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ROBECO
The Investment Engineers

The truth about sustainability investing

FACT-CHECKING NINE COMMON IDEAS

Sustainable Investing Expertise by ROBECOSAM

Special edition for Sanlam Investments

The truth about sustainability investing

Fact-checking nine common ideas

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Preface

Sustainability investing has now been around for decades, but in the past year interest has picked up massively. With the growing interest, the amount of stories and opinions on sustainability investing is also growing rapidly. The debate mostly centers around terminology and performance, and there are many hurdles and questions to overcome.

Many people – in the investment industry as well as in wider society – still believe it is a niche form of investing, or they think social and environmental issues are not relevant for companies or investors. Others believe it only involves excluding 'sin stocks' or using other forms of negative screening. And some think it is only an issue that is discussed by millennials, with nobody older than 30 remotely interested in it.

Even those investment professionals who do subscribe to the principles of sustainability investing have their hang-ups about how useful they think it can be. Some believe that using environmental, social and governance (ESG) analysis only works with equities, while others think it cannot possibly work in emerging markets. Is there enough data to be able to make a decision? And does it really benefit society, or just self-interested shareholders? Perhaps most common of all is the notion that integrating ESG considerations in the investment process means sacrificing performance.

These are the many myths that serious sustainability investors often find themselves debunking when they talk about it with clients or prospects. In this booklet, we have identified the nine most common myths about sustainability investing, and discussed them in turn. Some have recurring themes, while other myths emanate from misconceptions about what sustainability actually is (and is not) in the first place. If you are yourself still skeptical about some parts of sustainability investing, ESG metrics and their integration into the investment process, we hope you enjoy reading them.

Masja Zandbergen
Head of ESG Integration, Robeco

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Do principles come before profits?

You can have the best of both worlds

Let's talk about... Performance

Sustainability investing is subject to more myths than any other style of investment. And perhaps the first and foremost is the idea that it means sacrificing performance – giving up returns in pursuit of some sort of perceived ideal.

So, where does this myth of poor performance come from? Part of the reason is that in some cases, adopting sustainability does require investment – it costs money to implement it. Energy companies retooling to focus more on renewables do indeed need to spend millions on new infrastructure. Sourcing products from suppliers that pay their employees properly means costs go up. Less tangibly, a company with poor diversity may need to pay third parties such as recruitment consultants, also raising costs and cutting short-term returns.

This should, in theory, mean that companies that take sustainability seriously underperform. In fact, the reverse is usually true: the use of ESG principles by companies and investors can be shown to enhance performance. This is primarily due to the ability to reduce risks, particularly as standards are raised in all three domains to combat climate change or bad corporate behavior.

Financially materiality is key

At the core of improving decision-making by including ESG information in the process is taking an investment perspective and only analyzing issues that are financially material – they go to the core of a business. In other words, the focus should be on researching those ESG issues that have a direct financial outcome on company results in the longer term, and therefore feed through into investment returns. For a utility, these would be issues related to energy efficiency of its operations and its strategy towards the energy transition. For a bank, this would be governance, risk management culture and product stewardship.

Further, adopting ESG can lead to opportunities, or reduce risks. For example, the trend towards the adoption of electric cars has generated investment opportunities in both the car makers and their suppliers, including the new smart materials being produced such as lithium for batteries. Meanwhile, the role of ESG in reducing risks can be seen in how it has exposed potential supply chain problems in industries that had been reliant on cheap labor such as fashion and retailing. This in particular allows investors to pick the 'wheat from the chaff' when deciding which stocks or bonds to buy, in a 'best-in-class' approach.

'A growing body of evidence concludes that companies which are progressively more sustainable today will reap the rewards in the future'

Four studies prove outperformance

Four studies looking at this 'added value' issue in the past three years are particularly noteworthy. The extent to which this can add and not subtract value was first demonstrated in abstract in a 2015 study, 'From the stockholder to the stakeholder: how sustainability can drive financial outperformance' by Oxford University and Arabesque Partners. This examined more than 200 sources including academic research, industry reports, newspaper articles and books, and concluded that "80% of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance."[1]

A separate survey later that year by Deutsche Bank's asset and wealth management division in conjunction with the University of Hamburg went much further. The research examined the entire universe of 2,250 academic studies published on this subject since 1970, using data spanning over four decades until 2014. It concluded that ESG made a positive contribution to corporate financial performance in 62.6% of meta-studies and had negative results in only 10% of cases (the remainder were neutral).[2]

Higher stock returns

Better corporate results should in theory feed through into higher share prices. A 2016 study by Harvard Business School directly linked better performance and disclosure on material ESG issues to higher share prices for the first time. The paper entitled 'Corporate sustainability: first evidence on materiality' made a clear case for the financial benefits feeding through into asset values.[3]

And sustainability investing is also about active ownership, partly achieved by engaging with companies to improve their ESG standards. This can also be shown to enhance returns. A 2017 research paper by three academics analyzed a dataset of 660 companies that had agreed to some form of engagement for a range of ESG issues, with 847 separate engagements in total.

The research found that the engaged companies saw stock returns that were 2.7% higher than non-targeted firms in the six months after the engagement ended. The results for companies which previously had had low ESG scores were even more marked, as their share prices outperformed non-targeted companies by 7.5% in one year after the end of the engagement.[4]

Changing business models

Taken together, this growing body of evidence concludes that companies which are progressively more sustainable today will reap the rewards in the future – and it may even save their businesses. Oil companies, for example, are slowly changing their business models to replace fossil fuels with renewables, while car makers are switching to electric vehicles, and retailers are sourcing only from suppliers with verified human rights records.

Should carbon limits ever be introduced, those companies that are cutting their carbon footprints now will be better placed to deal with new regulatory or governmental regimes in the future. This is already an issue for real estate companies, and for virtually all utilities. Meanwhile, the greater efficiencies enjoyed today will cut costs and raise profits.

Put simply, taking sustainability issues into account leads to better-informed investment decisions, and that leads to better returns in the long term. This is why Robeco remains convinced that it works, and has integrated ESG analysis in the investment process for fundamental and quantitative equities, and for fixed income. ■

1. *Clark, Gordon L. and Feiner, Andreas and Viehs, Michael, From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance (March 5, 2015). Available at SSRN.*

2. *Deutsche Asset and Wealth management, 'ESG and corporate financial performance: mapping the global landscape', December 2015.*

3. *Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724.*

4. *Tamas Barko, Martijn Cremers and Luc Renneboog, 'Shareholder Engagement on Environmental, Social, and Governance Performance', Working paper for the European Corporate Governance Institute, 2017.*

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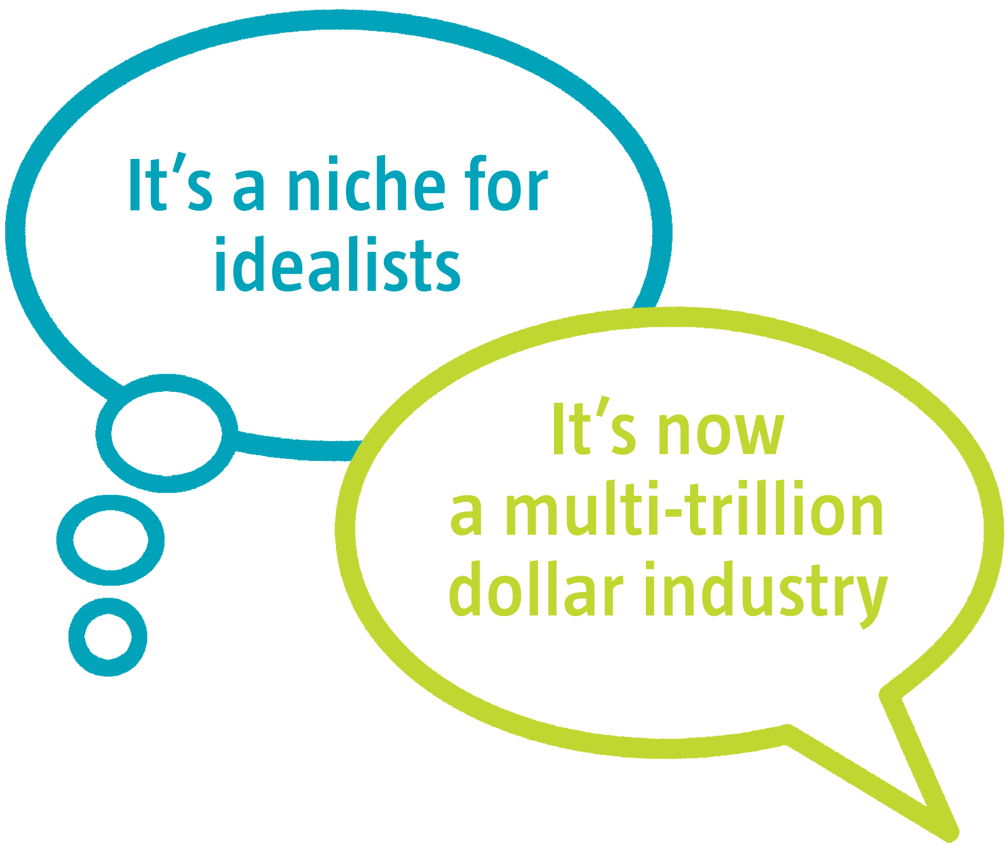
It’s a niche for idealists
It’s now a multi-trillion dollar industry

Let's talk about... Idealists

Sustainability investing has come a long way in recent decades – though some people still think it's only about green issues. Others believe it's only relevant to a handful of idealists, led by pressure groups.

Both myths persist because one of the origins of modern sustainability was indeed in the 'save the world' campaigns of the 1960s. Organizations such as Friends of the Earth, founded in 1969, lobbied hard to stop some of the plainly unsustainable practices of that era, from deforestation (which sadly is still continuing) to pollution.

There were some major environmental successes in the 1980s, with a ban on dangerous DDT pesticides and the Montreal Protocol for phasing out the use of CFC gases after scientists warned that aerosols were destroying the ozone layer. In the 21st century, the interpretation of sustainability has greatly widened, particularly in the scale by which it has been adopted as a mainstream practice by governments, corporations and investors. It now involves people from all walks of life – not just campaigners – and accounts for trillions of dollars' worth of investment.

Uniting the Nations

This can be seen in the United Nations' list of 17 Sustainable Development Goals (SDGs) which target wider issues that make life better for everyone. Launched in 2015, the goals include fundamentals such as providing clean water, a decent standard of education, affordable health care and equal rights. The goals have now been adopted by 193 countries.[5]

Business plays a key role because the UN specifically invited corporates and financial institutions to contribute towards achieving the goals within 15 years. And it is not only about big business, or those sectors directly accused of unsustainability, such as oil companies or plastics manufacturers. It is simply about doing good business – for all companies.

'Embracing social is not just a feel-good factor; research bears out the idea that happy workers are productive workers'

For example, banks should focus on having the right loans at the right rates, having the highest ethical standards and a clearly defined risk culture, particularly after the Global Financial Crisis. Health care companies should focus on innovation, human capital and fair pricing models for essential drugs. And food and beverage processors should attempt to produce healthier products, such as by removing sugar.[6]

For investors, many pension funds and asset managers, including Robeco and RobecoSAM, have taken up the challenge of meeting the SDGs, incorporating objectives to meet as many of these goals as is practicable into the investment process. The concept of using free market capitalism as a means of improving global living standards was laid down in an earlier UN initiative, the Principles for Responsible Investment. Launched in 2006, the UNPRI has six principles that commit investors to ESG criteria in their processes as far as possible. Robeco and RobecoSAM were among the first to join, and the UNPRI now has 1,750 signatories.[7]

The S and G in ESG

The widespread adoption of ESG has played its own part. It has made companies and their shareholders aware that sustainability is financially material – it can directly affect company results and share prices. As ESG adoption has grown, sustainability has been shown to be a smarter way of making money, rather than some sort of idealism. And while the 'E' does indeed incorporate the green issues that investors still focus on – and now treat as a business opportunity in areas such as renewable energy – much more emphasis is now on the 'S' and 'G' than has been in the past.

Embracing social is not just a feel-good factor; research bears out the idea that happy workers are productive workers, and therefore it is a financially material issue. A 2011 study by the Wharton School at the University of Pennsylvania analyzed the relationship between employee satisfaction and long-term equity market returns. It showed that a value-weighted portfolio of the '100 best companies to work for in America' had stock returns that were on average 3.5% a year higher than the main market benchmark between1984 and 2009, and 2.1% above their relevant industry benchmarks.[8]

The results also showed that these companies also exhibited significantly more positive earnings surprises than those not on the list. The researchers came to three main conclusions: that employee satisfaction is positively correlated with shareholder returns and need not represent managerial slack; that the stock market does not fully value intangibles such as human capital; and that screening for highly social companies to place in portfolios may therefore improve investment returns.

Better governance also works

As with human factors, the idea that better corporate governance can enhance share prices has also been borne out by research by the Wharton School, in conjunction with Harvard University. Using the incidence of 24 governance rules that prevailed in 2003, the researchers constructed a 'Governance Index' as a means of assessing the level of shareholder rights at about 1,500 large companies during the 1990s. It then created an investment strategy that bought firms in the lowest decile of the index – those which offered its shareholders the strongest rights – and sold firms in the highest decile of the index (those with the weakest rights).[9]

It found that companies with stronger shareholder rights had higher market values, higher sales growth and profits, lower capital expenditures, and made fewer corporate acquisitions. It concluded that had such an investment strategy been real, it would have earned abnormal returns of 8.5% a year during the sample period.

So, it's no longer just about green idealists. It's now about the whole ESG spectrum, including the higher returns that can be made from implementing social and governance factors as well as environmental, and it's most definitely about everyone. ■

5. *The full list of the United Nations' SDGs is available here: http://www.un.org/sustainabledevelopment/sustainable-development-goals/.*

6. *For Robeco's campaigns for healthier food, see https://www.robeco.com/en/insights/2014/07/food-health-benefiting-from-the-trend-towards-a-healthier-lifestyle.html.*

7. *For more details about the United Nations PRI, go here https://www.unpri.org/about*

8. *Edmans, Alex, Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices (January 20, 2010). Journal of Financial Economics 101(3), 621-640, September 2011. Available at SSRN.*

9. *Gompers, Paul A. and Ishii, Joy L. and Metrick, Andrew, Corporate Governance and Equity Prices. Quarterly Journal of Economics, Vol. 118, No. 1, pp. 107-155, February 2003. Available at SSRN.*

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It's all about
excluding
sin stocks
hink positive:
it's also about
ESG integration

Let's talk about... Screening

A persistent myth about sustainability investing is that it only includes negative screening – mainly by excluding stocks that are deemed 'unethical'.

Negative or exclusionary screening means the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria. It has its origin in a refusal by Quakers in the 18th century to invest in the slave trade. Since then it has often been popularized as a green crusade, or a disapproval of 'sin stocks' such as tobacco – both on ethical grounds.

It usually means refusing to buy the stocks or bonds of companies such as 'sin stocks' that are involved in alcohol, tobacco, gambling or weapons. In the battle against climate change, it increasingly also means shunning fossil fuel producers or polluters. And in some cases, national law demands certain exclusions; Dutch legislation, for example, bars investing in any company making cluster bombs. Exclusionary and negative screening is the most applied implementation of sustainability investing involving 15 trillion USD in assets in 2016 globally.

As some of these excluded industries are well entrenched in mindsets – shunning cigarette companies goes back many years, while more recent exclusions have included thermal coal producers – it is easy to see why some people thinking that this is only what sustainability investing is about.

However, negative screening is only one side of the coin. Investing sustainably is also reliant on positive screening, as what is put into a fund is ultimately more important than what is left out. The Global Sustainable Investment Alliance provides an overview that is becoming the market standard. Besides negative screening, the following SI methods can be applied:

- **Positive/best-in-class screening**: investing in sectors, companies or projects that are chosen for their positive ESG performance relative to industry peers
- **Norms-based screening**: checking candidates for investment against minimum standards of business practice based on international norms
- **ESG integration**: the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis
- **Sustainability theming**: targeting themes that are specifically related to sustainability, such as clean energy or sustainable agriculture
- **Impact/community investing**: typically aimed at solving social or environmental problems, including community investing, where capital is directed to needy individuals or communities, as well as funding businesses that have a clear social or environmental purpose
- **Corporate engagement and shareholder action**: the use of shareholder power to influence corporate behavior, including direct engagement such as communicating with board members, filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

'It is Robeco's core investment belief that using ESG information leads to better-informed investment decisions and also benefits society'

Depending on the goal an investor has, specific applications are useful. Using ESG data in investments often is done with the aim of improving returns or reducing risks. Impact investing and active ownership often has a goal of making a difference, while also creating a financial return. As it is Robeco's core investment belief that using ESG information leads to better-informed investment decisions and also benefits society, implementation has focused on ESG integration and active ownership.

ESG integration

When it comes to ESG integration, the data gathered from many different sources is used to analyze and value a company. Generally, a security with a better ESG performance on material issues usually has a greater chance of making it into the portfolio than one with a lower profile. However, if ESG risks are already very much priced into the market, the portfolio manager can still invest if he or she thinks there is enough room for improvement to allow an upside for the stock.

ESG integration therefore enables a fully informed investment decision to be made, using both positive and negative sustainability screening techniques, along with other factors that may have a bearing on whether to buy or sell. This can include, for example, the principles of value investing, where the portfolio manager seeks stocks whose current price does not reflect the perceived potential of the company.

Active ownership

Exclusion – the ultimate in negative screening – should also be seen as a last resort. Most investors prefer to firstly engage with companies to try to find ways in which their corporate behavior can be improved. Robeco does this through a bespoke Active Ownership team with engagement specialists who talk to investee companies on a regular basis.

This process is preferred because once a company is excluded, it is not possible to engage with it, and investors cannot use their influence to seek ESG enhancements. Divestment presents a similar problem in that it simply transfers ownership from an unhappy investor to a more willing one, and does not address the underlying issue, such as in decarbonization.

And engagement can still work, even when dealing with long-standing and seemingly insurmountable problems. 'Big Oil' companies, for example, are still producing fossil fuels – but they have been successfully persuaded to change their business models to gradually put more focus on renewable energy. This has led to wind and solar farms becoming large parts of their business as they move away from traditional oil and gas, effectively aiding decarbonization and slowing climate change. ■

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Only bearded 20-somethings are interested

Eventually everyone will need a sustainable pension

Let's talk about... Millennials

Sustainability investing is often seen as something only pursued by millennials who are jumping on a bandwagon with their trendy friends. It is true that this age group seems to have the biggest interest in SI, but it is certainly not a hype. In fact, interest in sustainability is spread across the generations, and its roots go back centuries.

Stereotypes about people who are seeking a more sustainable world tend to focus on those born since the mid-1980s, since research does show that millennials are more interested in the issue. They are more likely for example to buy organic food, demand Fairtrade coffee and be more concerned about human rights than their parents or grandparents.[10]

They also grew up in the internet age and have enjoyed greater access to information exposing unsustainable activities, becoming more politicized by it. Research in the US showed that millennials were the "most progressive generation in 50 years" and were making the country more liberal.[11]

But when it comes to investing, demand for sustainability is fairly evenly spread across all age groups, according to a 2017 questionnaire by Robeco into the tastes of its Dutch retail investors. Some 70% of people aged over 50 stated a clear interest in sustainability compared to 66% of 34 to 50-year-olds and 67% of 18 to 34-year-olds. While not an exhaustive scientific study, it did reveal that sustainability was as popular among middle-aged and older people than it was among the millennials.

Those who went on to invest in sustainable funds were 28% of the over-50s, 29% of the 34 to 50-year-olds and 26% of the 18 to 34-year-olds – again showing that interest is evenly spread across age brackets, with the middle-aged still slightly in the lead. Meanwhile, the average part of a portfolio invested sustainably was 29% for the over-50s, 30% for 34 to 50-year-olds and 33% for 18 to 34-year-olds – so here, the millennials are slightly in the lead, though not significantly, Robeco's in-house research showed.

'As for a hype, the true globalization of sustainability achieved perhaps its finest hour with COP21, in Paris in 2015'

A long history

Sustainability is by no means a modern 'fad'. Its origins go back to the 18th century church, when Quakers launched the first exclusions by refusing to invest in anything involved with the slave trade. In more recent times it picked up speed with the first equal rights legislation in the 1960s and the environmental campaigns of the 1970s. One of the first major uses of exclusions was seen in the 1970s when companies refused to invest in South Africa due to its apartheid regime.

It reached the global stage in 1987 when the United Nations World Commission on Environment and Development (the Brundtland Commission) released its report, 'Our Common Future', tackling uncontrolled use of natural resources, led at the time by extensive deforestation. The document is most notable for coining the term 'sustainable development' that particularly aimed to encourage emerging markets to avoid destroying the environment as they pursued economic growth. In defining what its new phrase meant, Commission chair Gro Harlem Brundtland wrote: "Humanity has the ability to make development sustainable to ensure that it meets the needs of the present without compromising the ability of future generations to meet their own needs."[12]

Triple bottom line

Another famous phrase, known as the 'triple bottom line', was coined not by a millennial, but a middle-aged British businessman in 1995. John Elkington said any enterprise needed to consider the three Ps of 'People, Planet, Profit' (and not just the final word) as each being equally important for the long-term success of society. This concept was adapted to become environmental, social and governance factors, or ESG, which now forms the bedrock of most sustainability investing processes.[13]

The 'sustainability investing' phrase and theme entered common usage in the following decade, when it first started to be taken seriously by investors. It went through various incarnations including 'ethical investing', 'responsible investing' and latterly 'socially responsible investing or SRI', before 'sustainability investing' was widely agreed to be the most appropriate moniker to capture the different investment strategies that take into account ESG factors.

As for a 'hype', the true globalization of sustainability achieved perhaps its finest hour with the United Nations Climate Change Conference, known as COP21, in Paris in 2015. It produced the Paris Agreement, which challenged the world to limit global warming to below two degrees Celsius compared to pre-industrial levels. It was ratified by 174 countries on 22 April 2016 – now designated by the UN as 'Earth Day'.

So, while sustainability investing has been a fairly niche concept in the past, we are now clearly at an inflection point, and there is no way back. ■

10. *Produce Retailer, 'Younger consumers buy more organics'.*

11. *The Millennial Pendulum: A new generation of voters and the prospects for a political realignment, 2009.*

12. *Report of the World Commission on Environment and Development: 'Our Common Future'.*

13. *John Elkington, 'Enter the triple bottom line', 2004.*

5

SI is a vocal minority not the silent majority

Let's talk about… Impact

Sustainability investing has risen to become a high-profile form of managing money – but does it actually benefit anyone else? It can sometimes be difficult to show what positive impact it has on wider society, particularly if it is seen as coming at a cost.

An example of how green initiatives do not always lead to the intended results can be seen in Germany phasing out its nuclear power program following the 2011 disaster in Fukushima, Japan. While this in essence was a worthy cause, one side effect was that it made the country more reliant on its coal-fired power stations. This contradicted Germany's *energiewende* (energy transition) program which aimed to reduce carbon, raising emissions instead.

Subsequently, a more holistic approach is needed, where all the relative benefits (or damage) to the whole system should be measured, and not just parts of it. One way of demonstrating a measurable impact is by investing to meet the UN's Sustainable Development Goals. Few would disagree that this is not a good idea – so how is it done in practice?

Three steps to sustainability

Making a tangible impact on the SDGs when building a portfolio fundamentally means picking the right securities to begin with. Robeco and RobecoSAM do this in three steps. Firstly, we find out what a company produces, and whether its products contribute positively or negatively to the SDGs. Positive contributions include companies making medicines, assisting with clean water supplies, or improving health care. Negative examples would be companies involved in shale gas, tobacco, or high carbon-intensive utilities.

Secondly, we analyze how a company produces its goods or services. Analysis here includes looking at its previous business conduct, labor relations records and any red flags for human rights. Finally, we check for any known controversies surrounding the company, including pollution episodes, bribery allegations or mis-selling in areas such as financial services or pharmaceuticals. The outcomes are quantified in another proprietary RobecoSAM research tool, its SDG rating methodology.

This scoring methodology can be used across sectors. For example, higher scores are given to retail banks which lend more money to emerging markets, thereby contributing to SDG 1 (no poverty), or to food companies with more than half their range in healthier or low-sugar products, contributing to SDG 2 (zero hunger). Examples can be found for most companies for the rest of the SDGs, although some are excluded point blank as never being able to contribute to them, such as tobacco companies or weapons manufacturers.

'Research shows that money literally does talk, and engagement does create both a financial and a social impact'

Using Active Ownership

Another way of making an impact is through 'active ownership' – using voting and engagement to get improvements at companies whose behavior does not meet ESG best practices.

Shareholders who are unhappy with a company's policies can vote against them at annual general meetings, or block resolutions that they do not like. This was seen to great effect in 2017 when investors filed proposals at the shareholder meetings of two oil majors asking them to run stress tests on how their businesses would be affected by the need to meet climate change targets.

Both resolutions were passed with large majorities, compelling the oil companies to detail the impact on them of limiting global warming to two degrees Celsius. This includes the potentially costly issue of stranded assets – fossil fuel resources that cannot be burnt in order to meet the targets. Since everyone on the planet is affected by climate change, the social benefit of the role played by oil companies in minimizing it is obvious.

How engagement works

Engagement through an active dialogue is another powerful tool. It occurs when the investor meets with the company to seek improvements in one ESG field or another. Robeco routinely engages with its shareholdings and bond holdings, talking to around 200 companies in 2017. Over EUR 240 billion of assets were under engagement and over EUR 60 billion under voting at the year's end.

A 2017 research paper by three academics specializing in corporate governance aimed to find out whether such engagement by shareholders generally had any effect. It analyzed a dataset of 660 companies that investors engaged with for a range of ESG issues, with 847 separate engagements in total.[14]

Their conclusion was unequivocal: "The engagements lead to significant ESG rating adjustments. Activism is more likely to succeed for companies with a good ex-ante ESG track record, and with lower ownership concentration and growth. Successful engagements positively affect sales growth, without changing profitability. Targets outperform matched firms by 2.7% over 6 months post-engagement, while the (ex-ante) lowest ESG quartile earns an extra 7.5% over 1 year." This research shows that money literally does talk, and engagement does create both a financial and a social impact.

And investors do care about what impact they are making on society. A 2015 survey by the Responsible Investor media group said three-quarters of owners said ESG issues were one of their top five criteria when choosing an asset manager. Some 85% reviewed their asset manager's sustainability investing policies, while more than 80% wanted to better understand and improve the positive impact that their investments can have on society.[15]

14. *Tamas Barko, Martijn Cremers and Luc Renneboog, 'Shareholder Engagement on Environmental, Social, and Governance Performance', Working paper for the European Corporate Governance Institute, 2017.*

15. *ESG 2.0, Responsible Investor Asset Owner Survey 2015.*

6

IT IS TOO NEW TO KNOW
IF IT WORKS OR NOT

INFORMATION IS POWER
AND IT IS EVERYWHERE

Let's talk about… Data

They say that 'information is power', but is there enough of it available to show whether sustainability investing works? The problem isn't really in finding data, but knowing how to process it.

Like all disruptive new industries, SI is challenging established ways of thinking that go back decades or even centuries, and in that regard is a relatively new concept. The world has had since the 19th century to collect data on burning coal, and rather less time for studying solar power or electric cars. So, some investors are naturally skeptical about whether enough information exists to justify expensive new investments in this field.

However, data and information for use in sustainability investing is not only plentiful and easily accessible, it is also growing in its size and scope every day. Indeed, part of the reason why this data myth persists is some investors have become overwhelmed by it, and unable to process it all. As new sustainable projects come online every day, it becomes increasingly important for investors to be able to make sense of it.

Data and media providers

The growth of sustainability investing since the 1990s has been mirrored by a growth in the number of data providers and media groups covering the industry. Many specialize in a certain field, broadly operating in three groups. These are: gathering new data for use in investment processes; curating or analyzing existing data that can serve as a searchable database; or broadcasting sustainability news and organizing events to spread the word further.

Many specialized data providers now sell ESG information to investors to use in their decision making. Others offer proxy voting services and keep records of investor voting activity at shareholder meetings, which assists with engagement and governance work. Some services now even use artificial intelligence to analyze unstructured or random data and spot trends in them.

Curation firms have emerged to build whole libraries of investor white papers, annual outlooks and think pieces, while specialist media has emerged to cover the industry itself, organize conferences and share information. And some newswire companies cross all three fields, building extensive ESG databases and news archives for their clients.

There are also stock market index companies and ratings agencies specializing in SI. RobecoSAM has had a partnership with the Dow Jones group since 1999 when it created the Dow Jones Sustainability Investing World Index. This lists the world's most sustainable firms according to information gathered by RobecoSAM. Others have sprung up since, including the MSCI Global Sustainability and ESG Indexes and the FTSE4Good Index series. For ratings, specialist companies that rate investment funds according to their ESG credentials among other criteria include Morningstar.

Collecting data in-house

Within the investment industry, virtually all asset managers and banks now have their own in-house sustainability teams to collect data and then use it as part of their investment processes. Robeco uses the annual Corporate Sustainability Assessment (CSA) and twice-yearly Country Sustainability Ranking (CSR) produced by sister company RobecoSAM.[16]

The CSA is a questionnaire sent to more than 4,000 listed companies around the world, including the 2,500 largest. It asks between 80 and 120 industry-specific questions that directly relate to the companies' operations. For the last collection in 2017, some 60 industries were represented, with more than 600 data points per company.[17]

This proprietary research underpins much of the ESG integration work conducted at both Robeco and RobecoSAM. And because it has systematically assessed the ESG performance of large listed companies since 1999, RobecoSAM now owns one of the world's most comprehensive databases of financially material sustainability information.

Making sense of it all

The growth of all this information has created an industry of its own to improve the quality of it and enable investors to make sense of it all. Many companies have been willing to

'The growth of all this information has created an industry of its own to improve the quality of it and enable investors to make sense of it all'

say how they were progressing with Corporate Social Responsibility or other sustainability initiatives, but lacked the presentational skills to disseminate it in a meaningful way. The Global Reporting Initiative was launched in 1997 to promote the quality of sustainability reporting around the world, and now has more than 600 members.[18]

Similarly, the Carbon Disclosure Project is a not-for-profit group that reports on the environmental impact of companies, cities and countries. In 2018, the group released its 'Global Supply Chain Report' on emissions. Many other NGOs perform a similar function, such as the Task Force on Climate-Related Financial Disclosures, which provides detailed information on risks. These include changing weather patterns which greatly affect insurers and coastal businesses, among others.[19]

EU initiatives

Indeed, such is the spread of sustainability investing that the European Union is now working to create a level playing field where all present and future participants operate under the same rules. In January 2018, the European Commission published the recommendations of its High-Level Expert Group on Sustainable Finance, including some leading lights in the SI industry, after a year of studying the issue.

This work set out strategic recommendations for creating a system that can "deliver a roadmap for a greener and cleaner economy" across the EU. One of these ideas is to create a common framework, or 'taxonomy', that aims to harmonize the definitions within the SI spectrum and set standards for investments. Essentially it wants to define what is meant by sustainability investing, and what is not, since SI means different things to different groups. The final Action Plan on Sustainable Finance will be released on 22 March.[20]

This action plan builds on other multi-national initiatives to create a common framework for sustainability, particularly in the fight against global warming. These include the final Paris Agreement communique in 2015, a report by the G20 Sustainable Finance Study Group in 2016 and the OECD's climate investing initiative in 2017.

So the data is there, and the old phrase that 'you just need to know where to look' doesn't apply – but there remain issues in interpreting it and knowing what to do with it all. Data crunching can help, but this is an issue that many investors are still trying to come to terms with. ■

16. *For more information about how the CSR is compiled, go here: http://www.robecosam.com/en/sustainability-insights/about-sustainability/country-sustainability-ranking/index.jsp.*

17. *For more information about the CSA, see http://www.robecosam.com/en/sustainability-insights/about-sustainability/corporate-sustainability-assessment/index.jsp.*

18. *Global Reporting Initiative, 2018 https://www.globalreporting.org/information/about-gri/Pages/global-community.aspx.*

19. *Global Supply Chain report, Carbon Disclosure Project, 2018 https://www.cdp.net/en/research/global-reports/global-supply-chain-report-2018; Task-Force on Climate-related Financial Disclosures, 2018 https://www.fsb-tcfd.org/about/#*

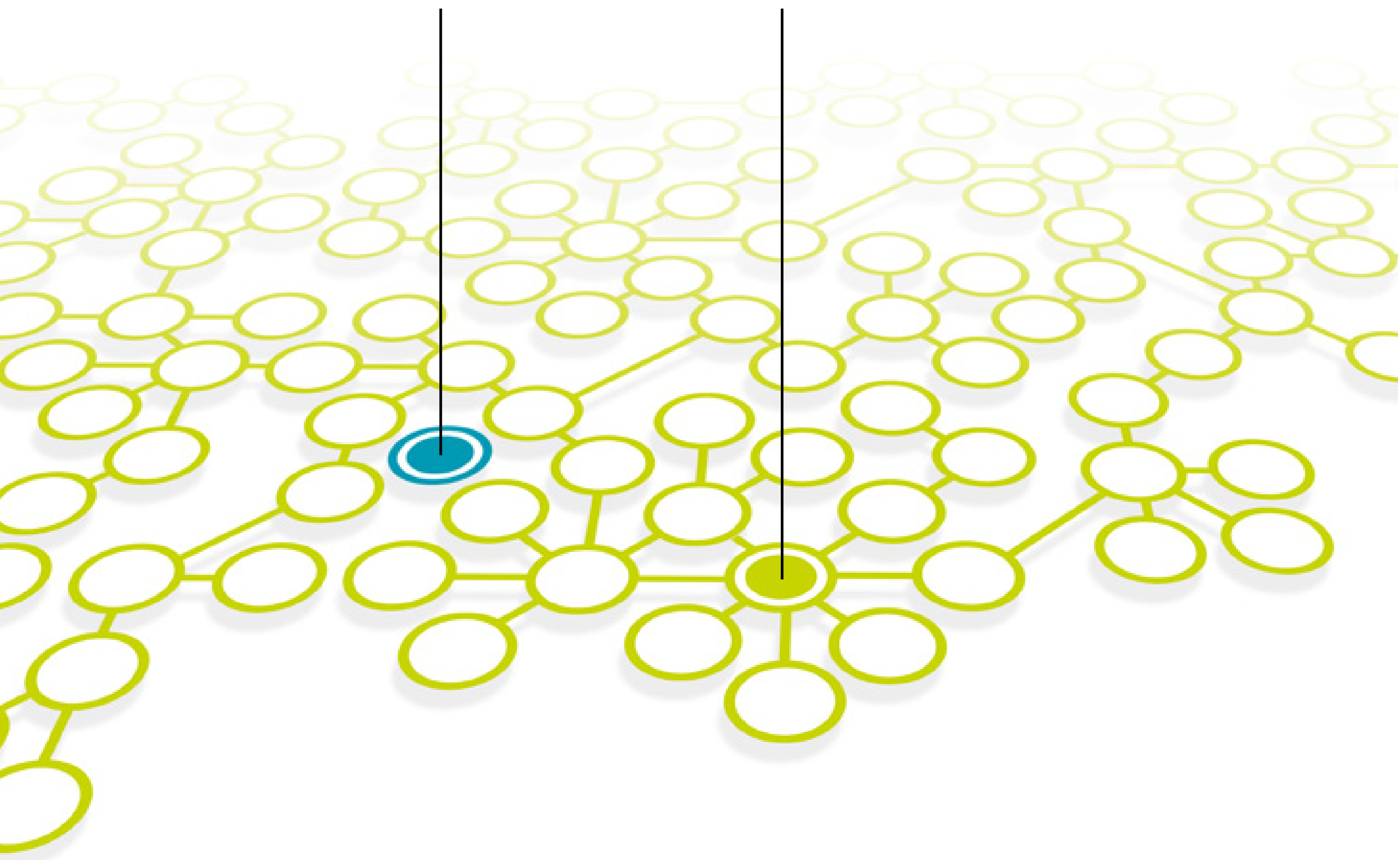
20. *European Commission, 'Final report of the High-Level Expert Group on Sustainable Finance', January 2018 https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en*

21. *Cop23 Paris Agreement 2015 http://unfccc.int/paris_agreement/items/9485.php; G20 Sustainable Finance Study Group reports, http://unepinquiry.org/g20greenfinancerepositoryeng/; OECD, 'Investing in Climate, Investing in Growth', 2017 http://www.oecd.org/env/investing-in-climate-investing-in-growth-9789264273528-en.htm;*

7

It only concerns special interest groups

Its popularity is growing as fast as bamboo



Let's talk about... Trillions

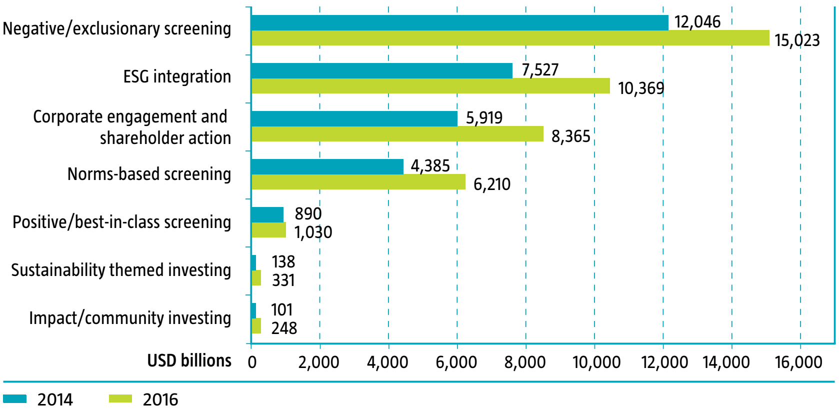
Sustainability investing has sometimes been considered niche – so the sheer size of it may come as a surprise. While some areas are indeed still niche, such as impact or thematic investing, the SI world is now a multi-trillion dollar industry that is becoming mainstream as more people commit to it every day.

The practice of investing sustainably certainly began as a niche investment concept in the 1990s when Robeco was among the first investors to start taking it seriously. At the time, the focus was on what was then (and sometimes still is) called Socially Responsible Investing and mostly revolved around excluding undesirable industries such as tobacco or weapons manufacture from portfolios. Actual investments tended to be highly specific, in niche industries such as organic food or the then nascent renewable energy business, and only in equities.

Two decades later, sustainability investing has massively broadened its horizons to focus on ESG factors that are increasingly integrated into the investment process across all asset classes. In Europe, more investors are now engaged in it than those that are not, with 52.6% of all assets managed under SRI at the end of 2016, according to the Global Sustainable Investment Alliance.[22]

Indeed, so widespread is sustainability investing in Europe that many asset managers are now playing catch-up, according to asset management analytics firm Cerulli Associates. "The stampede to address ESG concerns has left European fund managers running faster to stand still. Asset management companies have raised their game, and so have the companies in which funds invest," the company said in its September 2017 newsletter.[23]

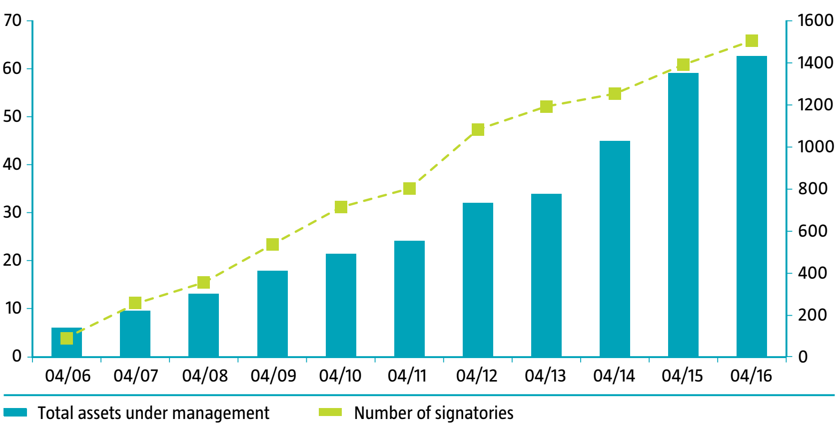
Figure 1: Money invested in types of SI strategy globally, 2014-2016



Source: Global Sustainable Investment Alliance Review 2016

One way to gauge the sheer scale of SI globally is to look at figures from the United Nations Principles for Responsible Investment, which works to encourage sustainability investing using six guiding principles. Operating in 50 countries, UNPRI signatories collectively manage about USD 70 trillion in investments, equivalent to three times the GDP of the United States.

Figure 2: Global assets under management (USD trillion)



Source: UNPRI

Other international groups have emerged to promote sustainability investing. The International Corporate Governance Network (ICGN) is dedicated to improving the G in ESG, and now has over 600 members managing assets of USD 26 trillion.[24] In the US, the Forum for Sustainable and Responsible Investment (USSIF) reports that assets which are managed sustainably have rocketed from under USD 1 trillion in 1995 to above USD 8.7 trillion at the end of 2016, accounting for 20% of the entire investment market.[25]

'UNPRI signatories collectively manage about USD 70 trillion in investments, equivalent to three times the GDP of the United States'

Integrated ESG

For Robeco, sustainability investing has been mainstream for many years. ESG is routinely integrated into the investment processes of the entire fundamental equity, fixed income and quantitative ranges of strategies. Of the EUR 152 billion in assets under management at September 2017, some EUR 91 billion is explicitly managed using integrated ESG, or 60% of the operating business. For other funds, other forms of ESG integration is implicit, since sustainability factors are always taken into account, although they may focus more on regionally or industrially specific issues.

Another way to gauge how widespread sustainability is used in the investment industry can be seen in Requests for Proposals (RfPs) – detailed forms that prospects send to asset managers asking about their products. Questions regarding ESG and sustainability now appear in 90% or more of all the RfPs received by Robeco, and the level of detail needed is getting longer. For example, potential investors now want to know the level to which sustainability is integrated and how it is done, rather than simply whether an asset manager adheres to the UNPRI.

With that, the ability of an asset manager to offer sustainability funds has become more important in recent years. Evestment, a global specialist in institutional investment data and analytics, has expanded its ESG data collection efforts with asset managers to satisfy the rising demand from investors for greater transparency into the managers' sustainability investing practices, reporting "a 150% increase in ESG screening activity worldwide in the last 18 months."[26]

Regulations and risk

Finally, politics and regulation is putting sustainability higher up the political agenda. The European Commission in January set out the recommendations of its High-Level Expert Group on Sustainable Finance to "deliver a roadmap for a greener and cleaner economy" across the EU.[27]

Most notably on the regulatory front is the Paris Agreement, which commits nations to limiting global warming to below two degrees Celsius and ideally to a maximum of 1.5 degrees above pre-industrial levels. This is having a profound effect on how the world creates energy, shifting away from fossil fuels and into renewables such as wind farms or solar power.

Much of this investment remains in thematic or impact funds, but it has become the fastest-growing area of sustainability investing, as nations take their commitments to combating climate change more seriously. Combined with the surge in use of integrating ESG in traditional equity or fixed income funds, sustainability is gradually moving to niche to mainstream to become the norm, and is likely to grow further. ■

22. *Global Sustainable Investment Alliance 2016 Review.*

23. *Cerulli Associates, the Cerulli Edge, European Monthly Product Trends, September 2017.*

24. *For more details about the ICGN see www.icgn.org*

25. *US Forum for Sustainable and Responsible Investment, 'Report on US Sustainable, Responsible and Impact Investing Trends', 2016.*

26. *Fundfire, 'Evestment expands how managers report ESG data, October 2017.*

27. *European Commission, 'Final report of the High-Level Expert Group on Sustainable Finance', January 2018.*

8

SI only works with equities

IT WORKS JUST AS WELL
WITH BONDS
AND CREDITS

Let's talk about... Portfolios

Hundreds of investors are convinced that sustainability investing offers a better way of buying equities. But few really apply it to fixed income portfolios – and that is a shame, since SI works just as well with bonds and can be essential for risk management in certain markets.

The myth that SI only works with equities exists because government bond prices are more sensitive to macroeconomic issues such as interest rates and GDP growth than to company-level ESG factors. And it is hard for some investors to see how ESG issues would have any bearing on debt that needs to be repaid anyway.

It basically boils down to trying to reduce risk, and a principle in credit markets that Robeco has long followed – it is more important to avoid the losers than necessarily always pick the winners in a portfolio. Avoiding the losers means making a careful analysis of the inherent risk in any bond: the ability of the issuer to pay the money back, or alternatively, default. This is where ESG analysis can help.

For government bonds, countries issuing them can be assessed for their risks using a wide range of ESG criteria. RobecoSAM's Country Sustainability Ranking contains masses of data gleaned about a country, puts it into a score, and updates the information twice a year. The score is based on 17 factors which receive a weight of 15% for environmental, 25% for social and 60% for governance. This greatly assists in country allocation; for example, the October 2017 survey was much more positive on Ireland and less so on Turkey, allowing the bonds teams to risk-adjust their portfolios accordingly.

Assessing credits' credentials

RobecoSAM also compiles the Company Sustainability Assessment, a detailed questionnaire about every aspect of a company's ESG performance, from carbon emissions to worker relations and board composition. This is used for both equities and corporate bonds, since the underlying data applies to the company rather than purely to the security. As with equities, all the information gleaned must be financially material; it must have a tangible impact on factors such as profit margins, revenues or costs. This has a direct impact on the company's ability to repay (or refinance) a bond. Whereas analysis for equities usually seeks an upside, the focus for fixed income remains on trying to deflect any downside.

The ESG information garnered is then integrated into a wider analysis of the merits of whether a bond is worth buying. At Robeco, this is done by creating a five-way 'F-score', using a company's financial profile, business position, corporate strategy and structure on top of the sustainability score, as seen in the diagram below.

Impact on one-third of cases

And it works… Robeco's experience found that for credit investments in 2017, ESG information had a negative impact on the total fundamental analysis in 30% of cases, and a positive impact on 3% of names in the investing universe. This directly influences investment decisions by the fixed income portfolio managers and has been instrumental in the buying and selling of bonds – just like in equities.

The relative importance of each ESG variable differs though between industries. Environmental factors and the need to reduce emissions is more important for the oil industry than for retailing, where worker relations is a bigger issue, or for banking, where governance has a higher priority in managing risk factors. Food companies face rising pressure to make healthier products; recent evidence presented to the UK Parliament complained that "sugar is the new tobacco" and should be taxed as such. This presents a clear risk to future profitability and a license for food and beverage makers to operate.[28]

'One area in which sustainability investing has developed an exclusive inroad into fixed income markets is green bonds'

Green bonds are becoming popular

One area in which sustainability investing has developed an exclusive inroad into fixed income markets is green bonds. These are credits issued to fund environmental projects ranging from wind farms to water purification facilities, mostly in emerging markets.[29]

They work just like normal government or corporate bonds, and most are investment grade. They are sometimes securitized, where the future revenue streams from the project (such as renewable energy sold to national power networks) act as a form of security for the issue.

The market has developed strongly since the first green bonds were issued by the European Investment Bank and World Bank in 2007. Now they're popular with mainstream investors, including Robeco, which includes them in selected fixed income funds. According to research by Bank of America Merrill Lynch, which launched a Green Bond Index in 2014, the total outstanding amount of green bonds exceeded USD 200 billion in 2017.[30] ■

28. *Dr. Aseem Malhotra, 'Sugar is the new tobacco, so let's treat it that way', 2016.*

29. *For more information about green bonds go to www.climatebonds.net.*

30. *Bank of America Merrill Lynch research, November 2014.*

9

Emerging markets are off-limits

Let's talk about... Emerging markets

Sustainability investing is well established in the West, though some doubt whether it can work in emerging markets battling with bigger issues. In fact, experience shows that emerging markets present both a huge investment opportunity and a distinct set of ESG risks and challenges.

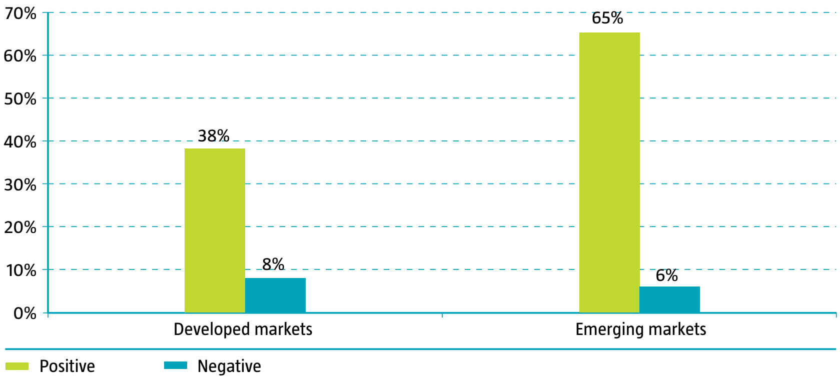
Environmental threats include mass urbanization and deforestation, while the continuance of child or slave labor along with low pay presents social problems, and high levels of state or private ownership give rise to governance issues. Some emerging countries can't adequately feed their own people, let alone adopt solar power or electric cars.

This sense of how poorly sustainability is adopted in Asia, for example, is reflected in figures by the Global Sustainable Investments Alliance. It said that of the USD 22.9 trillion invested by its members at the end of 2016, just USD 52 billion or 0.2% was in Asia outside Japan.[31]

So, is there any point in trying to invest sustainably in these regions? In fact, these very problems make using ESG even more important when building emerging market portfolios, particularly in knowing where to look for the bright spots.

And it has an even greater effect: research shows that while adopting ESG factors in developed markets has a positive effect on corporate financial performance in 38% of cases, for emerging markets that positive effect is seen in 65% of cases. Addressing the governance factor was shown to have the greatest influence.[32]

Figure 3: Relationship between ESG and corporate financial performance



Source: Friede et al (2015)

One way of creating more sustainable emerging markets funds is by taking a quantitative approach through factor investing, as discussed in a 2017 white paper by the Robeco quant team, 'Going for green alpha in emerging markets'. In practical terms, this is done by building a portfolio that is 20% more sustainable than the benchmark, with a 20% lower footprint for water use, CO^2 emissions, waste and energy use. In addition, this method uses an extensive values-based exclusion list, excluding companies from industries such as coal, tobacco, gambling and firearms production.[33]

'Getting reliable data to be able to make informed decisions is part of the battle'

It can also be important to combine differing emerging market strategies for equities, using both a fundamental approach looking at traditional ESG factors, and a quant approach seeking factors such as low volatility, where some markets offer the same returns at a lower risk. This is discussed in another Robeco white paper, 'Combining quant and fundamental to diversify your emerging market equity portfolio'.[34]

Targeting emerging debt

Getting reliable data to be able to make informed decisions is part of the battle. Robeco's emerging markets team has built a significant database that can assess risks and opportunities when building portfolios, using a combination of top-down factors to analyze countries and bottom-up criteria to find the best securities.

For the top-down assessments, the team makes use of RobecoSAM's Country Sustainability Ranking (CSR). This twice-yearly report looks at a range of factors that particularly affect emerging markets, including susceptibility to corruption, levels of internal dissent, relative freedoms of the press and vulnerability to commodity prices such as oil for economic success. It contains and all-country index and a bespoke emerging markets index. The bottom three nations in the October 2017 emerging markets CSR were Nigeria, Pakistan and Venezuela, while the top three were Singapore, Hong Kong and the Czech Republic.

Governance improvements

One area in which sustainability can be shown to have made a difference is in corporate governance improvements in Asia. Robeco has long engaged with investee companies to try to address issues such as the lack of women or independent directors on boards, or unfairly treating minority shareholders. Governance improvements have been so tangible in Japan and South Korea that stock market multiples are now expected to rise, Robeco reported in October 2017.[35]

Meanwhile, the adoption of voluntary Stewardship Codes in Asia which promote active ownership by investors has increased levels of engagement, voting at shareholder meetings, and exclusions of companies that don't meet minimum requirements, generally raising standards.

Perhaps the last word should go to the authors of an influential research paper by the specialist ESG data provider Sustainalytics entitled 'Bridging the gaps: effectively addressing ESG risks in emerging markets. "Emerging markets present both a huge investment opportunity as well as a distinct set of ESG risks and challenges," they said.

"Although investors generally perceive ESG risks to be larger in emerging markets than in developed markets, they are applying responsible investment strategies to a lesser degree when making emerging markets investments. Yet, especially in the context of emerging markets, addressing ESG risks can be very rewarding for investors wanting to reduce portfolio risks or looking for investment opportunities."[36]

31. *Global Sustainable Investment Alliance, 2017 Review.*

32. *Gunnar Friede, Timo Busch & Alexander Bassen, 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', Journal of Sustainable Finance and Investment, November 2015.*

33. *Wilma de Groot and Tim Droge, 'Going for green alpha in emerging markets', 2017.*

34. *Fabiana Fedeli and Wilma de Groot, Combining quant and fundamental to diversify your emerging market equity portfolio', 2017.*

35. *Interview with Arnout van Rijn, Chief Investment Officer for Robeco Asia-Pacific Equities, October 2017.*

Appendix

Sustainability pioneers

Robeco is a pioneer of sustainability investing, as one of the first asset managers to take it seriously in the 1990s. Since the creation of the first Groencertificaten (Green Certificates) in 1995 to the launch of the first sustainable equities fund in 1999, its importance within the firm has only grown over the past two decades. ESG analysis has been integrated in the mainstream investment process since 2010, and is now routinely applied across the entire fundamental equities, fixed income and quantitative fund ranges.

It's not just about investment: we have a dedicated Active Ownership team, with engagement specialists who enter into active dialogues with the companies in our portfolios, and those of clients. We vote at almost 5,000 shareholder meetings per year, using voting policies that are based on the internationally recognized principles of the International Corporate Governance Network (ICGN). Robeco is also a signatory to the UN Principles for Responsible Investment – gaining the top A* rating in 2017 – along with the UN Global Compact and other global and local initiatives.

Our sister company RobecoSAM, founded as Sustainable Asset Management in 1995, is an investment specialist that focuses exclusively on sustainability investing. It offers asset management, indices, impact analysis and investing, engagement, voting, sustainability assessments and benchmarking services. Asset management capabilities cater for institutional asset owners and financial intermediaries and cover a range of ESG-integrated investments in public and private equity, with a strong track record in resource efficiency themed strategies.

Together with S&P Dow Jones Indices, RobecoSAM publishes the globally recognized Dow Jones Sustainability Indices (DJSI). Based on its Corporate Sustainability Assessment (CSA), an annual ESG analysis of over 4,000 listed companies, RobecoSAM has compiled one of the world's most comprehensive databases of financially material sustainability information.

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