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# **From ‘why’ to ‘why not’:** Sustainable investing as the new normal

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# From ‘why’ to ‘why not’: Sustainable investing as the new normal

More institutional investors recognize environmental, social, and governance factors as drivers of value. The key to investing effectively is to integrate these factors across the investment process.

Sustainable investing has come a long way. More than one-quarter of assets under management globally are now being invested according to the premise that environmental, social, and governance (ESG) factors can materially affect a company’s performance and market value. The institutional investors that practice sustainable investing now include some of the world’s largest, such as the Government Pension Investment Fund (GPIF) of Japan, Norway’s Government Pension Fund Global (GPFG), and the Dutch pension fund ABP.

The techniques used in sustainable investing have advanced as well. While early ethics-based approaches such as negative screening remain relevant today, other strategies have since developed. These newer strategies typically put less emphasis on ethical concerns and are designed instead to achieve a conventional investment aim: maximizing risk-adjusted returns. Many institutional investors, particularly in Europe and North America, have now adopted approaches that consider ESG factors in portfolio selection and management. Others have held back, however. One common reason is that they believe sustainable investing ordinarily produces lower returns than conventional strategies, despite research findings to the contrary.

Among institutional investors who have embraced sustainable investing, some have room to improve their practices. Certain investors—even large, sophisticated ones—integrate ESG factors into their investment processes using techniques that are less rigorous and systematic than those they use for other investment factors. When investors bring ESG factors into investment decisions without relying on time-tested standard practices, their results can be compromised.

To help investors capitalize on opportunities in sustainable investing, this article offers insights on how to integrate ESG factors with the investment process—from defining the objectives and approach for an investment strategy, through developing the tools and organizational resources required to manage investments, to managing performance and reporting outcomes to stakeholders. It is based on more than 100 interviews we conducted with CEOs, chief investment officers, ESG leaders, investment managers, and others at a range of investment funds, about their experiences with sustainable investing: how they got started, what practices they follow, what challenges they encountered, how they resolved them, and how they have enhanced their sustainable investing approaches over time.

## Sustainable investing takes off and pays off

Once a niche practice, sustainable investing has become a large and fast-growing major market segment. According to the Global Sustainable Investment Alliance, at the start of 2016, sustainable investments constituted 26 percent of assets that are professionally managed in Asia, Australia and New Zealand, Canada, Europe, and the United States—$22.89 trillion in total. Four years earlier, they were 21.5 percent of assets.

The most widely applied sustainable investment strategy globally, used for two-thirds of sustainable investments, is negative screening, which involves excluding sectors, companies, or practices from investment portfolios based on ESG criteria. But

ESG integration, which is the systematic and explicit inclusion of ESG factors in financial analysis, has been growing at 17 percent per year. This technique is now used with nearly half of sustainable investments.

The scale of the sustainable investing market differs greatly from region to region. European asset managers have the highest proportion of sustainable investments (52.6 percent at the beginning of 2016), followed by Australia and New Zealand (50.6 percent) and Canada (37.8 percent). Sustainable investing is less prevalent in the United States (21.6 percent), Japan (3.4 percent), and Asian countries other than Japan (0.8 percent), but the gap is narrowing. From 2014 to 2016, the volume of sustainably managed assets grew significantly faster outside Europe than it did in Europe.[1]

Recent years have also seen some of the world's largest institutional investors expand their sustainability efforts. Japan's GPIF, the largest pension fund in the world with $1.1 trillion in assets, announced in July 2017 that it had selected three ESG indexes for its passive investments in Japanese equities. In December 2015, the Dutch pension fund ABP, which is the second largest in Europe, declared two ESG-related goals: to reduce the carbon-emissions footprint of its equity portfolio by 25 percent from 2015 to 2020, and to invest €5 billion in renewable energy by 2020.

Our interviews with institutional investors reveal a wide range of reasons they pursue sustainable investing. The three most common motivations are as follows:

*Enhancing returns.* Sustainable investing appears to have a positive effect, if any, on returns. Researchers continue to explore the relationships between ESG performance and corporate financial performance, and between ESG investment strategies and investment returns. Several studies have shown that sustainable investing and superior investment returns are positively correlated. Other studies have shown no correlation. Recent comprehensive research (based on more than 2,000 studies over the last four decades) demonstrates sustainable investing is uncorrelated with poor returns.[2] For many investors, the likelihood that sustainable investing produces market-rate returns as effectively as other investment approaches has provided convincing grounds to pursue sustainable investment strategies—particularly in light of the other motivations described below.

*Strengthening risk management.* Institutional investors increasingly observe that risks related to ESG issues can have a measurable effect on a company's market value, as well as its reputation. Companies have seen their revenues and profits decline, for instance, after worker safety incidents, waste or pollution spills, weather-related supply-chain disruptions, and other ESG-related incidents have come to light. ESG issues have harmed some brands, which can account for much of a company's market value. Investors have also raised questions about whether companies are positioned to succeed in the face of risks stemming from long-term trends such as climate change and water scarcity.

*Aligning strategies with the priorities of beneficiaries and stakeholders.* Demand from fund beneficiaries and other stakeholders has driven some institutional investors to develop sustainable investing strategies. This demand has followed greater public attention to the global sustainability agenda. Sustainable investing strategies seem to have particular appeal among younger generations: some two-thirds of high-net-worth millennials surveyed in the United States agreed with the statement, "My investment decisions are a way to express my social, political, or environmental values." More than one-third of high-net-worth baby boomers expressed the same belief—a noteworthy proportion, given that baby boomers are a major constituency for institutional investors.[3] Some investors wish to "do good" for society by providing capital to companies with favorable ESG features (without compromising risk-adjusted returns).

As more investors consider ESG factors, they are likely to encounter certain common challenges. There are some lessons they should keep in mind on how to define their approaches and maximize the benefits of sustainable investing.

## How leading investors integrate sustainability

In reviewing the experiences of leading institutions, one theme stands out: sustainable investing is more effective when its core activities are integrated into existing processes, rather than carried out in parallel. Deep integration is readily achievable because the disciplines of sustainable investing are variations on typical investment approaches. Below, we explore how elements of sustainable investing can be integrated with investors' existing capabilities across six important dimensions (Exhibit 1).

### Linking sustainable investing to the mandate

To succeed, sustainable investment strategies must derive from an institution's overall mandate. Yet investment mandates do not always call for sustainable strategies. The following questions can help investors interpret their mandates with respect to ESG issues and define targets for their sustainable investment strategies:

*Does the investment mandate demand sustainability? If so, what factors are emphasized?* Some investment mandates include ESG considerations or even specific ESG objectives. For example, the management objectives of Norges Bank, which manages Norway's GPFG, call for the bank to "integrate its responsible management efforts into the management of the GPFG" and note that "a good long-term return is considered dependent on sustainable development in economic, environmental, and social terms, as well as well-functioning, legitimate and efficient markets."

*How can the directives of a more general mandate help shape a sustainable strategy?* Many funds have a mandate similar to that of a large Canadian pension fund: to "maximize returns without undue risk of loss." A focus on value creation provides the basis for a strategy that accounts for long-term ESG trends by, for example, avoiding investments in companies or sectors exposed to material sustainability risks.

*How will the success of the sustainable investment strategy be judged?* Leading institutional investors define and track progress against clear metrics and targets for their sustainable strategies. Some targets have to do with their own activities: for example, the proportion of their portfolio managed with respect to ESG factors. (In some asset classes such as government bonds, sustainable practices are less developed and may thus take more time to apply than in asset classes such as public equities.) Others might consist of goals for the ESG performance of portfolio companies, such as reductions in carbon emissions or the ratios between executive pay and worker pay.

### Defining the sustainable investment strategy

A sustainable investment strategy consists of building blocks familiar to institutional investors: a balance between risk and return and a thesis about which factors strongly influence corporate financial performance. The following questions can help investors define these elements:

*Are ESG factors more important for risk management or value creation?* The balance between managing risks and producing superior returns will help determine the sustainable investing strategy. If the mandate focuses on risk management, then the strategy might be designed to exclude companies, sectors, or geographies that investors see as particularly risky with respect to ESG factors, or to engage in dialogue with corporate managers about how to mitigate ESG risks. If value creation is the

Exhibit 1 **Leading institutions apply sustainable investing practices across six dimensions of their investment process and operations.**

| Dimension of investing | Elements of sustainable investing |
|---|---|
| Investment mandate | • Consideration of environmental, social, and governance (ESG) factors, including prioritization<br>• Targets |
| Investment beliefs and strategy | • Rationale for ESG integration<br>• Material ESG factors |
| Investment operations enablers | |
| Tools and processes | • Negative screening<br>• Positive screening<br>• Proactive engagement |
| Resources and organization | • ESG expertise and capabilities<br>• Integration with investment teams<br>• Collaborations and partnerships |
| Performance management | • Review of external managers (screening and follow-up)<br>• Follow-up on internal managers (including incentives) |
| Public reporting | • Accountability<br>• Transparency |

focus, on the other hand, investors might overweight their portfolios with companies or sectors that exhibit strong performance on ESG-related factors they believe are linked to value creation.

*What ESG factors are material?* At first glance, this question might seem basic. Investors ordinarily look closely at factors they consider material and devote less attention to other ones. (Not surprisingly, research has shown that companies that focus on material ESG issues produce better financial performance than those that look at all ESG issues.) Determining which ESG factors matter, though, isn't always easy. Some efforts to identify material factors are under way. In the United States, for instance, the Sustainability Accounting Standards Board has developed the leading approach for identifying the unique ESG factors that are material in each sector. Investors may wish to conduct additional analysis to assess materiality for their own portfolios. The selection of material factors is often influenced to some extent by exposure to asset classes, geographies, and specific companies. For example, governance factors tend to be especially important for private equity investments, since these investments are typically characterized by large ownership shares and limited regulatory oversight.

## Selecting tools for sustainable portfolio construction and management

Most institutional investors that integrate ESG factors in their strategies use at least one of three main techniques for portfolio construction and management: negative screening, positive screening, and proactive engagement (Exhibit 2). Once an investor has set priorities, it can select these techniques accordingly, using the following questions as a guide:

*Is risk management a focus?* Negative screening is essential for investors that wish to constrain risk. It entails excluding companies (or entire sectors or geographies) from a portfolio based on their performance with respect to ESG factors. Negative screening was the basis for many of the earliest sustainable investing strategies. The availability of ESG performance data (for example, carbon emissions) now allows investors to apply more nuanced and sophisticated screens, filtering out companies that do not meet their standards or are below industry averages for particular ESG factors.

*Is value creation a focus?* Performance-focused investors can use negative screening to eliminate companies that may be less likely to outperform in the long run. They can also practice positive screening, by integrating the financial implications of ESG performance in fundamental analysis. With this approach, many of the same research and analysis activities that investors perform to choose high-performing assets are extended to cover material ESG factors. In this way, investors can seek out assets with outstanding ESG performance or sustainability-related business priorities (such as high energy efficiency). For example, the Third Swedish National Pension Fund (AP3) more than doubled its investments in green bonds during 2016 to lower the fund's carbon footprint, on the grounds that a more sustainable portfolio can improve both the return and the risk profile of the fund.

*Does the investor engage with management teams?* Some institutional investors try to improve the performance of portfolio companies by taking board seats or engaging in dialogue with management. This approach can also be helpful in sustainable investing strategies: an institutional investor might choose to acquire a stake in a company with subpar ESG performance, then engage with its management about potential improvements. If an institutional investor ordinarily takes board seats or engages management teams, then it might consider adding sustainability issues to its agenda. Some investors also take part in external collaborations, such as Eumedion in the Netherlands, that collectively engage companies in dialogues on sustainability issues and pool shareholder voting rights to influence management decisions.

## Developing sustainable investment teams

A few leading investors embed ESG specialists within their investment teams, though some opt for other arrangements. The following three questions can help institutional investors fit their ESG-focused staff and resources into their existing operations:

*What expertise is needed to carry out the sustainable investing strategy?* The factors and techniques an investor chooses will determine what expertise is required. Investors that emphasize environmental performance, for instance, will need specialists in relevant environmental topics and management practices. Those that actively engage with management teams may need specialists with executive experience. Companies that rely on screening techniques will likely benefit from expertise in quantitative analysis.

Exhibit 2

## Institutional investors use at least one of three techniques to integrate ESG factors in portfolio construction and management.

| | Negative screening | Positive screening | Proactive engagement |
|---|---|---|---|
| **Description** | • Avoid material environmental, social, and governance (ESG) risks or comply with values-based investment thesis<br>• Exclude particular companies or sectors from investment universe based on ESG concerns | • Acknowledge potential positive correlation between ESG quality and returns<br>• Integrate financial implications of ESG factors in research and analysis<br>• Weight fund toward holdings with higher ESG quality | • Identify ESG as a lever for value creation<br>• Pursue improvements in a company's ESG performance by engaging with board or management |
| **Examples of application** | Exclusion of companies for such reasons as:<br>• Noncompliance with values chosen by the government or fund<br>• Recommendations by ESG team<br>• Additional qualitative analysis of ESG risks | • Investment managers include ESG factors in fundamental analysis<br>• Investments concentrate on specific sustainability themes (eg, green bonds, clean tech, low carbon) | • Dialogue and involvement with enterprises in which investors hold significant stakes and see potential to create value by improving ESG performance (eg, by increasing energy efficiency) |

*How should an investor obtain ESG expertise?* In-house ESG teams range from one or two full-time staff members to 15 or more, depending on portfolio size and approach to sustainable investing. Some investors may not need full-time ESG staff at all. Commercial databases offer good-quality information about companies' ESG performance, and external advisors can provide targeted support. In addition, many institutional investors take part in external networks such as the United Nations Principles for Responsible Investment (PRI) and the Portfolio Decarbonization Coalition, which support investors in incorporating ESG factors in their investment decisions. Leading investors also continuously build the ESG capabilities of their portfolio managers.

*Where should ESG specialists fit into the organization?* Some investors put their ESG specialists outside the investment team (for example, within a communications group). Leading investors typically embed ESG experts within their investment teams, with a head of ESG who reports to the chief investment officer. ESG specialists then provide ongoing support to portfolio managers. Some funds have made it a priority to hire ESG specialists with strong investment backgrounds. For example, the Canada Pension Plan Investment Board hired a senior investment professional as its head of ESG. Other funds have chosen not to have dedicated ESG specialists, but to assign responsibility for related issues to ESG-trained portfolio managers. At one Scandinavian investor, portfolio managers must fully account for all drivers of risk and return, including those related to ESG factors.

## Monitoring the performance of investment managers

Whether institutional investors use internal or external managers to oversee their portfolios, they must regularly review managers' performance. Before hiring external managers, they also conduct thorough due diligence. Our interviews suggest that institutions with sophisticated approaches to sustainable investing have made ESG considerations an integral part of their performance-management processes. The following two questions can help investors devise effective means of monitoring performance:

*How can we ensure external managers conform to our sustainable investing strategy?* Leading funds have integrated ESG elements into their due diligence processes for external managers. The United Nations PRI has developed an ESG-focused questionnaire for this purpose, and some investors have created their own ESG scorecards. Side letters, which augment the terms of a contract, can be used to specify ESG performance standards for an external manager. Once an external manager has been hired, leading investors evaluate their ESG performance as part of their semiannual or annual performance reviews. The Second Swedish National Pension Fund (AP2), for example, developed an ESG assessment tool for reviewing external private equity managers. Some leading investors have a continuous dialogue with their external managers, through which potential ESG issues can be flagged and discussed.

*How can we ensure our in-house investment team adheres to the sustainable strategy?* Leading funds also make ESG considerations part of their processes for managing the performance of in-house portfolio managers. Some funds have tools for checking whether portfolio managers have complied with ESG requirements and, in some cases, whether the ESG performance of their portfolios meets certain standards or contributes to the investor's overall ESG targets. A few investors have also begun experimenting with linking managers' ESG performance to their compensation.

## Reporting on sustainable investing practices and performance

Leading institutional investors reinforce their commitment to sustainable investment by disclosing performance and describing their management practices. The most advanced provide detailed descriptions of how they are enacting their sustainable investment strategies, along with quantitative measures of their performance relative to targets. The following questions can help when it comes to shaping effective approaches to external reporting:

*What is the goal of reporting on ESG performance?* Investors should define what they hope to accomplish via external reporting and disclosure. Government pensions, for example, may have to fulfill public-policy requirements. Other institutions may wish to demonstrate how they meet beneficiaries' expectations, or use reporting as a means of holding portfolio companies accountable to drive change. This technique is particularly relevant to proactive engagement: investors can exert influence on portfolio companies by describing the performance gaps they have identified and the improvements that companies are making.

*What information should be disclosed*? Investors generally have wide discretion on what to disclose about their sustainable investment approach: strategies, companies excluded, ESG performance measures, and accounts of management dialogues, to name a few. Over the past few years, disclosures have become more detailed in areas like policies, targets and outcomes, focus areas, and specific initiatives. For example, the Fourth Swedish National Pension Fund (AP4) issues disclosures on all of these topics, along with a list of excluded companies and an assessment of the direct environmental impact of the fund's operations.

Disclosing different kinds of ESG information serves different purposes. To fulfill public-policy requirements and show that practices meet beneficiaries' expectations, some investors disclose how policies and strategies are integrated in the investment process, measureable ESG targets and outcomes, and data on shareholder votes or company dialogues. To encourage portfolio companies to strengthen ESG performance, disclosing information about high-priority ESG factors, company dialogues, and exclusion lists may be helpful.

## What's next?

Embedding sustainable investment practices into investment processes is a long-term endeavor, by which most investors gradually adopt more sophisticated techniques. The practices described above, already in wide use, can help investors develop or refine sustainable investing strategies. It is also worth considering the following approaches, which are still evolving among investors at the front of the field:

*Assessing the entire portfolio's ESG risk exposure.* A few funds have begun to systematically assess how their entire portfolios are exposed to material ESG risks (notably, climate change and energy consumption). Such a broad review requires significant staff time, resources, and capabilities. It also means developing a view on the long-term development of ESG-related factors and related market forces (for example, sales of electric vehicles and movements in energy prices) and their impact on the financial performance and valuations of holdings. In addition, advanced investors are developing dashboards of key indicators to watch, with trigger points that call for mitigating actions to manage risks effectively. Recent efforts to establish industry-wide standards for measuring a carbon footprint have resulted in progress, but an established set of metrics across most other sustainability topics has yet to be developed.

*Using ESG triggers to find new investment opportunities.* If assessing a whole portfolio with regard to ESG risks is one side of a coin, then seeking investment opportunities based on ESG factors is the other side. As with assessing risk exposure, institutional investors will need a point of view about ESG-related trends and their long-term effects on asset prices. One way to develop a thesis is to identify the most significant trends and the sectors they influence (for example, asking what opportunities will be created by the widespread shift toward renewable energy).

*Integrating the UN Sustainable Development Goals.* The 17 SDGs were developed to "end poverty, protect the planet, and ensure prosperity for all." Several European funds are exploring ways to link their sustainable investing strategies to the SDGs. Early approaches involve prioritizing certain SDGs and planning investment strategies to improve corporate performance in those areas. For example, in July 2017, the Dutch pension funds APG and PGGM jointly published the Sustainable Development Investments Taxonomies, with an assessment of the investment possibilities associated with each of the SDGs. AP2 also publishes examples of how its investments contribute to the SDGs. This creates transparency on how the institutional-investor community can be a catalyst for change for a more sustainable society, addressing some of the prioritized challenges of humankind.

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The sustainable investing market has grown significantly as demand for sustainable investment strategies has surged and as evidence has accumulated about the benefits of investing with ESG factors in mind. Some of the world's leading institutional investors are at the forefront of adopting sustainable investing strategies. Most large funds are seeking to develop their sustainable strategies and practices, regardless of starting point. While some are struggling to define their approach and to make good use of ESG-related information and insights, our interviews with institutional investors make clear that this doesn't have to be the case. The methods that institutions already use to select and manage portfolios are highly compatible with sustainable strategies, and close integration can have significant benefits for institutional investors and beneficiaries alike. ■

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[1] *Global sustainable investment review 2016*, Global Sustainable Investment Alliance, March 2017, gsi-alliance.org. The review's definition of "sustainable investment" includes the following activities and strategies: negative/exclusionary screening, positive/best-in-class screening, norms-based screening, integration of ESG factors, sustainability themed investing, impact/community investing, and corporate engagement and shareholder action.

[2] Alexander Bassen, Timo Busch, and Gunnar Friede, "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies," *Journal of Sustainable Finance & Investment*, 2015, Volume 5, Number 4, pp. 210–33.

[3] *2014 U.S. Trust insights on wealth and worth*, U.S. Trust, Bank of America, June 2014, ustrust.com.

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