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RESPONSIBLE INVESTING

“All investing should be responsible...”
-Wendy Jeffus

It would be irresponsible of me not to point out the strong cultural differences that underpin two philosophies of fiduciary duty.

A **fiduciary** is defined as someone who manages assets on behalf of someone else; the law requires a fiduciary to manage another’s property for their *benefit*.¹ In an investment context, this is especially important because the asset owners who stand to benefit (e.g. pay-outs from a pension or life assurance) do not control the investment decisions. Traditionally in the United States the “benefit” has been defined in terms of the shareholder wealth for a given level of risk while other parts of the world tend to focus on a broader group of stakeholders.^{2,3} For example, in 2021, the European Commission amended the concept of fiduciary duty to require that insurance and investment advisors obtain information about their client’s sustainability preferences.⁴

“Culture is the collective programming of the mind that distinguishes the members of one group or category of people from others.”
-Geert Hofstede⁵

Competing cultural lenses is not a new phenomenon, but if there is hope to get to “authentic solutions to our global challenges” then a brief review of global perspective can be beneficial. For example, in some parts of the world, **individualism**, which is focused on the rights of the individual, dominates. While in other parts of the world **collectivism**, which emphasizes the rights of the community, dominates the rights of the individual. These differences affect everything from family dynamics to government policies.

Beyond individualism and collectivism, many other cultural differences have been established; the most relevant to Sustainable Finance is the different emphasis on various *stakeholders*, defined as those having a “stake” in the success of an organization. Examples of stakeholders include: employees, management, customers, suppliers, community groups, regulators, taxing authorities, and stockholders.

¹ Source: <https://www.forbes.com/advisor/investing/financial-advisor/what-is-fiduciary-duty/>, Retrieved February 12, 2023.

² <https://www.eurosif.org/press-room/the-european-commission-launches-a-fiduciary-duty-consultation/>, Retrieved February 21, 2023.

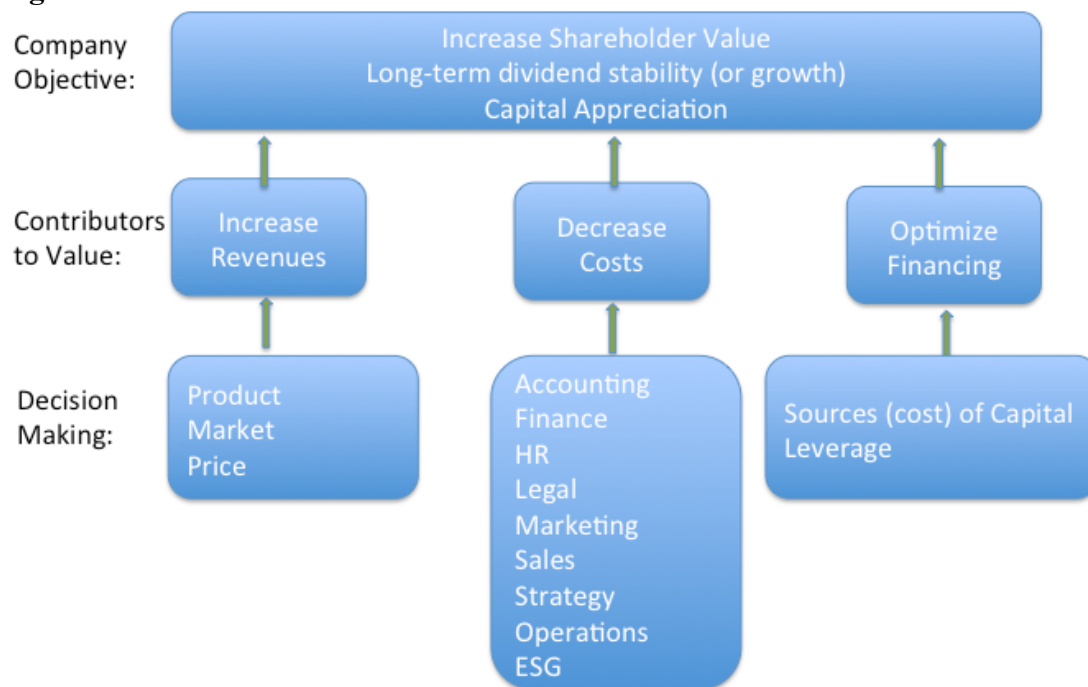
³ See Fiduciary Duty in the 21st Century: Final Report (2019), Available at: <https://www.unepfi.org/wordpress/wp-content/uploads/2019/10/Fiduciary-duty-21st-century-final-report.pdf>, Retrieved March 11, 2023.

⁴ European Commission, “Communication from the Commission to the European Parliament, to the Council, the European Economic and Social Committee and the Committee of the Regions: EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal,” April 21, 2021 Available at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021DC0188&from=EN>, Retrieved March 23, 2023.

⁵ Hofstede Geert (2011). Dimensionalizing Cultures: The Hofstede Model in Context. Online Readings in Psychology and Culture, 2(1). <https://doi.org/10.9707/2307-0919.1014>

The elegance of the shareholder wealth maximization model is that shareholders are *residual owners* of the organization. In theory, shareholders are paid after all others have been taken care of (e.g. employees, suppliers, taxing authorities, lenders, and other creditors) therefore maximizing the residual should take care of others (if regulators ensure that externalities are properly taxes).

Figure 1: Shareholder Wealth Maximization Model



Source: Adapted from Environmental Finance by Sonia Labatt & Rodney White Figure 2.1 p. 18
See also Willis and Desjardins (2000) and Havemann and Webster (1999)

The downsides of the shareholder wealth maximization model can include a short-term earnings focused view of a company and sometimes ecological benefits are seen as costs (rather than profit opportunities). In addition, “The objective of ‘maximize shareholder wealth’ can be in conflict with host countries’ cultural, economic, political, social, ecological, or religious goals.”⁶

In addition, there are several common market failures that economists and regulators grapple with including: externalities, public goods, information asymmetry, monopolies and oligopolies, market power (of suppliers, buyers, intermediaries, governments), etc. The two we will focus on in this course are externalities and missing markets.

Missing markets are considered a market failure, characterized by the absence of market transactions (for a good or service). Future generations are an example of a missing market, as their needs and preferences are unknown and not accounted for by today’s markets.⁷

⁶ *Multinational Finance*, 3rd edition, by Kurt C. Butler, pp. 22-23.

⁷ I appreciate Dr. Josh Farley, University of Vermont for pointing me to this article: Jacobus A. Doeleman & Todd Sandler, 1998. "The Intergenerational Case of Missing Markets and Missing Voters," *Land Economics*, University of Wisconsin Press, vol. 74(1), pages 1-15.

EXTERNALITIES

An important concept, to dive into prior to reviewing different strategies employed to invest with purposeful attention to broader issues, is that of externalities. **Externalities** are the costs and benefits that impact someone other than the producer or consumer of a good or service.⁸ *Externalities exist when the damage (or benefits) a company does to society or the environment is omitted from its financial statements.*⁹ The economic consequences of externalities are an important backdrop for sustainable finance.

Example: Consumption Externalities - Smokers and Non-smokers

Imagine two roommates (Astrid & Beau) that have preferences regarding money and smoke. Assume both roommates like money, but only roommate Astrid likes to smoke. Astrid believes she has the right to smoke and Beau believes he has the right to clean air... *Consumption externalities* are impacts on outside parties generated by the consumption of a good or service. In the real world there are more than two parties and the situation is much more complicated.¹⁰

Example: Production Externalities – Polluters and Non-polluters

Imagine two companies (Company Swipple and Company Fipple). Swipple produces steel and pollution, which it dumps into a river. Fipple is a fishery that is downstream and is adversely affected by Swipple's pollution. The increase in the cost of fishing associated with an increase in pollution is sometimes referred to as a social cost. *Production externalities* are impacts on outside parties generated by the production of a good or service. Production externalities can be measured in terms of the actual cost of production of the good to the real cost to society, which are incurred without compensation (pollution, water scarcity, climate changes, etc.).¹¹

Externalities exist in all industries, examples include: violence in video games, chemical runoff, downstream waste, etc. Some are well covered (e.g. plastic straws), well litigated (e.g. asbestos) others are less known (e.g. hypoxic blobs). In addition, governments attempt to discourage negative externalities by taxing goods and services that generate *spillover costs*.

Not all externalities are negative. Positive externalities include medical breakthroughs, tree planting, exercise, etc. Again some are well covered (e.g. public broadcasting), some are well litigated “no good deed goes unpunished” (e.g. breaking a rib while saving a life) while others are less known (e.g. a barking dog). In addition, governments attempt to encourage positive externalities by subsidizing goods and services that generate *spillover benefits*.

As we dive into sustainability reporting, responsible investing, *and as you lead your own lives*, think about the impact and ramifications of externalities. Specifically, carbon pricing and ESG reporting are attempts to include some externalities into financial analysis.

⁸ Van Stratton, Sharon, “Externalities: It’s What Pandemics, Pollution and Puppies Have in Common,” *St. Louis Federal Reserve*, June 2, 2021, Available at: <https://www.stlouisfed.org/open-vault/2021/june/externalities-pandemics-pollution-puppies-in-common>, Retrieved February 21, 2023.

⁹ Environmental Finance: A Guide to Environmental Risk Assessment and Financial Products by Sonia Labatt and Rodney White pp. 1-2.

¹⁰ See Intermediate Microeconomics: A Modern Approach, 5th edition, by Hal R. Varian, pp. 570-580 for the complete example.

¹¹ See “The Problem of Social Costs,” by Ronald Coase (1960) *Journal of Law and Economics*.

ESG INVESTING STRATEGIES

The United Nations defines *responsible investment* as strategies and practices that incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.¹² ESG Investing aims to identify, evaluate and price Environmental (E), Social (S), and Governance (G) risks and opportunities.¹³

- **Environmental factors** – pertain to the use of and interactions with renewable and non-renewable resources throughout the global ecosystem.
- **Social factors** – are factors that affect the lives of people.
- **Governance factors** – include issues that relate to industry practices, transparency and corporate governance.

Under the umbrella of “sustainable finance” is sustainable investing. According to the CFA Institute, there are three critical elements of sustainable investing:

1. Sustainable investing is *additive to asset management theory* and does not mean a rejection of foundational concepts.
2. Sustainable investing analysis develops *deeper insights* about how value will be created going forward using ESG considerations.
3. Sustainable investing *considers diverse stakeholders*, consistent with corporate trends.¹⁴

Responsible investing attempts to achieve superior returns (investing *for* a positive impact) or at least to avoid inferior returns (investing to *avoid* a negative impact).¹⁵ Related to responsible investing is “active ownership” or “impact investing” which involves engaging with companies to attempt to improve their ESG outcomes and/or voting on resolutions. The table below is a good summary of the two sides of the ESG investing landscape.

CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (known as: ESG incorporation)			IMPROVING INVESTEEES' ESG PERFORMANCE (known as: active ownership or stewardship)	
ESG issues can be incorporated into existing investment practices using a combination of three approaches: integration, screening and thematic.			Investors can encourage the companies they are already invested in to improve their ESG risk management or develop more sustainable business practices	
Integration	Screening	Thematic	Engagement	Proxy voting
Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns.	Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor's preferences, values or ethics.	Seeking to combine attractive risk return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing.	Discussing ESG issues with companies to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors.	Formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolutions on specific ESG issues.

Source: United Nations Principles of Responsible Investing¹⁶

¹² Source: UN Principles for Responsible Investment, “What is Responsible Investment,” Available at: <https://www.unpri.org/an-introduction-to-responsible-investment/what-is-responsible-investment/4780.article>

¹³ Source: <https://www.unpri.org/an-introduction-to-responsible-investment/what-is-responsible-investment/4780.article>

¹⁴ Source: <https://www.cfainstitute.org/en/research/esg-investing/sustainable-investing>, Retrieved July 25, 2022.

¹⁵ Source: Source: CFA, Certificate in ESG Investing Curriculum, Chapter 1, p. 18.

¹⁶ Source: UN Principles for Responsible Investment “Introductory Guides to Responsible Investment: Screening,” May 29, 2020. Available at: <https://www.unpri.org/introductory-guides-to-responsible-investment/an-introduction-to-responsible-investment-screening/5834.article>, Retrieved March 17, 2023.

Note: there are no common industry guidelines for making the decision to adjust the discount rate when ESG factors are difficult to quantify.¹⁷ In addition, as Cornell and Damodaran (2020) point out: governance “has historically been defined in research in terms of responsiveness of managers at publicly traded companies to their shareholders.”¹⁸

When building a portfolio, analysts use an assortment of indicators, data sets and techniques in the examination of environmental and social concerns. The following table provides examples of four ESG integration strategies: fundamental analysis, quantitative tools, smart beta strategies, and passive strategies.

Table 1: ESG Integration Strategies

<p>Fundamental Analysis - investors use company data and informed assumptions to estimate future performance of a firm and assess the current fair market value.</p> <p><i>Example:</i> Relevant ESG factors can be integrated by adjusting revenue and operating costs, based on assessments of labor issues, R&D budgets, litigation risk, and governance.</p>	<p>Quantitative Tools – investors apply mathematical models along with systematic rules to estimate the current fair market value of an asset.</p> <p><i>Example:</i> “Quants” incorporate ESG data and/or ratings alongside traditional metrics such as momentum and volatility and often use their findings to adjust the weights of positions within a portfolio.</p>
<p>Smart Beta Strategies – are relatively new innovations to blend passive and active investment strategies to create portfolios that differ from conventional indices.</p> <p><i>Example:</i> Companies with high ESG scores may be added to a portfolio following a rules based selection process.</p>	<p>Passive Strategies - are typically indices of funds that are weighted by fixed proportions without regards to market conditions.</p> <p><i>Example:</i> Indices of stocks from specific sectors may be created, for example low carbon or water indices.</p>

For additional detail see: "A Practical Guide to ESG Integration for ESG Investing," *Principles for Responsible Investing*, Available at: <https://www.unpri.org/listed-equity/a-practical-guide-to-esg-integration-for-equity-investing/10.article>, Retrieved September 23, 2022

Beyond considerations for ESG investing strategies when building a portfolio, there are also active ownership or stewardship strategies. The PRI defines *active ownership* as “the use of the rights and position of ownership to influence the activities or behaviour of investee companies.”¹⁹ Some examples of how passive investors can also play a role in stewardship include: voting on shareholder resolutions, supporting ESG research and data providers, and advocating for ESG policies at the corporate, regulatory and governmental levels.²⁰

¹⁷ Source: “ESG Integration in Listed Equity: A Technical Guide,” PRI April 2023 p. 31, Available at: <https://www.unpri.org/download?ac=18407>, Retrieved May 18, 2023.

¹⁸ Source: Cornell, Bradford and Damodaran, Aswath, Valuing ESG: Doing Good or Sounding Good? (March 20, 2020). NYU Stern School of Business, Available at SSRN: <https://ssrn.com/abstract=3557432> or <http://dx.doi.org/10.2139/ssrn.3557432>, Retrieved May 30, 2023.

¹⁹ Source: “Introduction to Active Ownership in Listed Equity,” UNPRI, Available at: <https://www.unpri.org/listed-equity/introduction-to-active-ownership-in-listed-equity-/2719.article>, Retrieved May 30, 2023.

²⁰ Source: “How Can a Passive Investor be a Responsible Investor?,” PRI, Available at: <https://www.unpri.org/download?ac=6729>, Retrieved May 18, 2023.

IMPACT INVESTING

“From an investment prospective, a grant is simply a very bad investment. It has a [negative]100% return, with zero volatility. The only justification for it is that it entails some positive social effect. But mightn’t there be ways to achieve similar social impact while recovering a portion of the capital? Even a money-losing investment, in this context, would be better than a grant. In a world where most investors are accustomed to ignoring opportunities with returns below the risk-free rate, this type of analysis requires significant mental adjustments.” – Evolutions in Sustainable Investing²¹

Impact investing – “investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.”²² The intention to generate measurable social or environmental impact puts an explicit focus on positive impact. That distinguishes the practice from “negative screens” used in socially responsible investing (SRI), where investors filter out sectors in which they do not wish to invest, such as tobacco, weapons, or alcohol.²³

Many types of investors are entering the impact investment market. Depending on the investor’s strategic goals impact investments provide a range of risk and return profiles including below market returns. The inherent subjectivity of goals and of placing dollar values on the achievement of impact goals poses problems for assessment.²⁴

Table 15: Target returns by organization type

	n	Below-market	Market-rate
Fund managers: for-profit	135	16%	84%
Fund managers: not-for-profit	32	72%	28%
Foundations	34	71%	29%
Banks / diversified financial institutions	13	31%	69%
DFIs	12	25%	75%
Family offices	9	22%	78%
Permanent investment companies	7	29%	71%
Pension funds	5	0%	100%
Other	19	58%	42%

Note: ‘Other’ organizations include university endowments, non-governmental organizations, corporations, community development finance institutions, cooperatives, and social impact investment wholesalers.

Source: GIIN

For additional detail see: "Annual Impact Investor Survey 2019," *GIIN*, Available at: https://thegiin.org/assets/GIIN_2019%20Annual%20Impact%20Investor%20Survey_webfile.pdf, Retrieved May 31, 2023

²¹ Source: Evolutions in Sustainable Investing edited by Cary Krosinsky, quoted from Chapter 38 p.436 written by Lloyd Kurtz

²² Source: Global Impact Investing Network (GIIN) Available at: <https://thegiin.org/impact-investing/need-to-know/>, Retrieved May 28, 2023

²³ Source: “A Short Guide to Impact Investing,” Case Foundation, Available at: <https://casefoundation.org/wp-content/uploads/2014/09/Short-Guide-Oct2015-Digital-FINAL.pdf>, Retrieved May 28, 2023

²⁴ It’s important to note that “one investor’s valued objectives may be loathed by another; while most people would celebrate a clinic providing low cost eye surgery, some would object to a clinic providing low cost abortions.” See Brest, Paul and Born, Kelly “Unpacking the Impact in Impact Investing” *Stanford Social Innovation Review*, August 14, 2013, Available at: https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing

ESG & IMPACT DATA PROVIDERS

There are many companies that offer ESG data services, a few of the most notable are listed below. *Note:* ESG scores have been shown to be poorly correlated across providers.²⁵

Bloomberg ESG Data Service provides environmental, social, and governance data for a global universe of publicly listed companies.

Carbon Disclosure Project (CPD) provides a global information system for investors, companies, cities, states and regions to manage their environmental impact.²⁶

Dow Jones Sustainability Indices (DJSI) track the performance of companies based in terms of economic, environmental and social criteria.²⁷

Global Reporting Initiative (GRI) Sustainability Reporting Standards are a set of voluntary guidelines for organizations to report on their sustainability performance.²⁸

Greenhouse Gas Protocol has developed a set of tools to help companies calculate their greenhouse gas emissions and measure the benefits of climate change mitigation projects. In 2016, 92% of Fortune 500 companies responding to the CDP used the GHG Protocol directly, or indirectly through a GHG Protocol-based program.

Morningstar (Sustainalytics) produces ESG risk ratings for more than 16,000 companies.

MSCI ESG Research provides in-depth research, ratings, and analysis of the ESG-related business practices of thousands of companies worldwide using a rules-based methodology that identifies leaders and laggards relative to peers.²⁹

Sustainability Accounting Standards Board (SASB) has developed 77 industry standards that are specific to each sector and are linked to the concept of materiality for investors.³⁰

Task Force for Climate-related Financial Disclosures (TCFD) was created by the G20's Financial Stability Board to enable stakeholders to better understand carbon-related asset concentrations in the financial sector, as well as the level of exposure of the sector and the financial system to climate-related risks.³¹

World Economic Forum (WEF) "Stakeholder Capitalism Metrics" at the 2020 Annual Meeting in Davos, 120 of the world's largest companies supported efforts to develop a common core set of metrics on non-financial factors and sustainable value creation for their investors and other stakeholders. The metrics are based on existing standards, with the near-term goals of accelerating convergence among major private standard setters and bringing greater comparability and consistency to ESG reporting.³²

²⁵ Source: <https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sa-ratetheraters-2019-1.pdf>, Retrieved May 18, 2023.

²⁶ <https://www.cdp.net/en/scores/cdp-scores-explained>, Retrieved May 31, 2023

²⁷ <https://www.spglobal.com/spdji/en/landing/investment-themes/sustainability/>, Retrieved May 31, 2023.

²⁸ <https://www.globalreporting.org>, Retrieved May 31, 2023

²⁹ <https://www.msci.com/our-solutions/esg-investing/esg-ratings>, Retrieved May 31, 2023

³⁰ <https://www.sasb.org/standards/download/>, Retrieved May 31, 2023

³¹ <https://www.fsb-tcfd.org/about/>, Retrieved May 31, 2023.

³² <https://www.weforum.org/stakeholdercapitalism/our-metrics>, Retrieved May 31, 2023