Active is: Sharing insights

PART 1

Added value or a mere marketing tool? What does ESG mean for investments?

"Sustainability", in the broadest sense of the term, has long ceased to be a new concept for investors. It encompasses, among other things, "corporate social responsibility" (CSR) and "environmental, social and governance" (ESG) criteria. But what does all this mean for investing? Part 1 of this study explains the concepts and examines how ESG has become increasingly important in the investment world.

Hans-Jörg Naumer
Global Head of Capital Markets & Thematic Research
Allianz Global Investors

Sustainable investment has gained significant momentum in recent years. While it remains the playing field of institutional investors, the share of retail investors is increasing, and is likely to increase even more rapidly in the future. Not least because the index supplier MSCI and the fund rating agency Morningstar are providing benchmarks and funds with ESG ratings.

The acronym ESG (Environmental, Social, Governance) can be understood as connecting corporate sustainability criteria with investment decisions. Through ESG, sustainability also pervades individual investment styles. Recent developments show that sustainability is increasingly regarded as an assessment criterion for minimising investment risks and enhancing overall returns and no longer as an anti-performance investment approach.

This study

- classifies sustainable investment approaches;
- provides an overview of their significance (part 1); and
- provides a review of the current academic research on what sustainability means for the equity and bond markets (part 2).

Value. Shared.

Allianz Global Investors

One thing is for sure: the fact that rating agency Morningstar and benchmark provider MSCI started using ESG criteria in early 2016 as a basis for assessing all funds and benchmarks, regardless of whether they are managed on a defined ESG basis, is a big step in the direction of a general acceptance of these investment criteria. "ESG goes mainstream" is the buzzword, as the higher the transparency, the higher the demand is likely to be for using sustainability criteria.

„E – S – G"

Corporate social responsibility is to companies what ESG related criteria is to analysts and investors. ESG criteria can be seen as the common denominator for companies on the one hand and analysts/investors on the other.

The acronym "ESG" stands for Environmental, Social and Governance (the latter meaning corporate governance). The term and concepts for ESG criteria were first introduced in 2004 by the United Nations' Global Compact initiative, in order to provide analysts and investors a set of standards based on the United Nations' "Six Principles for Responsible Investment".[1]

There is no all-encompassing and definitive understanding or definition of ESG criteria. The Sustainability Accounting Standards Board (SASB)[2], an independent non-profit organisation, has committed itself to defining accounting standards for unified ESG-based valuations. The following overview of ESG criteria was derived from these standards, based on three main "E, S and G" criteria and expanded with a few points from the "Principles of Responsible Investment"[3; 4]:

[1] Cf. "PRI Reporting Framework 2016 Main definitions", UNEP Finance Initiative, November 2015
[2] www.sasb.org
[3] http://materiality.sasb.org/
[4] PRI Reporting Framework, Main Definitions, 2013

Figure 1: ESG: Environmental – Social – Governance classification according to the Sustainability Standards Accounting Board (SASB)

Environment

- GHG emissions
- Air quality
- Energy management
- Fuel management
- Water and wastewater management
- Biodiversity impact
- Lifecycle impacts of products & services
- Environmental, social impacts on assets & operations
- Product packaging

Social

- Human rights
- Community relations
- Customer welfare
- Data security & customer privacy
- Fair disclosure & labelling
- Labour relations
- Fair labour practices
- Labour standards in the supply chain
- Employee health, safety & wellbeing
- Diversity & inclusion
- Compensation & benefits
- Recruitment, development & retention

Governance

- Systematic risk management
- Accident & safety management
- Business ethics
- Incentive structures
- Reporting & audit practices
- Competitive behaviour
- Regulatory capture
- Political influence
- Materials sourcing
- Supply chain management

Source: www.sasb.org

Figure 2: The PRI (Principles for Responsible Investment) is a voluntary set of 6 investment principles

Source: "PRI Reporting Framework 2016 Main definitions", UNEP Finance Initiative, November 2015, unpri.org.

ESG criteria can be further developed on this basis, for example by making them measurable and applicable in the form of key performance indicators, but without establishing a fixed set of criteria that, in the United Nations' view, cannot be definitive as it would quickly become outdated [5]. The strength of KPIs can be seen in the fact that they can be tailored to each sector and then integrated into company research.[6]

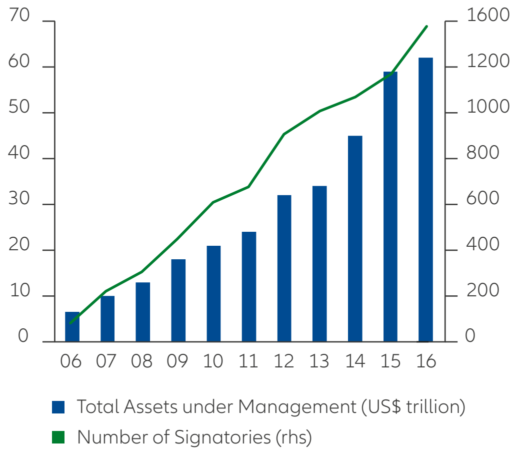
Strong increase in importance in recent years

CSR/ESG investments have long outgrown their status as a mere investment niche. This is reflected not just in their growing volumes – i. e., the money that is managed in accordance with CSR/ESG principles – but also in the growing body of research into this form of investment. Friede et al. estimate that the cumulative number of academic studies, which compare companies' ESG and financial performances, reached a record high of 2,000 studies in autumn 2015.[7]

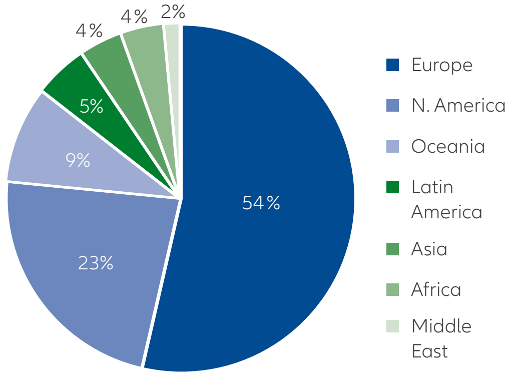
Assets managed according to ESG criteria have expanded just as dynamically. Money managed on the basis of the United Nations' principles of Responsible Investment (PRI) amounts to approximately USD 60 trillion – half of globally managed institutional assets.[8]

Figure 3: The PRI initiative has grown consistently since its launch in 2006

Over 1,600 signatories representing $62 trillion in assets



Signatories by region



Source: unpri.org. Data as of December 2016

„**Responsible investment** is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions."

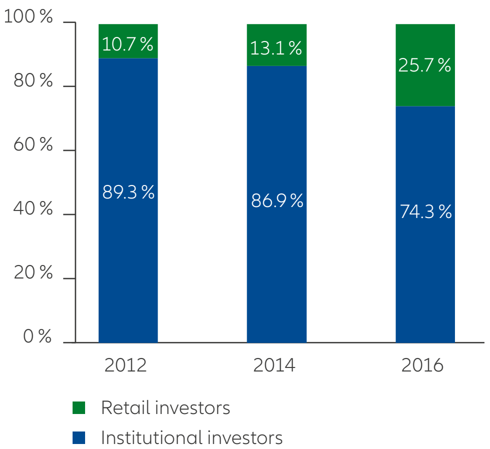
[5] Cf. UNEP Finance Initiative & World Business Council for Sustainable Development, "Translating ESG into sustainable business value", March 2010
[6] Cf. also EFFAS & DVFA, "KPIs for ESG" Version 3.0, 2010
[7] Cf. G. Friede, T. Busch, A. Bassen: ESG and financial performance. Aggregated evidence from more than 2,000 empirical studies, in: Journal of Sustainable Finance & Investment, 5. Jg. (2015), H. 4, p. 210–233
[8] www.unpri.org; „Signatory Base AUM Hits $59 Trillion".

Institutional investors still dominate the market, but retail investors' interest in sustainable investment is rising. While institutional investors accounted for 90% of sustainable investments in 2012, the figure had fallen to 74% by 2016.

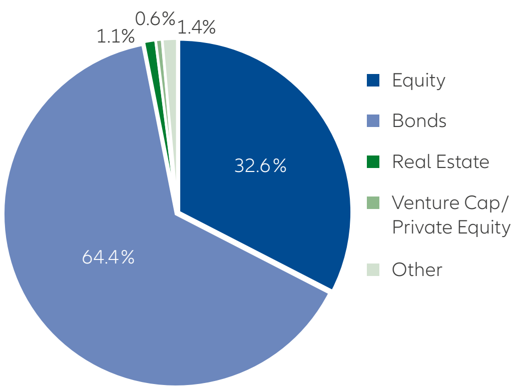
Broken down by asset class, the lion's share goes to equities (50%) and bonds (40%). Real estate, private equity and other forms of investment are much less represented, due no doubt to their lower overall market capitalisation in comparison with the two aforementioned asset classes.[9]

Figure 4: Institutional investors dominate the market, but interest from retail investors is growing

Breakdown of ESG AUM by investor profile



ESG asset allocation in Europe and Canada



Note: Other includes alternatives/hedge funds, money market/deposits, commodities and infrastructure.
Source: Global Sustainable Investment Alliance (GSIA): Global Sustainable Investment Review 2016.

A shift in analyst views

Another interesting fact: analysts also appear to have changed their views on CSR. Ioannou and Serafeim found that analyst recommendations in the early 1990s were rather negative on companies with high CSR ratings, but the situation has radically changed. Nowadays, a positive CSR rating increasingly has a positive impact on the overall valuation.[10] The perspective has evolved: CSR – and, accordingly, the observance of ESG criteria – used to be regarded as additional cost but is now seen as a way to enhance company management and investment returns. This raises the question whether, ultimately, it pays off to invest sustainably. Ideally, a sustainable investment approach should not be a drawback for an investment's risk-return profile. More on this in part 2, which provides an overview of the latest academic research.

Hans-Jörg Naumer

[9] Global Sustainable Investment Alliance (GSIA): Global Sustainable Investment Review 2016.

[10] Cf. I. Ioannou, G. Serafeim: The impact of corporate social responsibility on investment recommendations. Analysts' perceptions and shifting institutional logics, in: Strategic Management Journal, 36. Jg. (2015), H. 7, p. 1053–1081

Imprint

Allianz Global Investors GmbH
Bockenheimer Landstr. 42 – 44
60323 Frankfurt am Main, Germany

Hans-Jörg Naumer (hjn), Stefan Scheurer (st)

Data origin – if not otherwise noted:
Thomson Financial Datastream.

Allianz Global Investors
www.twitter.com/AllianzGI_DE

June 2017

Further Publications

AI & the Second Machine Age

→ AI – Artificial Intelligence Part of everyday life, driving our future

→ Capital Income for the second machine age

Active Management

→ Active Management

→ Active Management in Times of Disruption

Strategy and Investment

→ Capital Markets Monthly

→ Capital Income: Dividends

Alternatives

→ The Case for Alternatives

→ Liquid alternative strategies as an answer to the low interest rate environment

ESG

→ Added value or a mere marketing tool? What does ESG mean for investments? (part 2)

Capital Accumulation – Riskmanagement – Multi Asset

→ Multi-Asset: Your Assets in Perfect Balance

→ The Ulysses-Strategy of investments

→ The Ulysses-Strategy of investments (part 2)

Behavioral Finance

→ Behavioral Finance – outsmart yourself!

→ The 7 habits of successful investors