The Benefits of ESG Integration

Summary

- In a world where ESG concerns are more pressing than ever, investors and companies are increasingly paying more attention to ESG information as the benefits become more evident and the risks and opportunities from doing so grow.
- ESG Integration is a holistic approach to investing that incorporates material environmental, social, and governance (ESG) risk factors into investment analysis and decision-making.
- A growing body of evidence finds that those companies which pay attention to ESG concerns create long-term value, with better corporate performance (through enhanced competitive advantage and increased operational cost effectiveness) and lower risk exposure (due to enhanced risk management responses to the evolving complexity of systemic, global ESG risks).
- Companies with the very best ESG ratings (or those that are rapidly improving their ESG credentials) are better positioned to deliver improved risk-adjusted returns than companies with the worst ESG ratings (or slowest progress on improving their ESG ratings), which are at greater risk of under-performing due to their poorer management of ESG issues.

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Introduction

We are on the verge of profound changes to both society and our economic and financial systems. Accelerating ESG trends, such as climate change, transforming technology and changing socio-demographics, mean that the future will very likely look significantly different to today.

As the global economy and society transform, these trends will pose increasing challenges and opportunities for investors over coming decades. This is driving policymakers to focus more on sustainability and ESG issues, with increasing ESG-related regulation and commitment to internationally recognised principles for responsible investing and national stewardship codes.

ESG risks are commonly defined to include those related to climate change, environmental management practices and duty of care, work and safety conditions, respect for human rights, anti-bribery and corruption practices, and compliance with relevant laws and regulations. Also important, we believe, are the impacts from ESG trends, emerging regulations and guidelines (such as the UK Modern Slavery Act), and the disclosure and transparency requirements placed on wider stakeholders (such as disclosure on greenhouse gas emissions or impact on biodiversity).

This is leading to growing pressures on trustees and investors to consider ESG issues in their investment decision-making, to safeguard long-term investment objectives and the long-term value of portfolios.

The aim of this paper is to explain ESG Integration, why it is becoming increasingly important, and its benefits.

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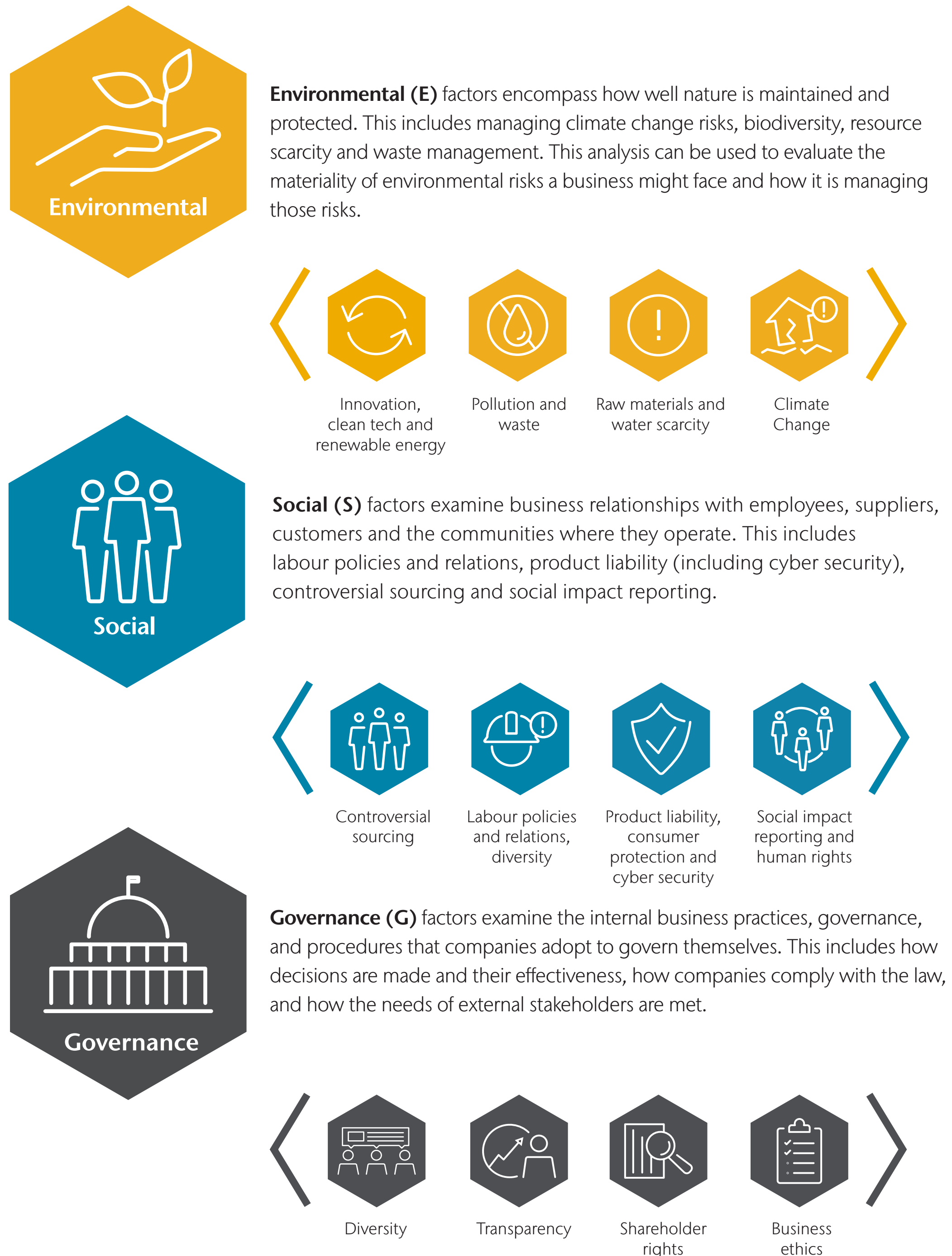
What is ESG Integration?

Consideration of ESG factors and underlying ESG trends allows for better informed investment decision making.

The Principles for Responsible Investment (PRI) formally defines ESG Integration as *"the explicit and systematic inclusion of Environmental, Social and Governance (ESG) issues in investment analysis and investment decisions."*

Put another way, ESG Integration is the analysis and consideration of all material ESG factors that influence the fundamental value of companies and assets, which in turn determines long-term investment value and returns.

Figure 1 - Environmental, Social and Governance Factors



Source: Aon

ESG factors are used by portfolio managers, in combination with other economic and financial indicators, to provide a more comprehensive investment analysis that leads to better-informed decision-making and asset selection processes.

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Why is ESG Integration important?

In the early years of responsible investing, ESG-related investing was rooted in religious and ideological values. Adherents followed investment guidance prohibiting investment in certain companies based on ethical or moral criteria. This led to the practice of applying negative screens to avoid companies engaged in controversial activities, believed to have a negative impact on society or the environment. This has led to common exclusions related to tobacco, gambling, alcohol and weapon manufacturing, and more recently fossil fuels.

ESG Integration delivers a greater focus on the financially material ESG factors that are most likely to impact financial outcomes of companies.

While such values-based investment approaches are still used by some investors, there is no explicit aim to better manage ESG risks and improve corporate performance on ESG issues under this values-based, negative screening approach. Hence, this approach may fail to maximise corporate value and achieve the best risk-adjusted returns.

In contrast, ESG Integration delivers a greater focus on the financially material ESG factors that are most likely to impact financial outcomes of companies. It does not necessarily require certain sectors, countries, and companies to be excluded from the investable universe.

Using this approach, investors gain greater insight into the purpose, strategy and management quality of companies, which is increasingly likely to influence corporate performance and correlate with equity return performance.

ESG Integration is expected to become more important in the coming years.

In the face of increased concern about the sustainability of economic activity, the impact of climate change and the survivability of humans, ESG Integration is expected to become more important in the coming years.

These concerns have galvanised international cooperation to tackle core ESG issues, with key agreements being put in place to prevent the worst long-term negative outcomes for the environment and society. This includes the ratification of the Paris Agreement, and the development of the UN Sustainable Development Goals (SDGs). Both initiatives aim to address the effects of climate change and social development on the wider environment, the first steps in a difficult journey for the global economy and society.

The increasing action on ESG serves to highlight the growing need to integrate ESG factors into investment processes and decision-making.

Aligned to these goals, many more investor initiatives are now pushing for de-carbonisation and greater sustainability. Initiatives include the Global Reporting Initiative (GRI), the Task Force on Climate-related Financial Disclosures (TCFD), the Sustainability Accounting Standards Board (SASB), the Carbon Disclosure Project (CDP), the Transition Pathway Initiative (TPI), the Task Force on Nature-related Financial Disclosures (TNFD) and the Workforce Disclosure Initiative (WDI). These initiatives all seek to create resilience in the global economy by redirecting flows of finance at scale towards achieving better environmental, social and sustainable outcomes.

The increasing action on ESG serves to highlight the growing need to integrate ESG factors into investment processes and decision-making, as it becomes increasingly important to identify those companies that are well positioned for the future and to avoid those likely to underperform or fail.

What are the benefits of ESG Integration?

The benefits of ESG Integration filter through to all core areas of decision making. These benefits initially materialise at the company level and naturally diffuse to subsequent investment level decisions, such as asset allocation choices, portfolio construction and manager selection.

ESG Integration benefits companies

Better ESG practices can enhance corporate financial performance (CFP) and financial value.

The long-term financial benefit of ESG Integration at the company level is that better ESG practices can enhance corporate financial performance (CFP) and financial value.

Improving corporate performance

There is a growing body of evidence highlighting improved company performance associated with better ESG practices. In one of the largest studies of its kind to date, research from Deutsche Bank and the University of Hamburg examined over 2,000 empirical studies, relating to ESG Integration and CFP[1]. They found that ESG Integration did not adversely affect investment returns in 90% of cases, with ESG adding value in most cases (with 63% of studies finding a positive correlation). This suggests that the case for ESG investing is well founded.

In particular, the authors noted that:

> *"the orientation toward long term responsible investing should be important for all kinds of rational investors in order to fulfil their fiduciary duties and may better align investor's interests with the broader objectives of society"*

1 Results are summarised in Friede, Busch and Bassen (2015).

Better CFP from companies with higher ESG ratings is also evident in MSCI ESG data – one of the more comprehensive ESG datasets. This data has a consistent framework that closely mirrors SASB's focus on financially material risks to companies, focusing on risks and the management of those risks that are most likely to impact financial outcomes.

Not all risks are financial and non-financial ESG risks increasingly matter.

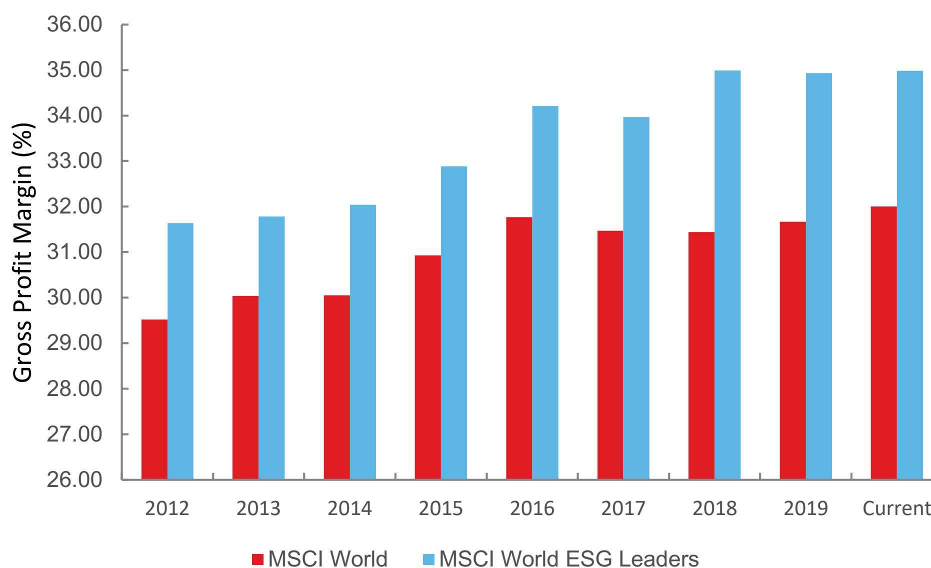
Materiality is a vital concept in establishing the relevance of ESG data for a given company or sector. Not all risks are financial and non-financial ESG risks increasingly matter. A focus on ESG performance can therefore significantly enhance CFP[2].

Figure 2 shows gross profit margins, a measure of CFP for companies in MSCI World, representing the broad global developed market, against MSCI World ESG Leaders, which tilts towards the best ESG-rated companies in MSCI World. The data in these figures indicate that high ESG rated companies generate higher profit margins than the broad market. A similar pattern is also evident in other common performance metrics, including higher returns on shareholder equity or assets, higher net and operating profit margins, as well as lower leverage and lower earnings variability. This suggests that high ESG-rated companies are more operationally efficient and tend to have better quality fundamentals than the broader market.

High ESG-rated companies use their competitive advantage to generate abnormal returns on capital, which ultimately leads to higher profitability.

This can be attributed to high ESG-rated companies being more competitive than their peers. For instance, competitive advantages can be achieved through greater resource efficiency and cost reduction, better development of human capital and better management of innovation. Furthermore, high ESG-rated companies are typically better at developing long-term business plans and have long-term incentive plans for senior management. This can help reduce ESG-related litigation and confer a reputational benefit from being perceived as well-managed, responsible companies with good sustainability credentials. High ESG-rated companies use their competitive advantage to generate abnormal returns on capital, which ultimately leads to higher profitability[3].

Figure 2 – Annual gross profit margin for MSCI World and MSCI ESG Leaders Indices



Source: Bloomberg. Current figures based on data as of 16 November 2020.

A recent study by MSCI goes further, exploring the causal link between ESG factors and CFP[4]. They find that higher-rated ESG companies tend to demonstrate higher CFP, controlling for other factors, such as quality, size and industry. This points to ESG being at least partially a factor in its own right, even though ESG factors are strongly correlated with quality and growth factors.

In our view, ESG factors are difficult to disentangle from growth and quality factors. However, there is evidence that ESG factors are important determinants of both quality and growth factors both now and in the future.

2 Khan, Serafeim and Yoon (2015) show that a focus on material ESG risk factors can deliver significant corporate outperformance.

3 Gregory, Tharyan and Whittaker (2014) explains the economic rationale, demonstrating how a corporation's ESG profile can impact corporate valuation and equity returns.

4 See "Foundations of ESG Investing" parts 1 to 4 authored by Giese, Lee, Melas, Nagy and Nishikawa (2018/19).

ESG Integration benefits portfolio managers

Portfolio managers can use ESG information and metrics to better inform portfolio construction and stock selection decisions and when exercising their ownership rights. This can help create additional long-term value, while demonstrating that they are taking responsibility as an asset owner by mitigating ESG risks.

Strengthening long-term future investment returns

Portfolio managers will want to account for ESG performance to try and enhance their returns. This seems natural as improvements in company level performance should eventually be reflected in better risk-adjusted, long-term returns. However, while academic evidence to substantiate this link is becoming increasingly well documented, it is not yet sufficient to be conclusive.

ESG data is still developing, which poses challenges as well as bringing new opportunities.

ESG information is still in its infancy and so historic returns are less indicative of the value of ESG factors than other market factors, like size or value. Table 1 highlights some of the key ESG data challenges, which are gradually being addressed. ESG data is still developing, which poses challenges as well as new oppurtunities.

Table 1 – ESG data challenges

Issue	Description
Quality	ESG data is largely self-reported and data collection approaches vary, which can result in reliability and consistency issues, such as missing data or data gaps. Guidance and regulatory requirements on disclosure and enhanced reporting frameworks are still being established.
Coverage	Most ESG data has been available for less than ten years. ESG data is more comprehensive for large companies, while data coverage for smaller companies, some regions (eg, emerging markets) or asset classes (eg, private and alternative markets) is patchy. Improvements in coverage are still at an early stage.
Consistency	Different providers of ESG data use different methodologies and give different weights to ESG metrics. This means ESG ratings from different providers have a low correlation with one another and care is needed when selecting a data provider.
Frequency	Many ESG metrics are low frequency, with data only updated annually, with a time lag in reporting. This makes it hard to find timely insights to manage risk or enhance returns.

Source: Aon

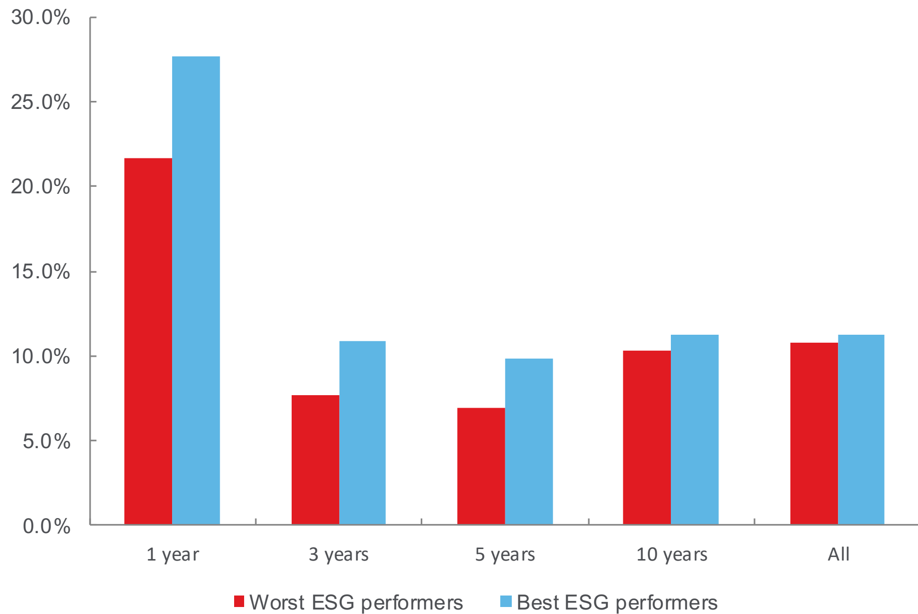
Older data tends to suffer more from these challenges, making it less reliable than more recent data. Importantly, ESG research has evolved over time and methodologies have improved, becoming more dynamic and relevant in recent years, which means that the quality of current data is considerably better today than data available even a few years ago. For example, the consistent alignment of ESG factors with material business risks is a reasonably new and developing area.

While it is too early to conclusively demonstrate that the proper consideration of ESG factors is supportive of returns, available evidence based on MSCI ESG data is encouraging.

Focusing on equity because of data availability, Figure 3 shows the annualised equity return performance of the best and worst ESG-rated companies, based on the highest and lowest quintiles, for developed market companies in MSCI World.

The figure shows that on average companies with the best ESG ratings outperformed those with the worst ESG ratings, by around +0.45% per year from June 2009 to November 2020. This suggests that tilting towards better ESG companies does not harm returns and potentially offers a small tailwind to returns overall.

Figure 3 – Performance of companies with the best and worst ESG performance over annualised periods



Annualised return performance of the best and worst ESG-rated quintiles for developed market companies. Return performance is calculated from an equal-weighted portfolio of companies. Historic return performance is not an indicator of future returns.

Source: MSCI.

Furthermore, the return gap between the best and worst ESG-rated companies appears to have widened in more recent years, with the return gap being just over 2.9% over the past five years (2015 to 2019).

We believe that the more recent outperformance can be explained by the increased demand for ESG assets and the improved relevance and value of ESG information in more recent years.

The growing importance of ESG trends has led to increased demand for equity exposure to companies with strong ESG profiles.

The growing importance of ESG trends has led to increased demand for equity exposure to companies with strong ESG profiles. As mentioned previously, ESG research is less evolved but rapidly improving, with constant improvement in ESG data quality, methods and ESG disclosure frameworks. ESG research is therefore becoming increasingly useful to investors. The adoption rate among investors has led to the development of quasi-passive ESG indexes, wider adoption of active ESG approaches (which focus on higher ESG-rated companies) and the avoidance of ESG laggards, as asset managers look to avoid underperformance and sidestep possible reputational risk. This has helped reinforce demand for higher ESG-rated companies over lower ESG-rated companies.

Having illustrated the significance of ESG factors to performance, it is worth noting that the relationship between ESG ratings and returns is not entirely monotonic. While, on average, the top 20% of ESG-rated companies tend to outperform lower rated companies and the worst 20% of ESG-rated companies tend to consistently underperform, there are times when middle ESG-rated companies underperform those with worse ratings.

While analysis in this section points to a positive correlation between ESG ratings and returns, further research is required to explore causation and linkages between other factors, once sufficient data becomes available.

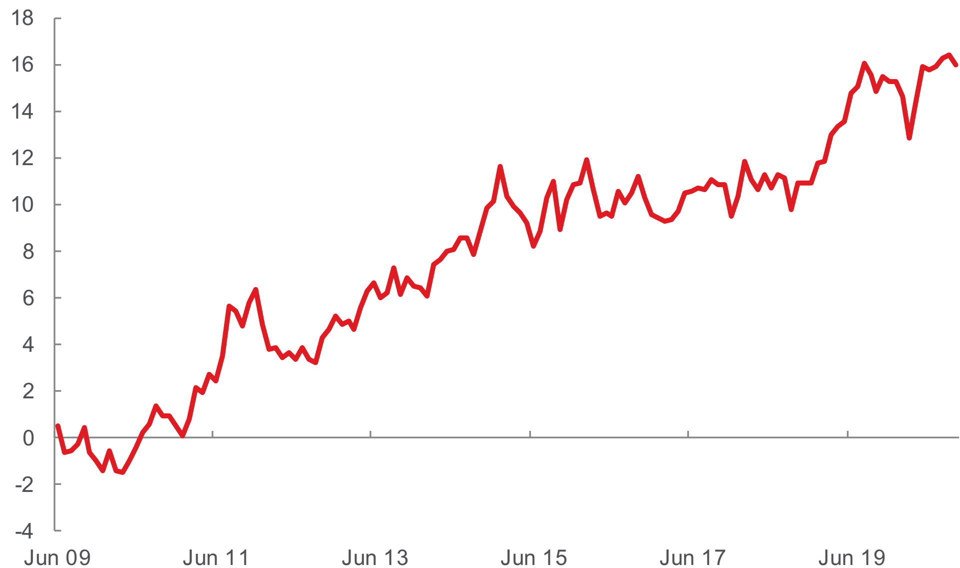
Progress on ESG Integration bolsters valuations and enhances investment returns

Portfolio managers will be attracted to improving the ESG profiles of the underlying assets they hold in their portfolios.

The growing importance of ESG trends and the benefits from managing ESG issues, as well as increasing ESG-related regulation, means that portfolio managers will be attracted to improving the ESG profiles of the underlying assets they hold in their portfolios.

Investment in companies that have stronger momentum in ESG ratings tend to see stronger improvements in their financial performance relative to investments with poorer momentum, resulting in greater valuation improvements and stronger investment returns.

Figure 4 – Performance of top versus bottom ESG momentum quintile portfolios for developed markets



Cumulative performance differential of the top and bottom ESG momentum quintiles for developed market companies. ESG momentum is defined as the prior 12 month change in ESG score. Performance is constructed from a hypothetical long-short indexed portfolio, going long for the equal-weighted upper ESG momentum quintile of MSCI World Index, while the bottom equal-weighted quintile goes short. The portfolio was rebased monthly. Data is from June 2009 to October 2020. Source: MSCI.

This is evident within the data. Figure 4 below shows the relative historic return performance of listed developed market companies with the strongest momentum in ESG ratings (top quintile) against those with the weakest momentum in ESG ratings (bottom quintile).

Portfolio managers and companies with strong ESG profiles tend to be more resilient when faced with challenging market conditions.

The results of the data show significant return outperformance from investing in companies with the strongest momentum in ESG ratings (which have improved their material ESG profile the most) over those with the weakest momentum in ESG ratings (which show limited improvement in their ESG profile). The outperformance was around 1.4% per annum over the past decade.

Importantly, outperformance of stocks in the higher ESG momentum-rated quintile was largely driven by stock-specific factors and not common or market factors[5]. Empirical analysis provides evidence that changes in a company's ESG profile has impacted valuation levels and investment returns over time, and that these are not explained by the general market or other factors[6].

Changes in ESG profiles are therefore likely to be a powerful financial indicator to be used alongside information on the actual ESG profile and portfolio construction profiles, when looking to enhance risk adjusted investment returns.

Greater resilience to severe risk incidents and lower return volatility

Neglecting financial risks from material ESG issues can severely impact a company's performance and adversely impact shareholder value.

Portfolio managers and companies with strong ESG profiles tend to be more resilient when faced with challenging market conditions. A combination of robust risk controls, strong compliance standards and embedded planning to deal with current, medium- and long-term ESG risks allow high ESG-rated companies to lower the risks of severe incidents, such as fraud, litigation and environmental or corporate governance issues.

Fewer severe risk incidents ultimately help to reduce stock-specific downside or tail risk events, which might otherwise decimate market value and result in sharp declines in a company's stock price.

Real world examples highlight that neglecting financial risks from material ESG issues can severely impact a company's performance and adversely impact shareholder value. In the most severe cases this may mean the business fails and ceases to operate. Table 2 highlights some examples of large fines and settlements relating to ESG risks.

5 This is shown in research conducted by Giese and Nagy (2018).

6 This is shown in Khan, Serafeim, and Yoon (2015), who find statistically significant predictive power of ESG momentum for equity returns.

Table 2 – Examples of Fines and Settlements Related to ESG issues

Company	Year	Cause	USD Bn
BP	2010	Criminal manslaughter and environmental crimes	20.80
Bank of America	2014	Financial fraud leading up to and during the financial crisis	16.65
Volkswagen	2015	Cheating on car emissions tests and deceiving customers	14.70
JPMorgan Chase	2013	Misleading investors about securities containing toxic mortgages	13.00
BNP Paribas	2014	Flouting US economic sanctions	8.90
Citi group	2014	Misleading investors about securities containing toxic mortgages	7.00
Anadarko	2014	Tried to avoid fines for environmental contamination	5.15
Goldman Sachs	2014	Misleading investors about securities containing toxic mortgages	5.00
Facebook	2019	Mishandling of user's personal information and data breaches	5.00
GlaxoSmithKline	2016	Misbranding and hiding drug safety information from the FDA	3.00
Credit Suisse	2014	Helping US citizens illegally avoid taxes	2.88

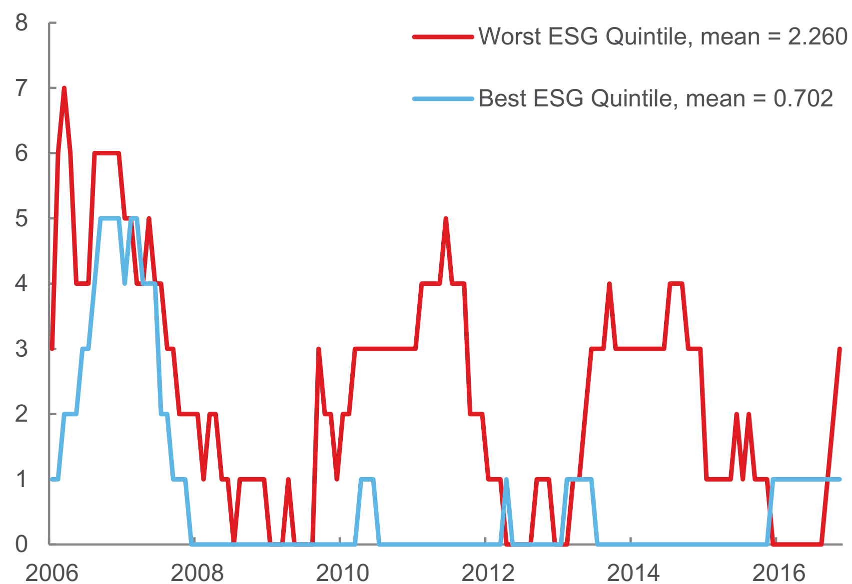
Source: Aon, Sustainalytics

While ESG ratings cannot be used to predict the next shock, tilting towards higher-rated ESG companies can reduce the incidence of such shocks.

Companies with the best ESG performance are more resilient to downside risks.

Empirical analysis of MSCI's ESG data shows that higher ESG-rated companies are more defensive and are less sensitive to downside risks, all else being equal. Companies with high ESG ratings typically have a more holistic view of current and future investment risks. This helps them to identify future risks and take steps to mitigate or adapt to them.

Figure 5 – Severe Risk Incidents of Top and Bottom ESG Quintile



Source: MSCI

Figure 5 shows the number of companies in MSCI World that have experienced a severe risk incident, three years after being categorised in either the top or bottom ESG quintile. A severe risk incident is proxied by a company having had a drawdown of more than 95% or gone bankrupt in the three-year period after the company was categorised in either the top or bottom ESG rating quintile.

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The figure shows that higher ESG-rated companies generally have a lower frequency of company-specific risk incidents, suggesting that high ESG-rated companies are better at mitigating serious business risks. This result is also replicable for smaller drawdown sizes (25% and 50%) and different length windows for risk to appear.

The strength and resilience to risks that higher ESG-rated companies enjoy extends to general market risks.

The strength and resilience to risks that higher ESG-rated companies enjoy extends to general market risks and is reflected in lower return volatility, as shown in Table 3. This feeds into higher risk-adjusted investment returns.

Table 3 – Volatility and risk-adjusted returns by ESG rating group

	Worst	Average	Better	Best
Average annual return (%)	10.2	10.8	10.9	11.3
Annualised volatility (%)	14.3	13.7	13.4	12.7
Return/volatility	0.72	0.78	0.81	0.88

The "Worst" ESG rated group include companies in the bottom 40% of ESG ratings, while Average, Better and Best cover the remaining ESG rating quintiles.
Source: MSCI

ESG Integration benefits pension schemes

At the pension scheme level, ESG Integration is relevant to asset allocation and involves the consideration of ESG risks and opportunities when making decisions between asset classes. Trustees may wish to make use of scenario analysis to consider the implications of climate change pathways on asset allocation.

ESG Integration is also relevant in manager selection, involving the scrutiny of portfolio managers, ensuring they have the necessary skills, ESG data and ESG tools to identify material risks and opportunities within portfolios. ESG considerations should be demonstrably integrated within the investment process and implemented across the full range of assets held by the pension scheme.

Conclusion

Fully integrating ESG into the investment process and investment strategy is inherently consistent with fiduciary duty and acting in the best long-term interests of stakeholders.

This paper has discussed the increasing value and relevance of ESG Integration. Identifying and effectively managing material ESG risks and opportunities, alongside other significant financial information, leaves trustees and investors better placed to successfully navigate transformative change and deliver competitive risk-adjusted returns over the long-term.

ESG issues can materially impact the performance of investment portfolios, and there are ample examples of severe risk events that can be pointed to that reinforce this view. Fully integrating ESG into the investment process and investment strategy is therefore inherently consistent with fiduciary duty and acting in the best long-term interests of stakeholders.

While some investment fads come and go, the trends driving the current need for sustainable business practices and responsible investment are very real and here for the long-term.

We conclude that ESG Integration is imperative to enhance long-term thinking about material non-financial issues, augmenting traditional financial analysis and helping to achieve the best possible financial outcomes over the long term.

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