An "ESG" smell test to separate the wheat from the chaff

"Asset managers should reallocate at least 30% of their 'Responsible Investment' marketing budget to internal ESG training for portfolio managers to avoid awkward situations."

-CIO, French asset owner
United Nations Principles for Responsible Investment Panel, Paris, April 2018

Sebastien Thevoux-Chabuel
ESG Analyst / Portfolio Manager

Looking at the number of press releases regarding funds being launched, or relabelled, as "sustainable" or "responsible", there is little doubt that "Responsible Investment" (RI) has become a significant trend in the industry over the past 18 months. Isn't it therefore fair to wonder if those in our industry are in danger of promising too much or outright misrepresenting their ESG records? What would the repercussions be if investors believe that companies are "greenwashing", i.e. portraying their products, activities or policies as environmentally friendly when in reality they are not[1], in order to appeal to a growing segment of their customers? One clue may be found in leaked news from *The Financial Times* that the United Nations Principles for Responsible Investment (UNPRI) recently compiled a non-public list of 185 investors that could be excluded from their signatories due to potential greenwashing[2].

Based on Comgest's bottom-up analysis that we use to assess the authenticity of a corporation's corporate social responsibility (CSR) strategy, we offer the below hints to help asset owners and other investors with their own research.

Firstly, in assessing the Responsible Investment (RI) strategy and the environmental, social and governance (ESG) performance of an asset manager, we recommend using the *"smell test"*, which simply means asking yourself: *Does this RI strategy makes sense in the context of everything else the asset manager does and reports upon?*

You can then start forming your opinion by asking the portfolio managers and financial analysts – not the ESG specialists – questions such as: *Why are you doing all of this? What's in it for you?* These basic inquiries may be answered very differently by people within the organisation, without anyone providing the true answer: to grow their assets. Another round of open questions could be, *how does this fit into your financial investment process? Can you provide evidence of your ESG impact? Will I get any financial returns from this?* Once you have their answers, you can begin to ask more precise and targeted questions, which should be responded to with numbers.

If truth be told, most ESG considerations do not show financial materiality for a few quarters. They generally start to matter over three to five years, or more, and just a handful of asset managers can afford to think over such long time-frames. Comgest would argue that claiming to integrate ESG and holding companies on average for a year or less does not make sense. Asking about the portfolio's turnover is a good start towards assessing an asset manager's candour on how material ESG is to improve the risk-reward of his or her investments.

In a similar manner, if ESG integration is so beneficial to the returns of their socially responsible investing (SRI) funds, then why would ESG integration not be systematically deployed across all funds of the firm and only to their SRI product line? Does this not risk a breach of fiduciary duty?

Regarding a company's investment process and research, one telling question to ask is how the asset manager sources its ESG research. Is it mostly internal research or via external ESG research providers? In our experience, there is no substitute to internal research if ESG is considered critical, just as it would be extremely difficult for a truly active manager to use only broker research without some internal expertise to form one's own opinion and actions.

In discussing engagement with companies, you should ask what an asset manager has done, or is doing, and what proved effective. Our smell test would be to ask, *on what percentage of owned companies have you cast voting instructions?* It is always surprising to hear from investors they engage with companies (in our view, usually in an opaque manner and with little effect in the end), but they only vote on a rather small percentage of annual general meetings (AGMs) in which they could vote. To us, one of the first responsibilities of an investor is to vote. Indeed, an investor's voting right can send a strong signal or even force change through the board, particularly when a vote is exercised with a clear explanation for its rationale. To assess how engaged an asset manager is through their voting activity, another relevant query would be, *what is the percentage of votes cast against management and the board, and on what types of items?* To assess how responsible the voting activity is another query could be, *what is the percentage of votes that follow your voting policy?* In our experience, no matter how sophisticated a voting policy may be, there will always be instances where it should not be applied due to the respective circumstances of a given company. Depending on the case, the vote may need to be stricter or looser than what the voting policy recommends. In our view, investors that vote 100% in line with their voting policy may be at risk of voting irresponsibly. That said, it is our view that in most cases voting at AGMs and company engagement should go hand in hand.

Consequently, investing responsibly and sustainably should in theory result in portfolios that are rather different and in a better position than comparative benchmarks in terms of various ESG metrics such as carbon footprints, net job creation or tax rates that companies in the portfolio pay versus their taxes owed. If the portfolios do not meet these "responsible" characteristics, then doesn't it stand to reason that the portfolio may be greenwashing?

FOOTNOTES

[1] Read more: Greenwashing. Investopedia. 09 Jul 2018.

[2] Thompson, Jennifer. "UN responsible investing body threatens to kick out laggards." The Financial Times. (subscription). 28 May 2018.

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