duty if they did not try to focus on creating long-term value. ESG should be seen as a value creator—not just as a risk management strategy or regulatory requirement.

During the panel “Innovations for the Long-Term”, participants discussed new themes and products that were emerging to help investors capitalize on ESG opportunities. One frequently mentioned opportunity was the Sustainable Development Goals (SDGs), and whether themes and products could be created to direct investment capital towards companies making progress in the SDGs.

The relative merits of active versus passive management were debated, with some arguing that asset owners and their managers needed more engagement with companies to drive change, while others said that passive solutions could be designed to drive change. For example, best-in-class methodologies that compare leaders and laggards can incentivize CEOs to improve corporate ESG performance.

The Holy Grail of Data?

Not for the first time, the importance of data was raised. ESG issues such as climate change have raised awareness of the need for more forward-looking data; for instance, how a company may be reducing carbon emissions in line with cuts implied by the Paris Agreement to limit global warming to 2°C.

While increasingly sophisticated ESG data was acknowledged as an important breakthrough, there was also a view that the search for perfect forward-looking data was akin to the search for the Holy Grail, and that a degree of uncertainty was inevitable. A wealth of historical data is available which investors can use to bolster confidence—the challenge is to pick the most material. The quest for perfect data should not be the enemy of progress. Just as financial data such as growth and inflation have many inherent assumptions, so too should we recognize and manage uncertainty in ESG data.

Opportunities and Innovation

The starting point of the final panel of the day, “Meeting the Demands of Investors”, was the recent OECD report that criticized modern portfolio theory for creating a herd instinct that focused on short-term gain at the expense of long-term value creation and ESG considerations. There was some agreement that business as usual was impeding the integration of ESG issues, with some only paying lip service without using ESG to inform investment decisions.

Nevertheless, several examples were given of ESG-themed products, from ESG integration and best-in-class approaches to risk premium or smart beta strategies offering an ESG tilt. There was also increasing interest in ESG in emerging markets due to the larger scale optimization opportunity, with enhanced green bond metrics providing comfort on positive impact outcomes.

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Some delegates perceived a change in attitudes, with millennials increasingly concerned about where their money was invested, as the student-led movement for divestment from fossil fuels has illustrated. To satisfy these demands, asset owners, investment managers and other market participants had to demonstrate that they were not just incorporating ESG into processes and procedures, but that they were achieving actual benefits for society and the environment.

S&P DJI would like to thank the strong line up of speakers from Principles for Responsible Investment, Hermes Investment Management, Environment Agency Pension Fund, Canada Pension Plan Investment Board, BlackRock, State Street Global Advisors, J.P. Morgan, AMF, PGGM Investments, Willis Towers Watson, First State Investment, Societe Generale, RobecoSAM and HSBC Asset Management.

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