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Clearing the Air:
Responsible Investment

JEFF DUNN, MARISOL HERNANDEZ,
AND CHRISTOPHER PALAZZOLO



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JEFF DUNN, MARISOL HERNANDEZ,
AND CHRISTOPHER PALAZZOLO

JEFF DUNN
is a principal at AQR
Capital Management
in Sydney, Australia.

MARISOL HERNANDEZ
is head of asset owners at
UN PRI in London, UK.

**CHRISTOPHER
PALAZZOLO**
is a principal at AQR
Capital Management
in Greenwich, CT.

KEY FINDINGS

- Although interest in responsible investment and ESG is vast, so too is confusion about what they entail.
- The authors propose a framework for responsible investment, seeking to “clear the air” for more-informed discussions.
- The framework defines both responsible asset selection and responsible ownership.

ABSTRACT: *Over the last several years, responsible investment/environmental, social, and governance (ESG) investing has gained prominence among institutional investors and indeed the broader investment industry. Asset owners have made this topic more central to investment decisions as they are increasingly concerned with both their fiduciary responsibility to deliver financial results and the nonfinancial impact on their constituents and the broader global community. Today, responsible investing’s reach is vast. However, so too is confusion around the meaning of the concept. This is unsurprising, given the many different motives for and approaches to considering ESG factors and many different opinions about exactly what they include. The authors therefore seek to “clear the air,” providing a framework of the various approaches and terms necessary to have an informed discussion and investment policy on responsible investment.*

TOPICS: *Portfolio theory, portfolio construction, ESG investing**

*All articles are now categorized by topics and subtopics. **View at [PM-Research.com](https://www.pmr-research.com).**

Over the last several years, responsible investment¹ has gained prominence among institutional investors and indeed the broader investment industry. Asset owners have made this topic more central to investment decisions as they are increasingly concerned with both their fiduciary responsibility to deliver financial results and the nonfinancial impact on their constituents and the broader global community.

Buoyed by this prioritization, ESG investing is now a common area of focus within traditional investment strategies and is a rapidly growing new product category in and of itself. At present, ESG adoption varies by region, but research by Greenwich Associates found that, of global investors not yet incorporating ESG, nearly three-fourths are considering incorporating it into their investment portfolios (Greenwich Associates 2018).

¹Responsible investment is inclusive here of all its aliases, such as sustainable investment (SI), socially responsible investing (SRI), and ESG investing.

EXHIBIT 1

United Nations Principles for Responsible Investment

<p>Principle 1</p> <p>We will incorporate ESG issues into investment analysis and decision-making processes.</p>	<p>Principle 2</p> <p>We will be active owners and incorporate ESG issues into our ownership policies and practices.</p>	<p>Principle 3</p> <p>We will seek appropriate disclosure on ESG issues by the entities in which we invest.</p>
<p>Principle 4</p> <p>We will promote acceptance and implementation of the Principle within the investment industry.</p>	<p>Principle 5</p> <p>We will work together to enhance our effectiveness in implementing the Principle.</p>	<p>Principle 6</p> <p>We will each report on our activities and progress towards implementing the Principle.</p>

Source: UN PRI, December 2018.

Responsible investing's reach is vast. However, so too is confusion around the meaning of the concept. This is unsurprising, given the many different motives for and approaches to considering ESG factors and many different opinions about exactly what they include.

We therefore seek to “clear the air,” providing a framework of the various approaches and terms necessary to have an informed discussion and investment policy on responsible investment.

Although this guide is not exhaustive, it is our hope that this guide will provide the structure necessary for asset owners and managers alike to articulate their priorities and constructively discuss the opportunities and challenges inherent in this space.

Our framework starts with the United Nations Principles for Responsible Investment (UN PRI; Exhibit 1). The principles were developed in 2006 by a group of the world's largest institutional investors, and now more than 2,000 such investors representing more than US\$80 trillion in assets under management have pledged adherence.

Most salient here are Principles 1 and 2. Principle 1 calls for the incorporation of ESG issues in the analysis and selection of investments, whereas Principle 2 speaks to ownership practices of assets once an investment is made.

This is an important distinction: It requires signatories to consider their investment decisions on a continual basis because the responsibility of ownership carries forward for as long as an asset is held.

The principles are intentionally nonprescriptive, allowing for a diversity of solutions for ESG incorporation. However, the flexibility also affords potential confusion around the application of responsible investment without a generally agreed-on framework for constructing such solutions. We propose a framework designed to allow for the application of a multitude of approaches while adhering to the applicable principles.

RESPONSIBLE INVESTMENT FRAMEWORK

Responsible Asset Selection

Responsible investment mandates the consideration of ESG issues that may affect the long-term pricing of an asset as well as the long-term sustainability² of the issuer's business model. This is *responsible asset selection* (Exhibit 2), which manifests itself in two broad categories:

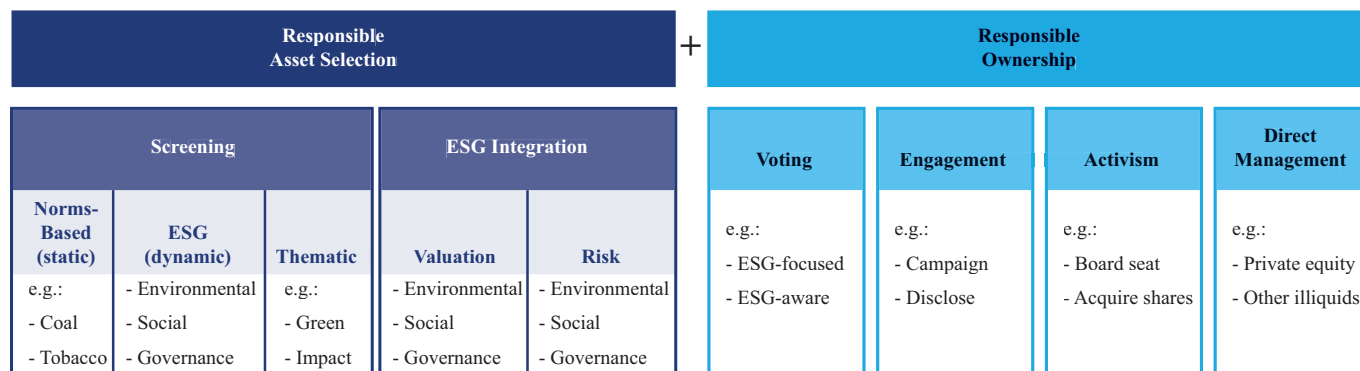
- Screening
- ESG integration

Screening. Perhaps the most common form of ESG incorporation in asset selection is **screening**, or choosing to exclude some subset of assets because they do not meet certain predefined standards. These standards

²Sustainability refers to the long-term efficacy of an asset, including its financial and nonfinancial externalities, which may be at risk of being priced-in at a future date because of public, investor, or regulatory pressures.

EXHIBIT 2

Responsible Investment Framework



Note: The framework is designed to allow for the application of a multitude of approaches.

may be based on norms (and generally static) or a more dynamic approach to ESG.

Screening is commonly associated with a **norms-based** exclusion applied to specific companies, entire industries, or other assets. This is ostensibly a simple translation of ethical values into a responsible investment policy, but it should be noted that a blanket screen approach is price agnostic. Some investors necessarily embrace this—for example, where the screened companies’ revenue sources directly contravene an organization’s mission and the investor is uncomfortable with any ownership connection (perhaps inclusive of shorting).³

Others avoid a static set of restrictions and instead apply a **dynamic ESG** approach that excludes assets based on an ESG score.⁴ This more relative approach will

³ Although theoretically the case for shorting a poorly ranked ESG name that is also expected to perform poorly from a pricing perspective is sound and may actually have a stronger impact on management than simply screening or refraining to hold it, there may be organizational sensitivities associated with profiting from a name ranked poorly on ESG, or even more so, profiting from a name in a restricted sector or industry, regardless of the position being a desire to see a fall in price, or, ipso facto, its extinction.

⁴ An ESG score evaluates a security issuer (either of bonds or equities, or perhaps other assets) on exposure to ESG factors, as defined by the ratings provider, by itself and against its peers. They are usually known in the market as ESG or sustainability ratings but are different from credit ratings; ESG scores are quantitative indicators, and methodologies vary. See the UN PRI ESG in Credit Risks and Ratings Initiative (<https://www.unpri.org/credit-ratings>) for an example of a push for transparency and consistency in this space.

exclude different companies over time given changes to their ESG policies and procedures. Dynamic ESG screens are distinguished from a pure norms-based exclusion in their comparative flexibility. Of course, the extent of the dynamism varies, and with it the prioritization of profit opportunities.

One example is a best-in-class approach, an application of positive screening. Best-in-class selects companies or industries with very strong ESG scores compared with salient peers. This can translate into a significant reduction in the investable universe. At any given point, a best-in-class strategy will only invest in the most ESG-friendly companies, which can be applied within or across industries, but it cannot follow companies on the journey some may take as they improve their ESG policies and procedures.⁵ In other words, it does not take into account momentum.

Screening may also be **thematic**, or more focused on a specific objective, and done with either a negative or positive screen. Popular examples are **green investment** (investment activities that focus on companies or projects that are committed to the conservation of natural resources, the production and discovery of alternative energy sources, the implementation of clean air and water projects, and/or other environmentally conscious business practices). Another example is

⁵ If applying a best-in-class approach without regard to industry, the result may de facto tilt the portfolio toward some industries and away from others; it may also lead to entirely exclude some industries. A best-in-class approach within industry may lead to investing in any or all industries.

impact investing (generating revenues from providers of constructive solutions for society, be they focused on issues like equality or protecting the environment). These too are forms of a positive screen and are applicable across both liquid and illiquid asset classes.

ESG integration. In contrast to screening, ESG integration is a holistic assessment of an investment's prospects using all available financial and nonfinancial data related to ESG factors. This does not ex ante preclude any investment, which is an important distinction between integration and screening. In an integrated approach, a manager may hold a company ranked poorly on ESG if the other attributes of that investment compensate for its inferior ESG profile. In other words, a security may be attractive if trading at a discount to fair value that is sufficient given possible associated ESG risks.⁶

We identify two avenues for ESG integration:

- Valuation
- Risk

This guide will not wade into the debate about whether and how much ESG affects the risk and return characteristics of an investment. However, these are two key lenses through which to view integration. With risk-adjusted returns, a key metric for upholding fiduciary duty, asset **valuation** and **risk** assessments may be made in tandem. They are generally a reflection of the issuer's health and are easily combined with existing measures that are not specifically ESG. The range of ESG measures certainly varies in specificity, and managers sometimes focus more on one (E, S, or G).

Just like strategies in the non-ESG landscape, integration here is possible on a spectrum from purely qualitative to purely score-based, or quantitative. Regardless of how it is applied, an ESG-integrated approach dynamically assesses a candidate for investment based on how it scores on various financial and nonfinancial metrics. Like a standard dynamic ESG screen, it continually considers the opportunity to adjust the investment universe as assets fluctuate in price, riskiness, and ESG friendliness. The extent to which a strategy tilts to

⁶Of course, a manager may overweight or underweight an asset based on an integrated approach to evaluating a company's ESG and financial information as well; it is not always a binary decision to hold or not to hold.

or away from companies based on ESG profile may vary, depending on preferences like tracking error bounds.

It is important to note that most ESG incorporation methodologies described here intend to align with the main objectives of the asset owner and achieve market-rate or even better returns. Whether this can be achieved depends on the quality of the investment, ESG analysis, and implementation. Some asset owners may feel that either their values or an objective to create positive real-world impact may lead them to accept slightly lower returns, which may be the case in static screening of entire industries. But that is a discretionary decision for the asset owner, as opposed to a truism about responsible investment.

Responsible Ownership

Responsible investment does not stop with a decision on asset selection. Rather, it requires awareness that there are other ways of interacting with companies to influence their business beyond just the decision to invest or not. Thoughtfulness in ownership is increasingly becoming codified, with several countries launching so-called stewardship codes that provide (soft law) expectations and guidance for investors to be responsible, active owners of the shares they hold in listed companies. The Organization for Economic Co-operation and Development guidelines for multinational enterprises, which cover global investors, also indicate the need for investors to mitigate potential negative effects of the business activities to which they are linked through their investments. Responsible ownership takes four common forms (see Exhibit 2):

- Voting
- Engagement
- Activism
- Direct management

Voting is a privilege afforded by ownership.⁷ As such it is an important responsibility for investors to ensure the appropriate policies and procedures to evaluate proxies and indeed to determine whether to vote on an issue or not. However, responsible approaches to voting vary. ESG may be the primary focus of proxy votes (ESG focused) or a factor in a broader set of

⁷Bondholders may in some cases have voting rights.

considerations (ESG aware). Voting policies may vary by account, starting with a general policy aimed at promoting good governance and undergoing ESG enhancements depending on client direction or the remit of a given fund. ESG here may be best defined on an issue-by-issue basis, and indeed the process by which voting direction is determined is a useful metric in ESG incorporation.

Voting may be related or lead to **engagement**—for instance, in case of unsuccessful votes about which the shareholder feels strongly. Engagement starts with a dialogue, and it may be a solo endeavor or a collective one (joining with similarly minded asset owners). Commonly it will relate to a portfolio company, with the aim of campaigning for change or enhanced disclosure on issues related to ESG factors. One example of an engagement activity may be promoting the advancement of UN Sustainable Development Goals, which seek to define the broad socially responsible objectives of society.⁸ This may be done through a company's investor relations department, direct to the executives running the business, or even to the board.

Sometimes investors also use the word *engagement* to refer to a preinvestment activity: speaking with a company to better understand its business, perhaps including ESG aspects. Strictly speaking, that is not an ownership activity—it precedes ownership and does not attempt to influence the company. As such, although it is a very legitimate activity, it does not qualify as responsible ownership per se.

One other form of engagement that may be undertaken is a dialogue with governmental or other regulatory bodies, often with the grander aim of promoting a financial system that incentivizes responsible, sustainable businesses and investments, often associated with a universal investor paradigm.⁹ This is also an example of responsible ownership, given the connection between this high-level dialogue and companies whose policies may need to change as a result; an increasing push for transparency is a good example. Finally, direct engagement with policymakers may be also undertaken by investors in sovereign bonds.

⁸For more information on UN Sustainable Development Goals, see <https://www.unpri.org/SDGS>.

⁹Large institutional investors may be considered universal owners because they own in aggregate a large portion of the investment universe globally.

Activism approaches may seek to effect change within a company by getting a board seat or acquiring a certain number of shares. Activism by itself does not amount to responsible ownership. That requires a commitment to promoting sustainable outcomes along ESG dimensions. When applied responsibly, activism, unlike voting or engagement, has de facto ESG integration in the asset selection stage.¹⁰ An interesting nuance is that investors who pursue ESG activism may more often deliberately invest in a company with inferior ESG characteristics if they believe it has a higher likelihood of benefiting from a positive sustainable impact or larger potential magnitude of such impact. The aforementioned approaches within the responsible ownership category all assume lack of control of the underlying organization or asset.

However, this will not always be the case, such as in private equity or indeed even in public equity if an organization or collective group have a controlling stake. Therefore, **direct management** is a fourth approach within the category, which speaks to directly effecting change in the underlying position. Of course, this may also involve other aspects of responsibility such as voting or engagement in the case of a public equity. Having enough of a position to exert direct management influence or control should afford the opportunity to manage the sustainability and improve along ESG dimensions in an efficient manner, highlighting the responsibility of responsible investors in these assets to do so.

CONCLUSIONS

Responsible investment has become increasingly important to investors globally, and the trend is likely to accelerate, with the majority of institutions that have not yet incorporated ESG into their investment process considering doing so (Greenwich Associates 2018). However, up until this point, there has not been a common framework of what responsible investment means or can entail. In fact, there are various ways that investors can customize an approach that best meets their needs while adhering to the UN PRI. In short, ESG is not a one-size-fits-all approach to investment. This framework is meant to serve as a communication tool for asset owners and managers to have an informed dialogue

¹⁰ESG-oriented activism here is distinguished from activist approaches that focus purely on share-price maximization.

about responsible investment rather than a prescriptive guide on how to apply these methodologies. Indeed, there will be many variations of how the principles will be applied within this framework, and, like many things, the details and skill in implementation matter.

We hope that our framework has clarified any confusion, and this shared language will lead to clearer communication and better results for investors.

ACKNOWLEDGMENTS

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REFERENCE

Greenwich Associates. 2018. “ESG Investing: The Global Phenomenon.” Summary, methodology, and report, <https://www.greenwich.com/institutional-investing/esg-investing-global-phenomenon>.

To order reprints of this article, please contact David Rowe at d.rowe@pageantmedia.com or 646-891-2157.

ADDITIONAL READING

The Cost of Socially Responsible Investing

TIMOTHY ADLER AND MARK KRITZMAN

The Journal of Portfolio Management

<https://jpm.pm-research.com/content/35/1/52>

ABSTRACT: In this article, the authors estimate the cost of practicing socially responsible investing. Using these results, investors may determine whether imposing restrictions on the available investment universe is the most cost-efficient method for promoting the particular social ideal. The authors design and execute a Monte Carlo simulation to compare the performance of a skillful investor in an unrestricted investment universe with the performance of the same investor in a restricted investment universe. They repeat this for a variety of skill levels and investment universes and find that the cost of socially responsible investing is substantial for even moderately skilled investors.

A Guide to ESG Portfolio Construction

MICHAEL BRANCH, LISA R. GOLDBERG, AND PETE HAND

The Journal of Portfolio Management

<https://jpm.pm-research.com/content/45/4/61>

ABSTRACT: In this article, the authors explore six quantitative environmental (E), social (S), and governance (G) strategies to provide insights into best practices for ESG portfolio construction. These strategies offer different approaches to the trade-off between desired ESG attributes and investment performance. They conclude that fully understanding the dynamics of these trade-offs will allow investors to select the strategy that best matches their ethical and financial views.

The Benefits of Socially Responsible Investing: An Active Manager’s Perspective

INDRANI DE AND MICHELLE R. CLAYMAN

The Journal of Investing

<https://joi.pm-research.com/content/24/4/49>

ABSTRACT: There has been a lot of research on the predictive power of environmental, social, and governance (ESG) ratings, the relationship between ESG ratings and subsequent stock performance, and whether using ESG data in stock analysis and portfolio management was value-additive or value detracting. In this article, the authors examine the relationship between the ESG ratings of a company and its stock returns, volatility, and risk-adjusted returns in the post-2008 financial crisis era. They explore the negative relationship between ESG and volatility in greater depth, given the well-documented low-volatility anomaly (outperformance of low-volatility stocks). Both (high) ESG rating and (low) volatility positively impact stock returns, but the ESG effect is independent of the low-volatility effect, and ESG is a positive contributor in its own right. Given the controversy surrounding the effect of ESG-based investment restrictions, the authors test the effect of restricting the investible universe by deleting the lower tail of ESG companies on portfolio performance. Asset managers can thus actively use the association between corporate ESG ratings and stock return, volatility, and risk-adjusted return to enhance their stock-picking and portfolio-construction abilities.