Applying ESG integration to mitigate risks, enhance returns

Experienced practitioners believe ESG integration represents a company’s – ESG drivers and conventional financial drivers – to be captured and assessed as so as to arrive at a more informed investment decision.

Defining materiality

A cornerstone of the ESG integration work shape might be ‘CFA Essentials and Principles for Responsible Investment’ (2006) that provided definitions for ESG factors. Although different definitions for materiality apply, the consensus among investors is that what counts as a material ESG issue is a fundamental value driver and can cause confusion. The failure of governance issues such as executive pay, corporate tax, and an ESG issue is that it is often difficult to associate any governance issues with financial and ethical issues. Often, however, if you look at the short-term and long-term, you can see that different ESG factors are material to different investors. The market for ESG integration requires all material value drivers of a company.

privacy concerns

Privacy concerns have probably over the last 20 years been considered a material factor for businesses and society. Fast forward to the present and you can see that it is a material factor that has become even more material over the years. The consensus among investors is that ESG issues are material to investors with different investment horizons. Although different definitions for materiality apply, the consensus among investors on what that means is what they are clear about. It is not necessarily any more difficult to integrate social factors into quantitative fundamental analysis than it is difficult to integrate environmental factors into quantitative fundamental analysis.

Quantitative integration versus qualitative integration

A workshop participant asked another question: “What is the threshold for calling it material? Is it a price change of 1 per cent, 2 per cent, or more? Is it about the probability of impact or probability of default? On a quarter or a percentage, is it the intrinsic value and the market value?”

Again, the answer will vary from investor to investor. What will also vary is the mix of quantitative analysis and qualitative analysis undertaken to assess the materiality and financial impact of ESG factors and make an investment decision. There are a number of different approaches to doing this, each having its own strengths and weaknesses. A well-thought-out framework for all of these and possibly even a systematic approach to developing different frameworks for ESG integration.

Increasingly, investors are quantitative and increasingly interested in ESG issues. There are a number of approaches to doing this, each having its own strengths and weaknesses. Some investors believe that ESG integration processes benefit from a holistic, systematic approach to investment analysis, whereas discretionary analysis is more qualitative. Some investors believe that ESG integration processes benefit from a holistic, systematic approach to investment analysis, whereas discretionary analysis is more qualitative.

You must, as an investor, take into account what society views as ethical or unethical and try to predict changes in society’s views on ethics, just like you would try to predict the market action or a service that a company offers. In this context, you can see that ESG issues are also ethical issues. The question is: ‘Are you a risk manager or an investor?’. As you start to see that ESG issues are also ethical issues, there is a clear opinion on what you want to do.

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Although different definitions for materiality apply, the consensus among investors is that what counts as a material ESG issue is a fundamental value driver of a company or society that affects the income of all participants in the same way. ESG issues are material to investors with different investment horizons, across different regions, or across different industries. Some investors believe that ESG issues are material to all investors, whereas others believe that they are not material to all investors, depending on the time horizon. In this context, you can see that ESG issues are also ethical issues.

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