Who Cares Wins, 2004–08

ISSUE BRIEF

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EXECUTIVE SUMMARY

The past years can be described as a period of intense experimentation and learning regarding the relevance of ESG issues for investments and their integration into investment decisions. The industry has progressed considerably since 2004; it is today a commonly accepted fact that ESG issues can have a financial impact on single companies or entire sectors. The industry has also become more sophisticated in understanding when and where this impact is relevant. Leading analysts have developed the necessary techniques to integrate ESG issues into financial analysis — proving that ESG integration is absolutely within the reach of the analyst profession.

However this know-how is not yet widely applied in the industry. Given the role of investors in assessing future economic developments and the potential for many ESG issues to change significantly the course of our economies,1 this lack of uptake is surprising.

To understand better the impediments to a wider uptake of ESG information by the financial industry, a systemic view is needed.

The WCW consultations looked in-depth at the relationships of key actors, honing in on the interaction between asset owners (pension funds and other institutional investors), asset managers, investment researchers, and regulators. The final report Future Proof? Embedding Environmental, Social and Governance Issues in Investment Markets offers a set of key recommendations for each of the actors in order to improve and scale up ESG integration considerably.

The dynamic nature of the financial industry means that each actor is highly dependent on other actors. It also means that changes in the behavior of key actors, such as the asset owners at the top of the chain, can rapidly unblock stalled situations and move the system to a new equilibrium.

In the coming years, the financial industry has the opportunity to reap the gains of the good work done so far by applying it more widely to mainstream investment processes. If the industry does not seize this opportunity, it risks failing to account for important developments

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1. Climate change and its policy response being one example.
that are shaping the future of our economies. This in turn could create systemic risks for the financial industry and the economy at large. The positive message is that ESG integration currently represents an important source of competitive differentiation and value creation for financial institutions that make it part of their strategy.

However, the next phase of ESG integration will require the leadership of the CEOs and CIOs of financial institutions and implementation at all levels of their organizations, or it will not happen. Employees working on ESG integration must be given appropriate incentives, different actors must agree on ways to share the costs and benefits of developing new ESG-inclusive services, and institutions’ strategies need to be communicated better to the market at large.

**PROGRESS IN ESG INTEGRATION**

The level of awareness of ESG issues among mainstream professionals has greatly improved since the launch of WCW, with new collaborative initiatives such as the Principles for Responsible Investment (PRI) facilitating the adoption of best practices. The development phase, characterized by experimentation and innovation in many areas, is now drawing to a close, leaving those institutions that have made a firm institutional commitment to the space with a springboard for scaling up ESG integration.

However, progress has not been uniform – ESG issues have not been taken up by investors to equal extents. Nor have the various actors in the investment system moved forward in unison.

**Asset owners** (e.g., pension funds, insurance companies) at the head of the chain have certainly improved their awareness of ESG issues, but their implementation efforts – investing in an ESG-inclusive manner – have been disappointing. In contrast, active ownership activities, including the exercise of voting rights and engagement with companies, have made good progress since 2004.

Likewise, the leading **consultants** have invested in researching what ESG issues are built in to standard services such as investment strategy, asset allocation, and manager selection. But the majority of the consultancy world is well behind the space set by a few leaders.

The clearest progress made by **asset managers** has been in terms of sourcing ESG-inclusive investment research from service providers. On the other hand, it is much less clear how the research is actually being used by asset managers. Indeed, asset managers are candid about the challenge of integrating ESG information into their traditional frameworks.

In the future, asset managers must provide a greater degree of transparency towards research providers and company management on the use of ESG data, and towards asset owners and consultants in terms of the objectives of their ESG-inclusive investment products and services. Further progress in asset management will also require clearer incentives for employees involved in ESG integration.

A big step forward has been made in the past years by academics and **investment researchers** in developing the analytical frameworks and demonstrating the rationale for ESG integration in investment research. Although the actual coverage of ESG by mainstream investment research has improved (from a low base), coverage remains patchy and is generally driven by specialist teams rather than by mainstream analysts. The key challenges ahead for researchers are insufficient incentive systems, the high cost of building teams and tools, and the lack of comparable company data on ESG issues.

**Leading companies** have advanced greatly in making ESG issues part of their strategy (arguably more rapidly than investors), and have shown that they are willing to engage in a sophisticated dialogue with investors on financially-material ESG issues. Figure 1 illustrates the ESG issues that investors raised most frequently to emerging market companies. Nonetheless, the production of ESG data that are robust and comparable, and the integration of the most material issues into investor relations communications remain areas of concern.

**Figure 1. Emerging Market Companies Describe the Issues that Investors Raise Most Frequently**

![Figure 1](image-url)
WCW also looked at the role of regulators and governments. The message from WCW participants is that, given the complex and technical nature of ESG integration, governments should not play an active role at the micro level but should focus on defining the right boundary conditions for the system as a whole. This includes requiring greater transparency on ESG integration from companies and investors, supporting efforts to give a price to public environmental and social goods, and relying on markets to apply the most appropriate ESG integration strategies. Regulators can also support ESG integration by stating explicitly that they see no contradiction between a thoughtful consideration of material ESG issues and fiduciary responsibilities.

The role of professional bodies and qualifications in increasing the industry’s awareness and knowledge, and in better training young professionals in the field of ESG was repeatedly stressed throughout the WCW consultations. The more active role undertaken by the Chartered Financial Analyst (CFA) Institute in this area provides an encouraging signal for the whole investment industry.

The annual full reports give a detailed analysis of the yearly gatherings, and a set of recommendations to kick-start the next phase in ESG integration in financial markets can be found in the 2008 Who Cares Wins report: “Future Proof? Embedding environmental, social and governance issues in investment markets.”