What's your ESG decree?

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Mark D. Sloss / 02 March 2020, 04:00

As more strategies come online all over the asset map in the same shades and colors as more traditional investing solutions, gatekeepers are faced with choosing a selection approach. Here are two.

A key stress gatekeepers are forced to wrestle with in vetting strategies and building out a menu or model of ESG-aligned funds or separate account strategies is one of philosophical orientation, or really, in our more common parlance, style. Outside of the ESG realm, we have all taken a big-tent approach to curating a list of managers, with room for the macro and the behavioral, value and growth, investment grade and junk, fundamental and quantitative, and so on. There is similarly no one universal ESG good, and in fact a diversity of approaches may actually be healthy for diversified portfolios and markets.

Over most of the last thirty-plus years the asset map in SRI – and now ESG – space has been sparsely populated at best. It was difficult to build a fully diversified portfolio across asset classes, styles, geographies and qualities with a complete roster of even remotely ESG-compliant strategies. Strategy selectors and trusted advisors were essentially forced into a blended approach in order to get close to comprehensive asset coverage. Some strategies integrate but are not defined by ESG considerations. Others narrowly address specific issues like carbon intensity or gender. A number are best-in-class, excluding nothing. And yet others are rooted in issue avoidance. Certainly a number of strategies cross one or more of these approaches in one philosophy and process. And of course, up until recently some corners of the asset map simply remained unaddressed for ESG usage.

From an allocator's point of view though, it was historically difficult to write a policy that clearly defined an ESG thesis and uniformly apply it across all assets without risking excluding some of the precious few products available. This led to fully allocated portfolios with differing degrees of integration and exclusion, even to the point of investing in multiple strategies in the same asset class where one manager might hold a position that the other manager specifically excludes and campaigns against. This eclecticism had some positive and negative benefits, trading off between diversification and dilution, but the levers were not there to pull and those outcomes were unmanaged outcomes of blended multi-manager portfolios.

Now, we have the opposite problem. We are approaching an embarrassment of riches as more and more strategies come on-line all over the asset map in the same shades and colors as more traditional investing solutions. That range has afforded selectors the ability to be more targeted on seeking a guiding philosophy behind a particular multi-asset strategy that is more responsive to an investment or values policy. The problem – and if there is such a thing it is a good problem – is that selectors building lists or models now have the opportunity or even the need to pick a lane. What kind of ESG thesis should be the pole star toward which selections should be oriented?

From a top-down perspective, there are two basic but equally deliberate methodologies available. The first, which we could label an orthodox approach, is to focus on a particular thesis and apply it comprehensively. Under this orthodoxy, all managers must reasonably comply with expectations around the central thesis. There is room to bring other approaches into the mix so long as they also adhere to the chosen thesis. An example might be an issue exclusion-based portfolio that also seeks best-in-class in terms of gender and inclusiveness after those securities exclusions are applied to the selection universe. Another might be an investment- only integration policy where ESG is employed exclusively in the search for alpha, but layers an issue or risk exclusion such as a fossil fuel screen to be responsive to marketplace demands.

The alternative to orthodoxy might be called a diversification benefit approach – a calculated and strategic blend of theses in order to achieve multiple objectives and reduce the risk of any one thesis failing. This approach is definitely a case of handling the double-edged sword, because even a well-crafted diversification approach can look haphazard in portfolio analysis if the narrative and metrics are not prepared that demonstrate the deliberateness with which those selections and allocations were made. Allocators similarly have to be mindful that, as in diversifying traditional asset management approaches, there is not an overshoot that results in diversification becoming nullification. Fully aligning with the UN Sustainable Development Goals and targeting real systems-change through allocation and investment may ultimately require this second, multi-pronged and diverse (and highly disciplined) approach. The road from here to there is rough with a lot of twists and turns, and rigid orthodoxy may not get us there.