actiam

PERSPECTIVE

ESG integration:

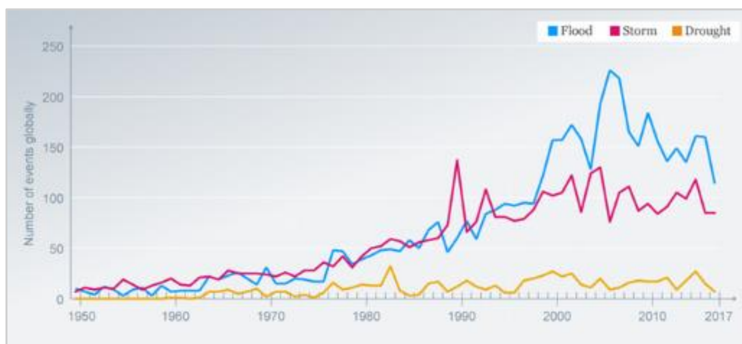
Balance is the key to success!

Given the global challenges we face on climate and on social & demographic issues, allocation to sustainable investing is rightly gaining more importance, especially in Europe. European companies are benefitting from a favorable environment which stimulates sustainable efforts as well as from wide public interest for sustainable investments. An integrated ESG and financial approach is required to make rational and balanced investment decisions. Integrating a companies' financial and ESG information can be achieved in several ways.

EUROPE: THE PLACE TO BE FOR SUSTAINABLE INVESTORS?

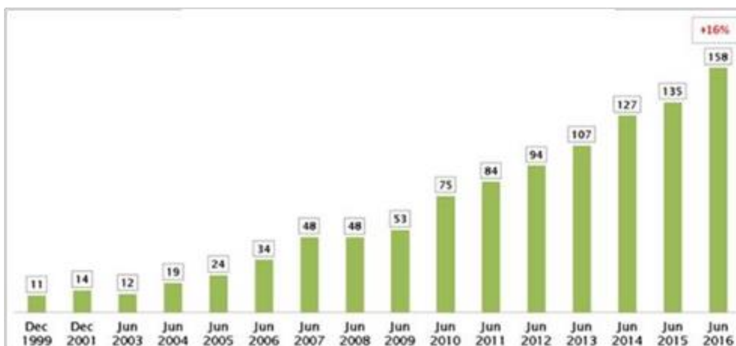
The increased risks related to climate, social and demographic trends and the potential impact of these risks on investments are attracting increasing attention of international organizations and regulators. We see Europe taking the lead in issuing regulation to stimulate sustainable investments and increase transparency by companies and investors. Next year for example the European IORP II directive will go into effect, imposing pension funds to integrate environmental, social and governance risk in general risk management and their reporting. Another example is the EU High-Level Expert Group that is examining measures to mobilize finance for sustainable growth. Regulatory policies, changing consumer preferences and an ever increasing amount of data that confirm the environmental and social challenges we have (see figure below), are an important basis to create an enabling environment in Europe for companies and investors to participate in a more sustainable economy.

Extreme weather on the rise



Source: The Emergency Events Database (EM-DAT), www.emdat.be
Reported events, not controlled for any variables.

Total AUM for SR funds domiciled in Europe (€bn)



Source: Vigeo Eiris (2016)

This is a publication of ACTIAM's equity team, consisting of nine professionals with an average of 18 years in the industry. The team is responsible for the management of our (responsible) equity products, with a total AUM of €10 billion (June 2018).

ACTIAM is the responsible asset manager for more than one million people. With over 100 staff we manage €56.3 billion (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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INTEGRATION: A BALANCING ACT BETWEEN ESG AND FINANCIAL PERFORMANCE

For years ESG investing focused on avoiding ESG risks. Through screening of companies on a broad set of ESG KPI's, investors tried to avoid the downside risk of companies having severe issues related to failures on their environmental, social or governance behavior. International treaties, best practices and conventions including the UN Global Compact give guidance to the standard of what is and what is not acceptable. Financial analysis of the company itself was not taken into consideration when selling these -on ESG grounds excluded- companies.

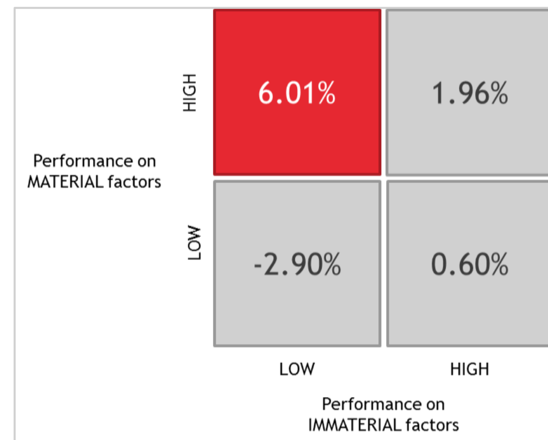
Nowadays, ESG ambitions of investors have increased. Besides risk avoidance investors look for companies that attribute positively to ESG goals in combination with sound financial returns. An integrated ESG and financial assessment is needed to establish their goals and to get the relevant financial return.

An integrated assessment is a matter of balancing, between the ESG and financial performance of a company. To facilitate this for your investment universe you should structurally capture the ESG and financial performance of all companies. A way to do this for the ESG performance, is defining an ESG score for each company. This score should reflect the ESG risks and strengths that are financially material to the company.

In order to create a diversified portfolio that outperforms the benchmark on both financial and sustainability criteria, the selection should not be limited to the highest scoring stocks on the combined ESG and financial score. Ideally there is flexibility to target a high average overall score balancing between different levels of individual ESG and financial company scores, within the portfolio. This balancing mechanism allows to take a nuanced and rational approach to sustainable investing. It is off course important to respect a minimum threshold for the ESG score when selecting a company. It is crucial to stay far away from companies with severe issues in their environmental, social or governance performance (even if they have attractive financial characteristics). Companies having severe issues and controversies could potentially have detrimental impact on portfolio performance.

Selecting high scoring ESG stocks and avoiding low scoring stocks is not only done to preserve the sustainable profile, but research shows that weak scoring companies on financial material ESG issues on average have a lower performance than companies scoring strong on financial material ESG issues. Where materiality is defined by the Materiality Map of the Sustainability Accounting Standards Board - SASB (see figure below). So, on top of the positive ESG effect, performance also benefits from avoiding the lower scoring ESG companies.

Khan et al. (2015) "Stock Returns (annualized alpha) by Type of Sustainability Performance"



Source: SASB (http://using.sasb.org/index/for-investors/)

A BLURRED LINE

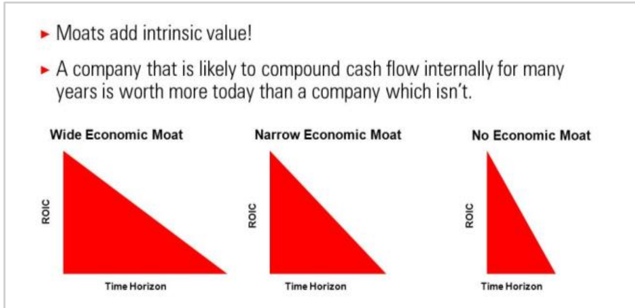
The approach described above offers a robust and structural method to integrate ESG in a portfolio. It assumes however that ESG and financial performance of a company are two separate things. In reality it can sometimes be a blurred line between ESG and financial analysis. ESG risks and opportunities can have a measurable impact on the financial strength of a company. Fines, stranded assets or investment opportunities related to the SDG's are examples of ESG topics having direct financial impact. ESG and financial analysis are more and more becoming inseparable and reinforcing each other, in making a balanced longer term investment decision based on fundamental analysis.

HOW TO INTEGRATE ESG IN THE FUNDAMENTAL ANALYSIS OF A COMPANY?

An important concept in analyzing a company fundamentally is the moat of the company as a basis to determine the long term expected value. It is widely believed that if a company has a sustainable competitive advantage, it is shielded against competitive forces and able to generate long term returns on investment above the cost of capital (it has a "wide moat"). Absence of or a weak moat, results in a reduced long term value of a company.

The right view on the moat of a company is thus crucial for the expected financial return of investment decisions.

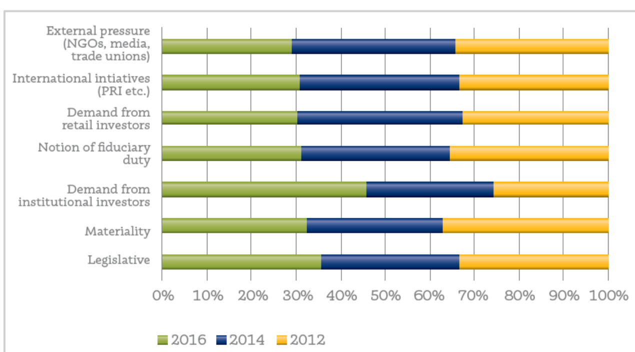
Why Moats Matter



Source: Morningstar

Nowadays, the moat and thus long term expected value of companies is becoming increasingly dependent on ESG risks and opportunities, what makes an integrated fundamental assessment of this moat more and more important. In doing this integrated assessment you can ask companies for their long term ESG goals, evaluate the fundamental motivation of management and the governance structure of companies. Alignment of products and services to ESG goals is another important factor to evaluate the moat. For example low alignment with the ESG goal of a low carbon economy can lead to losses of sales for car companies, high transition costs for utilities or stranded assets for oil & gas companies. Alignment can lead to rising sales for solar companies and capex opportunities for smart grid operators. Next to assessing the ESG topics above, one should also assess the standard long term financial characteristics of a company to take a final view on the moat. Long term financial characteristics you could look at are for example quality of capital allocation, evolution of margins or expected return on capital.

Drivers of SRI demand



Source: Eurosif European SRI Study 2016

Examples

Wide moat

A nice example of how ESG can reinforce the economic moat is the Belgian materials company Umicore. The past few years Umicore has been strengthening its moat by capitalizing on the ESG opportunity of a growing need for clean energy solutions. More specific it invests in emission control catalysts, materials for rechargeable batteries and recycling, where it benefits from rising demand and high entry barriers. This widening moat has a positive effect on the valuation one should be prepared to pay for this company.

Weak moat

Solar is seen as one of the most promising solutions to move to a low carbon economy. Whilst demand increased massively the moat has weakened. Increasing demand has stimulated competition leading to a rapid drop in prices and lower returns for the related companies. Currently there is a global solar panel surplus caused the Chinese producers who have continuously expanded production. The industry is going through a transition phase from an interesting 'green' technology to a mature industry. This weakening moat lowers the valuation one should be prepared to pay for these companies.

CONCLUSION

European companies benefit from a favorable environment towards sustainable investments, making this an interesting region for investors that want to attribute to a sustainable world. On the one hand an integrated rational approach protects investors from the downside risk of companies having severe issues related to failures on their environmental, social or governance behavior. On the other hand it offers investors the opportunity to achieve financial returns while attributing to a sustainable world. Due to the fact that the fine line between financial and ESG performance and analysis is fading, investors should look for investment solutions that on top of this balancing act integrate ESG and financial performance thoroughly in the fundamental analysis of companies. Assessing ESG risks and opportunities in the moat of a company is a way to do that.

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