# Responsible investment: debunking the myth

March 2021

**Every investor has financial goals. They also have a wide range of investment options to choose from. One option that has been gaining in popularity in recent years is responsible investment (RI). A growing number of investors want to make a difference by supporting a sustainable prosperity. When selecting investments, these investors take non-financial criteria into consideration. However, they may buy into the persistent myth that investing responsibly means compromising on returns. So is responsible investment an oxymoron? Here are the facts.**

## What is RI?

Buzzwords like ethical, socially responsible, thematic and sustainable investment abound. This can lead to confusion about what responsible investment means, so let's start with a definition.

Simply put, responsible investment involves considering environmental, social and governance (ESG) issues when selecting securities and allocating assets. When evaluating a company using an RI approach, you look at non-financial criteria that could have a substantial impact on an investment's value in addition to carrying out traditional financial analysis.

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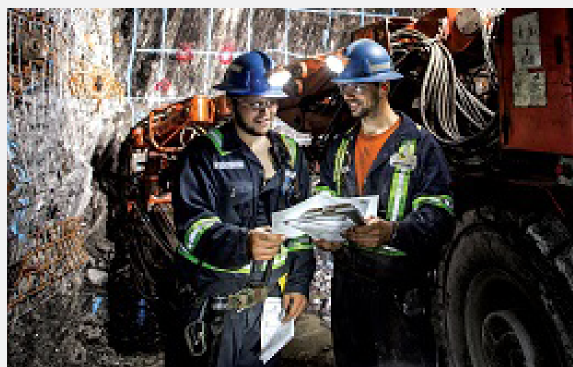

### Example: A mining company

As part of its business model, a mining company that operates near Indigenous lands should manage relations with stakeholders, including First Nations. It should also take steps to minimize the environmental impacts of its operations and provide for worker health and safety. If it doesn't, the company will be exposed to reputational risk in the event of a dispute or incident, which could have serious repercussions on its long-term profitability.

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# Profitable or unprofitable? A persistent myth

The first generation of "socially responsible" funds didn't always offer attractive financial performance, partly because most securities were excluded. Critics of this approach were quick to argue that "social" values were contrary to financial discipline. They said it limited the range of opportunities since there were so few eligible securities.

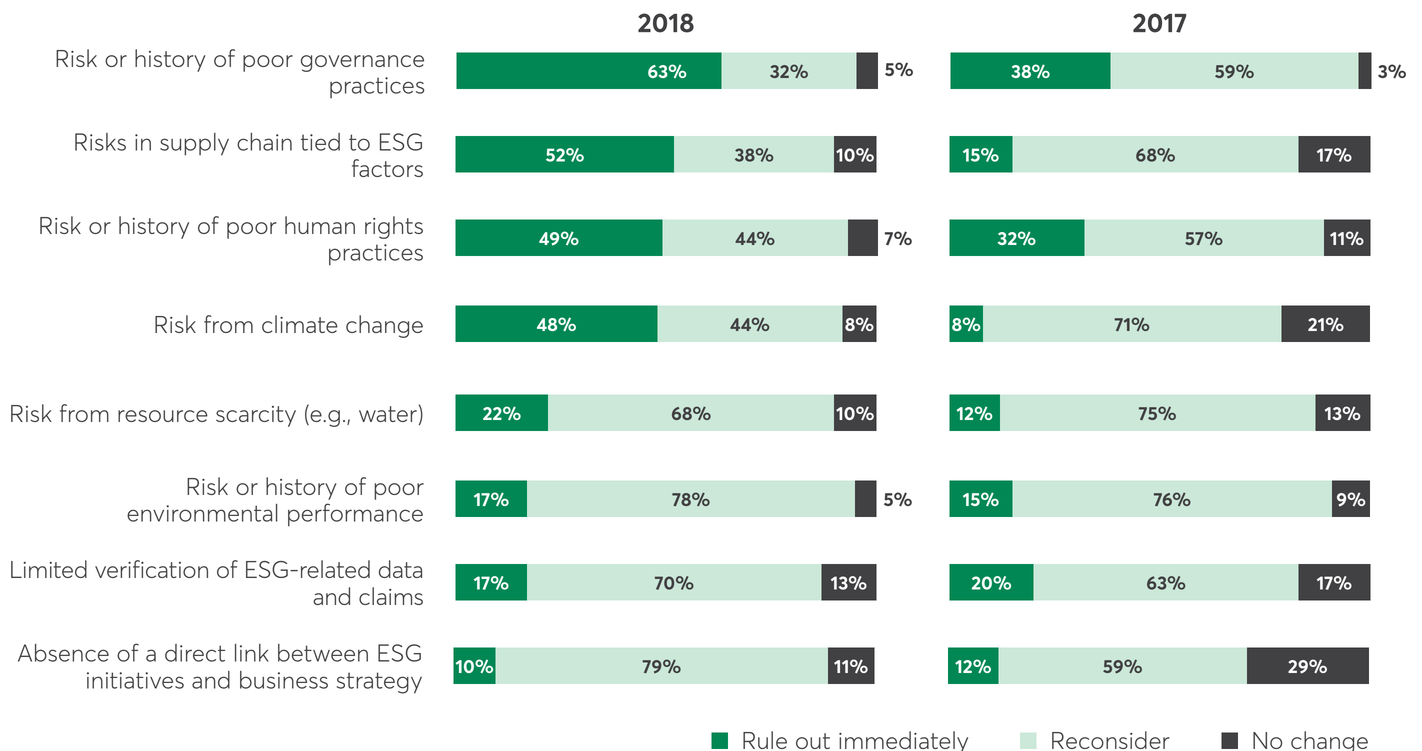
That was all it took for the myth to take hold that responsible investment practices generate lower returns than traditional approaches. And this myth lives on despite hard evidence that responsible choices can pay off.

# The trend toward RI

Right now, there's a growing movement toward responsible investment. An EY survey shows that institutional investors' decision-making process has evolved. A strong majority of respondents said that including ESG criteria doesn't hurt financial performance.

### Figure 1: Governance, supply chain, human rights and climate change are the main ESG factors in investment decision-making[1]

How would the following disclosures about a prospective investment affect your investment decision?




[1] Source: "Does your nonfinancial reporting tell your value creation story?", EY, 2018
https://www.ey.com/en_gl/assurance/does-nonfinancial-reporting-tell-value-creation-story.

This shift is due in part to the improvement in responsible investment approaches over time. By incorporating ESG factors into the security selection and asset allocation process, portfolio managers can identify risks and investment opportunities that are sometimes overlooked in traditional financial analysis.

For example, as the world fights climate change, some companies face a greater risk that their assets will decline in value if fossil fuel use drops sharply. If this were to happen, they would be left with "stranded assets." But these same companies could capitalize on the energy transition by investing in renewable energies.

Of course, there are many other ESG factors that could have impacts large and small. Understanding these factors and their impact on investment value can inform decisions that will help a portfolio outperform in the long term.

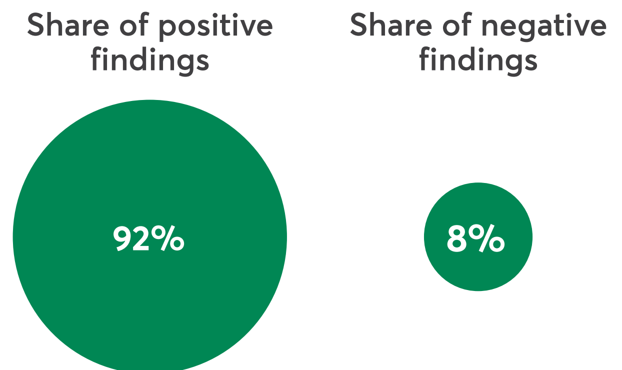
Perceptions about responsible investment are changing. Leading financial institutions are advertising their responsible investment practices, and companies are more attentive to investor concerns about ESG issues.

## The facts contradict the myth

A number of studies have debunked the myth that responsible investment is synonymous with underperformance. According to a meta analysis that appeared in the *Journal of Sustainable Finance & Investment*, over 90% of the 2,000 studies published since 1970 showed a neutral or positive correlation between corporate ESG performance and financial performance.[2] In other words, responsible investment doesn't mean inferior returns.

### Figure 2: Paying attention to environmental, social and governance (ESG) concerns does not compromise returns—rather, the opposite.[3]

Results of > 2,000 studies on the impact of ESG propositions on equity returns



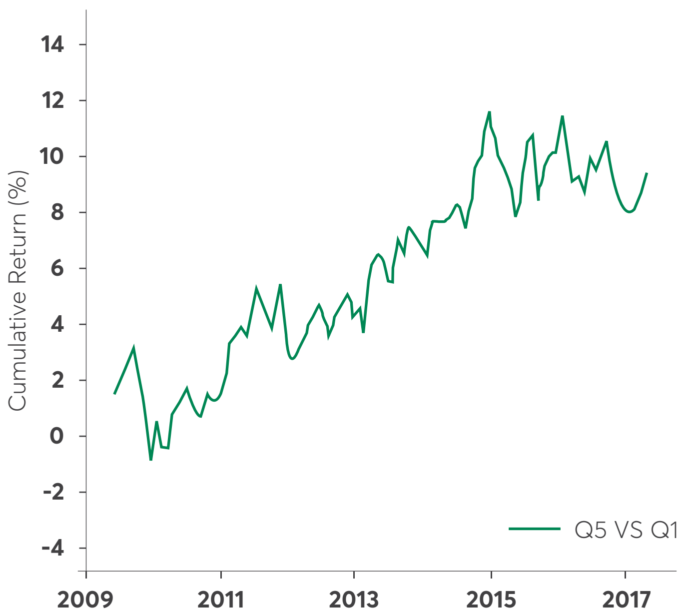

Source: Gunnar Friede et al., "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies, "*Journal of Sustainable Finance & Investment*, October 2015, Volume 5, Number 4, pp. 210-33; Deutsche Asset & Wealth Management Investment; McKinsey analysis

[2] Source: Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment, 5:4, 210-233. https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917

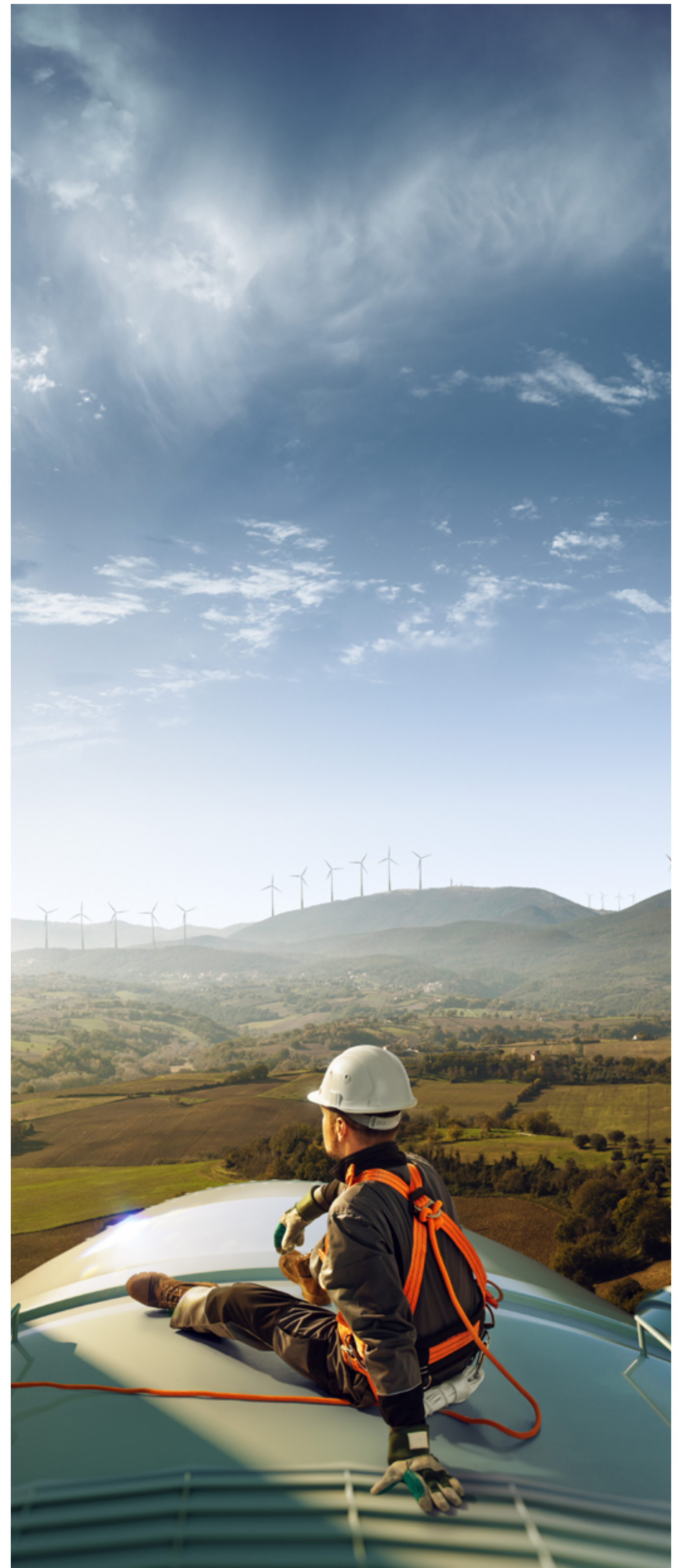
[3] Source: "Five ways that ESG creates value", McKinsey & Company, 14 novembre 2019. https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value

Other studies show a strong negative correlation between corporate ESG performance and stock volatility. This means responsible investment is associated with lower risk. And an MSCI study of over 1,600 securities between 2007 and 2017 showed that a company's ESG ratings are a good indicator of its financial performance. It found that companies that follow ESG best practices tend to be more profitable and pay higher dividends while having lower residual risks, less systemic volatility and a superior valuation.[4]

## Figure 3: Financial Performance of Top versus Bottom ESG Momentum Quintile[4]

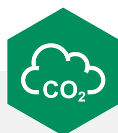



Notes: Cumulative performance differential of the top ESG momentum quintile versus the bottom ESG momentum quintile. ESG momentum is defined as the 12-month change in ESG score.



[4] Source: Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance", Guido Giese, Linda-Eling Lee, Dimitris Melas, Zoltan Nagy, and Laura Nishikawa, The Journal of Portfolio Management, July 2019, 45(5) 69-83. https://www.msci.com/www/research-paper/foundations-of-esg-investing/0795306949

# How ESG factors impact returns




### Emissions

Low emitters based on total greenhouse gas and Scope 1 emissions **logged 3.1% alpha* in relevant sectors**.

### Employee turnover

Low employee turnover is good for companies, **generating 0.8% (over 3 years) and 3.0% (over 5 years) in annual alpha***.

### Diversity

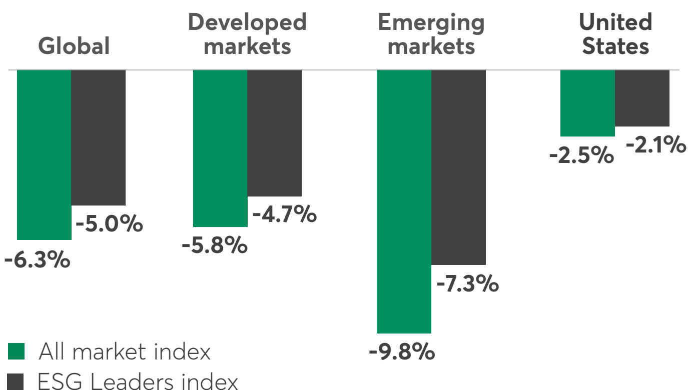
Companies with higher levels of female employees perform well and have seen **average annual alpha* of 3.3%** across all sub-sectors.

*Return in excess of a specified benchmark.
Based on retroactive tests. Source: The PM's Guide to the ESG Revolution, Goldman Sachs, April 2017, based on constituents of the MSCI ACWI global equity index, 2010–2015.

As part of a joint research project, Desjardins Global Asset Management (DGAM) and CIRANO showed that you can substantially reduce a portfolio's carbon footprint without altering its risk-return characteristics[5]. Based on the study's findings, Desjardins set out to reduce the carbon footprint of its portfolio by 25%.

And during the uncertainty created by the COVID-19 pandemic, companies with higher ESG scores were more resilient.

### Figure 4: Performance over the first half of 2020 (up to June 30, 2020).[6]




[5] Source: DGAM, 2017

[6] Source: https://www.jpmorgan.com/wealth-management/wealth-partners/insights/sustainable-investing-in-the-spotlight

## Responsibility and profitability can go hand in hand

In light of these observations, more and more investors believe that considering ESG factors can have positive impacts on portfolio returns in the long term. In their view, responsibility and profitability can go hand in hand. To achieve their objectives, investors must understand the nuances of the various responsible investment approaches available. A poor grasp of these differences could result in greenwashing, which in turn reinforces the myth of poor profitability.

Nevertheless, it's clear that considering ESG factors during security selection and asset allocation to manage risk soundly and identify investment opportunities is entirely consistent with a portfolio manager's fiduciary duty. The facts therefore suggest that responsible investment isn't an oxymoron after all. In fact, by definition, shouldn't all investment be responsible?

# The Desjardins Global Asset Management approach

At DGAM, we're proud to do our part to create a sustainable, inclusive prosperity. Our responsible investment practices are in keeping with Desjardins Group's mission of improving the social and economic well-being of people and communities.

## RESPONSIBLE INVESTMENT:

**DGAM's RI approach is grounded in 4 key convictions**

### IS CONSISTENT WITH OUR MANDATE AS PORTFOLIO MANAGERS.

We believe that incorporating ESG criteria into investment selection and allocation practices, while also providing effective risk management and seizing investment opportunities, is in complete alignment with portfolio managers' **fiduciary duty**.

### REQUIRES ACTION AND INNOVATION.

For innovation to be possible, actions must be grounded in facts and supported by exhaustive research. RI approaches have evolved and become more sophisticated over the years. Meanwhile, recent studies have **dispelled the myth that responsible investments underperform**.[7]

### INVOLVES INSPIRING AND INFLUENCING.

**Shareholder engagement** is an effective means to effect change at organizations. Dialogue and proxy voting allow us to exercise positive influence over companies. These actions often turn out to be beneficial for all stakeholders involved.[8]

### MEANS TAKING A LONGER-TERM VISION.

We need incentives to shift from a short-term perspective to a **long-term**, future-oriented vision of investing.

[7] Source: Gunnar Friede, Timo Busch & Alexander Bassen, December 2015. *ESG & Corporate Financial Performance: Mapping the global landscape. Deutsche Asset & Wealth Management and Hamburg University.*

[8] Source: E. Dimson, O. Karakas & X. Li, *Active Ownership*, August 2015. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724.

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