MACQUARIE

ESG goes mainstream

March 2021

Investment Update

ESG goes mainstream

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ESG is accelerating in importance for all stakeholders – investors, corporates & fiduciaries. Investors are showing their support via strong fund flows to ESG products and governments are planning green infrastructure led economic stimulus plans.	The COVID pandemic was in many ways a clarifying moment, proving a catalyst for stakeholders to boost their ESG focus. In hindsight, the COVID crisis may be the point ESG went mainstream.	The ESG investment industry is responding quickly to investor led demand. Key actions include improved measurement and transparency, greater stewardship, and introducing products with specific ESG goals such as temperature containment.

ESG is in the midst of an explosive growth phase. Investors are focused on investment options that incorporate ESG principals, investment managers are integrating ESG criteria into selection processes and businesses are increasingly focused on being better corporate citizens.

We see this as a very positive development. Better corporate citizens should, in time, be rewarded with a lower cost of capital and higher valuations. At the same time, more socially and environmentally aware behaviour has obvious positive implications for the wellbeing of the planet.

In this report we discuss what ESG investing is, why it has been growing, how COVID has impacted ESG, how it is being incorporated into the investment process, the options available for investors, what the Australian landscape looks like and finally our preferred investments.

What is ESG Investing?

ESG investing is an investment process which incorporates environmental, social and governance (ESG) criteria either alongside traditional financial analysis or on its own.

Environmental factors consider how a company performs as a steward of nature. Social factors examine how an organization manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with such things as a company's leadership, executive pay, audits, internal controls, and shareholder rights.

ESG investing, sustainable investing, responsible investing and ethical investing are all terms that describe investing strategies that consider how a social or environmental good can bring about a positive social change according to investor values.

ESG investment has grown to include a variety of approaches that are intended to enhance returns and better manage risks by including the pursuit of environmental and social change.

Why is ESG growing in importance?

ESG investing began with socially responsible investors looking to exclude stocks or industries or even countries that they believed did not satisfy their social ideals. Over time, investors, fund managers and corporates have come to appreciate the benefits of incorporating ESG factors into their investment process rather than just excluding "sin" sectors.

As a result, ESG investing has evolved from a narrowly applied set of criteria to a process that is now helping address some of the major issues facing society. For instance:

1. According to the World Economic Forum's 2018 Global Risk Report, Environmental dangers (E), inequality (S) and cyber vulnerabilities (G) are three leading trends creating both risk and opportunities for investors.

    - Significant decarbonisation on a global scale is required to meet the Paris Agreement challenge of containing global warming to 2 degrees Celsius above pre-industrial levels.

    - Rising inequality within nations is an important issue, driven in part by adverse consequences of technological advances and high structural underemployment.

    - Cybersecurity is a growing issue linked to the increased digitisation of society. With cybercrime growing quickly it is also creating opportunities for those businesses combating it.

2. Rules and regulations: The investment landscape is increasingly changing due to greater regulation. For example, ESG investing is helping to address the risks of government restrictions on developing trends such as sugar levels in foods, greater checks on supply chains, the use of child labour, and legally enforceable exclusions on controversial weapons such as cluster bombs;

UN's 17 Sustainable Development Goals

Source: United Nations

3. Sustainable Development Goals (SDG): The UN's 17 SDGs are a global initiative to create a better world while also earning a return on investment. The Goals tackle issues ranging from eradicating hunger to improving education for girls.

ESG and the recovery from COVID

The COVID pandemic, together with rising societal tensions, movements for racial justice, the 2020 US election and climate change have emerged as catalysts for investors to focus on aligning their investments with wider social concerns.

We see three ESG themes that have emerged in the aftermath of the COVID pandemic and subsequent recovery:

1. Corporate governance: Since the onset of the pandemic, boards are learning to deal with a multitude of issues that range from: rewriting their strategies; tracking a wider set of operating and performance measures; overseeing a long-drawn menu of risks; rethinking policies governing compensation; and reimagining employee wellness and experience.

2. Government and corporate commitments: 2020 was a historic year of climate change commitments by corporations, governments, and investors alike. These commitments are centred on achieving "net zero" – that is, building an economy that emits no more carbon dioxide than it removes from the atmosphere by 2050.

3. Investor focus: For some, COVID has even been a warning for how climate change can alter human existence. Investors are focussed more than ever about how they can use their investment funds to improve ESG outcomes. This is evidenced by strong sustainable fund flows. Sustainable funds performed well last year relative to conventional funds during the uncertain economic and market conditions caused by the pandemic, underscoring the value of considering ESG risks in portfolios.

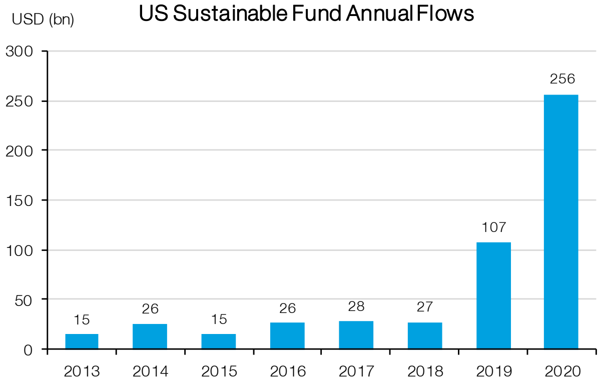
What ESG developments are emerging post COVID?

The COVID pandemic has also proved a catalyst for innovation. Renewables such as wind and solar generation suffer from less consistent delivery of energy and variable energy prices This is leading to a prioritisation of large-scale energy storage like hydro plants and grid scale batteries. In January 2021, Macquarie Bank was involved in the creation of a financial instrument by which energy storage can be traded, helping mitigate some of the risks of renewable energy.

The investment industry is also responding to the rapid changes seen over the last 12 months. A post-pandemic renewables investment wave could benefit the stocks of companies that produce more sustainable low-carbon products. BlackRock, the world's largest asset manager, continues to increase its emphasis on sustainable investing, with many other large asset managers beginning to follow suit. These actions by investment firms support a continued acceleration of sustainable fund flows in 2021.

As President Kennedy said many years ago, "Out of crisis can emerge new and incredible opportunities". The COVID pandemic was in many ways a clarifying moment, proving a catalyst for change that is coming rapidly. While there remains a need for a focus on global cooperation to fulfil the potential of ethical investments, in hindsight, the COVID crisis may be the point ESG went mainstream.

Sustainable fund flows strong despite market turmoil



Source: Morningstar, MWM Research, March 2021

What's coming for ESG investment?

The 2010s saw ESG enter the psyche of stakeholders, initially via a focus on corporate governance following the Great Financial Crisis in 2008. Investment stewardship and engagement by investors with corporate management followed. Regulatory attempts at improving disclosure and more consistent reporting were kicked off. For Environment and Social factors, oil spills and data privacy events brought these factors into focus for investors and the Paris climate agreement was established. ESG themed products grew strongly in response to investor interest.

Progress continues to be made on addressing ESG issues that are often nuanced and dependant on investor philosophy. For example, a greater acceptance of companies in "transition" is enabling carbon emitting companies to gain funding for renewables investment. Investors are also increasingly accepting that small or emerging market companies lack the resources of large developed market companies and that they must be assessed in this context.

We believe the next decade will be driven by the following themes:

1. Climate Change will dominate – Governments across the globe are introducing more climate related regulations. Commitments to net-zero emissions by companies are growing and will become the standard before the end of this decade. Emissions intensive sectors are embracing the transition to a low-carbon economy as they recognise the risk and opportunities linked to addressing climate risks.
2. Greater role of politics – The Biden administration will refocus stakeholder attention on ESG issues and climate urgency. The new administration will bring a significant change in tone to addressing climate risk with steps already been taken for the US to re-join the Paris agreement. Other global governments are more likely to follow this precedent as fiscal stimulus via "green" infrastructure spend gains momentum.
3. Social issues will gain traction – Following the COVID pandemic, investors will continue to pressure companies to prioritise social issues such as worker safety, inequality, flexibility, ethical sourcing and diversity. In addition to this trend being customer and investor led, global policy is increasingly addressing social factors.
4. The impact on Australia – While it's easy to point the finger at our nation so dependent on resources, ESG does not necessarily mean a negative impact. The transition to renewable energy sources will prompt critical investment in renewable technology, batteries, carbon capture and storage, electric vehicles, and hydrogen. Australia has the potential to be a beneficiary of that investment as well as provide many of the raw inputs required for the manufacture of renewable energy.

5. More standardised and widespread disclosures – Intensified pressure from investors is acting as a catalyst for change. Regulations will increasingly define best practice for corporate disclosures. Reporting on ESG investment impacts are aligning behind the UN's Sustainable Development Goals.
6. Direct indexing – Investors have a desire to personalise their values and achieve greater engagement with their investments. Better technology and data are enabling customised portfolios to a broad range of people.

ESG Investing misconceptions

Despite the rapid growth and increasing acceptance of ESG, misconceptions continue to impede its uptake. Some of these are discussed below:

1. ESG leads to lower returns: Some believe ESG investing hurts performance. Adopting sustainability can indeed incur up-front costs, however companies that make these investments can often enjoy improved returns and lower risk. At its core, addressing ESG risks is managing financially material issues for a company. Academic studies support this argument and suggest that "prudent sustainability practices have a positive influence on investment performance".
2. ESG funds are expensive: Our analysis of funds available to Australian investors suggests that Integration ESG funds are on average 5-10bps more expensive than comparable non-ESG funds. The news on Exclusion ESG funds is not quite as good and we find that fees are 20-40bps more expensive than non-ESG passive funds.
3. ESG remains dominated by "E": While the environment is sometimes more tangible for investors, social and governance issues remain relevant for most companies.
4. ESG is limited to equities and developed markets: Bonds and emerging markets are fast growing areas for ESG investing as portfolio managers integrate ESG factors into their analysis and more data becomes available.
5. ESG is only for millennials: While young people are more likely to be interested in sustainability than their parents, investors of all ages have been shown to be interested.

ESG in an Australian context

High engagement: Australian investors and investment providers are among the most ESG aware globally. Australia currently has 141 signed and active ESG investment providers that have products aligning with the United Nations Principles for Responsible Investment (UNPRI).

Integration dominates: Integration and corporate engagement are the dominant ESG strategies in Australia. Globally, the Exclusion strategy which screens industries that don't align with investor values remains the dominant ESG strategy. The prevalence of Integration and engagement in Australia is led by the dominant superannuation funds which support the UNPRI and their recommendation of integrating ESG factors into the investment process and engaging with corporates to improve their awareness of and performance in ESG issues.

Equities and bond options: Most Australian domiciled funds available to retail and institutional investors are for the domestic and international equities asset classes. The availability of bond ESG funds while still small is growing quickly as managers incorporate ESG factors into their credit analysis and the issuance of green, social and sustainable bonds grows.

Limited options for REITs and Alternatives: At this stage, there are limited investable ESG fund options in asset classes other than equities and bonds. This is not all bad news though as Australian listed property funds already rank well in their performance on environmental issues, without being dedicated ESG funds. The environment is the primary issue facing the sector with real estate companies increasingly setting greenhouse gas emissions targets and working to reduce energy and water consumption.

Limited market depth: Australia is still a relatively small investment market globally and we find that the ESG funds on offer do suffer from a lack of depth across asset classes and strategy types. Australian ESG funds are also less likely to have dedicated ESG investment teams versus those on offer for global strategies.

ESG investment philosophy

ESG investing means different things to different investors. Our recommended ESG portfolio reflects our ESG principles, which include:

- Using a broad range of ESG methods in seeking to improve risk adjusted returns.
- A preference for engagement with company management on relevant ESG issues.
- A recognition and support of businesses that are undergoing a transition away from restricted industries to more sustainable ones.
- While it is difficult to align investors values, we recommend funds with no or limited exposure to product manufacturing, distribution or reserves in industries including alcohol, gambling, tobacco, weapons (controversial weapons and small arms) and fossil fuels (extraction or power generation from thermal coal).

ESG industry exclusions

Industry exclusion guide – Limited exposure to product manufacture, distribution or reserves
Alcohol
Gambling
Tobacco
Weapons – controversial weapons and small arms
Fossil fuels – extraction or power generation from thermal coal

Source: MWM Research, March 2021

- Best-in-class – Investment in funds with an investment process that selects companies and sectors for their superior ESG performance relative to peers.
- Awareness of developing trends, e.g., restrictions on sugar.

Integrating ESG into the investment process

There is no silver bullet for integrating ESG into the investment process.

ESG as an investment criteria is still fluid. Standards and definitions are evolving and changing quickly.

Managing ESG objectives across a portfolio is substantially more difficult than across a single asset. The ultimate aim is that ESG is not differentiated within and across asset classes.

A lack of standardisation of incorporating ESG into the investment process suggests there will be trade-offs between achieving sustainability objectives and portfolio diversification.

ESG investing is not a concept that suits all investors in all circumstances. It has evolved to offer a number of approaches suited to a range of client preferences in combining financial returns with achieving social objectives. These client preferences, or motivations tend to fall into the three categories which are discussed in more detail below:

1. Exclusion: The original way of incorporating ESG into the investment process is to restrict investment in companies that have controversial business practices. These practices can range from activities that are deemed harmful to health or the environment such as tobacco, alcohol, gambling or controversial weapons. What is regarded as controversial is always evolving as the concerns around such things as fossil fuels and sugar have recently reflected.

2. Integration: This is the analysis of financially material ESG criteria to improve the risk/return profile of investments. In practice, investment managers implement this process using a wide variety of techniques. ESG integration involves integrating only the material ESG issues that are considered highly likely to affect corporate performance and investment performance. Sources of analysis can also differ with some firms

conducting their own ESG research while others rely on external analysis of specialist ESG research firms.

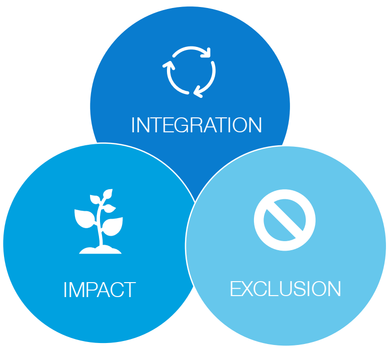
3. **Impact**: This involves making investments with the aim of creating specific beneficial social or environmental effects in addition to positive financial returns. Importantly, the extent of the investment impact should be measured and reported to investors. Examples include investing in a fund that aims to bring clean energy to emerging markets or improving nutritional standards in food.

Choosing an ESG approach

The different methods used to incorporate ESG into the investment process also provide investors with the opportunity to satisfy their ESG requirements at various levels.

1. **Exclusion** is most suitable for investors with a clear idea of which products or behaviours conflict with their values. In practice though, it can be difficult to find funds that align exactly with the investor's views. For example, investors may want to exclude fossil fuels from their investment whereas available funds may focus on excluding only controversial weapons and tobacco.

Incorporating ESG into the investment process



Source: MWM Research, November 2019

Lack of consistency in manager implementation can also be an issue, particularly in the areas of social and governance. Lastly, investment characteristics of the investment portfolio can be affected by negative screening, with the portfolio being exposed to a more limited universe of investment options and often a bias towards small-mid capitalisation companies.

There is a broad and growing selection of Exclusion funds available for the Australian and international equities asset classes. These funds tend to have lower management fees than Integration or Impact funds.

2. **Integration** is a better option for those who want to use ESG factors to better inform investment decisions. The inclusion of ESG factors with traditional metrics helps to better assess the sustainability of a business and its actions leading to a reduction in exposure to long term risks. Integration also tends to result in less unintended consequences in terms of investment portfolio characteristics. Integration works well for bonds as well as equities as portfolio managers can incorporate ESG factors into the credit analysis process.

   There is a broad range of Integration funds available across both Australian and international equities, which in practice are often a combination of Integration and Exclusion. Most ESG bond funds are best categorised as Integration but the processes typically are a combination of Integration and Exclusion and Impact, with a proportion of funds invested in green and social bonds.

3. **Impact** investing best suits investors who want to use their investment capital to make a positive impact on society while achieving a satisfactory return on that capital. Specifically targeting investments in sustainable agriculture, for example, might help reduce the global crop yield gap, while also making a financial return from the production of those crops. The availability of Impact funds is more limited than that of Integration or Exclusion but is expected to grow.

How we implement ESG

The 3 ways of implementing ESG into an investment portfolio include:

1. Direct equities,
2. A managed fund level,
3. A pre-selected ESG portfolio.

Each method has its advantages and disadvantages, for example, ease of implementation vs consistency with an investor's preferences.

Our portfolio construction combines our ESG principles with best-in-class funds applying these principles as part of their investment process. Our portfolio construction goals include:

- Portfolio investment characteristics similar to that of a non-ESG multi-asset portfolio including asset class mix, fund diversification, return expectations & return volatility.
- Moderate weightings to Impact funds due to the more concentrated security holdings and reduced sector diversification.
- An acceptance of a higher level of tracking error to our multi-asset benchmark due to the more concentrated fund holdings and reduced sector diversification.
- A reasonable management fee.
- Diversified securities holdings and broad sector exposures subject to restricted industries.

A roadmap for Advisers

When implementing an ESG investment solution for clients, advisers must consider:

- Where a client wants to sit on the sustainability spectrum;
- What a client is prepared to sacrifice for their social objectives; and
- How individual preferences will impact the portfolio.

More specifically, to produce a suitable ESG investment outcome the adviser needs to determine:

1. Client evaluation - The clients investing objective – what level of impact do they want with their investment and what are they willing to sacrifice.
2. Investment universe – The asset classes and funds which match the objective, e.g., Fixed income, emerging markets.
3. Fund assessment – Identify "true to label" funds with a rigorous process.
4. Investment selection – Select the investments consistent with the client's "value" objectives.

Implementation challenges

In what is still a rapidly evolving space, challenges remain in ensuring an ESG investment implementation achieves its goals.

These challenges can include:

1. Data inconsistencies; While improving, company disclosures and ESG firm ratings still vary greatly.
2. Heterogeneous ideas of materiality. Which ESG factors matter to which businesses?
3. Varying levels of ESG integration across asset classes.
4. Concentration risk via negative screening.
5. Time frame constraints, e.g. tactical vs strategic implementations.

Evaluating the "organisation"

Being truly ESG compliant is now a multi-level process. Clients are moving from evaluating the "investment" towards evaluation the "organisation" issuing the investment option and the organisation providing the "platform".

We are approaching this issue by doing the following:

- Separating out ESG funds vs funds with an overlay.
- Preferred ESG funds must satisfy the highest criteria.
- Annual surveys of organisations with "investment grade" products.
- Applying an internal rating system to ESG providers.
- Engaging external providers to access comprehensive data sets quantifying ESG compliance.

Jason and the Investment Strategy Team

The report was finalised on 9 March 2021.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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