

Sustainable Investing: Opportunities and Challenges



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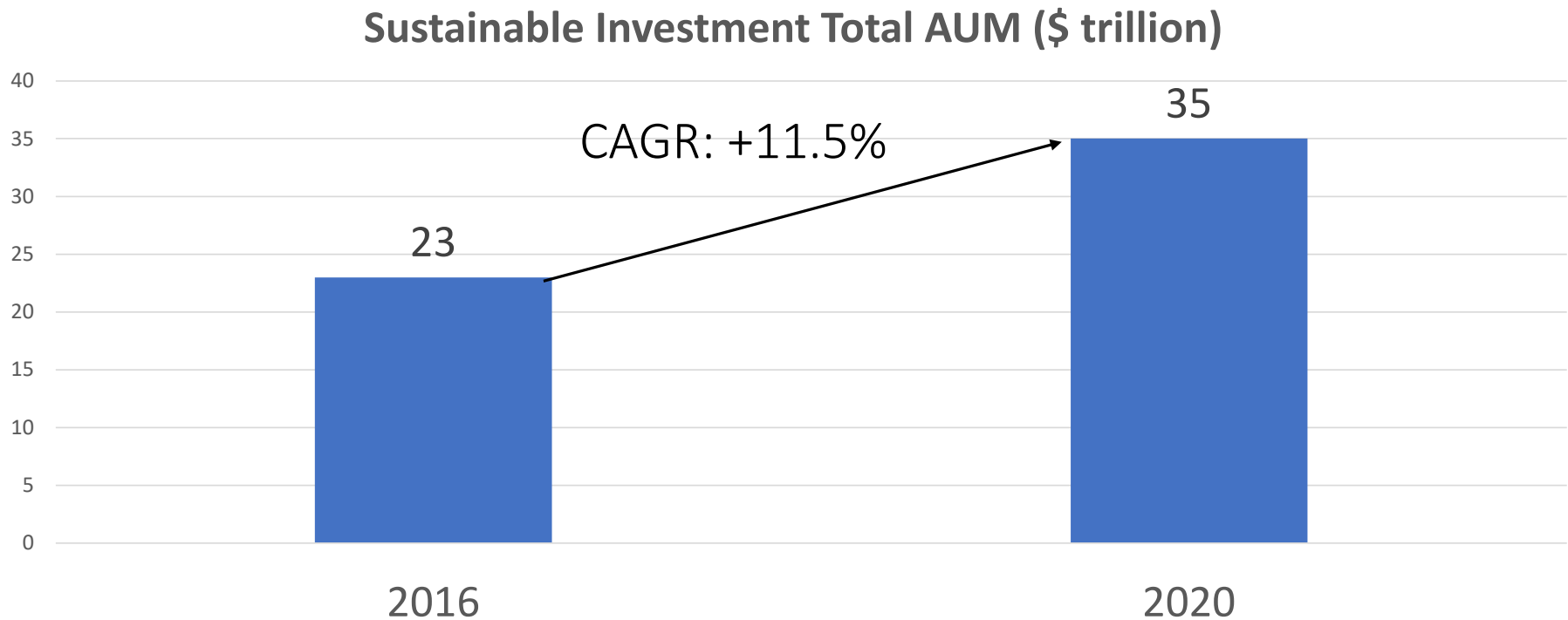
ESG/Sustainable investment (SI) is on a roll: 3 recent headlines from the FT...



...but recently also the focus of more critical scrutiny and controversy



SI assets under management (AUM) in 5 of the largest global markets* grew at an annualized 11.5% over the last 4 years

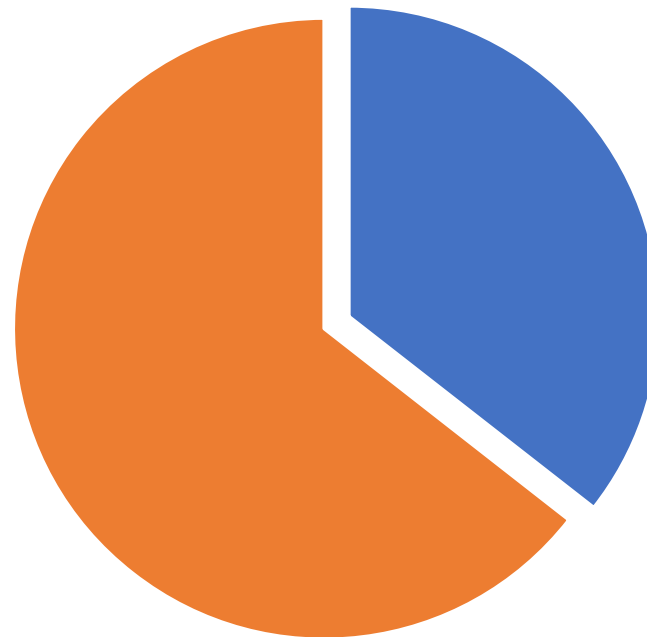


*US, Canada, Europe, Japan, Australasia.

Source: <http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf>

In 2020, more than one third of total AUM in 5 of the largest global markets* follow “sustainable investment” principles

Total AUM in 2020: \$98 trillion*



\$35 trillion or 36%
classified under
“sustainable investing, up
from 28% in 2016”

*US, Canada, Europe, Japan, Australasia.

Source: <http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf>

How is “sustainable investment” defined?

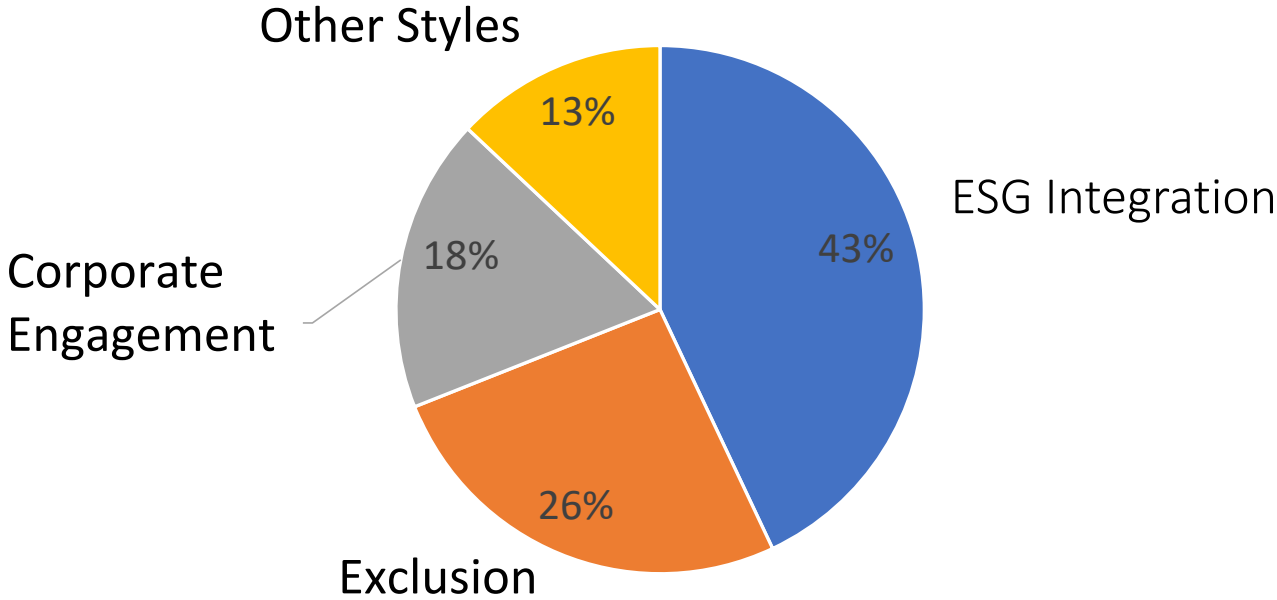
3 Main Investment Styles:

- **ESG Integration:** The systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis.
- **Exclusion:** The exclusion from a fund or portfolio of certain sectors, companies, countries or other issuers based on activities considered not investable. Exclusion criteria (based on norms and values) can refer, for example, to product categories (e.g., weapons, tobacco), company practices (e.g., animal testing, violation of human rights, corruption) or thresholds (e.g. carbon emissions).
- **Corporate Engagement:** Employing shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

* The 4 “Other Styles” include: “Norms-based screening” (7%), “Sustainability-themed” (3%), “Positive/best-in-class” (2%), “Impact/community-based” (0.1%).

These three styles account for 87% of sustainable investment AUM*

Sustainable Investing Styles



*US, Canada, Europe, Japan, Australasia.
Source: <http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf>

But how to
measure
ESG?

ESG measurement has become big business: up to 100 companies now publish ESG ratings

Little consistency in ratings methodology: recent academic studies show low correlation of ESG scores between different providers.

Recent CFA
Institute
study
confirms lack
of ratings
consistency

- “To find out, we conducted an analysis of six separate ESG ratings providers (incl. S&P, MSCI, Bloomberg) for a cross section of over 400 companies across 24 industries.
- Our conclusion? Different ratings methodologies tell vastly different stories about the same company. This demonstrates the immaturity of the current ESG ratings environment and highlights the need for improvements.”
- Correlation of long-term debt ratings of S&P and Moody’s: 96%
- Average correlation of ESG ratings: 35%

Source: <https://blogs.cfainstitute.org/investor/2021/08/10/esg-ratings-navigating-through-the-haze/>

More
standardization
on the horizon?

- On 3 November 2021, the IFRS Foundation Trustees announced the creation of a new standard-setting board—the International Sustainability Standards Board (ISSB).
- The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions

Two main motivations to follow SI



Investors may expect higher risk-adjusted returns.



Investing in SI will satisfy investor's stakeholders' expectations and avoid reputational risks

Larry Fink vs. Milton Friedman

“Sustainability and climate integrated portfolios can provide better risk-adjusted returns to investors”... “A company’s prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders.”

Larry Fink, CEO, Black Rock (2020)

“There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”

Capitalism and Freedom (1962)

<https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html>

A governance conundrum: who defines SI?

Should corporate managers decide on social policy issues?

On what basis should finance professionals who have not stood for election be making decisions about social policy?

Should investors delegate SI decision to institutional investors?

With the increasing trend towards index funds, the “Big 3” (BlackRock, Vanguard, State Street) have increased their share of S&P 500 companies from 5% in 1998 to more than 20% in 2020

Sustainable investing @ ADB

Two areas

- **Liquid asset corporate bond portfolio:** \$1.7 billion portfolio externally managed
- **ADB Pension Fund:** \$4 billion global portfolio externally managed

ADB corporate bond portfolio

2016: introduced a "socially responsible investment filter" to exclude aerospace/defence and tobacco sectors

2019: Remove issuer names with a 5% or greater share of their estimated revenue derived from business activities related to:

- Alcohol
- Tobacco
- Adult entertainment
- Gambling

In addition, also remove issuer names that are flagged as having any tie to the following business lines:

- Civilian firearms
- Weapons
- Nuclear power
- Child labor
- Cluster bomb
- Landmine

ADB corporate bond portfolio (cont'd)

In 2021,
two new
filters
were
applied:

- Issuers whose activities are flagged as having any tie to **fossil fuel reserves** were excluded from the benchmark.
- Introduced **MSCI's carbon emissions metric**, and exclude all issuers above an MSCI threshold of 100 (a metric that measures issuers' carbon emissions per sales (tons CO2 / \$M sales),
- Impact on expected book yield marginally negative at -5 basis points.

ADB Pension Fund

Since 2016:

- Exclude issuers that are involved in coal mining or power generation mainly from coal
- Exclude issuers with past record of violations of the United Nations Global Compact Compliance and Norms based on MSCI screening
- Invested in global ESG Fund
- Exclude issuers with main revenue source (over 50%) from the following:
 - Tobacco production and sales
 - Weapons production and sales

ADB Pension Fund (cont'd)

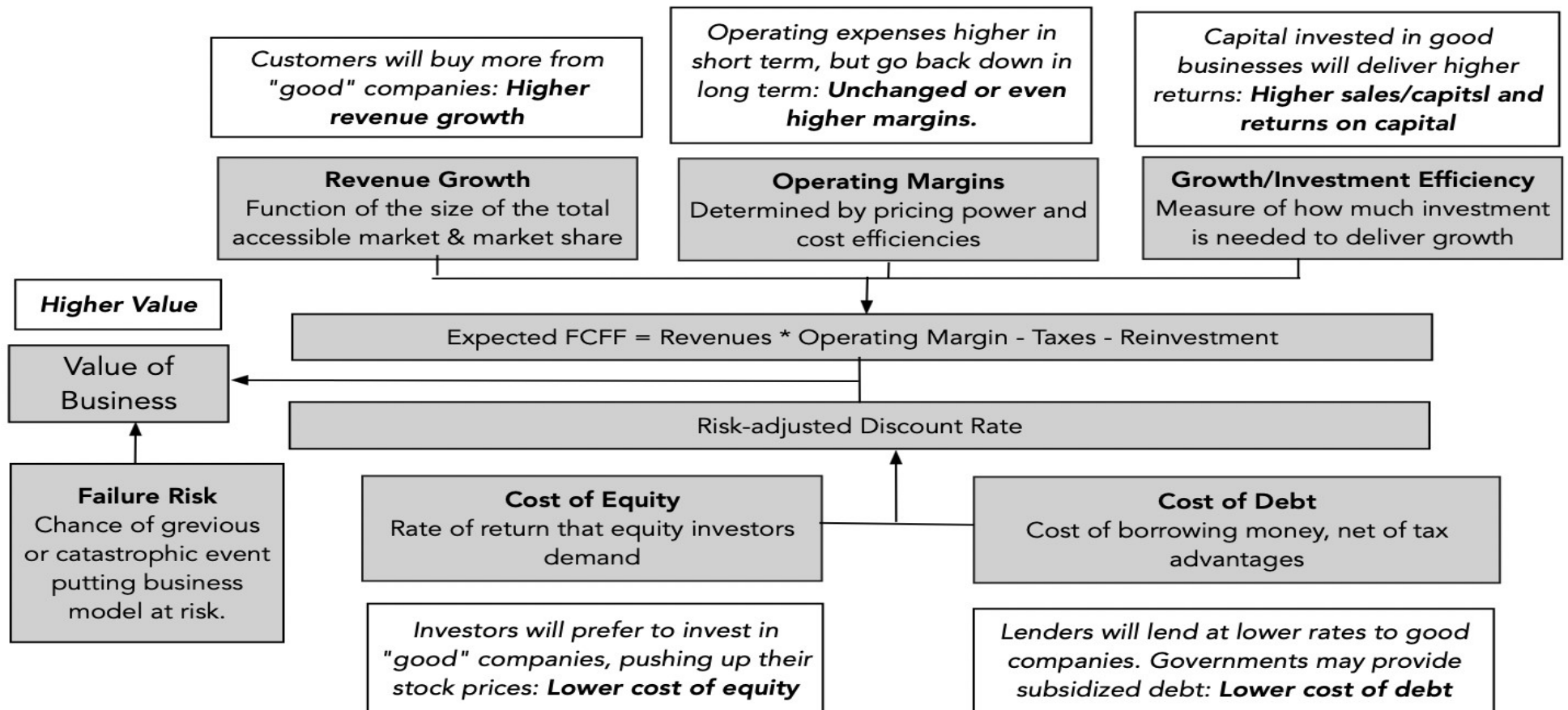
In 2022:

- Selling ESG Fund
- Shift passively managed global equity portfolio to MSCI World Global Low Carbon Index.
- Expected impact: marginally higher tracking error compared to investing in global benchmark (+30 basis points)

Appendix

Higher returns by investing in SI?

Figure 2: The Payoff to Being Good: The Virtuous Cycle



...or lower returns?

Figure 4: The "Bad" Companies win: The Dystopian Vision

