ASCALON CAPITAL

Sustainable Investing

Key concepts, trends and developments (March 2021)

Are you ready to add value in the investment process by improving investment governance?

Introduction

Sustainable investing has grown rapidly in recent years. A growing number of the largest asset owners and institutional investors globally have embraced Environmental, Social

and Governance (ESG) investing approaches. But demand for sustainable investing is also evident across the global financial ecosystem including retail wealth management.

Sustainable investing captures a wide range of beliefs, processes, and challenges. The disparate methods of implementing those beliefs and processes can result in varying investment outcomes. There is a growing body of sustainable investing regulation, oversight bodies and measurement standards. This has made it challenging for investors to easily align their portfolios with their own sustainability beliefs.

Sustainable investing has the potential to unlock long-term value creation. But there is not a unifying framework for quantifying sustainable investments and measuring the resulting performance relative to an objective. That makes it difficult for investors to clearly show they are managing material sustainability risks within their investment mandates on one hand, while pursuing sustainable outcomes that could represent a trade-off in long-term financial performance on the other.

Our white paper provides an overview of key sustainable investing concepts, trends, and developments. And we provide some key takeaways and considerations for investors considering implementing investments within a sustainable framework.

Introduction	2
What is sustainable investing?	5
How big is sustainable investing?	7
Is sustainability a source of alpha?	9
What trends and risks should I be aware of?	11
Acronyms and jargon	13
Implementing sustainable investing	15
Embrace sustainable investing!	17
Key takeaways	18
References	19
Appendix 1: Covid19 and sustainable investing	20
Appendix 2: Regulatory developments	21

What is sustainable investing?

"We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole."[1]

1. UN PRI, 2020

Sustainable investing has quickly grown to be a critical part of investing in global capital markets. But defining sustainable investing remains a challenge. This is the case despite the

growing weight of capital allocated to it.

Different investors will interpret and implement sustainable investment principles differently. This is likely to depend on the context of each investor and organization. That context will likely depend on investment beliefs, investment objectives, governance, and organizational size, to name a few.

We define sustainable investing as investing that ensures short- term actions do not compromise long-term outcomes. Long-term outcomes include better returns and lower risk. Sustainable investing is therefore a broad term used to identify investments that seek positive returns that consider certain non-financial factors.

This means that sustainable investing needs to take account of some measure of:

- Return,
- Risk, and
- Intergenerational equality (which includes long-term responsibility for future generations).

The sheer scope of this definition means there are a range of sustainable investing areas for investors to explore. In this paper, we will refer to sustainable investing as a broad term, and clearly indicate when we are speaking about specific forms of sustainable investing that exist within a range of sustainable investing types. That range sits within a broader spectrum that includes investing based on financial and social returns.

1. UN PRI, 2020

Figure 1 demonstrates that spectrum.

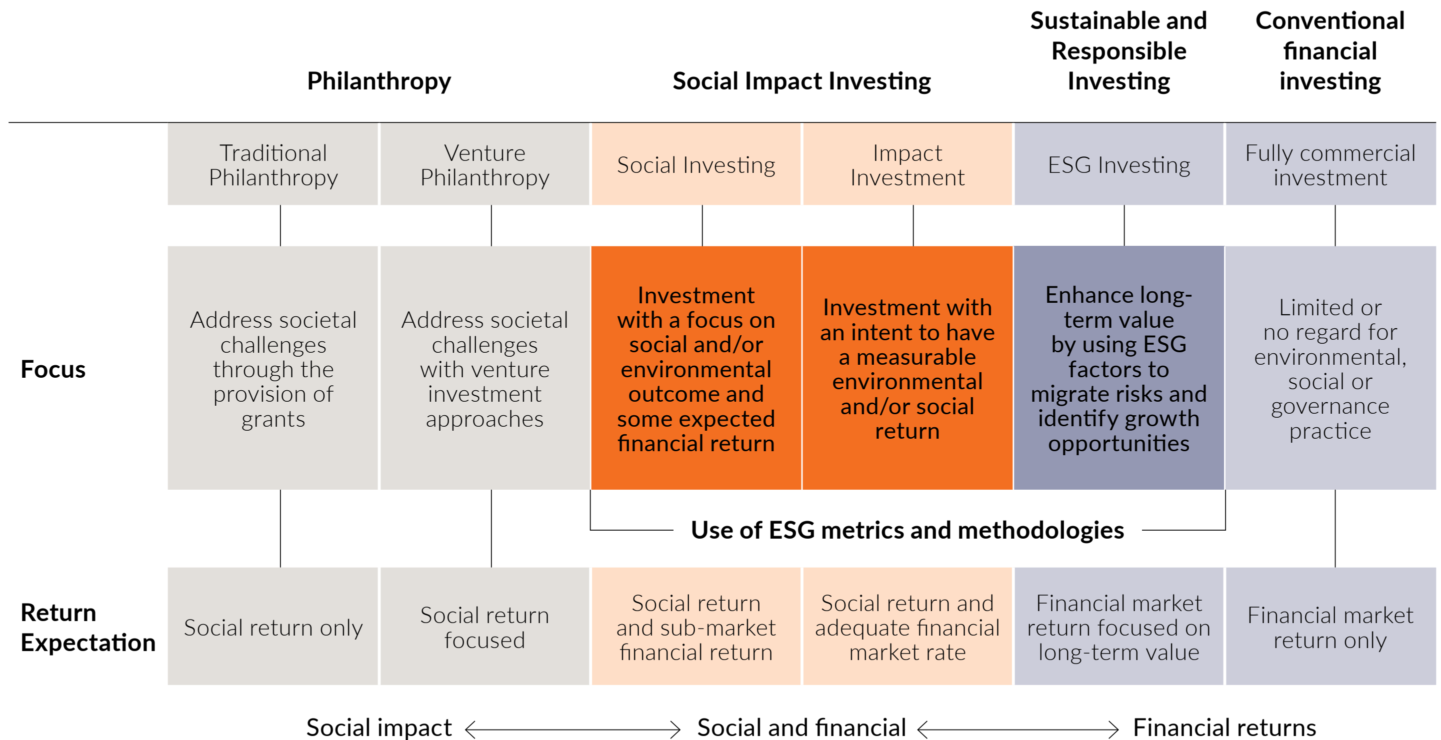
At one end sits pure financial investing. This traditionally pursues shareholder and debtholder value maximization. In terms of sustainability, it potentially efficiently allocates resources to parts of the economy that will maximize benefits and contribute to long- term economic development.

At the other end is pure social investing. This is typically implemented through philanthropy or charitable donations. Pure social investing pursues social returns. These social returns to the investor are related to environmental or social benefits, human rights, and gender equality among others, without a complementary financial gain to the investor.

Sustainable investing sits between the two extremes. Figure

1 shows various subcategories. All of these fit the definition of sustainable investing. But they differ in the extent they focus on financial returns versus social returns.

Fig 1: THE SPECTRUM OF SOCIAL, SUSTAINABLE AND FINANCIAL INVESTING.[2]



Takeaway: Sustainable investing exists along a broad spectrum that allows investors a range of sustainable investing areas to explore.

How big is sustainable investing?

Sustainable investing has grown significantly in recent years. That growth has been led by investor demand, regulatory pressure, and a growing understanding of the long-term alpha

potential from sustainable investing.

The amount of professionally-managed funds that have integrated ESG or sustainable elements exceeded USD27 trillion in 2018.[3] According to the US SIF foundation[4], more than USD17 trillion was invested in the US alone in 2020, an increase of 42 percent from USD12 trillion in 2018. Deloitte[5] estimates that could grow to almost USD35 trillion by 2025. According to the Financial Times[6], the first six months of 2019 saw USD8.9 billion added to sustainable funds, compared with USD5.5 billion for all of 2018.

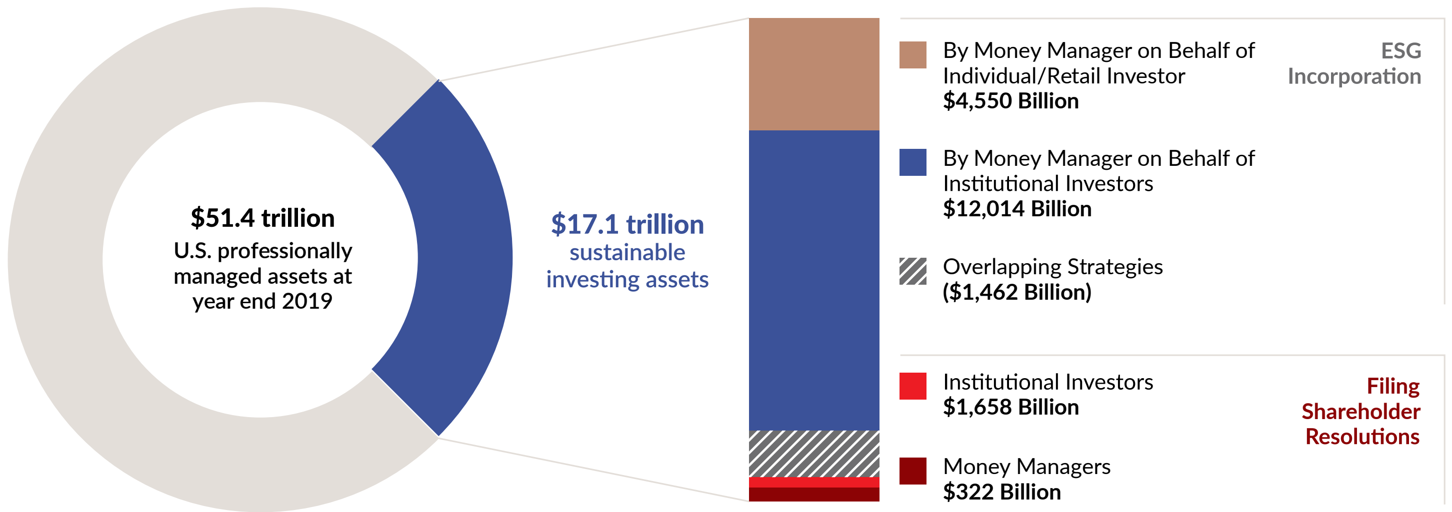
The growth of ESG and sustainable related investment products available to retail investors has also increased rapidly. Client demand originally was largely from institutional investors and large asset owners. Increasingly retail investors have been demanding access to sustainable investment options. According to the US SIF Foundation, client demand is now the top reason reported by money managers to incorporate ESG factors into investment decisions.[7]

Growing client demand and interest in sustainable investing reflects a rising belief that environmental, social and corporate governance opportunities and risks can be a driver of long- term investment performance and risk. The top three specific ESG issues for money managers and their institutional client in 2020 were climate change/ carbon emissions, sustainable natural resources/agriculture and board issues.[8]

The growth in demand for sustainable investments has largely been via active investment managers. The US SIF Foundation reported that 92% of ESG investment was delivered through actively managed investments. That may change in the future, with providers of index services and ETFs increasingly offering benchmarks and passive investment solutions.

3. Deloitte Center for Financial Services, 2020
4. US SIF Foundation, 2020
5. Deloitte Center for Financial Services, 2020
6. Nauman, 2019
7. US SIF Foundation, 2018
8. US SIF Foundation, 2020

Fig 2: SUSTAINABLE ASSETS ARE LARGE AND GROWING.[10]



"ESG-mandated assets in the United States could grow almost three times as fast as non-ESG mandated assets to comprise half of all professionally managed investments by 2025."[9]

Takeaway: Sustainable investing is big, and growing rapidly. Investors cannot afford to ignore it.

9. Deloitte Center for Financial Services, 2020
10. US SIF Foundation, 2020

Is sustainability a source of alpha?

Sustainable and ESG investing is often perceived as being at least partially nonfinancial in nature. That is, the investment is seen as doing good, rather than being a long-run source of alpha.

But that is changing. Sustainable investing is increasingly being seen a principally concerned with improving risk and return outcomes.

And there is a growing body of compelling empirical evidence to support this.[12]

In 2018, a US study published by the UN PRI[13] based on a time series of 15 years of ESG data from developed markets found that ESG information offered an alpha advantage in the construction of equities and fixed income portfolios. The report indicated that

attractive investment opportunities were available in US companies through the use of ESG integration.

Research performed by Morningstar[14] examining the long-term performance of a sample of 745 Europe-based sustainable funds shows that the majority of strategies have done better than non- ESG funds over one, three, five and 10 years. Morningstar found that sustainable funds have greater survivorship rates than non-ESG funds: 72% of ESG funds that were available 10 years ago still exist, compared with 46% for traditional funds.

From a fund manager perspective, there are several reasons for integrating ESG and sustainable processes into the strategy. But surveys indicate that institutional investors and professional asset managers seek to incorporate ESG factors primarily to improve risk- adjusted returns and risk management[15]. Figure 3 shows the results. Beyond returns and risk, brand image, reputation and regulatory requirements all feature highly.

"Astute long-term investors recognize that ESG factors are not necessarily nonfinancially related factors, as is often perceived, but rather an additional source of insight into the risk and return profile of an investment."[11]

11. Willis Towers Watson, 2017
12. See, for example,Willis Towers Watson, 2017
13. UN PRI, 2018
14. Bioy, 2020
15. BNP, 2019

Fig 3: BNP SURVEY OF DRIVERS OF ESG INTEGRATION.16

Takeaway: A growing volume of evidence supports the view that sustainable investing is a potential source of alpha for long-term investors.

What trends and risks should I be aware of?

"71% of CEOs feel it is their personal responsibility to ensure that the organization's ESG policies reflect the values of their customers."[17]

We are seeing a global trend moving clearly towards sustainable investing. That trend is being driven by investor and customer demand, a belief in the alpha-generating nature of ESG, and by regulatory pressures.[18]

From an investment perspective, we expect consideration of sustainable investing will be seen as part of the fiduciary duty owed to asset owners. Asset managers and investors who do not incorporate ESG into their investment processes will need to explain why they don't see ESG as a portfolio risk or investment opportunity. This has been proposed in the European Union and we expect the practice will spread globally. In 2019, the world's largest sovereign wealth fund (Government Pension Fund Global, Norway) sold 42 companies following assessments of ESG risks, including 16 power producers and 12 mining companies.

Improved historical data is changing the ESG investing landscape. Investors are demanding quality ESG data that is based on financially material issues with clear linkages to long-term risk and return performance. Investors want to be able to quantify and compare companies' operational performance on ESG risks and opportunities. Large financial institutions have taken note and are increasingly integrating comprehensive ESG datasets to be made available to institutional and retail investors. The trend of more in depth ESG data and greater disclosure is likely to continue.

ESG and sustainable themed funds have become widely available for retail and institutional investors over the last decade. But that has brought its own challenges. As demand for ESG related funds has increased, so has the phenomenon known as "greenwashing".

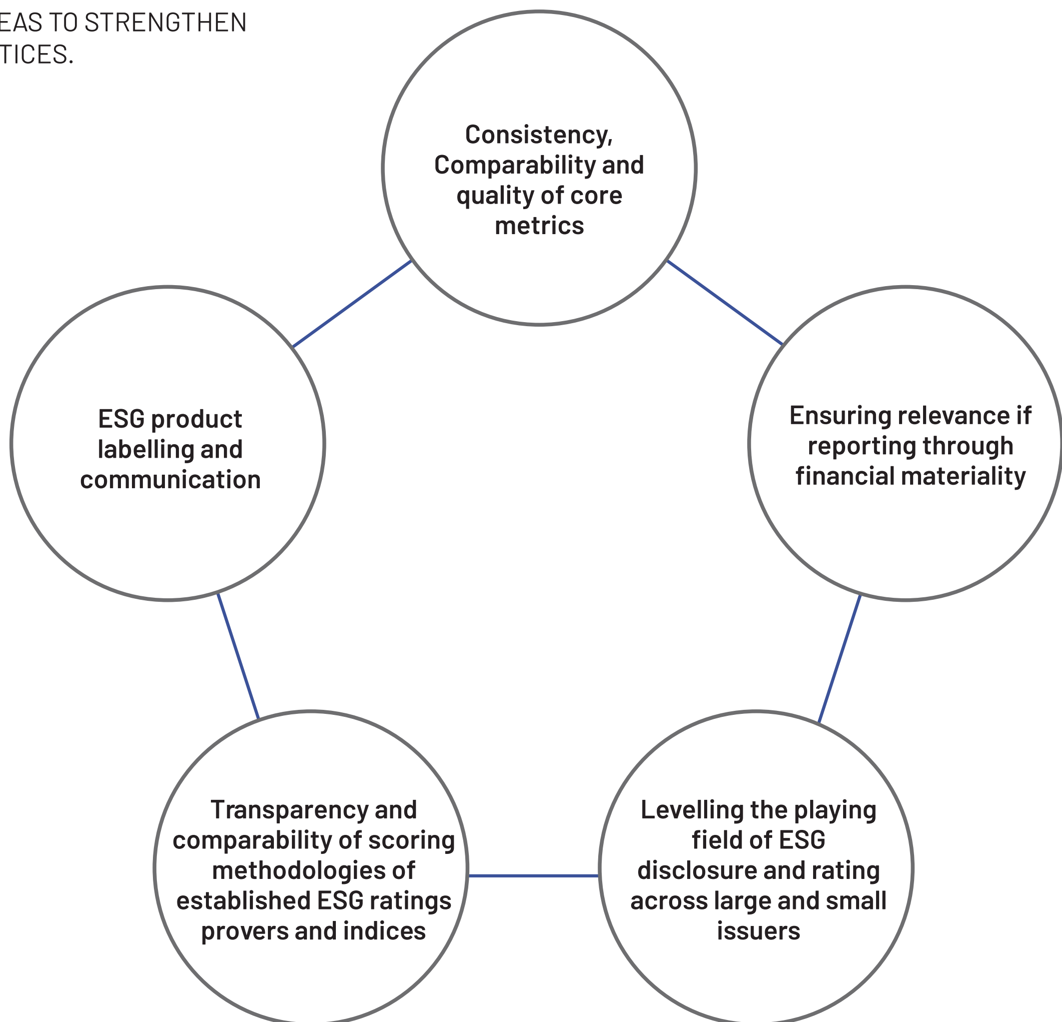
Greenwashing is a form of marketing deception used to persuade the public that an organisation's products, aims and policies are environmentally friendly. Various ESG and sustainable rating systems, regulation and research organisations have tried to tackle this issue.

17. KPMG, 2019
18. See Appendix 1 for a summary of Covid19 impact on sustainable investing trends.
19. See Appendix 2 for a summary of recent regulatory developments.
20. Boffo & Patalano, 2020

There has been a growing push by regulators to demand greater transparency from companies reporting on ESG issues. But without a consistent framework governing sustainable and ESG principles, investors are left with a wide range of definitions and regulatory developments.[19]

The OECD has identified five key areas to strengthen global ESG practices and transparency, shown in Figure 4[20]. Further development in these areas would help the industry move closer to a coordinated, coherent approach to managing sustainable investment practices.

Fig 4: FIVE KEY AREAS TO STRENGTHEN GLOBAL ESG PRACTICES.



Takeaway: Sustainable investing is constantly developing. Investors will need to keep abreast of industry developments to satisfy their fiduciary duty.

Acronyms and jargon

"It highlights the wide variety of metrics, methodologies, and approaches that, while valid, contribute to disparate outcomes..."[21]

Sustainable investing is a broad definition. Investors and asset owners are increasingly recognizing that their investment choices can be distributed along a spectrum of sustainability.

That spectrum is not universally recognised and a wide range of metrics, methodologies, processes and practices have been developed.[22]

That broad spectrum is detailed in Figure 1. Below in Figure 5, we provide more detail on ESG, impact and ethical investing. We also detail some of the groups and organisations that provide guidance and encouragement towards ESG investing. As ESG has become more publicised, fund managers and advisers have partnered

with such ESG organisations to be able to publicly certify their commitment to ESG. This has helped investors gain confidence in the sustainable bona fides of their investment efforts.

Fig 5: ACRONYMS AND JARGON.

ESG investing	ESG investing is a broad term for investments seeking to manage risk and achieve positive financial returns while considering 'non-financial' factors. ESG investing explicitly acknowledges the relevance to investors of ESG factors, and the long-term health of the market. "ESG" stands for Environmental, Social and Governance. Environmental factors determine a company's environmental impact. This includes waste and pollution, resource depletion, greenhouse gas emissions, deforestation, and climate change.[23] Social factors consider how a company treats people and focuses on employee relations and diversity, working conditions, local communities, health and safety, and conflict.[24] Governance factors include corporate policies and how a company is governed, with a focus on tax strategy, executive remuneration, donations and political lobbying, corruption and bribery, and board diversity and structure.[25]
Impact investing	Impact investing is the use of money and investment capital to help a business or organisation complete/ develop a project or do something which has a positive benefit to society. Impact investing aims to generate a financial return that ranges from below market to the risk-adjusted market rate. Impact investors typically invest in privately held businesses across asset classes.

21. Boffo & Patalano, 2020
22. Boffo & Patalano, 2020
23. ADEC Innovations, 2020
24. ADEC Innovations, 2020
25. ADEC Innovations, 2020

Social investing	Social investing involves investment into companies and funds that have positive social impacts. Where impact investing primarily focuses on enacting positive change through investment, the main goal of social investing is maximizing financial returns.
Ethical investing	Another form of social investing is ethical investing. Ethical investing is the practice of selecting investments based on ethical or moral principles. Ethical investors typically avoid holding investments in 'sin stock' companies that are involved with stigmatized activities such as gambling, alcohol, smoking or firearms.
Green investing	Green investing seeks to invest capital in environmental assets, including funds, bonds, companies, infrastructure and other projects. This could include low carbon energy, pollution control and waste management, for example, or technologies and processes that help solve an environmental problem.
United Nations Principles for Responsible Investment (UN PRI)	The UN PRI is a UN-supported international network of investors working together to implement six 'principles'. These principles aim to support the PRI's goals of understanding the implications of sustainability for investors and supporting signatories to facilitate the incorporation of ESG issues into their investment and ownership practices. Through adopting the principles, signatories contribute to the improved sustainability of the global financial system.
The Global Sustainable Investment Alliance (GSIA)	GSIA is a collaboration of membership-based sustainable investment organisations around the world. The GSIA's mission is to deepen the impact and visibility of sustainable investment organisations at the global level, and to realize a world where sustainable investment is integrated into financial systems and investment chains. Their goals include enhancing the impact and visibility of GSIA members at the global level, developing synergies and coordination between GSIA members, and providing advice and support to local and regional sustainable investment organisations.
The SRI Label (also known as Label ISR in France)	SRI Label was created in 2016 by the French ministry of economics and finance, whose objective is to offer better visibility to investment funds respecting the principles of socially responsible investing. The label has historically been allocated to UCITS (Undertakings for the Collective Investment in Transferable Securities) funds, since 2020 the label can also be given to real estate funds and more generally to alternative funds.
Responsible Investing Association Australasia (RIAA)	RIAA champions responsible investing and a sustainable financial system in Australia and New Zealand. Comprised of over 350 members managing more than $9 trillion in assets globally, including super funds, fund managers, banks, impact investors, property managers and trusts among others. RIAA provides a voice for responsible investors in the region, including influencing policy to support long-term responsible investment and sustainable capital markets. It helps deliver tools for investors to better understand and navigate towards responsible investment products and advice. There is support for continuous improvement in responsible investing practice among members and the broader industry through education, benchmarking and promotion of best practice and innovation. Importantly, RIAA is a trusted source of information about responsible investment.[26]

Takeaway: Sustainable investing is a broad field, with its own jargon, organisations, regulation and implementation.

Implementing sustainable investing

Integrating sustainable investing, and sustainability metrics, into the investment process is challenging. It has proven challenging for large institutional investors and asset owners as well as retail

investors.

Many asset owners and investors have started with identifying their sustainability beliefs. This could focus in on specific sustainable investing types – ESG investing, or social or green investing, for example – or it could identify types of assets that need to be excluded from their portfolio based on certain ESG characteristics.

This is a useful start. But integrating sustainability across the investment process is a greater challenge. This involves deeply integrating sustainability across all the steps that make up an investment and governance framework.

We think this has so far eluded most investors. It is likely to take time to achieve full integration. But good governance and best- practice stewardship requires a focus on continued improvement. We think full integration should be the goal of all investors that hold a fiduciary duty.

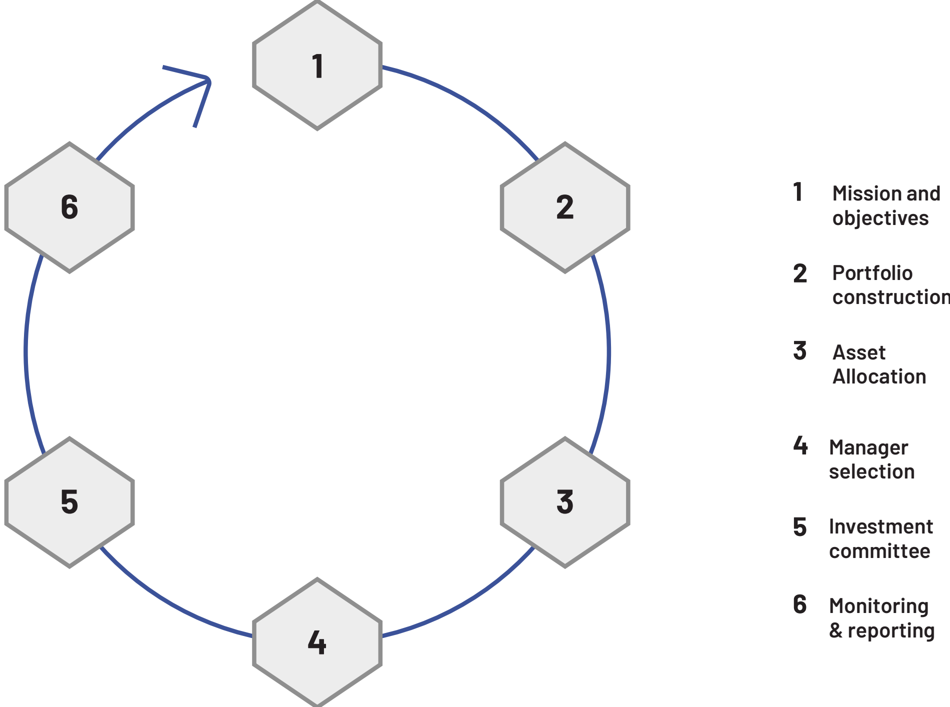
Our investment process is shown in Figure 6. The challenge for investors is to clearly demonstrate how they consider sustainable investing in each of these areas and how that helps to satisfy fiduciary duty.

"Failure to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty."[27]

27. UN PRI, 2020

Points of reflection for best-practice stewardship

Fig 5: SUSTAINABLE INVESTING WITHIN THE INVESTMENT PROCESS.



Process	Comments
Mission	Identify sustainable beliefs. Incorporate sustainability into investment objectives.
Portfolio Construction	Identify the impact of long-term sustainability risks on capital market return and risk assumptions. Select benchmarks that measure the success of sustainable strategies.
Manager Selection	Review and monitor a strategy's sustainable beliefs and integration. Implement through beta or alpha. Review performance relative to suitable sustainable benchmarks.
Asset Allocation	Negative or positive screening of assets.
Investment Committee	Manage reputational and regulatory risk.
Monitoring and reporting	Review and report on success relative to financial and non-financial objectives.

Takeaway: Implementing sustainable investing across the investment process is challenging and will take time, but is important in fulfilling a fiduciary duty.

Embrace sustainable investing!

ustainable investing is a growing trend that is not going away. The weight of capital dedicated to sustainable investing has increased rapidly in recent years. Regulatory pressures and

investor demand, as well as a focus on managing long-term risks, is driving that rapid growth.

Institutional and retail investors across the globe are gaining access to sustainable investment opportunities. But not all sustainable opportunities are the same. And there is no clear unifying framework to assess the quality of a sustainable investment. From an investment perspective, implementing a sustainable framework across the investment process is challenging and will take time,

Even so, we expect sustainable investing will become the standard for much investment through time. Now is the time to embrace

the concept and build it into governance and investment processes. This is particularly important for investors that must satisfy a fiduciary duty.

It is time to think deeply about how sustainability could impact your long-term investment performance!

Key Takeaways

Takeaway: Sustainable investing exists along a broad spectrum that allows investors a range of sustainable investing areas to explore.

Takeaway: Sustainable investing is big, and growing rapidly. Investors cannot afford to ignore it.

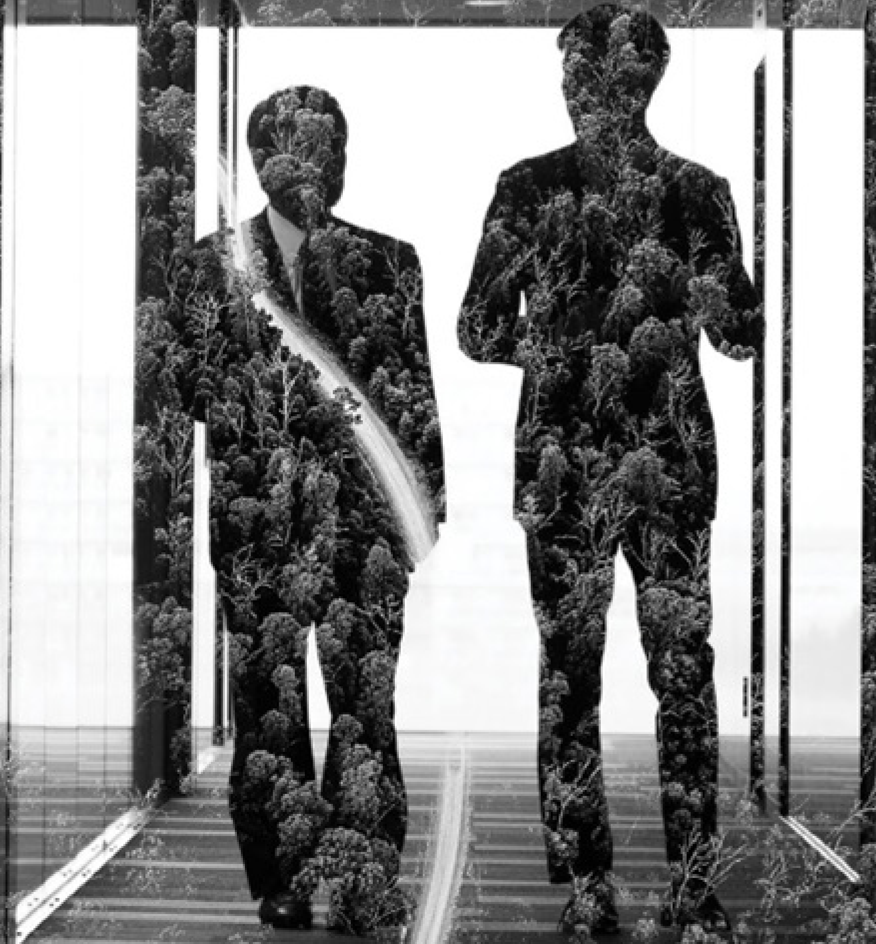
Takeaway: A growing volume of evidence supports the view that sustainable investing is a potential source of alpha for long-term investors.

Takeaway: Best-practice stewardship means demonstrably putting the client's interests first in every decision.

Takeaway: Sustainable investing is constantly developing. Investors will need to keep abreast of industry developments to satisfy their fiduciary duty.

Takeaway: Sustainable investing is a broad field, with its own jargon, organisations, regulation and implementation.

Takeaway: Implementing sustainable investing across the investment process is challenging and will take time, but is important in fulfilling a fiduciary duty.



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Appendix 1: Covid19 and sustainable investing

Over the course of 2020 and into 2021, sustainable and ESG investing faced a challenge from the strong focus on Covid19. During the uncertain economic period, with the

global pandemic causing a virtual sudden stop in economic activity, institutional investors deprioritized ESG.

Out of a sample of 600 institutional investors evenly spread across six major global economies, 79% said their firm was deprioritizing ESG given the impact of COVID-19 on the economy.

Despite the reduced focus on ESG investing during the pandemic, many large funds with explicit ESG criteria have outperformed the market during the pandemic. This at least partly reflected ESG funds typically holding overweight exposures to technology

stocks that had strong outperformance during the market rally that began in March 2020. ESG funds also had low exposures to non- renewable energy companies, giving them a distinct advantage when oil and gas suffered steep price declines in March 2020.

That performance, along with increasingly widespread awareness of ESG issues among retail and institutional investors alike, led ESG funds to experience record inflows in 2020 even with so many investors deprioritizing ESG investing. ESG funds attracted extremely large net inflows between April and June 2020, exceeding the combined total for the previous 5 years.

Covid19 represented a pause in the focus on sustainable investing. But as vaccines were developed and rolled out, investors quickly reacknowledged the need to incorporate sustainable investment practices to meet client expectations. Edelman showed that after the initial reduced focus on ESG, 96% of US investors expect their firm to increase prioritization of ESG during the recovery from Covid19.

Appendix 2: Regulatory developments

Region	Key Regulatory Developments	Status
ECB Banking Supervision, Europe	• Institutions must: integrate short, medium and long term climate-related and environmental risks when determining/implementing strategy/risk management frameworks. • Identify ESG accountability within management. • Generate risk data reflecting exposures to climate-related and environmental risk to enable decision-making.	Agreed by legislators
EU Taxonomy Regulation, Europe	• Economic activity is deemed environmentally sustainable only if it contributes substantially to ECB environmental objectives without causing significant harm elsewhere. • Public entities must include details of these activities on non-financial statements.	Becomes mandatory in 2022/2023
United Kingdom	• UK asset managers must respond to the updating of the country's Stewardship Code by the Financial Reporting Council, the introduction of policies relating to pension funds' Statements of Investment Principles (SIPs) by the Department for Work and Pensions, and the launch of a new supervisory mandate that affects insurers by the Prudential Regulation Authority. • Pension funds should have updated their SIP policies to include an engagement policy as of October 2019. Reporting on the enforcement of SIP policies began in October 2020 will drive change.	Guidance, incoming 2021
United States	• The SEC's proposed amendments to management discussion and analysis rules published in January 2020 did not include requirements for ESG disclosure. • President-elect Joe Biden immediately re-joined the Paris Climate Agreement, and will almost certainly enact policy driving investors towards low carbon and fossil fuel-free portfolios.	Significant policy changes from 2021 onwards
Australia	The Government's Australian Sustainable Finance Initiative (ASFI) launched a roadmap comprising 37 recommendations, including: • Mandating the use of TCFD sustainability reporting framework for listed companies and assets owned by financial institutions. • Developing best practice principles to guide financial product design and disclosure.	Significant recommendations and policy changes from 2021 through to 2030

Region	Key Regulatory Developments	Status
Hong Kong SFC Strategic Framework for Green Finance	• Main goal is to enhance listed companies' reporting of non-financial information. • Maintains a public list of regulated funds that meet ESG criteria.	Guidance, agreed by legislators 2018
Sustainable & Green Exchange (STAGE), Hong Kong	• Acts as Asia's hub for data and information on ESG investment.	Guidance resource, launched 2020
HKEX, Hong Kong	HKEX published new requirements in its ESG reporting guide for listed companies: • Introduced the mandatory disclosure requirement on board's statement covering ESG management approach and strategy and methodology used to review progress towards ESG-related goals.	Mandatory policy, launched 2020
Japanese Green Bond Guidelines	• Support the expansion of issuance and seek to promote market integrity and transparency through disclosure.	Guidance, launched 2017
Platform for Promoting Green Bond Issuance + Green Finance Portal, Japan	• Platforms where information related to green bonds can be collected and disseminated to relevant stakeholders, with the additional aim of preventing greenwashing practices.	Guidance, launched by MOEJ in 2018, 2019 respectively
Singapore	• Very new to ESG integration • MAS has partnered with the International Financial Corporation (IFC) to promote the growth of green bond markets in Asia. • MAS is encouraging Singapore based asset managers to launch more ESG funds to meet demand. • Mandatory ESG policy appears far from realization.	

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