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Understanding ESG Investing: Assessing Risks and Opportunities Beyond Traditional Metrics

Financial markets have always been where new ideas and capital converge. In the past few years, there has been a surge in innovative approaches to funding new concepts, or at the very least, a more imaginative approach to promoting these inventive financial methods. Investors are increasingly utilizing non-financial factors as a part of the analytical process to assess investment risks and growth opportunities. Perhaps the most popular arena for this added layer of non-financial analysis is in ESG (environmental, social and governance) investing.

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The basic idea behind ESG investing is the use of metrics that are not commonly part of mandatory financial reporting. These metrics help to vet investment opportunities in a way that adheres to certain values of the investor. For example, many investors, both institutional and individual, have long had restrictions on financing industries, such as alcohol, gambling and firearms. What's different is that many proponents of ESG investing now go much further than just excluding certain companies or industries that are deemed undesirable for one reason or another. Through the application of various scoring mechanisms, ESG investors attempt to layer various values-based standards onto the traditional investment process to advance environmental, social or governance goals.

Predictably, what sounds great on paper is difficult to implement. Different ESG scoring mechanisms and standards yield different scores for the same companies. For example, a company, such as Tesla, might score well on an environmental factor but not well on a governance factor. Different weightings for the various subjective values will therefore produce inconsistent ESG scores.

Additionally, the available research regarding the returns produced by ESG investing compared to traditional investing is inconclusive. A recent Vanguard study showed there was no real difference in terms of "alpha," the component of investment returns not explained by overall market returns. Another recent study by MIT professors found widespread divergence in ESG ratings. This is not surprising, as there is no set of uniform standards to define ESG. There are however, numerous institutions, such as the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI) and the Task Force on Climate-related Financial Disclosures (TCFD) that are working to create standards for the future.

What's interesting, though, is that, even without clear benefits and a clear definition, demand for ESG investing continues to grow. This mirrors a trend beyond investing. Sustainability marketing is a huge driver not just of investment products, but of all consumer products. According to one study, sustainability-marketed products represented more than half of all market growth in the total CPG market in dollar terms between 2013 and 2018. Perhaps the most striking aspect of the surge in the interest in sustainability is that it is occurring globally. Moreover, some of the countries in which consumer preferences are the strongest in favor of sustainability appear to be some of the same countries in which environmental health is perhaps most at-risk, such as China and Indonesia.

To meet this surging demand for ESG products, fund providers have slapped the ESG label on a myriad of funds and ETFs. This proliferation of ESG-branded products, amid the lack of uniform standards and definitions, has been a growing source of confusion and has perhaps contributed to ESG investing's recent drift into the political debate.

For the sake of our sanity, let's eschew the politics of ESG and focus on how ESG products tend to be constructed. Whether managed actively or passively, ESG funds generally fall into two categories: exclusionary or inclusionary. Exclusionary ESG funds utilize a screening process to exclude companies, sectors or countries that do not align with certain ESG criteria. Conversely, inclusionary ESG funds seek to include companies that meet certain standards based on ESG ratings, data or proprietary assessments. There are also impact funds, which seek to produce a measurable financial return while generating some arbitrary social or environmental impact, as well as thematic funds, whose components support specific ESG themes, such as clean tech or green real estate.

While ESG covers much more than just climate, as evidenced by the growing number of measurables, such as mentions of diversity and inclusion on corporate earnings calls, it is unquestionably climate that is the most measurable aspect of ESG, with the most obvious theoretical benefit to investment results. That's because, at its core, the incorporation of a measure of environmental risk, while perhaps difficult, is not controversial in the least.

Measuring environmental risk is just measuring an externality, which business school students and others have been doing for decades. An externality is a cost created by a firm or an industry, but held by society at-large. Carbon emissions by firms impose societal costs that these companies typically do not internalize. From an economic perspective, such negative externalities are best addressed by inducing companies to internalize the social costs of their activities. This can be done by imposing carbon taxes or by subsidizing activities that both reduce emissions and invest in developing technologies to reduce future emissions. Governments of the world's largest producers of greenhouse gasses are now working toward a "net zero" future, in which emissions are reduced or offset. To the extent that investors can produce estimates for these externalities, they can now make more informed decisions about potential environmental liabilities that could impact future cash flows.

From our perspective, it is this type of ESG investing that makes the most sense both intuitively and practically. That's because integrating an environmental sustainability factor is a natural extension of our core investment philosophy, which already seeks to tilt portfolios toward certain factors that have been demonstrated to yield added premiums over time. For any investor seeking to incorporate ESG goals into their process, the key is to start with a good process.

At Trust Company, we regularly utilize Dimensional Fund Advisors (DFA) in our pursuit of investment outperformance, which stems from factors, such as value, small caps and earnings quality. Therefore, it is a natural extension of our relationship that we would rely on DFA to deliver ESG solutions while staying true to our philosophical underpinnings.

Dimensional employs an emissions-focused sustainability scoring system to assess companies, which involves comparing them based on specific environmental concerns across their entire portfolio, as well as within individual sectors. For example, if the objective is to reduce a portfolio's exposure to greenhouse gas emissions, the worst offenders across all industries may be de-emphasized or excluded from the portfolio altogether. Dimensional's approach may also rate portfolio companies on sustainability considerations relative to their sector peers, emphasizing industry leaders with better environmental profiles and underweighting or excluding sustainability laggards.

The key takeaway for investors interested in ESG is to start with a sound investment process. Merely overlaying a subjective set of restrictions onto a broad basket of random companies is unlikely to result in favorable investment outcomes. On the other hand, investors who start with a diversified set of businesses and who use a logical investment process, rooted in evidence and not merely subjective limitations, position themselves for greater long-term success.

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