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Responsible Investing—The World Tour

By Michael Lewis and Robert Bush



INVESTMENTS & WEALTH INSTITUTE®

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Environmental, social, and governance (ESG) activity is evolving around the world at an accelerating pace. In this article, we will investigate the instigators of change—from investors, businesses, governments, regulators, supervisors, and civil society—to better understand the geographic differences as well as trends in the rate of change.

INVESTMENT STYLES AND GEOGRAPHIC BIAS

Earlier this year, the Global Sustainable Investment Alliance (GSIA) published its biennial report examining sustainable investment trends around the world.¹ The GSIA pools ESG data from regional organizations that enables a comparison of ESG assets by region and investment style. The GSIA published its first report in 2012, providing for some interesting observations.

First, when the inaugural report was published eight years ago, the GSIA survey reported on ESG assets across seven regions compared to just five today. This may reflect the challenges of gathering robust ESG data for emerging markets. Today, GSIA reports on ESG assets in Africa separately and via the African Investing for Impact Barometer, which reveals ESG assets are concentrated in the Republic of South Africa (93 percent) with the regions of West Africa (4 percent) and East Africa (2 percent) making up the majority of the balance. GSIA has just begun to track sustainable investing trends in Latin America.

Second, since 2012 the size of ESG assets in the five key regions has increased by 130 percent, with the smaller regions of

Japan and Australia/New Zealand posting the fastest growth over this period. This has meant that the concentration of ESG assets held in Europe and the United States combined has moderated somewhat, from 94 percent to 85 percent of ESG assets globally.

Third, ESG investment styles are dominated by just three strategies: (1) exclusion screens, (2) ESG integration, and (3) corporate engagement and shareholder action (see figure 1). This is as true today as it was eight years ago.

Fourth, regional biases continue to persist, with exclusion screens the most dominant strategy in Europe, ESG integration most prevalent in the United States, and corporate engagement the preferred strategy in Japan, a reflection of the importance of Japan's Stewardship Code.²

Fifth, although sustainability themed and impact investing styles continue to show strong growth, volumes remain trivial relative to other investment styles. Moreover, assets in both strategies are predominantly concentrated in the United States.

Sixth, the proportion of ESG assets relative to managed assets has grown across all regions since 2012. The most dramatic increase has occurred in Australia and New Zealand, where the share has leapt from less than 15 percent to 63.2 percent (see figure 2). Meanwhile in the United States, the ratio has more than doubled from 11 percent to 25.7 percent. Notably, the proportion of ESG assets relative to total managed assets has declined in Europe; since

2014 it has fallen 10 percentage points to 48.8 percent. GSIA assigns this declining trend to stricter definitions as to how to classify ESG assets.

As part of effort by the European Union (EU) to improve the trust and integrity of the sustainable finance market, we expect ESG definitions and standards to become even stricter, with potential implications for Europe and further afield if the taxonomy of the EU action plan for financing sustainable growth (EU Action Plan) becomes a template for other regions.³

GREEN CREDENTIALS AROUND THE WORLD

Green credentials vary significantly among financial centers around the world. One of the most comprehensive surveys ranking international financial centers based on the depth and quality of their green financing activities is conducted by Finance Watch in its Global Green Finance Index.⁴ The objective is to assess the penetration of green finance in a financial center's overall financial activities (depth) as well as to rate a financial center independently from its market volumes (quality).

The survey attempts to assess the degree to which green finance makes up a significant proportion of the financial center's activity, or whether the scale and scope of green finance is limited and eclipsed by a larger amount of "brown activities" such as fossil fuel financing. Consequently, having a robust audit of the green and brown financing activities across global financial centers provides a useful assessment of the risks and opportunities these

cities may face in the transition to a low-carbon economy. For example, in the event that technology, regulation, and carbon pricing schemes trigger a downward revaluation of fossil fuel assets, those stock exchanges with a disproportionate share of such company listings would be particularly exposed.

In its most recent edition published in March 2019, the Global Green Finance Index examined 63 financial centers around the world. It revealed significant divergence in green finance activity, with European cities leading and many Asian centers lagging (see figure 3).

Within the European universe, Amsterdam ranks top overall, but London leads when ranked solely on green finance quality. North American centers are typically middle ranking, with San Francisco and Montreal ranked top in their respective countries, and New York on a par with Tokyo.

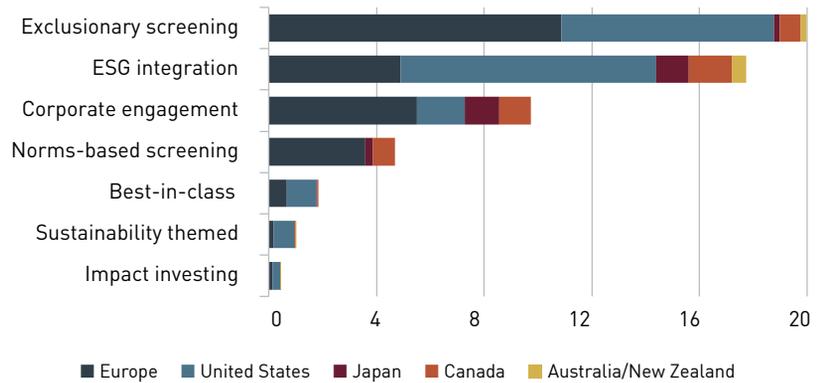
Other Asian centers are divided between middle ranking centers and laggards. For example, Sydney and Melbourne are competing strongly with Shanghai, Beijing, and Singapore, while Mumbai, Bangkok, and Kuala Lumpur are ranked at the bottom of the list on both depth and quality.

Between 1970 and 2015, approximately 2,250 unique studies have examined the link between ESG and corporate financial performance (CFP).⁵ The most compelling result from this DWS-University of Hamburg analysis is the strong correlation between ESG and CFP in the group of emerging market studies. The results revealed that, where there was a regional identifier, 65.4 percent of studies showed a positive link between ESG and CFP, significantly higher than in developed markets (see figure 4).

The more compelling results for emerging markets corresponds well with survey evidence published by the United Nations-supported Principles for Responsible Investment (PRI), which

Figure 1

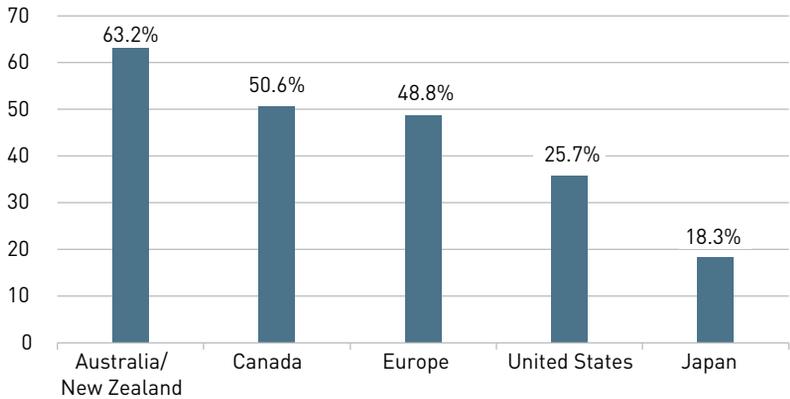
ESG ASSETS BY STRATEGY AND REGION 2018 (USD TRILLION)



Source: GSIA (April 2019). Global Sustainable Investment Review 2018

Figure 2

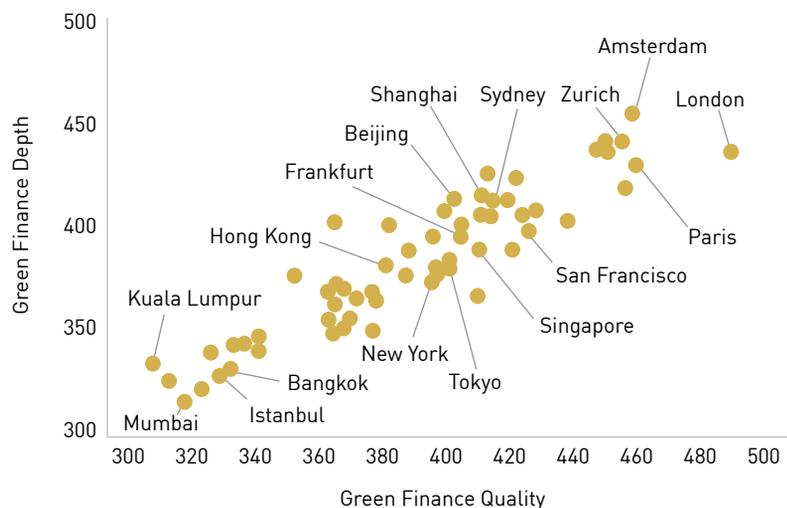
PROPORTION OF ESG ASSETS RELATIVE TO TOTAL MANAGED ASSETS



Source: GSIA (April 2019). Global Sustainable Investment Review 2018

Figure 3

GREEN FINANCE RANKINGS BY DEPTH AND QUALITY AROUND THE WORLD



Source: Global Green Finance Index 3 (March 2019)

found that retail investors in emerging markets such as Brazil and South Africa appeared to be more engaged on ESG issues than their counterparts in the developed world.⁶

The PRI survey polled workers in the United States, United Kingdom, France, Australia, South Africa, and Brazil who are investing for retirement. It revealed that respondents in emerging market countries often had the highest levels of concern when it came to key ESG issues such as the burning of fossil fuels, the use of child labor, excessive chief executive officer remuneration, and corporations that made use of tax loopholes.

U.S. INVESTORS, CORPORATIONS, AND STATES ARE IMPORTANT ROLE MODELS

When it comes to the adoption of key ESG initiatives, the United States plays a crucial role. For example, the United States has the largest combined number of asset owner and asset manager signatories to the PRI (see figure 5).⁷ One of the obligations of a PRI signatory includes the incorporation of ESG issues into the investment process; beginning in 2020, it will become mandatory for PRI signatories to report how they have considered specific climate risks in their investment portfolios.⁸

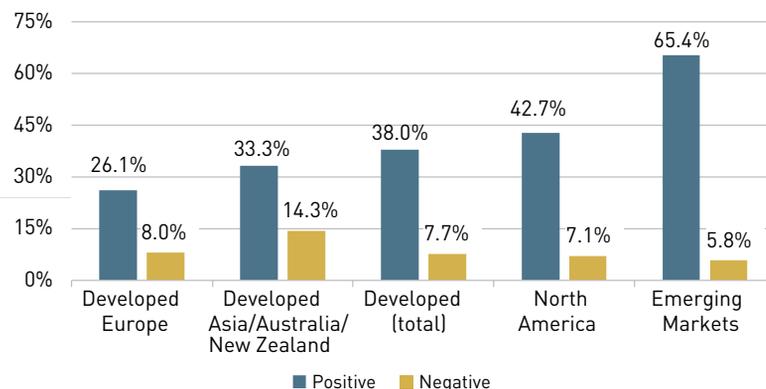
In terms of corporate commitments to renewable electricity, corporations based in Anglo-Saxon countries lead the world (see figure 6). This is highlighted by the RE100 initiative, which brings together major companies committed to sourcing 100-percent renewable electricity globally in the shortest possible time span, by 2050 at the latest. We find that the RE100 initiative is dominated by companies headquartered in the United States, followed by the United Kingdom. Combined, these two countries make up just more than 50 percent of RE100 corporate signatories, which in July 2019 totaled 190. Altogether, these companies are creating demand for more than 188 TWH (terawatt hours) of renewable energy every year—almost enough to power a country like Thailand with a population close to 70 million.⁹

Research conducted by The Climate Group reveals a direct correlation between companies signed up for RE100 and those companies achieving above-average financial performance as measured by net profit margin and earnings before interest and taxes margin.¹⁰ This outperformance is irrespective of the sector in which the company operates. From our perspective, this means that RE100 companies are typically leaders in their sectors. Interestingly, a survey conducted by the Climate Group and CDP in 2018 revealed that 88 percent of RE100 members cited the economic case as a key driver for joining RE100.¹¹ A reflection of the rapid decline in renewable power prices over recent years suggests that an increasing number of companies may be making renewable commitments in the years ahead.

Another factor bringing ESG—and specifically climate change—into the heart of business and investor operations is the growing trend to use the courts of law to enforce and accelerate climate change action. Research by Clyde & Co., the global law firm, revealed that to date 1,200 climate change cases have been filed across 30 jurisdictions including

Figure 4

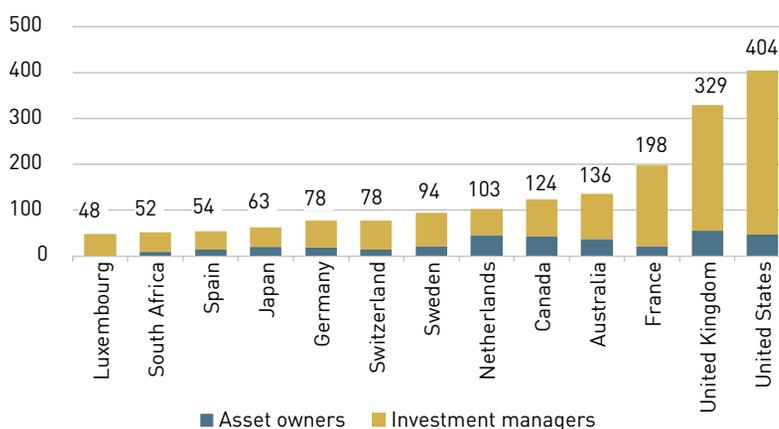
EMERGING MARKETS POST THE STRONGEST POSITIVE LINK BETWEEN ESG AND CORPORATE FINANCIAL PERFORMANCE



Source: DWS-Global Research Institute white paper (December 2015). ESG and Corporate Financial Performance

Figure 5

THE UNITED STATES LEADS WHEN IT COMES TO THE NUMBER OF ASSET OWNER AND MANAGER PRI SIGNATORIES



Source: PRI signatory database (August 2019)

Australia, the United Kingdom, New Zealand, Brazil, Spain, Canada, and India.¹² However, the lion's share of climate change litigation is taking place in the United States with more than 950 cases filed there so far. Examples include nine U.S. cities and counties from New York to San Francisco suing major fossil fuel companies and seeking compensation for climate change damage such as pollution and rising sea levels.

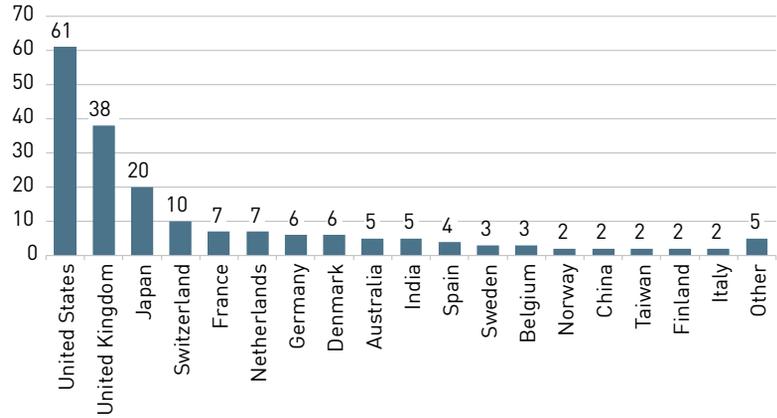
Consequently, investments that might have been viewed as safe from a litigation perspective are anything but, particularly given the rapid advancements taking place in the field of climate change science and specifically extreme event attribution. This assesses the degree to which an extreme weather event is attributable to climate change, natural weather patterns, or random climate variability. In the event that the science behind extreme event attribution proves more reliable, we would expect greater litigation risk around climate.

In addition to litigation risk, there is considerable focus on the financial loss triggered by extreme weather events in the United States such as hurricanes, floods, and wildfires (see figure 7). Between 1980 and October 2019, 254 weather and climate disasters have hit the country with a cumulative loss in excess of \$1.7 trillion.¹³ Hurricanes remain the most damaging and costly weather events to affect the United States: Between 2016 and 2018, the United States was impacted by six separate billion-dollar hurricanes incurring total losses of \$329.9 billion and 3,318 fatalities.¹⁴ In 2018, California also experienced its costliest, deadliest, and largest wildfires since records began in 1933. In total, more than 8.7 million acres burned across the United States in 2018, well above the 10-year average of 6.8 million.¹⁵

Floods also have caused significant disruption across the country. For example, since 1993, the Mississippi River Valley has sustained successive 100-, 200-,

Figure 6

THE UNITED STATES DOMINATES WHEN IT COMES TO THE NUMBER OF COMPANIES SIGNED UP FOR THE RE100 INITIATIVE

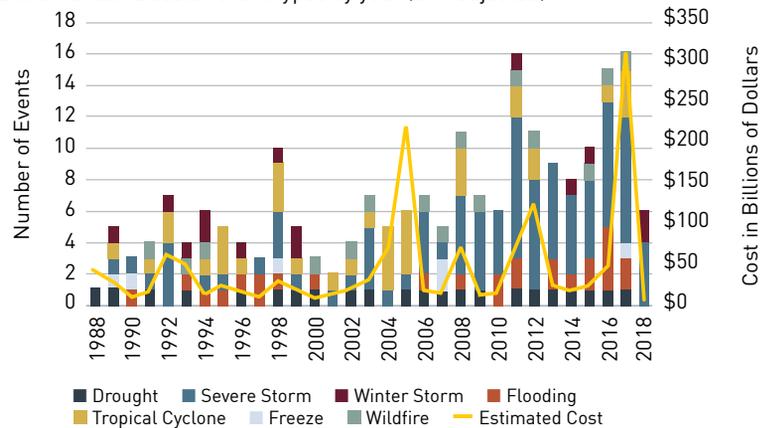


Source: The Climate Group (August 2019). RE100.

Figure 7

CLIMATE EVENTS AND FINANCIAL LOSS IN THE UNITED STATES (1988-2018)

Billion-dollar disaster event types by year (CPI-adjusted)



Source: NOAA National Center for Environmental Information (NCEI) U.S. Billion-dollar weather and climate disasters (2019).

and 500-year flood events as well as a 50-year drought.¹⁶ Since the Mississippi River transports 40 percent of U.S. total agricultural output and the river crosses through 10 U.S. states, it is no wonder this has triggered the Mississippi River Cities and Towns Initiative (MRCTI).¹⁷ Since 2012, MRCTI's work aims to protect and restore the Mississippi River as well as build resilience for the 124 cities and towns whose welfare is directly linked to the river.

Asia, Central America, and Europe also are exposed to financial losses triggered by extreme weather events. In Asia, five out of six people live in an area vulnerable to extreme weather events.¹⁸

Between 1998 and 2017, five of the world's 10 countries most affected by extreme weather events were in Asia, namely Myanmar, Philippines, Bangladesh, Pakistan, and Vietnam. The primary risks across this region ranged from typhoons, droughts, sea level rise, and coastal flooding.¹⁹ The majority of the other most-affected countries were in the Americas and included Puerto Rico, Honduras, Haiti, and Nicaragua. Because Asia's population is increasingly urbanized and coastal, flood losses are likely to intensify in the years ahead, specifically in the high population centers of Guangzhou, Mumbai, Kolkata, Shenzhen, Jakarta, Bangkok, and Nagoya.²⁰

In Europe, the highest overall economic losses in absolute terms from extreme weather and climate-related events between 1980 and 2017 were registered in Germany, Italy, and France (see figure 8).²¹ The most-expensive climate extremes over this period were the 2002 flood in Central Europe, the 2003 drought and heat wave, the 1999 winter storms Lothar and Martin, and the October 2000 floods in Italy and France. However, when financial losses are assessed as a share of gross domestic product, Croatia, Czech Republic, and Hungary were the most impacted.

Not surprisingly, climate risk measurement and management have prompted global regulators and supervisors to act. Since 2010, a growing number of U.S. state insurance regulators are including climate risk assessments into their regulatory reviews. This effort has been supported by the National Association of Insurance Commissioners (NAIC). Today, the NAIC surveys in excess of 1,000 companies that write more than \$100 million in premium capturing more than 70 percent of the entire U.S. insurance market.²²

At a global level the Network for Greening the Financial System (NGFS) has moved beyond its eight founding member central banks to encompass 42 members and eight observers sharing

best practices, for example in the area of climate risk management in the financial sector.²³ In April 2019, the NGFS published its first assessment report including a call for action for central banks and supervisors to ensure the financial system is resilient to climate risks and to promote a more sustainable financial system. The NGFS's recommendations included integrating climate-related risks into prudential supervision as well as central banks integrating sustainability factors into their own portfolio management such as pension funds and reserves.

GLOBAL INITIATIVES TO ENHANCE THE INTEGRITY OF ESG

The EU Action Plan goes beyond mere recommendations for powerful legislative action that aims for the EU to meet its climate and energy commitments under the 2015 Paris climate agreement.²⁴ It calls for moving sustainability into the core activities of financial institutions operating in the EU, many of which will be required to demonstrate how they integrate ESG factors into their investment processes.

One of the most urgent tasks is a robust classification and labeling system to bring much needed consistency and trust to the market. So-called greenwashing is a growing problem that potentially undermines the whole

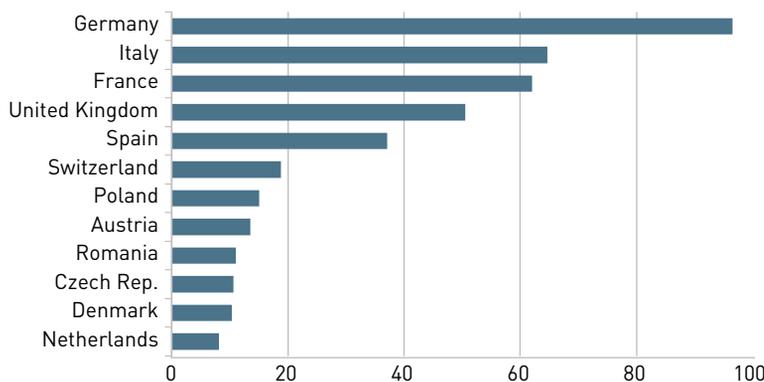
industry. The origins of greenwashing date to the 1980s when certain corporations overstated or even falsely claimed their positive environmental credentials, typically in marketing campaigns.

In response, many jurisdictions, such as the United States and United Kingdom, have attempted to tighten advertising standards around such activities through the Federal Trade Commission and the Advertising Standards Authority, respectively. The effort to stamp out greenwashing in Europe is being driven by a unified EU classification system for whether an economic activity qualifies as environmentally sustainable for investment purposes. This taxonomy will be used by regulators at a national and EU level, e.g., in labeling schemes and for verifying claims that financial products are environmentally sustainable. This will apply to all entities—whether EU based or not—operating and selling investment products in Europe.

Improved disclosure is also essential. We applaud the plan to require institutional asset managers to show exactly how their investments are aligned with their stated sustainability objectives. Indeed, we hope the EU Action Plan will encourage greater clarity on the duties of all investors as they relate to ESG factors. We believe this in turn should drive efforts to integrate ESG into investment processes. As a result, investors may benefit from a more-liquid pool of sustainable products and the increased pressure on companies to improve their sustainability reporting. Indeed, woeful levels of ESG-related information, particularly around climate risks, and ESG ratings based on incomplete or poor corporate disclosure pose a real risk for investors. This is one of the key objectives of the Task Force on Climate-related Financial Disclosures.²⁵

Even so, challenges for investors to identify climate risks as well as broader ESG controversies remain. ESG disclosure has come under fire because companies typically tend to report only on issues that paint them in a good light, but with

Figure 8 ECONOMIC LOSSES IN EUROPE FROM WEATHER AND CLIMATE-RELATED EVENTS (1980-2017), IN EUR BILLION

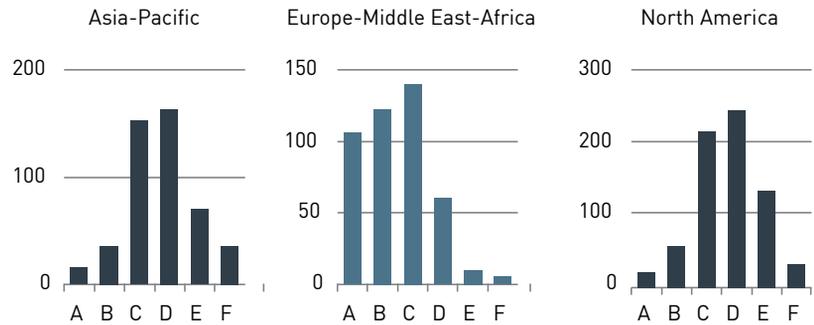


Source: NatCatSERVICE, Munich Re; European Environment Agency (April 2019). Economic losses from climate-related extremes in Europe.

little to no financial materiality. This is borne out by 2018 research that reveals ESG disclosure has a weak correlation to financial performance and introduces hazards for investors because ESG disclosure plays an important role in driving ESG ratings. As we have highlighted in the past, increasing the ESG quality of a portfolio simply may deliver a portfolio with a bias toward large market cap securities or be overly exposed to European securities, reflecting the uneven nature of ESG disclosure information by region (see figure 9).²⁶

Figure 9

ESG RATINGS DISTRIBUTION BY MSCI REGION (NUMBER OF CORPORATIONS)



Source: DWS Investment GmbH (April 2018).

Such concerns were highlighted by U.S. Securities and Exchange Commissioner Hester Peirce in June 2019. Efforts to improve ESG and specifically climate-related disclosure through the EU Action Plan, the Task Force on Climate-related Financial Disclosures, the work of the Sustainable Accounting Standards Board (SASB) as well as the European Bank for Reconstruction and Development (EBRD) and the Global Centre on Adaptation are therefore to be commended.²⁷

LOOKING AHEAD

It can be argued that today we are experiencing a new industrial revolution, fueled by technologies encompassing digitalization, artificial intelligence, automation, biotechnology, fintech, and clean technologies. Digital technologies, which are enabling more individuals and businesses to gain access to financial services via mobile phones and the internet, will encourage G20 efforts to increase financial inclusion. According to the World Bank, an estimated 1.7 billion working-age adults have no access to financial services and a disproportionate number (56 percent) are women.²⁸

The delivery of financial services is also part of the solution to a number of the United Nations’ Sustainable Development Goals such as ending poverty, gender equality, and good health and well-being.

Similarly, environmental or clean technologies such as wind, solar, water

efficiency (blue tech), and electric vehicles increasingly are viable due to improved cost competitiveness. For example, the costs of solar photovoltaic panels have declined by more than 80 percent since 2009. Because renewables represent just less than 10 percent of total power generation globally, but account for almost 50 percent of the growth in global power generation in 2018, this should trigger a transformation of the power-generating sector globally and curb carbon emissions across other parts of the economy, such as in the transportation sector.²⁹

For example, electric vehicles pose significant disruption risk to traditional auto makers given that more and more countries are introducing laws to ban the sales of gasoline and diesel cars, in some instances as soon as 2030. This is leading to a re-pricing in the car sector such that as of 2018 the 25 largest auto manufacturers made up just 20 percent of the market cap of the world’s 15 largest tech companies, compared to 60 percent eight years ago.³⁰

Technology is also part of the solution for building smarter and more sustainable cities. Cities account for almost 70 percent of the world’s energy consumption and a similar share of global carbon dioxide emissions.³¹ Part of the improvements in cities likely will come in the form of technologies invading the energy, transportation, and real estate

sectors—for example, smart meters are being installed in residential and commercial properties to improve efficiencies in the areas of heat, noise, and light, as well as security. Technologies also are being deployed to improve the efficiency of building materials as well as in the areas of packaging, processing, waste reduction, and recycling with particular focus on plastics.

ESG-focused technologies are therefore significantly more viable today than just a few years ago when government subsidies played a more important role. The more viable nature of ESG technologies today is important because many people question the extent to which ESG will survive the next economic downturn. Indeed, when the last recession struck in 2009, global efforts to address key ESG issues, such as climate change, collapsed alongside the removal of many government subsidies supporting green technologies.

CONCLUSION

On certain metrics responsible investing seems to be gaining ground. For example, in Australia and New Zealand the proportion of ESG assets relative to managed assets has risen from less than 15 percent to 63.2 percent since 2012. Yet, on other metrics, such as the size of the green bond market, which represents just 2 percent of total bonds outstanding, the responsible investing market is still in its infancy.

However, we see encouraging trends. For example, the growing number of signatories to the PRI, led by the United States, means an increasing number of asset owners and managers are committed to integrating ESG issues into their investment processes.

ESG also has varying regional investment repercussions, with the strongest correlation between ESG and CFP occurring in emerging markets. This makes sense because emerging market countries are particularly susceptible to key ESG issues such as the environmental impacts from the burning of fossil fuels, the social dimension of forced labor, and the incidence of corruption.

We believe another important catalyst for driving the ESG and climate risk agenda has been increasing international and regional regulation. This includes the EU Action Plan, the Task Force on Climate-related Financial Disclosures, and the Network for Greening the Financial System, as well as many insurance regulators around the world introducing climate considerations into their regulatory reviews. ●

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