Making an impact by defining the right mix of ESG strategies

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Views expressed here are those of the author, who is solely responsible for any errors and omissions.

Introduction

Whilst supranational institutions and NGOs have for too long been alone on the front lines of the battle against poverty, corruption, and resource depletion, both companies and the finance sector are now fully aware of the role they have to play in the transition to a more sustainable economy. So-called “megatrends” – demographics, globalisation, the environment, societal evolution – act as disruptive forces and offer growth potential for investors. The motivations of asset owners have evolved; they have become more elaborate, more complex and more meaningful, and now include topics that go beyond the unique consideration of achieving financial performance. Even if performance remains the primary objective, investors now want their portfolios to have an impact on both the environment and society, and want to measure the efficiency of this choice.

The search for Impact

Dealing with issues like climate change, ending child labour, improving work practices, reducing waste, safeguarding water resources – all these will only be properly tackled by changing behaviours over time, and continuing to do so. That means a continuous process of incremental change improving environmental, social and governance (ESG) impact. Whilst responsible investment was limited for a long time to a few pioneering investors, it has now become a major consideration for all long-term investors. There are now many who have realised that ignoring ESG challenges entails running risks for their portfolios. And equally, at the other end, new opportunities for creating return have emerged.

Impact investing is carried out in many different forms, because the motivations behind it are multifold. The choice of impact investing could stem from a “value” approach, driven by research into social and environmental impact or motivated by ethical or moral considerations; from a “risk” approach, aiming to achieve optimal risk management (reputational, operational, financial or regulatory); from a “return” approach to profit from financial opportunities related to the energy transition for example; or even from a “duty” approach, meaning a management strategy that is in line with the investor’s fiduciary duty, legal obligations or beliefs of the most well-known NGOs.

In order to respond to requests related to these four “drivers”, which can be combined and interconnected in many ways, asset managers must provide a selection of financial and operational solutions, that can in the same way, be combined to varying degrees. Thus, if delivering performance remains the asset manager’s primary objective, its role also increasingly involves accompanying asset owners in the development of their impact strategy.

ESG analysis, at the heart of responsible investment

Integration of ESG criteria can take many forms: best-in-class, thematic or exclusion approaches. More extra-financial information is available on companies than ever before, enabling asset owners and asset managers to more easily integrate these considerations into their investment decisions. Such ratings provide an invaluable insight into company practices, allowing investors to mitigate long-term investment risk by identifying possible sources of operational, reputational and regulatory risk for the companies in which they invest.

When analysing companies from an ESG perspective, there is a double objective. On the one hand, ESG ratings enable us to select, for each sector, the companies that best manage their opportunities and risks and that have integrated social responsibility into their business model. On the other hand, through our exchanges with issuers, ESG teams have the possibility to communicate their expectations as investors, discuss best practices and thus help companies to improve their sustainable development policy. We observe that companies are increasingly sensitive to the expectations expressed by the market and investors and are willing to understand how they are analysed and to identify areas for improvement. Corporate Social Responsibility (CSR) considerations are no longer just the preserve of large corporations; now the consideration of ESG challenges is being developed in companies of all sizes, and the evaluation of ESG criteria is spreading to private equity and even private debt.

Engagement: an effective lever of ESG policies

With ownership comes responsibility: investors, who own virtually all resources and productive assets in the world, have a huge duty to avoid doing harm while earning their return. Whilst ESG ratings are an exceptionally useful tool, we must go beyond. Being a committed player also means engaging in constructive shareholder dialogue and exercising voting rights at general meetings. In this view, Amundi teams attend around 2600 general meetings and handle over 32 000 resolutions every year. Over recent voting seasons, we engaged on various controversial themes, including "say on pay", transparency around climate-related risk management, multiple voting rights and board independence.

Moreover, dialogue between companies and their shareholders around environmental, social and governance topics outside of general shareholder meetings is becoming increasingly commonplace. Such a dialogue benefits both parties: on the one hand it gives companies the opportunity to improve their practices by measuring themselves against the highest industry standards and on the other hand this dialogue allows shareholders to better manage their investments risks and opportunities. Whether they lead to controversies, or conversely, future innovation – ESG challenges will have a potential impact on the valuation of issuers.

Divestment: Finding the fine line

In extreme cases, exclusion can be an alternative and effective tool for catalysing change. Over and above the normative exclusions that have been defined by international treaties and conventions (Human Rights, International Labor Organisation, Global Compact…), we can consider the divestment of controversial sectors and business practices, or issuers that are not willing to make progress. Divestment policies are currently experiencing an undeniable growth in popularity and a number of initiatives are demanding that investors apply exclusions based on environmental (fossil fuels, fracking, oil sands, operations in the Arctic), ethical or moral (arms, alcohol, gambling, tobacco…) reasons.

Exclusion remains a powerful sanction, but is not without its drawbacks. It is a one-off. The investor makes his point and walks away, giving up the ability to influence behaviour in the future.

A best-in-class approach blends engagement and the threat of divestment. Referred to as "positive screening", best-in-class involves ranking the assets with respect to specific ESG criteria, and selecting only the top companies, or overweighting/underweighting the best/worst performing companies. It mobilises the competitor instincts of company managements in the same sector. Take oil and gas. While renewables offer the prospect of limiting global warming, it will take years before we can live without fossil fuels. By using the best-in-class approach, the investment manager can remain invested in oil and gas companies, but only in companies with the better environmental scores. These scores are reassessed regularly, so that companies that are excluded but improve their practices may enter the investable universe in the future. Companies in the investable universe cannot be complacent given that, if they stand still, they will be overtaken. All the while standards across the global oil and gas industry are pressured to improve.

The rise of Impact investing

The 2015 COP21 conference in Paris and several environmental and governance scandals have provided stark reminders that portfolio managers need to be aware of risks beyond purely the financial. Thematic investing is an answer for long term investors seeking to convert those risks into returns, aiming to combine financial performance with concrete and positive impact responding to major environmental and social challenges.

Consideration of risks linked to global warming has been translated with innovative solutions in terms of low carbon investment and green infrastructure financing. Amundi is a member and co-founder of the Portfolio Decarbonization Coalition (PDC), a multi-stakeholder initiative launched by the United Nations and worldwide leading investors to decarbonise the portfolios of the main asset owners. The objective is to achieve portfolio decarbonization by withdrawing capital from particularly carbon-intensive companies, projects and technologies by sector and by re-investing that capital into particularly carbon-efficient companies, projects, and technologies of the same sector. Initially, the PDC aimed at reaching $100bn in decarbonization commitments. As of today, the coalition convenes 27 investors overseeing the decarbonization of $600bn in commitments out of $3.2 trillion in assets under management.

On the other hand, the development of "green technologies" comes with financing needs and equally brings promising investment opportunities, in the sectors of renewable energy, water and waste management, infrastructure etc. The Green Bond market is developing fast since 2015 when USD 42 billion was issued. This momentum has continued strong, with USD 200 billion in green bonds currently outstanding. There are projects for possibly USD 130 billion to be issued in 2017, according to the Climate Bond Initiative.

The global issue of climate change, however, should not obscure other ESG issues faced by the world. Social impact funds, which were the first to offer an approach explicitly bringing together financial performance objectives and a measurable social impact, also contribute to the development of new parts of the economy. They attempt to respond to the main challenges faced by societies, in both industrialised and developing countries, through projects including business start-up assistance for populations excluded from the labour market, support to dependent people, housing for impoverished families and financing innovative SMEs in the environmental field. Achieving the Sustainable Development Goals (SDGs) adopted in 2015 will take estimated investments of between US$5 and $7 trillion a year. On the positive side, the opportunities for companies to finance related projects (infrastructure, clean energy, water, sanitation, agriculture) are huge. The days of "funding" are being replaced by the days of "financing".

Conclusion

The popularity of ESG investing continues to grow. The ultimate goal is the mainstreaming of responsible practices across all asset classes and investment universes. ESG analysis, dialogue with issuers and engagement policies should simply be part of all investment process, in addition to traditional financial criteria. We are convinced that a strong sustainable development policy enables issuers to better manage risks and improve operational efficiency. It is also a way for asset owners and their asset managers to fully assume their responsibility in a world where there are numerous challenges, with consequences that go far beyond mere financial considerations.

It is difficult to see the case against this form of investing since there is little or no evidence that ESG investments yield lower returns than conventional investments. As governments around the world start pricing in the real cost of pollution, they may very well enjoy a performance advantage.

The 300 Club

The 300 Club is a group of leading investment professionals from across the globe who have joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing. The mission of the 300 Club is to raise awareness about the potential impact of current market thinking and behaviours, and to call for immediate action.

Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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