Sustainable investing beyond compliance: Listed equities

Insights from BlackRock Systematic Active Equity
Sustainable investing beyond compliance: Listed equities

Investors today have made sustainable investing a fundamental part of their strategies, yet sustainable investment still remains a broad, and often vague, category, with few trustees or investors as experts. Given this state of affairs, and because we care deeply about ESG (environmental, social and governance issues) and the principles of sustainability that underlie it, the question on our minds is this: Can we move beyond a compliance-only mindset, and in the process make sustainable investing more sustainable?

For most of its recent history, sustainable investing and ESG has been characterized by a clamor for externally imposed standards. A host of third-party vendors has responded to this demand by providing ESG scores or ratings. To date, the information used for these scores relies heavily on company disclosures, which third parties then process into scores and then into indices. Passive products based on such indices represent a cost-effective implementation of basic ESG features.¹ While this approach can provide comfort to those who are still getting used to the whole idea of considering ESG issues, vendors inevitably miss out on meaningful and insightful observations about firms.

So, what about those — like us — who genuinely want to capture differences among companies and are willing to face the conceptual and measurement challenges head-on? BlackRock CEO Larry Fink, in his 2020 letter to CEOs, emphasized the importance of companies developing strategies and operations that account for long-term outcomes, and what impacts them, in addition to today’s shareholder returns. In this paper, we offer some more ambitious solutions, and in so doing also highlight key weaknesses of third-party ratings. We endeavor to offer an approach to sustainability that is driven by results, rather than mere compliance; one that is intentional, rather than ad-hoc.

Our goal, summarized in Figure 1 below, is to make use of multiple data sources and maintain an analytical approach — the right column of the chart — so that we can deliver objective, accurate and meaningful sustainability in our portfolios.

**Figure 1: Results vs. compliance mindset**

<table>
<thead>
<tr>
<th>Compliance mindset</th>
<th>Analytical approach</th>
<th>Results mindset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reactive, and growing sets of ad-hoc indicators <em>respond to market areas of interest.</em></td>
<td>Components of an analytical approach: Help observe and predict outcomes.</td>
<td>Parsimonious set of indicators: <em>Help observe and predict outcomes.</em></td>
</tr>
<tr>
<td>Rely on company reports. <em>Bias toward firms/regions with more complete reporting.</em></td>
<td></td>
<td>Skepticism toward company reports: <em>Embrace indirect indicators of deep company attributes.</em></td>
</tr>
</tbody>
</table>

For illustrative purposes only.

---

2 Larry Fink 2020 Letter to CEOs.
1 What you measure matters

Basic screens such as to exclude things like tobacco or alcohol do present a few challenges to portfolio construction (discussed in the next section) but are reasonably unproblematic. We can be confident of achieving the limited objective of not investing in these specific areas.

The most popular way to go beyond basic exclusion screens and incorporate ESG views into investment decisions is to rely on external providers. These include MSCI and Sustainalytics; existing information service businesses; and a fast-growing set of startups that compile scores to provide assessments of companies on sustainability dimensions — essentially ESG “grades.”

However, even a quick glance at prominent ratings reveals some immediate problems; if we dig deeper, the picture becomes even murkier. The most obvious issue is the lack of agreement and consistency across prominent ratings providers (there are too many references to cite). This lack of commonality, which Professor Roberto Rigobon of the MIT Sustainability Initiative has dubbed the “aggregate confusion project,” springs from a host of reasons, including the use of different methodologies, definitions, measurements, and companies compared.

A second, and equally jarring, issue is regional bias. Some scoring approaches would go so far as to suggest that investors effectively underweight entire countries, at all times — even one as large as China. But we know from our experience, which includes investing in China by assessing locally sourced, unstructured information in local language, that such a bias is wrong and unnecessary. To avoid entire parts of the world that have significant growth and innovation damages investors (and the avoided nations). There are meaningful ways to differentiate company operations, including on sustainability dimensions, that don’t simply impute country-level considerations. ESG scoring agencies are becoming aware of the regional bias issues and some now advocate looking for companies that transcend their “country ESG.” While we agree that country-specific rules and norms impact business environments, we don’t agree that differences in sovereign assessments necessarily reflect genuine good, or poor, practices across individual companies.

A third problem with ESG scores is that of their reliance on company-reported information. In fact, we recently published a deep-dive study that shows, sadly, that such information often points in exactly the wrong direction. (Please see Figure 2.) The results of our study, which was global and received one of the Journal of Investment Management’s 2017 Markowitz prizes, remain true within countries, even China (2017-2018). In mid-2017, half the firms in the MSCI China Index universe had three or fewer ESG policies and of these only 13% had an ESG-related controversy in the next 12 months.

However, for the half who had more than three ESG policies and were thus presumed to be more “ESG-friendly,” the controversy incidence was over 60%.

---

3 Aggregate Confusion Website (accessed February 2019).
4 BlackRock, China’s Onshore Equity Markets, June 14, 2018.
5 ESG Disclosures Reflect Vulnerabilities, not Virtues, JOIM, Volume 15, Number 2, 2017.
6 2017 Journal of Investment Management Harry M. Markowitz Award. Please refer to the end of the paper for additional information pertaining to this award.
All companies need sustainability policies and we care deeply about ESG — and the principles that inspire it. Our goal, as we stress in our paper, is to understand why firms with more ESG policies in place often have more controversy incidents. The mistake many third-party data vendors make, in our view, is to assume the mere existence of a policy is a good thing and then credit companies for having a policy while completely ignoring company performance on the same dimension. In so doing, they may position an investment portfolio toward more controversial firms — the opposite of the intended outcome. We can see that an effort to simplify company ESG performance fails. Instead, we aim to be systematic by determining what considerations and metrics we should use and asking whether they actually work — we understand that what you measure matters.

In summation, while company disclosures are readily available, they generally don’t deliver the goods that investors seek. ESG reporting is not standardized, and even if it were, companies know far more about their businesses and problems than we do. Our research illustrates the challenges of misplaced reliance on corporate disclosures and of a simple compliance-based approach to ESG investing. Rules-based reporting may or may not uncover the insights that investors want to incorporate into sustainability portfolios.

**Figure 2: ESG policies and percent of firms with controversies**

![Chart depicting ESG policies and percent of firms with controversies](chart)

- Percent with ethics controversy
- Percent with anticompetitive action

Notes: Chart depicts ESG policies in a given year and the occurrence of a controversy in the following year in a sample of all MSCI World Index and MSCI EM Index firms covered by Thomson Reuters’ Asset 4 database from 2003 to 2014 (17,999 firm-years). The sample uses Thomson Reuters’ Asset 4 database Policy and Controversy definitions. Detailed notes and methodology presented in the published paper, “ESG Disclosures Reflect Vulnerabilities, not Virtues.” Abstract: It is widely believed that ESG investing reduces regulatory and reputational risks. In a large global panel, we find that business ethics controversies and regulatory issues are more likely for firms that disclose a richer set of ESG-friendly policies. The effect is attenuated by controlling for size, industry and country, but remains economically and statistically significant. We also show that some prominent ESG indices favor companies that disclose more ESG policies and, as a consequence, have greater controversy exposure than an ESG-unaware benchmark.  

7 ESG Disclosures Reflect Vulnerabilities, not Virtues. JOIM, Volume 15, Number 2, 2017.
An illustrative example: ESG vendors decide Nissan is rogue

As mainstream investors became aware of Nissan’s difficulties, causing the stock to fall, one group was cheering loudly: sustainability champions. That’s because Bloomberg Good Business reported that only 5 of 60 United States ESG funds surveyed held Nissan at the time. Certain funds even took out advertisements in Institutional Investor to proudly proclaim they had the wisdom to avoid Nissan as a holding, along with publishing third-party ESG ratings of Nissan’s reported ESG performance, as shown in Figure 3 below. Nissan went from “BBB,” to “BB,” then “B,” and finally “CCC.” The final slide to CCC took place in August 2018 — just after news of altered emissions testing became public in July 2018, and in the wake of the 2017 inspection scandal.

Figure 3: Nissan ESG rating history

Without intending any criticism of a particular fund, or approach, let’s focus on measurement and ask:

1) Exactly when did these surveyed funds decide that Nissan had gone rogue and move to “no hold” status? (We’ll talk more about exclusions in the next section.) Did these funds all sell Nissan at the moment it had an ESG rating from one of many providers move from B to CCC?

2) Are investing decisions so clear-cut and stark that moving by a letter grade should move multiple investment fund holdings from “pass” to “fail”?

3) Finally, how does company-generated messaging influence investor decision-making and opinions? We note with interest that Bloomberg praised ESG investors for avoiding Nissan at the end of 2018. But, just six months earlier, in May, Bloomberg Businessweek had positively profiled Nissan for its focus on promoting gender equality and recent success in attracting women engineers.

We aren’t against scoring — to the contrary, a quantitative approach demands it. However, we also believe it essential to take multiple issue areas into consideration when assessing sustainability, including indirect indicators of deep company attributes. Everything we consider must have an ability to tell us something about security performance, and not just headline issues. In determining what to measure, we insist that our research deliver objective, accurate and meaningful information that can give us an ability to help forecast and be predictive about likely outcomes, even as we describe and assess the current moment. It is this eagerness to measure what matters that often brings us to have a different view than the market: We take into account all of what we study about firms — regarding sustainability, and otherwise.
Robust sustainability portfolios are all about navigating difficult trade-offs

As investment managers, our work is to develop liquid, diversified, high-breadth, core holding stock portfolios in which we depart from prominent and liquid benchmarks in ways that reflect our research and our unique ability to derive investment insights using technology. We consider portfolio exclusions, previously discussed, as an option for certain investors. They are straightforward to implement (assuming we don’t attempt to address indirect exposure through supply chains) and effectively mute unwanted exposure to a specific company or kind of operating activity. But because our approach is to focus on the core of a portfolio — with “core” including hundreds of companies and a broad range of sustainability touch points — rarely do we encounter investors who are interested in only one sustainability issue.

On the contrary, we typically encounter investors who are motivated by multiple sustainability issues. For them, to avoid multiple companies and/or multiple kinds of operating activities at once would result in a significantly reduced investment universe. However, with our focus on breadth and a diversified core, we are able to meet the needs of such multi-issue investors and can deliver strong results by using our research to differentiate companies — not simply remove them.

In Figure 4 below, we illustrate the reduction in investment universe if exclusions are relied upon to express one, versus multiple, investor areas of interest. As you’ll see, once multiple issue areas are in play, the investment universe shrinks quickly and dramatically. Exclusion screens remain a viable approach for investors with niche sustainability interests, or those who don’t require listed equities in their portfolios (because at some point the significant use of exclusions amounts to minimal, or potentially no, investable listed equities). However, exclusions as a primary tool to construct a sustainability portfolio remain a limited or implausible option for investors with mandates to remain invested in publicly listed equities.

**Figure 4: Investment universe size and exclusions (illustrative)**

An illustrative example: Higher returns with lower carbon emission and no industry biases.

Carbon emissions offer a useful illustration of our insistence on measuring what matters and using research to develop portfolios that reflect informed trade-offs. A typical approach to express reduced carbon emissions in a particular portfolio would be to simply tilt away from major carbon-emitting industries and toward companies in less carbon-intensive industries. This seems simple enough, but does it really make sense? Is it what investors want? We would argue no — a more nuanced position entailing both measurement and research is more sensible and efficient.

Adherence to a dogma that suggests all utilities, materials companies, and energy firms must be underweight as a requisite to reducing carbon emissions in a particular portfolio is unnecessary. Figure 5 shows active weighting, deviations from reference benchmarks around which portfolios are built: slightly more than benchmark weight for materials and utilities sectors; nearly equal weight to the benchmark for the energy sector; and lower than benchmark weight for the industrials sector. In fact, as noted in research by Andersson, Bolton and Samama (2016) — and realized in our portfolios — it is possible to reduce carbon emissions by more than 50% versus a benchmark without taking on large industry misweights. A dynamic portfolio allows active holding weights of companies, and the industry sectors they represent, to change along with research findings.

We seek to deliver significantly reduced carbon emissions in diversified portfolios that demand sector weightings not dissimilar from a benchmark, and that are dynamic, with holdings and sector weightings designed to change over time. We expect improved financial performance from this approach. At first pass, this might seem surprising since there have been no significant regulatory or tax policies to punish large carbon emitters. But our research reveals something even more fundamental than regulatory risk: Lower carbon emission relative to industry peers is a reflection of superior efficiency.

In essence, carbon emissions represent an inevitable input and side-effect of most productive processes, and can thus be viewed as a measure of efficiency. Companies that produce with fewer emissions are more productive, and this can show up as stronger sustained profitability, as well as returns. (To understand more on our research about carbon and the economic intuition for carbon emissions, please see our research published in the Journal of Investment Management in 2018.) Using ESG issues to create a sustainable and profitable portfolio does require trade-offs, but these are not the easy ones that investors might assume and the investment universe in which they are made need not be narrow.

Figure 5: Portfolio illustration
Sector active exposures and carbon emission reduction vs. MSCI All Country World Index benchmark

---

Portfolio construction is key to sustainable investing

Active weighting, or deviations from reference benchmarks around which portfolios are built, can address multiple investment objectives simultaneously by, for example, meeting investor desire for sustainable investing insights, efficient risk management, and financial returns in a core portfolio. Comparing securities on the strength of a number of characteristics, and those characteristics in combination, is the goal. Portfolio construction that takes sustainability seriously has taught us that:

The combination of detailed research and multiple objective optimization allows for dynamic views about multiple research areas.

Discussions about sustainability and portfolio construction are often distilled to a startlingly simplistic perspective that essentially asks, “Are you seeking sustainability, or alpha?” But sustainability is not a binary. Active managers seeking to deliver investment results for sustainability portfolios are responsible for both sustainability outcomes and financial returns. We ourselves are able to optimize multiple objectives simultaneously because our research capabilities allow us to develop views that are both subtle and precise. Portfolio construction that allows for dynamic use of active risk to express views significantly mitigates the risk of clinging to stale, static perspectives about geographies, or industries.

Investors who employ a deep set of research and portfolio tools, as we do, aren’t required to think in terms of an either/or trade-off between “sustainability” and “alpha” — we expect, and can achieve, both by design. In our view, the “be sustainable” vs. “get returns” debate is fundamentally spurious because it ignores that well-developed investment theses insist that portfolio inputs reflect both.

Sustainability adds differentiation and alters portfolio correlation to the market.

As we work to achieve our objectives, we seek to use any relevant securities data we can find as part of our research. Sustainability considerations often have the added benefit of providing us with information that is both critical and distinct to what has been traditionally studied in markets. These sustainability insights can be differentiated — less correlated with what markets purport to already understand, and in this sense additive — which makes them orthogonal in our portfolios in useful ways. Less correlated information is also important to us because in an optimization process that takes multiple considerations into account, we’re able to have our portfolios make dynamic and efficient choices that employ all of our insights.

Sustainability models, combined with multi-factor, risk, and transaction cost models, yield results.

We avoid simple arguments that seek to trade off sustainability and alpha in blunt terms. Instead, we treat the combination of sustainability and return objectives as something we can quantify and optimize to reflect our clients’ motivations while always taking into account all we know about risk and factors and transaction costs. Accounting for innovative sources of potential returns and multiple factors is, of course, our deeply rooted practice.

16 CFA Institute Research Foundation & Ron Kahn’s November 2018 The Future of Investment Management.
Final thoughts

Academics Hart and Zingales\(^\text{17}\) make the general case that companies should openly pursue social issues beyond profits. Their assessment in some instances separates social issues and profits and at other times combines them. The degree of integration between the two will continue as a rich area for research and debate.

Implementation and execution are a far less settled, or studied, matter. Hart and Zingales argue that companies should “pursue policies consistent with the preferences of their investors” and focus on shareholder voting as a means to achieve this. But, as many have pointed out, shareholder voting is an imperfect tool. Shareholders need not agree and many lack the detailed knowledge required to advise and change company policies. Their preferences also may shift over time, and sometimes with great rapidity. We believe companies should adopt a diverse set of approaches and shareholders can then choose those they prefer. But this process of choosing requires serious thought and information gathering, and not a simple reliance on compliance-oriented scores.

Fortunately, as research- and innovation-oriented systematic active managers, we are quite accustomed to making forecasts using imperfect and noisy information — and equally accustomed to amending our views when our forecasts prove wrong. Portfolio construction, difficult and full of surprises as it is, deserves nothing less. It is through this process of moving sustainability beyond compliance that sustainable investing will itself remain sustainable.

About BlackRock Active Equities

BlackRock Active Equities offers clients an opportunity to seek above-market returns in pursuit of their individual goals. Our active equity solutions are built upon a legacy of innovation and enduring commitment to risk management. Expertise across systematic and fundamental disciplines offers clients choice — and the potential to access differentiated sources of investment return.

Learn more at blackrock.com

Third Party Awards

The award referenced on page 4 of this paper was bestowed as follows:

The Harry M. Markowitz Award (2017)

The Harry M. Markowitz Award is determined by a special selection panel composed of Nobel Prize winners Harry M. Markowitz, Robert C. Merton, Myron S. Scholes and William F. Sharpe. The Harry M. Markowitz Award (sponsored jointly by the Journal of Investment Management and New Frontier Advisors, LLC) recognizes the seminal and transcendent impact of Dr. Markowitz’s work as a financial economist and mathematician on both theoretical finance and the practice of asset management. The award has been established to honor his legacy and to support future research and innovation in practical asset management. Candidates for the annual award are chosen from among papers published in JOIM in a calendar year. Final selection consists of Nobel laureates Harry M. Markowitz, Robert C. Merton, Myron S. Scholes, and William F. Sharpe. An honorarium of $10,000 will be bestowed to the winning paper. Two additional finalist papers will receive a Special Distinction Award along with a $5,000 honorarium, which was awarded to SAE research. There is a fee to submit research to JOIM, though this is operational and not related to the selection of the award. The Journal of Investment Management is not associated with BlackRock, Inc.

THE INFORMATION CONTAINED HEREIN MAY BE PROPRIETARY IN NATURE, AND MAY NOT BE REPRODUCED, COPIED OR DISTRIBUTED WITHOUT THE PRIOR CONSENT OF BLACKROCK, INC. (“BLACKROCK”).

This information should not be relied upon as research, investment advice, or a recommendation regarding any products, strategies, or any security in particular. The opinions expressed are as of July 2020, and may change as subsequent conditions vary. This is for illustrative and informational purposes and is subject to change. It has not been approved by any regulatory authority or securities regulator. The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will come to pass.

The environmental, social and governance (“ESG”) considerations discussed herein may affect an investment team’s decision to invest in certain companies or industries from time to time. Results may differ from portfolios that do not apply similar ESG considerations to their investment process.

Any reference herein to any security and/or a particular issuer shall not constitute a recommendation to buy or sell, offer to buy, offer to sell, or a solicitation of an offer to buy or sell any such securities issued by such issuer. These materials are being provided for informational purposes only and are not intended to constitute tax, legal or accounting advice. You should consult your own advisers on such matters. Additional information is available on request.

Investing involves risk. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Diversification does not ensure profits or protect against loss.

© 2020 BlackRock, Inc. All Rights Reserved. BLACKROCK is a trademark of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

Prepared by BlackRock Investments, LLC, member FINRA.

Lit No. SUSTAININEQ-WP-0720 2051.32T-0720