Global Asset Management

The future of ESG integration

"ESG integration" is defined as including environmental, social and governance (ESG) factors as a component of fundamental analysis to identify potential sources of alpha or risk reduction.

Responsible investment

Responsible investment (RI) now represents 26% of all professionally managed assets globally with US$23 trillion of assets managed under RI strategies.[1] These strategies include ESG integration, engagement, screening, sustainability-themed investing and impact investing[1]. The focus of this piece will be ESG integration – a responsible investment strategy that has grown globally by 38% from US$7.5 billion managed in 2014 to US$10.4 billion in 2016.[1]

The prevalence of ESG integration

RBC Global Asset Management released its global ESG survey at the end of October 2017. The survey sought to better understand the views of institutional asset owners and investment consultants in Canada, Europe and the United States on the role that ESG considerations play in portfolio management. The survey revealed that, while RI has moved into the mainstream, a number of questions and contrasting opinions surrounding ESG integration persist.

In the survey, 67% of respondents said they use ESG principles as part of their investment approach and decision making. In Europe, 85% of respondents say they integrate ESG principles. The United States and Canada fall behind, with 49% and 73%, respectively.

What is driving this ESG integration (or lack thereof)? The top three drivers as identified by respondents that use ESG principles in decision making are: multiple factors used in investment decision process and not just financial factors (57%); clear value proposition (higher risk/return profile; 37%); and mandates from boards and other stakeholders (36%).

Institutions that do not incorporate ESG principles into their analysis provided the following reasons: no demand from a board or stakeholders (52%); unclear value proposition (risk/return profile; 40%); and only financial factors are used in investment decision process (35%).

There is a clear gap between institutions that incorporate ESG principles and institutions that do not, as the debate continues whether incorporating ESG principles results in alpha generation.

Driving alpha and reducing risk

There is a significant divergence of opinions between Europe/Canada and the United States on using ESG analysis as a source of alpha and/or risk mitigation. In Europe and Canada, 77% and 68% of respondents, respectively, consider ESG integration to be a risk mitigator, compared with only 28% of respondents from the United States. What might cause these diverging views? Perhaps the U.S. respondents do not consider ESG risks to be material or perhaps there are differences in cultural or regulatory environments. Without knowing the specific cause for the divergence, it is clear that there are inconsistent opinions on the effectiveness of ESG analysis as it relates to identifying and managing portfolio risk.

Considering the integration of ESG factors as an alpha source, the divide shifts to one between Europe and North America. In Canada and the United States, 21% and 17% of respondents, respectively, think of ESG factors as an alpha source, compared with 51% of respondents from Europe. In the United States and Canada, 59% and 37% of respondents, respectively, do not think of ESG factors as an alpha source, leaving a considerable percentage of the United States and Canada unsure about ESG factors as a source of alpha.

Overall, there is evidence that using ESG analysis to mitigate risk and/or drive alpha has become mainstream in Europe, but is still evolving in North America, especially in the United States.

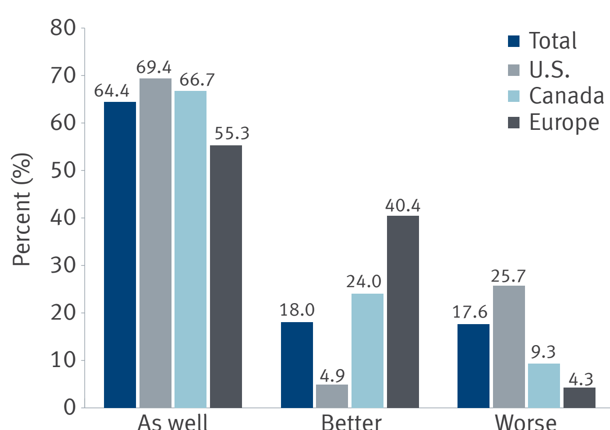
[1] Global Sustainable Investment Alliance, "Global Sustainable Investment Review 2016."

ESG integration and returns

Asset managers increasingly believe that integrating ESG analysis into the investment process will have a material impact on investment risk and/or returns. However, the survey revealed that institutional investors have a persistent fear that a non-financial investment factor will lead to lower returns.

The survey highlights another significant divide regarding the impact of ESG integration on performance and, again, U.S. respondents are skeptical about the issue. Only 5% of respondents answered definitively that they believe ESG investments are likely to perform better than non-ESG investments, while 26% of respondents believe that ESG investments will perform worse.

Exhibit 1: Do you believe ESG investments are likely to perform as well as or better than non-ESG investments?



Source: RBC Global Asset Management Inc.

On the other hand, 82% of all respondents believe that ESG investments are likely to perform as well or better than non-ESG investments. Additionally, 67% of all respondents expect that companies with high-quality ESG practices will see improved metrics that relate to sustainable long-term returns.

The issue of performance as it relates to ESG investments is polarizing. The survey highlights that, particularly in the United States, a significant percentage of respondents struggle with accepting that ESG integration can lead to improved investment performance while another significant percentage of respondents consider it to be a non-issue. This presents an opportunity to educate investors on performance of ESG investments and to dismantle the myth that considering ESG factors means that investors have to sacrifice returns.

Momentum of ESG integration

Where is ESG integration headed? Adoption of ESG investing appears to be growing as 25% of respondents said over the next year they plan to increase their allocation to managers that incorporate ESG factors into their investment management process or ESG-based investment strategies.

What has the potential to impede the growth of ESG integration? A majority of investors who employ ESG criteria across all regions are dissatisfied with the quality of reporting from issuers. Additionally, there is no consensus on who should be driving the industry toward better reporting practices. In the United States and Canada, 43% and 38% of respondents, respectively, said that shareholders should take the lead through proxy ballot initiatives, while in Europe, 43% of respondents said government regulators should take the lead.

Another trend that might impact the momentum of ESG integration is the shift in investor demographics. The survey reveals that lack of demand explains why some respondents have not opted to integrate ESG analysis into their decision-making process. However, millennial investors view the management of ESG risks and opportunities as crucial to the long-term performance of their portfolios.[2] As the intergenerational transfer of wealth to millennials gathers momentum over the coming years, we expect to see an increase in demand for ESG integrated strategies.

Europe is a clear leader in ESG integration. One major factor contributing to the lag in North America is uncertainty surrounding the performance of ESG investments. Amid uncertainties and a lack of consensus on key issues, plans to increase allocations to ESG strategies over the short term indicate an increase in the rate of global adoption. To keep this momentum going, there is a clear need for education on the topic of RI with a focus on the value proposition of ESG integration.

[2] Morgan Stanley Institute for Sustainable Investing, “Sustainable Signals: The Individual Investor Perspective.”

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