Integrating ESG into investment process and valuation

Theory and practice
What is ESG?
What is ESG? Different things to different people.

- ESG is different things to different people and different asset classes.
  - Similar to different aspects of “financial” analysis.
- But with certain principles and philosophy which tends to be shared.

Source: Pixabay

RBC Global Asset Management
Why do investors care about ESG

- Meeting requirements under fiduciary duty or regulations
- Meeting client/beneficiary demands (growing capital source)
- Lowering investment risk
- Increasing investment returns
- Tools and techniques to use in analysis
- Improving the quality of engagement and stewardship

RBC Global Asset Management
Interconnectedness: Transparency to end user driving change

People
Culture
...Employees, Customers, Investors, Voters...

Pensions
Investments

Asset Managers

Companies
Employees | Customers
Suppliers | Regulators
Owners | Community
Innovation | Standards

Governments / Non-Profits
Policy | Tax | Innovation
Intangible and ESG value is hidden from accounts

GDP doesn’t include most intangibles or ESG… …neither do company accounts.

R²’s of market values regressed on earnings and book values of companies entering the public market in successive decades 1950-2013

Source: Capital without Capitalism, Westlake & Heskel, 2017.
Value found in items we can not easily account for

Not everything that can be counted, counts.
Not everything that counts, can be counted.
ESG potentially generates sustainable long-term returns

ESG could be a return (Alpha) source due to inefficient markets

Some Academic literature backs up this idea but ultimately will “hard to prove definitively” either way

- Happy and Engaged employees make better companies and make better stock returns
  - Edmans.  
    
    [Does the stock market fully value intangibles? Employee satisfaction and equity prices](#)

- Incentives aligned to long term decision making make better companies and make better stock returns
  - Flammer and Bansal.
    
    [Does a Long-Term Orientation Create Value? Evidence from a Regression Discontinuity](#)

- CSR proxy proposals are be positive for companies both in company fundamentals and stock returns
  - Flammer.
    
    [Does Corporate Social Responsibility Lead to Superior Financial Performance? A Regression Discontinuity Approach](#)

- Companies with good performance on material sustainability issues significantly outperform firms with poor performance
  - Khan, Serafeim, Yoon.
    
    [Corporate Sustainability: First Evidence on Materiality](#)

- Active ownership and positive engagements improves company operating performance and stock return
  - Dimson, Karakas, Li.
    
    [Active Ownership](#)

Still considerable investor debate on Financial “Value factor”
ESG techniques vary by strategy and asset class

Source: Guidance and Case Studies for ESG Integration: Equities and Fixed Income (CFA Institute 2018 in collaboration with Principles for Responsible Investment (PRI).

RBC Global Asset Management
Theory: How do firms create long-term value?

Combine various “capitals” to produce goods/services and more “capitals”

Source: Integrated Reporting Council
RBC Global Asset Management
Where ESG fits into a theory of firm & portfolio value

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Stock specific ESG
Credit specific ESG
Stewardship
Portfolio construction
Factor ESG

RBC Global Asset Management
Fundamental active: Philosophy and process

Starts with philosophy (or purpose).

“A sustainable company is: (1) one whose current earnings do not borrow from its future earnings (2) one whose sustainability practices, products and services drive revenues, profitability and competitive positioning, and (3) one that provides goods and services consistent with a low-carbon, prosperous, equitable, healthy and safe society.” (Generation)

“Our purpose is to make a positive difference to our clients, to the companies we own and society as a whole through responsible long-term investment.” (RBC Global Equities)

However, “Purpose” not pre-requisite to using ESG techniques.
Broad techniques: Materiality or risk maps & scorecards

Investment process typically has these stages:

1. Research stage
   • Data gather primary, secondary; quantitative/qualitative
   • Generate ideas, may screen, checklists, scorecards
   • Assess materiality

2. Valuation stage

3. Portfolio construction stage

ESG Integration techniques at all stages possible
Broad techniques: Materiality / Risk maps and scorecards

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Example map. Different authorities can disagree.

Source: CFA Certificate in ESG investing Official Training Manual; SASB

RBC Global Asset Management
Broad techniques: Materiality / risk maps and scorecards

Example sector map

- Often varies by company and/or subsector
- The actual score can differ

Source: CFA Certificate in ESG investing Official Training Manual; SASB

RBC Global Asset Management
Fundamental: ESG valuation and assessment techniques

Adjust DCF inputs: cost of capital / fade rates / terminal growth etc.

Scenario analysis

• Explicit adjustments
  ▪ e.g. P&L sales, balance sheet, cash flow and margin adjustments from ESG assessment

• Valuation radio adjustments
  ▪ e.g. price to earnings ratio

• Sustainability of business model: ESG opportunities

• Asset quality or efficiency assessment

• Employee retention or incentive assessment

• Precedent Transactions +/- “ESG Premiums”

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Fundamental: ESG techniques | Pros & Cons

Adjust DCF inputs: cost of capital / fade rates / terminal growth etc.

- Theoretical Strong Basis of Intrinsic value
- Open to manipulations; economic justification of “50bps” spreads weak
- Cross-comparisons harder / relative values; complexity, sensitive to assumptions
- Overconfidence in details

Scenario analysis

- Complexity, no “correct” answer
Fundamental: ESG valuation and assessment techniques

• Explicit adjustments
  e.g. P&L sales, balance sheet, cash flow and margin adjustments from ESG assessment
  ▪ Theoretical Justification
  ▪ Complexity; Over-detail; Materiality Judgement error

• Valuation radio adjustments
  e.g. price to earnings ratio, Price / Sales etc.
  ▪ Simpler; Relative Value
  ▪ Pitfalls of all ratio techniques; weak economic justifications of spread

• Precedent Transactions +/- “ESG Premiums”
  ▪ Judgement in “Premiums” plus market transaction data difficulties

## Credit lens

### Credit based ‘ESG’
- Similar flow of assessment but focus on what impacts credit ratings / default risks.
- Assessment criteria differ for Governments but similar concepts.

### Extra-financial factors
- Customers
- Regulators
- Environment
- Community
- Colleagues
- Suppliers

### Business performance
- Employee engagement
- Governance
- Customer satisfaction
- R&D effectiveness
- Corporate culture
- Stewardship
- Maintenance & safety

### Corporate performance
- Debt
- Cash flows
- Financial assets
- Margins
- Dividends
- Sales

### Share price performance
- Credit specific ESG

### Portfolio performance
- Stewardship

### External risk factors
- Credit specific ESG

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**RBC Global Asset Management**
Credit investor techniques

Fundamental credit measures e.g. margins, leverage, cash flow
Qualitative or quantitative assessments: Emissions, board, employee retention

e.g. A beverages company:

**E**

**Strength:** Collaboration with suppliers to improve water efficiency by 15% in high-risk areas. Aligned greenhouse gas emissions reduction goal with Science Based Target Initiative.

**Challenge:** Weak disclosure on progress being made to reduce packaging waste.

**S**

**Strength:** Comprehensive human rights and supplier code-of-conduct protocols.

**Challenge:** Certain talent retention and recruitment strategies trail best practices. Products are primarily sugary drinks, despite introduction of healthier brands.

**G**

**Strength:** Robust antibribery policies governing interactions with suppliers. Board of directors formally oversees sustainability initiatives. Rigorous, year-round stakeholder engagement includes consumer groups.

**Challenge:** No significant challenges seen.

Internal rating can be adjusted up/down compared to external ratings
Making an investment accordingly is judged to be mis-priced

RBC Global Asset Management
Tilting or rules based ESG

Thesis:
• “Real” World factors translate into “data” factors
• Or “behavioural” drivers translate into factors.
Third party ESG ratings are not consistent

Comparison of ESG evaluation by FTSE and MSCI

Current situation of ESG evaluation:
- Unlike financial analysis, ESG evaluation does not have a long history, and the standard method of evaluation is yet to be established. Disclosure of information necessary for evaluation is also not sufficient.
- The correlation of ESG evaluations by FTSE and MSCI is very low.

Chatterji et al (2014) show only low 0.3 correlation between ESG data providers.

Source: GPIF 2017. Universe for the analysis are 430 Japanese companies commonly surveyed FTSE and MSCI (as at July 2016). The plot of the diagram shows the ranking of ESG evaluation of each company (from 1st to 430th)
Investors should not treat ESG scores as settled facts…

…but worthwhile analysis that needs to be understood before being acted on

The problem here isn’t the ESG ratings…

…but that they can be used as objective truth
Quant techniques

Factor based:

• Do ESG factors correlate with Quality / Value / Momentum?
• Correlation seems low depending on data set
• Alternative Data sets? Combination of data sets

Is there “Factor ESG” or “Idiosyncratic” ESG” – current debate (cf. Axioma paper)

Tilting or rules based:

• Is there second order exposure eg low carbon = Norway Bank ?
• Align “real world” impact eg Diversity Index ?
• Green Revenues / Taxonomy

RBC Global Asset Management
Consistent share price dispersion indicates persistent alpha opportunity

Rolling weekly standard deviation of 13 week returns for MSCI World & U.S. Indices

Source: Sanford Bernstein.
Greater opportunity in stock-specific risk than factors

**Factor risks**  
$\sigma = 13.2\%$  
Characteristics shared across multiple firms e.g.:  
- size  
- industry  
- country  
- leverage

**Stock-specific risks**  
$\sigma = 24.2\%$  
Characteristics unique to an individual firm e.g.:  
- culture  
- human capital  
- innovation  
- decision making

The challenge for active managers is to:  
- demonstrate an ability to exploit this market opportunity  
- construct portfolios that capture intended sources of returns

Private Markets, Property, Infrastructure, Venture Capital

ESG ideas and techniques applicable across asset classes

Specific techniques may vary

- Building assessments
- Engagement
- Active ownership
- Performance standards
- Carbon assessments
- Board structure
- Private markets
- Water assessments
- Proxy voting
- Buy-outs
- Event driven (ESG activism)
- Governance

WeWork, Uber highlights potential value in private market assessments
Company ESG engagement enhances outcomes

Engagement as an ESG technique

- Enhances stock returns
- Enhances company fundamentals
- Enriches extra-financials

Source: “Active Ownership” by Elroy Dimson, Oğuzhan Karakaş and Professor Xi Li (last revised 2016).
ESG integration challenges and debates

**Challenges**
- Data
- Comparability
- Judgements
- Materiality
- Culture
- Innovation
- “Purpose”
- Incentives
- Diversity

**Critiques**
- “Bad actors”
- Dubious criteria
- Data
- Differing judgements
- Ethics
- Differing Geographies
- Balancing Stakeholders

**Debates**
- Regulation
- Stakeholder Capitalism
- Where SDGs fit? “Real World” impact
- Active vs Passive vs Factor approaches
- Stewardship / Climate / Systemic Risks
- Greenwashing
- Where is the idiosyncratic alpha? What fees?

*RBC Global Asset Management*
“Someone is sitting in the shade today because someone planted a tree a long time ago.”

– Warren Buffett
Ben Yeoh

Senior Portfolio Manager, RBC Global Equity

Ben is a Senior Portfolio Manager and the Global Equity team’s Healthcare sector specialist. In addition he is the team’s ESG expert and sits in a non-executive advisory capacity for Responsible Investment and ESG for a leading UK investment trust.

Ben holds an MA (Natural Science) from Cambridge University gaining the top first in his year. He won a scholarship to Harvard University and studied there at post graduate level specialising in behavioural neuroscience. Ben is a CFA charterholder, a member of the UK’s Financial Reporting Council’s Investor Advisory Group, part of the Consultative Group for the International Accounting Standards Board (IASB) and chairman of the External Advisory Committee for the Royal London's Sustainable Investment Trusts.

Ben is also co-author on CFA the text book on ESG Investing (2019) and a playwright.

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RBC Global Asset Management

Benjamin Yeoh

ESG Exchange VI
Come and join us at our next UK flagship ESG event - contact me for details.
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