

## ESG – Understanding the term

### Introduction

The global market for Environmental, Social and Governance (ESG) ETFs has grown more than eleven-fold since January 2016, reaching US\$68bn across 293 funds globally in February 2020.<sup>1</sup> The popularity of passive investing coincides with rising demand from investors seeking to invest in companies with sustainable business strategies. We believe that investor demand, growing market awareness, and new guidelines for sustainable financial products will continue to drive growth, supported by a view that ESG factors are financially material and can, alongside traditional financial analysis, be good indicators of corporate performance.

### What is Sustainable Investing and ESG?

Sustainable investing is an investment philosophy that incorporates ESG factors alongside financial considerations in the investment decision-making process. Sustainable investment products have grown significantly over the past decade, with investment opportunities spanning equity, fixed income, private equity, and the passive investment space. Between 2016 and 2018, dedicated sustainable investment products grew by 34% to reach US\$31tn in global AUM.<sup>2</sup>

There are many different investor approaches to ESG and we highlight four of the most common sustainable investing strategies below.

- **Exclusionary screening** represents one of the earliest approaches to ESG and is also known as responsible or ethical investing. Investors use an exclusionary approach to avoid certain companies or sectors that conflict with the investor's values or are associated with increased ESG risk. The practice began in the 1960s as some investors began to exclude stocks or industries from their portfolios based on business activities, such as tobacco production or involvement with certain political regimes.<sup>3</sup>
- **ESG integration** refers to the practice of systematically incorporating ESG factors alongside traditional financial analysis and is grounded in the belief that sustainability metrics can provide valuable insight into corporate performance. ESG integration is growing at a faster rate than exclusionary screening, and in asset-weighted terms, is now the most popular sustainable investing approach in the United States, Canada, Australia, and New Zealand.<sup>4,5</sup>
- **Thematic investing** involves investment in broad sustainability-related themes, such as renewable energy, water and waste management, or gender diversity. Approaches to thematic investing are varied and can involve funds or single stocks, multiple or single themes, and active or passive strategies.
- **Impact investing** refers to targeted investments that are aimed at achieving a positive social or environmental impact while generating a financial return. Frameworks such as the UN Sustainable Development Goals (SDGs) can provide investors with a way to monitor the positive social or environmental impacts of their investments.<sup>6</sup>

### Why Do Investors Care About ESG?

One claim that has been advanced against sustainable investing centers on the idea that an ESG-driven strategy comes at the expense of returns. However, evidence to the contrary is rapidly stacking up.

BlackRock posits that strong performance on key ESG factors is a proxy for operational excellence, and studies by MSCI have found that stronger ESG performers are associated with higher profitability, lower exposure to tail risk, and lower cost of capital.<sup>7,8</sup> At the same time, other studies have shown that weaker ESG performers have a higher cost of capital, higher volatility due to controversies and ESG-related incidents such as environmental spills, corporate fraud, and other governance irregularities.<sup>9</sup>

ESG as an investment strategy largely rose to prominence during the most recent bull market, raising questions of how this investment approach would perform during an economic slowdown. Early indications suggest that ESG is outperforming during the COVID-19 crisis. Recent research from RBC Capital Markets found that on a sector neutral basis, S&P 500 companies with better overall ESG risk profiles outperformed those with worse ESG risk profiles during the recent stock market drawdown. At the sector level, companies with better ESG risk profiles outperformed those with worse ESG risk profiles within most sectors. The analysis also found that generally, names with better overall ESG risk profiles tend to have higher multiples, higher ROEs, and slightly higher growth rates than names with worse overall ESG risk profiles.

Mainstream investors are increasingly using ESG factors as an alternative dataset to provide insight into material non-financial risks that may not otherwise be captured in traditional financial analysis. The Sustainability Accounting Standards Board (SASB), an independent non-profit organization with a mission to help companies disclose material sustainability information to investors, has developed industry-specific sustainability accounting standards on topics that are likely to affect a company's financial value.<sup>10</sup> Ultimately, incorporating ESG factors into the investment decision-making process allows investors to be better prepared to evaluate and manage a wider scope of longer-term risks and opportunities.

### **How Do ESG Factors and Passive Investing Intersect?**

In Canada, the market for ESG ETFs has grown rapidly as the rise of passive investing corresponded with the launch of robo-advisors. Inflows into Canadian-listed ESG ETFs have been strong in recent years, with more than \$450 million in the past two years.<sup>11</sup> The majority of ETF launches in Canada this year have been focused on sustainability, and as of late May 2020, the total AUM within Canadian-listed ESG ETFs approximated US\$1bn.<sup>12,13</sup>

Sustainable indices are distinguished from traditional market indices due to the inclusion of environmental, social, and/or governance criteria in the security selection process. Integrating ESG criteria can be done in a variety of ways, including through exclusionary screening or by tilting exposure to over-weight strong ESG performers and under-weight weaker ESG performers. Sustainable indices can be used to create financial products focused on sustainable investment, to perform research and identify sustainable companies, and to benchmark performance for sustainable investment portfolios.

As investors have looked to rebalance their portfolios following the COVID-19 downturn, indications show that they are increasingly preferring sustainable funds over more traditional ones. Recent research from BlackRock demonstrates that in the first quarter of 2020, global sustainable open-ended funds, which include both mutual funds and ETFs, brought in US\$40.5bn in new assets, a 41% year-over-year increase.<sup>14</sup>

### **Closing Thoughts**

We believe that investor demand, growing corporate awareness, and new guidelines will continue to drive growth in the market for sustainable financial products in the years ahead. ESG ETFs in particular have shown tremendous growth in recent years and reflect the growing recognition that ESG factors are financially material and, when incorporated alongside traditional financial analysis, can provide investors with valuable insight into corporate performance and material non-financial risks.

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<sup>1</sup> ETFGI. "ETFGI reports Environmental, Social, and Governance (ESG) ETFs and ETPs listed globally gathered 7.54 billion US dollars in net inflows during February 2020." 20 March 2020. <https://etfgi.com/news/press-releases/2020/03/etfgi-reports-environmental-social-and-governance-esg-etfs-and-etps>

<sup>2</sup> Global Sustainable Investment Alliance. "2018 Global Sustainable Investment Review." [http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR\\_Review2018F.pdf](http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf)

<sup>3</sup> MSCI. "ESG 101: What Is ESG?" <https://www.msci.com/what-is-esg>

<sup>4</sup> Global Sustainable Investment Alliance. "2018 Global Sustainable Investment Review." [http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR\\_Review2018F.pdf](http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf)

<sup>5</sup> MSCI. "Foundations of ESG Investing." May 2018. <https://www.msci.com/documents/10199/55c3d22d-1f45-18a8-77be-2411906915ee>

<sup>6</sup> MSCI. "ESG 101: What Is ESG?" <https://www.msci.com/what-is-esg>

<sup>7</sup> BlackRock. "Sustainable investing: resilience amid uncertainty." May 2020.

<https://www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf>

<sup>8</sup> MSCI. "Has ESG affected stock performance?" <https://www.msci.com/www/blog-posts/has-esg-affected-stock/0794561659>

<sup>9</sup> MSCI. "Has ESG historically compromised financial returns?" <https://www.msci.com/what-is-esg>

<sup>10</sup> SASB. "SASB Conceptual Framework." <https://www.sasb.org/wp-content/uploads/2019/05/SASB-Conceptual-Framework.pdf>

<sup>11</sup> Balji, Divya. "ESG-hungry investors have plenty of ETFs to pick from in Canada." BNN Bloomberg. February 4, 2020.

<https://www.bnnbloomberg.ca/esg-hungry-investors-have-plenty-of-etfs-to-pick-from-in-canada-1.1384554>

<sup>12</sup> Tam, Ian. Morningstar. "10 best sustainable ETFs in Canada." April 22, 2020. <https://www.morningstar.ca/ca/news/201638/10-best-sustainable-etfs-in-canada.aspx>

<sup>13</sup> Bloomberg Finance L.P.

<sup>14</sup> BlackRock. "Sustainable investing: resilience amid uncertainty." May 2020.

<https://www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf>