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ESG Integration Series

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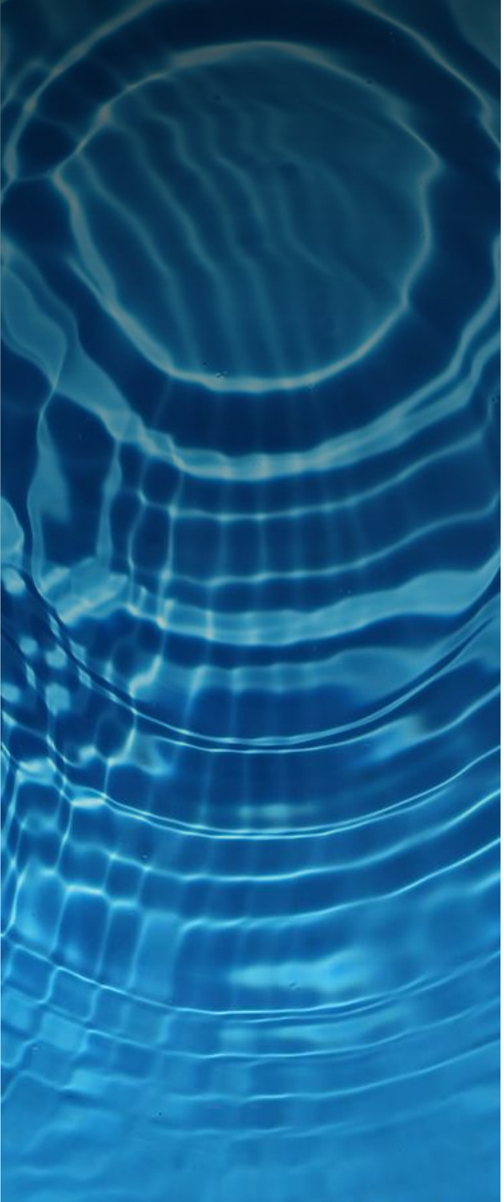

The ESG ecosystem update week ending 7 May 2021

Investors

Is ESG investing a fad? Yes, if we continue to make it a broad category without going into the details of what they represent and the context of which these topics are addressed.

In a Bloomberg article, **Japan's Government Pensions Investment Fund (GPIF)** was confronted with the 'dilemma' of having to choose between fiduciary duties and investing in a thematic social index. Some interesting data was presented, and sensible questions asked. It is important that these questions keep coming so that we can reflect on how to improve sustainability and responsible investment in spirit and in practice.

For **Norway's Government Pension Fund (GPF)** and its dedicated manager **NBIM**, the refinement of ESG strategies is already well underway. At a parliamentary hearing, it announced changing its policy on new stocks that enter the index it follows.

"*This would enable NBIM to consider environmental and social issues at the firms at an earlier stage.*", says NBIM CEO @Nicolai Tangen. "*Given that they can impact companies' long-term profitability …. they are most certainly financially relevant,*"

I am particularly pleased with the way he debunks the segregation of financial and non-financial (ESG) factors as ESG data had often been labelled as 'non-financial' data. The problem is not categorisation, but how ESG indicators are constructed. If having a 'human rights policy' or a statement committing to UNGP scores a point without a structured approach for implementation and hence better risk management, then of course it is hard to find correlation between ESG factors and financial performance.

Allianz announced its sustainability performance 2020 and new guidelines regarding carbon-based businesses, including an acceleration of the company's exit from providing insurance services to coal producers and coal-based energy companies who do not have credible transition strategies. Allianz's updated coal policy tightens its restrictions to coal producers to companies that mine more than 10 million tons of coal annually, pledging that they will no longer receive property and casualty insurance and financing beginning 1 January 2023. The same restriction applies to energy companies that build new coal-fired power plants or generate more than 25% of their energy or more than five GW annually from coal, and service providers that generate more than 25% of revenue from coal.

Academia

The article ESG outperformance narrative 'is flawed', new research shows highlights the controversial and long lasting debates around whether sustainability factors deliver outperformance. The NYU Stern / Rockefeller Asset Management paper has six key takeaways. I resonate with most but especially the point on sustainability as mediating factors that improve risk management and innovation, with innovation being a proxy of growth drivers, and therefore improve financial performance. Managing low carbon future is clearly one form of risk management integrated with business model transformation (especially in some industries).

Which Corporate ESG News does the Market React to? Professor @George Serafeim and @Aaron Yoon used TrueValue Labs data to track stock price reactions to ESG news and found that investors react to news that are financially material, such as issues related to customer welfare, product quality and safety. The authors did not find a significant market reaction to negative human capital issues. For natural capital issues, negative news generates negative one-day reactions of 55 basis points on average, so some day trading opportunities.

In a separate paper, Professor Serafeim, @Dane Christensen and @Anywhere Sikochi found that greater ESG disclosure leads to greater ESG rating disagreement (causality rather than correlation?), and rating agencies disagree more about ESG outcome metrics than input metrics (policies). Given increased disclosure from corporates, we shall expect discrepancies to maintain or widen. A summary can be found on the Harvard Law School Forum on Corporate Governance.

Google and UC Berkeley jointly published a paper calculating the energy use and carbon footprint of popular AI models, including the famous 'AI-augmented author', GPT-3. Chief Scientist of Google @Jeff Dean and the researchers found that the choice of algorithm, the programme that implements it, the number of processors that run the programme, the speed and power of those processors, a data centre's efficiency in delivering power and cooling the processors, and the energy supply mix can reduce carbon footprint by up to 100 times. To help reduce the carbon footprint of machine learning, energy usage and CO2 emissions should be a key metric in evaluating models. The paper is part of an effort to address allegations on climate change impact of AI. The latest findings will no doubt catch the attention of responsible investors.

Companies

Engagement on **biodiversity** has stepped up a notch.

Forty food businesses (such as **Ahold, Sainsbury Waitrose, Tesco, Morrison**) sand investors (such as **AP7, LGIM, Skandia**) sent an open letter to the National Congress of Brazil urging the withdrawal of proposal PL510/21 on land tenure regularisation which could legalise the private occupation of public land, commonly seen as rewarding Amazon land grabbers especially if regularisation can take place without on-site inspection and if stakeholder consultation is not conducted in a thorough and transparent manner.

Co-op became the world's first supermarket to commit to net zero by 2040 for its own brand food and drink. For companies with a long and complicated supply chain, it is often difficult to commit to net zero due to factors outside of their control upstream and downstream. In its 14-page ten-point climate plan, the company sets out from products and packaging to power and pension fund investments, how it plans to do that.

Do social factors matter? Yes, when it comes to remuneration at **Rio Tinto** this year. More than 60% votes at AGM opposed the remuneration report over the exit package of the former CEO where mine expansion in a site in Western Australia cost him his job in September 2020. NBIM which represents Norway's GPF US$1.3 trillion and the UK's Local Authority Pension Fund Forum, which manages about £300bn in assets, were among those to vote against the report. There may be wider implications too. The company said it would engage with shareholders and "reflect" on any "new input" as it implemented the remuneration policy. Although it was only an advisory vote, shareholder support of this item is likely to catch the attention of regulator. Will an advisory vote stay advisory if a large proportion of shareholders continue to vote against it?

98% vote support for a climate proposal at **General Electric,** presented by AsYouSow on behalf of Amalgamated Bank and supported by the management. The proposal calls for GE to report across all its operations and products, including the largest emissions component covering Scope 3 product emissions. At the same meeting, 58% of shareholders rejected executive pay.

Government

The **U.S. Department of Energy (DOE)** announced up to US$12 million for technologies that can make geothermal systems more efficient for clean, renewable energy production. This is a modest amount compared to BP and Chevron's US$40m investment into Eavor. It reminds me of a conversation with a banker this week when we discussed investment rate of return (IRR) of renewable projects given the flood of 'ESG' money, " *I agree a lot of times the wind or solar farms IRR is not great for the oil majors to acquire, but I feel it is more hedging than investment for them. The entire renewable business of these companies could be just the value of one tanker of oil, so it is indeed not a quick transition! They have flexibility because they are cash rich.*" So what should investors expect from energy companies on dividend payout, capex and low carbon transition acceleration plan? None of them should be considered in isolation. #ESGIntegration

Germany announced a 42 page new Sustainable Finance Strategy with a planned 'traffic light' system to make it easier to identify green investment opportunities. S&P will develop the ESG Eurozone 60 Bund-SV Index to serve as a benchmark for Federal Special Pension Funds. Thanks @Asma Khan for sharing.

Japan plans to add a 'respect of human rights' provision in its Corporate Governance Code. Contrary to what has been highlighted in this Nikkei article, I found the amendments focus (see source document from the FSA) on group governance, hence the governance of subsidiaries; clarification of internal audit directly reports to the board, audit committees and the *kansayaku* board and the emphasis on the effectiveness of whilst-blowing system particularly helpful. The proposed revised Code also consists of the topics aligned with the current ESG trends, from board responsibility for sustainability to investment in human capital management.

Hong Kong announced in the 2021-22 Budget that the Government would consolidate the Pilot Bond Grant Scheme and Green Bond Grant Scheme into a Green and Sustainable Finance Grant Scheme (GSF Grant Scheme) to provide subsidy for eligible bond issuers and loan borrowers to cover their expenses on bond issuance and external review services.

The Belgian Vigilance Proposal establishes the principle of corporate responsibility to respect human rights, labour rights and the environment as well as mandatory due diligence obligations for all companies established or active in Belgium, with respect to their entire value chain (all stakeholders). For more information, see this post by @Anna Triponel.

Events

UNEP and AIIB hosted a webinar 'Integrated Approaches to Sustainable Infrastructure investment led by AIIB's Chief Economist @Erik Bergolf, also a former colleague at the LSE. As stewardship is expected to cover all asset classes, this is a much welcome sharing amongst stakeholders, especially following the recent launch of the AIIB sustainable development bond framework. AIIB is rated by three ESG rating agencies: ISS ESG, Sustainalytics, and Vigeo Eiris. More useful materials on sustainable infrastructure can be found here.

Finally, **RIP to David Swensen** who pioneered the Yale model of endowment fund management. He transitioned the fund from a conservative portfolio of domestic government and corporate bonds to one that is global, diversified and multi-asset. The Yale Investments Office managed US$31.2bn (as of June 2020), and said it had averaged annual returns of 12.4% p.a. over the past three decades. In the 2021 fiscal year, its contributions accounted for more than a third of the university's overall revenues, underscoring its importance to Yale at a time when many educational institutions have been crippled by the Covid-19 crisis.

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