ESG: What's Really in the Portfolio?

Values-based investors can benefit from gaining a better understanding of the ESG investment process

Viewpoints

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Increasingly, investors are searching out investments that align with their values. Assets invested with money managers that incorporate ESG criteria—screening for environmental, social and governance issues—grew from $1.4 trillion in 2012 to more than $8 trillion in 2016. But while demand is rising for ESG investments, there is a lack of clarity around the criteria investors and portfolio managers use to evaluate these types of investments. How should ESG be defined? Should it be an overall evaluation of the company, or an evaluation of the product produced by the company?

This uncertainty makes it all the more important for investors to understand how to evaluate ESG investments and to better understand how the funds in which they invest select their holdings. After all, investors often look to ESG as a way to align their values with their investments. Gaining a clearer understanding of the ESG investment process can offer an instructive roadmap to investors hoping to become more knowledgeable about their own ESG investments.

Understanding the ESG universe

Among ESG funds, investors will find portfolios that have a broad mandate to invest in socially responsible companies. *Socially responsible investing* (SRI) often looks broadly at a company's impact on a range of environmental, social and governance issues. SRI funds make up the bulk of the ESG market.

Impact investing is a smaller piece of the ESG landscape. Impact funds often evaluate companies on a single issue. Some funds may only invest in companies in which women make up a meaningful number of the senior management team and the board of directors, or in companies directly involved in renewable energy sources such as wind or solar. For example, the AllianzGI Global Water Fund has three primary goals: it invests in companies that improve water supply, water efficiency or water quality.

Due diligence

The variety of funds in the ESG universe gives investors more options to find investments that truly align with their values. It also means that not all ESG funds are alike.

It may surprise some investors that Elon Musk's Tesla* isn't a perennial favorite among ESG money managers. After all, the company makes environmentally friendly products such as electric cars and energy storage systems. But while Tesla's end products are very environmentally friendly, the firm by some measures receives low scores on governance and social issues due to factors such as employee compensation, employee turnover and even cybersecurity measures. The company's governance model, for example, is a source of concern because Mr. Musk holds so much power at Tesla. That's not a judgment of his abilities, but a judgment of how the governance and voting rights are structured. That said, Tesla may find a home in portfolios that put more emphasis on a company's end products than on internal measures such as employee turnover or management control.

Firms such as MSCI, RobecoSAM, MSCI, and Sustainalytics provide ESG ratings that evaluate a company's adherence

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*Tesla is not a holding in the AllianzGI Global Water Fund as of 9/30/2017.

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to environmental, social and governance criteria. All three of those firms, however, approach ESG differently. One rating system may put more weight on the environmental component of ESG, while another prioritizes governance or social issues.

Rarely do you see a company receive an equal weighting on all three areas. Different companies face different risk factors. A mining company may be more highly weighted on environmental factors because there are more risks from the company's carbon footprint than from, say, employee turnover. The materiality of ESG risks to a particular company and/or industry is a key component.

What's more, different stock market sectors often are rated differently because certain ESG risks are more material for certain types of companies. For instance, the overall rating for a financial services company likely places more emphasis on social and governance issues because those issues are most likely to be risk areas for that company.

Understanding how a fund approaches ESG investing requires more than simply checking the name of the fund. Investors interested in applying ESG criteria to their investment strategies should dig into available research, including fund prospectuses and third-party research on individual funds. Doing so can tell investors volumes about how managers approach ESG investing, and the types of factors they may prioritize in their portfolios. In the process, investors can feel more confident that the funds in which they invest align well with their own values.

About Christian McCormick

Mr. McCormick, CFA, is a senior ESG product specialist and a director with Allianz Global Investors, which he joined in 2015. His is a senior product specialist for the firm's Best Styles strategies in the US and Canada; Mr. McCormick also has product-specialist responsibilities in the US for the firm's Europe-based equity strategies. He has 18 years of investment-industry experience. Mr. McCormick has a B.A. from Principia College.

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