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ESG Research: Solving Integration Challenges

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ESG investing has been a significant growth area for active managers, particularly in equity and fixed income funds. Asset managers desiring to participate in this growth will be under increasing pressure to demonstrate that the integration of ESG principals into the investment process is more than superficial.

The rapid growth of the category has led to accusations of "greenwashing" in which some funds billed as "ESG" are only nominally incorporating these considerations. European regulators have responded by imposing significant "ESG" reporting requirements beginning in 2021 in an attempt to ensure that ESG funds are doing what they say on the label.

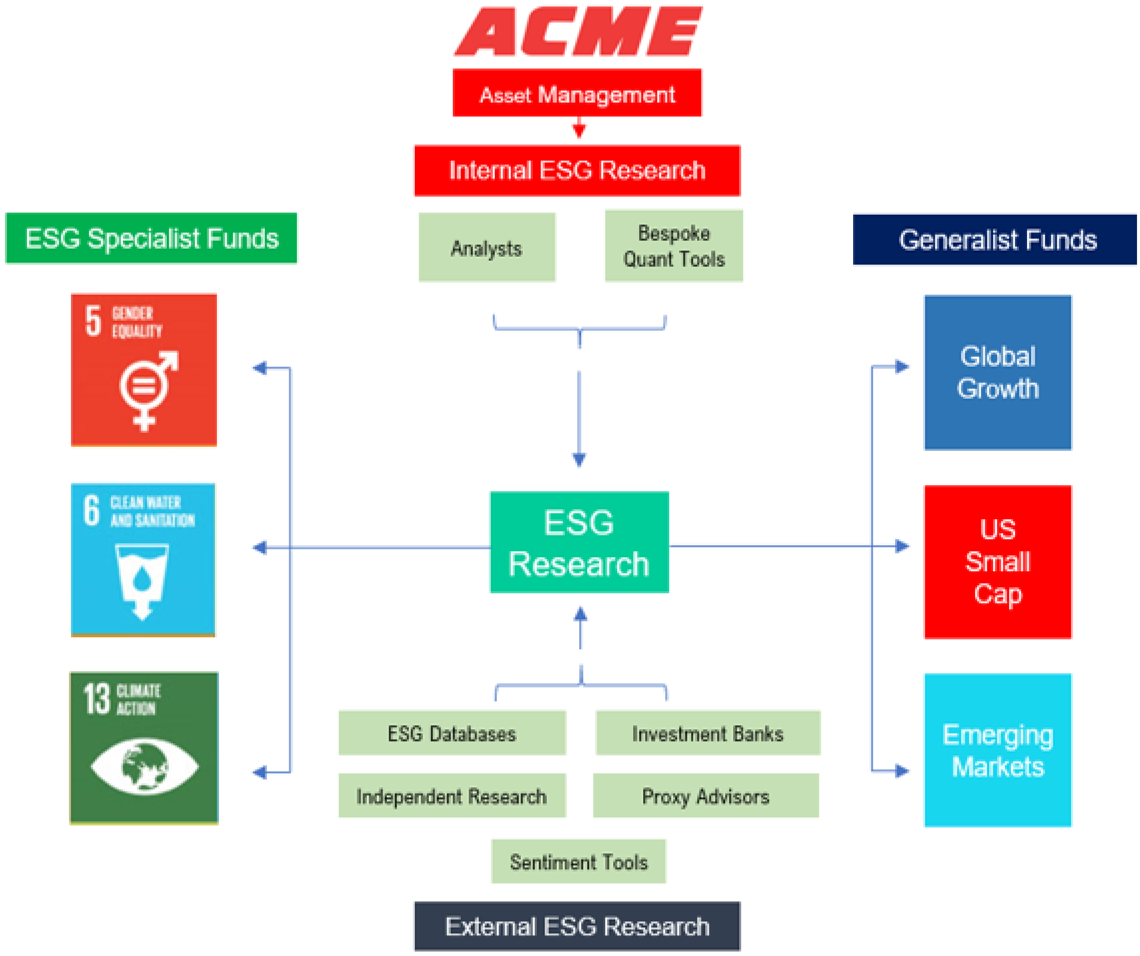
In the US, the SEC has been less inclined to require detailed reporting. However, investors themselves, (particularly institutional asset owners/consultants), will be looking for more evidence that ESG considerations are more than a "wrapper." This is a key challenge for asset managers. In many cases ESG teams have worked in relative isolation, quite separately from the traditional fundamental investment teams. They must support multiple products; both specialist ESG funds (Climate Change, Clean Energy etc.) and as an overlay on non-specialist funds. Integrating ESG principals into the latter category may require traditional fundamental investors to adopt new analytical frameworks.

The tools of ESG research are also more varied than the research inputs of traditional strategies. They include databases, research from both investment banks and independent research producers, proxy advisors, sentiment trackers, web-scrapers and all manner of specialist inputs reflecting the range of activities and objectives contained in the UN's 17 Social Development Goals (SDGs)

Given the breadth of the SDGs, each asset manager that wants to run "ESG" funds must choose which areas to emphasize. In addition, there are multiple ESG implementation strategies that can be employed in different proportion.

The earliest ESG funds just focussed on excluding companies involved in activities like tobacco or arms manufacturing. This has evolved in a more complex series of approaches including investing in companies that are taking active steps related to the SDGs as well as actively engaging with company managements.

Consequently, the way in which asset managers demonstrate the integration of ESG research in their overall investment processes will be a function of the ESG strategy choices they have made, reflected in the following diagram:



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ESG research inputs are particularly difficult to value, given:

1. The variety of approaches and ESG implementation strategies used by different Managers, and
2. The fact that important ESG research inputs, including databases, do not lend themselves to document or interaction counting.

This raises key questions:

- How can managers determine the value of ESG research inputs:

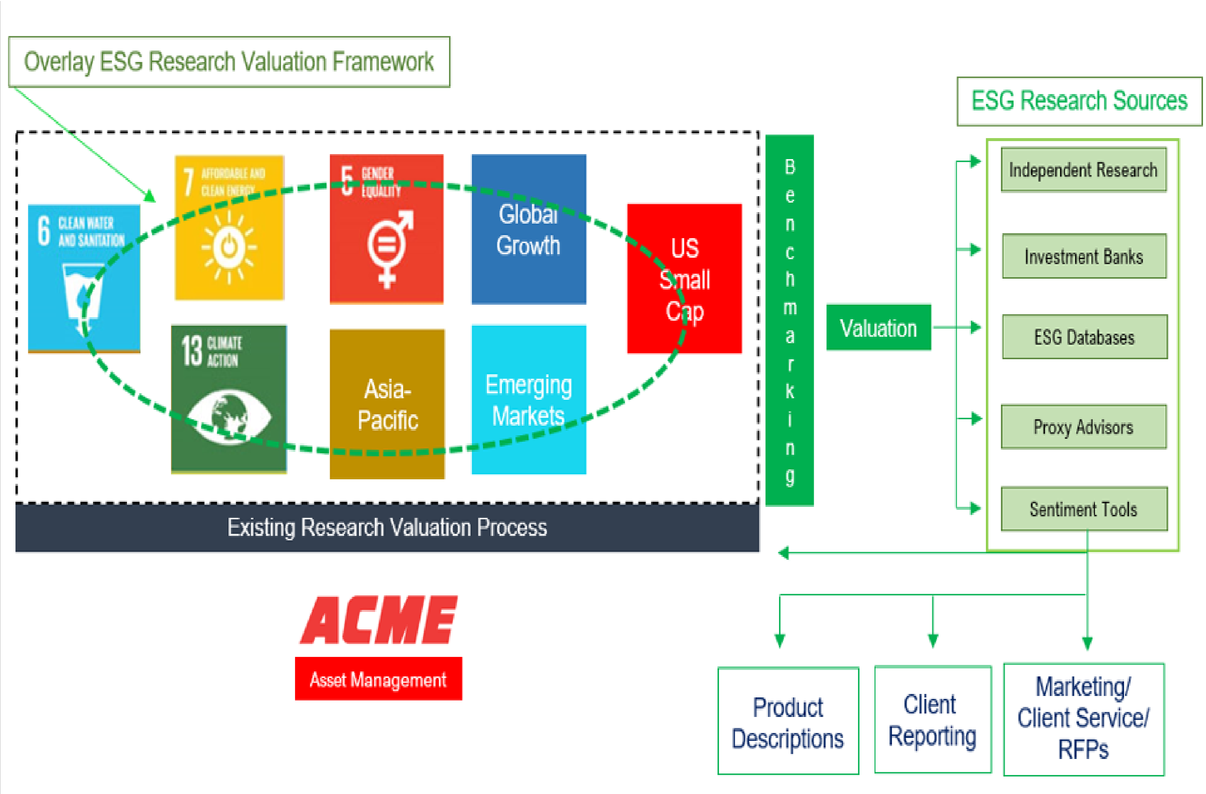
1. Given the manager's particular ESG process?
2. Given input diversity (data/documents etc.)?
3. At the fund/client level?

- How can managers demonstrate the integration of ESG research in our wider research process to clients/stakeholders?

- How can managers determine whether incremental ESG research spending should be internal or external?

What is required is an ESG research valuation process that can overlay the manager’s existing research valuation methodology in order to a) value the ESG research inputs based on the manager’s ESG product and implementation approaches and b) demonstrate how that is applies across all of the manager’s funds.

This can be augmented by benchmarking this research spending.



Managers that can demonstrate this to asset owners/consultants will be well-positioned to capture the growth offered by the ESG category.

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