SUSTAINABLE STRATEGIES

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When it comes to socially responsible investing, integrating the search for the best companies with avoidance of the worst will yield top results

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Much of the criticism heaped upon socially responsible investing (SRI) strategies over the past two decades is rooted in the realities and fallacies of the effects of portfolio exclusion.

Concerns include performance deficits, high sector concentration, style and regional biases, and unconstrained tracking error. Environmental social and governance (ESG) investing, which could be viewed as SRI 2.0, has sought to address some of those real and perceived obstacles through a more inclusionary approach to portfolio construction. Instead of screening out the worst offenders, it includes 'best-of-breed' companies across the economy.

We can find a variety of implementations of best-of-breed, some of which incorporate issue- or involvement-based screens to construct an ESG-ready universe as a preamble to bottom-up security selection. Others eschew exclusions and will conceivably own any company or security provided it is the best in relative economic and ESG terms against its asset class, sector or industry.

The thesis behind best-in-class selection is that good ESG business practices lead to superior risk management and value creation. These practices may also be leading or trailing indicators of innovative business cultures and management teams. There are, for instance, quantifiable relationships between such practices as strong diversity and gender equity policies in the management ranks and company performance. Employee satisfaction, reduction of off-balance sheet environmental risks and sustainable supply chains all perpetuate a virtuous cycle of growth and opportunity. ESG becomes part of the fundamental case to own rather than just the top-down reason to exclude.

INTENTIONAL INTEGRATION

In my last column I discussed intentionality – an ESG portfolio is the product of a series of deliberate choices to shape it based on environmental, social and governance factors. Taken further, the allocation of capital could be made in a calculated way to intentionally increase the odds of a particular environmental or societal outcome. Related to that is integration – the ESG elements of the process being folded directly into security selection and portfolio construction.

Paul Hilton, partner and portfolio manager at ESG specialist Trillium Asset Management, explained: 'To get the full value of the information it must be examined by experts in integration. Separating the ESG analysis from the financial decision making negates the benefit. The materiality of specific ESG issues varies by industry – so in depth industry knowledge is critical for understanding which issues to highlight and what sources of data can make meaningful distinctions between companies.'

BEST OF BOTH WORLDS

From a portfolio analyst's point of view, how does one uncover degrees of integration?

Integration is hard to observe at the portfolio level without probing the underlying process. Does ESG analysis begin and end with universe constraints? Do the ESG analysts and securities analysts interact? Are they actually one and the same? Are the portfolio managers part of the decision tree on how to assess ESG factors? Are the PMs as articulate on the ESG thesis as the fundamental thesis, or going further is ESG a facet of the fundamental thesis itself? What is the relationship between ESG factors in support of ownership and those warranting exclusion?

Is an integrated process inherently better or even necessary to achieve superior results or to engender authenticity? A constrained universe approach (the 'old' SRI) may be entirely effective when combined with a process that normalizes risk premia to account for what is lost in the screens. Any active investment process, whether qualitative or quantitative, makes some use of exclusion to define a universe of eligible securities. Therefore, we know from vast experience that the process of exclusion does not automatically yield inferior investment results.

But, the effects need to be recognized and either proactively embraced or managed. If the investor requires that ESG factors constrain ownership, exclusion must be on the table, with or without a best-in-class ESG approach. Ideally, as Hilton asserts, continuing to a fully integrated process allows portfolio managers to wring the most value from the information in front of them. Seek the best or avoid the worst? A process that integrates both with financial, economic and operational considerations raises the probability of reaching the financial and non-financial objectives for the investor.