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01 Foreword

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As summer temperatures rise again to record levels and wildfires rage across Europe and North America, it is a fitting time to reflect on environmental risks and opportunities, and our impact on the world. Publication of the Intergovernmental Panel on Climate Change Sixth Assessment Report underlines a need for immediate and considered action to meet Paris Agreement climate targets. In this edition of Responsible Investment Quarterly we explore how such actions are being implemented at a portfolio, firm, national and global level.

According to the International Energy Agency (IEA), China accounted for 30% of global carbon dioxide emissions in 2019 and contributed just under two-thirds of the world's increase in emissions since 2000.[1] China's success in delivering its 2060 net zero target will greatly influence global carbon budgets and the likelihood of limiting warming to less than 2°C. The country offers both challenges and solutions. Around 70% of industrial carbon emissions are generated by steel, cement and chemicals with China alone accounting for 60% of steel and cement production.[2] Conversely, manufacturing capacity for clean energy technologies such as batteries and solar photovoltaic panels is concentrated in the country. Jin Xu and Jess Williams discuss investment implications in greater depth below.

While China has been a primary contributor to warming in recent decades, as of 2012 the US remained the largest contributor on a cumulative basis since the industrial revolution. In a dramatic volte face, President Biden's administration has recommitted the US to the Paris Agreement and is acting on newly announced net zero commitments. In our Country Focus on the US we explore sustainable investing Stateside and the trillion-dollar infrastructure plan which promises an economic renaissance built around low-carbon transport and green energy.

China accounted for 30% of global carbon dioxide emissions in 2019.

Source: iStock.

Can a trillion-dollar infrastructure bill solve these problems? The IEA, in its 2020 Energy Technology Perspectives report, estimates that more than $100 trillion of infrastructure investment is required from 2019-2070 to meet net zero, according to its Sustainable Development Scenario. 90% of this investment relates to electrification. While government support is necessary, especially in aiding the adoption of new technologies, effective allocation of capital in the private sector is required to fill a substantial funding gap. Financial institutions therefore occupy a critical role in deploying capital, identifying opportunities while helping their clients meet net zero targets, mitigating physical climate risk and instigating a capital allocation-like approach to carbon budgets. Representing our Credit and Responsible Investment teams, Paul Smillie, Rosalie Pinkney and Natalia Luna provide an update on how climate change stands to impact banks' financial performance.

London-listed banks and insurers accounted for nearly 20% of the FTSE100 in 2015; today, this has fallen to just 13%.[3] In addition to highlighting significant valuation discrepancies, Sonal Sagar and Michael Hamblett in UK Equities illustrate how the market's constituents are increasingly aware of and aligned with UN Sustainable Development Goals. Their viewpoint discusses how our investees produce or facilitate improved outcomes in both environmental and social spheres, from decarbonisation to investment in healthcare, social equality and sustainable infrastructure. This trend is likely to continue as the UK forges new regulation governing sustainable business and investment activities, learning from the European Green Deal, EU Taxonomy and related disclosure regulations. A Green Technical Advisory Group (GTAG) was formed in June to oversee the government's delivery of a Green Taxonomy.[4] This is reminiscent of the earlier EU Technical Expert Group which has helped shape the region's sustainable finance regulation.

A central responsibility of the UK government's GTAG is to clamp down on greenwashing.[5] This objective marks a recognition by authorities of the grey area around sustainability in which corporates, including asset managers, operate. Regulatory pressure is mounting worldwide with similar comments made by the US SEC, illustrated most recently by fund guidelines issued by the German Federal Financial Supervisory Authority (BaFin). Here at Columbia Threadneedle we are cognizant of shifting legislation during the construction and management of funds, emphasising client returns and downside risk management. With respect to Responsible Investment integration, a firm-wide transition is ongoing and enhanced investment tools and dashboards are entering beta-stage development. We adopt the same rigor when analysing issuers' claims and decarbonisation targets and have developed a proprietary cloud-based tool to assess their credibility. This not only aids the identification of industry leaders and laggards but facilitates more effective engagement and the prioritisation of research into new and existing investments.

Environmental factors encompassing climate change are important components of analysis, varying in materiality according to industry, location and idiosyncratic exposure. However, the equitable consideration of social impacts – even for environmental investments such as carbon offsets – is vital. In many cases, the compromise of social values may sooner jeopardise a company's licence to operate than transgression of environmental standards. It is encouraging to note the industry's appreciation of this, and increased attention towards operating policies and practices with reference to the UN Global Compact and Guiding Principles on Business and Human Rights.[6] Exploring this theme further, Kelly Cavagnaro closes the quarter's commentary by rethinking the social purpose of asset management.

Source:

1 Energy Technology Perspectives 2020 (windows.net)
2 Net Zero by 2050 – A Roadmap for the Global Energy Sector (windows.net)
3 FTSE 100 Index weights by Industry Group (GICS) for 'Banks' and 'Insurance' calculated by Bloomberg on 25 August 2015 (19.6%) and 25 August 2021 (13%)
4 Independent expert group appointed to advise Government on standards for green investment - GOV.UK (www.gov.uk)
5 New independent group to help tackle 'greenwashing' – GOV.UK (www.gov.uk)
6 Efforts underway on Human Rights equivalent to CA100+ (responsible-investor.com)

02 Portfolio manager's viewpoint

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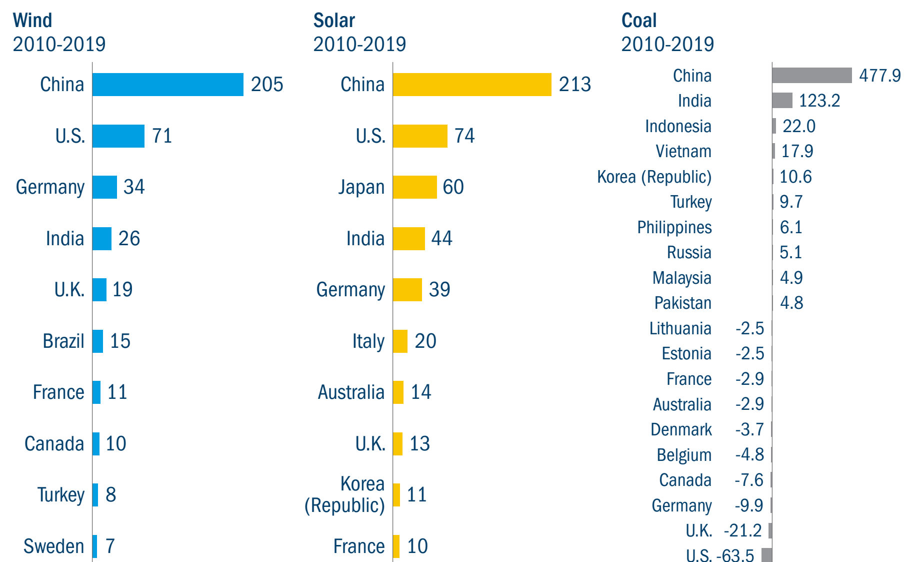
China is a double-edged sword: it is the world-leading renewables developer, installing more than double the gigawatt (GW) capacity of its nearest competitor over the past decade both in terms of wind and solar power (Figure 1), but at the same time it has seen the highest coal capacity additions over the same period – nearly quadruple that seen in India. The Chinese government announced it is aiming to reach peak coal emissions by the end of the current five-year plan ending in 2025, but new coal plants with 40-year life spans do not fit well with a 2060 net zero emissions target. China is a country of great progress and great opportunity, but also of contradictions.

Figure 1: China's renewable output



Source: Bloomberg New Energy Finance, 2020.

In absolute terms, China is the biggest contributor to global emissions – but this is mostly due to its size. When looking at emissions on a per person basis it is much lower than the US and roughly in line with the EU – the big difference, however, is that after more than a century of rising emissions, the EU is now on a downward trajectory while China's are not (Figure 2). Another point to consider with country level emissions is that these are production-based emissions figures. This means that the emissions generated from the production of Chinese-made goods which are consumed in the EU or the US is captured in China's footprint. If we looked at per capita consumption emissions, China would likely look much better than the EU, the US and the UK.

Fig 2: Comparing emissions

Per capita emissions (tonnes C02e)	2017	2018	2019
United States	16.2	16.6	16.1
China	6.9	7.0	7.1
EU-27	7.0	6.9	6.6
United Kingdom	5.8	5.7	5.5

Source: Our world in data, 2020.

With China's new net zero targets and its existing leadership in the renewables space – the country produces 70% of the world's solar panels, half the electric vehicles and has a large share of a lot of the materials that underpin battery technology – it is unsurprising that investors have been taking a closer look at the Chinese renewables market. Increasing investor attention, especially from ESG-conscious investors, has driven a rise in corporate attention to sustainability disclosure. The use of forced labour in supply chains is a particular area of focus and risk currently.

Towards the end of 2021 it is expected that a more detailed decarbonisation roadmap will be published. This could solve some of the coal conundrums and is likely to focus on three key areas: carbon pricing, green finance and tech investment. These developments have the potential to accelerate the already bullish scenario.

The market size of the opportunity is huge. The International Renewable Energy Agency (IRENA) predict that by 2050 8,519 GW of solar would be required in a <2 °C degrees of warming scenario in line with the Paris agreement – this represents an 18x increase on 2018 levels. Asia, and mostly China, is predicted to account for more than 50% of total installed solar power compared to 20% in North America and 10% in Europe. Onshore wind predictions tell a similar story, with 5,044 GW required by 2050 – 9x what had been installed by 2018. IRENA predicts that more than 50% of this capacity would also be in Asia.

With the recent announcements indicating a step change in the focus on energy transition, the improving disclosure standards and the significant opportunity set, we believe the Chinese market could be one to watch. Although, importantly for international ESG investors, this will be conditional on ensuring that supply chains have no exposure to the Uyghur human rights abuses in Xinjiang.

03 Country focus – United States

While one in every three dollars in the US is managed following sustainable investment strategies, and the nation is the world's largest country issuer of green bonds, there remain significant opportunities for growth. Early signs indicate the Biden administration could provide a 'turbo boost'.

When it comes to climate change, the intentions of President Biden's administration could hardly be clearer: within hours of assuming power he had announced that the US would rejoin the Paris agreement.[1] Since then the US has announced targets in line with Article 4 of the Paris Agreement to cut emissions to 50%-52% below 2005 levels by 2030 and to achieve carbon neutrality by 2050.[2]

There has been similar positive impetus in responsible investment (RI). Biden's choice as head of the National Economic Council, Brian Deese, is an expert in sustainable investing. Further, Biden has created the position of climate tsar on the National Security Council. Most crucially, he has also begun to roll back key regulations introduced in the Trump era which were designed to discourage investments based on environmental, social and governance (ESG) criteria.

Earlier this year the Department of Labor announced it would not enforce a requirement for plan sponsors such as 401(k) providers to take and document certain steps to confirm that they were not sacrificing financial returns when devoting money to environment, social and governance -focused investments.[3] Separately, having voted in 2020 against requiring certain disclosures relating to ESG, the Securities and Exchange Commission (SEC) is now preparing a framework of rules to govern ESG reporting.[4]

Despite a pushback against ESG investing under the Trump administration, the sector is well-poised. At the start of 2020, total US domiciled assets under management following sustainable investment strategies[5] had grown to $17.1 trillion, up from $12 trillion at the start of 2018 and representing a third of all assets under professional management.[6]

Institutional investors make up a large proportion of this, accounting for $6.2 trillion at the end of last year, with public pension funds representing more than half that total.[7]

Sustainable funds in the US also continue to attract record inflows. In 2020, flows into US open-ended and exchange-traded sustainable funds hit $51.1 billion, more than double the year before and almost 10 times the level of 2018, both of which were record years.[8] According to research from Morningstar, investments into sustainable funds represented 24% of total flows into US stock and bond funds in 2020.

The Covid-19 pandemic, combined with the 2020 election result and growing concerns over climate change, are likely to support continued strong investment flows into sustainable funds.

When it comes to green finance, the US also boasts a vibrant market. In green bonds, it tops global rankings with $51.1 billion of issues in 2020, according to Climate Bonds Initiative.[9] However, Germany and France, in second and third place with $40.2 billion and $32.1 billion of issuance respectively,[10] have more developed green bond markets relative to the size of their economies, in part because both countries have launched benchmark-setting sovereign green bonds.

To date, there has been a reluctance by the US Treasury to follow suit. But, given Biden's commitment to tackling climate

change, analysts are closely watching whether the current US government will soon commit to launching a green bond, a move which would add further impetus to the market.

Even so, counting all cumulative debt issued, the US remains the world's largest single country issuer of green, social and sustainability (GSS) bonds, buoyed by multiple repeat issues of green and social bonds by Fannie Mae, a large guarantor of mortgages. In fact, Fannie Mae is the largest green issuer in the US: by the end of Q1 2021 it had launched 4,200 deals totalling $94 billion.[11]

Green bonds have a significant role to play in transitioning the US to a greener economy. Globally, energy was the most popular use of proceeds of green bonds in 2020, followed by low carbon buildings and low carbon transport. The US is little different. Since the inception of the US market, buildings have been the leading use of proceeds of green bonds followed by renewable energy.

Despite this, the US economy remains heavily reliant on fossil fuels. Last year the country was the largest oil and natural gas producer globally, and in 2019 82% of primary energy production in the US came from fossil fuels – down from just 86% in 1990.[12]

But the Biden administration has set ambitious targets for change. Currently, almost two thirds of electricity generation comes from fossil fuels. Under the US decarbonisation policy, Biden has set a goal to reach 100% net neutral electricity by 2035. This should help underpin further strong growth in US green bonds.

There is certainly massive growth potential. Despite its size, GSS debt represents only a tiny proportion of debt markets and, in the US, just 0.6% of the $46 trillion US bond markets.[13]

To date, the largest green bond from a non-financial corporate is the $1.5 billion issue by Apple in 2016, the proceeds of which were used for renewable energy and energy and water efficiency projects. Indeed, companies like Apple, Microsoft, Berkshire Hathaway and Visa are viewed as leaders in sustainability, helping propel the US to 13th place in a global ranking of 48 countries, according to the latest Morningstar Sustainability Index.[14] However, Europe continues to lead this index with the Netherlands, France and Finland the top three countries in the world when it comes to corporate-level sustainability.

It is clear the European Union (EU) has progressed further than the US when it comes to sustainable investing. This has been partly through the European Green Deal which is aiming for European climate neutrality by 2050, and EU Taxonomy rules which require financial services firms to disclose how products fare in terms of environmental sustainability.

Despite a strong global position in green bonds and sustainable investing, it is time for the US to play catch up. From roll backs of anti-ESG rules to the US government's $2 trillion climate plan, the early signs from the Biden administration for both green finance and responsible investment are positive.

Source:

1 https://www.state.gov/the-united-states-officially-rejoins-the-paris-agreement/
2 United States of America Nationally Determined Contribution, April 21, 2021.
3 U.S. Department of Labor Backtracks on Controversial Trump-Era ESG Rules, *ESG Today*, https://www.esgtoday.com/u-s-department-of-labor-backtracks-on-controversial-trump-era-esg-rules/
4 SEC to Move Quickly on Proposed ESG Disclosures, *The National Law Review*, https://www.natlawreview.com/article/sec-to-move-quickly-proposed-esg-disclosures
5 US SIF counts two main strategies as sustainable investing: ESG incorporation (applying various environmental, social and governance (ESG) criteria in investment analysis and portfolio selection) and filing shareholder resolutions on ESG issues.
6 The US SIF Foundation's Biennial "Trends Report" Finds That Sustainable Investing Assets Reach $17.1 Trillion, *US SIF*, https://www.ussif.org/blog_home.asp?Display=155
7 Sustainable and Impact Investing – Institutional Investors 2020, *US SIF*, https://www.ussif.org/Files/Trends/2020%20Trends%20Report%20InfoGraphic%20-%20Institutional%20Investors.PDF
8 A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights, *Morningstar*, https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights
9 https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html
10 Record $269.5bn green issuance for 2020: Late surge sees pandemic year pip 2019 total by $3bn, *Climate Bonds Initiative*, https://www.climatebonds.net/2021/01/record-2695bn-green-issuance-2020-late-surge-sees-pandemic-year-pip-2019-total-3bn
11 North America State of the Market 2021, *Climate Bonds Initiative*, https://www.climatebonds.net/files/reports/north_america_sotm_final.pdf
12 North America State of the Market 2021, *Climate Bonds Initiative*, https://www.climatebonds.net/files/reports/north_america_sotm_final.pdf
13 North America State of the Market 2021, *Climate Bonds Initiative*, https://www.climatebonds.net/files/reports/north_america_sotm_final.pdf
14 Morningstar Sustainability Atlas, *Morningstar*, https://www.morningstar.com/content/dam/marketing/emea/shared/guides/Sustainability_Atlas_2021_April.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=22496

Mention of specific issuers is not a recommendation to deal.

04 Climate change to bear upon banks' financial performance

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For investors evaluating financial institutions, the climate crisis will soon become a key consideration. Our research shows there is already a wide dispersion between the sector leaders and laggards.

In his historic 2015 speech, Mark Carney, then Governor of the Bank of England, invoked the spectre of a "Minsky moment", a climate-driven collapse in asset prices. Back then his words seemed dystopian, a distant prospect. Today, however, they look more prescient.

A broad spectrum of central banks fear climate change could spark the next financial crisis. For this reason, regulators in Europe and the UK are already beginning to scrutinise banks' resilience to climate change – looking into both the likely stresses from the shift to a zero-carbon economy over the coming decades, and the impact of extreme weather.

For now, though, central bankers' anxiety is not reflected in fixed income or equity markets, which seem relatively unaffected by climate risk. Yet over the next few years climate change could become a key driver of financial performance and an important factor for investors evaluating banks. Even in the short term there are risks to earnings, while in the medium term it is likely that banks judged to have higher climate-related exposures will face higher capital requirements, not to speak of reputational risks.

But this is not just a question of risk. Looking ahead a few years, there may also be opportunities for the banks that lead the financing of the transition to a zero-carbon economy. Indeed, it is estimated that green investing and financing could harvest as much as $50 billion of revenue over the next five to 10 years.[1]

Drivers of change

As climate change becomes a defining topic, we believe it will soon no longer be enough for banks to make high-level climate pledges. Under mounting scrutiny they will have to improve climate risk disclosure, show that climate considerations feed through into underwriting standards and reduce their carbon footprints.

Although the extent of banks' lending exposure to fossil fuels is relatively modest – carbon-intensive sectors to-date represent less than 10% of European banks' lending exposure – a climate crisis could increase banking system losses by up to 60%, according to European Central Bank (ECB) calculations , and impact earnings as fossil fuels account for 10%-15% of global wholesale banking revenues.[3]

Already reputational risk is rising. Take the criticism of JP Morgan Chase in 2020 for its energy lending.[4] It was revealed as the biggest financier of fossil fuels globally in a report compiled by a collaboration of non-governmental organisations (NGOs)[5] including Rainforest Action Network and BankTrack. With public feeling about climate change mounting, the possible damage to reputations should not be ignored.

Bank regulators are beginning to enforce change, especially in the EU and the UK. The French and Dutch central banks ran climate stress tests in 2020; the Bank of England did so in 2021; and the ECB plans to in 2022. Looking forward to 2025, the European Banking Authority intends to introduce its ESG capital review, which will differentiate the capital treatment of assets according to environmental and social factors. In the UK, banks will have to abide by the standards of the Task-Force for Climate-Related Financial Disclosures by 2025, providing standardised information on their climate risks.

In the US, too, tougher regulation is clearly coming. In November 2020 the US Federal Reserve identified climate change as a risk to financial stability for the first time. What's more, President Biden has stated that he views climate change as a priority and plans to require public companies to disclose climate-related financial risks.

Leaders and laggards

So far, though, there is little evidence that banks are cutting back their fossil fuel lending, with the important exception of coal. But investors may soon start differentiating between the leaders and laggards as better regulatory disclosure allows them to do so. Additionally, shareholder engagement and NGO activism could soon impact bank stocks' valuations.

We conducted an engagement exercise with more than 50 banks globally. We asked questions around climate strategy and climate risk management and followed up with a series of meetings. We found clear patterns emerging. At a high level, some of the UK, Dutch and Swiss banks are performing well. The Nordic, French, Spanish and Japanese banks are a little further behind and the Irish, German, Italian and Chinese banks are lagging.

We have started to factor banks' exposure to climate change risks into our research. While climate change is not yet impacting banks' earnings or capital requirements, it could do so as soon as two to five years from now. As we look forward two years when evaluating companies, we are now incorporating this into our fixed income research and assigning relative ratings to banks. These ratings are beginning to affect portfolio construction.

In our view, it will not be long before investors generally start to differentiate between the leaders and laggards. That will create an opportunity for active investors, while rewarding the banks that have acted early to address climate change with a competitive cost of capital.

Source:
1 Morgan Stanley, 2021.
2 European Central Bank, 2021.
3 https://www.banktrack.org/article/banking_on_climate_change_fossil_fuel_finance_report_card_2020
4 FT.com, JPMorgan Chase promises to shift portfolio away from fossil fuel, 7 October 2020.
5 Banking on Climate Change, https://www.ran.org/wp-content/uploads/2020/03/Banking_on_Climate_Change__2020_vF.pdf, March 2020.

05 The case for sustainable investing in the UK

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In the UK, vaccination rates were rising and pandemic restrictions easing as we moved into the summer. As this becomes something increasingly seen around the world, it gives us an opportunity to reflect on the existing trends the Covid-19 pandemic has accelerated, including a focus on environmental, social and governance (ESG) analysis and sustainable investing.

Greater company awareness of ESG factors, particularly the social factors as they pertain to employee health and safety, and the investment community's desire to become more responsible custodians has shifted the narrative of what the true goal of investing should be.

Tailwinds for sustainable investing

Since 2015, the United Nations' 17 Sustainable Development Goals (SDGs) has represented a catalyst for change.[1] The past 20 months of the pandemic have been a watershed moment for governments globally – with structural trends supporting achievement of the goals:

Decarbonisation There has been an acceleration of net zero targets from governments around the world, including China by 2060[2] and the US by 2050.[3] In November 2021 the UK will be the focus of the world when Glasgow hosts the 26th United Nations Climate Change conference, where the focus will be on increasing the pace of global decarbonisation,

with implications for all sectors. We expect decarbonisation targets to become more ambitious.

Sustainable infrastructure
Forthcoming infrastructure spending is material: the EU will invest more than €600 billion in the next five years[4] and President Biden's $1 trillion infrastructure bill is making its way through the Capitol. In the UK, public sector investment is at its highest level in 65 years.[5] With the built environment contributing around 40% of the UK's total carbon footprint,[6] sustainability will form a key part of budgeting decisions.

Social equality and inclusion
People in lower-income communities have been disproportionately affected by the pandemic. The increase in focus on the S in ESG means addressing social inequality is a key part of economic recovery programmes through, for example, improving access to education, financial services and technology.

Healthcare The importance of innovative healthcare companies and strong systems has been highlighted by the pandemic, as has the need for encouraging healthier habits and lifestyles, across all age groups. Governments worldwide will increasingly focus on public health programmes such as around mental health and wellbeing, in addition to obesity reduction strategies, including healthier eating and encouraging exercise.

The case for sustainable investing in the UK

There is a strong desire to align global investment positively with the SDGs. The backdrop of structural megatrends mentioned above should be good news for investors in the UK equity market, which has a plethora of companies exposed to these trends and which we continue to believe is undervalued (Figure 1 and Figure 2).

Around 75% of companies in the FTSE All Share earn their profits from outside the UK,[7] and so offer global exposure to under-the-radar sustainable leaders, backed up by the market's solid corporate governance practices. Yet there is a large valuation disparity between both the index and some of those global sustainable leaders (Figure 2).

Figure 1: The UK provides a rich set of opportunities to invest in global sustainable leaders

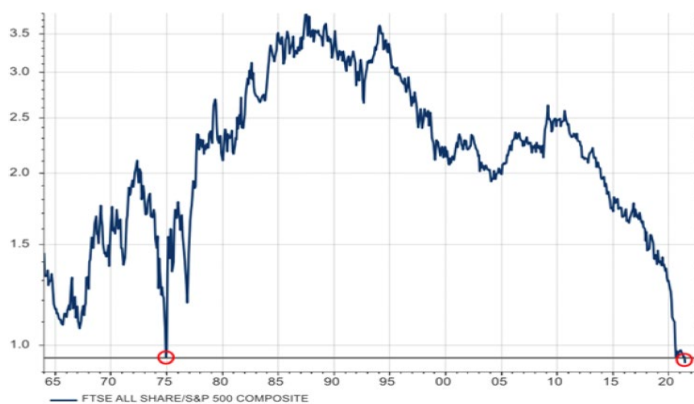
Structural theme
Infrastructure ■ UK public sector investment to highest level in 65 years. £100 billion over 5 years ■ A boost to growth of 0.3-0.4% of GDP[1]
Decarbonisation and Energy Transition ■ Increase in global net zero targets, COP26 as a driver
Healthcare innovation ■ Support of the UK's world leading hub for life sciences **Inclusive education, financial services and technology** ■ Financial inclusion, Social mobility, levelling up

Source: Columbia Threadneedle Investment, August 2021.

Figure 2: UK versus US and Europe

Valuation	Price to Earnings 2021E	Dividend Yield (%)
UK	13.4x	4.0
Europe ex UK	18.5x	2.6
USA	22.7x	1.4

UK shares at record low relative to US



Price-to-book valuation of UK versus US[3]

Source: Bloomberg, as at July 2021. The mention of stocks is not a recommendation to deal.

We see value in the UK market which continues to trade at too wide a discount relative to international indices. The certainty around Brexit and success around the vaccine roll out should put the UK market in a strong position to perform. In the first half of 2021 the FTSE All Share has rallied but continues to remain a laggard versus some global indices. The opportunity for valuation arbitrage remains and, as a result, merger and acquisition activity in the UK is at record levels.

Our investment process

For those products that target specific sustainable outcomes, we aim to identify businesses with strong, long-term performance potential whose products and services have a demonstrable positive impact on the environment or society, measured through revenue alignment with the SDGs alongside strong or improving ESG characteristics, fundamentals and an attractive valuation.

Engagement is a key part of the UK Equity team's investment process, which often utilises non-standard ESG and sustainability data. We meet CEOs and CFOs during results roadshows, as well as chairmen, other board members and heads of sustainability to assess thoroughly companies' fundamentals, financials, ESG risk management, targets and, crucially, sustainability. Essentially we are interested in how these companies are mapping their strategies with a global shift to sustainable investment.

Our robust and fully integrated process – focusing on ESG, sustainability and strong fundamentals in an undervalued market – means we are well positioned to benefit from the UK's broad opportunity set of global investment, megatrends and the rise of ESG analysis and sustainable investing.

Source:

1 Then for end: https://www.un.org/development/desa/publications/sdg-report-2017.html
2 https://www.reuters.com/article/un-assembly-climatechange-idUSL2N2GJ105
3 https://www.theguardian.com/us-news/2021/mar/15/race-to-zero-america-emissions-climate-crisis
4 Recovery and Resilience Facility, 28 May 2020.
5 https://www.ft.com/content/8c6b43ec-5fc3-11ea-8033-fa40a0d65a98
6 https://www.ukgbc.org/climate-change/
7 https://www.investorschronicle.co.uk/ideas/2021/05/10/could-the-uk-be-the-trade-of-the-decade/

06 Rethinking the social purpose of asset management

Kelly Cavagnaro
Head of Global Consultant Relations

Growing up in suburban Boston in the 1990s there were a few certainties in my life: the Red Sox were never going to win a World Series, girls who liked maths were just not cool, and pink should be worn at every opportunity. A more esoteric "truth" during that time was the belief that societal initiatives and capital allocation were mutually exclusive. Today, writing this while sporting my brightest pink scarf, I am happy to report only one of those "certainties" remain – a subtle but powerful recognition of a changing world where, increasingly, capital allocators are appreciating the benefits of aligning their investment decisions with societal trends as part of a holistic process that aims to improve investment outcomes – and society – together.

Over the past few years within the asset management community there has been growing support for investment decision making frameworks that better assess and incorporate factors that were historically considered "non-financial", such as climate change and diversity in all forms.

Driven by mounting evidence that consideration of such factors can help identify investments that are better positioned to manage the risks, challenges and growth opportunities inherent in a business, it has become increasingly clear that this is no longer the age old "value versus values" debate, but rather there has been an extraordinary and exciting definitional change whereby factors that were historically considered non-financial by many are now objectively material. For example, Aon recently concluded that "integrating ESG into the investment process and investment strategy is inherently consistent with fiduciary duty and acting in the best long-term interests of stakeholders".[1] Enter the convergence of societal initiatives and capital allocation – an integration that is redefining investment decision making.

Asset managers undoubtedly play a vital role in allocating capital for investors, including assessing the financial impacts of these evolving societal initiatives. In fact, prudent allocation to well managed companies who consider all factors impacting risk and return is often considered an essential component of a sound investment process. At Columbia Threadneedle Investments we have found similar efficacy in our own responsible investment (RI) ratings as signals of potential long-term competitive advantage. Through this lens of expanding investment research to include newly deemed material factors that influence a risk/return profile, even the most capitalistic investor is challenged to rethink their approach if they are to remain aligned with evolving market drivers.

For example, it has become a commonly accepted principle that assessing the risks involved in energy transition can shape an informed view of a company compared to its peers and provide a more thorough picture of investment opportunities and challenges. Indeed, such a view is quickly becoming foundational to identifying businesses that are better equipped to deliver long term value.

Driving these developments is the increasingly critical role that both regulation and demand play in addressing climate change, diversity and other important societal issues – laying the groundwork for more engagement for the common good. Capital is flowing strongly towards businesses with a focus on sustainability as a lever to create a more secure tomorrow: sustainably invested assets globally grew 15% over the past two years;[2] 36% of all professionally managed assets are now managed sustainably; and as at the start of 2020, total US domiciled assets under management following sustainable investment strategies had grown to $17.1 trillion, up from $12 trillion at the start of 2018.[3] Clearly, these are major forces at play that are shaping global capital markets, influencing change and highlighting an industry in transition.

Likewise, public policy and regulatory developments further contribute to the integration of societal initiatives and capital allocation as topics such as climate change become a more significant focus in Washington, DC and around the world. Here too, organisations that can anticipate and take action to improve items such as sustainability and reporting ahead of governmental policies can seize the opportunity to create and deepen material competitive advantages. In the US, for example, sustainable investing regulations are becoming ever more intertwined with fiduciary responsibility as the Department of Labor recently announced a decision to not enforce a requirement for plan sponsors such as 401(k) providers to take and document certain steps to confirm that they were not sacrificing financial returns when devoting money to environmental, social and governance-focused investments. Likewise, the European Union Sustainable Finance Action Plan has established new definitions for sustainable and responsible investment embedded in legislation, accelerated by an international sustainability agenda that highlights the role of finance in effecting meaningful change through global agreements like the Paris Agreement and the United Nations Sustainable Development Goals.

RI encompasses many important issues, one of which is diversity. This is another initiative that has rightfully and powerfully taken centre stage with an emergence of research supporting better decision making by companies with diverse teams. There is no shortage of data reflecting the simple truth that varied backgrounds, experiences and overall world views can help foster a mosaic approach that improves business strategy. For example, Willis Towers Watson recently found that “investment teams with diversity, particularly ethnic diversity, tend to generate better excess returns”.[4] Diverse environments have rightfully become sought after for broader thinking and innovation; inclusive cultures are seen as the bedrock for creativity and forward thinking. We know the statistics here: Fortune 500 companies with a higher representation of women on their boards outperform their peers by 53%; and organisations with high ratings for inclusion and diversity are 70% more likely to have success in new markets and 45% more likely to improve their market share.[5] Whether it be social factors such as diversity, or environmental factors such as carbon usage, the data is plentiful to support the clear alignment of these historically non-financial factors into a sound and defensible investment thesis.

While seemingly obvious today, this is the ah-ha moment. Thirty years ago – even just five years ago – it would have been incomprehensible that societal ambitions could be a key component of successful fundamental research, containing quantifiable sources of competitive advantage for asset owners and managers. Such transformational shifts in capital allocation decisions occur so rarely in our industry that we must pause and reflect that we have arrived at a new paradigm – that there exists a new social purpose within asset management. In place of community service days and grants to worthy causes (which are still great things to do!) we now talk about a fiduciary responsibility to incorporate such insights as vital inputs into research processes, thereby enhancing the ability to identify companies best positioned to generate sustainable long-term returns.

The social purpose of asset management does not stop at integration of societal insights into sound investment processes, however. When viewed as additive from a return generation perspective, it becomes clear that responsibility lies with asset managers not just to source and incorporate these factors, but to lead on advancing societal initiatives that we believe can enhance return on investment, such as diversity or environmental, social and governance issues. If we believe there is untapped value creation to be found in these areas, it becomes our obligation as fiduciaries to help unlock it.

Further, it becomes necessary for us to support regulation that strengthens the disclosure requirements of the companies in which we invest and to lead effective engagement and stewardship programs to further enhance client outcomes. While not a given, many asset managers today – Columbia Threadneedle included – have begun to take a more focused approach to engagement, emphasising direct dialogue with both companies and policymakers on ESG issues that have a material impact to sustainable long-term performance.

What can be easily overlooked in this argument, however, is that this social purpose of asset management also does not stop outside of our own glass houses. Ultimately, if we are to be authentic in our conviction it is equally our responsibility to hold that mirror up to ourselves, to ensure that we are on the same journey to live up to the standards we are setting for the companies in which we invest. This means continuing to shine a light on the relevance of these critical factors until it is common practice to integrate such material considerations into every fibre of our culture. It means advocating for environmental awareness of our own carbon usage, further bolstering the privacy of our networks, publicly supporting regulatory regimes that demand transparency, understanding and sharing our own data, and embracing true diversity among our teams.

Leading by example in this way can quickly seem an overwhelming journey with generations of complex factors to untangle; yet as fiduciaries, such self-directed social purpose must be approached as an additional tool for enhanced long-term valuation, even if that value is our very own. Like so many things, the way forward often begins with the simple recognition that change occurs first from within, acknowledging small truths and setting attainable goals towards meaningful change, no matter what glass might break along the way. For me, that first small step is celebrating the certain truth that took this suburban Boston baseball fan decades to verbalise: girls who like maths are, undoubtedly, cool.

Source:

1 Aon, New Aon paper outlines the benefits of ESG integration in investment, 19 March 2021.
2 Global Sustainable Investment Alliance, Global Sustainable Investment Review 2020.
3 The US SIF Foundation's Biennial "Trends Report" Finds That Sustainable Investing Assets Reach $17.1 Trillion, *US SIF*, https://www.ussif.org/blog_home.asp?Display=155
4 https://www.willistowerswatson.com/en-US/Insights/2020/10/diversity-in-the-asset-management-industry
5 Catalyst: The Center for Talent Innovation.

STEWARDSHIP IN ACTION

Our stewardship activities are integral to our investment process, allowing us to detect inflection points and long-term trends, and influence companies' standards around ESG risk management and sustainable outcomes. A key focus is to enhance our investment research so that we can make informed capital allocation decisions as active investors.

The ultimate goal of our stewardship approach is to enhance our understanding of risks and opportunities, strengthening our ability to deliver sustainable long-term value for clients. In approaching these responsibilities we are mindful of market trends; company, local market and industry-specific issues; and relevant best-practice standards – but we will ultimately be guided by what is in the best long-term economic interests of our clients.

The research and analysis emerging from this, and the ongoing engagement with companies, is disseminated globally throughout the firm as part of our culture of research intensity and helps us identify potential issues at an early stage.

In prioritising our engagement work, we focus our efforts on the more financially material or contentious issues and themes, and the issuers in which we have large holdings. There are many companies with which we have ongoing engagements, as well as a number that we speak to on a more ad hoc basis, as concerns or issues arise.

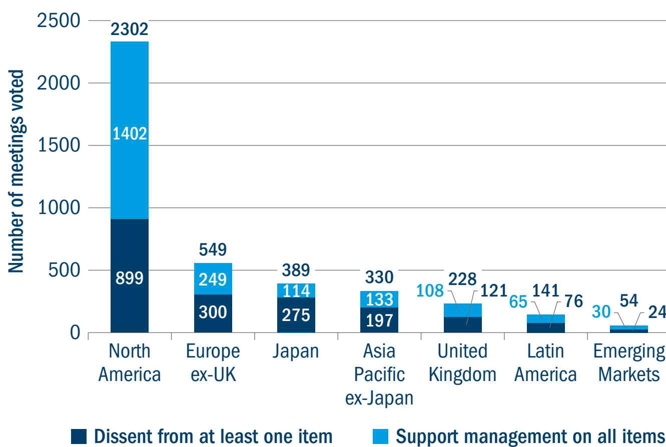
We vote actively at company meetings. We view this as one of the most effective ways to signal approval (or otherwise) of a company's governance, management, board and strategy, or standards of operating practice. While analysing meeting agendas and making voting decisions, we use a range of research sources and consider various ESG issues, including companies' risk management practices and evidence of any controversies.

Our final voting decisions take account of research issued by proxy advisory organisations such as ISS, IVIS and Glass Lewis, as well as MSCI ESG Research. Although we subscribe to proxy advisors' research, votes are determined under our own custom voting policy. Within this, material or controversial proposals receive enhanced due diligence and are voted on by the investment team, with support from the RI team. Votes are cast identically across all mandates for which we have voting authority. All our voting decisions are available for inspection on our website seven days after each company meeting in EMEA/APAC, and are updated annually in September in the US.

07 Voting Q2

Between April and June 2021 we voted at 3,993 meetings across 58 global markets. This compares to 620 meetings voted across 44 global markets in the previous quarter (Q1). Of the 3,993 meetings, 3,588 were annual general meetings, 181 combined annual/special, 201 special, 13 court, nine proxy contests and one written consent meeting. We cast at least one dissenting vote in 1,892 meetings (47%).

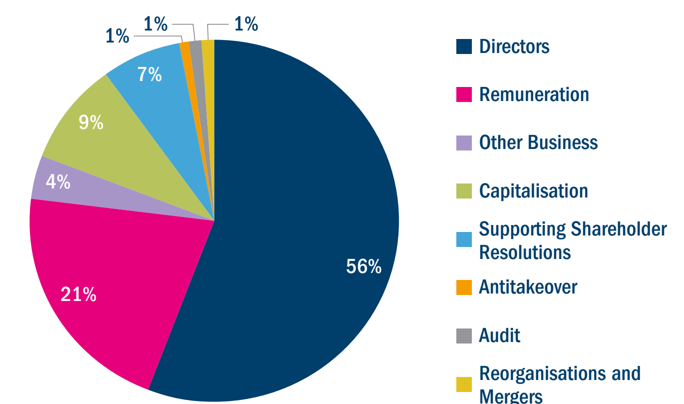
Figure 1: Meetings voted by region



Source: Columbia Threadneedle Investments, ISS ProxyExchange, 30 June 2021.

We voted in 58 separate markets in the second quarter. Most meetings were voted in the United States (2,212), followed by Japan (389) and United Kingdom (228). The majority of the voting items that we did not support throughout the quarter continue to be related to directors, followed by remuneration and other business-related proposals.

Figure 2 Data: Proportion of dissenting votes per category



Source: Columbia Threadneedle Investments, ISS ProxyExchange, 30 June 2021.

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