



Reinventing “Value”

AN ADVANCED ESG PRIMER

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Jefferies

Reinventing “Value”

An Advanced ESG Primer

SRI. *Socially Responsible Investing*

CSR. *Corporate Social Responsibility*

ESG. *Environmental, Social & Governance*

25%

ASSETS
INVESTED
IN ESG
GLOBALLY

More than one-quarter of globally invested assets come under a sustainable, responsible or impact investing umbrella. ESG professionally managed assets in the U.S. that fall into such a category **grew nearly fourfold in the last few years - from \$3.74 trillion in 2012, to \$8.1 trillion in 2016 and \$11.6 trillion in 2018.**¹ And the **biggest ETF launch in more than a decade** was a March 2019 \$846 million ESG focused vehicle by DWS.

Why is this happening, what *IS* ESG investing, and what do you need to know about it?

We are at a watershed time for sustainable investing – and, to be clear - ‘ESG’ or sustainable investing are *not* uniform endeavors. Part of the explosion is because **“ESG investing” is shorthand for a variety of ways and methods to allocate capital.**

In 2018, for the first time, **hundreds of earnings calls** from companies across sectors reference ESG efforts. Among the discussions: BlackRock commented on the rapid growth of their initiatives, UBS highlighted the tripling of their ESG assets under management, and even Advance Auto Parts highlighted the publishing of its inaugural Corporate Sustainability and Social Report.² These trends are only expected to accelerate as the data underlying ESG investment decisions improves, and interest from public institutions, insurance companies and millennials grows.

Until recently, our industry has taken SRI, CSR or ESG to mean, simply, investing my values. But a growing contingent of investors, allocators and issuers know they can mean more. This paper is about how they can also mean **investing to secure value.** It helps to explain what prompted the world’s largest pension – Japan’s Government Pension Investment Fund (GPIF), with more than \$1.3 trillion under management – to raise its ESG investments from 3% to 10% of the portfolio in 2018.³

Reinventing “Value” explores what ESG is in practice in 2019, having taken multiple turns to get here. We explain **why there has been an explosion of interest and allocation** to the space. We investigate **who is investing in these products** – and **who is offering them.** We question how ESG investing may **impact a portfolio’s return profile.** And we dig into **what may lie ahead** for companies, investors and allocators alike.

We hope this Primer helps to further the discussion around sustainable investing and contributes to broader efforts to enhance the thorough and strategic approach to our clients’ research processes.

CONTACTS

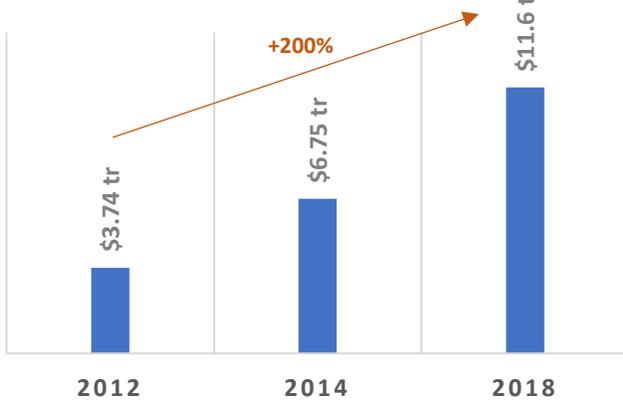
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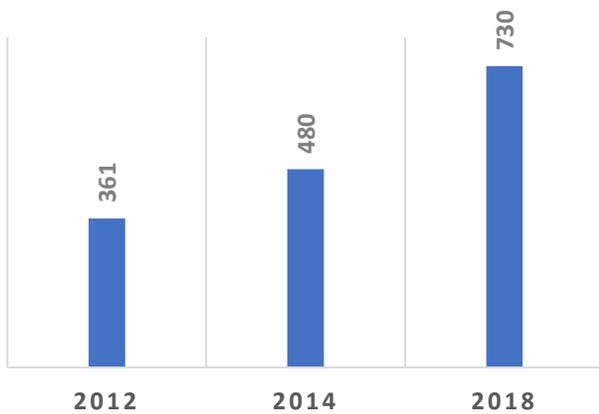
ESG by the Numbers

GROWTH IN ESG MANAGED ASSETS (U.S.)*



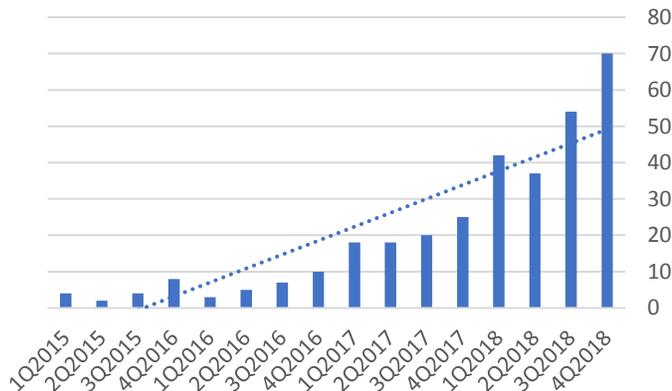
*In trillions USD; Source: Forum for Sustainable and Responsible Investment

ESG INCORPORATION BY REGISTERED INVESTMENT COMPANIES



Source: Forum for Sustainable and Responsible Investment

ESG MENTIONS IN EARNINGS TRANSCRIPTS



Source: Jefferies, AlphaSense



Assets invested in ESG globally



Number of current ESG related job openings at traditional or alternative investment houses



Offering ESG research, rankings, ratings or indices



Covered by rankings and ratings



To the UN PRI – Principles for Responsible Investment

Let's Start With the Basics: What IS ESG Investing?

ESG (environmental, social and governance) is one way investors expand the scope of capital allocation beyond considering solely financial returns. It is, admittedly, **a very broad topic** – and encompasses **dozens of different approaches across equities and fixed income, active and passive asset management**.

This follows years of social or impact investing, corporate social responsibility, and the double or triple bottom line – many different approaches to incorporating sustainable or social factors into economic and investing decisions over the years.

ESG By Any Other Name...

Many terms have referred to positive or negative investments that involve an additional social, ethical or environmental component in addition to traditional cost/benefit or financial returns.

Socially Responsible Investing (SRI): An earlier incarnation of investing in companies, funds and other assets that meet certain standards with a social, ethical or environmental overlay. May encompass exclusionary or negative screens.

Impact Investing: Like SRI, the practice of making investments in companies, funds or assets that are informed by additional social, ethical or environmental concerns; but impact investing specifically looks to invest *in* these entities that generate positive social or environmental impact in addition to a financial return

Corporate Social Responsibility: The actions by companies to improve or enhance the impact of conducting their business on various stakeholders. It is an extremely broad concept that can vary across sectors and issues.

Triple Bottom Line: An accounting framework with multiple dimensions – financial, social and environmental. It is an attempt to address “total cost accounting.” For example, if a firm turns a financial profit, but their product or process causes physical harm or death or an environmental disaster that comes at considerable cost for insurance or to clean up – is it net negative for a community/society?

ESG Investing: An umbrella term for investing that incorporates environmental, social and governance behavior and impacts of an asset. The UN Principles for Responsible Investing (UNPRI) established six principles for investors focused on ESG issues in 2005.

Sustainable Investing: Among the broadest terms – encompassing types of investing ranging from exclusionary screening to active impact investing, and everything in between, to reflect social, ethical, religious or environmental principles in a portfolio. Sometimes used interchangeably with ESG investing.

For our purposes, we hold ESG investing to be *any investment that incorporates additional environmental, social or governance considerations along with financial ones; this may incorporate both negative screens and/or intentional impact investing.*

It is important to understand the breadth and depth of financial and capital markets decisions that can be included under ESG investing. Unlike some of its predecessors, it is intentionally broad, so as to incorporate the idiosyncrasies and diverse portfolio goals of various investors.

Types of ESG Investing

There are more than a dozen different approaches to incorporating ESG concerns into investment processes, including:

- Negative screens
- Positive screens
- Thematic investing
- Informing valuation
- Risk management/overlay
- Active ownership/activism
- Intra-sector comparisons
- Any combination thereof

In fact, a recent Harvard Business School/Saïd Business School study reported, “Future research that seeks to understand the performance or other investment characteristics of funds that use ESG data needs to recognize the fact that *investors exhibit different ‘ESG styles.’*” (emphasis added)⁴

Why Has ESG Taken Hold *Now*?

A number of factors have converged to help “ESG” rise to the fore.

Drivers of ESG Growth



Rise of data availability



Growth in demand for ESG products



Increase in ultra-customization of product supply



Expansion of coverage of social and environmental topics in business & media



Increase in spotlight on foundations' and philanthropies' investment processes

We'll address each in turn.



First – **rise in data availability**. This is an area that has evolved considerably, but one that even ESG and data experts say has a long way to go. One of the cornerstones of ESG investing is gathering and analyzing data that allows people to make better decision involving social, environmental or governance inputs. ESG data has traditionally come from a diverse body of sources, including: the companies themselves, regulatory reporting, third party activists, news organizations or other non-profits or non-governmental organizations.

While **the standardization of data and reporting remains a challenge** (an MIT project dedicated to harmonizing ESG reporting standards is, in fact, called [Aggregate Confusion](#)), the growth in available data and the increase in the ability to harness multiple data sources to create a God's eye view of a company's ESG footprint is improving. Now, with more than 150 providers (and with ever more entering the space monthly) - they cover more than 13,000 issuers and half a million securities.⁵



Second – growth in demand for ESG products. Blame the [millennials](#).⁶ Blame the media. Or maybe ESG investing – which has had a longer history in Europe than in other corners of the globe – has just expanded out of the neighborhood, as institutions like GPIF in Japan and CalStrs in the U.S. take an increasing leadership role in the space. GPIF recently increased its ESG equity exposure from 3% to 10%. We have seen a tripling in ESG managed assets in recent years in the U.S., with a variety of asset managers large and small considerably growing their offerings in recent years. This doesn't even begin to address the separately managed accounts, funds of one or co-investments that allocators and alternatives managers have created to meet specific portfolio needs. Almost 10% of 401(k) options fall under an ESG category – a percentage many expect to grow substantially.⁷

Sustainable investing for ESG is another area where an increase in demand from clients globally, coupled with BlackRock's investment and technology expertise, is driving large-scale momentum.
BlackRock 3Q2018 Earnings Call



Third – increase in customization of product supply. We addressed this in our earlier [State of Our Union 2019: Turning Point](#) piece. We live in an era of ultra-customization – both on the supply and demand sides. Allocators are increasingly cognizant of their own unique needs of liabilities and liquidity management and are increasingly comfortable adding other factors as overlays throughout the asset allocation process. Many asset management firms cite “client choice” as a leading driver for the addition of ESG product portfolios. And firms have the ability to offer a broad and diverse number of ESG products – whether focusing solely on climate change, addressing gender disparity or workers’ rights, to enforcement of best governance practices. Ultra-customization has been a growing trend in both passive and active management – with more than 1,500 ESG indices globally, and an estimated two-thirds of active alternatives managers receiving requests to customize a pre-existing product for an allocator.⁸ Beyond indices, some cite more than 1,100 ESG available products as of year end 2016.⁹



Fourth – expansion of coverage of environmental and social issues in the mainstream and on social media. As the entire world has begun to live its collective life online – it is much easier for investors to be cognizant of a wide range of these issues. Where in the past, headlines of major newspapers focused on mega-disasters or issues like the Bhopal disaster, the Exxon Mobile or BP oil spills or human rights issues along consumer supply chains – current media trends bring many more issues across news feeds. With social media running lives, and millennials increasingly running businesses and portfolios – these issues matter.



Fifth – the debate about the difference in spending philanthropic monies on charitable issues versus how the philanthropic corpus is invested. While a smaller part of the momentum behind the staggering growth in ESG assets, this may be a canary in the coalmine for future action. Laurene Powell Jobs pointed out in a March 2019 *Recode Decode* podcast: There are some “who put all their wealth into a foundation and built out a philanthropy, [and] would use 5 percent a year of their payout, of the corpus, to do good work, and then they ignored how the 95 percent was invested, and often those two things were at odds with each other.”¹⁰ There is a growing sense that the philanthropic spending and financial management of charitable funds should be more in harmony with one another. After all, it isn’t difficult to understand why some raise questions about the consistency of a foundation that may be focused on improving the health and welfare of humans – while at the same time, investing in companies that make firearms or other products whose main purpose is to take human life (even if in the process of defense).

These five factors – while diverse and both quantitative and more qualitative in nature – are all impacting the enormous growth we are seeing in environmental, social and governance investing.

IT IS NOW CLEAR THAT THERE IS
NO INHERENT TRADEOFF
BETWEEN INVESTING YOUR
VALUES, AND
INVESTING FOR VALUE

Does Grime or Crime Pay? The Cost or Benefit of Including ESG Factors in Investing

The research about ESG investing and its impact on portfolio performance is vast and – to this point – fairly limited in its unanimity. Some deep dives have been conducted around various dimensions of ESG investing – for example, using various ESG factors in equity investing, or focusing on governance issues to bolster long term creditors – but given the diversity of motivations for ESG investing, and variation in measuring what success means, research to date has been similarly varied.

AQR Capital Management reports that “stocks with poor ESG exposures tend to have higher total and specific risk and higher betas, both [now] and as far as five years into the future.”¹¹ BlackRock reports, “We examined the performance of traditional indices alongside ESG-focused versions that were optimised to increase sustainability scores while adhering closely to their traditional counterparts. The ESG indices’ annualised total returns since 2012 matched or exceeded standard benchmarks in both developed and emerging markets, with comparable volatility. In emerging markets, where shareholder protections, natural resources management and labour relations can have a significant effect on performance, we found that ESG indices can outperform the standard ones.”¹²

We take AQR and BlackRock at their words as well as researchers from across the academy – but it is also critically important to remember many of the drivers of allocations into ESG products are myriad, and often for reasons *in addition to* financial performance. Just as different verticals prioritize capital preservation versus absolute return versus alpha generative portfolios, so, too are the motivations for including ESG factors in investment processes diverse.

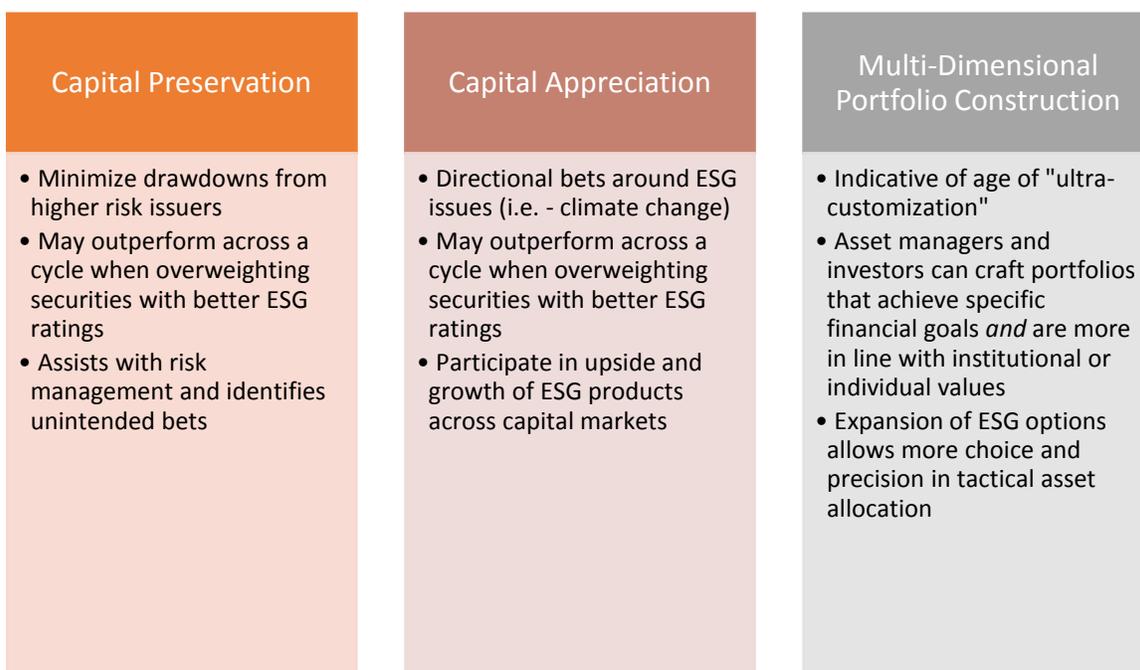
Some of these motivations include:

Given the diversity of data and products available, could I run my portfolio with a similar risk/return profile, but in a way that more closely aligns with my organization’s values?

Capital preservation is my prime goal...does incorporating governance inputs help avoid drawdowns or exposure to companies with higher material risk profiles?

I have a directional bet that climate change will be a considerable external factor in driving long term enterprise value...can I build a portfolio that buys securities associated with mitigating climate change and shorting those that exacerbate it?

One of the most important points we want this primer to make is the broad and considerable variability by which ESG investing “success” is measured. Just as diverse portfolios have different primary and secondary goals, so, too is ESG investing a multi-dimensional undertaking.



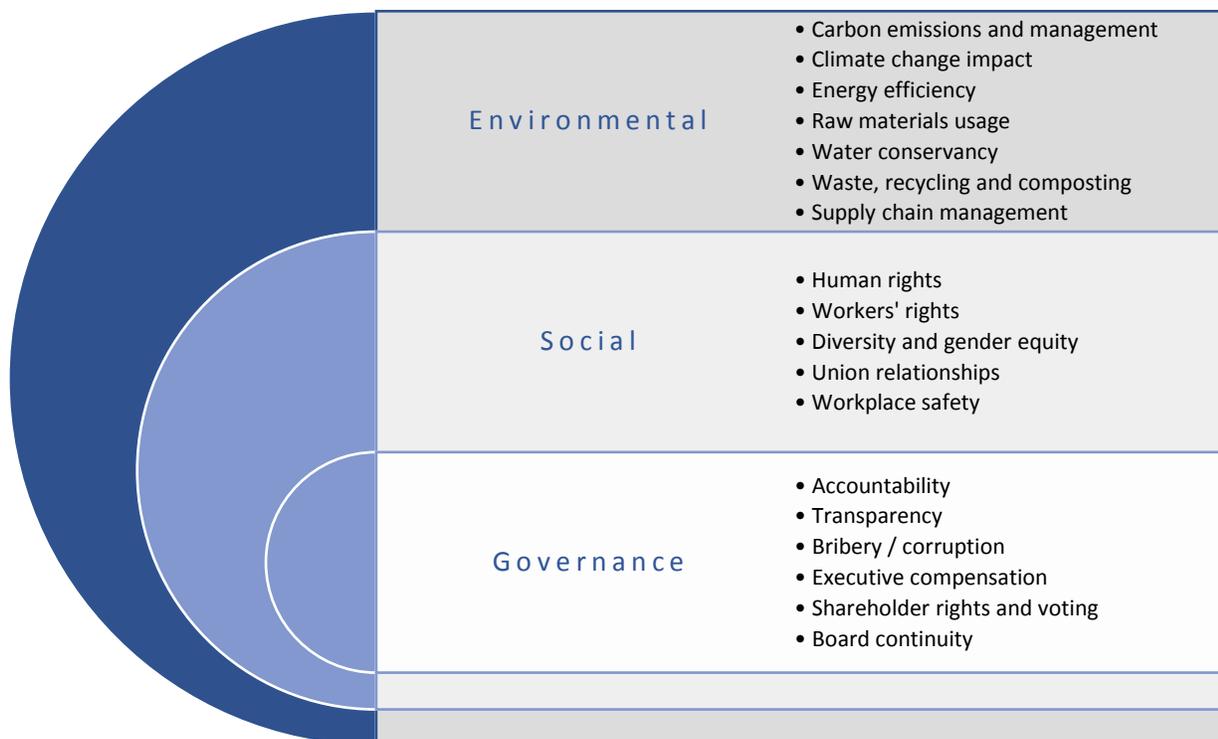
Where research **does** seem to agree: **the idea that there is an inherent and unavoidable trade-off in performance and allocation on the basis of ESG factors is very likely not true, particularly given the diversity of motivations and use cases for ESG data.**

Could there be? Of course – but that is the case behind nearly every other asset allocation decision. What is critically important is that **there is a large and growing body of allocators and asset owners who desire to at least vet potential ESG factors in their investing decisions – and these groups are being provided with ever more (and more accurate) information on which to base their decisions.**

McKinsey reports an estimated 26 percent of global funds under management were run with environmental, social and governance (ESG) considerations last year, up from 21 percent four years earlier.¹³

What Topics Does ESG Cover?

Maybe a better question is – what topics does ESG *not* cover? As we highlighted earlier – ESG is an umbrella term, and the drivers for leveraging ESG data points are myriad. The below is a comprehensive, though not exhaustive, list of current ESG considerations investors leverage in their processes.



What Does This Mean for Corporates

Many things – particularly as awareness of and value of sustainability and good governance issues continues to grow. Interest may be greater in some markets than others, particularly Europe, where ESG has long been an issue for institutional investors, or Japan, where GPIF's recent move has prompted many companies to re-evaluate their sustainability efforts. But even the U.S. is witnessing massive asset growth in ESG investment products.

As a result, being seen as a good corporate citizen or a company that is better than its peers from a sustainability standpoint can have far reaching implications. Zuhair Kahn, Jefferies Head of Japan Equity Research, recently released [Japan Equity Strategy: Good Governance Equals Outperformance](#), noting: “We find strong relationships between board governance structures and performance metrics such as share price performance, ROE, dividend payout and share buybacks.”

And a 2014 Harvard study, [Corporate Social Responsibility and Access to Finance](#) noted that there is “one specific mechanism through which corporate social responsibility (CSR) may generate value in the long run” – by removing capital constraints and other market frictions that firms can face in financing operations and strategic projects.¹⁴ This is one of many studies that outlines the potential upside at the issuer level to embrace environmental, social or governance considerations in running their businesses.

But for our purposes – the simple growth in demand of ESG focused products should itself inspire firms that look for growing interest and engagement of investors – to consider how putting these issues at the fore of their business models and reporting, could help make them a more attractive investment.

What Lies Ahead?

It is not an exaggeration to say: **more of everything**. More interest. Increase in product supply. Better, more standardized data to build a complete picture of companies' efforts (and successes or failures) in environmental, social and governance issues.

Perhaps most critically – there is a growing body of topics addressed by these investing questions. A decade ago, data privacy would not have cracked the top 20 risks to a firm. Now – it is a headline business risk, and one many ESG ratings firms are squarely focused on.

As the era of ultra-customization and shifting demand for products continues, and the data, interest and spotlight on ESG accelerates – we anticipate an exponential forward growth of these products. Moves by blockbuster institutions like GPIF, CalStrs, and the Government Pension Fund of Norway have served as the beachhead for many others, and issues like growth of interest, rise of data, and expansion of product are converging such that this inflection point may help us witness parabolic growth in the years to come.

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Endnotes

¹ [https://www.ussif.org/files/2018%20Infographic%20overview%20\(1\).pdf](https://www.ussif.org/files/2018%20Infographic%20overview%20(1).pdf)

² 4Q2018 Advance Auto Parts earnings call. Edited Transcript of Advance Auto Parts Inc earnings conference call or presentation Tuesday, February 19, 2019 at 1:00:00pm GMT

³ [“Japan's GPIF expects to raise ESG allocations to 10 percent: FTSE Russell CEO,”](#) *Reuters*, July 14, 2017.

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⁵ “Responsible Investing: Guide to ESG Data Providers and Relevant Trends.” Elyse Douglas, Tracy Van Holt, Tensie Whelan. *Journal of Environmental Investing* 8, no 1 (2017). Accessed at:

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⁶ Jefferies Millennial Survey Series, Phase 1: [Social Media and Content Habits](#)

⁷ [“BlackRock, Wells Fargo Are Betting on Ethical Investing Funds for 401\(k\)s,”](#) *Bloomberg*, June 13, 2018.

⁸ Jefferies Prime Services and ETFdb.com

⁹ US SIF

¹⁰ “Laurene Powell Jobs,” *Recode Decode* hosted by Kara Swisher, minute 15:11

¹¹ “Assessing Risk Through Environmental, Social and Governmental Exposures.” Jeff Dunn, Shaun Fitzgibbons, Lukasz Pomorski. Accessed at: https://www.aqr.com/-/media/files/papers/aqr_assessing-risk-through-environmental-social-and-governance-exposures.pdf

¹² [“Better data makes sustainable investing pay,”](#) *The Financial Times*. Philipp Hildebrand. January 31, 2019.

¹³ [“From ‘Why’ to ‘Why Not’: Sustainable Investing as the New Normal,”](#) Sara Bernow, Bryce Klempner, and Clarisse Magnin. McKinsey, October 2017.

¹⁴ Cheng, Beiting, Ioannis Ioannou, and George Serafeim. [“Corporate Social Responsibility and Access to Finance,”](#) *Strategic Management Journal* (forthcoming).