Sustainable Equity Whitepaper

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Welcome to CAMRADATA's Sustainable Equity Whitepaper

The rise and rise of sustainable investment has been clear over the past decade, with inflows hitting all-time highs amid the pandemic, as investors reflected on the implications of their capital allocations.

Additionally, national and supranational governments have given significant nudges to pension funds and other non-profit-led organisations to not just consider, but also report on how their asset selection might affect the rest of us in the long term.

Yet "sustainable" means a variety of things to a range of different people, a phenomenon that has played out in the fund management market place.

With only a few exceptions, financial institutions around the world have rushed to offer a dazzling array of new products, ranging from exclusion funds to straight-up impact vehicles.

But with such a large (and profitable) bandwagon comes the inevitable issue of smoke and mirrors, with accusations of greenwashing and "fake it 'til you make it" being bandied around the sector.

Furthermore, thanks to such a rapid and unstructured rise, the sustainable tag relies on acres of data fields that range from unstandardised to downright deceiving, leaving investors caught in a bind.

This quandary has caused inflows to funds taking this sustainable label to slow in the last 18 months, but is this just a blip while investors reassess?

We must also add into the mix that, ultimately, the vast majority of investors are still seeking a financial return over societal or environmental impact.

With equity funds leading the sustainability pack by some margin – both in terms of products and inflows – it is time for a discussion on how far this market has come, and what it needs to do to ensure its own sustainability.

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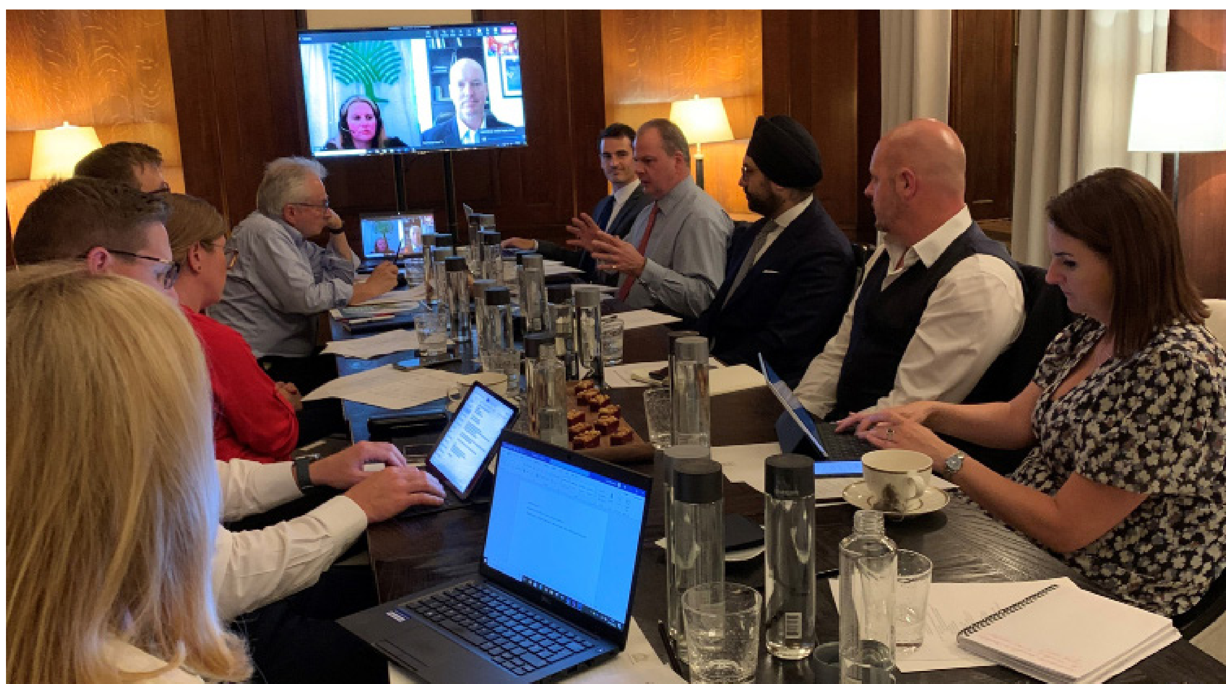
Sustainable Equity Roundtable

The Sustainable Equity Roundtable took place in London on 7th July 2022



The state of sustainable equity investing

At a recent CAMRADATA roundtable, experts discussed how an attitude change among institutional investors over the past five years is driving momentum in sustainable investing.

Sustainable equity investing has gone from fringe and niche to fully mainstream over the past few years. Inflows hit an all-time high amid the pandemic as investors reflected on the implications of their capital allocations.

At our sustainable investment roundtable on 7 July 2022 in London, Amandeep Shihn, head of sustainable investment manager research at WTW, said there has been a general increase in allocation over the last five years or so. But where that demand comes from varies significantly, and the products investors are seeking has changed too.

Shihn noted the "boom" in the DC pensions market for various ranges of ESG self-select funds, typically.

Yet he also said an increasing number of DB pension funds were trying to become more sustainable within their remit and budgets. He said many were also looking more towards employing quant or smart beta strategies for this exposure where tracking errors and risk exposures could be controlled or optimised.

He noted a large increase in allocation to climate funds in the past few years.

Attitude shift

David Wheeler, portfolio manager for AllianceBernstein's Sustainable Climate Solutions portfolio, said there had been a change of attitudes among institutional investors over the past five years.

He explained that, increasingly, the investment community believes that sustainable investing doesn't require giving up returns. Indeed, there is a growing understanding that it may lead to better risk-adjusted returns and reduced risks.

"Interest in this from our clients is not only at an all-time high but it is also spread geographically," said Wheeler. "Initially, a lot of the interest was EU-based but it has become very diversified – now the US has been caught up by Asia, and Latin America are active participants from the institutional standpoint."

Wheeler said this suggests the sector was still at a very nascent point of time in terms of acceptance – but there had already been a significant shift.

However, Alex Quant, investment consultant and head of ESG research at XPS, who primarily advises UK-based DB schemes, said the ESG take-off continues to be mixed. "We certainly do see pension trustees go through that conversation, and then make a decision and invest, but I think it's fair to say for the majority, whilst appetite to engage is definitely growing, it's still early stages conversation."

He also said there is still some lingering belief that sustainable and

“Arguments around fiduciary duty come into the conversation, and the feeling that payment of pensions is the ultimate responsibility, so that longer-term sustainable themes, and considering climate change, are in some people’s minds at odds with the broader pension scheme objectives”

responsible investing means taking a hit on performance.

“Arguments around fiduciary duty come into the conversation, and the feeling that payment of pensions is the ultimate responsibility, so that longer-term sustainable themes, and considering climate change, are in some people’s minds at odds with the broader pension scheme objectives,” Quant added.

Mark Irish, deputy head of ESG consulting at Isio, explained that much of what drives the conversation with clients is whether they think the sustainability label is values-based or financially focused.

“If the client thinks its value based, they will be a lot more hesitant to make these changes because of fiduciary duty, the DC charge cap or value for members – all this feeds into pushing them down a certain pathway towards perhaps passive smart integration-type approaches, however for those clients that believe sustainable investment is financially focused, they are more likely to allocate to more active ESG solutions,” he explained. He noted Isio’s clients are increasingly moving to sustainable investment as a financially motivated decision.

Some larger Local Government Pension Scheme funds have the governance to start looking at some of these more active funds and can implement a framework that offers proper oversight.

Robin Ellison, chairman of the Cambridge Colleges’ Federated Pension Scheme, said while most pension trustees want to do the right thing and were aware about the importance of climate change and ESG, most mid-sized and smaller schemes do not have the bandwidth to deal with the required level of scrutiny and oversight. However, Ellison highlighted that a wide range of asset managers were beginning to build ESG elements into their general portfolios, so the need to look at specific sustainable equity funds may soon no longer be a talking point.

“Most pension fund trustees who are not full-time trustees have other lives as well, and the debate has been very complicated with many different terms,” he said. “They expect their mainstream asset managers or their investment consultant to build this into the package anyway without having to necessarily have a dedicated discussion.”

Strategies

Mark Whitehead, head of sustainable global equities at Sanlam Asset Management UK, said his strategy had always been to invest in high-quality businesses that generate strong structural growth of the top line that translates into decent earnings growth and strong cash generation supporting an attractive dividend.

“We’ve found this is the sweet spot of investing for us,” said Whitehead. “We’re not a value fund or high dividend yield fund. We are a dividend growth fund, where yields are just a little bit more than the index, but the companies have strong capital allocation rewarding shareholders with a dividend return whilst also investing for future growth.”

The MSCI World ESG Leaders index has outperformed the MSCI World Index over the long term, while the MSCI World Dividend Masters index has also outperformed its parent index, he pointed out. Sanlam is trying to harness both these styles, which gives a “very good outcome” of high-quality sustainable companies that pay a consistent and growing dividend and that will lead to strong total returns. “Our investee companies are leading in terms of their environmental and social policies,” he added.

Wheeler said his fund was also positioned to generate good, risk-adjusted returns. He explained: “Benchmarks are backward looking, reflecting yesterday’s winners. What we’re doing is researching what the future is going to look like. We identify themes that are going to show strong secular growth over the next decade and beyond, and find the companies that are going to be the winners of tomorrow.”

The firm uses the UN’s Sustainable Development Goals (SDGs) as an investment framework as some 193 countries have signed up to the sustainable agenda and working to attain them all will see significant capital investments - $90 trillion over 15 years - and regulatory tailwinds over the long term.

“Companies that are providing products and services to help address the climate challenge, for example, are going to have great opportunities to grow profits for the next decade on the back of secular growth trends regardless of the economy,” Wheeler added.

Sarah Bratton Hughes, head of ESG and Sustainable Investing at American Century Investments, said her firm was investing in and providing capital to transitioning companies, which she believes, should deliver sustainable outcomes.

She warned about some parts of the investment community ignoring these companies and just dedicating investment to new clean technologies.

“We must acknowledge that there are dirty industries that we are going

to need to help us to meet our climate goals in the future," she said.

"We can't just concentrate on the money that's going to be allocated to these high growth, new and innovative companies; we also must think about the companies that exist right now – there is a real opportunity in value investing from the prospective of both financial and ESG returns."

Bratton Hughes describes these companies as offering "alpha plus" – that is, traditional financial alpha combined with environmental/social alpha.

Engagement and voting

For Sanlam's Whitehead, engagement with companies is important and can have a huge impact on change in corporate behaviour.

He said: "We write to all our companies and tell them how we're voting at their AGMs and give them a reason why we're voting against their resolutions, and if we don't get responses then we follow that up when we engage with the companies."

He highlighted construction and mining machinery manufacturer Caterpillar as an example of how asset managers can have huge influence on corporate agendas. The company faced a shareholder proposal last year asking them to set a Paris-aligned 2050 net-zero target, and management were recommending the rest of their shareholders vote against the proposer.

"We voted against management but interestingly, now faced with another similar shareholder net-zero target proposal this year, the company has done a U-turn and is advising the rest of their shareholders to vote for that resolution, and they have committed to implement the policy," said Whitehead.

"Hopefully, we were a very small part of a larger movement to put pressure on the company to improve. There are now bodies of asset managers that are getting together to really put pressure on companies to improve, and this is really making an impact," he added.

Challenges in ESG

The huge spectrum of diversified strategies can make ESG a very challenging space, said Shihn: "A number of these products seem to have been created from a particular client demand, which then gets offered out to more clients. It creates a huge variation in strategy type and how a single ESG topic might be approached, which may not be right for all investors. The breadth of products with slight variations on the same topic and different outcomes creates a challenge for investors looking to understand the landscape of ESG focused products and how it may or not be suitable for them."

While he said a UN SDG-based approach works, he also pointed out that the SDGs are broad; some SDG strategies can focus on two things, while others will try and cover everything. "That becomes a very complex topic, and from a pure capital allocation perspective, as an investment consultant, you cannot possibly have a rating on every variation of every product that exists."

Irish said the variation can be as useful as it can be difficult, as managers have different clients with different objectives in different circumstances.

Quant said that for end investors there are challenges in separating the wheat from the chaff, pointing out the choices on offer and variation of ESG approaches taken are overwhelming.

"We assess the process that's in place to ensure investment decisions are informed by robust analysis, and that analysis is being fully integrated into the process. Independent labelling such as that which exists in the EU and is coming soon to the UK will help, however in our experience there is still a need for further due diligence to ensure the fund is doing what it says it will."

That there is huge variation of approaches is a good thing, said Quant, because clients have different objectives but also, as everybody is learning in this space, different managers will inevitably take their own direction.

One of the major issues with ESG is lack of standardisation in data.

"We have regulations trying to standardise what sustainability and ESG data are, however, this differs across regions and regulators. On the flip side, could this narrow the focus to 30 or 40 different principle adverse indicators, rather than investment managers forming an opinion where they know who these companies are and know their issues, and how those companies might respond to various ESG events, or reputational risks or litigation risk, or whatever it may be," he said.

Ellison wondered whether the asset management industry has not pushed back hard enough against the new stringent regulatory framework, warning that measurement can do more harm than good. This is because accurate measures are often difficult to obtain, which can lead to unintended consequences.

When asked how he chooses between different approaches and whether cost is a factor, Ellison said most trustees are not too bothered by asset management costs, within limits. But he pointed out there is huge pressure for pension funds to look at firms which are "free riding on the engagement by the active managers".

He added: "The obsession by central government on measuring investment management costs is bizarre and is having unintended consequences in private equity and infrastructure. And there are lots of organisations now focusing on transparency and producing measurements of asset management services, among others. But personally, I'm quite relaxed about it."

Shihn said WTW looks at how asset managers vote on different resolutions, particularly ESG-focused resolutions and whether they support shareholder proposals or not. "And for our delegated equity funds, where we have segregated

accounts, we still leave proxy voting discretion to the underlying asset managers, but we overlay that with a proxy voting advisor where we know they have a strong focus on environmental and social issues. The proxy advisor will offer their thoughts on voting proposals and share this with the underlying managers and open up the avenue for a conversation around the resolution. In our view this creates a stronger stewardship model with traditional asset managers, who benefit from learning from a different perspective, broaden their knowledge base and start to evolve the implementation of their investment process based on ESG information," he said.

Irish noted that regulations were being introduced on UK pension schemes to push them away from simply delegating stewardship activities to its underlying managers and take a more "hands on" approach including setting stewardship priorities.

Wheeler said it is incredibly hard for clients to compare various types of strategies. This is why it is important that managers go above and beyond to define what they do and demonstrate how they do it. An example is a client who wants to invest in climate.

"The available climate data has a focus on carbon footprints, but that illustrates the negative impacts of a company's operations and only tells part of the story," said Wheeler. "In our approach, we also focus on carbon handprint, which is the carbon emissions directly reduced by a company's products and services. Often times carbon handprints are far more important than carbon footprints when evaluating investment opportunities."

Approaching shifts in sustainability goalposts

Changing attitudes to sustainability in addition to changes in regulation across the world mean that investors must adapt.

Bratton Hughes said the goalposts around sustainability are constantly changing: "If we're standing still, we'll fall behind, because that's how fast it's moving from a regulatory perspective, but also consumer expectations and preferences going forward, that we need to continue to assess what was good practice three years ago is not necessarily good practice today."

American Century Investments approaches these shifts from a risk perspective and opportunity perspective, as well as looking at it holistically.

"There's no such thing as a perfect company so it is about assessing and weighing those trade-offs," she said. "We have our proprietary materiality mapping, and what we're underpinning that by is looking through industry by industry and sector relative data analysis. Not only are we looking at where our company is now, but also forward-looking trends."

On the opportunity side, the firm is focused on major super trends, which it believes are key to defining a more sustainable economy. These trends can be categorised as healthcare, empowerment and inclusion, quality jobs, sustainable living standards, the environment, biodiversity, and digitalisation.

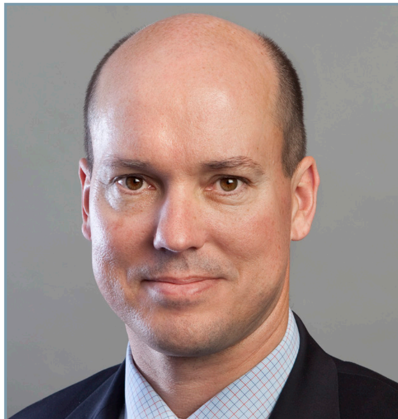
What next for sustainable equity funds?

For Quant, biodiversity is set to be the next big topic of conversation in the coming years, and he believes there is likely to be regulation around it.

"Pension trustees may roll their eyes and think it's another thing to think about, but I think it is very important to articulate the idea that biodiversity is all encompassing climate change," he said. "You can't hope to deliver successful climate transition without considering natural capital in the whole."

Bratton Hughes would like to see continued momentum of the just transition: "When we think about biodiversity, it's very important because a lot of the biodiversity in the world is in our emerging markets, and yet these individuals are the least responsible for the situation we find ourselves in."

Roundtable Participants



David Wheeler, CFA

Portfolio Manager—Sustainable Climate Solutions; Senior Research Analyst—Sustainable Thematic Equities

Personal Profile

David Wheeler is a Portfolio Manager for the Sustainable Climate Solutions Portfolio and Senior Research Analyst for the Sustainable Thematic Equities Portfolios, covering the energy, industrials and materials sectors for the portfolio team.

Prior to joining the firm in 2008, he was a managing director, analyst and portfolio manager at Neuberger Berman. Before that, Wheeler worked at J.P. Morgan as a research analyst for the energy sector.

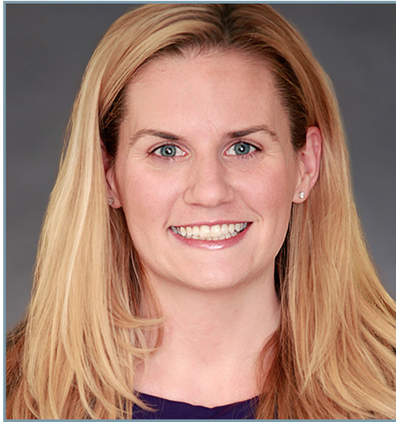
He holds a BA in economics from Middlebury College, and is a CFA charterholder. Location: New York.

AllianceBernstein

Company Profile

AllianceBernstein is a leading investment-management firm with $735 billion in client assets under management, as of 31 March 2022. We provide forward-looking perspective, independent research and investment discipline across asset classes, from equities and fixed income to alternatives and multi-asset portfolios. Our worldwide clients—including institutional, high-net-worth and retail investors—face new investment challenges and opportunities every day.

Through our unique combination of expertise, research and global reach, we apply collective insights and leverage our extensive global footprint to help keep our clients at the forefront of change.



Sarah Bratton Hughes

Senior Vice President,

Head of ESG & Sustainable

Investing Equities

Personal Profile

Sarah is responsible for driving and executing the firm's sustainable investing strategy and the management of its ESG research platform and active ownership practices. In her role, she oversees the firm's dedicated ESG & Investment Stewardship team. Sarah and her team serve as the centre of ESG expertise for all investment teams – implementing firmwide ESG research and training, innovating ESG assessment tools, managing the ESG engagement and proxy voting protocol and driving sustainable investment initiatives and client solutions.

Sarah earned a bachelors degree in economics and business management from St. Francis College.

In 2021, Sarah was named to Crain's list of Notable Women on Wall Street and won the Markets Media Women in Finance award for Excellence in Sustainability. Additionally, she has authored thought leadership and insights of U.S. sustainability policy as well as social sustainability topics globally.

American Century Investments

Company Profile

American Century Investments is a leading global asset manager focused on delivering investment results and building long-term client relationships while supporting breakthrough medical research. Founded in 1958, American Century Investments' 1,400 employees serve financial professionals, institutions, corporations and individual investors from offices in New York; London; Frankfurt; Hong Kong; Sydney; Santa Clara, Calif.; and Kansas City, Mo. Jonathan Thomas is president and chief executive officer, and Victor Zhang serves as chief investment officer.

Delivering investment results to clients enables American Century Investments to distribute over 40% of its dividends to the Stowers Institute for Medical Research, a 500-person, nonprofit basic biomedical research organization. The Institute owns more than 40% of American Century Investments and has received dividend payments of $1.87 billion since 2000. For more information about American Century Investments, visit www.americancentury.com

Roundtable Participants

Mark Whitehead

Head of Sustainable Global Equities

Personal Profile

Mark joined Sanlam in December 2020 to launch a sustainable global dividend strategy. He has 15 years of experience in global income investing with an increasing focus on sustainability.

In 2007 Mark launched one of the first global equity income funds and has experience in managing both open-ended and closed-end products as well as charity portfolios.

Sanlam Investments

Company Profile

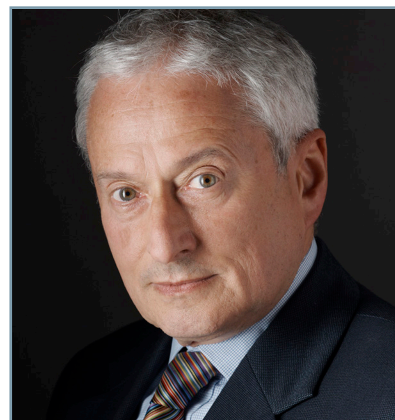
Sanlam Investments UK is the global asset management arm of the Sanlam Investment Group both of which are wholly owned entities of Sanlam Limited. Sanlam was founded in 1918 in Cape Town, South Africa and is now a global financial services group with a footprint in 45 countries, is the largest non-banking financial services group on the African continent, a market capitalisation in excess of £6.5bn and a AA+(zaf) National Long-Term rating from Fitch Ratings.

Sanlam Investments UK is a boutique asset management business which brings distinctive asset management expertise across a range of high conviction active strategies encompassing equities, fixed income, and alternative asset classes. Our sole focus is asset management and our offerings are housed in UCITS, IFSL pooled fund structures and segregated accounts. The business was originally established in 2006 as Four Capital with Sanlam taking their first stake in 2009 and subsequent transactions resulted in the business becoming a wholly owned entity.

Mark Irish, CFA, CAIA

Deputy Head of ESG Consulting

Mark is a Consultant in the Investment Advisory team at Isio, where his focus is on developing and delivering investment advice to Isio's clients. Mark is also Deputy Head of ESG Consulting as part of Isio's ESG Research Team whose focus is on strategic ESG considerations and funds that explicitly integrate ESG into the investment process. Mark joined Isio in November 2020 from Willis Towers Watson and has experience in advising UK institutional investors on all aspects of their investment arrangements.



Robin Ellison

Chairman of the Cambridge Colleges' Federated Pension Scheme

Robin Ellison is Chairman of the Cambridge Colleges' Federated Pension Scheme, and a consultant with Pinsent Masons, the international law firm, based in its London office where he specialises in the development of pensions and investment products. He acts for a number of government agencies and foreign governments and has been an adviser to the House of Commons Select Committee on Work and Pensions. He wrote a monthly column on pensions law for 40 years for Pensions World.

He is Visiting Professor in Pensions Law and Economics at The Business School, City, University of London, and is trustee of a number of pension plans both in the UK and overseas. He gained his PMI Diploma in Pension Trusteeship in 2021.

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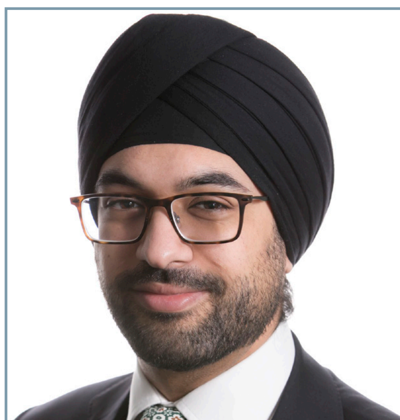
UNIVERSITY OF CAMBRIDGE

Roundtable Participants



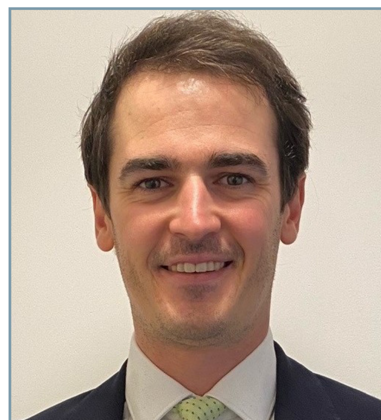
Amandeep Shihn

Head of Sustainable Investment Manager Research

Amandeep Shihn leads WTW's Sustainable Investment manager research efforts and sits on the Investment Committee for WTW's Diversified Equity Fund.

He led WTW's Global Emerging Markets Equity manager research for four years until mid-2021. Particular areas of focus are researching Global, Emerging Markets, Chinese equity strategies, and sustainable investing. In this role he is involved in portfolio construction for WTW's global client base, sourcing and developing new investment ideas and has designed a number of the tools and frameworks used to research asset managers and monitor their portfolios from a sustainability perspective.

Amandeep graduated from the University of Bristol with a BSc in Economics and Imperial College Business School with a MSc in Finance.

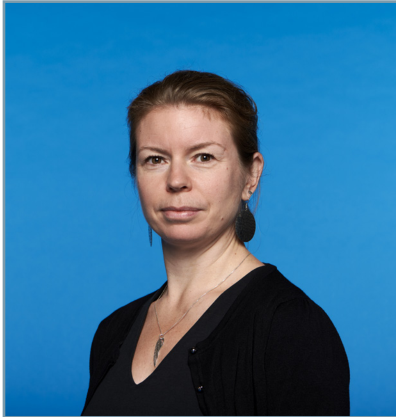


Alex Quant

Investment Consultant and Head of ESG Research

Alex is an Investment Consultant and Head of ESG Research at XPS. Alex is responsible for assessing and engaging with investment fund managers to make sure they take into account ESG and climate change when making investment decisions, and also working with pension schemes to help them effectively review and further embed sustainability in their investment portfolios.

Moderator



Elizabeth Pfeuti

Chief Client Officer

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes.

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

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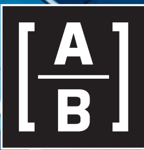

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At AllianceBernstein, we're fostering a culture of diverse perspectives and innovation to help advance our clients' success. And we're doing it responsibly—from how we act to how we invest—because outcomes mean more than financial returns.

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55 Years	of investment management and research
$687 Bn	in solutions for investors ranging from individuals to the world's largest institutions
51 Locations	on-the-ground presence with 347 investment professionals across 26 countries and jurisdictions

All figs are as at 31 May 2022.

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Our culture engages people with different backgrounds, viewpoints and ways of thinking, bringing out the best in our firm for our clients.

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We challenge convention by applying new information sources and disruptive technology to advance our capabilities and the ways we serve clients.

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We pursue responsibility—from how we work and act to the solutions we deliver to clients.

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Carbon Handprints: A New Approach to Climate-Focused Equity Investing

Investors are strengthening their commitment to help combat climate change. But as inflows to climate-focused funds accelerate, more questions are being asked about the investing approaches of these portfolios. What type of companies are held in climate-focused portfolios? Can you fully assess a company's impact on the environment by looking at its carbon emissions metrics alone? And how does a climate-focused fund contribute to global efforts to accelerate decarbonization?

Investors often seek simple metrics to determine which companies are "good actors" in the fight against climate change. The most common metric for evaluating a company's environmental impact is the carbon footprint—total greenhouse gas (GHG) emissions generated by business activities. But a carbon footprint doesn't tell the whole story of a company's impact, and can also be misleading. There are many other ways for companies to promote a transition to a low-carbon world that simply won't register in carbon footprint data. And there are many ways for companies to lower a carbon footprint that don't help in tackling climate change.

So how can investors gain confidence that an equity portfolio is invested in companies that are really helping to address climate risk? Instead of focusing exclusively on a company's carbon footprint, we believe investors should look at a company's carbon handprint. In contrast to a carbon footprint, which measures the negative impact of a company's operations on the environment, a carbon handprint measures the positive impact, or carbon avoided, by using a company's products. These products represent the positive solutions to global climate challenges created by a company. From clean energy to recycling, transportation to energy efficiency, diverse companies with a big carbon handprint are making major contributions to solving the world's climate crisis.

Author:

David Wheeler, *CFA* | *Portfolio Manager—Sustainable Climate Solutions; Senior Research Analyst—Sustainable Thematic Equities*

Applying the Carbon Handprint Principle

There are different ways to quantify a carbon handprint for each solution group. But across solutions—among them agriculture, clean energy, transportation and energy efficiency—the unifying principal that anchors our analysis is how much carbon is avoided.

This metric becomes the lens for identifying and evaluating a carbon handprint. For example, clean energy companies will be judged on the amount of zero-carbon energy generated, while resource efficiency companies are ranked on their ability to save energy for other companies and entities.

In our whitepaper entitled 'Carbon Handprints: A New Approach to Climate-Focused Equity Investing', we present case studies that show how to apply a carbon handprint analysis. Consider Schneider Electric, a French multinational company that provides energy management systems to help buildings, data centers and industrial facilities reduce their emissions. These technologies helped companies avoid 45 million metric tons of CO2 emissions in 2020—85 times more than Schneider's emissions during the same year (Display). Vestas Wind Systems, a Danish manufacturer of wind turbines, generated 73,000 metric tons of CO2 through its manufacturing processes in 2020, but will enable its customers to reduce carbon emissions by 45 times more than that annually over the next 20 years.

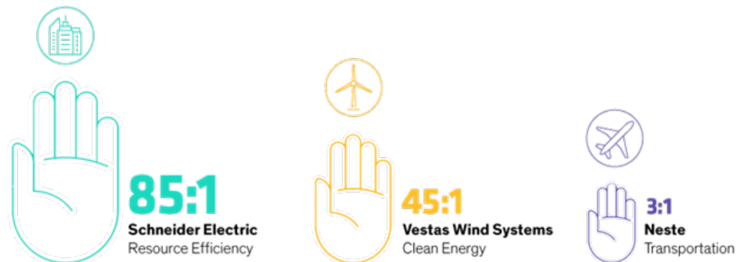
Author:

Daniel C. Roarty, *CFA* | *Chief Investment Officer—Sustainable Thematic Equities*

Disclosure of carbon avoided is not an industry standard. As a result, investors can't rely on company reports or third-party rating agencies to understand how much carbon is avoided through climate solutions. By actively engaging with management and conducting independent research, we believe investors can obtain the information needed to measure a company's carbon handprint accurately and convincingly. Establishing a clear carbon handprint metric allows investors to assess how a company is contributing to the fight against climate change, and how its contribution is evolving over time.

Carbon Handprints Point to Real Climate Solutions

Ratio of Carbon Handprint to Carbon Footprint



Past performance and current analysis do not guarantee future results.
As of December 31, 2020
For Schneider Electric: 45 million metric tons of CO_2 emissions avoided in 2020 from energy efficiency savings from its energy management and automation products vs. 527,000 metric tons emitted during 2020 (scopes 1, 2 and 3). For Vestas: carbon avoided by a wind turbine over its lifetime vs. carbon emitted during manufacturing, transporting and installing a wind turbine. For Neste: renewable transportation fuel enabled customers to reduce GHG emissions by 10 million metric tons in 2020. Neste's carbon emissions were 2.9 million metric tons in 2020.
Source: Company reports and AllianceBernstein (AB)

"Establishing a clear carbon handprint metric allows investors to assess how a company is contributing to the fight against climate change."

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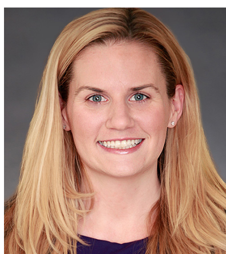
Sri Lanka: A Cautionary Tale About a 'Just Transition' to Sustainability

"If developed markets funded the cost of transitioning to cleaner energy, household consumption would increase, and global GDP would rise by over $108 trillion."



Author

Sarah Bratton Hughes

Head of ESG and Sustainable Investing

Climate change doesn't recognize national borders. It doesn't equitably distribute its devastation in proportion to the greenhouse gases each country emits. Melting polar ice caps, rising sea levels, increasingly destructive wildfires, hurricanes and floods affect the whole world.

The message is clear: No matter what hemisphere you live in or whether your country is at the higher or lower end of per capita gross domestic product (GDP), we are all in this fight together.

In our view, that's essential to keep in mind as we push toward greener economies and a low-carbon future. The world must pursue these goals in a way that doesn't punish people living in emerging markets (EM)countries, most of which have contributed relatively little to the historic emissions causing the problems we see today.

During this shift, we must also consider countries that may stand to lose economically. The recent unrest in Sri Lanka provides a textbook example of how good intentions can have negative consequences and why implementing a just transition is essential to achieving sustainable growth.

The headlines about the uprising in this EM nation of 22 million people described thousands of people storming the presidential compound in Colombo to demand the resignation of President Gotabaya Rajapaksa after the economy collapsed. He was forced to do so amid the chaos.

How does this first financial and political collapse of an Asian nation since the late 1990s relate to a just transition?

Sri Lanka Economic Crisis Explained

Sri Lanka, which the World Bank categorizes as "lower middle income" with per capita GDP similar to Algeria and Egypt, suffered the effects of ill-advised economic policies. The country had taken on heavy debt without paying much attention to how it could support it.

This situation should ring an alarm bell for other nations that have done the same thing, but there is more to the story. Several factors led to the inflationary spiral that caused its economy to collapse.

The COVID-19 pandemic decimated tourism and caused many Sri Lankans working overseas to return home. Remittances (money sent home from abroad) typically contributed about $6 billion of income to the country per year, a decent chunk of Sri Lanka's annual GDP.[1] Without this remittance income and tourism dollars, the government was forced to spend much more on imports and servicing its debt.

Then when fuel prices rose following Russia's invasion of Ukraine, Sri Lanka didn't have enough money to import the fuel its economy needed, causing high inflation and fuel shortages. People waited days to refuel their vehicles, and the power was cut repeatedly.

Meanwhile, Sri Lankans were also experiencing food shortages thanks to the former president's efforts to push the country toward a greener economy. In spring 2021, he abruptly (not gradually!) prohibited chemical fertilizers. While well-intentioned, this ban caused farmers to produce less food for consumption and export, reducing incomes and creating food shortages.

Implications of the Economic Crisis in Sri Lanka for Other Developing Nations

The World Economic Forum (WEF) recently reported that emerging markets need about $94.8 trillion in additional investment to help transition to a net-zero economy by 2060.[2] Such spending represents more than the entire world's annual GDP, but it would be spread out over time.

EM governments have committed to investing in reducing carbon emissions to help meet long-term global warming targets, according to a 2022 Standard Chartered Bank study.[3] But the WEF says research shows if emerging markets had to self-finance this effort through higher taxes, it would result in a "disruptive transition that could make some of the world's poorest communities even poorer. The scale of the financing task is simply too great for emerging economies to bear alone."[4]

According to Standard Charter calculations, if emerging markets had to raise this money through higher taxes and borrowing, average annual household consumption would fall by 5%.[5] That would make EM households roughly $2 trillion poorer each year.

If you are already struggling to feed your family, higher taxes that cut your income by 5% may start to sound like a recipe for civil unrest. This would likely discourage climate action and make the net-zero transition more likely to fail.

Here's where we think the just transition argument gets even more compelling: If developed markets funded the cost of transitioning to cleaner energy, household consumption would increase, and global GDP would rise by over $108 trillion.[6]

Developed markets still have much to do to cut carbon dioxide emissions and transition to a sustainable energy future. At the same time, they must provide additional funding to less developed countries that need support to help the world meet critical emissions-reduction targets to prevent catastrophic, irreversible damage impacting everyone across the globe.

Our Commitment to a Just Transition

According to a recent report from the U.N. Governmental Panel on Climate Change, at least 3.3 billion people are already "highly vulnerable to climate change" and 15 times more likely to die from extreme weather.[7] People are already being displaced by extreme weather. "Displaced" is typically used when talking about refugees from a war, and we think that's the correct analogy. And, as with war, the world's poor are hit the hardest.

At American Century Investments, we believe investors must pursue a just transition to a greener world. Otherwise, well-intentioned efforts will likely lead to suffering, civil unrest and worse. Sometimes, this may mean taking measured steps rather than insisting on immediate change. That can be frustrating and worrisome to some, but we believe it is the best approach to achieving sustainable change that supports rather than hampers economic growth.

We firmly believe sustainability issues shouldn't be viewed in isolation or in Environmental-Social-Governance silos, which is why we have a top-down thematic framework that allows us to look at sustainability risks and opportunities holistically.

To us, the concept of a just transition isn't merely fodder for philosophical debate. We actively assess how companies are positioning all stakeholders for success in a decarbonized economy and use engagement as a critical lever to produce meaningful insights that may help lead to better outcomes for all.

1Debra Kahn, Jordan Wolman and Lorraine Woellert, "Is organic farming to blame for Sri Lanka's crisis?" Politico, July 19, 2022.
2Charlotte Edmond, "Here's why developed economies must bear the $100 trillion cost of the net-zero transition in emerging markets," World Economic Forum, April 5, 2022.
3Standard Chartered Bank, "Just in Time: Financing a just transition to net zero," April 2022.
4Edmond, "Here's why developed economies.
5Standard Chartered Bank, "Just in Time."
6Standard Chartered Bank, "Just in Time."
7H.-O. Pörtner, D.C. Roberts, E.S. Poloczanska, et al., eds., Summary for Policymakers, "Climate Change 2022: Impacts, Adaption and Vulnerability," Contribution of Working Group II to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change, February 2022.

Many of American Century's investment strategies are subject to the incorporation of ESG factors into the investment process employed by each strategy's portfolio managers. When portfolio managers incorporate Environmental, Social and Governance (ESG) factors into an investment strategy, they consider those issues in conjunction with traditional financial analysis. When selecting investments, portfolio managers incorporate ESG factors into the portfolio's existing asset class, time horizon, and objectives. Therefore, ESG factors may limit the investment opportunities available, and the portfolio may perform differently than those that do not incorporate ESG factors. Portfolio managers have ultimate discretion in how ESG issues may impact a portfolio's holdings, and depending on their analysis, investment decisions may not be affected by ESG factors.
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Investment Director, UK Consulting firm

"Just a note to say thank you for organising the panel and having me on it. I found the full group discussion super informative."

Portfolio Manager, Global Asset Manager

"The CAMRADATA virtual roundtable went really well, as well as the live events, which was quite surprising! It was informative and interesting, and I know our Fund manager enjoyed being a part of it."

Business Development Manager, UK Asset Manager

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Sanlam Investments has deep expertise across all key asset classes brought about by years of experience. We focus on harnessing this talent to provide differentiated specialist funds to our clients.

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Reflections of a sustainable investor

Sanlam Investments

> *"We are surprised at how many funds have managed to be classified as 'Article 8' funds."*

Credibility

Credibility, the quality of being trusted and believed in, has become the byword for the sustainable investor.

It has been widely reported that a financial advisory firm, after an extensive review, culled more than 1,200 funds with combined assets of $1.4 trillion from its European sustainable fund list earlier this year. This cull represents around 40% of the assets under management that the company had considered sustainable at the end of September 2021. Our response? Too right!

Most of the funds rejected were classified as Article 8 funds under the Sustainable Finance Disclosure Regulation (SFDR). SFDR sets out the mandatory ESG disclosure obligations for asset managers and aims to bring in a level playing field for financial market participants and provide transparency in relation to sustainability risks. As managers of the Sanlam Sustainable Global Dividend Fund, an 'Article 8' fund, we know how important the external validation of sustainability credentials is.

We are surprised at how many funds have managed to be classified as 'Article 8' funds. Any action by research and data providers to raise the hurdle and help ensure greenwashing is eradicated should be applauded.

At Sanlam, we believe several things are key to help ensure credibility in sustainable investing. In addition to negative screening, where certain subsectors are excluded, sustainability analysis must be embedded in the research process for choosing which companies to invest in. A clear test of this is that you can demonstrate that companies that fail your sustainability analysis will not be invested in.

In the same way that you wouldn't invest in companies that you felt had weak business models or were expensive. We employ a sustainability scorecard as the first part of any company analysis. If a company scores negatively we will not proceed.
Engagement with companies is also an important part of sustainable investing. Voting is key here as it allows for scrutiny of a board's actions. We vote on all items and proposals on behalf of our clients. When we vote against management proposals, we let the company know why we have voted the way we have. This naturally leads, in most cases, to engagement and we can then further assess the responses we are given.

We believe external validation of sustainability credentials by the likes of Morningstar and MSCI is key as is having targets for portfolios related to such bodies. We target an MSCI ESG rating of AA or AAA, the top two ratings, for our fund, always.

Author

Alan Porter

Fund Manager

Exclusions

Exclusions, companies removed from consideration in a portfolio, have become a hot topic in sustainable investing this year.

Most sustainability funds apply at least one exclusion criterion where they exclude certain companies from investment. Controversial weapons are the most excluded category followed by tobacco and thermal coal. The Sanlam Sustainable Global Dividend Fund excludes companies that derive more than 10% of their revenues from tobacco, alcohol, gambling, adult entertainment, weapons, and fossil fuel extraction. There are debates surrounding the use of exclusions that are worth considering.

Some argue that exclusions are costly to investors because of the performance

missed out on by not owing certain areas of the market. The only evidence we have seen that supports this is based on analysis covering the last 20 years. We would argue that the growth of sustainability funds that use exclusions has only taken off in the last few years. Using 3, 5 and even 10 years of history would show that sectors like tobacco and integrated oil & gas have performed poorly.

Others argue about the effectiveness of exclusions on changing behaviours. They state that regulation is the bigger driver in the reduction of say, controversial weapons or tobacco consumption. We would argue that timeframes are important. Many of the key regulations such as the UN Convention on Cluster Munitions (in force in 2010) or the World Health Organisation Framework Convention on Tobacco Control (in force in 2005) pre-date the growth of sustainability funds.

We believe exclusions have several clear positives. One of the criticisms of many funds that claim to take environmental, social and governance (ESG) issues seriously is that it is hard for investors to see the evidence of this. We have always felt that one sure way to evidence the integration of ESG is to show that stocks are not invested in because of ESG issues. There are two ways to do this, one is to exclude companies the other is to demonstrate a research process where stocks fail because of rigorous ESG analysis. We do both, we exclude certain sectors and if a company fails our sustainability analysis we will not invest. Indeed, sustainability analysis is the first part of our company analysis.

The use of exclusions also has an indirect impact by raising public awareness of environmental and social issues. Funds that employ exclusions tend to state this up front and visibly to investors which helps with raising this awareness. But for us the most important positive is client choice. Clients want the option of investing in funds that exclude areas of the market that they are uncomfortable investing in. Who are we to disagree?

Data

Data, facts, and statistics collected for reference or analysis, is a key issue for the sustainable investor.

As managers of a strategy that invests in companies that combine strong sustainability and dividend credentials, we often get asked about the quality of sustainability data and reporting. Sustainability reporting has improved over recent years and this needs to continue to allow investors to make informed decisions over how to allocate their clients' capital. However, we believe that perfect sustainability data should not be the enemy of good data, that is, investors should focus on companies with data and reporting goals that are directionally improving.

Other items we could have discussed: voting; engagement; executive remuneration; and carbon pricing. One thing we are sure of, sustainable investing will only gain in importance whatever the discussion points.

To read the full article and disclaimer please visit https://www.sanlam.co.uk/our-fund-range/sanlam-sustainable-global-dividend-fund

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