ESG Investing: Growing and Evolving

With Schulte Roth & Zabel's Stephanie Breslow

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The Forum for Sustainable and Responsible Investment (US SIF) estimates that $12trn of assets are now managed taking account of ESG factors. "ESG investing started with socially responsible investing (SRI) and negative screening, excluding companies involved with weapons, conflict minerals, corruption, child labour, or those threatening jobs in particular regions," says Stephanie Breslow, a Schulte Roth & Zabel partner who serves as co-head of the investment management group and as a member of the firm's executive committee. "But there has been a recent trend towards affirmative ESG that may foster positive change through engagement, proxy voting or impact investing."

SRZ's investment management and activist practices advise on ESG issues, working with clients including dedicated ESG funds and activists who consider ESG factors. Breslow explains how ESG has evolved, saying that, "It started in Scandinavia and other parts of Europe including the Netherlands, and has now been adopted by US state and local governments and endowments. It has animated millennials and is more sought after by women than men."

Defining ESG

The lack of a common ESG definition makes it easy to fret that some managers are "green-washing", or simply applying ESG cosmetically. The UN PRI suggests that the US Department of Labor needs to clarify multiple issues. Breslow's view is that, "The UN PRI is chiefly looking for reporting around ESG now. It would be helpful to have a greater understanding of what it constitutes. It might not be a one-size-fits-all definition, as many groups define ESG according to their principles. We need a common and more granular understanding of what ESG means in order to produce a general set of guidelines. Exclusion lists can be clear, but other criteria such as board diversity, or countering global warming, need to be defined."

It's illustrative of the problem that while the European Union is about to introduce a taxonomy of sustainable funds, based on the work of the Technical Expert Group (TEG) on sustainable finance, the labelling system has already been criticised for being rather narrowly focused on a subset of environmental criteria.

Some of the more contentious issues around defining ESG include shorting and ESG improvement. Shorting assets with poor ESG qualities can either be perceived as a source of alpha, or such assets can be excluded from the investment universe altogether on the basis that it would be morally wrong to profit from a "bad" company. "The question of whether investors believe shorting furthers an ESG mandate is not clear," says Breslow. A pertinent question is whether an ESG strategy needs to start by investing in companies with high ESG scores, or whether it could invest in "bad" companies with the aim of improving them. A classic example of this could be utilities transitioning from fossil fuels to renewables for electricity generation. Some academic studies have suggested that the greatest investment outperformance has come from identifying these improvers; companies that already have high ESG scores may enjoy relatively high valuations. Arguably, one of the oldest ESG strategies is a type of activism, which identifies out-of-favour companies that may be cheap due to suboptimal governance, and then tries to improve their governance in order to increase their valuation.

Fiduciary duty

The degree of freedom to pursue ESG varies according to the type of mandate. "If high net worth individuals, or indeed anyone with a self-funded pension plan such as a 401k, are making their own investment decisions, then of course they are free to choose a strategy that might sacrifice returns, so long as this risk is made clear. But if managers are responsible for managing other people's money – and have a fiduciary duty to those people – then ESG has to be in the furtherance not sacrifice of returns, unless the ultimate investors have instructed otherwise," says Breslow. US employers have been criticised for offering very few, and sometimes non-existent, ESG investment options in their 401k plans, and some firms have only just started offering a single ESG option over the past year or so.

Whether ESG is consistent with fiduciary duty (including associated concepts of exclusive benefit, prudence, loyalty and care) – and the intermittently updated Department of Labour guidance – has been debated for decades in the US. Breslow's opinion is that, "It is actually quite hard to argue that ESG has zero impact on returns. The easiest case to argue is that ESG is a prudent way of avoiding losses or underperformance that could be caused by ESG issues such as pollution, coal, poor labour practices, poor governance or consumers revolting against products such as plastic straws," she says.

"But if managers are seeking to exclude entire categories of profitable investments to make the world a better place, that would have to be an objective that investors had signed up to. The US laws do not currently allow for sacrificing investor returns for the sake of other stakeholders, such as employees, consumers, or the broader environment. Investors would need to explicitly consent to a mandate including longer term social and environmental factors," says Breslow. "It is not clear what level of consent members of defined benefit pension schemes would need to provide," she adds.

Internal or external ESG analytics

ESG analysis can be based on internal or external analysis or both. There are multiple ESG ratings agencies, some of which have been taken over by credit ratings agencies.

"In general, where asset managers rely on third party ratings to implement an ESG policy, this should be made clear in the offering memorandum in the context of a general description of the ESG strategy which need not be completely prescriptive but should have some specifics," points out Breslow. But the appropriate modus operandi does vary by strategy. "Private equity managers should do their own, detailed, thoughtful, bottom up analysis as should a liquid bottom up manager," she continues. "Conversely, an actively traded systematic manager might find it more difficult to implement ESG."

Conflicts

In principle, any different but partly overlapping strategies can give rise to potential conflicts, and ESG is one case of this general issue that requires transparent disclosure of conflicts and policies designed to mitigate them. Breslow thinks that, "it is unlikely that one vehicle would be long an asset that is a short position in another structure. But two vehicles might be invested in different assets in the same sector, such as an ESG one in alternative energy and a non-ESG one in conventional energy." There could also be complications if different strategies vote proxies differently. "We would not recommend a manager vote against itself."

Vehicles

ESG could be pursued through one or more of: managed accounts; funds of one; share classes or excusal rights. "It is generally cheaper and simpler to set up an excusal right – whereby investors avoid exposure to a particular industry or asset – than to set up a separate vehicle. If the exclusion is only likely to be occasionally invested in, and would make up a small proportion of assets, then it is easy to grant an excusal right. But if green energy is being sought in an oil and gas fund, then the excusal right would become very disproportionate," she points out. Headline and reputational risks are another consideration. "If an investor wants to be completely dissociated with investments in certain companies and industries, then they would prefer a separate vehicle over excusal rights."

"It is very unlikely that side pockets would be used to facilitate ESG, or carve out prohibited assets, since they tend to be used for assets that are less liquid than the main fund. But an ESG fund could have ESG co-investment opportunities, and co-investors may also be able to opt in and out of investments based on ESG factors," she concludes. **THFJ**

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