The case for ESG

How integrating environmental, social and governance considerations into investment processes can mitigate risks and enhance performance.

From the diesel emissions scandal to the perceived exploitation of zero-hour contracts, there have been many examples in recent years of how failures in the way companies are run can have a harmful impact on the environment, society and investor returns.

We believe that integrating environmental, social and governance (ESG) factors into investment processes can help mitigate the risk of such episodes afflicting the companies held within a diversified, long-term investment portfolio. Such an approach, in our view, can also enhance performance, lower overall portfolio volatility and meet clients' growing appetite for investments that better reflect their values.

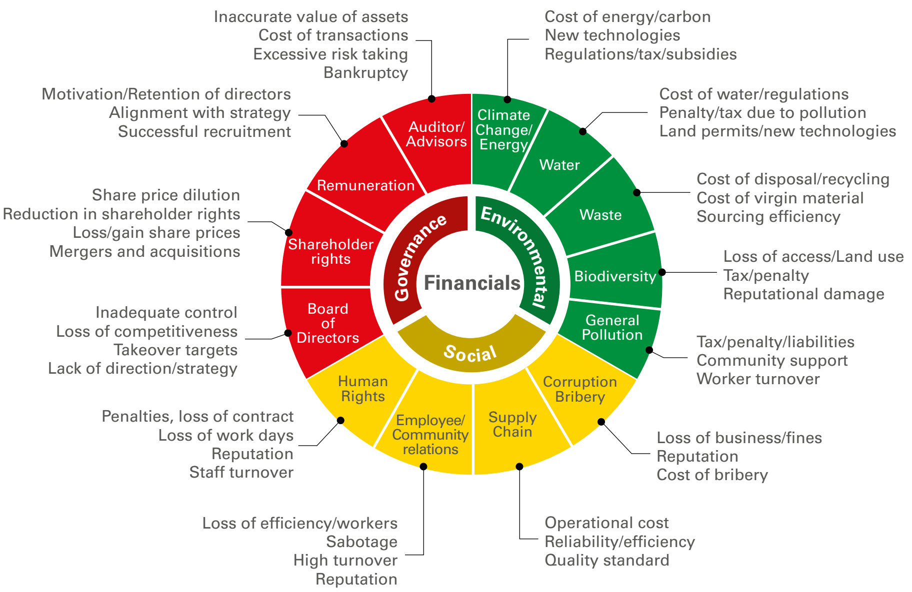
In this guide, we explain the rationale behind this view and outline how ESG considerations can be hard-wired into index-tracking portfolios.

BEYOND THE BALANCE SHEET

At the simplest level, ESG is about good management. Companies with strong governance oversight are less likely to provide investors with unpleasant surprises; equally, companies that are aware of their impact on wider stakeholders are less likely to face political or regulatory pressure.

Such companies are also better positioned to withstand – and even benefit from – shifts in the market environment. Examples of the challenges that ESG can help to address include the impact of climate change on energy markets; the interplay between the growing digital economy and security; and the rise of the 'conscious consumer.'

Figure 1: ESG risks



In order to assess the true strength of a company's governance, we believe it is important to ask questions about stakeholders and timeframes that conventional analysis and traditional investment solutions might overlook. When our clients expect us to look after their pensions for decades into the future, these are precisely the questions we cannot afford to avoid.

Some risks faced by companies will not be obvious, given the vast amount of information that lies outside of the balance sheet, as detailed in figure 1.

Legal & General
INVESTMENT MANAGEMENT

In order to make a formal assessment of these risks – and opportunities – investors can compare and contrast different companies' performance on key ESG metrics.

As we discuss later on, this need not ultimately involve the blanket exclusion of certain sectors and stocks; for example, tobacco or defence companies. Such action forms a subset of responsible investing known as 'ethical' strategies, which we will not address in this guide.

Figure 2: Share-price performance one year after an ESG risk event

ESG Risk Event	Date	1Y (%)
Energy accounting scandal	8/14/01	-99.6
Telecommunications accounting scandal	3/11/02	-98.6
Upper Big Branch Mine explosion	4/5/10	-52.7
Deepwater Horizon oil spill	4/20/10	-28.2
Automobile airbag recall	1/21/14	-53.5
Pharmaceutical accounting scandal	8/5/15	-91.5
Automobile emissions scandal	9/20/15	-26.4
Average loss to shareholders after 1 year		**-64.4**

Source: Morgan Stanley

PREVENTABLE SURPRISES

We believe incorporating ESG factors into investment processes can play an important role in mitigating risks, whose crystallisation, as demonstrated in figure 2, can take a toll on stock performance.

Even though some events can be labelled 'black swans,' many surprises will be preventable: a 2016 study by Bank of America Merrill Lynch suggested that exposure to 15 out of 17 US bankruptcies since 2008 could have been avoided through the integration of ESG within conventional analysis.

A 2016 report from Barclays, meanwhile, showed that bonds with high ESG ratings had lower spreads and higher credit quality than other securities in the Bloomberg Barclays US Corporate investment-grade index. Furthermore, it found that introducing ESG factors into the investment process of a corporate bond portfolio generated a 'small but steady performance benefit.'[1]

ENHANCING RETURNS

The majority of academic and industry studies suggest that incorporating ESG factors into an investment process does not detract from performance; that is, there is no 'virtue' discount applied to taking such an approach. Indeed, research indicates that a process which incorporates ESG factors can, in fact, help to boost returns.

Of the 2,250 peer-reviewed studies published on this topic between 1970 and 2014, the overwhelming majority identified a positive link between high ESG scores and corporate performance, according to a review conducted by Deutsche Bank and Hamburg University.[2] This result held true for 47% of the individual studies and 62% of the meta-studies examined. By contrast, a negative correlation was found in fewer than 9% of studies.

This highlights the opportunity for engagement and active ownership, whereby asset owners and managers aim to incentivise the adoption of best governance practices at investee companies.

While most of the studies published have focused on equities, there has been promising research on other asset classes. Of those published before 2014, high ESG scores were linked to the performance of bonds in 63% of studies, and with the performance of real estate in 71% of studies. Unlike for equities, the review found no studies showing a negative correlation for these two asset classes.

DAMPENING VOLATILITY

ESG integration also helps to reduce the volatility of an investment, according to research from Harvard Business School,[3] Morgan Stanley,[4] MSCI,[5] JP Morgan[6] and State Street,[7] among others.

Indeed, Bank of America Merrill Lynch notes, "ESG appears to isolate non-fundamental attributes that have real earnings impact: these attributes have been a better signal of future earnings volatility than any other measure we have found."

1. https://www.investmentbank.barclays.com/our-insights/esg-sustainable-investing-and-bond-returns.html
2. https://www.db.com/newsroom_news/K15090_Academic_Insights_UK_EMEA_RZ_Online_EN_151216_R2a.pdf
3. https://hbswk.hbs.edu/item/the-impact-of-corporate-sustainability-on-organizational-process-and-performance
4. https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf
5. https://www.msci.com/www/blog-posts/integrating-esg-into-factor/0523543282
6. https://yoursri.com/media-new/download/jpm-esg-how-esg-can-enhance-your-portfolio.pdf
7. SSGA, ESG Institutional Investor Survey, 2017

Lower volatility is in the interest of long-term investors. This might seem counterintuitive – after all, with volatility comes the potential for gains, not just losses. However, this ignores second-order effects, particularly the phenomenon of 'volatility drag' (also known as 'variance drain,' a form of sequence risk).

For example, a loss of 10% in one year is not cancelled out by a gain of 10% in the following year: if you start with £1000, you end up with £990. If the gains and losses fluctuate by 50%, you end up with £750.

These beneficial effects – potentially enhanced returns and lower volatility – are in line with the fiduciary duty of pension scheme trustees.

Indeed, in 2014, the Law Commission stated that, "Where you think environmental, social and governance (ESG) factors are financially significant, you should take these into account."[8] More recently, in December 2017, the government noted that meeting schemes' central purpose of maximising retirement savings and investing for positive social change should go "hand-in-hand."[9]

Moreover, under the EU's Shareholders' Rights Directive, institutional investors and asset managers are required to be transparent about how they invest and engage with the investee companies. Through increased transparency requirements, the directive encourages the adoption of a more long-term focus and the consideration of ESG issues that, it states, "can help improve the financial and non-financial performance of companies."

ESG FOR INDEX INVESTORS

Broadly speaking, there are three ways in which long-term investors can implement ESG criteria within a global index portfolio:

- **Tilts:** This means constructing an index of a broad universe of companies (such as the FTSE All World) that overweights and underweights companies according to their performance on specific criteria. The main advantage of this strategy is that it retains very similar return and offers diversification, but can also reduce exposure to certain ESG risks and capture ESG opportunities.

- **Engagement:** By engaging with companies, investors are able to communicate their interests and expectations, in order to find grounds for mutual benefit. This entails meeting with company boards and other stakeholders, and voting at shareholder meetings. According to a study from the London School of Economics, a firm's returns were about 2% higher following an initial ESG engagement and 7% higher following a successful ESG engagement.[10]

- **Exclusion:** While blanket divestment from companies and sectors can be a risky strategy, since it results in a more concentrated portfolio, limited exclusion – and the threat of it – is still a potent tool. Some companies can certainly be excluded with very little likely impact on a mainstream portfolio, such as 'pure-play' coal miners. Others can be excluded in the event that proactive engagement does not result in positive change.

The increased scrutiny of ESG data as part of these steps can also incentivise companies to manage and report their impacts better, focusing on sustainability and reliable returns. The market can exhibit reflexivity,[11] whereby there is a self-sustaining cycle that penalises the worst offenders and rewards the best performers.

LGIM'S APPROACH

At LGIM, we seek to combine the benefits of the ESG tools at the disposal of index investors to provide portfolios with risk/return profiles that are very similar to the broader indices, while aiming to make a significant market impact.

The use of a tilt allows a diversified portfolio to implement a consistent approach to incentivising and disincentivising companies in their ESG behaviours. Even though we have a large in-house engagement team, it is impossible to apply the same methodologies of ESG standards across thousands of securities. Our model thus allows us to create a level playing field with the right incentive structures.

It is essential that companies understand how they are being incentivised or penalised. Accordingly, we seek to disclose the methodology that tilts exposures, allowing for open communication with investee companies.

8. http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties_summary.pdf
9. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/668301/pension-funds-and-social-investment-interim-response-to-law-commission-report.pdf
10. Li et al, Active Ownership, Review of Financial Studies (RFS), Volume 28, Issue 12, pp. 3225-3268, 2015 (behind paywall). A presentation of the summary results is available here
11. George Soros - Fallibility, Reflexivity, and the Human Uncertainty Principle, *Journal of Economic Methodology, January 13, 2014*

To further strengthen the ESG impact, LGIM has implemented its Climate Impact Pledge, a targeted engagement process where we work directly with the companies in which we invest to bring about positive change. We communicate our expectations for governance and disclosure clearly in relation to climate resilience, supporting companies over time to improve their performance.

We are launching funds to take this one step further, so that a failed engagement could ultimately lead to divestment, where stocks can be excluded within a tightly controlled tracking error margin. As a result, the impact on returns is expected would likely to be minimal while the message to the companies is magnified.

LGIM's commitment to disclose publicly the methodology and final divestment candidates means there is a tangible incentive to respond to engagement, thereby improving the market practice overall.

NAVIGATING NEW CHALLENGES

According to Morgan Stanley, 80% of millennials want their investments to reflect their social and environmental values. At the same time, financial returns clearly remain the single most important criterion for investment choices. Products that aim to provide both strong investment returns and a positive ESG impact are likely, therefore, to appeal to a wide set of investors.

Meanwhile, the fortunes of long-term investors cannot be separated from those of the societies in which they live, as well as the broader trajectory of the global economy. Because the world is likely to look very different in ten years' time to how it appears today, we have grouped the key macroeconomic issues into three long-term themes: demographics, energy and technology.

Our engagement strategy has mapped out the possible societal consequences of these themes, alongside a component that emphasises the importance of a well-functioning market, to help us and our investors successfully navigate the challenges they pose.

More broadly, due to our confidence that addressing ESG factors is both in our clients' financial interests and those of society as a whole, we have put it at the core of LGIM's offering. In a period of unprecedented change for the global economy, we strongly believe that this approach can help us to deliver sustainable value for our clients over the long term.

CONTACT US

For further information on anything you have read in this report or to provide feedback, please contact us at corporategovernance@lgim.com. Please visit our website www.lgim.com/corporategovernance where you will also find more information including frequently asked questions.

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