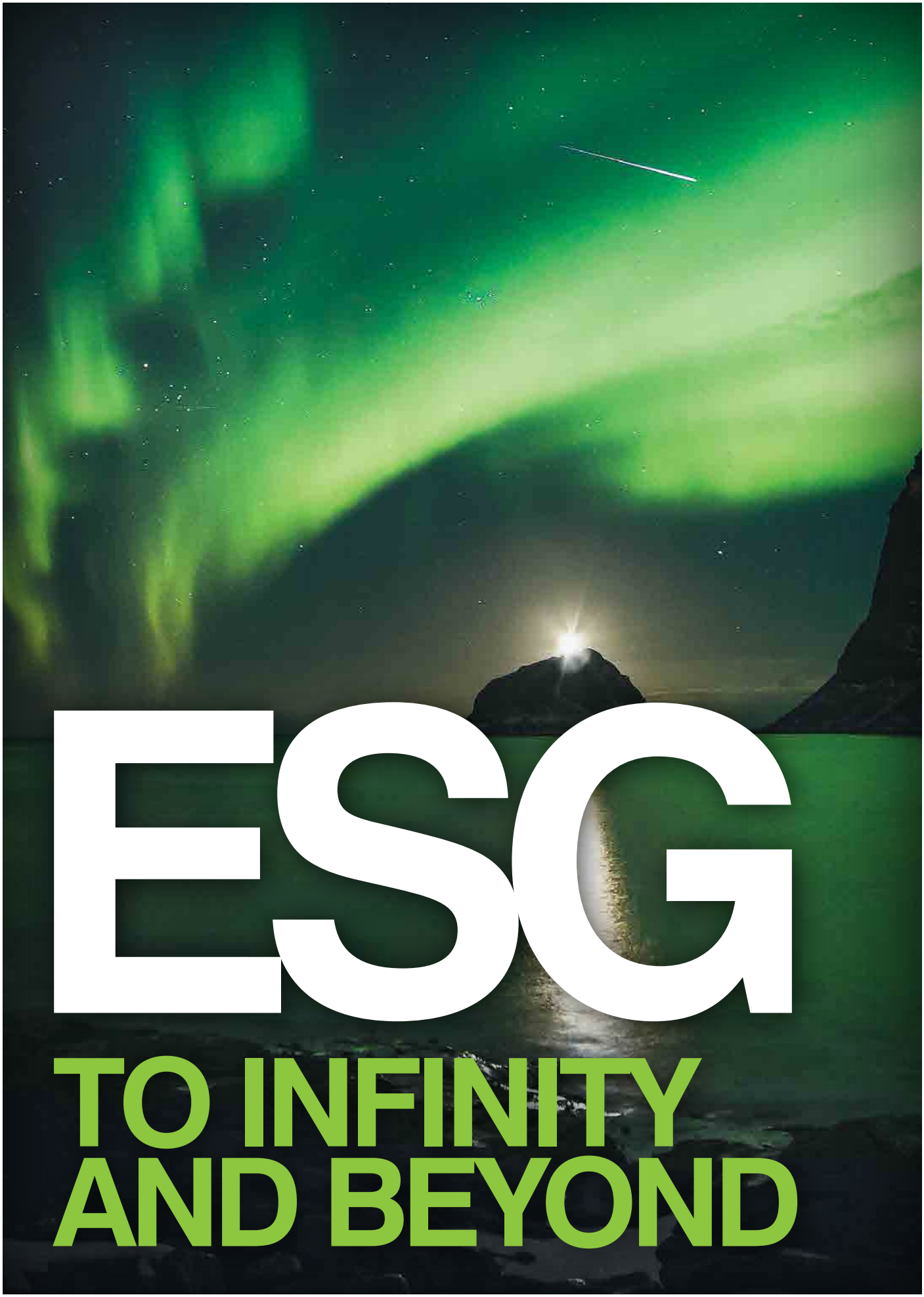

ESG

TO INFINITY AND BEYOND

The means to integrate ESG strategies systematically is now at hand. This is allowing more asset owners and their managers to improve their stewardship activities.

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There is little new under the sun

The issues that motivate ESG investors today have their historical counterparts. Financial history is littered with examples of myopic analysis and poor governance leading to financial crises and economic slump[1]. The issues we describe today as market failure, externalities and coordination problems were addressed in the 19th century by municipal socialism, where local officials formed companies or raised subscriptions for schools, water and sewerage systems, bridges and basic social safety nets. That today we might find some of the motivations uncomfortable is a minor detraction when set against the huge positive impact these investments had on the lives, mortality and welfare of the people. Likewise the heated debates, occasioned by revulsion at apartheid, over disinvestment and legal sanctions can be heard as a faint echo in today's debates on climate change.

Agent's of the people

Modern institutional arrangements are very different from the relatively recent past. Much of the world's financial assets are not in the hands of individuals but in pension schemes controlled by agents who have legally enforceable fiduciary responsibilities. Institutional investors face increasing calls to use the assets they control to address modern day ESG issues. Many funds are wrestling with how to balance their fiduciary responsibilities against these new demands.

Cynically, these new demands may just be an example of Sutton's law – pension schemes are where the money is. Collectively pension schemes have huge assets and outsiders can see many ways in which they might usefully be deployed.

Alternatively, there is an argument that institutional investors should take on responsibilities befitting their recently acquired scale. Pension funds are the dominant suppliers of investment capital and how they deploy their capital affects economic and social outcomes, so thinking about the impact of investment decisions is aligned with their fiduciary duties.

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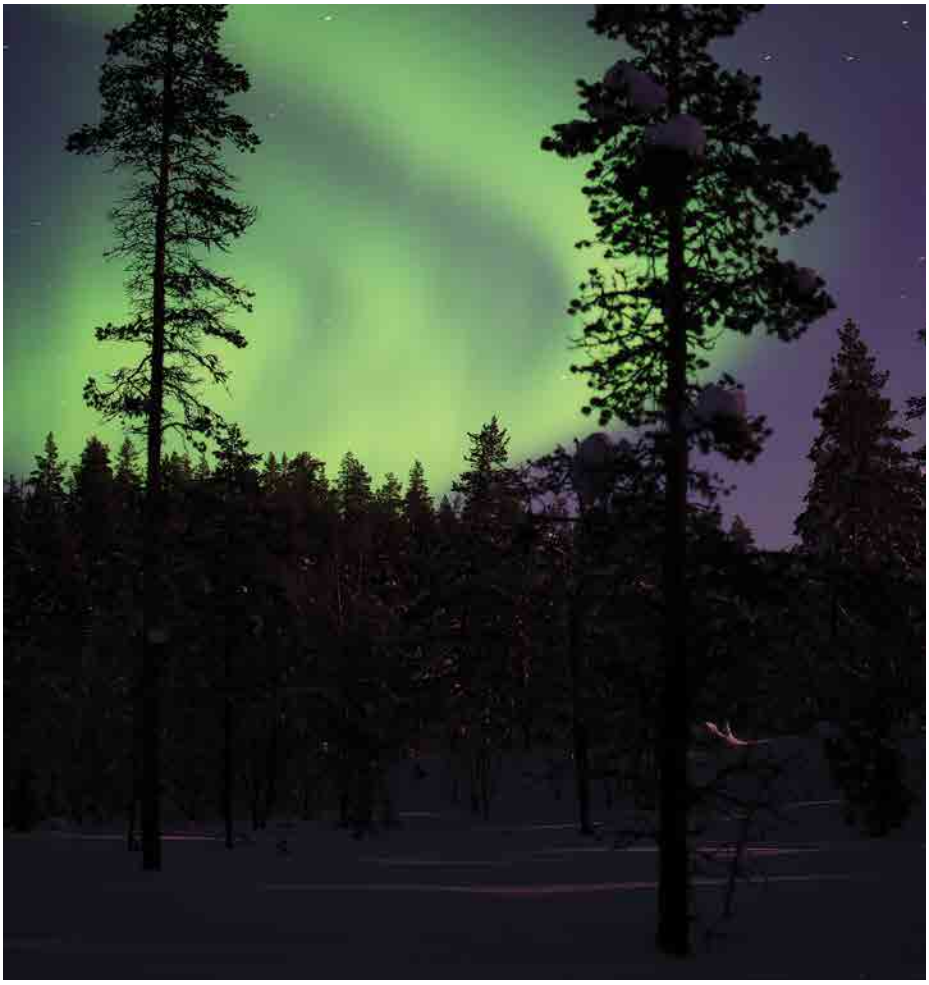
Each view has an element of truth. Regardless, the Global Financial Crisis (GFC) and the threats posed by climate change have given impetus to the calls for institutional investors to address modern day ESG issues.

Three entwined strands of ESG investing have now emerged providing greater clarity, these are: to manage to ethical norms; to avoid unrewarded risks; and/or to achieve an impact through investment.



History rhymes

ESG is an acronym for a portmanteau of concerns. In the wake of the GFC, regulators worried that investment analysis was blinkered, focusing too narrowly on financial measures, turning a blind eye to issues of governance and ignoring off-balance sheet risks. At the same time, the perception that the GFC was caused by the amoral actions of banks and financial analysts led to a resurgence of interest in portfolios that reflected investors' moral convictions. This can also be seen in an increased desire among some investors to influence corporate behaviour and to use investment for good, especially tackling climate change and inequality.

These various concerns, although referred to collectively as ESG, were only loosely related. Lacking a common purpose, the ESG movement spawned a terminological zoo: styles of investment being variously and enthusiastically described as 'Responsible', 'Sustainable' or 'Ethical'; and investment objectives ranging from 'Doing Well by doing Good', through 'Impact' to pure philanthropy.

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Ethical norms

The first of these typically uses exclusion lists to forbid investment in issuers, such as tobacco or gaming companies, whose activities conflict with clients' ethical norms and have long been part of client requirements.

These lists are best used when investors consider the issue to be binary in nature – for example where tobacco, gambling or thermal coal investment are unacceptable investments in any circumstance; or when there is an issue peculiar to the company or country – for example it appears on a sanctions list.

The chief advantages of an exclusion list when it meets these criteria are that it is simple to implement and readily communicated. However, when it does not, it can be hard to ensure the list is comprehensive, leaving the investor vulnerable to accusations of inconsistency. In this case, investors might be better advised to adopt an engagement, or, more broadly, an impact approach.

The risk-based approach to ESG

The second of the three entwined strands seeks to address some of the regulators' post-GFC concerns. This approach aligns most closely with the UN Principles of Responsible Investing and implies that ESG is fully integrated into the investment approach. Investors will evaluate the risk and pricing implications of an issuer's poor ESG practices or inadequate policies. A bond investor will judge ESG risks to be material if it is conceivable that they might affect an issuer's ability or willingness to meet their debt obligations. This focus on materiality is ideally suited to bonds as tail-risk for a bond investor means either default or catastrophic credit deterioration.

As Institutional investors have grown to be the dominant suppliers of capital they have become more concerned by the agency problem: how do you encourage management to act in the best interest of shareholders rather than themselves?

From agency problems to active stewardship

The third strand represents a broadening of the stewardship approach to investment to embrace standards of corporate behaviour and citizenship. As Institutional investors have grown to be the dominant suppliers of capital they have become more concerned by the agency problem: how do you encourage management to act in the best interest of shareholders rather than themselves? Their response has been to become more active in voting their shares. However, the interests of shareholders may not align with other stakeholders, which for some includes society at large.

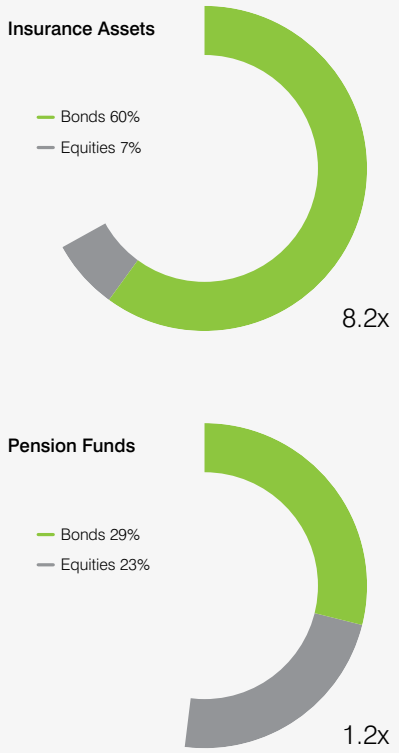
This is the concern addressed by the impact approach, under which bond and equity investors seek to use their respective sources of influence to broader effect. This is a more general definition of impact investing than that commonly used. Conventionally, an impact investor might choose to invest in companies or projects that are expected to bring some environmental benefit; for example, investing in Green Bonds. Alternatively, encouraging an oil company to return capital to shareholders rather than invest in exploration may have a greater positive environmental impact than funding a project that would have been financed anyway.

This requires active engagement and attempts to use shareholder resolutions to force management into taking certain actions have not always been successful. For example, in April 2019 Exxon successfully argued that it need not put a resolution to shareholders on climate change, because amongst other things it was:" an attempt to interfere with its management responsibilities"[2]. To influence companies, shareholders need to use their vote, but they can only vote on resolutions put to them.

Bonds – Nobody does it better

Possibly, because of the limited efficacy of their votes, some investors have begun to think about what influence their bond portfolios might allow them to bring to bear. The bond market may have some advantages over the equity market in this regard. First, the bond market is where companies fund themselves.

FIGURE 1: INSURANCE ASSETS AND PENSION FUNDS



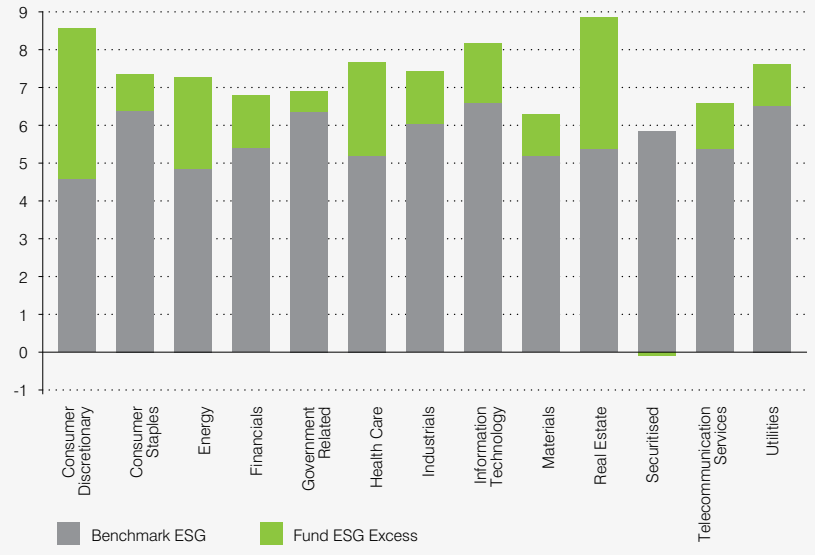
Note: Asset Allocation as of 2017
Source: OECD

In a typical year, the US bond market raises more money for companies than the US equity market does in a decade. Secondly the nature of bonds makes it very easy to compare the costs of borrowing of one issuer to another. If an ESG risk leads to an increase in an issuer's cost of borrowings, then it is a simple matter to quantify the cost and, therefore, the benefit of remedying the issue.

Spreading the message of ESG

The greater clarity of purpose that has emerged over the last decade has encouraged a more rapid diffusion of the ESG movement's ideas. This happened partly by standardisation. Some institutions are happy to adopt the policies of others, if they are an approximate reflection of their norms, for example: many institutions elect to use the Norges Bank's exclusion list; the MSCI USA Catholic Values Index is an equity benchmark designed to be consistent with the United States Conference of Catholic Bishops' Socially Responsible Investment Guidelines.

FIGURE 2: ESG COMPARISON – FUND VS BENCHMARK



Note: The Cameron Hume Global Fixed Income ESG Fund seeks to invest in issuers that Cameron Hume believes manage their ESG risk better than their peers. To evidence this is the case the chart uses data from an independent third part, MSCI, and the aggregate MSCI ESG score by sector and for the fund. The Fund's margin in excess of the benchmark is highlighted.

Sources: MSCI, Cameron Hume

Clear Communication

A particularly important catalyst to the spread of ESG has been the investment that the data providers have poured in to their ESG analysis, methodologies and coverage. It is now feasible to compare portfolios to benchmarks not only on the basis of ESG ratings, but also on each of the 3 pillars of E, S and G, and by important themes such as climate change, or human capital.

Guided by the history. We think there are parallels between the historical development of credit ratings and ESG ratings. The original concept of credit ratings by Messrs Moody and Poor was to provide investors with an opinion of the quality of an issuer's credit. This was communicated by the now familiar credit rating. Over time, as coverage improved, analysts were able to identify financial ratios that were typical of issuers with a given credit rating and to calculate the historical default rate of issuers with that rating. We now have over a hundred years of experience with credit ratings and although they attract much criticism they are ubiquitous.

Credit ratings are useful, not because they are accurate, although we might hope them to be reasonably so, but because they are independent of both the investment managers and their clients. This independence makes it possible for the two parties to agree an investment management agreement that sets out the clients' appetite for credit risk as measured by the rating. Few asset owners would be prepared to accept solely the opinion of their investment manager on the credit quality of the issuers they have selected. In short, for most asset owners, credit ratings, imperfect though they are, are the best way to communicate their credit policy.

From data, insight; from insight, impact

And this is precisely what ESG measures from third party data providers do for ESG policy. By expressing an ESG policy in terms of a third party's concepts and measures, asset owners can communicate it clearly to their asset managers, and other stakeholders. This is not to argue that ESG ratings are the best that they could be, but only that they are useful notwithstanding their imperfections. This is a profound change for ESG, which goes some way to realising the original desire of the ESG movement. In a sound bite: measurability confers manageability.

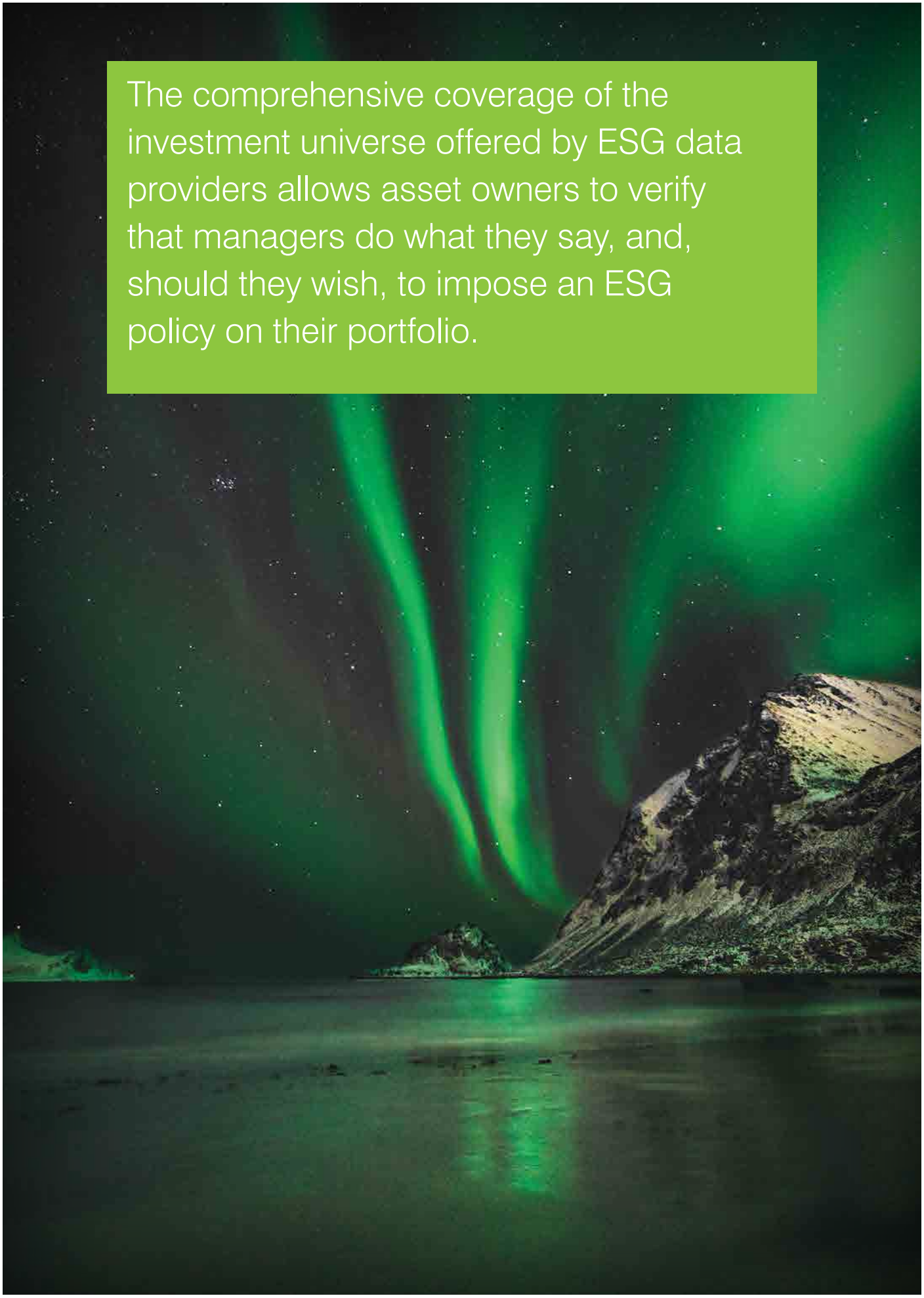
At last, it is possible for asset owners to measure the ESG exposures in their portfolio and thus hold managers to account. Owners now have a resolution to the agency problem where before they had no choice but to take on trust the assurances offered by managers that ESG risks are managed. The comprehensive coverage of the investment universe offered by ESG data providers allows asset owners to verify that managers do what they say, and, should they wish, to impose an ESG policy on their portfolio.

Tomorrow's world

The means to integrate ESG systematically are at hand. Using third party data we can codify objectives, report exposures and communicate clearly the policies we are pursuing. There is therefore the potential for asset owners and their managers to take a more active approach to stewardship. Not everyone will wish to, but for those that do it appears to be simply a matter of ambition and action.

Footnotes

1. See for example: Charles Kindelberger – "Manias, Panics and Crashes – A history of Financial Crashes"; John Kenneth Galbraith – "The Great Crash 1929"; and S.G. Checkland –"Scottish Banking: A History, 1695 – 1973"
2. https://www.reuters.com/article/us-usa-exxon-mobil-climatechange/u-s-regulator-rules-out-exxon-shareholder-vote-on-climate-resolution-idUSKCN1RE2E5



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