



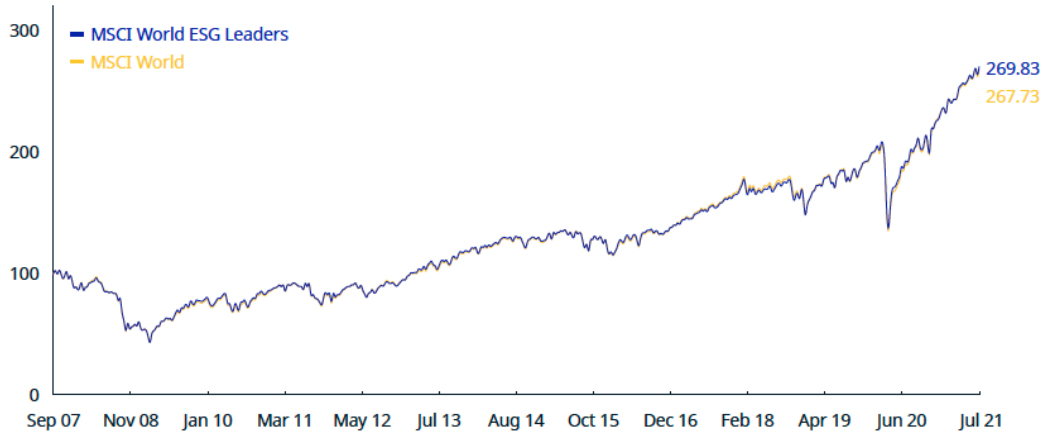
ESG Investing: Institutional Investor's Dilemma?

by Sunil Rana, August 2021

Of late, there have been a growing number of reports in the media that have highlighted a core issue surrounding ESG investing today: *Perceived vs real returns from ESG investing*. Several sections of stakeholders are increasingly wary about the gold rush towards responsible investing due to the 'greenwashing' phenomenon, which is primarily owing to the lack of clarity around taxonomy and labelling. In Australia, where the superannuation funds together hold close to A\$ 3 Trillion (US\$ 2.15 Trillion) in assets, fourth largest in the world, this has not gone unnoticed⁽¹⁾ with the Australian Securities and Investments Commission (ASIC). This concern is also echoed by the regulators in several other developed markets globally.

But more fundamentally, there is also a growing debate regarding the actual returns that ESG centric investments truly deliver. Take for example, the former Chairman of the Japanese Government Pension Investment Fund's (GPIF) Eiji Hirano. Mr. Hirano recently raised concerns regarding what he sees as "signs of a bubble" in ESG investing⁽²⁾. He is not the first, and expectedly will not be the last, when it comes to senior industry executives raising a key concern with ESG centric investing. His concern, in essence, is about the ability of the ESG investments to deliver the target returns that meet the financial obligations towards the investors in such funds.

That the issue and concern persist, despite the numerous reported studies by various entities that point to the advantages when it comes to the ESG based investing, is worth reflecting on. A study⁽³⁾ by Mark Anson, Deborah Spalding, Kristofer Kwait and John Delano published in the Journal of Portfolio Management in March 2020 highlighted the underlying concerns with ESG investing today.



ESG Investing: Elusive Long Term Advantage?

Cumulative Index Performance, Gross Returns (USD) measured from Sep 2007 to Jul 2021 indicates that the performance of MSCI World ESG Leaders Index vs. MSCI World Index is marginal at best

Source: MSCI

Some of the key findings⁽⁴⁾ from their study may be summarised as follows:

- i. Majority of the portfolio managers earned lower returns while pursuing sustainable mandate or applying sustainability metrics (13 vs. 11)
- ii. The negative alpha of those managers that generated negative returns was larger than the positive alpha generated by those managers with positive returns.
- iii. The average alpha generated across the full sample of managers was almost -1% and was statistically significant at the 5% confidence level (t-stat of -2.01). They noted that the sample was small though.

This topic gains even more significance when you consider the weight of the mandate of the superannuation (pension) funds to secure the financial future of its investors, who rely on the funds' performance to see them through their post retirement life. On the other hand, and equally importantly, pension funds wield significant influence when it comes to establishing and inspiring such investment trends and approaches. And therefore, it is imperative that the issue and concerns not be neglected and that these continue to be addressed proactively and diligently.

While the debate may rage on, one cannot deny the onus on the pension funds and other institutional investors to provide support for the ESG agenda given the ever-increasing concerns around climate change and sustainability.



ESG Investing: Dilemma and Risks

Institutional Investors; pension funds and ESG funds to an even greater extent, need to ensure their approach to ESG centric investments is capable of meeting their investors' expectations and fiduciary obligations.

We believe there are practical steps that investment funds, particularly those with significant moral and fiduciary responsibilities - such as pension funds or ESG focused funds, can take to ensure that the ESG agenda is more directly coupled with the underlying business performance drivers of the investments. This will ensure that while the ESG objectives continue to be meaningfully addressed, the performance on returns is being addressed too.

This possibility can be enhanced through appropriate decision-making support when it comes to investing in such ESG centric investments. The solution lies in enabling investment managers to sagaciously navigate the options that are offered as ESG centric investments in order to identify options that have the potential to create better returns in the longer term.

With greenwashing concerns, it is incumbent upon the investors to firstly validate the ESG credentials, and then assess the returns potential of the investment choices using smart and predictive analytics. To be able to deliver better returns, it is critical to employ a model that undertakes a calibrated approach to driving the ESG agenda, which should meaningfully align with the objectives and expectations of the funds' investment managers, the investors and the broader stakeholder universe.

We recommend taking an integrated approach towards ESG analytics in order to address these seemingly conflicting but pressing priorities facing the institutional investors. We term our approach - “**ESG^x Connect™**”. Our framework focuses on bottom up cross-functional integrated analysis driven through multiple lenses - sustainability yes, but also beyond that, through the business performance and operational excellence lenses.

Our model is designed to work in conjunction with existing ESG investment decision drivers, such as the ESG ratings, and enables the investment managers to:

1. Create an **integrated analytics view** that enables rapid comparison of the value creation potential of the options’ ESG capabilities
2. **Calibrate** ESG investment options against investor returns obligations
3. Identify underlying **ESG capability gaps** in the target companies, to ensure that truly impactful ESG agenda is being driven
4. Support the target companies’ leadership in **formulating and implementing a meaningful action plan** to realise the associated ESG objectives.
5. Provide ongoing analytics that can enable investment managers to calibrate and **adapt the ESG investment portfolio with agility** on an ongoing basis
6. Establish strong **cross-portfolio view** of the impact of the ESG investments on the overarching portfolio performance parameters
7. Identify and benchmark long-term, cross-sectoral and geographic **trends to inform future decisions** related to ESG investing on an ongoing basis

It is prudent on our part that we continue to work towards strengthening ESG investing, but also to enable investment decisions that can help funds to meet their obligations towards their stakeholders. An ESG agenda that is not innately linked to the core drivers of the business performance, and therefore not clearly able to demonstrate returns, is bound to continue to attract pressure and scrutiny from investors, regulators and other stakeholders. And in the process, we may be able to address, what one can term, ‘valid concerns’ being raised by industry leaders such as Eiji Hirano.

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- (1) <https://asic.gov.au/about-asic/news-centre/articles/what-is-greenwashing-and-what-are-its-potential-threats/>
 - (2) <https://www.bloomberg.com/news/articles/2021-06-29/beware-of-esg-bubble-says-ex-chair-of-world-s-biggest-pension>
 - (3) <https://jpm.pm-research.com/content/46/4/124>
 - (4) <https://valuewalkpremium.com/2020/09/new-challenges-to-the-merits-of-esg-investing/>

About the author:

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Sunil is the Founder & CEO of Vyzrd. Prior to founding Vyzrd, Sunil held senior and leadership positions across leading global management consulting firms such as BCG, Mercer and Oliver Wyman. He has extensive experience in advising the CxOs and Boards of some of the largest global firms and government organisations on topics related to investment, growth and risk. He also served as senior advisor to one of the top ESG investment research firms, which was subsequently acquired by a leading global ESG ratings company.

About Vyzrd:

Vyzrd™ is an AI powered analytics platform that provides a targeted portfolio of scalable, incisive and cost-effective business capability diagnostics, investment and risk management solutions.

ESG solutions: Vyzrd's ESG research and analytical solutions focus on ensuring that we enable Institutional Investors to meaningfully address their ESG investment objectives. Our approach to ESG analytics is arguably the most comprehensive and uniquely differentiated in the market today. The analytics platform is designed to present predictive analytics on key ESG variables that have fundamental impact on business performance and long term value creation.

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