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Value or Values?

THE CHOICE OF ENVIRONMENTAL, SOCIAL & GOVERNANCE VALUES IN ASSET MANAGEMENT

January 2021

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INTRODUCTION

As investors increasingly seek strategies that both deliver returns and advance core values, asset managers have been testing different approaches. While the current debate around Environmental, Social and Governance (ESG) investing often treats this as either a fresh, new challenge or a passing fad, investing that reflects social values has a deep and rich history that is rooted in local culture and beliefs. What is not a part of that history is a widely agreed approach to pin down lofty principles into an actionable set of values for investing, embedded in a clear and coherent rationale.

The challenge is especially daunting. First, ESG values, or standards, may respond to different imperatives. They may represent risks to performance that investors want to mitigate and thus opportunities to enhance risk-adjusted returns, or they may offer the opportunity to select investments based on an investor's ethics and morals. Also, ESG values can measure virtually every aspect of a firm's behavior.

- Environmental criteria refer to the ecological impact a company may have because of its activity, including from the types of energy it uses, the waste it discharges, and the resources it needs.
- Social criteria address the relationship a company has, and the reputation it fosters, with people and institutions in the communities where it does business, including labor relations, diversity and inclusion.
- Governance involves the internal system of practices, controls, and procedures a company adopts in order to manage itself, make effective decisions, comply with the law, and meet the needs of external stakeholders.

In selecting criteria that allow investors to track ESG values, some may care more about current performance along these dimensions, others may be concerned about companies' efforts to improve, and others still be interested in companies that are developing innovative practices or products that can have a beneficial impact on people and the planet. In light of the many challenges outstanding, investors, civil society and regulators are increasingly looking to asset managers to articulate a coherent framework that combines values and value.

This paper explores objectives for investors and companies to consider as they incorporate ESG practices and proposes a framework for making decisions. The first section describes how the debate surrounding value-based investing is age-old. On one hand, these broad values may be hard to translate into standardized investment decisions, as many are based not only on local beliefs but also on still-evolving scientific discoveries. On the other hand, these principles offer a durable framework in which specific ESG investment strategies can evolve. The second section suggests how to select standards that translate broad ESG values and pin down actionable criteria to help assess firms' ESG behavior. If society values protecting the environment, for example, investors may set firms' carbon footprint as a standard and pick reliance on renewable energy as a criterion to assess progress. Selecting an ESG standard will remain a dynamic process, as beliefs, societal development paths, and regulations differ. Still, a choice has to be made, and the final section presents frameworks that help express values through investment decisions.

1. A BRIEF HISTORY OF ETHICAL INVESTING

Ethical investing is broadly defined by participants as a "values-driven approach." Profit continues to be sought, but the capital is deployed with the intention of supporting a social or environmental value. It is also called sustainable and socially-responsible investment, conscious capitalism, fair capital, purposeful business, and profit-with-purpose business. It is sometimes dismissed as a relatively recent fad or political agenda that clouds hard-nosed analysis and erodes returns. But ethical concerns and values are as old as investing itself.

Its current form is founded on faith-based investing, rooted in the morals and doctrines of certain religions and, accordingly, has been centuries in the making. Most of the major religions include guidance on the appropriate use of, and approach to, money in their founding texts. Usury, or charging interest, was condemned by religious and philosophical leaders ranging from Moses to Gautama Buddha to the Prophet Mohammad. In Islam, the word for interest, riba, translates directly as excess. This concept of an excess of wealth as inherently sinful has, for many, evolved towards the idea that excess wealth can be put to redemptive use through financial markets—not just through charitable deeds and donations.

The prohibitive approach of many religions changed through the ages. Notions of the sinful nature of usury were cast aside, with focus instead on how to avoid immoral capital allocation. The Quakers had embargoed investments in the slave trade from 1758; in 1759 one of the founders of Methodism, John Wesley, outlined his take on the basic tenets of ethical investing in his sermon 'The Use of Money'[1]:

"[Money] is a most compendious instrument... of doing all manner of good... By it...we may be a defence for the oppressed, a means of health to the sick, of ease to them that are in pain;"

"[We must] gain all we can without hurting our neighbor (...), we may not engage or continue any sinful trade..."

The religious nature of the narrative is now often left by the wayside—those in control of capital flows are usually secular in their approach—but the exploration of what is and is not ethical still stands: using money to do "all manner of good," earning money "without hurting our neighbor."

SINFUL TRADE

Faith-based investing became "values-based investing" though the approach continued to exclude investment in firms and sectors involved in ethically dubious and otherwise harmful practices. Rejecting usury evolved into avoiding investments in alcohol and tobacco. It paved the way for economic boycotts of racially segregated South Africa in the 1980s, and current investment exclusions that range from private prisons to handguns to gambling.

The focus gradually turned to environmental concerns, following scientific confirmation of the rapid deterioration of the Earth's climate, amid a global movement to promote sustainability that carries moral dimensions.

Norway's pension and sovereign wealth funds, for example, which are some of the largest globally, have a Council for Ethics to determine which investments are prohibited, including those that are excluded specifically because of their environmental impact. It may seem paradoxical to ban fossil fuel assets on ethical grounds when Norway built its wealth producing carbon-intensive energy. Still, it is a moral principle that lies beneath the funds' ESG constraints on investments.

ALL MANNER OF GOOD

Recently, "sustainable investing" has turned its attention towards Wesley's "all manner of good." Instead of focusing only on which bad investments should be left out—an "exclusion" strategy—some investors now focus on which should be kept in to deliver an altruistic impact while still creating financial value. This "positive screening" strategy may involve selecting investments that either have best-in-class environmental and social practices or are making efforts to improve these practices. It can also imply setting up investment portfolios that focus on an ESG theme considered to benefit society or the environment, like firms significantly involved in renewable energy or sustainable agriculture.

Flipping screening from negative to positive also allows a less-prescriptive approach. The investor is exposed to opportunity rather than simply protected from risks. This requires a more fulsome investment process, with full knowledge of the environmental and social performance of an entity, as well as the governance that underpins that strategy. Some of these areas may have already been considered as part of standard economic analysis, but others would have been considered immaterial. This is changing as a critical mass of investors take a moral view and their decisions move markets.

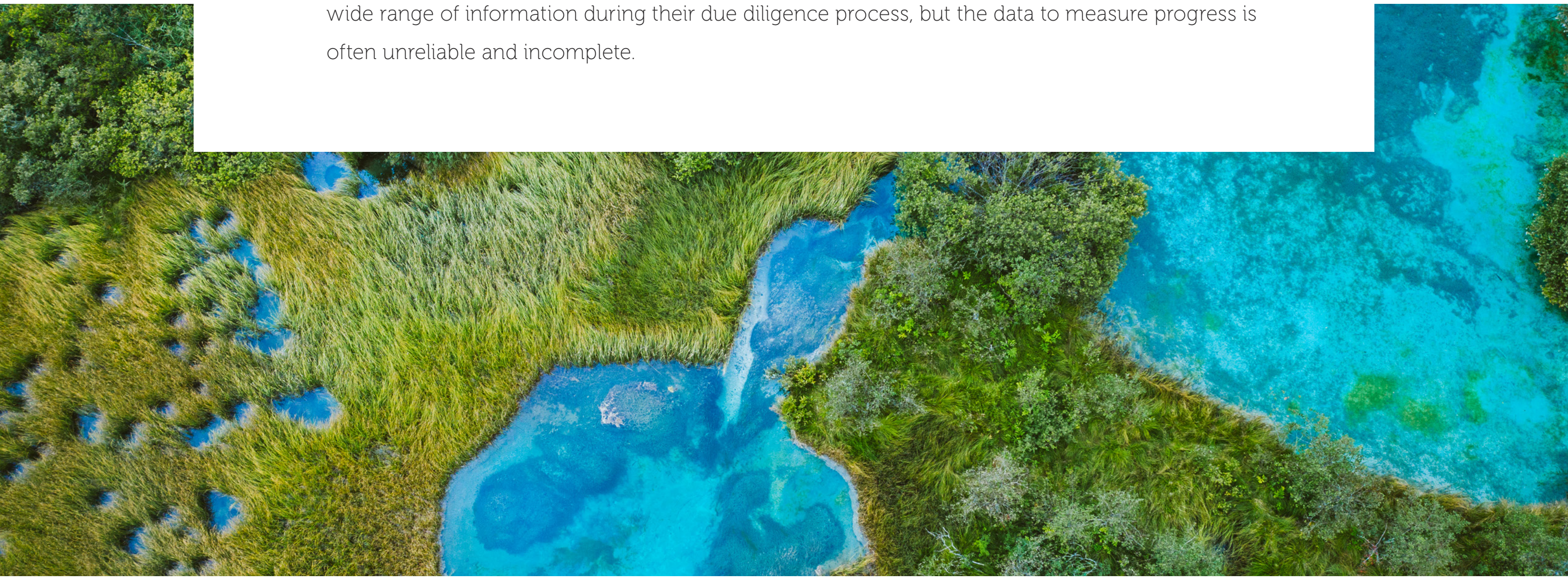
This shift also requires the consideration of the end-results of investment decisions. Funds may focus not just on an investment that is best-in-class socially or environmentally, but rather on a desired goal–a world without carbon emissions or with gender equality. Little of this is new, either. Indeed, in Hinduism and Taoism, wealth is viewed a means to an end, the end being generosity, charity and the avoidance of anarchy.

Investors who are deemed responsible today use the power of their capital to drive change. Where once such influence was known as shareholder activism—and was associated with a public, adversarial approach—we now use words like engagement and stewardship. They point to a softer power based on shared information between investor and investee, and of change realized through discussion and mutual understanding instead of confrontation. Some investors target pure environmental or social improvement; others only pursue progress that can deliver a realization of financial value at the same time. Instead of divesting the areas of the market that seem morally dubious, potentially allowing investors with fewer qualms to step in, many now invest to try to drive change where it is needed most.

2. FINDING E, S & G STANDARDS THAT DELIVER ETHICAL INVESTING

Even as momentum builds behind age-old aspirations for investment strategies that do good, investors still face difficult questions around how. Who can define and rank what is good and bad in investment? How should conflicting impacts be weighed? Should climate change mitigation count more or less than gender equality? Scientific results, local conditions, economic outcomes, and cultural changes all affect what society values. Decisions may also be based on uncertain evidence—or evidence that evolves with scientific progress. While evaluating ESG metrics can be more complicated than traditional economic or financial analysis, it requires similar judgements to what is required in choosing where to place a quantitative value in fundamental analysis.

As religious values have receded from most financial decisions, many investors have turned to the United Nations and its Sustainable Development Goals for direction (included on the next page). But even the U.N. Global Compact,[2] which attempts to turn these goals into actions, offers only limited guidance. This lack of standardization, both of standards to reach and of criteria to assess how well they are achieved, also hampers data collection. Investors need to collect and analyze a wide range of information during their due diligence process, but the data to measure progress is often unreliable and incomplete.



WHAT IS SUSTAINABLE INVESTING?

The United Nations has formalized the political consensus on the nature of sustainable investing by formulating the Sustainable Development Goals (SDG).[3] The goals, which governments have pledged to achieve by 2030, define the nature of sustainable growth in a variety of areas, and present 17 values that require action for the good of humanity and the planet **(FIGURE 1)**. The current goals were updated in 2015 from the 2000's Millennium Development Goals, which addressed global poverty issues, with a focus on education, health, and arresting climate deterioration. The objectives are more aspirational than concrete, with no standardization offered about how to achieve them.

FIGURE 1: Sustainable Development Goals

SOURCE: United Nations.

The U.N. Global Compact helps translate these aspirations into corporate actions, delineating ten principles that firms can incorporate in their operations. Some examples include: eliminate all forms of forced labor, support a precautionary approach to environmental challenges, and work against corruption. Even this is often not very specific, but they have however created a thoughtful process of how to translate theory into practice.

While investors test a wide range of approaches, a few overarching principles may help select the most useful and actionable ESG standards:

- Firms should be judged according to how well they engage and collaborate with local communities and help to advance values that are considered unalienable today. For example, gender equality may not be in line with some local practices, yet improving on the local norm is a form of corporate citizenship.
- Adhering to ESG standards should strengthen a firm's resilience. While it may raise near-term costs, it should improve the sustainability of its activity and long-term growth prospects. In achieving social standards, recruiting a more diverse workforce requires more training at first but may lead to better performance over time.
- All standards, and approaches to reach them, should align with laws and regulations. There are many areas where governments are best-placed to advance ESG goals. Regulation helps price risk and opportunities where markets may fail to do so: if the negative externality of a deterioration in the climate is hard to value by markets, then regulation, including through carbon-trading rights, helps market participants internalize the costs. For some topics, laws and regulations may not go far enough, and companies' standards may prove more ambitious.
- The investment strategy should reflect the values of asset owners. An ESG framework forces investors and asset owners to reveal their concrete values, minimizing an agency problem whereby shareholders delegate the use of their capital to firms to generate profits for them, without being able to observe the end investments in detail.

With these fundamental principles in mind, it becomes easier for investors to begin to select standards that align investments within an ESG framework.

"If the journey is in many ways the destination, even the roughest navigational charts and sextants can help. The United Nations has identified key sustainability development goals for society and the planet; now these must be translated into actionable measures."

ENVIRONMENTAL STANDARDS

The science behind climate change is widely agreed. More controversial, though, is organizing the regulatory approach. Climate change is a global phenomenon, yet policies are local; this means businesses can shift their emissions to countries with lower regulatory standards and undermine the effort.[4] There are also daunting trade-offs to consider when deciding the right regulatory approach and thinking about environmentally friendly investments:

- Lowering global emissions implies using renewable sources of energy, which often require fossil fuels to build. For these reasons, the Norwegian wealth fund has chosen[5] not to cut all oil and gas companies in its portfolio. Not only are these firms crucial in financing the move to renewable, they themselves are gradually investing in renewables.
- Many energy technologies rely on batteries that deplete the planet of materials that are becoming increasingly rare.
- Renewable energy sources cannot yet guarantee reliable supply.
- Sensitive environmental policies to promote biodiversity can have unexpected consequences. Cane toads were introduced in Australia to contain beetle populations that were destroying cane crops. Unfortunately, the toads were poisonous to larger predators and created an unexpected threat to endangered species like the northern quoll, a rare type of marsupial. There are other examples.[6]
- Rising concerns over the level of toxic chemicals in solar panels and difficulties in recycling the panels.

There are also difficult questions around the economic costs of the energy transition—and who should pay for them. So far, the response has been to put the onus of the adjustment on the advanced world and China, a relatively richer emerging economy, both of which are top CO_2 emitters. Nevertheless, the cost of the economic and social restructuring needed to reach a climate-neutral economy is considerable and some governments are starting to address it by setting financial resources aside to support a fair transition.

FINANCING A JUST ENERGY TRANSITION

The 2015 Paris Accord sets forth a carbon budget of CO_2 emissions of 580 Giga Tonnes before global temperatures rise 1.5°C and trigger accelerated climate consequences, but leaves difficult choices around who should cut back faster. The clock[7] is ticking–few years remain before the carbon budget is depleted.

In many cases renewable energy production is now cheaper than conventional sources, which supports the financial case for transition. However, it remains costly to develop the storage and transportation infrastructure this energy grid needs to ensure reliable power supply. The transition may also create temporary headwinds to growth, which raises the question: what's the best way to allocate the carbon budget across investment projects—and countries?

Such concerns have given rise to solutions for a "just transition" to a climate-neutral economy, especially for those industries and regions that will be hardest hit. The shift away from polluting industries tends to hurt workers and regions that are reliant on such activities for income. As the transition progresses, some mines or refineries and the communities that depend on them may become stranded assets—trapped without proper investment and unable to move.

Governments have been called on to support this process, including by setting public resources aside to compensate the short-term losers. The European Union established a Just Transition Mechanism[8] that requires governments to prepare plans through 2030 that set out the social, economic and environmental challenges stemming from the phasing-out of fossil fuel-related activities and decarbonizing of greenhouse gas-intensive processes. The EU will then provide funding to mitigate the impact and support the diversification of the local economy and retraining.

Measurable investment criteria that take this debate into account to help achieve the environmental standard of a reduction in greenhouse gas emissions might include:

- Improvement in **resource efficiency**
- Contribution to **decarbonizing the supply of electricity** through greater reliance on renewable sources of energy or even nuclear energy
- Progress toward **fuel switching**, including electric vehicles powered by clean energy
- Use of **carbon sinks** through new crop planting or reforestation

There are many other environmental issues, although quantifying business and societal reliance on these unpriced assets and the impacts of their degradation is still nascent.

SOCIAL STANDARDS

There is no one-size-fits-all solution to improve social standards, and there may be even more difficult trade-offs to resolve. For example, in developing countries that lack a viable social security net, parents often have to choose between starvation and sending their children to work. The rights of children, alongside other human rights, are universal and inalienable, but blunt prohibitions on child labor can hurt more than they help; a child may leave a regulated workplace (a factory) and enter a less-regulated, more dangerous one (mining or prostitution). A family may fall deeper into poverty.

In this case, banning child labor is not enough to achieve a positive societal outcome and a comprehensive solution is required, but even this is complicated. Companies should pay workers a living wage so children don't have to work and should consider on-site education and meals for workers' children. These added costs may drive away new investments if low-income countries become uncompetitive, reinforcing the cycle of poverty. Preventing child labor requires a complete approach and, when relevant, accompanying measures to alleviate serious adverse effects.

Similar contradictions arise around policies to support certain racial or social groups, whether U.S. efforts at affirmative action or Malaysia's Bumiputera policies to advance ethnic Malays. An even stronger version applies in India, where the constitution itself grants Dalits (those deemed lowest in the caste system) privileges, including public sector job quotas. These may be well-intentioned, but they are difficult to implement without raising resentment among those who do not get the advantages.

In light of this discussion, there are a number of key social criteria that can help investors narrow their focus:

- The extent to which the **health and safety** of workers and the surrounding communities are supported, especially in large industrial operations. The COVID-19 pandemic has highlighted these concerns.
- Whether firms provide **equal opportunity** to employees without discrimination by gender, sexual orientation,
- skin color, religion, race, geographical origin, age or disability.
- The importance that firms give to offering **training and development** opportunities to retain and advance the workforce and members of the surrounding community. This becomes particularly relevant in industries where technological progress may require fewer workers who will need support finding other work.

GOVERNANCE STANDARDS

In many ways, governance is the start and end point of ESG analysis, including business strategy, incentive schemes and policy. And yet, some academic studies find that there is no clear-cut governance alchemy that leads to better chances of firm viability.[9] The PRI study points to significant disagreements among data providers about what should be measured and how, with the highest discrepancies in ESG scores in the area of governance. The conflicting information on what constitutes good governance shows the importance of fundamental, bottom-up and qualitative analysis, as well as the dangers of an approach that lacks nuance.

Still, the most resilient and successful companies suggest some criteria for governance do matter.

- **Board independence** helps avoid conflict of interest, although government influence in national champions can be considered beneficial. The independence of the chairman and CEO roles is one of the most regularly cited indicators and predicators of strong governance, even if some studies find that the link to company performance is unclear.[10]
- Although evidence regarding the materiality of **board diversity** is inconclusive, recent studies have found positive links between board gender diversity and shareholder returns.[11] As board diversity—by gender, ethnicity, and experience—grows, the links will become easier to explore.
- **Business ethics** is obviously key. It is difficult to measure such an intangible value. Investors often look for reliable whistle-blower schemes as one measure. The presence of anti-bribery and discrimination policies, supported by training programs, is complementary information.
- Strategic goals that ensure **management compensation structures** can include environmental and social sustainability, in parallel to other investments that enhance longer-term business performance.[12]

3. TRANSLATING "ALL MANNER OF GOOD" INTO A SENSIBLE INVESTMENT RATIONALE

Even after investors choose actionable standards to advance ESG goals—and relevant criteria to assess achievements—there are further challenges to address. Investors need to frame the ultimate objective of their application of ESG standards to investment decisions. Many asset managers are motivated by the role that ESG standards play in enhancing financial performance. They pick an ESG framework that helps to achieve higher returns in the longer run. Some are searching for an ESG framework that combines this profit motive with a broader intent to advance shared, universal values. Such constructs remain in their infancy. Some fresh approaches may prove useful.

THE PROMISE & PERILS OF MATERIALITY

A lot of attention has revolved around picking ESG standards that are "material" to financial performance. This concept of materiality means that there are certain ESG factors that have the potential to impact the financial performance of a company or asset, and others that do not. However, it does not mean that financially immaterial factors are ignored. As the first section argues, all investment decisions are implicitly anchored in values. Fundamental, bottom-up analysis will always involve financial analysis. Materiality provides a realistic framework to enable investment professionals to focus their efforts on the ESG factors that have the greatest likelihood of affecting the investment case for a company, while influencing the quality of its long-term growth.

Finding financial relevance is no small task. Good practices adopted by firms may take years to benefit their own performance and translate into societal change. ESG information is also no different from other areas, with a proliferation of data and topics but relatively few that may move the value needle. An investor's strategy depends on several factors, including their philosophy, expertise, resources, and time frame.

There is a growing understanding that the most pressing social and environmental issues are intertwined with long-run economic performance. Efforts made toward these long-run objectives aim to strike a balance between a reduction in risks and an increase in costs. There is reputational risk and some financial risk to a firm that strays from widely-held moral values, but other risks are more directly financial in nature.

The impact of ESG values and standards on long-term financial performance may come from a number of factors.

- Climate change will make operations more challenging if companies do not adopt resilient, environmentally friendly, energy-efficient processes and avoid future regulatory costs.
- Labor standards are growing more demanding. Attracting and retaining talent requires adjusting to what society values (work-life balance, health and security standards, maybe even pay-scale adjustments that close the gap between the lowest and highest paid in some countries).
- Weak governance structures can be costly. Mining accidents reveal weak corporate governance and raise the risk to returns.

But conclusive connection to returns has been elusive.

The early focus solely on exclusions—that is, simply limiting the investable universe by avoiding "sin stocks"—has led to the widespread perception of responsible investing as a value detractor. Some results confirm it;[13] more recent ones find otherwise.[14] Popular wisdom lies with the former, and many have rejected an ESG approach based only on exclusion due to this concern over financial loss.

As for more integrated approaches, it is still early to find definitive empirical evidence that embedding value choices in financial decisions enhances performance unconditionally. Many studies examine the link between good ESG practice and outperformance. An oft-quoted paper finds evidence of the positive impact of good ESG standards on investment over-performance,[15] but the analysis has been criticized for a loose definition of ESG standards.[16] Other studies find that ESG does not detract from performance but requires active engagement to produce continued returns.[17] A sub-group of papers found evidence that governance is particularly correlated with stock performance[18] but that environment standards are not.[19] Some authors find evidence of outperformance for certain select ESG values.[20]

If ESG considerations do not add to performance, they may nevertheless provide downside protection by selecting names that likely would lead to lower volatility in periods of market stress. The correlation between good ESG ratings and low stock volatility intensifies when market volatility is higher.[21]

The relationship between ESG and financial performance may also change over time, reconciling contradictory results. The costs of implementing ESG may first detract from performance—these could stem from investments in time and resources to improve expertise on ESG topics or in production processes that are greener. This may suggest that it is in the longer run only that an ESG approach contributes positively to investment performance, with a J-curve best describing the relationship between ESG and returns.[22]

The materiality framework for selecting ESG as an investment strategy may not be enough. First, the attribution of profit and loss to ESG may remain elusive, for a variety of reasons. Again, adopting good environmental standards implies, for example, investing in the production process and thus a short-term sacrifice in profits. It is over a very long time that firm owners (or their successors) are able to reap the benefits from such cleaner production processes, in particular as humans live in good health for longer. Second, there is no single set of values across systems and times. Good social standards are understood differently across work cultures, and corporate citizenship can be costly. Third, ESG permeates firms' behaviors, and it may be hard to distinguish what is due to specific ESG concerns from what is normal firm behavior, particularly in terms of governance. A related, important issue is the lack of data to measure ESG practices properly.

MATERIALITY & VALUES

In light of the mixed evidence around performance, some industry groups acknowledge the need to apply different criteria to different investments.[23] The reduction of water and power usage may be an important value driver for a mining company, but far less so for a bank. Emission levels matter in manufacturing more than in services, where social practices towards employees and customers can be fundamental to value creation. A broad reduction of exposure to polluters, however, can mitigate regulatory risk.

One approach is to identify a subset of ESG factors that, along with numerous other company characteristics, determine a company's economic worth. The Sustainability Accounting Standard Board (SASB) delineates the topics and data most relevant to different industries, using two key dimensions in the analysis of materiality by sector of activity: financial materiality and investor interest. Weights may vary. The SASB materiality map[24] offers a more sophisticated approach than a narrow focus on short-term profits. It may provide useful guidance to companies and investors on what topics and metrics may be relevant to their financial performance, even if a rigorous connection to investment returns remains untested.

Investors may also still wish to combine financial performance with other objectives as they choose where to invest, which brings the discussion back to the religious and ethical traditions of early investing. Instead of the world's faith leaders offering guidance, direction may be coming from the Big Four accounting firms. They may not offer much counsel on salvation, but they have called for selecting standards that aim also to achieve shared, universal values across industries and firms,[25] highlighting five characteristics for useful ESG standards:

- Widely accepted themes (consistency)
- Clear evidence that they impact value creation (materiality)
- Identifiable improvements and how they can be implemented (actionability)
- Broad relevance across sectors (universality)
- Easy measurability and monitoring (feasibility)

The pool of eligible ESG metrics, in their view, should also be closely aligned with the Sustainable Development Goals, including several values that are often underestimated, like health and safety and community relations.

- **Governance must drive financial *and* societal performance.** It sets a firm's aspirations with regard to protecting the planet and promoting social progress. Economic growth becomes coherent with sustainable growth.
- **Firms must demonstrate a good understanding of, and response to, their environmental impacts, including throughout the value chain of their production process.** Reporting should include science-based targets and clear plans to reduce negative impacts and increase positive contributions.
- **Social standards are a call to protect people, with an emphasis on respecting human capital and its social interlinkages.** This argues for assessing the respect of dignity and equality, health and well-being, and making sure people have the right skills for the future.
- **Alignment of corporate action with the advance of prosperity.** Firms should "protect and enhance assets that contribute to both long-term value creation and to society and the SDGs, even when there is not yet a direct link to financial performance."[26] Criteria may include the number of hours staff spend volunteering in the surrounding community, charitable donations as a share of pre-tax profits, or R&D spending relative to sales.

In addition to these broader industry efforts, some companies are making an effort to align their activities with their investors' values. Even in the most controversial mining sector, managers understand that good values improve long-term performance and reduce risk.[27] In a notable 2019 statement, the Business Roundtable offered a fresh definition for the purpose of a corporation,[28] shifting from an entity designed to serve shareholders to one that is designed to serve all stakeholders: customers, employees, suppliers, communities and shareholders. The statement was signed by hundreds of successful, profit-oriented CEOs, indicating that these businesses are not blind to the writing on the wall—stakeholders and shareholders alike will not be forgiving of bad players.

A POSSIBLE PATH BEYOND MATERIALITY

Some of these approaches suggest a more modern approach to ESG investing allows for the selection of ESG topics and principles that can prove valuable to a company's ability to protect people, communities, and the planet. European and, increasingly, Asian regulators have accepted the inclusion of non-financial ESG factors as essential to proper investment management. The European Union is even planning to make it mandatory for large asset managers. This does not fail the fiduciary responsibility that requires asset managers to put the economic interests of shareholders first, and no investor would select investments they believe would underperform. However, challenges remain. In the United States, the Department of Labor recently proposed[29] ruling out ESG practices for private-sector retirement accounts, considered a threat to profitability.

This section proposes a set of ESG goals that point to the interconnectedness of ESG within the broader sustainability picture. The value framework it represents could help target long-term financial returns and societal aspirations.

The Environmental Imperative

Arresting climate change

The financial opportunities from mitigating the effects and hindering the advancement of climate change will likely be numerous. The reuse of wastewater and development of thermo-solar energy is helping farmers in Israel to grow olive groves and other commercial plantations in the desert. Integrated crop and livestock agriculture, where nearby plantations help absorb the methane from livestock farming, is another example of a reorganized production process that helps fight climate change and is profitable.

Preserving ecosystems

Economic development has depleted the ecosystems within which many communities rely faster than it has replenished them. The biodiversity services that an ecosystem delivers to the economy—among them, flood protection, carbon storage, and pollination—are worth an estimated $125–$140 trillion[30] every year.

A sustainable approach to the regeneration of the ecosystems involves careful consideration of the quality of regeneration, as well as a means to encourage the biodiversity upon which healthy ecosystems rely. For example, in Brazil, converting degraded pastureland to sugar cane fields to produce ethanol provides a clean substitute to fuel while protecting biodiversity and the environment.

Developing the circular economy and showing responsibility along the supply chain

Circular economy principles aim to decouple economic activity from a reliance on single-use materials. Instead, products and production processes are designed to reduce waste and pollution. There may be opportunities for firms to expand economic practices to reduce, reuse and recycle.

The scaling-up of recycling technologies will improve the cost-benefit ratio of this inexorable change in the production process.

The Real Social Concerns

Entrenching diversity and equal opportunity

In addition to providing more workforce participants who can contribute to the economy, equality and diversity can also provide benefits for investing. A diversity of opinion may reveal risks and opportunities not otherwise identified by a uniform, homogeneous group with similar backgrounds. Equality of opportunity in society is best served by government-level action but, together with diversity in the labor force, it can also be addressed at a sector or company level as well.

Improving labor conditions

Business models that rely on modern slavery (or sub-standard working conditions) are not sustainable, and more supply chain transparency is needed. Even larger corporations struggle to provide clear and specific data about the parts of their supply chains managed by third-party contractors, which can prove challenging. But the risks of exposure to a scandal in this regard can be huge.

Beyond human rights abuses, which may only be likely in certain industries, a workforce that is properly compensated and afforded necessary and universal rights is likely to contribute more to the economy without strikes, low productivity and high turnover.

Safeguarding privacy and cybersecurity

In a world that grows more reliant on technology, cybersecurity becomes an increasing necessity in order to avoid legal, reputational and financial risk. Additionally, technology and the Internet, and the convenience and new services they offer, are interwoven with threats to privacy. As regulation and public wariness of tech's reach grows, firms and governments will need to form a more concrete view on the start and end of privacy boundaries on the Internet as well as in a connected society.

The Future of Governance Concerns

Promoting investment in innovation

Innovation is well-understood to be crucial for financial and economic sustainability. It can help reduce costs and spur productivity, supporting economic growth. It also enables the company to adapt to customers' changing needs, creating both economic and social value.

Aligning board composition and compensation with company values

If compensation is linked to long-term strategy, and this strategy is financially, socially and environmentally sustainable, then boards are inherently incentivized to focus on the sustainability of an entity. As with employee diversity, a board with diverse backgrounds and opinions may be more likely to identify a full range of strategic threats and opportunities, allowing for more value creation while aligning with a set of values that benefit society as a whole. Some companies[31] are already moving in this direction.

Focusing on Stakeholder Management

While shareholder primacy was once dogma, stakeholder capitalism and similar concepts are becoming popular. Companies and investors have understood the importance of the customer, employee, and civil society groups in realizing financial returns. Technology has led to greater transparency, with society able to gain more insight into the behaviors of investments and investees, and the ability to highlight perceived good and bad practices. The ability of users to easily exchange views and feedback via social media, and the interactive dynamics it offers to stakeholders, has opened a new era of communication that may help expose where values could be better aligned. Stakeholder perception and lobbying has led to outcomes ranging from regulatory changes to police investigations to product boycotts.

CONCLUSION

Investors want to make a profit and a difference, and many have been adopting an ESG framework to do so, even as they struggle with standards on how to score companies. The challenge is real, not only to identify values that are compatible with investment performance, but also to identify those that societies hold highest.

Investors may not be aware that their livelihood has long been engrained in ethical and values-based systems. This also explains why finding a consensus on standardized ESG values is so demanding. Values are rooted in local tradition, history and beliefs, including religion. It is likely that establishing what values matter remains a dynamic process. There will never be a perfect approach to ESG investing, but investors should expect to make continuous efforts to incorporate evolving values into a framework of rising standards.

If the journey is in many ways the destination, even the roughest navigational charts and sextants can help. The United Nations has identified key sustainability development goals for society and the planet; now these must be translated into actionable measures. The growing involvement of the private sector reinforces the effort considerably. Firms are now trying to advance proposals for a framework that attempts to be consistent across cultures, meaningful for company performance and economic growth, and actually feasible to implement. It's a tall order.

When beliefs help turn society's core values into standards and criteria that shape an investor's decision, a framework can help target both long-term financial returns for shareholders and environmental, social and governance goals for society as a whole. Looking further ahead, a focus on impact matters. Investment teams can choose the criteria they define to achieve the values important to them and their clients, and align their portfolios with those values. In picking the strategy, they should make themselves accountable for their impact. If the next decade follows the last one, environmental and social impact will increasingly exist alongside financial performance as a measure of their success.

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I would like to thank my Barings colleagues Amadea Bentheim and Sarah Munday for their insights and contributions in developing the argument in this paper. In addition, I am thankful to the Institute's Christopher Smart for his helpful comments to sharpen the message and Michael Henry for great editorial support. I benefited from insightful feedback across the firm, including from Ghadir Cooper, Marios Halloumis, and George Pell.

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