SO INSIGHTS: WHY WE INTEGRATE ESG

This short paper provides an introduction to ESG integration, in support of Railpen's Investment Beliefs.

Key takeaways

- Environmental, social, and governance factors are material to Railpen's long-term investment value
- Future regulation is likely to increase the internalisation of environmental and social costs for businesses
- Widely used ESG products can suffer from aggregating unrelated and poor-quality data fields
- Railpen's ongoing research continues to explore the investment relevance and usability of ESG data.

Introduction

The Trustees of the Railways Pension Scheme believe that incorporating and acting upon climate risk and other environmental, social, and governance (ESG) factors is a significant driver of investment outcomes and part of our fiduciary duty. Several considerations underpin this investment belief.

Growing awareness of ESG

The last few decades have seen a vast rise in environmental and social awareness from lawmakers, consumers, employees and wider society, and growing evidence of global environmental damage, including climate change.[1] Railpen invests in companies that we expect to understand and manage these dynamics, both in terms of risk management and strategic opportunity, supporting their capacity to generate sustained returns. High standards of corporate governance largely reinforce this value creation.

At the same time, national and international regulation has aimed to internalise some of the companies' external costs, reducing the harmful elements of commercial enterprise and bringing economic activity more into line with the interests of society and its environment.[2] For example, laws protecting worker rights and establishing emissions caps can raise costs for companies while reducing health costs for society.[3] Understanding the effect of these regulations on Railpen's investments remains a focus for our investment teams, as well as identifying companies that will profit from changing legislative landscapes.

Trends

Environmental and social trends that impact investments over ten and twenty-year periods are relevant for asset owners with similar investment horizons. Concerns such as climate change, working conditions and data security that affect individual companies will also affect the economy as a whole. Large institutional investors, including pension funds, are extensively invested in and reliant on the global economy.[4] Rundown natural environments or an ill-treated workforce are unlikely to support the returns needed by long-term investors.

For these reasons, the measurement and analysis of ESG performance, and including it in investment processes, has become a more significant part of the Trustees' fiduciary duty.

1 World Economic Forum (WEF). (2022) The Global Risks Report 2022: 17th Edition, World Economic Forum p.14 This survey of 959 governments, businesses and academics in 2022 found the four most severe global risks identified as climate action failure, extreme weather, biodiversity loss and social cohesion. An annual YouGov survey found 27% of Britons citing the environment as their biggest concern for the UK in 2019, up from 7% in 2010 and including 45% of 18 to 24 year olds.

2 United Nations (UN). (2019) Environmental Rule of Law: First Global Report | UNEP - UN Environment Programme. The report finds that environmental laws have increased 38-fold globally since 1972.

3 International Carbon Action Partnership. (2022) International Carbon Action Partnership: Emissions Trading Worldwide. As of March 2022 there are 25 emissions trading schemes globally, covering 17% of global emissions and 55% of global GDP.

4 Urwin, R. (2011) Pension Funds as Universal Owners: Opportunity Beckons and Leadership Calls. Willis Towers Watson.

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ESG and long-term investment

As with any performance metric, ESG data is not very useful in isolation. The assessment of ESG information alongside traditional financial data, however, can add to the mosaic of company analysis, and ESG can be relevant to operational efficiency, sales growth, risk management or industry forces. In the transparency of our social media age, it is increasingly difficult for a company with a long-term strategy to rely on obvious exploitation, either of its workers or its environment.

Likewise, a company that fails to see the reputational benefits of sustainable business may well be missing other industry dynamics. A poor health and safety record is not simply a social issue, but a reputational and management quality issue. As a brand for customers and employees, a business is increasingly expected to show its ability to make money while promoting broader societal progress, particularly for millennial customers and employees. The belief that the two are incompatible has slowly faded as examples of profitable and sustainable companies have multiplied.

Research on ESG performance and company profitability continues to be mixed, and we are conscious of academic bias and ESG data flaws. However, there is little evidence to suggest that there is no correlation between ESG indicators and corporate financial performance.[5] For further reading, we refer to the academic research resource established by the UN-supported Principles for Responsible Investment.[6]

Unravelling ESG

Rapid industry growth has calcified environmental, social and governance analysis into the now widely known ESG acronym. However, the three pillars reflect different aspects of company performance, and their relevance to investment value can be most evident when looked at separately.

Pillar 1: Corporate governance

The well-established maxim of good corporate governance underlies a company's wider performance and is usually covered in traditional investment analysis. Research has found that the equity market is least reactive to corporate governance news compared to other ESG news, most likely because it is already priced into stock value.[7] The retention and incentivisation of high-quality management can be a key focus for investors, with good business performance expected to follow.

More generally, a company that is well governed and has developed positive relationships with its stakeholders can expect to benefit from better terms – on finance, with regulators and via the less obvious 'social licence to operate'.[8] Underpinning this, the importance to a long-term investor of a stable and well-respected board that provides strategic oversight, support and guidance to management has long been reflected in listing requirements and regional corporate governance standards.

Research has shown that specific corporate governance indicators, such as balanced board tenure, can correlate with better performance and lower risk.[9]

[5] *Friede, G., Busch, T. and Bassen, A. (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies. Hamburg University and Deutsche Asset & Wealth Management; Feiner, A., Clark, G.L. and Viehs, M. (2015) From Stockholder to Stakeholder: How sustainability can drive financial outperformance. Oxford University and Arabesque Asset Management.*

[6] *Principles for Responsible Investment, Top academic resources on responsible investment | Academic research | PRI (unpri.org).*

[7] *Serafeim, G. and Yoon, A. (2021) Which corporate ESG news does the market react to? Harvard Business School.*

[8] *Buhmann, K. (2016) Public Regulators and CSR: The 'Social Licence to Operate' in Recent United Nations Instruments on Business and Human Rights and the Juridification of CSR. Copenhagen Business School.*

[9] *Papadopoulos, K., (2018) Board Refreshment: Finding the right balance. ISS Analytics.*

Pillar 2: Environmental performance

When analysing a company's environmental performance, two operational aspects are relevant: physical assets such as offices or factories and the natural capital drawn for production inputs. Sustainable management of these environmental resources at company facilities and along supply chains ensures a reliable supply. Conversely, if environmental resources are overused or mismanaged, their productivity can decline or become more regulated, negatively impacting supply and input costs.[10]

The risks of environmental mismanagement have equally become opportunities for companies leading innovation in their industries. This is especially evident in resource-intensive sectors where environmental efficiency can lead to long-term cost reductions and readiness for future regulation, such as carbon taxes. The concept of 'eco-efficiency' has gathered attention as regulations have tightened and companies that generate less waste as a percentage of the economic value created have been found to outperform.[11]

Aside from company operations, if a company product is not environmentally efficient, it may face substitution threats and regulatory risks. The environmental sustainability of products and services can build competitive advantage across industries, driving brand value and increasing pricing power.

Pillar 3: Social/Stakeholder capital

'Social' metrics are possibly the broadest category of ESG factors, a catch-all bucket covering concerns with company relations such as with employees, customers, local communities, and regulatory and industry bodies. These stakeholder relationships are often grouped by different names, such as human capital or organisational capital. For example, researchers have suggested that intellectual capital is embedded in both people and systems, with the stock of human capital consisting of human (the knowledge, skills and abilities of people), social (the positive relationships between employees) and organisational (the processes and routines within the company).[12] Measuring the strength of this human, social and organisational capital can be difficult because of its subtlety and lack of specific and consistent data.

For example, a diverse team will usually generate knowledge benefits but harder to measure is the psychological safety associated with an inclusive working environment. If well run, this can engage and inspire employees, the associated reduction in stress allowing for more creativity and improved performance.

Despite measurement challenges, the role of human capital management in generating financial value is central, particularly as industries typically face competitive markets for highly skilled and specialised staff.[13] Companies with strong cultures often sustain a competitive advantage by retaining institutional knowledge and industry experience and attracting the best available talent.[14]

[10] *Smeets, B., Schellekens, G., Bauwens, T. and Wilting, H. (2021) What's the damage? Monetizing the environmental externalities of the Dutch economy and its supply chain. De Nederlandsche Bank.*

[11] *Derwall, J., Guenster, N., Bauer, R. and Koedijk, K.G. (2004) The Eco-efficiency Premium Puzzle. Maastricht University.*

[12] *Wright, P., Dunford, B. and Snell, S. (2001) Human resources and the resource based view of the firm. Cornell University.*

[13] *Beeferman, L.W. and Bernstein, A. (2015) The Materiality of Human Capital to Corporate Financial Performance. Harvard Law School. This review of 92 studies researched the link between strong human capital management (measured by a combination of performance and policies) and financial performance. Results found 67 studies showing a positive correlation, 17 had mixed results, seven found no correlation and one found a negative correlation.*

[14] *Deloitte (2021) 2021 Global Human Capital Trends | Deloitte Insights. This survey of 1,300 US full-time employees across industries and levels found 39% would leave their existing employer for a more inclusive company.*

ESG research frameworks

The ongoing harmonisation of reported metrics will support great transparency for investors on companies' ESG risk management. Railpen supports the global reporting framework developed by the Sustainability Accounting Standards Board (SASB), now part of the International Sustainability Standards Board (ISSB) established by the International Financial Reporting Standards (IFRS).[15] The framework provides a starting point for gathering company ESG data and can be built on to support investors' proprietary requirements.

The examples below give further detail on Railpen's research approach in this evolving area.

Environmental Performance: Energy Efficiency

Why do we measure it?

- **Sales growth**: A company with a lower environmental footprint will be a preferred supplier for sustainability-focused clients, and associated branding will drive growth in sales.
- **Costs**: More efficient and cleaner energy use will improve operating margins, leave less exposure to rising energy prices and ensure preparedness for regulatory tightening (carbon tax).
- **Cash flow**: Strong environmental performance can improve access to green financing.

How do we measure it?

- **Quantitative data:** Total energy use, energy intensity, percentage renewable energy used, energy efficiency capex/R&D spend.
- **Qualitative analysis:** Specificity and ambition of energy/carbon targets, sustainable strategy/commitment to new technologies, board responsibility for environmental performance.

Human Capital: Employee Engagement

Why do we measure it?

- **Costs**: Lower recruitment and retraining costs, lower salary costs due to employee loyalty, and lower absence rates.
- **Intangible assets**: Higher productivity and the ability to attract/retain the best talent, role in intellectual property generation and brand value.

How do we measure it?

- **Quantitative data:** Voluntary employee turnover reported by gender/age bracket/ ethnic minority, parental retention rates, employee Net Promoter Score, engagement frequency.
- **Qualitative analysis:** Responsibility at board and management level, track record, targets, and innovation in metrics used to measure employee satisfaction and development.

Corporate Governance: Board Quality

Why do we measure it?

- The quality of strategic oversight impacts all areas of company performance, from risk management to hiring and retention, competitive positioning, the strength of regulatory and other relationships, and corporate culture.

How do we measure it?

- **Quantitative data:** Percentage board independence, average board tenure, board attendance, board diversity.
- **Qualitative analysis:** Extent of relevant expertise (accounting, cyber security, sustainability), board and committee structures, board responsiveness.

[15] *IFRS - SASB Standards*

Challenges for ESG integration

Despite the relevance of ESG information to long-term investment value, using it in an investment process faces various challenges, primarily around data quality. We find its usefulness, therefore, varies from strategy to strategy, with fundamental portfolios presenting an easier route than quantitative strategies. Some key concerns and how the industry can move forward are outlined here.

Challenge #1: Data disclosure

Equity analysts typically face a wave of consultancy-driven communications on ESG, both from companies and investment managers. Reports often focus on selected stories and long-winded narratives that confuse sustainable capital allocation with corporate social responsibility or philanthropic projects. Meanwhile, the disclosure of quantitative ESG data is mainly voluntary and inconsistent and tends to be thin on environmental and social data fields.

Looking forward, investor and company support for standard-setting bodies, such as SASB and now ISSB, is driving convergence and better disclosure. As the availability of ESG information improves, analysts can continue to widen their focus from policy to performance. Railpen analysts seek audited data, both relative and absolute, targets for the short and long-term and honest commentary on how targets are being met or why they are not.

Challenge #2: Misguided data aggregation

Investors widely use aggregated ESG ratings, particularly where managers don't have in-house ESG resources. A single rating can be easy for investors to use and for data vendors to sell. However, the variety of ESG factors does not make it easy to aggregate. For example, a company's poor environmental performance may be outweighed by a high corporate governance score, meaning the regulatory and reputational risks of a relatively polluting company may be overlooked.

At Railpen, we believe good quality ESG investment analysis requires a deeper understanding of company value drivers, awareness of the limitations of quantifying certain risks, and knowledge of what is relevant to a company's strategy. In proprietary ESG models, the weighting of issues according to sector or regional materiality can improve the usefulness of ratings. For example, sustainable supply chain management may be weighted more highly for companies in the consumer sector, where the reputational and operational risks connected to poor supply chain management can be higher.

Additionally, metrics aggregation into an ESG rating can serve certain purposes, such as screening investment universes for reputational risks or highlighting 'red flag' issues early in the investment process.[16] A high ESG rating may indicate general management quality and give additional conviction when combined with fundamental company analysis.

Challenge #3: Accountability behind ESG ratings

Third-party providers of ESG scores aim to provide standardised assessments. However, critics highlight the opaqueness of methodologies and informational materiality. The regulation of ESG research provision, compared to sell-side research, which is regulated by the Financial Conduct Authority (FCA) or Securities and Exchange Commission (SEC), remains unclear. Critics point to the inconsistency of ratings across research providers, with an uncertain level of correlation between the informational content of ESG scores and investor perception of a firm's enterprise value.

Looking forward, ESG ratings may become more similar across different providers as company disclosure of ESG data improves. However, the qualitative analysis of how sustainable a company is and how well ESG is considered in its long-term strategy will naturally vary between analysts. The Railpen team uses specialist ESG research providers as an additional source of information and avoids relying on a specific source. Using several specialist providers provides a range of analyst opinions. Expanding ESG teams and research products from sell-side brokers in recent years is a welcome development for investment managers.

[16] *Verheyden, T., Eccles, R.G. and Feiner, A. (2016) ESG for All? The Impact of ESG Screening on Return, Risk and Diversification Oxford University and Arabesque Asset Management. The research used a sample of 2,267 global stocks during a six-year period 2010-2015 and screened out the worst 10% and 25% ESG performers. Findings were that the screened portfolios outperformed the unscreened on a risk-adjusted basis, although the 25% screened developing market universe marginally underperformed. Additional findings were that the ESG screen did not necessarily reduce diversification. ESG data from Sustainalytics.*

ESG research at Railpen

The Trustees of the Railways Pension Scheme believe that the ability of a company to manage ESG risks and exploit opportunities arising from sustainable economic growth is relevant to long-term investment value. It is, therefore, in our vested interest to consider ESG factors as part of the investment decision.

The impact on the broader economy of universal owners allocating capital to sustainable businesses, as opposed to companies with high external costs, has yet to be effectively measured.[17] However, there is sufficient conviction that a healthier society and a conserved natural environment will support Railpen's long-term investment and value generation.

Regulations

In recent decades, global corporates have seen stricter local and international regulations, particularly around labour rights, environmental standards and directors' liability for risk management. Regulations such as minimum wages, landfill quotas and restrictions on waste and emissions are meant to reduce companies' power to overuse people or the environment for corporate profit. It is likely that future regulation will further increase the responsibility of businesses and investors for social and environmental costs. Although this may push economies towards more efficient management of externalities, the effect of higher wages and the normally higher costs of sustainable materials on long-term structural inflation should be better understood.

Continual review

As part of our sustainable investment research, we continually review academic papers, industry reports and publications from non-governmental organisations. Predictably, we have found research results to be mixed, and investor opinions will naturally differ on the financial materiality of ESG data.[18] Yet a significant amount of recent research finds that companies that pay attention to ESG concerns do not experience a drag on value creation.[19] The correlation between ESG performance and cost of capital has been well established,[20] and correlations between specific ESG and financial data points continue to be investigated, for example, between employee management and credit risk.[21]

We continue to shape our understanding of ESG and long-term performance and welcome any contributions from our stakeholders. Please feel free to contact sustainableownership@railpen.com with comments or research ideas.

[17] *FUN Environmental Programme Financial Initiative. (2011) Universal Ownership: Why environmental externalities matter to institutional investors.*

[18] *Bruno, G., Esakia, M. and Goltz F. (2021) Honey I Shrunk the ESG Alpha: Risk-Adjusting ESG Portfolio Returns, Scientific Beta. The research constructed 24 long/short strategies between 2008-2020 using ESG scores, ESG momentum and a combined factor and found that while the ESG strategies largely have positive returns (3% annualised), adjusting these returns for risk shrinks alpha to zero. Sector biases and exposures to equity style factors capture the returns of ESG strategies with 75% of outperformance due to quality factors. ESG data was sourced from MSCI.*

[19] *Eliwa, Y., Aboud, A. and Saleh, A. (2021) ESG Practices and the cost of debt: Evidence from EU Countries Critical Perspectives on Accounting, vol. 79. Using a sample of 6,018 firm-year observations of listed firms in the EU from 2005 to 2016, the paper finds a negative correlation between the cost of debt and both ESG performance and disclosure. The paper provides evidence that lending institutions value individual dimensions of ESG performance, with environmental dimension having the largest impact on the cost of debt. ESG data was sourced from Bloomberg and Asset4.*

[20] *Fulton, M., Kahn, B. and Sharples, C. (2012) Sustainable Investing: Establishing Long-Term Value and Performance Columbia University and Deutsche Bank. The paper reviewed 19 academic studies on a broad array of sample sizes. 100% of the studies reviewed found a link between ESG performance and cost of capital - both debt and equity. 89% studies showed high ESG ratings linked to market-based outperformance, while 85% of studies show these types of company exhibit accounting-based outperformance, at least over the medium (3-5 yrs) and long term (5-10 yrs).*

[21] *Bauer, R., Derwall, J. and Hann, D. (2009) Employee Relations and Credit Risk Maastricht University and Deutsche Asset & Wealth Management.*

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