

Sustainable Investing: Why and How to Do It

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RSM - a force for positive change



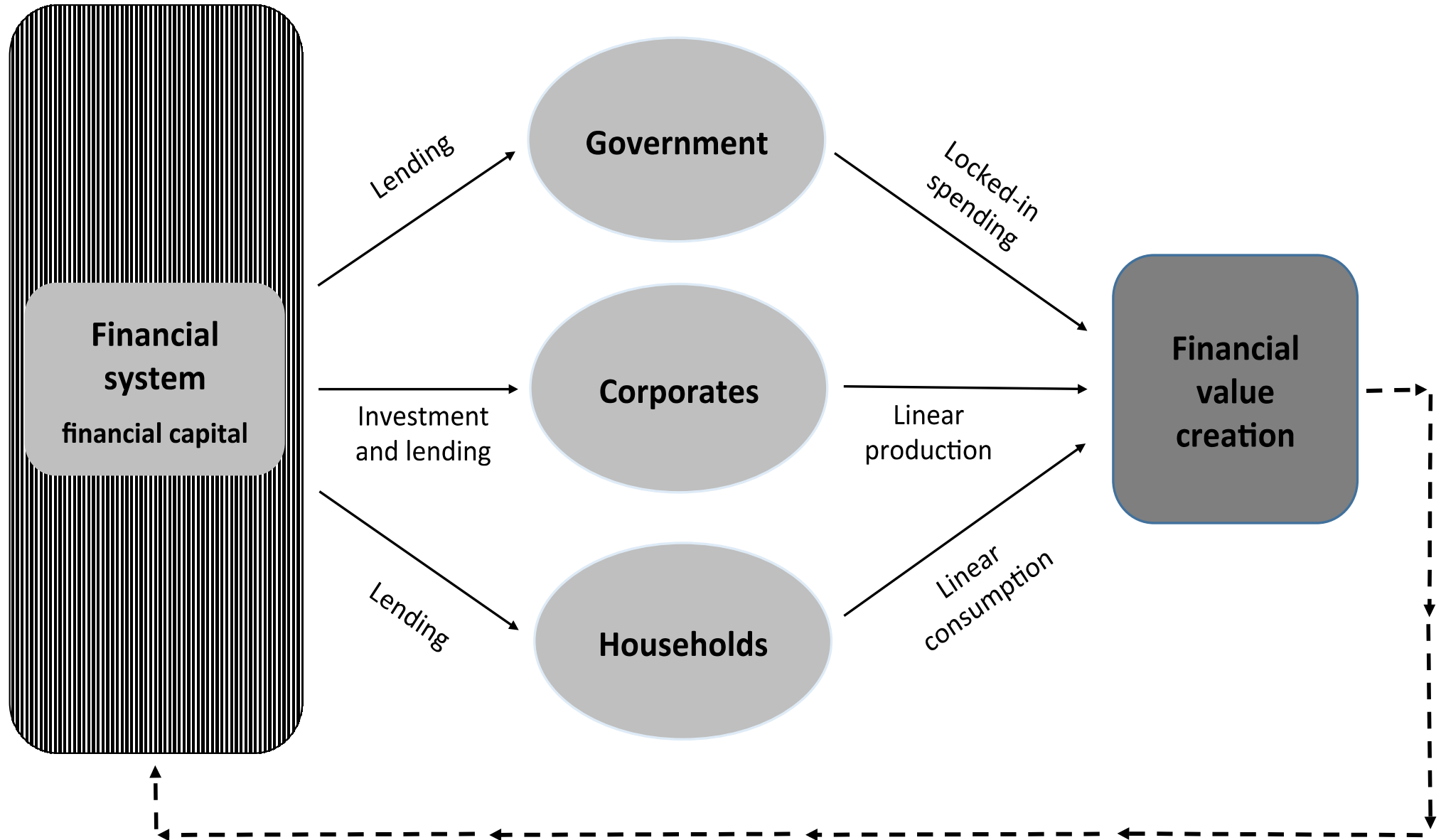


Agenda

1. Why sustainable investing?
2. Corporate objective: from shareholder (F) to stakeholder (F, S, E) model
3. Can investment approaches cope with broader perspective?
 - Neo-classical finance: only F dimension in market metrics
 - Answer: adding ESG factors to market metrics?
4. How to do it: new investment approaches
 - Need to analyse company's business model to uncover S + E
 - Fundamental equity investing

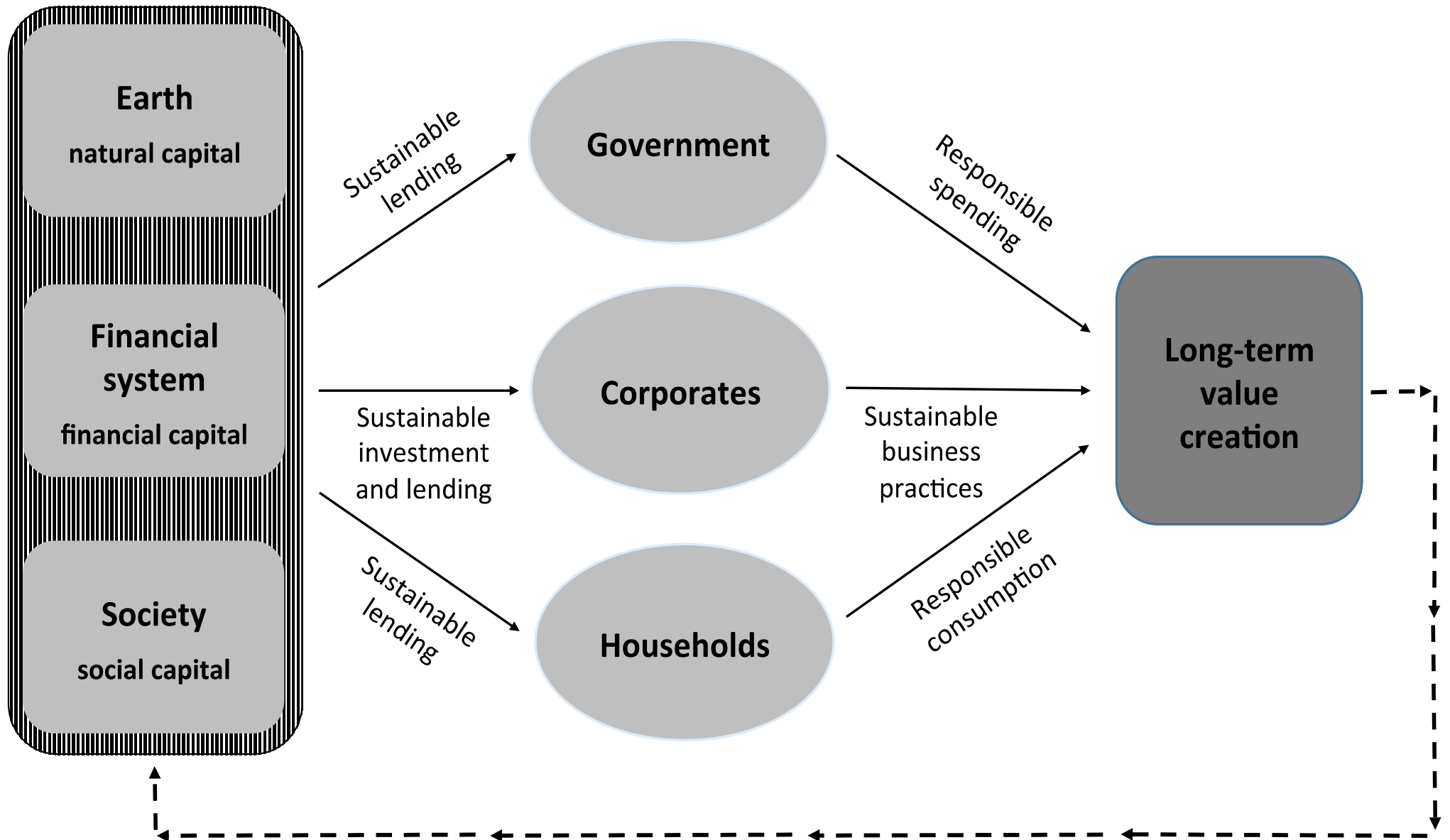


Financial value creation in traditional finance





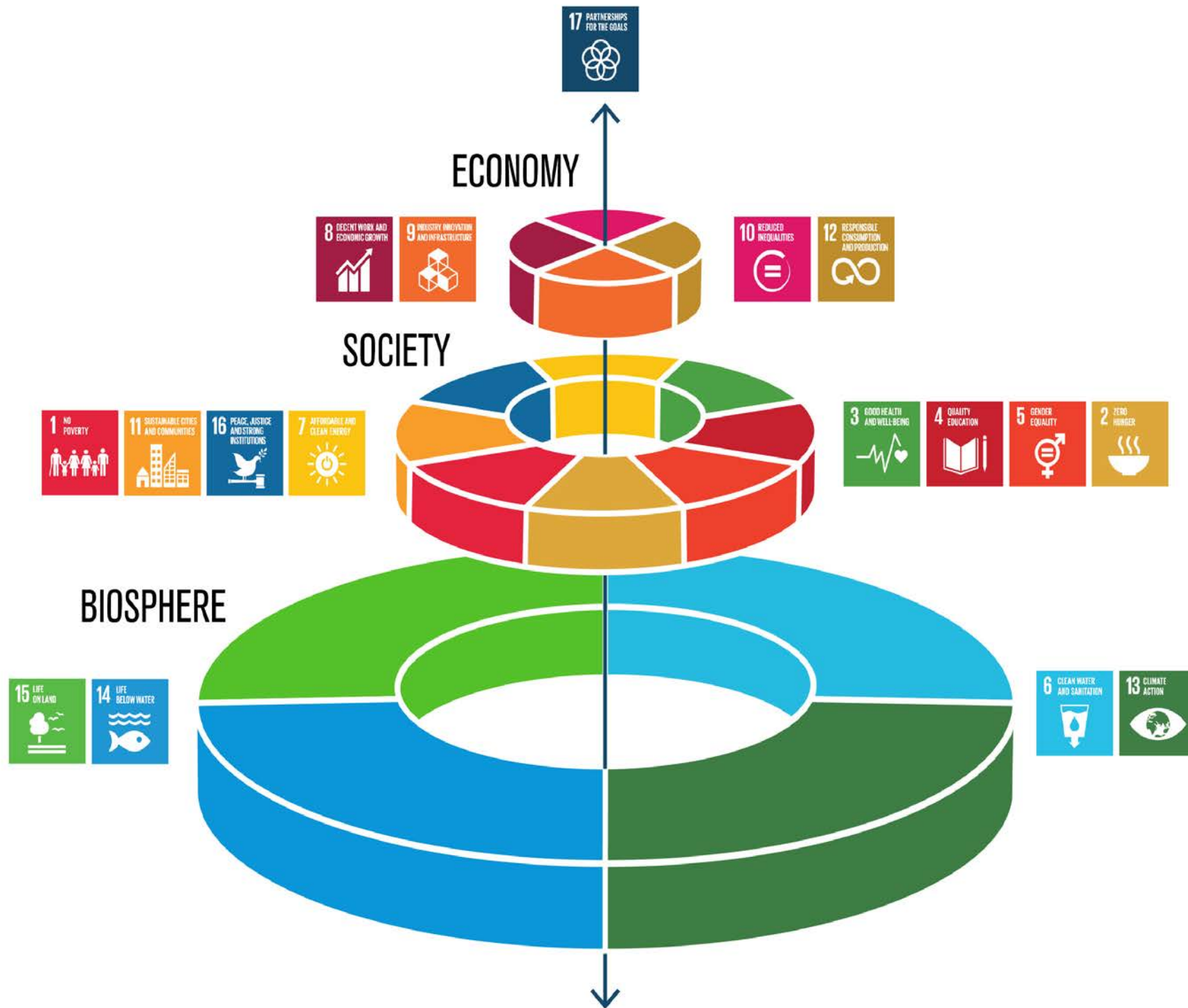
Long-term value creation in sustainable finance



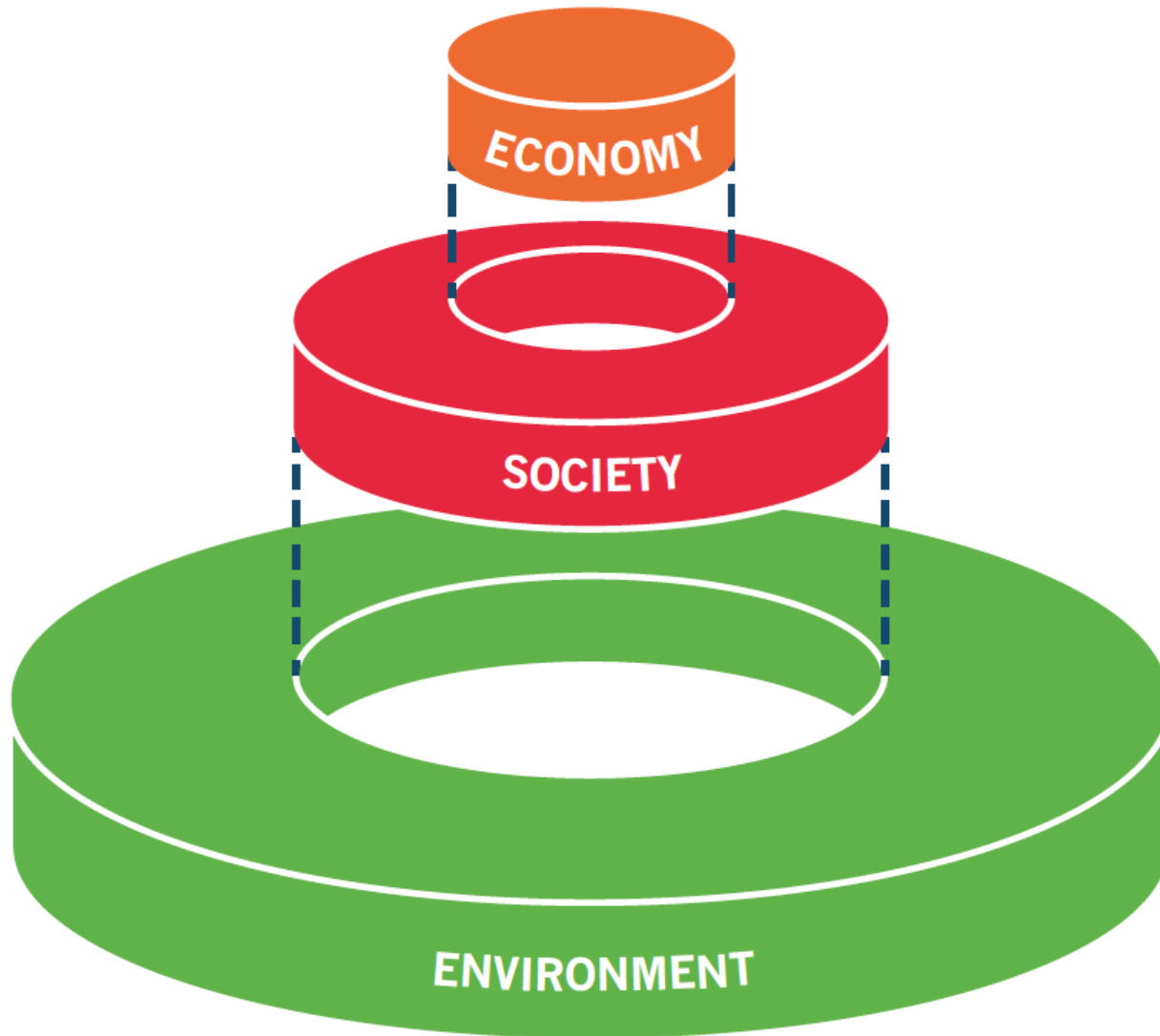


Why sustainable investing?

- New language in government and business
 - UN Sustainable Development Goals (SDGs)
 - Integrated concept with 3 dimensions: F, S and E
 - EU Policy: High Level Expert Group on Sustainable Finance
- Corporate sector can contribute through long-term value creation (LTVC)
 - LTVC: company optimises its financial value (F), social value (S) and environmental value (E) in the long term
 - Debate: shareholder model (F) vs stakeholder model (F, S, E)



Managing sustainable development



▶ financial return and risk: **F**

▶ impact on society: **S**

▶ impact on environment: **E**



What is objective of corporate?

- Hart and Zingales (CEPR DP, 2017), 'Shareholder Welfare'
 - Social and environmental externalities are not perfectly separable from production decisions
 - Companies face choice of degree of sustainability in business model
 - Guide choice: voting by prosocial shareholders
- Magill, Quinzii and Rochet (*Econometrica*, 2015), 'Stakeholder Corporation'
 - Companies should act in interests of stakeholders
 - Endogenous risks with impact on workers and consumers
 - Introduce new property rights for workers and consumers
 - Managers should max total value (shareholder + workers + consumers)



Internalisation of externalities

- Dynamic process – externalities connected to company's production process
- Materiality of externalities varies per industry and within industries
 - Depends on company's business model
 - Early evidence (Khan *et al*, 2016; Clark *et al*, 2015): companies that do well on material ESG issues show superior financial performance
- **Question:** how can investors integrate ESG properly?



Why integrate ESG?

- Why would corporates and financials look at ESG?
 - Anticipation of regulation / taxation (e.g. carbon tax)
 - Reputation – pressure from NGOs / consumers
 - Future-proof: transition to SDGs by 2030 (e.g. Energiewende)



How to do it?

- HLEG (2018): fiduciary duty of investors
 - Yes, excellent to include sustainability in fiduciary duty
- Who should be leading sustainable investments?
 - HLEG (2018): taxonomy of sustainable investments – no, administrative approach by officials
 - Our proposal (2018): market-led approach through fundamental investing



(Over)reliance on market metrics

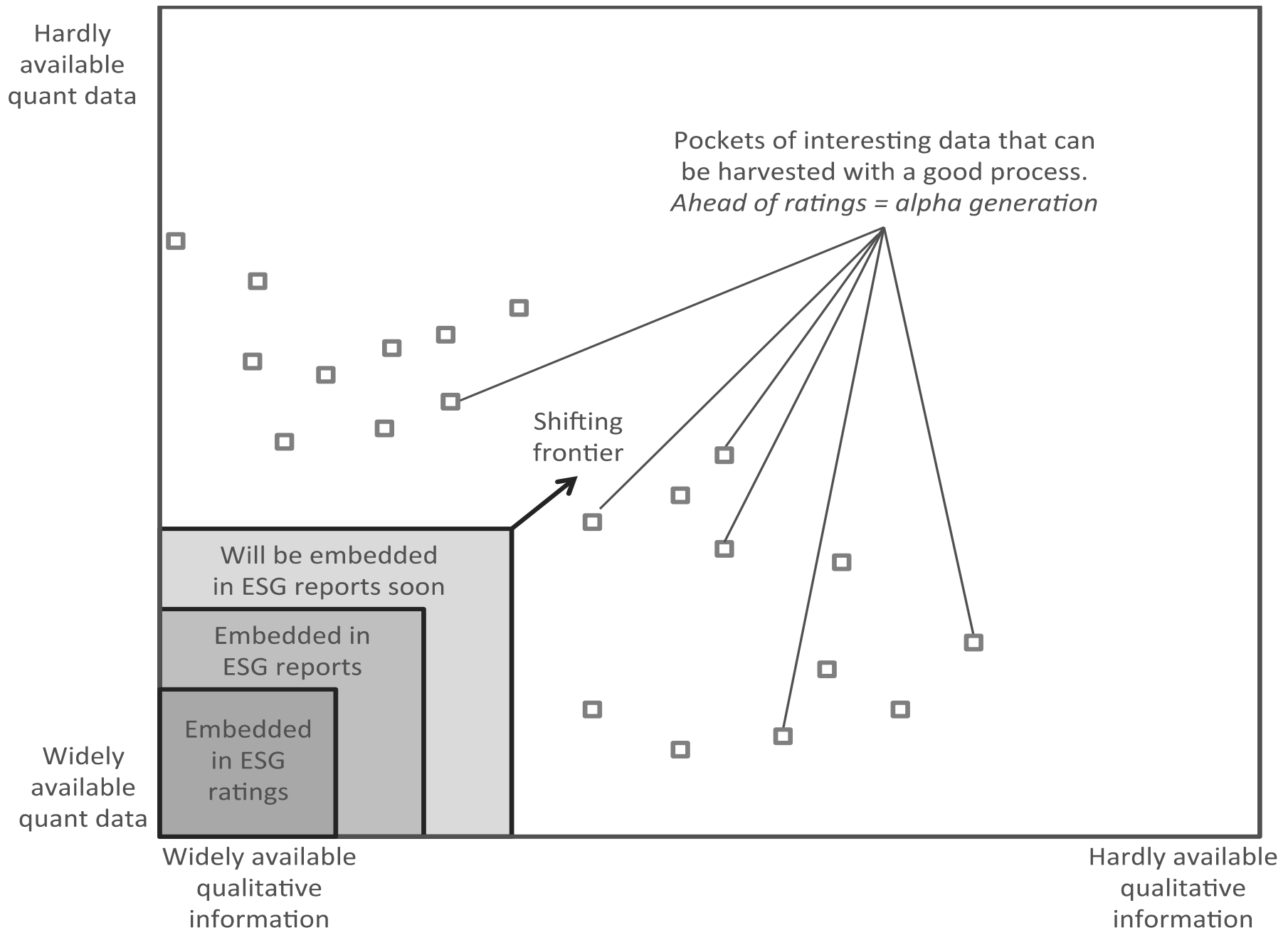
- Dominant theory: efficient markets hypothesis and portfolio theory
 - **Pricing:** efficient market hypothesis – all relevant info in market prices, but behavioural and more recently sustainability anomalies
 - **Allocation:** portfolio theory – financial risk-return space, whereby only systematic risk is priced -> market portfolio (index investing)
 - **Performance measurement:** benchmarking against market index
- Summing up: full reliance on market metrics -> F dimension



Can ESG ratings help out?

- **Idea:** supplement market metrics with ESG ratings
- But design limitations of ESG ratings
 - Too many things -> no focus on material issues
 - Based on reported data and policies (fraction of needed info)
 - Scores are industry neutral and based on operations (not on products / services)
 - Too many stocks (>70) per analyst -> no in-depth assessment
- ESG ratings need to get better

The ESG data challenge





Active investment approaches

- Fundamental analysis of companies' ESG factors
- **Aim:** to uncover companies' social + environmental value, next to financial value
- Adaptive Markets Hypothesis (Andrew Lo, Princeton University Press 2017)
 - Evolutionary perspective on pricing
 - Incorporation of ESG info in stock prices is adaptive process
 - Dependent on # of fundamental analysts + quality of their learning
 - Can explain why new risks (e.g. carbon risk) not yet priced in (e.g. because not enough investors are examining these new risks)

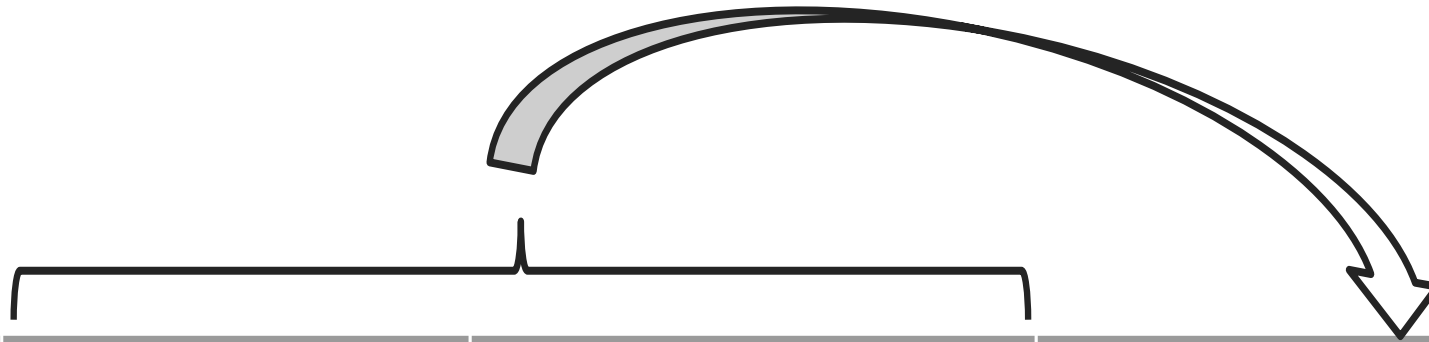


Allocation (1): fundamental ESG analysis

- Fundamental analysis of business model -> material ESG issues and their impact on valuation (Schramade, JACF 2016)
- Information advantage theory (Van Nieuwerburgh and Veldkamp, RES 2010)
 - Investor, who first collects info on particular shares, buys these shares (deviating from holding diversified portfolio)
 - Fundamental analysis on ESG is not widespread
 - Alpha generation
 - Adaptive process: shifting ESG frontier



Financial impact of qual + quan ESG info



Material issue	Qualitative ESG	Quantitative ESG	Financial impact
1. Human capital	Cultural aspects	Attrition, employee satisfaction, staff training	Margin advantage driven by staff costs & productivity
2. Innovation management	Nature of the innovation process	Pipeline success rate, R&D spending	Sales growth and margin driven by more successful products, partly offset by R&D spending
3. Environmental management	Superior environmental solutions & efficiency	CO ₂ emissions saved	Margin advantage driven by lower raw materials costs and later on CO ₂ pricing
Issue 4.			
Issue 5.			



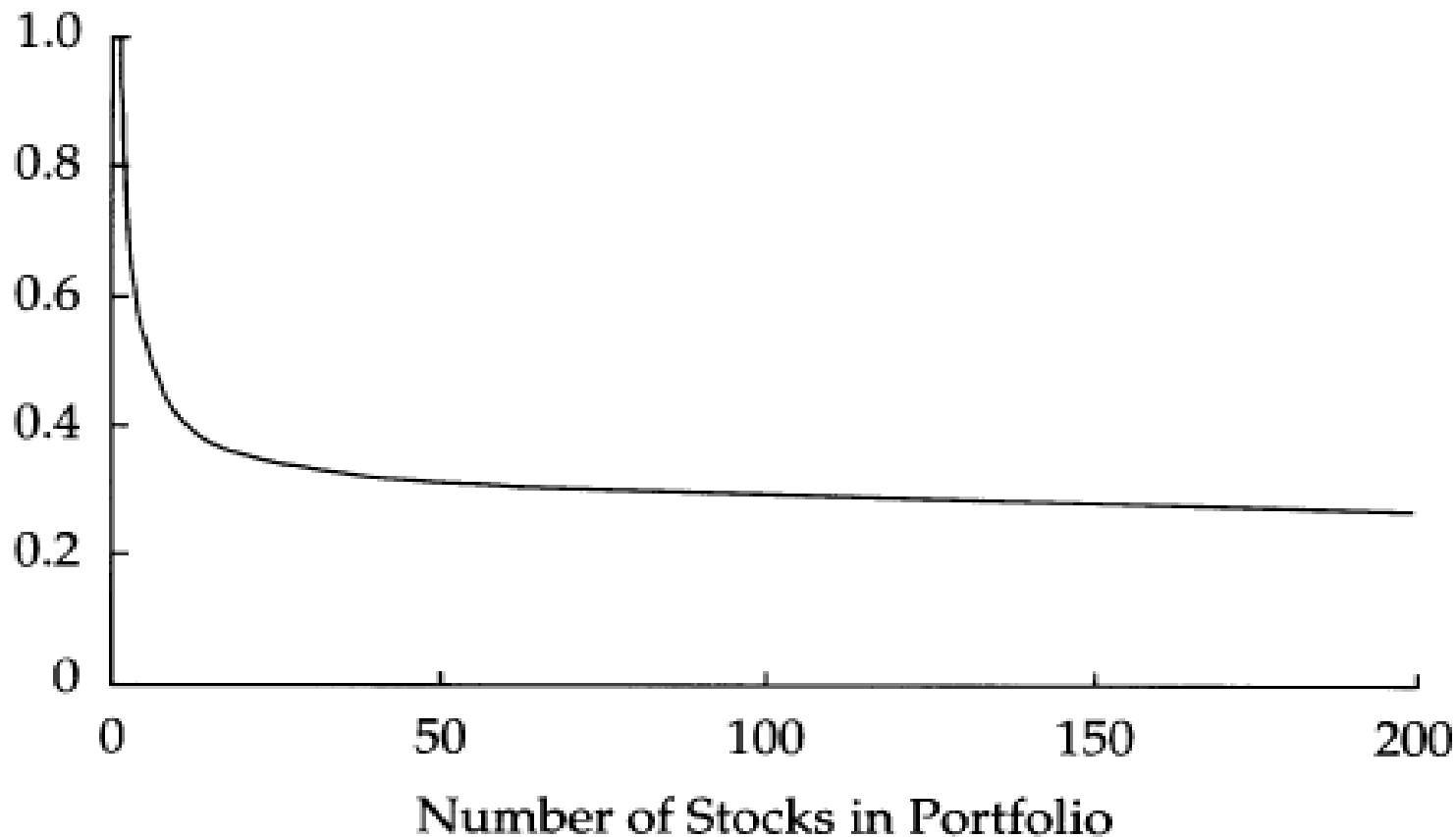
Allocation (2): concentrated portfolios

- Concentrated portfolios: Choi *et al* (JFE, 2017)
 - Fundamental investing leads to more concentrated portfolios
 - In large cross-country study among institutional investors, they find that concentrated portfolios lead to excess risk-adjusted returns, conditional on information advantage (on home market and selected foreign markets)
 - Institutional investors with higher learning capacity -> more concentrated
- Diminishing benefits from diversification
 - Statman (FAJ, 2004): well-diversified portfolio needs 50 to 100 stocks to eliminate idiosyncratic variance
 - Diversification over asset classes more important

Diminishing benefits from diversification



Standard Deviation of Portfolio





Engagement

- Currently silo approach
 - Investors (F experts) do allocation of stocks
 - Sustainability people (S + E experts) do engagement with companies
 - Often following proxy advisors (ISS or Glass Lewis) because of large portfolio
- New active approach ('integrated thinking')
 - Investment decision and subsequent engagement integrated
 - Concentrated portfolio: 100 stocks can be selected, followed and engaged by small team
 - Dyck, Lins, Roth and Wagner (JFE, forthcoming): growing importance of financial motivation behind institutional investors' push for ESG



Performance measurement

- Financial measures
 - Range of indices instead of single one
 - Peer group of comparable competitor funds
 - Absolute return target, possibly corrected for absolute risk metric
- Non-financial measures (still in their infancy)
 - Performance on specific key performance indicators (KPIs)
 - Externality valuation methods (e.g. TruePrice, True Value)
 - Contribution to global sustainability goals (SDGs)



LT investing in practice: Alecta

- Alecta: Swedish pension fund with €81 bn assets under management
- Investment strategy aimed at LTVC: 15-20 year perspective + ESG integration
- Concentrated portfolio: 104 listed shareholdings
- Active management (incl. engagement) by in-house team of investors
- Performance measurement: absolute return using 5-10 year average
- Total management costs: 0.09% AUM (investment man costs 0.02% AUM)

Investments	Market value (in EUR billion)	Share	Total return (in %)	
			2016	2012-2016
Shares	34.8	43%	7.2%	15.9%
Debt securities	40.1	50%	3.1%	4.5%
Real estate	5.7	7%	9.2%	11.8%
Total investments	80.6	100%	5.2%	9.1%

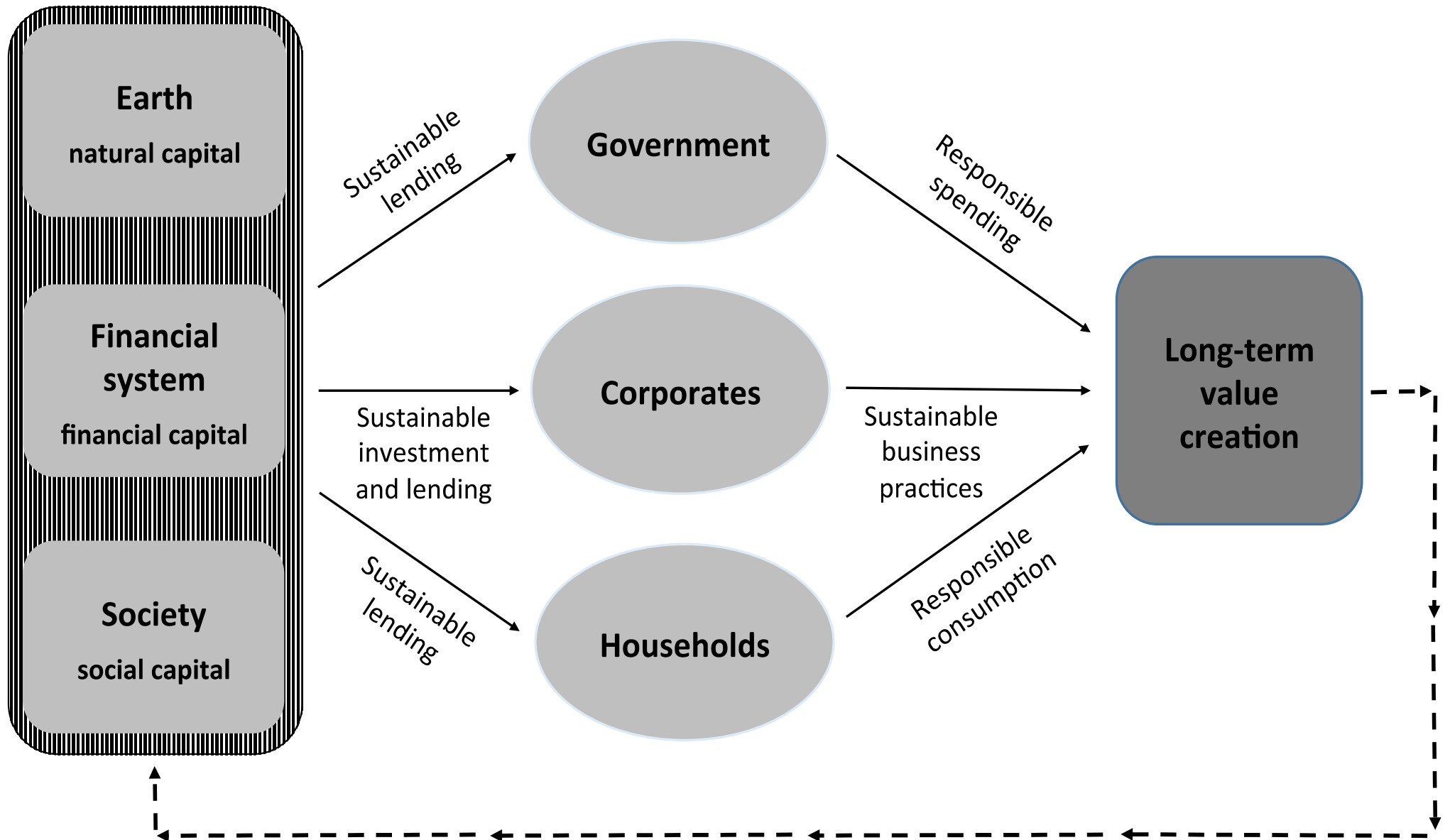


Conclusions

- Stakeholder view allows for achieving UN SDGs (long-term value creation)
 - From narrow F dimension to broader F, S, E dimensions
 - S + E externalities are linked to production process
- Current investment approaches still in financial risk-return space
 - ESG ratings are too superficial
- Need for fundamental analysis of companies' business model
 - Active ownership: selection + engagement
 - Concentrated portfolios
- Realign corporate finance and asset pricing on broader perspective:
F, S, E dimensions



Long-term value creation in sustainable finance





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