Identifying why and how ESG factors move the needle

GUILLAUME MASCOTTO OF AMERICAN CENTURY INVESTMENTS HIGHLIGHTS SOME KEY BUSINESS RISKS THAT CAN DEMONSTRATE THE VALUE ESG CAN BRING WHEN PLANNING AN INVESTMENT STRATEGY

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Despite recent advancements, environmental, social and governance (ESG) investing remains a mutable concept lacking uniform, coherent definitions and a solid baseline for analysis and measurement.[1] One natural response to conditions like this is a flight to so-called "scalable" evaluation – third-party ratings, scores and other beta-type filters. However, most approaches available in the ESG space are not contextualised per financial materiality and company fundamentals. As a result, an overreliance on guidance of this type runs the risk of limiting the ability of investors to understand which ESG issues are truly financially material and on what time horizon they will affect companies; in other words, it's important to identify why and how ESG factors could move the needle.

An alternate response to unclear guidance is to double down on enthusiasm for assets that are associated with positive societal and environmental impacts. Here, too, what defines impact is not clear and easily can be misguided (or "washed"). For example, a nuclear power plant is exposed to potential radioactive risks, but if it brings power to underserved communities or allows hospitals to run and continue saving lives, should the social impact be nullified? In such cases, an overreliance on the environmental impact theme could come at the expense of the social impact. This is where an approach to ESG investing that seeks to achieve an equilibrium between ESG quality and expected returns comes into play.

Filling in the gaps in information

ESG risk tends to be defined primarily through sector involvement (e.g., coal, tar sands, banking, forestry, tobacco). In addition, third-party ESG ratings tend to rely on issuer-level disclosures (e.g., policies or programmes and environmental ratios, such as carbon emissions/sales) that are not always integrated with fundamentals to evaluate an issuer's ability to mitigate a given ESG risk. Not surprisingly, large and well-established issuers with greater means

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to disclose ESG issues tend to score better than smaller issuers.

That's not to say that a high level of disclosure always translates into a high ESG rating. Rather, weak or lacking ESG disclosure often acts as an overhang on an issuer's ESG ratings, which can reduce an investor's ability to capture growth opportunities, especially from lower ESG-rated issuers that could be at an inflection point. While investors would benefit from increased disclosure on ESG matters, it is essential to distinguish between quantity and quality of disclosure. Integration can fill in the gaps.

Accomplishing more with integration

Focusing on bottom-up risk management analysis and integrated financial and ESG variables constitutes a more concrete understanding of an issuer's financial risk exposure to given ESG issues. In other words, to determine if risk exposure to ESG issues translates into investment risk, investors should contextualise the exposure per fundamental analysis, focusing not just on disclosure but also on the issuer's ability to manage any potential costs associated with exposure to ESG issues.

For example, if an investor determines that high carbon emissions of an energy issuer are a material risk, then investors should look at the issuer's carbon intensity profile via public disclosures per third-party standards such as MSCI or SASB[2]. Investors also should consider the potential impact on earnings visibility through supply/demand assessments and on the balance sheet through stress testing the margin of safety of issuers to service debt amid potential rising costs associated with the decarbonisation shift affecting the energy and power sectors.

The objective is to ensure investment analysts and portfolio managers participate in the ESG assessment by allowing them to provide input regarding the financial materiality of ESG issues to which their companies are or could be exposed. This is something ESG ratings cannot offer and a factor that a bottom-up ESG integration approach seeks to overcome.

Identifying downside and upside potential

Although ESG is often characterised as a risk input, it can also offer opportunities. However, exposure to a risk or an opportunity arising from an ESG issue may not materialise for five, 10, or even 15 years. Given this time horizon, it is important to focus on both the wherewithal of the company to manage potential ESG-related cost increases or liabilities, as well as the appropriate strategic direction for adapting to market dynamics as they evolve. Generating ESG assessments that are both risk-based and forward-looking can help assess an issuer's downside ESG risk propensity and capture ESG upside potential.

For example, instead of focusing only on an issuer's level of ESG disclosure or negative "externalities" (e.g., carbon emissions), analysts would dive deeper into the issuer's ability to manage any potential current or future costs associated with exposure to ESG issues. This involves evaluating whether a given ESG issue could alter an issuer's solvency and growth trajectory over the medium- to long-term. If the ESG exposure results in an immediate to short-term cost to the company's market valuation, analysts would then assess management's remedial actions and whether any decrements to the company's fundamental business profile could be warranted.

In the same way, an integrated approach to ESG would allow analysts to measure an issuer's management practices to mitigate risks stemming from ESG issues, it also could measure whether an issuer's practices are improving or worsening over time. For instance, new regulations or technological innovation can impact supply and demand fundamentals and by extension expose companies to potential risks. But these trends can also influence companies to react positively by innovating or repurposing assets toward business lines with lower regulatory compliance risks (e.g., environmental regulations) and stronger competitive advantages.

Generating meaningful ESG assessments

Two highly ESG-exposed sectors offer insightful case studies of ESG integration: energy for opportunities and pharmaceuticals for risk mitigation.

For upstream energy companies, the decarbonisation of global energy use patterns present both risks and opportunities. By analysing the reserve mix diversification toward natural gas, carbon emissions reduction track record and targets, as well as investments in renewable energy, investors can gauge a company's position to capture opportunities either in the form of compliance/operational risk reduction or growth inflection in new business lines. In this sense, while ESG integration captures the potential risks facing energy companies at the macro (climate change) and sector (regulation, market conditions, negative externalities) levels, it should also identify the best companies within that sector – those with solid margins of safety and quality characteristics and the appropriate strategic direction (resource planning and corporate development) for adapting to the global BTU transition and International Energy Agency's (IEA) 2°C scenario.

In the case of pharmaceuticals, key areas to focus on include a company's approach to supply chain of custody, certification to internationally recognised quality standards as well as the track record of regulatory infractions and product recalls. Between lost sales, replacement costs, government fines, and lawsuits, a significant product recall controversy can become an expensive ordeal. Investors can be quick at punishing companies when this happens. But if a company experienced severe product recalls and regulatory warnings, investors should assess whether this resulted or could result in material costs. If so, then determine if the company has the ability to absorb the cost of litigation, withstand brand reputation damage and is taking the right remediation steps to replace and fix defective products.

Preparing for risks on the horizon

Four emerging business risks demonstrate why implementing ESG principles into an investment program is becoming increasingly important.

Paris Agreement: The long-term goal of keeping the increase in global average temperature below two degrees Celsius (C) above pre-industrial levels (and pursuing efforts to limit even further to 1.5 degrees C) has led to tougher environmental regulations, particularly in Europe and China. For the conventional fossil fuel industry, these developments present potential risks, such as increased compliance costs, customer defections and stranded assets.

Rising Sea Levels: As oceans continue to encroach on various coastal metropolitan areas around the world, the rising waters have the potential to drive down real estate asset valuations and create material operational disruptions for companies whose operations are located in flood-prone areas.

Industrial Disasters: Recent events highlight the environmental and human health impacts of industrial

disasters: the Brumadinho dam collapse, the Deepwater Horizon oil spill and the Fukushima nuclear power plant meltdown resulted in serious reputational damage and material liability costs to the implicated companies.

Cybersecurity and Privacy: With ever-more stringent regulations (e.g., the European Union's General Data Protection Regulation), companies are facing increasing pressure to not only offer increased data/digital services to customers but also protect their privacy.

Managing these business risks depends on the underlying strength of companies' corporate governance and operational excellence programs. Consequently, issues such as links between sustainability targets/initiatives and executive compensation, board independence and business ethics likely will receive more scrutiny.

Achieving ESG Synthesis

The investment community's conceptual understanding of ESG and its role in investment decision-making is continually unfolding. A view now gaining traction is that accounting for risks and opportunities arising from ESG issues is in accordance with fiduciary duty and not disconnected from expected returns. Successfully achieving this alignment must be done with an investment-led approach that is focused on materiality and fundamental analysis, while being flexible to evolving client-specific values and guidelines. Solutions-driven ESG integration is thus emerging as a logical result of a long synthesis of otherwise extra-financial factors folded into the regular investment process to ensure the long-term viability of pensioners.

1. One example is the proposed disclosure rules under the EU's Sustainable Finance Action Plan.
2. Sustainability Accounting Standards Board

A strategy or emphasis on environmental, social and governance factors ("ESG") may limit the investment opportunities available to a portfolio. Therefore, the portfolio may underperform or perform differently than other funds that do not have an ESG investment focus. A portfolio's ESG investment focus may also result in the portfolio investing in securities or industry sectors that perform differently or maintain a different risk profile than the market generally or compared to underlying holdings that are not screened for ESG standards.

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