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"G"overnance Drives Performance in ESG Portfolios

By Kurt Lieberman, CEO, Magni Global Asset Management

Sustainable, responsible and impact investing have seen explosive growth over recent years and the trend is accelerating. From 2014 to 2016, these investments enjoyed a growth rate of more than 33%, increasing from $6.57 trillion in 2014 to $8.72 trillion in 2016. That's more than one out of every five dollars under professional management in the United States today — 22% of the $40.3 trillion in total assets under management, according to Cerulli Associates.

The explosive asset growth in these areas is largely driven by the strong desire of many individuals and institutions to find ways to invest consistent with their values and to incorporate sustainability issues into their portfolios, while retaining prospects for investment returns. Millennials are especially keen on the idea of responsible/sustainable investing. A survey by US Trust of high-net-worth individuals found 85% of millennial respondents agree that social or environmental impact is important to investment decisions, compared with 70% of generation X and 49% of baby boomers.[1]

From SRI to ESG: an Inclusive History

This increased popularity also reflects improvements made to sustainable offerings. When responsible investing began it was known generally as socially responsible investing (SRI) and consisted of primarily negative screening (excluding companies inconsistent with values). The investment returns traditionally underperformed the market. It has since evolved to include positive/best-in-class screening, ESG (Environmental, Social, Governance) integration, sustainability-themed investing, impact investing, and corporate engagement and shareholder action. These evolutions extend the reach of values into many different aspects of finance. One of the most important is the increasing use of positive screening which has been demonstrated to provide better investment results than negative screening. The same studies that have demonstrated the better investment results from positive screening also identify the strong emphasis on governance in investment portfolios as improving ESG investment performance.

Understanding the G in ESG

The most widely used investment strategies in Sustainable Investing are based on ESG issues. Most of the existing ESG investment products focus on screening factors that cover environmental and social aspects.

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[1] Source: 2017 U.S. Trust Insights on Wealth and Worth® survey

So, what about the G? The focus of most governance in ESG investing is at the company level and emphasizes the board of directors (independence, diversity, oversight, remuneration, term limits compliance), executive compensation, investor board relations (proxies, etc.), and corporate issues (auditing, labor, human rights, risk management, ESG and sustainability reporting). These existing factors mostly relate to the structure of a company and the intent of its leaders. As we have seen, behavior can be inconsistent with structure and intent. But behavior has historically been hard to measure. Consequently, it is important to evaluate whether the company is open, honest and transparent so that behavior can be observed.

Companies conform to the legal and regulatory systems, as well economic infrastructure, of the countries in which they operate. The country where the company's stock is listed has a very strong influence on conformance, e.g., listing requirements, accounting requirements, and corporate structure requirements. Understanding country governance requires more than financial data. While GDP is a measure of output, economic output is an incomplete measure for investment purposes. Governance should measure a country's ability to create an economic, legal, and regulatory environment where output can grow, investment opportunities are attractive, and investor rights are protected. This data is not easy to find and more difficult to quantify in the investment process.

Governance is a critical driver of performance

We've seen more research recently on the role that governance plays in ESG portfolios. "The results are unsurprising regarding good governance being a critical driver of investment performance," says Devan Kaloo, Head of Equities at Aberdeen Asset Management. He also notes that "…Aberdeen believes companies adopting best practices in corporate governance will be more successful in their core activities and deliver enhanced returns to shareholders." Deutsche Bank's 2012 whitepaper, *Sustainable Investing: Establishing Long-Term Value and Performance,* documents that better ESG performance came from positive screening and **governance had the strongest influence on financial performance**.[2] Nearly 90% of financial services decision-makers considered effective governance to be a critical driver of investment performance, according to data in the paper.

Governance can Make Environmental and Social Improvements more Sustainable

Research is beginning to be available that proves countries with good governance tend to have better environmental and social performance. Such a concept intuitively makes sense. The Social Progress Imperative (SPI) created its Social Progress Index in 2013 to measure social and environmental performance for every

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[2] "Sustainable Investing: Establishing Long-Term Value and Performance", DB Climate Change Advisors of Deutsche Bank Group, June 2012, page 8

country in the world. Their aim is to provide a framework for government, business and civic leaders to better measure the quality of people's lives. By meeting the needs of their citizens, a country's economic growth should flourish and everyone should benefit. Economic growth without social process creates risks of discontent and social unrest. SPI states, "We must move beyond Gross Domestic Product (GDP) per capita and make social and environment measurement integral to national performance measurement." Their vision is a world in which social progress sits alongside economic prosperity as a measure of a sustainable society. The SPI ranking of countries aligns relatively well with country rankings based on governance. Increasingly we should see research at the company level where companies with better governance will likely have better environmental and social performance.

Governance and the Caux Round Table

The Caux Round Table (CRT) is a non-profit organization whose vision/mission is for a free, fair and prosperous global society built on the twin pillars of moral capitalism and responsible government. The CRT launched its Principles for Business in 1994, and presented at the United Nations World Summit on Social Development in 1995.

The Principles for Business articulate a comprehensive set of ethical norms for businesses operating internationally or across multiple cultures. The CRT developed the Arcturus Corporate Responsibility Assessment Survey (Arcturus) to provide companies with a 360-degree self-assessment of their corporate responsibility and sustainability performance based on the individual assessments of directors, senior executives and/or employees. Arcturus is designed to engage senior leadership of a company in the behaviors across the full range of stakeholders in a company; not only shareholders and employees, but also customers, suppliers, competitors, and the communities in which the company operates. This comprehensive survey covers the G as well as many aspects of the S.

The Arcturus survey tool can be restructured to perform an external assessment of companies for the entities' governance. Such assessments are unique in providing a measurement of behavioral consistency with best practices in a holistic view and the resulting scores provide valuable investment information.

Portfolio Construction Starts with "G"

In summary, corporate governance that is open, honest and transparent, and is fair and equitable to all constituents of a company has been shown to be an indicator of that company's financial success. Simply put, good governance has been shown to be an important indicator of performance. It therefore makes good sense to start with governance when constructing ESG portfolios.

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Magni Global Asset Management provides management and advisory services based on the belief that Countries Matter™ when investing internationally and applies its proprietary research-driven investment strategy to create global equity portfolios. As part of its research, Magni ranks the investible countries of the world. The firm also researches corporate company-level governance to produce U.S. portfolios based on secular, Catholic and Islamic governance models.