Investment views

Combining business with humanity

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Rothschild & Co
Wealth Management

Cover: The skyscraper designed in 2014 by Boeri Studio is one of Milan's most radical urban redevelopment projects. Its innovative use of biodiversity integrates the sophisticated lines of design with nature to ever-changing effect, highlighting the natural rhythms of the alternation of the seasons.

Investment Insights: William Haggard, William Therlin, Julia Bergman
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Foreword

The European banker Siegmund Warburg wrote in 1926 of his summer working in the Rothschild family's offices in New Court, London:

> *"You provided me with many opportunities to learn. I learnt quite a lot of details of business-machinery. But I learnt something also which will be far more important to me in my future life. This is the fine tradition of New Court which combines business with humanity, without neglecting either."*

Combining business with humanity, without neglecting either, is a core value of the Rothschild family and is illustrated in the numerous social housing projects which the family sponsored in London and Paris during the 20th century.

Yet it is arguably now in the 21st century that such values are needed more than ever and are finding a champion in the financial sector through the rise of **responsible investing**. In the decade following the Great Financial Crisis of 2008, the world's capital and its investors are under increasing scrutiny. Business' impact on environmental, social and governance (ESG) affairs are being questioned by a new generation of investors looking to measure not just financial but also social impact. For investors, this requires looking to the long term:

> *"Someone is sitting in the shade today because someone planted a tree a long time ago."*

We are reminded by Warren Buffet, of the power of planning, foresight and prudence in bringing about social good. From *Extinction Rebellion* to corporate governance activists, the world is waking up to the need to plant shade for future generations. In the first of a series of publications exploring the many facets of responsible investing, we interview experts from across Rothschild & Co's businesses on how we approach responsible investing and what it means for our clients today.

Dr. Carlos Mejia
CIO, Rothschild & Co Bank AG

Responsible investments

From the abolition of slavery to the Great Financial Crisis, we track the rise of responsible investing and the origins of ESG

Where we are today

As the pendulum swings back in many societies from a multi-decade era of profit-first corporate led expansion, responsible investing has moved from the margins to the mainstream of modern investment strategies.

Often referred to as sustainable investing or socially responsible investing, the umbrella term "**responsible investing**" which we will use in this publication has its modern roots in the late 18th century movement to abolish slavery and its associated economic activities.

Fast forward to the 21st century and at the corporate level, there is increasing recognition that companies have both a financial and social responsibility to their surroundings as climate change activism and populism puts late 20th century free-market capitalism in the spotlight.

Against this backdrop, responsible investing assets have almost tripled in the last decade and today amount to around $30.7 trillion.[1] This figure represents nearly a third of global assets under management, which are concentrated in five major markets (Figure 1).

Regionally, responsible investing now makes up more than 60% of professionally managed assets in countries like Australia and New Zealand. Along with Japan and Canada, these were the fastest-growing responsible investing markets in the two years to 2018. In global terms of assets under management, however, Europe remains the largest region for responsible investing with $14 trillion assets under management, with the US close behind.[2]

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In the financial community, responsible investing is now championed by the integration of **environmental**, **social** and **governance** (ESG) factors in investment and decision-making processes (see *The Origins of ESG*). Today, more than 11,700 public companies worldwide now disclose ESG factors, from a company's carbon footprint to its community impact, how it pays its executives to how it engages with issues as broad as poverty to gender inequality.

The responsible investing spectrum

Investing through the integration of ESG factors is in fact part of a broader spectrum in which one can partake in responsible investing (Figure 2). From traditional "ESG-blind" investing where financial returns are the only measure with which to assess a company's track-record (Figure 2 A), through to venture philanthropy (Figure 2 D) and philanthropic donations (Figure 2 E), clients should be aware of the pallet of options which exist in today's market.

Focusing on those strategies which combine both impact with profit, we conducted interviews with our Wealth Management and Global Advisory divisions at Rothschild & Co. Through the interviews starting on page 4, we shed light on the topics of responsible investing for Wealth Management clients and how responsible investing impacts businesses' approach to corporate governance and shareholder engagement.

Figure 1: The leading responsible investing markets and growth in assets

Asset values are expressed in billions ($)

Region	2016	2018
Europe	12,040	14,075
United States	8,753	11,995
Japan	474	2,180
Canada	1,086	1,699
Australia/New Zealand	516	734
Total	22,890	30,683

Source: Global Sustainable Investment Alliance 2018

[1] *Global Sustainable Investment Alliance 2018*

[2] *Idem*

The origins of ESG

In January 2004 the United Nations (UN) Secretary General Kofi Annan wrote to some 50 CEOs of major financial institutions and invited them to support an initiative brought forward with the *International Financial Corporation* and the Swiss Government. The aim is to develop guidelines for the better integration of **Environmental**, **Social** and **Governance** (**ESG**) factors by investors.

18 financial institutions from nine countries responded to Kofi Annan's call to action by producing a landmark report called *Who Cares Wins* in 2005. In the report, they called for amongst other things:

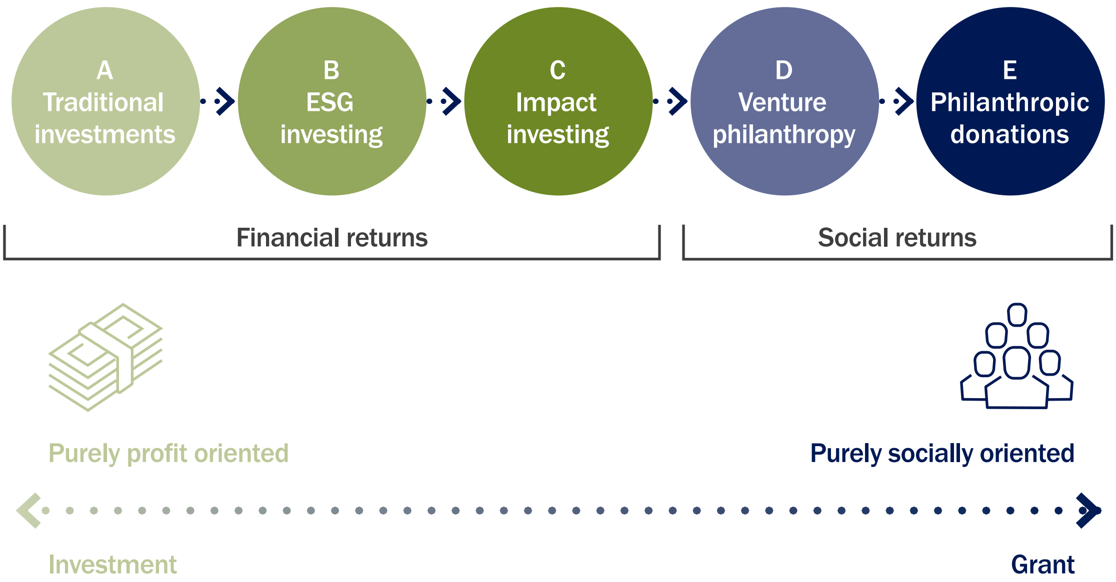
- **Analysts** to better integrate ESG factors in their security and market analysis;
- **Financial institutions** to commit to integrating ESG factors in their research and investment processes; and
- **Companies** to implement ESG principles and provide reports on related performance.

In 2006, the goal to integrate ESG into capital markets took a step forward with the launch of the UN's *Principles for Responsible Investment* (for more on the UN PRI – see page 7). Meanwhile, the New York Stock Exchange launched its first Sustainable Stock Exchange initiative. During these years, debate raged over whether ESG integration could be achieved without impairing financial returns and, if so, whether companies' duty of care to their shareholders extended beyond the maximising of profit to the consideration of ESG factors.

This debate was settled in the years following the financial crisis. In 2012/13 reports by academics such as George Serafeim, Bob Eccles and Ioannis Ioannou helped accelerate ESG's establishment in mainstream finance and demonstrated the positive financial impact ESG factors have in understanding corporate risks, strategies and operational performance.

As the decade developed, increased shareholder activism and political pressure has seen listed companies start to integrate ESG factors into their business models, conscious that investors are themselves coming under pressure to select businesses which have a strong ESG track-record.

Figure 2: The spectrum of responsible investment



ESG in managing wealth

Investment advisor Amaya Gutiérrez explores changing attitudes by private clients towards responsible investing

How relevant is responsible investing in the minds of wealth management clients today and why?

Recent market studies have shown that more than 80% of the general population show an interest in responsible investing. More importantly, that figure climbs to 95% in the case of millennnials, the younger generation born after the 1980s. This age cohort is particularly concerned about doing good, not just well: almost 90% of them expect investment advisors to look into a company's commitment to its values before proceeding to invest. In fact, more than half of millennials have discussed responsible investing with their financial advisor compared to only 11% of baby boomers.[3]

Growing awareness of the environmental movement and greater exposure to ESG considerations in the workplace (Figure 3) are important reasons why younger generations are turning to responsible investing today.

As a client, there are various ways in which you can approach the topic of responsible investing. Can you tell us what approaches people use?

The earliest and still most common approach applied in portfolios is to use "*Exclusion*" ESG criteria. This is where, with the client, we agree on a pre-defined list of sectors, activities or products which we will exclude from their portfolios. Such exclusions may include, for example, "*no alcohol producers*" or "*no companies with more than 5% of revenues selling firearms*".

Another popular ESG approach is to invest in "*Best-in-class*" businesses. In this case, we screen sectors to find the companies that have the best ESG ratings amongst their peers. This positive selection process tends to be done with the assistance of an ESG research house that scores companies depending on their environmental, social and corporate governance practices.

Beyond Exclusion and Best-in-class approaches, clients can gain a holistic exposure to ESG matters in their portfolio, through a full "*ESG Integration*" approach. This seeks to consider both the negative and positive ESG aspects of a business and involves the systematic inclusion of environmental, social and governance factors into our financial analysis. ESG integration tends to be accompanied by *Active Ownership*, where investors engage with companies so that they improve their best practices (see our interview with *Global Advisory*).

Finally, there is impact investing, an example of which is the *R-co 4Change Impact Finance Fund*. Given the need for specialist services in sourcing and reporting on impact investing, we tend to partner with a specialised platform for those wealth management clients wishing to invest in impact investing such as microfinancing.

An important question for clients then – what, if any, impact does ESG investing have on expected financial returns?

The overwhelming majority of studies in this field suggest that the impact of ESG factors on financial returns is at worst neutral and at times positive (see *Impact on financial returns* box).

[3] US Trust, Insights on Wealth and Worth, 2018; 2016; 2014. Survey of nearly 1,000 high net worth (HNW) and ultra high net worth (UHNW).

Six approaches to responsible investing

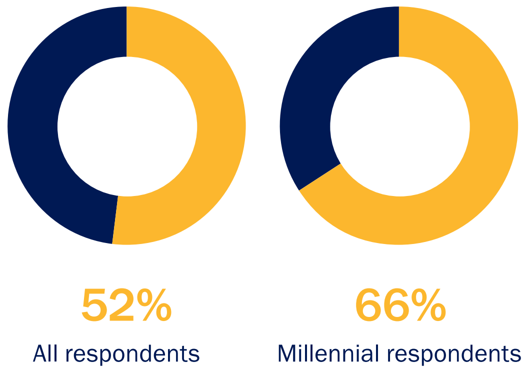
1. Exclusionary screening	Exclusion from a fund or portfolio of a sector, activity, product or service (such as firearms, weapons, tobacco and coal) in accordance with clients' wishes.
2. Best-in-class screening	Selection of securities based on their positive ESG performance relative to their industry peers.
3. ESG integration	The explicit integration by investment managers of environmental, social and governance factors into financial analysis and security selection.
4. Thematic investing	Within responsible investing, thematic strategies can be used to address long-term ESG challenges, with the aim of generating financial return.
5. Impact investing	Targeted investments aimed at solving specific environmental or social issues. Unlike thematic investing, investors measure equally social impact and financial returns.
6. Corporate engagement	The use of shareholder ownership to influence corporate behaviour and its application of ESG principals, either through direct engagement with companies' management boards or through proxy voting.

When looking at the data,[4] it should come as no surprise that companies with strong ESG credentials tend to have more sustainable business models. With better risk management and corporate governance, they also tend to have fewer negative, loss-making events associated with them such as fraud, litigation or environmental damage. In turn, these businesses have better access to capital and investors are willing to pay a premium for that. This is particularly so in emerging markets where corporate governance standards vary more widely than in the developed world.

In developed markets such as Canada and Europe where responsible investing represents almost 50% of total professionally managed assets,[5] companies which fail to display adequate ESG credentials will find fewer investors are willing to invest in them, impacting their share price. Moreover, poor ESG rated companies can be excluded from responsible investment indices, which in turn can also negatively impact on the company's share price.

Figure 3: Growing awareness

Integrating ESG factors in your business activities.



The percentage of high-net-worth (HNW) individuals who said they work for or own a company that is actively integrating positive ESG values into products, services and/or policies.

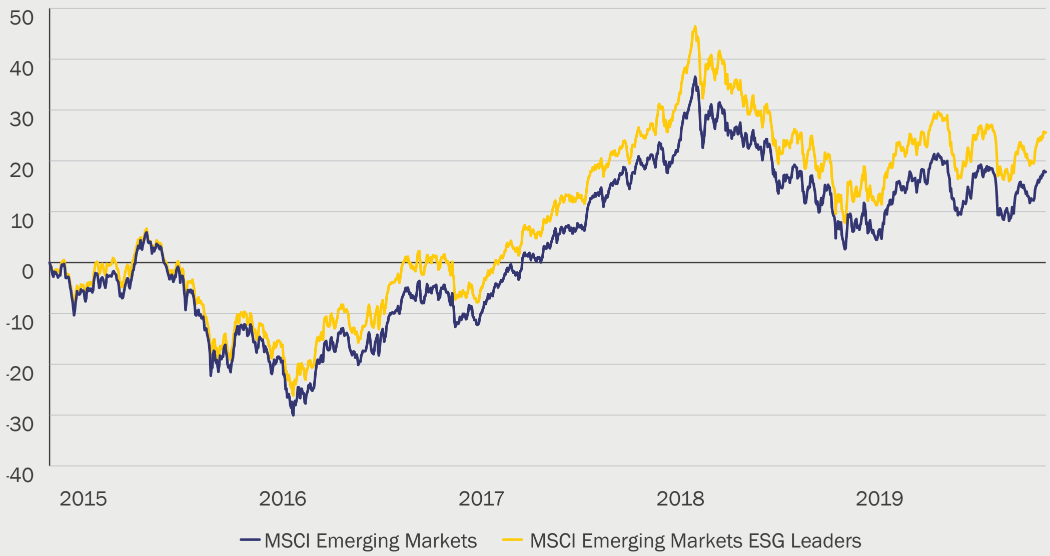
Source: 2018 U.S. Trust Insights on Wealth and Worth

Impact on financial returns

In the largest study of its kind in 2015,[6] the impact of ESG integration to investment processes was found to be in 90% of cases neutral or positive. Furthermore, in a second, smaller study that same year by Oxford University,[7] 80% of cases studied showed that ESG integration lead to enhanced financial performance for shareholders.

This positive trend is most evident when examining ESG integration in businesses from emerging markets. If we compare the MSCI Emerging Markets Index with the MSCI Emerging Markets ESG Leaders Index over the last five years, you will see that those who opted to invest in the ESG Leaders Index enjoyed an annual return of 4.6% over the 3.3% for the non-ESG index.

Figure 4: The impact of ESG on returns in emerging markets



Source: Bloomberg, MSCI

[4] *Giese, Lee, Melas, Nagy, Nishikawa. Foundations of ESG Investing: How ESG affects equity valuation, risk and performance, The Journal of Portfolio Management, July 2019.*

[5] *Global Sustainable Investment Alliance 2018.*

[6] *This involved the examination of over 2,200 separate cases: University of Hamburg, Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2,000 empirical studies, Journal of Sustainable Finance & Investment, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917*

[7] *Oxford, Arabesque 2015: Clark, Gordon L., Andreas Feiner, and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance." University of Oxford and Arabesque Partners. March 2015.*

Shareholder engagement and activism

James Laing from our Global Advisory business explains how ESG is shaping shareholder activism and corporate engagement

60-second brief

The rise of responsible investing has led to an increase in disclosure obligations and shareholder engagement as businesses seek to integrate ESG standards in their day-to-day activities. Since the launch of the *Global Reporting Initiative* in 2000, the *International Integrated Reporting Initiative* and the US-based *Sustainability Accounting Standard Board* have helped investors gain a greater understanding of companies' adherence to industry or sector-specific ESG requirements. On the specific topic of climate change, the *Task Force on Climate-related Financial Disclosures* has also led to an improvement in companies' reporting on de-carbonisation activities, where they face increased shareholder activism. To find out more about these initiatives and how companies are responding to ESG shareholder engagement, we conducted the following interview.

What challenges do companies and investors face in measuring the integration of ESG principles into everyday business?

A key challenge when advising companies on adopting ESG principles has been the lack of universally recognised classifications and standards in this field.

Defining the three pillars of ESG has proved difficult for many businesses and there is a danger that its adoption by companies can be "*window dressing*" if not done properly – this in the industry is called "*greenwashing*" and makes it difficult for investors to assess the true ESG impact of the companies they invest in.

Recently in Europe, the *2018 EU Action Plan* on Sustainable Finance has tried to address these issues by creating a unified EU classification system to assess whether an economic activity is environmentally sustainable (Figure 7). The Action Plan calls for:

- Standardised EU labelling for "green" financial products;
- Benchmarks for low-carbon investing;

Figure 7: 2018 EU action plan

The EU action plan aims to standardise ESG classifications and combat "*greenwashing*"

- Establish EU classification system for sustainable finance
- Create EU Labels for green financial products
- Clarify the duty of asset managers and institutional investors to account for sustainability in investment process
- Require insurance and investment firms to advise clients based on sustainability preferences
- Incorporate sustainability in prudential requirements
- Enhance transparency in corporate reporting

Source: European Commission

- Enhanced disclosure duties for asset managers; and
- Transparency requirements for environmental impact reporting.

All of these initiatives should help establish ESG's integration into businesses' every day activities.

Over the last few years, what has been a key shift in the ESG advisory work you undertake?

Until around five years ago, the emphasis of our advisory work was on **G** – governance. Corporate governance remains a central topic for listed businesses and we would argue a critical cornerstone around which any good environmental or social policies should be developed.

In recent years, with the rise of climate activism and the global concern around climate change, we have also seen a rise in the number of companies coming to us for advice on shareholder engagement regarding **E** – environment.

This is particularly the case in the energy and oil and gas industries which have had to rethink their environmental policies in the light of increased investor activism.

Why is corporate governance a cornerstone of a solid ESG policy?

Time and time again we see companies' corporate governance as a critical factor in retaining a happy and productive work force which in turn drives value for companies and its investors. One only has to look at public ratings websites like *Glassdoor* to see what the impact of a poor governance ratings can have not just on employee retention and recruitment but also on a company's share price. One of the key things we look for in good governance is an alignment between a company's strategy and its remuneration policy. As an advisor to many corporates we expect to see clear, publishable guidelines which explain how executive remuneration is correlated to the fulfilment of a company's business purpose and strategy.

With increasing awareness of responsible investing and greater shareholder engagement in ESG matters what are the key initiatives we need to look out for?

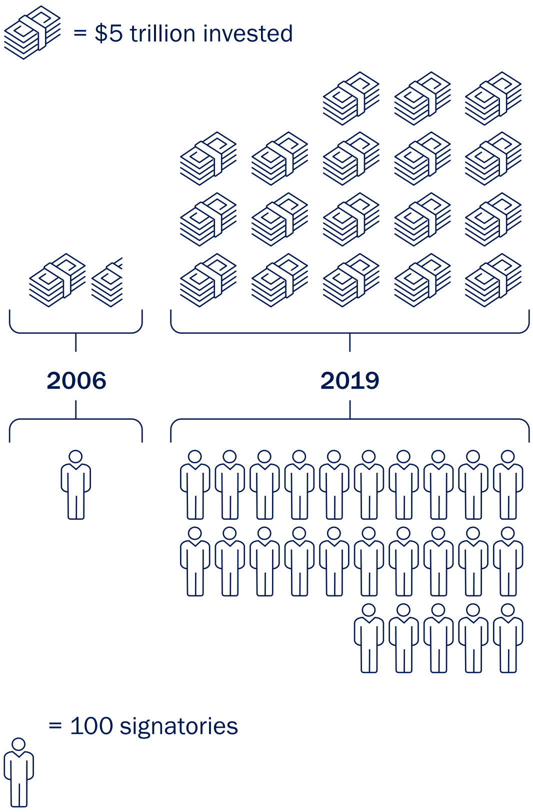
Many investment managers have signed up to the UN's *Principles for Responsible Investment* (see *The origins of ESG* on page 3). In 2006, investment companies with less than $7 trillion in assets under management pledged commitment to ESG standards. By 2019, this number had grown to $90 trillion (Figure 8).

On the company side, an increasing number hold annual votes on executive board pay and strategic ESG policies. This has given rise to greater shareholder engagement either through direct voting or through third-party proxy voting offered by agents like ISS or Glass Lewis.
In either case, the trend is towards greater investor voting engagement. This will continue as fiduciary duties to clients increasingly extend beyond maximizing returns, to a broader consideration and active say in companies' ESG policies.

In Europe, the EU's *Shareholder Rights Directive II* which came into force in 2019 applies to all EU listed companies and enhances this trend, encouraging investors to disclose how they vote in shareholder AGMs. This increases transparency and investors' accountability. Ultimately this initiative will empower shareholders with more information so that they can make more informed decisions when it comes to responsible investing.

Figure 8: Growth in UN PRI commitment

2,500 signatories investing $90 trillion have pledged commitment to the UN's PRI standards by 2019



Sources: European Commission, UN PRI, Harvard Business Review

Investment Insights

If you have enjoyed reading about responsible investing and wish to find out more, please do not hesitate to contact your client adviser.

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