Wilshire

Investor's Guide to Navigating ESG in the Current Environment

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From greenwashing concerns to climate change cynics to limited data, ESG has faced numerous headwinds over the years and the polarization of ESG is currently at an all-time high. Through our ABCD approach, we hope to offer investors a holistic and customized perspective on how to think about ESG investing.

The Nuances of ESG

ESG stands for environmental, social and governance, but its meaning differs from individual to individual and from organization to organization. Approaches to ESG investing can vary widely.

ESG is often associated with exclusion, also commonly referred to as divestment. Exclusion applies a simple screen, such as not investing in gun manufacturers, to limit the investible universe in alignment with a set of values. Yet, this exclusionary approach more accurately reflects ESG's origins than its current state. Investors, particularly mission-based organizations, may use divestment as part of their ESG approach; however, among practitioners, ESG is more commonly associated with integration. ESG integration augments traditional analysis with ESG considerations to incorporate material sustainability risks and opportunities with the goal of enhancing return and/or reducing risk over the long term. This approach does not put ESG considerations above financial objectives, but rather looks at financially material ESG considerations alongside traditional considerations such as price-to-earnings, profit margins and projected cash flows.

Aside from divestment and integration, other approaches include: 1) thematic investing, which seeks to capitalize on a particular sustainability theme such as affordable housing or the energy transition, and 2) impact investing, which has a dual mandate of generating returns alongside making positive change through specific key performance indicators (KPIs). Even among these broad categories, the implementation approach can vary by factors such as sophistication and scope.

ESG Strategies

	Exclusion	Integration	Thematic	Impact
Approach	Divest on basis of values	Invest using material ESG considerations to help inform traditional financial analysis	Invest based on an investment universe defined by a specific sustainability theme	Invest based on investment and social or environmental impact objectives
Objective	Align portfolio to values or mission	Increase awareness of ESG risks and opportunities to maximize long-term investment returns	Exploit opportunities associated with ESG themes, such as energy efficiency and sustainable water	Dual mandate to generate returns while making a positive impact around specific goals/outcomes

Despite the multitude of ways to approach ESG, too often ESG investing is viewed monolithically and deemed either "good" or "bad." Ultimately, considering all ESG "good" or all ESG "bad" is not prudent. This binary view fails to acknowledge the nuances of ESG investing. Like any investment, the product, people and process matter. Furthermore, this view of ESG limits the ability to see that folks on either side of the debate have a lot more common ground than the headlines and rhetoric would suggest.

ABCD Approach to Navigating ESG

Given the current climate of ESG investing in the United States, investors can face a daunting task. For investors who aren't sure where to start, we have created an "ABCD" series of suggestions. Though ESG's complexity makes it unlikely that these suggestions will resolve all issues, we hope to offer investors a path forward. Our lens views ESG as being a means to an end (e.g., reducing risk, enhancing returns, capitalizing on opportunities arising from structural changes etc.), rather than the end itself (e.g., investing or not investing in ESG strictly because of values).

A) Align ESG to Goals

If and how ESG aligns with an organization's goals should ultimately guide how it pursues ESG. While many plans will have similar objectives such as maximizing risk-adjusted returns, each organization is unique with different stakeholders and considerations. Being mindful of the unique goals of an organization will help determine if and how ESG aligns with these goals and can enable stakeholders to navigate ESG more effectively.

Common Organizational Goals and ESG approaches

Goal	ESG Approach
Maximize risk-adjusted returns	• Analyze traditional information alongside financially material ESG information using frameworks such as SASB's Materiality Map • Support investment decisions through documentation of key ESG risks and opportunities • Source investment managers with best-in-class ESG integration processes • Invest in thematic opportunities that capitalize on clean energy transition, for example, while being aware of your investment time horizon • Let value – rather than values – drive investment decisions
Paris-aligned portfolio/ net-zero initiatives	• Ensure stewardship efforts, including proxy voting and engagement work, are aligned to clean energy transition • Invest in thematic opportunities aligned with clean energy transition • Consider how climate change may influence strategic asset allocation decisions • Track total portfolio carbon exposure over time
Improve diversity, equity & inclusion (DEI)	• Include top tier diverse-owned managers in new product searches • Establish internal DEI policies and procedures • Engage with companies to measure, track and monitor pre-determined DEI KPIs
Increase commitments to local managers and products	• Include local top tier managers and investment opportunities in searches • Establish KPIs that meet the risk-return objectives as well as the goal to increase local commitments

B) Be Strategic with External Commitments

As the space continues to evolve and mature, there has been exponential growth in the number of ESG-related initiatives to which investors can commit. For investors, the alphabet soup of collaborative efforts and initiatives can be overwhelming and participating in too many initiatives is not feasible given resource constraints.

That said, being a part of a select number of external commitments can be value additive. From being able to collaborate with peers to aligning organization goals with a particular initiative, becoming a supporter/signatory can offer tangible benefits to participants. To this end, Wilshire has become a signatory to numerous initiatives including the UN-Supported Principles for Responsible Investing, the Data Convergence Project and the Institutional Investing Diversity Cooperative.

It is prudent for organizations to be strategic with their external commitments. And it is important that external commitments align with organizational goals and objectives. It is also key for organizations to be mindful of how each external commitment will be viewed by its various stakeholders. Notably, there are bound to be different priorities among stakeholders. It is particularly important to keep key stakeholders in mind, such as the plan's Board, when making external commitments.

Examples of external commitments[1]

General ESG Commitments

- Global Impact Investing Network (GIIN)
- United Nations Global Compact
- UN-Supported Principles for Responsible Investment

Data- and Reporting-Related Commitments

- Data Convergence Project (DCP) – Private Equity Focused
- Global Real Estate Sustainability Benchmark (GRESB) – Real Estate Focused
- Global Reporting Initiative (GRI)
- Sustainable Accounting Standards Board (SASB)

Climate-Related Commitments

- Ceres
- Climate Action 100+
- Net-Zero Asset Owners Alliance (NZAOA)
- Institutional Investors Group on Climate Change (IIGCC)
- Taskforce on Climate-Related Financial Disclosure (TCFD)
- Taskforce on Nature-Related Financial Disclosure (TNFD)

Diversity-Related Commitments

- CFA Diversity, Equity, and Inclusion Code
- ILPA Diversity in Action – Private Equity Focused

C) Confer with your Consultant

While many plans face similar issues, there are nuances regarding what is most important or most sensitive to an organization's stakeholders. If working with a global consultancy, inform representatives of any unique organizational considerations so that tailored solutions may be proposed.

In the past, Wilshire has helped clients throughout their ESG journeys by offering a range of services from board education to manager research insight to climate aware products. We understand that the needs of, and therefore, the work with each client is plan specific. We've found that some common places to start are 1) to identify what matters most to the client and their stakeholders, 2) clarify the ESG objectives within the organization, and 3) strategically plan for how the ESG work will evolve over time.

[1] This list is not exhaustive and does not indicate Wilshire's external involvement.

Identify What Matters

- ESG education
- Learn from peers
- Understand exposures

Clarify Objectives

- Set up working group
- Stakeholder engagement
- Develop and update ESG beliefs/policy statement

Plan Strategically

- Identify areas of improvement
- Track progress toward goals
- Consider ESG/Impact Funds

D) Data, Focus on It

As an industry, finance is data driven. Our industry values numbers and being able to point to data to justify decisions. This is certainly one of the headwinds that ESG has faced over the years; however, as ESG data improves, and additional research is conducted, investors can more confidently look to ESG for insights and decision-useful information. While there is still vast room for improvement writ large, good progress is being made.

Data confidence varies by asset class and by capital structure. For instance, the data available for large-cap public equities is abundant, and one could argue that ESG risks and opportunities are likely priced into existing valuations. For small-cap stocks and alternative investments, there is less available data.

In recent years there has been a push for increased disclosure on ESG-related items. While this is an important first step, for data to be useful it must be accurate and comparable. Disclosure alone, therefore, is insufficient. To allow for efficient and effective analysis, standardization of the data – so that investors can evaluate investments/managers apples to apples – is critical. Efforts such as the Data Convergence Project (DCP) are steps in the right direction. The DCP seeks to improve standardization in private equity where the data has historically been harder to compare.

Lastly, while data quality has improved in recent years and research which links many ESG factors to financial returns has emerged, there is still more progress to be made. Wilshire will continue to provide clients with educational resources by further researching the link between ESG and risk/return for different asset classes, industries and markets.

Holistic Approach to Risk includes ESG

2022 was a reminder that investing is not straightforward. Success requires discipline and conviction, yet flexibility to reconsider previously held beliefs. Like navigating the markets, we know that approaching ESG is not always straightforward either.

Since our founding, Wilshire has focused on managing risks and opportunities to help clients further their desired investment outcomes. We view the investment landscape through a framework of essential risk lenses that are faced by all investors including investment risks (e.g., drawdown, inflation, active and liquidity), organization risks (e.g., behavioral and shortfall) and broader risks such as ESG. We believe all of these risks should be viewed holistically, considered as an explicit part of the investment process, and balanced to strike an appropriate trade-off between risk mitigation and risk taking. We strive to help clients navigate these risks in accordance with the risk appetite of each client. Furthermore, when it comes to ESG, we know that every relationship and portfolio is unique, as is the right ESG strategy for each client's investment practice.

Important Information

More information

For more information, please contact us directly:

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