For Financial Professionals and Institutional Investors Only

# Responsible investment

SPECIAL REPORT 2020

## Exploring sustainable investment in a changing world

# Contents

# Introduction

Responsible investment – which integrates environmental, social and governance (ESG) investment factors[1] – continues to rise rapidly up the investment agenda, buoyed by international initiatives to restart local economies and tackle global threats such as climate change.

Global markets have seen some exponential growth in responsible investment inflows and a plethora of new fund launches in 2020, despite the rolling Covid-19 pandemic. According to ratings specialist Morningstar, money flowing into global funds taking ESG factors into consideration rose by 72% in the first quarter of 2020 alone and, as of 30 June, assets allocated to ESG funds totalled US$106 trillion.[2]

All of this comes amid wider government efforts, particularly in Europe, to boost public spending aimed at tackling climate change and creating more sustainable means of energy production, transport infrastructure and urban planning. Over time these could create a wide range of new investment opportunities in areas as diverse as renewable energy and healthcare.

With the United Nations (UN) Sustainable Development Goals (SDGs) now well established at a global level, companies and governments are also being encouraged to reconsider their governance approach and business practices while playing closer heed to social considerations. In turn, investors in both equities and bonds are more interested in scrutinising the companies in which they invest, encouraging corporates to improve their governance and working practices.

However, despite much progress in this area, responsible investment is not without its challenges. The various regional ratings systems, measurements and definitions within the orbit of responsible investment and the various ESG factors can present a bewildering array of often conflicting data to global investors.

Despite the best efforts of organisations such as the UN, universally-agreed standards and definitions for responsible investors remain some way off. Amid this tangle of ratings and definitions, financial regulators are also weighing in, pushing funds and companies to provide greater transparency on their responsible investment claims.

The UK Financial Conduct Authority, the Autoritē des Marches Financiers (AMF) of France and the US Securities and Exchange Commission are just three regulators currently fronting initiatives to improve accountability in this sphere.

Against this shifting backdrop, managers from across BNY Mellon Investment Management explore ways in which regulators, companies and governments are addressing the growing appetite for responsible investment. Here, we outline some of the key asset classes and opportunities being created, the growing levels of corporate engagement and some of the evolving risks and opportunities responsible investment presents in both developed and emerging markets.

1 Responsible investment also embraces the promotion of active ownership on behalf of investors via stewardship and the assessment of the ESG profile of investment portfolios.
2 *Citywire selector.* ESG flows leap 72% in Q2 2020, Morningstar report finds. 04 August 2020.

# A green kick-start

Increased spending world-wide as governments seek to kick-start economic growth may have added benefits – boosting sustainable projects. Could responsible investment solutions provide the necessary tonic for beleaguered policymakers and investors to change the face of both the global economy and society itself? Here, managers from across BNY Mellon Investment Management consider the likely road ahead.

While signs of a fragile normality in global markets appeared on the horizon over the latter half of the summer, the seismic economic ructions triggered by the 2020 Covid-19 pandemic continued to reverberate across global governments and businesses. This has raised many questions about the world's economic and social priorities and the way we, live work and plan for the future.

This crisis has also come at a time when global trade relations have been – and continue to be – unusually sour. Among these have been increased Sino-US trade tensions, while Brexit has created new divisions between the UK and European Union (EU). This has created questions over the future shape and viability of some long-standing supply chains and global trade connectivity.

Commenting on the growing focus on business and social links and business practices, Mellon senior portfolio manager Robin Wehbé says: "Recent events have really highlighted the social connections and inter-exchanges between the complex web of stakeholders in business and wider society. Where mega storms once alerted us to climate change, so a global pandemic has hopefully woken us up to more humanitarian challenges.

"Investors and other stakeholders are asking more questions about employment stability, pay equality and labour risks. How should companies manage an office full of people, a shop or a factory? Not only that, how do we now contemplate supply and distribution value chains?"

Some see the current time as an ideal opportunity to take stock and work to refashion our economies to make them both more sustainable and resilient. And if no further reason was needed, the growing climate emergency is one huge indicator for which this might make sense.

Newton's head of sustainable investment Andrew Parry says: "Is the business world about to tilt on its axis? A lot of people say the world will never be the same again, whereas others might think that could be wishful thinking because we may be seeing an acceleration of certain trends rather than a reversal of broader trends."

Either way, the sheer volume of government funding spent to head-off global economic collapse amid the pandemic has been stark. In July European Union (EU) leaders struck a post-coronavirus recovery deal worth €750bn in grants and loan[1]. Earlier in the year the US Senate approved a US$2 trillion emergency relief bill to address fallout from the pandemic.

Against this backdrop of spending, Parry sees a genuine opportunity to rethink the approach to sustainability and responsible investment across all three specific ESG spheres – environmental, social and governance. "Now may be the time for companies to rebalance expectations away from maximising short-term returns – the use of excessive debt and extended supply chains to reduce labour costs – towards the quality of those returns. In short, we have an opportunity to re-examine notions of efficiency in favour of resiliency," he says.

Much, Parry adds, will depend on the world's ability to learn from what he sees as critical mistakes made after the Global Financial Crisis (GFC) – when a reliance solely on market forces and cheap borrowing led to a compounding of challenges. This, he believes, resulted in a failure to deliver a more inclusive economic recovery, one that recognised the long-term benefits of tackling pressing social and environmental issues.

"While the arrival of quantitative easing in 2008 led to an economic recovery, it was a missed opportunity for governments to place incentives in the systems to encourage a flow of capital to areas of need rather than merely to bolster corporate profits – often at the expense of social and environmental challenges."

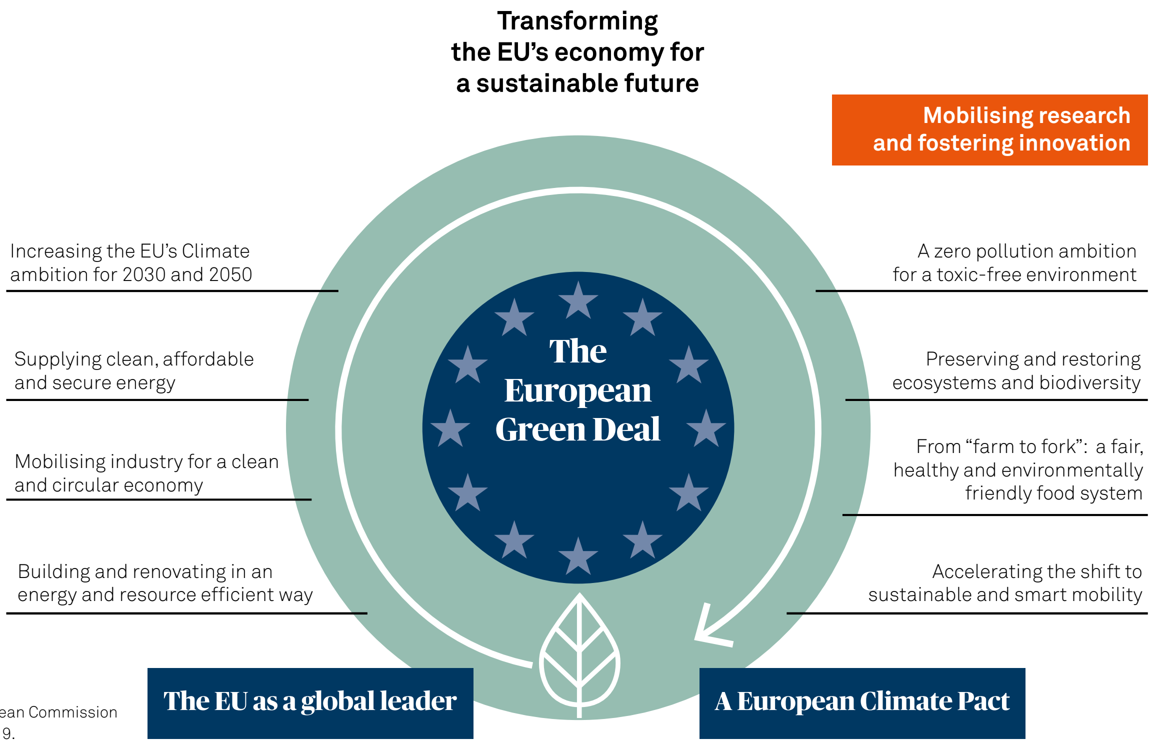
Parry believes today there are better financial economic models we can learn from. He points to the adoption of new thinking in the Dutch city of Amsterdam, drawing on so-called 'doughnut' economics. This is a framework created by the Oxford economist, Kate Raworth.

A central part of Raworth's economic model is the inclusion of the UN Sustainable Development Goals for 2030 (SDGs). These include goals such as providing affordable and clean energy and decent work and economic growth.

Amsterdam, says Parry, has officially embraced a sustainable development model as a way of emerging with purpose from the Covid-19 crisis to balance needs without harming the environment.

1 *BBC. Coronavirus:* EU leaders reach recovery deal after marathon summit. 21 July 2020.

KEY ELEMENTS OF THE EUROPEAN COMMISSION EUROPEAN GREEN DEAL




Source: European Commission December 2019.

Elsewhere, Parry points to the European Union's (EU) latest green initiatives, including its much touted Green Recovery Plan, as positive news for responsible investment within continental Europe.

At a global level, the UN estimates the successful delivery of its Sustainable Development Goals could ultimately add US$12 trillion to the global economy, alongside 380 million new jobs.

Yet Parry is concerned, there is still not enough progress being made to hit the UN's targets on climate change and other sustainability goals.

"In reality the flow of capital and tangible action needed to deliver on the SDGs have fallen well below target. The latest report from the World Business Council for Sustainable Development reveals that while 84% of its c200 strong member companies referenced specific goals in their sustainability reports, only 15% had aligned their business strategy to specific target-level SDG criteria.

"The danger in this is that SDGs become used as a conversational tool rather than as a broader framework to support capital allocation decisions. It also seems some companies rarely get beyond the headline goal in the relevant SDG – creating the potential for 'SDG washing.' Clearly, more urgent action is needed in this area over the next decade as we recover from the Covid-19 crisis with genuine partnership likely to be a key element of SDG's success." he says.

## PRIVATE SECTOR ROLE

Beyond the work of the UN and wider public sector initiatives, Insight head of responsible investment research and stewardship Joshua Kendall believes the private sector can also play a major role in driving sustainability initiatives.

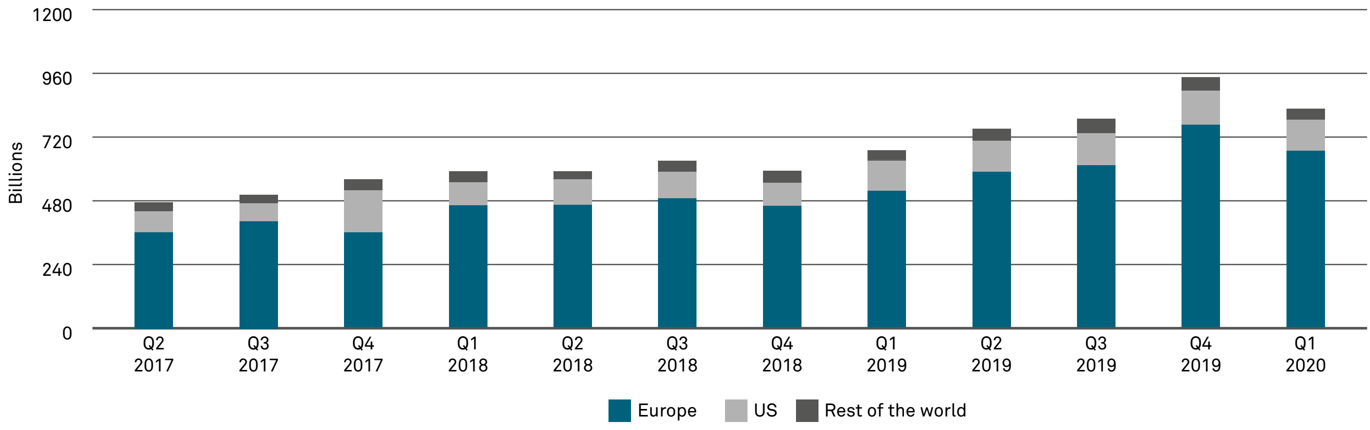
"The transition to a greener economy will be expensive for countries. I see Europe as a driver of change. But public money is not the only driver, companies are also investing in technology to reduce emissions and see clear support from major investors in the shift to a greener economy," he says.

Although the Covid-19 pandemic has proved an enormous global crisis, many companies are also still clearly focused on sustainability and the overarching threat of climate change. While the upcoming United Nations Cop26 intergovernmental climate summit has been postponed until 2021, investors are increasingly taking action into their own hands.

In August, the UK's biggest pension fund – the government backed National Employment Savings Trust (NEST) – said it was divesting from fossil fuels. The fund, which serves nine million members is to ban investments in companies involved in coal mining, tar sands or arctic drilling and said it will shift £5.5bn to more environmentally-friendly assets.[2] The fund joins a growing number of pension schemes and other institutions divesting from fossil fuels and related industries and further boosting environmental progress on ESG.

2 *Observer.* Largest UK pension fund goes green. 02 August 2020.

QUARTERLY GLOBAL SUSTAINABLE FUND ASSETS (US$ BILLION)




Source: Morningstar research data as of 30 March 2020.

Although historically questions have been raised over the potential for a drag on investment returns from responsible investments, recent research suggests the reverse might be true. Data provider Morningstar examined the long term performance of a sample of Europe-based sustainable funds and found the majority of strategies had done better than non-ESG strategies over one, three, five and 10 years.[3]

This may partly explain why responsible investment funds continued to attract a growing number of investors even as markets fell, with US ESG funds drawing a record US$10.5bn of new investment in the first quarter of 2020 alone.[4]

While much of this growth has come in equity markets, responsible investment is also increasingly taking centre stage across global fixed income markets.

In Europe, recent growth in this area has seen a particularly strong focus on social bonds, designed to deliver positive social impacts. The market grew by an estimated 43%to €66bn in the three months to 30 June 2020.[5]

While much of this growth has come as agencies and supranational issuers have sought to ease the economic and social impacts of the pandemic, other areas of ESG fixed income investing also see healthy growth. Issuance of impact bonds – investments in companies intending to generate a measurable social or beneficial impact as well as a financial return – alone surged to US$300bn last year.[6] Interest in ESG across other areas of fixed income investment also appears to be growing steadily.

As responsible investment and ESG rise rapidly up the investment agenda, Newton portfolio manager Scott Freedman believes the Covid-19 pandemic and its aftermath will leave a lasting legacy – strengthening the need to adopt a fairer, more sustainable investment approach.

"The crisis has made social and economic concerns much more pressing than they were before the pandemic and has actually really kick-started some of the more recent 'green' initiatives and perspectives we are seeing today.

"Going forward, companies will likely face greater scrutiny on how they dealt with the pandemic at its height but also whether they can sustain appropriate performance while supporting a broad range of stakeholders in what could prove to be a long, slow recovery," he concludes.

Many companies once sceptical of responsible investment, ESG and wider responsible investment initiatives have already had to take notice of growing shareholder scrutiny and public interest in corporate reputations.

As some corporations have found to their cost, avoiding or ignoring environmental, social and governance best practises can result in serious reputational damage.

Indeed, peak-to-trough market capitalisation losses of over US$534bn were reported for large US companies as a result of major ESG-related controversies over the past six years.[7]

Looking ahead Parry believes a revolution in responsible investment standards could ultimately bring some major benefits for companies, their shareholders and the wider world and he remains hopeful recent events could lead to a sea change in practice.

"In the final analysis, the reality is that a better society is actually good for business. Living in a healthy environment rather than a dystopian wilderness is better for sustaining profits and life on the planet and can help stem the systemic risk of climate change," he concludes.

3 *FT.* Majority of ESG funds outperform wider market over 10 years. 13 June 2020.
4 Morningstar. Global sustainable fund flows. ESG funds show resilience during COVID-19 sell-off. May 2020.
5 *Institutional asset manager.* Social bond and sovereign green bond issuance surges. 30 June 2020.
6 Worth.com. How to Keep Impact Investing Impactful. 27 July 2020.
7 *FT.* ESG controversies wipe $500bn off value of US companies. 14 December 2019.

## KEEPING THE LIGHTS ON… SUSTAINABLY

With the global renewable energy drive gathering pace, 2020 saw the first-ever International Energy Authority (IEA) Clean Energy Transitions Summit. This 'virtual' event saw global ministers representing over 80% of the global economy discuss how to achieve a definitive peak in global carbon dioxide emissions and put the world on course for a sustainable and resilient recovery.

According to the IEA's own Sustainable Recovery Plan, 35% of new jobs could be created through energy efficiency measures and another 25% in power systems, particularly in wind, solar and modernising and strengthening of electricity grids.

At a wider economic level, most major markets face potentially dire economic consequences from the coronavirus pandemic and so are looking to marshal recovery.

In June, the UK government sketched out plans for what it called a £5bn 'new deal' aimed at building houses and renewing infrastructure. It is expected to include £3bn of energy efficiency measures.

Welcoming the measure, Newton multi-asset manager Paul Flood says: "After the impacts of Covid-19, the UK government looks set to get the economy going again through fiscal spending and we expect a large part of that infrastructure spend will go towards the green economy and could help support the development of renewables in the future," he says.

Mellon portfolio manager Jim Lydotes also sees major potential in renewable energy investment across continental Europe, citing the EU as a driving force for change, with its individual members pushing renewables up the business agenda.

"We are seeing an impressive power build-up of renewables across Europe, with the biggest opportunity today in some of the southern countries of the EU such as Spain and Italy. These countries have dramatically reduced the bureaucracy that is required to build out renewable energy assets and look even better positioned to build further post Covid-19 than they were before the pandemic," he says.

"The falling cost of renewables has largely taken once prohibitive costs out of the equation and with governments highly incentivised to get people back to work after the pandemic, the renewable energy sector is enjoying significant tailwinds right now."

# European vision

A pledge to make the European Union (EU) carbon neutral by 2050 lies at the heart of The European Commission's European Green Deal. Here, Insight Investment head of responsible investment research and stewardship Joshua Kendall explores the scope of the plan.

When European Commission president Ursula von der Leyen announced Europe's Green Deal towards the end of 2019, she described the plan as seeking to "reconcile the economy with the planet" and has championed it as the principal mandate of her tenure.

The plan is heavily focused on achieving the bloc's long-term climate objectives and includes spending and financing programmes across areas spanning biodiversity, food and agriculture, low-carbon power generation and electric vehicles.

Central among the goals is a pledge to make the European Union (EU) carbon neutral by 2050. In effect this means EU carbon emissions will be offset by at least similar levels of carbon removal. This is a significant development.

As one of the largest carbon emitters, this marks a clear advancement of global decarbonisation goals and is a considerable improvement on prior pledges. Ultimately it is hoped the future growth path of the EU will be one that is sustainable, resource-efficient and competitive, and in the process one where economic growth is decoupled from resource reliance.

The Green Deal strengthens the EU's Paris Agreement commitments, the main goal of which is to keep rises in global temperatures 'well below' two degrees above pre-industrial levels.

The emergence of the Covid-19 pandemic redoubled the commitment to the Green Deal. As economic damage from shutdowns mounted, European governments agreed to a major €1.85 trillion recovery package. This is made up of a €750bn economic stimulus plan, named "Next Generation EU", and a €1.1 trillion seven-year budget programme. One third of the stimulus plan will be directed to climate action investments, integrating much of what was proposed in the 2019 Green Deal.

## GREEN OPPORTUNITIES

Achieving the Commission's target will require action across all levels of the European economy including:

- Investing in environmentally friendly technologies
- Supporting industry innovation
- Rolling out cleaner public and private transport forms
- Decarbonisation of power generation
- Improving building energy efficiency
- Working with international partners to improve global environmental standards

The sheer scope and scale of the Green Deal will provide considerable opportunity across all sectors of the economy. Indeed, stimulus efforts are much more likely to succeed if the much more sizeable funds in the hands of private investors are leveraged.

Private investors can now take advantage of this opportunity by re-orienting their portfolios towards more sustainable technologies and businesses directly affected by the Green Deal. This process will have been made easier with the recent adoption by the European Parliament of the Taxonomy Regulation, which will result in an EU-wide framework to "provide clarity and transparency on environmental sustainability to investors, financial institutions, companies and issuers thereby enabling informed decision-making in order to foster investments in environmentally sustainable activities."[1]

Delving a bit deeper, opportunities could potentially abound across sectors as diverse as energy, agriculture, construction, materials, food and industrials.

Investors may seek to focus on companies in these sectors that are actively seeking to reduce their carbon footprint or are devising solutions that contribute towards helping the EU achieve its goal of net-neutral carbon emissions by 2050. In turn, investors may benefit by not only allocating capital to such companies and investments but also by actively avoiding companies set to be left behind by the Green Plan.

With almost three quarters of the Europe's greenhouse gas emissions caused by energy production according to the European Commission[2], the shift towards renewables could present considerable opportunity for investors. Wind and solar power are expected to lead the way in the shift towards renewables, seeing some of the fastest rates of growth over the coming decade as the marginal costs continue to decline.

For example, the global offshore wind market grew nearly 30% annually between 2010 and 2018 and is likely to continue growing at a rate of almost 13% over the coming two decades according to the International Energy Agency[3]. The cost of renewables has fallen, and they have become competitive, if not cheaper, to operate than fossil fuel generation. Hydrogen as a form of clean energy is also a specific target of the Green Deal, with substantial investments measuring in the hundreds of billions of euros over the coming decades.

1 EU Technical Expert Group on Sustainability. Spotlight on taxonomy 2020.
2 European Commission. A clean planet for all. 28 November 2018.
3 IEA Offshore Wind Outlook 2019 https://www.iea.org/reports/offshore-wind-outlook-2019.

# Keeping it real

While ESG investment is seeing exponential growth, how can investors identify genuinely beneficial investments and avoid so-called greenwashing? Here Newton head of sustainable investment, Andrew Parry, considers the options.

Never before has there been so much interest in corporate sustainability. Despite the unfolding pandemic crisis in early 2020, responsible investments, including ESG and sustainable-labelled equity funds, saw record inflows in the first quarter of the year,[1] against a backdrop of environmental and social concerns.

Yet behind this – and despite wide and ongoing efforts to create common standards across responsible investment – problems remain. The quality of data, research and analysis on the market varies widely, it can be difficult to precisely define how much value responsible investment adds to portfolios and the different approaches to ESG and the use of different terminologies across the industry can confuse investors.

The large volume of standards and reporting organisations in this space adds to the challenge. The Global Reporting Initiative, the Climate Disclosure Standards Board, the International Reporting Council and the Sustainability Accounting Standards Board are all aimed at standardising what constitutes sustainable, ESG and 'green'.

Grey areas such as this can fuel fears of so-called greenwashing – conveying a false impression about the environmental soundness of a company's products and services in order to attract investment. Newton head of sustainable investment Andrew Parry acknowledges the problem but hopes the growing enthusiasm for responsible investments will ultimately help as investors seek clearer data and information on their underlying investments.

"Growing demand provides an opportunity for companies to demonstrate ESG is not a handy marketing acronym for asset managers, but an integral part of how a company takes its corporate purpose seriously to generate value for all stakeholders," he says.

## ETHICAL STANCE

Nevertheless, whether it is mining companies making claims about their ethical stance or fashionable clothing companies touting their position against climate change while relying on cheap labour or worse to produce their clothes, Parry acknowledges there are issues with establishing the commitment of some corporates against their apparent ESG credentials. Language and definitions in this area, he adds, remain both confusing and problematic.

"Greenwashing is a challenge and we need a clear language to talk about it. People have different interpretations of what ESG means. Greenwashing is an accusation directed at companies, not just asset managers keen to virtue signal. ESG should never be just about what a company is disclosing, but what it is actually doing."

Parry adds that, wittingly or unwittingly, rating agencies monitoring responsible investment are also contributing to the confusion around standards, producing conflicting metrics and ratings that allow less scrupulous corporates to 'game' the system in their favour by appearing to have high scores for their ESG awareness and adoption.

As some companies look to achieve good ratings by publishing more and more data in order to get a good score, there is a danger such ratings become little more than a label or, worse, a box ticking exercise, he adds.

"Part of the problem is the quality of data. As middle men, the rating agencies do have something of a stranglehold on data and can sometimes have a vested interest in normalising data," he says.

"We are all trying to find better, more transparent ways to report activity. It is not just about everyone trying to claim their virtue – which there is too much of in Europe – but it is finding a better way to be transparent in what companies and investment managers can report. This would give clients a better understanding of exposures in their portfolios so they can then make better, more informed choices."

More useful, Parry believes, is a deep, warts-and-all analysis of business practices, honestly engaging and assessing the underlying impacts across the ESG spectrum. This, rather than just relying on potentially spurious or misleading ratings he adds, can be helpful in establishing a businesses' true ESG impacts and commitments.

Parry says: "One of the easiest ways to spot greenwashing is when you find companies won't talk about the negatives involved in aspects of their business, only the positives. The reality is that measures such as the UN's Social Development Goals only exist because there are a whole series of environmental and social deficits they were designed to tackle.

"If you are open and honest about commitment to responsible investment you have to be prepared to talk about the negatives of your business. It is only by being honest and open about these downsides that you can tackle them and transition to a more sustainable way of doing things," he concludes.

1 Morningstar. Despite the Downturn, U.S. Sustainable Funds Notch a Record Quarter for Flows. 09 April 2020.

# A new climate

With the UK regulator, the Financial Conduct Authority (FCA), outlining new proposals for mandatory corporate climate related disclosures, what will this mean for companies and those who invest in them? BNY Mellon head of public policy and government affairs EMEA, Ben Pott, vice president of EMEA public policy and government affairs Benedetta Pascale and Newton head of sustainable investment Andrew Parry consider the road ahead.

As efforts to tackle global warming intensify, the UK investment market is set to embrace new rules designed to improve transparency on how companies may be impacted by climate-related risks and opportunities, allowing investors to allocate capital more effectively.

In March, the UK FCA announced it is to introduce a new rule requiring all commercial companies with a premium listing –including many companies listed on FTSE indicies – to either make climate related disclosures consistent with the approach set out by the Taskforce on Climate-related Financial Disclosures (TCFD) or explain any non-compliance.

Over time, the FCA expects consulting on extending this rule to a wider scope of issuers and the plans build upon the recommendations of the TCFD, an existing global standard. It is also seeking feedback on clarifications on how existing requirements applicable to all listed companies already require climate and other sustainability-related disclosure.

The regulator said it recognises standards for disclosure and company's understanding of the financial impacts of climate change are evolving. For this reason, where companies are not yet able to make full disclosures, it says they should instead provide an explanation of the reasons why.

At the March announcement, FCA chief executive Andrew Bailey said: "Climate change presents a serious and wide-ranging threat to global economic prospects, society more broadly and our natural environment.

"The changes we propose will help to provide the transparency the market needs to be able to assess how well companies are adjusting to the risks of climate change. Improved disclosures will support better asset pricing and enable investors to make more informed choices about where to allocate their capital – which will ultimately support the transition to a low carbon economy."

The work of the Climate Financial Risk Forum (CFRF) – an industry group the FCA launched jointly with the Bank of England's Prudential Regulation Authority in March 2019 – will also help to build disclosure capabilities via new industry guidance also grounded in the TCFD's recommendations (see box on next page).

The FCA is currently considering how best to enhance climate-related disclosures by regulated firms, including asset managers and life insurers, to ensure a coordinated approach. To this end it is working closely with the government and other regulators, including through a taskforce established by the Treasury under the Government's Green Finance strategy.

BNY Mellon vice president of EMEA public policy and government affairs Benedetta Pascale says: "For a while, we have witnessed a shift from an investment system based on the binomial model of 'risk and return' to one that additionally factors in the element of 'impact', adding a third dimension to the financial discussion. The voluntary TCFD disclosure framework helps investors and markets to make better informed investment decisions, and its success has led various regulators across the globe, including the FCA, to endorse it.

"Going forward we expect to see the rise of new disclosure standards focusing not just on climate-related data but also other areas of responsible investment. Connected to this rise, it would be interesting to see policymakers facilitating the creation of a public ESG corporate data space, where all this information could be maintained."

As environmental and wider responsible investment concerns gather pace, the FCA and associated government bodies are not the only UK financial organisations seeking to tackle this issue. The Investment Association (IA), which represents 250 members with £7.7 trillion under management, is asking companies to explain, in their annual reports, the impacts climate change could have on their business models and how these risks are being managed.

The IA also wants all companies that are listed in the UK to comply with standards set by the Task Force on Climate-related Financial Disclosures (TCFD), which outlines how companies should calculate and disclose their exposure to climate risk to investors, by 2022.[1]

## KEY QUESTIONS

Some of the key questions facing investors are what will these measures mean for them and can they really move the needle on tackling climate change? With many broad initiatives taking place across the responsible investment spectrum, including the development of a European Union Taxonomy covering responsible investment-related work on environmental protection, the danger is different countries and regimes adopt different or conflicting approaches.

While BNY Mellon head of public policy and government affairs EMEA Ben Pott, welcomes the FCA's latest initiative he warns that Brexit – the UK's withdrawal from the EU – threatens to obscure the picture if it leads to the UK adopting different rules and regulations on responsible investment to its EU counterparts.

"Broadly, we believe the new measures will have a net positive impact from an ESG perspective. That said, there is a risk we end up in a world where we have different taxonomies and different disclosure regulations across different European jurisdictions. In some ways the more global these agreements are the better and developments like Brexit could complicate the picture on rules and regulations," he says.

"If the UK were to decide it wanted a different set of disclosure requirements to the EU, then firms would have to double up efforts in order to comply. That would ultimately mean more work, more effort and more resources required."

Either way, Pascale sees European efforts gathering pace to further the responsible investment agenda via the new EU taxonomy and other initiatives.

As recently as July the European Commission published a new study on directors' duties and sustainable corporate governance. The study is designed to assess the root causes of 'short-termism' in corporate governance, discussing its relationship with current market practices and/or regulatory frameworks, and to identify possible EU-level solutions.

The Commission is currently seeking feedback from the industry with a view to launching a new sustainable corporate governance initiative in the first quarter of 2021.

Commenting on the EU and EC appetite to drive forward change in this area Pott believes the pace of change on European regulation could be swift.

"While political differences can create long delays in some areas of EU business it seems unlikely progress on sustainability will be particularly checked by this. The political wind behind efforts to improve sustainability and governance remains very strong and the 'green' agenda enjoys wide support across many EU member states. Everyone agrees these are areas we need to improve in and do something about," he concludes.

While most of the latest developments are corporate focused, Newton head of sustainable investment Andrew Parry believes managers and their funds should also be subject to greater scrutiny. "It is important investment managers are careful with the labels they use, as these should not be just about selling product. We believe greater transparency of reporting and clear descriptions are needed to help investors find funds aligned with their values," he concludes.

## THE CFRF: TOWARDS A NEW ROAD MAP

The UK Climate Financial Risk Forum (CFRF), co-chaired by the FCA and the Prudential Regulation Authority (PRA), shares best practice across financial regulators and industry to advance the sector's responses to the financial risks from climate change.

In June 2020, the Forum published a new guide to climate-related financial risk management. The guide is designed to help financial firms understand the risks and opportunities that arise from climate change, and provides support for how to integrate them into their risk, strategy and decision-making processes. As part of this, the guide considers how firms can plan for the impact of climate policies over different time horizons and assess their exposure to climate-related financial risks so they can adapt their businesses in response.

The guide contains four industry-produced chapters covering disclosures, innovation, scenario analysis and risk management), together with a summary co-produced by the FCA and PRA. It emphasises the importance of greater transparency and consistency around firms' disclosure of climate-related financial risks, the benefits of effective risk management and scenario analysis, and the opportunities for innovation in the interest of consumers.

1 *Guardian*. Leading investor group tells companies to set out climate crisis plans. 05 March 2020.

# Return to gender

While the global pandemic has negatively affected many sectors and industries, its relative impact on the lives and jobs of working men and women has also been marked. Newton head of responsible investment Ian Burger discusses what effect the current economic and healthcare crisis might have on gender equality, how companies can best address this and what it might mean for future investment policies.

May 2020 marked the 50th anniversary of the Equal Pay Act 1970 receiving assent in the UK. This landmark Act made it illegal for employers to pay men more than women for the same role. Yet although unequal pay is now illegal, the gender pay gap – the percentage difference between average hourly earnings for men and women – is still prevalent.

Since 2017, it has been mandatory for UK companies with more than 250 employees to publically disclose their pay gap data.

Yet Covid-19 has made monitoring workplace inequalities more challenging as the pandemic has complicated the picture, bringing forth redundancies, furloughing and pay cuts for thousands of companies in the UK[1] and many more around the world. Against this backdrop, some evidence suggests women may be disproportionately missing out.

According to the UK-based Institute for Fiscal Studies (IFS), women have been a third more likely than men to work in sectors that were or are now shut down as a result of the 2020 pandemic. This is mainly attributed to the disproportionate percentage of women versus men working in the hard-hit hospitality and retail industries, with Covid-19 related impacts likely to have a bigger effect on their earnings.[2]

Although the fortunes of the retail and hospitality sectors started to improve as businesses opened again, Newton head of responsible investment Ian Burger believes there isn't a short term fix to deal with the disparity between the job losses of men versus women.

"This situation is a culmination of the long-term issues surrounding gender inequality or lack of diversity. There is little a company can do in the short-term other than to take advantage of government schemes, such as furloughing those affected," says Burger.

"Covid-19 has brought to the fore the importance of managing the S – or social side – of environmental, social and governance aspects, and in particular, how human capital is managed. Companies need to ensure cultural gender biases do not exist and that they promote equal opportunity employment policies and practices moving forward," he explains.

A recent study from the IFS and UCL Institute of Education highlights this issue. It analysed the increased responsibility and lack of job security mothers faced during the lockdown. Those surveyed were 23% more likely than fathers to have lost their jobs temporarily or permanently during the crisis.

The study showed that of the parents who were in paid work prior to the lockdown, mothers were 47% more likely than fathers to have permanently lost their job or quit. They were also 14% more likely to be among the UK's

1 *The Financial Times*. 'Coronavirus claims thousands of UK businesses', 05 August 2020.
2 Institute for Fiscal Studies: 'Sector shutdowns during the coronavirus crisis: which workers are most exposed?', 05 August 2020.

8.4 million 'furloughed' workers. According to the results, as at August, mothers were nine percentage points less likely to still be in paid work than fathers.[3]

Burger believes this divide highlights the importance of the issue and increases the urgency with which gender inequality should be addressed. Investors, he adds, can help play a valuable role in fixing this by actively voting on shares they hold to influence corporate behaviours.

"Investors can play a pivotal role through constructive, pragmatic and persuasive engagement that evidences the value to companies and their stakeholders (including investors) from achieving a workplace that respects and promotes gender equality," he says.

"The threat of shareholder voting action against a company's failure to tackle this issue and enhance its performance is also a powerful tool that shareholders should be willing to use to help encourage this."

In addition, Burger believes this is a prime subject for investors to engage with not only with companies but also policy setters and regulators.

Aside from the wage gap, the issue of gender inequality runs through a range of different geographies, sectors and industries, with financial services just one sector that has historically employed considerably more men than women in senior management positions.

In this instance, Burger believes first and foremost better education should be put in place to promote gender diversity throughout both financial services and related sectors. "Promotion within formal educational systems is the obvious starting point and one that appears neglected; it is arguably where gender bias begins," he says.

"Industry-specific action plans are required to understand and address the causes and solutions that can tackle gender inequality. There will be and should be shared learnings that cut across industries so a degree of coordination is also required."

Responsible investment and ESG have increasingly become a focus for investors over the last few years. One positive effect the Covid-19 pandemic has brought forth is the spotlight it has put on the importance of specific responsible investment practices – including those designed to help build inclusiveness and wider gender diversity.

Now more than ever before, both consumers and investors are paying more attention to how companies treat their employees and what steps they're taking to achieve equality and embrace diversity.

Although there are many different responsible investment guidelines put in place that seek to address gender equality and that companies can learn from or choose to follow, many aren't mandatory and are generally specific to a jurisdiction or region.

"Guidelines for investors and companies are certainly a way to influence and advance the debate and action but there is certainly much more to be done in regards to raising awareness of them," says Burger.

While full gender equality is still some way off in many countries, there are some hopeful signs it is at least being acknowledged as an important goal.

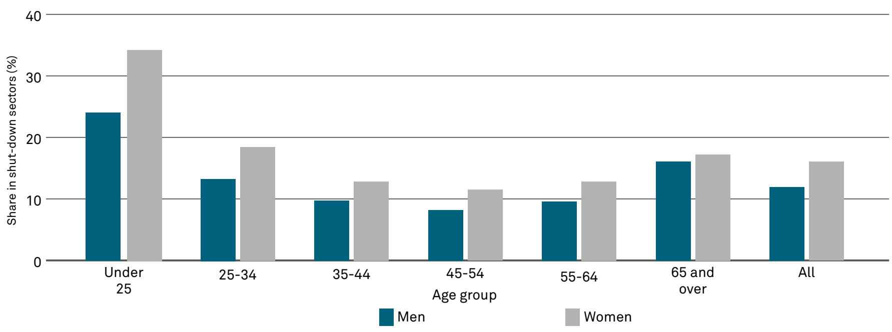
According to the United Nations, more than 100 countries have taken action to track budget allocations for gender-related issues; one of the UN's own sustainable development goals, goal five, is explicitly aimed at tackling gender inequality.

A recent survey by the US-based think-tank the Pew Research Center across 34 countries found a median of 94% of those surveyed said they felt it was important for women in their country to have the same rights as men, with 74% saying they felt this was very important.[4]

Beyond these green shoots there is no doubt the pandemic has exerted a heavy toll. Yet while the road ahead to recovery looks long, taking smart and conscientious responsible investment decisions in areas such as gender diversity today could help create better, more equitable and resilient business frameworks for the future.

Commenting on the need to address a changing business climate Burger says: "Companies both new and old need to be acutely aware of the viability of their business approach and ask themselves, truthfully, if their strategy, and also business model, are relevant and resilient – the value of good governance – including gender diversity – is even more apparent as we see those companies that have managed their risks well and identified opportunities in this changing environment."

## SHARE OF EMPLOYEES IN UK SHUT-DOWN SECTORS, BY GENDER AND AGE




Source: Institute for Fiscal Studies, as at August 2020.

3 *HR Magazine:* 'Mothers face job insecurity and increased childcare responsibilities during lockdown', 06 August 2020.
4 Pew Research Center. Worldwide optimism about future of gender equality, even as many see advantages for men. 30 April, 2020.

# Weathering the storm

With the world facing a growing raft of serious healthcare and economic challenges and the looming threat of climate change, what can global policymakers and investors learn from recent events and how might these shape future policy, investment and stewardship of our environment in the future? Mellon portfolio managers Robin Wehbé and Julianne McHugh consider the potential road ahead.

The "new normal" is a phrase that most people now hear on an almost daily basis, but it is important to consider how the aftermath of a global pandemic could reshape both our lives and the environment. Some things may have changed irrevocably, while others may quickly revert to previous norms.

There is a trade-off here. While the planet's carbon emissions have decreased materially in 2020 due to significantly reduced travel, the global economy is taking a massive hit. Balancing the competing demands of the economy and environment will present a considerable challenge in the months and years ahead.

## HOME TRUTHS

Perhaps one of the most obvious changes in day-to-day lives throughout an extraordinary 2020 has been the shift to work-from-home. For many people, this has proved surprisingly easy to manage. However, lockdowns across many developed countries have highlighted the stark divide between those who can earn a living remotely and those who cannot.

According to some estimates, approximately 37% of jobs can be performed from home today[1], including call-centre and customer service jobs. Mellon portfolio manager Robin Wehbé believes that with a few adjustments and the aid of helpful technology, that percentage could increase by up to another 30% over the next 10 years. As technologies continue to improve, he adds, the need for many functions to work from crowded offices could also diminish.

Yet Wehbé notes this will still leave a large majority of the workforce unable to join the work-from-home revolution. Additionally, while many people can function working from home, they may find it difficult to flourish in the absence of face-to-face interaction. With this in mind, and from an environmental standpoint, he fears it may be all too easy for developed countries to slip back into their old commuting and polluting transport habits once the worst of the pandemic's impacts have eased.

"Once this is all over, the danger is some countries could be right back to where they started in terms of their overall carbon footprint and environmental impact. In turn, this could also leave many struggling to meet their emissions obligations under the Paris Agreement and other climate change commitments," he says.

1 *Forbes.* 37% Of Jobs Can Be Done From Home, According To A New Economic Analysis. 09 April 2020.

## DIFFICULT BALANCE

For now, an uneasy status quo of social distancing and special measures remains in place. Wehbé adds: "Even with a vaccine, behaviour is not likely to revert entirely. We expect load factors to decline as we keep seats empty on mass transit and even with a vaccine, the lingering psychological impact of the pandemic is likely to prevent full reversion to full seats and normal load factors.

As people remain reluctant to come into close contact with others outside their household, car ridesharing is also likely to decline. In air travel, some flights have also been operating with empty middle seats to preserve social distancing, with many train and bus networks also following suit.

Wehbé adds there is a danger this could, in itself, unintentionally lead to an increase in carbon emissions as a higher ratio of vehicles to passengers will be required. This is despite attempts by governments in some countries to encourage more environmentally friendly means of transport such as walking and cycling.

## CONSUMER CAUTION

A key question for the transport and leisure sectors is how consumer behaviour evolves. One recent trend is the rise of the 'staycation', with people preferring to drive to local or domestic holiday spots rather than fly abroad. If this trend continues, it could benefit the environment as fewer people choose air travel.

Mellon senior portfolio manager Julianne McHugh expects unpredictable changes in quarantine restrictions to encourage this trend, at least in the short term.

"After an initial lull, air travel has always recovered from previous crises. We witnessed this in the US after the 9/11 terrorist attacks. Initially, demand for air travel fell sharply before rebounding and surpassing previous levels," she adds.

Consumer spending on travel is contingent on how quickly people can recover financially from the crisis. In turn, this financial recovery is dependent on broader economic progress.

It appears unlikely that a full recovery will occur before an effective vaccine is developed. Until then, the global economy will continue to reopen intermittently and with local variations along the way. Wehbé anticipates we will have enough data by spring 2021 to determine the new economic baseline.

As the recovery continues, more companies have placed a renewed emphasis on responsible investment and environmental, social and governance (ESG) issues, with an increasing number of global investors also taking note. Currently, most companies are concentrating on the social and governance elements rather than the environment, yet they are also being forced to consider the environmental consequences of the 'new normal' way of life.

"While travel and commuting have decreased, we must now contend with an immense rise in the use of disposable plastics, such as gloves, shields and shopping bags, as companies and society adapt to the pandemic," notes Wehbé.

Despite this, some progress is being made in 'green' areas such as renewable energy. Policymakers are using the pandemic recovery fiscal spend to drive energy transition to less climate damaging options as opposed to traditional fossil fuels.

"The clearest sign of environmental progress is being seen in the energy and industrial sectors. Spending is being slashed in traditional fossil fuel-based areas while green spending is escaping cutbacks," says Wehbé.

"Companies appear to be prioritising green strategies, helped by the fact green energy is both cleaner and more economical than fossil fuels. While this crisis has posed a number of critical challenges, it has provided a significant upside in the green space and the fight against climate change in that by the time we fully return to work, we may no longer require coal power."

There are also growing promises of green spending from politicians, with many now backing green stimulus and incentives.

## OPPORTUNITY AHEAD

Despite its many challenges, the crisis has created a number of investment opportunities. The recent performance of 'green' stocks and responsible investment funds reflects a healthy tailwind for companies that provide emissions solutions or alternative sources of energy. These companies and investments will continue to be the beneficiaries of green stimulus efforts worldwide and should also benefit from a renewed focus on clean energy and climate-related issues.

Technology companies including those that provide alternatives to crowded shops and entertainment venues have also benefited. Additionally, the pandemic has created opportunities for certain industrial companies that produce capital goods that help in the fight against the virus, including air filtration and climate control systems.

Conversely, a growing regulatory and consumer preference for green energy could signal the death of coal and further slow carbon fuel supply chains. This in turn could hit industrial equipment and companies that serve those energy sources in the oil, gas and coal sectors, adds Wehbé.

While his main conviction is that the global economy will establish its new baseline in the spring of 2021, Wehbé believes it could yet be confounded. If an effective vaccine is not developed and the pandemic persists, there is the potential for a considerable economic tailspin and significantly larger problems ahead.

"If the virus can be eliminated, its legacy, like that of other crises, may still be long lasting. Prior to the pandemic, people continued to stand in long security and check-in lines despite a material reduction in air terrorism.

"Will we still be wearing masks in public places in 20 years' time? It is a distinct possibility but we anticipate the green trend accelerated by the pandemic is one aspect that will also prove to be permanent," he concludes.

# A stitch in time

While global retail supply chains have a mixed track record on health, safety and ethical working conditions, market change and investor pressure are shifting attitudes and encouraging workplace and distributive improvements. Here, Walter Scott Investment manager Alan Lander explores how some retail fashion businesses are now putting greater emphasis on ESG factors to improve governance and working conditions.

While the global economy continues to face a raft of serious health and economic challenges, retail businesses have arguably been some of the sectors hardest hit by recent events. Global lockdowns forced many of these companies to temporarily shut their doors, hurting profit margins for some and causing others to shut down permanently, according to Lander.

As just one example, the fashion garment industry – where western brands often outsource manufacturing and production to emerging market factories – has seen retailers cancel many current and future orders from suppliers.

This has further exacerbated problems for textile and garment manufacturers in Asian markets such as Bangladesh and Vietnam, which were already grappling with uncertain futures with new orders dwindling as lockdown started.

Lander says: "Bangladesh has been hit particularly badly because its garments and textiles sector accounts for 80% of the country's total export earnings and 20% of its Gross Domestic Product (GDP). Order cancellations by Western firms have pushed factories to the brink of insolvency with losses and redundancies mounting on a daily basis."

According to Dr Rubana Huq, the president of the Bangladesh Garment Manufacturers and Exporters Association (BGMEA), as of March 27th as many as 1,089 garment manufacturers, employing 720,000 people in Bangladesh, had reported cancellations or withdrawal of orders worth around US$1.5bn – a number that edged closer to US$2.8bn by early April.[1]

While Bangladeshi Prime Minister Sheikh Hasina pledged a US$590m package to help supplement salaries of factory workers, Lander says large Western retailers, who ultimately rely on these manufacturers, also need to step up.

## A HELPING HAND

Unfortunately, a clothing brand's willingness to help supply-side manufacturers depends on its basic ability to do so – which, for some, has been left compromised by the pandemic. This crisis has shed light on both the strengths and weaknesses of retail product offerings, as well as the true nature of how retailers treat those at the bottom of the supply chain when things get tough, according to Lander.

"We often talk of the strength of leadership and corporate culture in the companies. It is times like now that those strengths come to the fore, and any weakness is exposed," Lander says.

However, not all retailers are created equal and some brands experience

1 Walter Scott: Supply Chains Trapped as Western Retailers Close their doors. 07 April 2020.

more profitability disruption due to the type of product they sell.

Against this backdrop of pronounced revenue corrosion, some retail management teams and stakeholders face an uphill battle to uphold sound ESG practices. According to Lander, these challenges can vary and should not be underestimated. For instance, some retailers do not have a strong online presence and are therefore struggling to absorb revenue shortfall while paying suppliers for already-completed work. However, online retail itself has not been entirely immune to the pandemic's impacts.

In March, overall US retail sales[2] – including those made online – suffered an 8.7% drop, which was the worst monthly decline on record since 1992. In April, nearly 630,000 outlets shut their doors, which caused sales to fall another 16.4%.[3] As retail companies tried to stay afloat, some were forced to cut costs by not paying manufacturing partners.

## GREEN SHOOTS

While the picture looks grim for some textile and garment manufacturers and wholesalers, some companies are actively trying to uphold their end of the ethical bargain.

Certain retailers, with the goal of positively influencing the rest of the industry, have signed the International Labour Organisation's Covid-19 call to action. Signatories to this agree to a set of commitments to help manufacturers survive pandemic-fuelled disruption and protect the wages, health and employment of garment factory workers.[4]

Lander, who spoke with the chairman of a company that had signed the call to action, says: "The firm honoured all its existing commitments with suppliers, including full payment of any orders already placed. As orders ramp up again, it's operating as normal in its contracts and payments with no steps to tighten margins or change terms as other financially-pressed retailers might do."

Elsewhere, at the end of March, a large Swedish multinational clothing retailer announced it would take and pay for any shipment of goods already manufactured for the company, as well as whatever was still under production, despite the financial squeeze brought on by the pandemic. According to Lander, even if it hurts in the near term, retail companies like this need to ensure ESG steps are taken throughout their supply chains if they want to perform well in the long run.

"These retailers know their long-term economic value comes from adherence to sound responsible investment principles and practices. The coronavirus crisis is placing financial stress on all companies as they seek first to protect their own staff and balance sheets," Lander says. "Any steps they can take to preserve their supply chain will produce benefits as they re-open for business," he adds.

Lander points out that if factories permanently shut down because of lack of support from retail brands – supply side business partners that once were, may be no more when these same retailers resume selling at high volumes. That in turn could lead to major disruption, especially if and when consumer demand returns to pre-pandemic levels.

On a separate note, some argue western brands – including fashion chains – should use this period to explore local production, which would enable on-demand manufacturing, rather than outsourcing to more remote Asia-based suppliers. If production is moved closer to the end consumer, brands could deliver to customers within days without holding on to inventory.

However, fashion brands, which understand the social aspect of business operations, have dismissed this because of the humanitarian impact it could have on the Asian garment industry, potentially leaving millions without jobs in the textiles and apparel sectors.[5]

While some brands may unfortunately have to choose between supporting supply-side partners and keeping their own employees and businesses financially stable, there are certainly companies that can, and will do both, according to Lander. He believes such companies will forge even stronger relationships with suppliers, which could pay-off in the long run.

Although environmental impacts are usually the first to come to mind when investors hear the term ESG, social aspects can be just as important. Retail relationships between brands and producers are also at an inflection point today, where any developments during the pandemic may fundamentally influence future success, according to Lander.

"This crisis provides a stark reminder that responsible investment remains as important as it has ever have been. Long-term wealth creation by individual companies depends on many attributes and responsible investment-related responses and actions are certainly among them. The crisis has concluded that debate," Lander says.

For retail brands that rely on large global supply chains, it's important for investors to question what these brands are doing to ensure manufacturers survive the duration of the pandemic. If suppliers don't make it through the pandemic, brands may not have the manufacturing support needed to accommodate a resurgence of consumer demand. How they help suppliers today will influence both long-term profitability and overall business staying power, according to Lander.

"How a company ensures the necessary and appropriate oversight of its supply chain, including outsourced third parties, has long been an area of conversation. Those conversations are perhaps more relevant and important than they have ever been," Lander concludes.

2 This includes the entire US retail industry. In other words, all retail segments.
3 MIT Sloan: Why Some Retailers Are Thriving Amid Disruption. 29 June 2020.
4 International Labour Organization: COVID-19: Action in the Global Garment Industry. Accessed July 2020.
5 Forbes: How fashion manufacturing will change after Covid. 13 May 2020.

# A journey without maps

What happens when two megatrends collide? For emerging market fixed income investors, the nexus between environmental, social and governance constraints and the 'new normal' of 2020 has created a new set of problems and opportunities, says Newton fixed income manager Carl Shepherd.

While developed markets endured a torrid first six months of 2020, emerging markets also shared the burden of a growing global health and economic crisis. Consequently, while Latin America, and Brazil in particular, faced much publicised pandemic problems, other countries in the developing world faced their own struggles.

By the third quarter of 2020, India, Russia and Mexico were heading towards – or had already reached – one million confirmed cases of Covid-19 each.[1] Other emerging market (EM) countries were heading down a similar path, with South Africa's half a million confirmed cases a worrying portent of potential things to come.

It's in the teeth of this maelstrom that EM investors have continued to grapple with an earlier defining issue of our times: the need for responsible investment concerns to be at the heart of their decision-making process. The question now is whether a focus on responsible investment, fully integrating ESG, might help mitigate the fallout from the pandemic – and whether ESG-aware issuers of debt and equity could be better placed to weather the storm.

For Newton fixed income fund manager Carl Shepherd, the question is an important one. He notes emerging markets experienced a significant sell-off starting in the early days of March when US and European investors began to understand how damaging the fallout from the pandemic was likely to be.

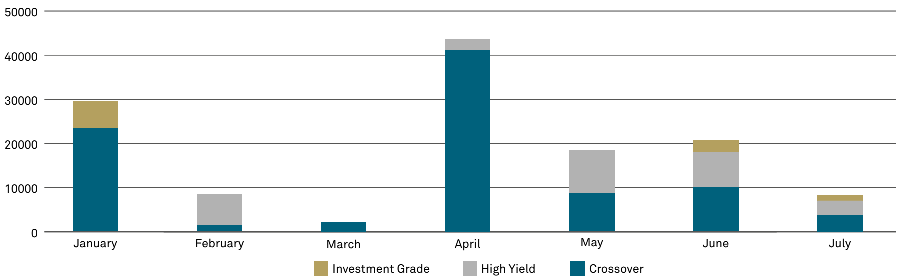
At that point, he says, it became clear this wasn't just going to be a rerun of the severe acute respiratory syndrome (SARS) epidemic of nearly two decades earlier – the spread of which was largely confined to Asia – but would be far more global and destructive. Yet following the intervention of the world's major central banks and governments – and once markets had stabilised somewhat – nearly all of those outflows reversed.

Here, Shepherd highlights the difference between the Global Financial Crisis of 2008-9 and the crisis this time around. "If you think back 10 years, no one really knew what was going to happen and there was sheer, blind panic while governments and central banks worked out what to do. This time, there was already a baked-in expectation that there would be a reaction from central banks who stepped in early to stabilise markets and that's when the sell-off in emerging market assets began to reverse."

Data from The Institute for International Finance underlines this view: it shows that after pulling some US$90bn out of EMs in March, cross-border investors bought back US$60bn of EM assets in April-June; predominantly debt.

1 Source: Johns Hopkins and The Guardian as at 04 August 2020. CSSE Note: The CSSE states that its numbers rely upon publicly available data from multiple sources, which do not always agree.

**EM HARD CURRENCY SOVEREIGN BOND ISSUANCE YTD BY MONTH* (US$MN) 2020**




Source: Bond Radar, Tellimer Research, created by datawrapper as of 31 July 2020.

Meanwhile, early signs suggest ESG-focused EM assets have weathered the pandemic storm better than their other peers. Witness the recent track record of the MSCI EM ESG Leaders benchmark versus pure emerging market equities, for instance, where the former enjoyed an immediate pick-up post the darkest days of March to outpace its non-ESG-focussed peer.

In fixed income, likewise, early evidence suggests that far from being cowed by recent global events, issuers have seized the opportunity of loose monetary policy to go in search of cheap funding. In April alone, according to data from Bond Radar and Tellimer Research, some US$40bn of investment grade EM debt came to market with high yield EM issuance also picking up in May and June up after almost a complete hiatus in March.[2]

For investors, though, what this means in terms of judging progress on responsible EM investing and ESG is still unclear, according to Shepherd. For one thing, the slew of support from the International Monetary Fund (IMF) and other supranational bodies for emerging market countries since the advent of the crisis has a tendency to blur the distinction between good and bad issuers.

In the dark days of March, says Shepherd, some 80 EM countries applied to the IMF for emergency funding even though many of them were yet to register any evidence of the pandemic themselves. To date the IMF has made US$250bn, a quarter of its US$1 trillion lending capacity, available to member countries, predominantly in emerging markets.[3]

"The initial concern of the IMF is to ward off humanitarian crises. This money is undiscerning, and understandably ESG considerations are not the primary factor," says Shepherd. "The IMF doesn't care whether the recipient is faring well or badly in terms of ESG. What it does is provide breathing room for countries that, before the start of the year, were under pressure to get their act together in terms of governance or social responsibilities.

"It also opens the door to questions around how resources are allocated. With the issues surrounding fungibility of funding, we cannot expect countries with lower ESG scores to allocate these new resources in the most effective manner. There is also the likelihood of graft increasing when money and funds are being thrown at a problem."

Added complexity comes in the form of quantitative easing (QE) programmes established across the emerging market universe. "Our main concern is that QE coupled with weak institutional strength is an accident waiting to happen.

We would like to see a concrete timescale for when this extraordinary policy will end, and, in our view, this end point should be at the earliest opportunity," observes Shepherd.

Meanwhile, for many countries and companies, the cost constraints imposed by the crisis have provided a convenient excuse to shelve social or environmental programmes in favour of more immediate populist 'sugar rush' measures. This is especially true of expensive, big ticket items whose results might only become apparent decades from now.

Says Shepherd: "One example I can think of is within a large the state-owned South African energy provider that had big plans to switch from $CO_2$-intensive power generation towards more renewable forms of energy. I would be surprised now if those plans now go ahead."

Part of the challenge, says Shepherd, is the reluctance of populist governments – numerous examples of which can be found in the EM sovereign debt universe – to make difficult decisions. Covid-19, with all the belt-tightening the pandemic entails, only exacerbates this. "This isn't just confined to the developing world but as an EM investor, you're looking for decision-making that hits the right beats in terms of responsible investment but which also benefits society, investors and the environment over the long term.

"On the environmental side, for instance, you might look at the build-out of infrastructure that reduces pollution, or, on the social side, you might be looking at increased spending on health or education. Crucially, you want those programmes to deliver benefits over the long run and to be sustainable enough for the next government in power to be able to pick up where their predecessors left off. For investors, that's the green light.

"All too often, though, we're beginning to find the opposite, particularly in a post-pandemic world: governments fixated on the next short-term pay-off. As an investor, that's a big challenge: to work out whether previous progress on ESG in emerging markets can stay the course in the current environment."

2 As at 03 August 2020.
3 *IMF:* 'COVID-19 Financial Assistance and Debt Service Relief', 31 July 2020.

# A Stateside view

As greater US regulatory scrutiny falls on responsible investment and ESG-branded funds, investors face the growing challenge of comparing strategies and portfolios and measuring key risk factors. Raphael Lewis, Julianne McHugh and Christine Cappabianca at Mellon, assess the market landscape.

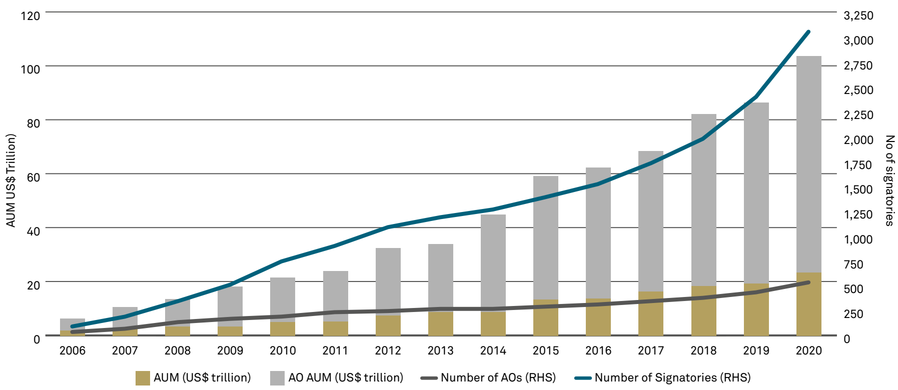
ESG factors have become a highly relevant risk consideration for a rapidly increasing number of investors and asset managers. Against a backdrop of growing investor engagement with the United Nations Principles for Responsible Investment (PRI) and other global initiatives, interest in responsible investing looks set to become increasingly important to global investment markets in the years and decades to come.

However, there is growing evidence that the increased interest in ESG-related considerations is creating distortions in the markets. This was likely not the case a few years ago, when the aggregate assets under management of ESG strategies was miniscule – but no longer. While the dollars invested in strategies and portfolios claiming a specific ESG profile or outcome are still relatively immaterial today, the growth rate is eye-popping.

From an investment standpoint, the factors responsible investors must consider have expanded dramatically over the past decade, making historical apples-to-apples comparisons within the responsible investment/ESG ratings industry increasingly challenging. For instance, not long ago investors generally failed to consider how public companies manage and consume water, inferring it was an inexhaustible resource.

Yet it is clear water utilisation and management are crucial not only to the planet's future but to a company's risk profile. The same can be said of several other issues, such as waste management, protection of biodiversity and emissions, all of which are sub-components of the environmental category. That was before Covid-19 swept the globe, forcing investors to further examine social and governance considerations such as worker safety and supply chain resilience.

## PRI SIGNATORY GROWTH




Source: PRI. AO stands for asset owners. As of June 2020. Total Assets under management (AUM) include reported AUM and AUM of new signatories provided in sign-up sheet that signed up by end of March of that year.

According to Mellon senior research analyst Christine Cappabianca: "Asset managers must accurately and diligently assess the true nature of ESG risks and rewards in any given investment as these factors will play an ever more important role in a given stock or bond's price. Just as important, is understanding which direction a company's ESG risks are moving, which will be more critical over time."

This point is underscored by a 2019 Harvard study which suggests companies that improve their ESG ratings materially outperform peers. Still more intriguing is the emerging evidence that "sustainability momentum," both positive and negative, can have a material impact on equity prices.

Cappabianca believes it is key for successful asset managers to identify and understand major risk factors as early as possible, both to avoid camouflaged risks and to capture veiled opportunities.

"Depending on a rating firm's methodology, weighting of metrics, inclusions or exclusions of the depth of research and attendant updates, the very same company can enjoy a positive ESG score at one ratings firm while enduring a low score at another. Indeed, some graphical representations of these disparities could serve as the dictionary definition of the word "random" or "noise," she adds.

To a certain extent, this lack of coherence in the ESG-rating ecosystem is a result of a lack of any universal definition of what, exactly, is being measured. According to Mellon senior

**ENVIRONMENTAL CRITERIA**


Source: Escrig-Olmedo, E., Fernández-Izquierdo, M. Á., Ferrero-Ferrero, I., Rivera-Lirio, J. M., & Muñoz-Torres, M. J. (2019). Rating the raters: Evaluating how ESG rating agencies integrate sustainability principles. Sustainability, 11(3), 915.

portfolio manager Julianne McHugh, the relevant ESG data fields are changing rapidly. "In 2019 there were over 500 sustainability related fields self-reported by companies in their relevant documentation. Investors will need to stay on top of this emerging data set until the key standard setting organisations are able to concentrate the reporting efforts," she says.

## REGULATORY SCRUTINY

With these points in mind, US financial regulator the Securities and Exchange Commission (SEC) is currently scrutinising a wide variety of ESG-labelled funds, with its commissioner Hester Peirce among those calling for greater oversight and clearer definitions of fund standards.[1]

The SEC is seeking to determine how much ESG marketing is a true effort to provide investors with 'responsible' instruments to express their world view in public markets.

While the exact outcome of this review remains unclear, some believe it could mark a watershed opportunity to disclose broader sustainability information concerning long-term risks to which companies are exposed.

According to Mellon research analyst Raphael Lewis: "The SEC has seen the exponential growth in assets under management labelled ESG in recent years but has significant questions around whether the label of some of these investments is accurate or if it could be just a marketing gimmick.

"While there is no stated time frame for the investigation to conclude and there may not be any specific outcome from it in terms of penalties, the implications are important. Some see this as a shot across the bow of the industry which has been quite a long time coming," he says.

While Lewis welcomes the investigation, he fears some corporations may be following the letter rather than the spirit of ESG investing, effectively 'greenwashing' their credentials.

"We believe there are some companies out there who are doing their best to build credible ESG stories by engaging consultants and bankers to help them build the most positive story they can – whether through corporate sustainability reports or other means. This raises red flags, because you could probably drive a truck though some of their holes on disclosure," he adds.

Importantly, adds McHugh, from a measurement standpoint, differing ESG rating agency methodologies can also sometimes lead to disparate outcomes. For example, some ratings agencies build an "E" score by evaluating a company's environmental impact. But other firms also measure the proactivity with which management teams seek to reduce their firm's environmental impact. More broadly, different rating agencies not only look at different factors to score E, S, and G considerations but also weigh these pillars differently, which impacts a score.

This more holistic methodology, while clearly well-intentioned, can lead to some paradoxical results, she adds. A financial institution, which by definition has a relatively low environmental impact relative to an energy or manufacturing company, can still be negatively impacted because a firm could rate E, S and G factors the same rather than adjusting weights based on materiality. Meanwhile, a "dirty" company can see positive ESG score impacts by developing a plan for reducing its harmful effects on the planet.

"We believe all these factors are too complicated to simplify into one score and that adjusted weights based on materiality to each sector could offer investors a more balanced view," says McHugh.

Lewis adds that while outside ratings can inform, they should not dictate investment decisions. He points to the sub-prime mortgage crisis – when many of the investments that folded held solid credit ratings – as a low water mark for rating agencies and an example of why they cannot always be relied upon.

McHugh also acknowledges that obtaining, cleaning and analysing raw data inputs can present a monumental challenge. However, she believes this is the best chance investors have of accurately expressing views of materiality and relevance.

"Inserting ESG ratings into an investment process without understanding the components, basis or biases of these ratings would be equivalent to using a sell-side research analyst's upgrade of a stock as the sole reason to buy said stock. We expect more from analysts and investors do too," says McHugh.

1 CNBC. 'Fooling ourselves' to focus on 'amorphous' social investing factors, says SEC Commissioner Peirce. 17 December 2019.

# Terms of engagement

Once the preserve of equity investors, corporate engagement is now increasingly important to fixed income investors. Here, Insight Investment head of responsible investment research and stewardship Joshua Kendall explores this growing area and the conventions which guide it.

Engagement by investors used to mean action by shareholders. Equity owners have votes, and therefore direct influence on what management might do, bondholders have no votes and consequently less influence. Or so the argument went.

But while fixed income investors don't have the ability to vote on company matters, companies (and sovereigns) need finance, and so fixed income investors can be hugely influential, particularly at the point of primary issuance. In the US market, corporate bond issuance has dwarfed new equity issuance for many years and the number of companies accessing bond markets for finance has grown substantially. Notably, in private markets, fixed income investors have influence where equity investors have no meaningful access at all.

In the wake of these trends, the power of fixed income investors is now widely acknowledged. Asset managers are routinely expected to explain how they engage with debt issuers. Investors request details on how their portfolio managers and analysts engage with investee companies, regardless of whether it is an equity or a fixed income portfolio. Issuers are more aware of investors' expectations on a wide range of issues and will proactively communicate and engage on topics that matter to them – with, in our experience, little distinction between equity and fixed income investors.[1]

Regulatory and industry initiatives also recognise this. The UK Stewardship Code, which has set a framework emulated by other stewardship codes worldwide, has been updated for 2020. The Financial Reporting Council, which sets and maintains the Code, has explicitly stated that the previous iteration of the Code was more focused on equity investment, but the update reflects that investors across all asset classes – including fixed income – can play a meaningful role in how they act as stewards of their assets, including how they engage with investee companies.

## RISK FOCUS

Equity investors are typically focused on upside potential, while fixed income investors are focused on downside risk. Engagement with issuers therefore tends to have a different emphasis depending on the asset class in focus.

This is not a theoretical concern for bond investors. It is noteworthy that the three largest emerging market corporate defaults in 2019, totalling US$5bn, all suffered from significant environmental, social and governance (ESG) issues, with very poor disclosure and weak governance. This demonstrates the need for proactive analysis, which engagement can directly support.

It is now widely expected credit analysts will identify engagement issues

1 Reflecting the broad acknowledgement of the role that fixed income investors play, the Principles for Responsible Investment (PRI) has an extensive range of materials covering engagement by asset managers and asset owners with regard to fixed income portfolios, available at https://www.unpri.org/investment-tools/fixed-income.

relevant for specific issuers, based on detailed data and qualitative analysis. These can be raised in meetings with company management or representatives.

Alongside such direct engagement, wider collaborative initiatives are available, via bodies such as the Principles for Responsible Investment (PRI) or by actively engaging with other investors, to achieve greater influence over the issuer.

These engagements can inform credit analyst views of the issuers and provide a platform not only for both increased transparency from issuers, but also ongoing engagement to change company behaviour where appropriate.

To offer a hypothetical example where engagement can support better understanding, quantitative analysis can signal weaknesses based on quantitative metrics, such as the number of individuals on a company board. However, whether this is a weakness – or other mitigating factors compensate appropriately for it – may be much easier to determine through proactive dialogue with the company.

In our experience, engagement has helped to refine the signals from quantitative data, which can be misleading or incorporate gaps due to a company's failure to disclose specific information. In this way, engagement can help build a more nuanced and well-rounded view on which decisions can be made.

Engagements can also result in unexpected discoveries, such as intelligence about other companies or events that might have no direct impact on the specific issuer, but ultimately inform investment decisions regarding other holdings.

## ENGAGING FOR IMPACT

Investors are increasingly focused on pursuing non-financial objectives, with the booming market for 'impact bonds' – where bond proceeds are used to finance projects with a positive environmental or social impact – reflecting a growing desire to invest in bonds for more than a financial return.

In our experience, companies and sovereign issuers are increasingly using impact bonds to signal their willingness to operate in new ways – reflecting the growth in demand for investments that do more than simply generate a financial return.

This is another area in which proactive engagement can directly support fixed income investors. The quality of impact bonds varies substantially, with some adhering to best practice with very clear parameters and oversight; others either vague in their approach or not demonstrably 'green' or 'social' in how they aim to use their proceeds. While this may have no effect on the credit risk or the financial return offered by an impact bond, it could dampen demand from investors who are increasingly discerning about exactly how their assets are invested.

Notably, sovereign issuers are also issuing substantial amounts of green and social bonds. This has presented an opportunity for fixed income investors to engage with sovereign issuers over their approach and the parameters for their issuance, with sovereigns seeking to understand exactly what investors are seeking from such debt.

### HOW BONDHOLDERS CAN ENGAGE WITH ISSUERS

- Timing matters: Bondholders can expect to have particular influence over issuers with regard to primary issuance, as the pricing an issuer can achieve on their debt will depend directly on demand. Other opportunities for focused engagement include when an issuer is seeking to renegotiate terms or refinance their debt.
- Collaboration counts: Shareholders and bondholders can work together to engage with a company – even if bondholders have no right to vote, by working together with equity investors they can exercise significant influence.
- Placement defines priority: Investors may be more able to engage directly with an issuer for privately placed debt issuance, both before and after issue: issuers in less liquid markets are typically more responsive to investors' expectations and suggestions on specific topics.

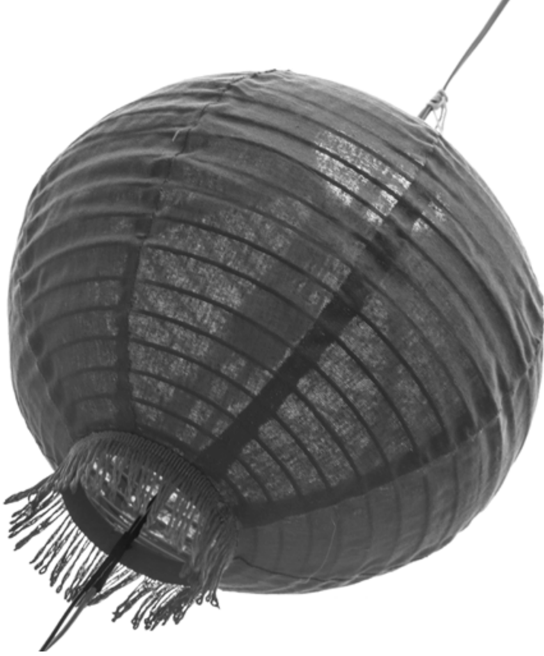
### THE POWER OF COLLABORATION

Collaborative engagements by fixed income investors are bearing fruit, encouraging better practice and greater disclosures by bond issuers. Here are some recent examples.

- PRI Advisory Council for Credit Risk and Ratings: This group has been instrumental in creating a new movement among rating agencies to proactively integrate ESG factors into credit valuations. A significant investment by the agencies has been made, including the development of internal ratings.
- Institutional Investors Group on Climate Change (IIGCC): In 2019, the initiative introduced a new collaborative group focusing on building portfolios that are aligned with a two-degree Paris Agreement-aligned world. Four working groups have been established, covering sovereign and corporate bonds alongside other asset classes.
- International Capital Market Association (ICMA): The ICMA is the flagship group promoting impact instruments and educating the market, and its Advisory Council for the Green and Social Bond Principles brings investors, underwriters and issuers together in defining frameworks for green and social bonds.

# Eastern promise

Asian nations such as China are among the biggest polluters on the planet but are also, paradoxically, some of the countries most committed to renewables. While Asia still has a long way to climb up the responsible investment ladder, the steps it is implementing could set the right pace for a brighter future, creating a range of potential new opportunities for investors. Here, the Insight Investment team comment on recent developments.



Asia Pacific is the fastest growing region in the world[1] and with that rapid growth comes opportunity and challenge. Although the pre-Covid-19 economic boom lifted many people and countries in the region out of poverty, it has also contributed to environmental degradation and rapid urbanisation, resulting in a rising demand for resources and growing health concerns.

Despite recent changes in the pandemic, a number of cities in China and India still have some of the highest urban pollution and smog rates globally. This, coupled with longstanding corruption issues affecting many companies operating across Asia, means it has a long way to go to match other regions such as Europe in integrating strong environmental, social and governance practices.

However, despite the challenges many countries and companies in Asia face, there is also massive room for potential change. Asia has been the home to many innovative practices, such as Bhutan's Gross National Happiness (a holistic and sustainable approach to development, which balances material and non-material values with the purpose that humans want to search for happiness)[2], Thailand's sufficiency economy and China's strong economic growth prior to Covid-19.[3]

"Managing sustainability risks and being seen as a sustainable enterprise does not compromise on financial performance. More businesses in Asia recognise that being sustainable is good for improving their resilience in increasingly challenging times," says Joshua Kendall, head of responsible investment research and stewardship at Insight.

Asia is also known for its potential for renewables. Global consultancy EY's Renewable Energy Country Attractiveness Index (RECAI) ranked seven Asian countries among the globe's most attractive markets for renewable energy sources, including wind power, hydropower and solar energy. China came in second on the index with India seventh and Japan in tenth place.[4]

There is also the wider allure of integrating ESG factors, which are growing in importance within investing and have recently gained heightened focus in terms of the need for sustainability. This has been especially relevant as companies deal with the repercussions of the Covid-19 pandemic. With many reputable companies in Asia becoming more 'ESG friendly', investors could help assist further positive change in Asian sustainability while also generating positive returns.

In addition, from a generational perspective, the grouping known to be the most environmentally conscious and interested in sustainable measures is the millennial cohort. Some 86% of this group live in EM countries, an important aspect for investors to consider, Kendall notes.

## SHARP DIVERGENCE

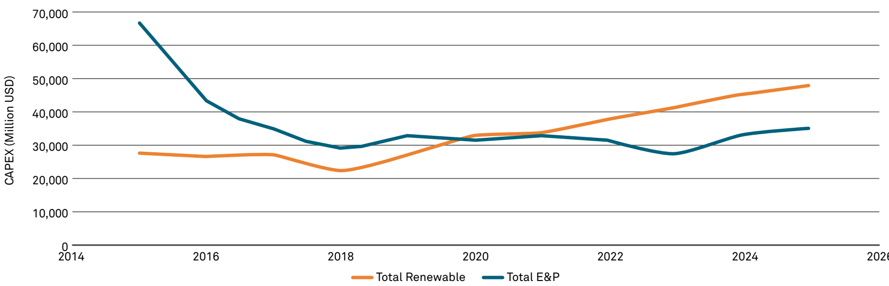
According to Rodica Glavan, emerging market debt manager at Insight, the experiences of EM millennials are diverging sharply from their western counterparts. This, she says, offers significant hope for future economic development and wealth creation and investment across swathes of the developing world.

"EM millennials are more affluent, better educated and have different perspectives and priorities than their parents' generation which tend to sacrifice present consumption for future. They will also, over time, become the largest part of the workforce so they will be a very important force in terms of shaping not only consumer spending but also company policy," she says.

More widely, Glavan believes portfolio managers are also becoming increasingly aware of the need to boost sustainability and the growing impact of and desire to accord with United Nations Sustainable Development Goals (SDG). The SDGs are designed to be adopted globally to help achieve a better and more sustainable world and are highly relevant to many emerging markets.

Looking towards the future and beyond the global pandemic, the renewables sector across Asia Pacific could become a key market to watch. Many countries in Asia have a strong representation in this space and it could offer significant new investment potential in the future, says Insight.

### RENEWABLES SPENDING IS ON THE RISE IN ASIA PACIFIC




Source: Rystad. 28 May 2019. 'E&P' is exploration and production.

1 www.Imf.org: 'Prolonged Uncertainty Weighs on Asia's Economy', 17 June 2020.
2 www.bhutanmindvacation.com 'What is GNH?', 17 June 2020.
3 Unenvironment.org: 'Our impact in Asia Pacific', 03 June 2020.
4 Consultancy.asia: 'Asia's top renewable energy markets: China, India and Japan', 10 June 2020.

# Socially mobile

As a growing appetite for social bonds helps to buoy the global sustainable debt market, Insight Investment, examines their appeal and the principles that guide them.

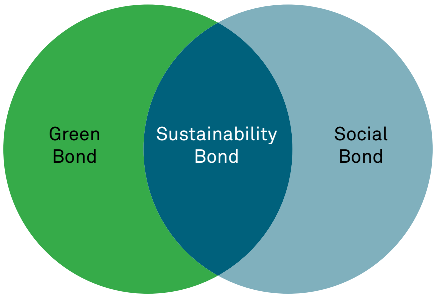
In the year to 27 May 2020, global markets saw social bond issuance of US$30.4bn. These were in areas such as housing, healthcare and employment and their recent growth spurt echoes a previous growth trend in so-called green bonds. Given this level of issuance, where does the appeal for such fixed income instruments lie, what do they invest in and just how big could the market become?

The growth of the sustainable debt market in recent years has shown how investors are increasingly building positive impact themes into their investment considerations and analysis. However, while the green bond market has gained in maturity and liquidity, social bonds have emerged as a new growth area in the impact debt capital markets.

It can be helpful to think of social bonds in the context of green bonds. While green bonds allocate proceeds to projects for environmental benefit, social bonds have the distinct feature of channelling capital to projects with positive social outcomes. (Bonds that intentionally blend green and social outcomes are referred to as sustainability bonds.)

The International Capital Market Association (ICMA), whose Social Bond Principles have become the leading framework globally for issuance of social bonds, defines them as fixed income instruments whose proceeds are "exclusively applied to finance or re-finance in part or in full new and/or existing eligible Social Projects".[1]

These projects aim to address or mitigate a specific social issue or seek to achieve positive social outcomes.




Unlike social impact bonds – whose proceeds to investors, are contingent on the success of the targeted social programme – proceeds from social bonds are channelled to projects that provide access to essential services like healthcare, education and financial services, affordable housing, and basic infrastructure such as sanitation, transport, and clean drinking water.

Appetite for sustainability bonds has increased as investors realise they can vote and engage on a range of ESG issues through their choice of fixed income investments. There have been several reasons for the increase in social bond issuance, but the most significant force has been investor demand, which has also driven governments and corporates alike to deliver on the premise of responsible investing.

A particularly attractive feature of social bonds is flexibility. Such instruments allow for a much broader range of projects than green bonds. Additionally, the increased demand for social bonds may also be attributed to familiarity: some investors may be more familiar with the concepts of socially responsible investing than they are with those of green bonds, which are more climate and/or environmentally focused.

## MARKET GROWTH

Green bonds have historically dominated the sustainable bond issuance market. More than US$744bn[2] has been raised in green bond issuance since 2007, when the European Investment Bank issued its inaugural impact bond. However, social bonds have followed green bonds' trajectory, particularly since Covid-19, with issuance in the first half of 2020 more than double the total amount of social bonds issued in 2019.[3]

Through 2020, there has been an uptick in Covid-19 related social bonds, where supranationals, sovereigns and agencies seem to be leading the way. For example, in March 2020, the International Finance Corporate (IFC) issued its largest social bond ever to finance its response to the coronavirus while the African Development Bank also launched a US$3bn "Fight Covid-19" social bond. Additionally, Unédic, the French unemployment agency, issued two separate €4bn social bonds in May and June 2020, the two largest social bond issuances ever.

In March 2020, the ICMA highlighted the relevance of social bonds in addressing the coronavirus pandemic and provided additional guidance for eligible social projects, which now include coronavirus-related health care and medical research, vaccine development, and medical equipment investments.

The increased scope of eligible projects is likely to encourage issuers to become more active in the space. Additionally, the diversification of issuers is likely to evolve in a similar manner to the green bond market, with supranationals leading in the market's early years and other investor types following as more and more issuers look to demonstrate support for social issues while delivering positive investment returns.

1 ICMA Group. Social Bond Principles. June 2020.
2 Source: Bloomberg. Data as at 30 June 2020.
3 Climate Bonds Initiative.

# About BNY Mellon Investment Management

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