

Responsible Investing: Internalizing the Externality

In 2004, Kofi Annan, then secretary-general of the United Nations, invited 50 financial institutions to endorse a report titled, *Who Cares Wins*. In it, Mr. Annan concluded companies that are well managed with regard to environmental, social, and governance (ESG) issues should compete more successfully and increase shareholder value. Those that don't might not be able to weather regulatory changes or stakeholder actions. In addition, such businesses tend to miss growth opportunities such as accessing new markets.

Who Cares Wins reminds us responsibly-managed companies should contribute to a "sustainably-managed society." To some, this sounded a lot like the many failed Economically Targeted Investment programs of the same era, which encouraged consideration of a "double bottom line." On the contrary, *Who Cares Wins* argued there should be a direct relationship between good ESG management and good financial management. But it has taken more than a decade for thought leaders to explain how this relationship might work. From this report emerged the United Nations Principles for Responsible Investment (UNPRI) in 2006.

The UNPRI consists of six principles designed to align investors with "broader societal goals." These principles form the conceptual scaffold around which signatories might build their internal ESG processes. The adoption of these principles has been noteworthy: from 100 at the outset to more than 2,300

today, including some of the largest asset managers in the world (**Figure 1**). While today’s headlines reflect plenty of disagreement about what the “broader societal goals” should be, the growth in adherents to the UNPRI mirrors a broader consensus that market failures are not as uncommon as some investors might like to believe.

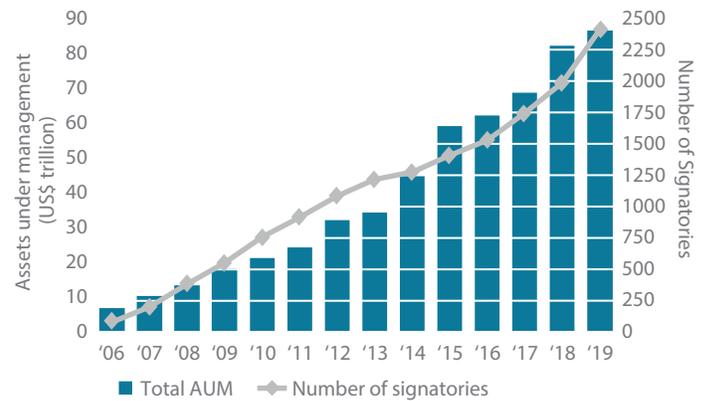
Secretary-General Annan was not the first to suggest companies could do well by doing good. The search for a relationship between ESG and corporate financial performance (CFP) traces back to the 1970s. Scholars and investors have published more than 2,000 empirical studies and several review studies on this relation since then. One paper has reviewed the findings of nearly all of them.¹ Roughly 90% of studies reviewed reported a positive relationship between ESG and CFP. Moreover, the positive ESG impact on CFP appears stable over time.

Eleven years after *Who Cares Wins*, all UN member states adopted the *2030 Agenda for Sustainable Development*. This document provides a “shared blueprint for peace and prosperity for people and the planet.” At its heart lie 17 Sustainable Development Goals (SDGs), which are based on the premise growth can better be achieved by alleviating poverty, reducing inequality, addressing climate change, and transitioning to a low-carbon economy (**Figure 2**). In essence: Growth needn’t be a zero-sum game.

The revolution in information and communication technologies has resulted in more and better data becoming available. These data allow us to view the complex world of ESG issues with greater clarity, to pinpoint where markets are failing to match costs with benefits. In the past we might have argued these externalities did not exist, were too complex to price, or were best resolved through a market-based pricing mechanism (e.g., carbon pricing).

Today a generational change is occurring. Millennials outnumber Baby Boomers, and a US\$30 trillion inter-generational wealth transfer is underway. Armed with greater political power and financial resources, Millennials are elevating their values and seeking out offerings that match. Pension fund portfolios are no exception. Their members

FIGURE 1 | PRI SIGNATORY GROWTH



Source: United Nations, March 2019.

FIGURE 2 | SUSTAINABLE DEVELOPMENT GOALS



Source: United Nations.

do not want nameless investments; increasingly, they want to understand the story behind the investment and to see concrete results—whether tackling climate change, preserving woodlands and waterways, or empowering marginalized groups. According to one recent study, sentiment for responsible investing among public pensions grew to 92% in 2019 from 70% the year prior; among corporate pensions, sentiment rose from 56% to 86%.²

¹ Friede, Funnar, Busch, Timo and Bassen, Alexander. 2015. “ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies.” *Journal of Finance & Investments* 210–233.

² Aon. 2019. “2019 Global Perspectives on Responsible Investing.”

Responsible Investing in Motion

In economics, externalities arise when a person or entity enjoys benefits (positive externality) or suffers costs (negative externality) as the result of a transaction in which they play no part. Pollution is the quintessential example—where a producer enjoys lower costs from being able to pollute, and their customers pay less for the goods they consume. Neighbors of the producer bear the cost of a dirtier environment in the form of higher healthcare costs or a lower quality of life—whether they buy the products or not. These externalities are the result of the market failing to correctly allocate all of the costs inherent in the transaction between the producer and its customers.

There is a role for government to play when markets fail. Regulations and taxes can require mitigation of costs (e.g., pollution control) or reallocation of revenue to offset costs (e.g., provision of healthcare). Sometimes regulations work as designed, and sometimes they have unintended consequences.

Take housing for example. Housing shortages in cities around the world have led to low vacancy rates and rising rents. This entices real estate developers to build new homes or revitalize older ones, resulting in more expensive housing, less socioeconomic diversity, and greater wealth inequality.

Diversity is a hallmark of organizational health. That is why affordable housing has become a priority for many local governments. However, rent controls to preserve affordable housing result in underinvestment by real estate developers who perceive they won't be able to reap appropriate returns on capital in a rent-controlled project.

In private markets, choosing the right GP for the job can make all the difference. Project Boxer, a recent investment made by our real estate team, provides an example of how the openness to ESG identified a market inefficiency that has led to an attractive financial return, while accomplishing the broader societal goal of reducing income inequality.

The project consisted of, among other things, redeveloping a 370 unit—post war apartment complex in Munich. The government would only grant the necessary permits as long as the current tenants were not displaced; some of the units were subject to rent controls; and the building was made more energy efficient. Several managers pursued the property, but felt they could not meet the government's conditions.

Our partner on Project Boxer struck a balance between meeting the government's objectives and satisfying their fiduciary duties to investors. The business plan provided for temporary housing to the current tenants, renting about one-fifth of the units at a 40% discount, and installing more efficient lighting and insulation. In exchange, our partner was not only permitted to renew the property, but also to build 150 additional units.

Information technology increases awareness of market failures, such as pollution, climate change, social injustice, and corporate malfeasance. A growing population of voters and consumers takes note of these issues. The power of social media allows influencers to galvanize grass-roots support for change in a way that simply wasn't possible even 10 years ago. Swedish teenage activist, Greta Thunberg inspiring millions to march for climate change is a case in point. The combined effect of these forces has engendered a number of movements to shed light on these complex issues.

- » Britain's Modern Slavery Act of 2015 brought social issues to the forefront and served as a model for other countries to pass laws that aim to eliminate forced or coerced labor. Australia followed in 2018. Still, an estimated 40 million people are living in modern slavery today.
- » An Intergovernmental Panel on Climate Change special report compelled greater efforts to limit temperature rise to 1.5 degrees Celsius (versus 2.0 degrees).³ Together, with the Task Force for Climate-Related Financial Disclosures, the two groups have kept environmental considerations front of mind for investors.⁴
- » In September 2019, the UN issued the *Inevitable Policy Response*. It forecasts governments will be forced to accelerate their action on climate change—an inevitability that has so far gone unaccounted in asset prices.
- » Matters of governance received renewed attention when the Business Roundtable declared corporations should be the benefactors of all stakeholders, not just shareholders.⁵ This alters the focus of the corporation from the purist mantra of shareholder value creation that has dominated thinking in listed and unlisted companies alike.⁶
- » The acquisition of Vigeo Eiris by ratings agency Moody's heralds a formal move to price ESG factors into asset values.⁷

StepStone Philosophy

Just as we have gone back to the powerful root concepts laid out in Mr. Annan's seminal *Who Cares Wins*, we believe it is important to explain the foundation of our approach. We share Mr. Annan's belief that effective management of ESG issues increases shareholder value. We also believe regulators, markets, and consumers are going to find ways to recognize externalities and more effectively allocate costs and benefits. Externalities are market inefficiencies. Historically they have persisted because of the lack of information or market mechanisms to recognize them. As this information becomes more available, private markets are well positioned to benefit from the arbitrage of these inefficiencies—identifying them and working to eliminate them. GPs and LPs ignore these factors at their peril.

Our philosophy can be reflected through the equation for the value of a perpetuity, which states the present value of an asset reflects the net present value of its future cash flows:

$$PV = \frac{\text{Future cash flows}}{\text{cap rate}}$$

Where the cap rate is the difference between the discount rate and the growth rate.

Typically, private market investors think about ESG as affecting the numerator—reducing waste in inputs increases profits; reducing pollution avoids potential environmental liability; or worker safety and labor relations trade higher costs in the short term against more stable and productive workforces in the long term. These are important considerations that fall well within the value-creation mindset of active shareholders.

³ IPCC. 2018. "Special Report: Global Warming of 1.5° C."

⁴ UNPRI and TCFD have linked hands in the effort to drive adoption, both sharing a similar conceptual framework and recognizing the benefit of requiring signatories of UNPRI to adopt TCFD and *vice versa*.

⁵ Business Roundtable. 2019. "Statement on the Purpose of a Corporation."

⁶ We would be remiss if we did not acknowledge that in Germany, the concept of *Mitbestimmung*—i.e., worker participation in a firm's decision-making process—was codified in 1976.

⁷ Vigeo Eiris offers specialized research and decision-making tools for sustainable and ethical investments.

The bigger impact on value, however, is in the denominator. This is where multiples are determined. Understanding how ESG can affect the discount rate is the key. For example:

- » In the retail sector, businesses with sophisticated supply chains that “track to source” and do not work with vendors that use forced or coerced labor are more highly rated.
- » In response to consumer demand, large American fast food companies discarded battery chickens in favor of the free-range variety. A frenzy of asset purchases in the agriculture sector ensued as supply chains were reorganized. Suppliers of free-range eggs and hens were rerated while assets associated with battery chickens were priced as stranded.
- » Upgrading an office building to LEED Platinum requires significant investment, reducing cash flow in the near term. But as weather becomes more extreme, energy costs rise, and consumer preferences shift, demand for LEED Platinum offices increases, reducing the cap rate for the property.
- » Analyzing a port's climate-change preparedness may identify risks to the port's business and operations. Rising sea levels, for example, will affect the port's physical assets, as well as its catchment area. Investors weigh the extent to which ports have invested in climate resiliency, requiring a higher cap rate for ports that have underinvested or are located in areas that are particularly susceptible to rising sea levels.

Some ESG factors (e.g., climate change) can be thought of as distinct risk factors, similar to inflation or interest rates. These are the most powerful ESG factors; they affect valuation multiples and cap rates, not just annual profit and loss statements. Incorporating these factors into investment underwriting is certainly not trivial, but the payoff to those who are able to could be significant.

As is the case with any risk decomposition, distinguishing ESG risks from some of the other risk factors can be tricky. For example, governance risk factors may be high in an emerging market country. In such a case, both sovereign and governance risks would be elevated. It is important not to double count or confuse what is driving risks. For example,

Brazilian companies caught up in the Carwash scandal that started in 2014 would have exhibited both elevated governance and sovereign risks. Scrupulous companies that avoided the scandal would only register sovereign risk factors. The inefficiency comes when the market confounds the two; a careful private market investor would recognize the scrupulous company through careful ESG review. The market would price an investment in the company incorporating both governance and sovereign risk in the discount rate; however, as the competition was eliminated through the anti-corruption movement, the scrupulous company would increase its market share, and be rerated with a higher multiple. This is the type of inefficiency that a functioning ESG program can turn into superior financial returns.

The discount or hurdle rate also introduces a time consideration. In private markets, holding periods are often counted in years or even decades, rather than days or minutes. This is particularly important as we consider ESG factors, some of which manifest over an extended period. Pricing in such factors is important because they can materialize within the holding period. Investments made today could still be on the books a decade hence, when temperatures are expected to peak (hopefully). How resilient will such assets be under hotter conditions? How will the asset's business strategy need to change? Whereas public markets may sell out of assets requiring a complex strategy shift to decarbonize their business plan, private ownership affords the opportunity for stewardship. Longer holding periods provide the opportunity to build revenue opportunities like carbon sequestration or a complete shift to renewables, which benefit from a long view of ESG factors.

As long-term investors, we need to recognize climate change, pollution, income inequality, and corruption as the externalities they are: a skew requiring future generations to subsidize the present through lower quality of life, higher taxation, and increased socio-political instability. As these externalities become more transparent, they will become easier to internalize—creating a link between ESG factors and financial returns.

GP Perspectives on ESG

If an investor has an ESG policy at all (many do not), they are likely to fall into one of the following buckets when it comes to ESG integration.

THE COST OF DOING BUSINESS

Some investors regard ESG integration as an additional task that is akin to a compliance cost. This can lead to a “tick-the-box” mentality, whereby ESG issues are not considered until the end of the due diligence to “tidy up” investment memos. In such cases, it is not uncommon to see ESG functions falling under the purview of the head of compliance.

HAPHAZARD APPLICATION

Other investors might give due consideration to ESG factors, but their approach lacks any systematic application. They do not label such considerations as ESG factors and may even go so far as to resist such nomenclature. Perhaps a root cause of this perspective is the mistaken belief that ESG considerations dilute profits or amount to a negative screen that reduces the manager’s investment opportunity set. This perspective may also be a residual effect from schools of thought that wrongly conflate ESG integration with concessionary impact investing (i.e., accepting a discount to commercial returns to achieve a non-financial objective). Some investors also confuse values with responsible investing, believing a moral compass is the same as ESG integration.

INTEGRATED APPROACH

Fortunately, a growing cohort of investors is embracing a structured ESG framework and working hard to integrate ESG factors into their investment processes. Yet even with this mindset, this group is encountering a number of challenges.

Challenges

In *Who Cares Wins*, measurement and disclosure are prominent themes. As the saying goes, “what gets measured, gets done.” Metrics are tangible. They create a feedback loop and

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quantify the externality. Without them, it is very difficult to effect change. But herein lies the rub: There is a natural tension between metrics that are tailored to specific business goals and standardization, which allows for peer group benchmarking.

We expect there to be greater standardization over time, particularly for headline metrics. Work to do so is already underway. For example, a landmark 2019 EU report establishes 67 criteria capital markets can use to determine whether an investment might mitigate climate change.⁸ Parsimony is not one of bureaucracies’ virtues, as can be seen in the 17 SDGs and this complex taxonomy. This complexity, however, inures to the benefit of private market investors who can take the time to dig into the particulars.

Related to the challenge of deciding what to measure is the task of tracking and reporting on the chosen metrics. Data and process auditing is another ordeal entirely.

This discussion on metrics and measurement is very relevant to private markets, which have a long history of effecting change in their portfolio assets through active engagement. One of the dominant trends over the last five years within private equity is the rise of teams specializing in operational value add. Residing within the GP, these groups are akin to consulting firms. They are increasingly a critical component of the pitch private equity managers make to the companies they are targeting. A similar trend is underway in the infrastructure sector as well.

⁸ EU Technical Expert Group on Sustainable Finance. 2019. "Financing a Sustainable European Economy."

ESG slots well into active management because it provides a richer framework across which to drive operational change and improvement. The focus needn't be limited to governance and strategic improvements. As private markets continue to become more competitive, improving, say, energy efficiency, will be more than a "nice to have." It will be a way to reduce costs and anticipate future policy responses to climate change and pollution.

As noted above, deciding on what to measure is fraught. Creating the systems to monitor and measure the chosen metrics has been lagging. The ability of GPs to measure a diverse array of metrics across their portfolios, as well as conduct benchmarking and scenario analysis is clunky and time consuming. But change is coming, and more service providers are moving into this space to help with this data management. Just as fiduciaries pushed their investment managers to make ESG a priority, they will push for better monitoring and reporting, which will characterize the next phase of responsible investing.

Conclusion

It has taken almost two decades for responsible investing to spill into the mainstream. We see no signs of the momentum abating and are hopeful that in another 20 years responsible investing will be the norm. Part of this optimism is rooted in the generational wealth transfer that is underway; future retirees will demand stewards of their capital contribute to a sustainably-managed society.

The other factor is the increased allocations to private markets where long holding periods and a proclivity for active management dovetail with the ESG agenda. As regulators, grass-roots activists, and other stakeholders uncover externalities, private market investors will be well positioned: Arbitraging inefficiencies is what we do. As capital markets both public and private become more efficient, thoughtful investors will want to care more about ESG as a way to identify inefficiencies to arbitrage. As foreseen by Mr. Annan, who cares about ESG wins higher financial returns.

ESG, Responsible Investing, Sustainability, Impact— Confused?

As the sector has grown, so too has the amount of jargon. There are a number of words that are used interchangeably but actually have different meanings.

ESG refers to the framework born out of the work of the UNPRI.

Responsible investing is the “how.” It is an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk, and generate sustainable, long-term returns.

Common themes in **socially responsible investing** include avoiding companies that profit from vice while seeking out companies focused on social or environmental issues.

Sustainable investing might effect a positive social or environmental result, but **impact investors** set out to do so intentionally. For them, quantifying the magnitude of change is everything. An impact investment might have a **double** or **triple bottom line** (i.e., people, profits, planet).

Corporate Social Responsibility is one of the oldest terms in the field. It refers to policies companies have in place to address ESG issues. Business ethics feature heavily.

Greenwashing is pretending to be more environmentally friendly than you really are.

SPECTRUM OF RESPONSIBLE INVESTMENT



Source: Social Impact Investment Taskforce. 2014. "Allocating for Impact: Subject Paper of the Asset Allocation Working Group."

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Global Offices

BEIJING

Kerry Centre
South Tower, 16th Floor,
1 Guang Hua Road, Chaoyang District
Beijing, China 100020

CHARLOTTE

1422 S Tryon Sreet, Suite 300
Charlotte, NC 28203

CLEVELAND

127 Public Square, Suite 5050
Cleveland, OH 44114

DUBLIN

Newmount House
22-24 Lower Mount Street
Dublin 2, Ireland

HONG KONG

Level 15
Nexus Building
41 Connaught Road Central
Central, Hong Kong

LA JOLLA

4275 Executive Square, Suite 500
La Jolla, CA 92037

LIMA

Av Jorge Basadre 607
San Isidro, Lima, Peru

LONDON

2 St James's Market
London SW1Y 4AH

LUXEMBOURG

124 Boulevard de la Pétrusse
L-2330 Luxembourg

NEW YORK

450 Lexington Avenue, 31st Floor
New York, NY 10017

PERTH

Level 24, Allendale Square
77 St George's Terrace
Perth WA 6000, Australia

ROME

Via Crescenzo, 14
00193 Rome, Italy

SAN FRANCISCO

Two Embarcadero Center, Suite 480
San Francisco, CA 94111

SÃO PAULO

Av. Brigadeiro Faria Lima 3355, 8th Floor
Itaim Bibi, São Paulo, Brazil 04538-133

SEOUL

Three IFC Level 43
10 Gukjegeumyung-ro
Youngdeungpo-gu, Seoul 07326 Korea

SYDNEY

Level 43 Governor Phillip Tower
One Farrer Place
Sydney NSW 2000, Australia

TOKYO

Level 1 Yusen Building
2-3-2 Marunouchi
Chiyoda-ku, Tokyo 100-0005, Japan

TORONTO

130 King Street, Suite 1205
Exchange Tower
Toronto, ON, Canada M5X 1A9

ZURICH

Klausstrasse 4
CH-8008 Zurich, Switzerland

For more information regarding StepStone's research,
please contact us at research@stepstoneglobal.com.

www.stepstoneglobal.com