Investment **Research**

Sustainable Investing:

Past, Present and Future

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This paper aims to provide a historical context for investors seeking to understand the sustainable investing landscape as they search for and evaluate investment solutions that meet their unique requirements.

Humanity faces the social and economic effects of an unprecedented global pandemic alongside increasing evidence of the impact of climate change. The global challenges we face mean that the relationships between companies and their stakeholders – including employees, consumers, suppliers, governments, and the environment– have never been more complex or critical to understand. The current backdrop has given impetus to much broader interest in the adoption of sustainable investment and ESG, which is fast becoming one of the most important strategic priorities for investors.

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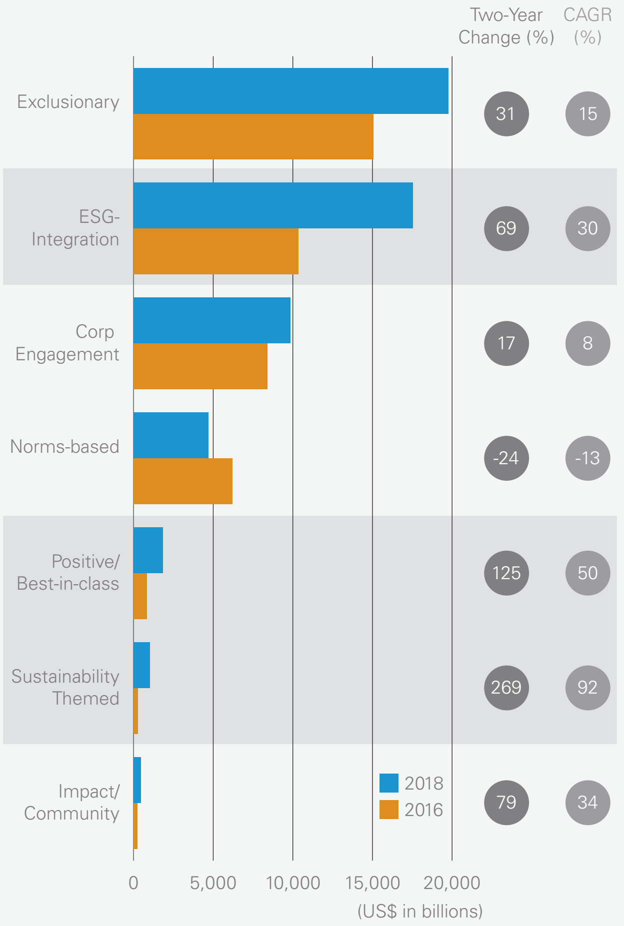
A Trickle Becomes a Flood

Flows into Sustainable Investment funds have hit record highs. Exhibit 1 shows the growth in aggregated flows globally by strategy type between 2016 and 2018. According to Morningstar, assets in sustainable funds now exceed $1 trillion, with global inflows into sustainable funds up 72% year-on-year in the second quarter of 2020 to exceed $70bn.[1]

Examining the rise in sustainable investing and ESG integration from their early roots in ethical investing can help dispel some persistent preconceptions, including the myth that sustainable investing automatically leads to lower returns.

Such a history can also set the stage for evaluating the different types of sustainable investing and the wide range of product solutions that now exist. These range from screen-based and exclusionary practices to a more contemporary approach that often combines fundamental analysis with quantitative assessments and active engagement.

Exhibit 1
Flows into Sustainable Investment 2016-2018



As at 31 December 2018
Source: Global Sustainable Investment Alliance's Review 2018, p.10

The Evolution of Sustainable Investing

Sustainable investing has undergone a number of phases during its evolution. Each of these have contributed tools and methodologies that sustainability-focused investors still use today. Most notably there has been a shift from an ethical or moral assessment of business activities to the integration of financially material environmental, social and governance risks and opportunities.

This shift has mitigated concerns of a financial performance trade-off as ESG-aware investors are not just focused on the adverse societal or environmental impacts of their underlying investments. They are also focused on the feedback loops between society and industry that are resulting in these impacts being priced into the market and thus affecting their portfolio's performance.

Ethical and Socially Responsible Investing (SRI)	ESG Integrated investing
Pre-2000s	2000 onwards
An early form of sustainable investing based on excluding companies or sectors considered to be "unethical", such as alcohol, tobacco, arms manufacturers, or Apartheid-era South African companies.	A move to the mainstream, integrating ESG considerations across investment platforms. With good corporate governance becoming accepted as a driver of long-term performance, investors start to engage more directly with companies to link material environmental and social issues to performance.

Tools and methodologies

Pre-2000s	2000 onwards
Excluding companies based on exposure to certain business activities that are not aligned with the investor's beliefs or societal norms.	Full assessment of relevant environmental, social and governance issues, to identify linkages to financial performance. ESG assessments often provided by external ratings agencies or proprietary research.

Implications for returns

Pre-2000s	2000 onwards
Ethical considerations often outweighed financial returns. Performance varied widely as the available universe of securities was restricted with exclusion lists, dampening broader investor interest due to the perceived conflict with fiduciary duty to deliver performance.	A consistent drive towards more comprehensive integration of ESG considerations into the investment process, alongside improving data/disclosure rigour, helps reduce risk and can help to identify alpha opportunities. Adoption by mainstream institutional investors helps to erase perception of return trade-off.

Pre-2000s: Ethical and Socially Responsible Investing (SRI)

Religious Roots

The earliest examples of attempting to invest with a conscience and bring about social change appeared in the 1700s when Methodist evangelists in the UK, led by John Wesley, pushed for a moral approach to investing. In the seminal text, "Use of Money",[2] Wesley places the value of stewardship at the heart of being a good Christian disciple.

He advocated against investments that could be considered against the "law of God or the law of the land", and included issues like tax evasion, business activities that could allegedly bring harm to your own body and mind, or bring harm to your neighbours. In 1758, the Quaker Philadelphia Yearly Meeting prohibited members from participating in the slave trade.

Today, the US Conference of Catholic Bishops continues to recommend excluding investments in businesses that engage in business activities deemed "sinful" such as alcohol, gambling, tobacco, weapons production, etc. Over the years they have added additional expectations of environmental protection and human rights stewardship.[3] We find similar glimpses of ethical and moral responsibility associated with money management in the Jewish and Islamic faiths, and religion continues to inform investment strategies designed to meet the beliefs of a variety of global religions, large and small.[4]

Socially Responsible Investing: Vietnam and Apartheid

The modern roots of sustainable investing as we know it today can be traced to the Socially Responsible Investing (SRI) movement of the mid-1900s. It likely first emerged as a movement to boycott companies that provided weapons in the Vietnam War. Some of the oldest among the funds included the Calvert Social Investment Fund Balanced Portfolio, the Parnassus Fund and the Pax World Balanced Fund.[5] Individual investors sought to avoid investments that conflicted with their personal belief systems and moral values. Like the earlier "sin"-based predecessors, this approach largely focused on excluding companies from an available investment universe based on a moral or ethical stance.

The catalyst for further development of these strategies included the oppressive Apartheid regime in South Africa. In the 80s, an effort to end apartheid in South Africa led to many individual investors, endowments of churches, universities and other institutional investors pulling capital from companies that operated in South Africa. The reverend Leon Sullivan, a clergyman and civil rights leader, developed a code of conduct for companies called the Sullivan Principles that were aimed at promoting corporate social responsibility and to apply economic pressure in South Africa in response to the apartheid system of racial segregation. Many years later, it is believed that the UN adopted an updated version of Sullivan's corporate code of conduct for companies as part of the United National Global Compact.[6]

In the 1990s, the growth of SRI mutual funds led to the establishment of the first SRI Index, the Domini Social Index now named the MSCI KLD 400 Social Index, and by 1994 it is estimated that over 26 sustainable funds totalling $1.9bn in AUM were available to investors.[7]

Performance of SRI funds tended to vary widely as different percentages of the index are excluded depending on the ethical or policy stance of the strategy. This opened these strategies to criticism that they conflict with the fiduciary duty to achieve, for example, the necessary outperformance against the benchmark and sufficient returns to pay scheme members' future pensions.

1980s-2000s: Environmentally Focused Investing

In response to concerns that population growth and rising living standards were contributing to new environmental problems, including ozone depletion and global warming, the UN's World Commission on Environment and Development (WCED) established the Bruntdland Commission in the early 1980s. The Commission successfully defined and popularised the concept of sustainable development and laid the path for both the Millennium and Sustainable Development Goals. The Commission defined sustainable development as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs".[8]

The push for sustainable development leveraged the work of the UN's Framework Convention on Climate Change (UNFCCC) and ratification of the Kyoto Protocol in 1992, the first international agreement for country-level reductions of greenhouse gas emissions. Although some of the world's major polluters were absent from the Kyoto framework, Europe went ahead and introduced ambitious policy objectives that came to be called the 20-20-20 targets, namely:

- 20% reduction in greenhouse gas emissions by 2020 (with 1990 as a reference)
- 20% reduction in EU energy consumption
- 20% share of energy mix from renewable methods by 2020

The subsidy regimes put in place to achieve these goals helped spark a renewables boom and wider adoption of "green investing". Initially this looked very promising, but it caused something of a bubble as too much capital chased a limited number of stocks. Following the global financial crisis, institutional investors continued to avoid ethical and environmentally focused investing, which they considered to be at odds with their fiduciary duty to deliver investment returns for beneficiaries.

Interestingly, many of the companies that came to market and were held in these early environmental funds have become important players in the transition to a low carbon economy. These include Danish wind turbine manufacturer Vestas and Finnish oil refiner Neste. They are now attracting much broader investor interest.

2000s Onwards: ESG Integration

Today, investors focus on fully integrating sustainability considerations into fundamental analysis and portfolio construction. This reflects much greater recognition of the value of incorporating an assessment of material environmental, social and governance risks and opportunities into research and analysis. There are several drivers for this evolution in thinking that have led to the significant growth in fund flows into ESG-integrated and sustainability-focused funds over the last two decades.

1. The Establishment and Growth of the UN-Supported Principles for Responsible Investment (UN PRI)

The widespread adoption of a more integrated approach is reflected by the more than 3,000 global investors and asset managers who have signed on to the Principles for Responsible Investment, representing over $20 Trillion in asset owner AUM (Exhibit 2). The principles were launched in 2006, but experienced greater adoption in the aftermath of the financial crisis as investors acknowledged some of the industry's own failings post financial crisis and signed up to become more "responsible" investors.

2. Recognition of the Financial Costs of Corporate Negligence: BP as a Case in Point

In many ways the value of greater scrutiny on ESG was encapsulated in 2010 by the BP Deepwater Horizon disaster which resulted in multiple fatalities and injuries (Exhibit 3). The environmental damage and resultant legal investigations led to significant value destruction for shareholders.

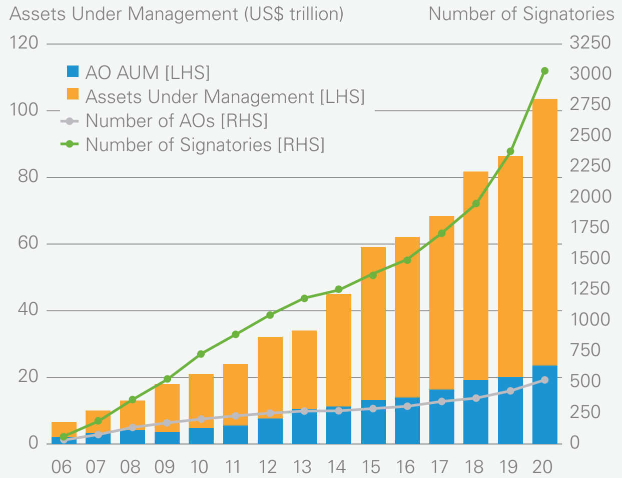
In the wake of the BP disaster, investors explored how a company's "corporate responsibility" strategy might more explicitly link to its long-term financial success.

3. Climate Change Reality Starts to Bite

The rapid degradation of biodiversity and a rise in extreme weather events have pressured policymakers to act to tackle what has widely become regarded as a climate emergency. There is a shared sense of urgency among governments, businesses and society to arrest the rise in atmospheric temperature by curbing emissions and improving resource management to design out waste and pollution from current methods of production and consumption.

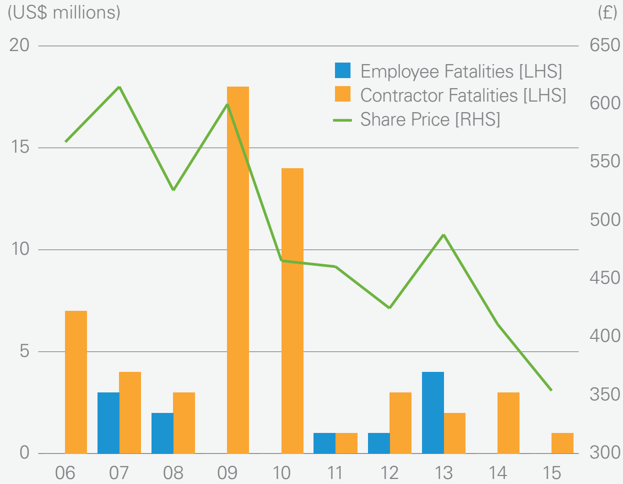
As the reality of climate change has sunk in, countries, companies, and even some of the world's largest pension funds and insurers, are pledging to accelerate change by helping to "green" economies and transition them to a low-carbon world. The UN-convened Net-Zero Asset Owner Alliance, representing over $4.7 Trillion in AUM, is an international group of 26 institutional investors delivering on a bold commitment to transition their investment portfolios to net-zero carbon emissions by 2050,[9] so as to be aligned with the 2015 Paris Agreement on Climate Change. This translates into dramatically increased demand for investment solutions that will help further that effort.

Exhibit 2
Growth of UN PRI Signatory Assets Under Management



As at 30 June 2020
Source: UN PRI

Exhibit 3
BP Share Price Variation with Fatalities (Contractors and Employees)



As at 31 December 2015
Source: BP Sustainability Report 2010, BP Sustainability Report 2015, BP ESG Datasheet 2019

4. Evidence of Improved Risk-Adjusted Returns

Traditionally, investments that pursued ethical or socially responsible investment goals either underperformed, or were thought to underperform, the wider market. This hampered wider take up by institutional investors focused on their prime fiduciary duty to their financial stakeholders, such as pension scheme members or insurance policyholders.

However, increasingly research is showing that the stock prices of companies that score high on sustainability considerations, and that successfully manage material environmental and social risks and opportunities, have generally delivered better long-term performance.[10]

Index providers like MSCI are starting to demonstrate how the ESG fund performance can be quantified. A recent analysis showed how ESG considerations cumulatively contributed 1.88% to the top 20 ESG funds' returns over the last ten years, with more than 80% of that return occurring in the last four years of the study period.[11]

Similar research suggests that ESG investments can help anchor portfolios during periods of market turbulence. For example, S&P Global Market Intelligence recently found that funds investing in companies based on their ESG ratings were "relative safe havens in the economic downturn." It analysed the performance of 17 ESG-focused exchange-traded and mutual funds with more than $250 million in assets from 1 January to 15 May of 2020. All but three outperformed the S&P 500 Index.[12]

Lastly, a more recent study by Prof. Bob Eccles,[13] investigates the role of the financial relevance and financial intensity of ESG materiality on stock market performance. Building on the previous empirical evidence that ESG financial materiality has a positive impact on financial performance,[14] in this paper Prof. Eccles et al. assess whether quantity and quality of materiality might represent an additional input in the selection and optimisation of a financial portfolio.

This research supports the hypothesis that the market rewards those companies that, all other factors being equal (including their ESG performance), have fewer and financially stronger material issues and therefore can focus sustainability policies on fewer factors with a more relevant expected result. It also adds evidence to the increasingly accepted view that stock returns are therefore positively influenced by an improvement in the ESG score and, indirectly, in the underlying components of the score.

5. Better Disclosure and Understanding of ESG Materiality by Businesses

Responding to the pressure from customers, investors and staff, businesses are responding by beginning to adopt a multi-stakeholder approach to long-term value creation. In 2019, the Business Roundtable, an association of CEOs of America's leading companies representing over $7 trillion in revenues, issued a new Principles of Corporate Governance Statement. In a significant departure from previous rhetoric, the new Statement, signed by 181 CEOs asserts that the purpose of a corporation is to deliver value to all stakeholders, including customers, employees, suppliers, and communities, not only shareholders.[15]

Alongside the increased recognition of stakeholders' contribution to long-term financial success, businesses now have the tools for more consistent disclosure on material ESG considerations. This has been made possible as corporate disclosure of ESG-related issues has improved greatly through the efforts of several groups. The EU, UK, and more than 20 other countries have enacted ESG disclosure requirements, and other markets are under increasing pressure to address the issue.

The Sustainable Accounting Standards Board (SASB), which works with businesses and investors to standardise and quantify ESG issues has made substantial progress in advancing the assessment of material issues across 77 subsectors. Today over 90% of the S&P 500 Index companies publish a sustainability report,[16] up from 53% in 2013. Sixty-five percent of these companies respond to CDP (f/k/a Carbon Disclosure Project) and 75% report in accordance with the GRI (Global Reporting Initiative), TCFD (Taskforce for Climate-related Financial Disclosure), or SASB frameworks. We expect this trend to continue, and as there is continued coordination among reporting frameworks,[17] we will see an improvement in quality and consistency of corporate ESG disclosure.

6. Regulators and Central Banks Add to Momentum

Regulators in Europe have supported early adoption of ESG integration and sustainable investment, but this is now becoming a fast-moving global trend, driven by EU benchmark regulations and a drive for further disclosures and new global stewardship codes (see below for a description of the evolution of global stewardship codes).

Central banks are also playing a part and have begun to increasingly integrate climate risks into financial stability monitoring as part of their micro-supervisory responsibilities. With over 66 central bank members and 13 observers, The Network for Greening the Financial System is tasked with "strengthening the global response required to meet the goals of the Paris agreement and to enhance the role of the financial system to manage risks and to mobilise capital for green and low-carbon investments in the broader context of environmentally sustainable development".[18]

One of the Network's work streams maps current supervisory practices and assesses the extent to which a financial risk differential exists between "green" and "brown" assets. Among the recommendations are ambitions to achieve a robust and internationally consistent climate and environment-related disclosure as well as the development of a taxonomy of economic activities. There are already expectations that climate policy and disclosure will become mandatory for companies and of new regulatory expectations for how banks manage the financial risks of climate change. The first system-wide climate stress test will be introduced in 2021 in the United Kingdom, for instance.

7. Expanding Concept of Stewardship

As the evidence mounts that climate change is increasing investment risks, alongside the evidence that suggests ESG considerations do not lead to an investment performance trade-off, asset owners have begun to redefine their fiduciary duty to their stakeholders.

The role of fiduciary duty began to expand in scope to encompass multiple regions and asset classes in 2015 when the UN PRI launched "Fiduciary Duty in the 21st Century", in collaboration with the UN Environment Programme Finance Initiative and The Generation Foundation.

New requirements promulgated under the EU Shareholder Rights Directive in 2020, Japanese Stewardship code requirements, and those by UK Stewardship Code 2020, among others, highlight the increasing importance of good corporate governance. It is no longer viewed as good practice to simply own the security without attempting to influence companies to move towards long-term sustainable practices.

The increasing stewardship requirements for both asset owners and asset managers have resulted in the emergence of separate stewardship teams who view this as almost a service that can effectively be outsourced. However, voting and engagement need to remain close to the investment decision maker as these are the most important stewardship tools that an active investor has.

The role of collaborative initiatives to seek solutions and affect change has also increased over the past decade. Climate Action 100+, a collaboration of over 450 investors representing over $40 Trillion in AUM, including some of the world's largest passive asset managers, has added momentum to the climate change mitigation efforts of investors via their collective engagements with corporations to "curb emissions, improve governance, and strengthen climate-related financial disclosures".[19] Similar collaborations are putting significant pressure on all participants in the investment value chain to act.

The Road Ahead

De-Emphasising External ESG Ratings

The industry's reliance on ESG ratings from external research providers has arguably distorted efforts for further integration of ESG analysis.

ESG ratings offer a way for investors to systematically compare a large number of securities, flag sources of potential ESG risk, and benchmark portfolios. As standalone measures, they have inherent limitations that can only be addressed by undertaking deeper independent and fundamental analysis to form a more rounded assessment of a company's business fundamentals and ESG practices.

A host of challenges will need to be solved when it comes to interpreting ESG data, including:

- Variation and inconsistency in disclosure
- Disparity in handling missing data (imputation techniques) and benchmarking techniques used by third-party ESG research and data analytics companies
- A lack of contextualisation of ESG issues whose materiality can vary depending on the sector, region, or on complete idiosyncrasies

Further Integration of ESG Considerations into Security Analysis

Asset managers' tendency to have ESG research teams work in silo from their investment teams has also hampered further integration. As the industry increasingly recognises the shortcomings of the current ESG data landscape and external ESG ratings and research, we anticipate an increased need for asset managers to evidence how ESG research is genuinely integrated into their investment process. They will also need to show how it contributes to better investment outcomes, via risk mitigation or alpha generation. We do not think this can be achieved via a reliance on eternal ESG ratings/research or a separate ESG research team whose work is largely divorced from fundamental analysis of companies.

Increased Use of Alternative Data Sets and Analytical Tools

Investors are increasingly seeking newer, more sophisticated alternative data sets and analytical tools to provide forward-looking views on environmental and social considerations. Our research has proven the need for access to more robust alternative data sets and the need to develop analytical tools that can interpret and manipulate such data which then needs to be contextualised by analysts who have a deep understanding of the sectors and regions in which their companies operate. This combination of skill sets will allow us to not depend on backward-looking data or purely qualitative analysis.

Moving Away from Segregated Stewardship Teams

While historically most asset managers have separated their stewardship capabilities from their investment processes, we believe that this will no longer suffice. Engagements and proxy voting decisions should be made in consultation with investment decision makers as it is the best way to effect change on sustainability measures in addition to finding new ways to unlock shareholder value.

We believe that fundamental research and active engagement are both crucial to impactful ownership. This requires investors to engage regularly with company managements and their boards, vote their proxies, and incorporate findings from their stewardship activities back into their financial models and investment decision making.

What Will It Take to Succeed?

The industry increasingly recognises that incorporating material ESG considerations into analysis provides a more comprehensive assessment of investment risks and opportunities. Rapid changes in the attitudes of consumers, citizens and policymakers on issues like single-use plastics, thermal coal and diversity illustrate that it is impossible to invest over the long term without thinking about the materiality of these issues and how they might impact the investment case for a company.

Despite decades of evolution, the opportunity of truly investing sustainably is yet to be fully realised. Complex global issues, including climate change, racial, gender and social inequality, and political polarisation, will continue to present investors with significant challenges as well as opportunities. Meeting those challenges and maximising the opportunities will require:

- A proprietary and forward-looking approach to ESG research, based on the ability to learn and adapt
- Active security selection with a dynamic and sophisticated research agenda
- The ability to combine skillsets beyond traditional approaches
- A global perspective built from diverse viewpoints
- An approach that is investment-led and provides a platform for genuine sustainable investment and strategies that deliver both financial and sustainability objectives

Notes

1 Global Sustainable Fund Flows, Q2 2020, July 2020. Source: Morningstar - https://www.morningstar.com/lp/fund-flows-direct

2 Source: https://s3.us-east-1.amazonaws.com/gbod-assets/generic/Use-Of-Money.pdf

3 Source: https://www.usccb.org/about/financial-reporting/socially-responsible-investment-guidelines

4 Ethical Futures, The Growth of Ethical Investment. Source: http://ethicalfutures.co.uk/assets/templates/ef/images/ef/whitepaper/Whitepaper-The%20Growth%20of%20Ethical%20Investment-0516.pdf

5 Launched in 1971, this fund was launched with the goal of avoiding profits that came from war, including the avoidance of investments in companies that were involved with controversial weapons such as Agent Orange. Two United Methodist ministers, Luther Tyson and Jack Corbett, are credited with the founding of this fund. Source: https://saylordotorg.github.io/text_the-sustainable-business-case-book/s16-02-pax-world.html#:~:text=Pax%20World%20was%20founded%20in,not%20support%20the%20Vietnam%20War.

6 Source: https://www.morningstar.com/features/esg-investing-history

7 Gould, C.: 1994, *"Social Responsibility Shake-up". Wall Street Journal, p. F14*

8 Bruntland Commission: Report of the World Commission on Environment and Development: Our Common Future. Source: https://sustainabledevelopment.un.org/content/documents/5987our-common-future.pdf

9 Source: https://www.unepfi.org/net-zero-alliance/

10 Friede, Gunthar, Journal of Sustainable Finance and Investment, July 2016. Meta-analysis of more than 2000 studies of the impact of high ESG ratings on corporate financial performance showed 63% positive, 29% mixed/insignificant, and only 8% negative. See also the *"ESG For All? Impacts of ESG Screens on Return, Risk and Diversification,"* Journal of Applied Corporate Finance, July 2016. The study found that removing the bottom 10% or 25% of companies by ESG rating led to higher return and lower risk.

11 Source: https://www.msci.com/www/blog-posts/quantifying-esg-fund/01760099215

12 Source: https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-remain-relative-safe-havens-in-coronavirus-downturn-58679570

13 Pages 23-25 of this paper include references to several previous academic research on ESG performance. One of the earliest and most notable papers is: Khan, M., Serafeim, G., and A. Yoon. 2016. *"Corporate sustainability: First evidence on materiality."* Accounting Review, 91 (6) : 1697–1724

14 Source: How Material is a Material Issue? Stock Returns and the Financial Relevance and Financial Intensity of ESG Materiality

15 Business Roundtable, Principles of Corporate Governance

16 Source: https://www.ga-institute.com/research-reports/flash-reports/2020-sp-500-flash-report.html

17 Five global organisations specialising in sustainability and integrated reporting frameworks and standards have declared their intention to work together to create a comprehensive approach to corporate reporting - https://www.accountancydaily.co/plan-create-unified-sustainability-reporting-standards

18 Source: https://www.ngfs.net/en/about-us/governance/origin-and-purpose

19 Source: https://climateaction100.wordpress.com/about-us/

Important Information

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