actiam
PERSPECTIVE

Sustainable transition forces investors
to reassess their portfolios

July 2020

For investment professionals only

Both government and the private sector are placing increasing emphasis on greening the economy. Along with the economy, their investment portfolios will have to undergo a transition.

'We see an unprecedented number of forces converging to transform the global economy', according to the Bank of America in its report entitled Transforming World: The 2020s. This and other investment reports that give investors a glimpse into the decade ahead have a common theme: the 2020s will be a decade of transformation.

Robotisation and automation will open up new opportunities but will also make millions of jobs redundant. The global population is projected to reach about 8.6 billion by 2030. With the rapid growth of the middle classes in emerging markets, the world's economic centre of gravity will shift even more to them.

This transition will have a major impact on how investors both large and small structure their portfolios. Doing nothing is not an option. This is most clearly thrown into light by the trend which, according to the World Economic Forum (WEF), is the most marked of all: the greening of our economy and society. And the foremost item on the sustainability agenda right now is tackling climate change.

SUSTAINABLE TRAIN HAS DEPARTED

A growing number of businesses and public authorities are striving towards greening the economy and society. The coronavirus pandemic has actually reinforced this trend by. With a budget of € 750 billion, the European Commission's Next Generation recovery plan aims not only to relaunch the economy after COVID-19, but also to drive sustainability. Most of the money will go towards supporting a 'recovery towards a greener, digital and more resilient economy and society'.

Climate change and tackling it through investments was the predominant subject of discussion at this year's meeting of the WEF. For the first time, the five foremost, most realistic risks facing us were all linked to climate and the environment in the WEF's Global Risk Report 2020.

Most realistic risks all linked to climate and the environment

Source: World Economic Forum

According to the WEF, 'It is critical that companies and policymakers move faster to transition to a low carbon economy and more sustainable business models. We are already seeing companies destroyed by failing to align their strategies to shifts in policy and customer preferences.' Companies are considered to be on a short leash. The fashion brand Abercrombie & Fitch still exists but has fallen out of favor with young people - the main target audience - after controversial, sexist statements by the CEO in the past. The same CEO seemed to have lost connection with his target audience, also in view of statements such as that he "would rather burn the clothes than give them to the poor".

One hundred and forty of the world's biggest companies have also agreed to prepare a common set of ESG metrics. Together with four major accountancy firms, the WEF has proposed a framework for this that will enable companies to report uniformly on their ESG progress, in line with the United Nations' Sustainable Development Goals (SDGs). This framework is in four parts, each with its own specific metrics.: governance, planet, people, prosperity.

In the Netherlands, banks, insurers and pension funds have combined forces in the Sustainable Finance Platform (*Platform voor Duurzame Financiering*), set up by the Dutch Central Bank (DNB) in 2016. One of its ambitions is to more accurately measure the impact of investments on these SDGs by using new indicators. Businesses must also improve their reporting on climate-related risks, and financial institutions are required to take account of these risks (and opportunities) in their investment decisions.

All of these developments make it clear that there is no alternative to sustainability and that it is becoming more and more urgent. Companies and sectors that turn a blind eye to this risk falling by the wayside.

Examples

One of the first energy companies to experience the tendency of climate change ten years ago and to act accordingly was the Danish Oil and Natural Gas (DONG). It relinquished the coal activities and the upstream oil and gas activities were also phased out. During that process, the company used the experience to build oil platforms for the switch to offshore wind farm production. In 2017, the company changed its name to Ørsted. It is now the global market leader in the development of offshore wind farms.

Hummer is an example of a car brand that clearly did not feel the new wind. Arnold Schwarzenegger bought the first copy for consumers (Hummer started as a military vehicle). But where the California movie star and politician set a more sustainable course, the car manufacturer did not. Too late, the producer saw the changes among consumers, who increasingly made sustainability play a role in purchases. Owners of a Hummer almost got a stigma attached. In 2009, parent company General Motors pulled the plug on production after a last attempt to save the company by selling it to a Chinese party failed. The irony is that now - more than 10 years later - Hummer (previously the worst gas guzzler on the US market) is returning as an electrical sublabel of GMC.

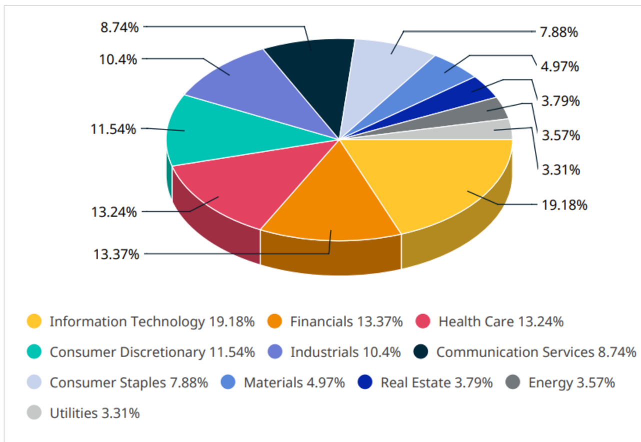
Read more >>>

DRASTICAL CHANGE IN BENCHMARK COMPOSITION

In twenty years' time the average investment portfolio will look a lot different. In any case, it will contain more sustainable companies and sectors. The energy sector will probably consist mainly of companies that generate sustainable energy or that generate energy as a side-line. Oil companies will have either modified their business profiles or ceased to exist by that time.

At sectoral level, sustainable energy, e-commerce, IT and health care will carry much more weight in future portfolios. Few investors will have shares in stranded assets, i.e. traditional energy companies and retail businesses. IT and health care will be the biggest sectors, together representing about 60% of a global benchmark such as the MSCI World All Countries. Businesses in the IT sector already account for the biggest share, followed by financials and health care. Apple alone represents 3% of it, only slightly less than the 4% occupied by the entire energy sector.

Sector weights MSCI ACWI (USD)



Source: MSCI, as at end of May 2020

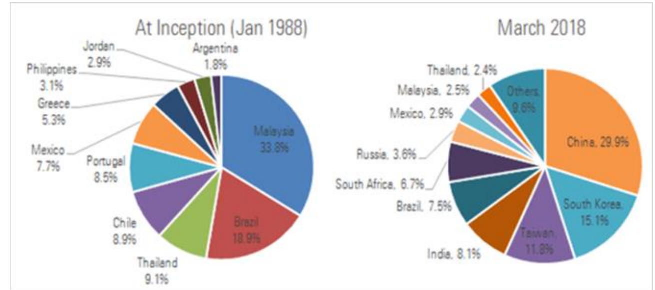
Major companies such as Apple and Amazon will see further growth in their shares over the next few years. IT's share could well have grown exponentially by 2050, particularly since more and more fintech businesses no longer belong in the financial sector but qualify as IT companies. Demographic and technological developments will put the health care sector in second place in the benchmark and in many investment portfolios. Companies in this sector will look different than now though: the survivors being those that are able to combine and to continually generate innovation in technology and care.

One other development is that emerging markets will feature more prominently in investment portfolios. At the end of last year these accounted for about 11% in the MSCI World All Countries index, with China alone representing over 4%.

Given that the seven biggest emerging markets (China, India, Brazil, Mexico, Indonesia and Turkey) are soon set to account for fifty per cent of global GDP, their part in the index will at least have doubled if not tripled by 2050.

It should be noted that economic growth is not a direct reflection of investment potential. It is also debatable whether we will be able to describe these countries as emerging markets by that time.

Country weights MSCI Emerging Markets Index



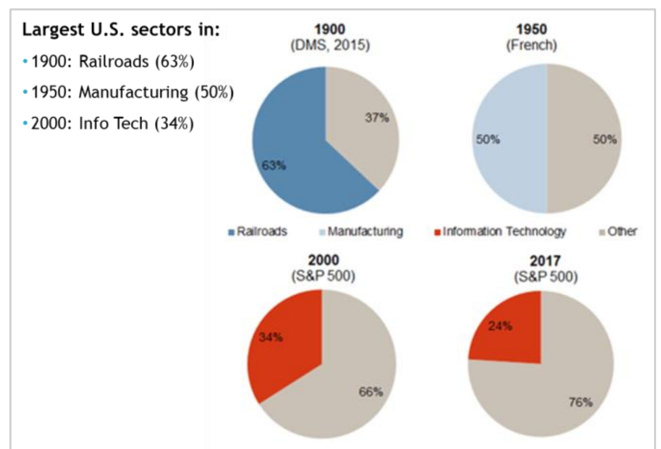
Source: MSCI, Morningstar Direct, as at end of March 2018

RISE AND FALL OF SECTORS

Why is the growth and decline of sectors in the major indices important? First of all, because investors do not want to veer away too sharply from the benchmark. However, this also provides important information for so-called unconstrained investors. If sectors become more important, this indicates growth accompanied by a trend of rising share prices of the companies in question. In that light, the declining importance of a sector also provides a pointer for investment decisions.

Major sectoral shifts are not new. A hundred years ago, railways were far and away the biggest sector in the American economy. Investors that held on to them in their portfolios ultimately came a cropper when the sector's importance dwindled.

As economies change, sector compositions change with them (US)



Source: Dimson, Marsh & Staunton database, Kenneth French data library. "Global Applications of S&P 500 Sectors, S&P Dow Jones Indices (2018)

actiam

At the end of 2005, banks and insurers accounted for 40% of the AEX. Investors who built their portfolios accordingly would not have been very happy about that decision in 2008. Both examples make it clear that a sector occupying a strong position in a benchmark can also be a risk for investors. A good analysis of how realistic valuation levels are, can provide some protection against this.

RAISING THE BAR FOR BUSINESSES

Current shifting trends have consequences for how investors and analysts will have to look at businesses. The first challenge will be to apply sustainable or ESG as well as financial criteria to business assessments, given that sustainability is going to be one of the foremost trends in the next 20 years.

In doing so it will be important to limit ESG-related risks whilst not overlooking financial returns. ACTIAM assesses these risks on the basis of seven fundamental material drivers, including the use of fossil fuels, use of water, land use and chemical waste management. Not all of these drivers are equally important to all businesses and it is important to select the ones that are actually relevant to a sector or company. Companies or sectors that do not properly gear themselves towards the future will be too risky to include in an investment portfolio.

Companies' entire business models will also have to be assessed at all times. Will they still be viable in 10, 20 or 30 years, for example? And will there still be a demand for the products and services they provide? In any case, this is an essential issue for long-term investors. This obviously requires a properly substantiated vision, now and in the future, whereby detailed analyses of the business models are essential due to the rapid developments.

When it comes to research and investment processes, attention must also be paid to the speed of changes. These will certainly occur rapidly at company level, given new legislation or fast-moving technological developments. After the first television set, only 13 years passed before 50 million households had one at home, while it only took Facebook 3½ years and Angry Birds a mere 35 days to register 50 million users.

REASSESEMENT INVESTMENT PORTFOLIOS

DNB emphatically draws the financial sector's attention to the risks of unsustainable investments. They can lose value, for example if assets produce more CO_2 than is allowed. Investors can also be caught short by stranded assets whose value has not yet percolated through to the share price. However, the transition to a sustainable economy also offers upward potential according to DNB. Where sustainable investments were initially driven by reputational risks, DNB's view is that the accent is now clearly shifting to financial risks.

The WEF advises active investors to design their strategy to limit the risks arising from trends. As regards climate policy, for example, this would mean tilting portfolios towards companies with low-carbon benchmarks. Long-term investors would able to take advantage of the opportunities offered by long-term trends. For example, systematic disruption can also be used to generate alpha, specifically by investing in companies that benefit from new environmental legislation. This can be done by maintaining this theme throughout the entire investment process, or by reserving part of the portfolio for thematic or impact investing.

Index investors can also anticipate the sustainable transition. ACTIAM recently boosted the sustainability of its index funds by introducing stricter screening based on financially material principles. This will weed out companies that are inadequately prepared for the transition to a sustainable society.

Furthermore, a sustainable set of instruments for investors is now being developed in Europe. The EU Taxonomy Regulation serves as a classification system that enables investors to determine which investments are sustainable and to identify areas where sustainable investments have the greatest impact. An approved investment must contribute to at least one of the six main objectives set out in the regulation, which include tackling climate change, making the transition to a sustainable economy and protecting ecosystems. In addition, it must not have any adverse impact on the other five objectives.

Which ESG investments are truly sustainable?

Source: Refinitiv

CONCLUSIE

Investment portfolios will (have to) change drastically over the next few years. Greening of the economy and society will in itself pose major risks for companies and sectors that do not adjust. It will also alter the balance between sectors in the economy. Businesses need to be assessed based onfinancially material issues by raising the bar, supported by active ownership.

Investors therefore have to go through a transition themselves in order to secure their financial and social return!

Read more >>>

actiam

ACTIAM manages assets of almost €60 billion (ultimo March 2020), making us one of the ten largest Dutch asset management companies. Our solid (impact) strategies and sound performance track record will help you to achieve your goals. We offer sustainable solutions to insurance companies, pension funds, banks and distribution partners. This is achieved through actively and passively managed investment funds and mandates.

Read more about ACTIAM or go directly to our fund overview.

CONTACT

Marketing & Communications

+31-20-543 6777

marcom@actiam.nl

www.actiam.com

Disclaimer

ACTIAM NV strives to provide accurate and actual information from reliable sources. However, ACTIAM cannot guarantee the accuracy and completeness of the information that is given in this presentation (hereinafter called: the Information). The Information can contain technical or editorial inaccuracies or typographic errors. ACTIAM does not give guarantees, explicitly or implicitly, with regard to the question if the Information is accurate, complete or up-to-date. ACTIAM NV is not obliged to adjust the Information or to correct inaccuracies or errors. The recipients of this Information cannot derive rights from this Information. The Information provided in this presentation is based on historical data and is no reliable source for predicting future values or rates. The Information is comparable with, but possibly not identical to the information that is used by ACTIAM for internal purposes. ACTIAM does not guarantee that the quantitative yields/profits or other results with regard to the provided Information will be the same as the potential profits and results according to the price models of ACTIAM NV. The discussion of risks with regard to any Information cannot be considered as a complete enumeration of all recurring risks. The here mentioned Information shall not be interpreted by the recipient as business, financial, investment, hedging, trade, legal, regulating, tax or accounting advice. The recipient of the Information himself is responsible for using the Information. The decisions based on the Information are for the recipient´s expense and risk.

July 2020