Environmental, Social and Governance (ESG)

CanterburyConsulting

Introduction

Most foundations, endowments, or nonprofits have probably considered environmental, social, and governance (ESG) investing, or soon will. Interest has escalated, and as a result, advice abounds and it is clear ESG investing is complex. It seems every answer leads to two questions, and it's no surprise that many turn away after an initial look.

The good news is that while it is true that ESG investing is complex, it doesn't have to be complicated, and contrary to old beliefs, it doesn't necessarily damage returns. With a solid understanding of what an organization wishes to accomplish, investment committees can implement ESG in a way that doesn't necessarily sacrifice returns—but does bring investments into alignment with a foundation's greater goals.

ESG's Origins

First things first: ESG is not a new way of investing. It's simply a set of criteria layered onto an organization's existing investment guidelines. Environmental, social, and governance investing has been called by other names, and has been around for at least 30 years (some might say since the genesis of investing). It started with avoiding entire business categories for religious, moral, or ethical reasons, such as a Catholic foundation avoiding military, firearms, or adult entertainment. It expanded into environmental concerns, such as avoiding fossil fuels, or companies known to pollute.

Interestingly, the governance portion of ESG investing is often considered the newest, yet good managers have always used governance criteria. Corporate governance is one of the best predictors of long-term success; transparency and good governance leads to fewer losses, missteps, and regulatory problems over time. This has been a consideration of excellent managers for far longer than ESG terminology has existed.

The Power of ESG

The attraction is simple: It's a way to do more good with more money, expanding an organization's positive effects from just the proceeds of a portfolio to the entire portfolio. With ESG criteria, the organization is able to use its capital to support the same goals as its grants and spending, without sacrificing returns.

Often, we see interest from large family foundations seeking to increase their overall effects in their communities. Also seeking ESG guidance are large funds who recognize the conflict inherent in investments that public scrutiny might deem hypocritical or in opposition to the fund's goals or beneficiaries. What once might have been ignored is now fodder for public outcry, such as with a recent New Jersey pension fund invested in payday loan companies, which are both illegal in the state and seen by many as predatory. Adding ESG criteria to investment guidelines both enhances a foundation's long-term effects upon society and helps shield against criticism. It can also improve long-term returns due to its focus on governance, according to many researchers.

Where to Begin

When clients ask for ESG guidance, we start with a basic, fundamental question: Why do you want to do this and what do you hope to achieve? Clients often don't have an answer. Commonly, they've heard of ESG and know that they want their capital investments furthering the same goals their grants address, but they're unsure of next steps. It can seem daunting, enough that many will abandon the idea before finding an advisor who can show them how to accomplish those goals without increasing risk or lowering expected long-range returns. Before becoming mired in details that may not pertain to their organizations, clients should determine exactly what they hope to accomplish with ESG criteria. That answer drives the implementation strategy and nuances within that strategy.

Six Implementation Strategies

There are essentially only six implementation strategies. Two will best suit most organizations—exclusionary screening or best-in-class selection—though we are seeing more interest in impact investing. The remaining strategies require more effort and often more capital, and are not as common. Regardless, it's good to be familiar with each.

Exclusionary screening is the oldest and simplest. This strategy excludes companies based on core or significant business activities; entire sectors may be excluded (e.g., alcohol, tobacco, or gambling). Note that it is rare and not recommended to draw a hard line against entire industries. Overly broad proscriptions create too much risk and can generate returns quite different from the initial strategy. There's often disconnect between an idealist view and market reality, such as absolutists who pressure an endowment to eliminate any company profiting from the coal industry. Doing so leads to unacceptable risk and underperformance that could jeopardize the endowment, because such an overreaching mandate would include trucking and transport companies, manufacturing suppliers, power companies, even construction industries or banks and accounting firms that do business with coal companies. Exclusionary screening has a greater effect on a portfolio's risks and returns when compared with the next two strategies.

Best-in-class selection is often called positive selection or positive alignment. This strategy focuses investing on companies with better ESG track records compared with peers, but does not exclude entire categories of securities. Many indices are available for help measuring ESG parameters, such as the MSCI ESG Index, though this is not to say that this strategy requires investing in an index. The index rankings are helpful for comparing a company against its sector and industry peers. A portfolio composition can remain the same, but be weighted more toward companies with better ESG rankings across the parameters important to the foundation's board. Because no sector is excluded, it avoids adding unnecessary risk, as can occur with exclusionary screening.

ESG integration, unlike best-in-class selection, does not require ranking or comparing companies based on ESG scores, but rather takes ESG issues into consideration when evaluating specific investments. This is a hands-on approach that requires resources beyond indices. Many active managers implement this to varying degrees.

Thematic investing refers to investing only in companies that address specific ESG criteria, such as health care for underserved populations, green building, or alternative energy. The risk with thematic investing is that its focus necessarily chooses companies serving two goals: profits and social good, such as a health care company that serves poor or rural populations. Often, one must subordinate to the other.

Impact investing generates interest because investments are selected with specific outcomes in mind with respect to selected ESG issues, while achieving a stated return. In this implementation, the investor actively measures and reports the impacts on ESG issues, which requires resources. Impact investing also suffers the same risk as thematic investing, in that it is difficult for a company to achieve high returns while also serving a social good.

Active ownership is the most time consuming, and refers to engaging with companies on ESG issues as a vocal shareholder or investor. This strategy is resource- and capital-intensive and lies in sharp contrast with exclusionary screening, in which investors "vote" solely by divesting ownership.

Balancing ESG with Returns

There is no indisputable evidence that incorporating ESG criteria has a positive or negative effect on portfolio returns. It can help avoid losses from badly managed companies whose labor practices, environmental policies, or governance lead to fines, shut-downs, or catastrophic losses. But it can also forfeit gains from those same companies.

Even exclusionary investing doesn't have to expose a fund to extreme risk. Exclusionary strategies can set percentages to measure a business's acceptability, such as excluding only companies that earn more than 20% of revenues from the targeted industry. This avoids eliminating large sectors that generate solid returns, and often also serve businesses or charities aligned with the foundation's goals.

In general, if you approach ESG criteria with clear goals in mind and implement those goals in a balanced and thoughtful way, you will end with a portfolio that looks different from previous incarnations, but should generate nearly identical returns, or at least ones that do not significantly differ from the original mandate. It may also have lower long-term risks due to selecting stronger companies with better management. There will undoubtedly be costs for restructuring the portfolio, though it's possible to limit or manage those costs. But aligning a foundation's investments with its goals can broaden its impact on society and avoid the risk of unseemly investment in businesses at odds with a foundation's stated goals.

In the long term, incorporating ESG criteria into a portfolio means that all of the organization's money, not just the earnings earmarked for charities doing great things, can accomplish good in the world. Ultimately, that is every foundation's—and every business's—goal: To be the most effective and efficient operation possible, generating the most possible return or impact with the least possible risk. ESG investing isn't a fad; it's a smart way to stretch a foundation's impact.

About Canterbury

Canterbury Consulting is a leading investment advisory firm, overseeing more than $17 billion for foundations, endowments, individuals, and families. Founded in 1988, the Company designs and manages custom investment programs aligned with each client's goals. Canterbury acts as the investment office for its diverse clients and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Canterbury Consulting strives to deliver performance and service that exceeds the needs and expectations of its clients.