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Q&A Talking Research

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ESG in Need: Beyond the ‘Good Karma’ Lens

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ESG investing has come to be known as the integration of environmental, social and governance factors into fundamental investment analysis and decision-making. The term "ESG" was first coined in a 2005 study called "Who Cares Wins", while the United Nations Principles for Responsible Investing (PRI), set up in 2006, brought ESG issues to prominence for financial valuation. Recognized as a distinct class of "sustainable investing", ESG investing has reached nearly USD23 trillion in managed assets, representing a quarter of the USD88 trillion in AUM globally.[1] In conversation, Jason Hsu uncovers some of the myths – and value – of ESG investing.

Q: Why does ESG matter?

At its core, ESG investing is about either (1) expressing a value judgment through one's investment decision or (2) influencing firm behaviors through one's investment activities.

Expressing a view in one's portfolio is generally relatively straight-forward. What is more difficult is to influence a firm's behavior. Not buying shares in a company which manufactures fighter jets has relatively little impact on the firm's actual business decisions. To meaningfully influence a firm's business decision, you will need to either be a significant shareholder or a significant customer.

Today, most ESG investing is largely about expressing a view that's consistent with the key stakeholders' value system. Religious organizations would exclude "sin" stocks (and each religious institution would define sin stocks differently); labor organizations would favor firms with better labor practices; many government pensions tend to favor firms with emphasis on greater inclusion of disadvantaged minorities or are working on "green" technology which helps toward preserving our environment.

Q: ESG principles first came to the fore 10-15 years ago. When and how did ESG investing start to matter to a notable portion of the market?

ESG investing has become more in vogue in the past five years. Part of this may be driven by an on-faith belief, supported by shallow anecdotal evidence, that investing in ethical companies (high ESG companies) must lead to better investment outcome. You could call this belief the "good karma" principal in investing.

[1]Sara Bernow, Bryce Klempner, and Clarisse Magnin, **"From 'why to 'why not': Sustainable investing as the new normal,"** McKinsey & Company, October 2017, https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal; Amy Whyte, Institutional Investor, "McKinsey: ESG No Longer Niche as Assets Soar Globally", Oct 27, 2017.

The underperformance of big oil companies and traditional automakers relative to the spectacular performance of Tesla have certainly contributed to this belief system.

Incidentally European pension funds and now Japan's Government Pension Investment Fund (GPIF) have been the most vocal when it comes to supporting ESG investing.

Q: ESG investing still feels like an emerging practice in its "take-off" stage. What are the common findings in ESG investing so far?

While ESG investing is now widely discussed, its adoption lags the expressed public interest meaningfully. The key reason is concerns about potential negative impact on the investment result.

While some investors may be okay with a decrease in portfolio efficiency resulting from ESG exclusion or a concentration in ESG themes, most pension organizations do have a primary mandate in producing returns for their stakeholders.

The good news is that empirical research mostly supports a conclusion that ESG-based portfolios don't perform worse than a non-ESG-based portfolio over time (historically). There is unfortunately also no evidence that corporate good karma results in better stock price performance over time.

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Q: Does ESG investing, in fact, lead to outperformance, vis-à-vis investing in non-ESG firms?

The more comprehensive and more rigorous research, my own recent paper included, do not find evidence of ESG outperformance. In fact, what we find is that the average high ESG firm does not produce very different returns over time versus the average low ESG firm.

Q: What piqued your interest in conducting research on ESG investing?

I am an idealist. I would like to find a way to express my value system in the way I invest and also get better returns. Basically I want my cake and eat it too.

Q: What is ESG in need?

ESG in need is the next evolution in responsible investing. It is investing in ESG firms with the highest costs of capital. These are the ESG firms that can't invest in all their great ESG projects due to insufficient funding. Luckily for the investor, these firms also have high expected returns.

Q: What makes Rayliant's research on "ESG in need" a novelty – how does it differ from other research on ESG investing?

The Rayliant "ESG in need" investing focuses on identifying ESG themes and firms that aren't getting enough publicity and, therefore, receive little "love" from the capital market. Let's say, for example, if solar energy companies have captured investors' imagination and attract substantial investment capital, then solar becomes an ESG initiative that is fully supported with ample market funding. That leaves less reason for true ESG investors to rush into a crowded trade.

At the same time, other alternative green energy sectors such as wind or biofuels may have no support from the capital market, making it hard to raise money to support more research to improve output and cost efficiency. This then represents a real opportunity for ESG investors to make a difference. We could bring about other viable alternatives to fossil fuel-based power by investing in the largely ignored green energy sectors other than solar.

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If we continue with the solar theme, we might say it was once a case of ESG in need that developed into a sector far from "in need" given its over-investment. Its global new investment ranked third in 2006, behind wind and biofuels, and took just five years to eclipse that of all other green energy sectors combined by 2011.[2] During that period, the sector's stock market value also began to shrink. Solar indexes that saw a boom in the early years after inception dipped sharply, with some dropping to values today as low as 95 percent below their peak in 2007.[3]

Over-investment in a popular ESG theme, like solar power, in turn led to an overproduction of solar panels, preventing each dollar from doing as much good as it could have done in another less loved ESG project at the time, such as wind or other clean energy sectors.

The important investment question is whether investing in the popular ESG firms who can access capital from Wall Street easily would result in better or worse investment returns versus investing in the neglected ESG firms who are in need of capital? Our research shows definitively that investing in those ESG firms in need delivers meaningfully better returns over time.

Q: In your research, how do you distinguish ESG firms "in need" from ESG in distress? In turn, how do you distinguish irrationally high costs of capital (ESG in need) versus rationally high costs of capital (in distress)?

How might one identify an ESG firm in need? We can simply look at cost of capital. A popular well-funded firm usually has low cost of capital—it can borrow easily and can raise equity capital effectively selling shares at high prices. A company in need almost tautologically has to face a high cost of capital. The million-dollar question

[2]Bloomberg New Energy Finance (NEF), Jonathan Gardiner, "Clean Energy Investment Trends, 3Q 2018", Oct 6, 2018, https://data.bloomberglp.com/bnef/sites/14/2018/10/BNEF-Clean-Energy-Investment-Trends-Q3-2018.pdf.

[3]Bloomberg data, World Solar Energy TR Index values from Dec 31, 2003, to Nov 6, 2018.

is whether an “in-need” company is actually running a bad business and faces financial distress. Investors probably prefer to support an ESG firm that is only temporarily “in need” of capital to propel it to self-reliance and success, rather than one that has a bad value proposition or is operationally incompetent.

> *“The million-dollar question is whether an ‘in-need’ company is actually running a bad business and faces financial distress.”*

So it is very important that we differentiate ESG firms that are truly in need and can be helped versus those that are structurally distressed and likely bad investments. To do so, we must look at other firm characteristics such as quality of cash flow, debt outstanding, productivity, among others.

Q: How can investors go about applying Rayliant’s research on ESG investing?

I would suggest investors take a more nuanced approach to ESG investing if they wish to express their values in a way that’s both more “helpful” and profitable. The way to do that is to invest in high ESG firms that face high cost of capital but are otherwise not distressed or poorly run.

Q: Where would you place China and Asia’s other key emerging markets along a development timeline for ESG investing? How receptive are their investors to ESG investing?

China and other parts of the emerging market have also recently latched onto ESG investing as a theme. This is unsurprising as emerging Asia has historically been a very fast follower when it comes to adopting innovations. However, it is very early days, and we have not seen much in ways of assets.

> *"Fast progress in sustainability and governance among Asian companies may offer some tailwind for the rise of ESG investing in the region."*

Fast progress in sustainability and governance among Asian companies may offer some tailwind for the rise of ESG investing in the region. In terms of corporate responsibility and sustainability reporting, large Asian companies, with 49 percent, once lagged those from the Americas and Europe (69 and 71 percent, respectively) in 2011.[4] But they have caught up in just six years, reaching 78 percent by 2017 and achieving parity with their American and European counterparts (83 and 77 percent). If this trend spills over to other areas, as already seen in regulatory requirements, then there is yet promise for ESG investing to make a larger impact in emerging Asia.

Q: How would China and other EMs in Asia stand to benefit – both their markets and investors – once ESG investing finds traction in the region?

I would love to see investors in China and other EM countries and in fact globally to really take a strong stance on ESG issues and then express those values in how we invest. It is a beautiful thing when one is able to align investing, which is generally quite a soulless and mercantile pursuit for more money, with positive values.

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[4]The KPMG Survey of Corporate Responsibility Reporting, 2011 and 2017 reports

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