GOOD benchmarks

BENCHMARKING SUSTAINABILITY CHARACTERISTICS AND IMPACT PERFORMANCE OF INVESTMENT PORTFOLIOS

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INTRODUCTION

Ongoing development in ESG integration and sustainable investing practice has resulted in a variety of investment products, with differences in intentions, processes, and outcomes. Coupled with the rapid development of data availability and assessment frameworks, this product variety has naturally produced some challenges in benchmarking performance. While we have many well-established means of assessing financial performance, we do not yet have equally well-developed ways to assess portfolio-level sustainability characteristics or social or environmental impact.

Our intention in this brief summary is not to offer a detailed or prescriptive set of tools, but rather to reflect on the core design principles that will allow for useful assessment of sustainability and impact performance for investment strategies. We offer these observations as a framework for describing the characteristics of effective measurement systems, helping to identify approaches that are fit for purpose, based on sound data, transparent processing, and relevant focus areas. In doing so, we aim to also identify opportunities to improve approaches that may involve poor underlying data quality, opaque assessment mechanisms, or a mismatch between analytical tools and investment context.

GOOD benchmarks

For the purposes of this analysis, we align our terminology with the recently published Investment Company Institute report, "Funds' Use of ESG Integration and Sustainable Investment Strategies."

- **ESG integration** is employed by many investment managers, most often through the consideration of financially material ESG factors in order to enhance risk-adjusted return.
- **Sustainable investment approaches** use ESG analysis as a central part of the investment process.
    - **ESG exclusionary approaches** exclude companies that do not meet certain sustainability criteria or investor objectives.
    - **ESG inclusionary approaches** generally seek investment returns plus positive sustainability-related outcomes by systematically focusing on ESG factors.
    - **Impact investing** typically pursues specific, measurable environmental or social outcomes alongside financial return.

NEED FOR THOUGHTFUL BENCHMARKING OF SUSTAINABILITY AND IMPACT

Given the differences in structures, processes, and objectives noted above, it is clear there is a need for benchmarking tools that are consistent in quality, yet context-specific in design and implementation. As noted in the introduction, we have many established and effective ways to assess financial performance of investment portfolios, but we do not yet have well-defined and consistent ways to assess sustainability and impact performance.

Clear design principles for sustainability benchmarking will help the field to develop more effectively, and in a way that is more aligned with both investment merit and positive social and environmental impact. Three design elements are especially useful:

- **Additive vs. duplicative** – Whenever possible, it will be useful to build upon existing corporate disclosure protocols and assessment frameworks. Many structures for evaluating sustainability performance are in place, though the quality of underlying data varies, as does the suitability of any particular framework for any specific investment product.

- **Descriptive over prescriptive** – Generally, descriptive benchmarking is more useful than prescriptive, and carries less danger of unintended consequences. For example, rigid frameworks that assess sustainability performance on single point-in-time metrics could ignore important insights that emerge from analyzing progress over time or in reviewing a multi-dimensional view of the issue at hand.
- **Capacity to adapt** – Similarly, adaptability is valuable, as the issues, data, and analytical tools are progressing rapidly. An overly static system will often not match the dynamic nature of the questions at hand. For example, an absolute level of performance that is considered outstanding in one period might well be insufficient in future periods.

DESIGN PRINCIPLES FOR EFFECTIVE BENCHMARKS

With the above context in mind, good benchmarks for sustainability and impact will demonstrate the following design principles:

- **Focus on financial materiality** – a good benchmark will explicitly focus on how the investment manager considers ESG issues that have long-term financial and investment relevance. This analysis will illuminate areas of fiduciary importance, potential differences in regional or asset class-specific protocols, and intentional distinctions in product design and investment process. The Sustainability Accounting Standards Board (SASB) materiality map is an example of a helpful framework for informing this type of financial materiality analysis for corporate issuers.
- **Focus on intentionality and impact** – a good benchmark will also reflect the stated intentions of individual investment products and processes, with relevant and context-specific assessments of impact. Though the particular metrics and data employed in these measurements might evolve over time, the underlying intentions should be constant for most products. The United Nations Sustainable Development Goals (SDG's) are an example of a helpful framework for organizing impact assessment.

GOOD benchmarks

- **Transparency** – a good benchmark will have visible data, processes, and construction, so that all users can easily understand inputs and methodology, and can assess the considerations that are relevant for their own investment contexts.
- **Adaptability** – a good benchmark will have the ability to evolve over time, and some of this flexibility can be embedded in analytical approaches. For example, some issues lend themselves to absolute metrics and others to relative assessments, and many might benefit from analyzing progress over time in addition to point-in-time reporting. Additionally, the nature of data inputs and related analytical models continues to change. For example, there is important insight to be gained from many forms of non-structured and non-corporate data, in addition to structured data and corporate disclosures.
- **Effectiveness, additionality & impact** – a good benchmark will build on existing resources, making better use of all that has been established to date, and avoiding complication without benefit.
- **Usefulness & inclusivity** – a good benchmark should not require intensive specialized training, but rather should be useful and useable for generalists, across all organizational sizes, geographies, and asset classes.

TRANSLATION TO PRACTICE

Putting the above principles into practice will result in reported outputs that reflect these characteristics:

- **Variation** – a diverse set of investment approaches logically results in variety within their benchmarking frameworks. Consider the range of investment examples below, which logically link to different mechanisms for reporting and assessment of sustainability characteristics and impact.
    - A public equity portfolio that focuses on incorporation of material ESG issues might report on their research integration process and analysis that confirms materiality.
    - A municipal bond fund that focuses on climate impact might report on carbon intensity, avoided emissions, or ecosystem impact.

  - A venture portfolio that focuses on innovation in the education sector might report on adoption rates for new approaches, student benefit, or testing outcomes.
  - A corporate credit strategy that employs ESG-based exclusions might report on differences in portfolio-level ESG metrics that result from those exclusions.
- **Data description** – for many ESG issues, data is improving at a rapid rate, yet is still incomplete. It is often useful and necessary for researchers to use estimated, self-reported, or partial data. Sources of information also vary, and might include primary disclosures from corporate issuers, governmental or NGO sources. Additionally, some analysis might involve use of unstructured data, data science, machine learning, or artificial intelligence tools. Benchmarking therefore needs to include consistent and candid discussion of data sourcing and data quality, along with explanation of the tools used to process primary information.
- **Process & engagement analysis** – as with all investment approaches, assessing both process and outcomes is important. For sustainable, ESG, and impact-oriented investors, activities like corporate engagement and partnership are often key parts of the investment process. Good benchmarking naturally encompasses reporting and analysis of these activities as well.

Given the data-related challenges noted above, it is important to note that there is a strong shared interest amongst all parties in improving corporate disclosure for financially material data, aligned with frameworks like SASB's industry standards. Likewise, the entire field will benefit from continued advances in market infrastructure related to disclosure mechanisms, data quality assurance, and information access. Good benchmarking will not be achievable without continued progress in these areas.

GOOD benchmarks

CONCLUSION

This is an important stage of development for the sustainable investing field. We have the opportunity to create benchmarking processes that are more deeply informed, more closely linked to product design, and more valuable to all investors, advisors, asset managers, and asset owners. Attention to the design principles outlined in this analysis will ensure that our assessments of sustainability and impact embrace the same analytical rigor and functional alignment that are hallmarks of all good benchmarking practices.