Invesco

Whitepaper

Sustainable investing ... but how?

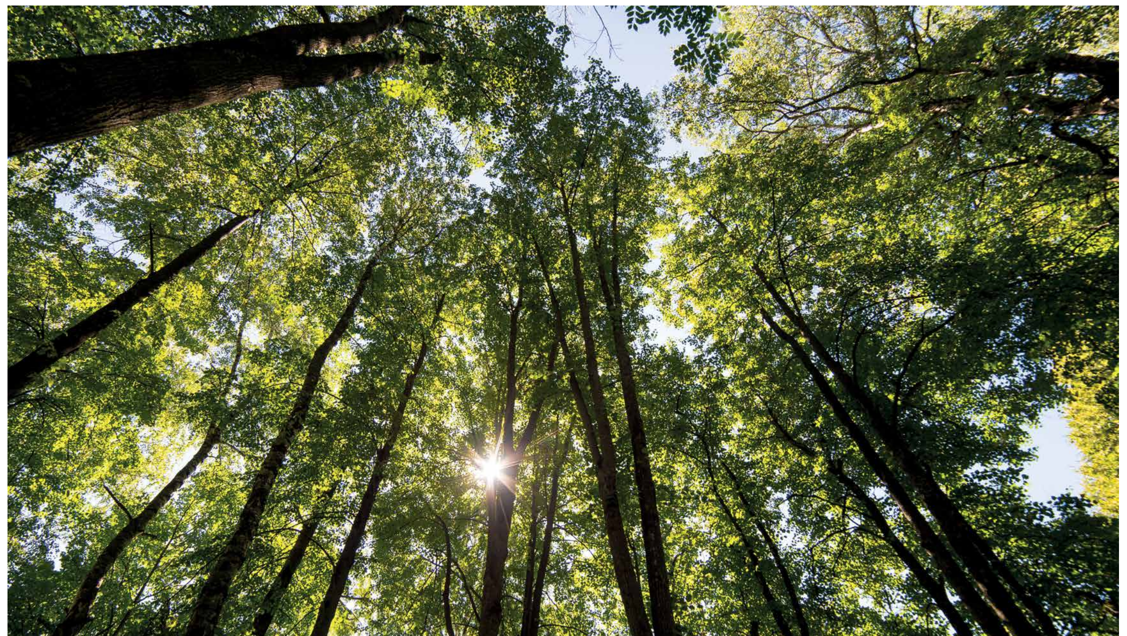
In brief

Ever more investors want their investments to be sustainable. But which of the many methods is the best? We present various approaches to sustainable investing. One method is based on the widespread best-in-class concept. This involves selecting the sector sustainability leaders to assure a degree of portfolio diversification that would not be possible if the focus is solely on the environmental sector. Which approach to choose also depends on each investor's individual goals. But one thing is certain: the old theory that sustainability is only possible at the expense of performance does not hold true.

In the last ten years, the sustainability demands on financial assets – e.g. CO_2 footprint, labour conditions, corporate governance, to name but a few – have risen. We consider various ways of implementing these criteria in a portfolio and explain why the effort may be worth it.

Does socially responsible management pay off for companies? This question crops up time and again due to the still widespread assumption that sustainable governance imposes too great a restriction on entrepreneurial freedom. The belief is that the impact of a sustainable business strategy is in no reasonable proportion to the costs. At the end of this article, we will consider this assumption once again.

But even if the economic considerations are left aside, for many years investors have been wanting to have an ever greater say in what happens with their money. Along the lines of "money makes the world go around", the credo is that with every euro or dollar that leaves my purse I can support certain activities – or not, as the case may be. How we put our money to use will ultimately determine the society of the future. And the same naturally applies to investments. Money means power, and many investors have come to realize that they are no longer willing to simply surrender this power but want to use it for their own purposes and goals. This alone justifies a departure from conventional index investments, with the invested funds being spread out over all issuers and the focus placed on companies whose philosophy fulfills certain criteria, whether environmental management, labor conditions or any other sustainability criteria. Index investments that do not exploit this potential are frequently cost-efficient but flawed in sustainability terms.



One example is dealing with companies that produce cluster munition. After a convention came into force under international law in 2010 which banned the use, production and distribution of certain types of conventional cluster munition, many investors responded to these new demands and excluded companies involved in the production of cluster munition from their investments. By November 2015 the convention had been ratified by 97 countries and the Holy See, and signed by a further 20 countries. As a consequence, at the end of August 2016 the last US producer of cluster bombs announced that it would discontinue production of banned weapons – a historical step forward because the convention has succeeded in putting cluster munition on the list of proscribed weapons together with biological and chemical weapons.

Another example are the so-called divestment campaigns in which investments in certain industries are rejected on principle. Divestment campaigns now exist in many countries of the world. Originally such campaigns were politically motivated, and became popular in the 1980s when an economic boycott against the South African apartheid regime was organized in the US. Public investors, such as churches, municipalities or universities were called upon to withdraw all funds from South African investments.

In past years, the objective of divestment campaigns has been to reject equities or other investment vehicles that are questionable in sustainability terms. For example, the global divestment campaign "Go fossil-free" achieved notoriety through the climate change debate. It called upon public institutions, organizations or pension funds to no longer invest in companies from the fossil energies sector. Furthermore, funds already invested in such companies were to be withdrawn and reinvested in sustainable companies. Many cities, regional authorities and universities in the USA and Europe have already withdrawn their investments in fossil energies. The Norwegian pension fund, one of the biggest state funds in the world, has completely withdrawn its capital from coal companies.

These examples clearly show that a combination of regulatory controls, investment restrictions and social ostracism can indeed achieve significant changes. Nonetheless, many investors still steer clear of sustainable investments amid fears of a loss in performance as a result of taking account of sustainability criteria. The argument is that a restriction on an investment universe would automatically result in performance losses.

Yet the original idea of sustainable investing is based on the assumption that companies competing against each other will generate above-average returns and increase shareholder value in the long term if they exploit ecological and social potentials for their corporate strategy. Companies that are already preparing themselves for the upcoming social and ecological challenges are, on the whole, quicker at both recognizing risks and seizing opportunities than others. They are also generally better prepared for regulatory changes. What is more, socially responsible management also strengthens trust and enhances a company's reputation.

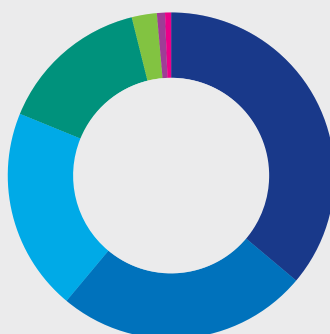
In the past, this issue in particular was frequently underestimated by companies. Consumers, business partners and investors are no longer indifferent to the conditions under which products are manufactured or services offered. The fulfillment of certain minimum requirements is now standard practice. Besides pure economic considerations, societal and social aspects are also growing in relevance. And it stands to reason that a company's reputation must not only be visible from the outside but must also be actually lived within the company.

Consumers, business partners and investors are no longer indifferent to the conditions under which products are manufactured or services offered.

To anchor the theme of sustainability in investments, various ESG strategies (ESG = Environmental, Social, Governance) exist which have established themselves in recent years. The global investment volume in these strategies focuses essentially on five approaches (figure 1):

1. Exclusion/negative screening: investments that involve the complete exclusion of certain themes.

Figure 1
Market shares of various sustainability strategies



Strategy	Share
Exclusion / negative screening	36.13%
Integration	24.94%
Engagement / shareholder action	20.12%
Norms-based screening	14.94%
Positive Screening / best-in-class	2.48%
Theme-based investments	0.80%
Impact Investing	0.60%

Source: GSIA (Global Sustainable Investment Alliance); 2016 Global Sustainable Investment Review.

2. Integration: systematic consideration of ESG factors in the investment process and classic financial analysis, i.e. besides classic valuation criteria, a company's quality is also directly measured according to ESG criteria.

3. Engagement/shareholder action: shareholder influence on companies pursuing critical activities through direct dialogue or proxy voting.

4. Norms-based screening: criteria are applied that are based on international standards and norms.

5. Positive screening/best-in-class: identification of companies that, within their sector, fulfil certain criteria from the environment, social and governance areas to an above-average degree.

Other forms of sustainable investing, such as impact investing (investments that not only pursue financial return aspects but are also aimed at having a social and ecological impact) or theme-based investments (investments geared directly and thematically to sustainability, e.g. renewable energies, environmentally friendly technologies etc.) generally play only an insignificant role.

According to a study published in January 2017 by the international GSIA (Global Sustainable Investment Alliance), the volume of assets managed in line with ESG criteria amounted worldwide to some USD 22.8 trillion with a growth rate in the past two years of roughly 25 percent. Previously, global sustainable investment assets grew 61 percent from 2012 to 2014.

Sustainable investing yes! But how?
Anyone keen to invest in accordance with the ESG criteria will need to answer two fundamental questions at some stage in time – how can ESG information on companies be obtained and processed, and how should the results be applied in a portfolio. We believe that a distinction must be made between two potential approaches:

- Positive criteria: by applying positive criteria, companies are identified that display excellence in sustainable management and sustainable products or processes. They fulfil ecological and social requirements particularly well, ranging from climate efficiency and low water consumption to labour safety and satisfaction.

- Exclusion and negative criteria: by applying these criteria, companies, sectors or countries can be excluded from the investment universe that fail to fulfil certain ESG criteria or that violate international norms and standards according to the definitions of the International Labour Organisation (ILO), the OECD or the United Nations. Negative screening is one of the most frequently used approaches.

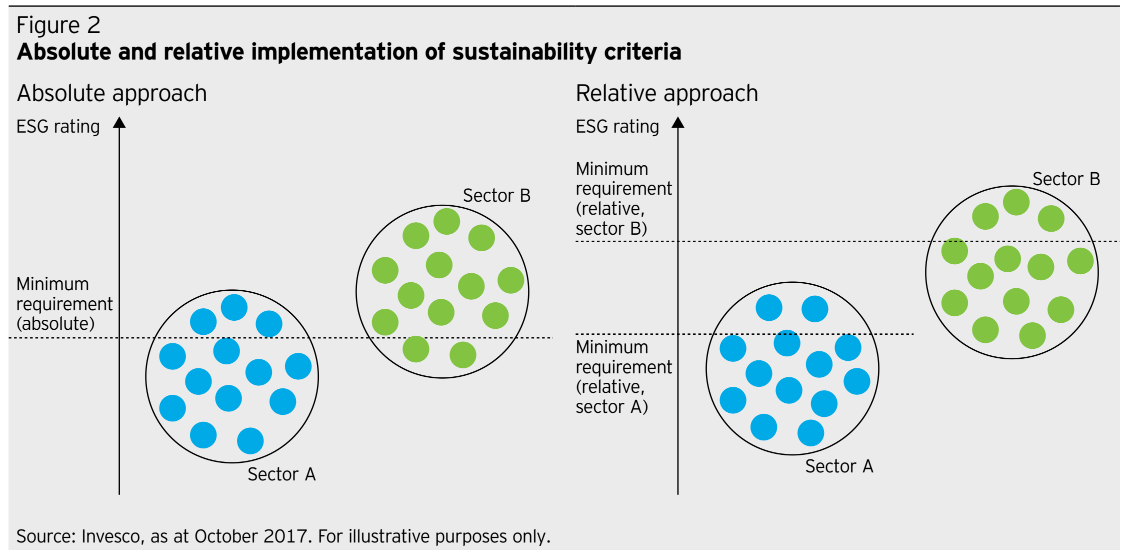
Furthermore, a distinction must be made between two fundamental considerations, the absolute and the relative approach (figure 2):

- Absolute approach: the ESG rating is calculated on the basis of absolute criteria. The focus lies solely on how well a company fulfils the ESG requirements, regardless of how it stands in relation to other companies. Similarly, negative screening allows companies to be excluded if they pursue or support certain activities. This can result in a very large number of stocks being excluded from one sector but only a very small number from another. Where necessary, certain sectors can even be fully excluded if their

ESG rating agencies
ESG ratings have grown in importance in response to the steadily growing interest in sustainability investing. Recent years have seen a growing number of ESG rating agencies introduced on the market.

ESG ratings aim to measure a company's sustainability. But because no standard exists for this, it is important to know the method being used to assess and weight the environmental , social and governance themes and the information sources on which the ratings are based. For example, many agencies use the best-in-class method while others prefer to apply their own catalogue of criteria or simply provide information so that the investor can decide for himself/herself what is relevant. The analysis results can therefore differ greatly or even contradict each other.

Figure 2
Absolute and relative implementation of sustainability criteria



Source: Invesco, as at October 2017. For illustrative purposes only.

activities are not commensurate with the ESG criteria. While the absolute consideration has the advantage of applying certain minimum cross-industry standards, the exclusion of specific sectors can greatly narrow portfolio diversification.

- Relative approach: when applying this approach, companies are initially sorted into groups, for example by sector or industry. The best stocks are then filtered out of the groups, for example in accordance with a predefined share.

The database EIRIS Portfolio Manager (EPM)[1] offers a way to implement the aforementioned positive, negative and exclusion criteria in sustainable equity and corporate bond portfolios. Because EPM does not prescribe any standardized rating, investors can define individual exclusion criteria and assess enterprises in accordance with their own criteria. EPM enables companies to be either excluded or selected on the basis of weighted positive and negative criteria. A combination of both methods is also possible. With its research on some 3,500 listed companies worldwide, EPM covers all the usual global and regional equity indices. Companies are analyzed on the basis of 250 different criteria for all relevant ESG fields. These include environment, corporate governance, human rights, labour conditions etc.

A so-called Country Sustainability Rating is available for sovereign bonds via Vigeo Eiris[2]. This sustainability rating can be modified in accordance with an investor's own personal requirements. To assess a country in terms of sustainability criteria, a large number of indicators are used from the areas of politics, social issues and the environment which are then combined into an overall rating. Reliable international sources, such as Amnesty International, UNICEF, World Bank and WHO, are used for the assessment.

Figure 3 shows selected ESG factors for companies and countries.

Sustainability indices
As the notion of sustainability covers a very wide area, sustainability indices that apply the best-in-class principle were developed as an orientation aid for investors interested in sustainability investing. They track the development of a sustainability-aligned equity universe. Examples of index series that are global leaders in this area are Dow Jones Sustainability, FTSE4Good or the MSCI sustainability indices that are offered in the form of international, regional or national indices.

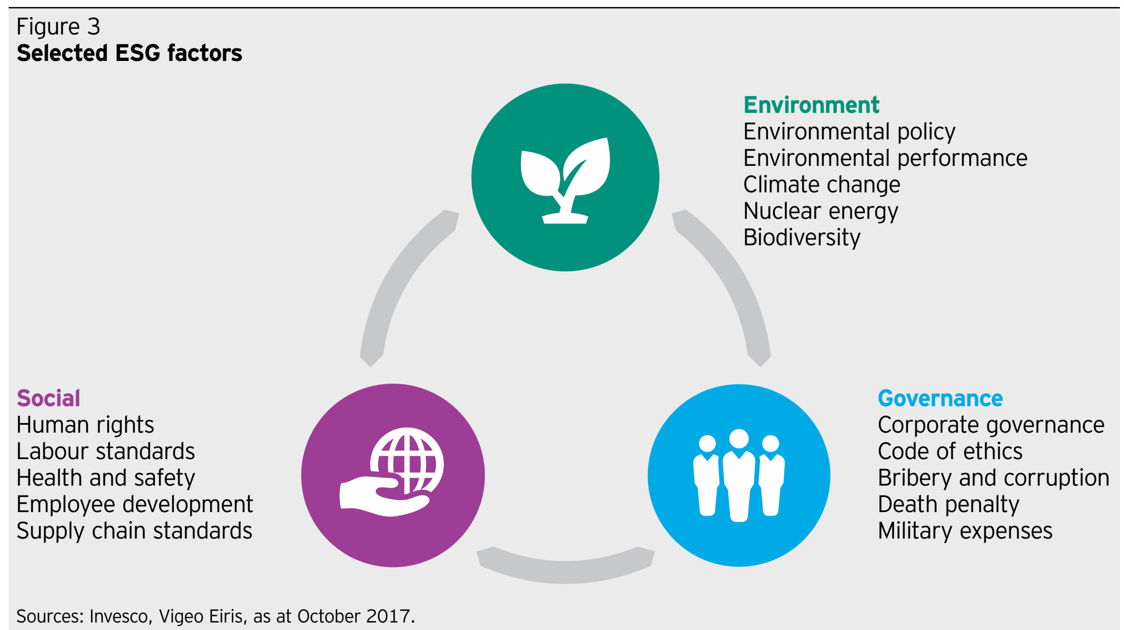
For a best-in-class index, companies that rank among the leaders of their sectors in terms of environment, social issues and governance are selected in accordance with this concept. In other words, the index is not restricted to classic sustainability sectors such as renewable energies or environmental technology. Carmakers or oil and chemical companies are also considered – provided they score particularly well in the ESG rating and are most effective at implementing ecological and social standards within their industry.

One of the greatest stumbling blocks of this approach is that these companies do not need to be particularly sustainable to be included in this index; it is sufficient for them to rank among the best within a peer group (e.g. a sector). This implies the risk of investing in stocks which, in absolute terms, are not particularly sustainable but which are still relatively well positioned in their sector. On the other hand, stocks might be excluded which do not rank among the best in their peer group but which are still better than most companies from another sector. But this is a general problem with all relative approaches.

The weighting method can pose a further problem as many best-in-class indices are weighted according to market capitalization. This means that relatively small companies that work entirely in accordance with socially responsible criteria have no chance of being given a significant index weight.

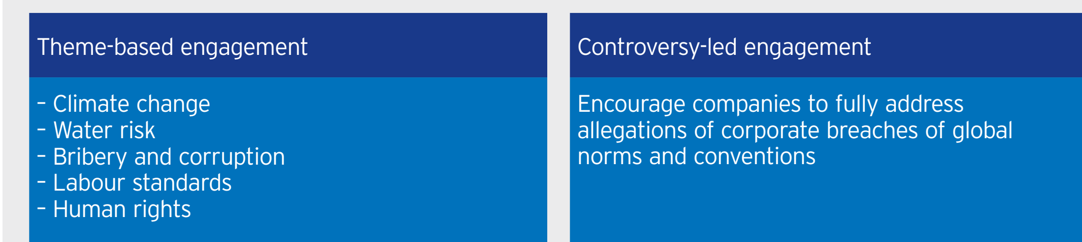
Further influence through proxy voting and engagement
There are various ways of exerting pressure on companies to make them more sustainable. Over the years, investors have realized the need to do more than simply exclude or sell stocks in companies that do not meet the investor's sustainability requirements.

Figure 3
Selected ESG factors



Sources: Invesco, Vigeo Eiris, as at October 2017.

Figure 4
The engagement approaches



Sources: Invesco, Vigeo Eiris, as at October 2017.

This gave rise to the desire to use voting rights as a means of influencing companies.

Key features of well-managed companies are responsible governance, transparent reporting and a performance-oriented corporate culture, with the focus both on the interests of the stakeholders as well as those of the shareholders. One way of influencing this is through proxy voting at annual general meetings (AGMs).

Another way is to exert influence by means of direct dialogue with management, known as engagement. Investors are given the opportunity of raising key sustainability issues with a company's management and point out irregularities.

Invesco Quantitative Strategies also enters regularly into dialogue with companies via VigeoEiris.[3] The objective is to identify weaknesses in the company's sustainability management and discuss these with management to enable the companies to achieve a better ESG performance in the medium to long term. Here, too, a distinction is made between two engagement methods (figure 4): theme-based engagement aims to encourage companies to expose and reduce systemic risks in areas such as climate change, bribery and corruption. Controversy-led engagement aims to prompt companies to observe internationally-recognized standards and conventions and correspondingly improve their company guidelines.

This typical process of engagement, in which the interests of several investors are bundled together, can often have a significant influence on companies: after all, companies that refuse or choose to ignore the improvements being suggested can face de-investment – to their own detriment.

Conclusion: sustainability, performance and risk
And so the circle closes. Bearing all this in mind, it is reasonable to conclude that consideration of ESG factors in investments should not lead to the frequently feared earnings losses. If investors give preference to sustainable companies, this will boost these companies' share prices – and the postulated connection between sustainability and performance will become a self-fulfilling prophecy as often happens on financial markets. The connection between sustainability and performance has meanwhile been confirmed by many scientific studies.[4]

Yet it is still important to consider that overly restrictive sustainability criteria can limit the investment universe to such an extent that portfolio diversification is greatly impeded. The exclusion of entire sectors can be detrimental to achieving an appropriate risk-return profile, no matter how sustainable the remaining companies are. It is therefore always vital to carefully weigh up the pros and cons, and from the various approaches presented in this article select the sustainability method that is most appropriate for the investment goals. This can be either an absolute or a relative approach, a screening concept or a best-in-class selection.

Investment risks:
The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

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Notes
1 Cf. http://www.eiris.org/pension-funds/products-and-services/eiris-portfolio-manager-epm/
2 Cf. http://www.eiris.org/asset-managers/products-services/country-bonds/
3 As soon as we have defined the themes of our engagement, we write to the companies and draw their attention to the weaknesses or missing processes. Together with Vigeo Eiris, we analyze the answers or ask further questions. The results are carefully documented. Engagement processes can take several years to complete.
4 For example, in its study "Alpha from Sustainability" published in June 2014, RobecoSAM examined the connection between sustainable corporate governance and returns. It revealed that on average, the share prices of sustainable companies performed better from 2001 to 2013 than those of their less sustainable rivals. The study, based on 530 developed market companies in the RobecoSAM research universe (the participants in the RobecoSAM Corporate Sustainability Assessment), shows that sustainability and profit maximization do not rule each other out.

Important information

Data as at 30.11.2017, unless otherwise stated.

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