Insight INVESTMENT

GLOBAL MACRO RESEARCH
THE SCIENTIFIC SCRUTINY OF SUSTAINABILITY

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BNY MELLON | INVESTMENT MANAGEMENT

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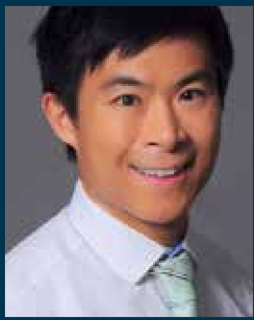

Alex Edmans is Professor of Finance at London Business School. Alex graduated from Oxford University and then worked for Morgan Stanley in investment banking (London) and fixed income sales and trading (New York). After a PhD in Finance from MIT Sloan as a Fulbright Scholar, he joined Wharton in 2007 and was tenured in 2013 shortly before moving to LBS.

Alex's research interests are in corporate finance, responsible business and behavioural finance. He is a Director of the American Finance Association, Vice President-Elect of the Western Finance Association, a Fellow of the Financial Management Association, and a Fellow of the Academy of Social Sciences. From 2017-2022 he was Managing Editor of the Review of Finance, the leading academic finance journal in Europe.

EXECUTIVE SUMMARY

We will accept a claim uncritically if it confirms what we would like to be true. This can be a particular challenge when it comes to sustainability and investment. If an investment fund claims that it has achieved long-term financial returns, as well as helped to decarbonise the economy and promote board diversity, we might be tempted to accept such claims uncritically.

But to avoid greenwashing we need to assess such claims scientifically. To assess the actual impact and implications of achieving sustainability outcomes, we need to answer two questions:

1. How do you measure sustainability?
2. How do you confirm that sustainability drives financial performance?

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MEASURING SUSTAINABILITY
LOOKING BEYOND QUANTITY TO QUALITY

THE PROBLEM WITH FOCUSING ON QUANTITY, NOT QUALITY

A chosen metric could simply measure the quantity of a particular activity, rather than a quality that investors actually value.

To illustrate this, consider an attack on hedge fund activism by US Senators Tammy Baldwin and Jeff Merkley, who said that activist hedge funds “make demands to benefit themselves at the expense of the company’s long-term interests.” They claimed that there was growing evidence that “firms targeted by activists experience lower investment and R&D”.[1]

Focusing on this latter claim, it indeed seems a clear negative that investment, and research and development, at a particular company might decline. Investment only measures the quantity of expenditure, not its quality. A separate research study found that, even though investment declines, firms targeted by activists actually became more innovative over a five-year period. The researchers said that in their analysis, companies targeted by activists “improve their innovation efficiency…Despite a tightening in R&D expenditures, target firms increase innovation output, as measured by both patent counts and citations.[2]

This highlights how it is possible to focus on a particular quantity, rather than the relevant quality.

Case study: shareholder voting measures can distract from activity that makes a difference

A common focus for sustainability and investment is shareholder voting. An investment manager might be ranked based on the number of votes for proposals focused on improving environmental or social performance, or against proposals that undermine such goals.[3] Investors may go further and make their own proposals – such as for a company to use less plastic packaging.

But a portfolio manager doesn’t need to be skilful to achieve 100% of votes in favour of sustainable proposals; a robot could vote to support every proposal related to sustainability outcomes. Also, proposals may be unnecessary or sub-optimal. Proposals may effectively micromanage a company’s operations, or distract management’s attention from other issues that are material either from a sustainability or a business performance perspective.

Instead of voting, stakeholders may focus on how many meetings a portfolio manager has with company management. But again, more meetings may not mean the investment manager is having targeted discussions about creating long-term sustainable value.

[1] The Problem of Short-Termism & Activist Hedge Funds (PDF), 7 March 2016.
[2] How Does Hedge Fund Activism Reshape Corporate Innovation?, 3 July 2017, Journal of Financial Economics.
[3] For example, see Voting Matters 2023: Are asset managers using their proxy votes for action on environmental and social issues?, 11 January 2024, ShareAction.

THE PROBLEM WITH USING QUANTITATIVE MEASURES

Simple quantitative measures can be partial and misleading

Many investors are seeking to make sure the companies in which they invest treat their employees well. One measure could be pay – such as the ratio between the CEO's and workers' salaries. Unfortunately, research has suggested that there is a dollar-for-dollar trade-off; that for every dollar more paid to workers, the market value of a company falls by a dollar. This puts an investor in a difficult position if they want to pursue social objectives, as it suggests they may have to sacrifice financial returns.

If we want a company that really treats its workers well, should we be focusing only on how much they are paid? You might think that is naturally the most important thing that a company gives – but not necessarily. Employees might care about not just pay, but also working conditions, flexi-time or holidays. They may value on-the-job training, a vibrant corporate culture, and skills development. Junior employees may look to join senior colleagues on meetings.

This led me to research a broader measure of how well a company treats its workers. I looked at the '100 Best Companies to Work For in America', a list compiled over many years and based on much more holistic and comprehensive information than just pay, but clearly it takes pay into account.[5]

This research showed there is a win-win: the companies that are higher on this list, which are great places to work, are generating positive alpha[6]. This was not just a flash in the pan – this was over a 26-year period including both booms and recessions.

Case study: quantitative measures of diversity can give misleading results

The relevance for investors becomes clearer when considering diversity metrics. When trying to evaluate an investment manager or investment fund, there are statistics available that highlight what proportion of the investment management workforce is male versus female, or from an ethnic minority background.

There are high-profile claims that gender and ethnic diversity can support financial performance. A study published by the Financial Reporting Council (FRC) and London Business School claimed that higher diversity is linked to higher financial performance.[7] However, none of the 90 tests underlying the study (regressions relating diversity to EBITDA margin) demonstrated statistical significance. In other words – none of them worked out.

Importantly, this result does not necessarily undermine the case for a link between diversity and financial performance; it just reflects that the measure of diversity used was only quantitative, not qualitative. It didn't look at other factors like cognitive diversity or diversity of socioeconomic background.

This prompted another research project which considered not just the percentage of ethnic minorities or females, but whether employees – both minority and non-minority – feel included and equitably treated.[8] Looking at a broader measure of diversity, equity and inclusion, the study found that this is indeed linked to future financial performance. These coefficients between diversity, equity and inclusion are positive, but if I just looked at demographic diversity – the proportion of women or minorities – that is not linked.

The key here was choosing a comprehensive measure that incorporated qualitative concerns, not just a partial quantitative metric.

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[4] The Effect of Wage Bargains on the Stock Market Value of the Firm, September 1989, The American Economic Review.
[5] More information is available from the Great Place To Work Institute, which compiles the list.
[6] Does the stock market fully value intangibles? Employee satisfaction and equity prices (PDF), 30 March 2011, Journal of Financial Economics.
[7] Board Diversity and Effectiveness in FTSE 350 Companies (PDF), July 2021, FRC.
[8] Diversity, Equity, and Inclusion (SSRN), September 2023, European Corporate Governance Institute.

MEASURING CAUSALITY
UNDERSTANDING THE LINK BETWEEN SUSTAINABILITY AND FINANCIAL PERFORMANCE

IDENTIFYING A CAUSAL LINK IS CHALLENGING BUT CRUCIAL

Distinguishing between correlation and causation is necessary

New parents may be encouraged to breastfeed their children – before my son was born I was assured that there's strong evidence that breastfed babies perform better on IQ, on various physical dimensions, and have lower susceptibility to illness. But breastfeeding can be very difficult and time-consuming, and require a supportive home or working environment, so working out whether this evidence in favour of breastfeeding is correlation or causation would have significant implications. Is it breastfeeding that is that is causing the better outcomes, or perhaps it reflects that breastfeeding mothers may be wealthier or have access to more supportive environments?

Emily Oster, an economist, examined the evidence and found just that – the evidence claimed does not support causation. For example, a "huge number of papers show a correlation between breastfeeding and IQ, but those that are able to adjust for differences across mothers – by comparing siblings or, in one case, with a randomised trial – do not show evidence for causal effects".[9]

A simple tool to tackle confirmation bias: imagine the opposite

There are claims which we may instinctively want to be true. To help us tackle our confirmation bias and consider the evidence for them objectively, we should reflect on how we might object to the opposite claim.

For example, in an article published in the Harvard Business Review, the author stated that "when colleagues and I looked at data for more than 3,000 firms between late February and late March 2020 – when global financial markets were collapsing – we found that the ones the public perceived as behaving more responsibly had less-negative stock returns than their competitors".[10]

To help us assess this claim, it may be useful to imagine if the claim was that these firms had more negative returns relative to their peers, rather than less.

This might prompt us to highlight that the time period in question is too short to make any inferences, that the returns are due to some sectors outperforming others, or that performance is driven by value stocks were favoured in the period over growth stocks (more sustainable companies are often classified as growth rather than value stocks).

We can then apply this scepticism to the actual claim and assess its validity.

[9] Is breast really best? I looked at all the data to find out, 20 June 2019, The Guardian.
[10] Social-Impact Efforts That Create Real Value, September-October 2020, Harvard Business Review.

Be aware of reverse causality – is the tail wagging the dog?

You might think that stopping smoking reduces mortality risk – but one study found that if you stop smoking, you are more likely to die, indicating “smoking cessation in late life to be associated with increased risk of all-cause mortality amongst oldest old people who have smoked for a long time”.[11]

At first glance, we might take this as evidence that stopping smoking would lead to an increased risk of death. But the causal relationship was actually in reverse: smokers, on being warned of the increased risk of death if they kept smoking, decided to stop.

Implications for investors: assessing the sustainable impact of an investment portfolio

Investment portfolios may report a wide range of sustainability measures, highlighting the positive outcomes achieved by companies in which they invest. The implication is that investment in the portfolio has led to these outcomes.

However, the question of causality remains. A fund with a sustainability focus would be more likely to invest in companies that would report such outcomes; and for an equity fund, it is disingenuous to claim or imply that buying shares in the secondary market might lead to these outcomes. No new capital is being provided to the company.

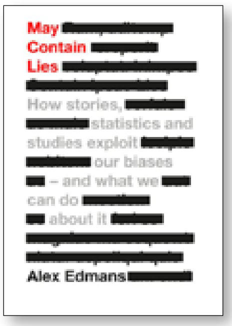
A key question here is whether the positive outcome would have occurred anyway.

CONCLUSION
THE QUESTIONS TO ASK WHEN CONSIDERING SUSTAINABILITY CLAIMS

When evaluating claims for an investment fund on sustainability outcomes, there are key questions to ask. These are important to tackle confirmation bias – and of course, they have implications for claims beyond the world of investments.

- **What is being measured?**
  - Is it quantity rather than quality?
  - Is it quantitative rather than qualitative?
- **What cause-effect relationships are being claimed?**
  - Are there common causes?
  - Would the effect have happened anyway?

FURTHER READING



May Contain Lies: How stories, statistics and studies exploit our biases – and what we can do about it

https://maycontainlies.com/

[11] Smoking cessation in late life is associated with increased risk of all-cause mortality amongst oldest old people: a community-based prospective cohort study (PDF), 23 January 2021, Oxford University Press.

ASSOCIATED INVESTMENT RISKS

ESG

- **Investment type:** The application and overall influence of ESG approaches may differ, potentially materially, across asset classes, geographies, sectors, specific investments or portfolios due to the nature of the specific securities and instruments available, the wide range of ESG factors which may be applied and ESG industry practices applicable in a particular investable universe.
- **Integration:** The integration of ESG factors refers to the inclusion of ESG risk factors alongside financial risk factors in investment analysis and research to judge the fair value of a particular investment and may also include the monitoring and reporting of such risks within a portfolio. Integrating ESG factors in this way will not typically restrict the potential investable universe, but rather aims to ensure that what we believe to be relevant and material ESG risks are taken into account by analysts and/or portfolio managers in their decision-making, alongside other relevant and material financial risks.
- **Ratings:** The use and influence of our ESG ratings in specific investment strategies will vary, potentially significantly, depending on a number of factors including the nature of the asset class and the structure of the investment mandate involved. For an investment portfolio with a financial objective, and without specific ESG or sustainability objectives, a high or low ESG rating may not automatically lead to a buy or sell decision: the rating will be one factor among others that may help a portfolio manager in evaluating potential investments consistently.
- **Engagement activity:** The applicability of Insight firm level ESG engagement activity and the outcomes of this activity relating to buy, hold and sell decisions made within specific investment strategies will vary, potentially significantly, depending on the nature of the asset class and the structure of the investment mandate involved.
- **Reporting:** The ESG approach shown is indicative and there is no guarantee that the specific approach will be applied across the whole portfolio.
- **Performance/quality:** The influence of ESG criteria on the overall risk and return characteristics of a portfolio is likely to vary over time depending on the investment universe, investment strategy and objective and the influence of ESG factors directly applicable on valuations which will vary over time.
- **Costs**: The costs described will have an impact on the amount of the investment and expected returns.
- **Forward looking commitments and related targets:** Where we are required to provide details of forward-looking targets in line with commitments to external organizations, e.g. Net Zero Asset Managers Initiative, these goals are aspirational and defined to the extent that we are able and in accordance with the third party guidance provided. As such we do not guarantee that we will meet them in whole or in part or that the guidance will not evolve over time. Assumptions will vary, but include whether the investable universe evolves to make suitable investments available to us over time and the approval of our clients to allow us to align their assets with goals in the context of the implications for their investments and issues such as their fiduciary duty to beneficiaries.

Insight applies a wide range of customized ESG criteria to mandates which are tailored to reflect individual client requirements. Individual investor experience will vary depending on the investment strategy, investment objectives and the specific ESG criteria applicable to a Fund or portfolio. Please refer to the investment management agreement or offering documents such as the prospectus, Key Investor Information Document (KIID/KID) or the latest Report and Accounts which can be found at www.insightinvestment.com and where applicable information in the following link for mandates in scope of certain EU sustainability regulations https://www.insightinvestment.com/regulatory-home/sustainability-regulations/; alternatively, speak to your main point of contact in order to obtain details of specific ESG parameters applicable to your investment.

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