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NEWTON
Investment Management

THE FUTURE IS SUSTAINABLE

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In recent years, as topics such as climate change – and the considerable risks that it presents to our planet and to humanity – have risen up the agenda, there has been a growing global awareness of environmental and sustainability issues and the impact they can have on investments. Against this backdrop, we have also seen increasing conviction from asset owners that careful consideration of sustainable criteria can lead to better long-term investment outcomes.

A focus on sustainable investing marks an evolution from the traditional strategy of excluding certain sectors (which, in our view, can be rather simplistic). Instead, a sustainable approach uses environmental, social and governance (ESG) analytics to differentiate between companies based on their actual fundamentals and strategies rather than their sector classification. We believe that this more engaged approach can help investors to avoid poorly performing companies and identify higher-quality companies regardless of their sector.

The case for ESG

This thinking has been backed up by a broad range of academic research. Since the 1970s, academics and investors have published over 2,000 separate studies looking at the relationship between ESG criteria and corporate financial performance. In 2015, a meta-study was published, combining the findings of these previous studies.[1] The aggregated evidence makes a positive case for ESG investing by highlighting how a large majority of the studies have shown that companies with positive ESG credentials have performed better, and that the ESG impact on financial performance appears stable over time.

Further research has served to show how active ownership – engaging with companies to address ESG-related concerns – can also have a beneficial effect on performance. One study analysed an extensive proprietary database of corporate social responsibility engagements with US public companies over a 10-year period from 1999-2009.[2] The findings showed that, after successful engagement, companies experienced improvements in operating performance, profitability, efficiency and governance. Furthermore, if engagement with a company turned out to be unsuccessful, there was no negative impact on investment returns.

“Research has served to show how active ownership – engaging with companies to address ESG-related concerns – can have a beneficial effect on performance.”

[1] ESG and Financial Performance: Aggregated evidence from more than 2,000 empirical studies, Journal of Sustainable Finance & Investment (Friede, Busch & Bassen), 2015
[2] Active Ownership (Dimson, Karakaş and Li), The Review of Financial Studies, December 2015

Engaging on climate change

Engagement with companies could be particularly relevant in the context of climate change, which is likely to become an increasingly significant investment topic as investors are challenged to disclose what they are doing in terms of identifying and taking action on climate-related risks and opportunities. While some investors have come under pressure to implement some form of fossil-fuel exclusion, the degree to which we are reliant on fossil fuels make this a far more complex divestment discussion than other historical campaigns such as tobacco and apartheid. Furthermore, if investors choose to exclude fossil-fuel investments from portfolios, they will in effect become powerless to make their voices heard by companies in the sector. Conversely, remaining invested in oil & gas companies could provide the best opportunity to enact change through engagement: a big oil company may be the very business with sufficient resources to research and invest in alternative, 'greener' energy sources for the future.

“Although it is still debatable to what extent millennials' words of support for such an investment approach will be matched by their actions, it is estimated that this cohort will form 75% of the global workforce by 2025.”

We believe engagement is an effective way for investors to make progress in this area. We recently joined a collaborative investment group, Climate Action 100+, a five-year investor-led initiative (with combined assets under management of £20 trillion) which works to engage with the world's largest corporate greenhouse-gas emitters to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures. A further initiative is the Task Force on Climate-related Financial Disclosures (TCFD), which provides recommendations on the climate-related information that companies should disclose to help investors make sound financial decisions. We integrate the recommendations made by the group in our engagement with companies, and a member of our team sits on the PRI (Principles for Responsible Investment) TCFD advisory group, which aims to establish recommendations for company engagement on this topic.

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Meeting millennials' expectations

One of the key drivers behind the growth in interest in sustainable investing in recent years has been the 'millennial' generation, which can broadly be defined as people born between the early 1980s and early 2000s, and which has become known for being technology-savvy, liberal, well-educated and socially and environmentally aware. According to research conducted by Morgan Stanley, 86% of millennials say they are interested in socially responsible investing. Millennials are also twice as likely to invest in a stock or a fund if social responsibility is part of the value-creation thesis.[3] According to the Schroders Global Investor Study 2016, which surveyed 20,000 end-investors in 28 countries, the millennial generation ranked ESG factors as equally important as investment outcomes when considering investment decisions.[4] Although it is still debatable to what extent millennials' words of support for such an investment approach will be matched by their actions, it is estimated that this cohort will form 75% of the global workforce by 2025,[5] and therefore the industry will ultimately need to respond to the changing requirements of both millennial and other modern-day investors.

3 https://www.morganstanley.com/ideas/millennial-sustainable-investing
4 http://www.schroders.com/en/media-relations/newsroom/all_news_releases/schroders-global-investor-study-2016-millennials-put-greater-importance-on-esg-factors/
5 https://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/gx-dttl-2014-millennial-survey-report.pdf

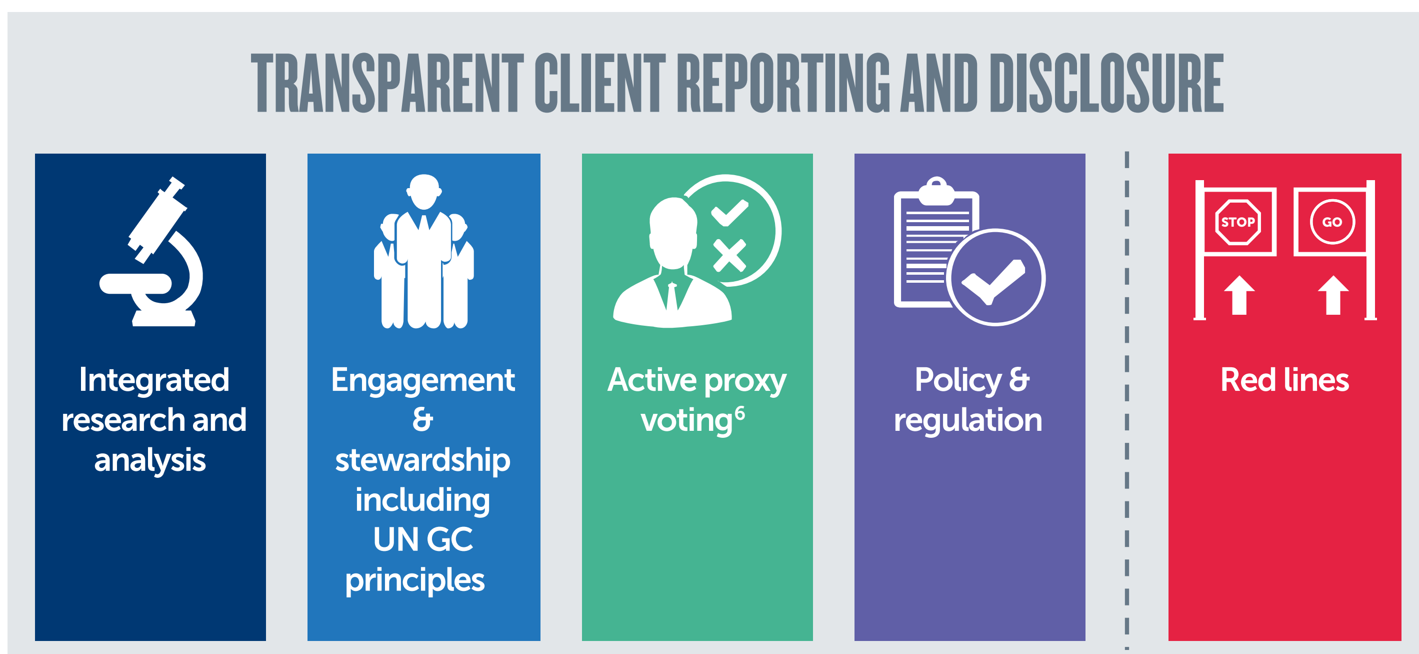
Sustainable 'red lines'

While many asset managers now incorporate ESG considerations into their investment process, sustainable and 'impact' strategies (investments made to generate a measureable social or environmental impact) are far less commonplace. At Newton, responsible investing has been a key part of our investment process for a long time, and we see sustainable investing as a natural evolution of this. Sustainable investment strategies move beyond ESG integration, putting ESG factors at the forefront of decision-making. In our view, the key elements of a successful sustainable investment approach include:

- Investing in companies that positively manage the material impacts of their operations and products on the environment and society, as well as businesses that have unrealised ESG-related opportunities.
- Giving responsible investment specialists veto power in the stock-selection process, enabling them to prevent a sustainable portfolio from holding a particular company. This transfers the ultimate discretion from a portfolio manager, where it traditionally lies, to specialist responsible investment analysts. We see this as a subtle but important shift, signalling a change in the priorities of the considerations that shape a portfolio – both to an investment team and to the external world.
- Establishing engagement plans with set timelines for companies that can be helped to improve through engagement.
- The use of 'red lines' to rule out certain companies from being considered for investment in sustainable strategies, such as those companies that are not aligned with the UN Global Compact's ten principles that promote responsible corporate citizenship, or with the aim of limiting global warming to well below 2°C.

We regard such considerations as increasingly important as client demand for ESG-oriented and sustainable strategies increases. Investors may feel that sustainable and impact investing comes with considerable challenges, in particular the difficulty of measuring the positive impact of an investment, as data provided by companies can be unreliable and often difficult to collect in rural or developing areas. However, we think ESG factors and sustainable investing are likely to become increasingly significant for investors as time goes on, and therefore the importance of addressing such issues ever more critical.

What investing responsibly means at Newton



6 Where we retain voting authority

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