

Portfolio

International Small Cap Managers Need to Go Extra Mile for ESG

By **John C. Fenley**

It seems all but guaranteed that the focus on environmental, social and governance investing will endure after a turbulent 2020.

While reliable ESG data is available for U.S. and European large caps, the quality of information can vary widely at a company level and be non-existent outside those regions. Therefore, significant additional effort by active quantitative and fundamental managers is required to assess ESG metrics in the international small cap arena.

Moreover, leading ESG ratings agencies can't be expected to cover the entire investable universe. As an example, third-party providers cover less than 40% of our fundamental international small cap portfolio holdings with a market value of less than \$2.5 billion.

That shifts the onus onto active managers to uncover relevant data points. For our fundamental international small cap strategy, this can take many forms including meetings with company executives, regulators and unions, in addition to site visits, employee surveys, and legal research. The need to overcome barriers such as geography, language and culture adds a further layer of complexity for those operating in the international small cap space.

Whether a manager takes a quantitative, top-down view or a fundamental, bottom-up approach,



they need to work harder and smarter in this asset class to ensure investment decisions account for the risk that unsustainable business practices pose.

Just like country or sector exposure, ESG is a risk factor. It is material to a company's prospects and responsible quantitative and fundamental managers in the international small cap space should commit to investing in companies with verifiable ESG practices.

While often difficult, such work can help to accelerate ESG adoption by companies. On one of our research trips to South Korea, a CEO had no

response when we asked about executive team diversity. Several quarters later, the investor relations representative emailed us a copy of the company's first attempt at an ESG mission statement, including actionable goals.

We believe the rate of adoption of ESG by international small cap companies will increase, assuming the explosive growth in ESG evaluation continues. At the end of 2020, 392 open-end mutual funds and exchange-traded funds in the U.S. claimed to have an ESG focus, a 30% increase over the prior year and a tenfold surge in a decade, according to Morningstar.

Allocation Growth

Allocations for the year reached \$51.1 billion, more than double a then-record \$21.4 billion in 2019 and a nearly tenfold increase over 2018, when flows hit a new mark of \$5.4 billion. It's a similar story in fixed income, where Moody's Investors Service expects the record \$491 billion raised through the sale of green bonds in 2020 to soar to \$650 billion globally this year. Overall, almost a quarter of net flows into stock and bond mutual funds in the U.S. in 2020 went to sustainable vehicles, Morningstar found.

While impressive, the U.S. significantly lags Europe, which accounted for almost 80% of flows into sustainable funds in the fourth quarter of 2020, or \$120.8 billion, Morningstar found, which helped drive global assets under management in ESG-related products to nearly \$1.7 trillion.

And perhaps not surprisingly, the trend also has a strong demographic tilt, with almost 90%

of millennials — those born between 1981 and 1996 — saying ESG metrics play a significant role in their investment choices, according to surveys by Morgan Stanley.

It would be naïve to think there aren't companies that make dubious claims about their ESG credentials. That's why active managers have to ensure they aren't being hoodwinked and why advisors should confirm that the managers they work with — whether they utilize a bottom-up approach or apply a top-down quantitative review of companies in their investible universe — are genuinely committed to ESG.

To retain the hard-won confidence of their clients, advisors should adhere to the Russian proverb made famous by Ronald Reagan — trust but verify.

International small-cap fund managers who integrate ESG into their quantitative and fundamental processes and who have done the necessary analysis to weed out companies that can't back up their ESG claims won't balk at being quizzed about their investment decisions.

In fact, they'll relish it.

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