RESEARCH PRIMER: Moving ESG Investing From Values to Value

INTRODUCTION

Environmental, social, and governance (ESG) investing has grown from a niche, values-driven strategy, into a mainstream financial strategy focused on company value. Modern strategies aim to deliver long-term value by integrating ESG considerations into decision-making processes. This shift reflects the growing recognition that a company's ESG performance can significantly influence its ability to generate sustainable financial returns.

This primer explores the historical roots of ESG investing and how they shaped three of the most widely used ESG strategies today: exclusionary screens, portfolio optimization and tilting and ESG-integration into broader smart-beta strategies. It also examines the ongoing transition from values to value, highlighting how active ownership and ESG integration are driving the next stage of ESG investing's evolution.

PART I:
POPULAR (AND IMPERFECT) ESG STRATEGIES

Many popular and current ESG integration strategies can trace their origins back to the start of ESG investing and grow in response to market demands and available data. In part I we explore four of the main ESG strategies: Exclusionary Screens, Portfolio Tilts, Smart Beta, and Index Tracking, as well as discuss why, as a whole, they are insufficient to truly create alignment between firm operations and investor values or generate consistent value to investors by way of risk-adjusted returns compared to benchmarks.

1. Exclusionary Screens

Early initiatives to encourage socially responsible investing targeted "offending" products like guns, tobacco, and pornography, or bad practices like environmental degradation and human-rights abuses. Investors would simply avoid buying such companies' stocks. Many early responsible investors were inspired by religious groups such as Quakers, Methodists, and Muslims, who had long prohibited investments in businesses tied to slavery, weapons, or alcohol. One notable example is the Pioneer Group, a mutual fund founded in 1928, which excluded companies involved in tobacco, alcohol, and gambling.

In the wake of the 1970s campaigns against the South African apartheid and the Vietnam War, values-driven investing became more popular. Financial institutions started to offer portfolios that omitted not just companies in the traditional "sin" sectors but also those operating in South Africa or contracting with the US defense department. Funds like the Pax World Fund (1971), The First Spectrum Fund (1971), and The Dreyfus Third Century Fund (1972) were among the early entrants.[1]

Investors in these funds were driven more by ethical principles than by the prospect of improving their risk-adjusted return.[2] Research has validated this: exclusionary strategies are unlikely to provide a financial advantage; they either mirror market returns[3] or slightly underperform them.[4] There may have been some financial benefits in the form of lower risk,[5] particularly during crises, although such outcomes were unintended and contested.

The impact of these strategies on corporate behavior was also limited. A growing body of theoretical and empirical research has challenged the effectiveness of excluding companies from a portfolio, or divesting, as a tool for driving change.[6] Studies suggest that only a handful of "offending" companies and industries changed their practices in response to the actions of these early responsible investment funds. The low signal strength of divestment and ability for firms to meet financing needs from other market participants meant that there was little need or incentive for them to change course.

> “In many ways, the rhetoric surrounding ESG tilts has outpaced reality.”
>
> - Witold Henisz,
> Vice Dean of the ESG Initiative

2. Portfolio Optimization and Tilting

More recently, ESG investors have gone beyond the binary choice of including or excluding companies. Instead, they adjust the weights of companies within their portfolios to reflect some view of ESG performance. With the proliferation of ESG ratings or rankings, it becomes easier for investors to leverage off the shelf data on ESG factors to compare companies within and between industries.

For example, investors might increase the weight of an oil company with relatively high ESG ratings while removing or reducing the weight of low-rated peers. That stands in contrast with an exclusionary investor, who may prefer to invest in a market-cap-weighted S&P 500 index fund that excludes the entire oil and gas industry.

This practice, often known as “portfolio optimization” or “tilting,” aims to increase an investor’s financial risk-adjusted return[7] and encourages companies to address societal externalities.[8] In short, it believes value (returns) is generated by pursuing values (strong ESG performance).

Naturally, researchers have tried to identify strategies that generate above-average returns by tilting toward higher-performing ESG firms,[9] those on an trajectory of ESG improvement, or those benefitting from strong ESG sentiment. However, not all studies support a strong link between ESG tilting and financial outperformance, in part due to inconsistencies and low-correlations between different ESG ratings providers.[10]

While the demand for portfolio optimization and tilt strategies is undeniably strong, the evidence is still piecemeal; ESG ratings may not be the ideal proxy for firm “goodness” (that is aligned with certain values) nor may they lead to better portfolio performance than the S&P500 benchmark. In fact, these tilts currently account for only 6% of assets under management (AUM).[11]

3. ESG as a Factor in Smart-Beta Strategies

Instead of re-weighting a portfolio solely based on companies' ESG performance, investors can integrate ESG factors alongside traditional investment criteria, such as value, momentum, size, volatility, and quality. This approach allows ESG considerations to complement traditional factors in portfolio construction rather than replace them.

Recent analyses show that companies with the highest ESG ratings tend to only partially overlap with existing strategies, suggesting that ESG can serve as a unique, standalone factor in portfolio construction. Moreover, since higher ESG-rated companies tend to exhibit lower volatility, an ESG factor can lead to better risk-adjusted returns in the form of a higher Sharpe ratio from lowered volatility alone.

Leaders in the development of the smart-beta ESG factor include RobecoSAM, with their Sustainability Investment Factor,[12] and MSCI.[13] Their efforts are supported by a growing body of research, particularly studies of credit risk,[14] that show the potential of ESG factors to reduce risk.[15] However, some studies dispute the existence of an ESG factor,[16] pointing once again to the need for more consistent and transparent data disclosure.

4. The Rise of Low-Fee, Passive ESG Investing

With high-fee, active managers still strugglingto prove they can generate alpha by integrating ESG into their investing processes, investors have turned their focus to lower cost, more convenient offerings. Low-fee funds, which largely mirror passive indexes, comprise the largest-growth segment in the ESG space (and in fact are largely popular in traditional investing as well). This more passive strategy can be found across the market from mutual funds to easy-to-access ESG ETF's.

When it comes to financial performance, moderate-, high-, and low-fee ESG funds perform similarly, all slightly underperforming their benchmarks; paying more fees for similar performance is not appealing for investors. More concerningly, low-fee ESG funds also fall below relevant ESG performance benchmarks and vary more substantively than their peers.

The outcome is that while investor interest in ESG funds surged from 2015-21, much of the capital flowed into funds that, by some metrics, had the lowest ESG performance within the category and may have even underperformed their ESG benchmarks. Many of these funds were run by established incumbent asset managers with scant track records in ESG investing. In some cases, these managers simply rebranded existing funds with an ESG label after making relatively superficial changes to exclusions or investment strategy.[17] "Claims of ESG greenwashing by fund managers appear well-founded," says Henisz.

The rise of low-cost ESG options, counterintuitively, raised the bar for those trying to integrate ESG factors into their core investment decisions. Specialist asset managers pursuing "active" ESG strategies and blending traditional and ESG analysis faced increasing competition. They had to contend with early ESG entrants and mainstream incumbents offering the allure of cheaper alternatives. New ESG investors needed a clear, compelling, and convincing evidence-based proposition to overcome deep-seated loyalty to incumbent fund managers.

REASONS FOR IMPERFECTION

Many of the reasons the aforementioned strategies fail come down to their inability to link ESG factors to values or the lack of reliability to generate long term value. Taking off the shelf ratings, or investing passively is often "cheap-talk" for those trying to ESG invest as it became en vogue. As mentioned above, these strategies may not only yield subpar returns, but also worse ESG results.

On the other hand, divestment from single firms (through re-weighting) or entire industries have little-to-no signal strength. Not holding shares gives little information to large firms, and thus their behaviors (i.e. poor performance on an issue) are unlikely to change.

PART II:
POPULAR (AND IMPERFECT) ESG STRATEGIES

The challenge for investors lies in the temptation to pander to stakeholder pressure by simply purchasing a new ESG data set or hiring token specialists. Instead, investors who believe that a company's impact on society and the environment affects its long-term value must find ways to fully integrate a company's ESG characteristics into their investment decisions. Only through such integration will ESG move from a temporary fad to a permanent standard in best-in-class investing.

Not surprisingly, skepticism is widespread. Annual surveys by the Callen Group[18] over the last eight years suggest that the majority of institutional investors do not consider ESG factors to be material to financial performance. Among the minority of respondents who have incorporated ESG factors into their investment decisions, motivations include stakeholder pressures, values- or impact-based arguments, potential correlations with risk, and financial returns. Notably, the prospect of "higher long-term returns" is among the weakest motivators.

Two trends in ESG investing may illuminate the way forward. The first is the full integration of ESG factors into fundamental financial and operational analyses. The second is active ownership: engaging directly with companies to drive improvements and, in doing so, increasing their value. Both of these have the potential to take ESG investing well beyond its current trajectory.

1. ESG Integration

True integration of ESG into fundamental analysis requires a bottom-up process, where environmental, social, and governance issues are integrated into financial-model forecasts. This means ESG data would not be treated as a distinct factor: instead it becomes part of the assessment of key line items such as revenue, operating margins, and risk — factors that ultimately influence intrinsic valuation and expected returns. ESG factors are financially material because they can affect top-line growth, cost structures, regulatory and legal interventions, employee productivity, and asset optimization.[19]

Investors have recently indicated a preference for scenario-based analyses as the best way to quantify ESG-related issues.[20] This trend has been driven particularly by calls from regulatory bodies, like the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD), for companies to report their own climate change scenarios.

An important challenge for the future will be training analysts to integrate ESG factors, including regulatory risk, gender diversity, energy efficiency, and human rights, into their core business assessments.

Such training is not only time-consuming but is also likely to encounter industry resistance given the immediate costs of investments in human capital, data, and modeling versus the longer-term benefit of higher returns, which may take three to five years to materialize.[21] Additionally, the dominance of passive, low-cost investment strategies amplifies this reluctance to accept this J curve. Unsurprisingly, this challenge also exists within companies looking to invest in better ESG practices.

For ESG investors, the holy grail is successfully integrating reliable ESG data into broader financial analysis. At the moment, a company's weight in an ESG-oriented portfolio is typically determined by ratings that are often inconsistent and uncorrelated —creating crude rankings that may lack rigor. What's needed is a bottom-up process that reflects the impact of ESG issues on a company's value.

The industry needs to build these capabilities in public and private markets, even amid political and financial headwinds.

> **"Analysts may know the businesses they cover inside and out, but they often lack expertise in climate, human rights, or other ESG issues needed to ask companies the right questions, adjust their fundamental models, or to make integrated recommendations."**
>
> - Witold Henisz,
> Vice Dean of the ESG Initiative

2. Active Ownership and Corporate Engagement

All of the strategies above—both historical and current—have focused on using ESG to make investing decisions. However, none address how investors can use ESG factors to guide their engagement with companies after purchasing shares. This is where active ownership emerges as a possible new direction for the ESG movement.

Pension funds in Europe and the US have long engaged with companies on ESG issues, particularly governance. Notable examples include CalPERS, NBIM, and APG. With "partnership" mindsets, long-term investment horizons, and sizeable ownership stakes, these players, at times, have had a significant impact on corporate strategy, behavior, and financial performance.

From 1987 to 2010, for example, CalPERS targeted a small number of companies it deemed to be underperforming on governance—notably in board quality and diversity, reporting transparency, investor rights, management of environmental and social issues, and shareholder alignment on executive compensation. The agency highlighted these companies in a name-and-shame campaign called the Focus List. After 2010, it shifted to a more private engagement strategy.

The impact has been significant. In 2014, Wilshire Associates, a consultant to the CalPERS board, published an analysis of 188 companies in the Focus List program from 1999 to 2013. Following engagement, these companies outperformed their Russell 1000 sector benchmarks by 11.9%.[22]

Other studies have also found evidence that engagement can deliver higher financial returns and prompt companies to take remedial action. For example, an analysis of plants targeted by the New York City Pension System's Boardroom Accountability Project, found substantial reductions in toxic releases, greenhouse gas emissions, and cancer-causing pollution due to the firms' subsequent investments in abatement technology.

Coordination by activists appears to be a determinant of successful engagements.[23] One study examined thirty-one campaigns on the Principle for Responsible Investing platform and found that coalitions with a lead investor from the same country as the targeted company, supported by a wide array of capable and influential backers, were more likely to drive change in firm behavior and boost performance.[24] Similar results were reported in a study of 256 engagements conducted by the Canadian Coalition for Good Governance.[25] However, some studies have cast doubt on the efficacy of even coordinated campaigns to drive reductions in emissions.[26]

Engagement appears to be a more effective way to achieve change than exclusionary screens, though it is more costly and allows other stakeholders to "free ride" on the efforts of engaged investors. In this context, the recent concentration of the asset management industry may be beneficial as efforts and clout are concentrated to larger, better funded actors. Some argue, however, that index-based investing (which allows for a swift exit) limits large funds' ability to make a significant impact.

Whatever the reasons, the current pace and scope of engagement activity are insufficient to achieve the systemic changes sought by the UN net-zero emissions target or the Sustainable Development Goals.

CONCLUSION

Throughout its history, ESG investing has meant many things to many people. For the earliest responsible investors, it was a way to purge "sin stocks" from their portfolios. But for some recent investors, the focus has shifted from "How pure is my portfolio?" to an understanding that firms who perform better on Environmental, Social, and Governance issues are likely to perform better over the long-term.

Investors want more than one thing, many clamor for options to invest in a way aligned with their views and consciensce (on all parts of the political spectrum) and they want to see returns. For industry professionals to generate alpha, they need to move past the low-effort cheap talk strategies in part I and lean into the hard work to create nuanced strategies discussed in part II.

For those looking to see better risk-adjusted returns and differentiate themselves in the industry, well-researched fundamental models with input from those with ESG subject-matter expertise is key to developing unique recommendations and strategies; if all firms simply invest in the same top 20 ESG performers, all excess returns are arbitraged away.

For those who instead view investing as a way to engage with firms and to drive them to a more sustainable future, divestment and tilting is not enough. Active management and long-term engagement, both publicly through proxy voting, and privately, through relationship building, yields more success and is higher in signal strength.

> **"Making change and returns can happen in synch, but only when efforts are meaningful and built upon strong data, nuanced analysis, and deep engagement."**
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> - Witold Henisz,
> Vice Dean of the ESG Initiative

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Witold J. Henisz is the Vice Dean and Faculty Director, ESG Initiative and the Deloitte & Touche Professor of Management in Honor of Russell E. Palmer, former Managing Partner at The Wharton School, The University of Pennsylvania. His research examines the impact of political hazards as well as environmental, social and governance factors more broadly on the strategy and valuation of global corporations. This work analyzes best practices in corporate diplomacy to win the hearts and minds of external stakeholders as well as the measurement thereof. It has been published in top-ranked journals in international business, management, international studies and sociology and he is the author of the book “Corporate Diplomacy: Building Reputations and Relationships with External Stakeholders”. Witold has won multiple teaching awards at the graduate and undergraduate levels and also teaches extensively on the topic of Corporate Diplomacy as well as ESG integration in open enrollment and custom executive education programs. He is currently a principal in the consultancy PRIMA LLC whose clients span multinational firms, asset managers, intergovernmental organizations and non-governmental organizations.

The Wharton ESG Initiative:

The Environmental, Social and Governance (ESG) Initiative conducts academically rigorous and practically relevant research that investigates gaps between the current pricing of ESG factors by investors and corporations and their long-term business and societal impacts. Informed by this research, we offer 30+ courses that MBA and undergraduate students can assemble into the ESG for Business major or concentration, over a dozen co-curricular experiences, four Executive certificate programs, and an expanding array of industry and policy convenings. We advance Wharton’s best-in-class education of current and future leaders, equipping them with the tools, skills, and perspectives needed to navigate a world in which ESG risks and opportunities are increasingly material. For more information, visit https://esg.wharton.upenn.edu.

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