The rise of ESG – King Canute and the tide

- **ESG investing is nothing but considering environmental, social and governance factors alongside financial factors when making investment decisions.**
- **ESG is going mainstream with interest in sustainable/impact investing rising strongly over recent years – thanks to a range of developments involving governments, corporates and investors.**
- **Incorporating ESG considerations into portfolios helps reduce the risk of negative shocks. In this note, we summarise different ways in which investors integrate ESG into their portfolios.**

Henry of Huntingdon a twelfth century historian, in one of his recordings, gives the account of "King Canute and the tide" as an example to illustrate the humility of Cnut Sweynsson (known as Canute) who was a king of the North Sea Empire around 1000AD. The legend has it that King Canute demonstrated to his flattering courtiers that he does not have control on everything by setting his throne by the sea shore and commanding the incoming tide to halt and not wet his feet and robes. Yet, continuing to rise as usual the tide dashed over his feet and legs without respect to his royal person. In our view, this incident of "trying to stop the tide" is similar to "arguing against the rise of ESG". We think ESG is going mainstream and investors ignoring this are doing so at their own peril.

Did you know?

- The majority of the global concerns corporate managements face are ESG related – climate change, water and migration[1].
- 51% of non-ESG investors would like their advisers to discuss ESG investments with them[2].
- Female investors are almost twice as likely as male investors to consider both returns and positive impact when deciding on investments[3].
- ESG strategies are being integrated into portfolios at a fast pace. The ESG portfolio integration growth rate is 17% a year[4].
- BlackRock, the world's largest money manager, intends to increase sustainably managed assets more than tenfold over the next ten years to more than USD1trn[5].

What: ESG is responsible investing

ESG investing allows investors to align their investments with their values. By and large, ESG investing is nothing but considering environmental, social and governance factors alongside financial factors when making investment decisions.

So what: ESG is going mainstream

Rapid evolution of risk factors is creating a sense of urgency amongst investors to reconsider their investment approaches and to incorporate some of the ESG considerations when creating their investment portfolios.

Now what: ignore ESG at your own peril

Not incorporating ESG factors into portfolios could bring in and retain an element of unwarranted risk. Investors, based on their reason/objective for/of incorporating ESG in their portfolios, might prefer to take different approaches – we summarise a few in this report.

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[1] http://www3.weforum.org/docs/WEF_ESG_Report_digital_pages.pdf
[2] State Street Global Advisors, The Transformative Power of Philanthropy: An Exploration of How the Desire to Make an Impact is Evolving Advisor-Client Relationships, 2016
[3] Morgan Stanley Institute for Sustainable Investing, "Sustainable Signals: The Individual Investor Perspective," 2015
[4] McKinsey and Company, "From 'why' to 'why not': Sustainable investing as the new normal," October 2017
[5] BlackRock is all in on firmwide sustainability, Pensions & Investments, January 27, 2020

What: ESG is responsible investing

Investment involves a careful assessment of the risk-reward profiles of various potential opportunities. However, not all risks are market-driven (think about the risk of a flood), at times not quantifiable (lobbying by companies) and may not always have immediate monetary implications (diversity and inclusion of workforce). Whilst these risks might not materialise over our investment horizons all the time, they may impact the asset prices quite significantly at times. ESG (Environmental, Social and Governance) framework tries to combine some such risks under one banner. More importantly, ESG investing allows investors to align their investments with their values. By and large, ESG investing is nothing but considering environmental, social and governance factors alongside financial factors when making investment decisions.

The ESG definition is broad to start with and is widening by the minute as more and more aspects of our global economy come under its ambit. Exhibit 1 summarises some of the aspects of ESG and classifies them as environmental, social and governance factors. Admittedly, there is no one exhaustive list of ESG examples. Further, various aspects of ESG are often interlinked and therefore it is a challenge to differentiate them amongst the factors – E, S and G. This is perhaps one reason why investors should focus on ESG investing rather than looking at individual factors. As it stands, whilst some of the aspects of ESG investing (for example, employee engagement) can be measured, their impact on the financials of a company (and eventually on equity prices) are not very easy to quantify. This makes ESG investing tricky but also interesting and highly relevant, in our view.

Exhibit 1: What falls under the ESG ambit

Environmental (conserving the nature)	• Biodiversity • Climate change • Deforestation • Energy efficiency • Pollution • Waste management • Water scarcity
Social (caring about people)	• Community relations • Customer satisfaction • Data protection and privacy • Employee engagement • Diversity and inclusion • Human rights • Labor standards
Governance (running a company)	• Audit committee structure • Board composition • Bribery and corruption • Executive compensation • Lobbying • Political contributions • Whistleblower schemes

Source: CFA institute, McKinsey and ADCB Asset Management

ESG is more than a fad or a feel-good factor. The evidence of the impact of incorporating ESG frameworks into the portfolios on their performance has been mixed – some arguing better returns and the rest arguing for no tangible impact. As highlighted by McKinsey[6], amongst more than 2,000 studies that looked at the impact ESG propositions have had on equity returns, 63% have concluded that paying attention to ESG concerns does not compromise returns — rather, the opposite and only 8% of the studies provided evidence on the contrary.

However, research does confirm that a strong ESG proposition correlates with higher equity returns, from both 'tilt' and 'momentum' perspectives[7]. Further, evidence that ESG propositions help improve the performance by reducing the downside risk (as evidenced by lower loan and credit default swap spreads and higher credit ratings) is rather strong[8].

In an attempt to understand how the ESG considerations impact the company performance, McKinsey study[9] identifies five different ways in which these linkages (ESG aspects and company performance) work. ESG considerations can help in:

1) facilitating top-line growth
2) reducing costs
3) minimising regulatory and legal interventions
4) increasing employee productivity
5) optimising investment and capital expenditures

Today, ethical considerations and alignment with values remain common motivations of many ESG investors but the field is rapidly growing and evolving, as many investors look to incorporate ESG factors into the investment process alongside traditional financial analysis.

[6] Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value: Getting your environmental, social, and governance (ESG) proposition right links to higher value creation. Here's why.", McKinsey Quarterly, November 2019
[7] Mozaffar Khan, George Serafeim, and Aaron Yoon, "Corporate sustainability: First evidence on materiality," The Accounting Review, November 2016, Volume 91, Number 6, pp. 1697–724, ssrn.com
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[9] Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value: Getting your environmental, social, and governance (ESG) proposition right links to higher value creation. Here's why.", McKinsey Quarterly, November 2019

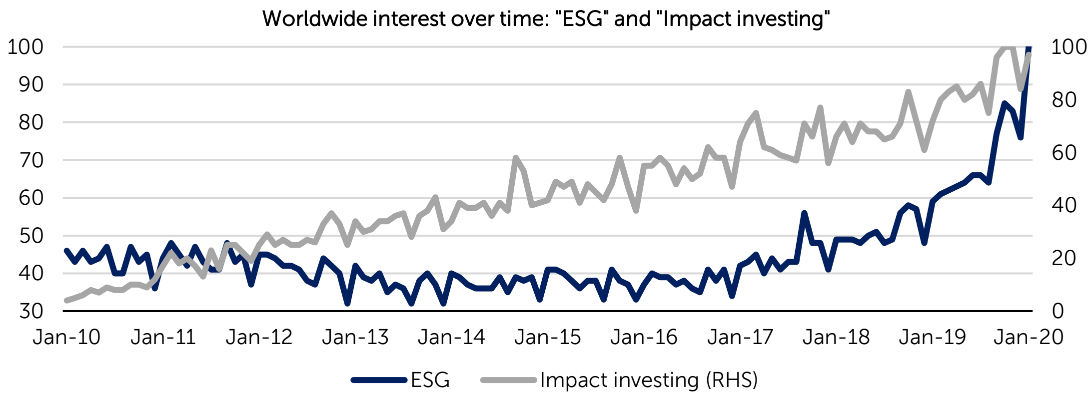
So what: ESG is going mainstream

ESG is growing in significance among both institutional and retail investors (exhibit 2). The practice of ESG investing began in the 1960s as socially responsible investing, with investors excluding stocks or entire industries from their portfolios based on business activities such as tobacco production or involvement in the South African apartheid regime.

Now, rapid evolution of risk factors is creating a sense of urgency amongst investors to reconsider their investment approaches and to incorporate some of the ESG considerations when creating/maintaining their investment portfolios. Whilst governments/regulators are doing their best to encourage investors in the direction of 'responsible investing' (for instance in the UK, investors may get tax advantages on impact investments), the trend is being accelerated by changes in corporates' and investors' mind sets. For example, "Statement on the purpose of a corporation" released by the US business roundtable in August last year strongly affirms business's commitment to a broad range of stakeholders, including customers, employees, suppliers, communities and of course shareholders[10]. Leading institutional investors are incorporating ESG factors into the investment process too. Since its founding in 2006, the United Nations Principles for Responsible Investing (PRI) has attracted support from more than 1,800 signatories representing over USD68trn in assets under management as of 2017.

On the investors' side, millennials who are taking over from the baby boomers, are more inclined to ESG investing. For the context, according to US trusts' insights[11], 67% of millennials consider investments as a way to express their social, political and environmental values; while only 36% of the baby boomers felt so. Morgan Stanley study too pointed at higher interest amongst millennials in sustainable investing – with 84% of the respondents saying that they are interested[12]. Further, 90% of the millennials want to grow their allocations to responsible investments over the next five years[13]. Against this backdrop, Accenture[14] estimates that roughly USD30trn of wealth will be transferred from the baby boomers to 90 million millennials over the next few decades. Putting all this together, Bank of America estimates that over the next two to three decades, the millennial generation could put between USD15trn and USD20trn into US-domiciled ESG investments, which would roughly double the size of the US equity market[15].

Exhibit 2: Interest in 'impact investing' has risen gradually over time and the interest in 'ESG' has risen sharply over the last couple of years



Source: Google Trends and ADCB Asset Management | Notes: Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term.

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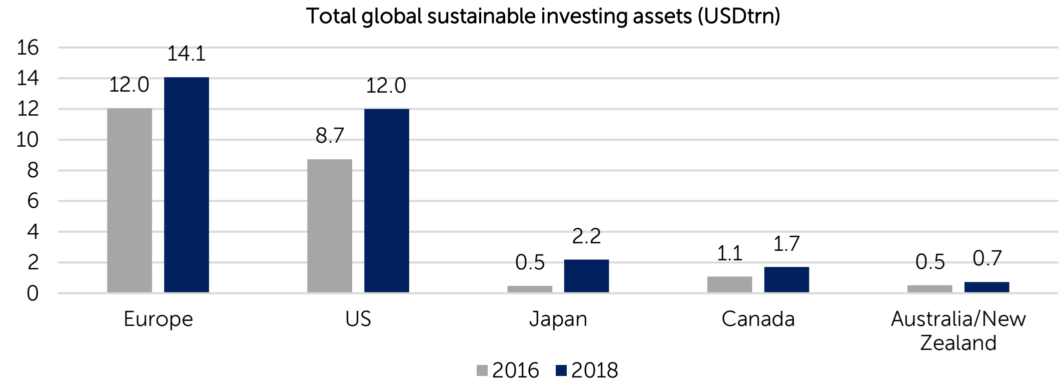
[10] https://opportunity.businessroundtable.org/wp-content/uploads/2019/12/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf
[11] US Trusts' Insights on Wealth and Worth 2014
[12] Morgan Stanley Institute for Sustainable Investing. Sustainable Signals: The Individual Investor Perspective (February 2015)
[13] FactSet's HNWIs' Vision for the Wealth Management Industry in the Information Age
[14] The "Greater" Wealth Transfer – Capitalizing on the Intergenerational Shift in Wealth, 2012
[15] Bank of America Corporation 2016 Environmental, Social & Governance Report

Some of these intentions/ambitions have already started to translate into an increase in sustainable investing assets globally. According to the Global Sustainable Investment Alliance, as of 2018, global sustainable investment in the five major markets reached USD30.7trn rising 34% since 2016. Some regions have seen stronger growth than others – for instance, in Japan, total global sustainable investing assets, starting from a low base of cUSD0.5trn grew 360% between 2016 and 2018. Total global sustainable investment assets in the US have lagged those in Europe; but the recent years saw a big catch up (exhibit 3).

Exhibit 3: Sustainable assets are growing across the world



Source: Global Sustainable Investment Alliance (Global Sustainable Investment Review - 2018) | Note: 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.

2019 was a stellar year for ESG funds in terms of flows – with a net of USD20.6bn in inflows. This compared quite positively with a net outflow of cUSD200bn from total equity funds during the same period. 2019 was a spectacular year for ESG fund inflows compared to previous six years when the net annual inflows averaged less than USD5.0bn. Also worth noting that since 2009, ESG funds have experienced outflows only for two years (2011 and 2012) and were only marginal. The supply of these ESG funds has risen too. According to Morningstar, there are roughly 300 mutual funds and exchange-traded funds with an ESG focus, much more than there were even three years ago[16].

Sustainable mutual and exchange-traded funds held USD137.3bn in total assets at the end of 2019 — or less than 1% of the USD20.7trn held in the universe of mutual and exchange-traded funds in the US, according to Morningstar. This shows the significant scope for the ESG assets to grow looking ahead, especially as demand for/supply of such products increases.

When it comes to impact of ESG integration on portfolio performance, admittedly, there has been mixed evidence. However, a majority of studies show that incorporating ESG does not compromise portfolio returns – this is also validated by exhibits 5 and 6 – which show that while in the developed market (DM) ESG leaders[17] performed in line with the market since 2010, in emerging market (EM) ESG leaders outperformed the market over the same period. Further, ESG considerations help reduce risk and therefore provide better risk-return trade-off, especially for EM investors. This is also evident from exhibits 7 and 8 which show that in both DM and EM earnings growth of ESG leaders proved defensive but valuations are not expensive relative to the market (exhibits 9 and 10).

[16] Money moving into environmental funds shatters previous record, CNBC, Published January 14 2020 at 10:54 AM EST
[17] The MSCI ESG Leaders Indexes target companies that have the highest environmental, social and governance (ESG) rated performance in each sector of the parent index. The indexes target a 50% sector representation vs. the parent index, aiming to include companies with the highest MSCI ESG Ratings in each sector.

Now what: ignore ESG at your own peril

Adding the ESG dimension to the traditional stock analysis techniques is known as 'ESG integration'. We believe that ESG is going mainstream and will likely reshape the investment landscape quite profoundly in the near future. Therefore, not incorporating ESG factors into portfolios could bring in and retain an element of unwarranted risk (as discussed on page 2). On this issue, Harvard Business Review article[18] states that "*A sea change in the way investors evaluate companies is under way. Its exact timing can't be predicted, but it is inevitable. Large corporations whose shares are owned by the big passive asset managers and pension funds will feel the change the soonest. But it won't be long before mid-cap companies come under this new scrutiny as well. All companies, though, should seize the opportunity to partner with investors willing to reward them for creating long-term value for society as a whole*."

Investors, based on their reason/objective for/of incorporating ESG in their portfolios, might prefer to take different approaches. The following table summarises various such approaches as identified by MSCI[19].

Exhibit 4: How investors integrate ESG into their portfolios

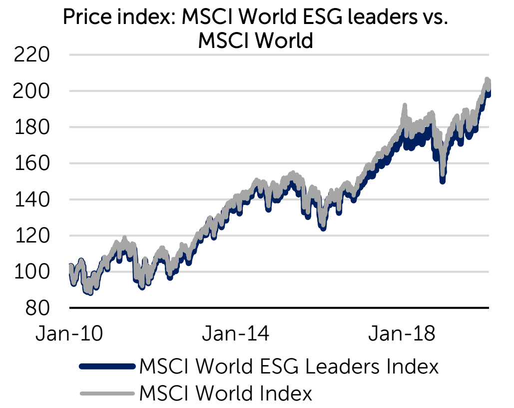
Investing with a systematic and explicit inclusion of ESG risks and opportunities with the intention to enhance long-term risk-adjusted returns.	Investing in alignment with an organization or individual's moral values and beliefs	Investing with the intention to support positive social or environmental benefits alongside a financial return
• Investing with a systematic and explicit inclusion of ESG risks and opportunities in investment analysis. • Investing with a systematic and explicit inclusion of ESG factors in portfolio construction. • Preferring companies with better or improving ESG profiles relative to sector peers. • Investing based on trends or structural shifts, such as social, industrial and demographic trends. • Entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change.	• Preferring companies with better or improving ESG profiles relative to sector peers. • Avoiding securities on the basis of an organization or individual's values, standards and norms, or other ESG considerations. • Entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change. • A traditional umbrella term that can be used to describe a values-based approach to investing, with an eye towards reducing exposure to negative externalities. Also known as "ethical investing" or "norms-based investing." • Aligning investments with faith-based values. Faith-based investing often involves avoiding investments in companies whose business activities are viewed as violating the teachings of a given faith. It may also include aims to generate measurable social (or occasionally environmental) impacts.	• Investing with the intention to generate measurable positive social or environmental benefits. • Investing based on trends or structural shifts, such as social, industrial and demographic trends. • Entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change. • Aligning investments with organisational values or to further philanthropic goals. Mission-related investments often aim to generate measurable positive social or environmental impacts. Often interchangeable with "impact investing."

Source: MSCI and ADCB Asset Management

None of the investment strategies are without risks. ESG investing is no exception. Risks associated with ESG investing, however, are more related to the lack of standard metrics/data to assess the standing/progress of companies on ESG aspects. Further, not all companies report their ESG metrics to the granularity that an analyst/stock-picker would like. However, rise of big data and analytical techniques could help remove this bottle neck.

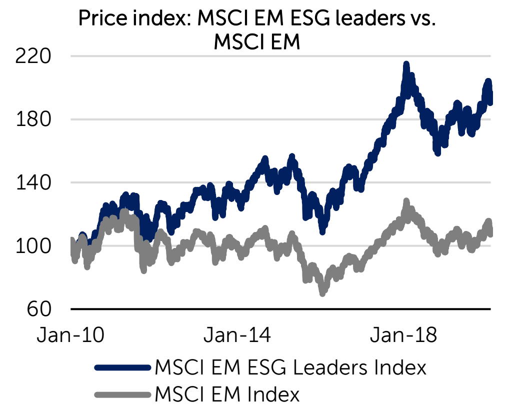
[18] The Investor Revolution, Robert G. Eccles and Svetlana Klimenko, Harvard Business Review, May–June 2019 Issue
[19] https://www.msci.com/what-is-esg

Exhibit 5: In DM, ESG leaders performed in line with the market since 2010, but ...



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 6: ... in EM, ESG leaders outperformed the market over the same period



Source: MSCI, Bloomberg and ADCB Asset Management

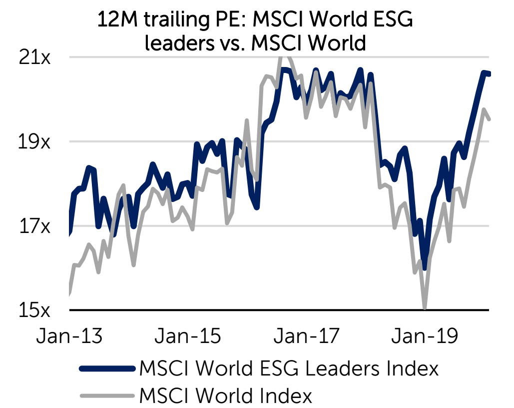
Exhibit 7: In DM, earnings growth of ESG leaders proved defensive ...

Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 8: ... so is the case in EM

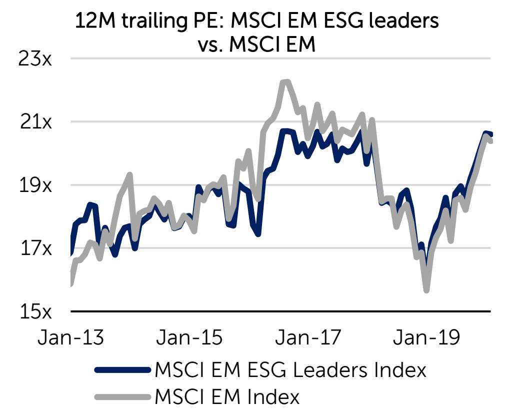
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 9: In DM, ESG leaders trade at a small premium to the overall market, while ...



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 10: ... in EM, ESG leaders trade at par with the market



Source: MSCI, Bloomberg and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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