Considerations on ESG Investment Implementation

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Growth in institutional investor interest in ESG

Principles of Responsible Investing (PRI) Signatories

- Assets under management (US$ trillion)
- Number of AOs
- Number of Signatories

Graph showing the growth over time.
Quarterly flows into U.S. sustainable funds

Source: Morningstar Direct, Manager Research. Data as of March 2022.
What is a sustainable or ESG investment?

- 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

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?**

<table>
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<tr>
<th>Positive Portfolio Tilt</th>
<th>Exclusion/Divestment</th>
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<tr>
<td>• Weight problematic ESG firms less</td>
<td>• Do not hold security at all; avoid complicity</td>
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<td>• Can engage and vote on proxies to pressure for better ESG</td>
<td>• Can’t engage or vote proxies</td>
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<td>behavior</td>
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<td>• Allows for diversifying across sectors</td>
<td>• Higher tracking error based on mechanical decision</td>
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Beyond exclusion, consider shorting?

- 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

Palazzolo, Pomorski, and Zhao, 2020; AIMA, 2020; Asness, 2021
Increasing number of sustainable finance policies and regulations across 86 countries

https://www.unpri.org/policy/regulation-database
Reporting on portfolio ESG qualities

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

- 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:
  - 3rd 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

- 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

- 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
Issues on ESG performance I

With the exception of this last quarter, ESG performance had the influence of high performance of the Tech sector and poor performance of the Oil and Gas industry.
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

- 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

- 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.