Responsible Investing

Responsible Investing (also called ‘sustainable investing’) is the practice of incorporating Environmental, Social, and Governance (ESG) considerations into the selection and management of investments. A wide universe of issues fall under ESG:

- **Environment** includes management of carbon emissions, water and energy conservation, waste, pollution and biodiversity.
- **Social** includes management of employees, customers, suppliers, and community and government stakeholders.
- **Governance** includes management of ethics and integrity of firm leadership including boards, shareholder rights, executive compensation, bribery/anti-corruption and codes of conducts.

Types of Responsible Investing

Responsible investing encompasses several types of activities.

- **ESG Integration** is the process of evaluating companies based on measures of their performance on the most ‘material’ ESG issues for the industry such as data privacy, water resource management, human rights in global supply chains, etc.
- **Restriction Screening** (also called ‘values investing’ and ‘faith-based investing’) is the practice of excluding entire product categories such as tobacco, alcohol, weapons, fossil fuels—or methods such as animal testing, GMOs.
- **Impact Investing** is the practice of making a portion of a portfolio dedicated to investments in companies which have a social impact thesis as part of their mission (i.e., affordable housing, social enterprises, green energy, etc.)

The focus of this brief is on the practice of ESG integration.

Trends in Responsible Investing

According to research by Morgan Stanley, as of July 2018, $22.8 trillion ($1 of every $4 under professional asset management globally) is invested according to responsible investing principles. Additionally, 70% of institutional investors (pensions, endowments, etc.) now incorporate ESG as part of their investment process. The trend is being fueled largely by demand from Millennial investors—90% of whom are seeking responsible investing options as part of their 401(k) plans and other investments.

The Business Case

There has been much debate as to whether investors have to accept lower returns in exchange for better ESG performance. Research completed in the last few years has shown that companies that perform high on ESG metrics that are most material to their industry outperform their peers in financial returns. Among companies that have high ESG performance, they tend to have better ESG management systems and procedures in place as well as executives and board members charged with oversight of ESG issues.

Materiality

Central to achieving better financial performance are materiality guides which prioritize which ESG issues to monitor and report by industry. The Sustainability Accounting Standards Board (SASB), which was established in 2011, provides overall guidance for each industry on which issues are most material—an extensive process which requires reviewing evidence on what impacts financial performance, as well as harmonizing standards set by industry associations, regulatory bodies, and international governance frameworks. SASB standards are frequently referenced by Limited Partners (LPs) and General Partners (GPs) in private equity when deciding which ESG issues to monitor and report.

There has also been much debate about the causality of ESG’s contribution to improved financial performance: does good management of ESG metrics lead to better financial performance or do companies that have better financial performance choose to invest more into ESG performance? While there is no easy way to settle this debate, a closer look at how ESG metrics can complement other business metrics sheds some light.
Growing Revenues

Having good performance on corporate responsibility issues has been shown to be linked to brand reputation and consumer trust. A recent survey showed that 75 percent of Millennials say they factor in a company’s values when making purchasing decisions. The ability to access new markets in the B2B and B2G sector is also tied to sustainability performance. Most large companies have ethical sourcing standards or supplier code of conducts which typically have requirements on wages, working conditions, and environmental management. In 2018, Unilever expanded its ethical sourcing policy to include not advertising its products on social media platforms that promote fake news or hate speech.

Investors and Businesses: Actors in Social Change

In the last decade, investors and business leaders have increasingly been playing a role in movements to advance environmental and social challenges.

Attracting talent is necessary to achieve innovative products, efficient operations and outstanding customer service. Nearly 75 percent of Millennials consider company values when deciding where to work—and moreover, the same percentage say they will take a pay cut to move to a company with better corporate responsibility practices.

Reducing Expenses

ESG management can also help companies lower operating costs. This is achieved through better water and energy conservation, and better management of workplace practices and procedures leading to reduced absenteeism, accidents, turnover, and quality control issues. ESG management can also support better risk management. This is achieved by having more resilient supply chains and better management of relationships with governments and local communities across global operations, thereby preventing costly disruptions to operations, lawsuits, and fines.
as the United Nations. Companies and investors can also become a signatory to voluntary guidelines and/or may sign onto specific commitments.

There are governance frameworks where investors and business commit to address specific issues. Among the most influential frameworks is the UN Guiding Principles on Business & Human Rights which lays out a comprehensive framework for addressing business roles in protecting and promoting human rights. The We Mean Business Coalition has collected action commitments in support of the Paris Climate Agreement from almost 900 companies representing $17 Trillion in market capitalization. The UN Business Call to Action platform for the Sustainable Development Goals (SDGs) has collected commitments from over 200 companies to make products accessible to the poor in developing countries. In the last few years, guiding principles have also been created around several technology issues including access to medicines, privacy, freedom of expression, and artificial intelligence algorithms—although they are still early in the implementation process.

Indexes and Rankings are built by third-party entities which evaluate and rate companies, typically on an annual basis. These ratings are typically restricted to publicly-listed companies. Many ratings are proprietary and developed by agencies such as Bloomberg, MSCI, and Thomson One. The largest publicly available index for rating companies on ESG performance is the JUST Capital Index, which includes assessments on some technology issues such as customer privacy.

Shareholder Activism campaigns typically led by coalitions of NGOs and asset owners organize to advance company performance on specific issues. The Task Force on Climate Related Disclosures (TCFD) is working to mandate and standardize disclosures on climate-related activities. The Workforce Disclosure Initiative is organizing investors to mandate disclosure on CEO-worker pay ratios, wages and working conditions in portfolio companies.

Technology-related issues have received limited investor interest - yet after two years of tech crises in the headlines, activist investors are starting to take notice. In 2019 the U.S. Security and Exchange Commission (SEC) ruled that a shareholder resolution could be put on the ballot at Amazon to stop sales of Rekognition, its facial recognition software program, on the grounds that it discriminates against minorities.

Implementing Responsible Investment Practices

Responsible Investment Frameworks are international norms that investors commit to as part of ESG due diligence and management. The main framework is the Principles for Responsible Investment (PRI), which was created by the United Nations in 2006. In 2018, PRI had nearly 2,000 signatories covering $81 Trillion in Assets under Management (AUM). Among the signatories are BlackRock, Fidelity, Vanguard, State Street, and PIMCO. In the same year, there were 703 signatories to the PRI with private equity assets, accounting for $2.15T in AUM; and approximately 70% of private equity funds integrated ESG as part of their screening and active management process. However, implementation remained a challenge as only 13% of private equity funds had staff dedicated to ESG.

Responsible Investment Policies are statements, typically publicly available on the firm’s website, which lay out specific commitments to conduct due diligence or otherwise factor in ESG considerations during the investment due diligence and active management process. The policy is typically developed by a member of the senior leadership team and is then ‘socialized’ through internal departments including legal, public affairs, investor relations, and executed by investment teams.

Due Diligence Questionnaires (DDQs) provide detailed questions investors should ask when evaluating an individual company for investment. Many private equity firms have created proprietary DDQs. There are also DDQs for private equity that are publicly available including the IFC Toolkit, the CDC Fund Manager Toolkit and the Invest Europe ESG DDQ. These toolkits are primarily focused on corporate governance, environment, labor, and community relations—and do not offer in depth guidance on technology-related issues. Similarly, existing toolkits are focused on the issues of mature companies and not earlier stage ventures.

Suggested Readings:

- Tavares, Rodrigo. “10 Reasons Startups should be Socially Responsible from Birth,” Green Biz, March 20, 2018. (Link)
- BSR, “ESG in Private Equity: How to Write a Responsible Investment Policy.” (Link)
- UNPRI, “Incorporating Responsible Investment Requirements into Private Equity Fund Terms.” (Link)
- UNPRI, “Limited Partners’ Responsible Investment Due Diligence Questionnaire,” (Link)
Endnotes


6 “Materiality” is defined as information that has “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.” (TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976)) and Matrixx Initiatives, Inc. v. Sirrusco, 563 U.S. ___ (2011).

7 The SASB standards can be viewed in the online interactive SASB Materiality Map https://materiality.sasb.org/?hsCtaTracking=28ae6e2d-2004-4a52-887f-819b72e-970f%7C7C160e7227-a2ed-4f28-a933-dff50a769c4f


12 We Mean Business Coalition. Accessed April 21, 2019 at: https://www.wemeanbusinesscoalition.org/

13 UN Business Call to Action. Accessed April 21, 2019 at: https://www.businesscalltoaction.org/

14 JUST Capital. Accessed April 21, 2019 at: https://justcapital.com/rankings/


16 Workforce Disclosure Initiative. Accessed on April 8, 2019 at: https://shareaction.org/wdi/


18 UNPRI. Accessed April 8, 2019, https://www.unpri.org/pri


23 “CDC Toolkit for Fund Managers,” CDC Group Accessed April 21, 2019 at: https://toolkit.cdcgroup.com/