ESG Investing Landscape

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The question whether a public for-profit company can "do good" and make money at the same time has never been more relevant. Public companies are being bombarded with messages, requests and demands around "ESG"-environmental, social and governance—matters. These come from shareholders, asset managers, special interest groups, activist investors, private equity funds, ESG rating firms, trade groups, politicians, regulators, academics and others. They take a variety of forms, including shareholder proposals, surveys and questionnaires, letter writing campaigns, proxy voting policies, investor stewardship reports, speeches, white papers, academic studies, and legislation. Topics covered (putting aside the "G"—the governance issues with which boards are likely to be familiar) are numerous and varied, including sustainability, climate change, water management, human capital management, gender pay equity, board and workforce diversity, supply chain management, political and lobbying expenditures and so on.

ESG should not be perceived as divorced from traditional economic metrics. The starting point involves consideration of ESG in light of the company's business strategy, which is the driver of shareholder value, the dominant component of shareholder welfare. Even in those cases where a particular ESG matter does not fit directly within a company's business strategy, a company may need to consider whether inaction or a failure to be responsive to an issue presents risks to a company. These might include negative perceptions by consumers, regulators, employees or the public that could lead to a boycott of the company's products, regulatory intervention, active employee protest or morale decline, negative publicity, or other forms of harm to the company's ability to compete and produce shareholder value.

Globally over the past decade or so, we have witnessed significant focus on ESG investing and increasing assets under management in this segment. Recent reports place the level of ESG-focused investment at approximately $20 trillion of assets under management. New ESG funds and exchange traded funds (ETFs) are being launched on a regular basis and with increasing frequency. The demand for ESG investment has also spurred a number traditional investors, activist funds and private equity funds to enter this space.

In line with global trends, even India has seen launch of ESG focused funds in the recent past. While still nascent, there are already 11 ESG focused funds in operation. At the end of June 2021, aggregate assets invested in Indian ESG funds identified by Morningstar reached a record level nearly Rs 12,000 crore, significantly up from Rs 4,200 crore at the same time a year ago.

Globally the ESG investing space is much evolved and has witnessed significant innovation in various ESG related investment products.

Asset owners and managers are pursuing increasingly diverse range of approaches, combining elements of both responsible asset selection and responsible ownership. Asset selection entails various forms of screening along with systematic integration of ESG factors in investment analysis and decision making. Responsible ownership encompasses voting, engagement with issuers and activism.

Within this umbrella, ESG investing can take various forms, for example making investments in companies viewed as positively addressing environmental or social issues, choosing to exclude companies in certain industry sectors viewed as problematic from an ESG perspective, or integrating ESG data into an assessment of risk-adjusted returns in order to make investment decisions.

Individual funds often combine several of these activities yet are classified under one of the few core responsible investment types. As outlined below, these range from exclusionary or negative screening to systematic ESG integration and engagement, best-in-class, positive screening and thematic strategies including sustainable funds and impact investments.

i) Exclusions: The broad strategies apply exclusions to certain sectors/ companies in the portfolio based on ESG criteria. For eg, tobacco, controversial weapons manufacturing etc
ii) Integration/ Engagement: This category includes strategies that systematically integrate ESG into investment decision making processes and/or employ proactive voting/ engagement activities
iii) Best-in-class & Positive Screening: These strategies pick those companies that have the best ESG score in a particular sector or in the universe. Also includes weighting allocations to companies with better ESG scores (tilts)
iv) Impact investing: These strategies explicitly target generating a positive impact on sustainable developments, alongside financial returns.
v) Sustainable/ thematic investments: This category includes a variety of thematic-focused strategies, including renewable energy, sustainable transport, water/waste management etc.

However, in India, all ESG funds are currently classified as thematic funds. This does not adequately distinguish amongst different ESG strategies as mentioned above. Adding further sub-categories rather than blanket categorization of ESG as thematic, will allow ESG funds to select their ESG traits in terms of what they do allowing them to be true to label and also help investors to understand and recognize what they can expect from the fund.

An inevitable corollary of the increase in ESG-focused investment is the demand by those investors for ESG data and the corresponding and exponential growth in the number of entrants into the business of collecting, aggregating, synthesizing and ranking that data. The challenge is that each ESG ratings provider has its own methodology, and a company may receive widely divergent ratings from different organizations. Moreover, the ESG rating agencies may use different combinations of data sources other than company disclosures, including press reports, litigation filings, internet postings and other third-party sources, even though the company may not agree with the veracity or accuracy of those data sources.

In some jurisdictions abroad, we have examples of external rating of ESG portfolios by external agencies. However, we believe this step can lead to confusion amongst investors in terms of appropriateness and comparisons of such ratings as the ratings from external agencies can vary significantly on the same company (similar to research ratings and recommendations from broking outfits).

Lack of adequate and standard disclosures from corporates have been a limiting factor for effective ESG evaluation in India. This is also act as a restricting factor for schemes to provide the exact picture of portfolio ESG parameters, especially on quantifiable metrics. The new Business Responsibility and Sustainability Report (BRSR) replacing Business Responsibility Report (BRR), may help in improving disclosures across top 1,000 listed entities. This may also lead to quantifiable metrics, which then may allow easy measurement and comparability across companies, sectors and time periods. BRSR being made mandatory from FY23 would mean that there would be more standardized disclosures on ESG factors from investee companies, thereby potentially helping mutual fund schemes to evaluate, compare, quantify, and build portfolio ESG parameters and report in a consistent manner.

A good ESG investing environment also needs adequate importance given to voting, stewardship activities and implementation of standardized disclosure requirements for corporates. We believe SEBI has been one of the most pro-active regulators in the world to implement some of these guidelines which are at par or better than those in some of the developed markets.

There is no single/ uniform standard practice followed on ESG aspects across the globe. Practices vary between different jurisdictions and different asset managers have adopted different approaches.

Disclosure and reporting norms vary by jurisdiction however membership to organizations such as the UNPRI drives disclosures and reporting on ESG more than do regulatory requirements at this point in time. Even in jurisdictions where ESG has been long followed, like the Nordic countries, the disclosure and reporting norms for Mutual Funds have always followed a few years after the introduction of stricter reporting and disclosures norms for the investee companies themselves.

In summary, the rise in ESG investing presents new risks and perhaps opportunities as well. ESG investors' dissatisfaction with a company's ESG policies (or lack thereof) or responsiveness may have significant adverse effects. On the positive side, understanding and anticipating ESG issues that may be promoted by investors might attract positive interest in the company and support from such investors.