PRI Principles for Responsible Investment

VOL. 10 | JAN. 2017

PRI ACADEMIC RESEARCH

RI QUARTERLY

IN THIS ISSUE

THE NEXT FRONTIER FOR RESPONSIBLE INVESTMENT

The PRI Academic Research programme aims to engage and inform signatories and responsible investment practitioners with academic research that analyses current thinking and future trends, provides practical recommendations and is thought-provoking.

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The RI Quarterly extracts the essentials and distils key findings from research in a clear and concise manner for investment professionals.

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INTRODUCTION

BACK

Any publication that comes out at the start of the year cries out for either a review of the past year or some crystal ball action. In our latest edition of *RI Quarterly,* after a hiatus, we touch on both. We have reviewed the past 12 months – and what a year 2016 turned out to be, with its unusually high dose of political nail-biting. We also look at several key issues that could be considered on the frontier for responsible investment but will become part of investors decision making.

We highlight the outcomes and takeaways from COP22, which was designed to build the foundations that would allow the pledges of the Paris Agreement to be put into action. The article also focuses on what we can expect from investors in 2017 in terms of climate risks and opportunities.

Related to this, we look at economic inequality. The debate on inequality parallel those of climate change: in terms of responsible investment, inequality is emerging as a central issue of the 'S' in ESG factors as climate risk is to the 'E'. This subject has been on economists' radars and is a significant political and social concern around the world. We are increasingly seeing the rise of populism and fragmentation, notably with two major events in 2016: Brexit and the US political election. Therefore, examining how and why investors might respond to economic inequality is crucial. We're proud to be collaborating on this with the Initiative for Responsible Investment at Harvard's Kennedy School.

While human rights cannot be considered a frontier issue, social issues have historically received less attention from investors than environmental and governance matters. We investigate the perception that it is difficult to measure and assess human rights issues or to link them to risk and return. There has been growing interest from PRI signatories along with requests to expand our work on human rights, inequality and labour standards. This reflects the growing prominence of social issues and the evolution of international standards such as the UN Guiding Principles and regulatory initiatives. It is demonstrated by significant investor interest in initiatives such as the UN Guiding Principles Reporting Framework, the Corporate Human Rights Benchmark, and participation in the PRI-coordinated engagement on human rights in the extractives sector. This has attracted support from 50 investors with $8 trillion in assets under management.

The article reports on two recent events that will frame research that will study the impact of corporate human rights policies, due diligence processes and external human rights-related issues and events on company valuations. 'Values to valuation' is a partnership with the University of California, Berkeley and the University of Manchester, and it will seek to understand the interplay of salience, materiality and financial performance.

In the same vein, this edition also brings together academic papers that explore the impact of ESG issues on returns and the volatility of stock performance. The final article focuses on finance technology, fintech, and the challenges and opportunities that lie ahead in this exciting and uncertain part of the financial world during 2017.

Many of us will be treading lightly into 2017, cautiously assessing the significant political and economic changes that we are witnessing unfold. Inevitably some of this will impact on the issues and areas that this RI Quarterly covers, but what this edition highlights is the fascinating on-going quantitative and qualitative research and debate that is developing in these areas of study. This can only be of benefit to all those interested in responsible investment.

Happy New Year!

Katherine Ng
Head of Academic Research

LONG WALK TO BELOW 2 DEGREES – REFLECTIONS ON COP22

BACK

Planning application ref. 16371 with Clare County Council, Ireland, makes for intriguing reading. Put forward by TIGL Ireland Enterprises Ltd, the application proposes a new wall as "coastal erosion management" to protect Trump International Golf Links and Hotel. For commercial reasons, the president-elect is developing long-term plans to adapt his investments to a changing climate. And just like him, canny institutional investors operate in the real world. A world driven by clients, the need to seek new opportunities, understand climate risk and protect investments.

Canny investors recognise the need to understand climate risk and protect investments.

Against this backdrop, COP22 was held in Marrakech in November 2016. The event was intended to build the foundations that would allow the pledges of the Paris Agreement to be put into action. Namely, the commitment to keep global warming well below 2 degrees Celsius above pre-industrial temperatures, as well as strengthening the ability of countries to better address the impacts of climate change. It was the first international meeting where participants could begin work on the policies that will put this into practice.

The PRI co-organised an investor side event during the conference in collaboration with IIGCC, Ceres, UNEP FI, Carbon Tracker Initiative, IGCC and AIGCC to manage climate risk and seize low-carbon opportunities. The PRI's key takeaways of 'Beyond Paris – investor actions to manage climate risk and seize low-carbon opportunities' were:

- **Emerging leaders:** China publicly reaffirmed its commitment to both the 2015 US-China Agreement and to have its emissions peak by 2030. Its representatives urged the US to uphold its part of the agreement. The Chinese delegation hosted several high-profile events, one of which the PRI spoke at to launch the new publication, Green Equity Investing. China is racing to be a global clean energy superpower: 38% of issuance of green bonds in the first three quarters of 2016 were Chinese and 330,000 new energy vehicles were sold in China last year.

FULL REPORT

Green Equity Investing

- **Other leaders:** Canada, Germany and Mexico announced climate change strategies up to 2050, while Australia and the UK ratified the Paris Agreement.
- **A rulebook for the Paris Agreement:** Those participating agreed they would write the rules of the Paris Agreement by 2018 to ensure that it can be put into action. These rules will cover finance, technology and capacity building to support the developing world, and transparency on emissions reduction. Added to that, progress was made on finance: countries pledged more than $81 million to the Adaptation Fund, $23million to a Climate Technology Centre and Network, and the Green Climate Fund approved $2.5 billion worth of projects.

- **Governments unlock green capital flows:** Currently, investors report to the PRI that many existing green investments are unsuitable. In 2016, the G20 Green Finance Study Group provided a good forum for the PRI to collaborate with finance ministry representatives on policy options to overcome this. In 2017, the PRI will support a new practical UN Global Compact initiative focused on how business and investors can support country climate change plans, with eight pilot countries.

Of note at the meeting, Morocco revealed that it will cover 42% of its electricity needs with renewable energy by 2020. The Morrocan Caisse de Depot e de Gestion Group, the African Caisses des Depots, the Nigerian National Pension Commission and PRI signatory, Caisse des Depots (France) launched a new African Investor Network, which will promote climate finance in Africa. The network will integrate climate change into funding decisions, use carbon footprinting, support African investment programmes and join the PRI.

SAVVY INVESTORS ARE SHIFTING CAPITAL

PRI signatories at COP22 highlighted actions they've taken since the Paris Agreement came into force:

- **AXA Group** announced a new 15-year research programme with the University of Cape Town on African Climate Risk, as well as progressing in tripling green investments and joining the Carbon Pricing Leadership Coalition.
- **Allianz SE** has increased direct and frontier market renewable energy investments, and is in the process of allocating $4 billion to renewable energy, while rolling out ESG scores across all equity and fixed income assets.

- **Aviva Investors**, following on from its climate change strategy that was announced in 2015 which covered carbon footprinting, engagement and infrastructure investment, published Seeing Beyond the Tragedy of the Horizons. This includes three suggested portfolio actions to manage transition risks relating to climate change, as well as suggested macroeconomic actions for investors and civil society. They include that asset owners should ask for information on how asset managers integrate climate risk into their investment process and ensure engagement with companies is forceful and covers voting. The macroeconomic suggestions include public league tables of corporate climate risk disclosure.
- **Deutsche Asset Management** announced they had become the first commercial bank accredited by the Green Climate Fund, an anchor investor with $78.4 million in the bank's new Universal Green Energy Access Program fund for Africa. Through this fund, Deutsche Asset Management will ultimately support up to $3.5 billion of investment in Benin, Kenya, Namibia, Nigeria and Tanzania.
- **LGIM** launched a new Future World Fund incorporating carbon efficiency, fossil fuel reserves and green revenues. It has been selected as the equity default option worth $2.3 billion for the HSBC Bank UK Pension Scheme.
- **The New York State Comptroller's Office** has allocated $5 billion to sustainable investing strategies, including a new low-carbon index, which reduces the fund's carbon footprint.
- **Montreal Carbon Pledge**: Investors with funds of $10 trillion AUM are participating, with an independent review by Novethic finding the initiative had accelerated investor climate disclosure. Good practice includes CalPERS using footprinting to identify 100 companies it will prioritise for investor engagement on climate change.
- **Portfolio Decarbonization Coalition**: A total of $600 billion has been committed to decarbonisation. Examples include: ERAFP's portfolio carbon intensity, which is 12% lower than the benchmark, and AP4's global equity portfolio emissions, which is 12.7% lower than the reference global index.

WHAT CAN WE EXPECT FROM INVESTORS IN 2017?

Investor interest in understanding climate risk and opportunity is growing at a country, industry, company, issuer and project level.

Countries:

- In the US, there could be significant green investment opportunities, particularly in infrastructure and property, offering real jobs, climate mitigation and resilience in the face of the physical impacts of climate change, such as hurricanes.
- China will continue building local green industries and attracting institutional investors to green bonds and equities, as well as implementing further new green policies.

Companies

- Company-investor dialogue will increase, including over the 2017 proxy-voting season, which will feature climate change resolutions at energy companies.

Investors

- Improvements will be made in the assessment of how well-positioned companies are in terms of climate risk and opportunity. The FSB Task Force on Climate-related Financial Disclosure's final report is due at the G20 in Germany in July.
    - Social issues such as inequality, employment, pollution and health will overlap with climate risks and opportunities, meaning that companies and investors will increasingly need to assess these together.

At PRI in Person in Berlin there will be a focus on supporting signatory action on climate risk and opportunity, following soon after the G20 in July and before November's COP23 in Bonn.

It's a long walk to below two degrees, but investors have set off. They may pause to assess country policy signals, but indications suggest they will ultimately put green money where governments and companies seek to attract capital flows.

ECONOMIC INEQUALITY: PUTTING THE 'S' INTO ESG

BACK

Economic inequality is understood as the gap between the rich and poor in terms of both income and wealth.

Economic inequality can be understood as both a macro and a micro issue. It is apparent on a systemic level, between countries, within countries and between different levels of society, affecting households and individuals. It also relates to issues around diversity and opportunity such as gender, disability, age, ethnicity and education.

As US economist James Galbraith surmised, it is the financial equivalent of high blood pressure: it affects the whole body and its prevalence is bad for the health, suggesting problems elsewhere.

As a term, it has been widespread for many years and there have been many policy attempts to redress the balance. The issue has, however, remained lower down on many governments' policy agendas and beyond the interests of all but the most socially-conscious investors. Now there are signs that the situation is changing.

Economic inequality is the financial equivalent of high blood pressure: it affects the whole body and suggests problems elsewhere.

A plethora of reporting suggests that, despite a growth in the world's middle class, in-country economic inequality is increasing in both developed and developing nations.

It has recently entered mainstream political discourse and is increasingly the subject of scrutiny. Two major political events of 2016 – Brexit and the results of the US presidential election – have been described as manifestations of the risks associated with it.

Whether or not this accurately reflects the issue is a cause for debate, but what these and other events have done is to push the issue not just onto the political agenda, but forced it up

FULL REPORT

Why and how might investors respond to economic inequality?

the list of priorities around the world. Alongside this, the UN's Sustainable Development Goals (SDGs) have given the issue greater focus. The UN has explicitly called on private investors to engage with the SDGs, particularly SDG 10, reduced inequalities.

Brexit and the results of the US presidential election have been described as manifestations of the risks associated with economic inequality.

Source: CNBC

At this stage, many of the suggestions being made about the long-term consequences of the issue are just that – suggestions. However, there is the sense that inequality might have negative consequences on long-term investment performance. Similarly, it might negatively affect financial systems, while its emergence as a topic of growing concern might change the risks and opportunities that investors face. As a new PRI report, Why and how might investors respond to economic inequality argues, in terms of responsible investment, inequality is emerging as a central issue of the 'S' in ESG factors, just as climate risk is to the 'E'.

INEQUALITY AND INVESTMENT PORTFOLIOS: WHAT'S THE EFFECT?

As a discipline, responsible investment suggests that investors can enhance their investment decisions through the integration of ESG information. A central tenet of responsible investment is that, in the longer term, the interests of both investors and society will converge. This underlines why economic inequality is such a key issue.

Current research is showing that, contrary to past conventional wisdom, there isn't a trade-off between growth and equality. In fact, increasing evidence suggests quite the opposite, arguing that in instances where there is excessive economic inequality, policies that strive to change this can improve economic performance.

However, judging how much inequality is 'excessive' is difficult, and typically linked to specific economic, political and cultural circumstances.

HOW INEQUALITY MAY AFFECT GROWTH

Reduced consumer demand: the wealthy tend to save more, so wage stagnation and the resulting inequality may reduce the spending power of everyone else in society.

Increased economic instability: as those without economic resources increase their debt for consumption, inequality may produce economic bubbles.

Rent-seeking and political power: the concentration of wealth may lead to increased political power and influence, capturing economic rents at the expense of productive activity.

Exacerbating social instability: there is the risk that social tensions, and with this political and social instability, will rise as the gap between the 'haves' and the 'have nots' grows.

Much of the recent research into economic inequality focuses on the policy options designed to allow the public sector to mitigate the problem. This excludes the investor, but it is an area in which their role could be key. Investor involvement has the potential to deepen participation in multi-sector efforts to understand, mitigate and redress the potential harm resulting from excessive economic inequality.

Why and how might investors respond to economic inequality?

PRI is collaborating with the Initiative for Responsible Investment at the Harvard Kennedy School. An international roundtable series is being held in Australia, Japan, Singapore, South Africa, the UK and the US. When the roundtables conclude, research will be commissioned to support and guide investors.

Investor involvement could be key to mitigating the harm of economic inequality.

Still, why should the issue really matter to investors? Research suggests that excessive economic inequality can cause or be a sign of low growth and financial instability. It is argued that the financial sector may play a part in generating harmful inequality, something that then harms the beneficiaries of investment they represent or serve. On the flip side, investment channels may help to mitigate economic inequality.

Considering the role of the financial sector in greater detail, recent research has drawn direct links between 'financialisation' and the rise in economic inequality.

Financialisation is understood as being the relative rise in the role of finance in economic affairs, the proliferation of financial products and instruments, and the extension of financial practices into new areas.

There are a number of ways in which this may affect economic inequality. For example, short-termism and its negative impact on equality. Following the financial crisis, attention has increased over the fees paid for financial services as compensation schemes, which are linked to short-term risk taking and speculative investing to the detriment of long-term productive activity. Other practices, such as cash allocation (e.g. share buybacks), may extract value from companies in the short term at the expense of other investments and wage increases.

Clearly, the time is ripe for investors to act. Areas that require attention include how investors tackle the systemic structure of finance and their role in shaping a financial system that better serves social objectives. Risk management tools may be used to inform investment decisions and determine shareholder engagement. Investors might also want to consider a wider range of issues that may pose reputational and/or political risk in light of increasing concerns over inequality to bring economic blood pressure in check.

Economically-targeted investment sees investors provide products that target specific, underserved areas or communities.

Microfinance has been specifically linked to the idea of financial inclusion, increasing access to financial services and opportunities for economic development for poor communities.

Bottom of the Pyramid strategies, with their focus on delivering goods and services to the poor, are often suggested as a means of mitigating poverty and so reduce inequality.

'Blended finance' has the potential to explicitly target social objectives such as inequality. The blend comes from the mix of investors, typically institutions, banks and governments attracted by the social objectives of the scheme, while investment opportunities provide a chance for private capital to participate.

VALUES TO VALUATION

BACK

The need to investigate the linkages between human rights and corporate financial performance (CFP) was explored through events held in Geneva, Switzerland, and Berkeley, California, the end of last year. The events were supported by a discussion paper, and research will be commissioned, entitled 'Values to Valuation,' that addresses the questions that were raised.

Alongside the PRI, researchers from the University of California, Berkeley, and Alliance Manchester Business School – University of Manchester, will study the impact of corporate human rights policies, due diligence processes, and external human rights-related issues and events on company valuations. They will consider a range of quantitative and qualitative factors that have the potential to influence investment decisions and outcomes.

Corporate financial performance (CFP) measures accounting-based performance (i.e., the balance sheet, income and cash flow statements) market-based such as stock price, operational growth performance, as well as risk and the performance of ESG portfolios.

There has been growing interest from signatories in addressing human rights, inequality and labour standards.

This has attracted support from 50 investors with $8 trillion in assets under management.

At the PRI, while social issues have historically received somewhat less attention from investors than governance and environmental issues, there has been growing interest from signatories along with requests to expand work on human rights, inequality and labour standards. This reflects the growing prominence of social issues and the evolution of international standards, such as the UN Guiding Principles and regulatory initiatives such as the UK Modern Slavery Act. It is demonstrated by the significant investor interest in initiatives such as the UN Guiding Principles Reporting Framework, the Corporate Human Rights Benchmark, and participation in the PRI-coordinated engagement on human rights in the extractives sector.

FULL REPORT

From Values to Valuation – Connecting Human Rights and Financial Performance: discussion paper

That said, the outlook isn't wholly positive – perceptions remain that it's difficult to measure or assess human rights issues, or to link human rights to risk and return, or that social issues may not be material and could be a digression from investors' fiduciary duties. These concerns underline the need for wider and deeper research into the subject.

The perception that social issues may not be material underlines the need for wider research into the subject.

SALIENCE AND MATERIALITY

In terms of human rights, salient issues are potential negative impacts on people that may arise through a company's activities or business relationships. As a concept, salience typically uses the lens of risk to people rather than risk to business as its starting point. However, it is also recognised that where risks to people's human rights are greatest, there is a strong convergence with risk to business. As a result, considering salient issues typically focuses the company's resources on managing risks to human rights and related risks to the business.

On the other hand, in the context of investment, materiality can be understood to mean "human rights-related issues and risks that an investor would consider to possibly have a measurable impact on corporate valuations and other generally accepted financial risk metrics."

Source: UN Guiding Principles

The discussion paper that the PRI has produced with UC Berkeley and Alliance Manchester Business School reveals the salience of human rights risk has been established, but as yet there has been little attempt made to engage in in-depth empirical or qualitative analysis to establish materiality. Through the testing of financial and investment materiality, the researchers hope that the study will push the issue of human rights risk further into investor considerations.

The paper also highlights several challenges, including the problem of establishing the nature of the link between human rights policies, practice and performance.

Identifying metrics which are publicly available and gauge how embedded companies' human rights policies or practices are will pose a challenge.

Another issue that will require some attention is that 'given assumptions' aren't necessarily correct. The paper argues that market-based studies typically work on the basis that the market is 'efficient,' with stock prices reflecting all available information about the present value of a firm's future cash flow. Experience suggests however, that the market is often slow to price in information. The report's authors have therefore proposed to distinguish between two levels of materiality in terms of the relation to CFP first and secondly, to the company's market valuation as reflected in its stock price. It is hoped this will offer a potentially important distinction, enabling the researchers to explore the 'dynamics' of human rights materiality at varying levels.

KEY QUESTIONS

The event in Geneva saw discussion of other key issues that the researchers will need to address.

Speaking at the event, Jelena Stamenkova van Rumpt, RI advisor from PGGM, outlined the challenges in making a case for engagement on human rights to both her colleagues as well as a business case when engaging with companies. Stamenkova van Rumpt also highlighted the challenge of integrating ESG issues across the whole investment chain; the commonly held perception that human rights is a nuanced area around which it is difficult to work out a common focus, and the need to find a way to quantify the risks arising from poor management of human rights.

Stamenkova van Rumpt questioned whether differences can be shown between salient and material to provide a better understanding, asking: "Can we explain the business case of managing the impact to right-holders?"

There were a number of issues that Stamenkova van Rumpt hopes to discover as a result of the Values to Valuation project. Top among these were whether a relationship can be developed between human rights impact and management systems. Also of interest is whether companies with human rights policies and good scores based on service provider analysis exhibit better long-term performance. Additionally, she highlighted that a key step that will help investors is if researchers can bridge the language of investors, which includes materiality and due diligence, with the language of the UNGP and OECD, which consider and define salience.

Participants at the Geneva and Berkeley events highlighted several 'wish list' items they would like to see as outcomes of the study – while it will not be possible to address all of these, ideas on useful outputs or outcomes included:

- Metrics-based analysis that is impactful for analysts and can influence buy/sell decisions.
- A better understanding of the efficiency with which human rights issues and metrics are integrated to markets.

- A prospective study able to identify factors which may be material in the future - recognising that what is material changes over Time Horizon, and that changing consumer and societal trends will also influence the materiality of human rights issues in the future.
- Clear identification of the lowest cost human rights risk avoidance measures – this would then guide engagement priorities for passive or index investors seeking to minimise risk in their portfolio.
- A matrix of issues likely to be salient and material for different sectors, identifying where they overlap.
- Understanding of what factors may influence or mediate the impact of human rights issues on financial performance – for example market location (developed vs. emerging, regional variations); a company's position as a relative leader or laggard as compared to peers; the quality of a company's human rights policy.

These ideas will be considered by the research team and explored further, perhaps through future events with portfolio analysts. On the back of this, we and our project partners will look to launch the research at PRI in Person in 2018.

HOW DOES ESG INVESTING AFFECT FINANCIAL PERFORMANCE?

BACK

Integrating ESG factors is beneficial for investment decision making. Increasing numbers of asset owners and investors can agree on this, but there is a growing realisation that deeper analysis is required. More and more, investment analysts are demanding further quantitative work on ESG issues and the impact they can have on returns.

With this in mind, a number of recent research papers have begun exploring the impact of the incorporation of ESG factors on the volatility of stock performance.

ESG Factors and Risk-Adjusted Performance: A New Quantitative Model by Kumar Nallan Chakravarthya et al takes what it describes as conventional financial wisdom, which suggests that less risk leads to lower returns, and turns this on its head.

> The paper's main argument centres on the belief that the incorporation of ESG factors provides companies with lower volatility in their stock performance when compared with their peers in the same industry.

Other key findings from the report include research suggesting that ESG factors have a different effect on each industry, and that companies that pursue an ESG agenda generate higher returns.

The authors underpin their findings through the use of their own quantitative model, which they use to show evidence of the link between ESG factors and investment risk-adjusted performance. They argue however that this relatively narrow focus overlooks the importance of further investigating the impact of ESG issues on risk. Among the questions that they pose are:

- Is there a difference in the average of the standard deviation of stock prices of ESG positive companies compared to non-ESG stocks?
- Is it possible to quantitatively demonstrate this difference and establish that firms that consider ESG issues bear less risk compared to non-ESG stocks?
- Given that lower risk has traditionally meant lower financial returns, how can ESG investment really offer a viable investment strategy?

ESG INVESTING = HIGHER RISK-ADJUSTED RETURNS

Until now, most studies have either focused on defining and evaluating ESG factors and their impact on stock returns or centred on specific investment vehicles such as private equity funds. Instead, this paper analyses stocks by industry in the hope of showing that efficient investment strategies can be developed around listed equity funds or mutual funds. The authors argue that what is different about their model is that it considers factors – notably constant internal and external interactions – beyond the historical assumption that higher risk produces higher returns. The research suggests that, by considering those interactions, the hidden value becomes apparent.

FULL REPORTS

- ESG Factors and Risk-Adjusted Performance: A New Quantitative Model
- The Materiality of ESG Factors for Equity Investment Decisions: Academic Evidence
- ESG and Corporate Financial Performance
- From the Stockholder to the Stakeholder

Therefore, the argument becomes not lower risk equating to lower returns, but that lower risk produces the same or higher returns, namely higher risk-adjusted returns.

SPOTLIGHTS ON INDUSTRIES

A key finding of the report is that ESG factors affect each industry differently. A total of 12 industries were studied. Energy proved to be the most volatile industry, and insurance the least. In the reference group, the difference between the two was 47%, while in the ESG group there was much less volatility, with just 11% difference. This would suggest that if ESG factors are taken into account when investing in the energy sector, some of the potential risks could be mitigated.

> The report found that ESG factors affect each industry differently.

The model also revealed that lower risk did not necessarily translate into lower returns. A total of eight out of the 12 industries showed better returns for ESG companies than their peers. Across all industries, the positive effect on equity return averaged out at 6.12%. Considering the eight industries where ESG factors had a notably positive impact, the average rose to 14.08%. Energy, food and drink, and healthcare showed the most positive results, while conversely a negative impact of ESG factors on returns was seen in the car, banking, durables, and insurance sectors.

Looking at these figures in greater depth, the model showed that equity investments in non-ESG companies could bear as much as 28% or more risk annually when compared to investments in ESG companies in the same industries.

Overall, the differences in volatilities were more pronounced in the group of non-ESG companies than in the ESG ones, prompting the authors to conclude that ESG practices could help companies reduce risk, with the amount depending on industry. Using popular measures for comparing risk-adjusted returns provided some interesting insights. The Sharpe ratio is calculated as the expected return per unit (volatility); so the higher the ratio, the greater the efficiency of the investment. Using this over the 12 industries showed that, with the exception of banking, energy and materials, the Sharpe ratio for ESG stocks in the other industries was on average 7.67% greater than those of the reference stocks in the respective industries.

Similarly, using the Treynor ratio, which compares the return earned on a stock against the beta or market risk of a stock as an alternative risk measure to standard deviation, ESG stocks showed higher Treynor ratios against their reference counterparts in nine of the 12 industries. In this case, the average was 11.81%. The exceptions were the car, banking and durables industries.

SIZE AND INDUSTRY TILTS

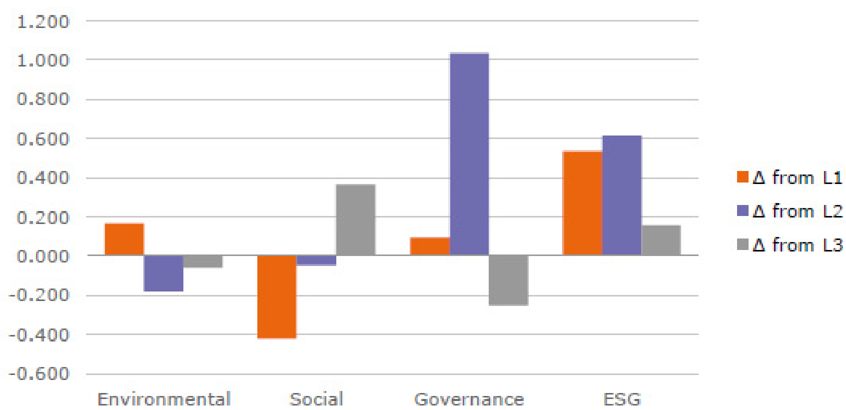
NN Investment Partners meanwhile sought to evaluate the performance of global equity portfolios that are formed using ESG criteria in its empirical study, [The Materiality of ESG Factors for Equity Investment Decisions: Academic Evidence]().

Among the paper's key findings are that standard ESG ratings/scores that are typically used in equity selection tend to be higher for larger companies. Notably, much like the quantitative model, this paper also found a variation across industries. The report's authors warn that this suggests that those using ESG criteria in their portfolio selection without first making the correct adjustments may find themselves with undesirable size and industry tilts in their equity portfolios.

The other key finding, which appears to support traditional thinking on ESG issues, is they often have a medium to long-term outlook. The paper argues that this underlines the concept that changes in ESG scores can be more informative about future returns rather than levels.

Other factors that improved performance included the exclusion from the rankings of firms that exhibited controversial behaviour (bribery, corruption, human rights

Shape ratio on a different portfolio that is based on a subset of stocks with low (L1), medium (L2) or high (L3) initial ESG levels: so long in stocks with strong ESG momentum and short in stocks with wak ESG momentum.



abuses, pollution, etc.). This suggests that a relatively simple way to improve portfolio performance is to exclude ESG controversies, which again runs contrary to popular belief.

A relatively simple way to improve portfolio performance is to exclude ESG controversies, which runs contrary to popular belief

Considering the subsets of ESG factors offers a focus for a third report in this area. ESG and Corporate Financial Performance includes 60 review studies and 2,250 unique primary studies and, as such, is the most extensive on the issue to date. It is a meta-study by Deutsche Asset & Wealth Management and the University of Hamburg, on which the PRI provided support on the communication of academic research insights. 62.6% of studies revealed a positive correlation between ESG investing and financial performance.

It looks at the individual impact of each subset of ESG issues, and found that governance issues produced higher positive results, registering 62.3%. Interestingly, governance-related issues also produced the highest percentage of negative correlations. Additionally, the study found that it was more beneficial to apply the subsets individually rather than as a whole.

The paper broke down the asset classes, revealing that bonds and real estate emerged as asset classes in which ESG investing and performance have a strong link.

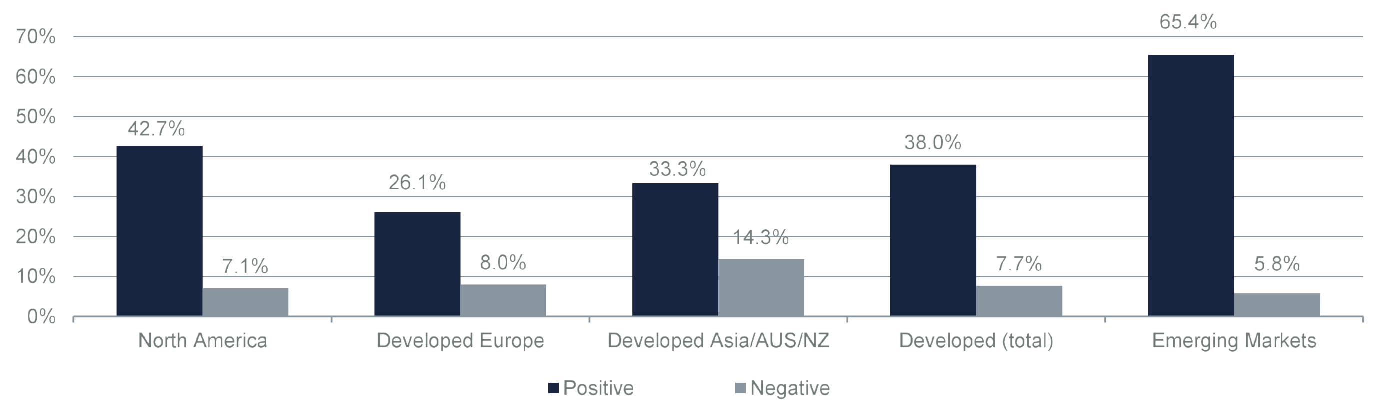
Regional variations were also noted, out of which emerged two distinct patterns: developed markets excluding North America showed a smaller share of positive returns. **Europe showed just 26.1% in positive results compared to 42.7% for North America**. The second pattern was the strong correlation between ESG and CFP in emerging markets, showing a 65.4% share of positive outcomes.

Governance was brought to the fore in a meta-study produced by The University of Oxford and Arabesque Partners. The report, From the Stockholder to the Stakeholder is based on the examination of over 200 studies. It investigates the business case for corporate sustainability and looks into cost of capital, operational performance and stock price. In terms of considering how sustainability can drive financial performance, it finds that superior governance quality results in better financial performance. It concludes however, that a more granular understanding of ESG issues is needed and that active ownership is the future of sustainable investing strategies.

What these reports highlight is that the materiality of sustainability is undisputed. However, challenges remain and further, deeper research is required to fully understand the impact of the integration of ESG issues on the investment process.

All the reports highlight that the materiality of sustainability is undisputed.

ESG and Corporate Financial Performance
Tracking the link between ESG & CFP across various regions (vote-count sample)



FINTECH: RESHAPING THE INVESTMENT INDUSTRY

BACK

Within the space of six years, finance technology – fintech – has gone from a technology that skirted the edges of the investment sphere to receiving billing at this year's G20 summit where the world's industrial leaders described its impact as something akin to a new industrial revolution.

Many terms are circulated when describing fintech's remarkable emergence. Its rapid march into what in some cases are centuries-old financial practices has resulted in heavy disruption, some casualties and a swift change in pace and outlook for financial institutions.

Fintech is the innovative use of technology in the design and delivery of financial services and products.

2016: A SUBDUED YEAR

For Faye Chua, Head of Business Insights at ACCA, 2016 represented a year when fintech started "becoming more normal," explaining that it has "slowly established itself in its own right." Chua doesn't yet regard fintech as a matured area and she is acutely aware of the risks and challenges that it poses, but she recognises its momentum, as well as how much more progress is required in the sector. Technology is often a catalyst for growth and fintech's impact across the financial services sector is explored in FinTech – transforming finance.

> "Fintech has slowly established itself in its own right."
>
> Faye Chua

Meanwhile, Dr Alex Money, Project Director at the Smith School of Enterprise, University of Oxford, describes 2016 as a quiet year for fintech "relative to its own exuberant standards" with broader macroeconomic effects instead taking precedence. From the perspective of fintech as a sector, Money views it as conforming to the expectations of most asset classes: early disruption, rapid innovation, capital coming into it, some outside successes, and a lot of early attempts that ultimately don't work out, before finally maturing.

FULL REPORT

FinTech – transforming finance

There are three areas that have been attracting the attention of Lenora Suki, Head of Product Strategy, Sustainable Finance, at Bloomberg. The first is the huge growth in passive management, particularly in the generation and development of information technology that can drive passive investing low-cost tools. These developments, she argues, have impacted on active managers, placing them under increasing pressure. As a result, part of the fintech innovation for them hinges on making insights regarding ESG performance issues more widely available and integrating these insights into their daily workflow. A third area, and an important driver for Suki's work, is the increasing commodification of financial data. Reflecting this, she is looking to fintech to develop data that helps generate actionable insights.

GEOGRAPHICAL SHIFTS

North America and Europe continue to dominate the sector, although political uncertainties surrounding the UK's decision to leave the EU and the US presidential election subdued overall growth in these regions. Continuing political uncertainty is expected to increase pressure on the UK to maintain its leading position in the European financial services sector.

Although there is no swift end in sight to the dominance of the more established fintech hubs, developments in Asia are of particular interest to Chua. Like other experts, she keeps a close eye on the rapid growth of the Chinese market, but alongside this points to developments in fintech hub, Singapore, as well as Hong Kong and Pakistan. In the coming months, Chua will be watching to see how Singapore works with the Financial Conduct Authority to expand plans to make the city state a global Smart Financial Centre. Alongside this, she highlights Hong Kong's move to launch its own innovation lab, which she views as a positive step away from its very regulated approach to something more open. In Pakistan, she is keen to see how fintech impacts on the market as the country switches from 3G to 4G mobile technology in 2017.

China is a key focus for Daniel Street, Asia-Pacific Strategist at the IFC, who is monitoring fintech's "increasingly crucial role in boosting financial access to traditionally underserved micro small and medium enterprise (MSME) groups in China, improving the quality and affordability of financial services".

China's rise in the fintech sphere looks unstoppable, boosted by a massive market, supportive government policy, and a large-scale need for the type of private sector-led financial intermediaries offering innovative business solutions.

As a result, fintech companies are, according to Street, "increasing their influence and reach in payments, microfinance, consumer finance, wealth management, and individual credit reporting".

The so-called Alibaba model of e-commerce, which sees the provider support microcredit companies, allowing them to originate and service loans at a far lower cost than traditional financial institutions is likely to have systemic effects in encouraging other financial institutions in China to enter or expand their financing of MSMEs. This will bring more unserved or underserved borrowers into the financial system. The resulting competition could lead to more affordable and accessible financial products and services for MSMEs.

However, Street goes on to warn of the need for sophisticated security-control mechanisms, arguing that: "Remote accounts are inherently riskier than traditional bank accounts, where a customer is physically present at a specific location."

GETTING GREATER VALUE FROM DATA

At the University of Oxford, the focus of one of the research areas is the use of datasets and specifically understanding the value around these. Money's team is currently working on scenario-based forecasting, essentially trying to figure out how they can get the data to help understand key strategic questions.

He argues that during 2016 there was definite progress in understanding the questions that need to be asked, figuring out how to apply technology as a potential intermediary of information, and realising that information is required in a more structural way.

The team's fundamental focus is "whether digital data can tell us more about things that matter as an ESG investor than they do at the moment." Money explains that normative statements exist suggesting a range of conclusions, prompting researchers to focus on whether data can actually provide possible answers. He hopes that his research team will be able to form the tools that allow anybody to pose questions, set out scenarios and see what the data suggests will happen in these scenarios.

Alluding to the work that Money's team is carrying out, Suki argues that the current challenge with ESG information is the quantity of non-standardised, variable quality information that is available. She explains that it's difficult for quantitative analysts to do much with the information that is out there because it's often backward-looking, subject to normative views, and lacking in transparency. For her, this poses a key hurdle for fintech, which needs to provide meaningful differentiated information while also adding value to the conventional financial analysis that is being done.

Looking ahead, Suki argues that the situation is likely to get "messy", but ultimately she sees five places where fintech has the potential to work well within the space in which Bloomberg operates, namely:

- creating datasets;
- lower-cost quantitative analysis and management;
- machine intelligence driven engines that extract value from unstructured information;
- data visualisation tools;
- open analytics, allowing anyone to query data across lots of different datasets like a quantitative analyst would do.

Of these, the first particularly interests her, though Suki warns that people have only so much capacity to try to use new information.

AN END TO DISRUPTION?

The term 'disruption' is commonly used to describe the industry and its impact.

Within this, companies are typically collaborative – working with the established entities to create something new – or competitive – aiming to go into direct competition with the existing order and its players. Chua is seeing a shift away from the directly competitive towards collaboration and innovation, and cites the fintech plans that Deutsche Bank has made over the course of 2016, which include investing €750m in digital products and advisory services by 2020.

Looking ahead, Chua's interest is focused on blockchain and specifically how it's going to be used, not just for banking, but within businesses themselves. Meanwhile, Money views 2017 as a year when we'll see the forms of disruption changing. He cites MiFID II, arguing that this will be a factor that will encourage greater corporate access to technology. "If it continues along the path we've seen to date, fintech will help fund managers become more transparent about how they are spending their money to their underlying investors, which is an area that hasn't yet properly evolved."

The potential for fintech remains ripe and in some areas it is beginning to be realised. Much of the earlier fanfare, as well as fear and mistrust, has died down, allowing the sector and its players to develop niches, respond to demand, and better identify what fintech can do to make the financial industry more efficient, responsive, cost-effective and add value.

UPCOMING EVENTS

BACK

PRI in Person

25-27 SEPTEMBER 2017

INTERCONTINENTAL, BERLIN

SAVE THE DATE

PRI in Person is the leading global conference on the responsible investment calendar, providing a platform for PRI signatories and other investment professionals to learn, network and collaborate in person over several days. The annual event allows attendees to discuss topical issues and share experiences from their own organisation and region with peers from around the world.

Discounted Early Bird registrations for PRI in Person 2017, 25-27 September in Berlin will open in February.

To register your interest and ensure you are notified when Early Bird booking opens, click the button below.

Register

The Academic Network will run a conference focussing on the latest insights in responsible investment research on the 27 September 2017, Intercontinental Berlin.

STAY TUNED FOR MORE INFORMATION.

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

UN Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact