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Dimensional

Navigating ESG Investing

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KEY TAKEAWAYS

- ESG funds often promise higher expected returns, lower risks, impact, or the opportunity for people to align their investments with their values.
- While ESG factors alone do not increase expected returns or lower risks, an ESG portfolio can still maintain sound investment principles.
- Even though real-world impact is hard to quantify, ESG funds can be effective at aligning investors' portfolios with their values.

ESG (environmental, social, and governance) funds may attract investors with promises of higher returns, lower risks, real-world impact, or the opportunity to align their portfolios with their personal values.[1]

Higher returns and lower risks relate to the impact of ESG on the investor's own portfolio. Values alignment and real-world impact relate to the investor's nonfinancial goals. Which promises a fund hopes to achieve, and assumptions about their validity, can lead to very different investment strategies. How should investors evaluate these promises?

RISK AND RETURN: USE THE INFORMATION IN MARKET PRICES

There is no doubt that ESG considerations can affect security prices. For example, companies expected to play an important role in the transition to a low-carbon economy sometimes command high valuations. Conversely, companies involved in ESG controversies can suffer. Faced with billions of dollars in potential liabilities, PG&E—California's largest utility—filed for bankruptcy after faults in its equipment led to devastating wildfires.[2]

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It is less clear whether investors can outperform the market by selecting and weighting companies based on ESG measures. The promise is an alluring one, but markets are not blind to ESG.[3] Market prices continuously reflect information about how companies address opportunities and risks, including those related to ESG. In competitive markets, any individual ESG expert or rating provider is unlikely to have an edge over the collective wisdom of market participants. Decades of evidence show how hard it is for stock pickers to beat their benchmark by second-guessing current prices.

The good news is that investors can take advantage of the information in market prices to manage ESG risks. We believe that portfolio weights that maintain a close tie to market prices will reflect the most up-to-date assessment of ESG risks and opportunities by market participants. Broad diversification also makes it unnecessary to guess which risks may be over- or underappreciated by the market, an exercise often loaded with assumptions and noisy estimates.

ESG considerations can be integrated into diversified portfolios that target the systematic sources of higher expected returns.

Investors can also use the information in market prices to increase expected returns. As a strategy integrates ESG considerations, it can still emphasize companies with a smaller market capitalization, lower relative price, and higher profitability. Thoughtful implementation can help manage the tradeoffs that matter for performance. This is the approach employed in Dimensional's strategies.

What can investors take away? Overall, there is no compelling evidence that ESG factors alone are a systematic source of higher returns or lower risks. But ESG considerations can be integrated into diversified portfolios that target the systematic sources of higher expected returns.

REAL-WORLD IMPACT: SET REALISTIC EXPECTATIONS

So far, we have focused on the impact of ESG on the investor's own portfolio. But many ESG investors are concerned about the impact their portfolios have on the world. When discussing this topic, we first need to be clear about what we mean by "impact." The impact of an investor is not the same as the impact of the companies they own. If they were the same, any diversified investor could claim to be helping the world. After all, a broad portfolio exposes investors to companies producing vaccines, engineering technological innovations, and providing ever-more-efficient goods and services.

Some academics therefore make a distinction between "impact-aligned" investing and "impact-generating" investing.[4] The former refers to investing in companies engaged in activities having an impact. The latter is more difficult to achieve: Investors can only claim to generate an impact if a change at a company, such as a shift to more sustainable operations, is a result of their investment or influence.

ESG funds may seek to influence the cost of capital of a company by acting collectively, raising the stock price of good companies and depressing the stock price of bad companies. But ESG investors often disagree about which companies to reward, as the low correlation between ESG ratings from different providers illustrates.[5] And as long as enough other investors are willing to hold the companies ESG investors shun, the influence of ESG funds on stock prices and the cost of capital may be limited.

To influence company management, ESG funds do not strictly need to change the cost of capital; they just need management to believe ESG issues are important to the firm's stock price. Management compensation is often strongly tied to stock performance. Managers will be incentivized to pursue ESG projects if they believe doing so will be rewarded by the stock market. ESG has clearly gone up the board agenda in recent years. In 2020, 96% of the 250 largest global companies by revenue published sustainability reports—three times the share in 1999.[6]

Investment stewardship activities are another potential tool for ESG investors seeking an impact. Shareholders can use their voice and their vote to influence management. In our experience, engaging[7] with companies and supporting the most competent directors can make a difference.[8] However, quantifying the impact of stewardship is challenging because it involves identifying decisions that company managers would not have made without ESG investors. ESG-friendly decisions, such as treating employees well, often overlap with shareholder value; company managers will make them with or without ESG investors.

Measuring the real-world impact of ESG funds is challenging. As ESG investing matures and further grows in popularity, its real-world effect may become clearer. But as things stand, Dimensional believes that we need to approach the question of impact with humility and be careful not to overstate our impact claims.

VALUES ALIGNMENT: CLARIFY PREFERENCES AND UNDERSTAND TRADEOFFS

"When you invest in a company, you own part of that company. You want that company to grow and succeed and thrive. You want that company to attract new customers. You want that company to sell more of its products. When it comes to tobacco, I could not think of anything that I wanted less."[9] So said Dr. Bronwyn King, a radiation oncologist, when explaining her decision to become a tobacco divestment campaigner.

Many investors identify personally with the companies in which they invest and want them to reflect their values. For such investors, ESG funds may play a role. When deciding whether to invest in an ESG fund, investors should consider at least three questions.

> *A carefully selected ESG fund can help investors align their investments with deeply held personal values.*

First, are there issues that they feel particularly passionate about? The overall market reflects the aggregate tastes and preferences of all investors. It includes companies that

provide useful products and services, employ people, and pay taxes. It can be a useful starting point. But the aggregate market is not as concerned about the dangers of tobacco as Dr. King, for example. Other investors may be deeply concerned about the impact of climate change on the world and seek to reduce their exposure to firms with high emissions. Or they may want to avoid exposure to firms that have ties to social issues deemed problematic. An ESG fund that targets clearly defined issues may be the right tool.

Second, what tradeoffs can they tolerate? Every exclusion reduces diversification. While a few targeted exclusions generally will not materially impair a broadly diversified portfolio, tackling many ESG considerations brings the risk of removing a significant portion of the investment universe. Thematic funds require particular attention. Restricting investment to a specific industry can result in a concentrated portfolio with high volatility and low expected returns. These tradeoffs may be worthwhile but need to be understood.

Third, how is the ESG strategy built? Before using ESG scores or investing in a fund relying on them, investors should check that the scoring methodology aligns with their values. Such scores often seek to measure the financial risks ESG factors pose to companies, not corporate virtue or real-world impact, and can rely on subjective estimates and heroic assumptions. Data availability and robustness also need to be assessed. Even when tackling the same issue, different providers of ESG scores can make different choices and arrive at drastically different conclusions.

A carefully selected ESG fund can help investors align their investments with deeply held personal values. Separately managed accounts, if appropriate, allow for even greater customization.[10] Whichever vehicle investors choose, a systematic approach that carefully integrates robust ESG data to target measurable ESG outcomes can help them pursue both financial and nonfinancial goals.

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1. This categorization was inspired by Florian Heeb and Julian Koelbel, "Investment Motivations Are Being Ignored in ESG," *Responsible Investor*, September 9, 2021.
2. See "PG&E: The First Climate-Change Bankruptcy, Probably Not the Last," *Wall Street Journal*, January 18, 2019.
3. See "Climate Change and Asset Prices," *Insights* (blog), Dimensional Fund Advisors, March 2021.
4. See "Impact Investments: A Call for (Re)orientation," *SN Business & Economics* 1, no. 33 (2021).
5. See "Do ESG Ratings Get High Marks?" *Insights* (blog), Dimensional Fund Advisors, October 2021.
6. Richard Threlfall, Adrian King, Jennifer Shulman, and Wim Bartels, "The Time Has Come: The KPMG Survey of Sustainability Reporting 2020," *KPMG IMPACT*, December 2020; and Richard Threlfall, Adrian King, Wim Bartels, Jennifer Shulman, and Mike Hayes, "Towards Net Zero: How the World's Largest Companies Report on Climate Risk and Net Zero Transition," *KPMG IMPACT*, November 2020.
7. Dimensional can discuss governance matters with portfolio companies to represent client interests, though Dimensional does not, on behalf of its clients, acquire securities with the purpose or intended effect of changing or influencing the control of a portfolio company.
8. See "2021 Annual Stewardship Report," Dimensional Fund Advisors.
9. "You May Be Accidentally Investing in Cigarette Companies" (TEDxSydney, 2018).
10. See "The Future of Investing," *Insights* (blog), Dimensional Fund Advisors, September 2022.

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