

Linda-Eling Lee Interviews ESG Pioneer Steve Lydenberg

Featuring: *Linda-Eling Lee and Steve Lydenberg*

Linda-Eling Lee: Hello, my name is Linda-Eling Lee. I am the head of ESG research at MSCI, and today I'm really honored to be joined by Steve Lydenberg, the 'L' in KLD, who is a true pioneer with an outsized influence on how this field has developed over the past 30 years. Steve, welcome. It's really great to see you.

Steve Lydenberg: It's a pleasure to be here and thank you for the opportunity.

Linda-Eling Lee: So you and your partners, Peter Kinder and Amy Domini had the amazing foresight 30 years ago to combine into one vehicle, two of the biggest trends reshaping our investments today, but what was your original purpose for creating the KLD 400? And why in 1990, when indexing itself was really quite nascent, did you choose to create an index rather than a social fund?

Steve Lydenberg: That's a good point, Linda, that in 1990 index investing was still a relatively new practice. Indexes had just began as an investment vehicle in the late 1970s, so less than 15 years and Amy Domini and Peter Kinder deserves a great deal of credit for their foresight and seeing that an index could be useful in resolving a number of the problems that were social investing, responsible investment, sustainable investing was facing at that time. One of those challenges was the question of performance in social and environmental standards setting cause a necessary cost, a financial costs to money management and that was one of the reasons for starting this in the index form. There were a substantial number of socially responsible funds out there in the 1980s, but establishing disaggregating lead management styles and the specifics social screens that they implemented from the financial performance was difficult.

So by creating an index that was matched to and managed according to the same disciplines as a standard well-recognized benchmark index at that time, we were creating a lie test going forward on the performance of an apples to apples comparison of what a social environmental screening had an effect on financial performance. So that was one of the primary reasons. There were two others that also figured in one was there was demand for an identification of companies that had better social environmental practices than others that are out there in the public markets and creating an index of such companies served that purpose. And third for simply the basic purpose of providing a financial vehicle for financial products.

Linda-Eling Lee: Well, as a researcher, one reason I personally think that the 30th anniversary of the index is a big deal is that 30 years is a very long track record in this field that we know is pretty short

on robust data history. So over these 30 years, the index has slightly outperformed its benchmark - are you surprised by that? How did you think that this index was going to perform when you launched it in 1990?

Steve Lydenberg: So first I would like to thank MSCI for its foresight in maintaining the KLD index over this extended period of time. As you say, 30 years is a long period, a track record for something that in effect provides a test for the question of performance. And as you say that over that time, while it is outperformed at certain times and underperformed at other times, there's been a slight up in performance. Well, I have to say in the first six months after launching the index, which is may of 1990, uh, I was a bit alarmed because that was the lead up to the Iraq war and oil stocks and military stocks were doing extremely well at that period and we were underperforming and I thought 'oh, terrific. We have now provided a live test and we are showing that there is a cost under-performance to social screening'. Subsequently during the 1990s, the index rebounded and performed very well. There had been, as I say, periods of outperformance and underperformance, but I think the main lesson and what I have felt especially from the outset is that properly implemented, setting social standards should neither be a cost nor a critical benefit to a financial product. So that is the primary benefit, that I see, of social indexes.

Linda-Eling Lee: So Steve, I want to talk to you about something that's close to my heart, the data inputs. I'm going to guess that as a longtime research director, you probably share my love/hate relationship with the ESG data. So today, of course, we are able to deploy the latest data science techniques to identify and extract and model ESG data and that has really opened up vast possibilities of accessing ESG information from all types of alternative data sources and we can go far beyond corporate disclosed information, but 20 or 30 years ago, what was that like? What kinds of data did you actually have available to you when you assess companies for selection into the KLD 400 index?

Steve Lydenberg: Thank you for that question. It's a very important question and the availability of data in around 1990 was much more limited than it is today and we were trying to identify the most important indicators and we could get three qualities, particular qualities. First, that they were available to us with or without companies cooperation. At that time, companies were not disclosing voluntarily much information, but you can have external sources, reliable, external sources that gave us insight into those companies. Second, we wanted information that was reasonable quantifiable, although a lot of this information nevertheless requires judgment and third was audited information that was meaningful in terms of the culture of the company and its commitment to the social environment issue as well as the quality of management.

Linda-Eling Lee: So Steve, where we sit today in our respective New York city apartments, I think it's been a little hard sometimes to look beyond this pandemic and the social strife all around us. But if we were to force ourselves to take stock and look forward 10, 20, maybe even another 30 years, how do you think the world will look? And what do you think will be the relevance of the MSCI KLD 400 index to the investment world?

Steve Lydenberg: Let me comment on the relevance of indexes first and then make a more general comment, but not simply the KLD 400 index, but all social indexes and the increasing number of them, MSCI has a broad range of social indexes. I applaud you for seeing the value of these indexes. It is my view that the combination of passive investment with it's key the advantages when it comes to price,

fees, et cetera, and social screening, social standard setting with its key advantages of being a lens on the behavior of large publicly traded companies and also a vehicle for communication and engagement with these companies to pursue further the betterment of their social and environmental practices, but that combination of two factors are strong factors in investing now and will really drive much of the evolution of finance as we go into an increasingly complex world where interconnection of different systems and key concerns are important.

I think one of the lessons from COVID pandemic is that is almost a time lapse, speeded up example of learning opportunity for what happens when one of our systems, one of the systems on which this complicated world is built, breaks down. How that one single system, its breakdown spreads throughout the rest of the systems in society, spills over into the economy, spills over into issues of inequality, racial bias, et cetera. So, these issues are likely to face us with increasing frequency, given the complexity of the world that we live in now, climate change is going to be a similar example, but spread out over decades rather than months and years. And it is that ability of finance to help tempt them to reduce the systemic risks by careful management of social and environmental issues, as well as identifying investment opportunities that show efficient allocation of assets, that combination of things I think is going to play an increasingly important role investment as we move forward.

Linda-Eling Lee: Well, Steve, I'd really like to thank you for your vision, your enormous contributions to this field. As you know, I'm personally so grateful to you for taking the time so many years ago now to convince me to make a career change into ESG research, I was really drawn, of course, to the measurement challenges in this field, but you convinced me that if we do this right, and we apply a systematic approach to linking companies with the external systems that they operate in, then investors would see that investing is not just a zero sum game, but it plays this critical role in making our whole system more resilient. So I thank you very much and I thank everyone for joining us.

Steve Lydenberg: Thank you, Linda, for the opportunity and for your fine work and MSCI's fine work in this area.

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