Verus

ESG & asset allocation

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Summary

Environmental, social, and governance (ESG) investing has come into the spotlight and is among the topics that many investors and their constituents are regularly discussing and contemplating. In this paper we acknowledge the common practice of applying ESG values at the security-selection level, and ask whether an additional focus on ESG integration within asset allocation decisions may help to increase an investor's total desired influence. As this type of investing mindset gathers momentum, we believe investors who have chosen to take into account ESG issues while building their portfolios should consider a more holistic integration into broader asset allocation decisions.

Introduction

In managing portfolios, we know that broad asset allocation, or "beta", decisions tend to have the greatest effect on absolute performance. Broad beta allocations are typically the most consequential decisions that are made in portfolio construction and have the greatest impact on where dollars are invested. Looking at this effect through an ESG lens raises the question of whether investors may be missing out on potential ESG influence by leaving these beliefs out of broader portfolio asset allocation decision-making.

In summary, we believe investors in many cases have the opportunity to have a larger total impact by integrating their ESG beliefs into the asset allocation process. First, we will discuss why asset allocation decisions may present such a great opportunity. Next, due to the potential complexities of ESG investing, we will divide ESG considerations into

layers to help simplify the decision-making process. Using this framework, we will demonstrate why expanding ESG implementation to broader asset allocation decisions may lead to interesting discoveries—perhaps opening the door to new avenues for making positive impact, or even to the realization that an investor's asset allocation decisions are somewhat opposed to their overarching ESG objectives. Overall, we hope that this assists investors in ESG decision-making, and provides a framework for higher-level portfolio discussions.

As always, when discussing the topic of ESG we feel it is important to preface the conversation by reiterating our neutrality with respect to views on specific issues. We recognize that our clients' views on ESG are diverse, and our neutrality is essential in letting our clients freely implement their own respective ESG beliefs, in their own respective processes. Please see our CIO Ian Toner's *Sound Thinking* paper "The Judgmental Waiter," for additional details on this perspective[1].

Asset allocation has the greatest impact on portfolios

Broad asset class decisions tend to have the greatest impact on where dollars are invested, and therefore will likely also have the greatest impact on performance. It is reasonable to expect that the more dollars that go towards an ESG decision, the more influence this decision will have. If ESG decisions are only being made across a single asset class (equities) and are mostly centered on a home market (such as the United States) which is only one part of the total portfolio, then the remaining parts of the portfolio are likely not working to further the investor's ESG objectives.

This effect is compounded for those investors who reside in a home market that is a developed economy and who focus most of their ESG efforts within that market. The United States, for example, ranks very highly in terms of pollution reduction[2], personal freedoms of citizens[3], LGBT rights[4], and environmental protections[5]. It may be reasonable to ask whether other country exposures in the portfolio—for example, in parts of the world which score very poorly on an investor's preferred ESG metrics—could provide additional possibilities for high positive impact. We do not in any way mean to suggest that the United States is perfect on any of the issues listed above—fighting for change at home is a noble and worthy cause. At the same time, the opportunities for enacting change outside of the United States may be more significant, or much more significant, depending on an investor's specific ESG goals. We recognize that many investors integrate ESG decisions across many parts of the portfolio outside of U.S. equity—this U.S. example is for illustrative purposes only.

It is important to note that in most cases it will not be economical, or even possible, to apply ESG screens to 100% of portfolio exposures. Deciding on sensible ESG screens for certain asset classes, such as cash or commodities, can introduce additional complexity. Furthermore, if there are few available skilled active ESG managers in an asset class, an investor will need to take this into account while deciding whether to pursue ESG integration within that asset class. We do expect that as ESG investing evolves, a greater number of highly-skilled active managers will pursue ESG strategies across the asset class spectrum.

With an asset-allocation approach to ESG, more layers are added to the decision

ESG implementation into broader asset allocation decisions is an arguably novel and less-charted exercise at this point in time. Some of the questions raised throughout this process may not yet be answerable, but continuing to ask them is an important step towards gaining a more holistic understanding of the ESG implications of a portfolio's construction. We believe separating an asset allocation-based ESG approach into layers can help add clarity to the process. We hope the layers below provide a roadmap:

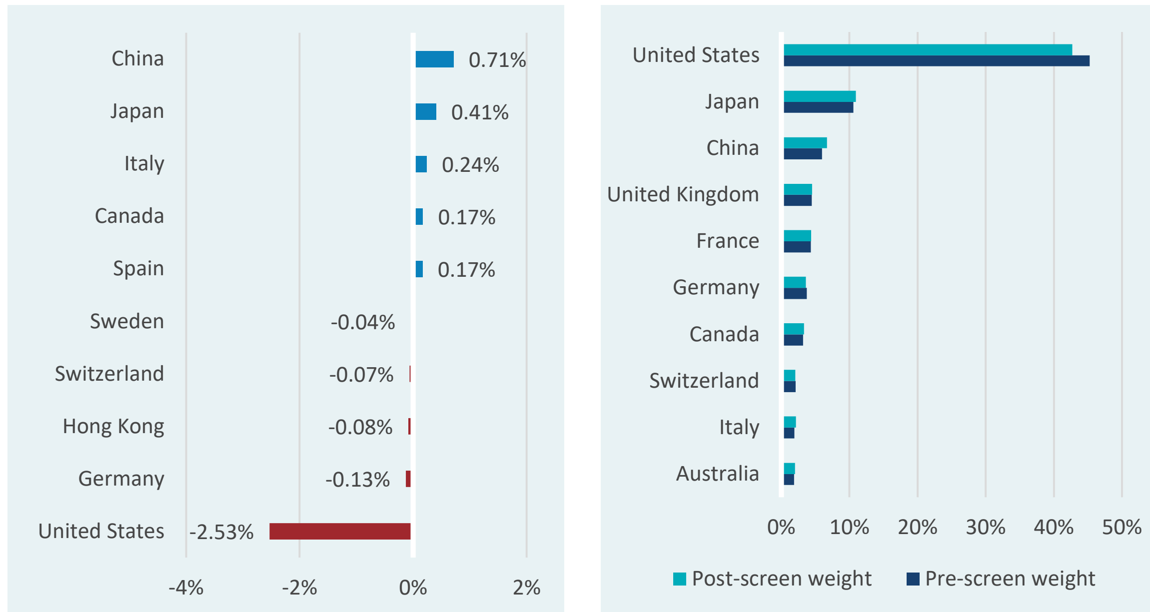
LAYER #1: WHERE ARE YOU INVESTING, AND WHERE ARE YOU NOT?

This layer aims to provide a 30,000-foot perspective of ESG factors and the extent to which they are considered around the world. It is unrelated to specific ESG strategies, products, and their availability. If an investor's primary tool for enacting positive change is through their decided dollar allocations, security-level decisions could be making a fairly-minor impact compared to the impacts of the investor's overall allocation to a region or asset class[6].

What are an investor's core ESG beliefs and how do these compare to where the portfolio is invested? If those core beliefs revolve around environmental sustainability, but the portfolio contains significant exposure to countries with outwardly poor environmental practices and compliance, is this acceptable? There may not be a right or wrong answer to this question. The goal of this layer is to illustrate that ESG-related portfolio construction decisions can lead to shifts in relative allocations which may or may not fit within an investor's overall mission.

It may be tempting to try and use traditional *security-level* exclusionary screens to determine appropriate broad market weights during this exercise. However, that approach may have unintended consequences and is not likely to produce attractive results. First, the availability of ESG data can be vastly different across various markets around the world, which means that a country might appear to score very well along a given ESG metric not because that market is full of good actors, but because there is not adequate reporting and transparency. Second, it is possible that data on individual corporations and their practices does not tell the whole story about a country or region's behavior. For example, if a market is overseen by a government that commits egregious human rights abuses, *security-level* ESG data may not capture this detail. In reality, investments in this market may provide funding to that government and assist in perpetuating poor behavior. In other words, more holistic market-level ESG data may be needed for the investor to correctly determine an appropriate total exposure to each market. For illustrative purposes, below we show the approximate country weight of a global 60-40 portfolio before and after the application of a Catholic values-focused *security-level* screen[7]. Also provided are the five countries whose allocations in the global 60-40 grew and shrunk the most as a result of the implementation of this screen.

SINGLE STOCK CATHOLIC SCREEN ON GLOBAL 60/40



Source: MSCI ESG Manager, Verus

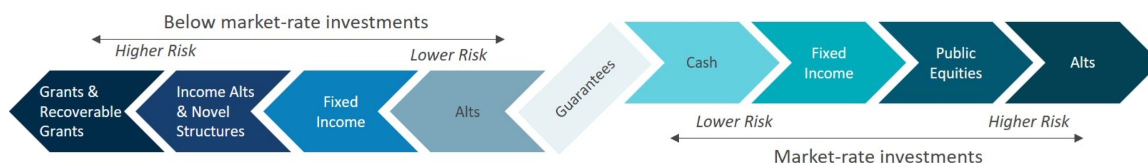
If an investor were to apply this stock-specific Catholic-values exclusionary screen, the portfolio impacts would include a meaningful underweight to the United States, and a slight overweight to China, Japan, Canada and Spain, relative to benchmark. It might be difficult to argue that these country overweights and underweights would necessarily align very closely with the goal of furthering Catholic values. It is worth noting that the outcome of a security-level ESG screen used in this way (which as we have explained, we do not recommend) would likely vary based on which ESG tool is used and which screens are applied.

LAYER #2: WHAT IS AN INVESTOR'S ESG OPPORTUNITY SET AMONG ASSET CLASSES IN THE PORTFOLIO?

Certain asset classes may better lend themselves to ESG screening and analysis, and other asset classes may not be feasible due to lack of data, transparency, and/or due to a limited (or nonexistent) product universe. This leads us to an important distinction—if investors possess enough time, resource, and willingness, ESG integration into most corners of the portfolio may be possible. Instead of traditional cash exposure in the portfolio, for example, an investor may pursue local small sustainable business development, targeted lending for underserved communities, or perhaps supporting organic farming and fair-trade produce. Instead of traditional exposure to commodities, an investor may decide to trade carbon credits, or may make targeted investments in biofuel production with the goal of positive environmental impact. However, these esoteric ESG strategies often require a considerable tolerance for higher portfolio tracking error and/or peer risk, might require the investor to accept below-market returns (see graphic below), and may require a significant amount of

board time and energy.[8] Additionally, many strategies may be smaller and more localized, which could introduce capacity concerns for larger institutional investors. The capabilities and depth of knowledge of the investor's advisor will also play a role.

ESG INVESTMENT STRATEGY SPECTRUM



Source: Heron Foundation

Verus possesses decades of experience in advising on the more obscure corners of the ESG marketplace, and the advice offered has been in most circumstances highly customized to the needs of each client and their situation.

LAYER #3: WHICH STRATEGY FOR ESG IMPLEMENTATION MAKES THE MOST SENSE?

As an investor begins to close in on ways in which they will work towards positive change, it will be important to decide on a specific ESG approach for each exposure. Might it be more impactful to pursue a thematic approach, focusing investing on trends? An example would be to invest in firms involved in water production, desalination, and transport. Or would it be preferable to pursue a lower tracking error approach such as applying a simple negative screen with the goal of removing those companies tied to polluting water sources? These considerations may create a feedback loop to Layer #1. For example, a targeted thematic investment approach within a given asset class might lead to the decision to *increase* rather than *decrease* investment in a country or region with overall poor practices. On the other hand, a beta approach to ESG such as the utilization of positive or negative screens may lead an investor to think carefully about their total exposure to various countries and regions around the world. As we have mentioned before, portfolio-level asset allocation decisions tend to have the greatest influence on where dollars are invested.

DECIDING THE INTENT OF AN ESG INVESTMENT

LAYER #4: HOW DOES AN INVESTOR ENSURE CONSISTENCY IN THEIR IDEOLOGICAL APPROACH TO ESG?

This layer requires an investor to think holistically about their portfolio structure, their ESG values and approach, and whether the two are consistent. Oftentimes, investors might be making asset allocation decisions without contemplating the ESG implications of those decisions.

- Consider the board of trustees of a multiemployer pension plan which chooses not to invest in U.S. companies with poor labor practices. How should this board approach investment in another country that is characterized by very poor worker rights, safety practices, and the utilization of child, or even forced labor?[9] How should the lowest-scoring (on a labor practices screen) companies in a high-standards market be assessed relative to the highest-scoring companies in a generally low-standards market?

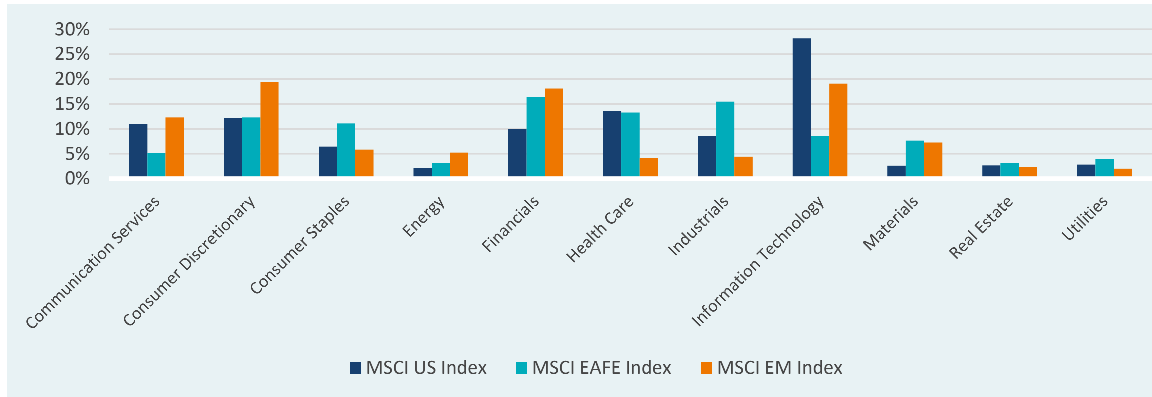
- How should investors whose primary ESG interests center around the environment approach the emerging market debt space? Certain emerging market economies have exhibited poor environmental practices such as vast deforestation. Might withholding capital from these countries send a message regarding realignment of the country's modus operandi with respect to resource extraction?

These issues are far from black and white, and at the end of the day each investor must make their own judgments on the wide-ranging implications of their ESG-related investment decisions. Our goal with this layer is to point out that a more holistic *asset allocation* approach to ESG may shine a spotlight on some of these possible inconsistencies. Divesting from certain assets necessarily means investing in others, and investors should spend equal time and resource in assessing both of those decisions. The result, we believe, may be greater influence and a better alignment of investment practices with ESG beliefs.

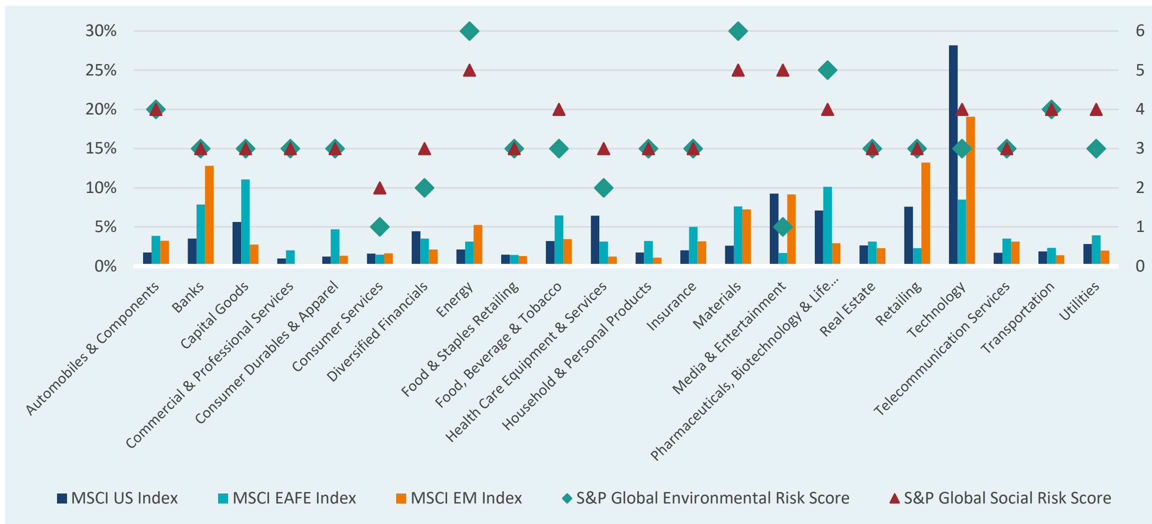
LAYER #5: WHAT ARE THE SECTOR/FACTOR IMPLICATIONS OF THE DECIDED ESG APPROACH?

Major U.S. equity indices differ considerably in terms of sector and industry group concentration, relative to international developed and emerging market stock indices. Investors should expect that meaningful changes to the portfolio resulting from ESG decisions will create tilts (imbalances) into and out of specific sectors and industry groups, which could materially impact relative performance. Below we outline those sectoral imbalances, and explore several examples of possible outcomes:

SECTOR ALLOCATIONS



INDUSTRY GROUP ALLOCATIONS

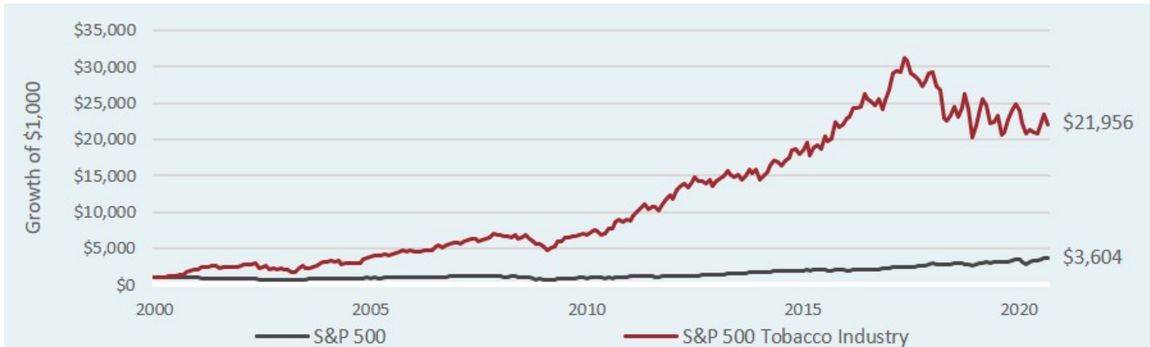


**Approximated GICS industry group ESG risk based on S&P Global's ESG Risk Atlas.*

— An investor may decide to reduce their exposure to entire countries or regions with ethical violations. These violations might include the persecution of religious and ethnic minorities, or state surveillance/censorship, or discrimination against women. Resources that can assist in these decisions include: Transparency International's *Corruption Perceptions Index*[10], Freedom House's *Freedom in the World study*[11], and the World Economic Forum's *Global Gender Gap Report*[12]. These types of broader asset allocation decisions will have implications for total portfolio returns and tracking error.

— Seemingly simple decisions to divest from certain companies, industries, sectors, or even countries, can create tracking error in the portfolio. Divestment from "sin stocks", for example, which traditionally include weapons, alcohol, gambling, and tobacco, will change

the composition of a portfolio and can lead to performance differences from the portfolio benchmark. If these exposures subsequently outperform, such as has been the case for the tobacco industry (shown below) for decades, an investor may underperform their benchmark.



— A decision to divest from fossil fuels may result in a significant underweight to value stocks which often reside in the Energy and Materials sectors. If value subsequently outperforms, this may lead to portfolio underperformance, whether originally intended as a value bet or not. As shown below, the effects of these positions can be notable, depending on the economic environment.

Conclusions

Investors have increasingly integrated their personal beliefs into the investing process. Environmental, social, and governance (ESG) mindful investing has entered the zeitgeist and many investors and their constituents are now regularly discussing its implications. This type of investing is very personal, and institutional investors must decide whether ESG is appropriate for them and what values their constituents might espouse.

In summary, we believe there may be opportunities for investors to have a greater global

influence by integrating their ESG beliefs into the asset allocation process. First, we discussed why asset allocation decisions could present a great opportunity to generate impact. Next, due to the potential complexities of ESG investing, we helped divide ESG considerations into layers to simplify the decision-making process. Using this framework, we demonstrated why expanding ESG implementation to broader asset allocation decisions may lead to interesting discoveries—perhaps opening the door to new avenues for making positive impact, or even to the realization that an investor's asset allocation decisions are somewhat opposed to their overarching ESG objectives. Overall, we hope that this research paper assists investors in their ESG decision-making process, and provides a framework for higher-level portfolio discussions.

For additional information regarding our insights into ESG and the integration of beliefs into the investment process, please reach out to your Verus consultant.

Notes & Disclosures

1. *Toner, Ian. "The Judgmental Waiter: Who Decides? ESG in Institutional Investing." Verus Sound Thinking, March 2020*
2. *IQ Air, World's Most Polluted Countries 2019. https://www.iqair.com/us/world-most-polluted-countries*
3. *Cato Institute, Human Freedom Index. https://www.cato.org/human-freedom-index-new*
4. *World Economic Forum, ILGA. https://www.weforum.org/agenda/2015/06/which-countries-have-the-most-equal-lgbt-laws/*
5. *Yale, Environmental Performance Index (EPI). https://epi.yale.edu/downloads/epi2018policymakerssummaryv01.pdf*
6. *Brinson, Hood & Beebower, Financial Analysts Journal, 1986*
7. *Screens included business involvement with abortion, adult entertainment, cluster bombs, contraceptives, firearms, global weapons production, landmines, and tobacco.*
8. *Often among the scarcest of resources.*
9. *In the United States, the Fair Labor Standards Act (FLSA) sets 14 years old as the minimum age for employment and limits the number of hours worked by minors under the age of 16 years old. However, it is possible to conceive that for some under-16-year-olds in the rural families of our frontier economies, moving into the city to pursue an industrial job may offer certain quality-of-life improvements, and opportunities for skills-development.*
10. *https://www.transparency.org/en/cpi#*

11 https://freedomhouse.org/report/freedom-world

12 http://www3.weforum.org/docs/WEF_GGGR_2020.pdf

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