Research

Strategic Response toward Growing ESG Investments

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Awareness and expectations toward the sustainability of the environment, society and governance have risen on a global scale, as represented by the Sustainable Development Goals (SDGs) and the Principles for Responsible Investment (PRI) advocated and adopted by the United Nations in recent years. Such a trend has led to the formation of a widespread view in the market toward ESG (Environment, Social and Governance) investment that seeks concrete efforts toward ESG from companies, and has a growing impact on the investment activities of not only the institutional investors, but also those of individuals. Meanwhile, companies that are receiving investments are required to come up with strategic responses toward ESG investments.

1. What is ESG investment?

ESG investment went into full swing following the announcement of the Principles for Responsible Investment (PRI) by the United Nations in 2006. The PRI is a set of principles that request for ESG issues to be addressed in investment analyses, decision-making processes, investment policies and the like. As of May 2017, it has gathered 1,708 organizations from all over the world as voluntary signatories, which include investors and investment organizations. By altering the investment behavior of the voluntary signatories to emphasize on ESG, the PRI aims to transform corporate activities into actions that help resolve global issues.

Socially Responsible Investment (SRI), which was first proposed in the 1920s, adopts a stance that companies are responsible for maintaining the soundness of the society and environment surrounding the company. In contrast, ESG investment is based on the premise that the soundness of a company and that of the society and environment are mutually dependent and inseparable from each other. In other words, ESG investment can be characterized by the view that efforts to address ESG issues are inextricably linked to the growth of a company.

Additionally, in 2015, the United Nations adopted the Sustainable Development Goals (SDGs), which define the development goals up to 2030, and 17 goals were established in relation to the environment, society and governance. Companies are requested to play an active role in achieving the SDGs as a partner of the United Nations. With the investing parties (investors and investment organizations) carrying out ESG investment while the invested parties (companies) make active efforts in achieving the SDGs, it is expected that a virtuous cycle will be created, which helps to resolve global issues including those concerning the society and environment.

2. Worldwide spread of ESG investments

Following the trend as described above, ESG investments are becoming more widespread on a global scale. ESG investment assets in the world show an average yearly growth of approximately 15% (between 2012 and 2016), reaching a total amount of $23 trillion by 2016 (Figure 1). This accounts for about one-quarter (26.3%) of the total investment assets in the world. In particular, ESG investments take up more than half of the total investments in Europe (52.6%).

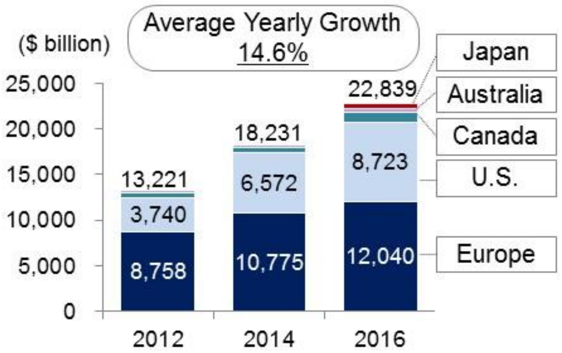

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Figure 1: ESG Investment Assets by Country/Region

If we look at the ESG investment assets by the investing entity as of 2016, approximately three-quarters were contributed by institutional investors. However, the share of individual investors in ESG investment has increased from 13.1% in 2014 to 25.7% in 2016, which shows that there is growing interest among individual investors.

Next, let us look at the increasing ESG investments in terms of investment returns. Studies have reported findings such as (1) though slightly lower than the main benchmark stock prices, the returns on index funds that are made up of ESG companies are growing stably (low risk of sharp increase or decline); and (2) there is a positive correlation between efforts toward ESG and changes in the corporate value as well as medium-/long-term ROA. These are reasons why ESG investment is attractive to investors who are expecting medium-/long-term returns. From the company's point of view, advancing efforts toward ESG may help to secure medium-/long-term funds.

3. Corporate rating based on ESG

What measures are necessary in order for a company to meet the criteria for ESG investment? In the following, let us examine the ESG investment strategies and ESG rating systems.

First of all, if we classify ESG investments by the type of investment strategy, constituting a majority of the current ESG investment strategies are negative screening (a method that eliminates specific types of industries or companies that are deemed to have an adverse impact on the society and environment as well as companies that do not comply with the international codes of conduct) and integration (a technique for making investment decisions based on ESG factors in addition to financial ones). In other words, investee companies are required to ensure that they remain on the list of ESG investment candidates.

Meanwhile, there are also other proactive investment strategies such as positive screening, which invests in companies that are deemed excellent from an ESG perspective. With the heightened awareness among institutional and individual investors toward ESG in the future, these strategies are expected to become more widespread, and more strategic responses will also be required of investee companies.

In response to the rising concern toward ESG, there is also a growing trend to assess and rank companies based on ESG (ESG rating). ESG rating constitutes one of the criteria for making ESG investment decisions among the investors, and thus companies need to understand the process of ESG rating in order to secure strategic ESG investments.

Although the ESG rating process varies across rating companies, there are some common features. Table 1 is a summary of the process of FTSE ESG Rating and MSCI ESG Rating, which are the two main ESG rating systems. As can be seen from the table, common features include: (1) companies and industries are not assessed with the same set of standards. Instead, critical issues (themes) are set according to the company or industrial characteristics; (2) maximization of value (business) and minimization of risks are assessed with regard to created values such as goods and services as well as value creation processes such as the production process and supply chain; and (3) a final numerical score is calculated for the rating.

Table 1: ESG Rating Process

	FTSE ESG Rating	MSCI ESG Rating
No. of Assessed Companies	Approx. 4,000	Approx. 5,700
Targets	• Establishes multiple critical issues (themes) by company or industry from the ESG perspective • Weights issues (themes) according to their importance to the target company	
Criteria	• Assesses each critical issue (theme) in numerical terms based on the following criteria: (1) Efforts made in the business activities (2) Degree of achievement in maximizing value (business) and minimizing risks (3) Efforts in value creation processes, e.g., supply chain	
Assessment	• Establishes KPIs for each issue (theme) and calculates the total numerical score • Final assessment by comparing with other competing firms	

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It is worth noting that lately, some of the ESG rating systems have been incorporating the SDGs. In Table 2, the 17 SDGs and FTSE as well as MSCI ESG rating assessment criteria are classified into E (Environment), S (Social) and G (Governance). As shown here, there is a high degree of affinity between the SDGs and the ESG rating assessment criteria. Recently, SDGs have become the common criteria of ESG endeavors with MSCI utilizing the SDGs in the evaluation process by re-classifying the 17 goals based on its own definition, as well as FTSE's announcement to include the SDGs in its evaluation items. That is to say, contributing to the achievement of the SDGs and commitment to improving the ESG rating are two sides of the same coin. In this respect, too, efforts to achieve the SDGs are crucial to investee companies.

Table 2: SDGs & ESG Rating

	SDGs	FTSE	MSCI
E	Affordable & Clean Energy Responsible Production & Consumption Climate Action Ocean Resources Life on Land	• Climate change, pollution and disposal of natural resources • Environmental opportunities	• Climate change, water resource pollution • Biodiversity • Environment SCM
S	No Poverty Zero Hunger Good Health & Well-being Quality Education Gender Equality Clean Water & Sanitation Decent Work & Economic Growth Industry, Innovation & Infrastructure Reduced Inequality Sustainable Cities & Communities	• Human capital • Product liability • Social opportunities	• Labor standards, health and safety • Human rights • Accountability toward customers • Social SCM
G	Peace, Justice & Strong Institutions Partnerships to Achieve the Goal	• Conduct of corporate governance companies	• Corporate governance, anti-corruption and tax transparency

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4. Strategic response toward ESG investments

In order to meet the criteria for ESG investment, it is important for a company to take actions including (1) minimizing risks and carrying out conversations with the investors to prevent being eliminated from the list of ESG investment candidates; (2) contributing to SDGs through business activities that address the critical issues (themes) of the company from the ESG perspective; and (3) disclosing the ESG efforts of the company by making use of KPIs that also include non-financial information.

At Hitachi Research Institute, research is underway to find ways to resolve social issues by utilizing means such as acquisition of real-time data and advanced analysis. Through these studies, we aim to make use of a diverse variety of data, including those for which acquisition and utilization were difficult in the past, to support companies' efforts to address global issues (such as SDGs) and making such efforts visible, and to contribute to the promotion of business strategies that are capable of resolving global issues while helping the company grow at the same time.