The Role of Top-Down Analysis in Responsible Investment

What is Responsible investing (RI)? It is essentially the catch-all term for allocating capital in an ethical, sustainable, impact, or environmental, social, and governance (ESG) risk aware manner. ESG is typically used to highlight key risks faced by a company.

The demand for RI products has been growing strongly in the past few years, but the events of 2020 will be remembered as the catalyst for projecting ESG from the sidelines to the mainstream.

The extraordinary combination of fires, floods, plagues, pandemics, Black Lives Matter, the #MeToo movement, and a Trump US Government led many people to reflect on their impact on society and the planet, and how they can "do their bit".

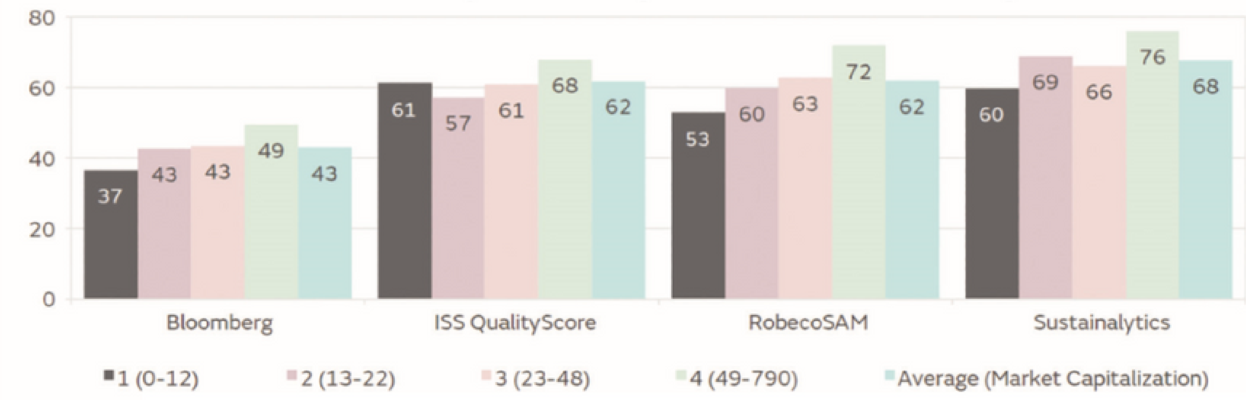
Research suggests that one way that people want to express these beliefs and values is through their investment choices. Demand for RI options is not just being driven by younger generations, it is increasing across all age cohorts. And demand for retail investment options is continuing to grow.

However, the world of RI has grown exponentially in complexity, as well as size, over the past decade or so. If you have not kept up with the changes and progression in this area, you may find yourself struggling to understand where to even start.

There are two primary ways funds can be assessed for RI credentials, being what we have termed 'bottom-up' and 'top-down' methods.

This paper looks at the advantages and disadvantages of each method. This should help to provide a clear way forward to understanding how to interpret the RI or ESG information you might be presented with on any fund.

Chart 1: The difference in ratings between companies across different market capitalisations



Source: Gulf International Bank

THE BOTTOM-UP APPROACH

Globally, there are over 160 ESG or RI data providers that collect and provide what we call ‘bottom-up’ data. Examples include the Morningstar-owned Sustainalytics, MSCI and RobecoSAM.

These providers take publicly available data on companies, in addition to their own surveys and company questionnaires, to create a proprietary ESG analysis and rating of a company.

Across the various ESG data providers, there are thousands of data points that are collected and measured on companies. Examples include:

- Environmental: Carbon footprints, total energy usage, CO2 emissions;
- Social: Employee turnover, total injury rate, lost working days, proportion of women in senior positions; and
- Governance: Board gender diversity, senior executive total compensation, board controversies.

This information is then sold to investors, such as fund managers.

Most providers come up with one score or rating for a company, such as 77/100 or a B+ for example. Fund portfolios can also be given scores, based on the scores of the underlying holdings.

Fund managers may also have their own proprietary models with a number of data provider feeds, thus creating their own ESG scores for a company as well. They might use this data only as a supplement to their own work, as a filter or even the major driver of their ESG work.

There are a few things to watch out for though. Although there is a plethora of information available, it can be difficult to decipher and interpret because, unfortunately, there are at least 160 methodologies employed by those agencies.

And wrapping up all of this company information in one score means that a lot of the detail is lost. There is sometimes little clarity as to whether a particular score means a company is good at, say, governance and pooer at say, environmental issues. In other words, the complexity of ESG can be lost in a simple score.

There seem to be some structural problems as well. Smaller companies, or those with less resources to respond to lengthy questionnaires consistently, generally do poorly.

From the point of view of funds and funds management, there is one further important drawback.

One way of thinking about a portfolio's sustainability score is akin to the price to earnings ratio (P/E) multiple for a portfolio. A combination of stocks in a portfolio gives you the P/E of the overall portfolio, the same way in which a combination of companies' sustainability scores gives you an overall portfolio 'sustainability' score.

Using this analogy and thinking about how we consider portfolios and fund managers, a portfolio with a low P/E doesn't necessarily imply the manager is a value manager. It can just be the 'luck of the draw', the time in the investment cycle or some other issue. We think of it as a necessary, but not sufficient, condition. Similarly, a high sustainability score does not imply the style or in this case, the RI approach being used by the manager. The sustainability score for the portfolio can potentially mask a host of underlying moving variables.

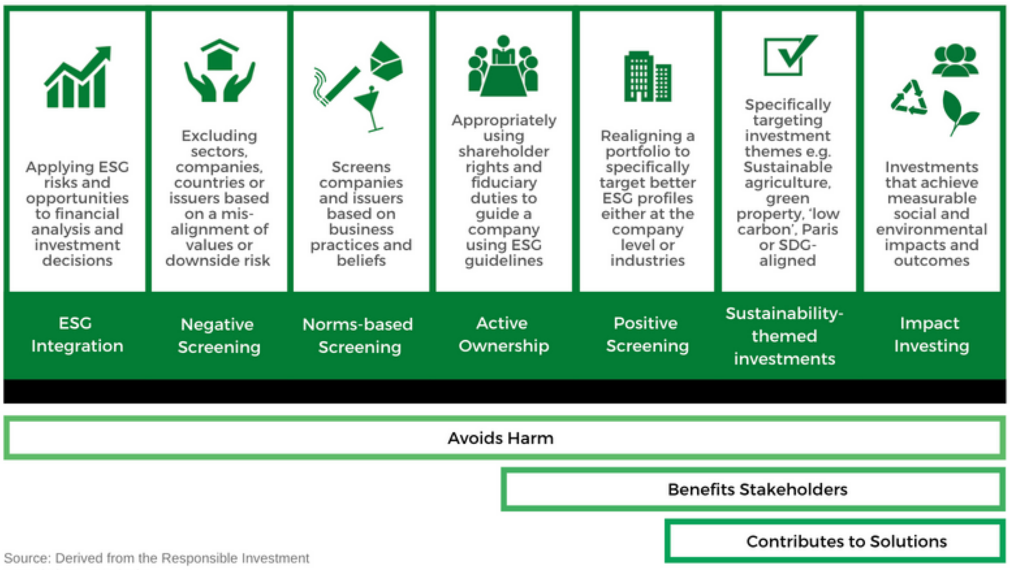
THE TOP-DOWN APPROACH

Another way to think about fund manager RI capabilities is to consider it from a 'top-down' perspective. This top-down approach assesses how a manager has integrated ESG and RI issues within their investment process. This method aligns more closely with the standard methodologies many consultants use to assess fund managers, and therefore may make more intuitive sense to consultants and advisers than a bottom-up approach.

In terms of our earlier analogy, this approach essentially looks at whether the manager's style and process means they are a value manager. That is, we look at the managers' intentions, rather than their actual portfolio on any given day.

A strong framework to consider various managers' approaches is the "Responsible Investments Spectrum" adopted by the Responsible Investment Association Australasia (RIAA) and which is shown in Chart 2.

Chart 2: Responsible Investments Spectrum



Source: Derived from the Responsible Investment Association Australasia

RIAA is the peak body for ethical investment in Australia, and many superannuation funds, institutional consultants and financial advisers have become members. The framework also aligns with the work of the United Nations Principals for Responsible Investment (UN PRI), meaning that it offers an approach that is globally accepted.

The spectrum classifies RI approaches at a high level from the lens of three primary objectives. Firstly, from the level of avoiding harm, secondly whether there is a benefit to stakeholders, and, finally, whether there is a positive contribution to changes to the environment or society. The approaches on the spectrum are ESG integration, negative screening and norms-based screening. These are the approaches that seek to mitigate risks through avoidance of owning companies subject to higher ESG factor risks. Active stewardship seeks change through engagement as shareholders. Positive screening, sustainable investing and impact investing target solutions – indirectly in the case of positive screening, or directly in the case of the latter two approaches.

A distinct disadvantage of this approach is that it is much more time consuming for fund managers and consultants to build and maintain a database of RI approaches than buying bottom-up data. And smaller fund managers who don't have the resources to devote to completing questionnaires may be at some disadvantage, in a similar way to smaller companies are in a bottom-up approach.

Further, the results are unlikely to be simply expressed as a single number. One approach to using this framework might be to score or rate managers across each of the seven areas of the spectrum, so that the depth of each manager's investment methodology in each area is measured. The resulting scores may be a little trickier to interpret but do provide a depth of insight not available through a bottom-up approach. In particular, this approach would allow analysts to classify managers such that they could have multiple approaches.

CONCLUSION

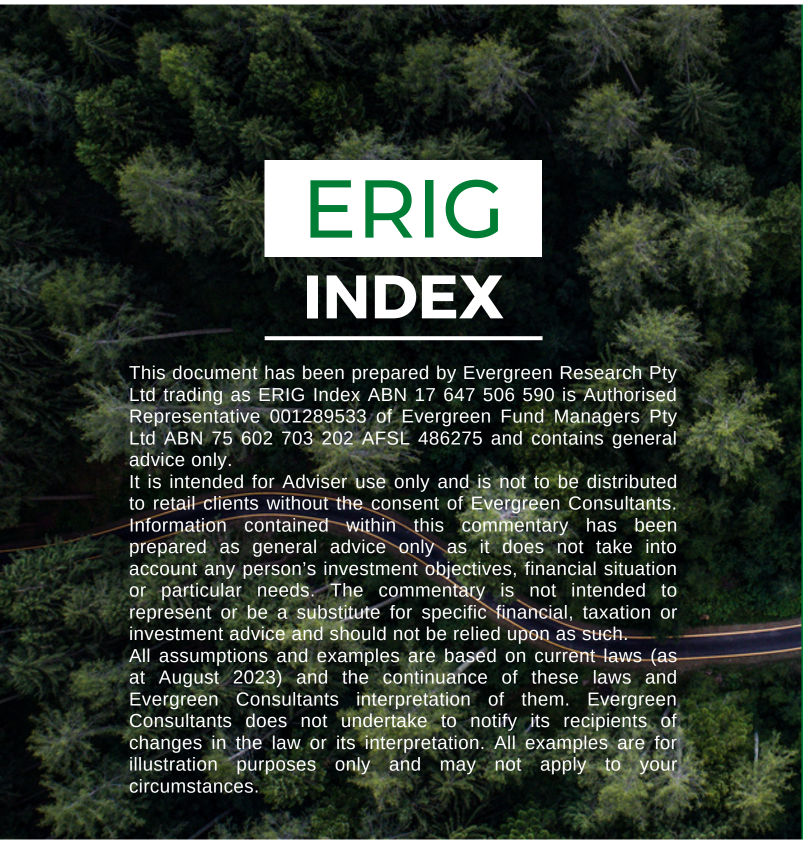
As the world faces issues as diverse as the #MeToo movement, pandemics and climate change, it is clear that the appeal of, and the demand for, RI will continue to grow. In fact, it is likely something that most financial advisers will have to consider in more depth over the coming years.

Given we are in a nascent phase in the growth of RI, the approaches that the industry will use to assess managed funds are in the initial stages of being developed.

This is the stage where we all can have a hand in developing a robust methodology that will become the new industry standard.

We have outlined above two broad methodologies, both of which clearly aim to provide industry participants with a framework to assess the RI features of managed funds.

In our view, the top-down approach is superior, as it aligns more closely with the approach many analysts have used to assess fund managers' investment processes. It also provides a degree of granularity that is sometimes lost in the 'single score' approach of the bottom-up methodology.



ERIG INDEX

CONTACT US

Don Gunawan
Relationships Manager
Don@erigindex.com.au
0404 033 792