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ESG in (advisory) portfolios.

Investing according to criteria which reflect environmental, social and governance (ESG) topics has gained strong traction in recent years. Three important factors have been the main drivers of this trend. First, a regulatory push mainly in the EU that aims at increasing transparency for investors; second, the broader public's awareness of environmental issues and good governance practices has increased, notably with pre-pandemic events such as Fridays for Future; and lastly, an increase in the availability of ESG investment solutions in the marketplace (e.g. dedicated ratings, indices and investment instruments). Additionally, various studies have shown that sustainable investing and generating attractive financial returns can go hand in hand. As a result, wealth managers must develop a strategy on how to integrate ESG-related topics in their service offering. The following guideposts can serve as a framework for external asset managers to navigate the ESG landscape and cater to diverse client needs in this space.

Different motivations for clients to bring up ESG

The motivation to include sustainability considerations in one's portfolio management differs from client to client. For private clients, the motivation can be very personal, for instance, a client wants to ensure that they are not invested in harmful businesses such as tobacco companies, or wants to support companies that, through their business model, seek to address social and environmental concerns, such as ocean protection. The Next Generation of a wealthy family might want to include their family's values in wealth management; for instance, some do not support animal testing, others want to support a social or environmental cause that is important to them. Traditionally, charitable foundations' primary concern has been to realize their mission effectively and efficiently. Increasingly, they consider environmental, social and governance (ESG) criteria in their investment decisions not only to accommodate the rising pressure for transparency, but also to align their investment strategy with their mission as well as to improve their portfolio's risk/return profile. Institutional clients such as pension funds consider sustainability criteria to make better-informed investment decisions and mitigate ESG-related risks.

Avoiding misunderstandings

The different end-client motivations to integrate ESG into the investment decision has brought forward a variety of approaches for taking ESG elements into account in a portfolio. This requires the wealth manager to have first and foremost an advisory process in place that captures the end-clients' ESG goals and preferences. The Credit Suisse Sustainable Investing framework provides insights on how client preferences can be captured. It consists of three core elements to cover the different degrees of client focus on the topic: (1) Exclusion (avoid harm) (2) ESG Integration and (3) Thematic and Impact Investing.

1. Exclusion (avoid harm)

Sectors and/or companies that are involved in controversial business areas or in major business practice controversies are excluded from the investment universe. These include norms-based exclusions (e.g. controversial weapons), values-based exclusions (e.g. tobacco, gambling, adult entertainment, thermal coal or weapons) and business conduct exclusions which focus on severe cases of controversial business conduct (e.g. breaches of the United Nations Global Compact Principles (UNGC)).

2. ESG Integration

The goal is to use insights on material ESG-related risks and opportunities in combination with financial research in order to make better informed investment decisions. This approach involves favoring companies that actively integrate ESG practices in their strategic decisions (e.g. high R&D investments in cleantech), making the company less vulnerable to reputational, political and regulatory risks.

3. Thematic and Impact Investing

Investing with the explicit intention to create positive, measurable social or environmental outcomes in addition to financial returns (e.g. via active ownership).

This three-tiered approach can address a broad range of the above-mentioned client needs as will be highlighted below with some specific use cases.

Addressing typical ESG questions: Some use cases

From the client needs outlined above we see the following use cases arising for investment managers, with different approaches on tackling them.

Case 1: A client is worried about structural shifts in the economy (out of oil into renewables)

The typical client is concerned about the structural shifts in the market shaping the economy of the future. The emphasis is less on the portfolio's ESG quality than on the right positioning in the market to be able to participate in the ongoing trend and anticipate investment opportunities early. Integrating a thematic perspective into the portfolio discussion as opposed to the traditional asset category and asset class allocation approach are useful means to integrate the client's investment preferences. Mutual funds (e.g. investing in the new energy ecosystem) or via a detailed analysis of the exposure of single securities are some of the solutions available. For clients with a longer term investment horizon, private equity solutions could also be suitable vehicles.

- Credit Suisse can provide insights into the positioning of individual companies with regards to new energy or with regards to new regulation.

Case 2: Client wants to avoid companies involved in weapons production

Certain business involvements and practices can be contrary to the client's individual values and hence the client wants companies which generate a significant portion of their earnings from these businesses to be excluded. Examples of business involvements of companies which can be singled out are shown in Figure 1. Data providers usually provide the % of a company's earnings. Companies with an involvement above a certain threshold (e.g. 5%) can be excluded. Depending on the threshold and the economic importance of the business in focus this can have a significant impact on the asset allocation of the portfolio and its risk/return characteristics. Therefore, it is important to optimize the portfolio after the removal of certain companies in order to have the requested characteristics.

- Credit Suisse can analyze the exposure of individual companies and provide guidance on the relevant threshold to choose and how to optimize the portfolio based on the eligible universe of stocks.

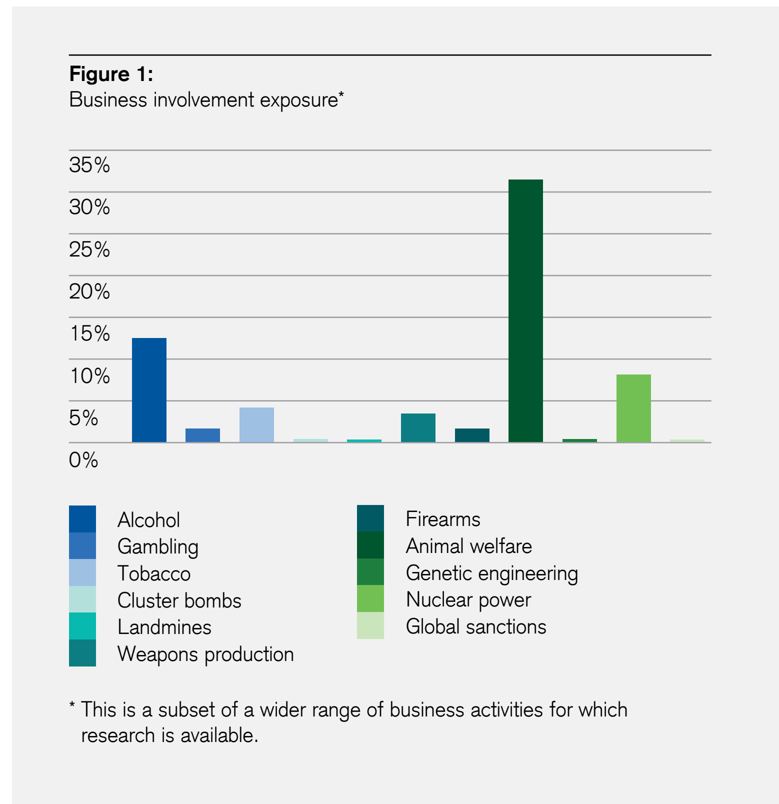


Figure 1:
Business involvement exposure*

* This is a subset of a wider range of business activities for which research is available.

Case 3: Client wants to make an impact with their investments

The distinction between ESG investing (i.e. exclusions, avoidance of certain risks and focus on investment opportunities) and investing to achieve a specific ESG target (e.g. environmental improvements) is not trivial. In this context, the client's investment goal has to be assessed precisely as a first step and both financial and non-financial impact aspects must be considered. Many ESG products cannot be deemed impact solutions because they do not have a measurable non-financial target, for example reducing the amount of waste in the oceans achieved by the invested money. In a second step, it is important to define which products meet the client's impact criteria (e.g. an ocean impact fund or a micro finance fund).

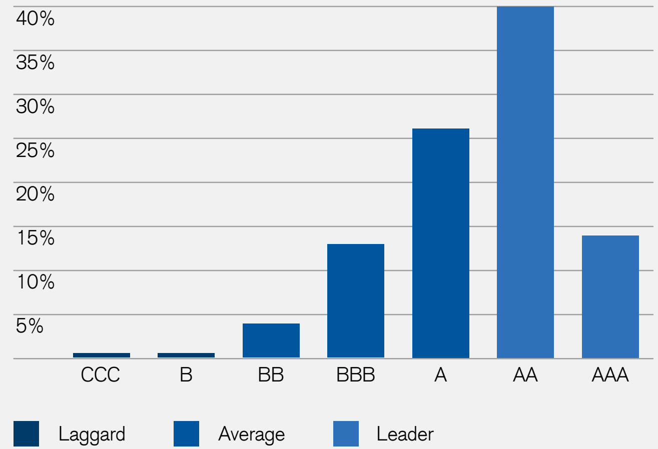
- Credit Suisse can provide you with a list of products that allow for impact investments ranging from mutual funds to private equity to philanthropy.
- CS can provide impact metrics (such as a portfolio's exposure to companies with a positive impact on society and the environment).

Case 4: Client wants to mitigate ESG risks in their portfolio

Companies involved in controversies might face further risks of litigation, reputational damage or similar headwinds, leading to drawdowns in their share prices. Therefore, a thorough analysis of the portfolio to identify potential risks can help to understand a client's portfolio exposures and lead the discussion around risks and ESG topics. Clients might simply be interested in knowing what the distribution of the traditional ESG ratings is in their portfolios and what the laggards are – and potentially reallocate to stocks providing opportunities arising from their ESG policies.

- CS can help screen the holdings and provide deep dive information on potential risks.
- CS can provide an analysis of the holdings with rating distribution and provide deep dives on individual names in the portfolio.

Figure 2:
Example of ESG rating distribution of a portfolio



The use cases in this article provide an overview on how to navigate ESG client preferences in a portfolio context. For a more detailed repositioning towards ESG-compliant investing, it can also make sense to enter into a strategic discussion with ESG expert teams to discuss solutions and pitfalls. In summary, a cornerstone of an EAM's ESG advisory process is to develop a clear approach for integrating ESG elements in portfolios, especially in light of the need to accommodate the different ESG preferences clients might have.

Data source: Credit Suisse unless specified otherwise.

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