CAMBRIDGE ASSOCIATES LLC

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INTEGRATION: FOR PERFORMANCE, FOR ETHICS, OR FOR BOTH?

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Executive Summary

- ESG integration refers to the practice of integrating environmental, social, and corporate governance factors into the investment decision-making process. ESG factors can include a wide range of indicators pertaining to a corporation's impact on its various stakeholders—those affected by a corporation's operations. Some examples of ESG factors include a corporation's carbon footprint, union relationships, or provision of useful goods and services to particularly vulnerable populations.

- We believe that ESG factors may be material to investment performance and are therefore legitimate factors (among many others) to consider when making investment decisions. However, we do not believe that using ESG factors *solely* to enhance investment performance will *necessarily and automatically* lead to the construction of a portfolio of companies with better ESG records, where the term better is meant to convey an ethical assessment. Consequently, we argue that it is critical for investors to be clear about what they hope to achieve through ESG integration—stronger investment performance, societal alignment through a portfolio of companies with better ESG records, or both—because their prioritization of these expectations will impact the types of ESG managers they ultimately select.

- The terms ESG and ESG integration bear a clear family resemblance to the older term socially responsible investing (SRI), in that all imply the consideration of environmental, social, and governance factors when making investment decisions. However, ESG and ESG integration are inherently more ambiguous than SRI with regard to the underlying rationale for considering these factors.

- We believe there is a theoretical case to be made that the consideration of ESG factors may help investors achieve their monetary performance objectives by uncovering market opportunities or identifying risks. To take this a step further, we argue that "financial" factors and "ESG" factors are *intrinsically* linked because prices, which form the basis of financial factors (e.g., revenues, expenses/ investments, earnings), are what mediate the relationships between corporations and their stakeholders.

- There are three important theoretical reasons for questioning whether ESG integration for the sole purpose of generating alpha will *necessarily* result in the construction of a portfolio of companies with better ESG records (i.e., ethically better companies): (1) investors may have legitimately differing views of what constitutes an ethically better company; (2) even if investors agreed on a definition of "better," there is no intrinsic guarantee that ethically better firms will enjoy a competitive business advantage relative to other firms; (3) even if ethically better firms have stronger business prospects, there is no guarantee that the prices of their stocks will ensure better investment results.

- A key question for ESG investors to ask of their managers is not so much *whether* they integrate ESG factors into their investment decision-making processes, but *why they do so.*

- Investors interested in ESG integration should not assume that traditional managers—i.e., managers that do not explicitly label themselves as ESG managers—are overlooking ESG factors. Some, if not many, do consider such factors when they believe them to be

material, even if they may not explicitly characterize their investment process as having an ESG integration component. However, investors should be aware that there is no guarantee that these managers' portfolios will be populated with the securities of companies with better ESG records. As a result, the challenge for the ESG investor is determining whether it is comfortable with a given traditional manager's more ethically agnostic approach to ESG integration.

- Managers use the ESG label to describe their alpha-generation efforts, their ethical commitments, or both. In some instances, the ESG label has supplanted the SRI label, though it can be quite difficult to discern whether this change reflects a true shift in *investment approach* or simply a shift in *marketing*.

- Should one presume that the use of ESG factors *necessarily inhibits* alpha generation? The simple answer is "no." In our experience, some skilled managers that use ethically based ESG screens and indicators have outperformed—and might be expected to continue to outperform—their benchmarks. As for alpha-oriented ESG managers, one cannot make blanket statements about performance expectations for these managers, just like one cannot make blanket statements about active managers in general. As with any active manager, the investment success of ESG managers will depend on their overall investment skill, not simply whether they use ESG factors.

- Three interrelated cautionary points regarding an ESG manager's alpha-generation claims are in order. First, be skeptical of vague generalities about how a given ESG manager's screens should help generate alpha. Second, push the manager to disclose any ethical commitments that might be "hidden" in the supposedly alpha-generative ESG indicators it uses. Third, be particularly suspicious of managers that purport to use ESG indicators for purely alpha-generative purposes if they run both traditional and ESG versions of the same strategy.

- Only by clearly understanding their rationale for ESG integration will investors be able to build a portfolio of managers that meets their objectives—financial, societal, or both. ■

ESG Integration: For Performance, For Ethics, or For Both?

ESG integration refers to the practice of integrating environmental, social, and corporate governance factors into the investment decision-making process. The United Nations Principles for Responsible Investment (UNPRI) program, launched in 2006, has done much to raise the visibility of this concept. By becoming a signatory, an investor affirms its agreement with the following statement:

> As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.[1]

In our experience, many investors that wish to integrate ESG considerations into their investment decision making share the dual expectations embodied in the UNPRI statement. Namely, they believe (1) that ESG factors *can be* material to performance and therefore *should be* evaluated in the investment decision-making process; and (2) that the integration of ESG factors into investment decision making may serve the greater good by better aligning investors with the broader objectives of society. With regard to the second point, these investors often view a portfolio as being "aligned with society" if it consists of companies with better environmental, social, and governance records.[2]

We share the view that ESG factors may be material to investment performance and are therefore legitimate factors (among many others) to consider when making investment decisions. However, we do not believe that using ESG factors *solely* to enhance investment performance will *necessarily and automatically* lead to the construction of a portfolio of companies with better ESG records, where the term better is meant to convey an ethical assessment.

The challenge for investors is that self-labeled ESG investment managers often *do* profess a preference for including companies with better environmental, social, and governance records in their portfolios, though their rationale for doing so may not be immediately clear. Are they using these factors in an effort to *outperform* the market, or do they reflect an *ethical* commitment on the part of the manager? Alternatively, does the manager believe, and have a sound basis for believing, that both the alpha-generation[3] and societal alignment objectives are in harmony with one another? Finally, what, in the manager's view, constitutes a better environmental, social, or governance record? The labels ESG or ESG integration do not provide immediate answers to these questions in and of themselves. Nor can an

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[1] For more information about the UNPRI, visit www.unpri.org.

[2] While investment in "better" companies is one common way of defining how an investor might be aligned with society, there are certainly other possibilities that are beyond the scope of this paper. For instance, the sheer demand for ESG information on companies may itself be socially beneficial, whether or not it is helpful for investment decision making, because it may provide other parties (policymakers, nongovernmental organizations [NGOs], etc.) with the data they need to make effective decisions. In addition, some investors may choose to integrate ESG considerations solely through their shareholder advocacy efforts, rather than through their security selection decisions. This paper focuses instead on investors that integrate ESG considerations through their choice of portfolio securities and, by extension, investment managers.

[3] Alpha is the term used to describe an investment's market risk–adjusted outperformance of a benchmark.

investor simply assume that traditional managers do not already incorporate ESG considerations into their analysis, even if they do not explicitly say they are doing so.

Consequently, in this paper we argue that it is critical for investors to be clear about what they themselves hope to achieve through ESG integration—stronger investment performance, societal alignment through a portfolio of companies with better ESG records, or both—because their prioritization of these expectations will impact the types of ESG managers they ultimately select.

Over the following pages we will further elaborate on this recommendation by discussing:

1. Examples of ESG indicators;
2. The ambiguity of ESG terminology;
3. The theoretical support for the materiality of ESG factors;
4. Why ESG integration for purely alpha-generative purposes may not lead to the construction of portfolios with better companies from a societal alignment perspective;
5. The opportunistic manner in which some traditional investors incorporate ESG considerations;
6. How ESG managers are defined and their prospects for generating alpha; and
7. Tips for investors wishing to select managers that engage in ESG integration.

Examples of ESG Factors

ESG factors can include a wide range of indicators pertaining to a corporation's impact on its various stakeholders—those constituencies or ecological systems affected by a corporation's operations. Some examples include, but are by no means limited to, a corporation's carbon footprint, human rights policies as these pertain to its business relationships with dictatorial regimes, union relationships, employee gender and ethnic diversity, product safety record, child labor policies, creation of products that serve particularly vulnerable populations, and creation of products that mitigate or prevent environmental damage.[4]

Investors and their investment managers may, of course, differ with regard to which ESG factors they emphasize in their analysis. For instance, some may emphasize only environmental factors, others may focus on social factors, and still others may look at a broader range of considerations. Thus, investors should strive to have a clear understanding of which ESG factors prospective investment managers use.

ESG Integration and the Ambiguity of Terminology

The terms ESG and ESG integration are of recent vintage, having entered into more common usage in the mid-2000s. They bear a clear family resemblance to the older term socially responsible investing (SRI), in that all imply the consideration of environmental, social, and governance factors when making investment decisions. However, *ESG and ESG integration are inherently more ambiguous than SRI with regard to the underlying investment rationale for considering these factors.*

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[4] For other examples, see the CFA Institute's May 2008 publication *Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors*, available at www.cfapubs.org/toc/ccb/2008/2008/2. The website of the Global Reporting Initiative, a multi-stakeholder network that has developed a standardized framework for corporations to report on sustainability indicators, offers a still more comprehensive review of ESG factors. See, for instance, the Global Reporting Initiative's website, in particular the page "What Is GRI?," available at: www.globalreporting.org/AboutGRI/WhatIsGRI.

Socially responsible investing is a term that implicitly suggests *restraint* on the part of the investor—a restraint that is intended to ensure that the investor considers interests broader than its own narrowly defined interests when making investment decisions, thereby exercising social responsibility. Certainly, many SRI investors have also historically argued that the consideration of ESG factors would either not adversely impact financial performance or potentially enhance financial performance. However, one can make the case that the term SRI itself suggests that ethical concerns and objectives are the *primary* reasons why these investors incorporate ESG factors into their investment decision-making process.

In contrast, the term ESG integration does not implicitly or explicitly offer the motivation that drives the investor. Instead, it simply implies a category of investment *process*, while not specifying the *reason* investors might consider ESG factors. As a result, it leaves open the possibility that investors might use these factors either to enhance alpha, address ethical/societal considerations, or both.

For instance, two investors may both decide to avoid tobacco companies given the negative health impact of their products. However, one investor may avoid these firms as a purely moral statement, without any view on the performance outlook for tobacco stocks. The other might avoid tobacco stocks because it believes looming legal liabilities related to negative health impacts have not been adequately reflected in tobacco stock prices, making avoidance of these stocks prudent from a purely alpha-driven perspective. Arguably, they have both made an investment decision based on their consideration of ESG factors, but they have done so for quite different reasons.

Thus, the term ESG integration is a broader, but less precise, term than SRI with respect to its investment rationale. As a result, it is important for investors to be clear about what they hope to achieve by integrating ESG factors into their investment decision-making processes. It is also important for investors to gain clarity about what their investment managers and other service providers mean by the term to better ensure that they receive the services they hoped for.

Why is it so important for investors to clarify whether they are seeking alpha generation or societal alignment? Do these two goals have to be mutually exclusive? We begin to address these questions in the next section by exploring the argument for why ESG factors may be financially material.

ESG Integration and Alpha Generation

We believe there is a theoretical case to be made that the consideration of ESG factors may help investors achieve their monetary performance objectives by uncovering market opportunities or identifying risks.[5]

ESG and Market Opportunities

Markets are a key mechanism for addressing human needs and desires (i.e., demand). They clearly play an important role[6] in providing necessities such as food, clothing, shelter, medicine, energy, tools for communication, and transportation, as well as more discretionary items and conveniences. In addition, while human consumption patterns have arguably placed great

[5] Similar concepts were explored in our 2007 report *Social Investing*.

[6] But by no means the exclusive role, as governments, NGOs and families/individuals may provide these services directly and/or create the infrastructure in which these markets operate.

strains on the environment, it is also possible that markets could play a role in mitigating those strains through more efficient resource use and/or pollution reduction, thereby reducing the costs of raw materials, improving health outcomes, maintaining the utility of natural systems, providing recreational opportunities, etc. Put simply, *markets are intended to serve social needs*.

Consequently, by being aware of unmet or sub-optimally met[7] human needs and desires (demand), some of which will have environmental dimensions, entrepreneurs and their investors may be able to identify profitable ways of addressing this demand.

Examples of current market efforts to meet arguably urgent or critically important human (social) needs and desires include efforts to bring to market technologies and energy sources that reduce our collective carbon footprint. Other, more recent, market innovations have been designed to address the previously pent-up financial and consumer desires of the poor. Examples include microfinance or consumer products developed in emerging world countries at substantially more affordable price points.[8]

However, we would argue that every sector of the economy is ultimately addressing some human—and therefore social—need or desire.[9] Thus, being aware of social and environmental factors can of course be helpful, and always has been helpful, in identifying potential market opportunities.

[7] For example, there may be ways to provide the same product at a cheaper cost or a higher-quality product at a similar-enough price.

[8] An October 20, 2009, article in the *Wall Street Journal* "Indian Firms Shift Focus to the Poor," aptly illustrates this point. The article discusses how engineers at Indian firms are radically redesigning certain products (e.g., refrigerators, cars, cell phones) so that they can be sold at notably less expensive prices than their developed world counterparts.

[9] Though admittedly often by causing unintended consequences that lead to new unmet needs and desires!

ESG and Risk Mitigation

From the perspective of uncovering risks, bringing a product or service to market requires the cooperation[10] of numerous parties, including the communities, consumers, employees, governments, investors, and suppliers affected by the production and use of these products and services. In addition, all of these parties (sometimes referred to as stakeholders), along with the products and services they create, depend on the earth's provision of an innumerable host of natural services for their very existence. Thus, to the extent that there are frictions present in any of these relationships, there is a risk that the costs of maintaining them may become less attractive or even unbearable. If that occurs, the profitability of a business line may suffer.

To take this line of reasoning a step further, we argue that "financial" factors and "ESG" factors are *intrinsically* linked because prices, which form the basis of financial factors (e.g., revenues, expenses/investments, earnings), are what mediate the relationships between the various stakeholder groups noted above. They do so theoretically by quantifying a point at which both parties in a particular transaction perceive the transaction to be to their mutual benefit.[11] Thus, as a given stakeholder group's aggregate perception of the benefit of the transaction changes, so, too, may prices, and by extension the financial factors that are derived from them.

Suppose a firm builds a factory in a particular community. At first, the community is content to receive the added tax and employment benefits of that firm's presence. However, if the community becomes dissatisfied with the factory's operations, it might impose new regulations to rectify the situation, raise taxes, or change zoning laws to

[10] Or *coercion*—we say more on this later.

[11] We say more on the degree to which prices actually do reflect this point of "mutual benefit" later in the paper.

oust the business from its midst, all of which would result in real costs to the firm that affect its profitability and, to that extent, its stock price. Alternatively, a firm with a record of strong community relations may have an easier time getting permission from communities (i.e., local governments) to expand operations into new locales, thereby lowering its costs relative to those of its competitors and improving profitability.

To the extent that an investor's analysis of ESG factors is synonymous with an assessment of the dynamics of these various stakeholder relationships, then ESG analysis could provide another means of helping investors better anticipate changing pricing dynamics that could affect the value of a security.

Thus, we believe a case can be made that ESG analysis *could* help financial performance. The question now becomes whether it can do so in a way that *also* "may better align investors with broader objectives of society," as UNPRI states.

Potential Conflicts Between Alpha Generation and Societal Alignment?

To begin to assess the potential conflicts between alpha generation and societal alignment, one must first define what exactly constitutes "investor alignment with society." As noted earlier, many ESG-/SRI-oriented investors presume that such an alignment is characterized by allocating capital to security issuers whose products and business operations are beneficial to society, and away from those whose are not, thereby aligning their portfolios with societal objectives. In other words, these investors assume that ESG integration will tend to drive investors to build portfolios that consist of companies with better ESG records that are consequently "better for society."

While ESG investors may of course *choose* to allocate capital in this manner, it is less clear to us that *the quest for alpha alone will inevitably drive them in this direction.* Indeed, there are three important theoretical reasons for questioning whether ESG integration for the sole purpose of generating alpha will *necessarily* result in the construction of a portfolio of companies with better ESG records (i.e., ethically better companies):

1. Investors may have legitimately differing views of what constitutes an ethically better company;
2. Even if investors agree on a definition of "better," there is no intrinsic guarantee that ethically better firms will enjoy a competitive business advantage relative to other firms; and
3. Even if ethically better firms did have stronger business prospects, there is no guarantee that the prices of their stocks will ensure better investment results.

We will explore each of these risks to a harmonious relationship between alpha generation and societal alignment in more detail below.

Differing Investor Definitions of Better

What constitutes a better company[12] from an ESG perspective? Because investor definitions differ, it is difficult to establish an objective, universally recognized definition of the universe of better companies. Thus, one cannot definitively state that the alpha-generation imperative will necessarily lead to a portfolio of better companies without reference to a particular ESG investor's definition of "better." We contrast three of the more common frameworks ESG investors might use below.

[12] For simplicity, we focus on corporate security issuers, though this discussion could be extended to non-corporate issuers like countries and nonprofits.

Economic Non-Coercion Framework. A key attribute of an idealized free market is that all market transactions that take place do so under non-coercive conditions. In other words, all parties that are involved in (i.e., impacted by) economic transactions have freely chosen to be involved in them. Thus, from an economic non-coercion perspective, better firms are those that do not force other parties to incur the costs of their operations or products unless those parties freely choose to incur those costs, presumably in the belief that the benefits will outweigh the costs. Under these ideal conditions, all parties that engage in business transactions with the firm (e.g., customers, employees, investors, vendors) do so because they believe the transactions will improve their well being. Society is consequently better off because those involved in such business transactions benefit from them, while those not involved are, at the very least, not harmed.

Implicit in the economic perspective is the view that imposing costs on others without their consent (e.g., by externalizing costs such as pollution onto third parties or future generations, stealing others' property, or obtaining consent through fraudulent claims) is the evil to avoid.

From this perspective, a better firm would be one in which (1) all employees freely choose to work there because they are satisfied with their compensation, work environment, and work/life balance; (2) customers believe the service provided by the firm adequately compensates them for the costs of its products; (3) the firm adequately compensates its vendors and covers the costs of any environmental impact; and (4) shareholders feel they are sufficiently compensated for any risk they incur. A less "good" firm might violate any of these conditions. For instance, it might offer an even cheaper product to its customers by not cleaning up the pollution generated by its factories, thereby forcing these costs onto communities.

Moral Framework. Investors adopting a moral framework for defining the better firm might agree with many aspects of the economic perspective noted above. However, they might also argue that even if a given market transaction does not involve coercion, it may still be immoral in some other (often religious) sense, and therefore not consistent with the "objectives of society" as defined by their particular worldview.

For instance, many religious SRI investors avoid tobacco and alcohol stocks. However, it is difficult to argue that the adult consumers of these products have been coerced into doing so (if we assume that they did not become addicted to these products before they were adults). Certainly, these products have addictive qualities, but adult consumers are presumably aware of this and nevertheless choose to consume these products at the risk of addiction. As a result, tobacco and alcohol firms may not violate the economic principle of non-coercive transactions,[13] but may still offend an investor's moral sensibilities given the potentially self-destructive effects of the consumption of their products. The better firm, from a moral perspective, would not offend these moral sensibilities.

Stakeholder-Centric Framework. Others, whether consciously or subconsciously, may define the better firm as the one that best serves the more narrow interests of a particular group of stakeholders with whom they empathize.[14] For instance, a labor union may push for better benefits and compensation, while company management may resist these requests to keep expenses down. Given this scenario, what constitutes a better relationship between the union and management? The answer

[13] For simplicity we exclude the impact of the consumption of these products on third parties, such as the inhalation of secondhand smoke by the children of smokers.

[14] Even as they may project those more narrow interests to be representative of broader societal objectives.

depends on which perspective—the union's or management's—the investor prioritizes.

Similar tensions are present between all parties in market transactions, which could lead to conflicting definitions of better given the differing vantage points of the various stakeholders. ESG investors may, in turn, differ with respect to which of these vantage points they choose to give precedence to in their analysis.

As noted earlier, the economic, moral, and stakeholder-centric perspectives are three of the more common frameworks for ESG analysis, with investors often implicitly referencing more than one in their ESG approaches. While these frameworks often overlap notably in their assessment of issues of concern, they may also raise important differences that lead ESG investors down differing implementation paths. In addition, while two ESG investors may view similar ESG factors to be important, they may differ in the relative weightings they apply to these factors. For instance, one investor might decide that a firm's strong environmental track record outweighs its record of poor labor relations, while another investor may decide the opposite.

For all of these reasons, it is impossible to make a definitive *universal* statement that the consideration of ESG factors for alpha generation alone will necessarily drive investors to construct portfolios of better companies from a societal alignment perspective given the absence of a universally applicable definition of better. *Such a statement can only be affirmed or rejected with respect to a given ESG investor's definition of better.*

Opportunities and Risks for Better Companies

Let us assume for a moment that all investors *do* adhere to the same framework for defining better companies. Is it reasonable to believe that better companies, as so defined, would also have better business prospects than their worse peers? As we discuss below, better firms in each of the three categories face both opportunities and risks with respect to their business prospects, and there is no certainty which outcome will prevail.

Prospects for Economically Better Firms. A strong argument can be made that firms that coerce others (e.g., through externalizing costs or by fraud) are at risk of incurring higher future operating costs or lower revenues. This is because the parties injured by the firm's behavior are likely to have varying degrees of leverage at their disposal to redress their grievances and thereby bring about the internalization of these costs. For instance, consumers and employees may leave the firm, or citizens may impose stricter regulations that will negatively impact the profitability of offending firms, thereby enhancing the competitive positions of their better peers.

However, there is certainly no guarantee that these coercive, hidden costs will ever be reflected in the price of a good. Or, if they ultimately are, the time horizon over which this occurs may be impractically long from an investor's standpoint.[15] The longevity of the institution of slavery in America is a somber case in point.[16]

Consequently, if one accepts that markets are imperfect—that externalities and coercion do

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[15] As Martin Luther King, Jr., once said, "Let us realize that the arc of the moral universe is long but it bends toward justice."

[16] Jared Diamond's book *Collapse: How Societies Choose to Fail or Succeed* (Viking, 2004) also provides several historical cautionary tales of the inability of certain societies to alter their course in the face of imminent destruction.

exist, and will probably always exist—then it follows that sometimes worse companies may be able to outcompete their better peers, or at least do so over a time horizon that is relevant for investment decisions.

Prospects for Morally Better Firms. Firms that are better with respect to a particular moral framework may be in an advantageous position if that moral worldview ends up having widespread appeal, shifting the sociopolitical context and, thereby, pricing. However, as with better firms from an economic perspective, there is uncertainty as to whether the moral worldview will prevail and when it will do so. (For instance, will taxes on alcohol sales increase? Will tobacco firms face heavier litigation in the future?) Thus, there is no guarantee that morally preferable firms will ultimately have a business advantage over other firms.

Prospects for Better Firms from a Stakeholder Perspective. As noted earlier, firms must (generally) attend to the interests of various stakeholders to secure their cooperation (e.g., productivity from employees, purchases from consumers). Thus, the better these firms serve stakeholder interests, the easier it should be to secure that cooperation, suggesting that better firms from a stakeholder perspective may have better business prospects.

However, this relationship holds only up to a point. Stakeholders generally wish to reap maximum benefits from their relationship to the firm at the lowest cost. Accordingly, at some point, attending to certain stakeholder demands will no longer cover the firm's opportunity costs for doing so, thereby impairing profitability. For instance, if a firm offers its products to consumers for free—which would obviously satisfy consumer preference—it would destroy its earnings.

Consequently, whether better firms, as defined by a given stakeholder-centric framework, have better business prospects depends on the degree to which the firm is compensated for its stakeholder-friendly characteristics, either via higher revenues, lower costs, or both. Thus, better firms, from the perspective of stakeholder interest, are not necessarily better businesses.

The Importance of Security Pricing

Even if a better firm actually has better business prospects (e.g., better long-term profit growth), the price of the firm's securities may not make it an attractive investment candidate. For instance, what if the market has overestimated the firm's growth potential? If so, then the current price of the firm's stock is too high and will likely fall as earnings disappoint, even if earnings growth is higher than that of its competitors. Conversely, what if the market has grossly underestimated the earnings growth prospects for a firm with a less favorable ESG record? If so, then realized earnings will likely boost the firm's stock price as analysts recalibrate their growth expectations, even if earnings growth is lower than that of a peer with a better ESG record.

Divergent ESG Analyst Challenges

Thus, it is by no means a foregone conclusion that ESG analysis undertaken for the sole purpose of generating alpha will *necessarily* drive investors to construct portfolios that are better aligned with societal objectives. Indeed, the purely alpha-seeking, ESG-integrating securities analyst faces a narrower challenge than the analyst seeking to achieve both alpha *and* societal alignment.

The central challenge for the alpha-seeking securities analyst is to determine whether the current price of a security adequately reflects all significant risks, including the risk that, say, negative externalities will be eventually

internalized (e.g., through litigation, legislative change, or rejection of the firm by communities, consumers, or employees), and to what extent they will be internalized.[17] If the analyst believes that the price of a security adequately—or, better yet, more than adequately—compensates the investor for these risks, then the security should logically be considered a candidate for purchase from a purely financial perspective.

The challenge is arguably different for the analyst pursuing alpha while also seeking to align a portfolio with the broader goals of society. In this case, the analyst faces a dilemma if, for instance, he believes that the target firm's externalized costs are unlikely to be internalized over a relevant time horizon (if ever), and that, in any event, the risks of internalization are more than adequately priced in.[18] Would purchasing such a security be consistent with societal alignment? Would not purchasing it be consistent with the goal of alpha generation? As we discuss later, the answers will depend largely on whether there are other suitable alpha-generating substitutes for the controversial stock.

The key point is that both of the two analysts above have integrated ESG considerations into their investment decision-making processes, and yet each may come to different conclusions about whether to buy a particular security based on their underlying objectives for analyzing ESG criteria.

In our view, a key question for ESG investors to ask their managers is not *whether* they integrate ESG factors into their investment decision-making processes, but *why they do so*. Only by asking this question will the investor be able to assess whether the manager's objectives are aligned with the investor's own.

Traditional Managers and ESG Integration

Investors should not presume that traditional investment managers—i.e., managers that do not explicitly label themselves as ESG managers—are blind to classic ESG factors[19] when making investment decisions. Some, if not many, do consider such factors when they believe them to be material, even if they may not explicitly characterize their investment process as having an ESG integration component.

In the process of writing this paper, we spoke with several traditional managers we follow closely to gauge their sensitivity to ESG issues.[20] In some cases, they did not immediately recognize the term ESG. However, they often showed a keen awareness of environmental litigation facing some of their holdings, regulatory issues affecting their industries, major community concerns facing other holdings, product safety

[17] We could have easily added the risk that a given moral worldview will predominate, or that the needed cooperation of a particular stakeholder group will be jeopardized. We follow the economic line of reasoning more for simplicity of argument.

[18] Similar questions clearly arise with respect to potential moral mispricings, and/or claims of mispricing made by dissatisfied stakeholders.

[19] We have inserted the word "classic" as an adjective for ESG to recall our earlier observation that, in our view, market prices serve as a rough shorthand for underlying social value, making it difficult to clearly distinguish between ESG and financial factors. However, we acknowledge that in more common usage, ESG indicators refer to those factors that help characterize the nature of a security issuer's relationship to such stakeholders as communities, consumers, employees, governments, vendors, and the environment.

[20] Cambridge Associates does not systematically and proactively ask the managers it follows whether or how they incorporate ESG considerations into their investment decision-making processes (unless they explicitly describe themselves as ESG/SRI managers). Our goal is rather to assess the logic and execution of the most salient aspects of a given manager's investment process, as he describes it himself. We believe there are many ways to generate alpha, and we are agnostic about the approach taken.

issues, and other arguably ESG-type factors. In addition, a number of them noted the importance of assessing the quality and character (i.e., ethics) of the management teams of potential investment candidates. As one manager noted, examining these issues was simply good fundamental research. Another said that, from a risk management perspective, "the more information you have the better" adding (perhaps hyperbolically) that "all risk factors are looked at."

However, generally speaking, we noticed two key differences between these traditional managers and ESG/SRI managers. First, the traditional managers did not adhere to an ESG checklist. In other words, they did not have a set list of ESG factors that they systematically looked at when considering a particular company (e.g., environmental fines, labor union relations, relations with indigenous people, board diversity) The factors considered were only those that seemed to them to be most *financially* material to a given security. In contrast, many ESG/SRI managers often have a clearly articulated list of factors that they systematically review, which might be applied universally or on a sector-specific basis.

Second, and most importantly, the traditional managers are (almost) purely alpha driven, so their decisions are made based on risk/return expectations alone.[21] In other words, they fit the profile of the alpha-driven analyst cited above. For example, one energy analyst discussed his analysis of an oil company facing severe environmental fines at a former non-U.S. facility. The analyst believed that the amount of the fine reflected in the oil company's stock price far exceeded how much he felt the firm would actually pay, thus providing an attractive buying opportunity. From an ethical or societal alignment perspective, one could argue that this firm was a poor corporate citizen, but from a *price* perspective, the analyst felt it was a compelling candidate. Another portfolio manager was acutely aware of the community relations concerns raised about a particular retailer, discussed them with management, reflected on them, and ultimately decided that these concerns were misguided and would be proven so in time.

Thus, while these particular managers clearly took ESG factors into consideration, their decision to hold a security ultimately came down to pricing, not ethics. As one concentrated value manager said, "everything has a price."

To reiterate, investors interested in ESG integration should not assume that traditional managers are overlooking ESG factors.[22] However, investors should be aware that there is no guarantee that these managers' portfolios will be populated with the securities of companies with better ESG records. As a result, the challenge for the ESG investor is determining whether it is comfortable with a given traditional manager's more ethically agnostic approach to ESG integration.

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[21] A few of the managers we spoke to had very concentrated, low-turnover portfolios. Interestingly, one of these noted that his strategy never held tobacco or gambling stocks because he preferred to own companies he could "root for" given the time and emotional energy involved in following them. The tobacco and gambling exclusion was not part of his marketing pitch, but rather a personal decision.

[22] Neither should they assume that all traditional managers consider classic ESG factors. However, many investment managers do emphasize the quality of the management teams of the firms they invest in. Speaking in generalities, investment managers like to see that management teams have a good track record of capital allocation and/or solid plans for capital allocation going forward. Implicit in this assessment is the investment manager's usage of the management teams' capital allocation track records as *proxies* for their ability to navigate stakeholder relationships. Said differently, rather than examine the underlying nature of the various stakeholder relationships, these managers examine instead management's track record as evidence of management's agility with those relationships.

ESG Managers: Definitions and Alpha Generation

What Is an ESG Manager, Anyway?

As the reader may have surmised, it is difficult both to: (1) clearly define the universe of ESG managers and (2) understand, by the ESG label alone, the self-labeled ESG manager's rationale for using ESG indicators. As a consequence, the ESG manager universe will be defined, in significant part, by investor preference rather than by an external set of criteria.

For instance, with respect to the first point, if a traditional investment manager (like those described in the preceding section) considers certain classic ESG factors because it believes them to be material, does that qualify the firm to be an ESG manager? Or, if a manager invests in sectors of the economy that have "significant" social benefits, should that manager be categorized as an ESG manager? To that point, could not one argue that *all* sectors of the economy—consumer discretionary, consumer staples, energy, financials, health care, industrials, information technology, materials, telecommunication services, utilities—offer social benefits, recognizing, of course, that they may also impose uncompensated social costs?

As for the second point, in our experience managers use the ESG label to describe their alpha-generation efforts, their ethical commitments, or both. In some instances, the ESG label has supplanted the SRI label, though it can be quite difficult to discern whether this change reflects a true shift in *investment approach* or simply a shift in *marketing*. From the cynic's perspective, such a shift makes marketing sense because it could enable these managers to attract both alpha-focused and ethics-focused clients. However, a less jaundiced view would simply acknowledge that the oft-perceived dichotomy between financial and ESG factors is by no means clear since, in theory at least, financial prices are, or should be, reflective of perceived underlying social value.

Thus, it behooves investors to know what they are looking for in their ESG managers. Are they hoping to be assured that the manager is adept at considering all risks, including more qualitative ESG-related risks, in the pursuit of alpha, even if such consideration may not lead the manager to invest only in companies with better ESG records? Alternatively, does the investor hope that the ESG manager will be committed to investing only in companies with better/acceptable ESG records on moral grounds in the pursuit of alpha, which *might* lead the manager to overlook good investment opportunities with worse ESG records?

ESG Managers and Alpha Generation

Should one presume that the use of ESG factors *necessarily inhibits* alpha generation? The simple answer is "no." However, we shall comment separately on managers that use ESG criteria to express ethical commitments (i.e., SRI managers) and those that are, or purport to be, purely alpha focused.

SRI-Type ESG Managers and Alpha. Like any active manager, SRI-type ESG managers generally build their portfolios from a subset of the investable universe. It is entirely possible that the portion of the investable universe that remains after the ethical screening process may still have enough candidates left therein to build a portfolio of stocks that can outperform the benchmark. This result is especially plausible if the screens themselves have some unintentionally financially useful attributes.

The challenge for the investor then is to forecast the effect of the ethical screening process. To do so, investors should focus on two key questions. First, to what extent do the ethically motivated

screens limit the number of stocks that remain in the investable universe and/or skew the remaining universe's factor exposures (e.g., sector, capitalization, growth, value)? One would presume that the greater the limitations, the harder it may be for the manager to generate alpha—unless a strong thesis can be made for why the screens themselves might actually be expected to help performance. Second, is the manager skilled at security analysis and portfolio construction? *In our view, this second factor—manager talent—is likely to dominate the first in terms of portfolio results.*

In our experience, some skilled managers that use ethically based ESG screens and indicators have outperformed—and might be expected to continue to outperform—their benchmarks. Admittedly, our base hypothesis is that their performance would be better still if they did *not* dogmatically employ ethically based screens since the screening process could inhibit them from selecting their "best" security ideas. However, we are aware of exceptions to this hypothesis.

Alpha from Alpha-Oriented ESG Managers. As for alpha-oriented ESG managers, one cannot make blanket statements about performance expectations for these managers, just like one cannot make blanket statements about active managers in general. As with any active manager, the investment success of ESG managers will depend on their overall investment skill, not simply whether they use ESG factors. However, three interrelated cautionary points are in order.

First, be skeptical of vague generalities about how a given ESG manager's screens should help generate alpha. For instance, it is all too easy for a manager to explain in very broad terms how breaches of ethical conduct on the part of a company may pose a risk at some point over the longer term. Push ESG managers to explain their expectations for the probability and timing of such a risk coming to fruition, and the factors that have led them to these conclusions. Have them explain why they think that risk is not already embedded in the security's price. Ask for historical evidence of inefficiencies with respect to these types of risks. As noted earlier, it may take a long time for these risks to be acknowledged by the rest of the market and/or to impact company profitability. Make sure the ESG manager has good theses to support its views.

Second, push the manager to disclose any ethical commitments that might be "hidden" in the supposedly alpha-generative ESG indicators it uses. One approach might be to ask whether the manager would continue to use a particular ESG indicator even if it was discovered *not* to be alpha generative over the long run. If the manager would continue to use the indicator under adverse financial circumstances, then perhaps that indicator is actually evidence of an ethical, rather than alpha generative, commitment after all.

Third, be particularly suspicious of managers that purport to use ESG indicators for purely alpha-generative purposes if they run both traditional and ESG versions of the same strategy. Having two strategies, in our view, suggests a lack of conviction in the alpha-generative efficacy of the ESG indicators. Otherwise, why would the manager not use these indicators in the traditional strategy as well?

Our hope is that these cautionary points will help investors distinguish between ESG alpha-generation claims that have merit and those that are merely clever marketing.

Tips for Investors Interested in ESG Integration

In brief, the following are our key recommendations for investors interested in having their

managers integrate ESG considerations into their investment decision-making processes:

- **Have a clear rationale for integrating ESG factors.** Does the use of ESG factors reflect ethical commitments, an alpha-generation thesis, or both? If both, which rationale dominates? Are there differing rationales for different factors? If so, which ones are more ethically driven, and which ones are more alpha driven? What is the theoretical or empirical basis for the alpha-generation thesis? Is it a sound one?

- **Keep in mind that financial factors and ESG factors are intrinsically linked.** Recall that prices mediate the relationships between corporations and their stakeholders, thereby intrinsically linking ESG factors to financial factors. However, the degree to which prices ultimately reflect the mutual benefits derived from these relationships should be assessed on a case-by-case basis. Consequently, investors should remain cognizant of the potential disconnect between market prices and good corporate relationships with stakeholders. In addition, investors should assess the probability that this disconnect will be rectified.

- **Do not assume that traditional managers overlook ESG factors.** Investors should ask prospective traditional managers how they think about ESG factors the investor finds particularly salient. Are these factors material to the manager? Why or why not? If not, what other material factors are considered instead? Does consideration, or lack of consideration, of the ESG factors of interest seem defensible from an investment standpoint? As a prospective investor in these funds, is the manager's position one that is ethically comfortable for the organization?

- **Understand why ESG managers consider the factors they do.** Do the manager's ESG considerations reflect ethical commitments? Does the manager believe these considerations are alpha generative? If so, does the manager have a strong thesis for the alpha-generative efficacy?

- **Above all, focus on the manager's security selection and portfolio construction skill!** Manager skill, rather than use of an ESG checklist, is likely to be a central determinant of the manager's performance results.

Conclusion

Prior to the development of the terms ESG and ESG integration, terms like SRI more explicitly announced an investor's or manager's commitment to certain ethical principles that would inform investment decisions. At the same time, alpha-driven non-SRI investors may have considered environmental fines, labor relations, and other arguably ESG factors, or invested in socially beneficial sectors, in their quest to outperform the market, without consciously thinking of themselves as socially responsible investors.

With the rise of the term ESG, the line between the two camps has been more decidedly blurred. Perhaps some degree of blurring was inevitable, as there is, in our view, always a necessary link between financial and social factors given the role prices play in mediating a firm's relationships with its various stakeholders. Nevertheless, investors must still come to terms with why they seek ESG integration—is it primarily performance, primarily ethics, or a sincere belief and defensible thesis in the potential to maximize both? Only by clearly understanding their rationale for ESG integration will investors be able to build a portfolio of managers that meets their objectives. ■