

WHAT IS ESG?

ESG

ENVIRONMENTAL | SOCIAL | GOVERNANCE



CHAPTER 1

What is sustainable investing?

While traditional investing has focused on financial metrics, sustainable investments combines the best in class practices of traditional investing with insights about society to produce better outcomes for investors in the long term. The three most common forms of sustainable investments are socially responsible investing, impact investing and ESG investing. Socially Responsible Investing (SRI) involves screening out some companies from investment consideration based on specific ethical guidelines e.g. screening out companies engaged in tobacco, alcohol, firearms, environmental damage etc. Impact investing aims to generate specific social or environmental outcomes, in addition to financial returns. Impact investments may be focused on specific sectors like healthcare, education, agriculture renewable energy etc. ESG is the most popular form of the sustainable investments. ESG is the acronym for Environmental, Social and corporate Governance.



→ What is ESG?

ESG investments refer to the impact of these three factors viz. environmental, social and corporate governance, on the sustainability of a company's financial performance. Experts who advocate investments based ESG principles believe that companies whose managements adopt these principles have the potential of delivering superior earnings growth in the future and at the same time will have lower financial risks.

→ Building blocks of ESG Research

Research and consulting firms engaged in ESG Research collect information about companies' performance on the different ESG factors, analyze them and then provide their rating or recommendations. The building blocks of ESG research can be classified in three broad categories :-

ENVIRONMENTAL

- 🍃 Climate Change: Carbon emissions, carbon footprint, vulnerability to climate change regulations etc.
- 🍃 Natural Resources: Raw materials (including its sourcing), water management, land use etc.
- 🍃 Pollution: Toxic emissions, waste management, packaging etc.
- 🍃 Opportunities: Focus on renewable energy (e.g. solar, wind etc), green buildings etc. are opportunities for companies.

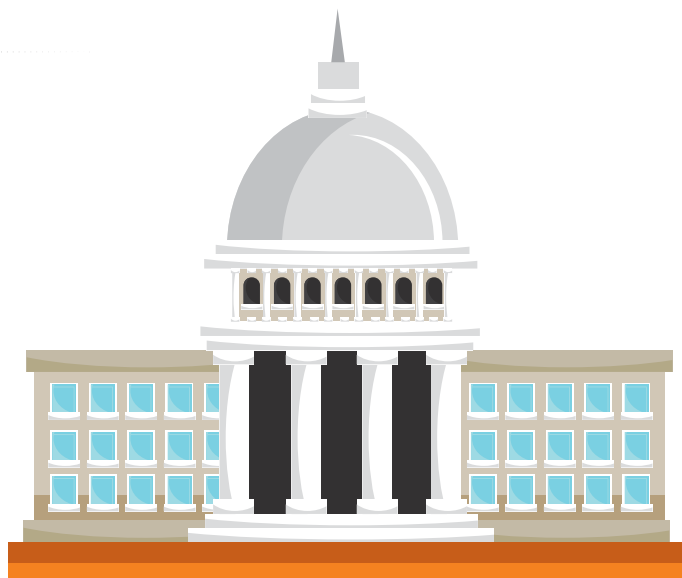


SOCIAL

- ▶ Human Resources: Labour issues and management, occupational health, safety standards, labour standards of suppliers etc.
- ▶ Product: Product quality, product safety, security of financial products, data privacy and safety, environment friendly product etc.
- ▶ Stakeholders: Relationship with suppliers and customers.
- ▶ Opportunities: Improving communication (telecommunication, data, software etc), access to funding, improving healthcare etc. are opportunities for companies.

CORPORATE GOVERNANCE

- Ownership and management control
- Protection of interests of minority shareholders
- Composition of board of directors
- Accounting standards and practices
- Financial and non-financial disclosures
- Corporate behaviour – business ethics, transparency in tax matters, anti-competitive practices, processes for preventing corruption etc.



CHAPTER 2

Why ESG?

Though awareness about ESG investing is low in India, it has gained considerable traction in developed economies. Business leaders around the world are showing greater commitment to ESG values. The US Business Roundtable in August 2019, affirmed commitment of leading American companies to broader range of stakeholders, including shareholders, customers, employees, suppliers and communities – which is fundamental to the ESG framework.

Along with increasing focus of companies towards ESG principles, investors' interest in such companies/stocks is also growing at a fast pace. As per McKinsey Quarterly (November 2019), global investments in ESG theme is over \$30 trillion growing at a CAGR of 15% over the last 15 years.



→ Why is ESG theme gaining popularity with investors?

- ▶ Global sustainability challenges such as environmental risk factors, changing demography (ageing global population), data privacy and security related matters, changing regulations etc. result in companies facing new complexities.
- ▶ Demographic shift among investors especially towards millennials and women investors has resulted in preference for ESG investments. According to MSCI, millennial investors can put an additional \$15 – 20 trillion in ESG investments in the US over the next 20 – 30 years.
- ▶ Since its founding in 2006, the United Nations Principles for Responsible Investing (PRI) which involves commitment to ESG principles in investments as a key requirement has attracted support from more than 2,500 institutional investors.

→ How strong ESG proposition helps companies create value and be more future ready?

Companies who have strong ESG propositions integrated in their business model, operations and management philosophy are able to create value and be more future ready:

- ▶ **Superior revenue/growth by tapping new markets and expanding market share in existing markets.** For products or businesses which need regulatory or Government approvals, companies with superior ESG track record and established processes linked to ESG factors, are likely to get faster approvals. This enables them to bring products to market faster and get competitive advantage over their rivals.
- ▶ **Build stronger customer relationships and brands.** With growing environmental and social awareness, business and products which score high on these metrics enjoy more customer loyalty and brand value. Companies with strong ESG proposition can attract more customers with sustainable products and may not need to compete on price only.
- ▶ **Cost efficiency and superior operating margins.** Companies which integrate ESG principles in their factories and operations can achieve significant cost savings, in terms of raw materials, energy, water, waste management etc.
- ▶ **Superior productivity.** Companies with superior employee relations will be able to attract and retain talent. Higher employee satisfaction has a direct linkage to productivity. On the other hand, companies which do not have strong employee relations, will not be able to attract or retain talent resulting in loss of productivity. In some cases, poor employee or labour relationships, can even lead to strikes and operational shutdown leading to further loss of productivity.
- ▶ **Better access to resources.** Companies which have strong ESG principles are likely to have better relations with Government (both central and state) and the community. They will also be able to resolve issues faster with the support of the Government and the community. There are many examples of projects not taking off due to opposition from the local community.
- ▶ **Less regulatory interventions.** Companies with strong ESG track records and established processes are likely to face less Government scrutiny and regulatory interventions. Companies which have weak ESG principles are more likely to face regulatory interventions which can cause production delays till the issue is resolved.
- ▶ **Less vulnerable to lawsuits.** Companies which are committed to the environment and society, including diversity and inclusion, are less vulnerable to lawsuits from customers and interest groups that can harm revenues and profits. Lawsuits can result in restrictions on advertising, distribution and can even cause companies to incur fines and penalties.
- ▶ **Superior return on invested capital.** Companies which invest in sustainable assets (e.g. plant, equipment, products, technology etc.) are able to deploy their capital more efficiently in the long term. They can avoid investments that may not generate returns in the long term due to environmental issues and regulatory changes.

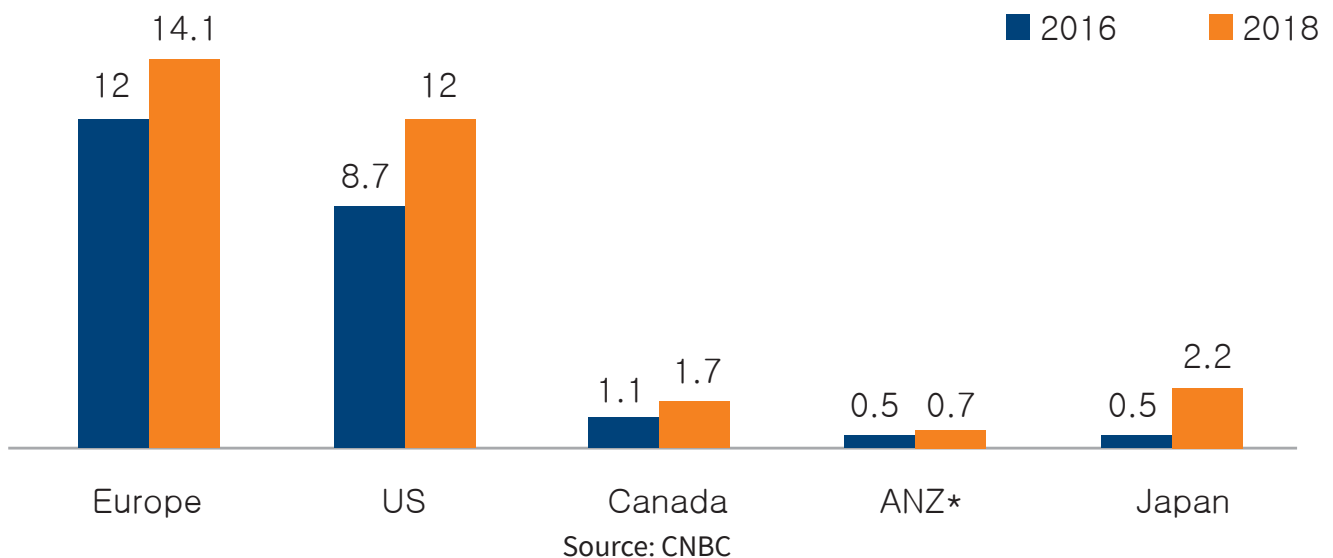
CHAPTER 3

How does ESG investing add to portfolio performance?

ESG Investments are gaining currency in the developed economies around the world. According to CNBC, it grew from \$22 Trillion in 2016 to \$30 Trillion in 2018 and is expected to cross \$40 Trillion in 2020. While Europe is ahead of the others in ESG investments, other developed economies (particularly the US) are also catching up. According to Bank of America, \$25 Trillion is expected to be invested in the ESG theme in the US over the next two decades.



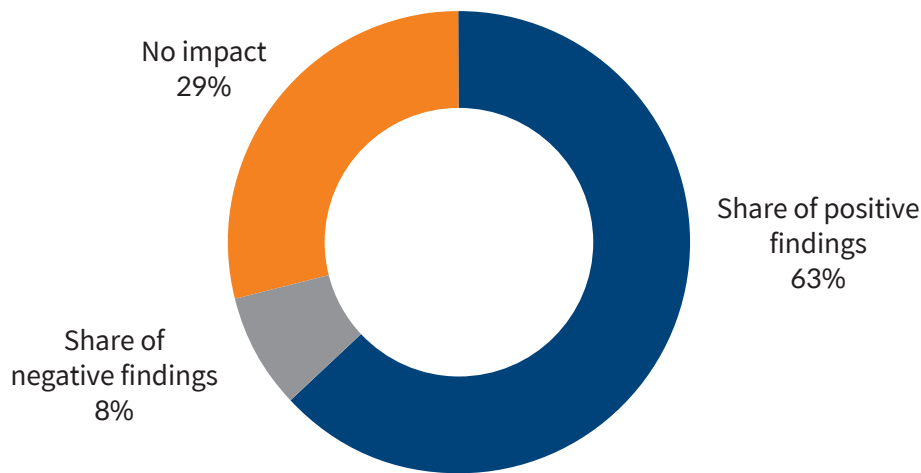
Growth in ESG Investments (\$ Trillion)



Can integrating ESG principles in investments produce better returns?

McKinsey and Company has analyzed more than 2,000 studies on the impact of ESG propositions on equity returns and found that integrating ESG principles in investments produces far more instances of favourable outcomes than unfavourable or neutral outcomes.

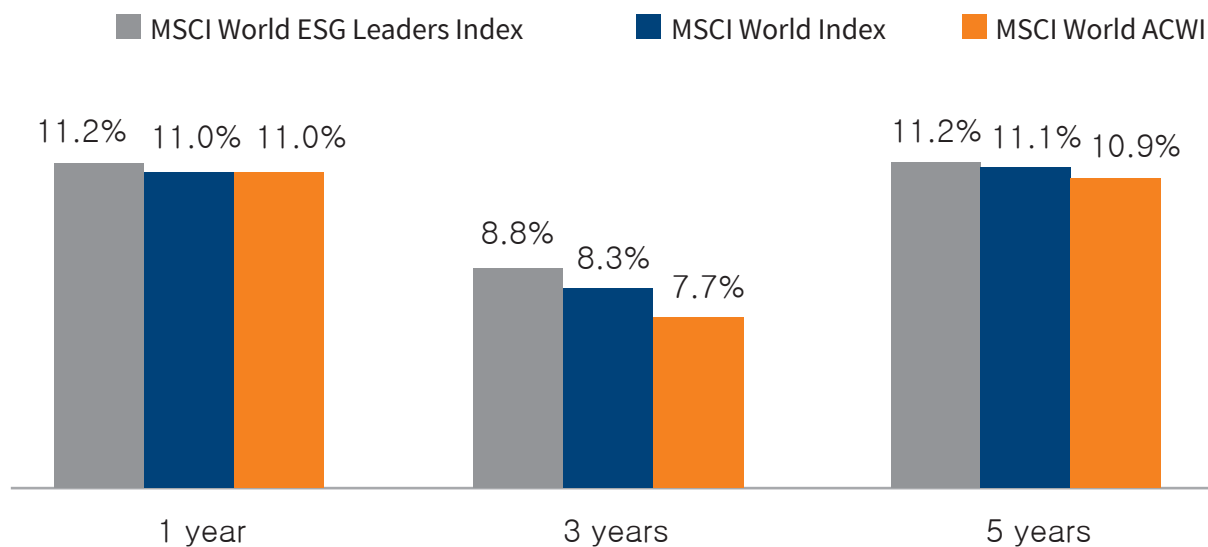
Result of impact of >2,000 studies on impact of ESG on returns



Source: McKinsey (October 2015)

MSCI World ESG Leaders Index has consistently outperformed its parent index, MSCI World Index which represents large and midcaps across 23 developed markets (as on 30th September 2020). We have also shown the performance MSCI World ACWI Index, which includes 26 Emerging Markets, in addition to developed markets included in MSCI World Index. MSCI World ESG Leaders Index's outperformance relative to its parent and MSCI World ACWI Index shows that ESG risk factors and returns thereof are not geography specific.

MSCI ESG Index versus Parent Index



Source: MSCI, Advisorkhoj Research (as on 30th September 2020). Disclaimer: Past performance may or may not be sustained in the future.

→ How does ESG produce favourable results for investors?

▶ **Enhancing returns:** Several studies have suggested that integrating ESG in investments has a positive effect on returns (see the chart above). According to MSCI, higher ESG rated companies tend to produce higher sustainable free cash flows and better returns than lower ESG rated companies. Many investment experts are of the opinion that higher ESG rated companies are better managed and are able to generate superior operating margins and net profits.



- ▶ **Lower idiosyncratic risks:** Idiosyncratic risk refers to the inherent factors that can negatively impact individual securities or a very specific group of assets. According to MSCI, high ESG rated companies have lesser idiosyncratic risks compared to low ESG rated companies. Companies have seen their revenues and profits decline after pollution spills, accident in factories, weather related supply chain disruptions, products which have harmful chemicals etc. Higher idiosyncratic risks will result in bigger drawdowns.
- ▶ **Lower systematic risks:** According to MSCI, high ESG rated stock have lower earnings volatilities and lower betas than low ESG rated stocks. Therefore, in adverse market conditions (e.g. bear markets, volatile markets), high ESG rated stocks tend to be less volatile than low ESG rated stocks.
- ▶ **Superior return on capital employed:** According to MSCI, high ESG rated companies also have lower costs of capital compared to low ESG rated companies. Therefore, high ESG rated companies/stocks can deliver superior return on capital employed. Research has shown that stocks with higher ROCE are able to deliver higher returns to investors.

→ Summary

Some investors may think of ESG investments as a way to express the personal values towards their fellow citizens, wider community and the planet. However, investments must have financial objectives. There is no dissonance between “doing good” for the society/planet and getting financial returns. You do not have to sacrifice returns to make socially responsible investments. In fact, you can potentially get superior risk adjusted returns by investing in ESG theme.

CHAPTER 4

Why ESG investing matters in India?

Though ESG investments are becoming popular in the developed markets with more than 3,400 funds and over \$1 Trillion of Assets Under Management (AUM), it is still a very new investing concept in India.



→ Evolving Regulations for ESG disclosures

In 2009 the Government (Ministry of Corporate Affairs) published Corporate Social Responsibility Voluntary Guidelines, recommending that all businesses formulate a Corporate Social Responsibility (CSR) policy. Two years later, the guidelines were superseded by the expanded and more detailed ‘National Voluntary Guidelines on Social, Environmental, and Economic Responsibilities of Business’. In 2011, the capital markets regulator, SEBI mandated the Top 100 companies report on Environmental, Social and Governance (ESG) initiatives undertaken by them. In 2015, the requirement was expanded to the 500 largest companies.

SEBI requires companies to disclose CSR/ESG initiatives in a prescribed format in their Annual Business Responsibility Report. The business responsibility report required companies implementing the core nine principles – ethics transparency and accountability, product life-cycle sustainability, employee well-being, stakeholder engagement, human rights, environment, policy advocacy, inclusive growth, customer value – as well as compliance to spend 2% of its average net profit over the past three years on CSR initiatives. SEBI has a set of questions for each of the nine core principles which companies need to provide answer/disclosures in their business responsibility reports.

SEBI is set to widen ESG disclosure requirements to the top 1,000 companies. The regulator has released a consultation paper on its new Business Responsibility and Sustainability Report (BRSR), which improves on the Business Responsibility Report mentioned in the previous paragraph.

The new requirements include disclosure on redressal procedures for complaints, including on those pending resolution, R&D spends on better environmental and social outcomes, employee skill levels, including of those differently-abled persons, and provision for insurance, maternity, paternity and day-care facilities. As per the consultation paper, companies will also be required to disclose energy consumption, water consumption, the percentage of recycled or reused input materials to total raw material usage among other non-financial parameters.

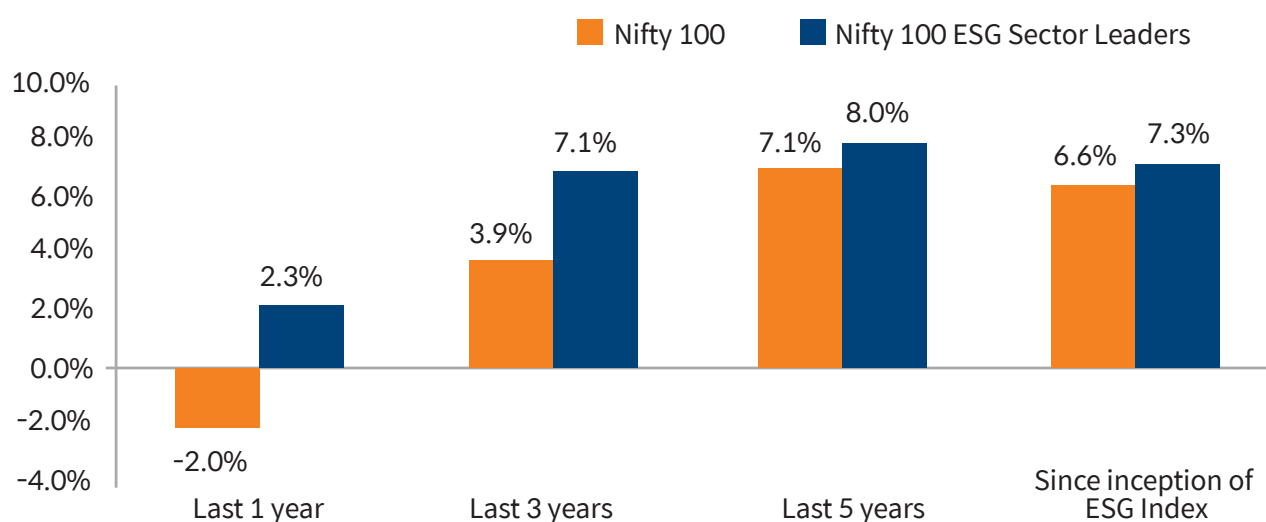
→ ESG Indices in India

National Stock Exchange has constructed an ESG index for the top 100 companies by market cap in the exchange. The index is named Nifty 100 ESG Index. The index constituents need to fulfil the following criteria :

- ▶ Be a constituent of Nifty 100 Index
- ▶ Companies should have ESG scores
- ▶ Nifty 100 Companies are assigned into 5 controversy categories based on events of 10 areas across E, S and G pillars
- ▶ Companies with controversy category of 4 and 5 (high and severe impact respectively on environment and society) are excluded from Nifty 100 ESG Index
- ▶ Companies engaged in tobacco, alcohol, gambling and controversial weapons are excluded

In addition to the Nifty 100 ESG Index, National Stock Exchange has also constructed a Nifty 100 ESG Sector Leaders Index. The main difference between the Nifty 100 ESG Index and the Nifty 100 ESG Sector Leaders Index is that the latter tracks a portfolio of select large cap stocks within each sector performing well on ESG parameters. In this index, different industry sectors have adequate representation in portfolio weights based on ESG parameters. Nifty 100 ESG Sector Leaders Index has variable number of stocks and is rebalanced semi-annually.

Though Nifty 100 ESG Sector Leader Index was launched very recently (in June 2020), it has historical data going back to 2014. The chart below shows the performance of Nifty 100 ESG Index versus Nifty 100 Index over different trailing periods ending 30th September 2020.



Source: National Stock Exchange, Advisorkhoj Research (As on 30th September 2020).

Disclaimer: Past performance may or may not be sustained in the future. The above comparison should not be construed as investment recommendation.

→ Challenges for actively managed ESG Fund

We had mentioned earlier that ESG as an investing concept is fairly new in India, unlike developed markets where ESG factors (sustainability) are in core diversified equity funds, apart from pure ESG funds. Though the chart above shows that ESG as an investment theme can beat market returns, we do not know how the actively managed ESG funds will perform because they will be overweight/underweight on some stocks relative to the ESG index.

Fund managers of traditional schemes usually look at factors like market size, market share, financial performance, balance sheet etc. in selecting stocks. In addition to these factors, managers of ESG funds also need to look at Environmental, Social and Governance related factors, many of which are qualitative. Integrating the E, S and G factors in the investment process will take a bit of learning and experience. AMCs also need to build ESG research capabilities and tools to support their fund managers. This will take time and involve costs, which may result in higher expense ratios for these schemes.



→ Passive investments may be a better option for ESG investments

Passive investments may be a better option for investors who want to invest in the ESG theme for several reasons :

- ▶ ESG investment products in the market are fairly new and it will be difficult for investors or financial advisors to select products on performance track record.
- ▶ Expense ratios of ESG products will be on the higher side because the AMCs will have to invest in ESG research.
- ▶ Passive funds will leverage the expertise of third party ESG research and/or index providers. Their expense ratios will be much lower. Lower expenses can generate higher returns.
- ▶ There is always a bias in actively managed funds because fund managers will be overweight/underweight on certain stocks/sectors relative to the ESG Indices. It remains to be seen whether they will be able successfully create alphas. There will be no such bias in passive funds because they will simply track the index.

→ Conclusion

ESG investments not only reduce downside risks but can also generate superior risk adjusted returns for investors in the long term. We have seen that even in India, ESG investing can beat market returns (Nifty 100 ESG versus Nifty 100). The market of ESG investment products in India is still in very early stages of development. Like any other product concept, it will take some time to mature.

Passive investments may be a better option for investments in the ESG theme due to low costs and no bias, if funds leverage proven expertise of third party research providers. Across the developed markets, thematic ESG ETFs are increasingly becoming popular. We may see a similar trend with regards to ESG investments in India.



An investor education initiative by Mirae Asset Mutual Fund.

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