Università Commerciale Luigi Bocconi

The Role of ESG Criteria in the Asset Management Industry

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Outline and objectives

- What is ESG in asset management?
- Statman and Glushkov (2009)
- Amel-Zadeh and Serafeim (2019)

What is ESG/SRI?

- Exponential growth in the number of companies that report

① environmental data (e.g., carbon emissions, water consumption, waste generation)

② social data (e.g., employee composition, product information, customer-related information)

③ governance data (e.g., political lobbying, anticorruption programs, board diversity)—that is, ESG data. Whereas fewer than

- In short, ESG data
  - From 20 companies that disclosed ESG data in the early 1990s, the number of companies issuing sustainability or integrated reports has increased to nearly 9,000 by 2016
  - As of 2016, the 2006 UN Principles for Responsible Investment had been subscribed by firms with an AUM of about $60 trillion, https://www.unpri.org/signatories/signatories/
- A literature has shown that ESG has deep economic effects
  - ESG disclosures are associated with lower capital constraints, lower costs of capital, and large price movements around mandatory ESG disclosures

What is ESG/SRI?

- The Social Investment Forum (2006) describes socially responsible investing as "an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis"
- Typical socially responsible investors (SRIs) tilt their portfolios toward stocks with high scores on SR characteristics and shun companies associated with tobacco, alcohol, gambling, firearms, and the military
- Screening is the most prevalent form of SR investing
  - Negative screening excludes/reduces the portfolio weights of companies with weak environmental, social, or governance records
  - Positive screening includes/increases weights of strong records
- A literature compares the returns of SRIs and aggregate indices, such as the S&P 500, but informativeness is limited as indices overlap
  - E.g., the Domini 400 Social Index and the S&P 500 share approximately 250 companies
  - SRI criteria and their relative weights vary among indices, e.g., the Calvert Social Index excludes all tobacco companies, the Dow Jones Sustainability Index (DJSI) does not

What is ESG/SRI?

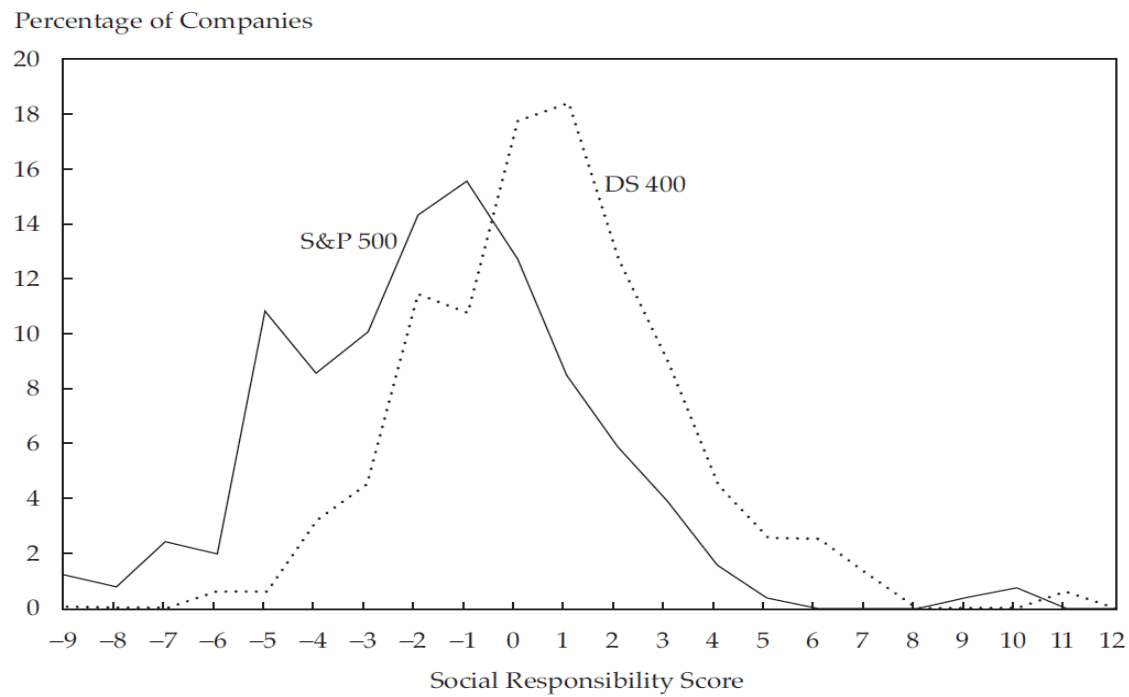
- Three hypotheses address the relative returns of the stocks of SRI vs. conventional companies
- "Doing Good but Not Well": the returns of SR stocks are lower than those of conventional stocks as the benefits of company actions that tilt it toward ESG fall short of the costs
  - Barnea and Rubin (2006) suggest that managers engage in SR actions whose costs exceed the benefits to shareholders because they reap private benefits, such as awards and other expressions of appreciation
  - Insiders in companies that rank high on SR hold few shares of their company and thus bear little of the cost of the accolades they receive
- "Doing Good While Doing Well": the returns of SR stocks are higher than those of conventional stocks as managers and investors underestimate the benefits of being SR or overestimate its costs
- "No Effect": the expected returns of SR stocks are equal to conventional stocks, as actions are costless, such as when actions amount to no more than words
  - Hypothesis might also be true if costly company actions increase benefits by as much as they increase costs

KLD Social Responsibility Indices

- Statman and Glushkov (2009) use KLD Research & Analytics data
- KLD is a company that produces social investment research, rates companies on strengths and concerns in the following list:
  - Corporate governance (e.g., limited compensation to executives and members of the board, lack of tax disputes)
  - Community (e.g., generous giving, support for housing)
  - Diversity (e.g., promotion of women and minorities, family benefits)
  - Employee relations (e.g., strong union relations, cash profit sharing)
  - Environment (e.g., pollution prevention, recycling)
  - Human rights (e.g., labor rights in outsourcing)
  - Products (e.g., product quality and safety, provision of products for the economically disadvantaged)
- KLD analyzes information relevant to each indicator of strength
  - It assigns a score of 1 when a company demonstrates strength on an indicator and 0 if it does not
  - Similarly, it assigns a score of 1 when a company's record raises a concern on an indicator and 0 otherwise

Statman and Glushkov (2009)

- The score of a company on a given characteristic is the difference between the number of its strength indicators and concern indicators



- Companies with same overall KLD score differ in their characteristics scores
- Statman and Glushkov (2009) formed year-end portfolios on the basis of 1992-2007 KLD scores
  - By the nature of industries, companies in some industries have lower scores, on average, than companies in other industries
  - Therefore, they classified companies by best-in-class industry-adjusted scores, where the score in each characteristic is the difference between its score and the mean score of all companies in its industry that year
- Divide companies into 3 groups of the same number and calculate the returns of an equally weighted ptf long the stocks of the companies in the top-third group by a characteristic and short the bottom-third

Statman and Glushkov (2009)

- These long-short ptfs are rebalanced every year
- They present abnormal returns by each of three performance benchmarks: CAPM, 3-factor Fama-French, and four-factor Carhart's model
- Stocks of companies with high SR scores yielded higher returns than stocks of companies with low scores
- The alphas are positive and statistically significant for the community, employee relations, and environment characteristics but not for diversity and products

Table 4. The Performance of Equally Weighted Portfolios by Top-Overall minus Bottom-Overall, Accepted minus Shunned, and DS 400 minus S&P 500, January 1992–September 2007

Performance Benchmark	Annualized Excess Returns	Market Factor	Small–Large Factor	Value–Growth Factor	Momentum Factor	Adjusted R^2
Top-overall minus bottom-overall						
CAPM	3.18%	–0.01				
	(0.08)	(0.84)				–0.01
3-Factor	6.12%	–0.14	–0.02	–0.31		
	(0.00)	(0.00)	(0.78)	(0.00)		0.19
4-Factor	5.54%	–0.13	–0.03	–0.30	0.05	
	(0.00)	(0.00)	(0.65)	(0.00)	(0.11)	0.19
Accepted minus shunned						
CAPM	–3.34%	0.1583				
	(0.02)	(0.00)				0.13
3-Factor	–2.62%	0.1090	0.07	–0.08		
	(0.07)	(0.01)	(0.15)	(0.07)		0.19
4-Factor	–2.27%	0.0996	0.07	–0.09	–0.03	
	(0.13)	(0.02)	(0.13)	(0.06)	(0.45)	0.19
DS 400 minus S&P 500						
CAPM	0.48%	0.0370				
	(0.52)	(0.01)				0.02
3-Factor	1.32%	–0.0002	0.00	–0.09		
	(0.11)	(0.99)	(0.97)	(0.00)		0.09
4-Factor	1.20%	0.0030	0.00	–0.08	0.01	
	(0.15)	(0.87)	(0.95)	(0.00)	(0.49)	0.09

Opposite result! Negative screens (shunning) do not work...

Statman and Glushkov (2009)

- The abnormal excess returns for the human rights and governance characteristics are negative, but not significant
- They find no statistically significant relationship between governance and stock returns
- The generally higher returns of stocks of companies with high social responsibility scores are especially evident in a long–short portfolio of top-overall and bottom-overall companies
  - A top-overall company is one in the top third of companies by two or more SR characteristics and not in the bottom third by any characteristic
  - A bottom-overall company is one in the bottom third of companies by two or more SR characteristics and not in the top third by any characteristic
- The annualized excess return of the "top-overall minus bottom-overall" portfolio is 5.54%, with a 0.00 p-value, by a 4-factor model
- The portfolio is tilted toward growth stocks and stocks with high momentum, with no significant tilt toward large- or small-caps
- These findings are consistent with the "doing good while doing well" hypothesis: **ESG is on average a good investment idea!**

Amel-Zadeh and Serafeim (2019)

- Amel-Zadeh and Serafeim (2019) survey investment firms that are customers of Bank of NY Mellon, for a AUM value of US$31 trillion
  - The majority of the responding institutions have no or only a small allocation to ESG specific funds so that the sample reflects the views of largely mainstream investment professionals
  - They distributed the survey via email to senior investment professionals at 4,523 asset-managing and asset owning institutions compiled by Bank of NY Mellon and Ipreo on 18 January 2016
  - They received 652 responses, for a response rate of 14.4%
- The majority of respondents (82%) suggest that they use ESG information because it is material to investment performance

Percentage of AUM Allocated to ESG	
0%	35%
1%–5%	27
5%–10%	7
10%–25%	16
25%–50%	5
50%–99%	10
100%	0
Total	100%

Type of Organization	
Asset management company	65%
Corporate pension fund	13
Public/local authority pension fund	6
Charity/endowment/religious organization	4
Insurance/financial institution	4
Sovereign wealth fund/government agency	3
Family office	2
Other	2
Total	100%

Amel-Zadeh and Serafeim (2019)

- Little is known about investors' motivations for considering corporate prosocial behavior in investment decisions; if they do, whe-ther they have performance, financial motives (i.e., product strategy), or norms-based (i.e., ethical) motives is unclear
- A large majority (82%) of respon-dents consider ESG information

		All (N = 419)	AUM Size			Region		
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Response		Large	Small	Diff.	US	Europe	Diff.
	Yes, because . . .	**82.1%**	**85.9%**	**80.3%**		**75.2%**	**84.4%**	
1	. . . ESG information is material to investment performance	63.1	60.3	64.5		55.7	64.4	
2	. . . of growing client/stakeholder demand	33.1	54.3	22.4	**	33.0	39.3	
3	. . . we believe such policy to be effective in bringing about change at firms	32.6	31.9	32.9		25.8	40.7	*
4	. . . it is part of our investment product strategy	32.6	43.1	27.2	**	47.4	30.4	**
5	. . . we see it as an ethical responsibility	32.6	25.0	36.4	*	18.6	40.7	**
6	. . . we anticipate it to become material in the near future	31.7	31.9	31.6		29.9	37.0	
7	. . . of formal client mandates	25.0	37.1	18.9	**	23.7	30.4	
	No, because . . .	**17.9%**	**14.1%**	**19.7%**		**24.8%**	**15.6%**	
1	. . . there is no stakeholder demand for such policy	26.7	15.8	30.4		21.9	24.0	
2	. . . we lack access to reliable nonfinancial data	21.3	21.1	21.4		18.8	32.0	
3	. . . ESG information is not material to invest-ment performance	13.3	5.3	16.1		21.9	4.0	
4	. . . we believe such policy to be ineffective in inducing change at firms	12.0	15.8	10.7		12.5	16.0	
5	. . . it would violate our fiduciary duty to our stakeholders	12.0	5.3	14.3		21.9	8.0	
6	. . . such information is not material to a diversified investment portfolio	10.7	5.3	12.5		6.3	16.0	
7	. . . including such information is detrimental to investment performance	4.0	5.3	3.6		6.3	4.0	
	p-Value of difference (yes vs. no)	<0.001	<0.001	<0.001		<0.001	<0.001	

Amel-Zadeh and Serafeim (2019)

- The use of ESG information is driven **primarily by financial rather than ethical motives** but motives vary considerably by geographical area
- The greatest challenges investors face in integrating ESG into their investment processes are the lack of cross-company comparability and the lack of standards governing the reporting of ESG information
- Slightly less weight to ESG information being costly to gather and analyze, lacks detail, and is difficult to quantify

		All (N = 368)	AUM Size			Region		
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Response		Large	Small	Diff.	US	Europe	Diff.
1	Lack of comparability across firms	44.8%	49.2%	42.7%		45.8%	49.3%	
2	Lack of standards in reporting ESG information	43.2	51.6	39.0	*	42.1	48.6	
3	The cost of gathering and analyzing ESG information	40.5	41.8	39.8		40.2	45.0	
4	ESG information disclosed by firms is too general to be useful	39.4	45.1	36.6		42.1	42.1	
5	Lack of quantifiable ESG information	37.8	43.4	35.0		40.2	40.0	
6	Lack of comparability over time	34.8	38.5	32.9		38.3	35.7	
7	The disclosure of ESG information by firms is too infrequent to be useful	28.3	27.9	28.5		31.8	28.6	
8	Lack of reliability of data/lack of audit and assurance	26.4	46.7	16.3	**	31.8	27.1	
9	There is too much disclosure, making it difficult to filter out what is material	16.6	16.4	16.7		14.0	20.0	
10	Our clients' mandates prevent us from using ESG information	1.4	0.8	1.6		1.9	1.4	

- A lack of standardization and quantification are the main obstacles to ESG data integration; other respondents noted the lack of "sector-specific ESG data and industry adjusted scoring."

Amel-Zadeh and Serafeim (2019)

- Little is known about how investors use ESG information
- The literature has concentrated on comparing the performance of self-labeled socially responsible investing (SRI) funds with that of conventional mutual funds, with emphasis on negative screening
- In general, these studies have found that performance does not differ between SRI and conventional funds!
- **Full integration** into individual stock valuation is the explicit inclusion of ESG factors into trade-tional financial analysis
- **Negative screening** is the exclusion of certain sectors or companies from a fund or portfolio on the basis of specific ESG criteria

		All (N = 337)	AUM Size			Region		
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Response		Large	Small	Diff.	US	Europe	Diff.
1	Engagement/active ownership	37.1%	42.7%	34.4%		27.1%	48.1%	**
2	Full integration into individual stock valuation	34.4	37.3	33.0		27.1	35.9	
3	Negative screening	30.0	50.0	20.3	**	40.2	32.8	
4	Thematic investment	20.8	29.1	16.7	*	15.9	26.7	*
5	Overlay/portfolio tilt	14.2	20.0	11.5	*	13.1	19.1	
6	Positive screening	13.4	22.7	8.8	**	17.8	14.5	
7	Risk factor/risk premium investing	11.3	9.1	12.3		6.5	11.5	
8	Relative screening/best-in-class screening	9.2	10.9	8.4		11.2	9.9	
9	We do not use ESG information in our investment process	16.6	10.9	19.4	*	21.5	11.5	*

Notes: This table reports responses to the question, How do you integrate material ESG information in your investment process/ how do you use ESG information to define your investment universe?

Amel-Zadeh and Serafeim (2019)

- The literature provides mixed evidence on the financial effects of integrating ESG information into the investment process
- Some studies have found that portfolios that exclude certain companies on the basis of ethical norms or are formed on the basis of aggregate ESG measures underperform their peers
- Others have found that portfolios formed after positively screening on material ESG issues or formed on the basis of individual ESG data points, such as employee satisfaction, outperform their peers
- Full ESG integration is considered the most beneficial strategy by investors in terms of its impact on performance

		All (N = 295)		AUM Size			Region		
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Response	% Moderately or Significantly Positive (Ranks 5 and 4)	% Moderately or Significantly Negative (Ranks 1 and 2)	Large	Small	Diff.	US	Europe	Diff.
1	Full integration into individual stock valuation	61.2%	5.8%	3.70	3.71		3.54	3.81	*
2	Engagement/active ownership	52.7	6.5	3.47	3.70	*	3.46	3.80	**
3	Positive screening	59.6	10.5	3.64	3.51		3.60	3.56	
4	Risk factor/risk premium investing	42.4	8.4	3.43	3.52		3.26	3.52	*
5	Relative screening/best-in-class screening	49.7	11.0	3.34	3.52		3.38	3.49	
6	Thematic investment	42.4	10.4	3.35	3.38		3.34	3.36	
7	Overlay/portfolio tilt	37.4	11.0	3.24	3.35		3.17	3.31	*
8	Negative screening	39.1	28.2	3.07	3.09		3.07	3.12	

Notes: This table reports survey responses to the question, Which of the following ESG strategies do you believe improve or reduce investment returns compared to a market benchmark?

Amel-Zadeh and Serafeim (2019)

- Negative screening is considered to be the least financially beneficial ESG investment method, albeit with a neutral impact on returns
  - The results for this strategy contrast with results in Table 4, which found negative screening to rank as the third most used investment style
- Investors in Europe are generally more optimistic about the financial impact of the various ESG strategies than are US investors
- Ethical motivations are associated with a higher likelihood of negative and positive screening and with a significantly lower probability of thematic investment or integration
- The survey contained a question about how important the ESG investment strategies will be for investors in the next five years
- Overall, investors ranked positive screening as the most important strategy in the future, although its rating is not statistically higher than the ratings for active ownership (the second ranked), negative screening (the third ranked), and full integration (the fourth)
- Thematic investment, relative screening, risk factor, and portfolio tilt are considered to be less important in the next five years