Socially Responsible (ESG) Investing

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Socially Responsible Investing (SRI)

"*Socially responsible investing (SRI), or social investment, also known as sustainable, socially conscious, "green" or ethical investing, is any investment strategy which seeks to consider both financial return and social/environmental good to bring about social change regarded as positive by proponents.*

Recently, it has also become known as "sustainable investing" or "responsible investing". There is also a subset of SRI known as "impact investing", devoted to the conscious creation of social impact through investment.

In general, socially responsible investors encourage corporate practices that they believe promote environmental stewardship, consumer protection, human rights, and racial or gender diversity. Some SRIs avoid businesses perceived to have negative social effects such as alcohol, tobacco, fast food, gambling, pornography, weapons, contraception/abortifacients/abortion, fossil fuel production or the military. The areas of concern recognized by the SRI practitioners are sometimes summarized under the heading of ESG issues: environment, social justice, and corporate governance." (Wikipedia)

Intro

Socially Responsible Investing, or *Sustainable and Responsible Investing* has moved from a niche investment strategy to the mainstream.
Wide definition: SRI is any investment strategy which pursues additional goals to a pure financial one.
SRI has become central to any financial investor.
To understand where it is coming from, first discuss a related concept, *Corporate Social Responsibility*.

What is Corporate Social Responsibility

"Corporate social responsibility (CSR) is a type of international private business self-regulation that aims to contribute to societal goals of a philanthropic, activist, or charitable nature or by engage in or support volunteering or ethically-oriented practices. While once it was possible to describe CSR as an internal organisational policy or a corporate ethic strategy, that time has passed as various international laws have been developed and various organisations have used their authority to push it beyond individual or even industry-wide initiatives. While it has been considered a form of corporate self-regulation for some time, over the last decade or so it has moved considerably from voluntary decisions at the level of individual organisations, to mandatory schemes at regional, national and international levels." (Wikipedia)

Corporations

Where do corporations fit in society?
Purpose: Provide economic services to citizens.
Corporate governance
Many competing choices for how corporations are organized.

- cooperative governance
- partnerships
- employee-run.
- state-run
- Capitalist model: Equity-owned, management-run.

Why the capitalist model?

Capitalist model: Residual claimant are the owners of *capital*.
Most corporations: Combining labour and capital in provision of services.
Why capital owners makes decisions?
Possibilly: The most important component gets decision power?

- Expect labour-intensive firms with little physical capital to be partnerships or employee-run.
- Capital-intensitive firms those where more likely to see the capitalist model.

Empirically, capitalist form typical outcome
Possible explanation: Asymmetry – capital easier to withold.
Lack of capital $\rightarrow$ immediate bankrupcy (Flyr).
Critial for providers of capital: information allowing the understanding of the risks involved.
Thus, even labour-intensive firms may optimally be run using a capitalist model.

Separation of ownership and control

Modern companies, large, complex.
Employees (managers) run firm for owners.
How to ensure that management runs the firm in the interest of owners?
Governance structures:

- stick (supervision)
- carrot (align interests of management and owners).

Governance Structures

- Corporate board - supervise corporation on behalf of owners.
- Renumeration of management - e.g. stock options - incentivise management to maximize stock values.
- Financial structure as a governance mechanism.
  - Equity owners run the corporation when firm is doing well.
  - Debt holders can take control and protect values when firm in trouble
- External threat – Corporate takeover market.

What is Business' Social Responsibility?

Economic institions based on two key principles:

- Creation of Value
- Accountability

Key for accountability:

- Does the firm internalize all consequences of its decisions? Example: Pollution. Would be part of the firms decision of there was an environmental tax (e.g. CO2 pricing). But what if there is no such tax?
  Thus, specifically: To what extent do firms' internalize *externalities*

Operationalizing Business' Social Responsibility

Corporate Social Responsibility a "fuzzy" notion.

Example, EU definition:

> *"a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis."*

Key word: "voluntary".

More concrete ways of discussing CSR.

- Is the enterprise *sustainable* in the long term?
- Does the enterprise show the *ethical behaviour* expected by its stakeholders?
- Corporate Philantrophy

Long term sustainability.

- Well known discussion: Short termism in corporate decisions. Are corporate decisions made to maximize next quarter earnings? Or are they maximizing the present value of *all* future cashflows?
- Broader notion of sustainability. For example – climate.

Ethical behaviour.

Desire among stakeholders to be (or be seen as) “good people”.
Taken on by the corporation (delegated philantrophy).
Challenges to delegated philantropy

- Free Riding.
  Are we prepared to make individual sacrifices to limit global warming?
- Limited information.
  Is it possible for stakeholders to verify that claimed socially responsible policies really are so (Greenwashing)?
  Proliferation of ESG/CSR rating agencies to provide verification services.
- Weighing objectives. How to aggregate the various dimensions?

Corporate Philantrophy

Use of corporate profits for philantropy.
Controversial

- Is this not just marketing? (Greenwashing)
- Are managers choosing the "right" philantrophy?
  Corporate giving means tax reduction.
  Prioritizing of where tax revenues go not considered by managers choice of what to support.
- (Friedman, 1970): Give the shareholders the money and let them decide what to do with it.

Socially Responsible Investment

Equity investments are portfolios of stocks.
Equity investors:

- Menu of equities (corporations)
- Corporate Social Responsibility (CSR) of the potential assets (corporations) affect investment decisions.
  Theory behind SRI: Same as theory behind CSR.

Socially Responsible Investment – issues

- How large is it?
- Methods of SRI
- Exclusions from considerations – what are the criteria?
- Implementing SRI – constructing ESG indices.
- The potential benefits of SRI:
- The costs of SRI

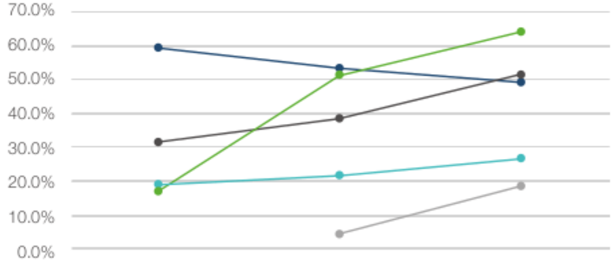
Snapshot of global sustainable investing assets 2016–2018

Region	2016	2018
Europe	$ 12,040	$ 14,075
United States	$ 8,723	$ 11,995
Japan	$ 474	$ 2,180
Canada	$ 1,086	$ 1,699
Australia/New Zealand	$ 516	$ 734
TOTAL	**$ 22,890**	**$ 30,683**

Note: Asset values are expressed in billions of US dollars. All 2016 assets are converted to US dollars at the exchange rates as of year-end 2015. All 2018 assets are converted to US dollars at the exchange rates at the time of reporting.

Source: Global Sustainable Investment Alliance (2018).

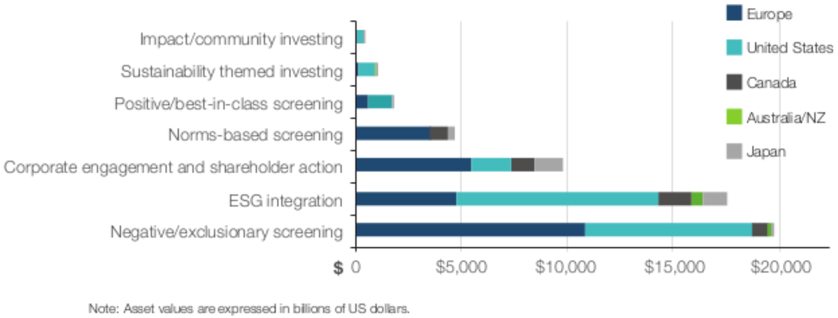
Proportion of sustainable investing relative to total managed assets 2014–2018



	2014	2016	2018
Europe	58.8%	52.6%	48.8%
United States	17.9%	21.6%	25.7%
Canada	31.3%	37.8%	50.6%
Australia/New Zealand	16.6%	50.6%	63.2%
Japan		3.4%	18.3%

Source: Global Sustainable Investment Alliance (2018).

Sustainable investing assets by strategy and region 2018



Source: Global Sustainable Investment Alliance (2018).

Methods

1. Negative/exclusionary screening
2. Positive/best-in-class screening
3. Norms-based screening
4. ESG integration
5. Sustainability themed investing
6. Impact/community investing
7. Corporate engagement and shareholder action

Methods

1. NEGATIVE/EXCLUSIONARY SCREENING: the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria
2. POSITIVE/BEST-IN-CLASS SCREENING: investment in sectors, companies or projects selected for positive ESG performance relative to industry peers
3. NORMS-BASED SCREENING: screening of investments against minimum standards of business practice based on international norms, such as those issued by the OECD, ILO, UN and UNICEF
4. ESG INTEGRATION: the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis
5. SUSTAINABILITY THEMED INVESTING: investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture)

Methods

6. IMPACT/COMMUNITY INVESTING: targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose
7. CORPORATE ENGAGEMENT AND SHAREHOLDER ACTION: the use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines

Screens

Tobacco Avoid manufacturers of tobacco products

Alcohol Avoid firms that produce, market, or otherwise promote the consumption of alcoholic beverages

Gambling Avoid casinos and suppliers of gambling equipment

Defense / Weapons Avoid firms producing weapons for domestic or foreign militaries, or firearms for personal use

Nuclear Power Avoid manufacturers of nuclear reactors or related equipment and companies that operate nuclear power plants

Irresponsible Foreign Operations Avoid firms with investments in government-controlled or private firms located in oppressive regimes such as Burma or China, or firms which mistreat the indigenous peoples of developing countries

Screens (ctd)

Pornography / Adult Entertainment Avoid publishers of pornographic magazines; production studios that produce offensive video and audio tapes; companies that are major sponsors of graphic sex and violence on television.

Abortion / Birth Control Avoid providers of abortion; manufacturers of abortion drugs and birth control products; insurance companies that pay for elective abortions (where not mandated by law); companies that provide financial support to Planned Parenthood

Labor Relations and Workplace Conditions Seek firms with strong union relationships, employee empowerment, and/or employee profit sharing. Avoid firms exploiting their workforce and sweatshops

Screens (ctd)

Environment Seek firms with proactive involvement in recycling, waste reduction, and environmental cleanup. Avoid firms producing toxic products, and contributing to global warming.

Corporate Governance Seek companies demonstrating "best practices" related to board independence and elections, auditor independence, executive compensation, expensing of options, voting rights and/or other governance issues.

Business Practice Avoid firms with antitrust violations, consumer fraud, and marketing scandals. Seek companies committed to sustainability through investments in R&D, quality assurance, product safety

Screens (ctd)

Employment Diversity Seek firms pursuing an active policy related to the employment of minorities, women, gays/lesbians, and/or disabled persons who ought to be represented amongst senior management

Human Rights Seek firms promoting human rights standards. Avoid firms which are complicit in human rights violations.

Animal Testing Seek firms promoting the respectful treatment of animals. Avoid firms with animal testing and firms producing hunting/trapping equipment or using animals in end products.

Renewable Energy Seek firms producing power derived form renewable energy sources.

Screens (ctd)

Biotechnology Seek firms that support sustainable agriculture, biodiversity, local farmers, and industrial applications of biotechnology. Avoid firms involved in the promotion or development of genetic engineering for agricultural applications.

Community Involvement Seek firms with proactive investments in the local community by sponsoring charitable donations, employee volunteerism, and/or housing and educational programs

Shareholder activism The SRI funds that attempt to influence company actions through direct dialogue with management and/or voting at Annual General Meetings

Non-married Avoid insurance companies that give coverage to non-married couples

Source: Renneboog, ter Horst, and Zhang (2007)

Measurement of ESG

Example: Show the groups of criteria that go into MSCI Intangible Value Assessment (IVA) measurement.

Environmental

Environment Pillar			
Climate Change	Natural Capital	Pollution & Waste	Env. Opportunities
Carbon Emissions	Water Stress	Toxic Emissions & Waste	Opportunities in Clean Tech
Energy Efficiency	Biodiversity & Land Use	Packaging Material & Waste	Opportunities in Green Building
Product Carbon Footprint	Raw Material Sourcing	Electronic Waste	Opportunities in Renewable Energy
Financing Environmental Impact			
Climate Change Vulnerability			

Social


Social Pillar
Human Capital
Product Liability
Stakeholder Opposition
Social Opportunities
Labor Management
Product Safety & Quality
Controversial Sourcing
Access to Communication
Health & Safety
Chemical Safety
Access to Finance
Human Capital Development
Financial Product Safety
Access to Health Care
Supply Chain Labor Standards
Privacy & Data Security
Opportunities in Nutrition & Health
Responsible Investment
Insuring Health & Demographic Risk

Governance


Governance Pillar
Corporate Governance
Corporate Behavior
Board
Business Ethics
Pay
Anti-Competitive Practices
Ownership
Corruption & Instability
Accounting
Financial System Instability

Benefits of SRI?

- Affecting portfolio (investment) decisions
  - It may help identifying high performing stocks (in the returns sense)
  - It may help removing low performance stocks (future problems not priced in).
- Marketing to customers (greenwashing)

First Consequense of SRI: Necessary to gather information/intelligence on investments relevant for SRI.
Is this information relevant for investment decisions?
Yes.
Example: The "good Governance" results of Gompers, Ishii, and Metrick (2003).
Construct a measure of governance quality. That measure predicts firm value, better governed firms perform better.
Not completely priced in.

Costs of SRI?

- Direct:
  - Costs of subscribing to ESG information services.
  - Extra investment officers dealing with SRI/ESG.
  - Additional Transaction costs from SRI motivated trades.
- Indirect:
  - Reduction in investment universe.
    Restrictions on portfolio remove potential high return stocks?
    Diversification cost?

For the diversification costs, see example on “sin stocks”

Socially responsible investing – Summary

Background: Corporate Social Responsibility (CSR)

SRI: As an equity investor, look at CSR of potential stocks in portfolio

Typical actions

- Interactions with corporations (voting)
- Exclusion

Costs

- Direct: Data, manpower, time
- Indirect:
  - Reduction in investment universe
  - Missing high return stocks?

Milton Friedman. The social responsibility of business is to increase its profits. *The New York Times Magazine*, 13(1970):32–33, 1970.

Global Sustainable Investment Alliance. 2018 global sustainable investment review. Report, 2018.

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