Nordea

The Guide to Sustainable Investing

- The ability to sustain
- The different ESG approaches explained
- Doing well by doing good?

#1

NORDEA SUSTAINABLE INVESTMENTS
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The ability to sustain

Ethical -, ESG-, Responsible-, Sustainability investing – many names have been going around the last couple of years. What started as investors wanting to avoid owning certain companies due to ethical and moral reasons has grown into investors recognising that some of the most dominating challenges and opportunities are related to environmental, social and governance (ESG) factors.

Sustainability has been quoted in several different ways but the most frequent quoted definition is from the from the Brundtland report, Our common future;

"Sustainable development is the development that meets the needs of the present without compromising the ability of future generations to meet their own needs"

When you reflect upon how this definition relates to sustainable investment it is clear that companies we invest in need to be well positioned to future challenges in order to sustain over a long period of time or even better being in a position to proactively contribute to solving the global sustainability challenges we are facing.

Every year global experts, decision makers, company leaders and industry shapers gather in the World Economic Forum to discuss and rank what their biggest economic concerns are. The forum defines a "global risk" as an uncertain event or condition that, if it occurs, can cause significant negative impact for several countries or industries within the next 10 years. In January, the World economic forum published the Global Risk report for 2020[1]. For the first time in the history of the Global Risks Perception Survey, environmental concerns dominate the top long-term risks by likelihood. Top risks are ranked as follows: Extreme weather, Climate action failure, Natural disasters, Biodiversity loss and Human made environmental disasters. In order to reduce these risks, researchers state that the global warming needs to be kept below a 2 degree temperature rise (and preferably 1.5 degree since this would significantly reduce risks and impacts of climate change) from pre-industrial levels. To succeed, the world needs to achieve carbon net zero emissions by 2050 and the next 10 years will shape the outlook for climate risks for the rest of the century (source: IPCC).

Investing sustainable has grown into supporting companies that are taking their responsibilities as well as a way of identifying future risks and opportunities.

The interest in sustainable investing has grown significantly over the last decade. The below graph illustrates the significant growth of Assets under management (AuM) over the last 12 years, the number of asset owners and managers around the world who are committing to the UN Principles of responsible investments and the increase in regulations.

Even though many of the sustainability challenges are long term risks which will impact the whole economy, there are also stock specific sustainability risks that will abruptly affect the company's ability to continue to operate – accidents, environmental scandals, not following the law, tax evasion to mention a few.

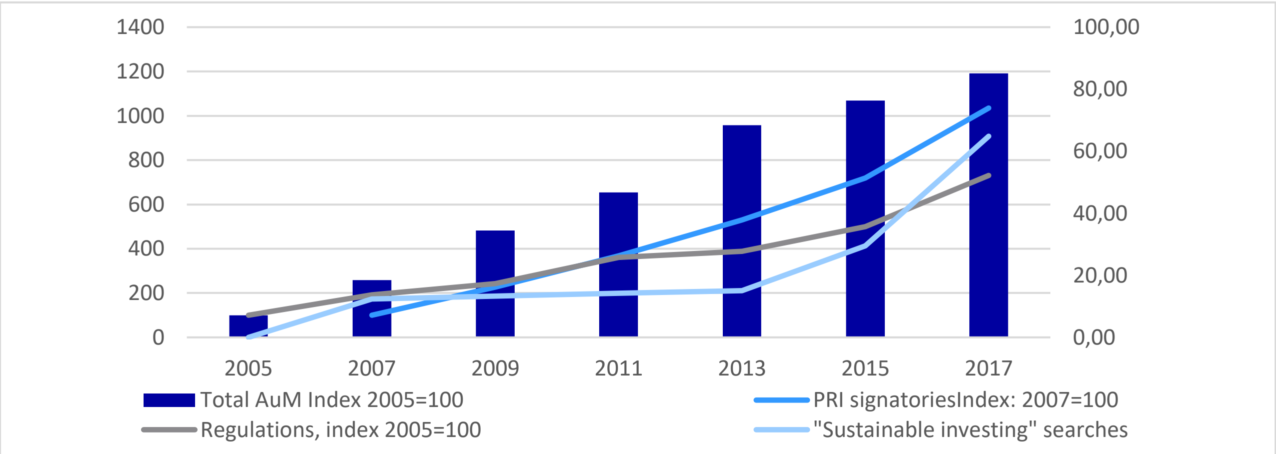

Figure 1. Indexed development. Source: UN-PRI 2020, Eurosif SRI Study 2006-2018 & Google trends 2020, PRI Regulation data

[1]http://www3.weforum.org/docs/WEF_Global_Risk_Report_2020.pdf

Figure 2 illustrates some of these risks and what investors should consider when wanting to invest in a sustainable way. In the following articles in this publication we will explain the many approaches on how to identify these risk and opportunities as well as what to expect of the performance

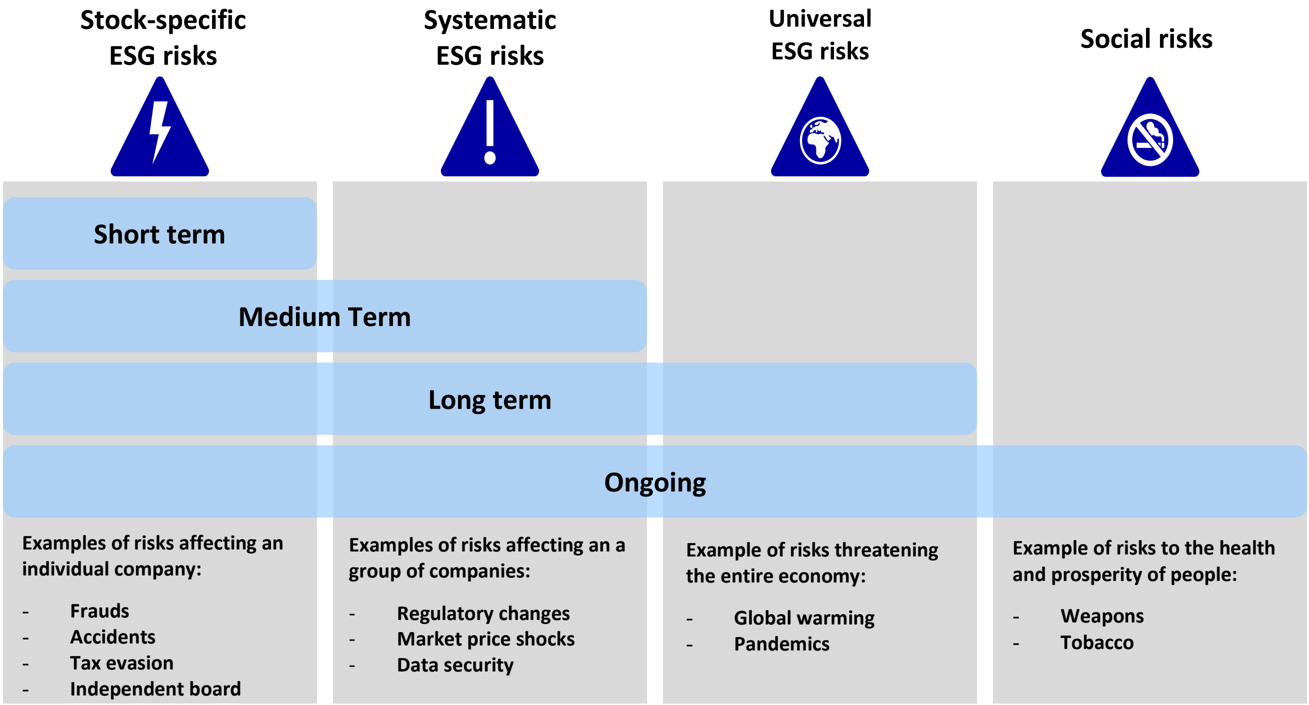

Figure 2. Time horizon of different types of ESG risks. Source: Adapted from MSCI Foundation of ESG investing part 2. May 2018

The different ESG approaches explained

How ESG risks and opportunities are incorporated in the investment process vary greatly between asset managers and portfolio strategies. ESG approaches can differ quite substantially, in what you achieve from a sustainability point of view as well as the risk-return profile of the investment strategy. There is yet no standard definition for what sustainability is, even though the EU is working on several regulations that will help investors define what a sustainable investment is, such as the EU taxonomy that so far focus on environmental and climate risks.

But in the meanwhile, in this article we aim to clarify six of the most common approaches and what implication those have from an ESG and investment perspective. We will go through the background, how the approach has grown and what is the impact and investment consideration for each approach. The 5 approaches:

- Norm-based approach
- Exclusion approach
- ESG integration
- Sustainability themed
- Impact investing.

Investment strategies commonly include a combination of different ESG approaches but most have a predominant way of investing.

This overview will give you a general understanding and can serve as a foundation when looking into different investment solutions, although the ESG impact will differ depending on the individual investment solution design, for example how actively managed it is.

Table 1 shows the ESG strategies development since 2005 in Europe based on the studies conducted by Eurosif. The two largest strategies, norm based and exclusion, have had a massive growth but declined or slowed down during the last couple of years in favour of thematic and impact investment

Strategy type (Europe, in €Bn)	2005	2007	2009	2011	2013	2015	2017	Growth 2005-2015	Growth period 2015-2017	The full period 2005 - 2017
Norm-based screening	134	398	989	2 132	3 634	5 088	3 148	3697%	-38%	2249%
Best-in-class/Positive Screening	67	128	133	283	354	493	586	636%	19%	775%
Thematic Investments	7	26	25	48	59	145	149	1971%	3%	2029%
Negative/Exclusionary screening	204	1204	1749	3 584	6 854	10 151	9 464	4876%	-7%	4539%
Corporate engagement & shareholder action	730	1291	1668	1 763	3 276	4 270	4 858	485%	14%	565%
ESG Integration	641	969	2828	3 204	1 900	2 646	4 240	313%	60%	561%
Impact/community investing				9	20	98	109		11%	1211%

Table 1. ESG strategies development in Europe. Source: Eurosif SRI Study 2006 – 2018. The full period for impact investing is from 2011.

Norm-based screening

Ensuring investments meet the vital responsibilities of human rights, labour, environment and anti-corruption

Many traditional funds, especially in Europe, perform a basic level of exclusions called norm based screening. The method focuses on identifying companies that do not adhere to international norms such as human rights, labour standards, anti-corruption and environmental protection as outlined in the UN Global Compact and other important international frameworks (e.g. the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles for Business and Human Rights). Once a company is identified in the screening, the investor can choose to either exclude the company or start an engagement process in order to achieve a change in the company's behaviour.

Norm-based screening was first developed by Scandinavian asset owners and responsible investment service providers in 2000 and has since the mid-2000s come to be widely used as input to active ownership strategies[2]. In 2006 the six UN Principles for Responsible Investments (UN-PRI) were developed and where today over 3000 investors have signed their commitment to follow the principles[3]. One of the principles implies that the investor (asset owner or asset manager) commits to being an active owner and incorporate ESG issues into their ownership policies and practices. As the norm-based screening is used as the foundation for many investor's active ownership policies, the growth can partly be explained by the increasing number of PRI signatures.

According to the Global Sustainable Investment Review 2018[4], investments strategies including norm-based screening constituted 15% of total assets within sustainable investments, where Europe contributed with 77% of those assets. In the Eurosif SRI study from 2018, the most common norm-based screen was to comply with the UN Global Compact, followed by ILO Conventions and the OECD Guidelines.

Impact outcome: The norm-based screening approach defines the minimum ESG level of investments. For the UN-PRI signatories who use the norm-based screening as a foundation, this approach can stretch across their product offering and if used together with engagement strategies, have an impact on how companies operate. However, the norm-based screening focuses on companies that are in breach and is not applied to identify companies who are in the forefront of contributing to the solutions to key sustainability challenges. Thereby some would claim that it is not a sustainable investment approach but purely a responsible investment approach.

Investment consideration: Generally speaking, excluding or engaging with companies via the norm-based approach would not have a large impact on the active risk in terms of tracking error[5].

2 ISS Norm based research: Research and methodology February 2020

3 https://www.unpri.org/

4 http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf

5 Active risk is the additional level of risk taken compared to the index. Tracking error is variation (measured as standard deviation) of the difference from an investment compared to an index. It is based on historical numbers. A low number would imply that there are low variations and the return over time of the investment will not differ that much from the index.

Exclusions

Avoiding sectors that don't contribute to a sustainable future or ethical values

Exclusionary screening, sometimes called negative screening, is the approach where the asset owner or manager systematically excludes specific sectors, countries or companies from their investment universe based on a specific criteria. Several ways exists, but exclusion is typically based on the investor's ethical values (e.g. pornography, alcohol, gambling), or the belief that the company, sector or country does not contribute to a sustainable future (e.g. fossil fuels). The method requires company specific research and analysis as exclusion criteria often are based on the revenue derived from the unwanted activity. Some restrictions, such as breaches of human rights and illegal weapons normally follow a 0% tolerance, while for example fossil fuels may have a higher acceptance rate. Exclusions can be applied to individual funds but increasingly also at asset manager or asset owner level across the entire product range of assets.

Exclusion based investing is the oldest way of investing sustainably with roots going back to the 18th century. It was first publicly implemented by faith-based institutional investors who coined the term "sin stocks". "Sin stocks" referred to equities that generate a percentage of their revenue form industries that were in conflict with the religious conviction of the faith-based organisations e.g. weapons, alcohol, pornography, child labour or gambling.

Today, exclusion is by far the most common sustainable investing approach, with a total of $19.8 trillion assets being subject for exclusions. It thereby represents over 50% of the total Sustainable Investing strategies. Europe and the US have the largest regional share of this strategy with 55% and respectively 40%[6]. Figure 3 shows the most common exclusion criteria. Below we explain some of the reasons why controversial weapons and tobacco are common exclusions.

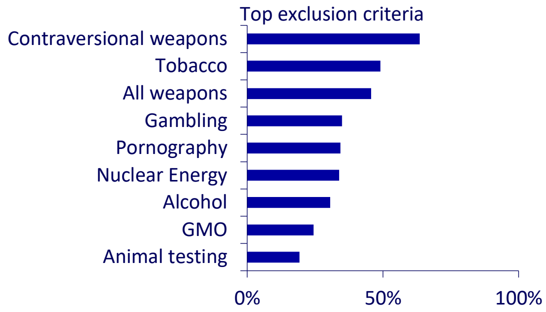

Figure 3: Top exclusion criteria. Source: Eurosif 2018

Impact considerations: The sustainability impact of exclusions as a standalone approach can be questioned. Arguments for this is that you generally can't impact companies that you don't own and for everyone who divests there will be another buyer. Thereby investors will not affect the incentives of the company management whose compensation are tied to the stock price or the cost of finance when rising capital in the primary markets (bonds and equities). However, exclusions can serve other ESG purposes such as not wanting to be associated with companies that are not aligned with the investor's values. Strong coordinated disinvestments by several investors can also give a strong signal and put pressure on companies to change.

Investment considerations: Exclusions is a common approach, both as a standalone approach but also combined with other ESG approaches. For passive investments an exclusions screen will have an impact on the tracking error. How much will depend on the level of the exclusions. As seen later in this article in Figure 5 the MSCI ESG screened index has a tracking error (TE) of 0,5 compared to MSCI ACWI, hence no significant impact on the active risk as an effect of the exclusion.

Controversial weapons

There is no universal definition of controversial weapons and the definition can thereby differ. Most weapons commonly considered controversial are subject to international treaties such as the Convention on Cluster Munitions and the Anti-Personnel Mine Ban Convention. These conventions generally prohibit the development, production, acquisition, stockpiling, transfer and use in armed conflict of weapons and methods of warfare causing unnecessary injury or suffering.

Tobacco

Nicotine contained in tobacco is highly addictive and tobacco use is a major risk factor for cardiovascular and respiratory diseases, over 20 different types or subtypes of cancer, and many other debilitating health conditions. Every year, more than 8 million people die from tobacco use. Most tobacco-related deaths occur in low- and middle-income countries, which are often targets of intensive tobacco industry interference and marketing.

6 Global Sustainable Investment review, 2018

ESG integration

Integrating Environmental, Social & Governance factors in the investment process

The objective with ESG integration is often either to reduce the risk in the portfolio, adding positive return and/or achieving higher ESG level. Investors can practice ESG integration by analysing ESG factors that may affect the securities of a company that they are considering investing in or already own. Table 2 gives examples of what ESG factors can be taken into account within each area.

While the exclusionary approach fundamentally prohibits certain securities, ESG integration does not restrain an investor in such a “black or white” way. Instead the approach focuses on incorporating environmental, social and governance factors in the security selection in addition to the pure financial analysis. To what extent ESG analysis is integrated into the investment process can however differ. Ranging from a qualitative approach where the financial analyst would conduct a thorough ESG analysis and integrate the analysis into the security selection, to a more quantitative approach where an ESG rating can be one input factor to a financial model (where the ESG rating can be from an external providers).

The analysis can for example include how well the company’s management handles the ESG risks and opportunities, the company’s overall business model and how ESG issues can affect the financial aspects of the company’s balance sheet, income statement or cash flow models (by affecting costs, revenues, and business growth assumptions).

Integrated analysis for active bond-picking and other debt funds involves analysing how ESG issues can affect an issuer’s creditworthiness.

The ESG analysis often results in an ESG score which summarizes how the company performs in the different areas. One company can receive different ratings depending on who is conducting the ESG analysis. Typically, the asset manager would look at each individual sector and outline which risks they believe are most important for that specific sector. For example, an environmental issue is more likely to have a greater importance in the analysis of an energy company compared to a telecom company. When assessing the telecom company more weight would instead be put on for example governance issues.

Positive selection and Best-in-class are examples of ESG integration approaches where ESG is normally given a high importance in the security selection.

Best-in-Class

This strategy selects companies with the best ESG scores within a specific sector. The companies are analysed from an ESG perspective and then ranked relatively towards their peers in the same sector. To be included in an actively managed best in class portfolio, the company need to meet both the established ESG criteria as well as traditional financial evaluations.

	Environment	Social	Governance
What?	Environmental criteria evaluates which environmental risks might affect a company’s business and how the company is managing those risks. Environmental factors can become substantial issues for companies if they own contaminated land, cause water pollution or do not comply with environmental regulations.	Social criteria focus on how companies’ business models impact the societies they operate in. Key factors include the working conditions and labour rights for their own employees and if their suppliers hold the same values that the company itself claims to hold. It also includes looking into whether the companies support their local communities.	Governance criteria are set to identify whether companies are operating in a way that is aligned with business ethics, e.g. uses accurate and transparent accounting methods, works to combat corruption, avoiding conflicts of interest and have whistle blowing functions in place.
Example	Climate change, greenhouse gas (GHG) emissions, use of raw materials, resource depletion, including water, waste and pollution deforestation, noise generation, biodiversity, land-use, energy	Human rights, labour rights, including slavery and child labour, equal opportunities, health & safety, union and association rights, consumer protection, product safety, personal data safety and privacy	Bribery, corruption & fraud, board composition and independence, accounting risk, audit committee structure, aggressive tax planning, executive pay political lobbying and donations

Table 2: Example of ESG analysis.

Positive Selection

Positive selection is an ESG integration method which implies investing in companies which have a favourable ESG profile but are also evaluated as improving. The ESG profile is based on either the investor's own analysis or by a rating agency. The investment process can set a specific hurdle of what ESG rating a company must adhere to in order to be investable. Compared to the Best-In-Class ESG integration approach, the fund manager does not necessarily only invest in the best ESG rated companies but where the investor sees a potential and positive trend in the company ESG performance.

Impact considerations: With positive selection and best-in- class the investor allocates its capital to companies that are well positioned for the future sustainability challenges and opportunities. When using the Best-In-Class approach the investor wants to select companies who are the best ESG rated within its sector and thereby rewarding the companies which are doing better than their peers. This would lead to that the average ESG rating of that fund would be high compared to some of the other ESG approaches. However, as positive selection generally is more exposed to improving companies, a potentially larger impact could be achieved through engagements as they would have more to improve than an already high ESG performing company.

By integrating ESG analysis into the investment process companies are better positioned for the ESG related risks and opportunities that they are facing today.

An indirect effect of integrating ESG analysis with a qualitative approach is that portfolio managers will ask questions directly to companies regarding their handling of ESG risks and opportunities. The more managers who do so, the more pressure it will put on companies to have answers as well as policies and processes in place to handle these issues. It is important for asset managers to ensure that the companies comply with their commitments in order to avoid greenwashing[7].

Integrating ESG into the investment process does not per se create an impact or create a stronger ESG profile. Instead it depends on how great importance the analysis is given in the strategy, and to what extent company engagement is carried out.

Investment considerations: Funds who practice positive selection and best-in-class are expected to have significant deviation from a traditional index. The actual deviation would depend on the investment strategy (stock picking etc) but also on the ESG threshold. As previously mentioned Best in class would generally have a higher ESG threshold which would narrow down the universe to a larger extent.

Sustainability themed

Invest in the solutions

A sustainability themed fund enables an investor to target a specific theme which they find important. For example, if an investor wants to own companies that contributes to climate solutions, energy transitions or to reduced water scarcity, sustainability themed funds would be an option which could target those specific issues. Investors can combine a broader exclusion approach with investing in a sustainable themed fund. For example investors concerned by climate change can create a portfolio combining a broader global equity fund which excludes companies involved in fossil fuels with an investment in a sustainable themed funds which focuses on companies that specifically invest in the climate solutions. By combining these two ESG approaches the climate conscious investor both minimises the risk of exposure to stranded assets[8] and at the same time invests in companies that are part of the solution to climate issues. According to the Global Sustainable Investment review 2018, sustainability themed funds has grown in AuM globally by 269% between 2016-2018.

Impact and Investment considerations: Sustainable themed funds generally have a very focused investment universe which would lead to significant deviation from a traditional index both on a country and sector level.

7 When a company, industry or government is claiming they have more environmental friendly practices through branding, packaging or public relations than they actually have in practice.

8 Stranded assets are assets which likely to become worthless due to combination of technology, market changes and regulations. For example the impact of the energy transition of fossil reserves.

Impact investing

Investing for a deliberate impact

Impact investing is about the connection between the allocation of capital by investors, and the aim to solve problems as well as address opportunities within social or environmental areas. At the core of impact investing lies the commitment of the asset manager to measure and report the social and environmental performance and progress of underlying investments, ensuring transparency and accountability while performing the practice of impact investing. The growth of impact investing has been substantial over the last couple of years, from EUR 20 billion in AuM in 2013 to EUR 108 bn in 2018[9].

Antony Bugg-Levine and Jed Emerson states in their article “Impact Investing: Transforming How We Make Money while Making a Difference" that the term “impact investing” was the outcome from discussions in 2007 between a group of investors and industry pioneers. The group was involved in different types of investments (the green technology investors, the first institutional investors in microfinance and the low-income housing lender) and what unified them was an interest in assessing the potential and real performance of their investments, and they wanted to use their capital to positively contribute to society. Their article goes on by saying that the terms “Socially responsible investing” and “ethical investing”, which are commonly used, seemed burdened with moral obligation, personal judgment, and a history of screening that focused on what type of firms to avoid. “Impact investing”, however, evoked the optimism and action orientation of this group and is a term with a wide range of investors to use.

Impact investing is a strategy that is utilised across all asset classes. Public equity investors can generate impact for example through a shareholder advocacy campaign, and investors pursuing this approach have had a meaningful impact on corporate practices. However, the most efficient way to use investments to achieve social impact is to place capital directly into companies and projects and therefore the impact-investing movement tends to focus on private equity and direct lending. This is confirmed by the Global Impact Investing Network (GIIN), who in their 2020 Impact Investor Survey[10] reports that impact investors deploy capital through a range of asset classes, but private markets remain the most common. As Figure 4 shows, 70% of the impact investors allocate to private equity and 58% allocate via private debt, which account for 17% respectively 21% of total AuM. Much capital also flows to public markets, with 19% of AuM in public equities and 17% in public debt.

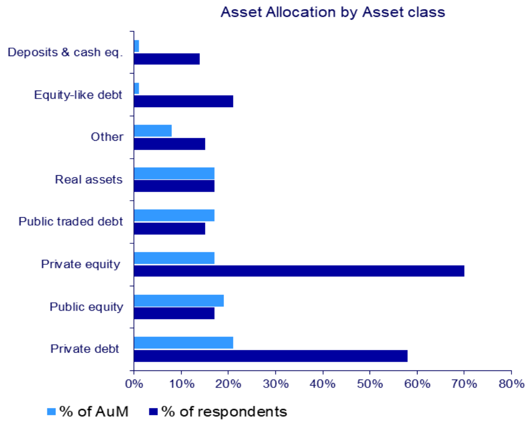

Figure 4. Asset Allocation by Asset class. Source: GIIN, 2020, Annual Impact Investor Survey. % of respondents with any allocation to each asset class. Respondents may allocate to multiple asset classes.

Sectors targeted by impact investment can vary, but according to the GIIN survey the largest allocation is to the energy sector in terms of AuM, followed by forestry, financial services , food & agriculture and Microfinance.

Impact consideration: As its name implies, impact investing has one of the clearest goals out of the different sustainable strategies - to have a concrete social or environmental impact through the investment. The focus on measuring impact, although still challenging to do so, makes it easier for the investors to see the connection between their investments and the ESG impact.

Investment considerations: The shortest link between impact and investments are in the private markets where the investors need to consider illiquidity risk. There are investment funds that invest in public equity and by its nature tend to be high conviction portfolios (i.e. fewer holdings compared to an index which can make the portfolio more volatile, as a price change in one of the holdings will have a bigger impact on the whole portfolio. The volatility can also be a consequence of a heavy weight to a specific sector, industry or country.

[9] Eurosif SRI Study 2018.

[10] https://thegiin.org/research/publication/impinv-survey-2020

Summary - The trade-off

Sustainable investing has developed from incorporating ethical objectives to using ESG analysis to identify how companies are positioned to some of the key challenges we are facing today. This is done by integrating ESG analysis into the investment process and identifying ESG risks and opportunities.

Investment funds can either be an actively managed (where a portfolio manager makes decisions about how to invest) or passively managed (which follow and market index and not active investment decisions are made) and the investment profile, investment process and philosophy of the fund will have an impact on the risk-return profile as well as the active risk of the fund. This is also true for ESG funds. In order to isolate the impact of the ESG approach we have used indices (MSCI ESG index family) to illustrate the effect on how the ESG profile affects the active risk.

Figure 5 illustrates the different indices with MSCI ESG score on the y axis and the tracking error on the x axis. The size of the bubbles in the figure illustrates the percentage coverage compared to MSCI ACWI[11]. The larger size of the bubble, the more similar to the parent index. As illustrated, a pure exclusion approach (sector and norm-based) has little effect on the ESG profile of the index. As the ESG level increases, narrowing down the universe, the active risk increases as well.

Due to impact investing's clear objective which limits the investment universe this approach has the highest active risk.

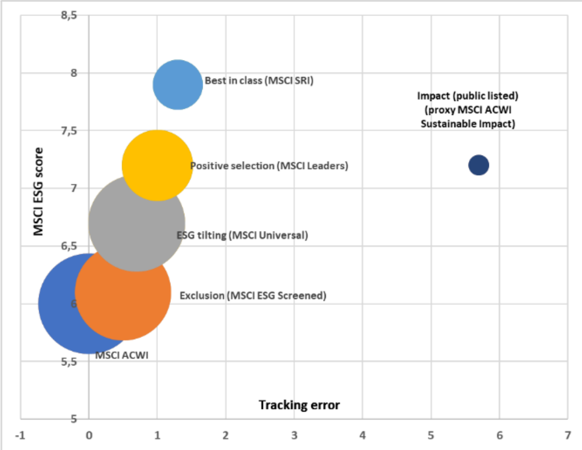

Figure 5: Trade-off between tracking error (x axis) and ESG rating (Y axis). For illustrative purpose only. Source: MSCI 30/11 2015- 29/5 2020. MSCI ESG score as of May 29 2020. The ESG score indicates how well the index companies manage their most material ESG risk relative to sector peers. Score range from 10 (best) to 0 (worst). Nordea has assigned the approaches to the MSCI index.

In Figure 6 we summarise the approaches as well as include findings from the next article in this publication *"Doing well by doing good?"*.

	Traditional investments	Exclusions/ Norm-based	ESG integration: Tilting	ESG integration: Positive selection	ESG integration: Best in class	Sustainable themed	Impact investing
Focus	Limited or no regards to sustainable investments.	Norm based screening focuses on identifying if companies adhere to international norms such as human rights, labour standards and environ mental protection. Exclusions can also include specific sectors, countries or companies due to a specific criteria often based on ethical values.	The strategy do not exclude companies but will tilt the weight of the companies towards a higher ESG rating.	Positive selection is an ESG integration method which implies investing in companies which have a favourable ESG profile based on either the investor's own analysis or by a rating agency. The ESG threshold can vary but normally would include companies which are not the highest rated but have a positive trend to improve.	An approach where leading or best-performing investments within a sector are selected or weighted based on ESG criteria.	Sustainability themed investments inherently contribute to target specific social and/or environmental challenges such as climate change, eco-efficiency and health.	Impact Investments have the intention to generate social and environmental impact alongside a financial return. Can target a range of returns from below market-to-market rate. The impact of the investments needs to be measurable and intentional.
Impact intentions	Agnostic	Avoid harm	Manage ESG risks; Manage ESG opportunities				Intentional and measurable impact
		Active ownership and engagements can be applied with all approaches but tend to be strongest in ESG integration and Impact.					
Performance and investment consideration		Research states that exclusion based on purely ethical reasons are less likely to provide a return in line with the market.	Does not exclude but include the non financial information from ESG. Research says it does not harm performance and sometimes able to enhance it.	The positives selection could be the "sweet spot" because they take advantage of ESG factors, have a high level of sustainability but not restricting the investment universe too much as the best in class eventually tend to do.	The Best in Class strategies will most likely benefit the most when sustainable assets are in favour or when the sustainable risks are most in focus.	Sustainability themed funds will mot likely deviate significantly from a traditional index and performance will highly depend on the outlook of the specific the sector and theme.	The primary objective in the past of impact investments have not to achieve higher financial returns.

Figure 6: Summary of the different approaches, impact intentions and performance. Source: Nordea

11 MSCI All Country World Index. The percentage coverage is the average sum of the constitute weights in the benchmark (based on monthly data).

Doing well by doing good?

Over the last couple of decades Sustainable Investing has gained popularity among both institutional and private investors. Sustainable investing has become mainstream. This has led to a proliferation in offerings, where investors can include non-financial objectives relating to the enviroment, social aspects and governance while still meeting their financial objectives in terms of a market return. In other words: Investor can be *doing well by doing good.* This naturally raises the question of whether the sustainable investment strategies can enhance the market return; or at the very least not harm the return by investing sustainable.

Investors have found little help in the past academic literature where results have been either inconclusive or conflicting in relation to this important question; see Berg et al (2014) or Lieberman (2020). Because value-based strategies, which simply excluded non-sustainable assets, were mostly used to implement sustainable investing in the past, historical research has often been conducted on this type of strategies as well. Early research indicated that sustainable investors would struggle to receive a performance in line with the market; see Fulton et al (2012). The outperformance of the so-called “sin stocks”[12], which the sustainable investor often exclude, was seen as evidence of this; see Hong and Kacperczyk (2009). Yet, an increasing amount of research pointed to a more promising perspective for the sustainable investor; see Clark et al. (2015).

Unsurprisingly, this has caused confusion among investors and a great deal of scepticism. It has added to the confusion that the reach of the whole sustainable concept is vast and investors have very different motives for investing sustainably. Some investors are pursuing purely financial objective and hope sustainable investing can help them to enhance the market return, while others are mainly motivated by non-financial objectives such as climate change. Some investors are trying to achieve both. Clearly, there is *no one size fits all* and this is important to consider when trying to unlock if there is a positive link between sustainable investing and financial performance; see Hill (2020).

To provide more clarity to investors Friede et al. (2015) conducted a study based on more than 2250 academic studies and found in 70% of the cases a positive link between strategies that included non-financial ESG information/factors and an improved financial performance. Whereas these results may seem promising investors should be careful not to put too much emphasis on them, as they should not be relied on in the future due to the rapid changes in the sustainable investing space. Investors should instead direct more attention to what is likely to drive the future performance of sustainable assets and the specific choice of strategy to implement sustainable investing. They all differ in what the investor can expect in terms of risk, return and level of sustainability. As there is *no one size fits all* investors will, in general, face trade-offs between these when pursuing financial and non-financial goal.

In this article we reviewed the existing literature to see if it is possible to draw any conclusions on how the different ESG approaches discussed in the article “The different ESG approaches explained” can be expected to perform in the future.

The selection, the trend and the impact effects on asset pricing

To understand how the different sustainable strategies can affect the financial performance of sustainable assets, it is useful to distinguish between three potential channels: A *selection effect*, a *trend effect* and an *impact effect* for sustainable assets. They all affect the relative demand for sustainable versus non-sustainable assets, and therefore also asset prices and ultimately the performance, but from different sources:

- The *selection effect* is the direct effect on asset prices (and therefore also the return) when investors add ESG factors into the traditional risk and valuation analysis and this changes the selection of the assets. Investors may select companies that are better managed from a social,

12 “Sin stocks” is a term that refers to stocks within adult entertainment, alcohol, gambling, tobacco and weapons

environmental and governance perspective and avoid companies that appear to have weaknesses on these dimensions. At some point in the future these potential risks could materialize and have a *significant financial impact* on the performance. There seems to be solid empirical evidence that there is a link between companies adopting sustainable business practices and lower cost of capital, better profit margins, higher sales growth etc.; see Gompers et al (2003).

- The *trend effect* arises from a general shift in the demand for sustainable assets. This effect is distinguished from the selection effect in the sense that the demand is not changed because of the inclusion of ESG factors alongside traditional economic fundamentals into the selection process. It is a change in demand that is caused by a global increase in the interest and focus on sustainable assets. This could be anything from changes in the regulatory environment, availability of new sustainable funds to institutional investors that are now including a significant share of sustainable assets in their portfolios. The significant change in focus on sustainable assets among all investors makes it hard to imagine that this has not increased the asset prices of them.

- The *impact effect* is the shift in demand for some sustainable assets which offer solutions to some of the global challenges in the years to come and have businesses that are aligned with the 17 UN Sustainable Development Goals. This may or may not be companies that are the best ESG rated companies, but also companies that could be in high demand because of what they offer in terms of a better global sustainability.

To focus the discussion and understand what investors can expect from sustainable investing, all the different sustainable investment strategies are divided into three overall categories. Each of them has unique financial and non-financial objectives:

- Exclusions: Strategies that apply exclusions on non-sustainable assets
- ESG Integration: Strategies that incorporate ESG factors into the investment process
- Impact: Strategies that pursue sustainable impact

Different approaches to sustainability and the expected link to performance

Exclusions

Sceptics of the ability for sustainable strategies to enhance performance, when exclusions are used, are often arguing that this will necessarily lead to lower returns and/or greater risks because the investment universe is more constrained by the exclusions. As the number of excluded assets increases, the more pronounced the adverse effect will be on risk and return, which is seen in a higher active risk (i.e. tracking error)[13]; see Branch et al (2020). This argument is not specific to sustainable investing but is true in general when the investment universe is constrained; see Asness (2017).

Sceptics may also argue, that if a sufficient large number of investors sell of a stock, then the price off it will drop and in fact lead to a higher (future) expected return on the disliked stock. One can think of this additional higher return as a compensation to those (fewer) investors, who are willing to hold the stock. If this return differential becomes large and persistent, because prices are systematically depressed under their fundamental value, investors who are willing to hold the stock are collecting a risk premium for the systematic risk (e.g. a risk that investors cannot avoid by further diversification). This will be an additional headwind (to the negative effect from a narrower investment universe) for the sustainable investor to face when comparing to the market return.
There are other reasons why investors should not expect strategies with exclusions to reward with a market return. Strategies based on exclusion are unable to benefit from either the *selection effect* (i.e. better understanding of the asset's risk) or the *trend effect* (i.e. increased demand for sustainable assets) because the asset selection process is not linked to the ESG information/factors that are believed to carry useful information about the future performance[14].
There is a possibility that these strategies could benefit from the *impact effect* if the excluded assets are assets that will not be in high demand in the future because they are not well positioned for the global challenges, for example companies with high CO2 emission[15].

13 Tracking error is measuring variability of returns versus the benchmark returns
[14] This does not imply that portfolios with exclusions cannot outperform. Excluding assets can be thought of as taking an active bet (against benchmark) and active bets can always perform if the underweighted or excluded assets underperform.
[15] Nordea has historically been arguing that these types of assets should be considered "stranded assets" with less long-term potential for investors due to their unsustainable business model.

However, the notion that some of the excluded assets, for instance the "sin stocks", carry a risk premium and therefore is a headwind for sustainable investors, is probably weak. The risk premium of "Sin stocks", famously documented by Hong and Kacperczyk (2009), was subsequently showed to disappear once controlling properly for two systematic risk factors, profitability and investment, as in a Fama-French (2014) asset pricing model; see Blitz and Fabozzi (2017).

Nevertheless, sustainable strategies with value-based exclusions are less likely to provide a return in line with the market for the long-term investor. The strategies make most sense for an investor who clearly do not want to be associated with that specific investment.

ESG Integration[16]

ESG Integration strategies cover a very broad range of sustainable strategies as discussed in "Different approaches to ESG investing explained". It includes strategies such as "ESG tilting", "Positive selection" as well as "Best-in-class". As opposed to value-based exclusion strategies, these strategies are based on the idea that including information on E (environment), S (social) and G (Governance) can lead to better informed investment decisions and a higher risk-adjusted return. How much ESG is integrated depends on the specific strategies. If ESG factors can help to enhance returns it is because they can explain some of the asset specific risk after the systematic risk factors (value, momentum, quality etc.) as well as industry and sector differences have been properly controlled for[17].

ESG integrating - Positive selection & best in class

Positive selection and best-in-class strategies are a more modern way of implementing sustainability. The key difference to ESG tilting strategies (see below) is that positive selection and best-in-class strategies only include assets with a certain level of sustainability. Some assets, even if they have some desirable properties in a portfolio context, cannot be included due to their ESG profile. This is an attractive feature for investors who are motivated by only having assets with high ESG standards, but it can come with a cost as some of the excluded assets may have other desirable properties. In this sense, the positive selection and best-in-class strategies face similar challenges in terms of constraining the investment universe as strategies with exclusions do. Investors might also suspect that negative effects on performance from loss of diversification could become important when the investment universe becomes too narrow. However, what is in favour of these strategies is that they include ESG factors and can benefit fully from the *selection effect* and the *trend effect*. Potentially they also benefit from the *impact effect* if the assets with high ESG scores are also the companies that will provide solutions to the future global challenges. Compared to ESG tilting strategies, the positive selection strategies implement ESG in a more direct way as only assets with a certain level of ESG are included.

Historical evidence suggests that strategies with positive selection and best-in-class can provide the investor with better opportunities to receive a market return or above. By comparing the performance of companies with the 20% highest ESG scores, the "best in class" in Q1 (1st quintile), with the performance of companies with the 20% lowest ESG scores in the Q5 (the 5th quintile), the best-in-class companies appear to outperform; see Drei (2019). This is illustrated in Figure 7a and 7b.

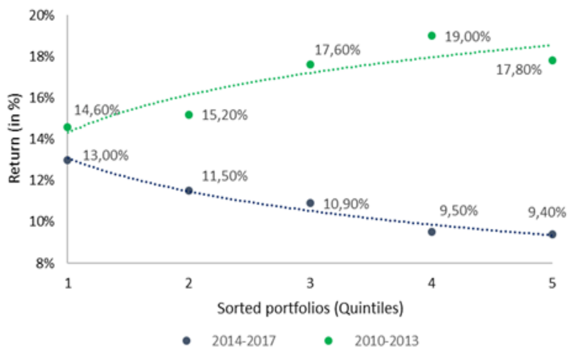

Figure 7a: Sorted portfolios for North America. (Notice: Past performance is no guarantee of future return). Source: Bennani et al (2018)

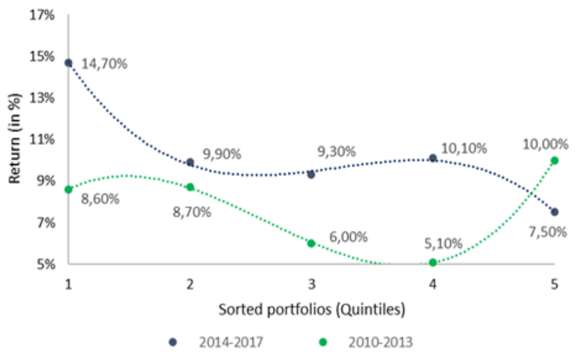

Figure 7b: Sorted portfolios for Europe. (Notice: Past performance is no guarantee of future return). Source: Bennani et al (2018)

[16] ESG Integration is defined as an investment process with a "systematic and explicit inclusion of ESG factors".
[17] It is claimed that many sustainable strategies often outperform the traditional counterparts. While this may or may not be true it is sometimes unclear to investors because the conclusions are drawn on data before differences in their exposure to systematic risk factors (momentum, value, quality, size etc.) have been controlled for; see Morningstar (2020) as an example.

Investors should, however, pay attention to the fact that the effect is most pronounced in Europe and the positive effect is mainly found after 2014. Prior to 2014 the evidence is more inconclusive. It is tempting to interpret this as an indication of the trend effect caused by the significant shift in the demand for sustainable assets in recent years. The selection effect can also have benefitted the best-in-class strategies and at the same time been unfavourable for the strategies that include companies with the lowest ESG scores.

Strategies with positive selection and best-in-class are therefore well suited for rewarding the investor with an enhanced return in times where the demand for sustainable assets is high and where the selection process is favourable to sustainable assets. This may not always be the case (as history has shown) which means the performance of these strategies also must be expected to have some tracking error to the market. The demand for sustainable assets is high and is likely to continue which could increase the likelihood of these strategies providing a market return at or above market in the coming years due to (at least) the trend effect.

ESG Integration - tilting

Contrary to any type of positive selection and best-in-class strategies, ESG tilting does not exclude holdings of any assets in the investment universe. Instead "tilting" of the asset weights, relative to the benchmark/market, is done based on both traditional financial information as well as the ESG factors. This means all assets can be used to optimize and include in the portfolio. Again, it is the hope that the inclusion of material non-financial ESG information can lead to better informed investment decisions. How much the individual asset weights are tilted based on the ESG score relative to the benchmark depends on investor's preferences and risk tolerance.

There are several reasons why ESG tilting strategies may enhance the return by including ESG factors. Since the approach does not use exclusions of any kind, it does not suffer from the potential drain on performance from a reduced investment universe. At the same time, these strategies can still potentially benefit from both the selection effect as well as benefit from the trend effect, where increasing asset prices are caused by a shift to a higher demand of sustainable assets. It is less likely to benefit from the impact effect unless there is a link between the selection of assets and assets that will be in high demand because they provide solutions to global challenges.

A historical evaluation of ESG tilting strategies suggests a performance in line with the market return; see Nagy et al (2015). However, it is also clear that if the investor would like to improve the ESG score of the portfolio in this approach, then it is (only) possible as long as the investor is prepared to take additional active (tracking error) risk; see Bennani et al (2018). This is the trade-off investors face and the cost for pursuing a higher ESG score; see Figure 8.

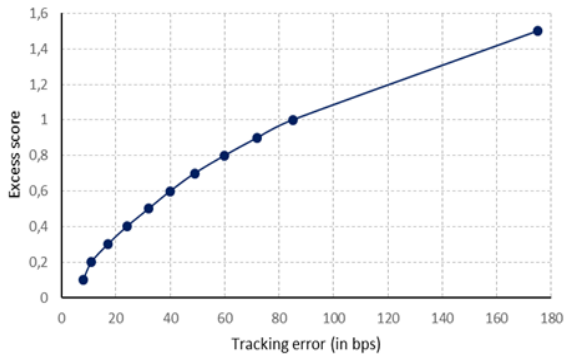

Figure 8: The link between an increase in excess ESG score and the tracking error. Source: Bennani et al (2018)

Historically, investors have been rewarded for taking this extra active risk with an enhanced performance after 2014. Prior to this date it is more challenging to document an outperformance of ESG tilting strategies relative to the market. This suggests the success of these strategies in recent years is related to an underlying positive shift in the asset prices of sustainable assets that is likely to be caused by the increased interest and focus on sustainability issues globally. That is both the selection and the trend effect.

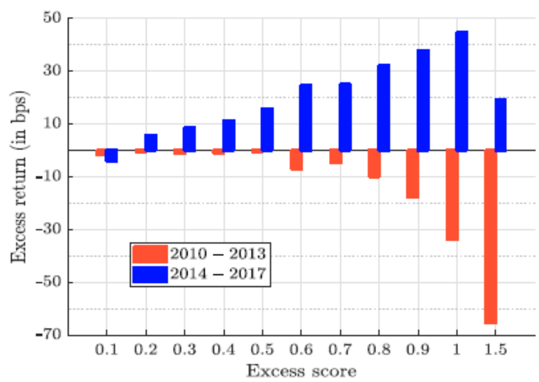

Figure 9: Increase in excess return as the excess score increases. (Notice: Past performance is no guarantee of future return). Source: Bennani et al (2018)

Several studies have also indicated that as investors try to increase the ESG score of the portfolio by taking more active risk (i.e. higher tracking error) this will at some point harm the performance; see Drei et al

(2019). This makes intuitively sense because to achieve the highest obtainable value of the ESG factors, the investor is essentially applying a positive selection where only the best-in-class assets are included. While this in the beginning can enhance performance as the level of sustainability increases, then the negative effects from the inability to diversify sufficiently well within the investment universe will start to dominate at some point and create a drag on the performance. This is illustrated in Figure 9 for two periods, while being evident for both periods the effect is larger from 2010-2013.

It is important to notice the trade-off between performance and the level of sustainability. By extending one of the most famous workhorses in finance, the Capital-Asset-Pricing-Model, to include ESG factors, Pedersen et al (2019) illustrates how including ESG information can improve the Sharpe ratio (risk adjusted return) but as the investor prefers to increase the level of sustainability further, the (Sharpe ratio) will at some point begin to decline from the optimal level.

It seems reasonable for investors to expect tilting strategies can deliver a market return or slightly above, but it comes with the cost of potentially having assets with less impressive ESG scores. ESG tilting strategies can certainly benefit from both the selection and the trend effect but compared to strategies that apply positive selection of assets based on their ESG values, the effect is likely to be less pronounced. In other words: ESG tilting strategies must be expected to have less tracking error to the market than ESG positive selection strategies; see Lieberman (2020).

This suggests the positive selection strategies could be a "sweet spot" because they take advantage of ESG factors, have a high level of sustainability without restricting the investment universe too much as the best-in-class strategies eventually do.

Impact investing

Impact investing is the third main type of approach the investors can take to implement sustainable investing. The overall aim is to generate a measurable social or environmental impact alongside a financial return. Historically, investors have mainly been motivated by engaging in this from a more philanthropic perspective with the expectation of a financial return below the market return; see Hill (2020). This might also explain why some investors traditionally have believed there is a trade-off between pursuing impact on society or the environment and the ability to obtain the market return. Impact investments have mainly been done as Private Equity, Private Debt and Real Estate type of investments; see Mudaliar et al (2017). While this may have been true in the past, impact investing is, as it is the case for sustainable investing in general, a rapidly evolving area in many ways.

The philanthropic motive continues to be the primary motive behind some charitable investors and in these cases the expected financial return is likely to be below the market return. However, the motivation among investors are much more diverse and it includes the financial motivation to improve the long-term risk-adjusted return. If investors are prepared to take some active risk, sustainable impact strategies are available in the public market. These strategies can document a measurable impact as well as seeking a market return (or above); see Menou et al (2016). Other investors, who prefer a narrow focus through the private market, can do so but must in general expect to take a higher active risk to gain an above-market return. That impact investing can provide the investor with a market return at a comparable risk is confirmed by recent research; see Mudaliar et al (2017). With this broad range of sustainable impact strategies available, what investors can expect of financial return depends on the exact type and motivation behind the individual strategy.

On a deeper level there are reasons to be optimistic for the medium- to long-term investor and to question the traditional view of a trade-off between impact and a market return. Contrary to ESG integration strategies, where the source of enhancing return is the inclusion of ESG factors, the source of potential enhancement for impact investment strategies is directing capital toward companies that are providing solutions to the global societal and environmental challenges. Economic history has proven that investing in new technology that solves challenges and/or increases productivity/efficiency is usually profitable for the long-term investor.

Understanding the implications on what impact the global sustainability challenges have on the global economy and assets prices is presumably not fully understood and thereby not incorporated into the asset prices. Because of this, companies that are likely to hold some of the solutions to these challenges may be undervalued; see Lieberman (2020). Investors with a medium- to long term investment horizon can take advantage of this and wait as the new global conditions become clearer to the market. This is essentially the impact effect, which can increase the future asset price and enhance the return. Impact strategies are also likely to benefit from the trend effect as investors on a global scale are increasingly in interested investing in sustainable assets and strategies.

Financial materiality as a source of enhancing return

The selection of the right ESG factors that have business impact on the individual assets, sectors, industries etc. is essential, if the inclusion of them into the investment process should have a positive effect on the financial performance. Only ESG factors with a material financial impact should be included; see Principles for Responsible Investments (2018).

There is no clear consensus on what the material financial ESG factors are for assets in different industries and sectors. In some cases, the “E” is most relevant whereas in other cases it could be the “S” or the “G” factor. Identifying the right ESG factors in itself therefore creates an opportunity for some asset managers to outperform, see AQR (2019), but it may also explain why some studies on sustainability performance were inconclusive, i.e. because the evaluations were simply done on non-material factors; see Khan et al 2015.

The amount of research needed to identify the material financial ESG factor is an extensive and costly task, but it may also (at least partly) explain why integrating ESG factors into the investment process may help to enhance performance. This is related to whether markets are efficient, see Fama (1970), and all available ESG information on assets are fully reflected in current asset prices.
The ESG factors are ultimately derived from the bulk of ESG data that companies are voluntarily self-reporting. No overlaying process exists for identifying potential errors and inaccuracies. Seen from this perspective, it is not clear, that investors could find any useful information embedded in ESG data. To overcome this, professional investors are either buying data on ESG factors from an external data vendor, for instance MSCI or Sustainalytics, or have an in-house team with similar competences. Besides cleaning up the company reported data, the value of this approach is to identify which ESG factors have a material financial impact on the specific asset; see Hill (2020).

When information is clearly costly to obtain, as it is the case with material financial ESG factors, it is hard to believe that markets are fully efficient. Instead, asset managers will only engage in this, if they can somehow use the costly obtained information to take better positions in the market and by that be compensated with a higher return; see Grossman and Stiglitz (1975). Nonetheless, sustainable investors may take advantage of less efficient markets to enhance performance by implementing strategies, that include relevant ESG information.

What does the future hold ?

There are reasons to be optimistic from a sustainable investor point of view since the focus on sustainability is likely to continue and the strategies available to investors (and the understanding of how they work) have increased in recent years. Five aspects deserve to be mentioned

1. **Predicting the future cannot rely too much on the past:** The area of sustainability investing has evolved much over the past decades in terms of types of strategies available to investors, the asset pricing and the focus on sustainability issues on a global scale. The awareness of the sustainability risk has increased and we expect this to intensify as governments and society need to enhance their actions in order to mitigate the impact of climate change and the recovery after the Coronavirus Crisis. Many important milestones have occurred the last 5 years such as the Paris Agreement, the Sustainable Development Goals and the EU "man on the moon moment " of the Green Deal. Because of this, investors should be cautious to rely too much on previous historical research in trying to predict the future. The inconclusive and often slightly sceptic historical evidence on the prospect of sustainable investing does not provide an accurate picture for the future.

2. **ESG will be an integrated part of the investment process:** A continuous research on relevant ESG factors is likely to continue, also in relation to what the material financial factors are for different assets. Important initiatives such as the SASB (Sustainability Accounting Standard Board) focus on developing sustainability accounting standards to help public corporations to disclose financially material and useful sustainability information to investors. Another example is the TCFD (Task Force on Climate related Financial Disclosures) - a market-driven initiative to develop consistent climate related financial risk disclosures for companies, with the ambition to make physical and transition risk related to climate change more transparent. As the demand of investors for transparency will increase, it will enable investors to take this into account when investing. The link between businesses that adopt ESG practices and financial performance is fairly solid. It should therefore be possible for investors to take advantage of this to enhance the risk-adjusted return by including this type of information into the investment process.

3. **The trend will continue:** The global focus on sustainability is likely to continue and one should not underestimate the demand effect as more investors allocate to companies well positioned from an ESG point of view. There are several global trends (risks themes), including (but not limited to) climate change, which will affect businesses and the financial market which investors must pay close attention to. Some sustainable strategies can probably provide some protection against these global risk themes.

4. **Impact investing:** Impact investing strategies are, in a historic context, new, and not only interesting for investors because they pursue real impact on society and the environment to achieve a better global sustainability. For the long-term investor these strategies are also interesting because they pursue companies that may hold some of the solutions to the global challenges.

5. **Regulations will play an important role:** The regional differences in the historical analysis points to the regulatory environment. There seems to be a link between the regulatory environment and performance because financial markets incorporate these signals into the asset prices when trying to anticipate the future performance of assets. The recent success of European sustainable strategies coincides with significantly more regulations in Europe during the same period (see figure 10). Regulations (or the lack of them) can take many forms, but investors should look for everything from governments withdrawing from the Paris Agreement, implementation of carbon taxes and capital requirements related to the asset's ESG ratings. Such events will continue to affect the asset prices from a basic supply and demand perspective and ultimately transmit into the performance of sustainable assets relative to the market.

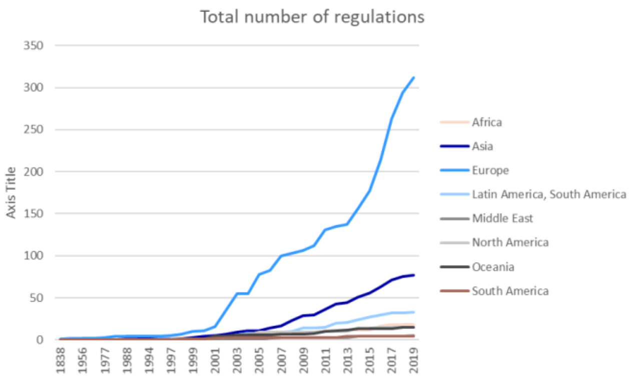

Figure 10: Regulations across the world. Source: PRI Regulation database (2019)

With sustainable investing there are both financial and non-financial motives. Ultimately, investors must decide how their investment should balance between the financial and sustainable objectives. This depends on individual preferences. There is not a one-size-fits-all choice but as always in economics a trade-off. Sustainable investing does not change that. The question is therefore not so much if you can ”do well while you do good” but more “how well or how good” do you want to do and at what risk.

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