

## ESG as an Investment Tool

The emergence of sustainably based ESG as an investment tool needs to be clearly distinguished from the field of Socially Responsible Investment (SRI) and other similar terminology.

The fundamental distinguishing feature between these two approaches is motivation. **Whereas SRI is essentially motivated by pseudo ethical imperatives and aims to actively shape the market, ESG integration is motivated by economic imperatives and is a risk-analytics tool aimed at capturing the effects of environment, social and corporate governance considerations on the risk-adjusted return of portfolios.** In this regard, **ESG integration is arguably a more tangible and effective method of addressing such issues** following conventional investment practice, which relies heavily on **quantitative measures and standardised benchmarks.**

SRI literature has a long history stretching back to the 1980s where it had strong uptake amongst European funds such as the Stewardship Fund in the United Kingdom and Varldnaturfonden in Sweden (Louche and Lydenberg, 2006). The attempt behind these early funds was to focus investment in assets that were regarded by those investors as 'socially responsible'. From the practitioner perspective, sell-side analysts were engaged in constructing portfolios that satisfied a particular appetite for non-financial goals. Within the academic literature, however, **defining which investment goals are 'socially responsible' has been contested based on different moral, ontological, ideological, and functional definitions of social responsibility (Sandberg et al., 2009).** SRI has been used to describe investment portfolios that achieve a sufficient level of financial return as well as offering social, environmental and other non-financial benefits (Sparkes and Cowton, 2004).

### Agreed Definition?

**"The definition of SRI is fundamentally politicised because each investor, as a consumer of financial products, demands their own mix of non-financial goals and outcomes making the construction of a commonly agreed upon 'SRI portfolio' impossible" (Davis and Thompson 1994, Hendry et al., 2007).**

Separately to this prerogative, a body of literature has developed on the *economic* consequences (as opposed to the ethical consequences) of social, environmental and corporate governance variables on the financial performance of the investments. This literature has spawned many streams of academic research in finance, law (Black and Coffee, 1994) and management (Davis and Thompson, 1994).



On the one hand, quantitative research has been carried out trying to use social (Orlitzky et al., 2003), environmental (Bauer et al., 2005) or governance (Bauer et al., 2008) variables to explain shareholder returns. This literature at times has faced methodological **challenges by virtue of the fact that often environmental, social or corporate governance data has been located within SRI-related products**, either in an aggregated fashion or in the form of **self-assessed qualitative metrics**. This has given reason to qualify the conclusions of much of this quantitative research. On the other hand, the literature has focused on the ability of ownership rights and shareholder activism to change corporate management. This literature has mainly focused on changing company's governance in light of Jensen and Meckling's (1976) agency theory (Clark and Hebb, 2004, Hebb, 2008, Neubaum and Zahra, 2006). Whatever limitations may be placed on the conclusions reached by this research, **it is clear that the underlying economic motivations of this research stream, (ESG) fundamentally distinguish it from the ethical/emotional overtones of the SRI literature.**

**ESG integration has emerged as an investment tool that clearly falls within this latter economic-focused literature and is better defined by financial academia.** Championed to a large extent by the United Nations Environment Programme Finance



Initiative and major sell-side investment houses around the world such as Goldman Sachs, UBS, and JP Morgan, **ESG integration is a new investment tool which is focused on risk analytics and identifying long-term 'alpha' drivers (above benchmark returns). In other words, it is about more precisely determining the impact of environmental, social and corporate governance considerations on asset pricing and the future**

cash flow of businesses. As such, it is a split from the primarily social/ethical/market-transforming mandate of the SRI community and as such has attracted some consternation from academics within this community.

The importance of ESG integration in financial analysis is partly grounded in the failure of financial actors to fully price the value of quantitative data regarding a firm's environmental, social, and governance performance into asset pricing (Clark and Knight, 2009). Furthermore, it is also grounded in the shortcoming of financial valuation models, for example



discounted cash flows, to capture the growing intangible asset base of new paradigm firms, including the effect of qualitative ESG considerations on firm valuation.<sup>1</sup> For instance, the book value of assets in the S&P 500 only account for 20-25% of corporate valuation (Ned Davis Research 2007). The remainder is represented in intangible assets such as future innovation, reputational value, good will, and relationships (Clark and Salo, 2008). Intangible assets have been identified as a relatively larger proportion of the asset base of 'new paradigm' firms as opposed to 'classical model' firms, which are largely reliant on physical and tangible assets (Clark and Salo, 2008). The growth of the intangible asset base highlights the importance of continuous innovation of products, processes and organisations designs for new paradigm firms (Lev, 2001).

**ESG considerations share a close synergy with firms' intangible assets especially to the extent that they encompass new product markets, for example, alternate energy production, General Electric's campaign to sell its 'Eco-magination' product**

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<sup>1</sup> A 'New paradigm' firm is a term which has emerged in the management literature to describe the unique business model of numerous firms over the past 25 years. The market valuation of these firms involves intangible assets such as good will, corporate reputation and brand valuation. These assets mean that the firm's market valuation is at a significant premium to the firm's book value. This is in contrast to "classical model" firms which dominated the early 20<sup>th</sup> century. Here, market valuation is closer to book valuation because the firm's assets were primarily physical and tangible assets such as plant and equipment. CLARK, G. L. & SALO, J. 2008. Corporate governance and environmental risk management: a quantitative analysis of 'New Paradigm' firms. In: QUARTER, J., CARMICHAEL, I. & RYAN, S. (eds.) *Pensions at Work: Socially Responsible Investment of Union-Based Pension Funds*. Toronto: University of Toronto Press.

**line in 2008-2009 or the growth in sales for hybrid cars for the Toyota Motor Corporation in 2006-2008. Another example is the strong relationship between strong environmental performance and a firm's reputation amongst consumers and stakeholders**, as demonstrated by the losses suffered by Royal Dutch Shell following the Brent Spar incident (Esty and Winston, 2006, Gunningham et al., 2003) and more recently The BP disaster.

All leading 'ESG' ratings agencies had BP in their top ranking 'ESG' performers. However the underlying calculations to support this position were entirely SRI based and not ESG based. These serve to illustrate how the emergence of ESG integration is in close harmony with the emergence of new paradigm firms and the growing importance of intangible assets, and other factors such as reputation and legitimacy, in certain sectors and geographies.



With exposure to a wide variety of asset types and geographies over a long time horizon, asset owners such as pension funds may have the potential to improve their overall returns by taking into account various considerations into their investment choices. However, given the relative recent rise of

ESG integration as an investment tool available in financial markets, its uptake, is partly contingent on the ability of investment consultants to understand and engage with ESG in advising their clients, and to convince clients of the potential merits of ESG integration. This is because investment consultants are uniquely positioned to collaborate with trustees (or investment boards) and direct the flow of fund assets, utilising ESG considerations.

### **Real ESG Metrics When You Want Them & How You Want Them**

Comprehensive research and product development, amongst a range of potential applications for Sigma, strongly guided how ESG Metrics were required to be delivered. Below is just one illustration of the resulting "face of real ESG Metrics". More realistically called F-ESG, since traditional financial risk analysis is presented along with each individual aspect of the ESG risk matrix, several other formats are available and custom applications are encouraged. Whether it is an Index or one of many other applications, such as Mergers & Acquisitions', Financial Instruments, major infrastructure projects, GHG Projects or in fact

any application that requires real quantifiable ESG risk metrics, either predictive or actual and current, there is a format.

Unlike SRI based Metrics, Sigma does not require use of expensive ratings agencies, can be achieved at your desk, and implemented as an Index constructor, it can rate and compare any listed or non-listed company in any of 162 Countries across all business sectors.

	Parent Company	Subsidiary or Business unit	Beta	Sigma	CFAR-m Indice	Rank
1	Metsa Board	Meulemans	1,3800	1,8601	1,00000	1
2	Metsa Board	Tako Carton (Järvenpää)	1,3800	1,8601	1,00000	1
3	Metsa Board	Tako Carton (Tampere)	1,3800	1,8601	1,00000	1
4	Stora Enso	Arzamas	1,2300	2,0833	0,99076	4
5	Stora Enso	Balabanovo	1,2300	2,0833	0,99076	4
6	Stora Enso	Loviisa	1,2300	1,4881	0,80194	6
7	Stora Enso	Sunila	1,2300	1,4881	0,80194	6
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14	UPM-Kymmene Oyj	Otepaä	1,1500	1,6234	0,78398	14
15	UPM-Kymmene Oyj	ZAO Chudovo	1,1500	1,6234	0,78398	14
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34	Metsa Board	Pont Sainte Maxence	1,3800	1,1419	0,77794	34