INVESTING & WEALTH

CFA SINGAPORE INSIGHTS

By Matt Orsagh

Applying ESG integration to mitigate risks, enhance returns

Experienced practitioners believe ESG integration requires all material value drivers of a company – ESG drivers and conventional financial drivers – to be captured and assessed so as to arrive at a more informed investment decision

WITH ESG now firmly on the radar of asset owners, we have seen owners assessing external portfolio managers to ensure that they are fully embedding environmental, social, and governance integration into their strategies and processes and not just bolting on ESG data and tools to their existing investment process. Many investment managers are not clear about what that means and what they need to do to better align themselves with these expectations.

This article summarises how experienced investors are approaching ESG integration.

Risk and opportunities

Unlike exclusionary screening, which is implemented before investment analysis takes place, ESG integration fully embeds financial information and ESG information into the investment analysis. While exclusionary screening reduces the investment universe, ESG integration allows for investments in all companies, sectors, or countries in the investment universe.

A key component is lowering risk and enhancing returns. As investors develop their ESG expertise, they often begin implementing ESG integration as a risk management tool before developing their process to identify investment opportunities to generate alpha. The two types of opportunities are (1) products and services benefiting from an ESG theme, such as auto electrification; and (2) best-in-class ESG management.

Defining materiality

A common theme across the ESG integration workshops run by CFA Institute and Principles for Responsible Investment (PRI) was that participants asked for guidance or a framework on how to identify material ESG issues.

Although different definitions for materiality apply, the consensus among investors is that what counts as a material ESG issue is a fundamental value driver of a company or security that affects the income statement, balance sheet, and cash-flow statement positively or negatively. These investors assess whether companies are managing their ESG issues well or poorly and evaluate how those issues are linked to corporate financial performance.

In addition to absolute assessments, investors also undergo relative analysis and ranking of peer companies to identify material ESG issues. When all other factors are equal, a company which consistently mismanages ESG issues over the long run often is assessed to underperform an identical company that manages those same issues well.

Investment horizons

Investment horizon is a parameter that influences judgment around materiality. Investors are spending a lot of time identifying which ESG factors are material and predicting when they will be material.

Privacy concern has probably over the last 20 years been considered a material factor for businesses and society. Fast forward to the problems that Facebook has had with privacy, which suggest that it has become a more material factor than it was 20 years ago. PHOTO: REUTERS

Investors also regularly mention that securities can be exposed to different material ESG factor(s) over the short term, medium term, and long term. Within the fixed-income world, different bond issuances can be exposed to their own unique ESG factors, which could mean that short-dated bonds issued by a company could be investible, whereas the company's long-dated bonds may not be – if the investor perceives that the ESG risk will not materialise within the next five years, for instance.

ESG factors also can move from the long term to the short term and vice versa, and multiple ESG factors can be at play, too. As Ben Yeoh, CFA, portfolio manager at RBC Global Asset Management, points out: "ESG issues are not stationary. . . depending on the day of the week, the material ESG issues may change even within the same sector."

One example of this is privacy concern, which has probably over the last 20 years been considered a material factor for businesses and society. Fast forward to the problems that Facebook has had with privacy, which suggest that it has become a more material factor than it was 20 years ago and maybe you would have said it was never a material factor 20 years ago.

As different ESG issues can be material in the short term and long term, this can mean that different ESG issues are material to investors with different investment horizons.

Sudip Hazra, head of Sustainability Research at Kepler Cheuvreux, highlights the importance of recognising this: "It's important to consider the timeframes in which ESG issues are material. Sometimes, ESG opportunities and risks do manifest in the short term and if that's your timeframe, that's acceptable.

"However, if your focus is the long term, where a lot more ESG insight is generally derived, then sometimes looking at a series of shorter-term timeframes consecutively as periods in which the same ESG issue or thematic materialises in different forms can be productive. Ultimately a long-term outcome is still a set of ongoing investment decisions".

Quantitative integration versus qualitative integration

A workshop participant raised another question: "What is the threshold for calling it material? Is it a price change of 1 per cent, 2 per cent, or more? Is it about the probability of impact or probability of default? Or is it a percentage difference between the intrinsic value and the market value?"

Again the answer will vary from investor to investor. What will also vary is the mix of qualitative analysis and quantitative analysis undertaken to assess the materiality and financial impact of ESG factors and to make an investment decision. Several variables are at play, including investment strategy and data. Rules-based strategies will use more quantitative analysis, whereas discretionary analysis will use more qualitative analysis. When less ESG data is available, such as the case with small and midsize companies and emerging-market companies, more qualitative analysis is necessary to fill in the data gaps.

Increasingly, investors are quantifying and integrating ESG issues into their company and issuer valuations. (For examples of qualitative and quantitative analysis of ESG factors, see the CFA Institute report "Guidance and Case Studies for ESG Integration: Equities and Fixed Income".)

Governance versus environmental and social factors

The many acronyms and terms associated with ESG investing can cause confusion. The labelling of governance issues such as executive pay, corruption, and tax as "ESG" issues has resulted in many investors not associating their governance analysis as a part of ESG analysis, especially those that associate ESG investing with ethical investing. In many cases, this same issue is apparent with social issues. Health and safety, employee training, and customer relations are social issues that many investors are assessing but that are not being considered as social issues.

"You must, as an investor, take into account what society views as ethical or unethical and you need to try and predict changes in society's views on ethics, just like you would try to predict the success of a product or a service that a company is offering."

Rob Wilson, research analyst, MFS Investment Management, on ESG integration and ethical investing

Governance factors are considered to be more important than E&S factors by both equity and fixed-income practitioners. Although governance factors are material for all companies, E&S factors are not universal and depend on the sector and country; this situation can lead to investment opportunities and long-term, risk-adjusted returns.

Another reason attributed to the alpha-generating properties of E&S issues is that less E&S analysis is being done by the investment industry, which suggests that E&S issues are not being priced in the markets.

When comparing social issues with environmental issues, the perception is that it is more difficult to integrate social issues. Arguments attributed to this belief are (1) the larger set of raw environmental data compared with social data allows for a deeper understanding and integration of environmental issues, and (2) social issues aren't quantifiable – that is, how do you value human rights or community relations?

Aaron Ziulkowski, CFA, investment analyst and Manager, ESG Integration at Boston Trust Walden, has a different perspective: "With readily available metrics on energy use, it is straightforward to construct a quantitative model on the direct impact of a carbon tax. However, while social issues such as human capital are less quantifiable, it is not necessarily any more difficult to integrate social factors into qualitative fundamental analysis of a company."

Really: what is ESG integration all about?

Ultimately, ESG integration is about mitigating risks and enhancing returns. Asset owners care about their risk-adjusted returns and expect their external managers to care about them, too. As explained by Michael Marshall, director of Responsible Investment and Engagement at asset owner LGPS Central Ltd: "We're looking for a manager that is dutiful to the mandate and uses ESG to make their risk-adjusted returns better whether that's more consistent, more sustainable, larger in the case of returns, smaller in the case of risk."

To achieve a strong risk-adjusted performance, leading investors believe that ESG integration practices require a holistic, systematic approach to investment analysis, in which all material value drivers of a company – ESG drivers and conventional financial drivers – are captured and assessed to develop a more informed investment decision.

Said in a similar way by Masja Zandbergen-Albers, head of ESG integration at Robeco: "ESG integration is about getting enough information on a company and how a company structurally manages its externalities and its intangibles. You then can have a clear opinion on whether or not the company is actually undervalued or overvalued and whether or not the market reaction is warranted. So ESG integration is not about only ESG, it's about combining all the information that is available."

So, is ESG integration not the same as ethical investing? As explained by Rob Wilson, a research analyst at MFS Investment Management: "We can't make values-based or ethical decisions for our clients, because we have clients in over 35 different countries and each have their own values and views as to what's ethical and what isn't. But you must, as an investor, take into account what society views as ethical or unethical and you need to try and predict changes in society's views on ethics, just like you would try to predict the success of a product or a service that a company is offering. So, does ethics play into how we think about ESG? Yes, absolutely it does, but in a way that might be different than how a lot of people talk about it."

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GOLD REPORT

By Benjamin Lu

Gold clocks 3-month highs over bullish technical posturing

A weekly market summary for gold, Dec 30-Jan 3

A DOVISH hold on US monetary policy has kept the greenback on its back foot while strengthening bullion appeal, as investors deliberate opportunity costs for the precious metal. Bullish technical posturing (chart patterns) kept gold prices positive despite renewed global risk appetites and an extended rally in the US equity market. Escalating tensions in the Middle East lent further strength to the yellow metal as investors sought safe haven shelter over heightened geopolitical risks.

What should investors look out for in the longer term?

A strong rally in risk assets has yet to deter gold prices from moving north as traders fixate against persistent US dollar weakness and looming tensions in the Middle East. Seasonality trends along with strong Asian retail buying activities has lent further support to the precious metal. Though we remain dim on bullion prospects over signs of stability in the global economy, bullish technical posturing and simmering geopolitical tensions will keep gold prices solid for the immediate term.

Technical Analysis for Spot Gold (XAUUSD)

Gold prices rallied upwards strongly as market bulls breached key technical level of US$1,525.00. The precious metal has extended gains for the fourth consecutive week as gold bulls retain control of the positive trend scenario. A successful breach at 2019-highs of US$1,559.00 will support a bullish rise in price levels as market forces target the next main station of US$1,578.00. On the flip side, failure to hold price levels above US$1,525.00 will effect a bearish correction towards key trend line support of US$1,510.00.

Weekly Market Assessment:
Mildly Bullish
Key Resistance Level (1): US$1,559.00
Key Resistance Level (2): US$1,578.00
Key Support Level (1): US$1,525.00
Key Support Level (2): US$1,510.00

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