NATIXIS
INVESTMENT MANAGERS

MANAGER POINT OF VIEW

Into the heart of ESG

It’s often been said that ESG investing is a means both to improve long-term performance and to mitigate risk. The market downturn and ongoing impacts of Covid-19 lockdown continue to test to that hypothesis, yet not all ESG managers have been created equal.

Jens Peers, CEO, CIO and portfolio manager at Mirova US, discusses the factors that influence the longer-term sustainability game.

mirova
Investing in sustainability

Jens Peers
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Why is sustainability investing so important to you?

Many people have different definitions of sustainability. And different clients may have different reasons as to why they want to have sustainability embedded in their portfolios.

When we talk about sustainability investing, we often talk about ESG investing. Knowing the environmental, social and governance behaviour of a company may help to better measure its financial performance.

So we look at how a company's operations or the use of its products, including the supply chain, impacts the environment. That includes raw materials and broader uses of the product.

Social metrics focus mainly on the relationship between the company and their broader stakeholders. This includes the employees, in terms of how they motivate them, but also their suppliers, their customers and the wider community in which they operate.

And on the governance side, we focus on policies and practices related to the companies, the way companies are run, the leadership, executive pay, shareholder rights, but also oversight through the board.

In short, looking at environmental, social and governance factors, there's many different ways that one can actually orientate a portfolio around ESG. That’s why I believe SPINE is extremely important.

What is SPINE?

It’s an acronym. Each letter stands for a different way people can use sustainability in their investment process. Many mainstream managers today that have developed any kind of sustainability solution are focusing on what we call financial materiality and sustainability integration **[see box out on page 3]**.

When ESG factors are believed to have a material impact on performance of a company, then, and only then, will it be used to make financial decisions. The rest will not be looked at necessarily, but when they believe it's the case, they will integrate it.

So, there are ESG factors that may impact the performance of a company and therefore it needs to be integrated. But the reality goes far deeper.

The other letters – P, I, N and E – also have a level of intentionality, although its broader and deeper than integration alone. They other four letters focus on what we call positive selection, impact investing, negative screening and engagement, all intentionally want to create a specific ESG profile, beyond just creating good financial performance.

Many investment strategies will implement one of these approaches or a combination of them. Our global equity strategy applies elements of all five SPINE approaches.

How does SPINE have an impact on performance?

The graph **[see over the page]** shows the valuation of the broader markets, taking the S&P 500 as a proxy for US equities. This is based on a study by a consultant called Ocean Tomo, a specialist in intellectual property. It looked at the history of the S&P 500 and how much of its value is driven ▶

> *“There are ESG factors that may impact the performance of a company and therefore it needs to be integrated. But the reality goes far deeper.”*

by tangible assets – equipment, buildings, inventories, machines, and that sort of thing – and how much has been driven by intangibles – goodwill, brand awareness, image, motivation of people, and so on.

In 1975, the vast majority – 83% of the valuation of the S&P 500 – was in tangible assets. In those days, knowing the book value of all the company's assets was a good indication of the company's value. Today, it's the opposite. In 2015, 84% of the valuation of the S&P 500 was in intangible assets and only 16% was in the tangible, real assets of a company.

This graph tells you two stories. One, the returns of the S&P 500 over those years was generated largely by focusing on the intangible assets, which goes towards creating client loyalty, employee satisfaction and better returns over the long term. Second, the biggest risk you take is in not managing it properly.

From a risk perspective, it's really important to take ESG factors into account when you're looking at any assets, if you want to generate positive financial return.

Beyond performance, why is ESG investing important?

In 2015, the UN agreed on a set of 17 goals that is calls the sustainable development goals or SDGs. Those 17 goals cover a range of areas and are estimated to generate about $12 trillion of additional GDP if they are achieved by 2030. We have seen in the last couple of years that the asset management industry has increasingly used these SDGs as the basis to determine what is actually sustainable and what is not. They will also help us to develop impact reports for advisers and investors to share.

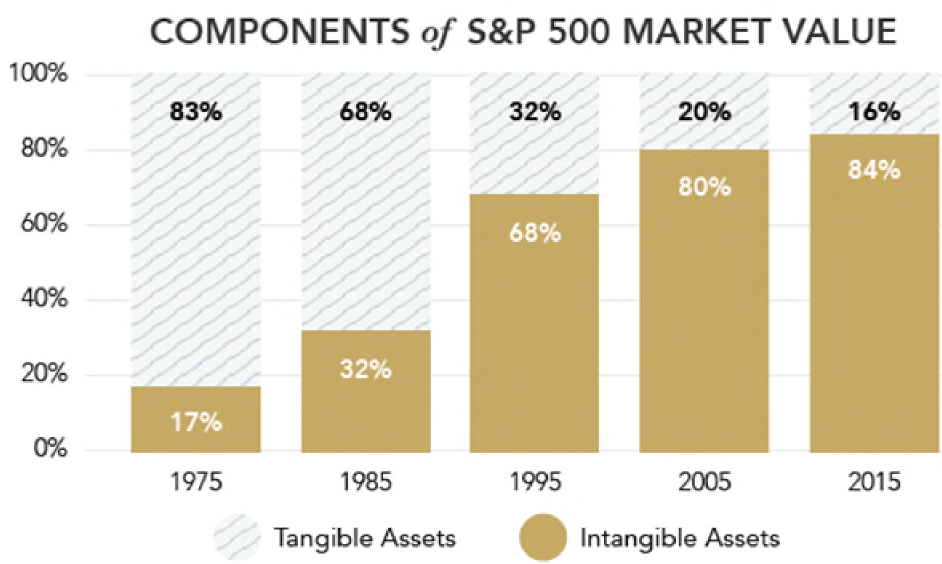
Natixis Investment Managers, our parent company, conducted a survey[1] that asked 9,100 investors in 25 countries whether they find ESG investing important. It found that seven out of ten investors believe that if a strategy is more in-line with a 2°C global warming scenario, they would be more inclined to invest in it.

Seven out of ten also said that it's very important for them to have a positive social impact through their investments. Six out of ten think there's also a link between good ESG practices and performance.

Meanwhile, three quarters would like to see more investment options in their retirement plan and don't have access because there's not enough sustainability options available, or offered to them by their financial adviser.

How would you describe your investment philosophy?

First, we want to outperform the broad global equity market. We measure global equities by the MSCI World index. But we also want to do that with a much better environmental and social profile. ▶



SOURCE: INTANGIBLE ASSET MARKET VALUE STUDY 2017

[1] **Source**: The 2019 Cross-Survey ESG Report, im.natixis.com/intl/research/esg-investing-report-2019

In terms of performance, we think equity markets are taking too much of a short-term focus. As a result, they don't see or don't integrate enough of the growth opportunities. Yet they are supported by important long-term trends that are reshaping our economy and generating long-term return opportunities.

We also believe that ESG risks are not properly priced into the market. Indeed, unfortunately, we've seen too many examples of well-known companies with poor environmental, social and governance practices, where that risk had materialized and led to significant under performance. Think about Volkswagen with its fraud, or Tokyo Electric Power with Fukushima – or BP in the Gulf of Mexico. There are many others across the world.

> *"We've seen too many examples of well-known companies with poor ESG practices, where that risk had materialized and led to significant under performance."*

How does your investment process generate alpha?

There are four key distinct steps in our process. The first is to identify the long-term trends that will reshape our economy and the way we live over the next decade or so. Those companies that are well positioned in those transitions will outperform the ones that don't. We focus on demographic, technological, environmental and governance-related transitions.

After identifying the companies that we believe offer solutions for those long-term transitions, and that are well positioned to benefit from them, we analyse investment opportunities in great detail, to make sure they have the right characteristics that we believe will create long-term value. These include: high barriers to entry, strong competitive advantages, a well-diversified and strong management team and a strong financial structure.

We also focus on the ESG characteristics of a company during this process. Not only do we want to avoid investing in companies that take irresponsible risks, we are also convinced that by having the right ESG characteristics, a company may be able to generate even better returns.

Many investors are ignoring this ESG information, which means that not all the information if fully factored in by current valuations. This gives us many opportunities to generate alpha and outperform.

Written in April 2020

SPINE explained

S = **Sustainability integrated**. When an ESG solution is believed to have a material impact on the performance of a company. For example, if an analyst looks at whether the models of a car manufacturer will be in line with future environmental regulation.

P = **Positive selection**. Where there's the intention to create an ESG or positive profile, or at least avoid the negative impact through the investments. Positive selection looks for companies that essentially have a positive impact on our society.

I = **Impact investing**. This puts impact first – and normally a single impact. For example air quality in a very specific region in the world. Even if the performance is not to the desired standards, the impact alone is a comfort for an impact investor.

N = **Negative screening**. This is a traditional ESG investment approach where you screen out tobacco companies, gambling, weapons and maybe fossil fuels. Many investors, particularly religious clients, want to do negative screening.

E = **Engagement and activism**. This means being an active investor: taking ownership very seriously, engaging directly with the management – potentially putting resolutions up for votes – and making sure that you put that pressure on the company.

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