Interview

"How sustainable is sustainable investment?"

Editor-in-chief Marty-Jörn Klein talking to Dr Steffen Hörter, Co-Head Investment Consulting & Portfolio Analytics, AllianzGI Global Solutions/risklab, Munich

What role does sustainable investment play for institutional investors?

Dr Steffen Hörter: Overarching trends, such as climate change and global warming, can potentially impact returns and investment risks severely, as can specific ESG[1] risks associated with individual asset classes or issuers. Extensive research is now available to support these investment theories. Incorporating environmental, social and corporate and national governance factors (ESG factors) helps investors with a long-term horizon to manage their risk comprehensively. A lot of institutional investors in Europe confirm the importance of ESG in investment practice, as demonstrated by recent surveys.

You mention ESG risks. What do you mean?

Generally speaking, they are future trends in the fields of environmental, social, and corporate and national governance that can potentially impact investment performance very adversely. ESG risks can relate to individual securities and investment segments, or even to an entire portfolio.

For example, institutional investors are currently debating whether and to what extent risks are associated with investing in companies and commodities from the fossil energy sector.

[1] Environmental, Social and Governance (ESG).

ABOUT DR STEFFEN HÖRTER

Dr Steffen Hörter Dr Steffen Hörter is responsible for Investment Consulting & Portfolio Analytics Services at risklab within Allianz Global Investors Global Solutions. He advises institutional investors in Europe on investment strategy, risk management and sustainability. In recent years he has published various studies about incorporating sustainability into investment strategy. Prior to joining Allianz Global Investors, Dr Hörter worked as a Management Consultant for banks and risk management at an international consultancy firm. Dr Hörter studied Business Administration in Regensburg, Edinburgh and Ingolstadt/Eichstätt. He holds a doctorate from the Catholic University of Eichstätt-Ingolstadt, where he worked as a lecturer at the Department of Finance and Banking at WFI – Ingolstadt School of Management.

Briefly, the discussion is centring on the fact that there are significantly more known oil and gas reserves the world over than could ever be used up without risking even more severe global warming, with its harmful consequences for our climate. Political intervention to strictly limit greenhouse gas emissions would result in "fossil" assets having to be written off because they would become unsellable. The term used in this respect is "stranded assets".

As a result, equity and commodity prices in these segments would collapse. In an effort to control this risk, some major international investors have started to systematically measure and reduce the implicit CO_2 footprint of their investments. This procedure was advocated in the "Portfolio Decarbonization Coalition"[2] and in the "Montreal Carbon Pledge"[3] at the end of September 2014.

On the other side, where do you see ESG opportunities?
In addition to ESG risks, investors should indeed not neglect the opportunities offered by ESG. Megatrends – such as reducing carbon dioxide emissions, raising energy efficiency, or even assuring access to clean water – already offer opportunities to generate additional returns, and will become even more important as time goes by.

Take a look at China: there is an urgent need to rapidly lower the fine particulate pollution in Beijing and other cities with populations of millions. Numerous industries – some of them new – will benefit from these megatrends.

Are there other reasons why institutional investors should consider sustainability factors when making investment decisions?
To start with, there is the management of reputation risk. Investment committees want to avoid being linked to investments that make headlines and inspire controversial debate in the public domain; intolerable business practices, for example, such as child labour or massive neglect of health and safety regulations by subcontractors supplying to global companies. Smartphones and social media now mean that the whole world becomes aware of evil practices and reputation risks much more quickly. If a company is then boycotted by consumers as a result, experience has shown that its share price will fall.

The reasons you have listed so far in support of sustainable investment are, however, all voluntary – is that not so?
Yes. There are, however, also some interesting trends emerging in Europe towards making ESG a legal obligation for institutional investors. Since the beginning of 2014, Dutch law has prohibited

[2] The Portfolio Decarbonization Coalition (PDC) is a multi-investor initiative that is driving the reduction of emissions by committing institutional investors to gradually eliminating fossil assets from their portfolios.
[3] The Montreal Carbon Pledge is an initiative launched by institutional investors who have committed initially to measuring and annually disclosing the carbon footprint of their investments, and steadily reducing this by implementing specific strategies. Equity portfolios will be first, starting in September 2015.

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investing in companies that make cluster munitions. In addition, disclosure of the extent to which ESG plays a role in investments is mandatory, both there and in the UK. The UK also specifies disclosure of a "Statement on Investment Principles" describing how important a role ESG considerations play in respect of investment objectives. As far as German investors are concerned, ESG reporting obligations are currently limited, and basically only apply to pension schemes that are subject to German insurance supervision law (Versicherungsaufsichtsgesetz, VAG).

Sustainability is increasingly affecting the exercise of voting rights as well. What is that all about?
Interesting trends influencing corporate decision-making are emerging around the world. As a result of the so-called Minder Initiative, from 2015 onwards pension funds in Switzerland will be legally obliged to exercise the voting rights conferred by the equities they hold, and to vote on issues that include executive pay. Other significant national guidelines exist alongside the legal requirements – some of which are already being discussed at EU level. The UK Stewardship Code, for example, requires institutional investors to accept more ownership responsibility as shareholders. That includes talking with the company, actively exercising voting rights, and reporting on their activities. The Code was introduced in 2010, and works on the principle of "comply or explain": anyone who doesn't comply must disclose the reasons why.

Can you name actual examples of how ESG can impact investment performance?
In the equity investment universe, for example, companies with good ESG ratings tend to demonstrate less volatility than their peers with poor ratings. Recent studies dealing with government bonds show that countries with high levels of corruption and weak democratic structures tend to display a higher risk of default than the average. In the case of real estate and private market investments, such as infrastructure investments or investments in unlisted companies, a direct link often exists between the management of sustainability factors and long-term performance. Given the illiquidity of these investments, taking a very close look at ESG risks is particularly recommended, both before investing and while invested. For example, if the operator of an infrastructure plant ignores environmental requirements, regulation may become stricter, incurring costs that, in turn, shave off some of the return.

Are there studies to prove this?
Yes, there are corresponding studies with different areas of focus. A recent meta study at Oxford University, for example, evaluated more than 190 ESG studies of an academically high quality. 80% of these studies reached the conclusion that a strong ESG strategy positively influences a company's share price performance. Various recent studies, including an analysis conducted by the UNPRI[4] in 2013, show that ESG factors can help when estimating

[4] Principles for Responsible Investment issued by the United Nations.

"Accordingly, the default risk tends to be higher in extremely corrupt countries."

the default risk of government bonds. Accordingly, the default risk tends to be higher in extremely corrupt countries. The situation becomes particularly explosive when an autocracy encounters a population that is aspiring to more, is well connected through social media, and is striving to be free.

Alongside research focusing on individual asset classes, the ESG effects on portfolios have also been analysed. In our "Returns without regrets reloaded" study, we conclude that optimising ESG risks as part of the strategic asset allocation process can improve portfolio performance expectations. A sample comparison of mixed portfolios revealed that the portfolio risk can be reduced by as much as a third.

And what about the practical implementation of ESG in investments?

Investors are well advised to take a pragmatic approach and exercise a sense of proportion. First of all, the objectives, instruments and portfolio allocation to sustainability strategies must be defined for the investments. We offer our fiduciary management clients both a pragmatic entry-level solution and a more advanced "better practice" solution. The basic solution helps to comply with minimum requirements and obligations under supervisory law. Subsequent expansion to a more extensive solution is possible at any time.

It is important that the sustainability strategy is interlinked seamlessly and transparently with the investment strategy. In doing so, the entire investment process must be considered: from structuring the portfolio up to its implementation. During this process, material sustainability factors must be incorporated into conventional analysis tools, such as strategic asset allocation and investment risk measurement.

Speaking from personal experience, investment committees are only willing to accept a sustainability strategy if its quantitative impact on the risk/reward profile of the portfolio is completely transparent. Consequently, we have spent recent years investing a lot of money in building the expertise needed to make this risk/reward transparent for our clients when integrating ESG factors.

Dr Hörter, thank you for sharing your thoughts with us.

Marty-Jörn Klein, Editor-in-chief was talking to Dr Steffen Hörter