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RESPONSIBLE INVESTMENT

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Responsible investment and risk management

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Responsible investment (RI) in portfolio management is often associated with environmental factors (E). There are, however, two other elements to be considered: social factors (S) and governance (G).

These three ESG components in turn contain several elements. For example, environmental factors refer to risks related to climate change, pollution, and water management; social factors include human rights, working conditions, and weaponry; and, finally, corporate governance involves, for example, the composition of boards of directors, executive compensation, and computer security. Thus, RI's reach extends far beyond the environmental boundary. Reduced to its simplest form, a company that has established a good governance structure (G) will tend to factor in environmental (E) and social (S) issues in its day-to-day operations.

To date, pension and investment committee members have been made aware of the importance of managing multiple types of risk in investment management, such as market volatility or interest/exchange rate risks. On the other hand, risks linked to an inappropriate assessment of ESG factors are all too often overlooked. One must also avoid mistakenly thinking that having an RI strategy means other types of risk can be forgotten; we must "simply" learn to integrate RI as an additional risk to manage.

Given the diversity of subjects it relates to, one must admit that RI can be difficult to take into account. Committees often lack training and may believe that their portfolio managers have things under control. Although more and more of them are integrating RI into their management processes, pension committees still share part of the responsibility, and should therefore question their managers and remain up-to-date on RI matters. These two elements are also a good starting point on the road to better RI risk management.

What questions should you be asking your portfolio manager? Since there are many ways to integrate RI into portfolio management, one must first understand the manager's approach. Answers can be numerous; consideration of ESG factors in the choice of securities, exercise of voting rights, shareholder engagement (dialogue with companies), impact investment, etc. If the manager claims to be applying some form of RI, he should be required to provide an accountability document in that respect (e.g., portfolio carbon footprint and ESG score). Although valuation methods remain imperfect, the subject must still be addressed.

Another mistake would be to believe the pension fund is too small to make a difference and that large pension funds are assuming all responsibility. Every little bit matters in terms of RI, primarily on the part of asset owners, regardless of the size of assets under management.

Integrating RI as a risk management element will improve governance and performance, and evidence to this effect is steadily adding up. The conclusion of a 2015 analysis listing more than 2,000 studies on the relationship between financial performance and the integration of ESG factors is revealing: "Long-term responsible investing should be important to rational investors of all types in fulfilling their fiduciary obligations and can better align investor interests with the broader objectives of society as a whole." Have you taken your first steps?

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