Sustainable Investing: How to Do It

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Agenda

1. Motivation

2. Rise of sustainable investment (SI)

3. Stakeholder approach by companies

4. Policy proposals European Commission
   - Taxonomy of green investments (administrative approach)

5. Active investment approach
   - Private investors following a market-led approach

Motivation

- Last year's Bruegel essay on the why question:
  - Investing for the Common Good: A Sustainable Finance Framework
- Now the how question
  - Sustainable Investing: How to Do It
- Two issues on the how question
  - Who is in the lead: officials (taxonomy) vs market
  - Which method: ESG ratings vs fundamental investing

Rise of sustainable investing

Table 1: Proportion of Sustainable Assets to Total Assets Under Management (2015)

Region	SI assets	Total AUM	Proportion SI assets
Europe	11,059	21,025	53%
United States	8,012	37,094	22%
Canada	998	2,639	38%
Asia	483	18,583	3%
Australia	474	937	51%
Total	21,026	79,947	**26%**

Source: Bruegel calculations based on GSIA (2017)

Why integrate ESG?

- Why would corporates and financials look at ESG?
  - Anticipation of regulation / taxation (e.g. carbon tax)
  - Reputation – pressure from NGOs / consumers
  - Future-proof: transition to SDGs by 2030

Long-term value creation

- Social (S) and environmental (E) externalities linked to company's operations and products
  - Companies have choice of degree of sustainability in their business model

- What to maximise?
  - **Shareholder model**: max profits (F)
  - **Stakeholder model**: max integrated value (I=F+S+E)

- Institutional investors force behind sustainable invest.
  - Have powerful role in corporate governance
  - Business case: material ESG issues -> superior financial performance

Role institutional investors

Table 2: Share of institutional investors in equity (2016)

Type of institutional investor	Amount (in € trillion)	Share in equity markets
Pension funds and insurance companies	21.7	39.1%
Investment funds (excl. pension funds/insurers)	10.6	19.1%
Traditional institutional investors	**32.3**	**58.2%**
Sovereign wealth funds	3.1	5.6%
Hedge funds	0.9	1.6%
Alternative institutional investors	**4.0**	**7.2%**
Total institutional investors	**36.3**	**65.4%**

Source: Schoenmaker and Schramade (2019).

Policy proposals

- European Commission's Action Plan (HLEG)
  1. EU classification system for sustainable activities
  2. Incorporating sustainability in investors' duties
  3. Strengthening sustainability disclosure

- Why taxonomy?
  - ➢ Standards/labels, differing capital requirements, sustainability benchmarks, etc.
  - ➢ Technical expert group (ESAs, private sector, academia) advises Commission (keeps final responsibility)

Assessment of official taxonomy

- Official taxonomy may stifle innovation SI
  - Transition is dynamic process of ‘creative destruction’
  - Large incumbent companies will lobby Commission to include current business practices (status quo)
  - Small, more innovative, lack resources and time; and might be labelled ‘uncertain and unproven’
- Example – tighter emissions standards for cars
  - EP + EC keen to move
  - Car lobby managed to water down standards (Council)
- Alternative: market-led investment approach

Which method: ESG screening vs fundamental

Table 3: Sustainable investments by method (2015)

Method	Sustainable investments (in € billion)	Share (in %)
1. Negative/exclusionary screening	10,163	44%
2. Norms-based screening	5,094	22%
3. Positive/best-in-class-screening	494	2%
4. ESG integration	2,650	12%
5. Corporate engagement	4,275	19%
6. Sustainability themed investing	145	1%
7. Impact investing	98	0.4%
Total	**11,059**	

Note: The figures do not add up to the total, as some investors combine several methods for sustainable investment.

Source: Bruegel calculations based on GSIA (2017)

ESG ratings is not solution

- ESG ratings have limits by design
  1. Little focus on material issues
  2. Based on reported data and policies (fraction what is needed + bias towards large companies)
  3. Based on operations (e.g. least bad tobacco or coal company) and not on products/services

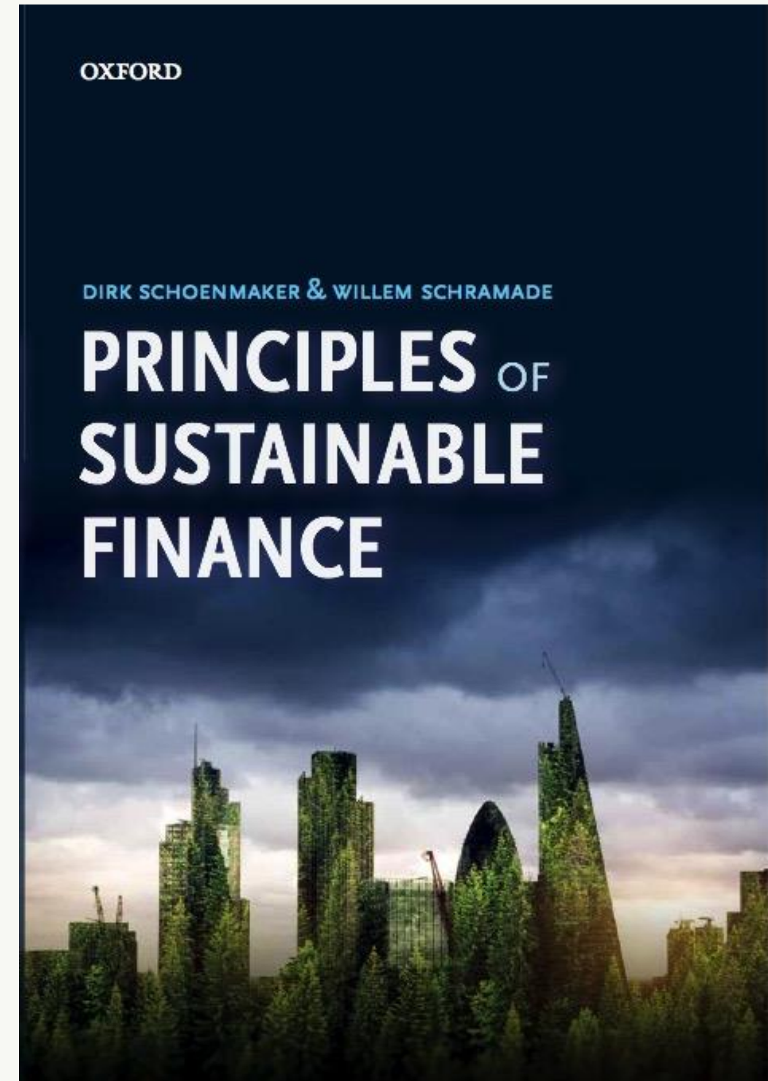
- Low correlation between ESG scores: 26%

- Big disconnect
  - ➢ More sustainable investments
  - ➢ But no improvement in sustainability outcomes

An active investment approach

- Institutional investors can realise LT returns by investing in and engaging with companies that pursue long-term value creation (I=F+S+E)

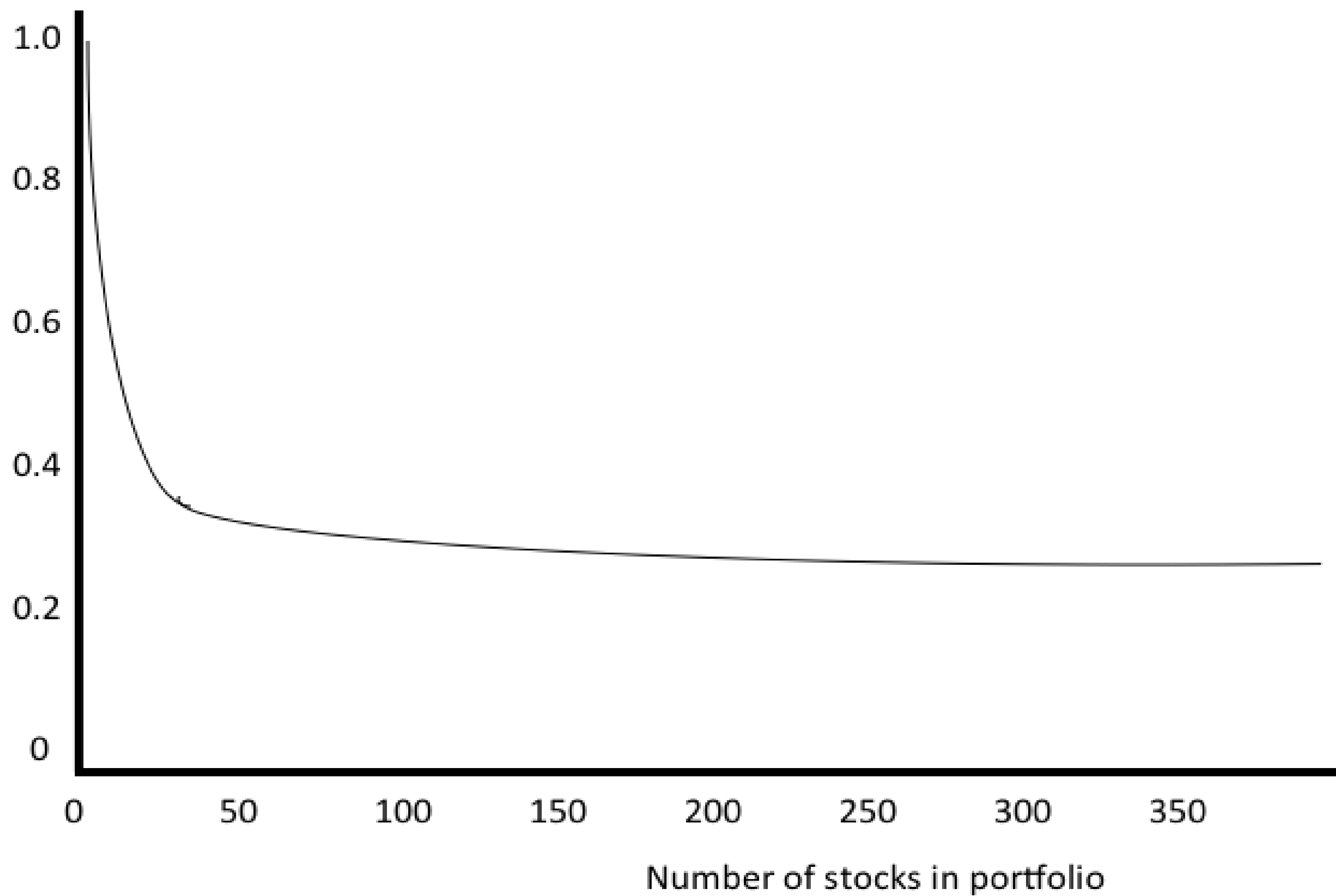
- Requires fundamental analysis of companies' business models to uncover companies' social (S) + environmental (E) value, alongside financial (F) value



Points for sustainable investing

1. Long investment horizon (intended holding period)
2. Active management in concentrated portfolio
   - You can only do fundamental analysis of 50/100 companies
   - Information advantage: investor reaps benefits
3. Effective engagement by analysts
4. Performance analysis of value-added
   - Market benchmark counterproductive
   - Absolute return target, e.g. 5-year average

Diminishing benefits from diversification



Conclusions

- Active investment approach with concentrated holdings
  - ➢ Fundamental analysis of business model (I=F+S+E)
  - ➢ ESG ratings too superficial (like credit ratings)
- Commission proposals on sustainability
  - ➢ Yes, include in fiduciary duty + more reporting
  - ➢ No official taxonomy: transition is dynamic process, while taxonomy may stifle innovation