Active management and sustainable investing

WHITE PAPER

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How active management can create added value to sustainable investing

Sustainable investing is firmly in the spotlight. So naturally, many active managers are developing sustainable strategies. At the same time, passive providers like Blackrock and Northern Trust are coming up with ESG index funds and trackers to satisfy growing demand.

This raises an intriguing question: What is the added value of active management in sustainable investing? Generally, in large-cap equities the debate has been focused on financial returns - whether active management actually leads to investment alpha. Passive investing will probably soon become more prevalent than active (based on the value of assets under management). This trend is being driven by low costs and broad diversification. In sustainable investing, investment alpha is still important, but in the context of the outcomes for all stakeholders.

In this paper we will discuss what sustainable investing is about, the transition to a sustainable economy and ESG integration. For us there are three arguments in favor of an active approach considering investment alpha:

1. Dispersion of leaders and laggards.
2. Inefficiency of ESG data.
3. Active ownership is rewarded.

In addition to delivering investment alpha, active managers have an important contribution to make by having a continuous dialogue with companies on long-term strategy and in particular ESG. This contribution through active management is to the benefit of all stakeholders and will become clearer in this paper.

What is sustainable investing?

Our definition of sustainable investing is allocating capital to companies run on sustainable business principles. We see sustainable investing as the synthesis between traditional long-term investing and ESG integration. This way of investing enables the transition to a more sustainable economy; an economy consistent with a low-carbon, prosperous, equitable, healthy and safe society. The strategy of sustainable investing is well-positioned for achieving attractive long-term returns with interests of all stakeholders at heart. This is based on two beliefs:

- The society at large is in a significant transition to a sustainable economy with associated risks and opportunities for companies. This transition is demanded by society to build and preserve quality of life for all.
- The ability of a company to achieve attractive long-term returns is dependent on striking the right balance to reflect the interests of all stakeholders. Integration of ESG in the business strategy is necessary to find that right balance.

Sustainable investing is about identifying the companies that integrate ESG risks and opportunities into their long-term strategy. They can create value by leading the transition to a sustainable economy while mitigating

downside risks. As an investment team we call these companies sustainable leaders and we consider them as strong candidates for our portfolio. A company can lead the transition for example by being vocal, participating in industry groups, setting an example or by developing and offering products and services that have impact. One way to measure impact is by analyzing the contribution of products and services of a company to achieve the Sustainable Development Goals (SDGs).

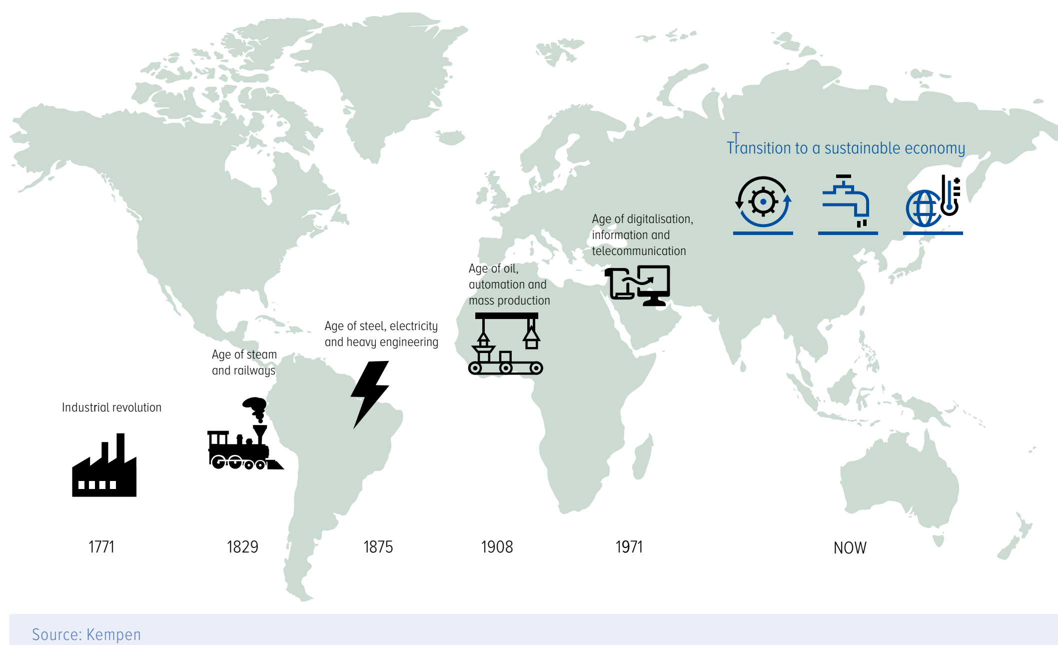
Research[1] shows that firms with good performance on material sustainability significantly outperform firms with poor performance on these issues. This suggests that sustainability-driven investments enhance shareholder value. A well-known meta study of more than 2,000 scientific articles[2] showed the business case for ESG investing is empirically well founded and that investing in ESG pays off financially.

Looking at climate change, Mercer[3] estimates that the cumulative impact up to 2050 of a 2^{0}C rise in global temperatures between sustainable themed global equities and developed market equities is around +38.0% in investment return. The difference is explained by incumbent industries suffering losses on the one hand and many notable investment opportunities becoming available in a low-carbon transition on the other.
In our opinion we must look at the following characteristics to identify a sustainable leader:

- **Opportunity for growth:** do demand drivers, like the transition to a sustainable society or digital economy, offer the company opportunities for growth?
- **Quality of the company and the structure of the industry**: does the company have a competitive advantage and is it in the right industry with high barriers-to-entry and moderate competition? Or will it be disrupted?
- **Company strategy and management**: does the company have a sustainable mission and the right long-term strategy with ESG integrated? Is management rightly incentivised and executing well?

Transition to a sustainable economy

FIGURE 1 Next wave of innovation



Source: Kempen

1 Mozaffar Khan, George Serafeim and Aaron Yoon, *"Corporate sustainability: first evidence on materiality", The Accounting Review 91, November 2016*

2 Gunnar Friede, Michael Lewis, Alexander Bassen and Timo Busch, *"ESG & corporate financial performance: mapping the global landscape", Journal of Sustainable Finance & Investment, December 2015*

3 Mercer, *"Investing in a time of climate change", 2019*

Since the late 18th century the world has seen five waves of innovation. In the following picture (Next wave of innovation) the five waves are shown in line with the work of Carlota Perez[4]. In our opinion the next wave is the transition to a sustainable economy.

Innovations like clean technology, gene and cell therapy, artificial intelligence and green chemistry are enabling this transition and are changing society. Also new concepts like the access economy transform the economic environment. In this model a customer has temporarily access to a product instead of owning it. The product can be more efficiently used this way while the manufacturer is more incentivised to come with an enduring product. As an illustration, what if we would buy light instead of buying a lamp? Wouldn't this incentivise the manufacturer of the lamp to have its product last longer?

Society is demanding this transition. And it will become more and more urgent as climate change and scarcity of natural resources start to hurt severely. Consumer preferences continue to shift toward sustainability. According to a recent survey conducted by Nielsen[5] , 81 percent of global consumers say it's 'extremely important' or 'very important' for companies to help improve the environment.
A very good illustration of this transition is the broad interest in the UN Sustainable Development Goals (SDGs). These form the blueprint for achieving a better and more sustainable future for all. They address the global challenges we face: poverty, inequality, climate, environmental degradation, prosperity, and peace and justice. The UN estimated in 2014 the gap in financing to achieve the SDGs at $2.5 trillion per year in developing countries alone[6] . Even starker, a more recent study indicates that limiting the global mean temperature rise to below 2°C with a probability of 66% would require around $3.5 trillion, on average, in energy sector investments a year till 2050[7].

Renewable energy is at the centre of the transition to a less carbon-intensive and more sustainable energy system. An example of investment to mitigate climate change is the doubling of renewable energy capacity during the last 10 years. Renewables have grown rapidly in recent years, accompanied by sharp cost reductions for solar photovoltaics and wind power in particular.

Another example is the effort to create a circular economy in packaging material with investments needed to collect, sort and reprocess waste. In a loop of recycled plastic, high-quality output is needed to replace virgin material. Collaboration is needed to accelerate the use of recycled plastics in packaging material. These collaborators include collection, sorting, reprocessing, packaging and consumer good companies.

Integration of ESG

As a long-term investor we not only analyse capital of a company presented on its balance sheet. For instance, human capital is not found on the balance sheet but is an important driver of future success. To evaluate capital generation ESG analysis is one of the indispensable tools to do so. A company generates financial capital by creating future business with attached cash flows to pay shareholders, employees, suppliers, governments etc. But for the long-term investor it's not only financial capital that is important. Manufactured, intellectual, natural and social capital are also relevant. Buildings, facilities and products are examples of manufactured capital. And intellectual capital comes in the form of patents, data and innovations. When it comes to natural capital, we're talking about climate change, water use and pollution. While a license to operate, human rights and social ties are examples of social capital. Finally, human capital concerns the health, training, job satisfaction and labour productivity of the workforce.

4 *Carlota Perez, "Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages", 2002*
5 *Nielsen, "Sustainable Shoppers Buy The Change They Wish To See In The World", 11-8-2018*
6 *UNCTAD's World Investment Report 2014*
7 *International Energy Agency, "Chapter 2 of Perspectives or the Energy Transition – Investment Needs for a Low-Carbon Energy System", 2017*

We believe analysing all forms of capital is critical as a long-term investor. How capital is generated impacts not only the shareholder but all stakeholders – clients, investors, employees, society at large, local communities and governments.

For example, if a company emits a lot of carbon, the environment is affected by long-term consequences such as more droughts, floods and hurricanes. Thus society at large is impacted. Negative capital is generated with perhaps a limited financial consequence for the company, clients and the shareholders up until now that is. The company is not really affected by lower profits or clients by more expensive products. But that's not sustainable as carbon emissions have to be curbed and will come more and more with a cost (say carbon pricing). So natural capital development must be considered when analysing long-term value creation.

Human capital is also an important consideration. We look for companies with a strong culture and high-quality workforce to help them compete in their sector. Research has shown[8] that businesses with high levels of employee satisfaction perform better than those without. Research from the University of Warwick[9] says happiness makes people 12 per cent more productive. For a shareholder, human capital is an important asset. So, employees, local communities but also investors are affected by human capital developments.

A third illustration is intellectual capital. This capital might be a barrier for competitors to replicate products and services. Also, this capital might be the platform for innovations. A short-term investor probably doesn't attach a lot of value to innovations as it can take many years before they become profitable, if at all. But looking at the lasting power of a company, innovations are essential. So, innovations are important to the shareholders and the company. Likewise, clients will be impacted by innovations as new, perhaps pioneering, products and services are developed. Furthermore, most of the time they will become available to society at large, for example universities and companies in other sectors, to have an impact.

Added value active approach

An investor has to combine financial analysis with ESG considerations. A passive investor can do so by relying on the market in pricing shares and using ESG ratings. The active manager is making an integrated analysis of financial and ESG data.

In our definition a passive solution is an ESG-tracker based on market cap, exclusions and ESG ratings. For active management we assume a concentrated portfolio with a high active share. In our experience this investment principle is a valuable approach to outperforming the market as the commitment of the investor is not diluted, and engaging easier because it focuses on a workable number of companies. This view is supported in research by Cremers and Pareek[10] .

In general investors looking to outperform the market should seek active managers in asset classes with high dispersion and low efficiency. They should look to passive investing if they want the benefit of low costs and broad diversification. Furthermore, to have impact as a shareholder by engaging with companies to improve the sustainability we think an active approach is the logical proposition.

8 *Alex Edmans, "Does the stock market fully value intangibles? Employee satisfaction and equity prices", Journal of Financial Economics 101(3), September 2011*

9 *Andrew Oswald, Eugenio Proto and Daniel Sgroi, "Hapiness and productivity", Journal of Labor Economics, 2015*

10 *Annualized abnormal outperformance of mutual funds, 2015*

TABLE Strengths active and passive investment solutions

SOLUTION	*STRENGTHS*
Passive	- Low cost - Broad diversification
Active	- Potential of better returns (investment alpha) - Impact of engagement by improving sustainability of a company

Now we will discuss three arguments in favor of an active approach to sustainable investing to create long-term value:

1. Dispersion of leaders and laggards;
2. Inefficiency of ESG data;
3. Active ownership is rewarded.

Dispersion of leaders and laggards

The transition to a sustainable economy can be partially made by existing products and services, although further innovations are needed. This offers companies growth opportunities, but there is also a high risk of disruption. The dispersion between leaders and laggards will be significant.

In a period of high dispersion following the broad market in a passive solution is perhaps not the optimal strategy. Being successful in selecting some leaders and avoiding most of the laggards will lead to a better result than the market average for example. Of course, the selection skills of the investor are critical, but the higher dispersion provides a reasonable opportunity set and improves the probability of outperformance. Historical results show that the cross-sectional dispersion of U.S. equity returns provides accurate forecasts of the dispersion of alpha over both 3-month and 1-year horizons[11] . Next to dispersion between companies in a benchmark, not all future leaders will already be in the major benchmarks and hence in passive solutions. Selecting these small- and mid-cap companies at an early stage will help investments to outperform the market.

A good example of what is in our view of a leader is the Danish utility company Orsted A/S. Orsted is the largest owner of offshore wind power in Europe and plans to expand the offshore wind capacity almost by five-fold to 11 GW by 2025. With these initiatives, Orsted is well ahead of industry peers in the transition of their business to renewable energy. Laggards are utilities with coal-fired units facing the need to reduce their carbon footprint based on economics and customer demand.

Active managers with a sustainability focus and expertise better understand the dynamics of the transition than active investors without this focus. This is amplified by short-termism in the traditional marketplace, which relies on historical models and falsely assumes that sustainable developments are far in the future. This creates a potential information advantage for such active managers.

ESG: Data inefficient

We don't think ESG is already priced efficiently in the market. Although there is much ESG and sustainability information disclosed publicly, often it can be difficult to identify and assess which information is most useful for making financially-related decisions. For efficiency broad accessibility, standardisation and transparency

11 *Larry Gorman, Steven Sapra and Robert Weigand, "The Cross-Sectional Dispersion of Stock Returns, Alpha and the Information Ratio, January 2010*

of information are needed. ESG and SDG data is becoming more widely available but is still limited and not yet fully standardised. As for climate change, the Task Force on Climate Related Financial Disclosures (TCFD) reported for example, that although most reviewed companies disclosed some climate-related information, few companies disclose the financial implications or describe the resilience of their strategies under different climate-related scenarios[12] . For measuring the contribution of companies to the SDGs much more detail in disclosure of information is needed to make a proper assessment.

ESG reports and ratings of providers are very helpful in analysing the sustainability profile of companies. The providers have a large number of analysts to track the exposures, policies and incidents of companies. But ESG ratings still have shortcomings given lack of disclosure, limited communication between providers and companies and rating frameworks that are not tested over a long period of time. Ratings show a relative high dispersion between agencies. Furthermore, investors have recently started to integrate ESG in their investment process but not all do and experience is limited.

The dispersion between rating agencies is illustrated by a cross-sectional correlation for constituents of the MSCI World Index of 53% between MSCI ESG and Sustainalytics, two of the most widely used ESG data providers[13] . JPMorgan, as an illustration, has a BB-rating at MSCI ESG (below average) while scoring 75/100 at Sustainalytics (above average).

Another example is Lonza. It has an AAA-rating (best available score) at MSCI ESG, but scores only average at Sustainalytics (55/100). As a comparison, the correlation in credit ratings between Moody's and S&P is above 95% [14].

A basic approach of investors is to have some exclusions based on risk and reputation in conjunction with ESG ratings. Exclusions help in avoiding high-risk companies that may be exposed in the transition to a sustainable economy. ESG ratings identify the companies that haven't had too many controversies in the past and have strong policies in place to mitigate ESG risks. Exposure to ESG-opportunities like achieving SDGs, is to a limited extent incorporated in the ratings. A rating does give an indication of the level of integration of ESG in the strategy and operations of a company. Also, momentum in ratings are of interest to see whether a company is improving or not.

But in our experience ratings are more backward looking and focused on policies and controversies. Rating agencies rarely talk to company managements to evaluate how ESG is integrated in the long-term strategy and how capital will be generated for all stakeholders. ESG integration starts with the tone at the top. If a CEO doesn't believe in sustainability value creation concerning all stakeholders is at risk.

As with credit ratings, ESG ratings are lagging and not forward looking enough. Active credit investors have, as a group, shown to be able to outperform market benchmarks over the long-term based on these credit ratings. We believe active managers have a similar role in sustainable investing, especially while ESG is still in its infancy.

Active ownership is rewarded

To identify and support sustainable leaders, now and in the future, we think active ownership is critical. The purpose of active ownership is twofold: impact and insights. Impact to support and influence management, insights to understand the long-term prospects of the company.

12 TCFD, "2018 Status Report", September 2018

13 State Street, "The ESG Data Challenge", 2019

14 Markit iBoxx EUR Corporate Index, May 2019

1. **Impact**: The investor has an active role in defining the long-term outcome of the company by having a continuous dialogue with management on long-term strategy and ESG. The investor as a shareholder will act as a long-term steward of the company. By investing in a company the cost of capital is impacted and as a shareholder you can explain what you like about the company now and what you would like to see happening in the future. Company managements are under a lot of pressure to perform in the short term. Also, today's companies face increasing pressure to respond to information requests from all sides. Managements are easily distracted and too focused on the short-term while most of the value of a company is related to cash flows three or more years out[15]. As a sustainable investor we have a role in keeping management focused on the long-term strategy. Engaging by having a continuous dialogue, influencing management and doing proxy voting is done with the aim of driving positive change.
   An illustration of the positive result of this dialogue is the study of Dimson[16] showing that after a successful engagement companies performed on average better in terms of financial returns. Actual engagement cases with companies concern capital allocation, remuneration, the transition to renewable energy, incorporating climate change in insurance models, environmental targets, privacy and data security, living wages and incentivization of employees.

2. **Insights:** Engagement produces precious insights in evaluating the long-term prospects of a business. To analyse the resilience of the business model, growth potential and ESG-issues, a deep understanding of the company and sector is paramount. That way the investor is able to assess the long-term risks and opportunities and what management is doing. One of the best ways to gain this understanding is by interacting with the company and visit for example an investor day. As a sustainable investor we have a strong preference for talking to the company about their long-term roadmap including current competitive advantages, strategy to build on these advantages to drive growth, objectives and key performance indicators. The signal a passive investor sends to management is present but limited. By constructing a passive sustainable portfolio rules are used concerning exclusions and ratings. These rules will tell management what to do to be part of a passive solution. A lot of companies will market the fact that the company is part of the Dow Jones Sustainability Index for example.

The passive investor doesn't engage with management to support sustainable value creation. Even if a passive provider offers engagement services related to ESG it will not be an integrated approach based on the long-term potential of the business. It is a standalone activity in that case and will be very much rule based and focused on policies and incidents. It's not principle based and doesn't address the strategic challenges faced by a company's management. How can you be a good partner for management as a passive investor and not understand their business?

Conclusion

The transition to a sustainable economy will be an important driver for equity returns. We expect a large dispersion between the leaders and laggards. Also ESG is not efficiently priced already in the market. An active approach in sustainable investing is recommended to add value in terms of investment alpha.
In addition, in the transition to a sustainable economy, active managers have an important contribution by having a continuous dialogue with companies on long-term strategy and in particular ESG. This contribution of active management benefits all stakeholders and cannot be made by a passive management.
When times are changing investors and companies cannot be passive and stand on the sidelines, but rather be part of a change for good.

15 *Dominic Barton, "Capitalism for the Long Term", Harvard Business Review, March 2011*
16 *Elroy Dimson, Oguzhan Karakas, Xi Li, "Active Ownership", Review of Financial Studies, 2015*

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