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Doing Good: Where Sustainable Investing Gets It Wrong

A high sustainability rating does not necessarily equate to real sustainability impact (and profit).

Annoying jargon exists in all business disciplines. *Responsible Investor* recently asked its readers for the words they would like to see banished from the lexicon of sustainable finance. The winner was "ESG" – environmental, social and governance – shorthand for the broad range of factors used to assess the sustainability performance of companies. "Doing well by doing good", a phrase often mentioned in the continuing debate about whether investing sustainably adds to, or detracts from, financial performance, was a runner-up. Readers were no doubt frustrated by the excessive use of this expression. However, a more fundamental objection concerns the misunderstanding of what "doing good" in sustainable investing really means.

It is clear that many institutional and retail investors want to "do good" through their investments. When asked by **Morgan Stanley**, 85 percent of individual investors, and an even higher 95 percent of millennials, expressed an interest in sustainable investing even though almost two thirds agreed with the statement "investors must choose between financial gains and sustainability".

When choosing where to invest, many associate a fund's ability to "do good" with its sustainability credentials as measured using ESG data. Best-in-class ESG indices screen out stocks with low ESG scores, while retail funds are nowadays evaluated based on the weighted average ESG score of the stocks they hold. Moreover, these sustainability assessments drive investor behaviour. When Morningstar introduced its sustainability ratings for some 20,000 American mutual funds in 2016, funds with the highest rating of five globes attracted inflows while those with a single globe rating suffered outflows. **Academic studies** indicate that investors who are more interested in sustainability favour funds with higher ratings.

But does a higher ESG score for an investment product necessarily translate into doing more good?

Outcomes, not inputs

Sustainable investing covers a wide range of strategies, from exclusion of firms on ethical or moral grounds, through ESG integration that seeks to incorporate sustainability issues alongside financial risk and return, to thematic investing, focused on solutions to specific E, S or G challenges. Whether investing in active or passive products, most sustainable investors presumably want their investments to have real-world impact, looking for "good" in terms of *outcomes*. Over 80 percent of respondents in the Morgan Stanley survey expressed an interest in receiving reports measuring the social and environmental return of their investments.

However, in practice, for the vast majority of sustainable funds and strategies investing in publicly traded equities, "doing good" is often measured simply by the degree to which sustainability or ESG considerations are used as *inputs* in investment decision making: in designing a best-in-class ESG index, or in selecting a "sustainable" mutual fund.

Does investing in a fund with a five-globe sustainability rating result in the most impactful sustainability *outcome*? While it is true that the companies held by such a fund score highly on ESG issues, the fact that the fund has overweighted the *existing* shares of these companies and underweighted, or even divested from, those deemed less sustainable in and of itself should have no *direct* effect on any of the companies' access to capital or behaviour. The only thing that changes is the list of names in the shareholder register.

In publicly traded companies, the primary mechanism for investors to influence management on sustainability issues is through shareholder engagement, whether voting or more active forms of ownership. The success of **Climate Action 100+**, an investor initiative, in helping steer large greenhouse gas emitters, such as Royal Dutch Shell and Nestlé, to set increasingly ambitious emissions reduction targets and clearly defined business strategies for achieving them, is testimony to the real impact that large shareholders acting in concert can have.

Moreover, **research** has shown that successful engagement on financially material environmental and social issues can deliver financial outperformance or "alpha", making shareholder engagement the channel through which "doing well by doing good" can actually work in terms of outcomes, rather than inputs. This is particularly good news for active sustainable funds which, whether motivated primarily by alpha or sustainability impact, can in principle achieve both rather than having to trade one for the other.

The potential for shareholders to drive significant change on sustainability issues is likely to arise in companies that are currently underperforming on these metrics. Therefore, somewhat counterintuitively, the best funds in terms of both sustainability outcomes and financial performance may well be those that do not score highest on traditional sustainability metrics, such as the current weighted average ESG scores of their holdings. Investing in companies that already have high ESG ratings, where engagement on these issues is not really called for, is likely to have little, or even zero, incremental impact on sustainability outcomes. And, in the absence of further upside, these companies' sustainability performance may already be reflected in current valuations, with no potential for alpha from ESG in returns.

Corroborating **evidence** comes from the alpha documented for ESG momentum strategies that invest in, or overweight, those companies whose ESG scores have increased the most over a certain period. While these strategies may be entirely rules-based and not involve any shareholder engagement, they do underscore that financial performance and real impact (here reflected in an improving ESG score) can go hand in hand. In addition, these studies have shown that the ESG momentum alpha is mostly driven by companies with middle-ranking, not high, ESG scores.

Measuring investing impact

The idea that investments should also be evaluated in terms of sustainability *outcomes* is gaining popularity. For example, the UN Principles for Responsible Investment recently announced that it is updating its reporting requirements for signatories to increase the focus on real-world impact. What is typically being measured though is how the companies in an investment portfolio contribute to meeting various global sustainability targets, such as the Paris Climate Agreement or the UN Sustainable Development Goals, not what investors are doing to shape those outcomes by engaging with companies.

Ultimately, whether companies' sustainability performance is measured by ESG or SDGs, investors have to decide whether they want to invest in companies that are already "doing good" on these metrics or whether they want to influence companies to actually "do good" by being active owners. If it is the latter, and the evidence on real-world impact as well as financial performance seems to favour this, then investors should pay more attention to funds' policies and track records around voting and engagement on sustainability issues than to their sustainability ratings.

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