Sustainable investing:
the past, the present and the future

October 2020

For investment professionals only

actiam

2020 marks the 5th anniversary of the listing of the ACTIAM Responsible Index Funds on the Dutch stock exchange. A lot has happened over these five years; 5 years ago Obama was still president; Trump was still campaigning to become the Republican nominee; Greece was the talk of the town with another support package from the EU; there was something about Volkswagen and diesel; ABN Amro listed on the stock exchange again and Ahold and Delhaize merged.

Other progress over these five years saw the development and increased importance of ESG investing. Where 5 years ago studies needed to show that "going green" wouldn't be at the cost of performance, now there are numerous studies showing ESG alpha and there is an increased interest in "alternative" ESG data being crunched by quants in order to extrapolate potential alpha signals.

Reason enough to reflect on the past 5 years of ESG investing and to take a look at sustainable investing in the next 5 years.

THE PAST

2015 was the year of the UN Paris accord on climate change, which was the first time we had seen substantial private sector participation in international climate negotiations. The resulting Paris Climate Agreement boosted the ESG movement by creating urgency and a globally recognised framework of concrete objectives for addressing climate change risks. This spawned movements towards things like science-based targets which urged companies to become signatories and to commit to goals on reducing carbon emissions, among other things.

Another big UN-driven development was the Sustainable Development Goals (SDGs), established by players in both the public and private sectors. And although these were written in the context of governmental action, the private sector and investors saw their importance and looked to implement these goals in investment products.

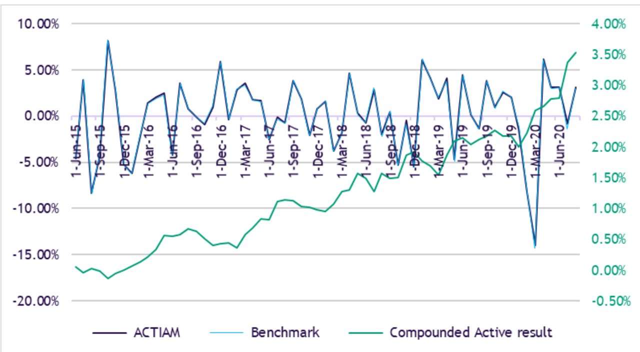
These last 5 years have, however, not been free of ESG-related controversies within some companies. Where environmental and social issues have been in the spotlight for some time, governance issues such as privacy and fraud have already started to come to prominence in the eyes of regulators, investors and the general public. New technologies, especially, are coming under increased scrutiny. Some prominent examples are Volkswagen with the diesel emissions scandal, which reached the global news as the fraudulent activities took place all over the world. There was also controversy at Wells Fargo, brought about by the creation of millions of fraudulent savings and checking accounts for Wells Fargo clients without their consent. And Cambridge Analytica used Facebook data in order to manipulate the Brexit election. Of course there are more examples, such as Vale and a broken dam, as well as Danske and money laundering. Although the number of such examples is still problematic, exposure through the financial markets and the media shows that there is increased interest in and importance placed on the way companies conduct their business.

These developments in ESG investing can be seen, in part, in the implementation of policies within the ACTIAM Responsible Index Funds between the launch 5 years ago and now. In 2015, most topics that are still important within the ESG investing arena were already important. However, the implementation of exclusionary screens was limited to norms-based screening. At ACTIAM these were reflected in the Fundamental Investment Principles, constituting a list of products and services that were deemed to be ethically unsound and where investment in such a company could not be justified. Back in 2015 the list primarily covered controversial weaponry-based exclusions, such as Thales and Boeing.

Over the years this list has expanded; in 2017 the list also included tobacco, adult entertainment and gambling. This expansion not only made sense from an ethical standpoint, but industry trends in, for instance, tobacco were pointing to ever more troublesome headwinds. Regulators were under increased pressure to limit the growth in demand for tobacco and to discourage "new customers" or the younger generation from using products from these companies. In 2019 the list was extended to cover companies that were active in thermal coal and that had not changed their practices after being engaged by ACTIAM.

The acceleration of the general importance of sustainable investing, as well as the increased spotlight on ESG issues in the investment portfolios of pension funds and insurers, created a paradigm shift. Initially the implementation of ESG in investment portfolios was geared to limited exclusions supplemented, as a last resort, with engagement and voting. One of the main reasons for this "exclusion light" strategy was that exclusions result in increased risk in the portfolio. Specifically, for index funds this means more differences between the portfolio and the index resulting in tracking error (standard deviation of the difference between the returns of the index and the portfolio), which in turn could result in underperformance compared to the benchmark (both in the short term but potentially also in the longer term). This in turn would increase risks as regards performance and the needs of clients. In the last couple of years, however, the emphasis on tracking error has declined, investors are willing to increase exclusion lists based on their (ESG) investment beliefs and the conviction that ESG does not necessarily hurt performance and can actually result in outperformance compared to the index.

ACTIAM Responsible Index Fund Equity Europe



Source: ACTIAM, as per end of August. For illustrative purposes.

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The same was true for most of the exclusions in the ACTIAM index funds up to 2020 which still mostly related to ethical norms. However, with investor buy-in and with a refocused and future-proof Sustainable Investment Framework emphasising ESG risks, ACTIAM felt comfortable enough to change this investment strategy on the back of the investment belief that ESG implementation on index funds could, in fact, reduce overall risk (instead of increasing it).

THE PRESENT

As things stand, we can state that responsible investing has officially become mainstream: the biggest investors in the world have seen the shift and are positioning themselves on the right side of the equation with increasing ESG teams and more tracking of specific ESG benchmarks.

And even though the validity and actual substance these teams provide to asset managers might be questioned (as it does seem like a lot of marketing with a limited mandate), the general gist seems to be increased ESG interest in the investing community. Last year was a year of big developments in ESG investing and these will continue. At least in the EU. The Green Deal from Frans Timmermans and the support packages due to COVID-19 have one common theme: more green investments. And slowly but surely, sanctions for non-compliance with a 2-degree world are being put on the table.

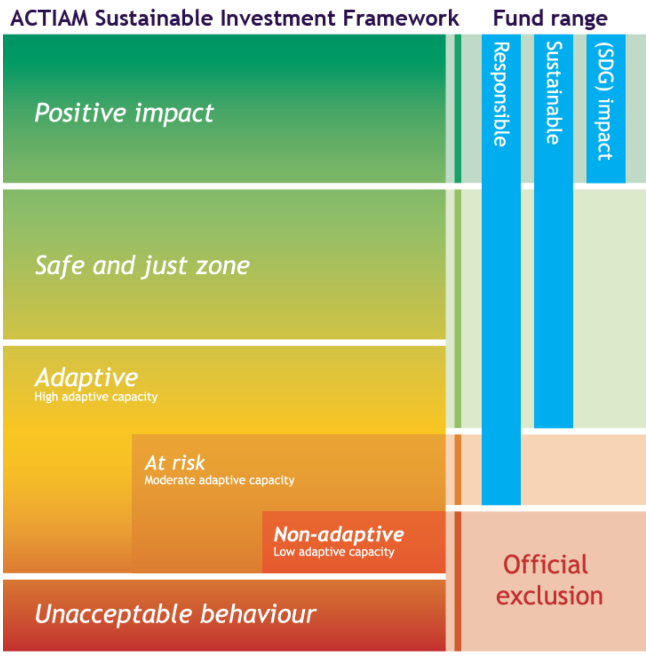
The acceleration of the importance of ESG within investments and regulations necessitates shifts in the implementation of ESG in investments, which will especially have an impact on ESG indices. Increased scrutiny of investment policies due to increased expertise on ESG investing, as well as regulatory pressures, will constitute a need to adapt to these new conditions. As the realities of climate change become more apparent, as well as the impact of water supply scarcity or deforestation, there will be more of a need to shift investment strategies.

These changes will materialise in the coming years. The Dutch Central Bank has recently calculated the magnitude of the risk of biodiversity loss for the Dutch financial sector. This showed that more than €510 billion of investments are dependent on ecosystems. Investment strategies should therefore reflect these changes and if possible also pre-emptively adapt in anticipation of these changes.

2020 was a year in which there was a major investment strategy shift for the ACTIAM index funds in response to these foreseen changes. The forward-looking view of ACTIAM is that ESG will keep on being of increasing importance within the investment arena, with financially material changes to stock prices being linked to ESG-related risks, given the need for the shift to a more sustainable world.

In addition to the exclusions on ethical terms, ACTIAM implemented exclusions based on the adaptivity of companies. Looking at the competence of management, the current situation of a company and the level of change it needs to go through was captured in a new framework. This assesses whether a company is likely to be able to shift its strategy, production process or value chain in such a way that it is resilient to the changes in the environment and the accompanying regulations.

This new strategy constitutes more exclusions - both from an ethical standpoint, but also from an ESG risk standpoint - as the world is changing and companies incapable of change will eventually fail. Thus, this increases the resiliency of the portfolio and decreases risks related to ESG issues. And although the climate is a hot topic at this point in time, ESG issues such as biodiversity but also social issues relating to a company's dealings with its employees as seen during the current COVID-19 crisis, will keep on being important. With the implementation of the strategy, the index portfolios are acting at the intersection of risk management both from an ESG and financial point of view, without compromising return potential.



THE FUTURE

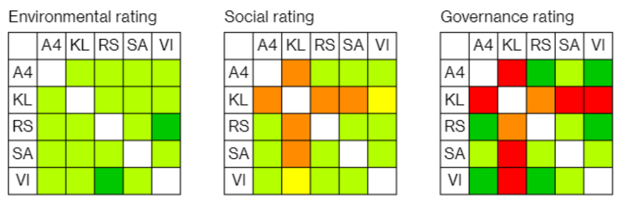
From 2020 onwards, there will be several certain changes happening in the ESG investment arena as well as a number of uncertain changes. The biggest certain change will be the push by regulators and the broader investment community towards a more uniform sustainability framework. As it stands now, the broader definition of sustainability is captured in the three pillars of E, S and G, but how these are measured and scored is far from uniform. A good example is the discrepancy between the ESG scores of data providers and their own definition of the underlying metrics of ESG.

Correlations of ESG ratings agencies' scores across a common sample of companies

Below 0.1 | 0.1 to 0.3 | 0.3 to 0.5 | 0.5 to 0.7 | Above 0.7

Overall ESG rating

Agency	Asset4	KLD	RobecoSAM	Sustain*	Vigeo-Eiris
Asset4	--	0.42	0.64	0.67	0.71
KLD	0.42	--	0.49	0.53	0.48
RobecoSAM	0.64	0.49	--	0.68	0.71
Sustain*	0.67	0.53	0.68	--	0.73
Vigeo-Eiris	0.71	0.48	0.71	0.73	--



* Sustainalytics
Source: MIT Sloan School of Management

Initiatives like the Task Force for Climate related Disclosures (TCFD) and the Partnership of Carbon Accounting Financials (PCAF) are currently already active in creating some uniformity in environmental metrics. Nevertheless, a further push is certain. In the short term, the implementation of the EU Taxonomy will be one of the biggest drivers towards uniformity. The EU Taxonomy is a regulatory framework for the EU investment industry where funds will only be able to be called sustainable when investee companies are compliant with a certain number of metrics.

This is a major step towards, at least partial, uniformity in metrics for the investment industry and will impact certain funds more than others. Funds that have been greenwashing for years will have to comply, otherwise they will be non-compliant which will certainly lead to outflows of investors. For funds that are already looking at these regulations or have a forward-looking policy, this will be a vindication. Apart from this EU initiative, global regulatory bodies are also looking into harmonising ESG scores. Recently, the international Organization of Securities Commissions (IOSCO) formed a taskforce to accomplish this. The implications of this standardisation will impact asset managers, investors and companies.

For asset managers, stricter due diligence on their investments will be required. By implementing these measures, investors will be able to make more sound investment decisions because comparisons between funds and companies will become easier. And above all, companies will have to step up to clear data delivery and will not be able to cherry pick metrics to deliver to investors and data providers. They will have to invest in their data collection and distribution within these frameworks.

Next to uniformity of data, more data in general will become available to investors. Big data is of increasing importance within the general investment arena and this is likely to spill over to ESG investing as well. The use of satellites for parking spaces will change to the use of satellites to monitor deforestation, which in will turn make due diligence by investors on their investee companies easier, spurring yet more dialogue and accountability.

One of the biggest uncertainties in the coming months, and therefore in the coming years, is geopolitics. In the trade war between China and the US, the push for climate action is becoming part of the dispute. Under Trump, the US has pulled out of the Paris agreement and has been soft on environmental regulations. China has, for some time already, been at the forefront of climate action and will want to have the moral upper hand in order to strengthen its international relations. However, looking at Biden's plan to invest a huge amount of money in sustainable infrastructure and sustainable energy, the differences in outlook after the coming election are massive. Although a lot of companies are becoming more aware of the need for ESG data and although ESG investing is becoming increasingly important in the US investment community, regulations and shifts in policies by the regulator will also be and remain hugely important.

Changes that linger are specific ESG themes that will be important, especially given the timeframes in which these will materialize. Every year the World Economic Forum publishes a list of risks relating to the global economy. For the last few years topics such as extreme weather events and climate action have topped these lists. The implications for investments in the next years strongly relates to the timeframes and the severity of for instance physical climate risks. Currently a strong focus within ESG investing has been on climate change prevention, and more specifically the reduction of carbon footprints. Physical risks on companies due to droughts or fires will become an immediate issue given their severity and when those instances occur more frequently. PG&E (a US utility company) filed for bankruptcy more than a year ago due to liabilities of forest fires; the impact on shareholders was severe. Furthermore, privacy and data security are increasingly a material factor within ESG frameworks and will expand. Other topics will also emerge as new technologies arise; artificial intelligence which will impact most of our lives for instance through applications in driverless cars or data gathering and analysis.

For the ACTIAM index funds, the current strategy and framework are forward-looking. Changes due to the taxonomy and data uniformity should not materially impact the strategy. The current strategy and framework use adaptivity as one measure to judge the capabilities of companies to adapt to the changing environment. The impact of the sustainable transition and climate change will certainly be a material factor in the coming decade, and excluding companies that are (most likely) behind the curve will reduce the risk in the long term. Furthermore, through the collection of a substantial number of metrics and reporting capabilities in terms of dashboards and footprints, this transparency will enable investors to assess the impact of their investments, thus making it easier to make investment decisions. Being stricter in the selection of investee companies now, will make for easier decisions in the future. In contrast: if an asset manager is behind the curve and is still investing heavily in companies unable to adapt, the impact will be greater. When these regulatory frameworks are implemented they will find it significantly harder to comply, resulting in significant divestments, tracking error issues and trading costs.

ACTIAM manages assets of almost €60 billion (ultimo June 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.

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Member of the PRI 2020 Leaders' Group Climate reporting

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