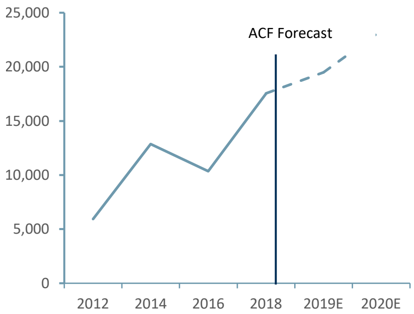
SPOTLIGHT

ESG Integration

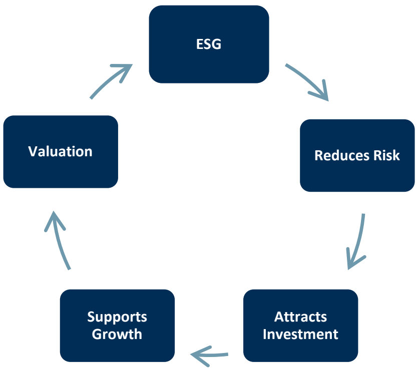
Environmental, Social, and Governance Policy Opportunity

2020E up 30%



ESG Sustainable Investing Assets in USD trillions

Friday, 24 April 2020



How to exclude yourself from USD 25.2 trillion

By not having an Environmental, Social, and Governance (ESG) policy as part of your core business by 2018, your company was excluded from USD 17.5 trn of potential investment funds. Based on our forecast in 2019 no ESG policy excludes a company from USD 21 trn and in 2020 USD 25.2 trn potential investors cash. ESG has replaced CSR (Corporate Social Responsibility) with a quantifiable set of metrics that investment/portfolio managers use as part of a screening process to measure a company's sustainable business activities. Since its inception ESG has received measurable significant support from financial institutions (FIs). Retail investors are also joining a market previously dominated by institutional investors. Our forecasts suggest that the share of retail investment money (direct or indirect via PCBs or equivalents) will reach up to 33% of total ESG funds in 20E up from 25% in 18A.

- $25.2 trillion of ESG filtered funds 20E up 30% vs. 18A;
- 28-33% of funds for ESG investing 20E will come from retail;
- ESG sustainable investment funding increased 41% in 18A vs. 16A;
- ESG ranks second vs. other investing filters;
- MSCI ESG rating increasingly used by investors to filter investments.

What is ESG?

ESG is such a critical trend for corporates wanting funding, and one that we only expect to accelerate post COVID-19 that it is worth reviewing its origins.

ESG was developed in the 1970s in order to put pressure on the South African government to end apartheid.

The forerunner to ESG was developed in the 1970s (then called Corporate Social Responsibility – CSR) following the global opposition to South Africa's apartheid regime. US and UK companies pulled out their investments from many South African companies adding pressure to the South African regime to end apartheid.

As a result, one of the most significant instances of selective disinvestment transpired, 'disenfranchising' a whole ethnicity. After this economic event, CSR's credibility as a force for change was firmly established.

Shareholder theory - The disinvestment in South Africa in the 70s and 80s and its attendant CSR policy driver sparked a contrary movement, which assembled itself around Milton Friedman's Shareholder Theory (The Friedman Doctrine). The theory stated that company valuations should only be based on reported numbers (rather than qualitative items such as a CSR policy) because companies should only have a responsibility to their shareholders (i.e. generate profit for their shareholders) and not to the public or society.

Responsible Investors emerged in 1988 as companies were encouraged to incorporate social and environmental measure into their business models.

Social capital - In 1988 James S. Coleman introduced the concept of 'social capital' as a measurement of value, and as a result, investors began encouraging companies to introduce social and environmental measures into their business models much more broadly. Such investors attracted the epithet 'Responsible Investors'.

ESG arrives – CSR evolved and became ESG largely because CSR was not verifiable. Companies understood that having a CSR policy was an easy win and required no material change in culture or business model as it was unverifiable.

The term ESG was coined in 2004 via a study carried out by the United Nations 'Who Cares Wins'. Who Cares Wins is a global initiative that was endorsed by 23 financial institutions from 9 countries which had total Assets Under Management (AUM) of USD 6 trillion.

ESG has three criteria that investors use when screening a company: environmental, social, and governance.

The main innovation was that ESG, unlike CSR, came with metrics that companies had to publish reliably and regularly to qualify as being ESG compliant entities. In other words, ESG requires commitment and action to its principles and values and invites verification. Investors found the metrics very attractive.

The environmental criteria are designed to show investors that companies are taking all the necessary precautions to make sure that their business activities have the least harmful effect on the environment.

The social criteria highlights company relationships with employees, clients, suppliers, and the surrounding communities where their businesses have been established.

The governance criteria monitors a company's leadership structure and how it manages shareholder rights.

So called responsible investors were drawn to ESG because it provided a business with a series of metrics that can be used for investment screening.

What was Corporate Social Responsibility (CSR)?

CSR was introduced as a self-regulation to guarantee that business practices are carried out ethically.

Corporate Social Responsibility (CSR) was the forerunner to ESG. It was introduced as a form of self-regulation for private companies to guarantee that business practices are carried out ethically while contributing to societal goals (social, economic, and environmental).

CSR has been discredited over the past 10-years. Companies report on CSR in their annual reports however, it has been difficult for analysts to try and assign a value to CSR when calculating company valuations, as it is a qualitative measure. Therefore, it has been largely ignored.

ESG is an upgrade of CSR providing investors with a quantitative measure.

ESG evolved as an upgrade of CSR so that companies can quantitatively measure their corporate social responsibility. Companies are responsible for keeping track of these metrics as they record business efforts towards reaching the global goal of reducing the carbon footprint.

Our view is that if companies wish to gain access to the increasing pool of sustainable investment capital, having an ESG policy as part of their core business framework is essential.

Investors began looking for verifiable metrics for investment screening which CSR did not come with.

Responsible Investors were originally drawn to CSR because it provided a business with a series of criteria that could potentially be used for investment screening, the problem was that CSR did not come with verifiable metrics. Embarrassing scandals ensued. Investors began looking for a different filter.

The rise and rise of ESG

We expect ESG to be the number 1 filter by YE20 as measured by funds under management.

ESG ranks second among the investing filters at USD 17.5 trillion.

The shift to ESG and away from CSR sparked a global movement to identify how ESG filters could actually be measured. The Global Sustainable Investment Alliance (GSIA) created seven different sustainable investing asset filters which are now accepted as global standards of classification. (Exhibit 1:)

ESG now ranks as the second highest filter as measured by funds under management amongst the myriad of investing filters. In our view, this only serves to highlight the importance to companies of having a mechanism to keep track of ESG criteria.

We expect ESG to be the number 1 filter by YE20 as measured by funds under management.

In 2018 ESG integration was the second most important screening technique for filtering investment opportunities after negative/exclusionary screening (ESG investment funds 2018A USD 17.5 trillion vs. negative/exclusionary screening funds 2018A USD 19.8 trillion).

Negative or exclusionary screening excludes companies that are involved in controversial or unacceptable activities not in line with ESG criteria.

Other significant screens and filters:

Corporate engagement and shareholder action filtering (AUM 2018A USD 8.8 trillion) identifies the act of using shareholder power to influence corporate behaviour.

Norms-based screening (AUM 2018A USD 4.7 trillion) assesses investments based on international (OECD, ILO, UN, and UNICEF) business practices.

Positive/best-in-class-screening (AUM 2018A USD 1.8 trillion) identifies companies, compared to their peers, that lead by example based on their ESG performance.

Sustainability themed investing (AUM 2018A USD 1 trillion) is used to screen investments that specifically relate to sustainability, such as clean energy or green technology.

Impact/community investing (AUM 2018A USD 444m) is for companies that have a clear strategy that involves making a positive impact on the communities within which they conduct business.

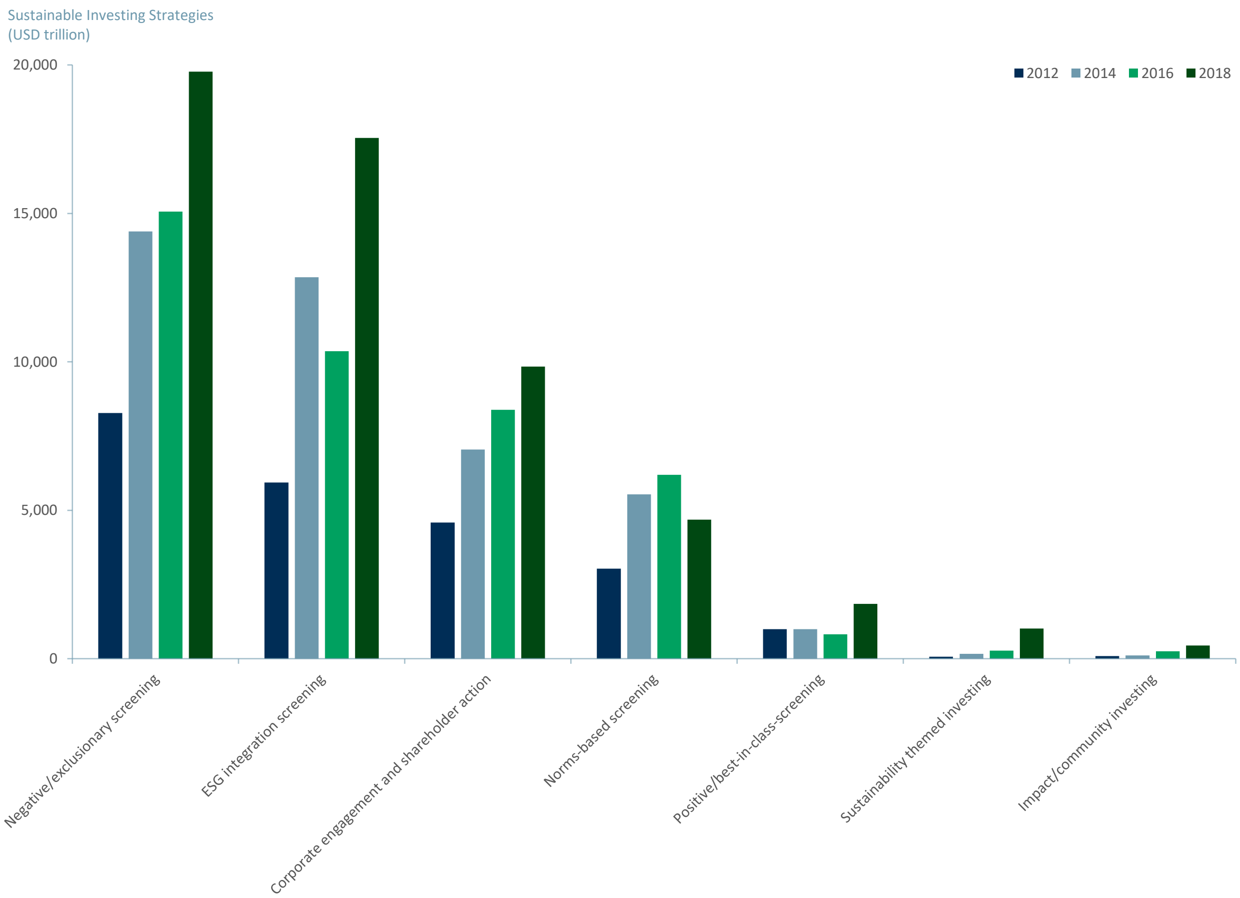
If companies want the 'responsible investors' to invest, then they must be socially responsible.

All of the above filters and screens are closely linked with one main goal – companies must be socially responsible if any form of investment is to be made by the so-called responsible investors.

We believe it is in corporate interests to work towards the Paris Agreement objectives, UN Sustainable Development Goals, and other government policies to reduce carbon emissions, improve governance, and improve labour efficiency through investment.

This has always been the true through the lens of micro-economics (theory of the firm). It is now inescapable in a globe dominated by communications infrastructure (mobile, fixed, satellite) and social media where company information is easily accessible by everyone.

Exhibit 1: **Growth of Sustainable Investing Strategies, 2012-18 (USD trillion)**



Source: ACF Research, Global Sustainability Investment Review 2014 & 2018.

ESG investing assets 2018 grew 41% vs. 2016. Our forecasts suggest that ESG funding will only continue to grow in real terms, increasing the pool of funds for companies seeking investments that have an ESG policy.

Not having an ESG policy will result in a shrinking pool of retail and institutional money.

Or put another way, not having an ESG policy will lead to a rapidly shrinking pool of retail and institutional money and eventually a desert.

In our view, this will all happen a bit quicker than might be imagined as we also believe that COVID-19, essentially a health crisis, will only serve accelerate the move towards ESG by making retail and institutional investors more susceptible, rather than less, to its apparent and actual merits.

The expected unilateral acceptance of ESG

ESG has had measurable significant support from financial institutions since inception.

Among the seven filters described above, ESG has the most impact and has had measurably significant support from financial institutions (FIs) since its inception.

What started in 2004 with the United Nations initiative, 23 FIs and AUM of USD 6 trillion, had grown by YE18A into investing funds with AUM of over USD 17.5 trillion.

Exhibit 2: shows the evolution of ESG - from the creation of the first MSCI ESG index and captures the history of all the initiatives and networks created specific to ESG since inception.

ESG Index - In 1990, MSCI created the first ever ESG index, the MSCI KLD 400. The MSCI KLD 400 is a market cap-weighted stock index of 400 publicly traded companies that have met certain standards of social and environmental excellence, focusing on Socially Responsible Investing (SRI).

Who Cares Wins - Since 1990 several initiatives and networks have been created to promote ESG with the most notable being the UN Who Cares Wins initiative launched in 2004. Who Cares Wins is a global initiative endorsed by 23 financial insitutations from 9 countries with AUM of USD 6 trillion.

The **United Nations Principles for Responsible Investment (UN PRI)**, created in 2006, is a set of six global standards for responsible investing specific to ESG.

The six principles outline the responsibilities that investors have when making investment decisions.

(1) Incorporate ESG into all investment decisions;
(2) Incorporate ESG into ownership policies;
(3) Seek appropriate disclosure of ESG by companies;
(4) Promote the principles in the investment industry;
(5) Work together to effectively implement the principles;
(6) Report on activities carried out to implement principles.

This evolution in ESG only further highlights the importance of sustainable investing and dictates green business practices. In turn this has shifted the interest in the market players where we see retail investors wanting a piece of the pie.

- **2007** - The first **green bond** was issued by the European Investment Bank (EIB) in 2007 to fund climate protection related projects that it had listed on the Luxembourg Stock Exchange (LuxSE).

- **2014** brought the **Portfolio Decarbonization Coalition**, a multi-stakeholder initiative set up to help reduce greenhouse gas emissions by supporting investors in decarbonizing their portfolios.

- **2015** the **Paris COP21 Agreement** was signed with the goal to keep global temperatures below 2°C and limit further temperature rises to 1.5°C.

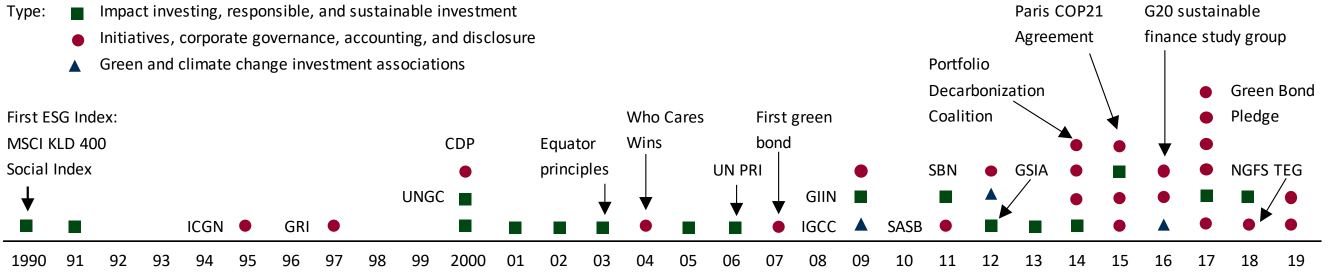
- **2016** - The **G20 Sustainable Finance Study Group (SFSG)**, previously known as the Green Finance Study Group (GFSG), came together in 2016 to brainstorm on how private investors could be encouraged to increase green investments. (Green investments are sustainable investments.)

- **2017** - The **Green Bond Pledge** was born in 2017 as a result of the SFSG. It declared that all bond transactions purchased for the purpose of funding long-term infrastructure projects should only be approved if climate risk is taken into consideration.

- **2018** - A group of central bankers got together to form the **Network for Greening the Financial System (NGFS)**. The NGFS is a consortium of highly specialized individuals coming together to share ideas on how to keep financial systems environmentally sound.

- **2019** - The **Technical Expert Group (TEG)** on sustainable finance was created by the EU in order to develop a unified classification system for green investments.

Exhibit 2: **Evolution of ESG Finance Associations, Standards, and Codes**



Source: ACF Research, IMF Global Financial Stability Report October 2019.

Market participants – the rise of retail

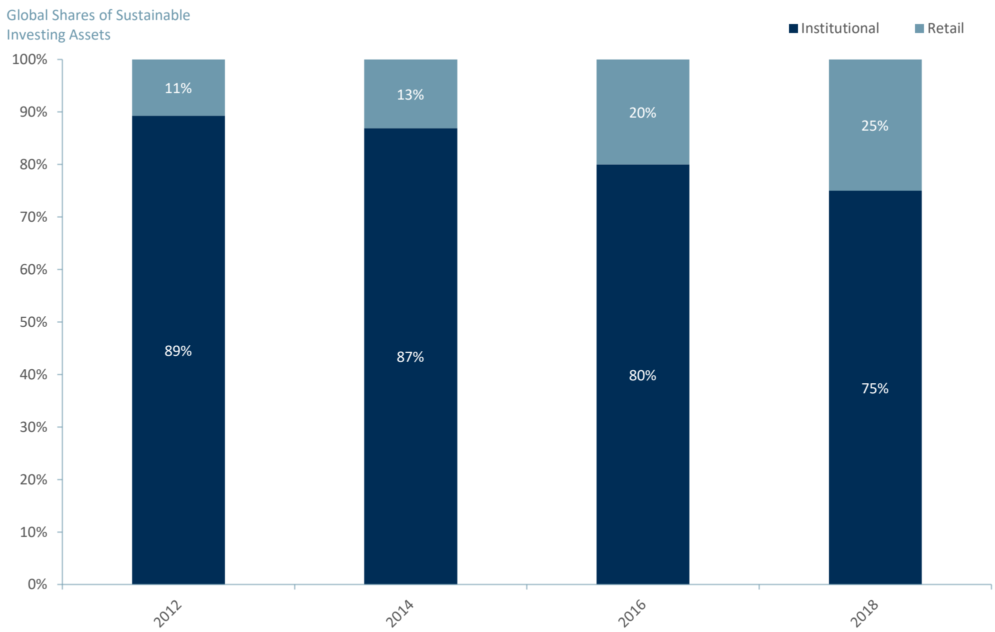
The share of retail money vs. institutional has been increasing.

Retail investors are also taking note of the increasing trend in investment sustainably and the importance of investing responsibly, joining a market that was dominated by institutional investors. There is a growing share of retail money in the total cash for ESG investing available to corporates, up to 25% by YE18 and we forecast that share of funds to continue to grow.

Observing the characteristics of the global market we can see retail investment now accounts for 25% YE18 of total funds available for ESG investing up from 20% in YE16. (Exhibit 3:)

We expect the percentage of retail investors to grow as a younger generation of investors will want to make their own decisions as to how they allocate their funds. This assumption is further explained in our forecasts.

Exhibit 3: **Shares of Institutional vs. Retail Investors 2012-18 (USD trillion)**



Source: ACF Research, Global Sustainability Investment Review 2014 & 2018.
Note: Institutional and retail investor data was not collected in Australia/New Zealand.

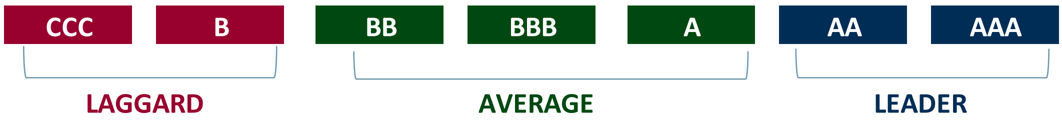
MSCI ESG rating system – how it works

As the rate of retail investor interest grows, how to qualify ESG filters appropriately is important.

The MSCI created an ESG rating ranking system comparing companies to their peers based on the ESG risks.

The MSCI has created an ESG rating system where companies are rated on a scale of AAA-CCC (Exhibit 4:).The companies are rated based on what kind of exposure they have to the different types of ESG risks as they compare to their industry peers in terms of trying to mitigate those risks (i.e. what actions are the companies taking to comply with ESG criteria vs. their industry peers).

Exhibit 4: **MSCI Rating Scale**



Source: ACF Research, MSC.

MSCI collects thousands of data points from each company however, the ratings are based on 37 key ESG criteria (MSCI), which can be grouped into three broader categories of environmental, social, and governance. (Exhibit 5:, Exhibit 6:, and Exhibit 7:)

Exhibit 5: **Key Environmental Criteria**

Environmental	
Climate Change	***Natural Resources***
Carbon emissions	Water stress
Product carbon footprint	Biodiversity and land use
Financing environmental impact	Raw material sourcing
Climate change vulnerability	
Pollution & Waste	***Environmental Opportunities***
Toxic missions and waste	Opportunities in clean tech
Packaging material & waste	Opportunities in green buildings
Electronic waste	Opportunities in renewable energy

Source: ACF Research, MSCI.

Exhibit 6: **Key Social Criteria**

Social	
Human Capital	***Product Liability***
Labour management	Product safety and quality
Human capital development	Chemical safety
Health and safety	Financial product safety
Supply chain labour standards	Privacy and data security
	Responsible investment
	Health and demographic risk
Stakeholder Opposition	***Social Opportunities***
Controversial sourcing	Access to communications
	Access to finance
	Access to healthcare
	Opportunities in health and nutrition

Source: ACF Research, MSCI.

Exhibit 7: **Key Governance Criteria**

Governance	
Corporate Governance	***Corporate Behaviour***
Board diversity	Business ethics
Executive pay	Anti-competitive practices
Ownership and control	Tax transparency
Accounting	Corruption and instability
	Financial system instability

Source: ACF Research, MSCI.

The MSCI criteria is succinct in highlighting the ESG filters that businesses need to make sure they incorporate into their business models. Having an ESG policy and reporting on an annual basis can only make a company more attractive to retail and institutional investors.

Businesses must ensure they follow the guidelines and principles that are in place in order to carry out activities in a way that does not compromise the environment, that is socially acceptable, and with improved governance policies.

Forecasts

ESG growth forecast

Our **ESG growth forecast** ranges from 6-10%. We are of the view that growth will be at the higher end of our range by 2020 resulting in total investments of USD 25.8 trillion made based on the ESG filter system. (Exhibit 8:)

Exhibit 8: **ESG Sustainable Investing Assets Forecast (USD trillion)**

Range	Current	Forecast High	Low
2012A	5.9		
2014A	12.9		
2016A	10.4		
2018A	17.5		
2019E	19.7	21.0	18.3
2020E	22.5	25.2	19.8

Source: ACF.

Drivers for our ESG forecast

Individuals are becoming more and more active in the fight against climate change. The COVID-19 pandemic has not changed that sentiment, if anything it has enhanced it. COVID-19 is first and foremost a health crisis, however we are of the view that it will cause a waterfall effect of other concerns such as economic (e.g. redistributing income to reduce poverty levels) and social (e.g. political corruption).

As a result of the lockdown the global levels of pollution have dropped significantly. According to the European Environmental Agency nitrogen dioxide (NO_2) levels have fallen between 30% to 60% in Barcelona, Madrid, Milan, Paris, and Rome. This is a direct result of approximately 20% of the world being in lockdown, airplanes begin grounded, and minimal road traffic.

While this is indeed a milestone to be celebrated, it is not a global one. Clean air, albeit temporary, is a luxury not shared by many and the most vulnerable will be in potentially worse conditions than before as COVID-19 is an airborne disease.

Companies will need to carry out business best practices that are not only in the interest of climate change. Social responsibility, primarily health and safety, will need to be enhanced. Governance policies will need to be improved in order to ensure that all changes are incorporated sustainably.

Share distribution forecast

Our **share distribution forecast** shows that the percentage of retail investors share versus institutional will increase. The retail share will be on the higher end and institutional on the lower end. Retail's share is forecasted to reach 33% by YE20. (Exhibit 9:)

Exhibit 9: **Share of Institutional vs. Retail (%)**

	Institutional		Retail	
Range	High	Low	High	Low
2019E	86%	79%	29%	26%
2020E	100%	83%	33%	28%

Source: ACF.

Drivers for our investor forecast

Many more Greta Thunberg's will emerge from this pandemic. Businesses will need to become more creative in how they can carry out activities sustainably and in-line with ESG principles.

What we will see is a lot of younger investors taking an interest in the markets. There will be a shift from them placing their funds in investment houses to investing their own money in what they think is important, which is the environment.

Glossary

AIM	Assets Under Management – Total market value of all financial assets that a financial institution (e.g. mutual fund, venture capital, or broker) manages.
CDP	Carbon Disclosure Project - UK based organisation that supports companies and cities in making environmental reporting a business norm.
COP21	21st Conference of the Parties (COP) – Paris climate conference that took place in 2015 and established the agreement to keep global temperature well below 2°C.
EIB	European Investment Bank – Publicly owned financial institution with shareholders from the EU member states.
ESG	Environmental, Social, and Governance – Metrics that measure the sustainability of a company or business.
FIs	Financial Institutions - Regulated institutions setup to control money supply in markets. (e.g. commercial and investment banks, brokerage firms, insurance companies, and asset management funds.)
GBP	Green Bond Principles – Clarify the approach to Green Bond issuances.
GIIN	Global Impact Investing Network – Non-profit organisation that promotes impact investing.
GFSG	Green Finance Study Group – Created to identify institutional and market barriers to green finance.
GSIA	Global Sustainable Investment Alliance – Globally increases the visibility of sustainable investment organisations.
ICGN	International Corporate Governance Network – Global organisation that promotes Corporate Governance standards.
IGCC	Investor Group on Climate Change - Largest global investor membership body that focuses on climate change. (AUM of USD 2 trillion)
LuxSE	Luxembourg Stock Exchange – Based in Luxembourg City.

MSCI	Morgan Stanley Capital International – US finance company that provides equity, fixed income, and multi-asset tools.
MSCI KLD 400 Social Index	MSCI KLD 400 - Market cap-weighted stock index of 400 publicly traded companies that have met certain standards of social and environmental excellence. (Focuses on Socially Responsible Investing (SRI)).
NGFS	Network for Greening the Financial System – A group of central bankers that promote sustainability to financial institutions.
PCB	Private Client Broker – A broker whose clients are private individuals.
SASB	Sustainability Accounting Standards Board – Non-profit that sets financial reporting standards.
SBN	Sustainable Banking Network – Unique, voluntary community of financial regulatory agencies.
SFSG	Sustainable Finance Study Group – Previously known as the Green Finance Study Group.
TEG	EU Technical Experts Group on sustainable finance – Was set up to develop a cohesive classification system for sustainable economic activities.
UNGC	United Nations Global Impact – Non-binding initiative to encourage businesses to adopt sustainable policies.
UN PRI	United Nations Principles for Responsible Investment – International network that supports investors to incorporate the 6 principles into their decision making.

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