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ESG : Going Beyond the Financial Statements

Sep 2020

Key Agenda

Back to Basics – An ESG Primer

1 Clarifying the confusion: What is ESG Criteria ?

2 Significance of ESG Factors in Investment Decisions

3 ESG Rating : How it is calculated ?

4 ESG Challenges and Opportunities

5 Understanding the ESG Taxonomy

6 ESG Research Summary

How to Read this Primer

We understand that some employees have a strong understanding of certain ESG concepts, but other are less familiar. As a result, we have structured this presentation so that it can be read cover to cover for comprehensive primer on this topic. It is intended for information purpose only.

1

Clarifying the confusion : ESG & Its Components

Environmental Social Governance

ESG refers to a class of investing that is also known as “sustainable investing.” This is an umbrella term for investments that seek positive returns and long-term impact on society, environment, and the performance of the business.

What are ESG factors ?

01 Environmental

- [1] Climate Change
- [1] Natural Resources
- [1] Pollution and Waste
- [1] Environmental Opportunities

02 Social

- [1] Human Capital
- [1] Product Liability
- [1] Stakeholder Opposition
- [1] Social Opportunities

03 Governance

- [1] Corporate Governance
- [1] Corporate Behavior
- [1] Tax Transparency
- [1] Anti-Corruption Measures

Key Takeaways - ESG investing is the consideration of environmental, social and governance factors alongside financial factors in the investment decision–making process. These broad components are just a starting point for an in-depth ESG risk assessment. ESG criteria can also help investors avoid companies that might pose a greater financial risk due to their environmental or other practices.

[1] Please note this list is not exhaustive , ESG issues are extensive and growing

2 Significance of ESG in Investment Decisions

A Rise of New Standard

ESG in investment decision making becomes more important as there is a need to pick companies which are responsible to Environment, Society and has good Corporate Governance in the portfolio so that the investment return can be sustained on a long run.

Why it is important for a companies to understand ESG factors?

- Understanding the ESG factors of a company helps understand corporate purpose, strategy, and general management quality
- While the investment managers are bound by their fiduciary responsibilities of generating adequate return as required by the investment objectives of the investor, with raising investor awareness coupled with changing geo-political scenario, require them to look at additional data points for investment evaluation beyond the traditional methods.
- ESG parameters aid investment managers to ensure sustenance of the investment return, since frequent churning of portfolio results in lag on investment returns on account of transactional / exit costs
- Using ESG Factors or an ESG framework, investors can select companies in which to invest
- The integration of ESG factors is used to enhance traditional financial analysis by identifying potential risks and opportunities beyond technical valuations. While there is an overlay of social consciousness, the main objective of ESG valuation remains financial performance

Key Takeaways: Investment decision making is not just about making financial returns but also needs to look at sustenance of the generated financial returns. ESG parameters when included in Investment decision making aids to evaluate the sustenance of financial return. ESG analysis can certainly help identify red flags and lead to better investment decisions.

Why using ESG help you build better portfolios ?

- An ESG focus does not have to mean compromising on performance
- Sustainable investing appears to have a positive effect, if any, on returns
- Most institutional investors that integrate ESG factors in their strategies use at least one of three main techniques for portfolio construction and management: negative screening, positive screening, and proactive engagement
- There is proven link between ESG and financial performance
- The top reason investment professionals consider ESG issues is to manage risks

The consideration of ESG issues is a complement to (not a substitute for) traditional fundamental analysis, and ESG issues remain relevant throughout the investment process—from the initial analysis to the buy/ sell/hold decision to ongoing ownership practices

Methods of Considering ESG Issues

ESG Integration	Best in Class Investment	Exclusionary Screening	Active Ownership	Thematic Investing	Impact Investing

ESG Integration – including ESG Factors in Fundamental Analysis (Widely used in investment analysis and decision making)

Best in Class Investment – selecting companies with strong ESG Performance

Exclusionary Screening – eliminating companies in industries or countries deemed objectionable

Active Ownership – engaging deeply with portfolio companies

Thematic – fund focused / target specific

Impact Investing – looking for companies that make positive impact on an ESG issue while still earning market return

ESG Ratings : How it is calculated ?

Measuring the Intangibles

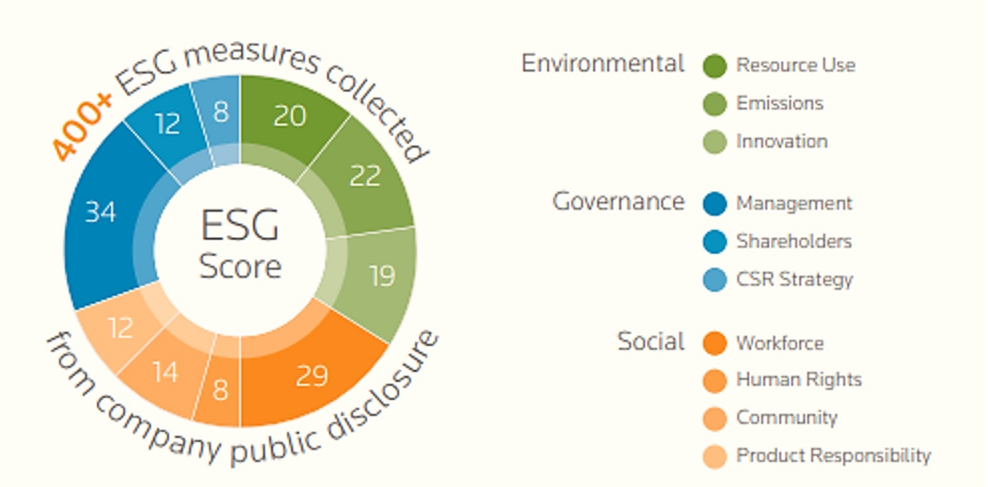
Integrating ESG Ratings into investment decision making can help identify risks or opportunities that may not be captured by conventional financial analysis

ESG Ratings

ESG Score	ESG Rating
8.6-10	AAA
7.1-8.6	AA
5.7-7.1	A
4.3-5.7	BBB
2.9-4.3	BB
1.4-2.9	B
0.0-1.14	CCC

How to calculate ESG scores ?

Combine key issues and weights and normalize relative to industry peers to derive the ESG Rating



Note: Report and ratings methodology, scope and coverage, however, vary greatly among providers

3

ESG Ratings : How it is calculated ?

Measuring the Intangibles

There are currently numerous ESG data & ratings providers, a summary of each of which is beyond the scope of this post, but some well-known third party ESG report and ratings providers include -

ESG Data Providers	Rating Scale
Bloomberg ESG Data Service	Out of 100 (Use third party)
MSCI ESG Research	AAA-CCC scale
Sustainalytics	AAA to D (being the worst)
RepRisk	Out of 100. Sector/industry-based comparison
Refinitiv	Category Score (Percentile Rank)
TruValue Labs	Positive/Negative Sentiments (NLP)

Key Points

- ESG ratings vary markedly by ESG ratings provider because each provider has a unique methodology for assigning company-specific ratings
- ESG ratings providers can evaluate the same company very differently
- ESG ratings and data have long been used by institutional investors to evaluate the ESG characteristics of their portfolios

4

ESG Challenges and Opportunities

More than just disclosures

Lack of Standardization

- No uniformity and aligned definitions in terms of ESG data from Legislator
- Without a common framework, institutional investors will find it difficult to compare and promote relevant funds and financial products

Quality of ESG Information

- Too much of the available ESG information is of poor quality
- Most data and certainly most real-time or current information that might reveal improvement trends is unstructured.

Education Gap

- Asset managers need to upgrade operational Capabilities to meet investor expectations
- Investor awareness is the seedbed for ESG innovation

Inconsistent disclosures

- Inconsistent ways companies disclose information about their environmental, social and corporate governance practices, which are not always comparable across corporations

Lack of Common Taxonomy

- No common benchmark to define the perimeter and the minimum requirements for sustainable activities

Need for ESG Integration

- Need to incorporate ESG data into investment decisions
- Need for real-time ESG data relevant to investment strategies

5

ESG Taxonomy

A generational shift towards responsible investment

The **ESG taxonomy** is a tool to help investors understand whether an economic activity is environmentally sustainable. Setting a common language between investors, issuers, project promoters and policy makers, it helps investors to assess whether investments are meeting robust environmental standards and are consistent with high-level policy commitments such as Paris Agreement.

What are its Objectives ?

- Create common definitions for sustainable activities and investment practices
- The taxonomy will set performance thresholds, or technical screening criteria, for different sectors of the economy
- Allow investors to compare financial products promoting or presenting environmental characteristics
- Reward companies who follow the direction set by this science- and evidence-based framework
- However, the Taxonomy will develop over time, with additional testing criteria and the inclusion of further industry sectors

The following table summarizes what the Taxonomy is and isn't:

Is	Is not
A list of economic activities and relevant criteria	A rating of good or bad companies
Flexible to adapt to different investment styles and strategies	A mandatory list to invest in
Dynamic, responding to changes in technology, science, new activities and data	Inflexible or static
Based on latest scientific and industry experience	Making judgement on financial performance of an investment – only the environmental performance

6 Executive Research Findings

Why ESG ratings differ so widely ? // MIT Sloan School of Management

The research team found the correlation among those agencies' ESG ratings was on average 0.61; by comparison, credit ratings from Moody's and Standard & Poor's are correlated at 0.99. That means the information the decision-makers receive from [ESG] ratings agencies is relatively noisy," the paper states — a condition researchers call "aggregate confusion."

Some major consequences from discrepancy in ratings the researchers write are :

- Corporate stock and bond prices are unlikely to properly reflect ESG performance as investors struggle to accurately identify out-performers and laggards
- The divergence can dampen the ambition of companies seeking to improve their ESG performance, thanks to the mixed signals they receive from ratings agencies about which actions are expected and will be valued by the market

Paper identifies three distinct sources of ESG ratings divergence

- **Scope divergence** can occur when one agency includes greenhouse gas emissions, employee turnover, human rights, and corporate lobbying in its ratings scope, while another doesn't consider lobbying
- **Weight divergence** can happen when agencies assign varying degrees of importance to attributes, valuing human rights more than lobbying, for example
- **Measurement divergence** occurs when ratings agencies measure the same attribute using different indicators. One might evaluate a firm's labor practices based on workforce turnover, while another counts the number of labor cases against the firm. While both capture aspects of a firm's labor practices, they are likely to lead to different assessments, the research cautions

RESEARCH FINDINGS

ESG Matters // Harvard Law School

Key Findings

1

High/favorable ISS ESG Corporate Rating Performance / High-EVA Margin Stocks tend to Outperform

2

High/favorable ISS ESG Corporate Rating firms are Good Allocators of Capital

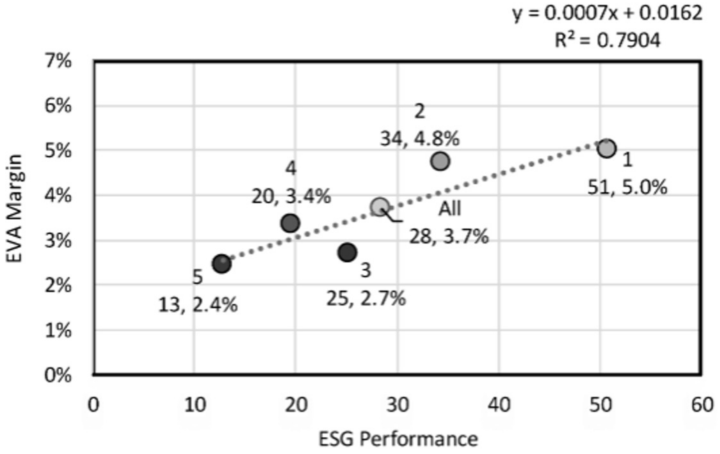
3

High/favorable ISS ESG Corporate Rating performance is Generally Positively Related to Valuation and Profitability and Negatively Correlated with Volatility

4

High/favorable ISS ESG Corporate Rating Firms Tend to be Less Cyclical and are More Likely to be in the Technology, Health Care, and Consumer Non-Durables Sectors

Key Observation



Higher Performance Related to Higher EVA Margin

Responsible Investing: The ESG-Efficient Frontier // NYU Stern School of Business

Executive Summary : Highlights

- This paper proposes theory in which each stock's environmental, social, and governance (ESG) score plays two roles: providing information about firm fundamentals and affecting investor preferences
- The solution to the investor's portfolio problem is characterized by an ESG-efficient frontier, showing the highest attainable Sharpe ratio for each ESG level
- The corresponding portfolios satisfy four-fund separation
- Equilibrium asset prices are determined by an ESG-adjusted capital asset pricing model, showing when ESG increases or lowers the required return.
- Combining several large data sets, we compute the empirical ESG-efficient frontier and show the costs and benefits of responsible investing
- Finally, paper tests the proposed theory's predictions using commercial ESG measures, governance, sin stocks, and carbon emissions

ESG : A Critical Review // CFA Institute Research Foundation

Executive Summary : Highlights

- Research highlights the many data quality issues and the ESG rating dispersion among data providers
- There are concerns over the growing influence of proxy advisory firms
- Asset classes beyond public equities are under researched
- There is no consensus on the exact list of ESG issues and their materiality
- The ESG issue that gets the most attention from institutional investors is climate change, in particular their portfolio companies' exposure to carbon risk and stranded assets
- When surveyed on ESG incorporation, a large fraction of PRI signatories report high levels of engagement, ESG integration, and negative screening
- The value of good corporate governance is “top of mind” for institutional investors, but there is a continued debate on its proper measurement

Managing Climate Risk In The U.S Financial System // Market Risk Advisory Committee

Executive Summary : Highlights

- This report begins with a fundamental finding—financial markets will only be able to channel resources efficiently to activities that reduce greenhouse gas emissions if an economy-wide price on carbon is in place at a level that reflects the true social cost of those emissions
- Insufficient data and analytical tools to measure and manage climate-related financial risks remain a critical constraint
- The disclosure by corporations of information on material, climate-related financial risks is an essential building block to ensure that climate risks are measured and managed effectively
- Demand for disclosure of information on material, climate-relevant financial risks continues to grow, and reporting initiatives have led to important advances
- However, the existing disclosure regime has not resulted in disclosures of a scope, breadth, and quality to be sufficiently useful to market participants and regulators

Thank You

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