Verus

# Integrating ESG into active portfolios

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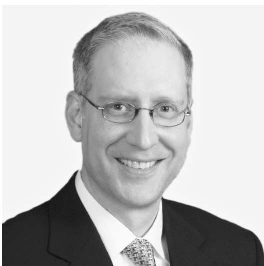

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## Summary

*As more institutional investors consider environmental, social, and governance (ESG) issues in their investment programs, Verus believes our role in the ESG discussion should focus on understanding how investment managers integrate ESG into their decision-making process, how ESG-related decisions are expressed in portfolios, and, ultimately, how these decisions impact client outcomes.*

## Introduction

In this paper, we address how environmental, social, and governance (ESG) considerations are integrated into our manager research process. We address Verus' approach to ESG issues when advising clients and link that to what ESG due diligence looks like in researching investment managers. Next, we consider the spectrum of ESG integration as defined by the primary objective of the product. Finally, we address the challenges that ESG considerations pose for hedge fund managers and private equity general partners.

### Verus' ESG viewpoint

In "The Judgmental Waiter," a Verus *Sound Thinking* piece from earlier this year, we established that our neutrality in the ESG discussion is essential to letting our clients freely implement their ESG beliefs in their portfolios without imposing our own viewpoints.[1] We recognize that our clients' views on ESG are manifold and diverse. Some may hold strong opinions

that ESG has no place in an investment program, while others may hold equally fervent views that ESG issues are integral to their organization's mission. As an objective advisor, it is prudent for us to approach ESG issues from the standpoint of neutrality. In researching investment managers, our role is to understand a manager's capabilities, to identify differentiated products in the marketplace, and to focus our attention on the aspects of an investment product that are critical to a manager's value proposition. Therefore, understanding a manager's consideration of ESG issues as part of their investment process – to the extent that such consideration is given – is a significant component of Verus' manager research effort.

### Managers' ESG objectives

Why would a manager employ ESG in their investment process? According to a 2015 guide on ESG investing, produced by the CFA Institute, ESG issues are worthy of investment professionals' attention because "systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions."[2] Specifically, risk management is often mentioned by investment managers as a justification for considering ESG as part of their investment management process. This is consistent with the literature on ESG issues, which often characterizes ESG primarily in terms of risk factors.

There are six primary types of ESG investing strategies that managers employ to implement ESG considerations in their decision-making process. As these methods are not mutually exclusive, managers may employ them independently or in various combinations.

1. **Exclusionary screening** is the oldest and most straightforward ESG method – it is also known as negative screening. As the name implies, exclusionary screening refers to avoiding securities of companies or countries based on specific ESG criteria. For instance, excluding stocks of companies connected to alcohol, tobacco, or gambling products or services, or avoiding securities due to ethical, human rights, or environmental concerns.

2. **Best-in-class selection** is an investment style that focuses on companies with strong or improving ESG metrics relative to industry or sector peers. Unlike the exclusionary screening method, best-in-class selection does not exclude entire categories of securities. Best-in-class selection is also known as positive selection or positive alignment.

3. **Active ownership** refers to employing shareholder power to influence the activities or behavior of investee companies. Corporate engagement and proxy voting are the two primary tools for this approach. Note that active ownership is not necessarily synonymous with activist investing, as the latter tends to be a more aggressive and confrontational approach to advocating change.

4. **Thematic investing** refers to focusing investments on themes or assets that address specific issues related to ESG, such as clean technology, renewable energy, food, water, education, health care, and agriculture. A thematic investing approach focuses on expected long-term trends that may be social, industrial, or demographic in nature.

5. **Impact investing** involves investing with the primary goal of achieving specific and measurable social or environmental benefits in addition to a financial return. In fixed income, green bonds and social impact bonds, which finance environmental and social projects, respectively, are examples of dedicated impact investment vehicles.

6. **ESG integration** refers to explicitly considering a range of sustainability and ESG-related risks and opportunities in concert with traditional financial analysis. ESG integration is meant to create a more holistic approach, where ESG information is used throughout the investment process, from security selection and valuation to portfolio construction and risk management.

### Review of the literature

Do sustainable investment strategies add value? To date, results from academic research and industry studies are mixed on whether ESG decisions help or hinder investment performance. In fairness, it is probably too early to make dispositive claims on the existence of an ESG premium, either positive or negative. For instance, in a survey from 2008, Renneboog, Ter Horst, and Zhang found little evidence that the risk-adjusted returns of socially responsible investment funds in the United States and the United Kingdom differed significantly from that of conventional funds.[3] Later in 2008, the same researchers released a broader survey, drawing from a larger global sample, that concluded sustainable and responsible investment funds had negative alphas; however, their underperformance was not statistically different than their conventional counterparts.[4]

In 2015, Friede, Busch, and Bassen published a meta-analysis of 60 review studies that combined over 2,200 unique primary studies dating back to the 1970s. The authors reported that 90% of the studies showed a non-negative correlation between ESG investing and financial performance, 63% of the studies reported a positive correlation, and just 8% reported a negative correlation.[5] That said, many caveats and systematic factors are behind these results, so it is difficult to establish a high degree of conviction in the conclusions from the meta-analysis.

In a paper published in 2016, Khan, Serafeim, and Yoon found that firms with good ratings on material sustainability issues outperformed those with low ratings.[6] Finally, recent research from BlackRock and Bank of America pointed to the outperformance of ESG investments relative to their conventional counterparts during the coronavirus-related market plunge in early 2020.[7,8]

Regarding research that indicates ESG decisions positively impact investment performance, there is an ongoing question of causation versus correlation. That is, do companies with strong ESG ratings outperform because of their focus on ESG, or do they achieve superior financial results because a solid ESG profile is a by-product of a high-caliber company? While the literature suggests that some managers may be able to generate positive outcomes from the inclusion of ESG factors in their investment process, it will take time – likely multiple market cycles – for the nature and scale of any ESG premium to be properly and robustly determined.

**Verus' approach to researching ESG for use in actively managed portfolios**

Our goal is to provide our clients with tools to consider ESG issues according to their views. As stated above, we believe our role in the ESG discussion is to remain neutral. As a firm, we do not have ESG preferences influencing our view – Verus' conviction concerning a product (i.e., our assessment of its investment case) is independent of ESG integration. Verus does not express an opinion on an investment firm's approach to ESG, although we consider the ESG resources provided by the firm. We also recognize there can be a correlation between ESG considerations and various more traditional factors, such as quality. Furthermore, we acknowledge that it is challenging to verify ESG as an explicit direct driver of alpha.

As introduced in "AEIOU > PPPPP," our *Topics of Interest* paper from earlier this year, Verus' manager research framework is structured around a key set of principles that reflect our core research beliefs.[9] To emphasize a differentiated focus, we deliberately define these principles based on the five vowels (AEIOU) – alignment, edge, implementation, optimal use of risk, and understandable performance – as opposed to the traditional manager research Ps (i.e., people, process, price, performance, etc.). Essentially, the Vowels concept is meant to focus our attention on a product's differentiators rather than merely its descriptors. When evaluating an investment strategy, while we certainly endeavor to learn about its various inputs, we are more interested in how these inputs work in combination to consistently meet a strategy's investment objectives. As a result, Verus' emphasis is on the outputs rather than the inputs.

Verus' five-principle Vowels framework is summarized in the table below.

| “Vowel” | Description |
|---|---|
| **Alignment** | — Alignment reflects how a strategy is supported by stable organizational, incentive and team structure<br>— Alignment influences an organization’s ability to attract and retain talent |
| **Edge** | — Edge reflects an articulation of an inefficiency or market-based belief and a willingness to assume risk based on that belief |
| **Implementation** | — Implementation reflects an investment approach that is sensible and repeatable |
| **Optimal use of risk** | — Optimal use of risk reflects an effective framework of assessing, exploiting and managing risk inherent in the investment process |
| **Understandable performance** | — Understandable performance reflects historical and future performance sensitivities that are consistent with a manager’s expressed process |

For managers who explicitly consider ESG issues in their investment process, using the Vowels framework as a guide, we specifically look for ways that they differentiate their approach from peers who manage without such considerations. When speaking with managers about their approach to ESG, we believe an organic “ask, then listen” framework is more fruitful than a checklist-driven, prescriptive one. Our goal is to understand how a manager integrates ESG in his or her process, how ESG-related decisions are expressed in portfolios, and, ultimately, how these decisions impact client outcomes.

| “Vowel” | Examples of full ESG Integration |
|---|---|
| **A** | — Firm actively promotes ESG principles<br>— Incentive compensation is ESG-aligned |
| **E** | — ESG features in product’s stated objective<br>— Product is differentiated from peers based on ESG approach<br>— Product’s “ESG-ness” is obvious to a client |
| **I** | — ESG principles explicitly incorporated in security analysis and valuation |
| **O** | — ESG elements are critical to portfolio construction and risk management<br>— Manager can cite multiple examples where ESG considerations influence active risk decisions |
| **U** | — Performance attribution reflects ESG elements or portfolio success is measured based on ESG elements or manager can demonstrate the ESG impact on return |

As we work through this process, we are watchful for dissonance. For instance, an investment firm may profess a strong commitment to ESG issues and widespread integration across its platform; however, evidence of this commitment might be lacking at the individual product level. We are also mindful of managers who profess to not explicitly integrate ESG, but who may still employ ESG elements in their investment process — a strong focus on governance, for instance.

### Special ESG considerations and challenges for hedge fund and private equity managers

As interest in ESG-related investments has grown, hedge fund and private equity managers have generally lagged their more-traditional counterparts in terms of ESG implementation. Below, we highlight some of the obstacles and challenges that alternative investment managers face when considering embedding ESG considerations into their investment process.

#### Hedge Funds

In a joint research effort involving KMPG, CREATE-Research, AIMA, and CAIA, a recent survey found that only 15% of hedge fund managers would classify themselves as being in the "mature" phase of ESG implementation, where ESG factors are embedded across their strategies via appropriate policies, committees, research, and data.[10] That said, the study found that three-quarters of surveyed managers were either in the "in progress" (44%) or "awareness-raising" (31%) phase of ESG implementation. When asked to identify the biggest obstacle to making ESG-oriented investment decisions, the lack of quality and consistent sustainability data was cited by the majority of respondents (63%).[11]

In addition to concerns about the availability and reliability of data, other studies cite the hedge fund industry's long-standing focus on unconstrained alpha as an obstacle to ESG integration. Essentially, managers are skeptical that they can justify narrowing their investment opportunity set, especially while operating in an absolute return framework.

Another wrinkle is the philosophical debate on whether short selling is appropriate for ESG-oriented portfolios. For instance, in December 2019, Japan's Government Pension Investment Fund (GPIF) announced that it would prohibit lending its global equity shares to short sellers, arguing that short selling is a short-term mindset that runs counter to GPIF's commitment to long-term sustainability.

#### Private Equity

Like their hedge fund counterparts, private equity general partners cite data issues as one of the biggest obstacles to wider ESG adoption within their industry. For instance, a recent study by Intertrust highlighted the three biggest challenges to implementing ESG programs at the portfolio company level as (1) quantifying and monitoring the ESG implementation process; (2) cost and resource constraints; and (3) complexity of managing multiple sources of ESG data.[12]

Tangentially, there is also the issue of disclosure requirements. As the name suggests, most private equity-owned companies have never been public, and they tend to be smaller than the average public firm. As a result, the vast majority of private equity-owned companies have not been held to non-financial disclosure requirements and often do not have the resources, expertise, or propensity to produce a sustainability report.

## Conclusion

For managers who explicitly consider ESG as part of their investment process, we believe a principles-based approach to manager research helps focus our attention on a strategy's differentiators rather than merely its descriptors. Our goal is to understand how managers integrate ESG into their decision-making process, how ESG-related decisions are expressed, and, ultimately, how these decisions impact our clients' portfolios.

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## Notes & Disclosures


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11. *Ibid.*
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