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PRIVATE EQUITY

Sustaining sustainability: What institutional investors should do next on ESG

Mainstream institutions have made progress integrating environmental, social, and governance factors into their investing, but they still have far to go. Six ideas can take them to the next level.

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Institutional investors face a moment of truth about their commitment to environmental, social, and governance (ESG) factors. Many have long realized that these issues—including climate change, workplace diversity, and long-standing corporate concerns such as executive compensation—can drive risks and returns. In fact, many large institutional investors have publicly committed themselves to integrate ESG factors into their investing. The UN-backed Principles for Responsible Investment (PRI) have been signed by more than 1,500 investors and managers, representing nearly \$60 trillion in assets under management.

Yet look a little deeper, and it's clear that many investors have struggled to convert their commitment into practice. For example, less than 1 percent of the total capital of the 15 largest US public pension funds is allocated to ESG-specific strategies, such as ESG-screened passive indexes, active management using ESG insights, or private-market management with a fully integrated ESG strategy. Moreover, many institutional investors continue to treat ESG as a sideshow rather than an integral part of their investing. While ESG and corporate-governance teams are commonplace, they are often held at arm's length from core

investment activities. Even the most successful funds have integrated ESG unevenly. While sustainable-equities strategies (such as low-carbon indexes) are no longer oddities, most funds haven't expanded ESG integration to other asset classes. Members of the PRI agree that more is required. Its board is considering a change that would allow it to remove signatories that haven't made sufficient practical progress.

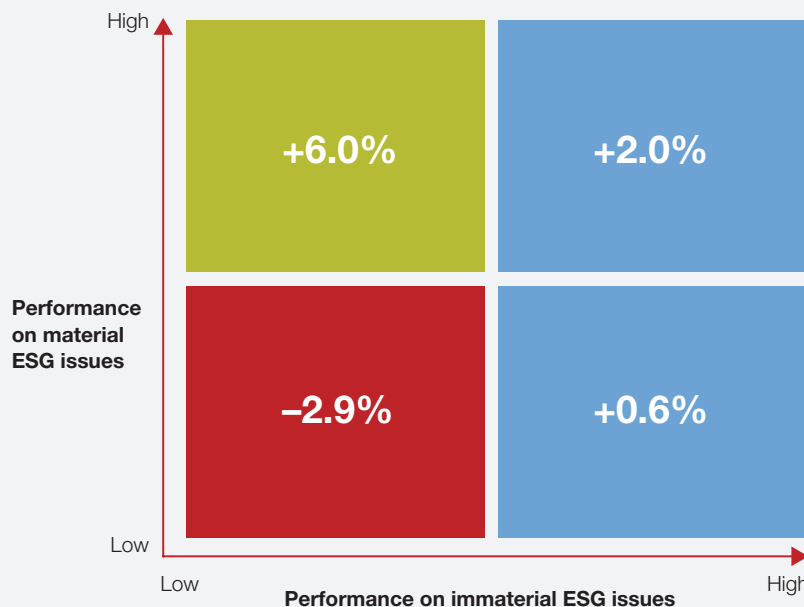
This is not to say that the industry has been standing still. In fact, three big problems have recently been cracked, setting the stage for continued growth. First, investors have struggled for some time to determine which ESG concerns

are relevant to particular investments. In response, some leading institutions have embraced the idea of "materiality," derived from the concept of material information in accounting. Much as knowledge that could influence investors' decisions is deemed material, so too are ESG factors that will have a measurable effect on an investment's financial performance. According to a recent study using the materiality framework of the Sustainability Accounting Standards Board (SASB), companies that address material ESG issues and ignore immaterial ones outperform those that address both material and immaterial issues by 4 percent and outperform companies that address neither by nearly 9 percent (exhibit). Generation Investment

Exhibit

A focus on material ESG issues drives greater returns.

Effect on financial returns of investors' treatment of environmental, social, and governance (ESG) issues,¹ annualized alpha



¹The study used data from 1992 to 2012 on companies' ESG performance across 45 industries in six sectors: financial services, healthcare, telecommunications, nonrenewable resources, services, and transportation. The study tested the effects of the Sustainability Accounting Standards Board's material factors while accounting for the effects of firm size, market-to-book ratio, profitability, leverage, and sector fixed effects.

Source: Mozaffar Khan, George Serafeim, and Aaron Yoon, *Corporate sustainability: First evidence on materiality*, Harvard Business School working paper, Mar 9, 2015, hbs.edu

Management, a sustainable-investing specialist founded by David Blood and Al Gore, put ESG materiality at the heart of its global equity strategy and has reportedly exceeded its benchmark by an annualized 500 basis points for over a decade.

Second, many institutions have found it hard to measure external managers' regard for ESG issues; they need a kind of "greenwashing" detector to see through the obfuscation that plagues some managers' activities. A number of institutions are now successfully deploying new mechanisms to increase accountability. The New York Common Retirement Fund, for example, recently developed a comprehensive scoring system based on the best available benchmarks. Managers that don't disclose information receive poor marks, hammering home the idea that transparency is paramount when someone else's capital is on the line.

Third, some board members and trustees of institutional investors have worried about whether, as part of meeting their fiduciary duties, they are considering ESG factors. Recently, the US

Department of Labor revised its ERISA¹ guidance to say explicitly that consideration of ESG concerns is a part of the pension plans' fiduciary duty. The department also specified that when a fiduciary considers two investments that are similar from a financial perspective, it should select the one that's better from the standpoint of ESG. Such cases come up frequently. In France, the Ministry of Finance recently announced new rules that require investors to measure their portfolios' exposure to carbon, among other ESG considerations. With the regulatory drumbeat picking up tempo, investors will probably soon adopt sound practices to determine materiality and evaluate managers.

Accelerating progress

Materiality, scorecards, and clearer definitions of fiduciary duty are only a launchpad. A commitment to ESG integration will remain merely symbolic unless institutions change their investment and capital-allocation processes in the ways required for this kind of investing to lift off. Investors should consider six steps to broaden and enhance their ESG impact.

“Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tiebreakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices.”

—US Department of Labor, 2015

[Require uniform corporate ESG-reporting standards based on the principle of materiality](#)

Considerations of materiality ought to be a two-way street: publicly traded companies as well as investment managers should disclose material ESG information. Some institutional investors have already been working with groups such as the Carbon Disclosure Project to push companies to report their ESG metrics (for instance, their carbon footprint or water usage), but more must be done.

Requiring companies to share all material information in a standardized, comparable way is necessary if institutional investors and their external managers are to assess the meaningful ESG-related risks and opportunities companies face. Institutional investors can work with the groups that have sprung up to advance the cause. The Sustainability Accounting Standards Board, for example, has rigorously defined materiality factors at sector and industry levels and is pushing for disclosure of material ESG factors in IPO and 10-K filings. Institutional investors should also collaborate with the Financial Stability Board's task force on climate-related financial disclosures (led by Bank of England governor Mark Carney and Michael Bloomberg) and support the efforts of the International Integrated Reporting Council to encourage more comprehensive corporate reporting, including reporting on material ESG factors. They may also wish to comment on the US Securities and Exchange Commission's recent consultation about whether investors would like to see more formal disclosure requirements for companies' sustainability measures.

[Build a shared ESG-rating system for external managers](#)

Institutional investors usually have a rigorous due-diligence process for evaluating their external managers, yet too many treat their assessment

of the managers' approach to ESG as merely an exercise in box ticking. Farsighted institutions are already building systems to rate external managers more thoroughly, but a shared system would multiply the benefits considerably. Rather than duplicating one another's work, funds could both cut the effort needed to make informed decisions and hold managers to a high standard for their ESG performance across the board.

A shared rating system should consider the sources of a manager's ESG insights and the ways it seeks to engage with the companies in which it invests. The system will need to reflect the nuances of different asset classes and investment styles; ESG factors will be less material for many hedge-fund strategies than for managers investing in real assets or global equities, for example. Over time, a shared rating system should help prime the market for ESG-informed investment strategies. Many of them have historically struggled to gain allocations because of their short investment histories or skepticism about whether the alpha they generate will endure. That's why institutional investors should invest in building a shared, open standard that their investment professionals will understand rather than simply outsourcing this task to investment consultants.

[Work together to engage with corporations](#)

Most investors recognize that as patient capital, engagement is for them both a social responsibility and a source of long-term returns. Yet most have small corporate-engagement teams that can work with only a few companies each year. Leaders such as the Canada Pension Plan Investment Board, the Ontario Teachers' Pension Plan, and Calpers have built relationship-investing strategies—they back engagement with dedicated capital and sometimes board seats. Large external asset managers such

“We recently introduced an ESG risk assessment to make sure our external managers are integrating ESG into their investment decisions and doing so on the basis of materiality. For all of our external managers, we can now take a fact-based view on whether they are simply ticking the ESG box or are considering ESG in a rigorous, thoughtful way that addresses material risks to our capital.”

—Vicki Fuller, chief investment officer, New York Common Retirement Fund

as BlackRock and Vanguard have strengthened their engagement teams and are working with their investors on this front.² But even these efforts have limits to what they can achieve.

Too many investors fritter away their best chance at engagement by relying blindly on third-party proxy-voting guidance. Investors have a real opportunity to move beyond ad-hoc collaboration; instead, they could agree on a specific and narrow set of principles, back these with capital, and commit their votes. From this platform, they could demand that laggards disclose material ESG factors. For example, they might join Fidelity in calling for the pay of all CEOs to be based on incentive plans that are at least five years long—or go further and call for such plans to be based on a mix of operational, free-cash-flow, and material ESG metrics.

Investors should also request better disclosure and ask companies to lay out long-term strategies showing how ESG factors may affect their ability to generate value. Businesses that depend on a “social license to operate” to maintain their pricing power

or that need to invest heavily in training to expand a peer-to-peer sales force should reveal these ESG-related dependencies. Investors might slap proxy motions on companies slow to respond.

[Stress-test portfolios for ESG risk factors](#)

Since 2008, many institutional investors have strengthened their risk management—for example, by adding tools and skills needed to run scenario analyses on how their portfolios might behave in times of stress. Yet most focus narrowly on “tail” value-at-risk scenarios driven by broad macroeconomic volatility. They ought to complement this approach with considerations of unpredictable shocks, such as regional water shortages, avian-flu pandemics, and increases in (or the introduction of) externality pricing.

Other institutions are embracing risk-factor investing: they evaluate their exposure to root sources of risk, such as currencies and interest rates, and then set limits for them. In both stress-test and risk-factor investing, material ESG considerations are not always taken into account, but they should

be. A risk-informed decision-making process allows institutional investors to fulfill their fiduciary duty as stewards of university and foundation assets or of the retirement savings of public-sector employees.

Public concern over climate change is a particularly acute risk factor and source of value at risk. Many institutional investors are considering whether to reduce the carbon exposure in their portfolios or even to divest out of fossil fuels entirely. We realize that some fiduciaries view this as a moral decision. Nonetheless, it is important for institutional investors to have a nuanced understanding of the actual ESG risks they are exposed to, so that they can choose whether and how to respond. Some institutional investors have decided against divestment in the short term but plan to test their portfolios continually for climate risk. They are setting clear limits that, when triggered, will require them to reduce their exposure, to encourage companies to return cash rather than invest in exploration, or ultimately to divest fully.

Use a long-term ESG outlook to unlock new investment opportunities

All investors ought to consider material ESG factors. But the long time horizons and broad market exposure of institutional investors mean that they are particularly vulnerable to the good or bad ESG decisions of the companies in which they invest. Some institutions have developed innovative investment strategies to deal with this issue. For example, several have created indexes that either screen out worst-in-class ESG companies or weight toward best-in-class companies. Since 2012, the Swedish pension plan AP4 has been running a low-carbon fund that excludes the 150 worst polluters in the S&P 500, thereby producing an index whose carbon footprint is about 50 percent lower than that of the broader index.

While differing liability profiles may make custom indexes the optimal solution for institutions, they should consider the scale benefits of collaborating with others. A good example is the \$2 billion



Innovative approaches to integrating ESG

Four investment managers demonstrate that environmental, social, and governance (ESG) investing is an area of innovation.

Affirmative Investment Management is one of a handful of investors that are exploring how best to integrate sustainability into credit strategies. It focuses solely on fixed-income and cash investments with explicit positive ESG outcomes. The company believes that ESG factors bring an additional layer of insight to fundamental credit analysis and can materially reduce default risk. It also sees itself as a market builder, helping to expand the demand for “green bonds.” In addition, Affirmative is committed not only to measuring its financial performance but also to reporting on the use of proceeds, including the known environmental and social impact of the activities funded.

Arabesque Partners, founded in 2011, integrates ESG data into the construction of its portfolios, including a “smart beta” fund and long-only alpha strategy. Alongside fundamental equity analysis, Arabesque thinks it has an edge by more thoroughly understanding the quality and limitations of the increasing volume of corporate ESG data: it believes that big data techniques can identify the material ESG factors that will shape risks and returns at a granular level. Both

of Arabesque’s strategies have outperformed their benchmarks since inception and rank within the top 20 percent of their Morningstar peer group.

Breckinridge Capital Advisors, with \$23 billion under management, is more established than the other investment managers in this group, yet it demonstrates how an established manager can develop cutting-edge approaches to ESG integration. In 2011 Breckinridge enhanced its rigorous credit-research process through the systematic analysis and integration of ESG factors. It argues that this integrated approach has provided it with a more comprehensive and forward-looking evaluation of each borrower’s risk/return profile and helps it keep a keen eye out for links between a borrower’s ESG efforts and its financial performance.

Ownership Capital, formerly an in-house manager at PGGM, is a long-only active equity manager with a long-term horizon and an explicit approach to integrating extrafinancial factors such as stakeholder and sustainability management. With a concentrated portfolio, it can actively engage with the companies it invests in and help to encourage improvement in ESG performance. Since its inception, in 2008, Ownership Capital has outperformed its benchmark by an annualized rate of more than 500 basis points.

committed by six big institutions to the Long-Term Value Creation Global Index, designed for them by S&P. Investors should also think beyond passive equities and consider how they can use ESG factors to reduce risk or identify alpha across a range of asset classes. An obvious possibility is direct

investments in companies and real assets where institutional investors have enough influence or control to upgrade the ESG management.

Finally, only a handful of ESG managers have ten-year track records. Institutional investors shouldn’t

wait passively for such track records to turn up—they ought to use their emerging-manager programs to seed and support innovative ESG-informed strategies. Several managers are pushing the boundaries of ESG-informed investing (see sidebar, “Innovative approaches to integrating ESG”).

[Confront the skepticism and misunderstanding that surround ESG head-on](#)

Successful investment organizations have strong cultures, but strengthening a culture takes time. At many institutions, ESG investing is caught in a cultural trap. For decades, conventional wisdom has held that ESG and its forebears, such as socially responsible investing, are merely a sideline, something to be worked on separately from the true business of investing. Changing this mind-set requires concrete action.

Chief investment officers must direct a cultural change within their investment teams. For a start, they can model the right behavior by leading the integration of ESG into the investment committee’s risk/return discussions. Institutional investors should also consider whether training and certifications may advertise the value they place on ESG fluency. Just as the CFA Institute’s Claritas certificate gives investment professionals a measure of credibility after only 100 hours of study, an industry-wide ESG certification could become a signal of qualification to institutional investors as they hire and invest. Bloomberg, the CFA Institute,

the SASB, and many universities already offer ESG courses, and some consolidation around a clear industry qualification would benefit everyone.



Turning a symbolic commitment to ESG into daily practice will not be easy. But faced with rising stakeholder demand for meaningful action, there is little choice. Institutions that get out in front of the growing wave will be the first to reap the benefits of sound ESG investing: better returns, lower risk, and—should these ideas be widely adopted—a more sustainable world. ■

¹ Employee Retirement Income Security Act.

² Kirsten Grind and Joann S. Lublin, “Vanguard and BlackRock plan to get more assertive with their investments,” *Wall Street Journal*, March 4, 2015, wsj.com.

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