Sustainable Investing for Institutions

A Case Study

By Chris Matteini

Sustainable investing is at once intuitive and confusing; it seems like the right thing to do, but there are many different ways to do it. It promises a contribution to solving global issues, but perhaps at the expense of investment returns. It represents new risks, opportunities, and ways of doing business in a rapidly changing world of finite resources. At TIFF Investment Management—a not-for-profit outsourced CIO firm managing approximately $9 billion on behalf of roughly 600 not-for-profit member institutions and this author's employer—environmental, social, and governance (ESG) research is one component of the manager selection process.

Investors need not bear the weight of the world to implement an effective sustainable investment strategy and make a difference through thoughtful capital allocation. Sustainability issues are business issues that affect corporate value, and investment analysis must consider ESG information to be considered complete; for example, energy use is a cost, and different sources of energy present different risks. Poor supply chain management, including the use of child labor, can destroy a brand. Diverse and independent boards are often more effective than homogeneous and intertwined ones.

The sentiment around business practices as they relate to environmental, social, and human capital is changing; business models are adapting to this, and ESG issues are increasingly becoming business issues. But not all ESG factors affect all industries, and decision-useful ESG data is still relatively hard to come by. There is no widely accepted domestic or global standard for corporate reporting of ESG information; therefore, not all companies report, and those that do use disparate approaches. Many investment managers incorporate some form of ESG into their research processes, but not necessarily in very thoughtful ways.

That said, the sustainable investment movement, in its different forms, has tremendous momentum. By the end of 2016, global negative/exclusionary screening assets under management (AUM) had ballooned to approximately $15 trillion, ESG integration AUM had risen to over $10 trillion, and corporate engagement/shareholder activism strategy AUM was over $8 trillion (Global Sustainable Investment Alliance, *2016 Global Sustainable Investment Review,* http://bit.ly/2MRLRCu). The United Nations' (UN) Principles for Responsible Investment (PRI) signatories, of which there are over 2,000, manage $81 trillion in aggregate AUM (UN PRI). The EU Nonfinancial Reporting Directive represents a critical step in the history of capital markets. UN Sustainable Development Goals (SDG) and the UN Framework Convention on Climate Change Paris Agreement are but two examples of international cooperation aimed at solving ESG problems.

Still, while institutional investors may believe in these initiatives, the concerns of investment execution and performance remain. TIFF's members, for example, have annual spending rates typically between 3% and 5%; their portfolios need to achieve real rates of return in line with those targets in order to support their missions while maintaining their purchasing power. Furthermore, investors may accept that ESG factors affect corporate value and are thus relevant to achieving performance goals, but there is still no standard framework for measurement or comparison across industries and companies. The Sustainability Accounting Standards Board (SASB) offers an excellent ESG reporting framework, but no one is required to use it. The EU Nonfinancial Reporting Directive is mandatory for approximately 6,000 large companies in Europe but provides a great deal of flexibility to corporations in terms of what they disclose: "relevant information in the way they consider most useful" (Robert G. Eccles and Mirtha D. Kastrapeli, *The Investing Enlightenment: How Principle and Pragmatism Can Create Sustainable Value through ESG,* State Street Corporation, 2017, http://bit.ly/2tJYkQi).

The current lack of ESG reporting standardization presents both investment risk and opportunity. The risk is in not fully understanding investment vulnerabilities associated with ESG factors; the opportunity results from information asymmetry. For example, the total share of global greenhouse gas (GHG) emissions that fall under a carbon pricing regime (e.g., carbon taxes, cap and

trade) increased from less than 5% in 2005 to roughly 13% in 2016. The number of laws and executive acts related to climate increased from just over 200 in 2005 to 1,200 in 2016 across 124 countries (Generation Investment Management, *2017 Sustainability Trends Report,* http://bit.ly/2KnMoxK), and these numbers are likely to rise. An analysis of companies with material exposure to carbon and climate-sensitive regions would be incomplete without an understanding of the costs of emissions and regulatory compliance, which is not standardized. Those investment managers who do the work to cover this information gap will have an edge.

TIFF's ESG Process

As stated above, TIFF believes that sustainability issues are business issues. ESG factors can affect direct costs (e.g., energy use and sources), revenue (e.g., increased demand for sustainably-manufactured products, decreased demand for non–sustainably manufactured products), assets (e.g., stranded coal plants), liabilities (e.g., lawsuits related to environmental degradation or poor labor practices), and cost of capital (e.g., higher for companies with physical assets in locations exposed to rising sea levels, increased storms, increased drought). ESG information, while spotty at the moment, is simply additional and relevant information that should be incorporated into comprehensive business analyses.

TIFF has a process for testing managers' understanding of sustainability trends and ESG factor impact. This process goes beyond asking for and reading ESG policies, which, if they exist, can be misleading at times. It begins with a line of questioning designed to assess how managers think about and process ESG information generally. One of the first questions is, "Do you have a formal ESG policy?" This may sound simple at first, but implied in this question is another: "Why or why not?" This can lead to a robust conversation about the manager's philosophy around sustainability, ESG, climate change impacts, and other matters. TIFF is not dogmatic about requiring formal ESG policies. Far more interesting is the why or why not and the myriad questions that result. For example: Formal ESG policy or not, do you consider ESG factors when evaluating businesses? If no, why not? If yes, how and when in the process? Who is responsible/accountable? How do you determine which factors are material to corporate value? Can you provide an example of how ESG factors have impacted an investment decision? This delves into the manager's process, creating an opportunity to add value to that process.

TIFF has several dozen questions related to general ESG philosophy and process. Not every manager is asked every question; rather, they are asked what TIFF considers to be material, depending on the manager, and their answers are tested through a discussion of specific investments. It is easy to write a formal ESG policy that states one believes in the importance of analyzing various forms of capital; the proof is in the actual incorporation of ESG information into business analysis. Questions that test for this include: What is the energy intensity (unit of energy per unit of output) of Company A, and what are its sources? What is Company A's exposure to climate risk, and how did you determine this? Has Company A experienced labor issues? Does it have a diversity policy? What is the composition of the board? Is management compensation tied at all to ESG metrics? Again, these are examples from a longer list, asked depending on what is material to the company in question.

There is no one right way to integrate ESG. Some managers with glossy ESG policies may not always practice what they preach; others without formal policies, who may not even know what ESG stands for, incorporate ESG information naturally as one component of a thorough due diligence process. Managers who avoid certain industries because of obvious negative environmental impacts (e.g., mining) may fail to recognize the less obvious impacts of the industries in which they invest (e.g., consumer products, via product life cycles). Managers who do invest in mining companies—the world will need metals to meet sustainability goals; think electric vehicles—may have robust processes around partnering with the most sustainable of these companies or engaging with management to improve sustainability performance, with the belief that this may improve a company's bottom line.

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Avoiding Simplistic Thinking

All of this emphasizes the importance of testing what is said and written. It also highlights why TIFF employs ESG research as one component of its manager selection process and not the dominant driver. TIFF's primary goal is to find managers with competitive advantages and strong alignment of interests.

Negative/exclusionary screening is effective in aligning investments with a set of values. TIFF subadvises a negatively screened portfolio adhering to United States Conference of Catholic Bishops (USCCB) guidelines. Because negative-screen investing is fairly easy to implement, it often does

not in itself offer an opportunity for significant investment outperformance, unless one believes that the excluded companies will underperform over the long-term. Certain underlying managers in other TIFF products do in fact avoid certain types of businesses, not because of a mandate to do so, but because they view these businesses as unsustainable by virtue of the fact that they sell products that harm their customers or the environments in which they live; however, while negative screening serves an important purpose, it is not a primary source of investment competitive advantage.

Positive screening, or investing only in those companies that score highest according to some ESG ranking methodology, also has a low barrier to entry. The vast majority of managers TIFF has met with who use positive screens use data or employ a methodology developed by a third party. This is herd thinking by definition, and certain ranking methodologies can be subjective and flawed. Impact investing is compelling for many reasons, but it is also highly idiosyncratic and a fuller discussion of it is outside the scope of this article. Shareholder engagement can be effective, but TIFF does not view this as a separate strategy, but rather as an extension of strong active management with long-term horizons.

An additional component of TIFF's ESG process is monthly ESG committee meetings attended by senior members of the investment team, representing all asset classes, and professionals from other groups within TIFF. All manager interactions related to ESG are documented, and an ESG section is included in all investment memos, which are submitted to the investment committee and the board. There is regular dialogue with SASB—TIFF CIO Jay Willoughby is on the board of the SASB Foundation—and the development of ESG frameworks and regulations are tracked. TIFF investment staff attends conferences, not only on sustainable investing, but also on industries that are experiencing and driving sustainability-related change.

This last point speaks to what is perhaps the most important thing TIFF can do when it comes to sustainable investing: partner with investment managers who have competitive advantages based on an understanding of industry changes driving the sustainability movement globally and the different businesses solving global issues. Managers will not find these businesses using negative or positive screens, but through excellence in investing, primary research, and a deeper knowledge of how ESG factors affect corporate value. ❑

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