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Spotlight on Sustainable Investing

Attractions of sustainable DGFs for Defined Contribution pension schemes

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- Defined contribution pension schemes facing the twin aims of building a sufficient capital base and delivering the income streams required, are increasingly looking to also achieve non-financial objectives.
- Investing in sustainable strategies can allow pension schemes to apply their assets where responsible behaviour is being demonstrated, towards the environment and society, as well as the opportunity to invest to make a positive contribution to some of the world's greatest challenges.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance

Diversification in assets and sustainability

The key characteristics that make a diversified multi-asset investment approach attractive compared to investing in a single asset class are well-documented, but are worth reiterating.

Broadening opportunity, spreading risk

Giving oneself the freedom to invest in a variety of asset classes increases the available opportunity set. By spreading the portfolio's risk over multiple asset classes, a portfolio has the potential to ride more smoothly through the periodic storms experienced by those asset classes individually.

Over a long-term time horizon, adopting an approach that blends different types of assets in a single portfolio, may be expected to achieve a more attractive combination of returns and risk than for a single asset class investment. The returns, may come in the form of income or capital growth, both of which are likely to appeal to pension schemes at various times. Importantly, compared to a single asset class approach, investors in a multi-asset, or diversified growth strategy, will likely expect the returns they experience to be smoother over time.

M&G's sustainable multi-asset strategy includes the flexibility to invest in opportunities we have identified across a variety of asset classes. They may be equities, bonds (both government and corporate issues), infrastructure assets, green bonds, social bonds, currencies and specialty funds.

Sustainability in the mainstream

Sustainable investment has moved into the mainstream in recent years. Investors, professional, institutional and private alike, have propelled the concept of investing for more than financial returns to the fore.

A sustainable approach or responsible investing may mean have a different meaning to different investors. However, the sentiment and purpose is generally much the same.

From restriction to opportunity

What began as ethical investing, seated in the beliefs of investors developed into norms-based exclusions and screens. This meant that until only a few years ago, incorporating environmental, social and governance (ESG) considerations into an investment process was typically regarded as focusing on negatives. The bulk of ESG assessment practice would have focussed on excluding sectors, or restricting allocations, as they represented risks to be avoided. An approach may have been confined to "avoiding the bad", but increasingly now it may equally focus on "embracing the better", those that exhibit desirable behaviours and practices, often through the use of positive screens.

Figure 1: The Spectrum of Sustainable Investing

Source: M&G, September 2020

Initially, we will screen the investment universe to exclude companies that are in breach of the United Nations Global Compact principles on human rights, labour, the environment and anti-corruption.

In a second phase, we further exclude companies that are producers of, or provide services in, controversial products and sectors, and we scrutinise CO_2 intensive industries such as oil and gas and utilities.

As the sophistication and depth of ESG assessment has developed recently, integrating ESG considerations and analysis into the investment process has become the a core feature of many sustainable approaches. This includes assessing the opportunities that ESG analysis can uncover and identifying those investments that are leading the way in their class.

We look to the assessment of a company's relative ESG characteristics compared to its peers, provided by independent analysis, usually MSCI. These assessments help us identify leaders, from which we can select those that we judge to also offer the most appealing value opportunity, for inclusion in the portfolio, as well as laggards, which may then be removed from consideration.

Engagement – collaboration for the better

Integrating ESG considerations into the investment process is now taken further by the logical extension of actively engaging with companies. We, and our clients, want to improve companies' behaviour and the outcomes of that behaviour. We want it to be easier to see where companies are on their sustainability journey and what they are doing to improve it.

Engagement seeks to encourage better ESG disclosure and transparency. Gaining access to greater detail and transparency on a wide variety of sustainable behaviours, including such things as more efficient resource use, improved workforce welfare and better corporate governance, and disclosing what has been achieved, can help give investors greater confidence.

Companies can build on the foundations of intention, and showcase the success of their efforts, by setting meaningful key performance indicators against which they may be judged. They have also become increasingly aware of the place ESG assessment is taking in the fund management risk analysis process. They can provide greater comfort to investors by communicating their ESG intentions and objectives clearly and publicly. It may help overcome situations where investors may otherwise be constrained from investing.

Case study in Engagement: Danone – 'One Planet, One Health'

The food producer is seeing a new generation of consumers focused on ESG topics, brand transparency, content of product – including sugar – and impact on the planet of what they eat. The company has four main priorities: climate change, water stewardship, circular economy and regenerative agriculture.

Objective: To gain deeper insight into how the 'One Planet One Health' vision of Danone's chief executive has affected long-term goals and the company's business model. We also wanted to understand how the company was progressing with ambitious sustainability and environmental targets related to emissions reduction, reduced deforestation, single-use plastic and board oversight.

Actions: We undertook a dedicated ESG engagement with three members of the company's sustainability team

Outcomes: We were impressed by the company's eagerness and ability to respond with confidence on some challenging issues. around supply chain transparency, emissions reduction, carbon neutrality and biodiversity protection Engagement continues, as we seek further clarity on oversight and ownership of targets, understanding of KPIs the company is using to measure and report progress, and stronger timebound commitments on deforestation.

At the same time, we as investors, can share with companies what we believe is important to our clients. In doing so, it may be possible for active intervention to help reduce instances of negative externalities, costs that arise, potentially unintentional ones, from the activities a company undertakes.

Positive impact – addressing global challenges

Not only does our sustainable approach allow investors to focus on ESG leaders, it also seeks to incorporate investments in companies and other entities that are deliberated and actively seeking to make a positive contribution to resolving some of the world's most pressing social and environmental challenges.

This discrete positive impact component is a flexible allocation consisting of equities, bonds and other assets types in M&G's sustainable multi-asset strategies, all seeking to contribute to one of more of the 17 United Nations Sustainable Development Goals (SDGs).

Case study in Climate action for Positive impact: SolarEdge Technologies

SolarEdge provides technology to improve the harvesting of solar energy. The company supplies smart energy products for residential and commercial use, thereby contributing to Climate action in the form of UN SDG #7 (Affordable and Clean Energy).

It has provided systems capable of creating 7.5GW of power to customers through the application of photovoltaic (PV) systems, as well as shipping more than 25 million power inverters. We believe that rapid deployment of solar PV could help solar become the largest source of low-carbon capacity by 2040. 100% of its revenues come from the supply of smart energy tools.

We add SolarEdge into our sustainable strategies during the period of equity market weakness in March 2020, when the share price became attractive to us. In the six months to the end of September 2020, the shares had generated total returns of 190% in US$ terms.

Past performance is not a guide to future performance.

Green bonds, and more recently in the midst of COVID-19, social bonds are becoming an increasingly important and popular part of the fixed income market. Germany's recent inaugural social bond issue was substantially oversubscribed by willing investors. At the same time green infrastructure investments are also keenly sought, with some providers of sustainable energy solutions (such as Hannon Armstrong Sustainable Infrastructure) seeing their share prices driven markedly higher during 2020.

Case study in Infrastructure: Hannon Armstrong Sustainable Infrastructure

Hannon Armstrong is a US company that seeks to invest in climate change solutions. It provides finance to companies focused on sustainable infrastructure, providing renewable energy and energy efficiency.

It aims to ensure that all businesses in which it invests is at least neutral on incremental carbon emissions, or has some equally beneficial environmental impact.

The company reports that, across its investments, it saved 381 million gallons of water in 2019 alone. It has also avoided the emission of 384,800 metric tonnes of CO^2 in the same period.

Our strategy has maintained and built on a holding of Hannon Armstrong since the first fund was launched. The company's share price has grown by more than 30% in 2020 until the end of September.

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Does taking a sustainable approach have a performance cost?

We believe that embracing a sustainable or responsible approach to investing does not come at a cost to portfolio performance compared to strategies that are unfocussed on responsibility. Instead, as sustainable investing has developed and become increasingly popular, companies that are ESG leaders, or those that are to the fore in making positive impacts, are often increasingly sought after, potentially driving share prices higher relative to their peers.

They may benefit from official government support or subsidies for the services or products they deliver. They may have more readily available access to cheaper funding, if the risks they represent to lenders is considered to be lower than their competitors. They may face less onerous regulatory oversight because of the positive practices they have in place. Features such as these, have the capacity to underpin the financial performance of a company.

We believe that embracing a sustainability mindset and approach, in the way the world generates and delivers products and services, is developing a positive momentum of its own.

Poor sustainability performance is unlikely to be rewarded

An extension to the belief that sustainable approaches create a drag on performance, is naturally one that says not adopting a sustainable approach offers opportunities to achieve strong returns. In our view, that is not a viable long-term prospect for achieving attractive financial returns. Failing to consider adopting a responsible approach within a business model, whether it may be to save costs or for other reasons, may soon become counterproductive as investors demand more and better adherence to sustainable practices.

Responsible behaviour begins at home

Incorporating greater focus on sustainability into the investment process is also gaining momentum across the fund management community. Companies are defining and improving their own contributions to challenges such as reducing carbon emissions, scaling back waste and improving social inclusion and diversity in their workplaces.

M&G aspires to reach net zero carbon emissions on its total book of investments under management and administration by 2050 and, as a company, we have pledged to reach carbon net zero by 2030.

We're committed to ensuring that our organisational values are reflected in the way our business is run and across all our activities as a corporate, asset owner, asset manager and through our community activity.

Community - We are actively engaged in helping to tackle social challenges in support of local communities. By using the commitment of our people, providing support through funding and skills-based volunteering, we establish long-term relationships with our charity partners to improve lives and build communities.

Employees and culture - We strive to create an inclusive working environment, where we continually develop our talent, reward great performance, protect our people and value our differences.

Environmental performance - This sustainability focus extends to how we manage our investments across asset types, and we are actively working to manage climate-related financial risk across our business.

Business integrity - Responsible and ethical behaviour is core to our business structure and how we govern our investments.

Supply chain - We hold all of our suppliers to the same high employment standards as our own employees. When sourcing goods and services, and in our third-party relationships, we strive to manage all ESG risks.

M&G's Multi Asset approach

The M&G Multi Asset team has been applying its unique investment philosophy and process for more than 20 years. While each fund manager bears responsibility for the management decisions of each portfolio, the group functions as a true team, continually sharing and testing investment ideas and assessing a wide variety of macroeconomic data.

The M&G Multi Asset team's principles are based on:

- Repeatable process applicable to all liquid asset classes
- Asset allocation and selection as the primary driver of performance
- A disciplined valuation framework to highlight asset mispricing
- Behavioural analysis to identify causes of mispricing