

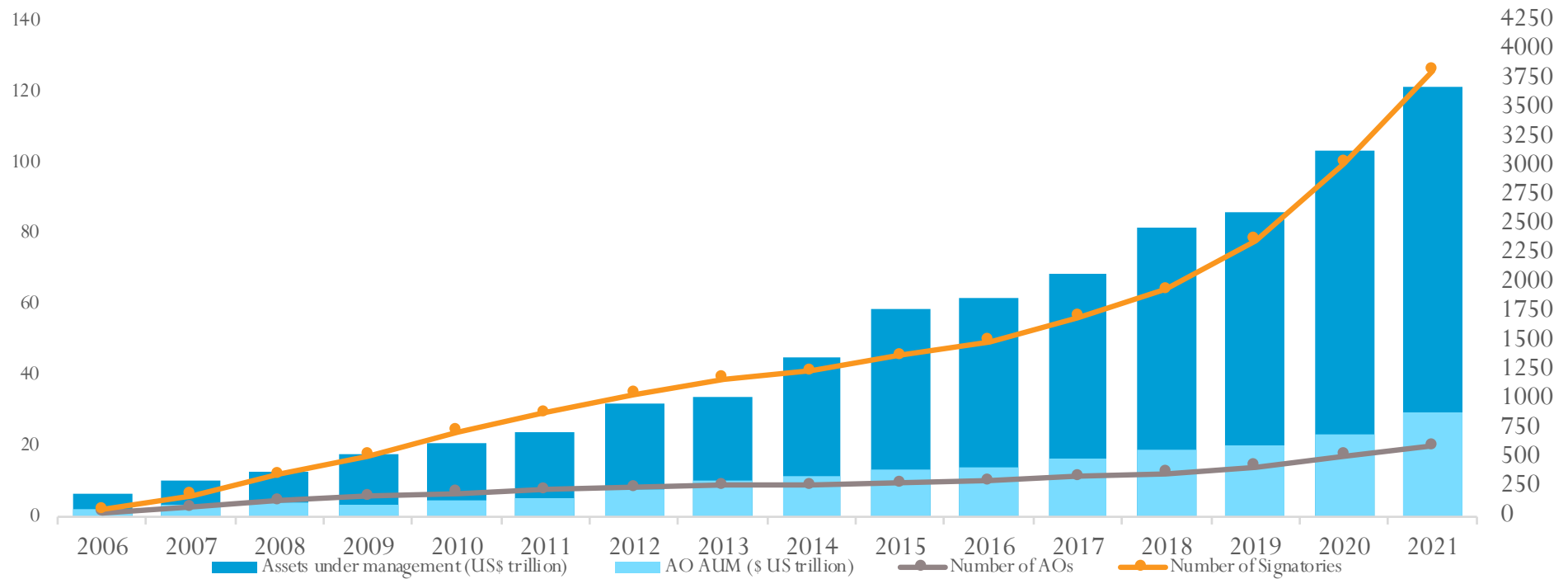
# Considerations on ESG Investment Implementation

Federal Reserve Bank of Atlanta  
Financial Markets Conference  
May 10, 2022

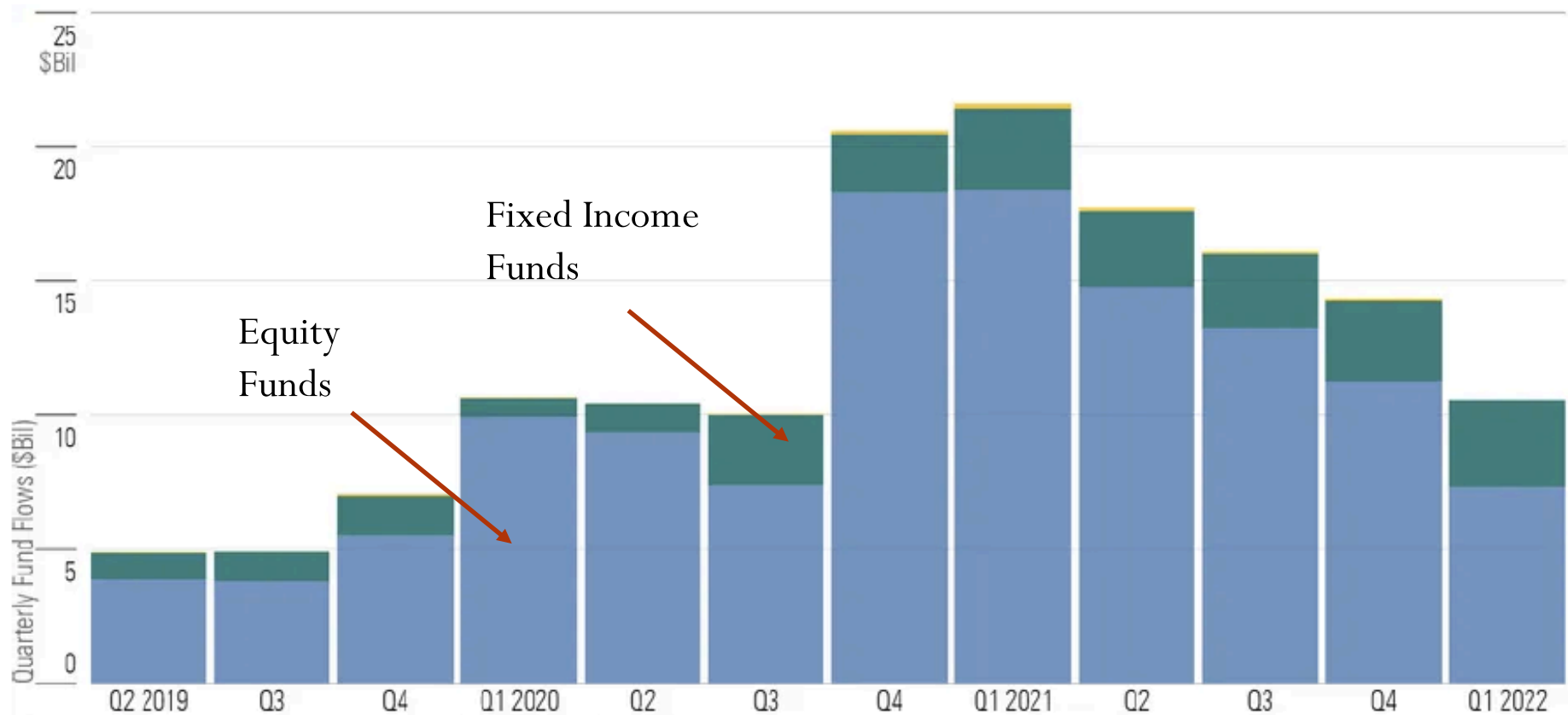
Laura T. Starks  
McCombs School of Business  
University of Texas at Austin

# Growth in institutional investor interest in ESG

## Principles of Responsible Investing (PRI) Signatories



# Quarterly flows into U.S. sustainable funds



Source: Morningstar Direct, Manager Research. Data as of March 2022.

# What is a sustainable or ESG investment?

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- These terms are ill-defined and definitions vary.
- There exists a lack of agreement on:
  - what ESG investing means
  - what ESG investing entails
- **Context is important!**

# Motivations for ESG investment

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The appropriate investment approach depends on motivation.

## *ESG Values*

- Preferences
  - Avoidance of complicity
  - Supplying capital
- Making an impact
  - Supplying capital
  - Engagement/stewardship

## *ESG Value*

- Risk management
- Return opportunities
  - Investment selection
  - Engagement/stewardship

# ESG investment approaches

## *ESG Values*

- Exclusion/Divestment/negative screening
- Positive tilt
- Engagement/stewardship
- Thematic investing
- Impact investing

## *ESG Value*

- ESG integration/risk assessment
- Positive tilt
- Engagement/stewardship
- Thematic investing
- Impact investing

# Positive or negative screening?

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## Positive Portfolio Tilt

- Weight problematic ESG firms less
- Can engage and vote on proxies to pressure for better ESG behavior
- Allows for diversifying across sectors

## Exclusion/Divestment

- Do not hold security at all; avoid complicity
- Can't engage or vote proxies
- Higher tracking error based on mechanical decision

# Beyond exclusion, consider shorting?

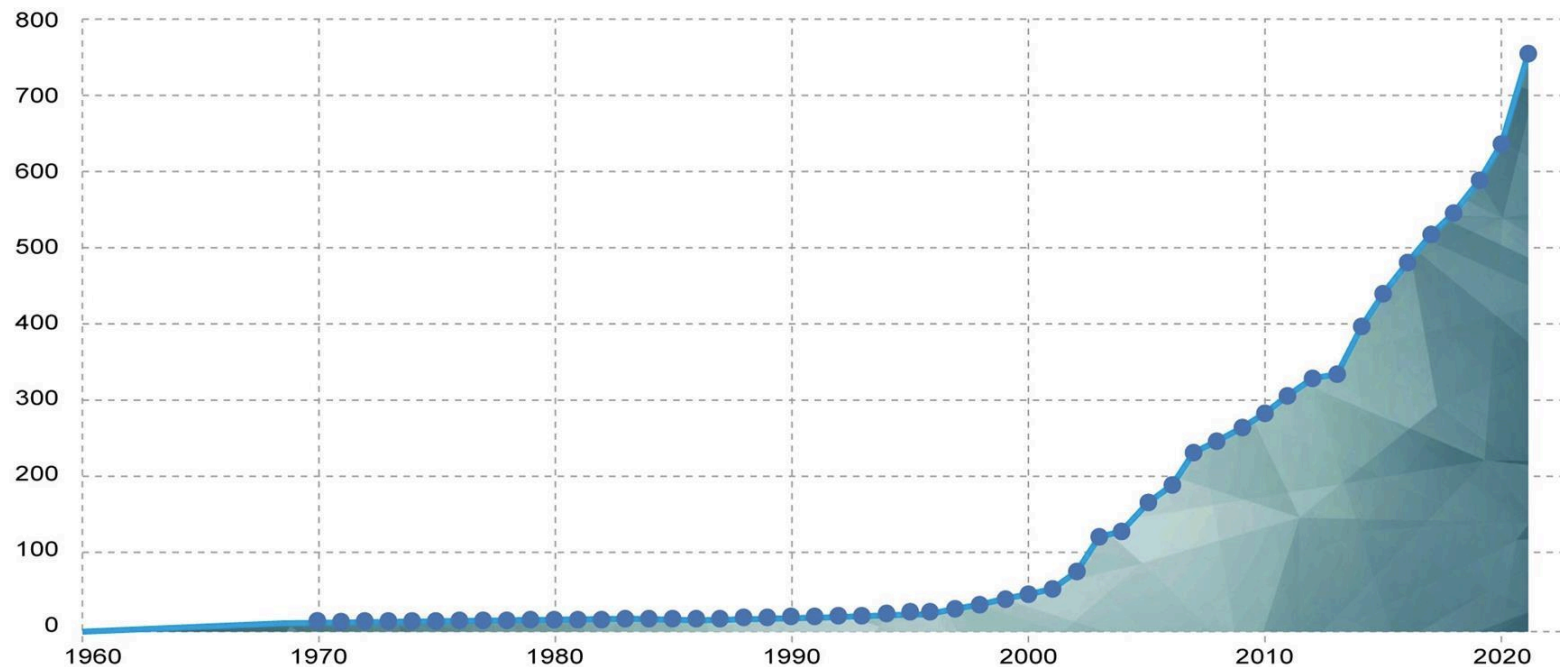
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- Short the low ESG firms, particularly carbon-intensive firms
- Depends primarily on value expectations
- Theoretical rationales (controversial):
  - Shorting problematic firms can increase returns
  - Puts more pressure on firm management through increasing their cost of capital
  - Can hedge against ESG risks
  - Can affect the portfolio's net zero goals



# Increasing number of sustainable finance policies and regulations across 86 countries

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<https://www.unpri.org/policy/regulation-database>

# Reporting on portfolio ESG qualities

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Beyond regulations, what are investor needs/demands for information?

- For *ESG values* – most important is ESG relevance
- For *ESG value* – most important is ESG materiality
  
- Where to report?
  - Everywhere - prospectus, fact sheet, website, annual report
  
- What to report?
  - ESG in total and E, S, and G separately
  - Both backward-looking and forward-looking measures

# Reporting on portfolio ESG qualities

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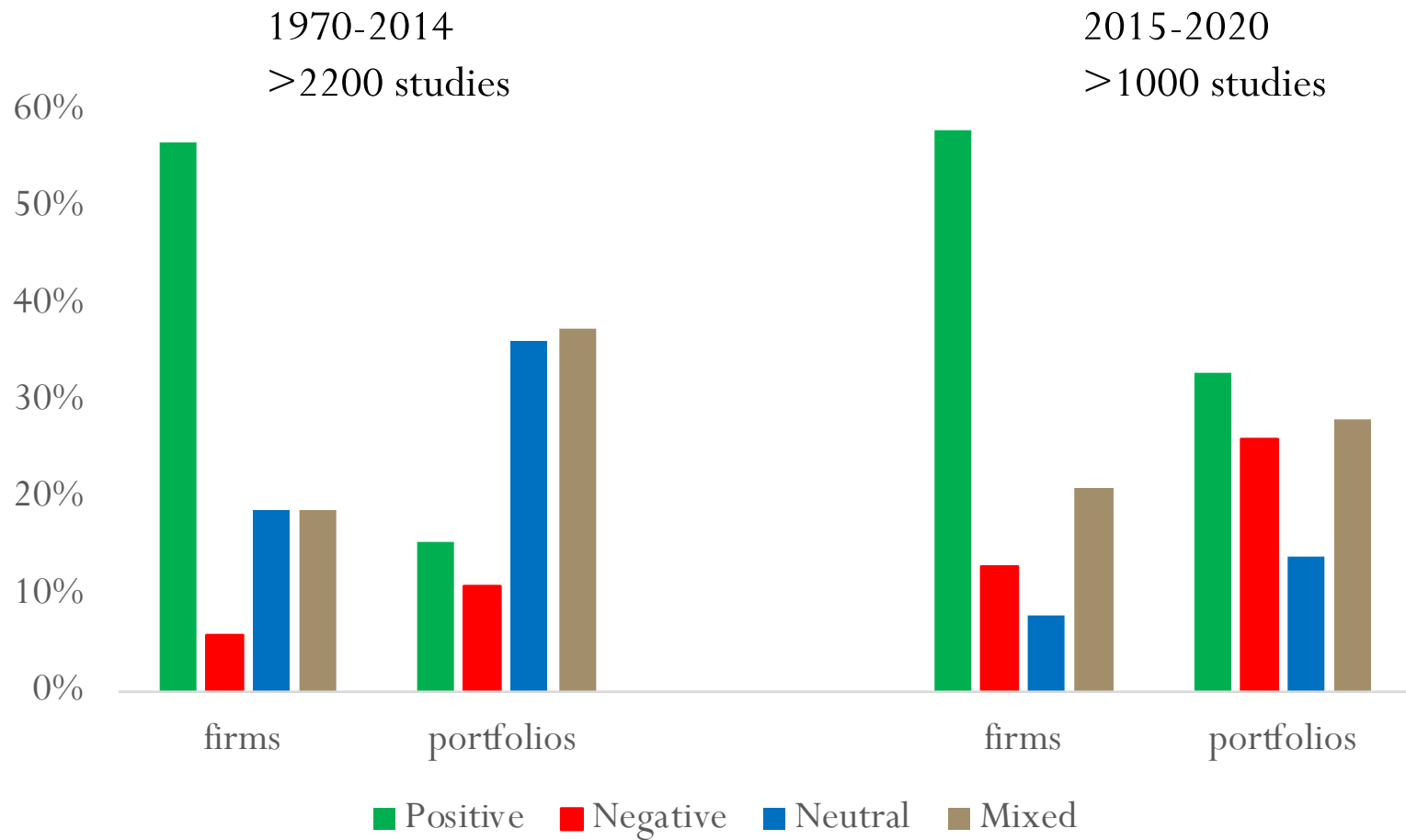
- If using Exclusion consider reporting on:
  - Sectors/business types/firms excluded
  - Number of firms eliminated
  - Which firms eliminated for controversies
  
- If using an ESG ranking system, consider reporting on:
  - 3<sup>rd</sup> party ratings
    - If possible, use at least 2
    - Interpret the ratings for the investors
  - Own proprietary system
    - Explain the system

# Reporting on portfolio ESG qualities

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- If using ESG integration process
  - Explain integration system
- If using Engagement
  - Explain engagement process and success (not necessarily naming firms)
  - This is particularly important if holding low-ranked ESG firms

# Meta Analyses of ESG Performance Studies



Friede, Busch and Bassen (2015)  
Journal of Sustainable Finance & Investment



Whelan, Atz and Clark (2021)  
NYU Stern Working Paper

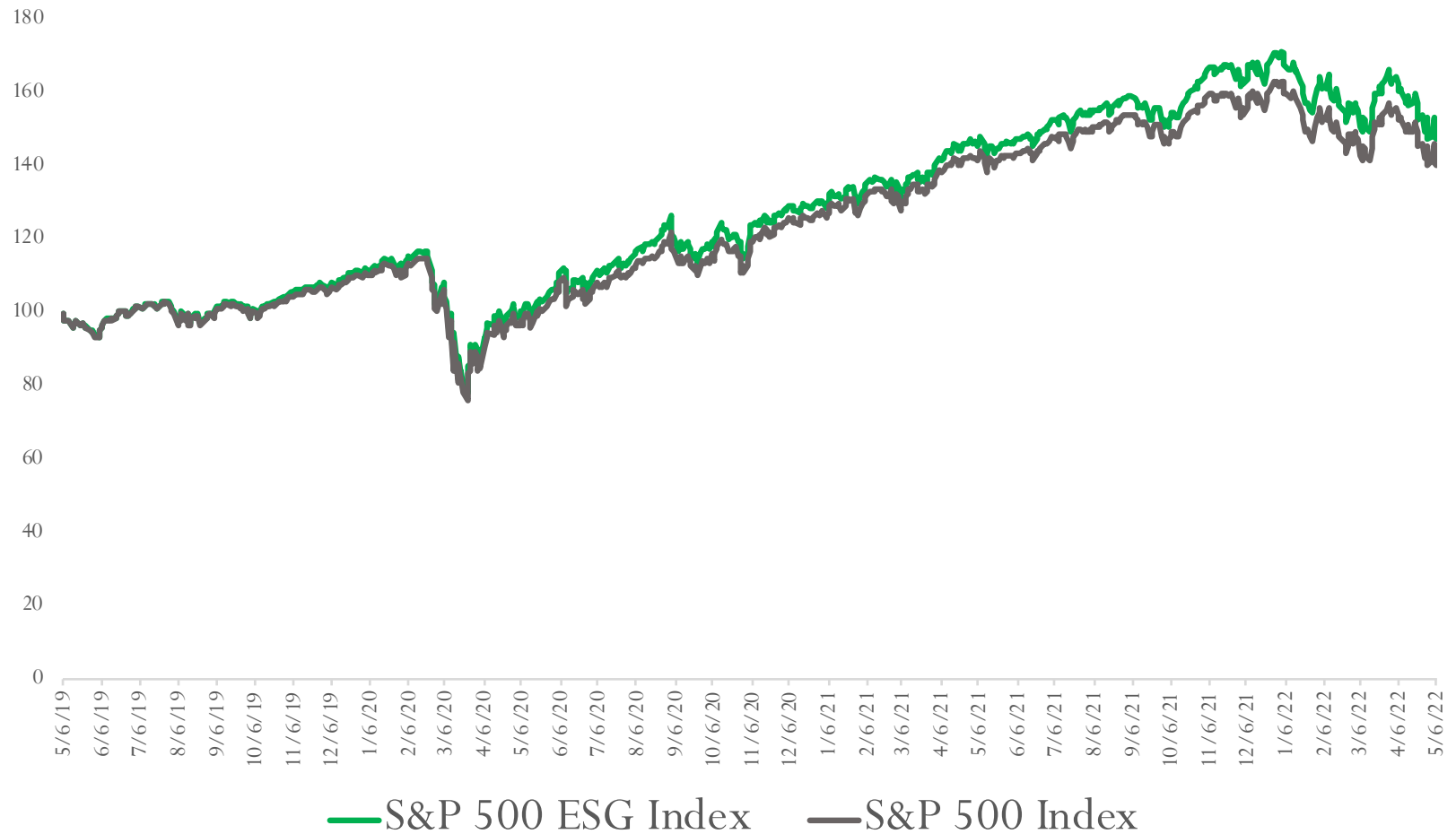
# ESG and performance

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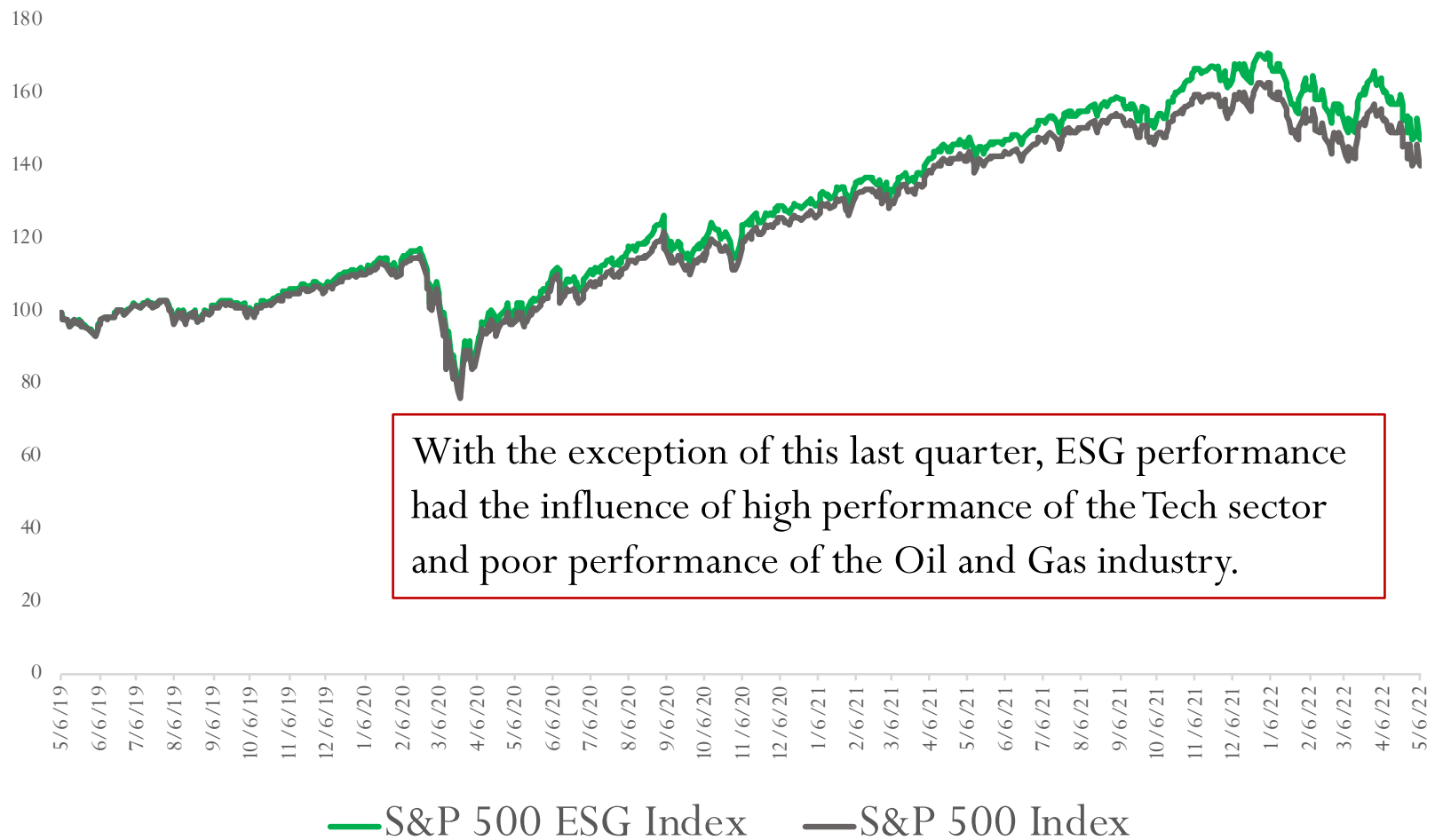
- Need clarity on the definition
- Evidence is mixed, resulting in very diverse opinions from both practitioners and academics
  - People have a tendency to interpret evidence according to their own beliefs.

# Performance of S&P 500 ESG Index versus S&P 500 Index over last 3 years

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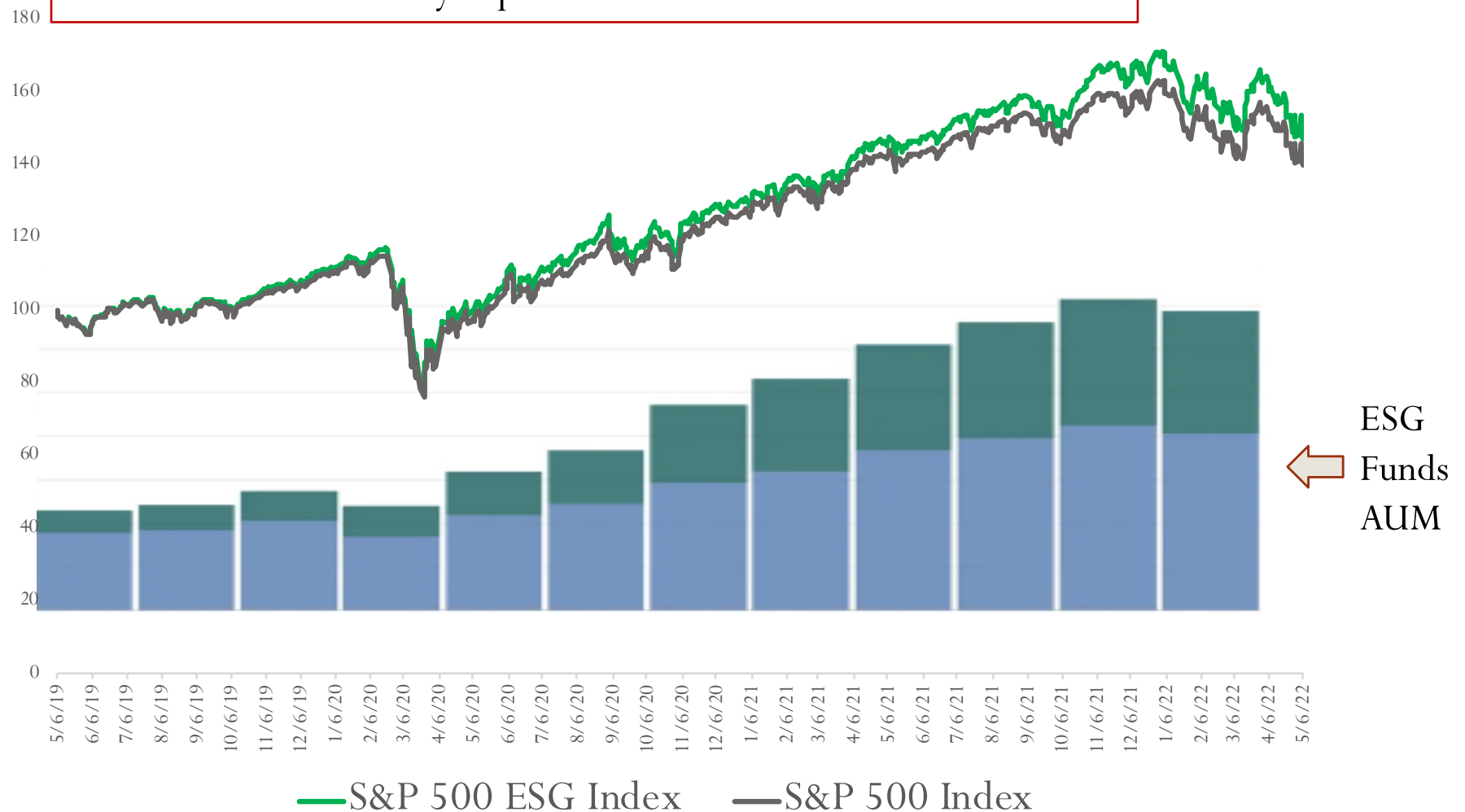
# Issues on ESG performance I





# Issues on ESG performance II

As pointed out yesterday by Lubos and by Anna and in their research, flows into ESG funds may explain the differences in returns



# Issues on ESG performance III

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- Reverse causality?
  - Do firms with higher ESG profiles have greater firm performance because of their ESG activities?
- Or
  - Do firms with greater firm performance have the resources to conduct more ESG activities and thus have a higher ESG profiles?
- Should E,S, and G be combined in measuring performance? Some of the studies examined ESG, some SRI, some E, S or G.
- One difference between the firm results and the portfolio results is that the firm results do not have the themed SRI portfolio influence.
- Measuring ESG is difficult and the ratings are noisy, resulting in biased performance analysis. (Berg, Koelbel, Pavlova, and Rigobon, 2021)

# Conclusions

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- What ESG investing means depends on the context.
- *ESG values* implies that non-financial factors are important
- But *ESG value* implies that the E, S and G activities can be financially material, particularly for long-term investors.
  - Risk management and return opportunities, including engagement
- Considerations on what investment approach to take, how to measure the ESG quality of a portfolio, how to report on the ESG quality of a portfolio and the relation between ESG qualities and performance depends on which context is important to the investors.