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Defining ESG Investing

WHITEPAPER
APRIL 2018

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This is one of a series of papers that will explore integration of Environmental, Social, and Governance ("ESG") factors into an investment program. Collectively, the papers will define ESG investing, examine different approaches to integrating ESG factors into both active and passive management, review the investment risk and return implications of ESG integration, discuss the ESG due diligence process, and discuss guidance for fiduciaries including ESG factors in their investment program. In this paper, we focus on defining ESG.

Defining ESG

ESG investing is the integration of Environmental, Social, and Governance factors into investment decision making and management. It can include investment policy, asset allocation, manager or fund selection, and security selection. While ESG factors are sometimes referred to as non-financial considerations, the foundation for considering ESG factors is the expectation that, while they might not be reflected in traditional financial statements, ESG factors may have implications for the long-term risk and return of an investment. As such, they should be evaluated and integrated into investment decision making.

It is important to note that ESG integration is not synonymous with "Impact Investing" or Socially Responsible Investing ("SRI"). While SRI and Impact Investing may be included in an ESG investment program, they generally focus on explicitly using the investments of the program to produce or influence a particular impact, ethical or social good. These could include, for example, an environmental impact (e.g., clean energy), an economic impact (e.g., job creation), or other specific, targeted benefits. These may, or may not, be part of a broader responsible investment program and ESG integration. Proponents of ESG integration, in contrast, believe that ESG factors may have a meaningful impact on the long-term risk or return of an investment. As such, there is a responsibility to consider ESG factors regardless of other social, ethical, or moral objectives of an investment program. ESG is generally seen as synonymous with Responsible Investing ("RI").

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ESG resources

As ESG discussion and integration becomes more widespread, a proliferation of resources has become available to asset owners, investment managers, and other investment professionals. There are two that we suggest as the starting place for an investor or investment committee member who would like to learn more. These are the United Nations Principles of Responsible Investment ("UNPRI") website (https://www.unpri.org/) and the CFA Institute's ESG Guide for Investment Professionals (https://www.cfapubs.org/doi/abs/10.2469/ccb.v2015.n11.1).

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ESG issues

Each investor may have a different perspective on which ESG issues will influence the value of an investment or best reflect the values of an investment program. As a result, there is no generally accepted single definition of ESG issues. In their Guide for Investment Professionals[1], the CFA Institute has provided a sample of potentially important ESG issues:

Environmental Issues	Social Issues	Governance Issues
Climate change and carbon emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committee structure
Biodiversity	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Community relations	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labor standards	Whistleblower schemes

It is noteworthy that integration of each of the ESG factors with traditional investment analysis has evolved over time. For example, not so long ago, most fundamental investment analysts would have told you that they didn't explicitly include governance

[1] Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals. Published by the CFA Institute, 2005.

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in their analysis. If they didn't like the management structure, they simply wouldn't make the investment. This logic carried over to proxy voting, where it served as the long-stated rationale for consistently voting with management. Today, by contrast, many analysts would agree that good governance factors can have a direct impact on corporate performance and, as such, they are included in fundamental analysis as well as in proxy voting policy. Similarly, environmental issues such as energy efficiency, pollution, or climate change may not have been included in fundamental analysis in the past. But, as the cost or risk of each issue becomes more evident, corporate management increasingly includes them in their planning, and fundamental analysts more often integrate them into their analysis of investments.

In their 2017 survey of investment professionals[2], the CFA Institute found that 73% of respondents asserted that they consider at least some ESG issues in their investment analysis and decision making. Slightly over half of the respondents claimed that the ESG considerations that they looked at were systematically included in their investment analysis. Governance, particularly Board Accountability, was the area most likely to be included, followed by human capital and environmental degradation.

[2] https://www.cfainstitute.org/learning/future/Documents/ESG_Survey_Report_July_2017.pdf

ESG adoption

The development of the United Nations Principles for Responsible Investment (UNPRI) in 2005 marked a significant milestone in the formal adoption of responsible investment strategies. In some markets, this has also been encouraged by formal changes in the regulatory environment. In others, including the United States, guidance from regulators has clearly enabled fiduciaries to feel like they are "allowed" to incorporate ESG factors into their investment program. While there is no definitive single source of information on responsible investment programs, the expansion of the number of signatories to the UNPRI provides one indicator of growth.[3]

[3] https://www.unpri.org/pri

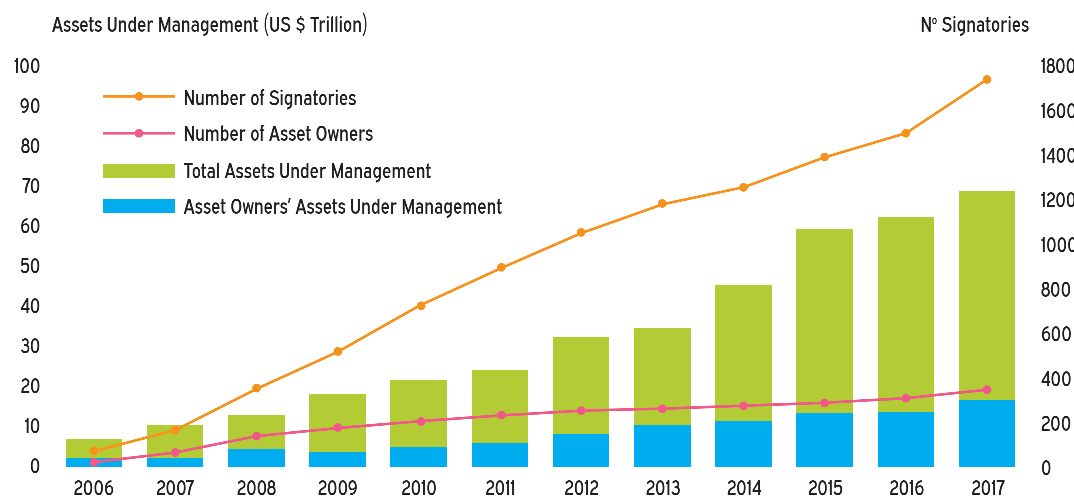

FIGURE 1
Growth in ESG Adoption

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ESG investing in practice

There is no single "right" way to include ESG factors into an investment program. This is consistent with the unique needs and circumstances of different institutional investment programs, as well as the diverse investment beliefs of individual trustees and practitioners. As advisors to a diverse group of institutional clients, we note that this is no different from other areas of investment policy. Every investment program is unique, and a cookie cutter approach to responsible investment strategies is no more useful than a cookie cutter approach to addressing other investment questions.

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In practice, we see investors who adopt responsible investment programs using a combination of the approaches identified in the CFA Institute's Guide for Investment Professionals. These include:

→ **ESG integration** This refers to the systematic consideration of environmental, social, and governance factors in investment analysis. As part of the analysis, consideration of the factors does not predetermine the results of the analysis or investments, just assures that they are considered along with valuation, growth, business opportunity, and all of the other issues that were previously evaluated in determining the value of an investment. The results of the analysis can have a meaningful impact on the valuation and, therefore, the attractiveness of an investment. For example, in valuing an investment in an insurance company, an analyst might apply a different discount rate to a company that is pricing and building a reserve for the impact of climate change on extreme losses, versus one that is not building such a reserve. Some form of ESG integration is currently the most widely used approach to including ESG factors in an investment program

→ **Negative or exclusionary screens** These are more often used in values- or morally-based investment programs, such as religious endowments or health care funds, though they can also be integrated into other institutional investment programs. With negative screens, the program simply prohibits investments in certain companies or industries, based on either the product or other specific

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considerations. This could, for example, include prohibitions on investments in tobacco companies, weapons manufacturers, gambling, or makers of alcoholic beverages. It is important to note that negative screening policies generally just omit a company or industry from consideration, regardless of valuation or other investment considerations. At times, this may have a meaningful impact on the performance of the investment program. Negative screens are probably the oldest and best known form of responsible investing, though institutional investors who have thoroughly embraced ESG generally use it only as a last resort.

→ **"Best in class" investing** "Best in class" ESG practitioners will look at the ESG characteristics of potential investments relative to peer companies in the same industry. In a sense, the ESG characteristics become a method of risk control, with the companies that have better characteristics versus their peers getting rewarded (i.e., positive selection) and others being underweighted or, in some cases, eliminated from a portfolio. Examples could include favoring, within an industry, companies that have better labor relations versus weaker labor relations. Or, in the energy industry, companies with less reliance on fossil fuels over companies that are exclusively dependent on fossil fuels. The result of this approach might be portfolios with sector and industry weights that are similar to other investment programs, but with very different scores on environmental, social, and governance factors. This approach is often positioned as focusing on controlling investment risk at least as much as potentially enhancing returns.

→ **Shareholder engagement and active ownership** Active ownership and shareholder engagement was pioneered by passive, index-oriented investors, though it can be integrated into both passive and active investment strategies. For index investors, it is based on the recognition that their engagement strategy is actually the only way that they can impact the long-term value of their investments. Hence, they actively encourage corporate managements to adopt policies and practices that may improve long-term economic results or reduce risk. Active owners recognize that, as shareholders of a company, they can engage with management, join with other shareholders to support and vote for specific proxy issues, propose shareholder resolutions, etc. It is noteworthy that index funds are generally the longest term holders of a security, as they will hold it for as long as it is in the index. Hence, they may have a longer time horizon than other investors or company management. As strong voices for improved ESG-related disclosure and greater transparency, such active engagement by these otherwise passive investors may also have the result of improving the information available to traditional active managers to use in analyzing an investment. In practice, for active managers, we see engagement as part of ESG integration into their investment analysis – when a prospective investment has weak ESG factor characteristics, but is otherwise a compelling value, they may choose to invest and

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use their ownership position to actively engage with company management and support improving the company's ESG characteristics.

→ **Impact investing and thematic investment** While impact and thematic investing are very different from each other, we classify them each as standalone subsets or components of an integrated responsible investment approach. Neither is a construct or strategy that is a required part of an ESG strategy, or that we would recommend for the sole strategy of a complete investment institutional program. However, either can be a component of a program, designed to meet the investment objectives of the program while targeting a specific impact or seeking to benefit from a particular theme in investments or the economy. For example, a fully diversified responsible investment program might also include an impact investment focused on job creation or economic development in a particular geography or region, and thematic investments focused on water resources or clean energy.

Conclusion

ESG Investing, also known as responsible investing, is focused on creating value in an investment program by considering environmental, social, and governance factors as part of the investment decision making process. The goal of the investor may be to better control risk or to enhance long-term investment returns. While there is no one size fits all approach to responsible investing, we see the combination of ESG integration with shareholder engagement and active ownership as the most likely approach to gain widespread use among institutional investors. These approaches effectively incorporate ESG factors into investment decision making while not precluding investments in otherwise attractive opportunities.

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