Key takeaways

- Many investors remain unsure how to implement responsible investing despite growing interest
- Factor investing provides a customizable approach that can accommodate unique ESG objectives
- Potentially adverse impact of ESG screening constraints can be neutralized by factor-based strategies

Responsible investing has evolved from a niche consideration to a mainstream focus as investors increasingly set objectives beyond pure returns. However, the understanding of how best to implement it has not yet caught up with the enthusiasm. Invesco’s Stephen Quance explains that factor investing is an approach well suited to accommodate ESG objectives, illustrating how investors need not sacrifice returns for the greater good.

Responsible investing (RI) takes environmental, social and governance (ESG) criteria into consideration during the investment process and seeks to align the portfolio with organizations that share similar values. The most common approach is through security screening. However, implementing this type of RI strategy imposes constraints that could potentially weigh on performance. For managers pursuing RI, they must strive to fulfill their ESG objectives while minimizing unattractive or unexpected investment consequences.
This challenge can be overcome by utilizing a factor-based approach to RI. Factor investing involves a process-driven, structured method of security selection that by its construction can accommodate unique ESG objectives. It compares favorably with traditional passive and active approaches when considering the full set of reactions to imposing additional constraints on a portfolio.

**Implementing a factor-based RI strategy**

ESG criteria provide a framework to adopt and align with RI principles. Issues for potential consideration are myriad, covering a wide range of operational standards including supply-chain labor practices, biodiversity impact, board-level gender diversity and water scarcity management (Figure 1). Adherence to a given set of standards can be measured through a straightforward “yes or no” or through a scaled score.

![Figure 1: ESG issues are complex and varied](source)

At its core, an RI screening strategy filters securities based on their parent companies’ adherence to ESG criteria and then builds a portfolio from the ensuing sub-set. This could take the form of negative screening, whereby an investor may exclude exposure to so-called “sin stocks” in the munitions, alcohol and tobacco sectors, for example. Investors may also choose to remove from consideration companies that do not comply with global standards as defined by agreements like the Paris climate accord or UN Global Compact. The complexity of ESG criteria necessitates a flexible RI strategy that can account for nuance and new trends.

Factor investing helps address the challenge of accommodating unique ESG objectives. Still new to many investors, this systematic, evidence-based investment approach targets certain characteristics of an asset, called factors, rather than focusing on sectors or geographies. Factors—such as value, quality and momentum—are quantifiable characteristics of a security that provide information about its expected risk and return (Figure 2).

![Figure 2: Factor investing focuses on certain characteristics of an asset](source)

1. For more details, read “Responsible investing and active ownership” available on Invesco’s Asia-Pacific Institutional website.
When applying a factor-based approach to RI, managers can generate a highly diversified opportunity set even after applying ESG criteria. A manager who is targeting the value factor, for example, starts broad by ranking all investable, ESG-screened securities according to his or her definition of the characteristic and then creates a portfolio accordingly. In this case, many of the securities in the initial universe might also be added to the portfolio because factor investing is not constrained by the number of holdings.

Neutralizing the potentially adverse impact of ESG screens
Screening out securities can reduce material exposure to factors that have historically delivered a premium. For instance, academics have claimed to find superior returns from equities that do not adhere to certain ESG criteria. Yet, research also shows that adding exposure to companies who meet ESG standards can actually deliver better returns on a long-term basis than those that do not. This divergence reflects that the actual investment impact of any screening strategy will vary depending on several variables including time-horizon, filtering criteria and allocation weights.

It is possible though to reverse any negative investment impact caused by ESG screens if we control for all relevant factor exposures. Research shows that when considering both the value and momentum factors, for example, one factor can be pursued while mitigating any negative exposure to the other. Controlling the impact of ESG screens on factor exposure is mitigated in a similar way. By broadening the selection criteria to include multiple factors, the manager has an even greater ability to modulate expected risk and return outcomes.

It is also worth noting that a factor-based approach to RI should not be exposed to meaningful idiosyncratic risk following ESG screens. For instance, a given screening may exclude securities that predominantly rank highly from a quality factor perspective. Since factor investing considers a broad initial opportunity set, a manager targeting the quality factor can adjust by simply increasing the portfolio weighting for the remaining quality-eligible securities.

With factor investing, managers can pursue excess return, and do it in a scalable way, because they are targeting a vast number of securities rather than just a select group. This makes it possible to manage large amounts of assets expeditiously without the constraint faced by active managers of having to cultivate personal relationships with companies or develop expertise with their unique lines of business.

When it comes to active management, removing a portfolio company could create a significant challenge for investors pursuing a concentrated, high-conviction approach. Most securities are already screened out at the fundamental level, so applying further restrictions to the opportunity set through ESG criteria could raise the concentration and implementation risk beyond acceptable levels.

"When applying a factor-based approach to RI, managers can generate a highly diversified opportunity set even after applying ESG criteria."

5. For more details, read “Factor investing: building balanced factor portfolios” available on Invesco's Asia-Pacific Institutional website.
Accommodating unique ESG objectives that express organizational priorities

Investors are increasingly developing unique ESG policies that express the priorities of their organizations. When using a factor-based approach to responsible investing, strategies can be customized to maximize the intended effects and adjusted to account for any new developments.

By contrast, passive investing may not necessarily accommodate the unique ESG objectives a manager intends to achieve. For one thing, passive investors must follow the ESG definition established by benchmark providers, which can sometimes differ from their own understanding. A low carbon index may seem like a suitable match for an investor who has a mandate to exclude high-polluting companies, for example, but the benchmark provider’s definition of acceptable emission levels may be skewed higher than the investor’s, resulting in an opportunity set that does not fulfill their RI goal.

Rebalancing lag is another issue that passive investors must account for when it comes to RI. Even though it may become clear, for example, that a company no longer meets the inclusion standards for a gender diversity–themed benchmark, it still may not be removed from the index until the next rebalancing period. Given that rebalancing may occur quarterly or semi-annually, or even annually, investors could be forced to maintain exposure to one or more securities for extended periods that are at odds with their intended ESG objectives. Factor investing enables investors to create a portfolio from a sub-set of securities that can be adjusted at any time by simply updating the ESG screening settings—rather than waiting for a scheduled rebalancing date—to account for any new developments.

Need for improved ESG reporting

The asset management industry’s commitment to RI has grown significantly. The United Nations-supported Principles for Responsible Investment (PRI) has drawn more than 1,800 signatures from investment managers, asset owners and service providers since launching in 2006. Meanwhile, the amount of investment assets globally that accounted for ESG criteria increased from US$18.3 trillion in 2014 to US$22.9 trillion in 2016, representing a quarter of all managed capital worldwide.

Despite increasing interest in RI, there is still uncertainty over how to implement it. One out of four asset managers globally do not pursue RI, and in Asia Pacific, the lack of ESG information has been cited as a primary reason. The opportunity set for RI screening strategies would increase if more companies published ESG information. Increased depth and breadth in the quality of available reporting information would also enhance the capacity to filter securities according to unique ESG objectives.

"Factor investing enables investors to create a portfolio from a sub-set of securities that can be adjusted at any time by simply updating the ESG screening settings."
Figure 3: Investors still unsure how to implement responsible investing strategies

<table>
<thead>
<tr>
<th>Why do you not consider ESG when making investment decisions?</th>
<th>Respondents (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of demand from clients/investors</td>
<td>33</td>
</tr>
<tr>
<td>Lack of information/data</td>
<td>33</td>
</tr>
<tr>
<td>Inability to integrate ESG into models</td>
<td>26</td>
</tr>
<tr>
<td>No added value</td>
<td>26</td>
</tr>
<tr>
<td>Unsure how to interpret ESG issues</td>
<td>26</td>
</tr>
<tr>
<td>Must focus on short term performance</td>
<td>15</td>
</tr>
<tr>
<td>Other</td>
<td>15</td>
</tr>
<tr>
<td>Not consistent with fiduciary duty</td>
<td>11</td>
</tr>
</tbody>
</table>

Source: CFA Institute. A survey from 9-23 May 2017 collected 1,588 valid responses from CFA Institute members who are portfolio managers or research analysts. Among respondents, 13% came from Asia Pacific.

In Asia Pacific, only one in five companies disclosed ESG information and the rate of reporting has stagnated across major markets (Figure 4). The increasing global focus on RI should ultimately lead to improvement in the depth and breadth of ESG reporting, however, particularly as fast-growing economies concentrate their efforts on achieving sustainable growth and addressing environmental concerns.

Disclosure requirements in the region are also increasing. In 2015, Hong Kong’s stock exchange operator announced listed companies would need to “comply or explain” with provisions in its ESG guide that were previously voluntary. Meanwhile, Singapore also announced listed companies would need to adhere to sustainability reporting on a “comply or explain” basis.

Figure 4: ESG reporting still has room to improve in Asia Pacific

Source: Bloomberg. Data from 1 April 2008 to 1 April 2018.

As interest in this area grows, factor investing should emerge as a preferred approach to implement RI strategies. It enables managers to accommodate unique ESG objectives without constraining performance, accommodates flexibility to make changes as new information becomes available and facilitates an objective comparison between investment options with clarity and purpose.

9. Bloomberg data as of 1 April 2018.
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