EQUITY

An Integrated Approach to Managing ESG Risks and Opportunities

November 30, 2018

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Information, data and research are the fuel for investment decisions. Over the years, as new information has emerged and evolved, investors have found innovative means to harness new insights to help inform their decisions. Today, some forward-looking investors are deepening their focus on environmental, social and governance (ESG) analysis to provide additional perspectives to complement existing research efforts. Julie Moret, Franklin Templeton's head of ESG, explains how ESG contributes to an evolved investment evaluation framework and serves as a tool to assess broader holistic risks.

We are living in a rapidly changing world. Sustainability challenges such as resource efficiency, climate change impacts and transitional risks continue to grow in relevance, as does the growing number of policy and regulatory pressures targeting sustainability issues.

We are seeing a more acute awareness among investors of an alignment between sustainability and financial impact, as evidenced by the growing number of signatories to industry-led initiatives such as the Principles for Responsible Investment (PRI).

An international group of institutional investors developed the PRI to reflect the growing importance of environmental, social and corporate governance (ESG) issues within investment practices. Since its launch in 2006, nearly 2,000 signatories representing US$81.7 trillion in assets under management[1] have signed up to the principles. Signatories commit to integrate ESG considerations into investment decision-making, ownership practices and reporting.

Despite that growth, there remains variability of interpretation and implementation of ESG practices. This is compounded by the tendency across the investment world to use a confusing and often interchangeable array of terms and acronyms, which in some cases actually refer to different concepts and objectives.

Analysing the Impact of ESG Themes

At Franklin Templeton, we make a clear distinction that ESG is different from ethical investing or values-based investing and doesn't require a trade-off in terms of performance. As active managers, we want to understand how these broad ESG themes impact the longer-term strategic risks and opportunities for the companies that we're invested in.

THE HISTORY OF ESG

So we believe ESG analysis should be an inherent component of research and investment decision making. We see value in the intersection of evaluating traditional financial measures alongside sustainability measures.

In our view, the combination of the two really helps deepen our fundamental research and provides an additional tool to differentiate between companies and sectors that are vulnerable to disruption and those that are adaptive.

Over time, these considerations can reshape competitive advantages and ultimately the sustainability of business growth and long-term value creation for shareholders.

ESG analysis can trace its roots back to the 1960s, when certain faith-based organisations adopted ethical screens to identify and exclude companies from their portfolios that did not meet their moral values. Typical so-called “sin” stocks included tobacco and alcohol. As the emergence of heightened social and political awareness grew in the 1970s, the practise of screening extended to encompass conduct, behavior and violations of internationally accepted norms and standards.

Today, ESG involves a nuanced approach that can incorporate a broad range of techniques from positive screening and/or the use of environmental, social and governance factors to mitigate risk or contribute potential alpha[2].

ESG as a Fiduciary Duty

As the business rationale for ESG crystallises, we expect investment managers increasingly will be forced to engage in this space as a matter of fiduciary duty as policymakers and regulators turn their attention to sustainability.

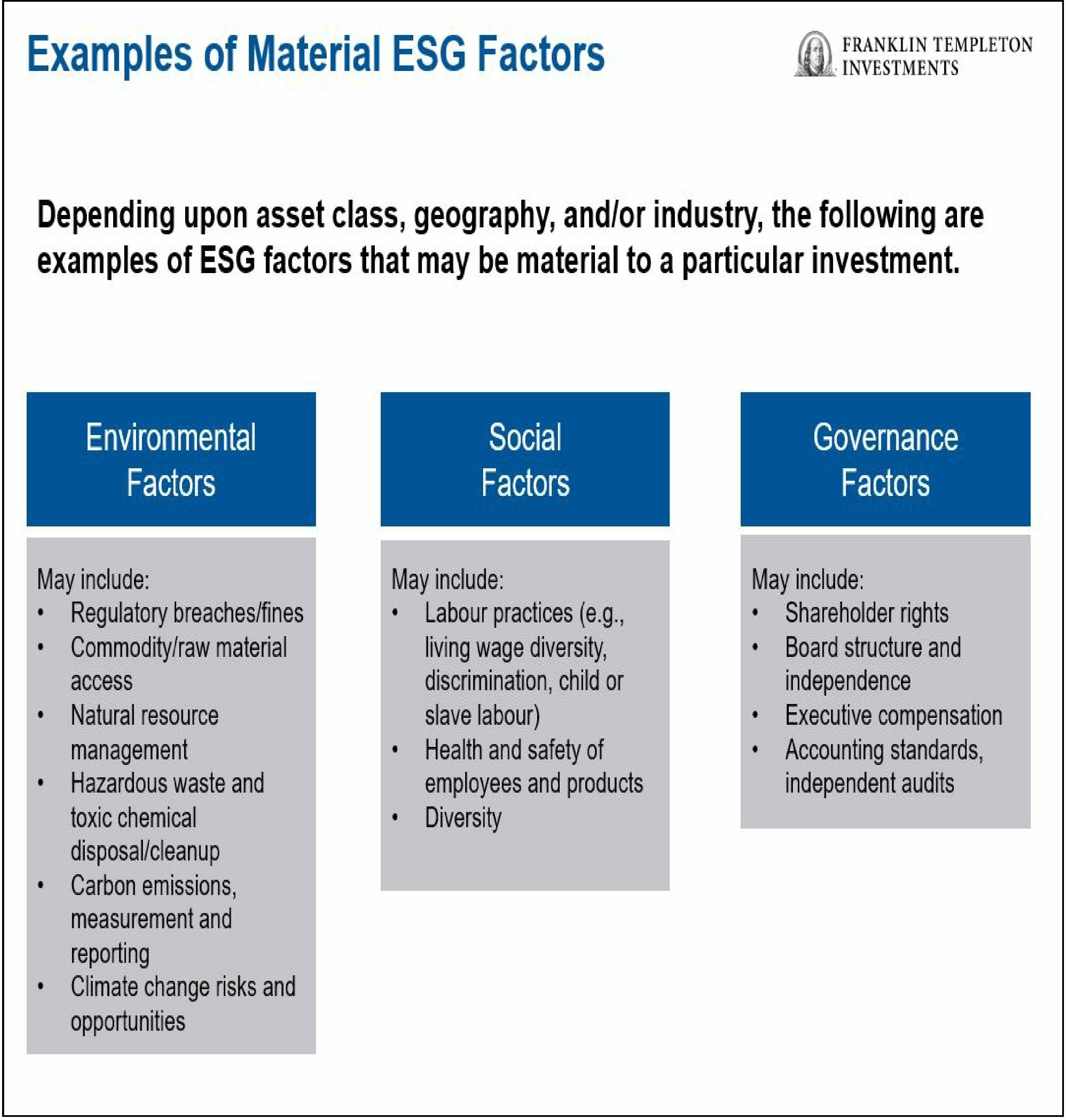
In the wake of the 2015 United Nations Climate Change Conference in Paris (known as COP21), the French authorities passed the French Energy Transition for Green Growth Law (or Energy Transition Law). The ambitious legislation sets out a roadmap to mitigate climate change and diversify the energy mix.

In June 2017, the Financial Stability Board’s (FSB) Task Force on Climate-Related Financial Disclosures (TCFD) unveiled a list of voluntary, consistent disclosure recommendations.

More recently, the European Commission has established a comprehensive framework to hardwire sustainability in the financial sector based on recommendations of its High-Level Expert Group on Sustainable Finance (HLEG).

The direction of travel is clear: there is a growing expectation that investment managers and investors should deepen their understanding of the scope and impact these issues pose to long-term operational business resiliencies and new avenues for future growth potential.

We believe there are likely to be wide-reaching implications from benchmark selection, reporting and investor duties.



Integrating ESG

Alongside augmenting existing research with deepened ESG analysis to assess intrinsic value and alpha potential, investment managers need to be able to measure and understand risk in order to manage it. At Franklin Templeton, we want to ensure risks we take in our portfolios are well understood and have the potential to be compensated. We believe that analysing the more traditional quantitative-risk measures—such as tracking error or beta—alongside more qualitative ESG risk metrics that capture quality of management and reputational risk provide for a more multi-dimensional perspective and deepen our understanding of potential downside risk.

ESG data can provide that new perspective to uncover potential hidden risks that lie beneath the surface of balance sheets and financial ratios alone. Correspondingly, we believe time invested today on evolving investment research to incorporate an ESG framework as part of the process will distinguish those firms that will likely be successful tomorrow.

ESG In Practice

Below is a categorisation of commonly recognized ESG approaches. In practice, one or more of these approaches will be combined.

Negative screening:	Positive screening:	Engagement:	Integration:	Thematic:	Impact:
• The exclusion of investments based on one factor or a combination of factors such as ethical, values, or religious considerations; or for violation of compliance with international standards and norms.	• The corollary of negative screening is consciously investing in those companies that score well on ESG criteria.	• Involves engagement with investee companies on ESG matters such as executive remuneration, shareholder rights, diversity and climate-risk disclosures.	• The explicit incorporation of ESG risks and opportunities evaluation alongside traditional financial analysis.	• Investments made on sustainability themes such as water, low carbon or climate-change adaptation.	• Investments made with the intention to generate a well-defined set of social or environmental goals alongside financial goals; for example, social bond fund investing in areas such as education or affordable housing.

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What Are the Risks?

All investments involve risks, including potential loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

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1. Source: UN Principles for Responsible Investing. Data as at April 2018.

2. Alpha is a risk adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.