ESG Investing: an introduction for GI actuaries

IFOA ESG working party
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Sophie Coleman (Lloyd’s)

GIRO
18/10/2017
The objectives for today’s workshop

Aiming to address the following questions:

• What is ESG investing?
• What it isn’t!
• Why now and why is it relevant?
• Incorporating ESG risks in investment portfolios
• Further information
Are ESG considerations part of your investment strategy?
What is ESG investing?

PRI definition:

“Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.”

Whilst there are similarities with approaches, Responsible Investment is **not** the same as:

- Socially responsible investing (SRI)
- Impact investing
- Sustainable investment
- Ethical investment
- Green investment
- Exclusionary screening
Global economic mega trends

- Population growth
- Ageing population
- Resource constraints
- Climate change

*These four mega trends will drive long-term investment returns*
Why consider ESG investing?
Why consider ESG investing?

**G:** Good governance is systemically important

**P:** Public-private partnerships are expanding

**C:** Climate change is a reality

**E:** Energy sources are changing

**A:** Ageing population

**D:** Demographics are changing

**S:** Social media is driving convergence

**R:** Regulation is providing tailwinds

**V:** Value chains are global

**T:** Technology is changing what we demand and consume

Source: Alex Struc Head of ESG Portfolio Management at PIMCO
Technological disruption – business is ahead of government

Tesla Motors

MODEL E

35,000 USD

- 210 miles Range per charge
- Under 6 seconds Zero to 60 mph
- 5-Star Safety Rating In all categories
- Autopilot Safety Features
- Seating for 5 Adults
- Supercharging Capable

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Growth in ESG investing

US SIF Foundation 2016 trends report:

• 33% growth over past two years; 14-fold increase since 1995

• Accounts for over 20% of dollars $ under professional management in the US

• Total US-domiciled AUM using SRI & ESG strategies grew to $8.7 trillion in 2016

Source: US SIF
What do we mean by ESG issues?

Source: MSCI
Environmental Factors (E)

• Considers the **externalities** produced by a firm
• **Costs not captured** in the manufacturing process
• For example, a firm’s carbon footprint or its waste production
• Arguably the **clearest** of the three risk factors

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**Environmental**

- Biodiversity / land use
- Carbon emissions
- Climate change risks
- Energy usage
- Raw material sourcing
- Regulatory / legal risks
- Electronic waste
- Waste & recycling
- Water management
- Weather events
Social Factors (S)

- Considers labour rights, such as working hours, fatalities and pay
- **Supply chain management** a key issue
- **Difficult** to source proper data
- Arguably the **most complex** of the three factors and the **most subjective**

<table>
<thead>
<tr>
<th>Social</th>
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<tbody>
<tr>
<td>• Community relations</td>
</tr>
<tr>
<td>• Controversial business</td>
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<tr>
<td>• Customer relations / product</td>
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<tr>
<td>• Diversity issues</td>
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<tr>
<td>• Employee relations</td>
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<tr>
<td>• Health &amp; safety</td>
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<tr>
<td>• Human capital management</td>
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<tr>
<td>• Human rights</td>
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<tr>
<td>• Responsible marketing &amp; R&amp;D</td>
</tr>
<tr>
<td>• Supply chain management</td>
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</table>
Governance Factors (G)

• An evaluation of how a **firm structures** its board, its disclosures, compensation practices and so on…

• An assessment of the firm’s **culture**
  – Wells Fargo: “Eight is Great!”
  – LIBOR scandal

<table>
<thead>
<tr>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Accountability</td>
</tr>
<tr>
<td>• Anti-takeover measures</td>
</tr>
<tr>
<td>• Board structure</td>
</tr>
<tr>
<td>• Bribery &amp; corruption</td>
</tr>
<tr>
<td>• CEO duality</td>
</tr>
<tr>
<td>• Executive compensation</td>
</tr>
<tr>
<td>• Ownership structure</td>
</tr>
<tr>
<td>• Shareholder rights</td>
</tr>
<tr>
<td>• Transparency</td>
</tr>
<tr>
<td>• Voting procedures</td>
</tr>
</tbody>
</table>
What do ESG factors impact the most?
A: Risk
B: Return
C: Risk & Return (both equally)
D: Neither (no impact)
ESG factors and the impact on expected returns

Whilst the majority of research suggests a good ESG score leads to improved returns, there is also lots of evidence to the contrary:

**Low ESG score = lower expected returns**

- A low ESG score (in particular governance) translate into unfavourable business decisions
- Companies more likely to suffer losses or incur increased costs of refinancing

**Low ESG score = higher expected returns**

- Investor preference matters: low demand for investments with low ESG scores
- Investor demand has impact on prices: Lower prices today and higher returns in the future

*Conclusion: academic research provides mixed evidence of the impact of ESG factors on expected returns*
ESG factors and the impact on risk

ESG factors leads to a range of potential impacts on stakeholders

Environmental
• Firm generating high levels of pollution may suffer from a future tax

Social
• Firm that poorly treats its employees or suppliers may be boycotted by consumers

Governance
• Firm with poor governance heavily fined by the regulator

Low ESG score = higher risk
• Events can have a meaningful impact on the value of the firm
• Impact is uncertain
• Timeframe is long and uncertain
ESG factors and the impact on risk

• Analysis by AQR Capital Management on the risk implications of incorporating ESG considerations into an investment strategy

• Clear support for the hypothesis that ESG exposures may be informative about the risks of individual firms
  – Stocks with the worst ESG exposures have total and stock-specific volatility that is up to 10-15% higher and betas up to 3% higher, than stocks with the best ESG exposures
  – A stock’s ESG score helps forecast future statistical risks up to 5 years later

• The findings suggest ESG may have a role in investment portfolios that extend beyond ethical considerations, particularly for investors wishing to tilt towards safer stocks

## Corporate fines from ESG issues

<table>
<thead>
<tr>
<th>Company</th>
<th>Year</th>
<th>Sector</th>
<th>$ billions</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>BP</td>
<td>2016</td>
<td>Energy</td>
<td>20.8</td>
<td>Deepwater horizon</td>
</tr>
<tr>
<td>Bank of America</td>
<td>2014</td>
<td>Financials</td>
<td>16.7</td>
<td>Financial fraud</td>
</tr>
<tr>
<td>Volkswagen</td>
<td>2016</td>
<td>Automotive</td>
<td>14.7</td>
<td>Emissions tests</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>2013</td>
<td>Financials</td>
<td>13.0</td>
<td>Toxic mortgages</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>2014</td>
<td>Financials</td>
<td>8.9</td>
<td>Flouting sanctions</td>
</tr>
<tr>
<td>Citigroup</td>
<td>2014</td>
<td>Financials</td>
<td>7.0</td>
<td>Toxic mortgages</td>
</tr>
<tr>
<td>Anadarko Petroleum</td>
<td>2014</td>
<td>Energy</td>
<td>5.2</td>
<td>Environmental fraud</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>2016</td>
<td>Financials</td>
<td>5.1</td>
<td>Toxic securities</td>
</tr>
<tr>
<td>GlaxoSmithKline</td>
<td>2012</td>
<td>Pharmaceuticals</td>
<td>3.0</td>
<td>Misbranding</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>2014</td>
<td>Financials</td>
<td>2.9</td>
<td>Tax evasion</td>
</tr>
</tbody>
</table>

Source: U.S. Department of Justice
Case Study - Volkswagen

“Our pursuit of innovation and perfection and our responsible approach will help to make us the world’s leading automaker by 2018…both economically and ecologically.”

Dr. Martin Winterkorn, 2014 Volkswagen report & accounts

“We find that firms with good performance on material sustainability issues significantly outperform firms with poor performance on these issues”.


Source: Bloomberg, as at 31 December 2015
Incorporating ESG factors in the investment process

• Fund managers are recognising the importance of understanding how ESG risk factors can potentially impact an investment
  – Analysis of ESG considerations should be embedded into the process and documented in research and recommendations
  – ESG events are infrequent and difficult to model and so may not be fully captured in traditional risk models which are typically calibrated to shorter-term time horizons

• Portfolios may have a deliberate tilt to equities and bonds which exhibit strong ESG characteristics

• Even if portfolios don’t have an ESG tilt, the manager still needs to ensure an understanding of the exposure to ESG risks and whether the return adequately compensates for this
Case study: ESG integration in fixed income

- MSCI ESG ratings report available for many Euro and US IG and HY issuers
- Quarterly ESG sector report reviewed by sector analysts and available on Bloomberg
- ESG report includes data from RepRisk, which tracks changes in levels of negative news on issuers, helping flag potential downside risk.
- Due diligence reports on private deals covering ESG issues in depth (Secured Loans)
### Environmental
Energy, Chemicals, Utilities, Industrials, Packaging
- Impact of CO2 targets on domestic policies
- Pollution and negative externalities
- Longer term environmental impacts
- Technological changes

### Social
Healthcare, Gaming
- Changes in government policy, regulation and country law that directly and indirectly impact issuers

### Governance
Relevant across all sectors
- Management history
- Related party transactions
- Management pay
- Shareholder base
- Aggressive accounting practices

<table>
<thead>
<tr>
<th>Case study: Murray Energy</th>
<th>Case study: EU Telecoms sector</th>
<th>Case study: Unione di Banche Italiane (UBI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental concerns. Acquired Foresight Energy, becoming one of the largest US coal producers. Competitive pressure from cleaner, renewable energy sources is placing pressure on coal.</td>
<td>Changes in the EU Commission (Telecoms &amp; Competition) has raised concerns that mobile consolidation transactions have a greater risk of regulatory deal failure, as seen recently in Denmark. We remain positive on fixed line regulation and fixed-mobile convergence M&amp;A, however our overall view on the sector has been tempered.</td>
<td>Governance and controls within the UBI have been strained by a continued search for acquisitions. The aggressive acquisition strategy has been at odds with messaging to investors and has negatively impacted credit metrics, with the core tier 1 ratio lower than peers and the non-performing loan (NPL) book significantly worse than peers.</td>
</tr>
</tbody>
</table>

Note: Sectors listed are examples, not an exhaustive list of areas that ESG factor could impact.
The above examples are intended for illustrative purposes only and are not indicative of the historical or future performance of the strategy or the chances of success of any particular strategy. Janus Henderson Investors, one of its affiliated advisors, or its employees, may have a position mentioned in the securities mentioned in the report. References made to individual securities should not constitute or form part of any offer or solicitation to issue, sell, subscribe or purchase the security.
Implementation

ESG refers to the integration of environmental, social, and governance factors in the investment process:

**Risk management**
- Inclusion of ESG factors into financial analysis to evaluate risks and opportunities

**Strategy**
- Explicit incorporation of ESG objectives into investment products and strategies

**Stewardship**
- Actively engage with companies to protect and enhance their value
## ESG Scoring

<table>
<thead>
<tr>
<th>Pillar</th>
<th>Category</th>
<th>Score</th>
<th>Weight %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental</td>
<td>Resource use</td>
<td>20</td>
<td>11%</td>
</tr>
<tr>
<td></td>
<td>Emissions</td>
<td>22</td>
<td>12%</td>
</tr>
<tr>
<td></td>
<td>Innovation</td>
<td>19</td>
<td>11%</td>
</tr>
<tr>
<td>Social</td>
<td>Workforce</td>
<td>29</td>
<td>16%</td>
</tr>
<tr>
<td></td>
<td>Human rights</td>
<td>8</td>
<td>8%</td>
</tr>
<tr>
<td></td>
<td>Product responsibility</td>
<td>12</td>
<td>9%</td>
</tr>
<tr>
<td>Governance</td>
<td>Management</td>
<td>30</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td>Shareholders</td>
<td>12</td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td>CSR strategy</td>
<td>8</td>
<td>6%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>20.6</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Score range</th>
<th>Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>27 &lt; score &lt;=30</td>
<td>AAA</td>
</tr>
<tr>
<td>24 &lt; score &lt;=27</td>
<td>AA</td>
</tr>
<tr>
<td>21 &lt; score &lt;=24</td>
<td>A</td>
</tr>
<tr>
<td>18 &lt; score &lt;=21</td>
<td>BBB</td>
</tr>
<tr>
<td>15 &lt; score &lt;=18</td>
<td>BB</td>
</tr>
<tr>
<td>12 &lt; score &lt;=15</td>
<td>B</td>
</tr>
<tr>
<td>9 &lt; score &lt;=12</td>
<td>CCC</td>
</tr>
<tr>
<td>6 &lt; score &lt;=9</td>
<td>CC</td>
</tr>
<tr>
<td>3 &lt; score &lt;=6</td>
<td>C</td>
</tr>
<tr>
<td>0 &lt; score &lt;=3</td>
<td>D</td>
</tr>
</tbody>
</table>
Will you now consider incorporating ESG into your investment strategy?
The ESG IFOA working party

Who we are:

• Formed in January 2017, 14 members - actuaries & non-actuaries
• Jointly report to R&E Board and F&I Board
• Diverse experience: academia, asset management, consultancy, environmental law, GI, life, pensions, risk management

Purpose:

• Co-ordinate & expand the IFOAs ESG-related investment activities & advance actuarial capacity in the field
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Useful links

- Principles for Responsible Investment  www.unpri.org
- The Forum for Sustainable & Responsible Investment  www.ussif.org
- UN Global Compact  www.unglobalcompact.org
- Global Reporting Initiative (GRI)  www.gri.org
- Sustainability Accounting Standard Board (SASB)  www.sasb.org
- The Social Stock Exchange  http://socialstockexchange.com
- Smith School of Enterprise & the Environment  http://www.smithschool.ox.ac.uk/
- Sustainalytics  http://www.sustainalytics.com/
- MSCI  https://www.msci.com/esg-ratings
- Bloomberg  www.bloomberg.com