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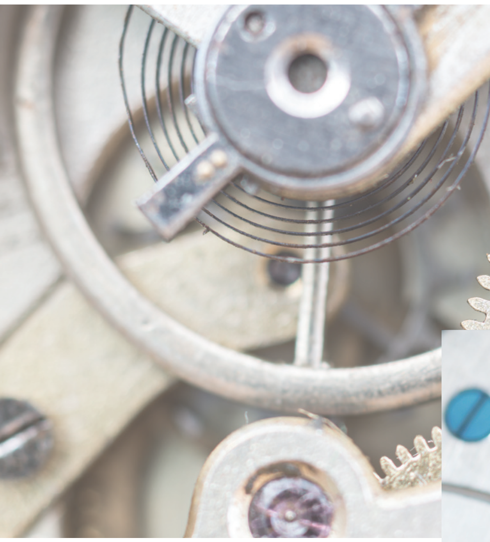

STEPHEN M. HORAN, ELROY DIMSON, CLIVE EMERY, KENNETH BLAY, AND GLEN YELTON explain the main challenges facing ESG investors and fund managers.
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"A passive ESG investment objective that invests in today's low carbon emitters may be at odds with an active or activist ESG strategy that invests in today's high carbon emitters. . ." — *Pg. 4*

"A recent survey of financial advisors and advised investors shows that lack of personal knowledge is a barrier to sustainable investing . . ."
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Practical Applications of

The State of ESG Investing: A Portfolio Management Perspective

STEPHEN M. HORAN, ELROY DIMSON, CLIVE EMERY, KENNETH BLAY, AND GLEN YELTON

Invesco

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Overview

In ***The State of ESG Investing: A Portfolio Management Perspective***, from the Summer 2022 issue of ***The Journal of Impact and ESG Investing***, authors **Stephen M. Horan** (of the **University of North Carolina)**; **Elroy Dimson** (of **Cambridge University)**; and **Clive Emery**, **Kenneth Blay**, and **Glen Yelton** (all of **Invesco**) explain the main challenges facing ESG investors and fund managers. ESG investors differ from traditional investors in that they seek to pursue nonfinancial goals through investments. Those goals vary widely, depending on investors' particular interest in different ESG topics, intensity of commitment to nonfinancial goals, and preferences among different investing strategies. Therefore, investors, financial advisors, and fund managers need relevant, reliable, and relatable information to help them choose investments that align with their ESG goals.

Unfortunately, there is a lack of such information—especially standardized company information that fund managers can aggregate to demonstrate ESG portfolio metrics over time. The authors present a framework to help investors articulate the information they need, help companies report information that investors and fund managers can use, and help regulators create reporting standards to make such information aggregable at the fund level so investors can easily compare and choose ESG funds.[1]

Practical Applications

- **Investors should determine which ESG topics matter most to them, how intensely they are committed to nonfinancial investment goals, and which ESG investing strategies**

[1] Following the publication of the article, the SEC proposed a package of ESG-related rules. See Securities and Exchange Commission, *Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices*, Release Nos. 33-11068, 34-94985, IA-6034, IC-34594, 87 Fed. Reg. 36654 (17 Jun 2022).

Authors: Stephen M. Horan, Elroy Dimson, Clive Emery, Kenneth Blay, and Glen Yelton
Source: The Journal of Impact and ESG Investing, Vol. 2, No. 4
Date of Article: Summer 2022
Report Written By: Doug McNair
Date of Report: Jul 12, 2022
Keywords: ESG investing, ESG intensity, greenwashing

Key Definitions

ESG investing

ESG investing considers the environmental, social, and governance activities of investee companies. Environmental criteria evaluate a company's sustainability activities (e.g., emissions, water, and waste). Social criteria assess a company's management of social relationships (e.g., employees, consumers, surrounding communities). Governance criteria cover the rights and responsibilities of the company's management (e.g., board, shareholders, and stakeholders). ESG investing is sometimes defined more narrowly as considerations of how a company's governance, and its environmental and social impact, affect its financial performance. In this narrower sense, ESG investing is distinguished from "socially responsible investing" (SRI), which seeks to promote social and environmental good by avoiding investment (through the application of negative screens) in disfavored products or services; and from "impact investing," which aims to achieve positive social or environmental impact by investing (through the application of positive screens) in favored industries or activities.

they prefer. They need relevant, reliable, and relatable information to decide which ESG funds align with their goals.

- **Financial advisors and fund managers should know their clients' ESG goals and construct portfolios aligned with those goals.** They need aggregable company-level information so they can accurately report the changing ESG metrics of each fund over time.
- **Regulators should develop a standardized ESG investment product reporting template, which would only apply to funds with nonfinancial objectives.** Each fund would have a document that concisely reports its ESG objectives, investment strategy, and outcomes.

Discussion

A marked increase in investors' focus on ESG issues in recent years has resulted in a huge influx of capital into ESG investment funds. A new generation of investors wants its investments and values to align. However, ESG investors have widely varying opinions about what sustainable or socially responsible investing means and what trade-offs they are willing to make between financial and nonfinancial goals. As a result, portfolio managers who offer ESG investment funds need to provide detailed information so investors can determine whether the funds align with their individual goals.

Unfortunately, such information is sorely lacking today. This leaves ESG fund investors in the dark about whether the funds are operating consistently with their marketing representations. The authors address this problem by highlighting the key challenges facing the ESG fund industry and then making specific recommendations for reporting useful information.

ESG INVESTING: WHAT DOES IT MEAN?

All ESG investors say they want their investments to be sustainable. But they give many different interpretations as to what that means, from "I'd rather not invest in oil and gas companies" to "I want to change the world." This points out the defining factor in ESG investing: While traditional investors only invest to pursue financial goals, ESG investors use their investments to pursue nonfinancial goals. Furthermore, different ESG investors prioritize their financial and nonfinancial goals differently. As a result, it's important for fund managers to understand what ESG investing means to different investors and to provide information that will allow investors to decide whether a given fund aligns with their goals.

Scope 1, 2, and 3 emissions

Scope 1 emissions are a company's direct carbon emissions from its own activities and from resources it owns and controls. Scope 2 emissions are a company's indirect carbon emissions from electricity purchased and used. Scope 3 emissions are a company's indirect carbon emissions from sources it does not own or control but that arise from its activities.

The authors provide a framework for categorizing ESG investors in three different areas: ESG topics, intensity, and strategy.

ESG Topics: ESG investors have widely varying levels of interest in environmental (E), social (S), and governance (G) issues. Some focus on one or two of these at a high level, such as wanting to know if a company has a mission statement that commits it to equal opportunity and inclusion. Other ESG investors are interested only in one or two subtopics within an issue category, such as climate change, for example. This poses challenges for portfolio managers trying to formulate standardized measures of ESG-ness for investment funds. It's also a challenge for climate change–focused investors, who need information not just on the general environmental friendliness of different companies and investment funds, but on whether and how much their investments have been reducing their carbon footprint over time.

ESG Intensity: Investors also fall along a continuum of commitment to the nonfinancial goals of ESG investing. The authors call the level of commitment *ESG intensity*, which they describe in terms of investors' varying emphasis on financial and nonfinancial objectives. They illustrate the continuum with four categories of ESG intensity: 1) traditional investing, 2) responsible investing, 3) sustainable investing, and 4) impact investing.

To help ESG investors achieve their goals, portfolio managers must provide information that can help investors and advisors differentiate whether or not, and to what extent, funds' investment strategies are financially focused. Investors also must be able to understand and communicate their ESG intensity so advisors can select investment funds that align with their goals.

ESG Strategy: ESG investors and fund managers can pursue nonfinancial goals by following any of three different strategies:

1. *Passive ESG Investing:* Investing in companies that already have good ESG metrics (for example, low carbon emissions).
2. *Active ESG Investing:* Predicting which companies are likely to have the most improved ESG metrics in the future (for example, companies most likely to reduce their carbon emissions by the greatest amount) and investing in those companies.
3. *Activist ESG Investing:* Investing in companies and then engaging with directors or managers to influence them to improve their ESG metrics (such as reducing carbon emissions).

> "A passive ESG investment objective that invests in today's low carbon emitters may be at odds with an active or activist ESG strategy that invests in today's high carbon emitters. The overarching point is the impossibility of evaluating a portfolio manager's performance without articulating the specific ESG investment objective. Consequently, we need portfolio objectives that identify the specific strategy and metrics that are clearly associated with the client's stated intent."
>
> ***—The State of ESG Investing: A Portfolio Management Perspective***

ESG FUNDS: INVESTMENT CHALLENGES

Investors and financial advisors can evaluate an ESG fund only if they have accurate information about 1) the ESG topics on which it focuses, 2) its ESG intensity, and 3) its ESG investing strategy. Unfortunately, this information is generally lacking, for several reasons. First, there are no uniform standards for company reporting on ESG-related information. Federal pollution regulations require reporting of emissions data, but beyond that, self-reported ESG data are often subjective and hard to quantify. Even easily quantifiable environmental data can be manipulated. For example, if a company wishes to report a reduced carbon footprint, it can simply sell off its carbon-producing assets (like factories or power plants) to a third party and then outsource its production. This reduces its direct carbon footprint without reducing its overall carbon emissions—a practice known as *greenwashing*.

Second, regulators generally do not require portfolio managers to disclose their specific ESG investment strategies or to demonstrate how their ESG funds are managed differently from traditional funds. Portfolio managers who market ESG funds often fail to follow through on their marketing by supplying metrics on their funds' strategies or nonfinancial objectives.

Third, the holdings of many self-declared ESG funds are nearly identical to those of traditional funds. The 20 largest ESG funds invest in companies that produce fossil fuels, alcohol, and tobacco—and overall, their holdings are similar to the S&P 500 Index. This raises the basic question of whether ESG-fund investors are receiving what they have bargained for.

Fourth, many investors and their financial advisors say they need more education on nonfinancial topics before they can successfully navigate ESG funds. Even highly trained financial professionals are not often experts on environmental, social, or governance-related issues. They need more nonfinancial knowledge to help them distinguish among different types of ESG investments and choose those that best align with different nonfinancial goals.

Finally, three-fourths of financial practitioners say the investment industry needs to improve its reporting standards to prevent greenwashing of investment funds. There is a lack of reliable, verifiable, consistent, and comparable ESG-related information at both the individual-company and investment-fund levels. Problems arise with even the most quantifiable company-level data because different companies may use different measures to report things like carbon output. One company may report its total carbon output per year, while another may report only changes in its net output over time. This makes it difficult for portfolio managers to aggregate such data to present a clear picture of the overall ESG-ness of their funds' holdings.

Because of these challenges, many portfolio managers and investors turn to third-party ESG ratings services that provide ESG scores on companies and investment funds. However, a single ESG score

> "A recent survey of financial advisors and advised investors shows that lack of personal knowledge is a barrier to sustainable investing . . . [F]inancial advisors have difficulty distinguishing between different types of sustainable funds . . . Like their advisors, investors find ESG terminology overwhelming . . . Therefore, investment practitioners need education and consistent and reliable data to manage portfolios to investors' nonfinancial objectives."
>
> *—The State of ESG Investing: A Portfolio Management Perspective*

cannot differentiate between funds that are a better or worse fit for investors who are focused on different ESG topics, have different levels of ESG intensity, or prefer different ESG strategies.

GOOD ESG INFORMATION: WHAT DOES IT LOOK LIKE?

Since the key challenge for ESG investors and the ESG investment industry is a lack of good information, it is important for companies and portfolio managers to know what good information looks like. Good ESG information is relevant, reliable, and relatable, as detailed in Exhibit 1:

Exhibit 1: Qualities of Desirable ESG Information

Relevant	Reliable	Relatable
• Aligned • Actual • Material	• Measurable • Accurate • Verifiable • Consistent • Comparable	• Accessible • Benchmarked • Timely • Aggregable

Relevant ESG information is aligned with investors' nonfinancial objectives and is material to their investment decisions. *Reliable* ESG information is accurate and verifiable, and consistent and comparable across companies because it adheres to widely accepted reporting standards. *Relatable* information is easy to understand, uses benchmarks allowing comparison of company and fund metrics, and is presented in a format that laypeople can quickly grasp (for example, with visual aids). An important factor is the amount of information presented: In ESG reporting, less is more. It is far better to give ESG investors a few relevant, reliable, and relatable data points than to flood them with information they cannot understand.

THE WAY FORWARD

To improve the overall state of ESG investing, all participants must do their part.

Investors: ESG investors must determine and articulate their nonfinancial goals. A practical starting point is to decide which ESG topics interest them most, what level of ESG intensity they have, and what ESG strategy they want to pursue.

Financial Advisors: Many ESG investors need help making these decisions, and financial advisors can guide them through the process and help them choose an ESG investing strategy.

Portfolio Managers: Fund managers should identify and invest in companies whose ESG metrics align with the goals of clients who are interested in different ESG topics, have different ESG intensities, and want to pursue different ESG strategies. They also need to provide information that helps clients clearly understand why a given fund is or is not aligned with their goals.

Regulators and Standard Setters: Given the lack of ESG information-reporting standards, regulators should develop and require the use of a standardized ESG investment product reporting template. Each ESG fund would come with a succinct document reporting the fund's objectives, investment process, and outcomes.

Beyond that, the industry must embrace standardized reporting on the huge variety of ESG issues and topics. Some ESG metrics (like company environmental data) are relatively easy to quantify, while others (like companies' efforts to advance social justice) are qualitative and based on personal judgments. This causes inconsistencies in data reporting among companies. The authors suggest regulators and standard setters begin by classifying ESG issues as either standardizable now or standardizable in the future. They should develop reporting standards for the ESG data that are currently the most measurable and most material to ESG investors' goal-based decision-making processes. Then, they can use the lessons learned in this first round of standardizing data on practical ESG issues to start creating reporting standards for more aspirational ESG issues that are more qualitative, harder to measure, and less material to ESG investor decisions.

Finally, regulators should require that individual companies report ESG data in a form that fund managers can aggregate at the portfolio level. This will allow investors to compare funds and determine which ones best align with their nonfinancial goals.

CONCLUSION

The main challenges to the ESG investing industry today stem from 1) clients having vague or uncertain nonfinancial objectives, 2) companies misrepresenting their data, and 3) reported information being neither standardized nor aggregable. All sides of the industry must work together to create a situation where clients understand

and communicate their financial and nonfinancial objectives; portfolio managers provide products that align with those objectives; companies and funds report clear, concise, standardized, and aggregable data; and regulators create and implement proper ESG data reporting standards. This will lead to real, measurable improvement of the ESG investing industry and improve clients' ability to achieve their nonfinancial investment goals.

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202211-2428673-GL