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# Why Do Investors Integrate ESG Into Investment Process?

ESG & Sustainability Transformation

Hung NINH

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ESG Transformation

## Why Do Investors Integrate ESG Into Investment Process?

With the rapid evolution of ESG investing in the context of the ESG globalization megatrend, this is a common question in the investor community, especially in emerging economies. It must be said that the development of ESG investing has never been supported more strongly by both advances in academic research and practice, especially with technological breakthroughs.

Many approaches to ESG analysis are used, and a multitude of ESG integration tools and techniques are available. These methods include company analysis, asset valuation, portfolio decision-making, and stewardship.

ESG analysis methods use various data sources, ranging from commercially available databases to primary analytical research.

In previous articles, we answered questions about the benefits of integrating ESG factors in businesses. In this article, we will answer this same question from an investor's perspective, regardless of the market, size, strategy, or investment product.

**Why do Investors Integrate ESG?**

An investment firm might have several different aims and objectives for integrating ESG into an investment process. These can include:

- Meeting requirements under fiduciary duty or regulations,
- Meeting client and beneficiary demands,
- Lowering investment risk,
- Increasing investment returns,
- Giving investment professionals more tools and techniques to use in analysis,
- Improving the quality of engagement and stewardship activities, and
- Lowering reputational risk at a firm level and investment level.

We will look at each of these objectives in the following sections.

The aims can differ depending on the nature of the firm. Some firms are pure asset managers, some are asset owners (e.g., pension plans), and some have mixed characteristics of both an asset manager and an asset owner (e.g., some insurance entities or large endowments that use both in-house asset managers and third-party firms).

**Meeting Requirements under Fiduciary Duty or Regulations, or Meeting Client and Beneficiary Demands:**

A significant number of investment professionals still do not integrate ESG. According to a 2017 CFA Institute global ESG survey, 24% of equity investors, 55% of fixed-income investors, and between 79% and 92% of alternative asset investors (across private equity, real estate, infrastructure, and hedge funds) do not integrate ESG into their processes. More recent studies continue to suggest that ESG integration is not universally accepted yet. The Royal Bank of Canada 2020 Responsible Investment Survey noted that 25% of respondents and, on a regional basis, 36% of US respondents did not integrate ESG.

However, these investors, or their asset owner clients, might fall under certain country regulations, such as the EU Shareholder Rights Directive, the UK Department for Work and Pensions' regulations, or the UK Stewardship Code. In these cases, the regulations or clients could demand a certain level of ESG integration, even though the investor might not believe that ESG integration enhances return or lowers risk. The aim is to meet minimum regulatory obligations or client demands.

The debate has evolved over the past two decades. Historically, legal questions arose as to whether some aspects of exclusionary strategies (e.g., excluding tobacco companies) were consistent with fiduciary duties (modeled on what a prudent person might do). Today, some legal and regulatory standards suggest that failing to integrate aspects of ESG might be inconsistent with fiduciary duties. The United Nations Environment Programme Finance Initiative (UNEP FI), along with legal firm Freshfields and the United Nations Principles for Responsible Investment (PRI), examined these questions over the past decade. Their analysis (across jurisdictions) argued that the fiduciary duties of investors require them to do the following:

- Incorporate ESG issues into investment analysis and decision-making processes, consistent with their investment time horizons
- Encourage high standards of ESG performance in the companies or other entities in which they invest
- Understand and incorporate beneficiaries' and savers' sustainability-related preferences, regardless of whether these preferences are financially material

As of 2021, regulatory updates include the EU Shareholder Rights Directive II, the UK Stewardship Code, and guidance from the US Department of Labor (DoL).

Of note, over the past decade, the tone of the US DoL guidance has fluctuated but regardless, the point has been that investors have to take note of regulatory requirements with respect to integrating ESG.

**Lowering Investment Risk and Increasing Investment Returns:**

Many investors seek to integrate ESG into investment processes to better understand and lower investment risk. Some also wish to enhance returns via ESG by seeking higher alpha. Recent surveys suggest that more firms do so to lower risk rather than enhance returns, but some firms do so for both reasons.

**More Tools and Techniques to Use in Analysis and Improving the Quality of Engagement and Stewardship Activities:**

Judging by ESG surveys undertaken by both academics and investment practitioners, not all firms believe that ESG integration leads to better risk-adjusted returns. However, many ESG integration tools, such as scorecards, can be used to engage with company management teams and aid stewardship activities. These same tools can also enhance the clarity of a company's business model.

**Reputational Risk at a Firm Level:**

Firms might view ESG integration as necessary to ensure a strong reputation and limit reputational risk with stakeholders. Evidence of varying views in the corporate world can be found in Business Roundtable's "Statement on the Purpose of a Corporation" (August 2019) signed by 181 CEOs (including those of major investment banks and asset managers) who committed to lead their companies for the benefit of all stakeholders—customers, employees, suppliers, communities, and shareholders.

These CEOs wrote:

*While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:*

- *Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.*
- *Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.*
- *Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.*
- *Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.*
- *Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.*

*Each of our stakeholders is essential. We commit to delivering value to all of them, for the future success of our companies, our communities, and our country.*

A core component of consumer brand surveys is attitudes toward sustainability and climates, as well as perceptions of diversity and inclusion. Managing ESG risks and opportunities therefore becomes an important part of managing brand and reputational value.

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!