The 'S' more central within ESG

A catalysing effect on long-term returns

December 2020

For investment professionals only

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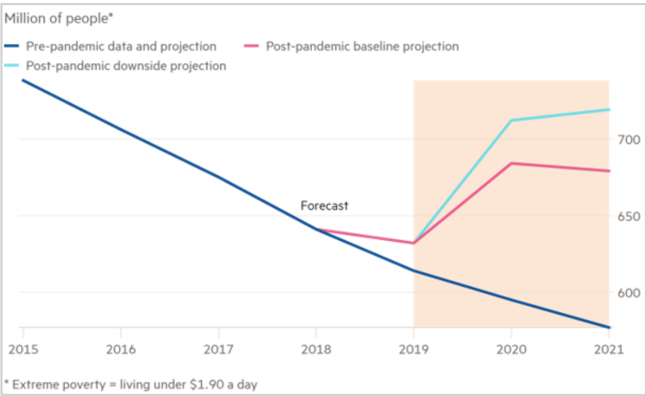
Up until recently the key focus and the political efforts were mainly directed at creating a green economy and therefore on the environmental aspects of ESG. The governance (G) component got increasing attention especially in banking and finance due to the level of controversies. The time has finally come for a shift in focus to the social aspect, which we believe is one of the most material long term drivers of both long term GDP growth and the level of company returns. The key recent catalysts that facilitate the process are the social effects of the Covid-19 pandemic and to some extent the recent US unrest on equality and social inclusion. It is likely that the European Commission will incorporate the social factors into ESG reporting (ESG disclosure regulation) in the near term.

THE SOCIAL PILLAR MOVES TO THE SPOTLIGHT DUE TO THE DISRUPTION CAUSED BY THE COVID-19 PANDEMIC.

The health and economic effects of the Covid-19 pandemic are well highlighted and discussed on a daily basis, in the meantime, a social crisis is still happening behind the scenes on multiple levels.

According to the World Bank, the economic consequences of the coronavirus will push around 100m people into extreme poverty (living on less than $1.90 per day) in 2020, due to inadequate welfare systems. In contrary to stereotypes, these people are relatively well-educated, living in urban areas of middle-income countries. The crisis really exposed the vulnerability of workers with non-standard types of contracts.

Pandemic reverses long-term fall in extreme poverty



Source: World Bank

As an example, think of workers on zero-hour contracts who were really affected during the first wave of coronavirus and often were let go with no notice, severance or access to a governmental social safety systems.

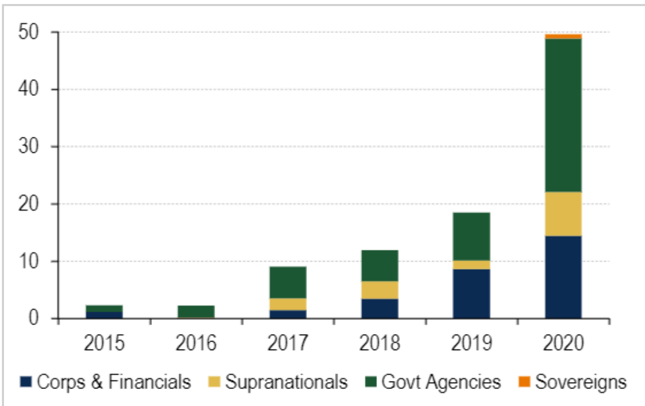
What is even more staggering, around 60 percent of the global workforce is informal, according to the International Trade Union Confederation, meaning no exposure to rights, social welfare or health and safety standards at all.

These numbers make us look a bit differently on the importance of social factors within the ESG framework.

On the macro level, human capital is the key for social and economic development. The piling up of unresolved social issues in the long term could negatively influence long-term GDP growth through a lower level of labour productivity, workforce participation and demographic change. Low income and a high level of inequality can lead to social unrest, which can in return have the potential to impact political stability, fuel nationalism, protectionism, changes in labour/capital flow and, as a consequence, low investment returns and higher spreads on sovereign debt. Brexit is a good example of these sorts of processes in actions.

As a sign of recognition of the social aspect, 2020 saw a substantial growth in social bonds issuance, with governments, agencies, companies and financial institutions looking to finance green and social projects. Social bonds are bonds issued to fund eligible projects that promote social change, like supporting workers displaced by the Covid-19 pandemic within the EU's Unemployment Risks in an Emergency (SURE) programme or so-called “pandemic bonds”. In April alone the global issuance has exceeded the level of 2019, while the growth of Asian issuance YTD surpassed 250% versus 2019, according to Bloomberg. So far, circa 70% of social bonds are issued by government agencies and supranationals. However, the corporate segment has been increasing rapidly, albeit from a low base. It is an attractive market, as green/labelled bonds tend to have bigger order books and come at tighter spreads, potentially lowering cost of debt. Besides, these bonds can positively impact issuer's image and signal leadership on social issues.

Social bond issuance has taken of in 2020 (in $ bn)



French Unédic (unemployment agency) and Nederlandse Waterschapsbank (lends to Dutch government entities) are the largest single issuers of the social bonds.

Source: BofA Global Research, Bloomberg

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THE "S" PILLAR ON THE COMPANY LEVEL IS GAINING IMPORTANCE AND TRACTION

The Social pillar on the company level is viewed through the prism of a company's relationship to its non-investor stakeholders such as employees, customers, suppliers, local communities and society as a whole. The social issues are relevant in both direct and supply chains of companies and can have lasting implications for performance and returns.

As an example, think about reputational damage; liability risks; extra costs due to low level of employee satisfaction & productivity leading to a high turnover or strikes; compensation for mistreatment of employees or if accidents happen due to flaws in health and safety standards. Think about a potential loss of sales and growth opportunities for companies that insufficiently protect/violate human rights or due to product recalls related to low product standards. Alternatively, consumers can just boycott products that are not produced under humane conditions. Failure to ensure sustainable supply chains could damage reputation and the ability to source products in a secure manner.

> *To illustrate, Boohoo's (the UK online fashion retailer) share price dropped by 40% in July 2020 on an unconfirmed article which reported that Boohoo's suppliers paid below minimum wages and did not provide sufficient protection and anti-Covid 19 measures. In response, Retailers such as Next, Zalando and ASOS have temporarily stopped selling Boohoo products.*

We do strongly believe that human and social capital are regarded as essential for companies in all sectors. However, decisions and financial materiality around social and workforce management will vary substantially across sectors dictated by the nature of sectors, business models or regions where companies operate. The weight of the "S" pillar was around 39% over the period 2002-2019 according to MSCI research, but ranged from 16.3% for energy to 59.8% for the financial sector.

Social management is particularly important for Health care, Industrials, Telecoms, especially in terms of Product Safety & Quality, Privacy & Data security and Access & Affordability.

Sectors for which social capital issuers are material

	Product safety & quality	Privacy & data security	Controversial sourcing	Access & affordability
Consumer discretionary	•	•	–	–
Materials	–	–	•	–
Financials	–	•	–	•
Consumer Staples	•	•	–	–
Health Care	•	•	•	•
Real Estate	•	–	•	•
Energy	–	–	•	–
Industrials	•	•	•	–
Communication Services	•	•	–	•
IT	–	•	•	–
Utilities	•	–	–	–

• Material for most companies in the sector

– Not likely to be material for any of the companies in the sector

Business segments with high materiality of human capital, including the supply chain standards, include Consumer Staples, Consumer Discretionary, ICT manufacturing, Extractives, Financials and Building & Construction. It is interesting that the top scoring companies on labour management have outperformed the bottom-scoring companies by an average of 3% per annum during the 2003-2019 period, according to MSCI.

In some sectors only certain human capital topics are financially material: health & safety is more relevant in manufacturing sectors than in services sectors; while career development is more important for in technology-heavy sectors, given the scarcity of skilled labour. For sectors with low-skilled workforces standard working conditions are more important.

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LINK WITH THE E AND G

One can ask a question on how E/S/G 's reinforce each other? The empirical evidence suggests companies with a strong culture tend to perform better in the long term due to a more holistic approach. While corporate culture falls under the governance pillar, it also ensures strong employee engagement, which in return allows easier implementation of changes related to all 3 pillars. Companies with a better culture also tend to have less controversies and a better oversight of material risks.

> *One of the negative examples is Rio Tinto. Rio's CEO and two senior executives have to step down, owing to stakeholder pressure after destruction of an aboriginal site in Juukan Gorge, Western Australia, in May 2020. On one hand, it is a Social issue exposing severe community impact. On the other hand, even though the top management claimed it was not aware of the cultural importance of the site, some people in the company were. The incident was possible due to the "a series of decisions that were taken over an extended period of time", which indicates the flaws in corporate behaviour ("G" pillar). The stock is on ACTIAM's exclusion list.*

In terms of risk materiality, impact on profitability and idiosyncratic risk, governance indicators are more relevant over a relatively short period (within one year), as governance-related event risks and incidents tend to have immediate impact on share prices. At the same time, the Social and Environmental indicators tend to be more relevant for evaluating risks related to the long-term investment horizon, as they tackle longevity and adaptability, according to the study made by MSCI Research for 2006-2019 period.

In principle, the investment managers can adjust the E/S/G weighting schemes depending on their investment horizon. At ACTIAM, we advocate for a pillar-balanced, per sector adjusted materiality approach, which better captures all the aspects of company sustainability developments, as we work with long term horizons.

COMPANY ENGAGEMENT IS THE KEY IN UNDERSTANDING WHAT LAYS BEHIND THE ESG SCORES

It is important to note that both overall ESG ratings and individual Social ratings differ widely among the third party vendors due to different frameworks, key metrics, qualitative judgement and the assigned weight of subcategories. It makes ESG scores less comparable across providers and led to different outcome of investment returns analysis per driver.

Often, a company (especially a smaller company with less ability to absorb fixed costs and resources to engage) prefers to focus on the requirement of a single ESG provider, rather than on the whole range of providers. As ESG vendors tend to penalize companies that disclose less, there will be a disbalance of scores between the ESG providers chosen or not. On a larger scale it will also lead to a size bias.

ESG criteria: major index providers

Pillar	Thomson Reuters	MSCI	Bloomberg
Environmental	Resource Use	Climate Change	Carbon Emissions
	Emissions	Natural resources	Climate change effects
	Innovation	Pollution & waste	Pollution
		Environmental opportunities	Waste disposal
			Renewable energy
			Resource depletion
Social	Workforce	Human capital	Supply chain
	Human Rights	Product liability	Discrimination
	Community	Stakeholder opposition	Political contributions
	Product Responsibility	Social opportunities	Diversity
			Human rights
			Community relations
Governance	Management	Corporate governance	Cumulative voting
	Shareholders	Corporate behaviour	Executive compensation
	CSR strategy		Shareholders' rights
			Takeover defence
			Staggered boards
			Independent directors
Key metrics and submetrics	186	34	>120

Source: Refinitiv, MSCI, Bloomberg, FTSE; OECD assessment

Due to these concerns, we believe that direct engagement with companies is very important. Both ACTIAM's internal ESG analysts and portfolio managers of active products engage directly with companies to steward them to drive a change in behaviour, as well as to dig behind the external ESG ratings. The outcome of these engagements is reflected in ACTIAM's internal ESG scores and investment decisions.

Kirin Holdings

Kirin Holdings, a Japanese beverage and pharmaceutical company, is flagged for human rights violations due to relations with the Myanmar Economic Holdings Public Company Limited (MEHPCL) through their joint-venture in the Myanmar Brewery and Mandalay Brewery. MEHPCL is owned by the military forces in Myanmar and Kirin has made several donations to the Myanmar authorities for humanitarian purposes. However, it cannot be proved that these donations, as well as the dividend payments were not used by the military forces in their activities against the Rohingya population.

ACTIAM has initiated an engagement with Kirin to urge them to investigate these donations and if possible revisit their stakes in Myanmar. The contacts with Kirin have been very constructive and important steps have been taken since the start of the engagement. Kirin has announced an independent review by Deloitte, is currently reviewing its business relations with the MEHPCL and has made contacts with Amnesty International and other local NGOs to discuss the matter. So far, Kirin postponed dividend payments to the MEHPCL, gives regular updates about the steps taken on their website and have updated their human rights policies in order to prevent similar incidents occurring in the future. Once the Deloitte review is ready they will make final conclusions.

Although within the MSCI framework the stock maintained its A rating after the issue was flagged, ACTIAM's scores were adjusted to below industry average. The scores will be adjusted as the investigation progresses and the further actions are taken.

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Going forward, help in harmonization of reporting should come from regulators. The EU Taxanomy will, hopefully, replace multiple different ESG frameworks and standards with a single standard for the EU. The environment pillar will remain the key. However, the recent developments suggest that near term expansion to social and governance factors is very likely, which in return should require harmonized reporting on a wider range of parameters.

We believe that more disclosure could mean higher ESG ratings, leading to another leg in momentum driven returns. This time, however, it should be driven by self-help and disclosures on the Social pillar. Currently, the “S” still has a limited reflection in companies share prices and valuations.

Safaricom is a truly admirable example of a socially oriented company, delivering solid financial returns

Safaricom is a Kenyan telecom provider. It brings not only connectivity, but also is improving the daily life of millions of Kenyans through a broad range of products and services. Most substantial social value creation comes through its M-PESA mobile payment solution. The social - economic development is amplified though a number of partnerships like M-GAS solution (enables low-income households to purchase gas on a pre-paid basis through M-Pesa), M-Kopa Solar, M-Tiba (micro-insurance healthcare product for low-income households), as well as Kilimo Salama (Seed Replanting Guarantee), ‘Shupavu 291’ (study tools), DigiFarm (supporting 1.4m farmers), maternal and child health programmes and many many others. The total impact of Safaricom on Kenyan GDP (direct, indirect and capital expenditure) is estimated at close to 6%, according to KPMG “True earnings” exercise.

In the case of Safaricom, the societal impact goes hand in hand with the financial performance, delivering 21.6% total shareholder returns of the last 5 years. The stock is held in ACTIAM’s Global Impact Fund (ACTIAM Impact Wereld Aandelenfonds).

CONCLUSION

We expect Sustainable Investing to remain the key investment trend for this decade with a broader range of market participants entering the ESG space both on equity and fixed income side. So far, the investment decisions were dominated by “E” and “G” criteria, while social SDGs lagged behind. In the meantime, Moody’s estimates that circa $8trn of the debt it rates is directly or indirectly exposed to social risks on the macro and company level.

The “S” is an important company risk mitigation: the engaged and satisfied employees work harder and provide better results for organization, while content customers, solid and inclusive relations with communities and a control over the supply chain help to eliminate brand damage risks. The social aspect and attractiveness of employers play an increasing role for millennials and, therefore, for future economic growth.

As the focus on “S“ grows, spurred by pandemic, so will the expectations of the rating agencies and investors. The ESG scores of rating agencies can be a useful guide for evaluating companies. However, additional efforts are advisable in understanding what they are based. We believe engagement with companies and a stewardship in companies’ behaviour is the key in this process.

We believe it is prudent to increase the materiality of the “S” pillar within the ESG framework especially for investors with a long term investment horizon to ensure a harmonized approach. It is even more beneficial to follow a holistic approach based on future opportunities and Sustainable Development Goals (SDGs), similar to the one we use at ACTIAM.

In the short term, the higher level of “S” disclosure, required by regulators, can potentially spur the next leg of ESG score upgrades and ESG momentum. From a valuation point of view, it will likely further decrease the cost of capital, accelerate the long term growth and ensure higher valuation premiums to the exposed stocks.

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ACTIAM manages assets of almost €58 billion (ultimo September 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

December 2020