Responsible Investing Roundtable

Not all approaches are created equal

April 2019

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A Reminder About Our Aims

Responsible Investment (RI) factors are transitioning from being 'nice to have' to an integral part of the investment process. Asset managers have woken up to what investors are demanding but from a global perspective, implementation has been far from homogeneous.

There is little doubt that Europe is leading the way on RI... indeed, institutional investors are looking beyond financial returns by making impact investments to contribute towards a sustainable future, without passing the cheque along to the next generation. As a double act alongside asset managers, they have the power to drive corporate change and prioritise people, profits and the planet.

The US and emerging markets appear to be lagging behind Europe and consequently, the scale of integration of RI across companies and regions varies greatly. While there is still some debate around whether ESG factors lead to higher profitability, time will ultimately determine the leaders and whether they have financially outperformed the laggers.

CAMRADATA's Roundtable seeks to question who would not want to invest in companies with sustainable environmental and social franchises that are well governed?

"Asset managers have woken up to what investors are demanding but from a global perspective, implementation has been far from homogeneous"

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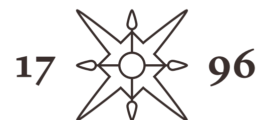

LOMBARD ODIER
INVESTMENT MANAGERS

Lombard Odier Investment Managers

Company Profile

Lombard Odier Investment Managers is the asset management business of the Lombard Odier Group, with AUM of 36 billion GBP (as at 31.12.18).

Our investment capabilities span Fixed Income, Convertible Bonds, Equities, Multi-Asset and Alternatives. Sustainability is absolutely central to our investment philosophy; we believe it is the founding principle of economic outcomes, and will drive investment returns over the long term.

Robert de Guigné

Head of ESG Solutions

Robert is head of ESG solutions for Lombard Odier Investment Managers (LOIM). Prior to his current role he was head of socially responsible investing for LOIM. Before that he was deputy for LOIM's CIO for equity and convertible long-only investment strategies. He joined Lombard Odier in June 2007 as deputy chief investment officer for the Institutional Investment Unit.

Prior to joining, Robert was a managing partner and co-founder of AQTIS, a management company specializing in the direct management of hedge funds, from 2004. Previously, he was head of research and information systems at CPR Asset Management, a Crédit Agricole subsidiary. Before that, he was head of EAFE & emerging equities portfolio management at AXA from 1996 to 2001. Prior to that, he was an international equities manager at State Street Global Advisor. He began his career at the financial management firm Meeschaert in 1987, originally as a financial advisor for a private client portfolio. In 1989, he became manager of convertible bond portfolios, and in 1991 took over fund management for the group's new life insurance company.

Robert earned an MBA in international affairs from ESC Reims – CEFA in 1986 and holds an engineering diploma from Ecole spéciale de Mécanique et d'Electricité in Paris. He also gained a financial analyst diploma from the French Society of Financial Analysts, a diploma in actuarial science from the Centre for Actuarial Studies and he is a member of the Institute of French Actuaries.

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M&G Investments

Company Profile

M&G Investments is the European asset management arm of Prudential plc, operating in the UK, Europe and Asia. As a trusted partner, our clients' individual needs are at the heart of our business. We align our interests with those of our clients and develop value-based strategies to generate strong and consistent returns. Our goal is to help our clients meet their long-term liabilities regardless of the market environment.

With £278 billion* of assets under management (including £120 billion* on behalf of Prudential) across fixed income, equities, real estate and multi-asset strategies, and around 450* investment professionals (including what we believe to be one of Europe's largest credit research teams), we have the scale and expertise to offer tailored investment solutions across a wide range of risk and return requirements.

M&G is an active investor – both in terms of how we manage our assets, and how we innovate and develop our offering to ensure that we continue to meet evolving investor requirements.

* As at September 2018

Ben Constable-Maxwell

Investment Specialist

Ben joined M&G Investments in 2003 and is now Head of Sustainable and Impact Investing, responsible for developing M&G's sustainable investment activities.

Ben is the Impact lead on the M&G Positive Impact Fund. Ben has been central to the development of ESG integration within M&G's investment processes and has supported the development of ESG solutions for clients across asset classes. He sits on M&G's Responsible Investment Advisory Forum, overseeing ESG-related activities at M&G, and is a member of the Investment Association's Sustainability & Responsible Investment Committee, chairing the Working Group on non-financial disclosures.

Previous to M&G, Ben spent four years with the Equities team at Invesco Perpetual. Ben graduated from the University of Newcastle-upon-Tyne with an Honours Degree in Classics.

Sponsor

Newton Investment Managers

Company Profile

Newton Investment Management is a London-based, global investment management firm, providing a focused range of investment strategies to public and private-sector DB and DC pension funds, corporations, charities and, via BNY Mellon, individuals.

We run a broad range of equity, fixed-income and multi-asset strategies, and have particular expertise in absolute-return, income-focused, high-conviction and sustainable investing. We use a global thematic approach to help achieve long-term perspective. Our themes inform both the rigorous fundamental analysis carried out by our experienced global research analysts, and the construction of portfolios designed to meet our clients' requirements. We consider environmental, social and governance issues in relation to every company in which we invest, in the belief that responsible investment is better investment.

www.newtonim.com

Lloyd McAllister

Responsible Investment Analyst

Lloyd is a Responsible Investment Analyst at Newton. His role includes conducting research and company engagement on environmental, social and governance issues. Previously he worked at KPMG where he qualified as a Chartered Accountant and worked within the Sustainability Consulting team.

Lloyd is a member the Climate Disclosure Standards Board's Technical Working Group and the Institute of Chartered Accountant's of Scotland Sustainability Panel. He is also the Treasurer of a small UK charity and holds a BSc from Loughborough University and an MSc from the London School of Economics in Political Science.

Participants

Matthew Cox

Investment Director

Matt joined the Esmée Fairbairn Foundation in 2013 and is responsible for overseeing the performance of the Foundation's investment portfolio.

He is a CFA charterholder and manages the day-to-day relationship with the Foundation's investment advisors.

Before joining the charitable sector, he spent fifteen years in the investment management industry as an analyst and portfolio manager, managing a variety of client portfolios for pension funds, high net worth individuals and charities.

He is also a trustee of a small community music charity.

CAMBRIDGE ASSOCIATES

Lydia Guett

Impact Investment Specialist

Lydia is an Impact Investment specialist at Cambridge Associates, working on implementation in client portfolios across the ESG and impact spectrum, and on ESG/Impact investment research. She works with Endowments and Foundations, Families and Pension Schemes across Europe to help align investment goals with the investor's values.

She also led the creation of "C|A Women", a global initiative and network championing diversity across the firm and in the investment industry.

Participants

Troy Mortimer

Director

Troy leads KPMG UK's Sustainability and Responsible Investment practice. He has extensive experience working with asset owners and asset managers on risk, regulatory and operational projects across the Americas and Europe during his 18 years with KPMG. Troy has previously led KPMG UK's Operational Due Diligence practice for asset management in addition to a variety of other asset management roles in relation to Governance, Risk, Capital and Control Frameworks.

Troy has extensive experience in ESG, risk, governance and operational matters relating to all asset classes across asset management. He is an active participant in various industry working groups in relation to responsible investment, stewardship and ESG, including the AIMA working group on responsible investment, alternate delegate on the EFAMA working group on stewardship, market integrity and ESG as well as member of KPMG's Global Sustainable Finance Working Group. Troy also speaks regularly at conferences and facilitates discussions on topics in relation to ESG and responsible investment

Honor Fell

Head of Responsible Investment

Honor leads Redington's Responsible Investment work. She oversees Redington's RI strategy, leads RI research, and works in conjunction with the Manager Research and Investing Consulting team to provide advice to a range of institutional clients. Honor is currently a member of the pensions workstream of the UK Implementation Taskforce on Social Impact Investing. In addition she has contributed to the PRI Asset Owner Passive Investment Working Group and the PRI Manager Selection Working Group.

Honor is a Vice President and joined Redington in 2013 after completing a Geography degree at Cambridge University. She is a CFA Charterholder and is currently working towards a Masters in Sustainability Leadership at Cambridge University.

Participants

Adam Gillet

Head of Sustainable Investment

Adam is the Head of Sustainable Investment at Willis Towers Watson – a global role, responsible for leading the integration of sustainable investment across our research, solutions and client advice. He works with a range of pension fund, insurance, foundation and sovereign wealth clients, providing advice on sustainable investment strategies, integration of environmental, social and governance (ESG) factors, effective stewardship, regulation and global best practices. Adam is also responsible for the thought leadership and content which shapes our sustainable investment advice and activities.

Adam has worked with some of the world's leading asset owners on a combination of investment strategy, governance and sustainable investment. Projects have included working with Future Fund (investment governance and best practice benchmarking), CalPERS (investment beliefs, risk and sustainability), Railpen (organisational change and governance) and the International Social Security Association (best practice investment guidelines) amongst others.

Adam graduated from Cambridge University, and supplemented this with a year at the Judge Business School reading Management Studies. He is a fully qualified Associate Chartered Accountant, holder of the UKSIP Investment Management Certificate, and Chartered Financial Analyst (CFA) charterholder.

Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

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Responsible Investing

Not all approaches are created equal

CAMRADATA's fourth annual Responsible Investing roundtable in London this spring drew together asset owners, asset managers and consultants to discuss trends in responsible investing. Key takeaways from this year's panel were:-

1. **Sustainability is an issue for all companies, even traditional sector leaders and those in emerging markets. Its adoption is uneven, however, which leaves asset managers to evaluate how genuine the company's RI policy is.**
2. **In turn, stewardship is a vital element to stockholding and consultants are looking for asset managers to demonstrate how they steward companies.**
3. **The degree of influence exerted by a shareholder or bondholder bears no correlation to the size of their holding. Belief in a cause will effect change, even though on profound issues this may take time.**
4. **Some consultants are sceptical of index-tracking strategies in terms of responsible investing. The concern is to what degree passive managers steward effectively when holding a rigid quota of shares.**

> "Since the publication of Thomas Piketty's Capital and the MeToo movement, asset managers are incorporating social and gender equality into their strategies as major themes for our age"

The mainstreaming of Environmental, Social and Governance (ESG) issues in investment management continues apace. The number of resolutions at AGMs on climate change has doubled in three years, challenging Big Oil to hasten its transition to renewable energy.

Asset owners, notably pension funds, face ever more regulatory requirements to enunciate their policy on climate change. And since the publication of Thomas Piketty's Capital and the MeToo movement, asset managers are incorporating social and gender equality into their strategies as major themes for our age.

One such case is Lombard Odier Investment Management (LOIM), the asset manager for Swiss private bank, Lombard Odier. In 2016, just SFr4bn of LOIM's assets under management were run on an ESG basis. Today 80% of all long-only strategies at the SFr65bn firm incorporate an ESG framework, according to Robert de Guigné, head of sustainability at LOIM.

"It's been a long path but we have a common philosophy across the entire bank. This has to come from the partners, the owners," he said. With a common philosophy agreed, Lombard Odier has constructed its own, three-pillar scoring methodology, which is part of all portfolios.

The first pillar identifies those companies delivering excess financial return. The second looks at a company's business practices through a proprietary ESG framework that aims to identify the companies walking the walk, not just talking the talk. The third pillar looks at long-term trends such as climate change and demographics to assess whether the company has a sustainable business model. De Guigné warned that individual managers can include any company they wish in their strategy "but they have to have a very good reason for so doing. It's a comply or explain culture."

> "Individual managers can include any company they wish in their strategy, but they have to have a very good reason for so doing. It's a comply or explain culture"

At Newton Investment Management in London, there is likewise a threshold for including companies – an aggregate score of 4 out of 10 derived from various ESG metrics. Individual managers can bring in lower-scoring companies to their portfolios but they have to justify how these companies are going to cross the threshold in the future. According to Lloyd McAllister, responsible investment analyst at Newton, the firm does have "red lines" that cannot be crossed. For example, it has categorically banned tobacco stocks and companies that violate the UN Global Compact on Human Rights, while also excluding companies that operate in a way that makes them incompatible with the aim of limiting global warming to less than two degrees Celsius.

So, the flexibility around that 4/10 threshold derives from other important, but not rigid, ESG criteria. For example, Newton tests whether any potential investment can retain profitability if carbon is priced at US$140 per tonne. There is no global price for carbon – as there is for commodities such as gold, wheat and oil – but US$140 is far above where the various regional carbon-trading markets currently trade. The test price is not, however, at all unrealistic by many of the estimates for limited global warming to a two-degree rise by 2050.

McAllister told the CAMRADATA panel that individual portfolio managers at Newton could make exceptions for companies they believe are transitioning successfully to a 2 degree scenario.

M&G's Ben Constable-Maxwell, co-fund manager and Head of Sustainable and Impact investing, discusses the recently launched listed equities impact strategy, and the importance of focusing on companies that overwhelmingly positively contribute to society and the environment globally, within a narrow portfolio. Ben outlines the three key types of impactful enterprises which the strategy concentrates on. The first are pioneering businesses such as Illumina's genetic sequencing equipment. The second are enablers of impact, which provide equipment and services for others to produce impactful outcomes, such as Schneider Electric with its extensive range of energy efficient products and services offered to industrial customers. The third are impact leaders in their field, such as Ørsted, the world's largest offshore wind power producer.

Constable-Maxwell explained there was a three 'I's analysis to evaluate if a company can be added onto the watchlist for future investment, which covers: the Investment case - is the company's business model sustainable and able to generate competitive returns over the very long term? The Intentionality - is the company's purpose impactful and is it backed up by strategic objectives and targets aligned with this mission? Thirdly, the Impact – can the impact be measured and is it meaningful as a percentage of the overall business?

"While screening continues in defining parameters, it is less significant within the process than more holistic, positive and forward-looking analysis of enterprise"

"We use our influence to determine and obtain the key impact indicators from companies we look to invest in," said Constable-Maxwell. "These companies are generally keen to assist as evidencing their impact credentials helps enhance their leadership position and boost their profile amongst the investment community. How they respond is also a valuable indicator to us of how aligned their impact goals are with their core business strategy."

Green screens

Historically, ESG was realised in portfolio management by means of negative screens, typically applied to "sin" stocks such as tobacco, gambling and alcohol. Most of the panel accepted that such negative screening remains germane to a number of responsible investors. But the asset managers' way of working demonstrates that while screening continues in defining parameters, it is less significant within the process than more holistic, positive and forward-looking analysis of enterprise.

"Many of our pension fund clients are not comfortable with negative screening," said Honor Fell, head of responsible investing at Redington, a consultancy.

"Instead, ESG integration and positive screening tend to be more popular approaches."

Even among Redington's clientele, nevertheless, there is a spectrum of attitudes to ESG. "We have a group which we label "Comply", which tend to be very mature Defined Benefit pension schemes with short time horizons that want their consultants to help them take the minimum steps to be in compliance with regulations," said Fell.

"Then there is "Measure & Manage" which are much more proactive, building up their knowledge, asking challenging questions of their consultants and asset managers but not yet changing allocations. This group is very interested in what they have to report." Redington's third category is "Seeking Alpha" investors, which are actively changing their asset allocation to support investee companies transition to the green economy and are aiming for positive social and environmental outcomes.

Cambridge Associates is investment adviser to many endowments, foundations, pension funds and families. Without the same liabilities and regulation as other institutional investors such as pension funds or insurers, one would expect more "Seeking Alpha" types among endowments and families.

Lydia Guett, impact investing specialist at Cambridge Associates, confirms that this is true but says even within this group there has been an evolution in responsible investing. "Some foundations would in the past have simply accepted the returns received as investment gains and focused their efforts on the expenditure of that income in line with their beliefs," she said. "But nowadays - and this is also true of the second generation in family offices – clients are asking: "What do we own?" This takes them back to the fundamental question about what their beliefs are and how those beliefs get put into practice in the portfolio."

One such organisation is the £1bn Esmée Fairbairn Foundation, a charitable organisation that gives approximately £45m a year to good causes up and down the UK. This Foundation's investment strategy focuses on best-in-class asset managers (so it would also fit Redington's third category of Alpha Seekers). Matthew Cox, investment director at the EFF, said investment managers should see engagement with investee companies as an opportunity to distinguish themselves and maintain a competitive advantage.

"Without the same liabilities and regulation as other institutional investors such as pension funds or insurers, one would expect more "Seeking Alpha" types among endowments and families"

Stewarding client assets

Adam Gillett, head of sustainable Investment at Willis Towers Watson, said many asset managers did not practise a major function of share ownership: “Stewardship is superbly underdone by the asset management industry,” he said. “Ninety-nine per cent of resources and time of the investment industry is spent on allocation, e.g. researching and analysing companies.” In Gillett’s opinion, this leaves an underwhelming effort on managing investee holdings even though stewardship is “long-term value creative."

“We want to know when the last time a manager filed a resolution was,” says Gillett. When his team challenges the ESG credentials of an asset manager by asking such direct questions, the consultancy is looking above all else for authenticity in the response.

> “In this day and age, companies want to be seen to be doing the right thing. We all know that a transition to renewable energy has to happen but there are financial pressures to deliver short-term returns”

“Integration of ESG issues needs to be authentic: well understood, well settled and well socialised in the organisation,” he told the CAMRADATA panel.

Cox agreed with much of this thinking. “We deal with campaign groups and NGOs that take just a single share in a company and effect change from there. We’ve heard of one individual who complained to National Express that its policy on passengers in wheelchairs was behind its peers. National Express altered their policy as a result.” The lesson appears to be you don’t even need to own a major stake in big companies; you don’t even need to be a fund manager. It is commitment and clarity of goals that counts. “I would say there doesn’t need to be a direct correlation between size of ownership and influence,” said Guett.

Cox then qualified his point. “There are certain low-hanging fruit which can be changed within months. In this day and age, companies want to be seen to be doing the right thing. But then there is the tragedy of horizons when it comes to global challenges such as climate change. We all know that a transition to renewable energy has to happen but there are financial pressures to deliver short-term returns. More than 70% of climate change has been caused by 100 companies but we know that some are hard to influence.”

Witness the campaign to make Big Oil express clearly its plans for a business in a two-degree scenario. There have been battles won since Royal Dutch Shell was first engaged by the Aiming for A coalition in 2015 but the war is not yet won.

“Some people would like to believe there is a silver bullet but there isn’t,” said McAllister.

"It's a gradual process. Step one: the company rejects the proposal. Step two: the company acknowledges it. Step three: you build support among the larger shareholder base. Step four: the proposal gets re-presented. And so on."

Regarding the heft needed to make a company listen, McAllister added the dimension of time. "We are investors in Pepsi. We hold it because we believe in the company's transition to low-sugar, low-fat products. Even though Pepsi is huge and Newton holds less than 1% of shares, we are heard because we are long-term investors."

De Guigné picked up one of Cox's points that countries in emerging economies may also be harder to influence. LOIM has a stake in Chinese noodle manufacturer, Tingyi. While the company's business fundamentals are strong, it wasn't providing sufficient information for LOIM to make a considered opinion on its ESG credentials.

"Six hours after we politely raised this request, we had a response from the chief executive's office to discuss the matter," recalls de Guigné.

Tingyi has since hired PwC to help it improve its sustainability reporting. De Guigné believes this example shows how ESG is taking hold globally, not just in the Western world. On reporting these issues in general, Troy Mortimer, head of sustainability and responsible investment at KPMG, said that significant work is still required to align sustainability reporting to investors' requirements. "Sustainability reporting continues to be challenging for companies and often burdensome for investors who have to troll through 350-400 pages," he said. "You have to ask the question: are the real messages for investors and other stakeholders getting lost in the detail? Key considerations such as the extent to which the C suite are really embedding ESG considerations in their operations and building responsible, sustainable business models are not being called out sufficiently."

Mortimer contends that lack of transparency around responsible business practices integrated into a company's business model is creating significant challenges for asset managers seeking to integrate ESG into their investment processes. "Transparency is crucial to effectuate change and promote responsible investing."

De Guigne agreed: "We all need audited disclosure but it is not standardised."

"Transparency is crucial to effectuate change and promote responsible investing"

Rating the raters

The panel then turned attention to the ratings agencies, those organisations that have helped asset managers understand what has to be audited but also further traits about ESG within companies. McAllister noted that asset managers and their clients had to get to grips with the different methodologies and hierarchy of criteria. As an example, he said that US electric car manufacturer, Tesla, was rated very differently by three major agencies. Thus, MSCI ESG, which looks for impact, scores it as a top company. FTSE, which prioritises disclosure, rates Tesla low. Meanwhile, Sustainalytics, ranks the carmaker somewhere in the middle.

> "We don't want every manager to think the same; ditto ratings agencies. There is a tendency to apply or expect higher standards in the sphere of sustainability services. I don't think it's warranted"

Gillett responded that he had no problem with different views on the same company. "We don't want every manager to think the same; ditto ratings agencies. There is a tendency to apply or expect higher standards in the sphere of sustainability services. I don't think it's warranted."

Constable-Maxwell agreed with Gillett that investors have a role to play challenging ratings agencies. He explained that if M&G had an understanding of a particular company that wasn't reflected in the rating, then it would sometimes enter into debate with MSCI, ISS et al. regarding their analysis. When challenged himself by the panel as to why M&G would not keep this intelligence for the benefit of solely its own clients, he responded that "better information makes better decision-making across the entire market. Raising the bar makes sense for everyone. It's then up to us as investors to apply our own analysis and interpretations."

As more asset owners demand such information, and more investee companies supply it, asset managers ought to be in a position to better price environmental, social and governance considerations in their portfolios.

Both Mortimer and De Guigné, however, raised the issue of cost of gathering all this extra information. De Guigné said that even the largest pension funds were unhappy with the charges for the services of the ESG ratings agencies. Mortimer queried whether additional focus on ESG outcomes within investment mandates might help incentivise asset managers to make greater investment in ESG data and systems and driver better ESG-oriented outcomes for investors.

One popular alternative is to go passive. De Guigné suggested that more than 50% of assets under ESG management were in index-tracking strategies.

But as he noted that MSCI alone has more than 300 Responsible indices, that complicates fair comparison while giving asset managers who don't know how to do RI an easy get-out. Fell acknowledged the cost constraints in active equity portfolios but also worried that with index-tracking, it can be complex to understand what the ultimate stock level exposures resulting from ESG-tilted strategies will be over time; and that, depending on the level of tracking error budget versus the index, these strategies may not fully avoid an ESG risk flagged up in the ESG data. She said passive managers can face a challenge effecting change in companies due to the sheer number of entities whose shares they are obliged to hold. In conclusion, both Fell and Guett said they preferred active management due to the current state of data availability and quality.

Regulation pertaining to ESG is on the rise. UK pension funds will have to make policy statements from October on considering climate change in their investments. Car manufacturers in the EU must show they are reducing noxious emissions from their vehicles. Democrats in the US are pushing legislation that would more than double the federal minimum wage over five years. These are examples of different policies that affect companies and the investors who finance their activities. But they all matter as ESG issues: evaluating their impact is the role of responsible investors and their advisers.

“Regulation pertaining to ESG is on the rise. UK pension funds will have to make policy statements from October on considering climate change in their investments”

UPCOMING ROUNDTABLE DISCUSSIONS

15th May 2019 - Diversity
22nd May 2019 - Multi-Asset Credit
10th June 2019 - Private Credit/Debt
19th June 2019 - DC

Interested in participating?

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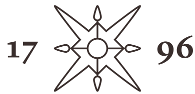

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Climate change is one of the most pressing sustainability challenges investors are facing today. It presents a systemic risk that is very difficult for investors to diversify away.

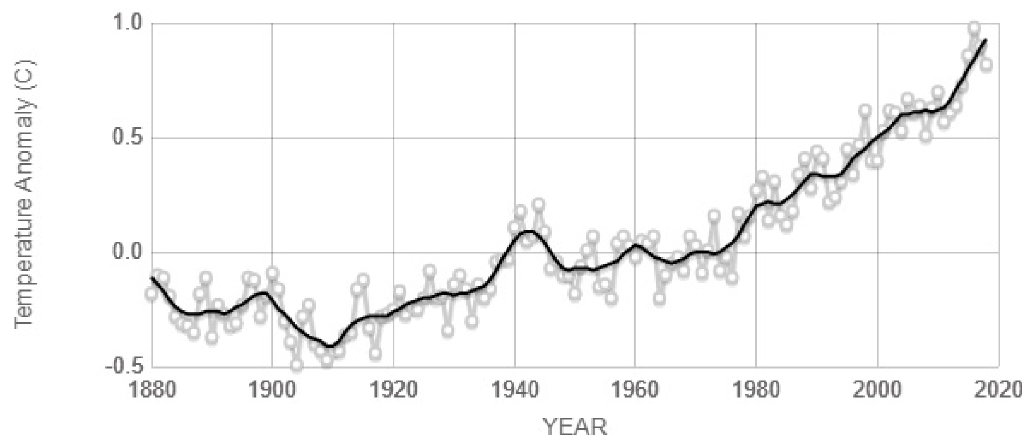
The physical risks associated with a rise in global temperatures, and the transition risks created by shifting towards a low-carbon economy are already having wide-reaching consequences for society, for the global economy, and for investment portfolios.

In response, we believe it is now mission-critical for the investment process to adapt and innovate to mitigate climate risk, and to take advantage of the many opportunities a transition to a low-carbon economy will create.

Climate change risk – an unstoppable force

The 2015 Paris Agreement, which brought global governments together for the first time in history in a landmark agreement to limit global warming to 'well below' 2 Degrees Centigrade this century, has set our economies on an irrevocable transition towards a low-carbon, more sustainable operating model. We believe there will be nowhere to hide from this transition as it will affect every investment portfolio over the course of time.

> "It is now critical for the investment process to embed consideration of climate change in order to mitigate the risks, and take advantage of the opportunities a transition on this scale will inevitably create"



Source: climate.nasa.gov

Adapting the investment process for the climate change era

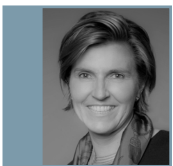
We believe it is now critical for the investment process to embed consideration of climate change in order to mitigate the risks, and take advantage of the opportunities a transition on this scale will inevitably create.

At Lombard Odier Investment Managers, we can do this in two ways.

First, we can favour companies with more sustainable environmental business practices and lower carbon intensity versus their peers. This works to reduce the exposure of the portfolio to climate change risk and we can do this across all our mainstream asset classes, whether that is equities, fixed income or convertibles.

This requires the collection, filtering, verifying and enhancing large amounts of raw data at the most granular extra-financial level possible. We do this through conventional and alternative routes, actively collaborating with data providers and research sources. This gives us a deep and diversified dataset, that also captures a forward-looking view of the physical and transition risks climate change presents at the company and asset level.

We then analyse this data from several different viewpoints. This includes our proprietary CAR approach (Consciousness, Action, Results), which helps us differentiate between companies that are achieving genuine results on the path to better environmental business practices, and those who are just talking about it. We also analyse the alignment of companies' environmental business practices to the Sustainable Development Goals (SDGs).



Written by

Carolina Minio-Paluello, PhD

Global Head of Solutions at Lombard Odier Investment Managers

Limited Partner of Lombard Odier Group

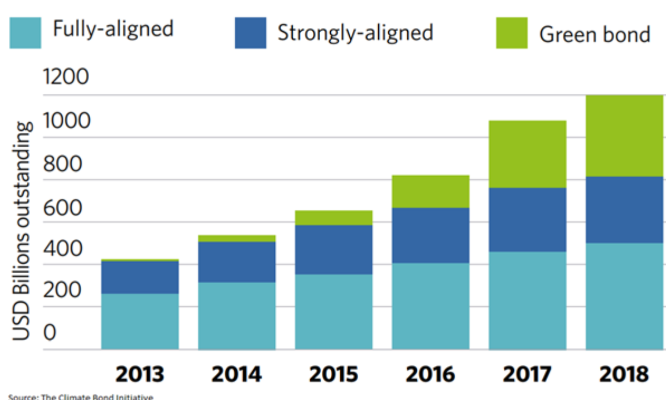
This approach gives us a better understanding of genuine sustainability that is more informative to the investment process than simply buying an external rating, and allows us to align portfolios to the SDGs, notably Goal 13 in the case of climate.

Second, in addition to tilting on climate-related business practices and carbon intensity, in fixed income we can invest in climate-aligned bonds to help avoid carbon emissions in the portfolio.

This is a rapidly growing asset class. The Climate Bond Initiative estimates the market for climate-aligned bonds has nearly tripled over the last five years to USD 1.4 trillion in outstanding bonds.

On the other hand, the physical environment is also changing, characterized by increasing severity and frequency of extreme events like hurricanes, droughts, floods, forest fires etc., as well as more long-term changes to our environment like rising sea-levels, changing ocean currents and prolonged heat waves. These changes have been shown to destroy significant value for investors.

> As the world transitions to a low-carbon economy, companies that are proactive in managing their exposure to climate risk will be more resilient as they are better positioned to adapt to new regulations, innovation, or a shift in consumer appetite



This gives us a much more diverse and liquid opportunity set, and because the use of the assets is clearly ring-fenced for climate-friendly projects, the outcome of the investment can be more easily measured in terms of carbon emissions avoided. Climate bonds represent a small, but growing segment of the fixed income market. We believe they will continue to grow in prominence as the transition to a low-carbon economy unfolds and the OECD is projecting the market could grow to in excess of $5 trillion by 2035.

We believe companies who manage their carbon intensity relatively well, or who issue climate-aligned bonds, are more likely to be better positioned in this changing environment. As the world transitions to a low-carbon economy, companies that are proactive in managing their exposure to climate risk will be more resilient as they are better positioned to adapt to new regulations, innovation, or a shift in consumer appetite.

By mitigating these risks in the portfolios, we can also help in the fight against climate change by creating a positive impact on the environment and society.

For us, identifying companies that are well positioned for the transition to a low-carbon economy is a key aspect of delivering sustainable investment returns in the future. Climate change, as a systemic risk, is something investors can no longer afford to ignore.

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A spiraling global population, social inequality and finite resources demand a new approach to investment. By switching to a more sustainable strategy, we believe financial models can secure future prosperity, both for investments and the planet.

Rethink sustainability at **LombardOdier.com**

rethink everything.

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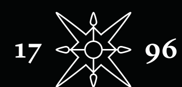

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Turning up the volume on sustainable returns

Many schemes need the certainty of a regular and sustainable income as their income requirements change over time. They need to ensure that they have the 'cushion' of an assured and consistent income stream to avoid having to sell assets at the wrong time in the cycle to meet pay-out obligations to members. In this context, this article brings together two investment approaches that we employ at Newton to help us drive long-term returns for our clients: dividend income and sustainable investing.

These approaches share a number of traits, such as emphasising the sustainability of a business and its cash-generation capability. Our sustainable investment strategies allow us to take a view on both the sustainability of a company's business model and its future prospects, while our dividend-income approach has always been tilted towards seeking out companies that can demonstrate sustainability in terms of the recurring dividend stream they provide to their investors.

We take a three-dimensional view on what 'sustainability' looks like within our investment process. First, we look for companies displaying the economic durability in their business models that can support a sustainable level of income over the long term; secondly, we take account of material externalities, by which we mean the consequences of commercial activity which affects other parties without being reflected in a company's own accounts, such as carbon emissions; and, thirdly, we harness our responsible investment analysts' research to evaluate the sustainability risks and opportunities of a company in an environmental, social and governance (ESG) context, alongside conventional financial criteria.

> "One of the best known (and yet most forgotten) truths of equity investing is that the biggest determinant of returns is the dividend income and the growth of the dividend over time, creating a powerful compounding effect over the long term"

The benefits of compounding

One of the best known (and yet most forgotten) truths of equity investing is that the biggest determinant of returns is the dividend income and the growth of the dividend over time, creating a powerful compounding effect over the long term. Within our equity income strategies, we implement a strict yield discipline in pursuit of a superior level of compounded income to the market. For us to buy a stock, it must offer a yield premium over the comparative index, and, if the yield on any stock that we own falls below that of the market, it must be sold.

Equities are often still primarily regarded as being in a portfolio to provide capital growth. However, thanks to the power of compounding, and with bottom-up fundamental analysis that seeks to unearth quality companies with strong business models at reasonable valuations, we believe that equities can also be more accurately regarded as a reliable and sustainable source of income. This is especially true if investors can look through the short-term volatility and view equities as a longer time-horizon asset in the way that alternatives such as infrastructure or private equity are regarded. While capital returns can be volatile, income returns are less so, and, as mentioned above, they are also the key determinant of an equity investor's long-term returns.

We have always viewed a healthy dividend in two ways: first, as a healthy cash reward for shareholders, and secondly, and more importantly, as a potential indicator of disciplined capital allocation. For healthy cash rewards to be sustainable and able to grow over the long term, capital allocation is crucial. For investors to exploit the power of compounding, a disciplined investment approach is equally crucial. The combination of the two can significantly improve the statistical likelihood of generating strong long-term investment returns.

Our responsible investment approach

We believe looking at ESG factors can help investors pinpoint risks beyond those identified in a company's financial statements – risks which can have a material impact on a company's performance and reputation. Analysing these non-financial issues can also provide a valuable window on a company's culture and emerging risks: in effect, how a company's managers behave when they believe no one is looking. This forms another layer of risk management alongside the more conventional financial analysis. It can also serve to highlight qualities and opportunities that could be missed in purely quantitative analysis. It is another perspective on how sustainable a company's cash generation is in the long term.

At Newton, we distil our responsible investment strategies into three broad categories. The first of these is exclusions and screening, which is an investment approach that we have run since 1988 for some of our faith-based and charity investors. The second is ESG integration, which is the way that we manage the vast majority of our clients' assets (and has developed as part of the evolution of our investment approach since our inception in 1978). In this approach, ESG analysis is a key input into the investment decision-making process. However, the ultimate decision about whether to include a security in a portfolio lies with the portfolio manager. This means that we may invest in companies which have a lower relative ESG score, if we believe that the valuation of the stock adequately compensates us for the risk posed by its weak ESG profile.

Finally, the newest element of our responsible investment approach is what we term 'sustainable' investing. In this category, we place added emphasis on positive ESG credentials, equal to the financial considerations. We omit companies with attractive financial characteristics, if those characteristics are accompanied by a poor or deteriorating ESG profile, unless we believe that through constructive engagement we can help bring about an improvement in ESG outcomes within a predefined timeframe. Our suite of sustainable investment strategies is increasingly gaining traction as investors demand greater levels of clarity and corporate accountability over ESG issues.

There is a growing belief within society that companies should be about more than simply financial profits, and that there should be evidence of a more sustainable approach to their business models. A cursory glance at the majority of regulatory and legislative changes taking place around the world can confirm the direction of travel. Around us on an almost daily basis, we observe companies affected negatively by consumer boycotts, union action, regulatory fines, huge clean-up costs, expensive lawsuits and damaging press and social media coverage.

All these actions show an increasing expectation of better execution of ESG considerations by companies. However, we believe responsible investing is about a lot more than simply aiming to avoid the potential pitfalls. To our minds, companies which are well aligned with this changing zeitgeist are likely to be in a better position to maintain and grow their dividend pay-outs over the long term.

"There is a growing belief within society that companies should be about more than simply financial profits, and that there should be evidence of a more sustainable approach to their business models"

Newton's 'red lines'

Our new sustainable strategies have principles-based 'red lines' which help to ensure the poorest-performing companies are not eligible for investment. We will not invest in companies that violate the UN Global Compact's ten principles that promote responsible corporate citizenship (relating to areas such as corruption, labour standards, human rights and the environment). We also avoid companies with characteristics which make them incompatible with the aim of limiting global warming to 2 degrees Celsius. Finally, we incorporate a tobacco exclusion as we do not view tobacco businesses as compatible with our commitment to sustainable investment.

In addition, the responsible investment team have a power of veto over investing in a particular security, if they believe a company or government is beyond redemption and cannot improve. We do not expect the veto to be needed, but it is a strong signal of what matters to our sustainable strategies both internally and externally.

By combining our pioneering equity-income and sustainable-investing approaches, we are merging two key strengths of Newton to create what we believe is a compelling investment proposition which should resonate with investors. By harnessing the power of compounding and the insights of detailed ESG analysis, we believe we can produce attractive income streams in a truly sustainable fashion.

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

Written by

Raj Shant

Portfolio Manager

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GROWING SUSTAINABLE FUTURES

Our sustainable investment strategies seek to help investors achieve their long-term goals in a responsible manner. We put environmental, social and governance (ESG) analysis at the forefront of our investment process in order to identify companies that have attractive investment attributes and manage positively the material impacts of their operations and products on the environment and society.

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Investment Management

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

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CAMRADATA
5th Floor, 80 Leadenhall Street,
London, EC3A 3DH

+44 (0)20 3327 5600
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