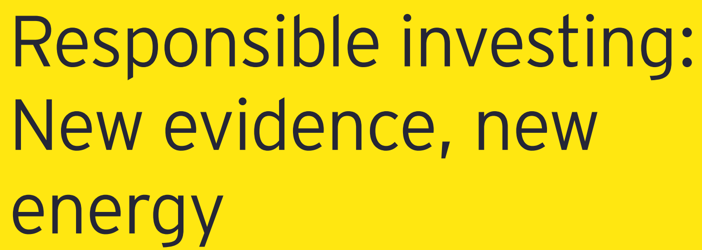

Responsible investing: New evidence, new energy

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Forewords

EY

EY is proud to have collaborated with Royal London on this paper. Now is the time for insurers and asset managers to broaden their offerings to customers demanding sustainable and responsible products, so that we can invest in a better future. For too long, there has been a myth that one has to make a choice between higher investment returns and responsible investing – I believe that this research helps to debunk that myth and makes it clear that investing responsibly ought to lead to better outcomes for the customer.

We must also continue to engage with our customers and their advisers to ensure that these offerings continue to meet their needs, from both a value and values perspective. As we do that, and as the quality of ESG data improves, we'll be able to make better decisions, improve our offerings and transform customer engagement by including ESG and impact metrics.

We know ESG data isn't perfect yet, but with the market moving rapidly, choosing to enhance sustainable and responsible investment product offerings is a better decision that businesses can make today.

Gareth Mee
Partner
Ernst & Young LLP

Royal London

Royal London is delighted to present this paper together with EY. It not only sets out new evidence of the financial benefits that responsible investing can deliver; it also makes a strong commercial and compliance case for financial advisers and other key players in the industry to embrace greater sustainability.

It is simply no longer feasible for anyone dealing with investors to view responsible investing as an optional extra. That may pose some challenges, but it also brings significant upsides. The growing demand for sustainability, reinforced by the COVID-19 pandemic, presents a valuable opportunity to strengthen relationships. We hope our paper will help advisers to engage more closely with their clients on this vital topic.

Lorna Blyth
Head of Investment Solutions
Royal London

Introduction

Interest in responsible investment is reaching new heights, with the impact of the COVID-19 pandemic providing an unexpected but powerful catalyst for change. As demand for responsible investment grows, the financial industry and society as a whole want to know how to practice responsible investing - and what results investors can expect from it.

EY and Royal London wanted to contribute to this debate, and decided to work together to review existing empirical evidence of how responsible investing affects returns. We began by identifying a set of hypotheses setting out how using Environmental, Social and Governance (ESG) principles could maintain or improve investment performance. We reviewed more than 30 academic and other published papers. This included literature reviews and meta-studies looking at over 2,000 global empirical studies during a 25-year period, to determine if the hypotheses are supported by evidence[1].

This paper summarises our findings, puts them into the context of the changing appetite for responsible investment and suggests some actions that advisers and asset managers can take to harness the power of sustainability for the benefit of investors.

[1]The historical data around ESG performance incorporates a wide range of approaches to ESG fund management without distinction. In the early stages of ESG investing, the vast majority of funds were focused on exclusions on ethical or religious reasons and were less focused on returns. Many of them also had a focus on smaller cap companies. As ESG investing became more mature, different approaches and styles of ESG investing emerged. There will be a bias in the performance of historical ESG funds based on the focus on ESG.

Our research of the empirical evidence shows that applying ESG principles delivers financial benefits, both in corporate performance and in the performance of investment portfolios. This is a significant finding, given the growing level of interest in responsible investing, and is backed up by the resilience of sustainable companies in the face of COVID-19.

Furthermore, this comes at a moment when grass roots demand for responsible investing is being pushed to a new level by the social and environmental effects of the pandemic, and when regulatory changes such as the amendments to MiFID II are adding significant momentum to the ESG agenda.

Together, we expect these three key drivers of evidence, demand and regulation to rapidly accelerate the investment industry's adoption of sustainable practices in a post-COVID world. Developing responsible investment capabilities is no longer an option, it's a necessity.

We do not underestimate the challenges that remain, especially in the complex areas of definitions and data comparability. However, we also believe that the investment industry doesn't need to wait for perfect information before incorporating ESG factors into its processes, services and operating models. In our conclusion we set out actions that every financial adviser and asset manager can take immediately to tap the potential of greater sustainability.

In our view, financial advisers, pension providers and asset managers face an unprecedented opportunity to match investors with companies that need their capital to 'build back better'. In the process, they will unlock financial rewards - for investors and for themselves. In contrast, businesses that are unable to adapt could find themselves left behind by the accelerating transformation of the whole investment industry.

Background

Responsible investing has grown explosively over the last five years, fuelled by investor appetite, belief in outperformance and regulatory change. The rapid increase in scale and sophistication is reflected in the expansion of the United Nations Principles for Responsible Investment (UN PRI) from 68 founding signatories in 2006 to over 1,800 in 2018. By the end of 2019, 96% of the world's top 50 asset managers were signatories, managing US $31trillion of the world's roughly US$100trillion of financial assets in some sort of sustainable mandate or fund[2].

Europe has been at the forefront of this global trend, and the UK has played an important role. Mark Carney's 2015 speech 'Breaking the tragedy of the horizon' was particularly influential. Less than five years later, Mr Carney wrote in an International Monetary Fund article 'Fifty shades of green' about the strides already taken, but also of the need to move further and faster to develop a new global system of sustainable finance.

It would not have been surprising if the global downturn sparked by the COVID-19 pandemic had halted the growth of responsible investing or led investors to abandon ESG principles altogether. In fact, the pandemic has strengthened the drivers of sustainability. Yes, questions over responsible ESG investing persist, especially among advisers and trustees who are unsure how to address sustainability in the context of their fiduciary responsibilities. But regulation has maintained its established direction. Investor appetite has continued to grow, boosted by grass roots activism and campaigns such as Make My Money Matter. And – even on a sector neutral basis – ESG's bias towards high quality, well-governed companies appears to have delivered for investors during the crisis[3].

So this feels like a good moment to take a fresh look at the evidence for ESG performance. EY and Royal London hope our paper will add depth to the global debate around responsible investing.

[2]UNPRI, Annual Report 2019, 09.08.20

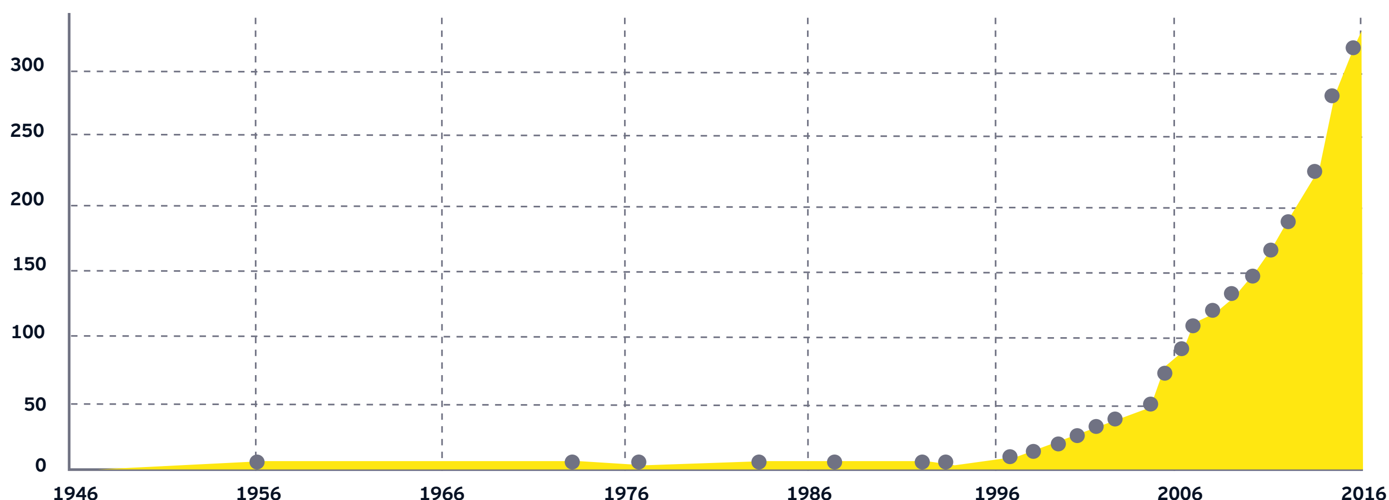
[3]Financial Times, 'Majority of ESG funds outperform wider market over 1, 3, 5 and 10 years' 13.06.20

Key findings

1. Regulation: The direction of travel is clear and strong

The sheer volume of ESG-related initiatives in the last few years has given a major boost to responsible investing. Climate change has seen the greatest focus, however many other sustainability and stewardship rules have been introduced. In 2016 the UN PRI found that ESG-related regulations were planned or had taken effect in 38 of the world's 50 largest economies, with several hundred pieces of investment regulation in force[4].

PRI: Cumulative number of responsible investment policy interventions per year



Regulatory momentum continues to build. In the EU this is shaped by the Sustainable Action Plan, with European Securities and Markets Authority (ESMA) proposing that investment firms should incorporate ESG principles into processes including product approval, investment reporting and risk management.

For the financial planning community, perhaps the most significant change is a proposed amendment to Article 25 of MiFID II – something that many financial advisers are reported to be unaware of[5]. This relates to the suitability assessment, and will require firms to take sustainability risks and clients' sustainability preferences into account.

For asset managers, proposed reforms to Undertakings for the Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund Managers (AIFM) mean incorporating the consideration of sustainability risks into governance structures and operating models.

[4]PRI Responsible Investment Regulation Database
[5]Portfolio Adviser, 'Advisers struggling to embrace ESG despite impending MiFID II regulation', 05.05.20

In the UK, 2019 saw the Financial Conduct Authority, Prudential Regulatory Authority, Financial Reporting Council and the Pensions Regulator publish a joint declaration on climate change welcoming the government's green finance strategy and committing to address climate change risks. Led by the Bank of England, regulators are working with banks, insurers and pension schemes to build ESG risks into stress testing. The Pensions Regulator has taken several actions, including telling trustees that weighing ESG risks is consistent with maximising financial returns, and requiring the trustees of local authority, defined benefit and defined contribution funds to disclose their approach to ESG factors.

Most recently, guidance from the UN PRI has explicitly linked the COVID-19 crisis with responsible investment imperatives. It plans to work with its signatories to mitigate the impact of the pandemic on public health, economic growth, social inequality and mental health. The PRI is encouraging investors to:

- Engage companies that are failing in their crisis management
- Engage where other harm is being hidden behind, or worsened by, the crisis
- Re-prioritise engagement on other topics
- Publicly support an economy-wide response
- Participate in virtual Annual General Meetings
- Be receptive to requests for financial support
- Maintain a long-term focus in investment decision-making

Looking ahead, it seems certain that the direction of regulation and legislation will continue to push investment firms to develop their responsible investment capabilities.

2. Performance: Positive evidence is mounting fast

Increasing consensus over the link between companies' adoption of ESG principles and relative outperformance has been a key driver of responsible investing over recent years. There is also strong anecdotal evidence that ESG investments have delivered relatively stable returns during the volatile markets and ratings downgrades of early 2020[6].

Given this background, we believe our research into the empirical evidence for responsible investing adds new depth to the ESG debate. Our work involved developing a set of hypotheses expressing specific ways in which ESG principles could enhance investment performance. These include reduced risks, lower volatility and lesser costs of capital. We then tested these hypotheses against the findings of over 2,000 studies, meta-studies and literature reviews.

[6]CBNC.com, Sustainable investing is set to surge in the wake of the coronavirus pandemic, 07.06.20

Summary of findings

Hypothesis	Conclusion	Commentary
1a. Companies that demonstrate strong performance on ESG have better corporate financial performance generating higher stock returns than those with weaker ESG performance. 1b. Corporate bonds exhibit lower costs of debt.	Our research supports these hypotheses.	Companies with better ESG credentials perform better than lower credential peers on return-on-equity (ROE); return-on-assets (ROA) and on stock market performance. There is a positive correlation between ESG ratings and cost of debt.
2a. Companies with strong performance on ESG demonstrate lower volatility in their stock returns. 2b. Corporate bonds with high ESG ratings have higher credit ratings.	Our research supports these hypotheses.	Companies with high ESG performance had better risk management which reduced volatility. High ESG ratings could result in both lower cost of capital to the company and lower spreads. Corporate bonds with higher ESG ratings are less likely to be downgraded.
3. Portfolios that incorporate strong ESG scores or performance of underlying securities demonstrate higher returns compared to those with lower ESG scores or performance.	Our research partially supports this hypothesis.	Portfolios consisting of companies with strong ESG performance perform better than those consisting of low ESG performers.
4. Strong ESG performance causes market outperformance.	Our research partially supports this hypothesis.	Strong ESG performance leads to lower likelihood of adverse company specific incidents due to poor risk management processes, i.e., idiosyncratic risk and higher company valuation,.
5. Returns from ESG integration will diminish as ESG is priced in.	Our research offers an alternative conclusion.	The relationship of ESG and financial performance is stable over time.
6. Markets where ESG integration is more mature demonstrate lower excess returns from ESG.	Our research partially supports this hypothesis.	There is broad but not fully conclusive evidence that returns from ESG integration are higher in markets that are less mature from an ESG perspective.
7. The correlation between corporate financial performance and ESG factors is equally positive for all three categories of factors.	Our research offers an alternative conclusion.	Good governance is more conclusively linked to corporate financial performance than other ESG factors.
8a. Sovereign bonds with high ESG scores have lower risk. 8b. Sovereign bonds with high ESG scores have higher credit ratings.	Our research partially supports these hypotheses.	The evidence shows a correlation between low ESG ratings and risk of downgrade. Low governance scores are linked to a higher cost of capital.
9. Issuers of high yield bonds with strong performance on ESG have lower risk of credit default.	Our research is inconclusive on this hypothesis.	There is insufficient research to reach a conclusion.
10. Sustainable properties have a sales premium.	Our research is inconclusive on this hypothesis.	Sustainable properties had a rental and sales premium which has been less pronounced in recent years.

As the table shows our findings support or partially support eight of our hypotheses, including several sub-hypotheses. Our work also allows us to make a cross-cutting review of the published research. Taken together, that enable us to form some overall views about the strength of evidence in two key areas.

The most persuasive findings relate to corporate financial performance. A variety of studies see neutral or positive evidence that companies that have pursued substantial environmental and social policies since the 1990s perform better than lower credentialed peers on accounting measures such as return on equity and return on assets, and in terms of stock market performance over time (expressed in terms of annual abnormal performance). One 2016 study shows that companies with a strong ESG performance (defined as inclusion in the Dow Jones Sustainability Indices) have a 6.12% higher return than baseline companies.

Connected with these findings, companies with higher ESG ratings exhibit lower share price volatility than ESG laggards, which suffer from more frequent stock-specific risk events (although this relationship is not apparent in the automotive, banking and durable industrial sectors). Good ESG performers generally have better risk management processes, more robust governance structures and more consistent engagement with stakeholders. These allow firms to reduce the frequency of idiosyncratic risk incidents, implying the ability to deliver higher risk-adjusted returns. That would explain the relatively strong performance of ESG leaders during periods of volatility.

In addition, there is evidence of a positive correlation between higher ESG rates and lower costs of debt. Corporate bonds with high ESG scores match or outperform returns from portfolios with lower ESG scores. In particular, companies with strong governance scores appear to be at a lower risk of downgrades than those with low governance ratings.

We also found positive evidence relating to the performance of ESG investment portfolios. Studies of comparative investment performance found that funds which integrate ESG demonstrate higher returns compared with those that do not. However, this research is typically based on a relatively short timeframe, given that integrated ESG funds have only become a staple of responsible investing in recent years.

In contrast, studies that include longer-established ethical investment funds (those that use ethical principles as a primary filter for investment selection) showed mixed performance results. In part this reflects the ‘negative exclusions’ that have often been applied by ethical funds in sectors such as alcohol, tobacco and gaming. This reflects the inherent limitations of comparing historical data around ESG performance.

Nonetheless, our overall findings show the balance of empirical evidence is in favour of incorporating sustainability risks into corporate and investment decision-making. Companies with better ESG credentials appear to deliver better performance for investors over time.

3. Sentiment: Investors demand sustainability as standard

Investor appetite for responsible investing has grown at an astonishing rate in recent years. Morningstar data shows that US$21bn of new assets were invested in mutual funds or ETFs based on environmental, social or governance themes during 2019, nearly four times the previous record set in 2018[7].

The COVID-19 pandemic has done nothing to halt this growth. In fact the crisis in public health, the importance of science, the power of collective action and powerful movements for social justice are accelerating demand for sustainability. Public scrutiny of corporate behaviour is growing, with politicians and campaigners calling for the economy to 'build back better'. Above all, members and savers – especially younger cohorts –increasingly insist on investing in line with their values[8].

In short, the onus is firmly on investment firms to demonstrate they have a robust approach to responsible investing. That will only be reinforced if, as we expect, ESG investments are shown to have performed well during 2020.

This perspective is backed up by research. EY's recent survey of 17 UK-based investment firms with a total of £9.5 trillion of assets under management revealed that institutional and high net worth (HNW) investors are willing to seed new ESG-themed funds without a 3-5 year performance track record. Research by BofA Merrill Lynch in 2019 highlighted growing use of ESG by institutional investors, with 26% claiming to formally use ESG factors in stock selection up from 19% in 2017[9].

Looking ahead, the EY Future Consumer Index - which tracks consumer sentiment across major markets – suggests that the COVID-19 Pandemic will boost appetite for responsible investing. The Index shows that more than 80% of consumers believe brands are responsible for making positive changes in the world (see Figure).

How strongly do you agree or disagree with the following statements (select one)

Brands are responsible for positive changes

Brands must put employees ahead of profits

Brands must put society ahead of profits

Company's behaviour is as important as what it sells

I can see the positive impact brands make

The brands' positive actions are good enough

Responses

Disagree   Somewhat agree   Completely agree

EY Future Consumer Index

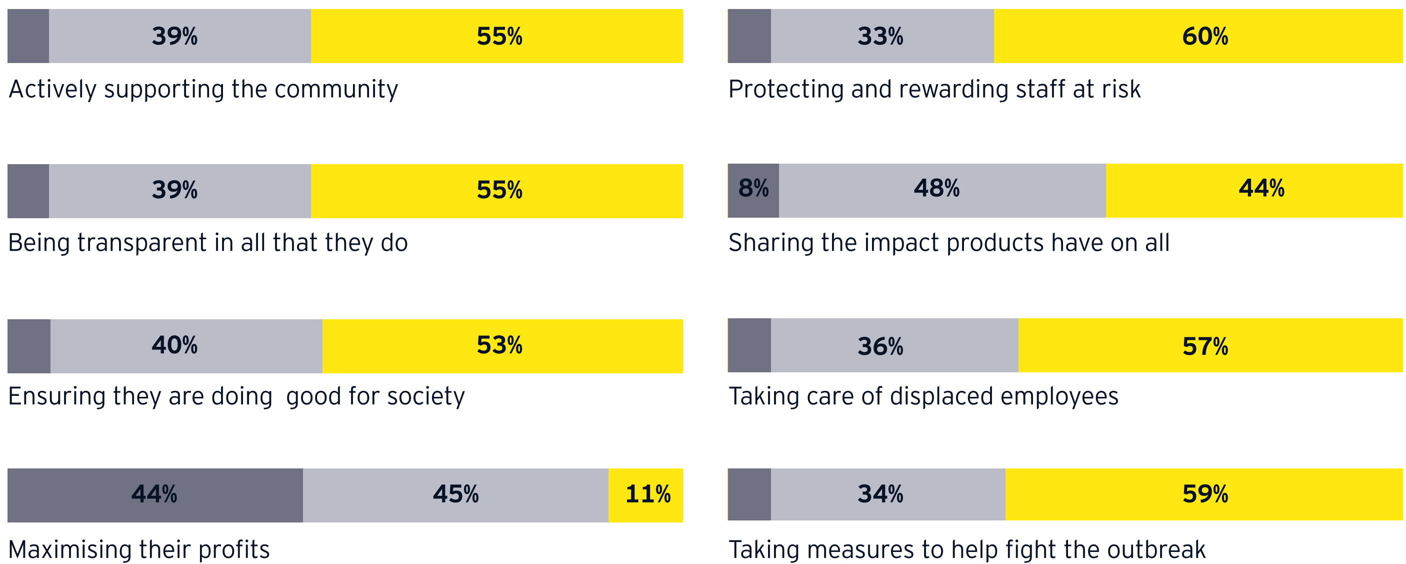
[7]https://www.cnbc.com/2020/01/14/esg-funds-see-record-inflows-in-2019.html 14.1.20

[8]https://www.ey.com/Publication/vwLUAssets/ey-sustainable-investing-the-millennial-investor-gl/$FILE/ey-sustainable-investing-the-millennial-investor.pdf

[9]BofA Merrill Lynch Global Research, 'Outlook spotlight: ESG – an increasingly important signal for investors', 23.9. 19

Moreover, a majority of consumers say that they are more likely to purchase from companies that support their staff, communities and society at large (see Figure).

How would the following company behaviours impact your future purchase decisions (Select one)



Responses

Make me less likely to purchase | Not impact my decision to purchase | Make me more likely to purchase

EY Future Consumer Index

Conclusion: Harnessing sustainability will benefit investors and industry alike

Investment firms of all kinds see credible responsible investing capabilities as increasingly vital to winning institutional, high net worth and retail inflows. Many have already taken significant steps to integrate ESG criteria into their systems, processes and culture. Data vendors and ratings agencies are also developing their ESG capabilities.

Meeting evolving demand for responsible investing requires more than applying ESG ratings. It calls for a broad stakeholder view and involves difficult decisions – such as balancing the imperatives of climate change with the need to address underemployment. It's also true that the lack of agreed definitions and taxonomy remains a significant challenge to analysis and decision-making.

In the long term, building a sustainable global financial system will require co-operation between governments, regulators and players throughout the investment industry. But firms can – and should – act now to harness the power of responsible investing. The current news flow, debate and energy around ESG provides an invaluable opportunity to build engagement between investors, advisers, asset managers and investee companies.

We believe there are four key attributes that asset managers and financial advisers alike can use to develop strong responsible investing capabilities. That includes organisations with limited resources, and those which have taken few steps so far to implement ESG principles. Those attributes are:

- **Listening and engagement.** Listening to the end investor can help firms to gather more insight and data on consumer sentiment and trends. EY's Future Consumer Index shows that enhancing environmental and social impacts is one of the leading factors that makes consumers willing to share their personal data.
- **Leadership and purpose.** It's important for firms to lead by example and demonstrate the values consumers seek. The impact of COVID-19 makes it even more important for firms to incorporate ESG principles into their own operations and conduct, not just their investment decisions or advice.
- **Consistency and communication.** Using internally consistent sets of ESG definitions and assumptions, aligned to global regulatory standards, will help to build a robust ESG framework, to make performance comparisons and to build trust and transparency with staff, investors and stakeholders.
- **Training and culture.** Training, education, leadership and culture are all essential to fully implementing ESG frameworks, and to increasing awareness of the benefits of responsible investing.

In conclusion, we expect regulatory change, evidence of outperformance and fast-growing demand to drive sustained growth in responsible investing. Meeting those needs will generate powerful revenue growth for financial advisers and asset managers. Conversely, those that fail to keep up risk being left stranded as the whole industry shifts onto a more sustainable footing.

Glossary

Environment, Social & Governance (ESG): Issues that are typically incorporated into investment analysis and decision-making when implementing responsible investing:

- Environmental: Issues relating to the quality and functioning of the natural environment and natural systems
- Social: Issues relating to the rights, well-being and interests of people and communities
- Governance: Issues relating to the governance of companies and other investee entities

Responsible investing: Incorporating ESG factors into investment analysis, investment decision-making and active ownership.

Sustainable investing: Investing in themes or assets that contribute to addressing sustainability challenges, typically those addressed by the UN's Sustainable Development Goals.

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