ESG investing: deciphering the labels

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Summary

Adoption of ESG investing is growing as investors recognise these strategies' potential for managing risk and driving performance. But as ESG labels proliferate, an understanding of the terminology involved is essential to finding the most appropriate approach.

Key takeaways

- ESG factors have become a mainstream concern for investors; US SIF data show assets invested in US ESG strategies rising by 38% in the past two years
- Adopting an integrated ESG strategy means ESG factors are considered as part of the existing investment process for a strategy
- An SRI strategy relies on screening out investments based on negative criteria; screening for positive criteria is at the heart of impact investing
- Regulatory change is adding to the impetus behind ESG

Environmental, social and governance (ESG) factors have become an increasing focus for investors. According to the Forum for Sustainable and Responsible Investment (US SIF), ESG investing now accounts for $12 trillion of assets in the US, a rise of 38% over two years.[1]

Investors recognise the potential for ESG factors to help manage risk and identify opportunities in an environment that increasingly demands selectivity. As a result, companies that manage their ESG profiles well – focusing on areas such as strong governance, human capital management and environmental impact – are likely to strengthen their positions in the coming years. They may find that their ability to gain funding depends on it.

Along with broader public awareness and demand, regulatory pressure is also driving implementation of ESG issues. From 2018, European Union law required large companies to disclose certain information about the way they operate and how they manage social and environmental challenges. Separately, the Task Force on Climate-related Financial Disclosures, an industry-led group established by the Financial Stability Board, has encouraged companies all over the world to disclose the risks that climate change poses to their business models.

What ESG labels mean

The rising interest in ESG has coincided with an increase in categorisation to address different philosophical positions and investor requirements, so it is important to be clear about what the different labels mean.

"Integrated ESG" – whereby ESG factors are integrated into an existing investment process – is gaining traction. At Allianz Global Investors, we are embedding integrated ESG into our risk management processes across strategies. Rather than relying entirely on external ESG ratings and third-party methodologies, our investment professionals question potential holdings with low ESG ratings.

We have built a digital platform for sharing our insights globally and crowdsourcing opinions among our analysts, enabling seamless worldwide communication and collaboration that transcends emails and conference calls.

The resulting debate and shared intelligence means we do not automatically rule out holding "risky" ESG companies. Instead we are in a unique position to engage with those firms to drive changes that seek to reduce risk and enhance performance potential over the long term.

Before investing in those "risky" companies, we seek to understand their practices, the decision-making behind them, and how well they themselves understand the risks facing their businesses and their industry. This kind of engagement and stewardship is core to our integrated ESG approach.

Socially responsible investing

Alongside integrated ESG, "Socially responsible investing" (SRI), which focuses on negative screening of particular sectors or stocks, or a positive tile towards the "best-rated" stocks in a sector, continues to be a favoured option for many investors.

SRI strategies may avoid companies that produce tobacco, alcohol or firearms, or those that cause pollution or employ child labour, for example. Investors may have specific exclusions or other requirements within their mandates that can be met only through an SRI approach. Our SRI strategies have dedicated sustainability and impact targets, investing in corporates with a higher ESG rating, aimed at indirectly impacting sustainability.

Elsewhere, "impact investing" is also growing in popularity. These strategies use positive criteria to invest specifically in those companies that contribute an active and measurable benefit to society, the environment or a community, defined by their direct impact. Examples may include renewable energy initiatives, zero carbon projects or organisations that finance hospitals in the developing world.

Responding to investor demand for ESG

AllianzGI has a long history of embracing responsibility and sustainability. In 2000, we launched one of the first global equity sustainability strategies in Europe. Since then ESG issues have become deeply embedded in our DNA. We are in the process of embedding ESG as a tangible factor across all strategies, regardless of asset class. Already, integrated ESG applies to EUR 116 billion of the assets we manage, as at 30 September 2018.

We also offer a diverse selection of specialist offerings built around SRI with €22 billion worth of AUM focusing on screening, and a further €6 billion focused on impact investment.

We consider ESG to be an important driver of investment performance across all our strategies. ESG factors are reflected in our processes, thinking and decisions.

Beyond the potential to generate a positive impact, investors have realised that investment in companies with a focus on sustainability does not have to come at the expense of returns: that good governance and good performance potential can go hand-in-hand. Indeed, as the graph shows, the MSCI KLD 400 Social Index, which is made up companies with outstanding ESG ratings, has historically outperformed the S&P 500 since its inception in 1990.

MSCI KLD 400 Social Index vs S&P 500

Source: MSCI, Evestment. Data as at 31 October 2018. Inception date of data matches inception date of MSCI KLD Social 400 Index in May 1990. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell a specific security, strategy or investment product. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Further, through positive engagement with investee companies, investors can seek to influence those companies to perform better and embrace business models that are more sustainable – in every sense.

In addition, some multi-asset strategies are not tethered to a benchmark index. This gives them more freedom to make adjustments according to market conditions, diversify risk, and produce a return stream designed to be uncorrelated with general market performance.

1 The Forum for Sustainable Investment's 2018 Report on US Sustainable, Responsible and Impact Investing Trends, published 31 October 2018.

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Summary

In all areas of our lives, disruptive forces and technologies are delivering efficiency, transparency and value by reinventing established models. Asset management is no exception, and the industry's future success will be shaped by how it embraces and applies disruptive thinking – to place the client at the centre of the business and build trust.

Key takeaways

- Asset management is changing, driven by shifting investor priorities and technological enhancements
- Disruption within the industry must focus on enhancing the client experience, and this includes new fee structures
- New sources of data – and the analysis enabled by technologies such as artificial intelligence – can help enhance the investment decision-making process
- The ability to access and manage their portfolios digitally is a key factor for a growing number of clients