Active is: Unlocking the potential of ESG

ESG is going mainstream because it's business-critical

by Steffen Hörter | 07/05/2018

Summary

Companies that recognise the importance of ESG factors – and manage them well – are increasingly attractive to investors, while companies that fail to pay attention to ESG can be perceived as higher risk. This is causing a paradigm shift in the investment world.

Key takeaways

- ESG investing is going mainstream in large part because it deals with business-critical issues such as water management, health and safety, board accountability and executive pay
- ESG factors can directly affect a company's reputation, intellectual property and brand value – which can impact its stock's valuation
- Socially responsible investing and impact investing use screening methods that can be limiting; an active, integrated ESG approach can be much more flexible and allow access to a broader opportunity set

Environmental, social and governance (ESG) factors are increasingly recognised as critical determinants in the success or failure of corporations of every stripe. Investors, too, are paying more attention to ESG factors because incorporating them into investment decisions can help manage risk and generate more sustainable long-term returns.

Intangible factors help determine market value

Analysing ESG factors is meant to be a supplement to, rather than a replacement for, more traditional research tools. While it is certainly always important to examine a company's balance sheet and public filings, a growing percentage of corporate assets today are of a more intangible nature.

These intangible assets include a company's reputation, intellectual property and brand value – and many are directly related to, or affected by, mainstream ESG factors:

- *Environmental* – climate change, pollution, water management, biodiversity
- *Social* – human rights, labour relations, health and safety, community relations, diversity
- *Governance* – board structure and accountability, executive pay, bribery and corruption

Companies grow increasingly attractive to investors if they recognise the ESG factors relevant to their enterprises, invest in them as business opportunities and manage them well. Conversely, poorly managed companies that ignore ESG factors may be riskier investments.

As the accompanying chart shows, one study found that over the past 30 years, intangible assets constituted an increasingly large component of companies' market value.

Intangible assets have grown increasingly valuable
Components of S&P 500 market value

Source: Ocean Tomo (2015), "2015 Annual Study of Intangible Asset Market Value". For illustrative purposes only.

Three ways to incorporate ESG

The growing interest in ESG is causing a paradigm shift in the investment world. While there are many approaches, ESG investments generally fall into one of three categories.

Socially responsible investing (SRI)

This approach typically aims to avoid companies or sectors with bad ESG practices, such as poor corporate behaviour. After applying negative screens or positive filters to their investable universes, SRI strategies are able to invest in only a portion of their benchmark indices. Since SRI strategies are a first-generation approach to ESG investing, dating back more than 20 years, they currently make up the bulk of the ESG market.

Impact investing

Part of the SRI landscape, impact investing aims to create a positive social and environmental impact along with a positive financial return. Impact investments frequently focus on one or more of the United Nations' 17 Sustainable Development Goals, such as providing access to clean energy or clean water, but they can also focus on areas such as providing quality education and gender equality. With this approach, there is a causal connection between making an investment and generating an impact.

Integrated ESG

This is a "next-generation" approach that we follow at Allianz Global Investors for our mainstream investment strategies. It is built around conducting deep, proprietary research on corporate ESG risks and opportunities. Integrated ESG portfolios are not constrained by ESG filters that narrow the investable universe; instead, portfolio managers make an educated ESG risk/return trade-off across all potential holdings – with a special focus on avoiding ESG tail risks. For example, a portfolio manager who wants to invest in a lithium company for exposure to the electric-vehicle revolution would need to consider whether its manufacturing operations could be shut down for safety or pollution reasons.

ESG and active investing

Corporate ESG issues are seldom black or white. That's why in our view, the practice of packaging up complex issues into passive ESG indices by indiscriminately applying rules-based criteria and third-party ESG research holds relatively little prospect of success. Active investment strategies, on the other hand, can build ESG factors into a portfolio in a far more flexible way by allowing access to securities that are mechanically "screened out" by many passive sustainability strategies. We believe it is in this broader opportunity set where the most attractive investment prospects are often found.

Another benefit of an active approach to ESG investing is active engagement between portfolio managers and corporate management teams. Our integrated ESG approach aims to improve how companies perform on financially material ESG issues by emphasising strong stewardship, consistent proxy voting and regular, direct contact with management. In this way, we aim to help corporations move towards more successful business outcomes – and help our clients improve their performance potential over the long term.

Learn more about our approach to active engagement

We've launched a new tool that provides real-time updates on how we are voting on resolutions at thousands of companies, alongside commentary on why we voted the way we did. We also invite you to learn more about our ESG approach by exploring how we integrate ESG criteria across the entire investment value chain.

About the author

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Dr Steffen Hörter is the Global Head of ESG at Allianz Global Investors which he joined in 2001. He is internationally responsible for the ESG integration strategy at AllianzGI including ESG Policy and Framework, ESG Investment Positioning, ESG Investment Offering/ Product Design and ESG Client Investment Advisory.

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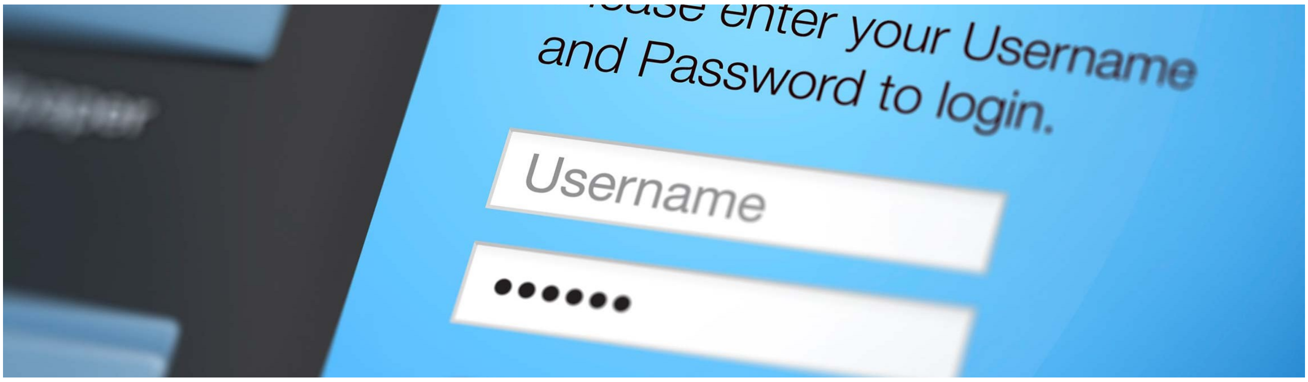

Summary

Our research has found that up to 50% of firms may not be prepared to follow the EU's tough new GDPR law, which is set to take effect in May. But stiff financial penalties aren't the only risk for businesses that aren't properly guarding their customers' digital data.

Key takeaways

- The EU's General Data Protection Regulation is set to take effect on 25 May 2018; any company doing business in the EU must comply or risk large fines
- Our research has found that many large firms are already GDPR-compliant, but many small- and medium-size businesses aren't
- It's not entirely clear how GDPR compliance will be enforced at first, but we believe regulatory actions could gain steam quickly after a slow start
- Firms that don't comply with GDPR could be hit with more than steep fines – including lawsuits, damaged reputations and a loss of access to digital data