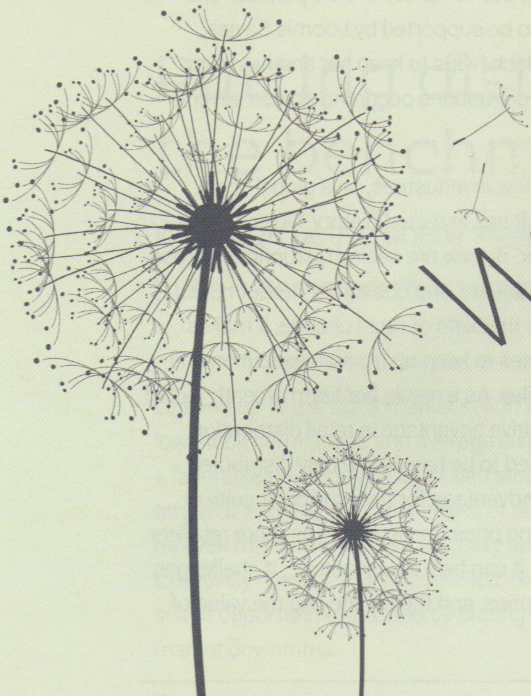


WATCH OUT FOR ESG DRIFT

MARK D. SLOSS

CHIEF EXECUTIVE, REGENERATIVE INVESTMENT STRATEGIES

As volatility returns to the markets, investors need to beware of strategies that ditch their sustainable credentials

It has been a while since we have seen real volatility in the market. In the first week of February it felt like there were no safe places left to hide – other than under the sheets with a flashlight. By the time this article reaches you, this bout of volatility will either have proved to be as fleeting as other episodes over the past few years, or will have blossomed into a full-scale correction.

However, where the market went – and where it may yet go – is not the focus of this article. Instead, I want to consider how ESG managers might react.

One of the challenges gatekeepers face in evaluating any strategy is tracking adherence to philosophy and process when that strategy is under stress. It is not the greatest achievement for a manager to stick to the script in a steady and rising market, so the takeaways there are limited when it comes to resilience.

The best insights come when analysts can observe how portfolio managers handle adversity. But we are awash with untested strategies right now. We are about to enter our tenth year of a low volatility environment that has been grinding higher since the financial crisis, with only a few sharp but relatively brief resets. There are analysts approaching the age of 30 who have not even experienced a serious, persistent correction in the course of their professional careers. Yes, I am old and shaking my fist at the sky. But we tend to do that once we have been around long enough to get hit by lightning (more than once).

Much like those young analysts, there are plenty of strategies and funds operating today that did not exist prior to the crisis, or even before the European sovereign debt crisis.

There is simply not a lot of empirical data to work with, and it is a whole order of magnitude harder to assess philosophy and process as it pertains to ESG. The positive for the market is that there has been an explosion of new products being offered to the public. The negative is that it is in fact all new, so there is very little history to analyze. What's more, there has been sufficient evolution in the ESG discipline itself – in terms of process as well as access to information – that history would be marginally instructive at best.

ASKING THE RIGHT QUESTIONS

Enter the concept of ESG continuity. I offer it for consideration as a qualitative assessment of the persistence of environmental, social and governance factors when non-ESG forces are putting the portfolio under stress. When the market lays bare the vulnerabilities of a strategy, ESG-minded gatekeepers might want to ask some of the following questions:

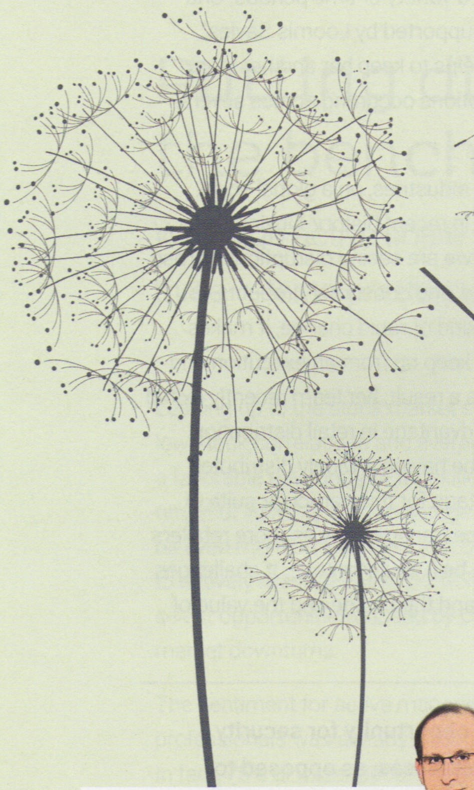
- Is there evidence that ESG criteria are deprioritized in favor of other fundamental or macro criteria in periods of market stress? Are the ESG thresholds for inclusion or exclusion modulated according to non-ESG factors when market volatility rises?
- Are new positions added in the name of diversifying risk that would not have cleared ESG hurdles under calmer market conditions?
- Do assertions that ESG is a source of value creation vanish when volatility increases or markets decline? Is ESG fundamental or incidental to the strategy when under duress?
- Do shareholder engagement and proxy priorities change when companies, industries or markets are under price pressure?
- In the fixed income space, do ESG bond underwriting criteria change when rate-induced volatility takes hold? For instance, does the importance of use-of-proceeds fade if there is a rate shock?

DRIFTING AWAY

In times of market stress, gatekeepers will find themselves having to distinguish between sustainability as a fashion statement and sustainability as a fundamental and integrated part of an investment process.

Most clients do not have the wherewithal – whether that's the time, the resources or the insight – to deconstruct strategies to ascertain whether they are self-identifying as ESG-compliant for the marketing advantage, or whether the commitment to ESG is tenuous and prone to breaking under duress.

A failure of continuity – call it ESG drift – should be as much of a concern as style drift. It is an expression of a lack of conviction or outright process fragility, for which managers should be held to account. ■



WATCH OUT FOR ESG DRIFT

MARK D. SLOSS
CHIEF EXECUTIVE, REGENERATIVE INVESTMENT STRATEGIES

As volatility returns to the markets, investors need to beware of strategies that ditch their sustainable credentials

It has been a while since we have seen real volatility in the market. In the first week of February it felt like there were no safe places left to hide – other than under the sheets with a flashlight. By the time this article reaches you, this bout of volatility will either have proved to be as fleeting as other episodes over the past few years, or will have blossomed into a full-scale correction.

However, where the market went – and where it may yet go – is not the focus of this article. Instead, I want to consider how ESG managers might react.

One of the challenges gatekeepers face in evaluating any strategy is tracking adherence to philosophy and process when that strategy is under stress. It is not the greatest achievement for a manager to stick to the script in a steady and rising market, so the takeaways there are limited when it comes to resilience.

The best insights come when analysts can observe how portfolio managers handle adversity. But we are awash with untested strategies right now. We are about to enter our tenth year of a low volatility environment that has been grinding higher since the financial crisis, with only a few sharp but relatively brief resets. There are analysts approaching the age of 30 who have not even experienced a serious, persistent correction in the course of their professional careers. Yes, I am old and shaking my fist at the sky. But we tend to do that once we have been around long enough to get hit by lightning (more than once).

Much like those young analysts, there are plenty of strategies and funds operating today that did not exist prior to the crisis, or even before the European sovereign debt crisis.

There is simply not a lot of empirical data to work with, and it is a whole order of magnitude harder to assess philosophy and process as it pertains to ESG. The positive for the market is that there has been an explosion of new products being offered to the public. The negative is that it is in fact all new, so there is very little history to analyze. What's more, there has been sufficient evolution in the ESG discipline itself – in terms of process as well as access to information – that history would be marginally instructive at best.

ASKING THE RIGHT QUESTIONS

Enter the concept of ESG continuity. I offer it for consideration as a qualitative assessment of the persistence of environmental, social and governance factors when non-ESG forces are putting the portfolio under stress. When the market lays bare the vulnerabilities of a strategy, ESG-minded gatekeepers might want to ask some of the following questions:

- Is there evidence that ESG criteria are deprioritized in favor of other fundamental or macro criteria in periods of market stress? Are the ESG thresholds for inclusion or exclusion modulated according to non-ESG factors when market volatility rises?
- Are new positions added in the name of diversifying risk that would not have cleared ESG hurdles under calmer market conditions?
- Do assertions that ESG is a source of value creation vanish when volatility increases or markets decline? Is ESG fundamental or incidental to the strategy when under duress?
- Do shareholder engagement and proxy priorities change when companies, industries or markets are under price pressure?
- In the fixed income space, do ESG bond underwriting criteria change when rate-induced volatility takes hold? For instance, does the importance of use-of-proceeds fade if there is a rate shock?

DRIFTING AWAY

In times of market stress, gatekeepers will find themselves having to distinguish between sustainability as a fashion statement and sustainability as a fundamental and integrated part of an investment process.

Most clients do not have the wherewithal – whether that's the time, the resources or the insight – to deconstruct strategies to ascertain whether they are self-identifying as ESG-compliant for the marketing advantage, or whether the commitment to ESG is tenuous and prone to breaking under duress.

A failure of continuity – call it ESG drift – should be as much of a concern as style drift. It is an expression of a lack of conviction or outright process fragility, for which managers should be held to account. ■