Link to Article on website

DWS Research on Why Responsible Investing is the Imperative New Approach

In a fascinating and probing report titled 'Responsible Investing – The World Tour', DWS Investment Research highlights some key trends in ESG investing, outlines how the US is leading the way, how Europe aims to be a global ESG rule setter, and how ESG is especially relevant for emerging markets. Hubbis spoke to one of the report's two authors, Michael Lewis, Head of ESG Thematic Research, who also explained why ESG should be a critical component of the risk management and selection process for any forward-looking investment portfolio. For Asia's very wealthy investors, ESG metrics should help identify winners, and eliminate possible losers.

DWS RESEARCH'S DETAILED AND EXTENSIVE REPORT FOCUSES ON THE KEY PROTAGONISTS OF CHANGE – FROM INVESTORS, corporate leaders, governments, regulators, or pressure groups in order to better understand, not just geographic differences, but also the direction of travel and the rate of change for ESG adoption.

"We found, for example," Lewis reports, "that public policy initiatives, such as the United Nations Sustainable Development Goals, are framing a new investment agenda which is increasingly being championed by a younger demographic, so we found that in the US, 93% of millennials agree that social or environmental impact is important to investment decisions. And those millennials are also in line to inherit USD30 trillion in wealth over the next several decades."

Many risks

The report also highlights the physical and legal risks of climate change, and notes that in Asia, five out of six people live in an area vulnerable to extreme weather events, while in the US, 250 weather and climate disasters have hit the country between 1980 and July 2019 with a cumulative loss of USD1.7 trillion.

"Litigation risk is big and growing," Lewis adds. "To date, roughly 1,200 climate change cases have been filed across 30 countries around the world, with the US, of course, the epicentre of such cases."

As all these developments take place, there are numerous risks and opportunities for investors. For example, efforts to curb greenhouse gas emissions through technologies, such as the electrification of the transportation sector, or through government regulation such as carbon pricing schemes, pose both a great upside and downside for many listed companies, as well as many of the unlisted private corporations numerous HNW and ultra-HNW investors are buying into increasingly across the globe. The world of insurance is of course directly impacted.

Standards required

Lewis notes that investors are increasingly seeking standards to help them filter out risky companies. But he notes that only recently, US SEC Commissioner Hester Peirce had highlighted the pitfalls and shortcomings of ESG ratings as they are today.

"We agree," Lewis reports, "and investors should certainly be aware of the practice of 'greenwashing', which is an optical illusion that we hope will be gradually eradicated, as an imperative to support the development of the sustainable finance industry."

The key, Lewis maintains, is transparency, so corporate disclosure in this area must be closely monitored, better standards defined and better ESG compliance achieved.

Positive inclusion

Lewis explains that as the world of ESG and sustainable investments expands, investors are moving away from negative exclusions - for example fossil fuels companies - and more towards positive inclusion of companies that offer impact and sustainability, for example, sustainable energy companies, or the numerous smart technologies that will help the environment.

"The acceleration of focus on ESG is dramatic," Lewis explains, "so, for example, momentum has been building since the 1970s, such that when it comes to the analysis between ESG and corporate financial performance about half of all analysis in this area has been released in the past decade and the pace is accelerating."

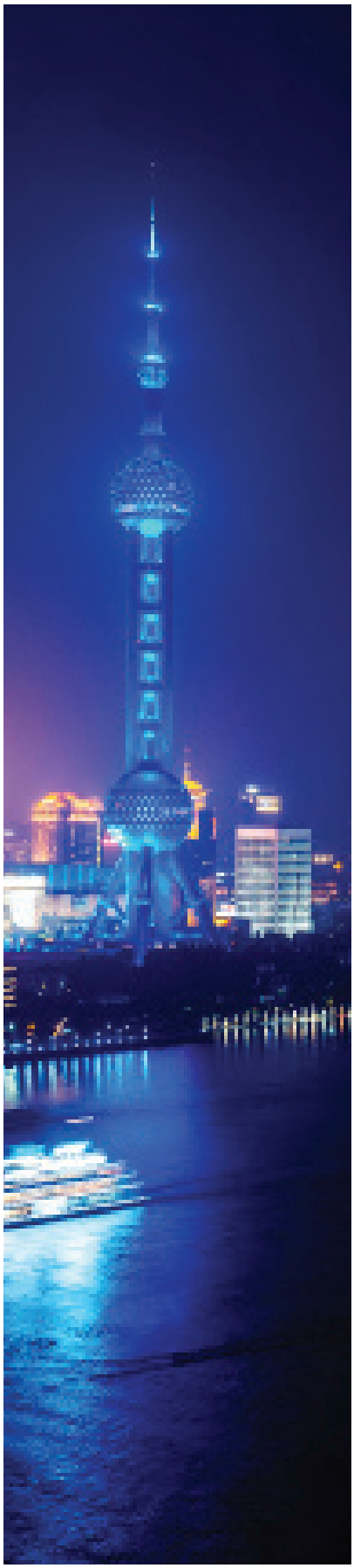
MICHAEL LEWIS
ESG Thematic Research

Responsible investing is now moving mainstream, and the key now is that the markets are increasingly understanding that not only does this help remove risks - for example, think of the VW emissions scandal - but also enhances returns, as those companies that score highest in ESG terms, Lewis explains, also tend towards better corporate governance and also towards more efficient use of capital.

Power in numbers

The institutional investment and investment research industries, aligned with initiatives such as the EU Action Plan, the Task Force on Climate-related Financial Disclosures, and the Global Sustainable Investment Alliance (GSIA) are all helping to drive responsible investing forward.

Lewis explains, for example, that GSIA has been publishing its ESG data since 2012, looking at ESG-credible assets by region and



investment style. "Since 2012," he notes, "the size of ESG assets in the five key regions of the world has increased by 130%, while the concentration of ESG compliant assets in Europe and the US combined has moderated, from 94% to 85% of ESG assets globally, indicating that the message is spreading far beyond the major developed markets. In Asia Pacific, Japan and Australia are currently leading the way."

Lewis explains that ESG investment styles are dominated by three strategies - exclusion screens, ESG integration, and corporate engagement/shareholder action.

tional investors. Lewis highlights a survey, the Principles for Responsible Investment (PRI), which found that retail investors in emerging markets already appeared to be more engaged on ESG issues than their counterparts in the developed world. The PRI survey polled workers who are investing for retirement in the US, UK, France, Australia, South Africa and Brazil.

"It revealed clearly that there is a great concern about ESG issues such as the burning of fossil fuels, child labour, excessive CEO remuneration and corporations that made use of tax loopholes," Lewis

"We believe that the many different initiatives taking place around the world and in the universe of research and investment will result in a dramatic elevation of credibility in the standards and the activity. This will help the major global investors, who account for trillions of dollars of funds, to buy more ESG compliant assets, both through passive and active strategies."

The search for return

"There is a growing weight of evidence that focusing on ESG and sustainable investing can produce higher returns," Lewis reports, "and many of the world's leading investors are acknowledging this with their investment behaviour. The body of research to date shows clearly, for example, that there is a strong and growing correlation between ESG and CFP, corporate financial performance, in the emerging markets, in fact, higher than in the developed markets."

Moreover, the impetus is not only amongst the major institu-

reports. "And it is important to also note that US investors, corporations and the states are important role models, so for example, the US has the largest number of asset owner and asset manager signatories to the PRI."

He adds that from next year it will become mandatory for these PRI signatories to report how they have considered specific climate risks in their investment portfolios.

Beware of the courtrooms

Lewis also points to the whip, as well as the carrot. "We see that nine US cities and counties from

New York to San Francisco have been litigating against major fossil fuel companies and seeking compensation for climate change damage such as pollution and rising sea levels," he reports. "Consequently, investments which might have been viewed as safe from a legal perspective are anything but, particularly given the rapid advancements taking place in the field of climate change science and specifically extreme event attribution."

In addition to litigation risk, there is considerable focus on the financial loss triggered by extreme weather events in the US such as hurricanes, floods and wildfires.

Robust classification – coming soon

In order to keep propelling this sustainable investment etiquette, Lewis explains that one of the most urgent tasks is a more robust classification and labelling system to bring much-needed consistency and trust to the market. He notes that greenwashing is a growing problem that has its origins back in the 1980s when certain corporates overstated or even falsely claimed their positive environmental credentials, which were typically deployed in marketing campaigns. As greenwashing remains prevalent today, Lewis sees it as a major risk factor.

"We believe that the many different initiatives taking place around the world and in the universe of research and investment will result in a dramatic elevation of credibility in the standards and the activity. This will help the major global investors, who account for trillions of dollars of funds, to buy more ESG compliant assets, both through passive and active strategies."

The snowball effect

As this happens, performance will likely be enhanced, as valuations of these target stocks rise, while the performance of those excluded from the ESG filters will likely weaken as major investors flock to responsibly managed corporations. "And as this happens," Lewis advises, "private wealth management advisers and investors should take heed, as this whole area will become an ever more important driver of portfolio performance, as well as of integrity."

And Lewis believes that emerging markets are increasingly defined by ESG. In another very recent DWS Research report, he highlights how ESG forces are moving deeper into emerging markets from the network of central banks sharing best practice, stock exchanges mandating ESG disclosure requirements, regulators acting in the area of fiduciary duty and the launch of new EM-focused investment products.

Asia in the ESG spotlight

"Emerging market countries are particularly exposed when it comes to environmental, social and governance issues such as population growth, income inequality, biodiversity loss, water stress, extreme weather events, corruption and forced labour," he explains. "While many of these issues also exist across developed markets, the macro stability risks for emerging markets are more acute and the institutions available to address them weaker."

Lewis' final comment is to advise Asia's HNW investors, or indeed any investor, to improve the sustainability of their investment portfolios from the ESG perspective, as in doing so the investor will not only be encouraging responsible corporate activity but also enhancing their portfolio performance and reducing risk exposure to negative impact events. ■