

ESG Investing After Covid-19



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BACKGROUND – THE ARRIVAL OF THE ESG INVESTING MEGATREND

The adoption of environmental, social and governance (ESG) criteria by institutional investors has reached a tipping point in the last few years, with more and more investors declaring their belief in investing sustainably and responsibly. In fact, it is now probably accurate to talk about ESG investing as being an investment megatrend such is its global reach and scale.

Consider some of the recent signs of the widespread adoption of ESG investing. In January 2020, Larry Fink, CEO of the world's largest investment firm, BlackRock, wrote that climate change has become a defining factor for companies' long-term prospects in his annual letter to company chief executives. As BlackRock manages over \$7 trillion in assets, much of it in passive exchange-traded funds (ETFs), its investment views carry weight and it now sees integrating ESG concerns, notably over climate change risk, as being good investment practice in today's world. Fink's letter commented: "Our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors"¹.

Fink's view is also in agreement with some academic papers, such as "From the stockholder to the stakeholder: how sustainability can drive financial outperformance", written by Gordon L Clark and Michael Viehs of the Smith School of Enterprise and the Environment at the University of Oxford, along with Andreas Feiner, of Arabesque Partners². This report, originally written in 2015 but since updated, looked at over 200 academic studies and sources on sustainability, to assess the business case for sustainability. It found that companies with strong sustainability scores outperform and that ESG investment strategies do better than comparable non-ESG strategies. While investors still want more information on the links between ESG investing and performance, as the findings in this report show, there is a growing consensus that ESG investing does not automatically detract from investment performance but can enhance it, by improving risk assessment and directing investment towards areas of future growth.

As well as asset managers, some of the world's largest asset owners are users of ESG investing. Japan's Government Pension Investment Fund (GPIF) is the world's largest pension fund with \$1.4 trillion in assets and is making more use of ESG investing than it did a few years ago, in the belief this is part of its fiduciary duty to its clients with long-term time horizons. Similarly, Norway's Government Pension Fund Global (GPFG), seen as the world's largest SWF with \$1.1 trillion in assets, supports responsible investing. Universal owners like GPFG and GPIF, who hold the shares in thousands of businesses worldwide, see sustainable growth as necessary for their long-term prosperity. Their views also influence other institutional investors, influencing the debate over ESG investing.

There is also an emerging view that there is an 'ESG premium' for companies with a good record on ESG factors, as more investors and asset managers seek to invest in companies and assets that score positively on ESG criteria. A recent McKinsey Global Survey³ found that ESG programs create value over both short and long terms, according to business leaders and investment professionals, and that they would pay a 10% median premium to buy a company with a positive ESG record over one with a negative record. And at the start of July 2020, it was reported that London-based hedge fund manager Marshall Wace is planning a new ESG-focused hedge fund. This is a sign of both the strong inflows into ESG investing and the expected outperformance of strong ESG performers compared those with a weaker ESG record.

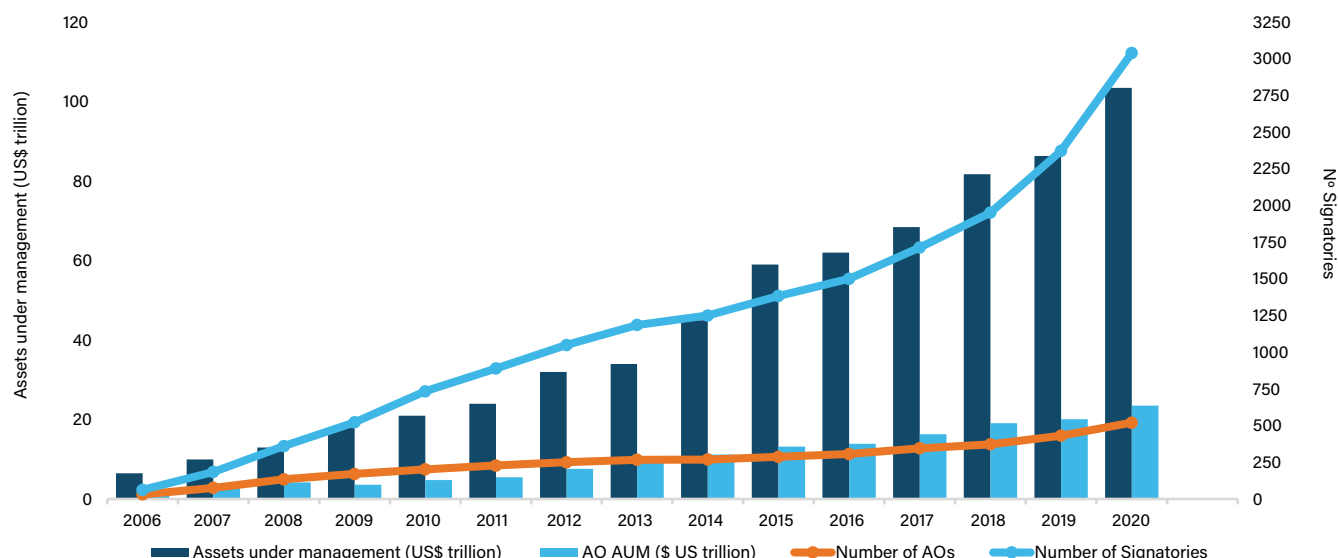
Another indicator of the ESG investing trend is the rapid rise in participation in ESG initiatives such as the UN Principles for Responsible Investment (PRI). Statistics from the UN PRI shows that it went from 63 signatory organizations in 2006, managing a combined US\$6.5 trillion, to 3,038 signatories in 2020, with total assets under management of US\$103.4 trillion. Numerous other collaborations between asset owners and asset managers, which aim to promote sustainable or responsible investing in specific areas or more generally, have seen similar growth in the last few years.

¹ <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

² https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281

³ <https://www.mckinsey.com/business-functions/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance>

UN PRI Signatory Growth 2006 to 2020



Source: <https://www.unpri.org/pri/about-the-pri>

While institutional investors increasingly see it as part of their role to take action to limit global warming as responsible long-term asset owners, governments are also nudging them in this direction. The 2016 Paris Agreement saw 194 countries and the European Union agree on a long-term goal of limiting the increase in average global temperature to below 2 degrees centigrade above pre-industrial levels. In turn, this is leading to new legislation, such as Article 173 in France, which requires institutional investors to report on how they account for ESG criteria, including climate change risk, in their investment policies. Similar moves are taking place in the UK, where new requirements have been introduced for pension fund trustees on reporting how they

consider ESG, stewardship and engagement in their investment approaches.

In addition, many individuals believe that investment portfolios held in their names should be aligned with their own moral values and beliefs. Research has found that younger age groups (the millennials for example) are more inclined to want this, but people of all ages are becoming accustomed to recycling domestic waste, taking care of the environment and applying their ethical beliefs as consumers where they can. Financial advisers and asset managers are aware of the need to cater to this trend among their clients, so the demand for, and supply of, ESG products and services for retail investors has risen.

FIVE KEY TAKEAWAYS

1

Improving risk-adjusted returns is a growing reason for ESG investing

Institutional investors increasingly see ESG and sustainability criteria as a means to obtain a better risk-adjusted return from investing. Globally, a third of institutional investors gave this as one of their main motivations to use ESG factors as part of their investment approach. This is up from just over one-in-five investors in research carried out in 2018 and 2019, showing a growing momentum for ESG investing to be used to both manage risk and improve returns.

2

The Covid-19 pandemic has not stopped the rise of ESG investing

Looking at investor views on ESG investing in the first part of 2020, compared to the two preceding years, does not show any slackening in the take-up of ESG investing. In fact, the use of ESG investing at institutional investors is rising, particularly those in Europe and Asia, with investors in North America lagging behind somewhat. The pandemic, along with global warming, could be seen as a dramatic warning on how environmental and social issues can have an impact on business and investment.

3

ESG is becoming more deeply embedded at institutional investors

In 2020, there have been significant increases in the full integration of ESG criteria in the investment approaches of institutional investing, and also in the use of impact investing, an approach where investors allocate in order to make a positive contribution towards ESG goals, as opposed to simply limiting any potential exposure to poor ESG practices. The uptake in both approaches to implementing ESG is a sign that it is becoming more embedded at institutional investors.

4

A big leap forward on ESG investing by Asian investors

The findings for 2020 show a sharp rise in the use of ESG investing in most of the ways it is implemented by Asian investors, even moving ahead of European investors. This is supported by other findings, for example a big rise in Asian investors taking account of a manager's ESG credentials. Concern about climate change and adoption of ESG by some very large investors, such as Japan's Government Pension Investment Fund (GPIF), are a likely factor behind this trend, as is the rising view that ESG investing improves risk-adjusted returns.

5

More interest in managers' ESG credentials and greenwashing

As institutional investors become more committed to the use of ESG investing, they are placing greater emphasis on the ESG credentials of asset managers, when looking to invest with an asset manager. At the same time, investors are also becoming more concerned about the practice of 'greenwashing', when managers or companies try to give the impression of being more committed to sustainability and good practice on ESG than is the case in reality.

CoreData

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Headquarters

AUSTRALIA

CoreData Pty Limited
Suite 7, Level 9, 66 Hunter St
Sydney, NSW, 2000
T: +61 2 9376 9600
E: coredata@coredata.com.au

UK

CoreData Research Ltd
6 Foster Lane, London ECV 6HH
United Kingdom
T: +44 (0)207 600 5555
E: info_uk@coredataresearch.com

US

CoreData Research LLC
15 Court Square, #450
Boston, MA 02108
T: +1 (857) 239 8398
E: info_us@coredataresearch.com

PHILIPPINES

CoreData Research Services Inc.
Unit E-1608 Philippine Stock Exchange Center,
Exchange Rd, Ortigas, Pasig City, 1605
T: +63 2 667 3996
E: info_ph@coredataresearch.com