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ESG Is The Third Wave Of Change In Asset Management After Graham And MPT

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Investing with an environmental, social or governance (ESG) focus has captured the attention of more and more investors and fund managers in recent years, but 2021 marked a major milestone for the strategy. Declaring 2021 to be "the year of ESG investing," Reuters reported in December that the year saw record inflows to ESG-focused funds.

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Thirty years of ESG investing

According to data from Refinitiv Lipper, investors poured a record $649 billion into ESG funds around the globe during the first 11 months of 2021, up from the $542 billion invested in such funds in 2020 and $285 billion in 2019. Ten percent of the assets invested in funds worldwide are now in ESG funds.

Clearly, ESG investing is not a fad that will go away anytime soon, but it's also not a new idea. In fact, ESG investing has been around for at least three decades. Amy Domini, one of Time's 100 Most Influential People, started one of the first socially responsible funds 30 ago.

She sees ESG as the third major wave of change in asset management, with Benjamin Graham's value investing and modern portfolio theory being the first two significant waves of change.

Meet ESG advocate Amy Domini

Domini describes herself as an advocate of what she calls impact investing or socially responsible investing, although the term "ESG investing" appears to be the one the investment world appears to have rallied around, at least for now. After many years of work, big names in investing like BlackRock's Larry Fink and Ray Dalio's Bridgewater have dived head-first into ESG.

The third wave of change in investing

Over the decades, numerous investors have impacted how other investors participate in the markets today. Legendary investors like Benjamin Graham, John Templeton, Peter Lynch and Warren Buffett will always be remembered. Some investors made a name for themselves purely through their success at investing, but others introduced revolutionary changes that have impacted the markets forever.

Domini noted that every so often, a very meaningful concept comes along within the investing world. She sees the first significant concept as coming in 1934 when Benjamin Graham introduced the idea of value investing in his book *Security Analysis*. Warren Buffett read the book, and it influenced his life and the way he invests forever.

"Benjamin Graham invented or popularized an approach to investing that has been with us ever since," Domini said in an interview. "I don't really think there was another new big approach to investing until modern portfolio theory... It didn't oust Benjamin Graham's writing. It supplemented it."

Domini pointed out that modern portfolio theory took the investing world by storm decades ago, although it doesn't always work in every kind of market. Similarly, ESG doesn't work in every kind of market, which may be one reason some investors are quick to dismiss ESG data when evaluating an investment. However, like modern portfolio theory (MPT), Domini thinks ESG is having a similar impact on the way investors and portfolio

portfolio theory is nonetheless accepted as a useful tool in asset management," Domini opines in an interview. "I think we're starting to see that development with the environmental, social, governance approach to managing a portfolio."

Investing trends continue

Just as value investing continues after the introduction of modern portfolio theory, Domini also expects MPT to stay in place during this new age of ESG investing. She also expects private equity and all the other things MPT enabled to continue.

Domini pointed out that prudent investor standards required trustees to buy stocks that were already widely held, preventing them from buying anything new and untried. However, modern portfolio theory argues that diversification reduces risk, reversing those prudent investor standards.

"Modern portfolio theory laid the table to make [prudent investor standards] less important than diversification," she says. "That opened the door to different types of hedge funds... Forty years ago, there was a list of what stocks could be owned by fiduciaries. It really moved the world to a whole new approach to investing because it added some value to investing."

Different ways of applying ESG methodology

In the same way, ESG is adding even more value to investing. Domini says that the value of ESG-types of information is being recognized on Wall Street.

"In the United States, we're starting to see a little bit more focus on the issue," Domini believes. "Is it real, or is it just somebody's personal idea of

Domini notes that ESG issues tie hometowns, communities and now humankind together. There are different tools for looking at the ecological and other impacts in different parts of the world. For example, some areas might focus more on hiring a certain number of employees with disabilities, while other countries might focus more on other kinds of ESG issues.

How investors can use ESG in stock picking

However, despite the different approaches to ESG in different parts of the world, Domini also pointed out the importance of standardizing ESG methodology. She thinks Wall Street is garnering some vital information from the standards in development today.

"You're able to look at a corporation and understand if the team in place is good at doing things and avoiding problems, and that goes right back to Benjamin Graham's first rule," she opines. "Don't make a mistake. I think it's the third wave of asset management. I don't see any turning back on it now."

Domini also thinks that the unique set of insights that ESG-related research brings into constructing a portfolio provides portfolio managers and investors with a toolset they didn't have before.

While investors may benefit from simply looking at companies' ESG scores purely because of the popularity of ESG-friendly stocks, the utility of those scores runs much deeper. As Domini mentioned, a company's handling of ESG issues can provide clues about whether its management team is strong and good at handling problems. Such qualitative issues cannot be measured or quantified.

include signs of cost-cutting measures and potential risks the company could face due to its ESG-related decisions.

The future of ESG investing

Domini noted that investors shouldn't be all in stocks. They should also be in other asset classes like real estate or art, but she sees a "whole big world of opportunity out there." She advises investors to not only use the methodologies that were introduced many years ago but also avoid holding themselves to one narrow construct. Domini believes that eventually, ESG will be applied to the other 90% of assets under management.

She noted that many of the ESG funds that exist today focus on a single issue, enabling them to collect assets from investors who are especially concerned about that issue. However, focusing on a single issue doesn't bring as robust a picture of a quality management team as looking at all the types of inputs that a broad ESG manager would look at. Domini believes a better approach to ESG investing is to look at the entire scope of a company's ESG-related practices.

Michelle Jones contributed to this report.

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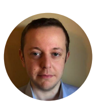

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