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# SUMMER SESSIONS

Refresh your knowledge of essential topics in investing

## Introduction to ESG Investing

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### Key Points

- The advent of increased ESG information and a richer data environment have created new opportunities and challenges for firms and investors alike, which will be crucial to understand going forward.
- Not all ESG issues are financially material. It is crucial to differentiate the materiality of ESG issues and how they affect each industry differently.
- During the COVID-19 crisis, a premium was observed among companies that placed emphasis on employee well-being and supply chain management.
- A key factor to consider in ESG investing is differentiation in a firm's ESG strategy, which has the ability to generate competitive advantage and profitability.

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As new ESG data and standards emerge, investors are scrambling to best understand these considerations and position their portfolios accordingly. This increased emphasis on ESG investing centers around materiality, as the more material ESG information is, the greater its correlation with risk-adjusted returns. New ESG data provides investors with a greater understanding of productivity, cost structure, revenue generation, and the competitive and regulatory environment. The rise in prominence of ESG investing can be ascribed to demands from clients and stakeholders, ethical responsibility, and as a tool for effecting change in firms. Current practices in ESG are varied and can range from engagement and active ownership, to thematic investment and negative screening, to full integration into fundamental stock analysis. With regard to impact on investment returns, research shows more positive returns from full integration of ESG consideration in equity valuation compared to other approaches.

It is important to consider that not all ESG issues are financially material. It is crucial to differentiate the materiality of ESG issues and how they affect each industry differently. During the COVID-19 crisis, a premium was observed among companies that placed emphasis on key ESG issues. Companies that emphasized human capital, proactive supply chain management, and repurposing of products and services to combat challenges saw better performance. Considering ESG as part of their organizational strategy signaled commitment to stakeholders, capacity, and innovation, realizing competitive advantages over their peers. Moreover, over time,

ESG strategy has become more homogenous between firms within the same industry, as they imitate one another. Research finds that only unique ESG strategy can give competitive advantage, and can lead to increased return on capital.

Additionally, ESG value for price must be considered in investing. In the past, firms with higher ESG ratings traded at a discount to competitors, whereas now they often trade at a premium. The key question here, is if the premium will signal greater returns in the future, and if the price to pay today is worthwhile. It has been observed that firms with low ESG sentiment and high ESG scores outperform firms with high ESG sentiment and high ESG scores, indicating that relative valuation of ESG activities on a market basis is key to alpha generation. It is observed that there is a greater positive reaction to positive news for low consensus ESG firms, although the inverse for negative news is not true. The market valuation of ESG activities in particular is a function of sentiment. It is observed that for the roughly six percent premium the market ascribes to ESG considerations, more recently, positive sentiment has nearly double the effect as negative sentiment (approximately 8 compared to 4%)

Carbon data is a particular focus in ESG investment, utilizing scope 1, 2, and 3 data. Each approach has different tradeoffs, and the power of the metric depends mostly on industry-specific context. The key consideration here, is the ability to determine what factors contribute to materiality in the specified industry. For example, in industries that climate factors pose a larger material issue, decarbonization of such portfolios leads to better performance. As we determine the materiality of each factor, investors can begin building out their long-short portfolios, overweighting and underweighting based on different climate data.


ESG investment is a nascent space, where investors are still developing the “rules and norms.” As new data emerges, disagreement in ESG ratings has risen. At this moment, a number of barriers exist to ESG investing. Lack of standardization in ESG reporting and limited accessibility of information limit comparability across firms. For all ESG considerations, context matters above all else. Disagreements among ESG inputs and outcomes from each decision demonstrate that investors still struggle to evaluate the value of ESG efforts. This is crucial because without a proper way to measure outcomes consistently, firms are sure to struggle with accountability.

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