

PRI Academic conference 2010
Mainstreaming responsible investment

A fund manager's dilemma: Integrating Environment, Social and Governance (ESG) principles throughout the process of managing investment portfolios

Dennice Allen, PhD Candidate
School of Finance, Economics and
Marketing

Introduction

Objectives

Research question

What are the legal, institutional and market considerations that influence a fund manager's ability to incorporate Environment, Social and Governance (ESG) principles into the investment decision making process?

Methodology

Quantitative

Qualitative

Literature review and theoretical framework

Current findings - challenges

Requirements from today's session

Appreciate feedback on: (1) presentation, (2) Nature of topic, and (3) content

Research tenets

- (1)** What are the legal, institutional and market considerations that influence a fund manager's ability to incorporate ESG principles into the investment decision making process?
- (2) What is the relative importance of each of these considerations in different countries?
- (3) What specific ESG factors are incorporated in the investment decision making process?
- (4) What is the impact on fund performance (returns and risk) of incorporating ESG factors in the investment management process?
- (5) Can ESG principles be incorporated in the investment management process uniformly across asset classes?
- (6)** Is the adherence to the principles of responsible investment in a convergent or divergent state across nations?

Two methods will be undertaken to consider the application and impact of ESG principles within the investment management process – a quantitative approach and qualitative approach.

Methodology - quantitative

- Seek to identify a set of ESG factors and examine the explanatory power of each factor.
 - The data will cover managed funds in China, Australia, the United Kingdom and Dubai
 - Monthly fund data and benchmark data (eg FTSE Global Sustainability Index Series and similar) to be used
- The date range to fall between the years of 1980 – 2008
 - Split into sub-periods of 1980 – 1989, 1990 – 1999, 2000–2004, 2005-2008.
 - The data is to be split into discrete periods that allow for a review of specific event-induced results.
- For comparative purposes three return generating models will be employed:
 - Market model
 - Three factor model as employed by Fama and French (1993)
 - Four factor Momentum model as expressed by Carhart (1997)

Portfolio performance metrics such as the Sharpe Ratio and Information Ratio will be constructed and tests for performance persistence will be conducted also.

Methodology - qualitative

A set of case studies will be conducted amongst managed funds in selected countries (Australia, China, Dubai and the UK), to address the following broad topics:

- Does the investment fund have a RI strategy currently in place, if so what is the asset coverage.
- Is this based on E, S and/or G principles. How was this formed – internal or external
- Have the United Nations backed Principles of Responsible Investment (UNPRI) been adopted and how does this flow through the investment management process
- Does the investment fund determine that ESG guidelines are part of a company's fiduciary duty
- How is the ESG policy implemented (positive/negative screening, active engagement, mix)
- Are any training programmes in place that specifically address ESG principles
- What governance mechanisms are in place to assess the on-going ESG principles

Literature review

CHINA

- Optimistic signs exist. Recent legal and regulatory changes have improved conditions for corporate and capital market development
- However, perceived constraints remain
- Benefits from other countries may highlight positive initiatives
- Corruption, human rights and adequate application of Labor law issues persist

AUSTRALIA

- The trend towards acceptance of ESG related factors in the investment decision making process has begun to grow
- Australia has created a cohesive framework that seeks to regulate elements of the investment arena
- A sea change has developed within the Australian investment community

Literature review

UNITED KINGDOM

- There are mixed views towards the use of ESG factors in the investment decision making process.
- Recent studies (EIRIS, UKSIF, Thompson Reuters) indicate a steady growth , although consistent barriers remain
- Systems for measuring and rewarding returns (not highlighting fulfilment of long term liabilities)
- Competencies of service providers (such as sell side analysts)
- Investment practices that focus on short term-ism

DUBAI

- Investment management regulations within Gulf Co-operation Council (GCC) are influenced by both a 'conventional' style regulatory reporting and Sharia Law.
- Early 'seeding stage' by organisations - Hawkamah Institute
- Abu Dhabi - NASDAR

Theoretical framework

Institutional theory

- The examination of convergence or divergence (and possibly a combination of the two), is essential in understanding the long term prospects of SRI. Is SRI here to stay?
 - As SRI takes on uniform standards, there is an increased likelihood that it leads to normative practices, organisations become homogeneous and therefore institutionlised

Global convergence, Local divergence or a combination

- Recent studies (Louche 2009) indicate that SRI differs from region to region and even country to country

Financial theory

- To be explored: market model, efficient market hypothesis, behavioural finance

Challenges and next steps

Research tenets - refinement

Methodology

- Quantitative analysis
 - Data availability
 - Time horizons
- Qualitative analysis
 - Case studies

Literature review

- Universal owner to be included

Theoretical framework

- Institutional theory
- Financial theory