



# ESG Integration across Asset Classes

## *A Synopsis and Review*

Topic of the month May 2013

### **Sustainable Investing at a Glance**

**S**ustainable investing - understood as the incorporation of environmental, social, and governance (ESG) analysis into investment decision-making - is a growing discipline that offers opportunities for long-term value creation both for investors and society as a whole. The industry is a continually growing and changing field that encompasses institutional investors, asset managers and financial service providers.

In recent years, an increasing number of industry experts and academics across the globe have come to believe that key ESG developments - from climate change, to globalization, to the transforming societal expectations for corporations and finance - can have a significant role to play in long-term performance.

This belief is also reflected in the practice of 'mission-related investing' (MRI)-investing in financial products that seek to achieve social and/or environmental goals as well as yield market-rate financial returns. Foundation and university endowments, pension funds, socially responsible investors including church pension funds and socially responsible mutual funds, high-net-worth individuals, non-profits, and others target investments create long-term societal wealth while also achieving institutional financial objectives. ESG analysis and MRI share a concern with identifying and evaluating investments likely to support the long-term betterment of society.<sup>1)</sup>

For asset owners, integration of ESG factors into the investment process may help address the 'gap' between the long-term nature of their investments (30 years and longer for certain pension funds) and the short-term behaviour of their managers. For asset managers, integration of ESG factors into the investment process aims to better assess long-term risks or risks that have high impact but low frequency of occurrence.

Sustainable investing has made progress on many fronts: tools for accessing information about ESG issues are increasingly available, and publicly available data around corporate social responsibility (CSR) and sustainability practices is continually expanding; institutional investment strategies focusing on ESG-themed investments or integrating ESG factors into the investment decision-making process are common across many traditional and alternative asset classes; and, finally, research into the relationship between financial performance and ESG factors, both academic and applied, continues to improve in quantity and quality (see more details below).

In addition, public communication standards with regards to sustainable investing-related activities and reporting have increased significantly.

*'The investment world is changing - it's accepted nowadays that ESG factors do have a potential effect on investments'*



The interest in ESG / sustainable investing has been driven by a variety of catalysts, including:

### **The Role of the PRI**

An increasing number of institutional investors are showing interest in ESG integration and are adopting sustainable investment strategies and policies. Since 2005, the number of signatories to the UN Principles for Responsible Investment (UN PRI) has grown steadily and reached 1,085 in July 2012, including 258 asset owners and 651 investment managers. Collectively they represent US\$32 trillion of assets.<sup>2)</sup> According to the UN PRI, about 94 percent of signatories have adopted RI policies.<sup>1)</sup>

This result underscores growing acceptance of the principle that investors cannot, in the long run, achieve their goals by investing in corporations that externalize their costs onto society.

### **The Role of Universal (Asset) Owners**

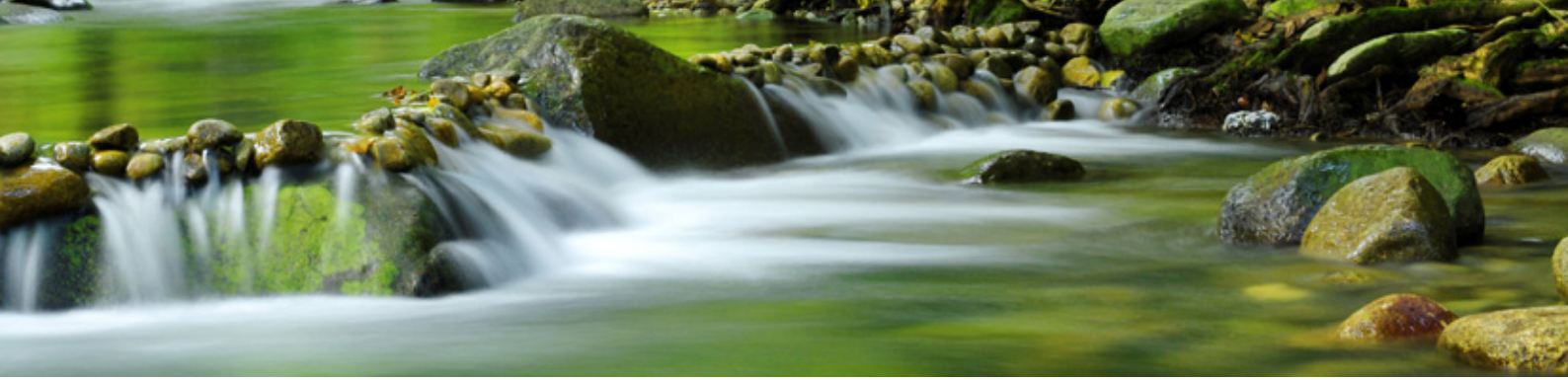
Central to the philosophy of sustainable investing is a concept called ‘Universal Ownership’.<sup>4)</sup> A Universal Owner is defined as a longterm owner of a diversified investment portfolio that is spread across the entire market or markets. As a result, Universal Owners collectively own a share of the economy and are effectively tied into this share in the longer term. Universal Owners subscribe to the hypothesis that the longterm financial interest of their investments depends on the ability of global markets to produce economic growth on a sustainable basis. As a result, they infer that their actions should involve managing their longer term risk through asset allocations and active ownership practices that are sensitive to longer term ESG factors.

A key argument supporting ESG investing from the perspective of a Universal Owner is the realization of portfolio externalities. Portfolio externalities are spill over production or consumption effects that cause other unrelated parties to incur costs for which no appropriate compensation is paid. Such unpriced economic costs or benefits can often be internalized in investors’ investment portfolios, typically through crossholdings. While investors are directly compensated by the current returns of their investment portfolios, they also indirectly own the externalities generated by companies, which may offset the portfolio return in future. Most longterm investors have the fiduciary responsibility to ensure multi-period sustainability of their investment portfolios.<sup>5)</sup>

### **Availability of ESG Data and Information**

ESG data and information has become more mainstream as well. Three main drivers have led to a greater availability of ESG information:

- *Regulation: An increasing number of regulations that require companies to disclose their ESG performance have been adopted globally, including in emerging markets.*
- *ESG (research) networks: An increasing number of financial institutions are forming their own ESG and sustainability research departments<sup>6)</sup> supported by regional sustainable investment networks.*
- *Mainstream data providers: The market demand for ESG information has led to the entrance of well-funded financial information providers on the market and to the consolidation of smaller and more segregated data providers.*



Today, MSCI ESG Research provides research, analysis and ratings for more than 5,000 global companies and MSCI ESG IVA Ratings are also mapped to over 260,000 fixed income securities.

### ESG Factors and Portfolio Optimization

On balance <sup>7)</sup>, academic studies and industry analyses indicated that investors employing ESG factors did not impose a significant performance penalty, that investors achieved comparable risk-adjusted returns to non-ESG tilted strategies, and that investors may have enhanced their returns through the use of certain ESG strategies. <sup>8)</sup> For long-term investors such as Asset Owners, the evidence increasingly shows merit in sustainable investment approaches practiced within the context of fiduciary duty. <sup>9)</sup>

In the first quarter of 2013, MSCI ESG Research released a whitepaper <sup>10)</sup> and webinar <sup>11)</sup> on ‘Optimizing Environmental, Social, and Governance Factors in Portfolio Construction’. In the paper, we outlined that institutional investors wanting to integrate ESG factors in their investment strategies need the right tools to measure portfolio risk characteristics and performance. MSCI’s BarraOne and Barra Portfolio Manager can provide this utility with Intangible Value Assessment (IVA) ratings from MSCI ESG Research.

We examine the use of IVA ratings with the Barra Global Equity Model (GEM3) to build optimized portfolios with improved ESG ratings, while keeping risk, performance, country, industry, and style characteristics similar to conventional benchmarks, such as the MSCI World Index. The risk model allowed us to separate systematic sources of active return - that is, common factor contributions - from asset specific return sources associated with IVA scores.

While our study was designed primarily as an enhanced indexing exercise, and focused on achieving benchmark returns comparable to the MSCI World Index, we identified three possible strategies during the observed period (February 2007 to December 2012) that raised ESG ratings with minimal effects on benchmark tracking error:

- *ESG worst-in-class exclusion;*
- *ESG best-in-class overweighting;*
- *ESG momentum toward ratings improvements*

### ESG Integration Strategies - Across Asset Classes

Recent research shows a trend toward developing models and tools for ESG integration across all asset classes, with a stronger penetration in the public equity space. <sup>12)</sup> Out of 5,175 ESG strategies analysed by the consulting group Mercer, around 57 percent were in listed equities, 20 percent were in fixed income, and the remaining 23 percent were spread across alternatives. <sup>13)</sup> While ESG integration is rising, not all ESG strategies, including ESG integration, screening, ESG-branded investment and governance / active ownership, achieve the same level of integration. <sup>14)</sup>

*‘Sustainable Investing is a growing discipline that offers opportunities for long-term value creation both for investors and society as a whole.’*



Active ownership is the most prevalent activity as the importance of proxy voting and monitoring corporate governance practices is typically considered to be a component of fiduciary duty within the mainstream financial community. Engagement activities have also been continually increasing due to the emergence of international collaborative initiatives.<sup>15)</sup>

A recent webinar series<sup>16)</sup> and online survey<sup>17)</sup> on ‘ESG Integration across Asset Classes’ conducted by MSCI ESG Research from April 1 to May 10, 2013, also showed that most survey participants (35% ) focused on public equities. However, at the same time, there was a growing interest in other asset classes such as fixed income (20% ), real estate (13% ), private equity (13% ) and other alternatives (13% ) (see fig. 1).

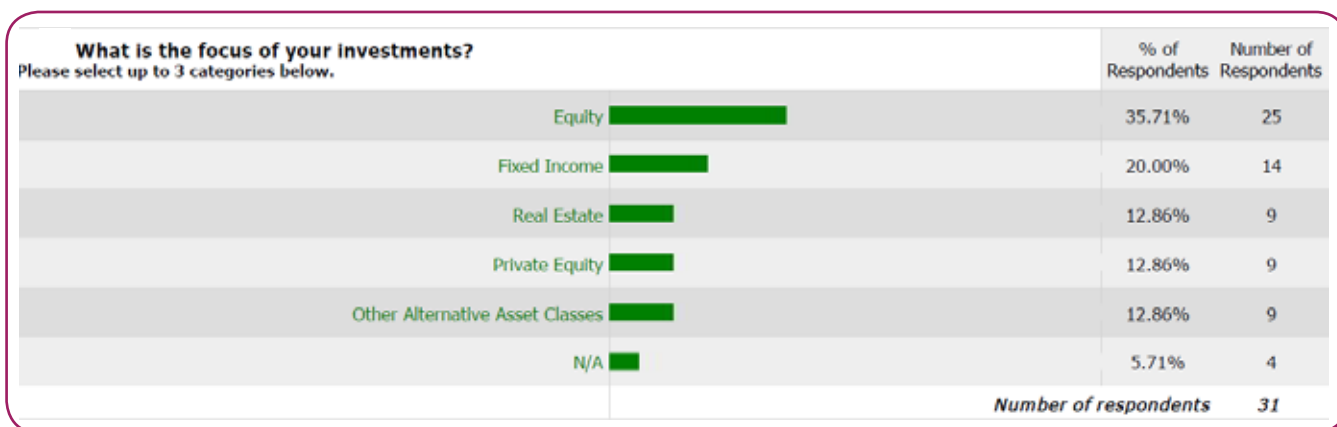


Figure 1, Questionnaire, (Source: MSCI)

Most participants (60% ) characterized the current state of ESG investing as limited or fragmented (see fig. 2).

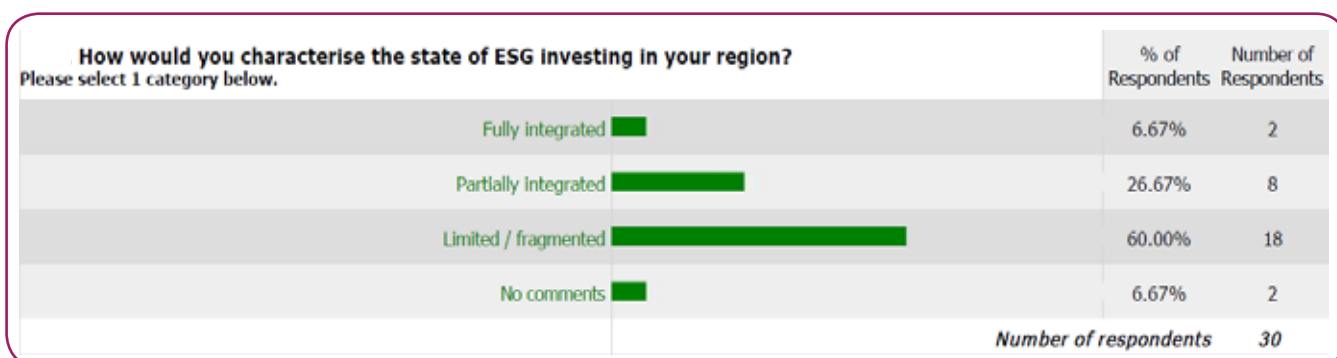


Figure 2, Questionnaire, (Source: MSCI)

Key drivers for ESG adoption were identified as follows: the PRI (25% ), asset owners (24% ), NGOs (15% ) and corporate institutions (11% ) (see fig. 3).










<b>Who is driving ESG adoption?</b> Please select up to 3 categories.		% of Respondents	Number of Respondents
Asset Owners		23.64%	13
Corporate Institutions		10.91%	6
Principles of Responsible Investment (PRI)		25.45%	14
(Non)governmental institutions		14.55%	8
Regulatory bodies		5.45%	3
Academics		5.45%	3
Other (Specify)		14.55%	8
		<i>Number of respondents</i>	<b>30</b>

Figure 3, Questionnaire, (Source: MSCI)

Participants mentioned a variety of key macro themes that feature in their investment analysis across asset classes, most commonly: 1st climate change (25%), 2nd corporate governance (25%) and 3rd resource scarcity (16%) (see fig. 4).









<b>Which ESG macro trends / factors feature commonly in your investment analysis across asset classes?</b> Please select up to 3 themes and / or add more comments below.		% of Respondents	Number of Respondents
Climate change		25.00%	17
Resource scarcity		16.18%	11
Human capital		7.35%	5
Gender and diversity		4.41%	3
Population demographics		2.94%	2
Financial market instability		7.35%	5
Corporate governance		25.00%	17
Other (Specify)		11.76%	8
		<i>Number of respondents</i>	<b>30</b>

Figure 4, Questionnaire, (Source: MSCI)

Last but not least, participants provided an outlook and perspective on ESG integration – most participants (60%) presumed that the current state of ESG investing (see fig. 2) will move from ‘limited / fragmented’ to ‘partially integrated’ (see fig. 5) in the next five years.

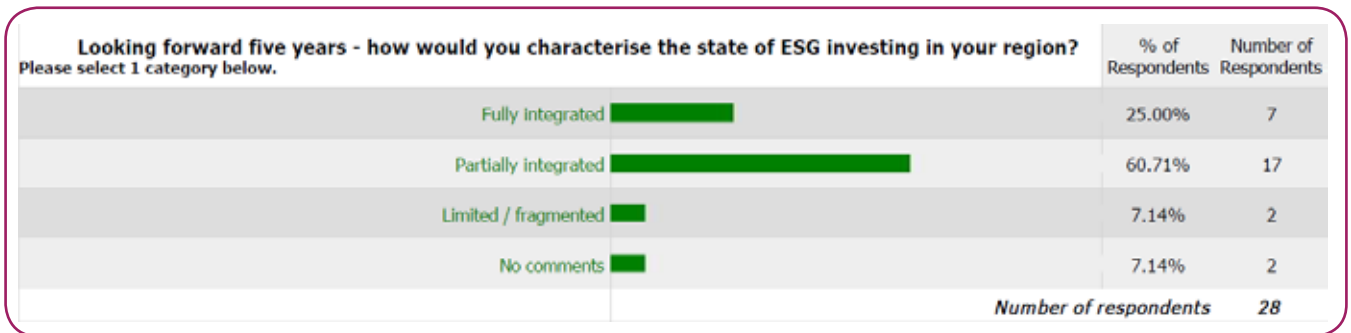


Figure 5, Questionnaire, (Source: MSCI)

## Conclusion

While financial markets globally have undergone substantial stress and change, an increasing number of institutional investors see ESG integration as a way to respond to the increasing client demand for sustainable investments.

However, without some general frameworks and how ESG products might serve the varied asset class needs, investors will remain restricted in assessing and implementing sustainable investing options, and systematic development of the field of ESG integration will remain slow.

More systematic use of portfoliolevel ESG risk measurement tools will help move ESG integration from a state that is too often aspirational to one that will have effective impact on portfolios.



**Author:**

Martina Macpherson  
 Vice President, MSCI ESG Research  
[Martina.Macpherson@msci.com](mailto:Martina.Macpherson@msci.com)

For further Information on MSCI ESG Research please visit [www.msci.com/esg](http://www.msci.com/esg) or contact ESG Client Service [esgclientservice@msci.com](mailto:esgclientservice@msci.com)

To hear more about ESG integration and the role of Asset Owners, please join us for the next MSCI ESG Research webinar debate on 'ESG – Part of the Problem or Part of the Solution for Asset Owners', May 28, 2012. For more information, please visit the MSCI ESG Research [online events calendar](#).



## Footnote and References:

- 1) *Handbook on Responsible Investment Across Asset Classes*, Boston College, Centre for Responsible Investment, in collaboration with Eurosif and Social Investment Forum, 2008, Link: - [Link](#)
- 2) *Principles for Responsible Investment Signatories*, Principles for Responsible Investment: Official Home Report 2012, Link: - [Link](#)
- 3) *PRI, 5 Years of PRI: Report on Progress*, PRI Report 2011, Link: - [Link](#)
- 4) See *'Integrating ESG into the Investment Process'* by Remy Briand, Roger Urwin, Ching-Ping Chia, MSCI ESG Research Whitepaper 2011, Link: - [Link](#)
- 5) See also *'Trends in ESG Integration in Investments'*, BSR Report August 2012, Link: - [Link](#)
- 6) See e.g. *'Do Investors Care about Sustainability? Seven Trends Provide Clues.'* By S. Lopresti and P. Lilak, PricewaterhouseCoopers LLP Report, 2012 Link: - [Link](#)
- 7) For a sceptic *'ESG / positive returns'* academic research study, see *'The Stocks at Stake: Return and Risk in Socially Responsible Investment'* by Galema R, Plantinga A, Scholtens B, *Journal of Banking and Finance*, 2008
- 8) See e.g. *'Responsible Investment's second decade: Summary report of the state of ESG integration, policy and reporting'*, Mercer / CaIPERS Whitepaper 2011, Link: - [Link](#) / *'Sustainable Investing: Establishing Long-Term Value and Performance'*, by M. Fulton, B. M. Kahn, and C. Sharples, DB Climate Change Advisors, Deutsche Bank Group, 2012; *'Sustainability: opportunity or opportunity cost?'*, RCM Sustainability Whitepaper, July 2011, Link: - [Link](#) / *'Portfolio Diversification and Environmental, Social, or Governance Criteria: Must Responsible Investments Really Be Poorly Diversified?'* by A Hoepner, University of St. Andrews, 2010
- 9) *'Responsible Investment's second decade: Summary report of the state of ESG integration, policy and reporting'*, Mercer / CaIPERS Whitepaper 2011, Link: - [Link](#)
- 10) *'Optimizing Environmental, Social, and Governance Factors in Portfolio Construction'*, MSCI ESG Research Whitepaper by Douglas Cogan, Dan Sinnreich, Zoltan Nagy, February 2013, Link: - [Link](#)
- 11) *'Optimizing Environmental, Social, and Governance Factors in Portfolio Construction'*, MSCI ESG Research Webinar, hosted by Douglas Cogan, Dan Sinnreich, Zoltan Nagy, April 2013, Link: - [Link](#)
- 12) *'Responsible Investment's second decade: Summary report of the state of ESG integration, policy and reporting'*, Mercer / CaIPERS Whitepaper 2011, Link: - [Link](#)
- 13) *'Mercer's ESG Ratings Update: 5,000 and Counting'*, by J. Ambachtsheer and K. Burstein, Mercer.com Insight, February 13, 2012, Link: - [Link](#)
- 14) *'Trends in ESG Integration in Investments'*, BSR Report August 2012, Link: - [Link](#)
- 15) *'Responsible Investment's second decade: Summary report of the state of ESG integration, policy and reporting'*, Mercer / CaIPERS Whitepaper 2011, Link: - [Link](#)
- 16) MSCI ESG Research Webinar Series on *'ESG Integration across Asset Classes'*, recorded on 11 April 2013, Links: - [Link 1](#), [Link 2](#), [Link 3](#)
- 17) MSCI ESG Research Survey on *'ESG Integration across Asset Classes'*, conducted from 1 April - 10 May 2013, 31 participants took part in the online survey



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