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ESG and sustainable finance

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# The business case for ESG in institutional investment

## The RI/MSCI round table debate

Martina Macpherson, Zach Oleksiuk, Bruce Kahn, Bill Mills, Tom Kuh, Gerard van Baar, Marcel Jeucken, Mariela Vargova, Rob Lake, Roger Urwin, Erika Karp, Andreas Hoepner, Noel Friedman, John Phillips, Sarah Cleveland, Chris McKnett, Linda-Eling Lee

**Part 1: ESG motivations, opportunities and risks**

**Roundtable Concept and Moderation:**

**Martina Macpherson,** *Vice President,* **MSCI** *& PhD Candidate,*
**Centre for Responsible Banking & Finance (RBF), University of St Andrews**

**Hugh Wheelan,** *Managing Editor and Co-Founder,* **Responsible-Investor.com**

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MSCI
ESG Research

Responsible investment (RI) is developing fast. In March this year, the United Nations Principles for Responsible passed the 1000 member mark, taking it to over $3 trillion dollars in terms of assets under the jurisdiction of its signatories. Yet, at the same time, RI is undergoing a series of mutations. These include the global consolidation of ESG (environmental, social and governance) research houses and more localized trends such as the closure of traditional, dedicated SRI investment teams – notably in the UK - in favour of ESG integration into asset decisions across the firm. These industry developments, in turn, are set against the backdrop of the impact of the financial crisis on institutional investment (governance) and the encroaching danger of issues such as climate change and resource stress (environmental) and ever-present controversies in corporate supply chains on issues such as human rights and pollution (social). In many ways, there have never been more questions about the activity and responsibility of investors in our economies and societies; yet few real answers to those questions and the role of investors as 'universal owners'.

Consequently, this is a good time to take stock of what responsible investment has become, what it means for institutional investors and where it is heading. To this end, Martina Macpherson from MSCI and Hugh Wheelan from Responsible-Investor.com brought together a panel of noted thinkers, practitioners and academics in sustainable finance to debate these topics, based broadly around the following questions. We hope you'll agree that it is a fascinating discussion!

**Hugh Wheelan,** *Managing Editor,* **Responsible-investor.com**

**Remy Briand,** *Managing Director & Global Head of Index and ESG Research,* **MSCI**

## Martina Macpherson and Hugh Wheelan hosted the RI/MSCI roundtable debate and evaluated the ESG business case for institutional investment:

- Is the business/sustainability case for ESG research clear: if not, why?
- What is needed to bring ESG research to the level of mainstream financial research: is it achievable?
- What are the practical 'real-world' implications of integrating ESG factors into investment processes: business case, materiality, practicality.
- How can ESG effectiveness be measured: analytic frameworks, processes and benchmarks.
- How are geographical, asset class and client segment developments shaping ESG, and what about the difficult US environment?
- Where will ESG be in 2015?

## List of participants:

**Martina Macpherson,** *Vice President,* **MSCI** *and PhD Candidate,* **University of St. Andrews/RBF,** UK

**Zach Oleksiuk,** *Vice President, Corporate Governance and Responsible Investment,* **BlackRock**

**Bruce Kahn,** *Director and Senior Investment Analyst,* **Deutsche Asset Management**

**Bill Mills,** *Managing Partner,* **Highland Good Steward Management**

**Gerard van Baar,** *Managing Director, Centre for Climate & Sustainability,* **Holland Financial Centre**

**Marcel Jeucken,** *Head of Responsible Investment,* **PGGM Investments**

**Mariela Vargova,** *Senior Sustainability Analyst, Socially Responsive Investments,* **Rockefeller Financial**

**Rob Lake,** *Director of Strategic Development,* **United Nations Principles for Responsible Investment**

**Roger Urwin,** *Global Head of Investment Content,* **Towers Watson**

**Erika Karp,** *Global Head of Sector Research,* **UBS**

**Andreas Hoepner,** *Lecturer in Banking & Finance, School of Management,* **University of St. Andrews**

**Noel Friedman,** *Head of Business Development,* **MSCI ESG Research**

**John Phillips,** *Senior Portfolio Manager, Chairman of RI Committee,* **AllianceBernstein**

**Sarah Cleveland,** *Founder & CEO,* **Sarah Cleveland Consulting**

**Chris McKnett,** *Vice President, Head of ESG,* **State Street Global Advisors**

**Tom Kuh,** *Executive Director,* **MSCI ESG Research**

**Linda-Eling Lee,** *Executive Director, Global Head of ESG Ratings Research,* **MSCI**

**Hugh Wheelan:** Is the business/sustainability case for ESG research clear today? If not, why?

**The word sustainability came to be thought of within the financial world as inappropriate**

**Rob Lake** PRI was founded, and is still driven, by long-term asset owners. In discussions about PRI, people tend to start with the six Principles. But since I've been at PRI, I've been carrying out what I call the Campaign to Rehabilitate the Preamble. It basically says: "We are a bunch of long-term asset owners, and we believe - actually we take it for granted in this day and age - that in order to do that job effectively, to discharge the long-term financial and fiduciary obligations that we need to be very serious about a whole range of issues, which are termed ESG: Environmental, Social and Governance. But the fundamental notion is that these institutions need to think in terms of their own long-term sustainability. They need to survive to do the jobs that they've been set up to do. i.e. to deliver pensions, whether those are defined benefit (DB) or defined contribution (DC). And they, therefore, need to take a long-term interest in the sustainability of the markets in which they invest in order to deliver the financial returns that they need. That leads them naturally into thinking about a range of other long-term issues and trends that might have a bearing on the performance of those markets. I think our thinking has been sort-of jolted back into that position by the financial crisis. I think there was a time when the word sustainability came to be thought of within the financial world as inappropriate, as being about bunny-hugging, chunky-jumper-wearing social investors rather than something that proper investors were allowed to think about. The term "responsible investment" was coined because the word sustainability, to a particular audience, had come to have connotations that didn't seem to be appropriate. But now, I think, in the context of the financial crisis, sustainability as a term and a concept can be rehabilitated because it makes sense both of long-term orientation and inter-generational equity, which are finance-driven concepts.

**Erika Karp** I think finance-driven conversations need to be grounded in objectivity. And the reason I personally like the term "sustainability" is because it is very holistic and inclusive, and it does not imply a value judgement, whereas some of the other terminologies do. That's seriously important from our standpoint of research in an investment bank where we have a huge range of clients we're trying to serve.

**Hugh Wheelan**: The SRI movement came from a 'values' proposition, not a pure 'value' proposition. Are we mixing two worlds here? Is it easier for the financial world to say: "this has to be objective and financial", otherwise we can't talk about this. Does finance exist in a moral vacuum?

**Erika Karp**: As with any discipline, finance can be deployed conscientiously or not. I prefer the former, which can then serve multiple missions…trying to do things with diplomacy, and inclusiveness. Words can be slippery. They can also be extremely powerful and constructive. I happen to think that the most inclusive, non value-judgement terminology within capitalism serves the most people who may have different priorities.

**The reason I personally like the term 'sustainability' is because it is very holistic and inclusive**

**Noel Friedman** The values motivation for ESG investing is different than the financial motivation. It has additional objectives beyond just financial return. When you're talking to the traditional, mainstream investment community, you need to be clear that there's a way of approaching ESG integration that has pure financial motivations. This exclusive focus on the financial is something that distinguishes the mainstream approach from that of the historical SRI movement, which had often complementary objectives, but non-financial as well as financial motivations.

**Chris McKnett**: I don't think you need to separate them out necessarily, but you can talk about delineations between motivation, process and outcomes. I think motivation can be clearly values or finance driven. Process can probably be clearly one or the other. But the outcomes could be both. It can be a confusing discussion when we're talking with our clients, who don't know where they are, but it is important to do because it defines the history and informs the present. Motivation is key, and that is clear. But the outcomes, and the process, those can be blurred. And that, to me, is the interesting part, and also the really challenging part for us when we're trying to develop solutions and strategies for our investors. You get a handle on the motivation, but the processes and the outcomes? That's a moving target.

**John Phillips:** It's human nature never to be able to agree on definitions. As an investor, I view an investment as a claim on cash. I suggest that our goal should be to think very broadly over the long-term about what the various claims on cash are going to be, including sustainability factors in our assessment of returns and risks. I think our discussion is set within a cultural evolution in which investors are becoming more oriented to the long-term. However it's defined, I think it's the same subject. Corporate behavior will affect cash flow negatively or positively. Any sensible, mainstream investor thinking for the long-term has to consider this behavior, since the investment ultimately is a claim on cash that could be enhanced or reduced by ESG or sustainability considerations. I think of SRI as a subset of ESG, or sustainability. It is a way of excluding investments, of saying: "I don't want to be involved." It's not a matter of considering them and engaging. I think that just as accounting works toward a standard, so does what we're involved with need to move toward a set of standards and credible assurance.

**Bill Mills:** Very often, I think it's easier to say what irresponsible, short-term investing is, as opposed to what responsible, long-term investing is!

**Sarah Cleveland:** Indeed! One of the things, I think, that differentiates the focus of sustainability is the long-term, forward-looking view, as opposed to a backward-looking view. That is really critical and very hard to do. How many of us can project the long-term value and expectations of individual companies? How far out do you actually go? We're making decisions under a lot of uncertainty, and doing the best we can. On SRI, I think historically it has been thought of as negative screening, but it's very inclusive now.

**How many of us can project the long-term value and expectations of individual companies?**

**Mariela Vargova:** Part of investing sustainably means collaborating with the companies in which we invest. This includes supporting and encouraging those companies to focus more on the long term by being progressive on social, environmental and governance issues.

**Erika Karp**: You also need to think of the inherent conflicts associated with the responsibilities of boards of directors. They're constantly balancing the needs of different stakeholders. If maximizing profits for the shareholders is the single-minded focus in the short-term as opposed to the long-term, you're going to have different, conflicting interests. That's one of the reasons why you need to be as objective as you can.

**Marcel Jeucken:** SRI, has a very long history and over most of that time was largely aimed at foundations and retail investors. When the PRI was set up in 2005/06, we had to shift that view to asset owners with a long-term focus integrated into their fiduciary responsibility. Each fiduciary can make their own assessment of value vs. values, depending on the beneficiaries or clients they serve.

**Getting the motivation for sustainability straight . . . is the single most important goal**

**Hugh Wheelan:** Roger, you speak to a lot of pension funds around the world, and not necessarily those who are convinced about the sustainability argument. Framing this discussion in the right way would obviously help to talk to people more about sustainability issues. But we seem to be a long way away from that?

**Roger Urwin:** That's a very familiar observation. The vast majority of pension funds are very confused by these different views. They see 'values' issues in sustainability more than they see the finance argument. And that's really where straightening out the two is critical. Like many subjects, it really is about getting clarity over some difficult subjects that are inter-connected. Getting the motivation for sustainability straight, I think, is the single most important goal. In my view most asset owners should see better performance as the prime motivation. But within asset owners – particularly on the boards of trustees - these sustainability subjects are seen as important, but certainly not urgent. And asset owners have other issues on the agenda that are more urgent, so sustainability is getting pushed down the list as a result.

**Bruce Kahn:** I think that the terminology we're discussing is just an amalgamation of different terms that have evolved over the past 30 years: some are vestigial, some are new. For example, we now have "impact investing" as a new term. There are people who invest because they think that, to echo John's point, "I want a claim on the cash of these companies,

whether it be bonds or stocks, because in the future they're going to face problems, and they're well equipped to face those problems, therefore, I think that cash is going to be secure." I call that 'investing for

## The fact is that we live in a short-term world

what the world will be', i.e. predicting what the world will be given certain policies and economics. There are other sets of motivations that are not necessarily moral/ethical, but rooted in that area all the same, i.e. You could call this: "I want to invest in what the world should be." And that's an entirely different subject. To put it another way, let's call it: "I'm investing in a claim on cash on where I think the world will go based on ESG relative performance." The third point I would like to make is the debate about the long-term/short-term. The fact is that we live in a short-term world. We as an asset manager, or we as an asset owner – I'm also on the board of a foundation - pay our grants or returns on a quarterly basis. I need that money quarterly, even though I know the longer-term vision is that we need more wind power, for example. The whole capital market really needs to address this issue of the difference between long-term or short-term vision. The cynic in the room will always say: "Yeah, I get the long-term issue, but I'm paying on the short-term." And that's a real challenge. Alternatively, asset owners or asset managers say, "We're in it for the long term," when they need an excuse for short-term bad performance. This is a major issue that needs resolution.

**Erika Karp**: Bruce's point is the perfect segue to what I think is one of the most critical discussions that needs to be had if we're going to really make a difference, and that's incentivisation across the entire market ecosystem: how they're linked together, how they behave, how they affect people's behaviors and performances and perceptions. Because you can make metrics, frankly, say whatever it is you want them to say. And if you put the wrong metric in place, the unexpected consequences can be huge. The metrics can be gamed to such an extent that you will completely distort the economic realities and outcomes that you are trying to get. If we can focus on incentivisation, then I think that would be a very constructive way forward.

**Tom Kuh:** One of the problems we face is that old habits die hard. If you look at the investment value chain, i.e. the relationships between asset owners, their consultants, asset managers, and the signals sent through the capital markets to corporations, then something has to change in order for that chain to result in different dynamics. If you get all of those players around the table and say to them: "We should be thinking long-term, and yet we live short-term and act short term, they'll point at each other and say: "Well, that's because someone else is responsible for the way I behave, I'm only really responding to my consultants, clients, or shareholders." I think that we've got a sociological problem to solve, which is, how do you train people in each of those roles, as agents, to act differently? How do you

**We should be thinking long-term, and yet we live short-term and act short term**

incentivise them to act differently to encourage the whole system to change? I think part of the answer is generational: for example, how we train new CFAs, changing the curriculum in business schools, as we bring a new generation of decision makers into the investment world who think of ESG as part of the 'conventional wisdom'.

**Bill Mills**: I think Tom is right, but I would also argue that people are taking long-term sustainability a lot more seriously than they used to. We may not be where we want to be, but I think serious notice should be paid to the trajectory. We are talking about 'vocabulary' here, which is a common occurrence when something is evolving.

**Chris McKnett**: If you look to the first decade of the century, it's clear looking back that traditional financial analysis does not anticipate the full spectrum of risks if you look at particular corporate events. That deficiency does open some minds a little. There's a recognition that there can be something more to properly value, securities and allocate assets.

**Rob Lake**: Hugh, you asked the question "Is the case for this made?" But the point is that it's another discussion about language. When advocates like us travel around talking to some pension funds and we say, "Yes, this is the new way of thinking about your fiduciary duty, and these long terms factors are relevant, and look at the BP situation, and look at this, that and the other, what a lot of people hear is: "Okay, you're telling me to turn the entirety of my €260bn pension portfolio over to offshore wind farms. Or, I'm not allowed to invest in coal and gas anymore."

I didn't actually say that, but that's what people hear….

But part of the problem is ours. Most practicing portfolio managers I've met would not respond to a company's ESG rating, do a back-testing and underweight or overweight a stock mechanically like that.

But a lot of the academic work that's been done for ESG seems to imply that that is the way people invest. I think this is not unconnected to the first response. When you say: Is the case for 'this' made, we don't articulate clearly enough what "this" is.

**Andreas Hoepner**: I think there's an enormous amount of low-hanging fruit in terms of opportunities from research. And I would like to point out one on the risk side. ESG factors at company level are usually good risk management and this should be reflected in the risk adjusted financial performance measures. However, some standard performance measurements which are used everywhere are far from being, technically speaking, 'good' risk management.

Take the Sharpe Ratio: excess return divided by risk. The Sharpe Ratio has its virtues when the return is positive. When the return is negative, however, the Sharpe Ratio fails completely. So if you're assuming a return of -5 for stocks A and B, and stock B has a risk of 10%, and stock A has a risk of 1%, then the Sharpe ratio will of course be higher for the stock with a higher risk.

If you introduce that into a computerized trading system and if you're a large pension fund and can't really drop out of all equities when the market is going down for a while, you have a serious problem. There is no publicly known solution to this problem…it's not even discussed within academia in a meaningful way.

**The Sharpe Ratio has its virtues when the return is positive. When the return is negative, however, the Sharpe Ratio fails completely**

Markowitz developed a wonderful solution, which we teach in business school, but his Efficient Portfolio Theory is actually pretty much academic marketing. The efficient investment frontier never works in practice because you never have perfect hindsight. The Capital Asset Pricing Model, however, works by-and-large because the capital markets work…by-and-large.

**Erika Karp**: Everybody thinks the Sharpe Ratio is where to begin. The disproof of the value of it, I think, is right. What is particularly interesting is what are 'perceived' as intangibles, and how they're reflected in investment evaluations. I think we have more tools than ever to show that these so-called intangibles are material. The crisis has provided proof. On top of that there's the great work being done such as the report, titled: "The Impact of a Corporate Culture of Sustainability on Corporate Behaviour and Performance" co-authored by Robert Eccles, Professor of Management Practice at Harvard Business School, George Serafeim, Assistant Professor of Business Administration at Harvard Business School, and Ioannis Ioannou, Assistant Professor of Strategic and International Management at London

Business School. There's also the work being done on diversity and the better decision-making that comes out of diverse groups at Columbia by Professors Cathryn and Damon Phillips. For one thing, they highlight the better decision-making and outcomes of diverse groups. But, importantly, they give insight into the challenges of embracing diversity… they show that outside perceptions of the effectiveness can be distorted based on the tensions within the group. I personally think those tensions are actually very constructive if managed well. These studies all get us closer to a proof that ESG issues can be material and must be addressed by the financial community.

I think the research out there is fresh, and it's new. If you talk with a portfolio manager like Dan Hanson at BlackRock, he'd argue that we didn't have the tools that we needed when the Chicago School was doing its thing in terms of market efficiencies. But the tools are here now, and I think the time is absolutely right. Personally, I don't use the term "mainstreaming ESG." I actually think that there are some purists that use the term "mainstream" almost as a dirty word. Professor Michael Porter at Harvard says: "Capitalism is magic." I happen to agree. And the mainstream is very

## How will we know if we're successful?

often what moves the capital markets. I think the real problem is cost, consciousness, and consistency because of the research required for ESG. We do need to move towards a pragmatic solution for comparable data. Here, I refer to the potential for transparency and would highlight the effort of Eccles, Jean Rogers, and the new SASB (Sustainability Accounting Standards Board) with which I am involved.

**Tom Kuh**: These are really important points on what we term 'materiality' (i.e. impacting on investment performance). I think many people when they think or talk about materiality believe something either is or isn't inherently material. The definition of material has to do with whether something is relevant to the investment decision. One of the fundamental purposes of what many of us have been doing is to make Environmental, Social and Governance factors material, right? We could put together a list of important issues that we have researched over the past 15-20 years that have become material, for example: the role of predatory

lending in the financial crisis, or the impact of global warming. If people look at ESG issues and say: "Well, that's not material, therefore it doesn't matter," that's really not the issue. What we're trying to do is raise some of these factors to the level of materiality even if they are not perceived to be material today.

**Bruce Kahn**: How will we know if we're successful? If this all gets integrated and we're perfectly pricing ES&G risk is that the outcome we're looking for? I would say that there's a whole other set of information that is not even in the dialogue currently such as the protection of ecosystems and societies' structure and function. Are

we looking at corporations and capital markets as mechanisms for achieving societal goals? If that is ultimately the outcome, then we need to be talking about this a lot more. Any good analyst worth his salt recognizes risk to their company and when it becomes material and will deal with it by reducing or selling the position. Then they say to me: "What else is it you want me to do?" So if integration becomes the new normal, and it's all getting priced, is that it? If you talk to scientific communities on climate change, water availability, soil quality or human health, all these issues are actually getting much worse. If we price all this stuff, that's great. But what outcome does it actually have in the real economy, in the real society and environment? That's really where we have to get to.

**Erika Karp**: That's why it's so important not just to talk about risk. Pricing risk is huge, yes. But price the reward, too. If you think about, for example, diversity as a driver of creativity, innovation, entrepreneurship and profitability: well that's opportunity!

**Rob Lake**: Two thoughts: one is that I no longer think that using the word "materiality" is very helpful for what we're talking about here. I think over the last 15 years or so, the SRI/ESG world has latched onto various terms - slightly half-digested concepts - rather triumphantly, thinking that these would help us sound like proper financial people and penetrate the bastions of the 'mainstream'. And materiality was one of those. But it's too binary. We think something has to be very big to be material, i.e. to move a share price or affect an analyst's thinking about share price. However, what we're talking

## Pricing risk is huge, yes. But price the reward, too

about here is much more subtle and sophisticated. It's about new kinds of information that will help us understand issues like company capacity for innovation in a rapidly changing world. Thinking in terms of materiality just doesn't do justice to the complexity and potential value of that way of thinking.

Secondly, long-term investors who come to an understanding that their own interests are bound up with the sustainability of the financial system and some of the things that underpin it, might well come to the conclusion that functioning ecosystems serve their own long-term interest. Although they'll need to think that through, and not just blindly assume that absolutely every part of the ecosystem is always relevant at all times to every company in every aspect they might choose to invest in. But, timescale is really important here. Even a long-term investor might conclude, callously, that certain bits of the ecosystem just don't offer materiality benefits.

But that's why we have governments to do things in the public interest.

**Bruce Kahn**: But we're combining both with the private market by saying: "Here's an externality, here's a market mechanism that government sets up and incentivizes for investment, such as around renewable energy. The crux of the challenge is to persuade institutional investors to invest into what they think that the world should be. i.e. a lower carbon-emitting world. In the asset management world, you hear a lot of: "Everyone is signed on to the UNPRI, where's the assets though?"