Leaning on the building blocks of ESG in uncertain times

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When President Donald J. Trump announced on June 1 that the United States would back out of the landmark Paris Climate accord, the world of environmental, social and governance investing shuddered.

Even before the president announced his decision, elected officials across the country, as well as corporate executives from Tesla's Elon Musk to J.P. Morgan Chase's Jamie Dimon, voiced their support for the climate pact, which, at its core, seeks to keep global temperatures from rising more than 2 degrees Celsius above pre-industrial levels.

"What does it mean from an investor's perspective? It puts a greater amount of responsibility and potentially cost on American businesses," said John Streur, president and CEO of Calvert Research and Management. "American businesses have to keep up in this global race toward a lower-carbon economy. It is a global race. That trend is well established."

That trend — or what Streur would call a set of global norms — has been evolving over the last 50 years but was energized in 2015 when the United Nations first published its Sustainable Development Goals and Pope Francis issued his encyclical on the environment.

That was the same year that Calvert, long known as one of the first managers to use social investing principles, created its own formalized set of ESG principles.

"We created the Calvert Principles for Responsible Investment to try to take the global norms and make them relevant in an investment context," Streur explained. "From those principles, we developed four pillars — performance, research, engagement and impact — and those pillars are a description of how we put the principles into action from an investor's perspective."

FOUR PILLARS

Calvert's ESG pillars are – not surprisingly – interconnected, but begin with performance. In the early years of ESG, or responsible investing, strategies were largely built on screening out investments such as the stocks of companies that sold cigarettes or alcohol, and common wisdom held that that approach, while potentially beneficial to society, meant giving up some level of return.

"We think about responsible investing from the perspective of an asset owner," Streur said. "What do I need to do as an investor in today's capital markets to be responsible in terms of discharging my duties? First and foremost, we need to get the performance equation right. We need to get an efficient portfolio structure, the right amount of risk and the right amount of return."

Over the years, as ESG investment strategies have been refined and improved, the fear that socially responsible investing means giving up return has been debunked.

Of course investment performance, whether in equities or fixed income, depends on the performance of the companies that issued the securities, and that's where Calvert's second pillar — research — comes into play.

"We know that company managements are working hard to make their companies and businesses more sustainable and to do a better job for society in ways that are material to their business," Streur explained. "That means something financially. Having the ability to understand the ESG performance of the companies that you're selecting from is critical."

To do that, managers such as Calvert rely on data developed independently, by a third party, or provided by the company. The data break down how companies are performing relative to various ESG metrics such as carbon emissions or water use. The problem is there are more than 150 data sources. Even in a world of big data, that's a lot.

"What we want are the pieces of information that really matter to the environment, society and the business," Streur said. "We want to focus on issues that matter to the business."

For example, in the technology sector, human capital management is a "critical capability," while in the transportation sector, workplace safety and product safety top the list, he said.

"We built our system from the perspective of — at a sub-industry sector level — what are the most material ESG factors and where can we go to find the key performance indicators that will inform us about these factors," Streur explained.

The third pillar — engagement — is illuminated by the data but goes beyond that.

"At the very least, corporate engagement means having an up-to-date, well thought-out proxy voting policy," Streur said. "It's our ability to have a dialogue and engage with corporate management to help move them toward best practices in ways that work for stockholders and bondholders."

In fact, engagement once was all about shareholder resolutions and asking companies to improve their environmental or social performance without linking back to financial returns.

"Today we are in a much better position to say, 'This matters to your investors,'" he said. "The ESG data we have today is very useful in the engagement process. We can say, 'Here are your five main peers, here's what they're doing, here's what you're doing and here's what we'd like you to change. And here's why we think it matters to your investors.'"

For plan sponsors and other institutional asset owners, Calvert's fourth pillar — impact — is crucial because it connects action and performance.

"Impact reporting is being able to demonstrate that we're having a positive impact, that the portfolio has lesser exposure to carbon emission or better exposure to gender diversity or lesser exposure to toxic chemicals," Streur explained. "Those types of things are important to be able to give back to the client and prove that their portfolio is better in those respects than the broad market."

REPORTING REQUIRED

In fact, more clients are asking, if not requiring, their managers to supply such information and including those requirements in RFPs for new mandates.

"Larger clients are coming in with a reporting requirement," Streur said. "They're looking forward to the next board meeting or the next committee meeting, and they know they need to bring the numbers. That's why ESG data is so important. We've got to prove it." ❖

CALVERT'S FOUR PILLARS OF RESPONSIBLE INVESTING

PERFORMANCE
Our first responsibility is to seek strong portfolio returns.

RESEARCH
We evaluate all material ESG factors that influence a company's business results — moving beyond negative, values-based screens.

ENGAGEMENT
As shareholders, we actively engage company management to help drive performance.

IMPACT
We believe the impact of your investments should be material and measurable.

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