ENIRONMENTAL, SOCIAL AND GOVERNANCE
OBJECTIVES AND OUTCOMES

Witold J. Henisz
Deloitte & Touche Professor of Management
henisz@wharton.upenn.edu
Recap

• Pensions and ESG: Institutional and Historical Perspective (P. Brett Hammond, Capital Group & Amy O’Brien, Nuveen, a TIAA Company)
  – Diverse and dynamic history of meanings, motives and players
  – Externalities, universal owners, stakeholder theory, ESG factors & data
  – As interest broadens, do we need more alignment? How to achieve?

• What Does ESG Investing Really Mean? Measuring Materiality (Linda-Eling Lee, MSCI)
  – Disagreement among ESG data derive from different motives not quality (aka effectiveness or confusion)
  – However, data do have issues in reliance on voluntary unaudited disclosure, media, alternative sources and imputation
  – MSCI “rating” with proprietary dynamic industry-specific weighting have predictive power for different outcomes over different time horizons
    • Cash flow
    • Idiosyncratic risks
    • Systemic risks
The Motivation for Both Papers

• Despite the growing investor interest in ESG, there remains a nagging sense of excess hype or a fad that is ahead of reality
  – What to measure? Values or value?
  – How to measure? Voluntary unaudited corporate reports vs. media and other alternative data (with imputation)?
  – How strong are the correlations to financial performance out of sample (i.e., do ESG funds outperform over the long-term)?
  – Consistent with fiduciary duty?

• Academic studies including those presented here trail practice
  – Rely on MSCI-KLD data (not same as MSCI)
    • Values > Value.
    • Voluntary corporate reporting > media or alternative data
  – Broadly supportive of win-win but not convincing to skeptics
    • Short time periods
    • Non-transparent
    • Inconsistent assumptions
Placing Both Papers in Context

• Diverse and dynamic history of meanings, motives and players
  – Religiously motivated screening: values and risk mitigation vs. tracking error. But, does divestment actually have impact? Only under select conditions.
  – Engagement of CALSTRS, NYC Pensions, UNPRI, Coalition for Good Governance and others shown to drive impact and value but at a cost in fees
  – Portfolio optimization, tilting and factor models and progress in ESG integration dependent upon a high quality independent ESG data signal

• What holds us back from realizing promise of reported investor interest in ESG?
  – Industry-wide pressure for low fees privileges exclusions and simple extensions of existing strategies using off-the-shelf data
  – Institutional Investors perspectives on ESG investing evolving but still hesitant
  – Disagreement in motives underlying data
    • MSCI-KLD focused on scoring companies for alignment with values of “just and sustainable world” followed by Sustainalytics, ASSET4, Vigeo-Eiris …
    • Innovest’s EcoValue and subsequent extensions focused on material impact of ESG on intangible asset valuation. RobecoSAM followed
    • TruValue Labs and others focus on media-reported stakeholder opinions
  – As interest in value > values, industry-specific materiality screens layered on top of discordant data providing improvements in fit
Fees Trending Downwards Overall & Relative to Benchmarks

Average Fees for ESG ETFs & Mutual Funds

- ETFs
- ETFs, Weighted by AUM
- Mutual Funds
- Mutual Funds, Weighted by AUM

Source: Morningstar
Active Share of ESG ETFs & Mutual Funds

Source: Morningstar
Ineffective Exclusions Gaining on More Effective Engagement Strategies

Exclusions vs. Engagement over the years from 2007 to 2020.
Low Fee ESG Funds Gain Share (of AUM) in 2018-2020

- High
- Medium
- Low

Wharton
University of Pennsylvania
Reasons Why Majority of U.S. Institutional Investors Still Have Not Incorporated ESG Factors

Source: Callen Group
Rationale for Incorporation of ESG Factors by US Institutional Investors

Source: Callen Group
<table>
<thead>
<tr>
<th></th>
<th>High Fee</th>
<th>Med Fee</th>
<th>Low Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Performance (relative to benchmark)</td>
<td>-0.004</td>
<td>-0.006</td>
<td>-0.003</td>
</tr>
<tr>
<td>ESG Performance (relative to benchmark), TruValue Labs</td>
<td>0.325</td>
<td>1.060</td>
<td>-0.086</td>
</tr>
<tr>
<td>Change in ESG Performance (relative to benchmark), TruValue Labs</td>
<td>0.026</td>
<td>0.028</td>
<td>0.016</td>
</tr>
<tr>
<td>-- Due to stock purchases and sales</td>
<td>0.030</td>
<td>0.017</td>
<td>0.007</td>
</tr>
<tr>
<td>-- Due to changes in stock's held</td>
<td>-0.004</td>
<td>0.011</td>
<td>0.009</td>
</tr>
</tbody>
</table>

Note: Statistics shown are the quarterly medians across all funds in the fee category, 2007-2020 Q2

Source: Chuah, Kevin, Witold Henisz & James McGlinch (2021) “Greenwash or Green: What Attracts Inflows into ESG Equity Funds?”
Recent Critique of Khan, Serafiem & Yoon (2016)

Source: Luca Berchicci and Andrew King (2021) “Corporate Sustainability: A Model Uncertainty Analysis of Materiality”

https://files.constantcontact.com/61462dbb001/dca0b5b2-16f7-471e-87d4-980013aaf8af.pdf
Recent Critique of Khan, Serafiem & Yoon (2016)

Source: Luca Berchicci and Andrew King (2021) “Corporate Sustainability: A Model Uncertainty Analysis of Materiality”
https://files.constantcontact.com/61462dbb001/dca0b5b2-16f7-471e-87d4-980013aaf8af.pdf
What’s Missing (and Desperately Needed)

- Third party validation of proprietary data including choices of assumptions, weighting, time horizons and imputation protocols
- Analyses that uses that data to show which ESG investments for which firms pay over what time horizon via what mechanism AND which destroy value
  - Top-line revenue growth
  - Cost reductions (including regulatory and legal interventions)
  - Productivity uplift
  - Idiosyncratic risks
  - Systematic risks
- Analyses that examine contingencies and moderators to these relationships
  - Individual investor demand
  - Asset manager incentives and engagement including proxy voting
  - Stakeholder interest (in an issue for a firm)
  - Availability of technological options for ESG issue
  - Existence of anti-competitive barriers in industry
  - Corporate (enterprise risk) management
The ESG Analytics Lab leverages Wharton’s demonstrated expertise in analytics to develop high-quality, replicable academic research and pedagogy resulting in insights that can help current and future investors, asset managers and other ESG integrators make informed decisions.

https://analytics.wharton.upenn.edu/esg-analytics-lab/