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Responsible Investment: what lies beneath

Sometimes the complex sustainable factors involved in making an investment are not all obvious on the surface. Here, Kristina Church, head of Responsible Strategy at BNY Mellon Investment Management, considers how managers can look beyond the headlines or conventional understandings to uncover what companies are actually doing to address environmental, social, and governance (ESG) concerns.

Achieving long-term sustainability goals will require far-reaching societal change, engaging all sectors of the economy and society. That may seem a tall order, yet in an increasingly responsibly-focused world, investments are routinely expected to deliver the benefits of financial returns *and* generate a positive impact on society and the planet.

Does that mean that to invest responsibly we need to divest immediately from all perceived 'bad' companies? No - because in order to drive the wholescale transition so urgently required, the effort will require not only engaging with critical industries to impact change but also to ensure that these businesses are not starved of the capital they so urgently need to achieve their objectives.

It is important to keep in mind that Responsible Investment is a spectrum of investing styles and that even the most sustainable investments can include companies which might today be scoring less well on the criteria checklist for investments that claim to have ESG friendly status.

Further, for all those concerned, we need to see greater focus by investors on identifying companies that are not simply 'best-in-class' on ESG issues today but also those which are transitioning to align with a lower-carbon world, or better social values.

If we were to rely only on external providers of ESG data and static scoring systems, we might be limited to a small number of best-in-class or 'ESG champion' investments, while potentially missing out on the extensive opportunities others outside this classification might offer.

Investing solely in best-in-class investments risks attracting a disproportionate amount of inflows to this area, not only creating the risk of overcrowding in favoured stocks and sectors but also risks directing flows away from sectors which are vital for future economic growth and most desperately need investment to achieve the necessary transitions.

If we take climate as an example, 'dirty' carbon-intensive industries (such as cement, heavy-duty transport, steel, and chemicals) face the most significant net-zero transition challenges and costs. We will continue to need these industries for future growth, therefore without financing their transition, *net zero will be impossible to reach*. Since the latest COP26 climate summit, 90% of global GDP now lies within some form of net-zero ambition[1], and just over one third of the 2,000 largest publicly listed companies have similar commitments[2]

To stay on track with the targets outlined in the UN's 2015 Paris Agreement, carbon emissions need to be halved from their 2010 levels by 2030. The latest Intergovernmental panel on climate change (IPCC) report[2] on climate vulnerability underscores that addressing the climate challenge requires transition on an unprecedented scale and cooperation across all sectors of society and all nations.

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[1] https://climateactiontracker.org/global/cat-net-zero-target-evaluations/

[2] https://zerotracker.net/#companies-table

The report also highlights that the most vulnerable people and systems will be disproportionately affected by climate change. Forward-looking investment management firms are beginning to move away from simply making low-carbon investments to investing in companies that are engaged in this wholescale clean-energy transition to address either climate mitigation or climate adaptation.

However, not all carbon-intensive companies have accepted the need to transition, nor are all able to do so profitably. To be investable, companies in carbon-intensive sectors need to have credible, public strategies to transition in line with the goals of the Paris Agreement and need to report their greenhouse gas emissions in line with recognised standards, such as the Science Based Targets initiative (SBTi) and Task Force on Climate-related Financial Disclosures (TCFD). It is vitally important to understand the decarbonisation pathway these companies are on, rather than just to view their current carbon footprint. Investors also need to be able to track how success is measured and set limits that might eventually drive divestment if the criteria are not met.

Analysing entities for investment often differs by geography. Emerging markets (EMs) are already exposed to high risks from climate damage (unprecedented heat waves, rising sea levels, and destructive wildfires to name just some threats) and desperately need to finance the infrastructure to adapt to further climate damage. Many of these countries have different pathways to net zero and, as such, they cannot be treated uniformly by investors.

The decarbonisation trajectory of a steel company in Europe, for example, may differ greatly from that of a competitor in Asia. There is often less data available on ESG issues in emerging markets, but this does not mean that investors should penalise EM-based companies, which urgently need to finance their transition. Against this backdrop, engagement will be key. Engagement with companies and issuers can focus on simply seeking information to support investment decision-making, or it can seek to drive change on issues which are material to long-term value creation, such as delivering more quickly on net zero goals.

Social issues

Social issues are also rising up investment agendas. Investors no longer rank the pursuit of profit as a company's sole motivation, recognising that a strong culture and clear purpose to drive societal impact can be critical to long-term value creation. If a company does not have a clear social purpose, this deficit can affect a company's social license with stakeholders, access to capital, and customer acquisition. Again, engagement with companies and other issuers is key to assess and influence the social factors that are material to their longer-term success. However, it is not just about selecting the companies already best aligned with a client's social values: engaging for change involves dialogue with companies and issuers to drive impact and delivery on social goals.

For instance, as society and investors pay more attention to social needs, progress on diversity, equity, and inclusion (DEI) is increasingly becoming a differentiator for companies and can impact their ability to attract top talent, raise capital and reflect the profile of their customers. Organisations with diverse experience, skills, and backgrounds are more likely to make optimal decisions and nimbly avoid the pitfalls of groupthink.

Yet, unfortunately, investors do not always have access to consistent data to analyse DEI factors. The most forward-looking asset managers recognise the information and data gaps, are anticipating the changes that are needed, engaging with companies to actively try to fill the gaps, and are also focusing on companies that are delivering improvement on specific DEI credentials.

The same is true for other key social issues which are rising higher on investor agendas.

New opportunity

All of this presents tremendous opportunities for the asset management industry but only if it is prepared to satisfy the demands of increasingly aware clients who want to see their values reflected in their portfolios. Investing in companies and other issuers that are actively transitioning to more environmentally friendly and socially acceptable business models can deliver greater change to the wider environment and society than investing in entities already aligned to low-carbon or socially responsible models. Beyond this, stewardship can also play a key role in driving more consistency and quality in ESG data and determining the success (or not) of each transition model.

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