Researching ESG investment products

Aman Ramrakha

When it comes to investing, information really is everything. Finding the right ESG investment product that delivers returns alongside positive impact, while sidestepping potential greenwash, unethical or risky business practices can be a rocky road—whether you are an institutional investor, a wholesale investor, or a financial adviser.

This paper reproduces the Q&A session on *'The Greener Way'* podcast conducted between senior journalist at FS Sustainability, Rose Mary Petrass (Rose) and executive director of research at Rainmaker Information, Aman Ramrakha (Aman).

Rose
What are the basics of researching investment products, whether for institutional investors, wholesale investors, or financial advisers?

Aman
I think at the heart of it, the process is very similar regardless of, I guess, the end purpose of that investment, whether it is a superannuation fund looking to invest in a fund manager or an adviser looking to recommend a particular fund to their clients or, for that matter, a self-directed investor seeking out the best fund to invest their own assets.

The ultimate process is the same. A lot of it is very much based on the people. So, if you can think of who the people are running the assets on behalf of the investor, what kind of skills and experience that they have, the size of the team, the resources that they have available to them.

The second part of it is the process. What kind of process do they use? How do they sort and filter what can be a very vast universe of companies or debt instruments to invest in and how do they narrow that down? So, you want to pay attention to what that process is: Is it repeatable and does it work, things along those lines.

Then probably the third piece is the organisation. Is it a stable organisation? Is it an organisation that will be around particularly for the time horizon of many investors, as we know that superannuation investors, in particular, have a very long time horizon, so you want that organisation to be there for as long as you need them to manage your money.

Other things like fees, past performance are also important factors to consider the validity of that investment.

Rose
When it comes to researching ESG investment products, are there additional factors to take into consideration?

Aman
Absolutely. I think first and foremost, this notion of investment merit should be at the forefront of any analysis that ultimate investors or

intermediaries should do. You want the skill of the investment manager to be assessed first. That skill is very much based on what I have previously mentioned, the people and in particular the process. That should be at the forefront of anything you do, even before you start to consider ESG. It is a very important skill, and it is important to have both that investment skill plus a good ESG process.

You can have the best ESG process in the world, but if you do not have that investment skill, then the likelihood of good outcomes starts to diminish. I think that is something that a lot of investors perhaps do not pay attention to—they sort of look at it from an ESG perspective and think, okay, that is good ESG. We think that a fund manager has captured what we are looking for from an ESG perspective, but perhaps they do not then pay enough attention to the investment skill. I think that is an important thing that most investors should take care with, in a perfect world you want to get both good investment skill and good ESG practices.

When it comes to analysing the ESG practices themselves, there is a whole bunch of things you can do, but you can probably distil it into sort of three things. Fund managers that work under some sort of ESG banner generally have three decision points when it comes to investing.

They can either avoid or exclude in the first instance, they can divest, particularly if it is an existing holding and something changes, or they can engage, and that in a simplistic sense is sort of the crux of ESG investing, particularly divesting, the sort of nuance between avoiding and divesting is, is an important one.

Quite often what happens is if you are already invested in the company and something changes and it no longer meets your ESG framework, you then have an opportunity to either engage the company or simply just divest. Those are important decision points that fund managers will make, and it is important for investors to understand that engagement is probably perhaps the hardest thing for fund managers to do.

Engagement requires them to influence companies on their behaviour and ask them to change their business practices. But you do see a cohort of managers willing to engage, particularly when it comes to things like transitioning.

A lot of companies are trying to transition to a net zero, or better environmental practices. It can be quite lucrative for a fund manager to actually go on that journey with those companies as the market starts to realise that this company that perhaps did not meet a lot of the ESG criteria at some point in the future, has become very ESG friendly and therefore is attracting more interest and more investment and if you have been there for that journey, you can actually get quite a good reward.

Rose

You have been in research since before ESG was a thing. How has the industry evolved to arrive at this place and do you think ESG is here to stay?

Aman

I think the evolution of ESG has been driven, like many things, initially by institutional investors as sovereign wealth funds and superannuation funds have turned their focus towards ESG.

In an expanded understanding of their fiduciary duty, they have started to think about things along the ESG spectrum. It is fair to say that ESG has always been part of an investment process, but you sort of had a scenario where governance was probably the most important. If you talk to fund managers 20, 30 years ago, they would have all been very much focused on governance. For instance: Is the management good? Is the board good? What kind of governance processes do they have? Do they treat their shareholders appropriately?

The ‘E’ and the ‘S’ were probably lesser of an issue and some of that was because data or analysis was not available, but I think it is fair to say that it started sort of in that institutional space as institutional investors became much more aware of their fiduciary duties, and then perhaps in more recent times, there has been a groundswell of investor interest.

Many people are thinking about things like climate change and the impact it has on their investments, where they are invested. They become a lot more aware of where their money is—whether it is their superannuation or their own investments—and they have become perhaps a little bit more informed by what is out there in the media in terms of what it is that is happening and so you are getting a lot more information around companies that are doing well or doing poorly in, in that sort of ESG space. So, you sort of add institutional starting, more recently retail investors pushing that sort of ‘bottom up’ demand on what ESG is.

The interesting part of that is, what ESG means to individuals can be very different, and what is available in product land can also be very different. So, one of the difficulties in that sort of ESG space is defining what ESG is.

It could be as simple as an exclusion, so all the nasties are taken out of your portfolio—there is no tobacco, there is no ammunitions, there may not be alcohol, things like that. That might be enough for some investors just to screen the nasties out, whereas others will want a lot more from their investments in terms of social impact, climate change and things along those lines.

So, you have got a very vast spectrum of what you could define as ESG and it can be problematic sometimes to try and find something that fits your own personal beliefs because at the end of the day, some of it is very much led by individual's personal beliefs.

Whether it is structural or cyclical, we are seeing plenty of evidence, to date on the performance side that suggests that it is cyclical. You have seen ESG perform well, you have seen ESG perform poorly and generally it is sort of linked to the resources cycle, so when resources are doing really well, ESG investments tend to do poorly and vice versa.

Aman Ramrakha, Rainmaker

Aman is Executive Director of Research at Rainmaker Information. He has over 30 years financial services experience and has held investment, research, technical, consulting, and advisory roles at Morningstar, Commonwealth Bank, BT Financial Group, Colonial First State and KPMG. Aman holds a Bachelor of Commerce, majoring in Economics and Finance, a Graduate Diploma in Applied Finance and Investments, Diploma of Financial Planning and is a Certified Investment Management Analyst®.

The quote

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We have seen that, through the pandemic and in more recent years where ESG performance has not been, perhaps as, as good as it was in the past.

I think one of the simplest ways to look at ESG and whether it is something that is going to be structural in the future is very much along the lines of sustainability of companies. At the end of the day, if you are the board and management running a company, you want that company to be around for a very long time. In order for companies to exist over very long periods of time, they generally have to not do things that damage the environment or have poor governance practices or treat their customers badly.

Generally speaking, companies that succeed will and should have good ESG practices already sitting inside them without the need to have them specifically call some of that out. It would be rare for companies to survive long periods of time if they are performing poorly in that sort of ESG space.

There are more people willing to call them out. There is more activist action that will force them to change their behaviour if they are not doing well and ultimately the flow of capital may move away from them in that environment if they if they are doing poor practices.

Rose

From your perspective, where do investors or advisers most commonly get it wrong when it comes to researching ESG investment products?

Aman

I think the simplest way that they do get it wrong is relying on a label. One of the difficulties that I mentioned is defining ESG, so to some extent, investors or advisers can fall into the trap of just simply relying on a label. The fund has ESG in its name and so there may be some element of perhaps clever marketing of products along an ESG spectrum.

You mentioned greenwashing in your introduction, and we have seen some evidence where the label does not fit how the money is managed nor how it is invested. So, I think that is probably the first area that investors and advisers can get it wrong—just simply relying on a label.

The other sort of piece of the puzzle is, again, to my earlier comment about focusing on the investment merit of the team running your investments or your clients' investments. I think that is another area where investors can get that wrong. Again, relying on a label, relying on perhaps what appears to be a very good ESG process, ticks all the boxes that I am looking for, focuses on the right areas, but at the end of the day, the people managing the money may not have the skill to do so in a manner that means that I will get a good investment outcome.

I think the last sort of piece of that is understanding what ESG can and cannot do for you. Like a lot of investment decisions, there is quite often a trade-off. So, if I do want to invest ESG, particularly if I have some specific requirements of what type of ESG I am looking for, I have to accept that going down that path may exclude certain parts of the universe.

As soon as I start to—and it is true of any investing, not just ESG—think about narrowing the universe of options that I can, or my fund manager can invest in, I have to accept that there will be some trade off, hopefully good trade off in, in many cases that is true but as market cycles happen, as macroeconomic factors can impact all investments, you will see times where ESG might underperform.

Understanding that ESG can underperform for periods, just the same as other factors like growth or value can underperform over cycles. ESG will have some similar characteristics, and so noting that, understanding that, and going into it accepting that are things that investors and advisers should make sure that they understand.

Rose

We have time for one more question. How do you see artificial intelligence influencing research or research methodology in the near future, especially with ESG?

Aman

AI, and I would sort of preface that by saying perhaps things like quantitative analysis has always been a part of investment research.

It has always been there, and the weight that you put on it has probably depends on how you are doing your research and so I think that AI in first instance will play a part in that. There is a wealth of data that you can access on performance and many ways you can analyse a fund manager's performance.

There is a whole bunch of financial ratios you can run them against. There is a wealth of quantitative data available that can be analysed to determine the merits or otherwise of research. AI has played some part in that, and I suspect will continue to play a part in that and frankly, make that quantitative process a bit more robust.

When it comes to ESG, the issue sometimes is the availability of data. So right now, I can get my hands on a lot of data on any given fund manager to analyse their performance and their investment merit. What is less available right now, and it is getting better, is data along ESG lines. The consistency and availability of that data is something that the industry is still grappling with and what form it is reported in, and so being able to, and I think to some extent AI may help in being able to analyse and scrub that data and put it into some sort of consistent form.

So, I think AI may have some place in that piece, but the availability of that data is something that is still, whether it is company or fund manager data, something that is in very early stages. Big companies are good at it. Smaller companies are probably not as well-resourced to provide that data and it is probably the same for fund managers, big fund managers can do it better while some of the smaller ones may or may not be able to produce the level of data that is needed for something like a generative AI tool to start to analyse it. **FS**