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Building and ESG Investment Portfolio

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ABSTRACT

Investors with an interest in environmental sustainability, governance, and social (ESG) issues usually consider climate concerns as the guiding principles to their investments (Halbritter and Dorfleitner, 2015). Such focus on environmental and social sustainability paid off during the market crunch with oil prices cratered (Crowl, 2020). Recent data continues to show and report greater emphasis on ESG. PICTET (2021) noted that the investment industry has been focused on meeting market demands through regulatory compliance. Yet, common definitions of ESG are not agreed upon. ESG should be evaluated and assessed as an "environmentally-friendly classified through a green taxonomy model for guiding portfolio managers in their economic activities" (Khan 2019, p.104). It is suggested to invest in organisations, companies, and countries with excellent records in social, environmental, and corporate governance adding long-term value from an investment or financial perspective (LGT, 2021). This paper recommends a thematic and holistic approach to building an ESG portfolio.

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Considerations in Sustainable Investing

The first consideration in sustainability management and building ESG is by embracing elements like society, environment, politics, and corporate governance. These major elements and factors should be crucial to defining and influencing the company's targets and corporate strategy (Halbritter and Dorfleitner, 2015). Building a proper ESG portfolio requires "careful assessment of the investment opportunities and an effectively planned investment strategy" (Branch et al. 2019, p.73). It calls for proper financial investment advice to protect the business from the market or economic shocks. ESG portfolio is created by first looking at the ESG held funds that interest the business line. Besides, it is necessary for the company to consider its scores on social, environmental, and governance criteria, and not just a single factor (Verheyden et al., 2016). The central themes represent different aspects of the firm's business. The first consideration is to use ESG score data, always available based on investor demands for information against the attributes of a public company and requirements by regulatory and government entities (Julius Bar, 2021). ESG portfolio is first built by considering the company-specific data on areas like social criteria, environmental compliance and boardroom diversity, and executive payments or wages (Henriksson et al., 2019). As companies are scored based on selected ESG characteristics, it is possible to construct the portfolio to underweight or overweight individual securities matching the specific social orientation optimally (Verheyden et al., 2016). This type or aspect of construction balances the competing priorities on the need for increasing the ESG portfolio scores and reducing possible tracking errors subject to the benchmark thereby permitting greater affordances for investors to modulate the ESG influence (Henriksson et al., 2019). The best approach to ESG investment is through a holistic approach bringing together responsible citizenship and responsible wealth management (Julius Bar, 2021).

Steps to ESG investing

Robeco (2021) identifies the following steps to ESG investing:

- *Proprietary research*: the research is based on footprint calculation, smart ESG scores, country scores, and measuring the investment contribution towards the realization of Sustainable Development Goals (SDGs)
- *Integrate ESG into the portfolio*: applying research in daily portfolio management. However, this process will take time, depending on the trial and error method since there are many variables involved with approaches differing between teams and organizations (PRI, 2021; Henriksson et al., 2019)
- *Active ownership*: using a collaborative approach in creating massive power. Sustainable investment funds should be sought to drive the investment portfolio, including best-in-class sustainability and pure exclusion funds (P Morgan. 2021)
- *ESG classification*: consider the building blocks of ESG
- *Performance and outcomes*: quantify ESG attribution aligned with the inherent goal of delivering wealth. Wealth should be about financial performance and measuring the reviewed performance impact

Possible Strategies

Cap-weighted Exclusion is singled out as a common basic strategy for ESG construction (Branch et al. 2019, p.69). Under this model, unwanted securities are omitted from a diversified benchmark and the remaining securities weighted proportional to their market capitalisations. It is an active bet although the exclusion will be cap-weighted. This strategy is more sensible for alpha-seeking investors with the belief that excluded securities underperform or the socially motivated investor with the decision of not holding or investing in certain securities because of ethical reasons (Branch et al., 2019). The strategy works perfectly in outperforming the expected benchmark when excluded securities are underperforming. Yet, the model has excessive tracking error, especially the higher return variability against the benchmark because residual risks from the exclusion are not managed or controlled anywhere in the process of investing. The second strategy should be *optimized exclusion* whereby unwanted securities are omitted, yet the remaining securities are again weighted for minimizing tracking errors (Branch et al., 2019). Errors are uncommon with this strategy and the portfolio delivers benchmark-like returns

Quality Screening Process

Before making such an investment, it is advisable to have the companies screened based on ESG scores or characteristics. An investor should begin by considering risk exposure, specifically “understanding the level of risk exposure (ESG risks) in the respective industry” (Branch et al. 2019, p.75). Secondly, investors should assess the company to understand risk management practices in place for managing or mitigating the said risks. ESG assessment considers the environmental aspect, as the firm's performance as a steward of nature including Greenhouse gas emissions and depletion of resources (Karspeck, 2021). For the social aspect, investors should consider assessing issues surrounding how the company manages its relationship with the community, clients, suppliers, and employees. They also need to screen the company to understand whether modern slavery exists, human rights, working conditions, child labor, and employee relations (PwC, 2021). Governance screening focuses on understanding the company’s leadership and governance (Moody’s Corporation, 2021). Focus should be on identifying corporate governance including tax structure, board diversity, and structure, executive pay, fraud, and bribery.

MSCI ESG Research

MSCI research is carried out to map out the different areas of performance of the organisation, including board, pay, governance, ownership and control, and the overall accounting practices. Companies are ranked based on governance percentile rank (Bush et al., 2020). The ranking also provides information on controversies through *Business Involvement Screening*, whether they are engaged in animal welfare issues, contraceptives, adult entertainment, gambling, nuclear power, fur, stem cell research, or civilian firearms (Kim et al., 2013). Also considered are the ratings or qualitative corporate responsibility, assessing global sanctions, women board members, and child labor.

The investment portfolio can also be assessed and evaluated based on different achievements, including better working conditions, regulatory compliance, sustainable sourcing, identifying hazardous chemicals, and general environmental or social responsibility compliance (Giese and Lee, 2019).

Tools for Screening

Positive screening considers "the selection of best-in-class funds or companies performing the best based on the defined ESG criteria" (Amel-Zadeh and Serafeim 2018, p.87). Secondly, negative screening is a tool used for excluding specific sectors, governments, or companies involved in unethical behavior like genetic engineering, tobacco, and animal welfare.

Thematic Investing

Thematic investing considers a focus on specific themes. For instance, themes like nutrition innovation, water scarcity, low carbon footprint, economic empowerment, health care innovation, and natural resource efficiency should be used in evaluating the investment portfolio based on ESG compliance (Amel-Zadeh and Serafeim 2018, p.94).

It is also recommended to have investments or companies with a sustainable mandate by first looking at their business code of conduct on ethical and responsible issues about the violation of human rights, controversial weapons (Bender et al., 2017). This assessment is also used to avoid certain investments, especially those engaging in nuclear energy. Better, it is recommended to build on portfolio promoting best-in-class approach through excellent corporate governance, environmental aspects like waste management, and social aspects including product quality and working conditions (Amel-Zadeh and Serafeim, 2018). Thematic investment should be arranged or organized based on active contribution to economic empowerment, health, low carbon, water, nutrition, and resource efficiency.

Adherence to Regulatory Requirements

Applicable regulatory requirements should be assessed. For instance, consider whether the company has an action plan for financing its overall sustainable growth, like whether it has an alignment with European Commission Plan on the same (CMS Law Tax, 2021). Consider whether the capital flows have been reoriented towards sustainable investment or financial risks from social and environmental issues are properly managed. Karspeck (2021) recommends the need for evaluating whether an investment complies with the Sustainable Finance Disclosure Regulation (SFDR), including the stipulated requirements for EU asset managers. Regulatory compliance, through European ESG ratings, has shown that disclosures on ESG are linked with improved return growth (Bermejo Climent et al., 2021). Care should be taken to avoid using opaque ratings because this limits informational disclosure transmission into the company’s performance.

Asset managers must require quantitative ESG data, calling for consistent and mandatory reporting based on international reporting requirements and frameworks. The demands can be met by getting data from S&P, Sustainalytics, Refinitiv, MSCI, and Moody's (Karspeck, 2021). While establishing the portfolio base, an investor should consider ESG that embraces compliance with regulations on sustainability in financial markets regulations (PwC, 2021). Consider whether the investment incorporates the EU's green taxonomy as the basis for ESG regulatory compliance (S&P Global, 2021). ESG solutions should be identified, including climate solutions, ESG measures, sustainable financing, and index solutions. An investment portfolio should integrate ESG into credit by using credit ratings and research, ESG classification, and credit scores (Moody's Corporation, 2021).

Conclusion

As shown from the above analysis, ESG investment portfolio is built by considering the ESG ratings of the specific investment opportunity. This begins by focusing on environmental sustainability, social responsibility and corporate governance. Also, one way to build the portfolio is through thematic analysis and arrangement of the different asset classes based on their ESG ratings. Overall, the investment portfolio should be built by focusing on a holistic approach to sustainability investment (ESG investment).

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