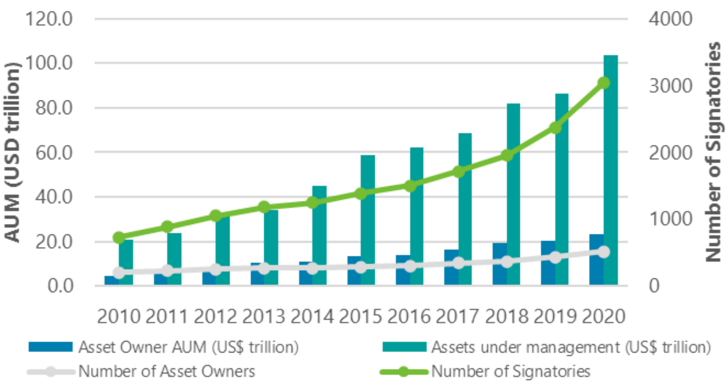
The Emergence of Sustainability Agenda to Investment - ESG Investing

A growing concern of sustainability has been emerging in the investment community over the past decade. It was an old thought that considering sustainability for society implied sacrificing financial returns of investment. The development of Environmental, Social, Governance (ESG) investing, however, has demonstrated a different story.

Engagement from Investment Community

FIGURE 1: Engagement on Principle of Responsible Investment



SOURCE: PRI

The Principle of Responsible Investment (PRI), launched in 2006, is the world's leading proponent of responsible investment with the aim to promote the ESG investment implications and facilitate its investor signatories on ESG integration. Over the past decade, there has been a robust growth of engagement from the investment community on PRI, with a compound annual growth rate (CAGR) of 17% for the asset under management (AUM) of signatories.

ESG integration, therefore, is gaining more and more attention from the investment professionals as part of the indispensable analysis. In the capital market, a series of ESG assessments provides a standardized framework to enhance ESG integration, which will further be examined in the following.

The Universe of ESG Assessment in Capital Market

ESG Disclosure Frameworks and Standards

A number of ESG disclosure frameworks and standards have been developed by different standard-makers, including Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), Task Force on Climate-related Financial Disclosures (TCFD), etc. to address cross-sections of ESG issues with various concepts on material factors. Taking GRI as an example, being one of the most widely used standards with thousands of reporters in more than 100 countries, it provides a reporting structure of sustainability information by specifying the required disclosure and recommendations for each topic listed below.

Accordingly, the GRI Standards enable multiple stakeholders, including reporting companies, investors or rating institutions, to access the sustainability information in a consistent and credible way.

TABLE 1: GRI Standards and Material Topic Examples

ESG Elements	***GRI Standards***	***Examples of Topics***
Governance	GRI 100 Series Universal Standards	• Composition of governance body • Conflicts of interests • Remuneration policies
Economic	GRI 200 Series Economic	• Financial implications and other risks and opportunities due to climate change • Infrastructure investments and services supported • Operations assessed for risks related to corruption
Environmental	GRI 300 Series Environmental	• Greenhouse gas emissions • Water consumption • Supplier environmental assessment
Social	GRI 400 Series Social	• Training and education to employees • Diversity and equal opportunity • Customer Privacy

SOURCE: GRI

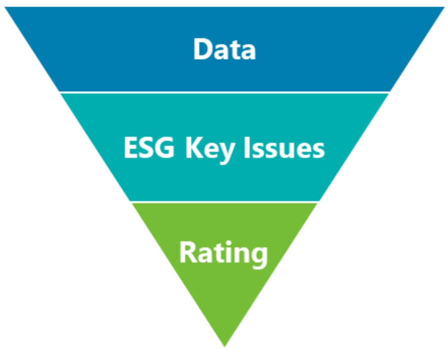
ESG Ratings

Enormous interest in socially responsible investing (SRI) by both individual and institutional investors has given rise to a relatively young, but fast growing, industry — ESG ratings agencies. Today, there are a handful of established agencies using rigorous criteria to evaluate companies based on ESG metrics, including MSCI ESG Ratings, Sustainalytics, Thomson Reuters ESG Scores, Bloomberg ESG Scores, S&P ESG Evaluation. Taking the MSCI ESG Ratings as a reference, it examines how the companies are exposed to and managing ESG-related risks and opportunities. Its rating methodology is illustrated as follows.

- MSCI ESG Ratings

Collecting data from over 100 specialized datasets, company disclosure and media, the MSCI's experienced analysts assess 35 ESG Key Issues updated annually for each industry, including Carbon & Toxic emissions (**E**), Health & Safety (**S**), and Board (**G**), etc. Under a scoring system with pre-set weights for the concerned issues, the MSCI will arrive at an overall ESG rating to the target company relative to the industry peers.

FIGURE 2: MSCI ESG Rating Structure



SOURCE: MSCI

TABLE 2: MSCI ESG Key Issue Hierarchy (Excerpt)

3 Pillars	*Themes*	*Examples of ESG Key Issues*
Environment	Climate Change	• Carbon Emissions • Product Carbon Footprint
	Pollution & Waste	• Toxic Emissions & Waste • Electronic Waste
Social	Human Capital	• Health & Safety • Labour Management
	Product Liability	• Product Safety & Quality • Privacy & Data Security
Governance	Corporate Governance	• Board • Accounting
	Corporate Behaviour	• Business Ethics • Tax Transparency

SOURCE: MSCI

More specifically, the issues identified as material are determined as ESG Key Issues to be incorporated into ESG Rating model and assigned with weights. A higher weight would be assigned where the industry is a major contributor to environmental or social impact, and the risk or opportunity is expected to materialize in short term, or vice versa. Subsequently, the MSCI analysts assess the key ESG risks and opportunities, as well as review those controversies unveiling the target company's risk management capabilities.

Following these key issues' identification, weightings and assessment generating the key issue scores, a final letter ESG rating for the target company is issued, with AAA being the best and CCC being the worst.

ESG Index

To reveal the investment implications of ESG investing, constructing an index helps evaluate the financial return of investing in those companies with more favourable ESG performance. The compilation of the ESG Index uses the ESG ratings of companies as one of the eligibility criteria for index constituents' selection. Examples comprise MSCI ESG Indexes, FTSE ESG Index Series, Dow Jones Sustainability Indices, Hang Seng Corporate Sustainability Index Series. Below takes MSCI ACWI ESG Leaders Index as an illustration.

- MSCI ACWI ESG Leaders Index

This index is compiled by using MSCI ESG Research products, of which MSCI ESG ratings act as the eligibility criteria to recognize those companies to remain in the index or to be considered for addition in the index (rated as 'BB' or above, and the MSCI ESG Controversies Score of 3 or above). Additionally, the companies with involvement in alcohol, tobacco, gambling, nuclear power and weapons are excluded from the indexes.

TABLE 3: Gross Returns (%) (Nov 30, 2020)

		Annualized	
	1-Year	3-Year	5-Year
MSCI ACWI ESG Leaders	15.84	10.17	11.69
MSCI ACWI	15.58	9.56	11.44

SOURCE: MSCI

According to MSCI, it could be seen that the MSCI ACWI ESG Leaders index outperformed the MSCI ACWI index over various time horizons as of Nov 30, 2020. It demonstrates how investment analysis integrated with ESG factors generate surprisingly positive returns, deviating from traditional perspectives. Therefore, it is worth examining the shift in focus on ESG issues, particularly under the COVID-19 pandemic.

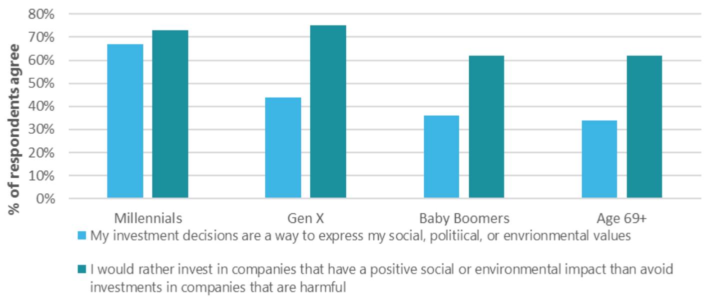
The Shift in Focus on ESG issues

Why have the investors been integrating ESG into fundamental analysis?

- Rising demand from investors for social impact in investment

The investors, especially the younger generation, are facing various issues including flood risk, sea level rise and data leakage, etc. These issues pose a threat to the sustainability of the planet and the society they and their offspring will be living in, which has been driving greater concerns on social and environmental issues.

FIGURE 3: Investor Attitudes on Environment & Social Integration



SOURCE: Bank of America US Trust

A survey result by Bank of America US Trust found that at least 30% of the respondents believed that their investment decision was not purely return-seeking but also a channel to deliver their social and environmental values. Over 60% of millennials respondents expressed their agreement on this belief. Moreover, a significant portion of millennials (73%) and Gen X respondents (75%) preferred to invest in companies which reveal positive social and environmental impact. Hence, the investment principle is evolving to extend the investors' beliefs and impact.

Why has COVID-19 accelerated the focus on ESG?

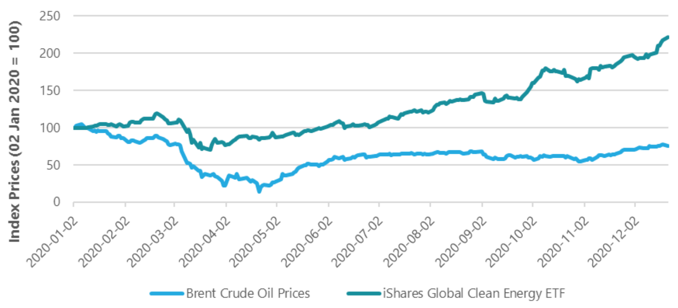
According to Bloomberg, there had been an explosive growth of capital inflow to global ESG-themed Equity ETF in 2020. The level of capital inflow surged from USD 8 billion in Q4 2019 to USD 34 billion in Q4 2020. It is worth examining why an acceleration emerged in ESG in 2020 surrounding with COVID-19 pandemic.

- **Environmental** – A rising interests in renewable energy

At the beginning of 2020, the strictest lockdown measures to contain the spread of COVID-19 disrupted the economic activity, which provoked the slump in oil demand and exceedingly volatility in oil prices.

Meanwhile, the health crisis impacting the businesses globally has also concurrently raised the awareness of global environmental sustainability under the climate crisis, which has been threatening the global supply chain stability. Accordingly, the volatility of oil prices and the increasing awareness to environment have induced the investors to shift their investment away from the traditional energy to the renewable energy.

FIGURE 4: Comparison of Brent Crude Oil Price and Clean Energy ETF



SOURCE: S&P Capital IQ, FRED

In the capital market, the investors increasingly allocate their investment to ESG funds which focus on renewable energy and often exclude investing in oil-related shares with a view to reducing the investment risks or unexpected loss from the volatility of oil prices. The performance of Clean Energy ETF outpaced that of Brent Crude Oil since the start of 2020 as shown above. The Clean Energy ETF has revealed a robust growth over the year, whereas the oil has not recovered from the slump.

Therefore, the oil market volatility and rising environmental awareness triggered by COVID-19 pandemic have increased the attractiveness of investment in renewable energy and ESG-themed investment vehicle.

- **Social** – A shift of focus on labour training and health considerations

Social distancing is also one of the measures encouraged to contain the spread of COVID-19, which induces the new normal - remote work. In July 2020, the technology giants, including Google and Amazon, announced that their employees could continue to work from home until 2021 for health considerations.

The initiative of remote work implies greater technology investment, labour training, and social programs in order to support employees' working efficiency in remote work model consistent with that in the traditional office space. Without these supports, the remote work model brings challenges and hindrances to inter-team collaboration, communication, and employee motivation with increasing loneliness, which will impact labour productivity. Therefore, technology training and mental health are increasingly concerned for whether the company can ensure the business sustainability and productivity in this unprecedented time.

Training and Health & Safety are the Social considerations of ESG integration, so the outbreak of COVID-19 inducing the new normal of remote work also accelerates the focus on certain aspects.

- **Governance** – An increasing concern on capability of risk management

The COVID-19 pandemic led to the unprecedented business shutdown and significant blow to cash flow, which precipitated mass layoffs for cost reduction and a surge in delayed payments to suppliers. COVID-19 pandemic, thus, has been increasing scrutiny on corporate governance in terms of risk management by the board of directors amid crises.

Under social distancing restrictions, the retail industry has been hardest hit by the COVID-19. Bed Bath and Beyond Inc., the retailer for home furnishings products, has demonstrated the role of board's management approach and strategy to manage material ESG-related issues about customers health and safety in COVID-19 pandemic. The retailer rolled out the buy-online-pickup-in-store (BOPIS) and contactless kerbside pickup services to their over 1000+ store locations to lower the customers' risk of infections and ease the slump in sales. In Q3 2020, Bed Bath & Beyond Inc. announced 77% growth of digital sales year-over-year, of which 16% could be attributed to the shoppers using BOPIS or kerbside pickup services.

Therefore, the COVID-19 pandemic highlighted the role of the corporate governance for how the board of directors effectively manage the risks arising from the potential crises in the future.

Alteration of ESG Integration underway with Emerging Green Investment

In the past, the investment community perceived governance as a relatively important factor among ESG to impact the share prices. Looking ahead, more and more investment professionals believe that the remaining Environmental and Social issues will also be the vital factors, constructing a more balanced consideration towards ESG.

TABLE 4: Survey Result about the Impact of ESG Issues on Share Prices

	Europe, the Middle East & Africa		***Americas***		***Asia Pacific***	
ESG Issues Impact on Share Prices	Will Affect in 2022	Change versus 2017	Will Affect in 2022	Change versus 2017	Will Affect in 2022	Change versus 2017
Governance	69%	+9%	80%	+12%	73%	+9%
Environmental	54%	+30%	60%	+40%	59%	+35%
Social	46%	+22%	52%	+36%	55%	+25%

- Remarks: Percentage represent the respondents who answered "often" or "always" that related ESG issues affect share prices

SOURCE: CFA Institute

As per CFA Institute, a survey's result revealed a double-digit growth in the percentage of respondents who believed Environmental and Social issues would "often" or "always" affect the share prices in 2022 versus 2017.

Among ESG, Environmental issues are increasingly deemed to have an impact on share prices than the past with the growth of 30% (Europe), 40% (Americas) and 35% (Asia Pacific), respectively.

In addition, the governments are also expected to implement significant investment plans to help fight climate change. In early 2020, the European Union presented EUR 1 trillion (USD 1.21 trillion) of sustainable investment plan over the next decade to support the economic transformation towards climate -neutrality. Furthermore, the US government is expected to roll out a USD 2 trillion spending plan in order to significantly escalate the use of clean energy in transportation, electricity and building sectors.

Hence, the focus on ESG integration will be altering to reveal more balanced emphasis among each factor with Environmental issues drawing increasing attention, which will accelerate the development of Green Finance going forwards. Below lists some of the clean energy funds with superior returns in 2020.

TABLE 5: List of Clean Energy Funds with Superior Returns in 2020

Clean Energy Fund	***Fund Ticker***	***Number of Holdings***	***1-Year Return***
Invesco Solar ETF	TAN	31	234.25%
Invesco WilderHill Clean Energy ETF	PBW	56	205.46%
ARK Genomic Revolution ETF	ARKG	52	180.55%

SOURCE: ARK Invest, Invesco

In the medium-to-long term, we predict that there will be irreversible capital inflows into the ESG-themed investing vehicles. With professional ESG assessment framework and increasing ESG awareness, the investors would be able to achieve an attractive financial return alongside delivering sustainability values.