Sustainable investing – challenges and best practices

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In the midst of nearly unprecedented market volatility, sustainable business practices are proving their mettle. Companies with strong stakeholder relationships, a deep commitment to employees, smaller carbon footprints and a longer-term focus are weathering the downturn significantly better than those without such standards. While no one would have chosen these particular testing grounds, the results are clear: sustainability has real-world consequences.

Industry-wide, however, approaches to ESG investing are currently overly generalized and inconsistent. Despite progress made toward recognizing the need for sustainability, the path to implementing an ESG investment approach is still strewn with performance, cost and suitability hurdles. The lack of consensus around a definition of ESG is confusing. Inconsistent methods of measuring ESG attributes also make it difficult for asset owners to enforce strict criteria. As a result, asset owners are hard-pressed to choose sustainable investments that actually meet their ESG goals, as well as their fiduciary duties.

At QMA, we applied 40+ years of quantitative investment experience to help solve these problems. Our framework **Evaluates, Expands and Integrates ESG** exposures in a process that (1) is transparent (2) does not compromise performance (3) is flexible enough to accommodate investor ESG preferences. Our customized approach offers ESG exposure at the same price point as non-ESG offerings across the risk-return spectrum.

Evaluating ESG

QMA uses an ESG framework developed by the Sustainability Accounting Standards Board (SASB) to evaluate ESG. Several features make SASB's framework attractive. To begin with, SASB's framework focuses solely on material issues that are important within certain industries. It is also highly transparent in terms of decision-making. The method SASB uses to determine the importance of each ESG issue is clearly delineated, so asset owners know exactly what they are investing in. Lastly, it is globally relevant, providing intuitive exposures to investors in all regions around the world. This framework does not reflect a predominance of views from policymakers or standard-setters in any one region.

In addition, we use a combination of effort and action-based metrics in our evaluation process to minimize exposure to ESG traps and the performance drag that is associated with them to help us avoid ESG "window dressing."

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Expanding ESG insights

A great deal of ESG data is still voluntarily disclosed and incredibly sporadic. Some items, mainly about companies' own practices and performance can be difficult or impossible to determine. To help solve for this, QMA uses a proprietary data completion methodology to expand ESG insights. Stock-return similarity helps us identify additional firms that are "good" or "bad" from an ESG perspective. Our research shows that the performance of firms we infer to have positive or negative ESG characteristics is comparable—if not stronger—than it is for firms with actual ESG data. This technique can also be applied to make inferences on individual ESG issues, which helps us address varying ESG preferences investors may have.

We are also actively researching approaches to supplement our data completion methods, such as Natural Language Processing (NLP) techniques, which also allow us to extract insights from various forms of unstructured data. We can create custom rules to search for insights relating to any ESG issue—another method of expanding ESG insights for client customization.

ESG integration

QMA uses a substitution method for ESG integration. Risk and alpha exposures in our ESG portfolios are the same as in non-ESG portfolios. They differ solely on ESG attributes. If all risk and alpha exposures are identical, the original performance objectives of a strategy remains intact.

We can also implement this substitution effect to target a specific level of ESG exposure, calibrated to suit investor preferences. That is one of the most compelling arguments for our framework: our approach to ESG integration allows investors to add ESG at any level to any investment strategy. At QMA, we believe that there is no one-size-fits-all ESG solution. Our customized offerings reflect that belief in a client-directed product lineup.

Conclusion

Many available ESG solutions fall short of asset owners' needs from ESG strategies and often require significant compromise either in beliefs, costs, or both. QMA's approach to ESG is rigorous and systematic. We provide transparency into both our exposures and the methods we use to measure and report ESG metrics. We do not expect clients to accept a performance haircut in order to invest sustainably. Nor do we expect clients to fit their specific ESG needs within predetermined guidelines. In our approach, QMA's investment professionals **Evaluate, Expand and Integrate** customized ESG exposures into equity portfolios across the risk-return spectrum—all at the same price point as non-ESG offerings.

We continue to evolve our ESG evaluation, expansion and integration methodologies, through extensive research into ESG factors that we expect to reduce portfolio risk, and/or improve returns. QMA's ability to evolve and adapt our thinking in this arena further reflects the importance of an active approach to ESG investing.

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