actiam PERSPECTIVE

The financial sector as catalyst

Transition to a sustainable society

September 2019

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Sustainability has become an entrenched feature of the financial sector. Clients are demanding sustainable solutions, while Dutch and European legislation is also making it increasingly important for financial institutions to show how they see their role in society.

Sustainability policies in financial institutions are evolving. In the early years the focus still was mainly on ethical principles and responsible investment, while recently the emphasis has shifted to climate. Nowadays, we're seeing a broadening towards other themes such as biodiversity, water, plastic, cybersecurity and modern slavery. We can also see a shift from policies that exclude non-sustainable companies towards more integrated solutions. This entails a growing demand for investment strategies that take into account the expected transitions towards a more sustainable society. What might such an investment strategy look like?

WHY ARE SUSTAINABILITY TRANSITIONS RELEVANT FOR INVESTORS?

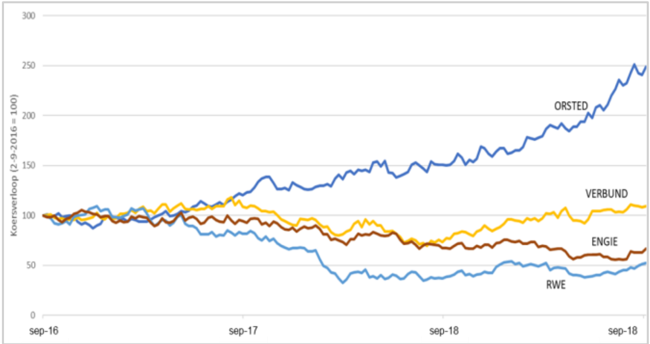
Investors play an important role in the transition to a sustainable society. They don't do this purely out of ethical considerations. From a long-term financial point of view, too, it is sensible to take sustainability into account. Earlier this year, the Dutch Central Bank (*De Nederlandsche Bank*) pointed out that, in addition to climate change, other ecological and social changes lead to financial risks. Scarcity of natural resources, pollution, income inequality and concerns about insecurity and privacy cause financial risks.[1]

> "As a global community, we have the resources and know-how to reach the zero-emission target by 2050."
>
> **Francesco Starace, CEO Enel**

A transition towards a more sustainable society is needed and it's only a matter of time before companies are called to account. These sustainability transitions go beyond climate, biodiversity and water. Issues regarding social and human capital are also gaining in importance, due in part to the focus on the sustainable development goals of the United Nations. These transitions are clearly visible in the energy sector.

The CEO of Enel, one of Europe's largest energy companies, recently announced that within ten years coal will have disappeared from Europe, supplanted by cheaper wind and solar energy. Figure 1 shows that this is already being cautiously reflected in stock prices. Sustainable energy companies like Orsted and Verbund have shown better price movements over the past three years than energy companies RWE and Engie, which are even more dependent on coal and fossil fuels.

Figure 1: Price trends in European energy companies



Source: ACTIAM, Bloomberg

Changes in government policy, markets and consumer demand also lead to transitions as regards the other global challenges. Companies are currently being severely penalised if they disregard their corporate governance policy. When Bayer acquired Monsanto, for example, it clearly misjudged the financial impact of the negative reporting surrounding the weed killer Roundup. Facebook too was taken by surprise when the controversies surrounding their data privacy policy led to such negative reporting and loss of customers.

By the same token, companies that take a conscious approach to sustainability or that offer solutions to sustainability challenges, such as the water technology company Xylem, are the ones doing well. Over the coming years this is expected to become even more apparent in company results. Sustainable processes will replace the old, non-sustainable activities. Companies that score highly in terms of social and human capital will be able to attract good employees more easily than companies that are lagging behind. Companies that get on board with this will be able to flourish; companies that don't, are at risk. Eventually, investors will also see this in their returns.

HOW DO YOU ASSESS WHETHER A COMPANY IS PREPARING FOR THE SUSTAINABILITY TRANSITIONS?

Nowadays, it is no longer enough to assess the sustainability of companies on the basis of their impact in the past. To prepare for the global social challenges it is important that, in addition to having a forward looking view of expected market developments, asset managers also have a future vision of the corporate impact of the sustainability transitions. The steps a company is taking to establish a sustainable business model, a model in which it operates within social and environmental boundaries, can be assessed to determine whether it is prepared for the transition to 'the safe and just space' text box.

[1] De Nederlandsche Bank (2019). Op waarde geschat? Duurzaamheidsrisico's en doelen in de Nederlandse financiële sector [in Dutch].

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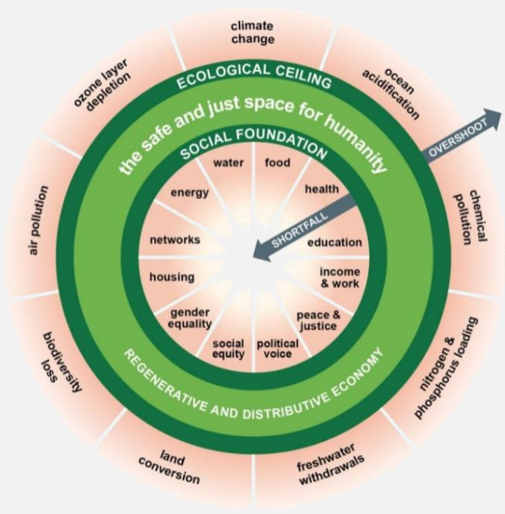
The ‘safe and just space’

The ‘safe and just space’ indicates both the minimum social level that we as a society find important and the maximum ecological impact that the earth can process – see figure 2. These limits are best reflected by the UN sustainable development goals and the so-called planetary boundaries[2]. Companies only attain this safe and just space if they are sufficiently adaptable to take steps towards meeting the sustainability challenges that are material to them. Back in 2016 Khan et al. pointed out that companies that score well on material sustainability factors do better than companies that don’t.[3] These companies prepare better for the sustainability challenges.

Figure 2: De grenzen van de “safe and just space”



Source: Raworth, 2018

It is possible to assess what steps companies are taking by using a number of business drivers. These drivers indicate how companies adapt their behaviour that impacts on social and environmental boundaries. Are companies, for example, making the transition from fossil to renewable fuels to tackle climate change? Do they only buy palm oil or wood with a sustainability certificate so that they cannot be held liable for loss of biodiversity? Do energy companies with their cold water intake and soft drinks companies with their water consumption take local water shortages into consideration?

Are safety and fair pay at textile manufacturers and gender equality and data privacy at banks, for example, being given a firm hold in their corporate culture to prevent social unrest and reputational damage? How companies organise their business drivers shows how they view the future and whether they are trying to relieve pressure on the social and environmental boundaries. Not every business driver is equally financially material for every company. But certainly when it comes to those drivers that are material for them, they must have sufficient adaptability to be prepared for the transition to a sustainable business model.

ADAPTABILITY DETERMINES INVESTMENT STRATEGY

Companies can be classified based on adaptability (see figure 3). Those that make the transition are in the ‘safe and just zone’ or contribute positively to sustainability. These companies have their sustainability risks under control; for example, because their production process is sustainable or because their products help others to become sustainable (see the “Positive impact” text box).

Positive impact

Cosmetics manufacturer **Natura Cosméticos** is strengthening its reputation as a sustainable and fair brand by promoting the protection of biodiversity in the manufacture of its raw materials and products, paying suppliers fairly and not using animal testing. In addition, it is succeeding in reducing its governance and human resources risks through its strong anti-corruption policy, training programmes and ethical codes. These were contributory factors to its growth in revenue from 7.4 to 13.5 billion dollars between 2014 and 2018.

The carpet manufacturer **Interface** distinguishes itself by producing carpets in a climate-neutral and completely recyclable way and using discarded fishing nets from the world’s poorest areas. This emphasis on sustainability and waste prevention has meant the company has been able to achieve a gross profit of more than 30% for some years now.

The biotech company **Novozymes** makes enzymes, micro-organisms and other products to increase crop yields and produce bio-fuels. Its focus on CO_2 reduction, clean water, and sustainable production and consumption has resulted in an EBIT margin of 28% and a continuous growth in its net profit over the past five years.

For certain companies, the question is whether they can make the transition. Can energy companies that are still investing in coal-fired plants on a wide scale instead of in sustainable forms of energy, or steel companies that are failing to innovate sufficiently in energy-efficiency, make the transition to a low-carbon economy in time? The Dutch Central Bank has already warned of stranded assets in carbon-intensive companies.[4] The closure of relatively new coal-fired plants due to the Dutch climate change agreement shows that this can actually happen. Not all companies are sufficiently prepared for new risks when it comes to other sustainability issues, either. Recent banking scandals surrounding corruption and money laundering practices, for example, show that banks cannot always adapt their organisations easily. These companies form part of the ‘non-adaptive’ category in figure 3. They run major risks, but fail to adapt sufficiently, making it risky to invest in them.

[2] Raworth, K. (2018). Doughnut Economics. Random House UK. Röckstrom, J., W. Steffen et al. (2009). A safe operating space for humanity. Nature, 461 (7263).

[3] Khan, M., G. Serafeim and A. Yoon (2016). Corporate Sustainability: First Evidence on Materiality. The Accounting Review, 91(6): 1697-1724.

[4] De Nederlandsche Bank (2017). De Nederlandse financiële sector veilig achter de dijken? Een nadere verkenning naar klimaatgerelateerde financiële risico’s [in Dutch].

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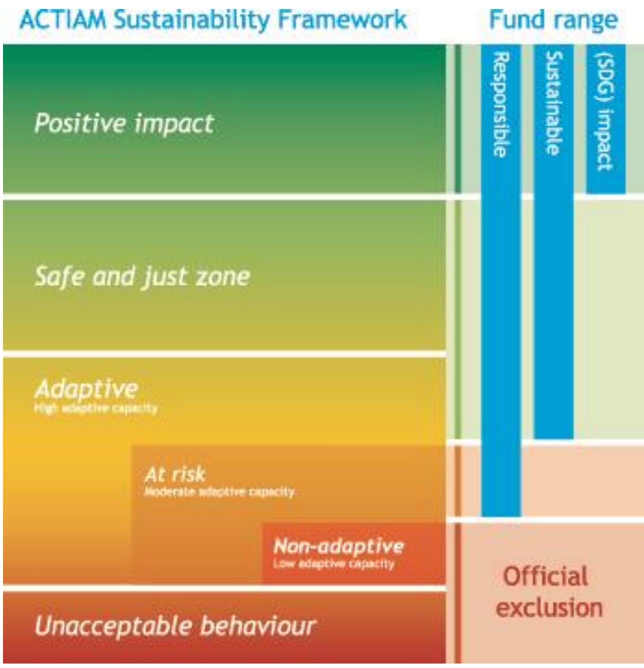
It is still not sufficiently clear whether some companies will be able to adapt in time. They run risks, but investors can encourage these companies to make headway with their transition by engaging with them and shaping their voting behaviour at shareholder meetings. Take palm oil companies, for example. Given their impact on deforestation these companies run risks due to increased regulation or consumer pressure, for example. Together with PRI and other investors, ACTIAM is trying to urge palm oil companies in Malaysia and Indonesia to become sustainable. By engaging with this goal, these companies commit themselves to increase their share of RSPO-certified palm oil and they provide greater transparency on deforestation in their monitoring and resistance value chain.

NEW VISION LEADS TO FORWARD LOOKING INVESTMENT CHOICES

Asset managers have a fiduciary obligation to explain to their clients how they invest their money responsibly. For this purpose, it is important to know how future-proof companies are in terms of the global sustainability transitions. Asset managers must also undergo a transition themselves in their sustainability policy; from backward looking with a focus on sustainability impact to forward thinking with a focus on materiality of sustainability transitions. This calls for a different way of looking at things and greater insight into the materiality of non-sustainable behaviour. Only then can investors properly prepare for the changes to come.

Figure 3: Sustainability Framework



This is a publication of ACTIAM's Sustainability & Strategy team, consisting of 9 professionals with an average of 11 years in the industry.

ACTIAM manages assets of over €60 billion (ultimo June 2019), making us one of the ten largest Dutch asset management companies. Our solid 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, as well as to private investors.

This is achieved through actively and passively managed investment funds, via impact investing, mandates and ESG Strategy Support (Environmental, Social & Governance).

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