KNOWLEDGE FOR ACTION

ENVIRONMENTAL, SOCIAL AND GOVERNANCE OBJECTIVES AND OUTCOMES

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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

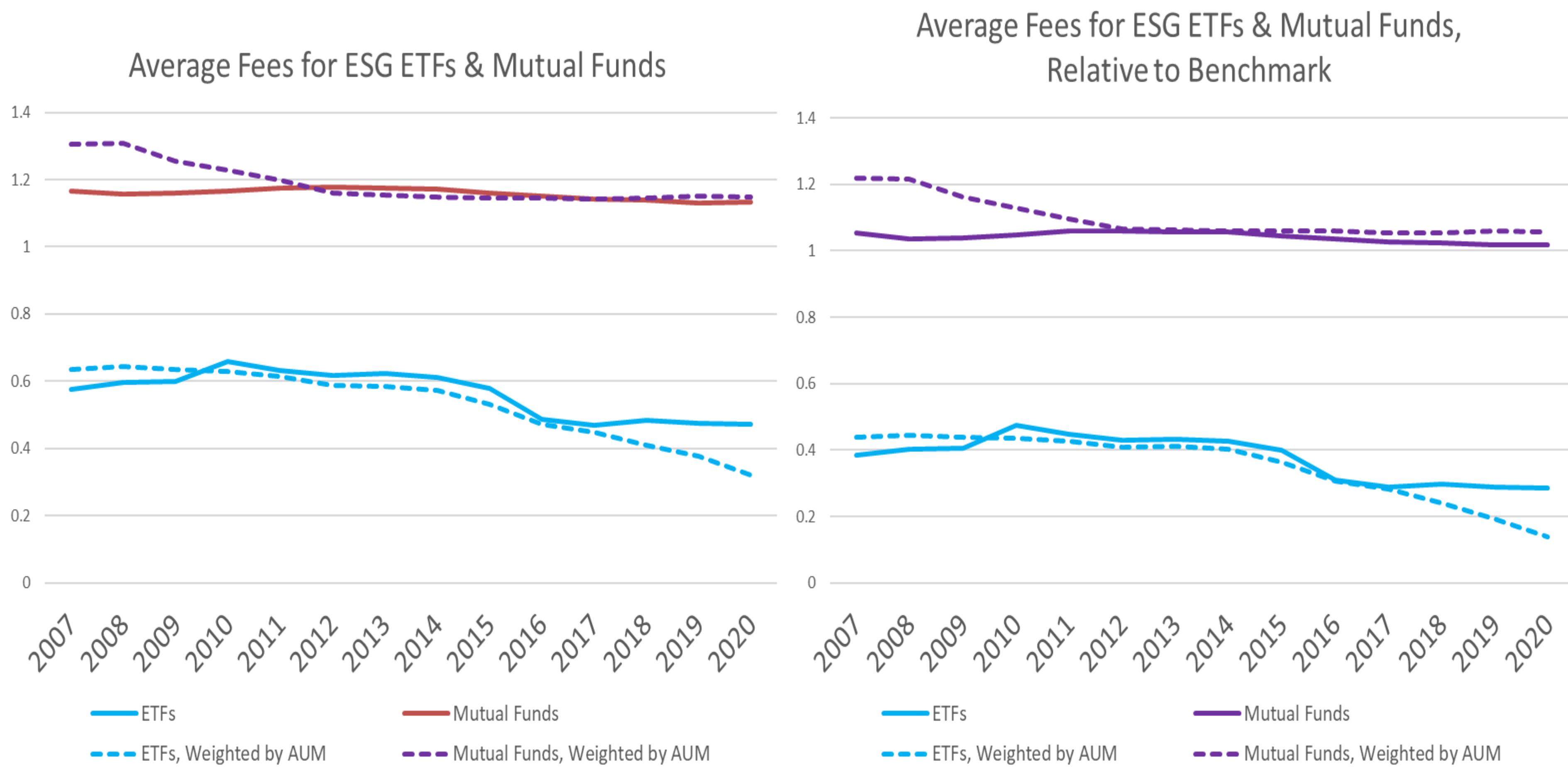
The Motivation for Both Papers

- 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



Source: Morningstar

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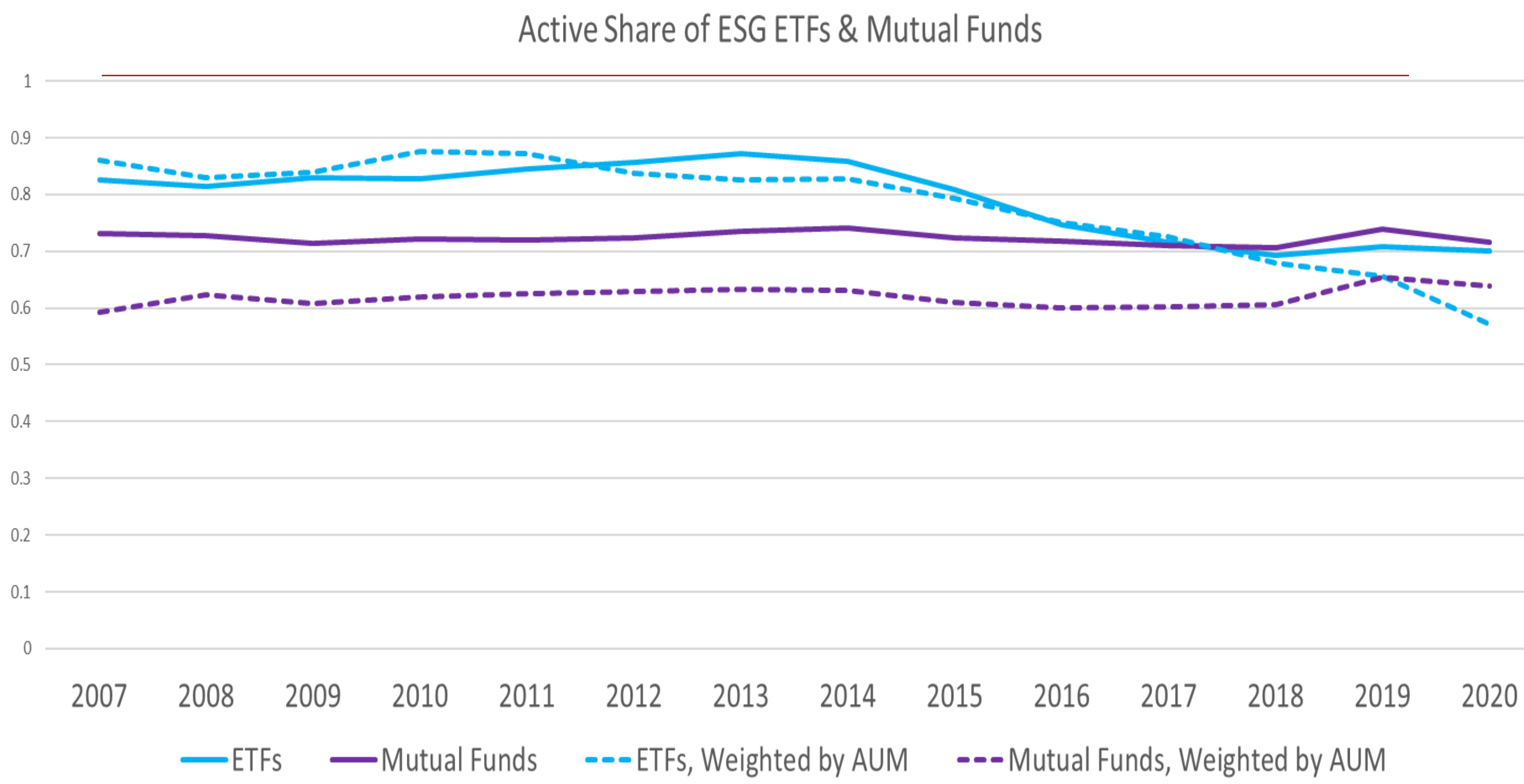

Source: Morningstar

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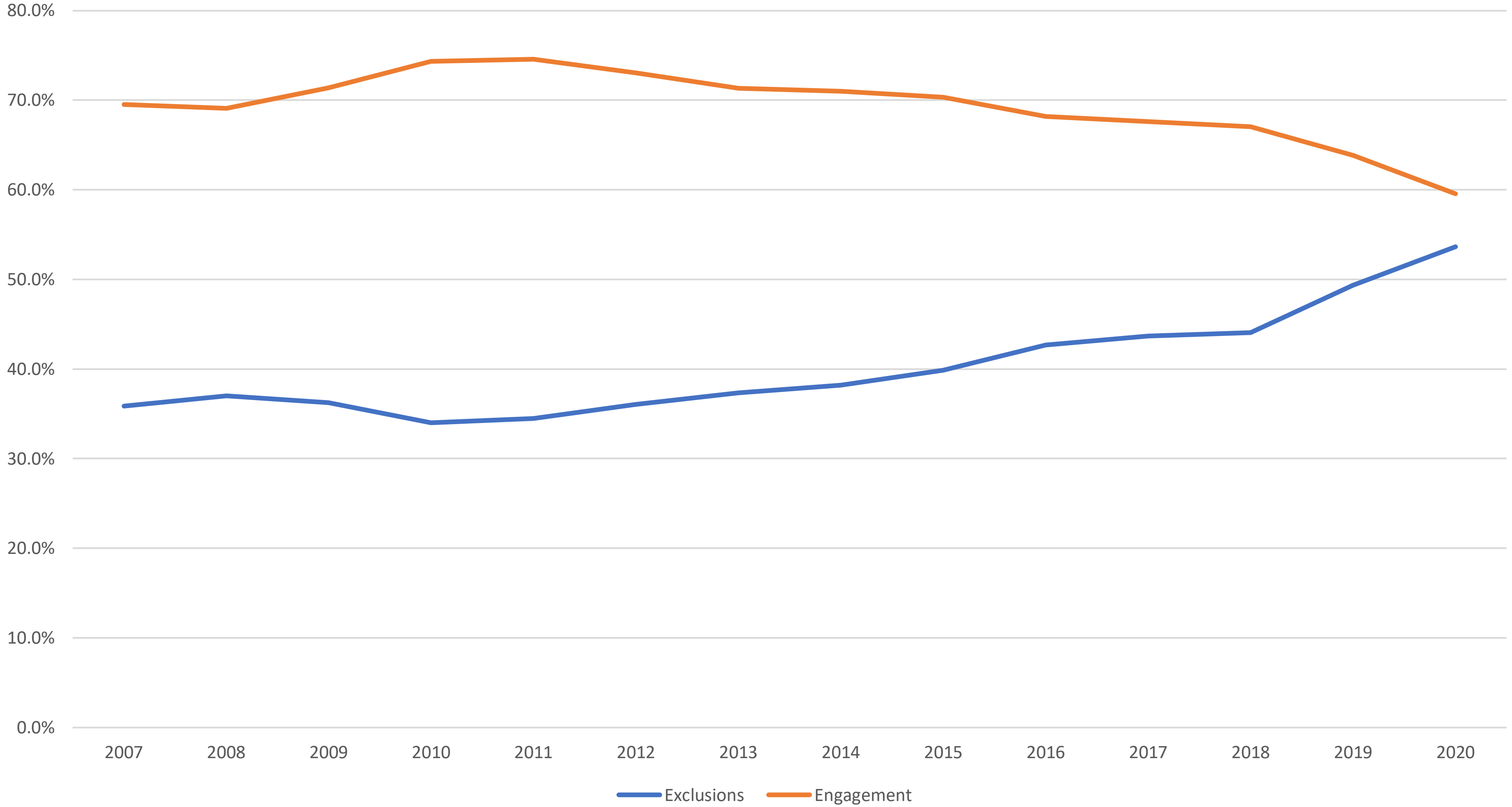
Ineffective Exclusions Gaining on More Effective Engagement Strategies



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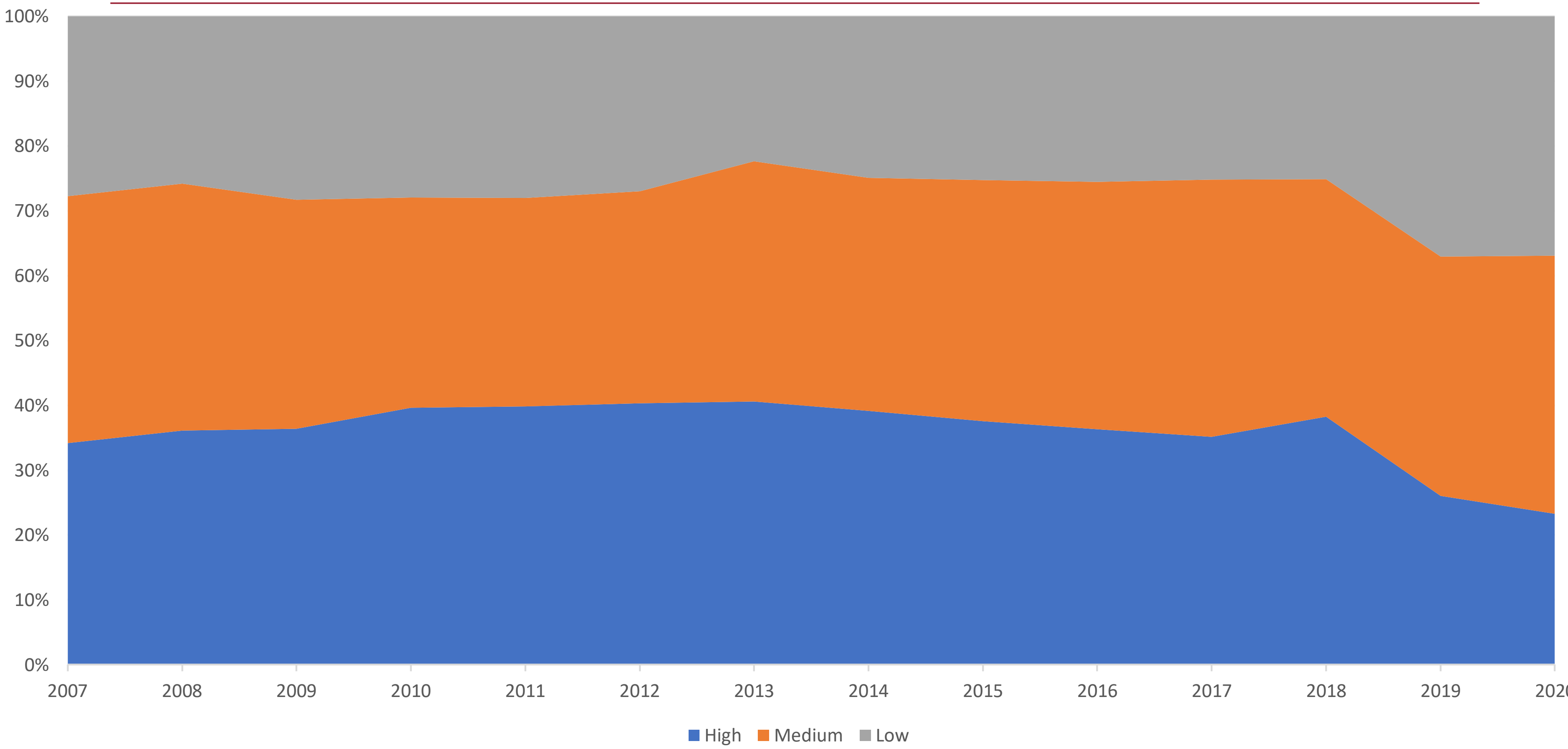
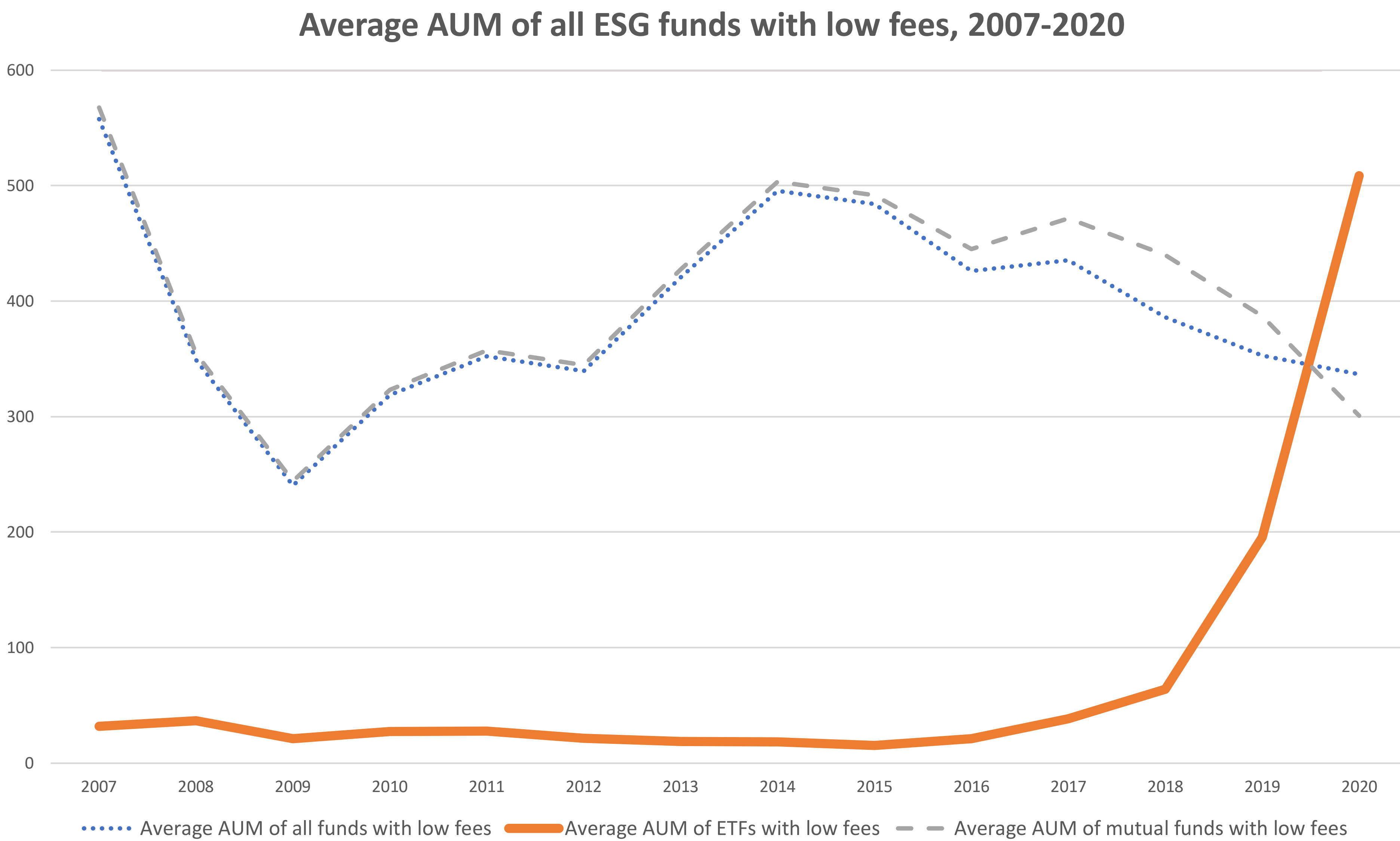
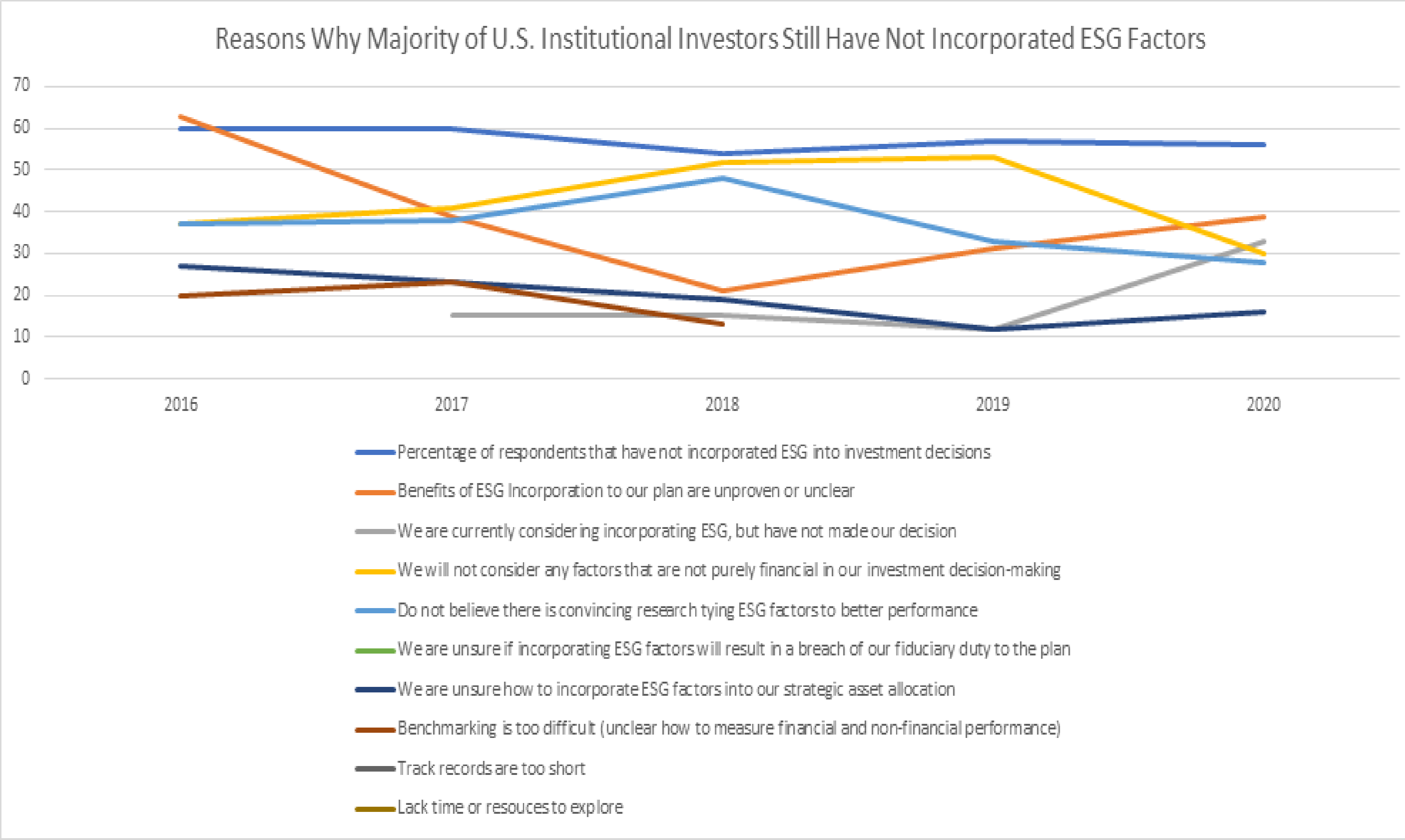
Low Fee ESG Funds Gain Share (of AUM) in 2018-2020

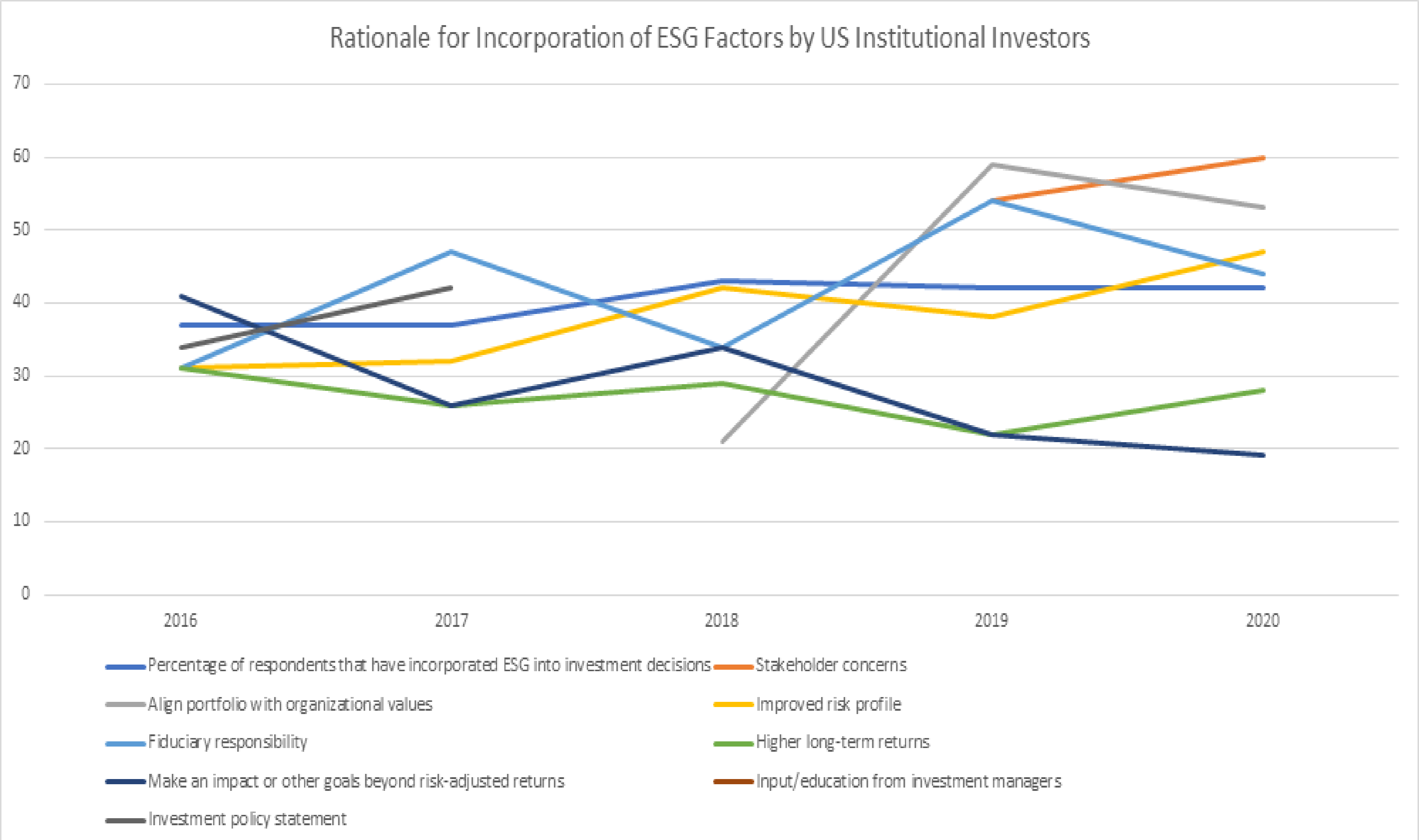




Average AUM of all ESG funds with low fees, 2007-2020
600
500
400
300
200
100
0
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
Average AUM of all funds with low fees
Average AUM of ETFs with low fees
Average AUM of mutual funds with low fees



Source: Callen Group



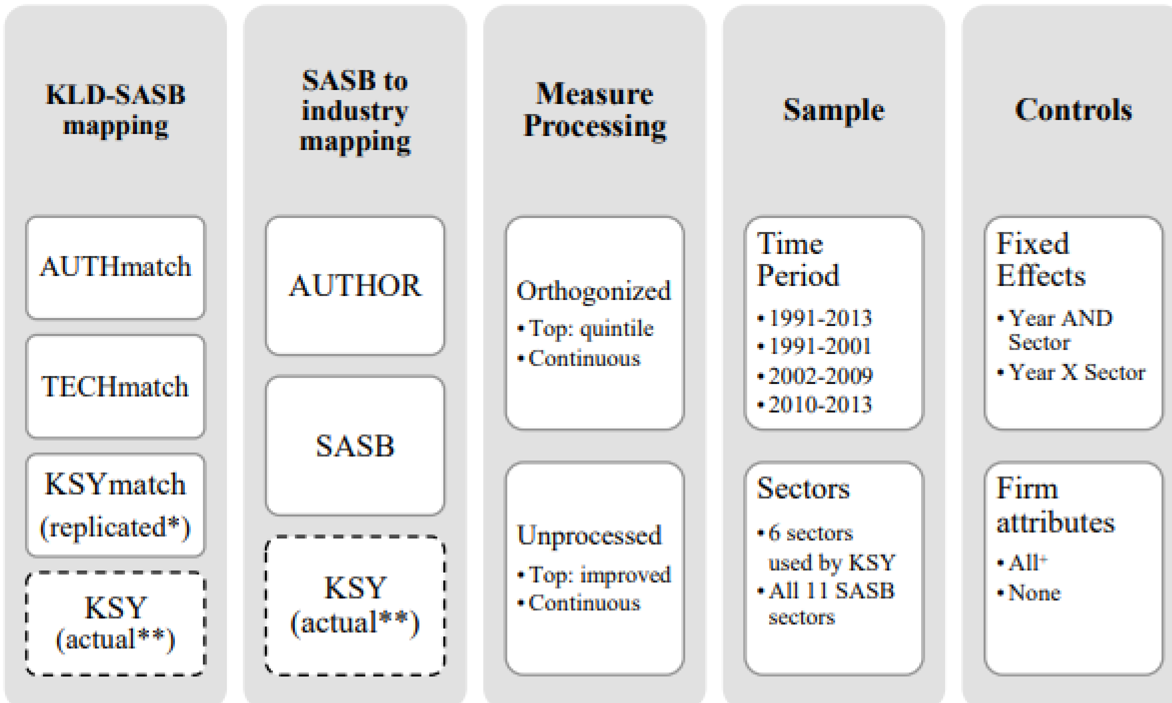
Source: Callen Group

	High Fee	Med Fee	Low Fee
Financial Performance (relative to benchmark)	-0.004	-0.006	-0.003
ESG Performance (relative to benchmark), TruValue Labs	0.325	1.060	-0.086
Change in ESG Performance (relative to benchmark), TruValue Labs	0.026	0.028	0.016
-- Due to stock purchases and sales	0.030	0.017	0.007
-- Due to changes in stock's held	-0.004	0.011	0.009
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)

Figure 1: Final Space for Model Uncertainty Analysis

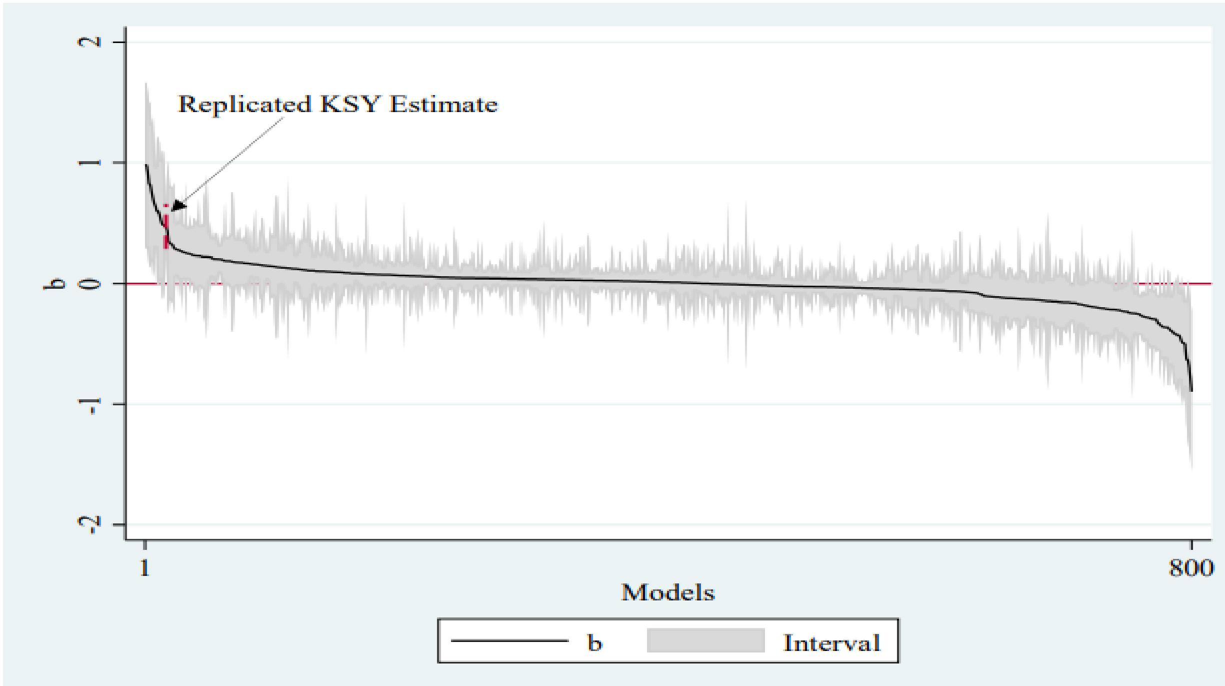


*We attempt to replicate part of KSY's mapping based on information in their publication.
**Because we have only KSY's actual measure, we cannot observe the mappings used to create it. Thus, its individual elements cannot be combined with other mapping assumptions.
+Previous year's annual returns, size, BTM, turnover, roe, analyst coverage, R&D, advertising intensity, SG&A, capital expenditure, leverage.

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)

Figure 2: Marginal Effects at Average – All Models



Estimates for the effect on stock return for all models and measures of material sustainability. Units are percent per month, so a value of one (1.0) represents a return of 0.01 per month for each of 12 months. Over the full collection of models, 54% of the coefficient estimates are positive and 46% negative; 80% of the estimates imply annualized returns less than +/-2%/year and 60% of the results imply annualized returns less than +/- 1% per year. 4.0% of the models result an estimate of a positive coefficient with a 95% confidence interval not inclusive of zero; 4.5% of models result an estimate of a negative coefficient with a 95% confidence interval not inclusive of zero.

A red line shows our replication of KSY's estimate using their binary measure, MatSust(ortho, topquint), but our sample and other data.

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

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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 <u>AND</u> 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

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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/

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