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The Ins and Outs of ESG Investing

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Between 2007 and 2012, in the face of one of the most severe financial crises the world had ever seen, the investment framework known as ESG boomed. As investors scoured the globe in search of reliable returns, investments guided by environmental, social and governance principles saw their value rise from around US$5trn to US$32trn, according to Business for Social Responsibility, a non-profit.

In the intervening years, as the global economy recovered, ESG has continued its rapid ascent. Today, practically all of the major asset-management houses have sizeable ESG teams, and global indexing firm FTSE recently announced plans to increase its ESG capacity, in response to growing demand in Asia and North America for indices underpinned by the model.

Yet misconceptions persist about ESG, not least because it is frequently seen as a vehicle aimed primarily at satisfying the ethical concerns of investors, and only then providing excess market returns. Of course, much has changed since the broader category of socially responsible investment arose, but ESG continues to face familiar questions: How does ESG differ from older forms of ethical investing? What does ESG investment mean in practice? And in a low-growth, low-yield world, can fund managers really make "responsible" investment a priority while maintaining their fiduciary obligation to their clients?

To answer these questions and more, we sat down with Jacky Prudhomme, an 18-year veteran of responsible investment, and now head of ESG integration at BNP Paribas Investment Partners.

1. HOW DO YOU DEFINE SRI (SOCIALLY RESPONSIBLE INVESTING) VERSUS ESG (ENVIRONMENTAL, SOCIAL, GOVERNANCE)?

The big difference between SRI and ESG is their specific investment roles. SRI is based largely on excluding certain companies from your portfolio, which you identify using a series of criteria related to, for example, environmental and social practices. Once a full list of companies has been analysed, sector by sector, you'd typically end up excluding the bottom-performing third from the portfolio, and those companies would essentially be off limits to fund managers.

Another element of SRI is to actively seek out companies making a positive impact in terms of their environmental or social practices. In the social realm, for example, the company could be investing in social housing or helping the long-term unemployed to find jobs. In the environmental arena, it could be investing in renewable energy. So you start by identifying social and environmental objectives, then you identify the best companies doing those activities and achieving those objectives, and then incorporate them into your portfolio to achieve a financial return.

And then, from the opposite perspective, we have ESG. There is common ground, of course, but the big difference is that you don't systematically look to exclude or include specific companies. Instead, a fund manager will incorporate ESG practices into a broader range of criteria, thus enriching his knowledge of the company and giving him more tools when he assesses the level of risk he wants to take in specific investments. Having an in-depth knowledge of the ESG dimensions of a company is a big plus for a better comprehension of that firm's strengths and weaknesses.

ESG is really about protecting you from reputational and operational risk, so you want to get some understanding of the risk inherent in the companies you're investing in. But it's not as in-depth or prescriptive regarding the integration of the indicators and selection rules as SRI. It doesn't mean that ESG is a kind of "SRI-lite" process; it just means that ESG can be applied to any management style; that you can plug the ESG information into the tool-kit of fund managers, and maybe provide better forecasts of the risk and soundness of the companies we're investing in.

2. DO YOU BELIEVE A PORTFOLIO'S LONG-TERM PERFORMANCE CAN BE ENHANCED BY INCLUDING ESG CONSIDERATIONS IN THE SECURITY-SELECTION PROCESS?

Initially, investors' key consideration with ESG was aligning their values with their investment. It was about making sure they minimised their impact in terms of, for example, environmental footprint. But I think now there is a strong enough track record in terms of managing responsible investment – around 20 years or so – to say that it can help generate value for portfolios. I think this is part of the reason that more institutional investors, and regulators as well, are becoming increasingly dedicated to pursuing longer-term objectives and to integrating ESG. They're recognising that if you get rid of controversial companies in terms of ESG, you're getting rid of potentially fragile companies that may end up with poor financial performance.

A growing number of people recognise that we are facing significant challenges in our society, and they have learned the lesson that if we are able to take information from ESG dimensions, it will help us end up with a better financial performance for our portfolios because it will be less risky and we'll be invested in the best companies. Also, what we call the fiduciary responsibility of investors – that is, our responsibility to maximise investors' returns – increasingly requires that we can demonstrate that we've also mastered the ESG-related risk linked to their investments.

3. ISN'T IT THE CASE THAT ESG IS BETTER SUITED TO SOME INVESTMENT STYLES THAN OTHERS? FOR INSTANCE, MIGHT IT NOT BE LESS APPROPRIATE FOR USE WITH ALTERNATIVE INVESTMENTS?

What I really want to promote through ESG is the idea that whether you invest through traditional or alternative classes, the best way to proceed is to really understand the business. The better you know and understand the company, state authority or supranational body, the better you can understand what the returns could be. ESG should never be considered an obstacle; it's a way to include more information.

That's why, if you look at all the different businesses that are now applying initiatives to promote responsible investment, you increasingly find companies from the private-equity world. It means they have also become interested in ESG, and that they want to invest in companies for the long term.

4. HOW WOULD YOU OUTLINE THE STEPS REQUIRED FOR FUND MANAGEMENT TEAMS TO INCORPORATE ESG INTO THEIR INVESTMENT PROCESSES?

The first stage is alignment with BNP Paribas Investment Partners' minimum ESG requirements. These are aimed at ensuring, first of all, that our clients aren't exposed to companies that are more liable to be involved in significant ESG-related controversies, like human rights abuses or significant environmental damage. Besides the reputational element, controversies like this could have a major adverse effect on a portfolio's financial performance.

These minimum requirements are based on two sets of criteria: the 10 principles of the United Nations Global Compact, and our own sector policies that relate to companies in sensitive areas like mining, palm oil, coal-fired power plants, nuclear energy and pulp paper. Our purpose is to exclude companies with the worst practices, which are potentially the most exposed to NGO activism and penalties for their infringement of local regulations.

The second stage is perhaps the most interesting – it's to make sure that the fund managers, wherever they are in the world, are plugged into ESG research, and can take advantage of all the knowledge we have in identifying ESG challenges and growth opportunities. And this is what we are working hard on: we work with portfolio managers to reshape their investment decision process, and maybe to favour the companies with the best ESG score – to better position the portfolios in terms of ESG profiles.

The point of this is not – and we're very clear about this – to transform all the funds into SRI portfolios. The objective is rather to help managers benefit from extra ESG research, and the upside opportunities to be found in the ESG dimensions. We want to help them enlarge the scope of their investments, as there are very interesting opportunities. When you open their eyes to other investments in promising technologies, for example in renewable energy or energy efficiency or education, there can be very big upsides that are of considerable interest to fund managers.

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5. HOW HAVE SOME OF THE INVESTMENT TEAMS AT BNP PARIBAS INVESTMENT PARTNERS INTEGRATED ESG FACTORS INTO THEIR INVESTMENT PROCESS?

There are two elements to this answer. The first one is about the SRI-specific management we have. BNP Paribas Investment Partners launched its own SRI department more than a decade ago, in 2002. We applied SRI-specific rules and also some specific exclusion filters, because they were requested by our clients at the time – for example, gambling, alcohol and arms.

It means that for the SRI portfolios, which now have more than €20bn under management, the rules are very strict: the fund manager has to accept that there are roughly one third of companies that are non-investable, and then it's up to the manager to manage risk, to overweight and underweight specific sectors, to make sure that his fund is as profitable as a traditional portfolio. With SRI, we have quite a good track record in terms of financial performance and we have been able to attract numerous institutional investors.

For ESG integration, we don't have as much experience in this area compared to SRI because I started my mission just a couple of years ago, when I left the SRI research team to promote ESG integration. The first thing we did was to apply a common layer of minimum ESG standards and requirements within BNP Paribas Investment Partners. What I'm doing now is meeting portfolio managers to explain how to better integrate ESG into their investment decision process.

We already have some people who are much more advanced in their integration of ESG than others. Our colleagues in the Netherlands and Scandinavia are very active in their integration of ESG, while our colleagues in Asia are very advanced in their incorporation of the environmental dimension.

However, there's one area where we have united everyone regarding ESG dimensions — more institutional investors are asking that we demonstrate an expertise in ESG, to help them better integrate it into their investments. And this is something that's now global.

So if I were to make a prediction, I'd say that within two or three years, all of our investment centres will be incorporating ESG into their investment-decision processes. It is turning into a must-have for our business.

6. WHICH SECTORS, REGIONS AND ASSET CLASSES HAS ESG HAD THE BIGGEST IMPACT ON?

What we notice is that there are different levels of practices – it really depends on the region where the companies are located. It's no scoop to say this, but Europe has many stringent regulations in terms of environmental protections and social standards, so it tends to have higher scores. What this means is if you want to incorporate ESG risk into your portfolio and you're a mainstream fund manager, you tend to favour European companies over Asian or North American companies.

But that may be changing. As you may be aware, China has been moving very rapidly, completely changing its way of perceiving environmental protection. And because the country is facing so many challenges – particularly health problems, because of poor air and water quality – they decided it was really time to make progress on these issues.

It's the same in the US, where there's been a kind of Obama effect in pushing companies to be more environmentally friendly.

But there is one area where the standards are quite different, and that's the social dimension. For the moment, I think this is where we have the biggest contrasts between the practices of different companies. And the main source of these controversies is outside of the developed world. There are many infringements of labour practices and human rights in emerging economies, and that's where we really ask for focus when analysing those companies – how they can be assessed, how they can be measured in terms of their labour practices.

Talking about the G part of ESG, we used to say that the US, the UK and Europe were perhaps the most advanced in terms of corporate governance. But what's interesting is that there's a document called the UK Stewardship Code that really spells out the requirements that companies need to meet in terms of corporate governance. Countries like Japan and Malaysia have been putting together their own codes based on the UK Stewardship Code, thus producing their own specific codes that nonetheless align to the same levels of conduct and expectations.

Last but not least, modern societies are facing the same global problems: climate change, a scarcity of resources, malnutrition and obesity, access to medicine, and social tensions. That's why the integration of ESG in finance is a global phenomenon that's becoming ever more appealing for asset owners and asset managers: it contributes to both investing in companies that can help solve these problems, and to minimising exposure to the companies that make those problems worse. Investing more responsibly is a key contribution to the future of our societies.

7. WHAT ARE SOME OF THE CHALLENGES YOU HAVE FACED IN IMPLEMENTING ESG PRACTICES? IS ONE OF THE THREE AREAS – ENVIRONMENTAL, SOCIAL OR GOVERNANCE – EASIER OR MORE CHALLENGING TO IMPLEMENT THAN THE OTHERS?

For now, the social element of ESG is the most difficult to assess. As an asset manager, we are increasingly asked to have a clear understanding of the value chains of the companies we invest in, and to assess the different social standards among the contractors and sub-contractors the company uses. And to be honest, that's very, very difficult to assess. Even if we try to work with some providers, and also with some brokers, it's really difficult to assess the sphere of responsibility of the company and its ability to export its best practices.

But things are changing, not least because of pressure from regulators on companies to investigate their value chains and their social risk. That's why a big part of the engagement we have with companies, directly or indirectly through engagement platforms or initiatives, is to focus on those social issues. One good example is our active involvement in the Bangladesh Accord on Fire and Building Safety, where, alongside other asset owners and asset managers, we have been engaging with the textile sector to improve social standards and working conditions at the contractors. There is huge room for asset managers to continue to encourage greater disclosure by companies.

Regarding corporate governance, there are two things. Standards tend to align in terms of the independence of the directors, and the requirement for greater disclosure of audit practices. But another area of corporate governance that is still an issue is business ethics and business practices. There are still anticompetitive practices, and despite the fact that there are ever more authorities trying to investigate and bring an end to those problems, we know that bribery, corruption and tax evasion are still big issues. To work with companies to better address these issues is something we would like to add to our agenda.

8. IN A LOW-GROWTH, LOW-YIELD ENVIRONMENT, IS IT DIFFICULT TO GET PORTFOLIO MANAGERS ENGAGED WITH ESG PRINCIPLES? DO THEY SEE THEM AS SOMETHING OF A DISTRACTION?

If you'd asked me this question five years ago, I'd have said it's very complicated to convince fund managers that the principles of ESG would have a material positive impact on their funds' performance. They'd have laughed at you, to be honest. But we've been going through a massive financial crisis since 2008, and I think it was a good exercise for SRI funds to showcase ESG-type practices as a way to help minimise our risk exposure.

SRI portfolios remained quite robust and saw further inflows; they continued to perform well, despite the financial crisis. Fund managers are curious creatures. They were keen to find out why the SRI portfolios had been performing well, contrary to some mainstream funds. And it was through explaining that there was value to be found in ESG that the door opened on the idea that things could be improved through integrating the ESG dimensions.

I'd say that most of our portfolio managers are now quite comfortable with ESG. This is especially because they've had some positive feedback from their clients, and some prospective clients are specifically asking about it. So for fund managers it's part of their strategy now, to look into ESG issues, and to find room in their investment models for specific ESG criteria.

Of course, as in any field, there are still some people who are reluctant. And some of these people really dislike it, and can't recognise its value. So that's part of my job, to work with those portfolio managers and provide examples of strong-performing companies and poorly performing companies, and show how ESG played a key role in their performance. And that's how I think we can convince many people to get on board.

ESG isn't just a key part of BNP Paribas Investment Partners approach – there's a massive trend toward ESG integration among other large investment managers and asset owners as well. And though the most forward-looking companies got involved around three years ago, there are many newcomers coming on board now as well. If you look around, major asset managers are increasingly recruiting ESG specialists. And if you get the big investment houses jumping on the ESG train, the smaller companies will follow. It's just a question of time.

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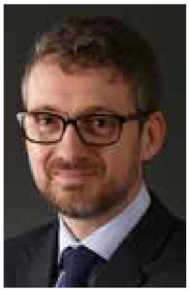
BIOGRAPHY



Jacky Prudhomme
Head of ESG Integration

Since September 2013, Jacky has been the Head of ESG Integration at BNP Paribas Investment Partners. Prior to taking over this role, he held various positions within BNP Paribas Investment Partners including Co-Head SRI Research/Head of Best in Class Research and was also a member of the SRI Research team where responsibilities included extra-financial assessment methodologies in SRI research and coordination of the European analysts team. Before joining the firm, he was sustainable development manager at Arcelor in Luxembourg, where he was in charge of the relationships with socially responsible investors. Jacky started his professional career at ARESE, now Vigeo, and was head of international relations, as well as a member of the industrial securities analysts team, where he participated in the creation of the first extra-financial rating agency. He has 18 years of investment experience.

Jacky holds a master's degree in economics & energy policy and a bachelor's degree in economics & finance, both from the University of Paris X.

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