

## **“A Study on the Impact of Environmental, Social, and Governance on Investment Performance”**

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### **Abstract**

The practice of addressing environmental, social, and governance (ESG) issues while investing has seen tremendous development from its beginnings in the exclusionary screening of listed securities based on moral ideals. These issues now form the basis of the ESG framework. When it comes to examining environmental, social, and governance (ESG) issues across asset classes, investors who are driven by value as well as values are increasingly using a range of strategies. There is, nevertheless, a persistent misconception that the corpus of empirical research suggests that issues of environmental, social, and governance (ESG) have a negative impact on financial performance. The assumption that systematically examining ESG issues would likely lead to more comprehensive investment evaluations and better-informed investment choices is a central one in the conversation around environmental, social, and governance (ESG) issues for investment professionals.

**Keywords: Environmental, Social, and Governance (ESG); Financial Performance; Impact Investing; Climate Change; Short-Termism.**

### **Theoretical Background**

It is not a new phenomenon to consider environmental, social, and governance (ESG) issues while investing for financial benefit. Many investors have for a long time included an evaluation of reputational risk, regulatory changes, or megatrends such as an aging population as part of their basic investment analysis. This has been the case for many of these issues. Traditional analytical frameworks, like Porter's Five Forces, also include additional ESG analysis. However, the present references to ESG analysis relate to a comprehensive evaluation of relevant and substantial ESG issues as opposed to a superficial inclusion of one or more of them. ESG issues are significant throughout the whole investment process, from the initial analysis through the choice to purchase, sell, or keep an asset, as well as continuing ownership practices. The evaluation of ESG issues is a supplement to traditional fundamental analysis, and ESG issues stay relevant throughout the process. There is a continued interest in environmental, social, and governance (ESG) issues in investing by civil society, policymakers, and of course the news media. This interest is sustained because large corporations play a prominent role in the global economy, and a large proportion of corporate securities are held by fiduciary investors. In addition, there is a challenge of trust in the financial system.

### **Moral Values Vs. Economic Value**

ESG issues are important to investors for a variety of reasons. Some people could only consider them in terms of the economic possibilities and dangers they present—a source of economic value. For some people, environmental, social, and governance (ESG) issues aren't merely a question of dangers and possibilities; they're also an issue of moral principles. Those who are driven by their moral beliefs may not want to be associated with behaviors that they find offensive, or they could want to have a constructive effect on society or the environment. In the discussion over "value versus values," one of the most important points to keep in mind is that all investors want the same economic value, even if their investment goals and time horizons are different; nonetheless, they will always have distinct ethical values. Traditional socially responsible investing makes use of a variety of exclusionary screens in order to assist explain the many principles that are included into the investment process. The practice of investment management accommodates both a values-based and a values-based ESG approach simultaneously. The rise and development of values-based investing are also evident. There is a great deal of interest among both investors and regulators in contemporary impact investing, which combines value and values in a holistic manner. Having said that, value-based investing is obviously far more widespread than value-based investing.

### **Short-Termism**

ESG issues do not mesh well with short-termism in investing, which refers to an excessive concentration on quarterly profits and a lack of attention to the development of long-term value by some business executives, investors, and analysts. This is a key and repeating subject

involving environmental, social, and governance (ESG) issues, and it is one of the most important aspects of these issues. Short-term thinking is prevalent in financial markets due to a variety of institutional factors and behaviors, the most prominent of which are financial incentives and culture. Because they have a tendency to effect financial performance over longer periods of time, environmental, social, and governance (ESG) issues do not mesh well with short-termism.

### Majority Consider ESG Issues

The debate on environmental, social, and governance (ESG) issues begins with the assumption that these issues, especially environmental and social issues, do not get adequate attention in the decision-making process about investments. There are several hypotheses that might be entertained to explain why this is the case. There are three that stick out:

1. It is challenging to put a monetary value on environmental, social, and governance (ESG) issues and to include them into quantitative models.
2. The disclosure of information by corporations relating to ESG may be restricted, not validated, and not standardized.
3. Environmental, social, and governance issues have a tendency to have a long-term impact on financial performance, although the investment horizons of many investors are very short-term, as was said before.

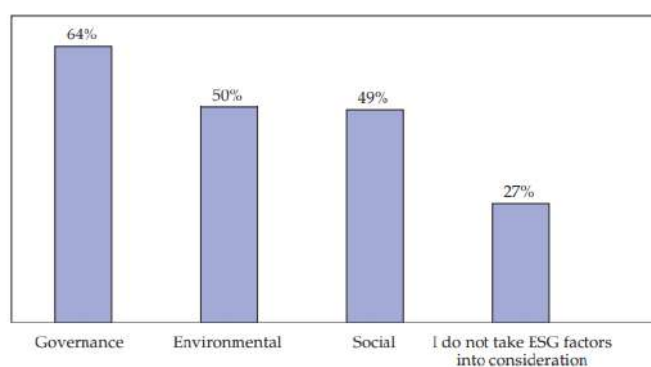


Figure 1: ESG Issues Considered

### ESG Issues in Investing

#### Climate Change and Other Environmental Issues

The continued emission of greenhouse gases is "increasing the likelihood of severe, pervasive, and irreversible impacts for people and ecosystems," as stated by the Intergovernmental Panel on Climate Change (2014). In order to mitigate the risks posed by climate change, "substantial and sustained reductions in greenhouse gas emissions" are required. According to the "Global Risks 2015 Report" published by the World Economic Forum, the "failure of climate-change adaptation" is ranked as the fifth most significant risk among the "top 10 risks in terms of impact" (World Economic Forum 2015, page 3).

Because of the dangers presented by climate change, carbon-intensive energy sources are going to be subject to increased regulation and taxes. It is quite possible that future climate change legislation will have an impact on many different businesses, even some that fall outside of carbon-intensive industries, most notably the insurance industry. Even if climate change is perhaps the most significant environmental challenge that investors are now confronting, it is apparent that it is not the only one.

#### Social Issues

When it comes to how the general public views investments, social issues are playing an increasingly crucial role. A company's image, and hence its ability to turn a profit, might take a hit if there is negative publicity around its health and safety record or abusive labor practices. In a similar vein, social movements, such as an increasing worry over obesity, are likely to influence the long-term prospects of some industries, such as the food industry.

On the other hand, the impacts of social issues are not limited to a person's reputation. A decline in a company's connection with its labor force or the areas in which it operates may have a

negative impact on the profitability of the business. Businesses are able to make changes to their procedures and persuade their stakeholders and investors that they have done so.

### **Governance Issues Taken into Consideration**

Governance issues have a tendency to continue to be material and relevant across all firms and industries. Corporate governance has received the greatest attention among the environmental, social, and governance (ESG) issues in academic programs for business and finance, as well as in investment research and analysis. However, social issues such as human capital and environmental issues such as environmental degradation are also included in the category of governance issues.

### **Principles, Standards, and Advocacy**

A number of principles, standards, conventions, and associated advocacy organizations serve as a common reference point for investors considering "ESG issues, including PRI, UN Global Compact, Equator Principles, OECD Guidelines for Multinational Enterprises, International Labor Organization Declaration on Fundamental Principles and Rights at Work, SA 8000 (auditable social certification standards for decent workplaces), and ISO 26000". Exclusionary screening and active ownership are only two of the ESG strategies that some investors use with the help of these frameworks.

### **Law and Regulation**

There are currently a variety of laws and regulations in existence that deal to ESG issues, and more are being added all the time. According to a research that was conducted in 2013 by KPMG, the Centre for Corporate Governance in Africa, the Global Reporting Initiative, and UNEP, there are 180 laws and regulatory standards in 45 countries that deal to corporate sustainability reporting. Of these, 72% are required for businesses. One obvious illustration of this would be the many codes of corporate governance that are used in various regions of the globe. Other instances include the prohibition of contentious weapons in Belgium, the establishment of a stewardship rule for institutional investors in the United Kingdom, and the disclosure of the corporate social responsibility actions of publicly traded firms in Malaysia. The demand that investors disclose the degree to which they take into consideration environmental and social issues when making investment choices and determining shareholder rights is a trend that is emerging in many different regions of the globe.

### **Relevance across asset Classes**

The majority of the discussion on environmental, social, and governance (ESG) issues has been centered on listed stocks; however, it is becoming more common practice to evaluate ESG issues in relation to other asset classes, most notably fixed income.

ESG issues are mostly focused on risk in fixed income. Issues like carbon emissions, labor relations, and corruption are just a few examples of how ESG analysis in fixed income takes these factors into account.

Governance in fixed income, much as in stocks, is the ESG problem that receives the greatest attention. Before making any choice on an investment, fixed-income investors need to have a comprehensive understanding of the corporate structure and governance of the issuing firm as well as any linked companies. One example of this would be an emerging market high-yield corporate debt offering.

### **Application: The Six Methods for Considering ESG Issues**

#### **Exclusionary Screening**

The term "exclusionary screening" refers to the practice of avoiding securities issued by firms or nations based on traditional moral values (such as avoiding items or services involving alcohol, cigarettes, or gambling), as well as standards and norms (such as those relating to human rights and environmental preservation). Exclusions that are driven by values place an emphasis on the operations of the firm while also excluding participation from whole market segments. When doing a screening based on norms, the primary emphasis is placed on the manner in which the business operates in relation to generally acknowledged norms in fields such as human rights and labor standards. In situations in which such values-based avoidance is written into the law that governs a situation (for example, a prohibition on funding contentious weapons), exclusionary screening may likewise constitute a legal requirement. The

most traditional approach to ESG is called exclusionary screening. When doing exclusionary screening based on values and norms, it is essential to keep in mind that the specific security in question will not be invested in, despite the fact that it may become economically desirable in the future. The explanations that MSCI provided in 2014 to explain the values-based and norms-based exclusions for its ACWI Select Global Norms and Criteria Index have been used for the rest of this section.

### **Best-in-Class Selection**

The term "best-in-class selection" refers to the practice of favoring companies who have superior or increasing ESG performance in comparison to their counterparts in the sector. It may be applied on either the level or the change in ESG performance, which would mean investing more in businesses that have superior ESG performance levels or momentum in comparison to other companies in the same sector. Methodologies that are considered to be the best in their field are frequently referred to as positive selection or positive alignment. The rest of this section is dedicated to a discussion of NN Investment Partners' use of a best-in-class selection strategy.

### **Active Ownership**

Active ownership is the practice of engaging in a conversation with companies about environmental, social, and governance (ESG) issues and exercising ownership rights and voice in order to affect change. The purpose of one's engagement with a corporation may be to either monitor or influence the results and practices pertaining to ESG issues. The concept that investors should "vote with their feet," that is, simply sell off the assets that are engaged in problematic practices, stands in stark contrast to the concept of "active ownership." There is a spectrum of degrees of aggression that may be seen in activism. Some investors may choose to take actions that are publicized and confrontational, while others may choose a strategy that is more discrete. It is important to keep in mind that "active ownership" is not always the same as "activist investing," which may depend more on the aggressive methods that are often associated with hedge funds. The following behaviors constitute active ownership of a property:

1. Vote at shareholder general meetings.
2. Compose a letter that you will send to the company.
3. Speak with personnel from the company.
4. Suggest a topic for discussion at a general meeting of the company's shareholders.
5. Put forth a resolution for the shareholders.
6. Make an effort to secure a position on the board.
7. Give notice to the shareholders that an extraordinary or special meeting will be held.
8. Make a formal complaint to the governing body or authority.
9. Distribute a statement to the various press outlets.

part investors opt to pool resources and outsource part of the operations linked to involvement since achieving the intended effects of active ownership takes time and comes with costs, most notably staff time. Next, we will examine specific instances of active ownership that are directly pertinent to environmental, social, and governance issues.

### **Thematic Investing**

Investing that is based on patterns, such as social, industrial, and demographic trends, is known as "thematic investing." A few investment strategies are centered on environmental, social, and governance (ESG) issues. These strategies include clean technology, green real estate, sustainable forestry, agriculture, education, and health care. Even while environmental, social, and governance (ESG) issues aren't the only ones that may be addressed through thematic investing, the examples we'll look at here are particularly relevant.

### **Impact Investing**

The term "impact investing" refers to the practice of making financial investments with the public goal of generating and measuring social and environmental benefits in addition to a

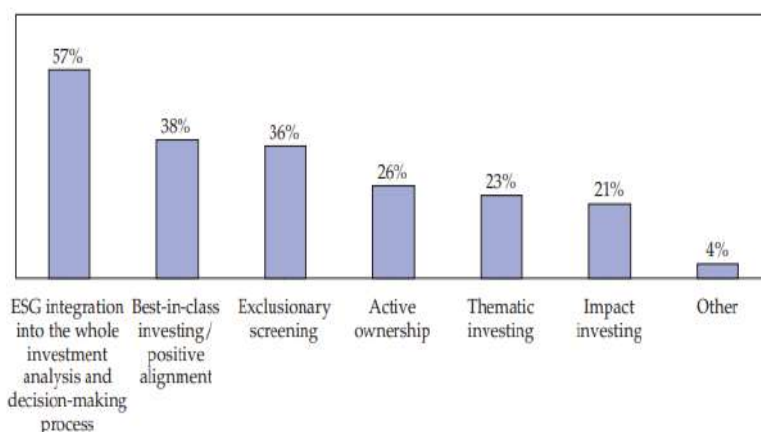


financial return. The Global Impact Investing Network identifies these four basic characteristics as being present in the practice of impact investing:

1. Investors want to have a positive social and/or environmental effect with their money.
2. It is reasonable to anticipate that investments will provide a financial return on capital and, at the very least, a return of capital.
3. The expected return on investments is between the market rate and a risk-adjusted version of the market rate.
4. Investors have pledged to monitor and report on the economic, social, and environmental repercussions of their investments.

### ESG Integration

Systematic and explicit incorporation of ESG risks and opportunities in investment analysis is referred to as ESG integration. ESG integration, in contrast to the best-in-class strategy, does not always need peer group benchmarking or overweighting (or underweighting) the leaders or laggards in the industry. In a same vein, there are no pre-established requirements for inclusion or exclusion with regard to ESG integration. Most, if not all, investors should consider integrating ESG risks and opportunities into their investment analysis.



**Figure 2. Methods of Considering ESG Issues**

### Challenges Regarding ESG Consideration

#### Disclosure Remains a Challenge

Investors are only able to take environmental, social, and governance (ESG) issues into account when making investment choices if they have access to information that is both relevant and current. At the moment, statutory corporate disclosure offers only a limited amount of information about the potential and dangers associated with ESG. It's possible that the disclosure about ESG-related matters may be made public at a different period than the ordinary financial statements, which would make integration more difficult.

It is important to note, however, that there has been an increase in transparency and data. Efforts are being made to increase ESG disclosure through a number of programs. One such effort is the Sustainable Stock Exchanges effort, which demonstrates how stock exchanges may collaborate with investors, regulators, and companies to promote corporate ESG transparency. In a similar vein, the availability of data is growing, even though there is a need for both improved quality and more quantity. For instance, the number of significant worldwide companies who disclosed their policies for water management, greenhouse gas emissions, and climate change to the environmental nonprofit group CDP increased from 295 in 2004 to 5,003 in 2014.

The difficulty associated with voluntary disclosure is that companies may choose to disclose and emphasize just those aspects of themselves that reflect well on them, while minimizing or omitting those aspects that do not reflect favorably on them. This tendency could restrict ESG analysis as well as skew the results toward focusing more on disclosure than performance.

### **Fiduciary Responsibility**

It is difficult to provide a comprehensive answer to this question since the law governing fiduciary obligation differs greatly from country to country. According to the findings of two separate reports titled "A Legal Framework for Integrating Environmental, Social, and Governance Issues into Institutional Investment," also known as the Fresh fields Report and the Fiduciary II Report, the consideration of ESG issues in the pursuit of economic value is permitted by legal interpretations of fiduciary duty and may even be required in some circumstances. Despite this, there is still a degree of uncertainty around the topic.

The report "Fiduciary Duty in the 21st Century" contends that "failing to consider long-term investment value drivers, which include environmental, social, and governance issues, in investment practice is a failure of fiduciary duty" (Sullivan, Martindale, Feller, and Bordon 2015, page 9). This assertion is based on an analysis of eight countries, including both common law and civil law jurisdictions, in the context of ESG integration.

When the law regulating fiduciary obligation makes it easier for investors to take ESG issues into account, the justification for doing so is enhanced. Take, for instance, the case of South Africa, where expressly incorporates references to ESG considerations: A fund has an obligation to operate in the best interest of its members, whose benefits are contingent on the prudent management of fund assets. This duty is known as a fiduciary duty. The practice of prudent investing requires taking into account any element that has the potential to meaningfully impact the sustainable long-term performance of a fund's assets. These types of issues include environmental, social, and governance considerations.

The logic that underpins the concept of fiduciary responsibility is inextricably tied to the impact that environmental, social, and governance (ESG) factors have on the financial performance of assets. There is still a widespread misunderstanding that the primary ESG strategy is exclusionary screening, which should only be used by investors who are driven by their values.

### **Financial Performance**

One of the areas that has garnered a significant amount of attention, if not the most attention, in research on ESG issues is financial performance. There are hundreds of research articles on ESG issues included in the Sustainable Investment Research Initiative Library, which is a searchable library of academic studies. A large number of these publications focus on performance. In 2014, the University of Oxford and Arabesque Partners collaborated on a paper that summarized and evaluated the findings of about 200 different research to determine how sustainable corporate practices might effect investment returns. The most important thing to take away from this is that the actual data does not support the idea that taking ESG factors into account would inevitably have a negative effect on performance. This conclusion makes logical sense in the context of ESG integration since, in theory, there should be no unfavorable effect on performance if it is just a matter of doing a more comprehensive investment analysis.

### **Fossil Fuel Divestment and Stranded Assets**

Campaigns to divest from companies have been a component of the development of ESG factors as an investing concern. During the 1980s, one of the most significant divestment campaigns targeted the apartheid administration in South Africa. These kind of campaigns often have the most effect when they are able to influence the public discourse, which may lead to the stigmatization of the companies and industries involved and, more crucially, may result in changes to the law that affects those companies and sectors. The most recent push for divestment focuses on fossil fuels in the context of climate change and impacts on a variety of sectors, including coal mining and steel. Students and other stakeholders exert a great deal of pressure on many school endowments, urging them to divest from fossil fuel. Some endowments have made public announcements on their choices to divest, while others have made public announcements regarding their decisions not to divest. One of the most important arguments stated by supporters of divestment is that no one should be allowed to benefit financially from wrongdoing. However, the divestment of an investment business based on moral values creates questions about the fiduciary obligation and the value of the financial performance. Stranded assets are one area in which the discussion on fossil fuel divestment becomes an economic factor for fiduciary investors. There is a possibility that certain climate-

sensitive assets, most of which are fossil fuel reserves, might be written off, revalued downward, or converted into liabilities primarily as a result of government legislation. It is possible that the performance of investments may suffer if the financial markets fail to price the risks of stranded assets.

### **Regional Differences**

The perceived willingness and capability of investment corporations to address environmental, social, and governance (ESG) issues in investing varies among regions, as well as within regions. For instance, investors in developed markets that have relatively robust regulation would reasonably assume that some of the environmental, social, and governance (ESG) issues are being addressed by regulation.

### **Innovations in Impact Investing: Green Bonds and Social Impact Bonds**

2007 saw the beginning of the green bonds market, which was first supported by multilateral institutions. Green bonds are a process rather than a finished product; yet, they make it possible to raise capital and make investments in environmentally beneficial projects, both new and current. The Green Bond Principles, which serve as its primary foundation, are a collection of voluntary rules concerning the process, which is why this is the case. Even if this sector of the market has expanded rapidly, one of the most important questions that pertains to green bonds is that of additionality; specifically, whether or whether green bonds finance projects that otherwise would not be financed. Green bonds continue to represent a very little portion of the total fixed income market, with annual issues expected to be less than \$100 million in 2015. The issuance of social impact bonds was an additional innovation in the field of impact investing; the first of these bonds was issued in the year 2010. A social impact bond is a contract between a special purpose entity and the government in which the government pledges to pay for better social outcomes, such as lower recidivism rates for prisoners. A social impact bond is an example of a contract with this kind of purpose. Investors have the opportunity to work toward solving social issues by investing in social impact bonds. They find a middle ground between giving money out of pure altruism and seeking a financial return only for one's personal advantage by offering both an economic return and a social return in addition to the economic return. According to estimates, the market for social impact bonds is far less significant than the market for green bonds.

### **ESG Issues and Passive Investing**

Although environmental, social, and governance (ESG) issues have traditionally been linked with active investing, it should be noted that these concerns are equally important to passive investing and, more broadly, rules-based investing. When ESG factors are included into the benchmark index, it opens up opportunities for investors to profit from those factors. There are a few indexes like this one that are available. In addition, passive investors may utilize active ownership as a risk management strategy for their environmental, social, and governance issues. However, they require a strategy and systems to guarantee that various investment managers do not adopt contradictory views on behalf of the same asset owner while exercising active ownership.

### **Modern Applications: Smart Beta**

ESG methodologies are now being integrated with strategies such as smart beta. In the context of stock indexes, the term "smart beta" most often refers to weighting methods that do not employ market capitalisation as one of their primary factors. There have been explorations into the possibility of combining smart beta with ESG standards. Utilizing an alternate weighting to stocks that have previously been picked for better ESG ratings is one method that may be used to form a smart beta ESG index. In 2015, a low-volatility smart beta ESG index was introduced. This index analyzes the performance of the 50 stocks within a selection of sustainable stocks that are the least volatile. However, it does not include stocks related to adult entertainment, alcohol, tobacco, gambling, weapons and ammunition, or adult entertainment. The alternate weighting scheme may also be constructed by first filtering stocks based on characteristics such as low volatility, and then applying criteria related to environmental, social, and governance factors.

### **Obstacles to Practical Implementation**

The manner in which ESG issues are considered has drawn some criticism. Some of the criticism is similar to the arguments that environmentalist and businessman Paul Hawken made in 2004 against socially responsible investing. According to Hawken, "the cumulative investment portfolio of the combined SRI [socially responsible investing] mutual funds is virtually no different than the combined portfolio of conventional mutual funds" (Hawken 2004, p.16). In other words, there is very little difference between the two types of mutual funds. The conclusion here is that the credibility of "responsibility" weakens if any company can be considered investable using one approach or another. There is no way to get around the fact that taking environmental, social, and governance factors into account is inherently subjective, just as there is no way to get around the fact that active investing in general is inherently subjective. However, the degree of subjectivity that exists regarding both the process and the product is still a problem that must be overcome for ESG integration.

There is good clarity on the process that these two analysts follow, and there are textbooks that have been around for a long time that describe this process. Nevertheless, the values that they arrive at might be substantially different from one another if they use discounted cash flow analysis. The same cannot be said for the integration of ESG. If "responsible" portfolios incorporate assets that have debatable ESG performance, then the increased subjectivity makes the problems about credibility even more apparent. Taking into account environmental, social, and governance (ESG) issues as a practice requires greater clarity on how to implement ESG methodologies, most notably ESG integration. Obviously, using evidence-based cause-and-effect attribution for ESG approaches may be somewhat challenging, and this is completely understandable. It is very easy to demonstrate how values-based exclusionary screening may lead to avoiding particular organizations, however demonstrating how values-based ESG integration can lead to better-informed investment choices is more difficult.

Without diminishing the magnitude of this challenge, failing to make an effort to record how ESG integration influences investment choices is not going to aid this cause. It is essential that the advantages of ESG analysis be not overstated in any way. It may not always provide investment insights and has some of the same limitations as traditional analysis. For instance, before the disaster at the Deepwater Horizon in 2010, BP had received good marks in a number of ESG evaluations. In a similar vein, Volkswagen received excellent marks in several ESG evaluations before the emissions issue that broke in 2015 came to light. Despite the fact that increased transparency on ESG issues by companies is still a demand made by certain investors, the topic is still up to discussion. One problem is that, while some investors seem favorably oriented to require more disclosure from listed companies, the disclosure practices of investment management firms and asset owners on ESG issues are not known to be substantially better. This is despite the fact that some investors seem favorably disposed to demand more disclosure from listed companies. According to one line of reasoning, in order for investors to bolster the argument in favor of more disclosure and make it more compelling to others, they need to show that they are prepared to walk the talk themselves. Those who are interested in environmental, social, and governance (ESG) issues have the expectation that as more and more investors take ESG issues into consideration, more pressure will be exerted on the companies in which they invest for those companies to improve their ESG performance. This should minimize the risk that investors face and should also make the world a better place. Nevertheless, there is a persistent conflict between being genuine and conforming to the mainstream. It will not assist to increase the credibility of ESG considerations if a rising share of global AUM professes to consider ESG issues without traceable change in investment decision making or in the conduct of investee companies.

### **Conclusion**

Both value-motivated and values-motivated investors take environmental, social, and governance (ESG) issues into consideration while making investment choices. When it came to investing, the practice of taking environmental, social, and governance (ESG) issues into account has come a long way from its beginnings in the exclusionary screening of listed shares based on moral values.



The practice of taking ESG issues into account while investing faces significant hurdles. The tendency in financial markets to focus on just the short term is a clear and fundamental difficulty that is not exclusive to ESG considerations. However, there are other others. For example, the "what" and "why" of ESG considerations have been established with sufficient clarity; nonetheless, there is a need to define "how to" implement ESG approaches, most notably ESG integration across asset classes. This is because the argument for ESG considerations has been made with sufficient clarity.

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