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Clearing the Air: Responsible Investment[1]

Introduction

Over the last several years, Responsible Investment[2] has gained prominence among institutional investors and indeed the broader investment industry. Asset owners have made this topic more central to investment decisions as they are increasingly concerned with both their fiduciary responsibility to deliver financial results and non-financial impact on their constituents and the broader global community.

Buoyed by this prioritization, Environmental, Social and Governance (ESG) investing is now a frequent area of focus within traditional investment strategies and is a rapidly growing new product category in and of itself. At present, ESG adoption varies by region, but research by Greenwich Associates found that, of global investors not yet incorporating ESG, nearly three-fourths are considering incorporating it into their investment portfolios.[3]

Responsible Investing's reach is vast. However, so too is confusion around the meaning of the concept. This is unsurprising, given the many different motives for and approaches to considering ESG factors and many different opinions about exactly what they include.

We therefore seek to “clear the air,” providing a framework of the various approaches and terms necessary to have an informed discussion and investment policy on Responsible Investment.

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1 This Framework is designed to be a "living document" and as such will evolve over time; please note its most current form will be available at www.aqr.com/ESG.
2 Responsible Investment is inclusive here of all its aliases, for example Sustainable Investment (SI), Socially Responsible Investing (SRI), or Environmental, Social and Governance (ESG) Investing.
3 Greenwich Associates, 2018: ESG Investing: The Global Phenomenon (summary, methodology, and report downloadable from https://www.greenwich.com/institutional-investing/esg-investing-global-phenomenon).

4 We thank all of those at UN PRI who reviewed this piece as well as those at AQR Capital Management, with special thanks to Nicole Carter for her contributions.

Although not exhaustive, it is our hope that this guide will provide the structure necessary for asset owners and managers alike to articulate their priorities and constructively discuss the opportunities and challenges inherent in this space.

Our Framework starts with the United Nations Principles for Responsible Investment. The Principles were developed in 2006 by a group of the world's largest institutional investors and now over 2,000 such investors representing over US$80+ trillion in assets under management[5] have pledged adherence.

Most salient here are Principles 1 and 2. Principle 1 calls for the incorporation of ESG issues in the analysis and selection of investments, while Principle 2 speaks to ownership practices of assets once an investment is made.

This is an important distinction: it requires signatories to consider their investment decisions on a continual basis, since the responsibility of ownership carries forward for as long as an asset is held.

The Principles are intentionally non-prescriptive, allowing for a diversity of solutions for ESG incorporation. However, the flexibility also affords potential confusion around the application of Responsible Investment without a generally-agreed framework for constructing such solutions. Below we propose a Framework designed to allow for the application of a multitude of approaches while adhering to the applicable Principles.

United Nations Principles for Responsible Investment

Principle 1

We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2

We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3

We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4

We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5

We will work together to enhance our effectiveness in implementing the Principles.

Principle 6

We will each report on our activities and progress towards implementing the Principles.

5 Source: UN PRI, as of December 2018.

Responsible Investment Framework

Responsible Asset Selection + **Responsible Ownership**

Screening			ESG Integration	
Norms-Based (static)	**ESG** (dynamic)	**Thematic**	**Valuation**	**Risk**
e.g.: - Coal - Tobacco	- Environmental - Social - Governance	e.g.: - Green - Impact	- Environmental - Social - Governance	- Environmental - Social - Governance

Voting	Engagement	Activism	Direct Management
e.g.: - ESG-focused - ESG-aware	e.g.: - Campaign - Disclose	e.g.: - Board seat - Acquire shares	e.g.: - Private equity - Other illiquids

Note: The framework is designed to allow for the application of a multitude of approaches

Responsible Asset Selection

Responsible investment mandates the consideration of ESG issues which may affect the long-term pricing of an asset as well as the long-term sustainability[6] of the issuer's business model. This is "responsible asset selection," which manifests itself in two broad categories:

Screening | **ESG Integration**

Screening

Perhaps the most common form of ESG incorporation in asset selection is **screening** — or choosing to exclude some subset of assets because they do not meet certain pre-defined standards. These standards may be based on norms (and generally static) or a more dynamic approach to ESG.

Screening is commonly associated with a **norms-based** exclusion, either applied to specific companies, entire industries or other assets. This is ostensibly a simple translation of ethical values into a Responsible Investment policy, but it should be noted that a blanket screen approach is price-agnostic. Some investors necessarily embrace this, for example where the screened companies' revenue sources directly contravene an organization's mission and the investor is uncomfortable with any ownership connection (perhaps inclusive of shorting).[7]

Others avoid a static set of restrictions, and instead apply a **dynamic ESG** approach that excludes assets based on an ESG score.[8] This more relative approach will exclude different companies over time given changes to their ESG policies and procedures. Dynamic ESG screens are distinguished from a pure norms-based exclusion in their comparative flexibility. Of course, the extent of the dynamism varies, and with it the prioritization of profit opportunities.

6 Sustainability refers to the long-term efficacy of an asset including its financial and non-financial externalities, which may be at risk of being priced-in at a future date due to either public, investor or regulatory pressures.

7 While theoretically the case for shorting a poorly-ranked ESG name that is also expected to perform poorly from a pricing perspective is sound and may actually have a stronger impact on management than simply screening or refraining to hold it, there may be organizational sensitivities associated with profiting from a name ranked poorly on ESG, or even more so, profiting from a name in a restricted sector or industry, regardless of the position being a desire to see a fall in price, or, ipso facto, its extinction.

8 An ESG score evaluates a security issuer (either of bonds or equities, or perhaps other assets) on exposure to ESG factors, as defined by the ratings provider, by itself and against its peers. They are usually known in the market as ESG or sustainability ratings but are different from credit ratings, ESG scores are quantitative indicators, and methodologies vary. See the *UN PRI ESG in Credit Risks and Ratings Initiative* for an example of a push for transparency and consistency in this space.

One example is a "best-in-class approach," an application of positive screening. Best-in-class selects companies or industries with very strong ESG scores compared to salient peers. This can translate into a significant reduction in the investable universe. At any given point, a best-in-class strategy will only invest in the most ESG-friendly companies, which can be applied within or across industries, but it cannot follow companies on the journey some may take as they improve their ESG policies and procedures.[9] In other words, it does not take into account momentum.

Screening may also be **thematic**, or more focused on a specific objective, and done with either a negative or positive screen. Popular examples are **green investment** (investment activities that focus on companies or projects that are committed to the conservation of natural resources, the production and discovery of alternative energy sources, the implementation of clean air and water projects, and/or other environmentally conscious business practices). Another example is **impact investing** (generating revenues from providers of constructive solutions for society, be they focused on issues like equality or protecting the environment). These too are forms of a positive screen, and are applicable across both liquid and illiquid asset classes.

ESG Integration

In contrast to screening, ESG integration is a holistic assessment of an investment's prospects using all available financial and non-financial data related to ESG factors. This does not ex-ante preclude any investment, which is an important distinction between integration and screening. In an integrated approach, a manager may hold a company ranked poorly on ESG if the other attributes of that investment compensate for its inferior ESG profile. In other words, a security may be attractive if trading at a discount to fair value that is sufficient given possible associated ESG risks.[10]

We identify two avenues for ESG integration:

Valuation	Risk

This guide will not wade into the debate about whether and how much ESG affects the risk and return characteristics of an investment. However, these are two key lenses through which to view integration. With risk-adjusted returns, a key metric for upholding fiduciary duty, asset valuation and risk assessments may be made in tandem. They are generally a reflection of the issuer's health and are easily combined with existing measures that are not specifically ESG. The range of ESG measures certainly varies in specificity, and managers sometimes focus more on one (E, S, or G).

Just like strategies in the non-ESG landscape, integration here is possible on a spectrum from purely qualitative to purely score-based, or quantitative. Regardless of how it is applied, an ESG-integrated approach dynamically assesses a candidate for investment based on how it scores on various financial and non-financial metrics. Like a standard dynamic ESG screen, it continually considers the opportunity to adjust the investment universe as assets fluctuate in price, riskiness, and ESG-friendliness. The extent to which a strategy tilts to or away from companies based on ESG profile may vary, depending on preferences like tracking error bounds.

9 If applying best-in-class without regard to industry, the result may de facto tilt the portfolio toward some industries and away from others; it may also lead to entirely exclude some industries. A best-in-class approach within industry may lead to investing in any or all industries.

10 Of course, a manager may overweight or underweight an asset based on an integrated approach to evaluating a company's ESG and financial information as well, it is not always a binary decision to hold or not to hold.

It is important to note that most ESG incorporation methodologies described here intend to align with the main objectives of the asset owner and achieve market-rate or even better returns. Whether this can be achieved depends on the quality of the investment, ESG analysis and implementation. Some asset owners may feel that either their values or an objective to create positive real-world impact may lead them to accept slightly lower returns, which may be the case in static screening of entire industries. But that is a discretionary decision for the asset owner, as opposed to a truism about Responsible Investment.

Responsible Ownership

Responsible Investment does not stop with a decision on asset selection. Rather, it requires awareness that there are other ways of interacting with companies to influence their business beyond just the decision to invest or not. Thoughtfulness in ownership is increasingly becoming codified, with several countries launching so-called "stewardship codes" that provide (soft law) expectations and guidance for investors to be responsible, active owners of the shares they hold in listed companies. The Organization for Economic Co-operation and Development guidelines for multinational enterprises, which cover global investors, also indicate the need for investors to mitigate potential negative effects of the business activities to which they are linked through their investments. Responsible ownership takes four common forms:

Voting	Engagement
Activism	Direct Management

Voting is a privilege afforded by ownership.[11] As such it is an important responsibility for investors to ensure the appropriate policies and procedures to evaluate proxies, and indeed to determine whether to vote on an issue or not. However, "responsible" approaches to voting vary. ESG may be the primary focus of proxy votes ("ESG-focused"), or a factor in a broader set of considerations ("ESG-aware"). Voting policies may vary by account, starting with a general policy aimed at promoting good governance and undergoing ESG enhancements depending on client direction or the remit of a given fund. ESG here may be best defined on an issue-by-issue basis, and indeed the process by which voting direction is determined is a useful metric in ESG incorporation.

Voting may be related or lead to **engagement**, for instance in case of unsuccessful votes about which the shareholder feels strongly. Engagement starts with a dialogue, and it may be a solo endeavour or a collective one (joining with similarly-minded asset owners). Commonly it will relate to a portfolio company, with the aim of campaigning for change or enhanced disclosure on issues related to ESG factors. One example of an engagement activity may be promoting the advancement of UN Sustainable Development Goals, which seek to define the broad socially responsible objectives of society.[12] This may be done through a company's investor relations department, direct to the executives running the business, or even to the board.

Sometimes investors also use the word engagement to refer to a pre-investment activity: speaking with a company to better understand its business, perhaps including ESG aspects. Strictly speaking, that is not an ownership activity — it precedes ownership and does not attempt to influence the company. As such, although it is a very

11 Bondholders may in some cases have voting rights.
12 For more information on UN Sustainable Development Goals (SDGs) see https://www.unpri.org/SDGS

legitimate activity, it does not qualify as Responsible Ownership per se.

One other form of engagement that may be undertaken is a dialogue with governmental or other regulatory bodies, often with the grander aim of promoting a financial system that incentivizes responsible, sustainable businesses and investments, often associated with a "universal investor" paradigm.[13] This is also an example of responsible ownership, given the connection between this high-level dialogue and companies whose policies may need to change as a result — an increasing push for transparency is a good example. Finally, direct engagement with policy makers may be also undertaken by investors in sovereign bonds.

Activism approaches may seek to effect change within a company by getting a board seat or acquiring a certain number of shares. Activism by itself does not amount to responsible ownership. That requires a commitment to promoting sustainable outcomes along ESG dimensions. When applied responsibly, activism, unlike voting or engagement, has de facto ESG integration in the asset selection stage.[14] An interesting nuance is that investors who pursue ESG activism may more often deliberately invest in a company with inferior ESG characteristics if they believe it has a higher likelihood of benefiting from a positive sustainable impact, or larger potential magnitude of such impact. The aforementioned approaches within the responsible ownership category all assume lack of control of the underlying organization or asset.

However, this will not always be the case such as in private equity or indeed even in public equity if an organization or collective group have a controlling stake. Therefore, **direct management** is a fourth approach within the category, which speaks to directly effecting change in the underlying position. Of course, this may also involve other aspects of responsibility such as voting or engagement in the case of a public equity. Having enough of a position to exert direct management influence or control should afford the opportunity to manage the sustainability and improve along ESG dimensions in an efficient manner, highlighting the responsibility of responsible investors in these assets to do so.

Conclusion

Responsible Investment has become increasingly important to investors globally and the trend is likely to accelerate, with the majority of institutions that have not yet incorporated ESG into their investment process considering doing so.[15] However, up until this point, there has not been a common framework of what Responsible Investment means or can entail. In fact, there are various ways that investors can customize an approach that best meets their needs while adhering to the UN PRI Principles. In short, ESG is not a one-size-fits-all approach to investment. This framework is meant to serve as a communication tool for asset owners and managers to have an informed dialogue about Responsible Investment rather than

13 Large institutional investors may be considered "Universal Owners," as they own in aggregate a large portion of the investment universe globally.
14 ESG-oriented activism here is distinguished from activist approaches that focus purely on share price maximization.
15 Greenwich Associates, 2018: ESG Investing: The Global Phenomenon.

a prescriptive guide on how to apply these methodologies. Indeed, there will be many variations of how the Principles will be applied within this framework and, like many things, the details and skill in implementation matter.

We hope that our framework has clarified any confusion, and this shared language will lead to clearer communication and better results for investors. We welcome any feedback.

Disclosures

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