Standardise to sustain

Will Bryant of Albourne reflects on beneficial changes that would help evolve ESG and give greater value to the field

Plenty has been written over the recent months and years regarding the increasing amounts of capital being allocated to Environmental, Social and Governance (ESG) investment strategies. This has come about on the back of increased investor focus due to several different drivers, including a shift of capital to younger generations and increased public and media pressure.

Alongside this there have been several articles on the different approaches to ESG investing. These range from simple screens and tilting strategies, whether exclusionary or positive targeted methods, to integrated approaches where ESG factors are embedded within the investment process, using active engagement as an added tool to further enhance positive change. Thematic and impact investing are included in this spectrum, where measurement of the environmental and social goals is a key output.

These different approaches to the inclusion of ESG or 'non-financial' data into the investment process will vary based on the characteristics of the investment strategy or the portfolio manager's belief in the efficacy of ESG integration. Whatever the approach, one thing that has become increasingly clear in conversations with investors and managers, is that the integration of ESG data in the investment space is here to stay. Investors are increasingly demanding ESG inclusion, asset managers are developing ways to integrate ESG into their processes, and corporates are beginning to grasp the potential long-term security valuation benefits of embedding ESG into their business.

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Will Bryant joined Albourne in 2005 working in the client and portfolio team in Europe and the US. Bryant's role is to help Albourne's wide range of clients with investments in the alternatives space. Among other things, this has brought Bryant into the world of responsible investing, helping to build an understanding of the activity within the alternative investment industry for those increasing number of investors focused on responsible investing. Bryant is a member of the PRI hedge fund advisory committee.

Despite the demand for ESG, one key area is holding back further integration. The lack of standardised non-financial data provided by corporates is the main hurdle for many fund managers to be able to easily integrate ESG into their investment strategies; the proliferation of questionnaires with different approaches is also a growing burden for corporates.

Albourne sits at the intersection of investors and alternative asset managers. From this position we have seen the development of the trends for ever increasing ESG integration and the issues that fund managers and investors face when focusing on ESG in their processes. Along with the rigorous investment, quantitative and operational due diligence Albourne currently completes on alternative funds, Albourne conducts a review of their ESG capabilities. Albourne has integrated ESG into its operational due diligence of fund managers to complement its existing ESG questionnaire, and subsequent report, through which Albourne has been gathering and conveying a manager's approach to ESG integration for over eight years.

To further widen ESG integration, Albourne is looking to promote and support efforts to move towards a standardised approach to data production as part of Albourne Investor Manifesto II, launched in 2018.

Current situation with ESG data

One of the key issues around non-financial or ESG data is that it can be difficult to directly correlate this data to security valuation or performance. Much has been written about the impact of ESG data on financial performance. In the 2015 paper by Deutsche Asset Management and the University of Hamburg[1] they reviewed over 2,000 empirical studies from the 1970s to present day, finding that 'roughly 90% of studies found a nonnegative ESG-CFP (corporate financial performance) relation', with the majority of studies finding a positive relation.

What remains unclear is how long it may take for this relationship to play out in the underlying securities price. For the hedge fund space, the timeframe for recognition of the ESG characteristics may not be compatible with their strategy or may get swamped by other characteristics for which the security is in the portfolio. This leads many investors to focus on the inclusion of ESG data from the perspective of risk mitigation.

At present the reporting by corporates of non-financial data is voluntary and non-standardised; this often sits within a separate Corporate Responsibility or Sustainability report. The fact that the output is not standardised unlike the reporting of financial data, makes it hard for investors to be able to easily compare companies with reference to these data points.

The increased demand for the inclusion of ESG data within the investment process has led to an increase in third-party ESG data and ratings providers. Many investors, asset managers and other stakeholders are increasingly reliant on the reports and ratings of third-party ESG agencies to assess, compare and measure ESG performance of their investment universe. Given that the inclusion of ESG data into the investment process is in the nascent stages, there is ongoing development, evolution and even debate around methodology and principles for best practice among providers.

Each of the rating agencies have different methodologies in how they arrive at their scores. This has led to a dispersion of overall scores dependent on the provider, a general lack of clear understanding by many consumers of the differences and ultimately, in our view, a slightly confused landscape. It is estimated that the correlation between credit ratings issued by S&P and Moody's stands at about 0.9, while the correlations between MSCI and Sustainalytics (two the most widely used ESG rating agencies) is roughly 0.3[2].

It is also worth noting that banks are advising corporates on how to improve their ESG ratings and benefit from positive screening in investor strategies.

Over recent years several initiatives have come about in order to create common reporting frameworks, such as the Global Reporting Initiative, the UN Global Compact and the Carbon Disclosure Project. These sorts of initiatives can lead to companies being more focused on how they perform relative to the criteria of the framework, rather than focusing on optimising their ESG impact within the framework of their business model.

What the future might look like

Currently, the biggest hurdle standing between the mass adoption of ESG, possibly after an (increasingly shrinking) investor belief that integration of ESG factors is not relevant, is the lack of consistent data.

What is required is a consistent global approach covering a range of different topics under the ESG umbrella, ideally with some level of third-party audit of this data. One standardised reporting protocol, with strict (and possibly regulated) definitions around the different metrics, would be simpler for corporates to produce rather than the plethora of existing reporting frameworks, which are currently the burden of corporate management.

> ***The standardisation of the information would allow for simple collection, collation and comparison of relevant data points***

Over recent years there have been isolated efforts to gain this standardised data in individual areas within ESG. Efforts include the Greenhouse Gas Protocol[3] and the UK Gender Pay Gap reporting[4], both examples provide standardised, well-defined ways to explicitly show data in an objective, quantifiable manner.

There is still very much a place for corporates to provide their own corporate responsibility or sustainability report or integrate this information within their annual report. This demonstrates to their stakeholders how they view their activities from an ESG perspective and how it fits within their own specific business model. However, this should sit alongside a standardised display of objectively defined data.

The auditing of this data is also a key step in the confidence that investors can take when using the output. As with the provision of traditional financial data, non-financial data should be treated to the same level of oversight and verification.

Conclusion

The requirement for the reporting of non-financial data is increasing, and what is currently voluntary is going to become required by many stock exchanges and regulators. There needs to be a coordinated approach across national agencies to avoid a fragmented reporting landscape. Ideally the industry needs to avoid the adoption of more than one approach as is seen in accounting standards (whereby investors need to be proficient in both US GAAP and IFRS methodologies).

Within the EU there is a will to create regulation around the standardisation of reporting on ESG topics, whereas in the US the approach seems to be to let the market naturally encourage companies to make adequate disclosures. This is likely to lead to a wide variety in quantity and quality of data as corporates can report in different formats. Currently corporates in the US must disclose material items, however what is material is currently at the judgement of directors.

A standardised approach would maintain a place within the industry for the existing ratings providers who are taking that data and using their own proprietary methodologies to distil the data into an actionable approach.

From Albourne's perspective, the above outline for the future of ESG data provision looks very similar to the creation of the Open Protocol[5]. That is because the aim and need are very similar, both are looking to standardise the reporting of information. The standardisation of the information would allow for simple collection, collation and comparison of relevant data points.

The use of standardised comparable ESG data by investment managers would then be defined by their interpretation of materiality and applicability within their relevant strategy, with the aid of frameworks such as SASB[6]. Allowing managers to continue to evolve their investment approaches and to be able to factor in all information that is relevant and material to an investment is the key to any investment strategy. HFM

[1] www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917?needAccess=true

[2] www.ft.com/content/a5e02050-8ac6-11e8-bf9e-8771d5404543

[3] ghgprotocol.org/

[4] www.gov.uk/government/news/gender-pay-gap-reporting

[5] theopenprotocol.org/

[6] www.sasb.org/standards-overview/materiality-map/