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PERSPECTIVE

Steering on impact increasingly important

Investors are increasingly investing with the aim to achieve social and environmental impact, next to financial returns. Mostly triggered by developments like the High Level Expert Group on Sustainable Finance, IORP II, TCFD and more local regulations like article 173 in France or the supervisor in the Netherlands (Dutch central bank). Next to that we see remarkable attention for the Sustainable Development Goals (SDGs), which are a universally agreed upon agenda by the United Nations and offer clear investment opportunities.

When you want to start implementing all of these developments or make your investment portfolio more sustainable, the first question is: where to start? The good thing is that the developments mentioned have some things in common. The common denominators are:

- Start with setting (quantified) targets: like lowering your carbon footprint or invest in line with the Paris agreement
- Look at the ESG-related risks in your portfolio
- Be transparent and report on the progress that you are making

As such, we see all of this as a start of a new phase in terms of sustainability. Where back in the days you could say: “I am contributing to building water wells in Africa”(and everyone was impressed), the question you nowadays get is: how many people have access to this well or how much less miles do people have to walk to have access to fresh water? Claiming to be sustainable based on a few show-case-stories is no longer sufficient. The new sustainability is all about providing proof and with that the use of data.

It all starts with defining what sustainability (or green, social or however you want to call it) is for you. Since there is a lack of clear definitions, you must determine your own set of rules. A good starting point to define sustainable investment are the principles set out in the UN Global Compact. And with that you will for sure mitigate the reputational risk that coincides with (sustainable) investments. This in turn could be part of setting targets (what is it that you want to achieve?), for example: 100% compliance with international standards.

Since Global Compact is a set of norm-based themes and not rule-based themes, there can still be a difference in interpretation when assessing a company. Moreover, a lot of (big) data is required for a correct assessment of your investments. So here the challenge is gathering relevant data (that goes beyond just screening on policies) and consecutively interpreting both the colected data and the norms set by Global Compact.

The second step you could consider is integrating ESG-related risks. As reports of SASB and Harvard Business University point out, not every ESG-theme is evenly relevant for every company or sector. The risk of child labour in the headquarters of KPN is very little. Cybersecurity and data privacy however are topics which certainly need attention at KPN. There are two ways to approach ESG-related risks. This approach is very much bottom up. Looking at specific companies and sectors. Again the amount of data that is needed to be able to apply this to the whole portfolio is humongous. On the other hand the reward you might receive does pay up for the efforts. Research of Harvard Business University shows consistent outperformance for companies focussing on the financially material ESG-topics for them.

This is a publication of ACTIAM’s Sustainability & Strategy team, consisting of 7 professionals with an average of 10 years in the industry.

ACTIAM is the responsible asset manager for more than one million people. With over 100 staff we manage €56.3 billion (ultimo June 2018) primarily for insurance companies, pension funds, banks and intermediaries. ACTIAM invests for its clients not only to achieve an optimal financial return, but also a social return. We do this by taking into account the consequences for the environment and society and continue to develop responsible investment solutions for the general public.

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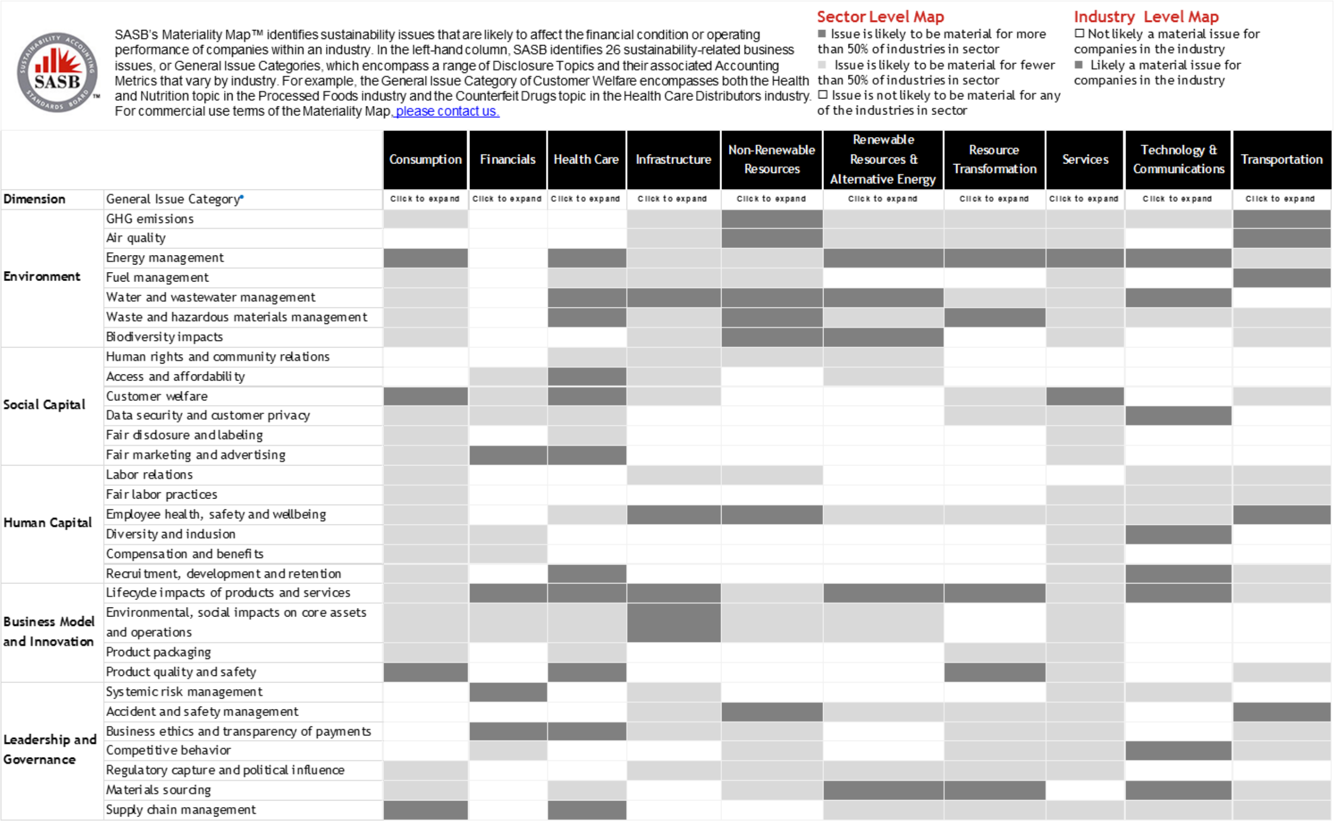
A first view of exposure to material sustainability risks across a diversified portfolio:



Bron: https://materiality.sasb.org (klik op afbeelding voor meer informatie)

Another approach to ESG-related-risks is a top-down approach. Look at bigger trends and risks like climate change or water stress, for the total investment portfolio. How are you exposed and what part of your investments is at risk? Next to the use of carbon- and water foot printing we see a growing attention for scenario analyses. These indicate which part of a euro is at risk in a 2 degrees alignment scenario. And what can I do to mitigate this risk? You can imagine that in this process and these calculations it is all about data. And especially the quality of it. As the saying in data goes, garbage in is garbage out: your result is as good as the quality of the input data. A whole industry on carbon and water data is evolving, all claiming to be correct or at least the best estimate.

The last big trend that we see, and where data is key, is related to the 17 SDGs. If we would achieve all of the underlying goals, we would have a sustainable society. So it is not that strange that, although the SDGs were not necessarily invented for the financial sector, lots of asset managers and asset owners embrace these goals. We finally have some kind of self-explaining framework on sustainability. With this drive to invest in the goals the question on how to measure your specific contribution arises.

Many investors struggle with the composition of investment portfolios, taking into account the impact on the environment and society. Reporting on this is still reasonably in its infancy.

Despite the rich sources of non-financial (ESG) data investors have at their disposal through data providers like MSCI, Sustainalytics and FTSE, there is a growing need for real impact data. This type of data provides insight into investments with a social impact compared to alternatives and helps investors identify investment opportunities with an impact on the real economy.

An example is investing in Green or Social Bonds. With these bonds, the proceeds are specifically used for a social or environmental purpose and therefore effectively an investment with impact.. But how do you measure this impact? Just looking at your AuM in Green Bonds is, although a good start, ultimately not enough. The first question is if you consider an investment in a green bond with the purpose of refinancing existing activities or projects impactful to the environment. The next question is on the methodology used to calculate the impact of the activities that are financed. Are all the carbon footprint reduction targets by different green bond emitting companies calculated set in the same way?

As a consequence, the question arises how investors are steering their investments and improving their impacts? And is it a paper impact or can we link it to the real world and real society? CityWire noticed a name change for a remarkable amount of mutual funds. They suddenly included the terms sustainability or ESG while the constituents of the portfolio in some cases remained the same.

It could possibly be related to the growing appetite of investors to choose for sustainable investment solutions. Together with the great opportunity to invest in a sustainable way, comes the risk of potential greenwashing.

Depending on the objective of investments and consequently the level of impact investors aim to measure, impact data quality requirements can become very high in terms of detail and size. For example, if your objective is to have zero investments in deforestation, you first need to identify the companies in your portfolio that can be involved in these activities, then you need to map the value chains in which these companies operate and then collect data on the land use change these companies are involved in over a certain period, by calculating the size of the area under production and comparing that to the area of pristine ecosystem this used to be before the company started operations. So far, there are mainly project-based an ad hoc data collection efforts to come to this type of data. For example, companies such as Olam, a large agri-commodity player, are investing in information systems at smallholder farm level in remote areas to improve supply chain transparency and environmental impact data, which will in turn help to collect more granular data in an automated way. There are more and more organisations such as Satelligence and trase.earth, which are collecting impact data at a more granular level and covering complete value chains through new technologies. This is a promising development as it also allows for more objective data compared to the self-reported sustainability data of companies.

STEERING ON IMPACT INCREASINGLY IMPORTANT

There will be a major shift in investment towards impact investing, which makes impact data the more relevant to trace how your investments are deployed. How many people did you help with access to financial resources, which basic needs did you support with your investment and which ecosystems have been restored through your investment?

Secondly, impact data will help you to optimize asset allocation and to use new money for those investment opportunities that have a large(r) positive social, environmental and financial impact. Take for example a company X with a high negative impact on water use, due to high water withdrawal in areas that are already under pressure. And consider a company Y operating in the same sector with a similar financial profile with a low negative impact on water use, due to water efficiency technologies it has implemented. In such a situation, it makes sense from an impact perspective to allocate investments to company Y. Especially when you combine the positive impact of the switch with the financial return as mentioned before. Ultimately using data to generate as much impact as possible, should also integrate the financial considerations before making a decision.

Thirdly, it shows whether your investment really generates an actual change in the behaviour of companies.

Fourthly, you can report your impact to key stakeholders. From supervisors that increasingly demand you to be transparent about the sustainable performance of your investments to participants, who increasingly want to know what the societal impact of their pensions is.