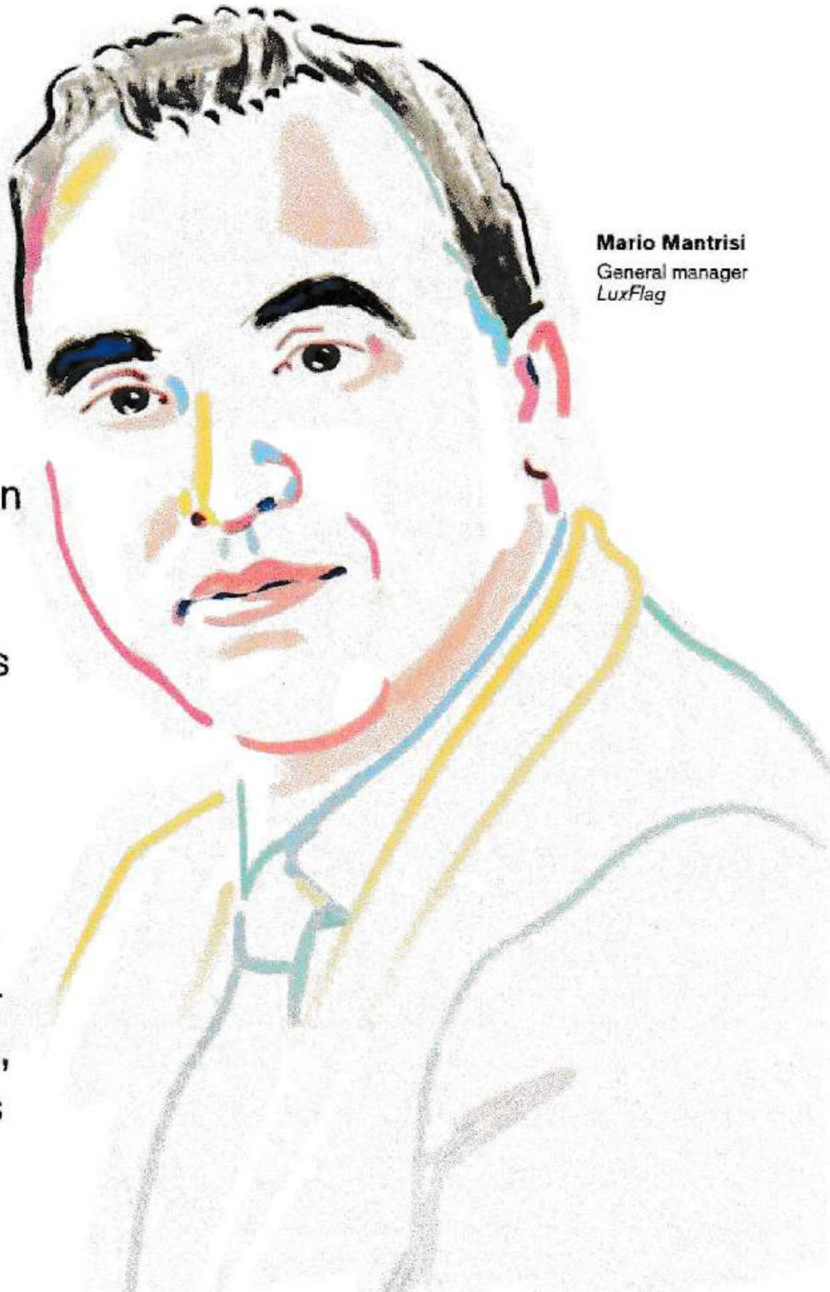
SUSTAINABILITY ENGAGEMENT

NO ESG, NO PERFORMANCE?



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For a long time, there has been a general market perception that sustainability underperforms. Market research proves current beliefs wrong. Mindsets are changing and traditional asset managers are now seeking the opportunity to develop ESG (Environmental, Social, Governance) product lines. What if, in the future, investment funds perform less if ESG factors are not taken into account?

The pressure for short-term performance has been hampering forward-looking investments in the financial industry. There was and still is this myth that sustainable investments, favouring a long-term perspective, are not bringing more money in your pocket but allow you to invest according to your values in exchange for returns. If there are still a number of people who believe it is the case, they might not yet have addressed the topic to a full extent. Doing well financially and doing good are often seen as two separate accounts in our investment decisions. However, philanthropic and financial actions should not be perceived as mutually exclusive but rather as a well-suited combination. The impression of underperformance of sustainable investments is often due to short-termism and the misperception that such investments are focused on exclusions only. Indeed, Modern Portfolio Theory points out that limiting your investment universe may result in less efficient portfolios as diversification is reduced. However, sustainable investing strategies are today much more than negative filters but imply positive screening and active approaches. The market evolved very quickly in the past years. Thereby, ESG analyses allow nowadays a deep dive into a company's credentials. Strong corporate governance can be an indicator of the future soundness, resilience and efficiency of a company. In the long run, sustainable companies could even become the most successful and efficient ones in light of changing mindsets and generational shifts.

"ESG investing might even become the new way of reaching high performance."

ESG IS PERFORMING

It has been a long way to achieve sustainable thinking in corporate and investment behaviour. The industry seems now to be ready for change. Every other day, the latest sustainability engagement of a large company makes it in the headline news. According to GRI (Global Reporting Initiative), over 80% of the world's largest companies already issue standardised sustainability reports. The quality of ESG data and metrics is improving, which helps identify future-proof companies that might be overlooked by traditional analysis. ESG investing might even become the new way of reaching high performance. Corporations with a strategic sustainable approach seem to gain high traction on capital markets. Engagements of a sustainable nature already give positive signals to the stock market. Recent announcements like Starbucks' ban on plastic straws or Adidas' pledge to use only recycled polyester by 2024 made both stocks jump up.

Even though the responsible investing market is still young, there is ample market research showing that ESG creates market-rate returns. It can even lead to outperformance as empirical evidence proves. A meta-study conducted by Friede, Busch and Bassen aggregated evidence from more than 2,000 empirical studies. The large majority of the analysed studies finds a non-negative relation between ESG and corporate financial performance. More importantly, most of them even report positive findings that are stable over time. ESG portfolios are keeping pace with traditional ones. Even though it cannot summon up for a generalised statement, we experience some compelling examples of how sustainability and performance are combined when we look at investment funds which hold a LuxFLAG label.

Alexandre Jeanblanc, Sustainability Centre, BNP Paribas Asset Management, underlines: "*There have been numerous academic studies on the impact of practices regarding ESG. More than 80% of them show that sound ESG standards result in the long run in a lower cost of capital, better operational performance and enhanced stock price returns. Consequently, all stakeholders, from corporate managers to investors and asset managers, should include sustainability parameters in their strategic decisions. This will likely be supported by a push by public authorities and regulators to increase companies' transparency and performance on environmental and social matters as well as improve corporate governance and corporate social responsibility.*"

Indeed, this does not only prevail for ESG funds but can also apply to more specialised investment strategies. Even though the green bond market is still at its early stages and findings are based on a short-term horizon, the argument seems to be valid here as well. Bram Bos, lead portfolio manager of the LuxFLAG labelled NN(L) Euro Green Bond fund,

500BN

According to a study co-edited by KPMG and the ALFI at the end of 2016, the sustainable funds represented 500 billion euros of assets under management out of a total of more than 3,700 billion. The 2017 figures will probably be higher.

indicates: "*We researched how yields of green bonds compare to yields of non-green bonds. The average yield of a green bond was 0.01% lower and we think this is an insignificant difference. If we compare the performance of the Bloomberg Barclays MSCI Euro Green Bond Index to the Bloomberg Barclays Euro Aggregate Index, we even find proof that a portfolio of green bonds outperforms the regular market.*" This gives clear hints that sustainability and financial performance go hand in hand.

AN INCOMPARABLE TOOL TO MANAGE FUTURE RISKS

ESG criteria are developing into an incomparable tool for risk management and mitigation. "*ESG will also require asset managers to consider climate risks and social risks in their risk management framework. This will give a new prism to assess the risks related to the portfolio held and will increase the assessment of the reputation risk when investing in some companies*" highlights Guillaume Brousse, member of the LuxFLAG ESG eligibility committee and director at Deloitte. As a matter of fact, companies with higher ESG scores tend to have a lower risk of suffering from reputation incidents.

Identifying those ESG issues that have a material effect for a company considering their stakeholder groups can be very helpful to establish a roadmap that addresses future threats and reveals opportunities. Ophélie Mortier, responsible investment strategist at Degroof Petercam Asset Management, points out: "*Integrating ESG criteria into investment portfolios is about identifying additional risks and opportunities. A very concrete example of risk mitigation can be found in our sustainable OECD and emerging market government bond portfolios. In this portfolio, indicators linked to transparency and democratic values constitute an important pillar of our scoring model because research has shown that the quality of a country's institutions is material for the quality of its policies and welfare on the long term.*"

MOVING FORWARD

Time will give even more track record to the sustainable investment market which might facilitate communication on its soundness. Knowledge, demand and investments have already grown tremendously in the past years. A clear understanding and reporting on which sustainable investing strategy is used and if measurable environmental or social impacts are created is fundamental. Particularly, because there can be many different strategies and levels of sustainability pursued. Investors need definitions and proofs to make an informed decision. This is not new to the financial industry. Education and communication on several levels will be key to help the market to further growth which is also the target of the foreseen regulatory measures of the EU Action Plan on sustainable finance. The sustainable value proposition needs to be spread to a higher granularity, including not only asset managers, but also administrators, distributors, banks and financial advisors. Millennials make no secret of their willingness to integrate sustainable aspects into their investments which gives high hopes for the market's future. Evidence is building up – the business case for sustainable investments has never been more compelling. It's high time to invest! ◆