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TalkingPoints

How to Engage ESG in More Meaningful Ways

Mona Naqvi
Senior Director,
Head of ESG Product Strategy
North America
S&P Dow Jones Indices

The outperformance of funds that take environmental, social and governance (ESG) issues more seriously than their peers has reinforced why investors might want to integrate these factors into portfolios via the type of tools that S&P Dow Jones Indices has developed.

Encouraged by evidence of the materiality of ESG issues during the Covid-19 led volatility, there is greater appetite for sustainable themes in investor portfolios to align investments with one's values and potentially generate higher risk-adjusted returns. At the same time, fuelled by greater transparency over how companies act and behave, and also spurred by trends in public opinion towards issues that matter to society as a whole, investors are seeking ways to leverage data and research to gain greater exposure to ESG factors.

Amid these trends, Mona Naqvi, Head of ESG Index Strategy for North America at S&P Dow Jones Indices (S&P DJI), spoke with *AsianInvestor* to explain the importance of financial materiality and other key ways to assess ESG, to help it be a core building block in portfolio construction.

AsianInvestor: How did market volatility due to COVID-19 impact how asset owners view ESG factors?

Mona: The pandemic has underscored the relevance of certain ESG issues - such as public health, worker health and safety, and supply chain risk management, for example - for investor portfolios and has accelerated what was already a growing trend in Asia — and beyond — toward greater allocations to ESG funds.

Aside from the growing body of academic and institutional research underpinning the financial materiality of ESG investing, the outperformance of many ESG funds and benchmarks over the year-to-date—including the new S&P ESG Index Series—has helped to dispel the myth of an ESG vs. performance trade-off that previously plagued the widespread adoption of sustainable investing.

That mind-set, common among mainstream investors, partly exists due to archaic forms of values-based investing, such as SRI, from many decades ago that to some extent did imply less portfolio diversification and therefore the possibility of lower investment returns. However, the emergence of new data, combined with more innovative index construction approaches designed to closely replicate the risk-return profile of an underlying benchmark, mean that investors now have a much more expansive toolkit to integrate ESG into the core of their investment portfolios without necessarily having to sacrifice returns. Indeed, as the recent outperformance suggests, these types of investment approaches might even offer a pathway for more resilient and differentiated returns.

AsianInvestor: Why is the economic downturn good for ESG investing?

Mona: The current crisis has shed light on the financial materiality of ESG issues, like how well positioned companies are to deal with disruptions in their supply chains through contingency planning, for example, that are not always considered through standard financial analysis of balance sheet flows. Indeed, contrary to what many investors might think, ESG is simply the process of incorporating financially material and relevant data into the investment process, informed by environmental, social, or governance issues, that are not adequately taken into account through standard financial analysis. It just so happens that many of these issues tend to align with topics we might also value from an ethical standpoint, like climate change and gender equality, but which may also be material drivers of financial success in many industries. On both fronts, be it through changing public sentiment (values) or the demonstrated materiality and relevance of these issues (leading to financial performance), the current crisis is reshaping the way investors think about their capital allocation decisions toward more sustainable investment approaches.

Another possibility is that the recent market volatility could be making prior investment allocations less profitable, thereby potentially freeing up assets for investors to reallocate elsewhere. This “de-anchoring” of assets might well amount to additional flows into ESG investment approaches for those investors that were previously intrigued by ESG but were unable to fund such allocations due to consistent returns elsewhere. Over the longer term, however, the fundamentals of ESG investing are what may ultimately make it more compelling for investors — with its potential for resilient and sustainable long-term value creation — notwithstanding these short-term market fluctuations.

AsianInvestor: Socially responsible investing (SRI) has been around for many years. Why does ESG add so much more value for investors?

Mona: Contrary to what many investors think, ESG doesn’t just mean ethical-based investing. Instead of the purely value-based approach of SRI, ESG investing provides a much wider lens (than traditional financial analysis) through which investors can assess how companies behave. As I mentioned, it is essentially the practice of incorporating additional information that is extra-financial, in that it comes from non-financial sources, albeit still very much financially material. The key is to take an industry-specific approach to ESG, as we do with our S&P Global ESG Scores, to focus primarily on the most relevant topics within specific industries. This enables a much more holistic, and thus potentially accurate, valuation of investment securities by incorporating more data and insights than is currently captured by standard financial analysis. ESG does not dictate any particular outcomes, but simply implies that you have assessed all available information and made a more informed investment decision.

AsianInvestor: What are the tools that enable investors to overcome ESG-related concerns such as quality of data, internal processes and buy-in?

Mona: Any diligent market participant looking to make an informed investment decision will want to consider all potential risks and opportunities to their investments. It makes sense, therefore, to turn to the financially material insights captured by ESG that go beyond what standard financial analysis can offer. Once investors understand this simple and rational approach to ESG investing, and are no longer plagued by misperceptions of inherent underperformance, it may make sense for them to embrace the greater transparency provided by the ESG toolkit.

That said, market participants must also always perform their own thorough due diligence on their information sources, in terms of how ESG data is collected and verified, especially when it comes to how the data provider deals with missing information as corporate disclosure is often patchy, sometimes inaccurate, and may suffer from time lags.

We differentiate the S&P Global ESG Scores through a comprehensive ESG research process built upon direct company engagement. We do not rely solely on public disclosures from companies but engage with them directly through the renowned SAM Corporate Sustainability Assessment (CSA), which is an industry-specific survey to companies that has been focusing on the most financially material and relevant issues to company business models for over 20 years. By engaging with companies directly, we have an unparalleled level of access to private information regarding corporate sustainability performance than what may be captured from simply collecting public disclosure, while requiring company responses to be substantiated with robust internal documentation. The CSA is particularly unique in that it was designed through the lens of an asset management process and benefits from more than two decades of real live investment performance to help identify the most financially material and relevant ESG issues, rather than simply a theoretical approach to ESG.

However, ESG still means different things to different investors, and not all market participants will necessarily share the same views on the relevance of underlying ESG topics depending on their individual investment strategy. The S&P Global ESG Scores are therefore available at multiple different levels, from the headline ESG score all the way down to the individual industry-specific criteria, for investors to manipulate as needed for their own investment process.

AsianInvestor: What initiatives can support greater take-up of ESG investing?

Mona: To some extent, regulatory authorities could potentially play a greater role in driving ESG standards for asset owners. For example, this could be achieved by requiring more corporate disclosure on sustainability topics as well as standardising methodologies for measuring certain ESG metrics to improve and deepen the quality of data. However, ESG adoption will ultimately rest upon the extent to which investors recognise the materiality and relevance of incorporating a wider pool of data and information into the investment process than standard financial analysis will allow. Perhaps then, the term ESG itself might one day become redundant, as standard investment decision-making expands to account for all possible sources of environmental, social, and governance information relevant to corporate valuation, currently captured through ESG.

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E-mail index_services@spglobal.com