STATE STREET GLOBAL ADVISORS

POST-CONFERENCE BRIEF

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The evolution of ESG investing: From exclusion to integration and finding alpha

At first, investing with an environmental, social and governance focus simply meant not buying certain stocks, such as tobacco or gaming companies. And for some investors, adoption of ESG is still hampered by a lack of understanding around how to incorporate it into a mandate. But for many, the idea of ESG integration is starting to take hold.

"Integration is probably the most broad use of ESG, because it becomes one of the components that we look at when we decide whether a stock is an attractive investment," said Anna Lester, vice president and senior portfolio manager of U.S. active quantitative equity at State Street Global Advisors.

"When you have, for example, exclusionary screening, what happens is that you can't own certain stocks, and that can affect the returns of the portfolio," she said at a recent *Pensions & Investments* ESG Investing Breakfast Briefing. "But it also means you don't have a voice with that company because you're not one of the investors. With integration, you may own some stocks that are less attractive from an ESG point of view, but you're making that decision knowingly. You have a methodology where you know exactly what the ESG issues are, so you can engage with the company."

Lester added that integration is not about being an activist investor. Rather, it's about being able to have a conversation with a company's management team "to understand why they're lagging, make them aware and give them the opportunity to improve."

As a quantitative portfolio manager, Lester analyzes a number of factors about a company before deciding whether or not to buy the stock, and ESG is now one of those factors. The team has found that including ESG in a list that is mostly financial — balance-sheet metrics, valuation, growth prospects — makes good investment sense. Adding ESG to the mix has proved to increase the chances of improving investment return over time.

What's more, academic research has shown that companies that are not paying attention to relevant ESG issues are riskier, have higher cost of capital and are more likely to be involved in a scandal or impropriety. Lester said that intangible factors — metrics that are difficult to evaluate through a financial statement — are becoming more important to investors and other stakeholders such as suppliers, employees and regulators.

"ESG falls into this category," she said. "Is the company prepared for climate change? What are its policies on cybersecurity? It's hard to quantify that. But we know these are really important issues companies should be thinking about."

The reason Lester and the quantitative group at State Street Global Advisors have been able to integrate ESG into their model is the availability of data.

> "The problem is not how to add ESG into the portfolio because it is popular, [but] how do we identify high-quality management that has a very long-term focus on sustainability.

"Data is probably the No. 1 issue in ESG," she said. "The data is not perfect, but we're right at the point where we have enough data to start to make inferences about ESG as an investment strategy. We took ESG through the same research process we take every other factor, whether value or other quantitative metrics. We treat ESG like we treat any new sources of information."

With enough data, Lester and the quantitative equity team were able to run it through their five-step process to test its veracity and whether ESG could, in fact, be added to the mix of other factors they analyze when deciding whether or not to buy a stock.

The five steps include:

- Identify an investment problem
- Develop a well-informed, testable hypothesis based on strong economic rationale
- Identify an effective method and relevant metrics to test the hypothesis
- Build the model and test the hypothesis
- Incorporate the signal into the stock selection model

"The problem here is not how to add ESG into the portfolio because it is popular at the moment, [but] how do we identify high-quality management that has a very long-term focus on sustainability of the firm," Lester said. "Because ESG manifests itself across a long time horizon, we felt it would be a good place to look for that information. And rather than going to an ESG rating agency, we chose to use the raw data and build our own ESG evaluation."

In terms of the economic rationale, she said that as a quality metric, ESG has fairly low correlation with others, such as those from a company's financial statement, which adds a diversification dimension to ESG. As for metrics specific to ESG, there are general factors applicable to any company in any industry, as well as specific factors for each industry.

"We linked down to the raw data and identified the metrics by industry that we thought were most relevant," Lester explained. "The way we look at a pharmaceutical company is very different from how we look at a real estate company.

"That is what's so fascinating about ESG right now," she added. "When you look at older research ideas, they had mixed results because the analysis was not done in an industry-specific way, because we didn't have that level of granular data. Now that we can be this granular, we've moved into the realm where ESG can generate returns."

The ESG metrics do not drive the stock-selection process, but if two companies have similar non-ESG metrics, those metrics can tip a decision one way or the other, Lester said.

"We want ESG enhancing the other components," she said. "Test results show that companies with the worst ESG scores underperform, but being the best player doesn't necessarily make you the highest returner."

Ultimately, the goal is to improve the performance of the portfolio. Putting ESG metrics through the five-step process is simply what Lester and the quantitative equity group do with any other factor. "It passed the test," she said.

Once ESG as a valid metric was established, however, the question reverted back to the definition and what clients expect from an ESG investment.

"Clients have to define how they want to incorporate ESG," Lester said. "They should understand that integration is different from exclusionary screening, and if a company is cheap and all the other metrics look good, we are likely to own it no matter its ESG rating. The client has to decide whether ESG as a component of the stock evaluation is enough or whether their constituents are demanding a stronger ESG statement.

"To the extent that asset owners can identify what their goals are," she said, "we freely admit to them we're doing integration, and if they need impact investing, that's not what we're providing. We can do it. We have clients for whom integration isn't enough, so they'll ask us to do exclusionary screening on top of that. We're happy to do that and to work with clients to meet their goals, but they have to define those goals." •

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