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The Rise of Responsible Investing

Responsible investing (RI), also known as ethical or sustainable investing, is a holistic approach to investing where environmental, social and governance (ESG) and ethical issues are considered alongside financial metrics when assessing potential investments.

The RI universe continues to grow at a rapid pace as investors increasingly demand that their savings are aligned with their personal values. Within Australia, the RI market grew 13% over 2018 to $980 billion, representing 44% of total professionally managed assets under management (AUM) according to the Australian Bureau of Statistics (ABS). This growth is also occurring on a global scale – the Global Sustainable Investment Alliance (GSIA) recently released its biennial *Global Sustainable Investment Review 2018*, showing that global RI assets in the five major regions reached US$30.7 trillion at the start of 2018, a 34% increase from 2016.

As the RI universe continues to expand, there is a growing number of increasingly complex and sophisticated products available to investors. Given the large number and variety of strategies available in Australia, investors should be able to find products and services closely aligned to their values and beliefs. There is a high level of variability in the degree to which these factors are incorporated into the decision making of each strategy.

Given the increasing interest and complexity surrounding the RI market, this report seeks to:

- provide insight into the changing dynamics of the RI market, including the driving forces behind increasing investor appetite and the related corporate response; and
- define and articulate the underlying practices of RI strategies in order to assist investors in identifying strategies that may best fit with their values.

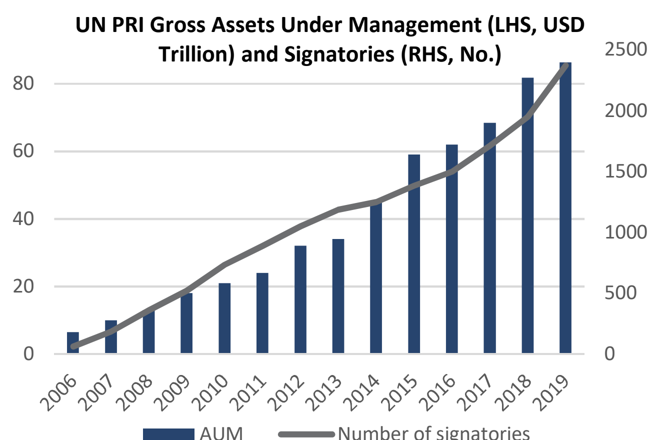
In order to assist with this process and to evidence the growing commitment Evans and Partners is making to this issue, we have referred to Australian Governance & Ethical Index Fund Portfolio Manager and RI specialist at Walsh & Company Asset Management, William Hart, as a reference for this report.

Given the impact created by RI investment varies markedly, we would encourage investors to seek out strategies where investment outcomes provide additional benefits to the environment and/or community in a way that is clearly defined and measurable. Given the growing interest and improving quality of investment strategies and structures within the RI market, we will increasingly seek to identify products and strategies and make them available when appropriate.

Regulations and the role of institutional investors

Regardless of the market or measurement tool used, the rise in the RI market has been extraordinary. Increasing conviction that the world's largest global challenges –i.e. climate change, environmental conservation and human rights – can be solved through the utilisation of investment capital has led to a marked shift in investor allocations and attitudes.

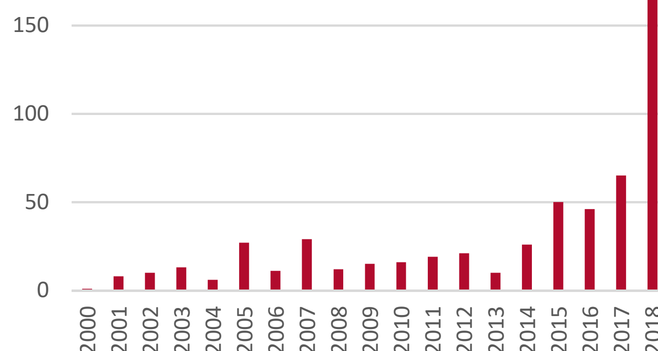
This is perhaps most evident when considering developments in institutional markets. In 2006, the United Nations (UN) launched an initiative known as the Principles for Responsible Investment (PRI). This initiative requires signatories (asset managers and owners) to commit to considering ESG issues in investment decision-making and engage with companies regarding ESG performance. Today, there are more than 2,300 UN PRI signatories worldwide, representing in excess of 80 trillion US dollars of capital – and this has been growing at over 20% per annum.



Source: UN PRI

The regulatory framework within which both investors and corporates operate is also rapidly changing. Since the year 2000 the number of ESG regulations introduced (either voluntary or mandatory) has grown exponentially. In 2018, more regulations and targets relating to ESG were introduced than in the previous six years combined. This has been evidenced by recent notable regulatory developments such as in Australia with the Modern Slavery Act – passed in December 2018 – which outlines companies' requirement to act on modern slavery risks in operations and supply chains. In addition, the UK also instituted a requirement to disclose the gender pay gap, while Japanese regulators require gender composition, retention and promotion of corporate staff be disclosed.

While historically ESG regulation has targeted corporates, it is notable that new regulations are focussed on investment products and processes utilised by investors. In 2018, 80% of new regulations targeted the roles and duties of institutional investors. Examples include the introduction of explicit rules that require the consideration of material 'non-financial' risks (such as climate change) in the fiduciary duties of investment decision-makers.



Source: MSCI ESG Research, 'ESG Trends to Watch 2019'

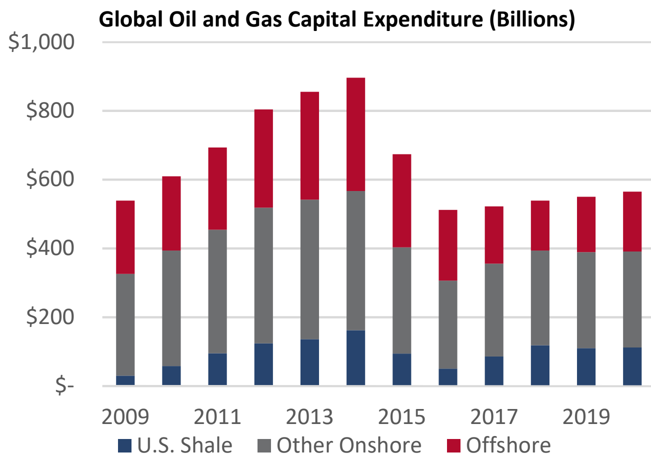
The corporate response

These regulatory developments and the ongoing growth in RI capital are having an impact on investment markets and economies as capital allocation decisions incorporate these changes. It is becoming evident that the sheer weight of capital being directed with an ESG policy or investment mandate (particularly in Europe) is forcing companies to adapt and implement ESG risk management into operations and decision making, or risk being left behind.

Source: Factset

One example of this is investment by global energy companies. Exploration and development spending by large listed oil companies has been significantly less in recent years than would have been expected, given the strength in the oil price. Some part of this has been the

pressure by investors for these companies to switch to renewable sources of energy.



Source: Rystad Energy UCube, Bloomberg Finance

While corporates on the whole have historically been slow to respond to these developments, it is becoming evident that the growing focus on ESG by investors is beginning to consume more corporate time. A review of quarterly earnings calls of S&P 500 companies shows there has been a 30% increase in references to ESG in the past year.

The growth in RI and scrutiny on corporates is unlikely to moderate with generational change and changes in consumer expectations expected to further drive demand. Both domestically and abroad, surveys continue to highlight the importance younger generations place upon sustainable businesses practices and ethical standards. According to Deloitte research, 87% of millennials want businesses to measure more than just financial performance, with priorities including the impact of their operations on wider society and ethical behaviour from management. This will have long-term implications for investment allocations – where by 2030 millennials will make up two-thirds of the workforce in Australia, representing the largest source of income and consumer spending.

The link between ESG and performance

There is also evidence that incorporating ESG factors into portfolio construction can improve investment returns. The Responsible Investment Association of Australia (RIAA) in its most recent benchmark report found that the average RI Australian and international share funds outperformed their average (i.e. non-RI) peers over all time horizons measured (1, 3, 5 and 10-year returns).

Performance of RI funds vs non-RI funds (domestic)

	1 Y	3 Y (p.a.)	5 Y (p.a.)	10 Y (p.a.)
Average Australian RI Fund	-1.24%	5.70%	6.43%	12.39%
Morningstar: Australia Fund Equity Large Blend	-5.29%	4.87%	4.42%	7.95%
Excess Return	4.05%	0.83%	2.01%	4.44%

Source: RIAA, 'RIAA Benchmark Report 2019'

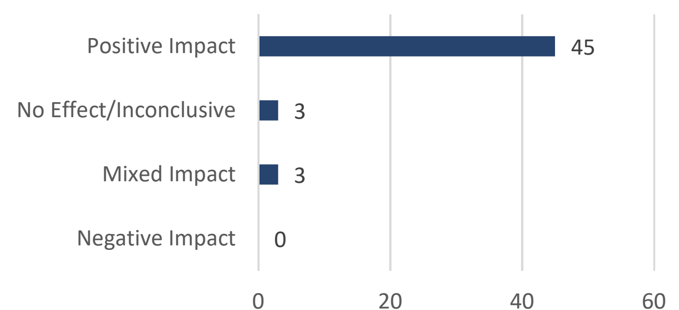
Performance of RI funds vs non-RI funds (international)

	1 Y	3 Y (p.a.)	5 Y (p.a.)	10 Y (p.a.)
Average International RI Fund	-0.03%	11.18%	9.48%	9.50%
Morningstar: Equity World Large Blend	-0.68%	6.37%	8.42%	8.97%
Excess Return	0.65%	4.81%	1.06%	0.53%

Source: RIAA, 'RIAA Benchmark Report 2019'

Outside of Australia, research from academics and asset managers has also increasingly found a link between ESG factors and improved financial performance, largely through risk reduction. Of 51 peer-reviewed studies published over a 35-year period on the link between sustainability measures (across governance, environmental and social factors) and corporate operational performance, 88% found a positive relationship. Notably, no papers showed a negative relationship existed.

Results of empirical studies on the relationship between ESG and corporate operational performance (No.)

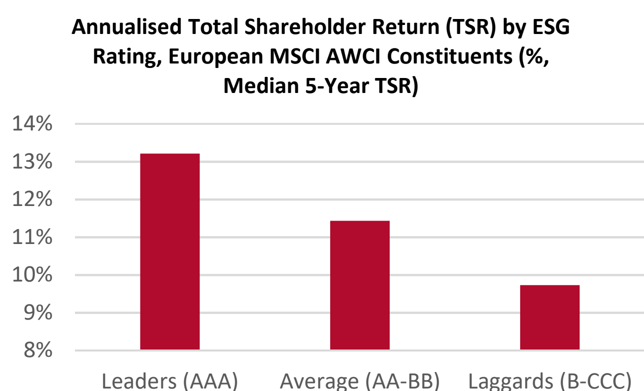


Source: Oxford University, Arabesque Partners, 'From the Stockholder to the Stakeholder'

Regionally, Europe is the leading adopter of ESG regulation so is a useful guide as to how investment returns might be impacted as other nations further implement ESG policies. Utilising data from global social RI firm MSCI ESG Research,

we analysed 5-year trailing returns of large-cap European companies by ESG rating. MSCI ESG Research analyses and rates all companies on an *industry-adjusted basis* utilising a ratings scale from AAA to CCC for ESG performance within their respective industry. We found that ESG leaders (i.e. AAA rated) outperformed ESG laggards (i.e. B-CCC rated) by around 4% per year over the last 5 years.

Annualised Total Shareholder Return (TSR) by ESG Rating, European MSCI AWCI Constituents (%, Median 5-Year TSR)



Source: Walsh & Company Asset Management, Factset, MSCI ESG Research

The results suggest that firms can focus on ESG without sacrificing financial returns, although further investigation is needed to determine whether an emphasis on ESG actually causes better performance.

Isn't it intuitive?

There are a number of ways in which a focus on ESG can give companies an edge. Those organisations that prioritise human capital development through treating staff well and encouraging training should foster innovation and create new revenue opportunities. Corporates with robust corporate governance frameworks (for example independent oversight and aligned remuneration structures) may decrease the risk of wilful corporate scandals and prevent regulatory penalties, brand damage and remediation costs. Investors should also be willing to pay a premium valuation for the earnings stability and growth potential afforded by those organisations that meet these criteria.

Recent examples both domestically and globally support this – challenges in the domestic banking industry regarding conduct and culture (and in both the US and UK prior) are increasingly being reflected in share prices, while high profile environmental scandals (BP, Volkswagen) and security breaches (Equifax, Capital One) are also impacting asset prices. As investors place greater emphasis on ESG performance, share price responses will likely become increasingly severe.

As ESG adoption and integration continues to grow it will likely have a larger impact on capital allocation decisions and investment market performance.

Defining the RI strategies

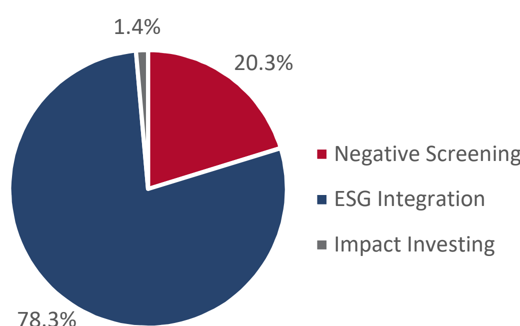
In Australia, the size of the professionally managed investment market as at 31 December 2018 was $2.24 trillion, according to the ABS. Of this, RI strategies account for $980 billion of the market, representing 44% of total AUM and growth of 13% on the $866 billion of AUM recorded at 31 December 2017.

As the RI market continues to expand, there is a growing number of increasingly complex and sophisticated products available to investors. Given the large number and variety of strategies available in Australia, investors must determine the approach to RI they wish to take.

In order to assist with this process, we have classified the RI strategy landscape into three primary categories, each different in terms of variability of impact and measurability. The categories are:

- Negative screening
- ESG integration, and
- Impact investing.

Composition of Australian RI Market by Strategy



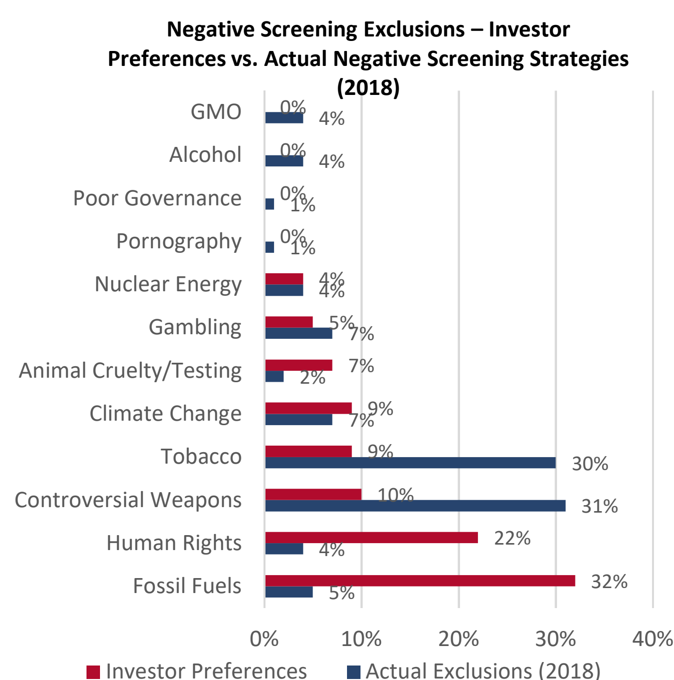
Source: Australian Bureau of Statistics, Responsible Investment Benchmark Report 2019 - Australia

Negative screening

Negative screening is the systematic **exclusion** of a company, sector or practice from a fund or portfolio based on predetermined ESG criteria. Negative screening has traditionally been the most popular RI strategy because of its systematic implementation, scalability and replicability across a wide range of asset classes. This type of strategy

ranks first in popularity globally, with an estimated $19.8 trillion in AUM at the conclusion of 2018.[1]

The most popular institutional exclusions weighted by AUM are for controversial weapons (31%) and tobacco (30%). The next most commonly excluded activities are gambling and fossil fuels, however the screens most commonly employed by investment managers appear at odds with what investors are searching for. A recent study by the RIAA found that the most common exclusions searched for by investors were fossil fuels (32%) and human rights violations (22%), which are only accounted for in 5% and 4% of strategies respectively.



Source: Responsible Investment Benchmark Report 2019 - Australia

For domestic equity funds, controversial weapons and tobacco exclusions are relatively easy to apply as direct listed controversial weapons manufacturers and tobacco producers are a rarity. From an international equity fund perspective, however, these exclusions are highly relevant.

The definitions and materiality of thresholds become very relevant when looking further down the supply chain of exclusions. Using tobacco as an example while there are no ASX-listed companies that produce tobacco, there are companies that are involved in the packaging and distribution of tobacco. It is therefore essential that investors clearly define tolerances and thresholds towards practices and functions, and diligently select strategies that best align with these.

ESG integration

ESG integration involves the systematic explicit **inclusion** of environmental, social and governance factors into the investment decision-making process. ESG integration is the most popular RI strategy within the domestic market, accounting for 45% of Australian RI strategies in 2018. It is the third most popular strategy globally with approximately $17.5 trillion in assets[2].

ESG integration can range from a simple, tick-box approach to a well-defined integration strategy systematically embedded in the investment process. Defining and measuring ESG integration practices is challenging due to limited disclosure and a broad variation in the depth of integration. As a result, we acknowledge three sub-categories of ESG integration being:

- corporate engagement & shareholder activism
- positive screening, and
- sustainability-themed investing.

Corporate engagement & shareholder activism refers to the employment of shareholder power to influence corporate behaviour. This may be conducted through direct corporate engagement such as communications with senior management or boards, filing or co-filing shareholder proposals and proxy voting in alignment with comprehensive ESG guidelines.

Positive screening is the inclusion in a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria. It may also be referred to as best-in-class screening, which involves investment in sectors, companies or projects selected from a defined universe for positive ESG performance relative to industry peers. Examples of positively screened companies include those that derive greater than 20% of their revenue from sustainable technologies, products and services.

Sustainability-themed investing relates to investment in themes or assets specifically related to improving social or environmental sustainability. This commonly involves funds that invest in clean energy, green technology, sustainable agriculture and forestry, green property or water technology. This category also includes multi-

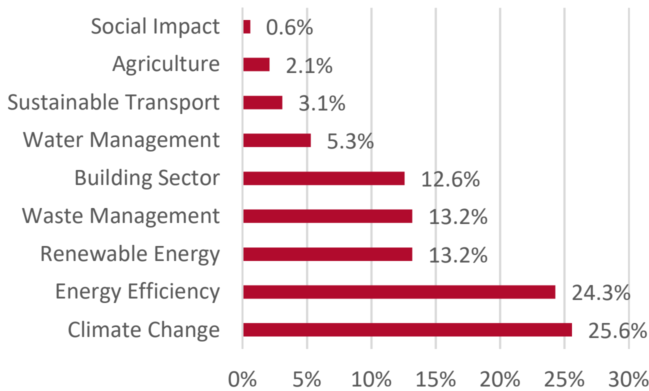
[1] Global Sustainable Investment Alliance, *Global Sustainable Investment Review 2018*, 2018.

[2] Global Sustainable Investment Alliance, *Global Sustainable Investment Review 2018*, 2018.

strategy portfolios that may contain a variety of asset classes or a combination of these themes.

While still in a stage of relevant infancy, sustainability-themed investing is quickly growing in popularity, with the domestic market more than doubling in the last 12 months, primarily driven by green property and sustainable equity funds.

Sustainability-themed investments by theme (AUM)



Source: Responsible Investment Benchmark Report 2019 - Australia

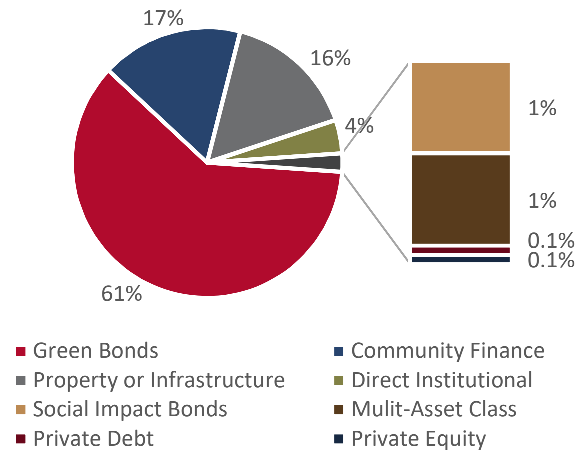
Impact Investing

Impact investment refers to 'investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.'[3] To be classified as an impact investment, the desired outcome of an investment must seek to resolve a societal or environmental problem in a way that provides additionality (the delivery of benefits beyond what could have occurred in the absence of the investment) and can be clearly measured (measurability).

Impact investing provides governments with an alternative and innovative mechanism to address social and environmental issues, while leveraging government and private sector capital. The uptake of impact investment, locally and globally, is a direct response to the finance sector looking to earn market rate returns, while having a social and environmental benefit at the same time. The impact investing asset class holds large upside potential as it is a form of RI that embeds positive environmental and social impact into tools that have traditionally only been focussed on value creation.

The most recent RIAA report noted that impact investing increased by 72% in 2018 to $13.8 billion. This shows there is a growing appetite and recognition for products and strategies that deliver measurable social or environmental impacts alongside financial returns. The six major impact investment sectors are housing, healthcare, education, clean energy, climate change and agriculture. Green bonds continue to dominate the domestic impact market, accounting for 61% of the market, including issuance of $2.8 billion in 2018.

Impact investments by type (dollar weighting)



Source: Responsible Investment Benchmark Report 2019 - Australia

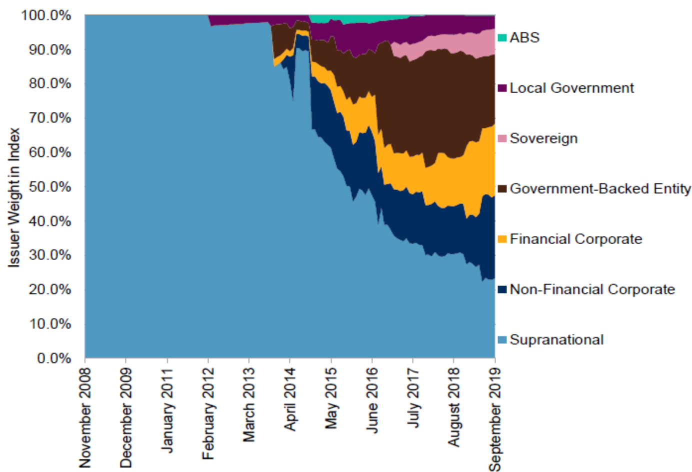
Green bonds date back to 2007 and are issued to fund projects that have positive environmental and/or climate benefits. These are typically asset-linked bonds where the proceeds are earmarked for green projects and are backed by the issuer's balance sheet. They also typically come with tax incentives such as tax exemptions or tax credits. Globally, the green bond market has exhibited strong growth in recent years, reaching total issuance outstanding of US$665 billion by mid-2019 and around US$167 billion of issuance in 2018 alone[4].

Examples of green bond issuances in Australia include Monash University's $163 million issuance funding solar and energy light installations in campus buildings, the Queensland government's funding for low carbon transport including a light rail network, and the Victorian government issuing bonds for investments in energy efficiency and water treatment.

Green Bond Issuer Types (S&P Green Bond Select Index)

3 Responsible Investment Association of Australia

4 Climate Bonds Initiative



Source: S&P Dow Jones Indices LLC and CBI. Data as of Sept. 30, 2019.

While there are a diverse range of investment approaches and impact strategies across the impact investment landscape, it should be noted that the impact created by these investments varies markedly. For example, social impact bonds aimed at creating employment opportunities for disadvantaged youth create a deep and measurable impact for a small number of individuals, while the "additional" impact of a green bond used to refinance a green building project may be difficult to quantify as it is likely the project would have been able to source an alternative source of funding in traditional markets.

As a result, we encourage investors to seek out strategies where investment outcomes provide additional benefits to the environment and/or community in a way that is clearly defined and measurable. Given the growing interest and improving quality of investment strategies and structures within the RI market, we will increasingly seek to identify products and strategies that fall within the aforementioned categories and make them available when appropriate.

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