There's a Blindspot in ESG Investing. Here's How to Fix It.

By focusing on large public companies and private impact investing, investors are missing out on small-cap opportunities.

- **Julie Segal**

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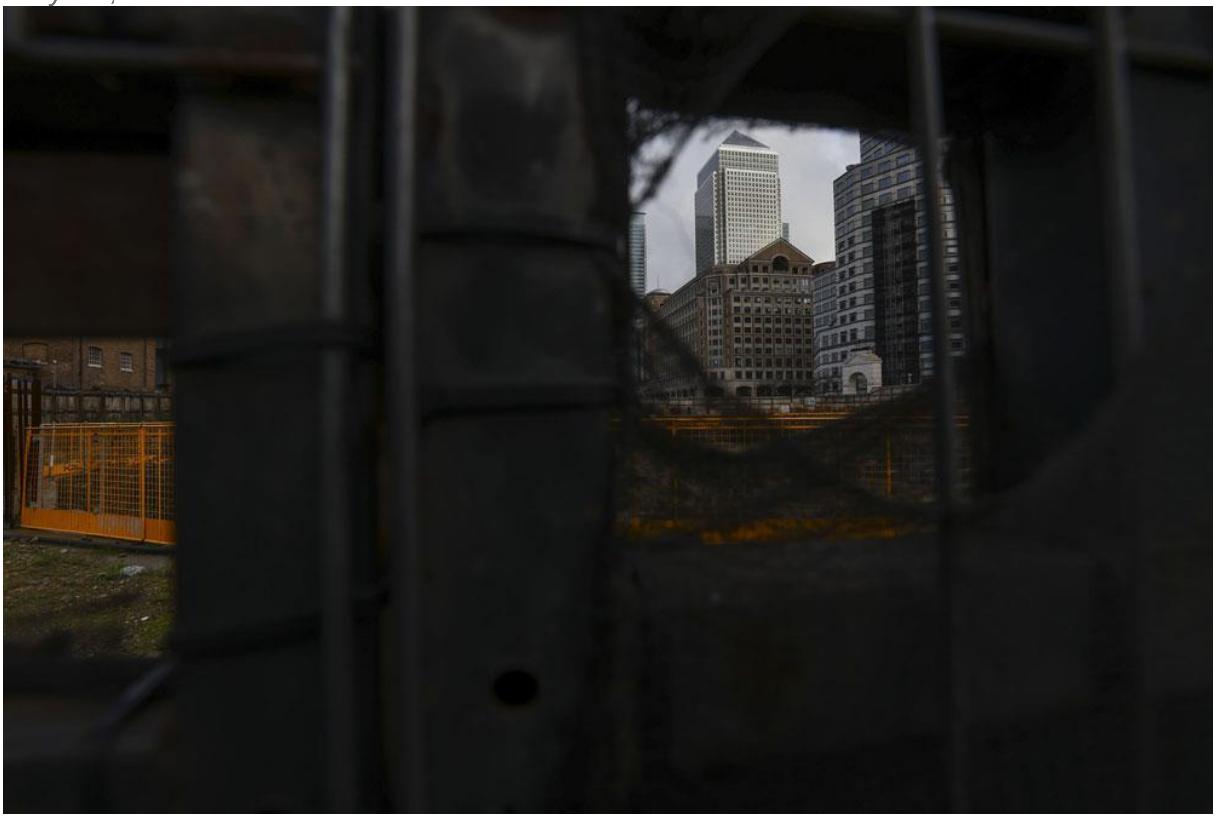

(Simon Dawson/Bloomberg)

Smaller companies are being overlooked by investors with an environmental, social, and governance mandate.

Corporate and public pensions, endowments, and foundations invest the majority of assets earmarked for ESG into the largest public companies.

In part, that's because true ESG initiatives don't come cheap and big public companies have used their deep pockets to adopt expensive reporting, standards, and disclosure programs, whether or not those policies ultimately lead to better ESG outcomes. At the same time, they've also been able to define some ESG best practices, such as the optimal structure of a board — even when those practices may not make sense for smaller companies.

The positive side of the disparity between large and small companies is that small-cap stocks are relatively unplowed territory for investors looking to invest through an ESG lens or use ESG information for risk management.

Conrad Doenges, chief investment officer of small-cap manager Ranger Investments, said many small-cap companies are doing meaningful work around ESG, but don't publicize those programs. "It's more of a pull from investors than a push that many larger companies are able to do," he said.

Doenges added that small caps, and especially micro-cap companies, also get overlooked because many asset managers have made what he calls a false choice between making ESG investments in larger companies on the public markets side and buying stakes in private businesses to do what's called impact investing, such as in clean water or affordable housing. Private markets managers sell their ability to make more wholesale changes when their companies are out of the quarterly earnings call views of shareholders.

Like private companies, investors do have more pull with smaller public firms. "While there is less data about small caps, it's also in small-cap strategies where we see institutional investors perhaps pay a little more attention to engagement strategies and impact," said Valentin Allard, senior consultant at INDEFI, a Paris-based strategy consultant for global investment managers that expanded to the U.S. in April. INDEFI's sweet spot, at least in Europe, has been ESG, sustainability, and private markets.

"When you're going down the market cap and you start investing in companies in which you'll hold a non-negligible amount of floating shares, then that puts you in a position where you're able to effectively deploy your engagement strategy. You're able to discuss issues with management, influence some practices, and gather the data you're lacking. So it's up to managers to figure out how ESG can actually be a differentiator in small-cap strategies rather than using data as an excuse not to invest here."

Not surprisingly, managers interested in small caps have to do their own research. In part, that’s because third-party research is biased toward larger companies. For example, as companies decline in size, ESG grades favor larger companies, according to Ranger’s own research. Ranger analyzed broad indices such as the MSCI USA Investable Market Index, which is made up of about 2,300 U.S. companies with a market capitalization of $100 million or more.

As of October 2020, the small-cap manager found that about 20 percent of companies in the top quintile based on size are rated AA or higher by MSCI, compared with only 3 percent of those in the bottom quintile. In addition, 34 percent of the firms in the bottom quintile are classified as ESG “laggards,” versus only 10 percent of the top quintile.

Many third-party research firms don’t even cover micro-cap companies, according to Ranger.

Andrew Hill, president and portfolio manager at Ranger, said his firm uses ESG information like other risk management tools in the portfolio. “If you look at any easily quantifiable metric, and you backtest that metric against historical returns in small caps and micro caps, the results are inconclusive,” he said. “There is no easily quantifiable ESG metric that by itself drives alpha across our universe. But we think that companies that do well on ESG can perform well with less risk than peers."

For example, Hill looks at social issues — the S in ESG — when investing in banks. Regulators also evaluate banks based on the Community Reinvestment Act and how well they perform in lower income neighborhoods in which they operate. "If a bank scores poorly, regulators could come in and limit its ability to grow mortgage loans," he said.

A small-cap investor at another asset manager said the lack of ESG attention on small caps is also a risk to investors who care about the environment and other social equity issues. "The more focus the better," the investor said. "If small companies aren't getting rewarded for this, they also know they might not be penalized for not caring about their carbon footprint," for instance.

Doeges said one of the best fundamentally performing restaurant companies coming out of Covid has been Texas Roadhouse. ESG factors were one of multiple considerations that Ranger used to identify and invest in the company. "In the face of the shutdown, this company paid employees' health benefits [and] committed $5 million from the corporation and the CEO into a fund to support employees," among other things, he said. "In the DNA of the company, you have what I call that soul."

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