Lombard Odier Champions Sustainability and Highlights Key Role of the Private Wealth Community

Lombard Odier has for a good number of years been earning a justified reputation for its dedication to promoting the expanding universe of ESG investments, adding to its multi-decade commitment to sustainability and climate change mitigation. In fact, the bank today aims to curate 99% of the bank's investment ideas, products, and strategies based on what they consider complex and comprehensive analysis of sustainability within the investment process. For example, the bank now has the capability to structure, track, monitor and refine portfolios based on what they compute to be the 'climate impact' trajectory of the names in each portfolio, thereby selecting companies with a clear plan and framework to curb their carbon emissions by 2050 and to be compliant with the Paris Agreement. They believe ESG-centricity significantly helps avoid a variety of risks and therefore potential significant losses, while also opening the door to a better selection of investment opportunities and uplift potential. Maxime Perrin, Head of Sustainable Investment at Lombard Odier Investment Managers, joined our ESG-focused Digital Dialogue event of September 9 as an expert panellist. We have summarised his valuable insights in this short report as they shed considerable light on the ESG revolution taking place in Europe and the gradual evolution emerging in Asia.

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MAXIME PERRIN
Lombard Odier

It was in July this year that the University of Oxford and Lombard Odier officially signed a multi-year partnership to foster sustainable finance and investment research, with a particular focus on climate change, the circular economy and nature. It is the first known endowed professorship in sustainable finance at any major global research university and involves collaboration between the banking group and the university on a range of sustainable finance projects.

Dr Ben Caldecott, the Lombard Odier Associate Professor and Senior Research Fellow of Sustainable Finance, commented at the time: "Sustainable finance is mission critical for tackling the massive environmental and social challenges facing humanity. As the Lombard Odier endowment implies, these questions and issues will endure in some form for many generations and at the University of Oxford we look forward to continuing to play a major role in creating, defining, and growing this major new field."

A deep and enduring commitment

Joining the virtual panel discussion from Geneva, he opened his commentary at our September 9 event by first reinforcing how keenly the bank aims to identify which companies put ESG into action through their business practices, and also how the bank then delivers investment advice around those findings.

"ESG metrics are based on historical data, but we think that forward-looking metrics regarding company activities are much more important, given the huge challenge we have in terms of sustainability, which centres on the decarbonisation of the economy over the next 30 or so years," he explained. He said that this is particularly crucial in Asia given the breakneck speed of development and the incredible speed of future transition over the next few years as highlighted recently by the Chinese government in 2020 and 2021 with their very ambitious decarbonisation targets.

Boosting accountability

He explained that as investors apply ESG metrics and analysis increasingly to their portfolios, companies are becoming more accountable for their behaviour through capital allocation, through engagement, and through proxy voting.

"We focus heavily on decarbonisation, which for some companies is quite a simple challenge, and for many companies in Asia and elsewhere is a huge and sometimes even existential challenge," he reported. And clearly those companies that score highest in ESG metrics and ratings are more likely to be on the right path towards boosting and enforcing decarbonisation.

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Regulation – inexorable global tightening

Maxime told delegates he agreed with comments from fellow panel experts that regulation will be a key driver and influence on how investors react, how asset managers structure their products, on the regime around disclosures, and so forth.

"We will see what happens when the European Union introduces SFDR, or the Sustainable Finance Disclosure Regulation, in 2022," he said. "This imposes mandatory ESG disclosure obligations for asset managers and other financial markets participants. And we have the latest EU categorisation or taxonomy also coming out in 2022. In short, we expect to see a gradual tightening of rules coming from the EU."

Self-declaration and the burden of proof

He noted that in March 2021, European funds needed to self-register on disclosing the integration of ESG factors or non-financial factors into their investment processes. And next year, European registered funds will have to disclose certain metrics, for example on carbon emissions, the carbon footprint, and so forth. He noted that on top of all that, the EU taxonomy will be aligned with the EU 'Green Deal', which also requires at the at the individual investment level, a certain amount of disclosure must be made.

Different approaches, similar aims

Maxime also commented that in the US, the approach from the SEC is a more 'naming and shaming' attitude to regulation, at least so far. "Both the US and European approaches really result in the same thing, which is forcing asset managers or banks to account for their own responsibilities and more broadly fighting greenwashing," he said. "As to how Asia approaches all this, I think it will be a combination of both strategies."

As to the limitations of ESG, and comments from detractors, he observed that at the entry level

"They need to be able to identify which companies are carrying a misunderstood or mispriced risk with regards to decarbonisation, for example, or climate change more broadly, risk that comes through stranded assets, regulatory friction, falling margins, a lack of competitive advantage, different levels of financial costs, and so forth. That opens the window to see more risk and more opportunity."

"Put simply," he said, "the EU is going to demand proof of claims made, so for example if you say you are launching a sustainable green fund, you will need to demonstrate some hard numbers around that And on top of all this, investment professionals will also begin implementing the recommendations of the taskforce on climate related financial disclosure, which is one of the emerging standard-setters for asset managers investing in climate change or decarbonisation, whose latest recommendations were published in June."

ESG is fairly simple, in that it helps filter out the more controversial investments. "But then when you delve deeper into the data, it does honestly become more difficult to penetrate," he conceded. "For example, there's a massive premium for large cap stocks; they have more resources, they give more data, and therefore their scores tend to be better. Hence, a large cap portfolio will have better scores than a very equivalent selection of mid and smaller cap companies. Ergo, the comparisons to companies with smaller resources might not actually be that accurate or useful."

The underlying truths

He extrapolated from this observation to say that one needs to look under the hood of the ESG scores, to their actual meaning. "If you take the two or three largest ESG data providers, they have slightly different methodology, and slightly different questionnaires," he reported. "One of them might rate Tesla highly, another much lower. But in my view that does not weaken the credibility of ESG; we need to look at these metrics without the kind of dogmatism that some ESG proponents have. It needs to be looked at for what it is, which is a huge amount of very useful and important non-financial data that the investment managers can use to inform their decisions."

He also commented that ESG is also very valuable in determining which companies are more in line with strong regulation, because they are likely to be less subject to regulatory friction. "Therefore, it's in everybody's interest for the engagement and proxy voting rules that we apply to reflect these ESG values," he said.

Looking forward

He closed his observations by reiterating his earlier comment that ESG is rated based overwhelmingly on past data, but that if investors seek to identify the companies undergoing sustainability transition, they need access to forward-looking guidelines.

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He elaborated on this, noting for example that a corporation in a sector with high CO2 emissions knows the regulators are coming and that the world is going to be a much more difficult place to emit CO2 over the next 5, 10 and 15 years. Similarly, for companies in industries such as steel, cement, plastics, chemicals, transport, utilities, investors need to be able to identify clearly which companies have credible plans to reduce environmental impact.

The survival game

He concluded that investors can then get nearer to identifying those which are likely to not only survive, but gain market share, even probably have greater pricing power. "And you can see those companies that are behind the game, perhaps just hoping they will be rescued by some kind of new technology that will save them from annihilation by the regulator, or by competition," he said. "I am exaggerating somewhat to make my point, but what we do know very clearly is that there are massive opportunities and substantial risks that we should look at."

And ESG metrics offer the prism through which we are more likely to spot those hazards and help investors seize on those opportunities. ■