OSSERVATORIO ESG

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During the last decades, and mainly in the last few years, the sustainable finance has been spreading rapidly and the regulator started to require additional transparency and disclosure for ESG data. Asset Managers, passive and active, are now facing the complexity to integrate ESG factors into the traditional financial analysis. The ESG investment process is the grounding of the ESG strategy and involves all company functions.

ESG INVESTMENT PROCESS

AIAF ESG Expert Group | Viewpoint edited by Barbara Ietto, CESGA®, CEFA®

Introduction

The methodology to implement ESG integration is very different from an asset manager to another.

Taking material ESG issues into account in an investment process requires the analysis of all the material factors correlated to the Environmental, Social and Governance.

First of all, it's important to stress that the ESG Investment process involves all company functions that must collaborate with each other in order to implement a solid process.

It is desirable that the commitment comes from the Board, as the process could take longer if there is not the endorsement of the ESG strategy. The ESG investment process is strictly correlated with the ESG strategy, in other words the process is the grounding of the strategy. The results may not be achieved without coherence between the strategy and the process and enough resources and personnel in charge.

Therefore, a methodical approach is crucial. Some pitfalls, as United Nation Principal of Responsible Investment - UNPRI has indicated, may include: skipping steps, lack of consensus/board-alignment, lack of detail/flexibility or creating a strategy without due consideration of how it will be implemented.

ESG data: collection

One important focus point is the collection of ESG data. Among the important sources are: companies, (reports, documents and the website), governments, ESG data providers, no profit organizations, international organizations, rating agencies. This data could be raw or aggregated. It is essential to know how to collect and to process it.

ESG data availability is spreading due to the increasing regulatory requirements for more and more disclosure about the sustainability risks (i.e., Non-Financial Disclosure Regulation - NFDR and Sustainable Financial Disclosure Regulation - SFDR) and the more specialized ESG data providers role. Some of these offer a very widespread set of ESG data, while other offer a specific set of information (i.e. regarding environmental). The regulation plays a crucial role to create a common language for the sustainable finance.

Asset managers could integrate this set of ESG data in their own systems, internal software or in a proprietary tool of analysis. More and more asset managers create a proper internal ESG score. This process is fundamental to create a strong internal ESG expertise.

ESG data: analysis

In the analysis of the ESG data, the real value added is to focus on the material issues and so which data keep in consideration. Materiality, according to the UNPRI, means that not all the information is considered to affect the understanding of the corporate performance and investment performance. In general, when some ESG issues are considered material, an assessment of their impact is carried out.

Materiality is correlated to sector and geography.

ESG data give a set of information to study in depth a company in order to pinpoint risks but, also the opportunities for a business in a long-term period.

ESG Portfolio Construction

Another important point is the definition of the investible universe that could be affected by the different sustainable strategies implemented and mentioned in the ESG Policy, such

as exclusion screenings, thematic focus and best- in- class screening.
In particular, negative screening means to decide which sectors or products (in general controversial sectors or harmful products) and so which companies are ineligible.
Until some years ago, there was the conviction that a reduction in the investible universe could penalize the portfolio's performance and in full in violation with the fiduciary duty.
Many academic studies have demonstrated that considering ESG factors, exclusions as well, could help in the portfolio downside protection and it could represent a better risk-return proposition in a long period.
In portfolio construction, an asset manager chooses the companies eligible and decide their weight. The stock picking is definitely more important for active managers than passive ones that remain firmly tied to the benchmark's composition.

ESG team

The team could be organized with a dedicated ESG team that carry out the analysis and interacts with the portfolio managers promoting a proactive communication, or with integrated investment teams where portfolio managers and analysts together manage the ESG analysis.
In each structure the dialogue and the sharing of spreadsheets, documents and analysis are a good practice in order to circularize the information, as meetings are useful to review the internal consideration about the sector view, internal ESG rating, valuations, internal and external data feed and so on.

ESG Portfolio monitoring

Another crucial point is the portfolio monitoring that must be carried out periodically and it represents an assessment in order to confirm the confidence of ESG risks and the analysis taken in consideration. This step is essential for the implementation of the SFDR regulation.

Active ownership

But probably the most difficult features of the process are the active ownership practices.
An organization, with a dedicated ESG team, the dialogue with the company is carried out through meetings, calls and voting decisions as well. This help to influence the company to obtain better ESG's metric with a better sustainability objectives and efforts. This activity requires high expertise and takes a long time. For these reasons, generally, engagement activity is easily delivered by dedicated providers.
The landscape of the ESG investment is evolving and, in the future, the ESG investment process could be affected by:

a) **INVESTOR DEMAND**: in the next years the ESG products demand is expected to increase by institutional as well as retail investors. The launch of the UN Sustainable Development Goals – UN SDGs in 2015 has created a general framework where the investor could aspire to contribute and to achieve these global objectives. Nowadays, a greater attention in climate risks, social issues and high standards in business conduct will influence the investor and the consumer choices rewarding the corporate in line with these goals and values.

b) **EMERGING TECHNOLOGY:** as the ESG data disclosure covers in particular large companies, some emerging technologies, like artificial intelligence, could allow investment managers to gather some additional relevant data that may not have been disclosed by a company. New technological tools are contributing to improve client experience and, possibly, to capture alpha (i.e. controversies trend-news database created by news from the web).

c) **REGULATION:** globally the regulator has started to require more transparency and disclosure for ESG data. This helps to create a common dataset and language to facilitate the comprehension and the diffusion of the sustainability finance. In this regard, the EU regulation has introduced the sustainable taxonomy and metric standards to evaluate ESG factors.

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