What is ESG integration?

Wealth Management
Dominion Securities

The topic of responsible investing is drawing a lot of attention, especially from investors. In Canada alone, responsible investing assets increased from $2.1 (CAD) trillion at the start of 2018 to $3.0 (CAD) trillion at the start of 2022, an increase of 43%.[1]

Environmental, social and governance (ESG) integration is one term that falls under the umbrella category of responsible investing. Ask your advisor for the ESG screening and exclusion, thematic ESG investing and impact investing definitions if you are interested in those.

Responsible investing

Responsible investing is an umbrella term encompassing the approaches used to deliberately incorporate environmental, social and governance (ESG) considerations into an investment portfolio. We believe there are four main applications of this data, and each applies this data very differently. The four applications are:

ESG integration

Systematically incorporating material ESG factors into investment decision making to identify potential risks and opportunities and to help improve long-term, risk-adjusted returns.

ESG screening and exclusion

Applying positive or negative screens to include or exclude assets from the investment universe.

Thematic ESG investing

Investing in assets involved in a particular ESG-related theme or seeking to address a specific social or environmental issue.

Impact investing

Investing in assets that intend to generate a measureable positive social or environmental impact.

ESG integration defined

ESG terminology is often a barrier to investors' understanding of the ESG approaches used in an investment product. Originally, socially responsible investing (SRI) was the most common term, but language continues to evolve. Responsible investing is now the umbrella term that is used for all ESG approaches. It should not be assumed that all the approaches are mutually exclusive. An investment product can incorporate more than one approach.

ESG integration is one of the four main approaches to responsible investing. It is the inclusion of ESG considerations within financial analysis and investment decisions, incorporating both traditional financial factors and material extra-financial, or ESG, factors. This may be done in various ways, tailored to different investment styles and approaches. Within ESG integration, ESG works in tandem with fundamental factors to define attractive investments and it is usually long-term returns focused. ESG integration goes beyond earnings, debt, ratios and other items you might find on your financial statements. It is the information about how a firm operates its business, inputs (i.e., water) used to make a product, how a firm treats employees and the management of a company.

ESG investing posits the idea that every company operates with some level of environmental, social or governance risk and opportunity. Some companies are good at managing these and some are not. With the ability to analyze these risks and identify the leaders at managing them, investors have found they can help improve the results of investment portfolios.[2]

ESG issues

Materiality

One of the key questions to consider when integrating ESG factors into an investment process is, "Which environmental, social and governance issues matter for the future performance of a company?" The answer isn't straightforward, because these issues don't uniformly impact businesses.

For example, an industrial business, like a tire manufacturer, has several environmental issues, such as resource procurement, waste disposal, product recycling and greenhouse gas emissions. However, a large technology company doesn't face any of those issues. Tech companies may have some energy usage due to servers and operations, but their environmental concerns pale in comparison. On the flip side, a technology company would have substantial exposure to social issues like data privacy, anti-competitive practices and the diversity and inclusivity of their employees.

The Sustainable Accounting Standards Board, or SASB, is the leading voice on the topic of materiality. SASB has published corporate reporting guidelines for 77 industries. SASB's materiality framework identifies material ESG-factors that drive long-term financial value across unique business models. Each sector has different material factors. This standard helps bring some uniformity to how companies report their ESG data. It also allows investors to focus on the metrics that are important to the future performance of those companies.

Environmental	Social	Governance
• Environmental policy and management	• Human rights	• Board structure, diversity and accountability
• Energy footprint	• Community relations	• Executive compensation
• Water supply	• Employee relations and labor conditions	• Business ethics
• Sustainable transport	• Child and forced labor	• Conflicts of interest
• Waste management	• Health and safety	• Financial policies
• Climate change strategy	• Consumer rights	• Shareholder rights

ESG scores versus ESG integration

As the industry has grown, the awareness of ESG scores has also increased. ESG scores are created by ESG data providers. Scores from providers like MSCI ESG, Sustainalytics, S&P ESG (formerly RobecoSAM), Moody's (formerly VigoEiris), ISS, FTSE Russell, TruValue and Refinativ are often used interchangeably. However, there can be a significant deviation between these scores.

Many ESG data providers use similar data, but there are many deviations in their methodology of measurement and how they assess materiality. Some are more focused on absolute ESG risk while others look more at relative risk by sector. All of these factors make it important to understand what ESG scores you are looking at before making an investment decision.

Active application of ESG data

ESG screening and exclusion is a passive application of ESG data. ESG integration is an active application of that data. Whether utilizing a team of ESG analysts or the data from one of the ESG data providers, all ESG investors digest this data in some way to construct their portfolios. As such, as the data improves and becomes more readily available, investors' approaches to assimilating this data have evolved and become more differentiated.

ESG exchange-traded funds (ETFs) largely rely on third-party ESG score providers like MSCI, S&P or Sustainalytics to create an ESG index. These indexes are going to have a deviation from traditional benchmarks. For example, a S&P 500 ESG ETF will seek to overweight names that have lower ESG risks and underweight names with higher ESG risks. This will create different weightings from a traditional S&P 500 ETF. This will also create a different performance profile from that traditional portfolio.

Two imaginary levers can be pulled in this equation: the level of ESG risk and tracking error to the underlying benchmark. This makes ESG ETFs another active application of ESG risk. If you lower the level of ESG risk you are willing to have in the portfolio, tracking error rises. If you want to lower the tracking error, or deviation of the performance of a portfolio relative to the performance of its benchmark, your level of ESG risk will likely increase.

Active ownership, engagement

Engagement is the practice of communicating with portfolio companies to better understand their ESG risks and perhaps influence their behavior to eliminate future ESG risks. Engagement is meant to constantly raise the bar on what ESG leadership looks like. What was acceptable last year may not be acceptable this year on topics like emissions or diversity.

The second level of engagement is through proxy voting. Proxies are often simply approving board of director appointments, but they can be a powerful tool for shareholders. Shareholders can recommend changes to corporate policies through shareholder proposals. If these proposals get a large enough vote from shareholders, the company must enact those policies. This is a way for ESG investors to impact the actions of a firm. In addition, the threat of a shareholder proposal from a large investor or a group of investors can get a company to implement a policy, even without a vote.

The performance question

One misconception that almost always seems to follow ESG is the idea that investors have to sacrifice performance to integrate ESG factors into a portfolio. Thankfully, recently, that idea has started to subside as more and more products come to market and offer comparable performance to non-ESG products.

In a previous study, ESG products were compared with non-ESG products for 15 years between 2004–2018, and ESG products performed at least as well as traditional investment products across every asset class, including in times of turbulent markets.[2]

In a recent study, stock funds outperformed across global markets over the last five years if they were weighted toward companies with positive ESG scores, according to research from sustainability data firm ESG Book, shared exclusively with Reuters in July 2022.[3]

ESG data is just data

Every company has ESG data. It is the extra-financial, or ESG, factors that are material to the future earnings of a company. Responsible investing encompasses all the applications (ESG Integration, ESG Screening & Exclusions, Thematic ESG Investing, Impact Investing) of ESG data into an investment portfolio.

Key considerations

ESG integration is the becoming the norm in the responsible investing world.[4] As more investment managers claim integration, it is even more important to be aware of what it means and its different applications. ESG integration should be the core of any portfolio when investors want to consider extra-financial factors into their portfolio. Some questions to consider when meeting with your advisor:

- Do you want your portfolio to integrate ESG factors, or are you looking to remove things from your portfolio? It's important to understand the difference. If you want to remove something from your portfolio, ask your advisor about ESG exclusions.
- What level of ESG integration do you want?
- Do you want to only hold ESG leaders? Or are you looking for improvement and growth opportunities? If you want to hold ESG leaders in your portfolio, ask your advisor about ESG screening.
- When picking an ETF, understand the level of tracking error targeted by the ETF and the ESG data that is used.

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[1] "Technical Report-2022 Canadian Responsible Investing Trends." Responsible Investment Association.

[2] Morgan Stanley. (2019). Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds.

[3] Reuters (2022) Positive ESG Performance Improves Returns Globally Research Shows. https://www.reuters.com/business/sustainable-business/positive-esg-performance-improves-returns-globally-research-shows-2022-07-28/

[4] Russell Investments' sixth-annual ESG survey. (2020). russellinvestments.com/ca/about-us/newsroom/2020/russell-investments-sixth-annual-esg-survey.

Past performance is no guarantee of future results. Due diligence processes do not assure a profit or protect against loss. Like any type of investing, ESG investing involves risks, including possible loss of principal.