Responsible Investing – A fad or the future?

Investment Advisory

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Introduction and background

Introduction

In his 1962 book, Capitalism and Freedom, Nobel Prize winning economist Milton Friedman argued that a company has no moral obligation outside of increasing profits for shareholders, albeit within the ‘rules of the game’, avoiding deception and fraud. In the decades that followed, increased skepticism of this view has been evident as socially constructed systems of norms, beliefs, and values have altered. Indeed, it could be argued that ‘rules of the game’ have changed significantly and that Friedman’s profit related obligation could in the long term be aligned with more socially responsible activity.

Greater consideration is now being given towards a range of stakeholders, as opposed to shareholders exclusively. Stakeholders include any person or entity that has a concern or interest in an organisation’s behaviour, be it financial or otherwise. Indeed, organisations are now encouraged to disclose material aspects of their operations to enable a range of stakeholders to assess their behaviour via corporate social responsibility reporting.

In line with society’s changing views, investors are now becoming more thoughtful with regard to how they choose to invest. Specifically, taking into account not only the risk of becoming more thoughtful with regard to how they choose to invest. Specifically, taking into account not only the risk of financial loss associated with investing, but also the wider risks associated with the impact of their investments on society as a whole. This can be described as Responsible Investment (‘RI’) or, more specifically, Environmental, Social and Governance (‘ESG’) driven investment.

The objective of this paper is to address some of the common misconceptions and formulate a better understanding of RI or, more specifically, Environmental, Social and Governance (‘ESG’) driven investment.

In this paper, we specifically focus on the following options available to investors:

1. Do nothing
2. Ensure investment managers have ESG policies in place
3. Appoint a manager that integrates ESG factors in its central decision making
4. Develop a bespoke ESG policy

RI Incorporating ESG factors

One could be forgiven for assuming that the often interlinked terms such as RI, ESG, Socially Responsible Investing (‘SRI’), Sustainable Investing (‘SI’), Green Investing and Impact Investing are all the same thing. They are not! SRI, SI, Green Investing and Impact Investing seek to combine financial return alongside investor-specific morals and ethics, which differs from RI.

The UN Principles for Responsible Investment (‘UN PRI’) defines RI as “an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.”

ESG factors can be defined within the headings:

- **Environmental** criterion looks at how an investee company performs as a steward of the natural environment.
- **Social** criterion examines how a company manages relationships with its employees, suppliers, customers and the communities in which it operates.
- **Governance** criterion is concerned with a company’s leadership, executive pay, internal controls, external audits and shareholder rights.

G drives E and S

Modern, public companies typically have many owners, most of whom are distant. Such a small stake structure can cause a separation between those that control the day to day operations of the company and the shareholders as the suppliers of capital and holders of risk. Corporate governance frameworks have evolved in order to mitigate the potential for conflicts of interest arising due to this separation of ownership from control. Strong frameworks typically include clearly defined principles, policies, procedures, responsibilities and accountability of managers. Therefore, corporate governance is arguably the foundation criterion of ESG principles. How a company behaves is driven from the top and therefore the stewardship is key to improving outcomes for stakeholders. Without a strong G, it is unlikely that E or S will be given sufficient focus.

Recent increased interest

The chart to the right shows the number of Google searches over time for both ‘ESG investing’ and ‘ESG Fund’, rebased to the peak amount of searches. As can be seen, the number of searches has trended significantly upwards over the last decade.

KPMG Investment Advisory view

At KPMG Investment Advisory, we believe that it is important for investors to understand this subject matter, so as to make informed decisions around how to incorporate ESG principles/factors into their investment strategy.

In this paper, we specifically focus on the following options available to investors:

1. Do nothing
2. Ensure investment managers have ESG policies in place
3. Appoint a manager that integrates ESG factors in its central decision making
4. Develop a bespoke ESG policy
1. Do nothing

It may well be that an investor decides not to incorporate ESG factors into their investment strategy. The key benefit here is the lower level of governance required. Put simply; you do not have to do anything beyond what you are already doing … But is this right?

Incorporating ESG factors into an investment strategy does require additional time and resources to set investment beliefs ensuring the investments are in line with the ESG preferences of the investor. Naturally, taking on additional work when an investor has no interest will be undesirable.

Additionally, for those investing in passive strategies, which aim to track an index, introducing an ESG overlay will cause deviations from the index known as tracking error. This could be considered as taking an active view on ESG factors and this tracking error risk would need to be understood in greater detail.

Risk impact – financial

It has been argued that ESG factors could increase an investment portfolio’s risk through reduced diversification potential. The rationale here is that by excluding certain companies or sectors, the investable universe is narrowed and this introduces potentially unwelcome biases.

Hamilton, Jo & Statman (1993) carried out one of the first investigations into whether investors were rewarded or penalised for implementing ESG strategies and their results found that the returns did not significantly differ from those of a selection of conventional mutual funds.

More recently, there has been a growing weight of evidence that introducing ESG factors can actually improve risk-adjusted returns. For instance, Weber, Marsfield and Schirmann (2011) found a positive relationship between ESG factor screens and risk-adjusted performance when comparing a pool of 151 global ESG-focused funds against the MSCI World Equity Index.

In reality the argument that implementing ESG narrows your investment universe is becoming less and less relevant. It is often assumed that the incorporation of ESG factors is associated exclusively with the negative screening of unfavourable companies or industries. While this was historically the case, the adoption of ESG beliefs is becoming increasingly focused on allocating capital for positive impact.

Therefore while the argument of a reduced universe may be relevant for exclusionary funds, it is questionable for other methods of ESG incorporation.

It is important to note that there is no uniformly accepted method of testing the impact of ESG factors screening on performance however, it is becoming more widely accepted that failing soul of ESG criteria can carry risks that may impact shareholder value. Thus incorporating ESG can be seen as a tool for managing risk and potentially improving return.

The chart below sets out the historical performance of a standard global equity index and one that incorporates ESG factors.

Risk impact – reputational

Another key consideration is the reputational risk of taking no action. As we have seen over the years, there has been growing scrutiny of the investments held by institutional investors, with details being reported in the media more frequently.

The media reporting of a company for any environmental, social or governance sanction may not only cause embarrassment for the organisation, but also may impact its perceived legitimacy. For a charity, this can be particularly damaging in the competition for resources. For a pension scheme, it can draw the ire of members who may place further scrutiny on how their retirement provision is invested and in turn, whether the trustees of the scheme are carrying out their stewardship duties appropriately.

Risk impact – regulatory

Since the implementation of the 1995 Pensions Act, trustees of pension schemes have had to disclose their ESG policies via the Statement of Investment Principles, while ESG Disclosure Rules for schemes became regulation in July 2000.

Additionally, the UK Stewardship Code published by the Financial Reporting Council in 2010 provides a set of guidelines for institutional investors to encourage interaction with the management of the companies in which they invest. Whilst it is strictly regulation, ignoring such guidance can draw criticism.

Investors should also be aware of international sanctions in place and ensure their portfolios are not falling foul of exclusion lists. This can largely be delegated to investment managers but the responsibility would clearly remain with the decision maker.

Summary

Opting not to incorporate ESG factors into an investment strategy is one option for investors. However, choosing to do so should be done objectively, taking into account the potential risks involved and more importantly the potential for underperformance as the industry moves forward. While doing nothing certainly helps to reduce the governance burden, it should be noted that it may come at a cost.

We believe that investors should be aware of the arguments behind ESG focused investment to allow them to have a robust and well-informed view on it, regardless of whether they choose to integrate it or not. KPMG Investment Advisor’s view is that such a rapidly growing area of the investment universe should not go ignored.

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<table>
<thead>
<tr>
<th>Year</th>
<th>FTSE World (B)</th>
<th>FTSE4GOOD Global (B)</th>
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<td>2012</td>
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<td>$100</td>
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<tr>
<td>2017</td>
<td>$150</td>
<td>$150</td>
</tr>
</tbody>
</table>


2. Ensure managers have ESG policies in place

For investors who wish to consider incorporating ESG principles, the first and most basic consideration is to ensure that their appointed asset managers have suitable ESG factor monitoring policies in place. Although this might initially appear to be a ‘box-ticking’ response, it is a good first step that requires only marginally increased governance from investors.

Most asset managers, particularly the larger houses, will have a strong view on ESG and incorporate it into their business model, with many seeing them as an effective tool to both improve their investment process, reduce risk and enhance long-term returns.

Many managers now state that they consider ESG factors and given the infancy of the market and the basic knowledge many investors have, the challenge will be to assess how well asset managers define, integrate and apply their stated ESG policies.

To address this issue, KPMG has surveyed all the asset managers we regularly monitor to determine:

a. Whether or not they have ESG policies in place;
b. How the asset manager integrates ESG in investment decision making;
c. Whether ESG is a long-term focus for the asset manager.

Not surprisingly, almost all of the asset managers we approached claimed to have strong ESG policies and practices in place, however the breadth, width and depth of the resources dedicated to ESG practices varied significantly.

A challenge is that as interest in ESG principles has grown, so has the potential for asset managers to use this increased coverage to their advantage.

For investors wishing to only hire asset managers with sound ESG policies in place, adding these extra evaluation criteria when reviewing investment strategies and asset managers will enable them to do so. An extension of this would be to only appoint investment advisors that consider ESG and to include ESG in evaluation criteria when reviewing the investment advisor in addition to the asset manager.

A section of KPMG’s sample questionnaire is shown in the Appendix. This provides an example of some of the areas we consider when reviewing the ESG practices of the asset managers we research.

3. Appoint a manager that integrates ESG factors in decision making

Appointing asset managers that have sound ESG policies in place is advantageous in terms of ‘entry level’ ESG forward investment, however, investors may wish to go beyond this approach. For instance, only appointing asset managers that directly incorporate ESG in their investment strategies and recognise it as central to the decision making process.

Strong investment stewardship governance is key to this approach and involves engaging with companies to protect and enhance the value of clients’ assets by encouraging sustainable financial performance over the long-term.

So why do investors view ESG integration as a function of good investing?

A greater amount of information helps an asset manager to make better informed decisions which could result in improved risk-adjusted returns. Understanding the wide-ranging sources of risk is key. As consideration of ESG factors naturally expands the opportunity set, it provides a basis for deeper investment analysis. A number of studies have indicated that there is a positive or at least neutral financial impact of implementing it.

For instance, the Oekom sustainability financial reporting study suggests investors receive a ‘double dividend’ in the form of a better rate of return with lower risk because companies that incorporate ESG factors are more conscientious, less risky and perform better in the long-term.

Where investors have ethical objectives, this approach can help the investors achieve them. Evidence is growing that investors no longer see financial performance as their sole objective, but are also seeking to align financial goals with their social goals by leveraging their assets to influence change and have a positive impact.

As noted earlier, embedding ESG factors in the investment decision making process can enhance risk management. For instance, it typically helps to minimise regulatory and political risk. This may help to promote the proper functioning of markets by reducing market failures that arise from weak corporate governance. For example, following a number of high profile corporate governance and accounting scandals, including those of Enron and WorldCom in the early 2000s, there has been increased recognition that ESG-related risks can impact shareholder value.

Since asset managers allocate capital on behalf of investors, investors may gain comfort in knowing that the asset manager has considered sustainability and the impact on the health of companies operating in financial markets. This may help in improving an investor’s reputation by aligning themselves with asset managers who incorporate ESG in decision making.
What should investors look for in an asset manager?

— The manager actively engages with companies on ESG issues to enhance influence on companies and ensure effective board leadership for long-term value creation. Ideally the manager has a policy for actively engaging ESG factors in influence and change.

— The manager would ideally have specialist ESG teams, e.g. a sustainability team that engages with the portfolio manager and wider team to integrate and develop their ESG approach. The team would work closely with the portfolio manager to assist with decision making.

— The manager’s stewardship policies focus on ESG issues, they are an active steward and believes ESG driven investment maximises the probability of long-term financial performance and reduces risk. This involves the manager exercising voting rights to influence management behaviour and assessing company documentation to set out sustainable governance risks in the portfolio.

— The manager shares common goals with the investor and has a framework in place to achieve them.

— The manager can formally define how they integrate ESG principles and practices each day and has a public ESG policy statement in place. For example; ‘is not applying ESG factors a threat to sustainable economic growth?’

Outlook for this approach

As increased regulation favours a shift towards ESG principles making the issue increasingly mainstream, it would be ideal if the industry evolved so that a set of standardised ESG disclosures within a consistent global framework is developed. Whilst transparent reporting of ESG factors is often cited as a challenge, due to increased attention from investors and the media, an increased interest in formalised reporting is emerging. KPMG Investment Advisory views this as a positive trend and views asset managers that monitor, engage and report on companies ESG policies as best practice.

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UN PRI Signatories and AUM

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Signatories</th>
<th>Assets under management (US$ trillion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>63</td>
<td>$65</td>
</tr>
<tr>
<td>2016</td>
<td>1714</td>
<td>$68.4</td>
</tr>
</tbody>
</table>

Taking ESG driven investing even further, investors could develop a bespoke ESG policy incorporating ESG factors. This is in line with 2nd UN Principle of Responsible Investment which states that “we will be active owners and incorporate ESG issues into our ownership policies and practices.

Once an investor has customised their own ESG policy, the investor can take an active ownership approach to actively engage directly with companies to encourage change.

How to actively engage in ESG?

— Understand your obligations as an investor (legal, regulatory etc.).

— Define or set investment goals.

— Establish a set of ESG beliefs which will form the basis for how these issues will be approached and how the assets are invested. A formal statement could be developed as a basis for investment decision making.

— Share investment beliefs throughout your organisation and lobby to implement them.

— Agree an investment strategy where the investment approach is aligned with investment beliefs.

— Establish governance processes, ensure ESG factors are incorporated in selection of all advisors. This could include assigning a specific weight to ESG factors in asset manager and investment advisor decisions.

— Monitor, review and report the implementation of investment goals. Scrutinise the manager’s approach to governance and stewardship.

Who might this appeal to?

Defined Contribution Pension Schemes – may receive pressure from beneficiaries who wish to incorporate ESG beliefs in their pension choice.

Defined Benefit Pension Schemes – trustees rely on the scheme sponsor for contributions. By maintaining an investment strategy that avoids reputational risk, the trustees and sponsor can maintain a good relationship. It has been a requirement for trustees to disclose ESG policies since 1996 Pensions Act.

Millennials – have grown up with issues like global warming so are conscientious of the topic.

Charities – can tailor their ESG policy to match the mission of the charity.

Family offices – may have specific ESG beliefs they wish to incorporate in their investments.
Conclusions and next steps

Conclusions

The integration of ESG principles into portfolio construction is a growing trend in asset management. Given that the topic is an ever-evolving area, KPMG Investment Advisory’s view is that investors should regularly review their approach to the integration of ESG principles.

It is becoming more and more important for investment advisors and asset managers to communicate the growing trend in ESG to clients. Many industry commentators are now communicating that it is no longer a nice to have, but something that is a key driver of financial returns and assists in reducing the volatility of those returns.

Whether or not investors wish to include ESG principles as part of their investment decision-making process depends on their beliefs and circumstances. It is worth noting that strong engagement could lead to a status quo, causing others to disinvest from industries that are perceived to be less favourable from an ESG perspective. This in turn may encourage sectors with poorer ESG practices in place to improve their standards. KPMG Investment Advisory views this as a positive externality.

Next steps for investors who wish to consider ESG factors:

— Ask your investment consultant about the options available to you.
— Consider the level of ESG integration currently reflected in your investment strategy.
— Define your own ESG principles.
— Agree the level of resource you are able to dedicate.
— Determine how active an approach you wish/are able to take in terms of engagement.
— Consider incorporating ESG criteria into the process for both selecting and monitoring investment advisers and asset managers.

Appendix

Sample questions for asset managers

<table>
<thead>
<tr>
<th>Question</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is ESG integration relevant for this asset class?</td>
<td>ESG integration may not be applicable for all asset classes.</td>
</tr>
<tr>
<td>Has the manager signed the UN PRI and are they compliant with UK Stewardship Code?</td>
<td>The UN PRI and UK Stewardship Code were created as a set of guidelines to help investors, investment managers and service providers incorporate ESG factors into decision making around RI. Compliance demonstrates an initial commitment to sustainability and RI, but both are complex and detailed and full incorporation of all aspects requires work and close manager monitoring.</td>
</tr>
<tr>
<td>Does the firm as a whole have a defined ESG/RI policy in place?</td>
<td>Firm wide policies tend to create more accountability for managers to meet ESG criteria when making decisions.</td>
</tr>
<tr>
<td>Specialist ESG teams?</td>
<td>A dedicated ESG team demonstrates the commitment to ESG policies and improving the quality of ESG research.</td>
</tr>
<tr>
<td>How is ESG embedded into investment process e.g. do they follow an index provider watch list?</td>
<td>Managers may vary how and at which stage they integrate ESG into investment decisions and the optimal approach is often down to the preferences of the investor.</td>
</tr>
<tr>
<td>Does the asset manager use third party data e.g. Bloomberg, Sustainalytics, Factset etc.</td>
<td>Third party specialist research and tools can aid managers in making more effective and informed ESG decisions.</td>
</tr>
<tr>
<td>Do they have an algorithm to provide ESG ratings?</td>
<td>Managers with internal ESG models are likely to place more emphasis on ESG factors in decision making.</td>
</tr>
</tbody>
</table>
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