NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

insights

SEMINAR REPORT

JUNE 2018

SYSTEMATICALLY SUSTAINABLE

ESG Integration in Quantitative Processes

FOR INVESTMENT PROFESSIONALS ONLY
NOT FOR PUBLIC DISTRIBUTION

TABLE *of* CONTENTS

3
from the editor

5
insights

7
who's who

presentations

4
perspectives

9
ESG at IPM

11
integrating the 'G' factor

13
a quant approach to RI

17
another kind of impact

round table discussion

20
ESG as investment factors

23
integrating SDGs: where to start

27
impact through engagement

30
show me the data!

36
about our partners

Aline Reichenberg Gustafsson, CFA
Editor-in-Chief, NordSIP

Welcome to our first issue of NordSIP insights. It is only the first of many, as our aim is to provide the asset management industry with a forum to share information, expertise and research, in other words unique insights to push the boundaries of sustainable investing.

The concepts of Environment, Society and Governance (ESG) and Responsible Investing (RI) no longer need debating. They have progressed fast and are here to stay. In the investment management industry, some actors are at the edge of innovation in the field, others are lagging behind. However, as long as our planet is still in danger and society presents challenges, no one, and especially not the industry as a whole can rest on its laurels.

NordSIP insights will showcase examples of best practice in specific domains, to help institutional investors as well as asset managers take better informed decisions, thereby pushing targets higher and achieve greater results with a triple bottom line in mind.

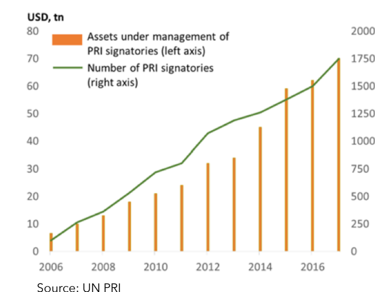
In this edition on systematic strategies, we aim, together with our partners, to paint a detailed picture of where the industry stands, what challenges remain and what concrete steps can be taken to integrate ESG in quantitative strategies.

by Daniel Leveau
IPM

Environmental, Social and Governance (ESG) investing has experienced a tremendous growth over the last decade and many asset owners have made it a prerequisite that their asset managers apply an ESG framework. This has resulted in a continuous development of the methodology on how to integrate ESG in the investment process. Which are the most prevalent trends today and what is academia telling us and how does IPM integrate ESG in its quantitative investment process?

In general terms, ESG has had an impact on investors' investment decision-making processes for as long as investments have been made. Initially, it was mainly driven by religious beliefs and social aspects. Until around the turn of the millennium, ESG still remained somewhat of a niche in the investment landscape and ESG investing mostly focused on not allocating to companies in a few so called 'sin' sectors such as alcohol & tobacco.

However, during the last 10 years, investors' interest in ESG issues has grown significantly. This is, among others, evidenced by the increase in the number of signatories to the Principles for Responsible Investment (PRI). The PRI was initiated by United Nations in 2006 with the objective to 'help investors align their responsible investment practices with the broader sustainable objectives of society'[1]. The total assets under management of the signatories have increased by a factor of 10 over the last decade to reach USD 70 trillion.



Source: UN PRI

ESG issues have thus been a focus area for both asset owners and asset managers, which has resulted in a continuous development of how to best integrate ESG in the investment process. Today the majority of investors are not content with only applying the 'sin'-based exclusion list, but expect their asset managers to implement a more comprehensive approach. This entails actively integrating ESG factors in the investment process as well as taking wide-ranging responsibility as active owners.

Academia and ESG

Over the years, numerous research papers have been published on the topic ESG and its links to investment performance. Their findings have been somewhat inconclusive with a wide range of studies showing positive, non-existing as well as negative correlation[2]. A criticism to the research has been the lack of a standardised underlying ESG methodology used to conduct the studies that often have focused on finding a correlation without necessarily questioning the ever so important causality[3].

Lately, a growing body of research[4] – often conducted by researchers within asset management firms – that focuses on financial metrics as proxies for e.g. good corporate governance has been published, making a convincing case for a factor-based approach to ESG investing. Additionally, as investors at an accelerating rate embrace ESG at the core of their investment process, it is not too bold a statement to make that ESG is expected to have an increasing positive impact on investment results going forward.

1 www.unpri.org/sdgs
2 E.g. Carpenter, G. and O. Wyman. (2009). "Shedding Light on Responsible Investment: Approaches, Returns, Impacts."
3 Harvey, C., Y. Liu and H. Zhu. (2016). "...and the Cross-Section of Expected Returns."
4 E.g. Lee, L-E., S. Doole., R. Marshall and N. Kumar. (2015). "Raising minimum governance standards."

insights

what you really need to know

1 the 'G' factor evidence

Quantitative analysis in ESG has shown evidence that the 'G' or 'Governance' factor has a quantifiable correlation with financial performance. IPM provides its statistics regarding the 'G' factor on **page 12**.

On **page 20**, Gideon Smith says: "When you run back tests using governance information, it delivers real alpha in some markets. We observed such a connection, particularly in emerging markets."

2 compensating for imperfect data

ESG data in general remains noisy and sometimes difficult to work with and interpret. Scores based on MSCI and Sustainalytics data, for example, only have a correlation of 0.4. On **page 15**, Gideon Smith explains how the quantitative still needs much qualitative work. On **page 20**, Stefan Nydahl explains that, at IPM, new data needs to pass high thresholds in terms of quality and consistency before it makes it into the models.

For Otto Francke, Portfolio Manager at SEB, ESG data providers are where fundamental data providers were 20 years ago. He comments on his team's approach on **pages 21** and **22**. On **page 31**, Richard Tyszkiewitcz mentions new data relying on AI and big data, while Gideon Smith remains cautious.

3 engagement has its place in the quant toolbox

GES's Tytti Kaasinen makes a brilliant case for applying engagement in conjunction with quantitative strategies on **page 22**. "If there's no data, if the data is messy or if it is impossible to integrate it into your model, then I would recommend using ESG in a qualitative approach."

Stefan Nydahl talks about IPM's engagement practices on **page 27** and Gideon Smith elaborates on the importance of collaboration on **page 28.**

4 between philanthropy and ESG: different shades of impact

Gideon Smith provides a useful graph in his presentation that plots financial returns against impact returns. While impact investing is traditionally the realm of private equity, he makes the case that listed equities can also achieve some positive impact, albeit in a different way (**page 17**).

5 SDGs: a transition from risk avoidance to opportunity

SDG-focused investing can be a way to link listed strategies with the notion of impact. Tytti Kaasinen sets the picture and Gideon Smith elaborates on the notion of 'SDG-light' investing on **page 25**. On **page 27**, Kaasinen also explains how to use the SDGs in engagement.

While SDGs are all the rage, Gunnela Hahn from the Church of Sweden reminds us on **page 25** that there are other interesting and relevant frameworks, such as the planetary boundaries (more details on page 26). On the same topic, Claudia Stanghellini from AP3 explains the SDG-linked approach her organisation has implemented. She believes that not all SDGs need to be addressed at once, but focusing on those that matter for the organisation is a good start, also on **page 25**.

6 the institutional investor's perspective

At AP3, Claudia Stanghellini observes a shift from risk avoidance to opportunity-seeking when talking about sustainable investing in general, she comments on **page 31**.

Richard Tyszkiewicz from bfinance shares his clients' perspectives throughout the discussion. On **page 20**, he points out that not many investors know that it is possible to have both ESG and systematic strategies in one.

Regarding engagement, institutions' approaches can differ depending on the size of the organisation. Often there is also a matter of PR-management behind the motivation for engagement, says Tyszkiewicz on **page 28**.

Interestingly, institutional investors are often open for asset managers' inputs to guide them in shaping their policies or putting in practice the principles they have adopted, he comments on **page 29.**

who's who

Stefan Nydahl, Ph.D.

Chief Executive Officer, IPM

Stefan is responsible for the day-to-day management of IPM. Before joining the firm in 2015, Stefan spent nine years with the Brummer Group, first as a portfolio manager at the Nektar fund, then in 2006 as a founding partner of Archipel Asset Management where he held the combined position as Managing Director and Chief Investment Officer until 2015. Previously he has held positions as portfolio manager at AMF Pension and Quantal Asset Management and as a research associate at Quantal International and economist at Sveriges Riksbank. He holds a PhD in economics from Uppsala University.

Gideon Smith, CFA

Europe Chief Investment Officer,

AXA Rosenberg Equities

Gideon joined AXA Rosenberg in 1998 and is the Europe chief investment officer co-heading the firm's London office. He previously held a number of positions at the firm, including Europe deputy chief investment officer, director of client services and head of strategy engineering for Europe. Before joining AXA Rosenberg, Gideon trained as a chartered accountant with Arthur Andersen working in their Financial Markets Division in London.

Gideon obtained his BSc from Manchester University in 1992 and received his MBA from London Business School in 2000. He is a holder of the Chartered Financial Analyst designation.

Richard Tyszkiewicz

Senior Director,

bfinance

Richard joined the firm in 2004 in order to build their investment advisory business in the Nordic Region. He has worked on major manager selection, ESG and portfolio strategy projects for over 40 private and public sector institutional clients in the UK, Sweden, Denmark, Finland, Norway and Iceland. Richard has over 26 years' experience within the investment industry, including senior international commercial roles at JP Morgan, Deutsche Bank and ABN AMRO Mellon in Brussels and London. He graduated with an MA (Honours) degree in Business Management and Spanish from the University of St. Andrews.

bfinance is an independent, privately-owned financial services firm that provides advice and support to institutional investors around the globe.

Tytti Kaasinen

Head of Stewardship & Risk Engagement,

GES International

Tytti has ten years of experience in responsible investment and joined GES International in 2011. As the Head of Stewardship & Risk Engagement, she is responsible for coordinating GES's proactive and bespoke engagements, which focus on identifying the most material and topical ESG themes and through structured engagements raising standards across industries and on creating positive change on some of the biggest challenges facing companies, investors and societies. Before joining GES, Tytti worked as a Responsible Investment Analyst at The Co-operative Asset Management in Manchester, UK. She holds a Bachelor's degree in Politics from Manchester Metropolitan University and a Master's degree in International Relations from the University of Manchester.

Daniel Leveau

Director,

Client Portfolio Management,

IPM

Daniel joined IPM as a senior member of the Investment Strategy Team with a primary focus to provide analysis and market insights to investors of the IPM Systematic Equity strategy. Daniel brings extensive experience in equity investing from the global asset management industry across research, portfolio management and product development. Prior to IPM, Daniel was at the Swiss private bank Wegelin & Co., where he was responsible for the design, development and portfolio management of factor-based equity strategies, a ground-breaking concept today better known as Alternative Risk Premia (ARP) strategies. Daniel is a recognised speaker in the field of quantitative equity investing and has frequently published in academic journals and finance magazines with his work being awarded the William Sharpe Award for best indexing research paper in 2012. He holds an M.Sc. in Finance from the University of Lund, Sweden.

ESG at IPM

Presented

by Daniel Leveau, IPM

Swedish-based IPM currently manages around US$9 billion in its two products. One is the IPM Systematic Macro fund, a multi-asset class long/short strategy that was launched in 2003, and the other is an innovative long-only equity product, the IPM Systematic Equity strategy.

Since it was launched in 2006, ESG has been an integral part of the IPM Systematic Equity Strategy, and represents one of the three core beliefs that it relies upon:

- Value investing: "undervalued stocks outperform in the long-term"
- Diversification: "profit from positive diversification properties from diversifying risk factors"
- Sustainability: "positive long-term impact on investment results"

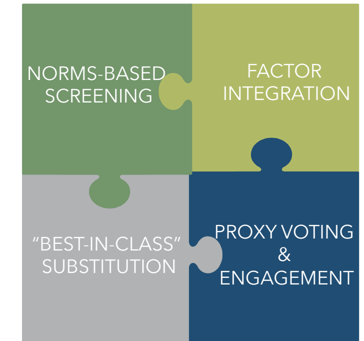
A walk down memory lane

In 2006, the strategy started out with a norms-based screening, coupled with engagement. Three years later, in 2009, IPM formalised its ESG work with the creation of the IPM ESG committee consisting of not only internal, but also external ESG experts. The same year, in parallel, IPM implemented a structured approach to proxy voting.

In 2010, the firm became a signatory to the PRI. 2012 saw factor integration in the quantitative investment process, and one year later, a "best-in-class" substitution was added to compensate unwanted tilts stemming from exclusions. Finally, in 2016, IPM introduced transparent voting, a vote disclosure website, where the firm publishes its voting intentions ahead of the annual general meetings, in addition to disclosing its historical voting records.

Today, the ESG integration in the equity strategy relies on four pillars.

IPM's Four pillars of ESG



Norms–based screening

IPM applies a norms–based screening that aims to avoid investing in companies that do not meet a required standard of business practice based on international norms such as UN Global Impact or weapons–related conventions. As a recent example, in 2017 IPM excluded companies that are deemed to be in violation of the letter or the spirit of the Non–Proliferation Treaty that is in place to prevent the spread of nuclear weapons and related technologies with an ultimate goal of nuclear disarmament.

"Best–in–class" substitution

Excluding companies from a portfolio or reducing their portfolio weightings will in all probability result in unwanted tilts arising (e.g. sector, region or country). To address this issue, IPM applies a "best–in–class" optimisation procedure to counter–balance the lack of exposure, arising from the excluded companies, with companies exhibiting similar characteristics that are in compliance with IPM's ESG policy. The portfolio thus applies a positive selection by increasing weights to companies exhibiting stronger ESG characteristics.

Integration - risk factor quality

Based on the rationale that a weak corporate governance focusing on a company's short–term goals will negatively impact the shareholder value long–term, IPM uses a systematic ESG factor integration in its investment process. The main objective is to discern certain governance risks related to a company's financial discipline – that traditional risk factors normally miss – applying metrics such as accruals and debt coverage ratio.

Accruals has proven to be a viable warning signal for (short–term) earnings manipulation, with the Enron case being the most infamous example, whereas the debt coverage ratio gives an indication of a company's inclination to take on excessive balance sheet risk as well as its ability to service its debt. IPM's ESG factor integration approach results in increased portfolio weightings for companies exhibiting a strong governance, and reduced weighting for companies with a weak governance. The impact on the portfolio is very closely linked to the impact from the risk factor quality.

Engagement and proxy voting

IPM is an active owner and engages with portfolio companies on an ongoing basis to improve their conduct and policies. Engagements are done either individually or through collaborating with other investors. Furthermore, IPM actively exercises its right – or rather obligation – to vote according to best corporate governance standards with the objective to maximise long-term shareholder value. IPM announces in advance how it intends to vote, and investors have on an ongoing basis access to the voting records of each of IPM's equity funds.

Integrating the 'G' factor

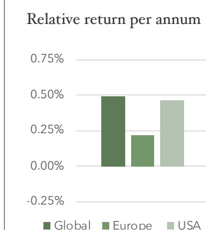
To assess what impact companies' governance has on investment results, IPM conducted an empirical study using various financial metrics as proxies for governance. The analysis was applied on the three equity universes global, Europe and USA for the period 1996–2018.

In a first step, initial portfolio weights were determined using the risk factor value, i.e. overweighting undervalued and underweighting overvalued stocks. In a second step, the initial weights were adjusted according to an aggregate governance score based on the various financial metrics. Portfolio weights for companies exhibiting a weak governance score were reduced and vice versa.

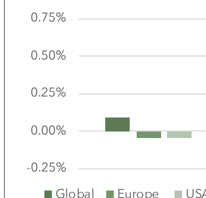
The adjacent graphs show that adjusting for the aggregate governance score had a positive impact between 0,25–0,50% on the average yearly return in all three investment universes, whereas there was no material impact on the volatility. However, risk is a multi-facetted concept and as shown by the maximum cumulative drawdown, adjusting for the governance score resulted in lower drawdowns. On aggregate, the investment results for the chosen period and investment universes thus improved after integrating a governance factor in the quantitative investment process.

Quantifying the G in ESG

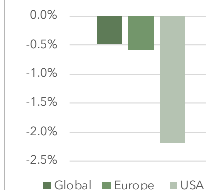
Relative return per annum



Relative volatility per annum



Relative maximum drawdown



Source: IPM analysis. Historical analysis conducted on global, European and US stock universe for the period 1996–2018. Analysis based on returns in USD.

A Quant Approach to RI

Presented
by Gideon Smith, AXA Rosenberg

Rosenberg's journey into sustainability

AXA Rosenberg has been managing quantitative equity strategies for thirty years. Gideon Smith has been with the group for twenty.

When he joined the firm, the first mandates Smith managed were SRI Mandates for religious clients, church organisations, sharia funds, and the like. Quantitative data was used for sophisticated screenings, which allowed portfolio managers to avoid or divest from negative stocks. Over the last 20 years, Smith and his firm have lived through a shift towards ESG integration, which in essence constitutes extra financial information. Today Rosenberg integrates ESG into all of its portfolios, whether clients request it or not. The next step is towards an SDG-focused world, one where impact becomes part of the conversation. Smith insists the word impact be used carefully as it can have different meaning for different investors.

Taking ESG factors into account is nothing more than considering extra financial information whilst evaluating the attractiveness of an asset.

A 3-step approach

"We are worried about the DNA of the company, and not about something that it does in terms of charity."

Rodrigo Amaral, Fundweb,
March 23, 2016

At the core of ESG integration, is this idea that ESG information is economic in nature. The extra financial information can change the fundamental opinion about what the company is worth or what its earnings forecasts will be, and therefore it affect the investment decisions. Taking ESG factors into account is just considering more information.

Optimisation + Targeting

To improve the characteristics of the portfolio, AXA uses data provided by MSCI, Sustainalystics, Vigeo, among others, as well as proprietary data in order and integrates those parameters in the investment decision. The goal is to maximise alpha, minimise risk, maximise positive ESG metrics, and minimise CO_2 impact and water intensity.

ESG data relates to economic decisions. There is a price associated with carbon, and with carbon footprint generation. Ultimately, the company will have to pay that price and if carbon is part of the investment decision, the outcome of the investment will be affected.

Screening + Avoidance

A norms-based approach also provides extra financial information. Controversy for example raises questions around a company's culture. Volkswagen is a current example of a company where controversy is not only relevant when evaluating its business, but also considering what culture the activities have engendered.

In some cases, screening can lead to excluding entire sectors. Rosenberg has taken the view to divest from tobacco based on an economic rationale. The industry is on a path of long-term decline, and while the transition to green coal might save one industry, transitioning to green tobacco is unlikely. Avoiding that industry therefore becomes an investment decision.

Voting + Engagement

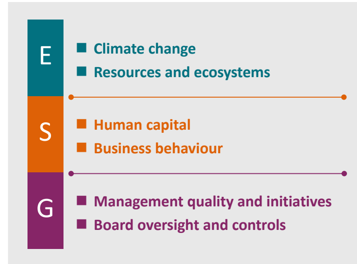
Proxy voting and engaging with companies is a core part of generating a positive economic outcome from investments. This is an area where the blurring between quantitative and qualitative approaches is most pronounced. While engaging with individual companies may be resource intensive it does not necessarily detract from the quantitative nature of the strategy.

Working with imperfect data

The availability of ESG-related data sets has been a game changer for ESG integration. Five years ago, Sustainalytics was one of the first to offer such information. Today, Rosenberg also relies on data from MSCI and Vigeo. In addition, Axa IM built a proprietary data set, which Rosenberg also benefits from.

Data in general remains noisy, and sometimes difficult to work with and interpret. The correlation between MSCI and Sustainalytics is only 0.4. So, what is an ESG score worth to a quantitative manager? Working closely with the data providers is essential to understand what how the data set is constructed. Sustainalytics focuses more on the quality of disclosure, for instance, which can be an important factor. MSCI, on the other hand, is more focused on outcomes. All information has value, but internal experts have to work hard to figure our its materiality.

After the internal data processing, Rosenberg's data set, which covers 6500 companies, is aggregated into 13 different soft factors associated with E, S and G, which result into six components, then into three pillars, and finally an overall score.

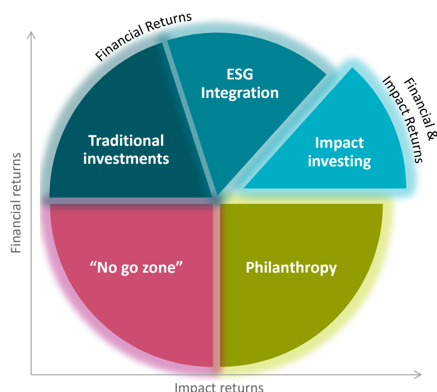


To generate portfolios, a quantitative system relies on data and optimisation. Compared to the usual quant model, Rosenberg's current one integrates the traditional financial inputs, as well as ESG data, such as carbon data or controversy ratings, and in addition to maximising alpha or minimising active risk, it also maximises ESG score, while minimising CO_2 impact, for example.

The quantitative still necessitates much qualitative work. Data sets will not provide the whole picture. An entire team looks at the stocks screened by the system, both the norm-based screen and the other criteria. For controversy stocks, for example, the ESG team helps identify the risks and opportunities behind the story. That information goes beyond what Sustainalytics or others might provide. In other cases there might be other companies that have not yet been identified quantitatively, but that have raised other flags that might lead to a revaluation of the investment rationale.

"I was going to call this 'Putting the AI into RI' but that's a lot of buzzwords... and we need to distinguish hype from reality."

Another Kind of Impact



Impact investing focuses on financing businesses and projects that are designed to have intentional, positive, measurable and sustainable impacts on society whilst simultaneously delivering financial market returns

The chart above maps out the types of investing that coexist in the world of responsible investing. Impact is on the horizontal axis and financial returns on the vertical one. Low impact, low financial returns is clearly an unattractive area. Moving up along the financial returns dimension is where traditionally investments have typically been. Those are typical funds, which goal is to outperform their respective market.

With ESG integration, funds can move to the right, along the impact dimension. The integration of ESG information remains based on an economic decision with the goal to ultimately improve financial returns.

Moving into the 'real' impact zone, people talk about a double bottom line (or sometimes triple bottom line): where the financial result of a typical P&L is complemented by another bottom line of social impact, and even, in third line, environmental impact.

When moving into impact investing, it becomes difficult to argue that there will be no trade-off between financial performance and social and/or environmental impact.

For many clients, giving up some financial performance for positive impact may still be relevant. In this case, investments should be made in financing businesses and projects that have been designed to have an intentional, positive, measurable, sustainable, impact on society, whilst delivering some financial returns at the same time.

This is traditionally the realm of private equity. When an organisation can only invest in public markets, however, there may still be attractive opportunities. 'Listed impact' is an interesting evolution in the field.

Listed impact can be easily linked to SDG-focused investing. The depth of involvement may not be as important as in private equity, but focusing on certain aspects of the SDGs may provide guidance when trying to generate positive impact in public markets. Not all the goals are achievable at once, but a number of them can be relevant when selecting stocks.

For a quantitative investors, it is key to identify vendors that are able to map the company's products and services and the revenues they generate onto the various SDGs. Rosenberg works closely with Oekom in this area. The firm provides data sets of both revenues that are associated with a positive impact and revenues that come in the way of the goals. The screening process is therefore able to focus on those companies whose products and services have a positive impact, but also identify and avoid those companies that obstruct the SDGs.

"For many clients, giving up some financial performance for positive impact may still be relevant."

The system screens the investment universe based on the relevant SDG-linked factors, and then the model optimises the weights by minimising positive-impact revenue and minimising obstructive revenue.

The prototype initially built by Rosenberg focused on four particular themes, focused on a particular client's objectives: Climate change, Health, Water Scarcity and Food Security. This opens an opportunity to propose customised products to fit the impact requirements of each client's philosophy, business activities and long-term goals.

The Sustainable Development Goals (SDGs), otherwise known as the Global Goals, are a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity.

These 17 Goals build on the successes of the Millennium Development Goals, while including new areas such as climate change, economic inequality, innovation, sustainable consumption, peace and justice, among other priorities. The goals are interconnected – often the key to success on one will involve tackling issues more commonly associated with another.

The SDGs work in the spirit of partnership and pragmatism to make the right choices now to improve life, in a sustainable way, for future generations. They provide clear guidelines and targets for all countries to adopt in accordance with their own priorities and the environmental challenges of the world at large. The SDGs are an inclusive agenda. They tackle the root causes of poverty and unite us together to make a positive change for both people and planet. "Poverty eradication is at the heart of the 2030 Agenda, and so is the commitment to leave no-one behind," UNDP Administrator Achim Steiner said. "The Agenda offers a unique opportunity to put the whole world on a more prosperous and sustainable development path. In many ways, it reflects what UNDP was created for."

Source: http://www.undp.org/content/undp/en/home/sustainable-development-goals.html

"We are quite conservative or rather prudent regarding the requirement we put on the underlying data."

Stefan Nydahl, IPM

ESG as investment factors

A delicate balance

Introducing the discussion, Stefan Nydahl summarises IPM's previous presentation and brings forward his firm's view on ESG as investment factors. "We have concluded from our work that certain ESG factors are easier to integrate into the systematic approach than others," Nydahl offers. "In particular, we believe that integrating the 'G' in ESG is the easiest for us to do. For the 'E' and the 'S', we have taken slightly different approaches. We use external experts and try to balance the qualitative nature of the data with our systematic approach, as mentioned in our presentation." Nydahl also stresses that IPM is rather careful when it comes to the type of data it integrates. "We are not the first movers in using new data. We are quite conservative or rather prudent regarding the requirement we put on the underlying data, for example when it comes to how far back in time the historical data are available." To summarise his firm's approach to ESG factor investing, Nydahl adds: "It is an intricate balance between the quantitative and qualitative; however, for us the most important thing is to include it in a systematic investment process."

ESG as a risk filter

Gideon Smith concurs that the "G" stands out as a factor. "Governance is an area where, through research, you can demonstrate a connection with investment performance. When you run back tests using governance information, it delivers real alpha in some markets. We observed such a connection, particularly in emerging markets. Whilst generally ESG data doesn't have enough history to enable this type of alpha-driven analysis, I do think it can still be justified on a risk-based approach. The information itself is uncorrelated with many of our other signals. As a result, when we 'switch on' ESG, we can maintain the same fundamental characteristics of the portfolio whilst still achieving the risk/return benefits associated with ESG."

The convergence of two trends

Richard Tyszkiewicz shares his clients' perspective. "From what I have seen, the adoption of ESG as investment factors has been a fairly slow process in general that suddenly accelerated in the last 18 months. Now pretty much everybody takes ESG seriously. What we have observed in all the searches we have performed is that, whenever people have come to us with stringent ESG requirements, they tended to be focusing more along the lines of fundamental stock picking. What is happening now – and perhaps that is why this discussion is so interesting – is that we may see a convergence of two trends. On the one hand, investors are starting to understand ESG much better. They view it less as an imposition and more as an opportunity or a way of managing risk. On the other hand, we see a

"When we speak to the ESG data providers, they are where the fundamental data providers were 20 years ago."

Otto Francke, SEB

trend towards more systematic strategies and smart data or factor-based investing. However, so far, I can say that we have performed extensive searches in smart beta where ESG hasn't been a major concern for our clients."

"We have also performed rigorous ESG searches," Tyszkiewicz continues, "but they focused on the fundamental managers. I believe it to be a promising trend and it is more likely to take off now that a more substantial body of data has become available. Now people can use that data to show evidence, rather than act on a hunch that ESG is the right thing to do."

Is ESG an actual risk factor?

Irene Mastelli, Strategist at Nordea, challenges the managers, however: "Many managers who talk about ESG, can't quite talk about it in terms of an actual risk factor, except maybe very few. So if you are a factor investor, for example, IPM, how do you think about ESG if you can't quite integrate it as a factor?"

Nydahl answers the question and refers back to IPM's earlier presentation. "We must distinguish between what is a quantifiable factor and what is less tangible. We can take qualitative data and work with engagement lists or other soft variables. But then we research ways to use those inputs and integrate them systematically into our investment processes. In some cases, this is more about making sure that we do not have a negative exposure to a certain ESG dimension, e.g. by excluding companies, while still keeping intact the profile of the portfolio. To a certain degree, it becomes related to factor investing, as we use ESG as risk factors to be avoided."

There are factors and factors

To frame the issue, Smith discusses the definition of "factors". "One of the challenges is that the term factor investing itself is quite loaded. It can mean many different things. There are four classical factors that people like to talk about: 'quality', 'momentum', 'value' and 'growth'." Smith makes the point that E, S and G are sometimes referred to as factors, and he emphasises that there can be a link. "My take is that factors are attractive because they're linked to fundamentals, and most of us are fundamental investors at heart. The reason why quality works is that lower volatility earnings deliver better, more stable, returns. I think ESG information, particularly governance, is a 'sub-factor' of quality. It's a proxy for a particular aspect of quality. Can we characterise ESG in general as a factor? I like the idea, but we don't have the data history to demonstrate the long-term connection to fundamentals. We have to take an economic view on that."

Nydahl's stresses that the use of ESG as factors may be made more difficult by the absence of clear investment rules. "We still lack a clear commonly accepted taxonomy for ESG. It's still open to interpretation regarding both what we as managers think is important and what our investors care about. You have this broad framework that we all agree is very important, but then still leaves much room for interpretation."

Questioning data quality and precision

Otto Francke, Portfolio Manager at SEB, shares his experience with imperfect data. "We looked at starting to use data from the quant perspective. When we speak to the ESG data providers, they are where the fundamental data providers were 20 years ago. They don't care about the point in time for the data they collect, for example. If we ask: when did you receive this data? When did it go into the database? - they don't know. Perhaps there was a lag of a few months, but who knows how many. From a quant perspective, this level of detail is fundamental when you integrate new data."

The link between factors and returns

Francke elaborates on how he and his team have started to think how factors can relate to returns. "Regarding the returns of the factors, we ask ourselves, why would this factor be rewarded? Is it a compensated risk factor, or not? And, if so, who is on the other side? Does it have behavioural-, structural- or risk based reasons for existing? We are currently discussing internally how we think about it, and how we address those issues."

An opportunity to use qualitative factors

Tytti Kaasinen makes a case for the qualitative aspects that can compensate for the lack of data. "There is a reason why ESG issues are often referred to as extra-financial. They don't always behave the same way as the financial factors. Also, they may often be more difficult to measure than other more traditional indicators. How would you put an economic number on human rights? Or on the value of a person's integrity in some company's supply chain? While they might not appear to be directly quantifiable, these are still issues that are expected to be taken into account by companies, and increasingly by investors, and different stakeholders have different expectations for companies.

Kaasinen makes a case for engagement: "If there's no data, if the data is messy or if it is impossible to integrate it into your models, then I would recommend using ESG in a qualitative approach. Any of the information that you get from having direct contact with companies takes a lot more time and effort than accessing data directly. Speaking directly to the companies, engaging and getting a feel for their management, however, may provide insights into whether they have a holistic understanding of their operating environment. Then we can better assess the company's preparedness relating to ESG risks and opportunities, which is often something that happens behind the scenes inside the company. There is also value in two-way communication between the company and the investor that can focus on different aspects. While it may be harder to include that type of value in a model, it is a rather straightforward process, and I would like to highlight engagement as a tool in parallel to the availability of raw data. It is perhaps a messier option, but exciting nonetheless.

"There is a reason why ESG issues are often referred to as extra-financial. They don't always behave the same way as the financial factors."

Tytti Kaasinen, GES International

Integrating SDGs: Where to start

The UN Sustainable Development Goals (SDGs) have become an increasingly popular way to analyse and identify issues of sustainability, and many investors look at these goals with the aim to generate positive impact with their investments. Kaasinen opens the discussion about how to integrate SDGs in the investment process. She insists on the importance of having an honest and transparent approach and warns against SDG-washing.

SDGs relevant for global investors

"SDGs have become undeniably relevant for investors, particularly universal owners who place money all over the world," Kaasinen says. "The sustainable development goals are aimed at solving issues around the world, and particularly in developing countries. If the situation improves through achieving these goals, the society, the economy and market conditions, in general, will benefit. For an investor who has exposure to different markets, these improvements are likely to provide better opportunities, or more stable economies to be involved in either directly or indirectly, in the short term as well as more long-term. This is why the SDGs are a directly financially relevant framework particularly for investors with a broad portfolio."

From avoiding risks to seeking opportunities

"What I like about the SDGs compared to more traditional ways of thinking about ESG, is that the SDGs more explicitly address also the opportunities and the future. ESG traditionally may have been more about avoiding risk while not harming either companies or investors," Kaasinen continues. "Very often, integrating ESG in the investment process in practice means avoiding tainted companies or divesting from certain sectors and avoiding ESG risk while minimising the impact on performance. With the SDGs, it widens the perspective to opportunities and possibilities, to the potential for a positive company impact and what needs to be done, not just focusing on what needs to be avoided. This is not to say that one shouldn't pay attention to the risk of having a negative impact through corporate activities or investments which hinder the progress towards these goals. SDGs are a framework that makes it easier to find interesting and sustainable investment opportunities, in a more structured way and in a way that contributes to developments which the whole world agrees are desirable."

SDG-washing: A World of Difference

"SDGs have existed for over two years, but the adoption was slow at the beginning. Only now are we starting to talk about it properly and see concrete measures. Today the level of related disclosure is much higher, from the companies as well as from investors. More people present their activities in light of the SDGs. It has taken off properly now, I believe. People should be careful about SDG-washing their normal activities, however. You can't just say that you are doing the same thing as you have always done but now, this is because of the SDGs. I believe that it is a good idea to pick the goals that are the most material for you or where you can have most impact and focus on those, instead of trying to pretend to address them all. It is just not credible, as you would be spreading yourself too thin. Individual investors and companies are not expected to address all the SDGs. Your clients or your fiduciaries are going to be more interested in what you do if you focus on the goals that are the most relevant to them, and therefore for you. If you are a teachers' pension fund, for example, the SDG related to education might be the right goal to focus on. The key is to integrate them thoughtfully, and not just tick the SDG box. Think of new opportunities and how what you're doing is really contributing to the goals. Doing just the same what you have been doing for the last 15 years – but now phrasing it differently – doesn't usually cut it."

'SDG-light': More than ESG integration, but not quite impact investing

Smith returns to a notion he elaborated in his presentation, where he talked about different shades of sustainable investing, where impact and ESG integration are part of different quadrants. "I think that there is a question of degree," he says. "It is in the interest of large 'universal' owners to focus on improving the condition of the society, economy and environment they operate in, and to set aside a part of their budget to do 'impact investing'. Within listed equity space there is a move to look at companies and entities through an SDG lens, which some may feel is simply 'SDG-washing'. However, one can argue that there is also an opportunity to bring the significant weight of public assets to bear. I hesitate to call it 'SDG-light', but that is not necessarily a bad thing. SDGs have a role to play in blurring the lines between traditional and impact investing. The volume of assets may be too large for a focused impact approach, but incorporating SDGs can still have a broader positive effect on society. We need to come up with the right language for it... be it SDG-focused, SDG-light or listed impact. It is not impact investing in the traditional sense, but it certainly goes beyond simple ESG integration."

"Focusing on the SDGs may lead us to forget the big picture."

Gunnela Hahn, Church of Sweden

Quantitative integration remains a challenge

For Nydahl, SDGs don't solve the problems raised earlier about quantitative integration. "It is a very important area," he says, "and therefore, it is something to take into consideration. Then again, the problem with quantifying SDGs is that there are very few standardised variables offered by reliable data sources that can be used. That, of course, will always be a challenge when integrating a concept into a quantitative process. Of course, to emphasise Gideon's point, you could argue that SDGs should bring something positive and therefore, there is a conversation to be had with investors.

"However, we then face the challenge of measuring the historical effects of such decisions on the portfolios. The question is not only 'does it help to make more money?' It is also about how it alters the risk exposure, and how it changes the profile of the portfolio. That is something that remains difficult to accurately assess without appropriate data."

A step towards common standards

For Tyszkiewicz and the clients he has worked with, SDGs perhaps fill yet another purpose: to help design mandates and find common grounds, but also to measure the non-financial results of sustainable investing. "Definitely SDGs help start to address a practical problem we have been seeing for a long time. While they may all be trying to implement an ESG policy, 90% of my clients prefer pooled funds. This issue always comes up and we end up having to launch a search for pooled funds 'preferred', but end up finding that the client needs a segregated account because something in the standardised product doesn't quite fit the ESG requirements. There is a long way to go because the SDGs have 169 sub-targets. The challenge is to build, first of all, a common language so that standardising is possible. As Gideon suggested, packaging them in thematic building blocks may allow clients to customise their own portfolio without having to take segregated mandates and the extra cost and hassle that that brings. I find this to be a very good initiative. It may take time, as Stefan alluded, given that the availability of data underlying all goals varies a lot. Developed markets and large-cap companies may provide solid data, but in emerging markets and with smaller companies, this data is harder to come by, and that is

where the legwork comes in. As that improves, over time, it may become easier to put these products together. In addition, another important aspect in our job, as well as from an investor's point of view, is measuring the non-financial performance of these products. Today, that is also very much a work in progress. Many different initiatives are trying to create a standard metric or common language that people can refer to, to show how well they have performed on a non-financial basis."

Contrasting a more scientific approach

Gunnela Hahn from the Church of Sweden intervenes at this stage to put the SDGs into perspective with other measurements she thinks are equally, if not more relevant. "With our financial policy, at the Church of Sweden, we want to invest for the benefit of society, all over the world, and have also added the 17 SDGs. However, focusing on the SDGs may lead us to forget the big picture. In the first place, we have to keep our planet healthy, in order to be able to achieve all these great and sustainable goals. But the SDGs address more social than environmental goals, which could become a problem. It may have become very fashionable to talk about the SDGs, but the world out there hasn't changed just because we have introduced these goals. Planetary boundaries, for instance, is another concept that is considered a buzz word in certain sectors or subcultures. It presents a more scientific approach, acknowledging the physical constraints on our planet, and I believe that we need to be mindful about earth system science when talking about investing for the future. How does a particular portfolio affect the planetary boundaries? Science-based targets are also something that investors can work with. They give us an understanding on how well a company is positioned to an absolute target, such as the two degree climate goal, that we need to comply with. Why should we only work with the SDGs? The science-based targets approach is very hands-on and is based on scientific facts and measurements that tell us if we really are on the right track or are not doing enough. What about sustainable cities? In the group of investors I work with on goal 11, Sustainable Cities, we focus more on how to find ways to make new investments than to measure the impact. And common sense is often enough. We know that energy, water and waste management as well as mobility and buildings need to be clean and green in a sustainable city, even if we cannot measure the total impact. If measurement is so central, why don't we measure all our current investments to see what our actual impact is today, both positive and negative?"

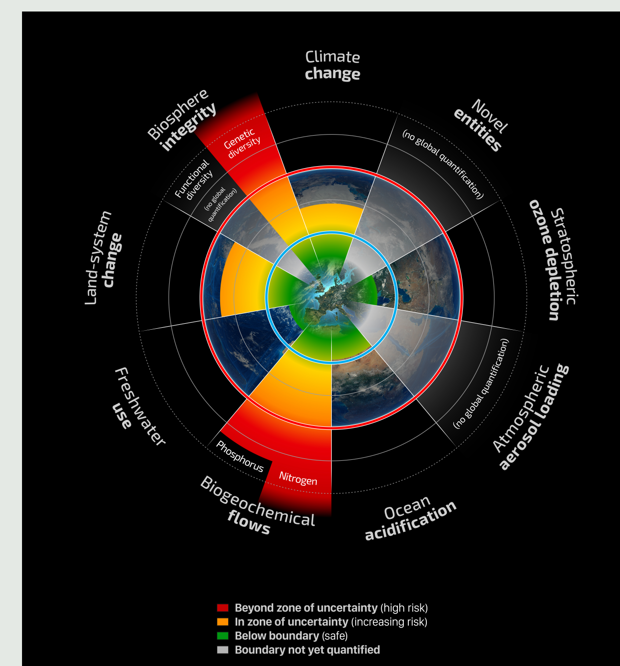
Examples of SDGs at work

Claudia Stanghellini, who works at the Swedish state pension fund AP3, shares how the SDGs have helped her organisation identify and set targets. She also emphasises the importance of determining a number of relevant goals.

"In 2014 we chose four sustainable development goals, and we set specific targets to be reached by 2018. For example, we decided to cut our carbon footprint in half and to triple our green bond investments. On the point about sustainable cities, we are large investors in real estate and infrastructure. The Swedish real estate company Vasakronan, for example, is an example that we want to bring forward for sustainable building and development. We want to set these kinds of targets for all our property and infrastructure investments. Of course, we are looking to invest more in sustainable investments. We are moving forward with these goals. It is a very long-term process, and we still have got a lot to achieve. The key is to choose some of the SDGs and to work selectively with some of them to try to implement changes progressively.

Claudia Stanghellini, AP3

The Planetary Boundaries



Credit: F. Pharand-Deschênes/Globaïa

The planetary boundaries concept presents a set of nine planetary boundaries within which humanity can continue to develop and thrive for generations to come.

In 2009, Johan Rockström, director at the Stockholm Resilience Centre (SRC) led a group of 28 internationally renowned scientists to identify the nine processes that regulate the stability and resilience of the Earth system. The scientists proposed quantitative planetary boundaries within which humanity can continue to develop and thrive for generations to come. Crossing these boundaries increases the risk of generating large-scale abrupt or irreversible environmental changes. Since then the planetary boundaries framework has generated enormous interest within science, policy, and practice.

The first scientific article on the framework was published in 2009 in the journal Ecology and Society and as of January 2018 has been cited 685 times. A feature article in *Nature* the same year generated more than 2,535 citations, according to Web of Science. New scientific insights on several of the processes were included in the 2015 update, published in *Science*. It stated that society's activities have pushed climate change, biodiversity loss, shifts in nutrient cycles (nitrogen and phosphorus), and land use beyond the boundaries into unprecedented territory. Research and debate continue on the boundaries for water-system change and chemical pollution.

Source: http://www.stockholmresilience.org/research/planetary-boundaries.html

Impact Through Engagement

Tytti Kaasinen, GES International

SDGs as a tool for engagement

Kaasinen returns to the core of her experience and shares insights into how to use SDGs in the context of engagement. But first, she elaborates a little about the way GES structures its engagement work.

"We have two kinds of approaches," she explains, "The first one is our traditional approach: norms-based, or screening-based, which means that we identify companies that are associated with some wrongdoing or breach of international norms in any areas related to ESG. We then engage reactively in order for the companies in question to both rectify the situation and strengthen their practices to mitigate the risk of getting involved in a similar incident in the future. The other approach is proactive where the company hasn't necessary been reported as doing anything wrong, but where we identify hot topics and material ESG issues that companies and investors should be aware of and managing before things get too critical. We choose an angle that makes sense from an investor and company perspective. Based on that topic, we select focus sectors and companies that we believe should be preparing for certain risks, or adapting to capture opportunities. As we represent investors, we want to ensure that the companies are well prepared in advance, instead of running their operation with a higher risk or postponing action until *after* they face setbacks."

"In both the reactive norms-based approach and the thematic, proactive one, we have been mapping our existing engagements against the SDGs to be able to show better how what we do on our clients' behalf contribute to the SDG agenda and to enable clients to know which SDGs they are supporting through our work. We also utilise the SDG framework to make sure that we are choosing relevant hot topics in our proactive efforts. We want to propose something that is in line with the comprehensive ESG challenges the world has collectively identified and decided to focus on. As we interact with companies and collaborate with our clients, we can contribute to this mutual framework. By using the SDGs to map our efforts, we make sure that we help reinforce and not accidentally contradict any parts of the SDG agenda, so that we can help achieve the right kind of impact."

Engaging in a systematic way

Nydahl goes on to explain how his firm uses GES's services. "For us, engagement is an important aspect of what we want to achieve. We realised early on that it would be more beneficial to use outside expertise to cover this area, so we decided at an early stage to engage with companies through GES. We aim to be systematic in our approach to engagement as well, even though GES's input is more qualitative in nature and involves a lot of human legwork. We have an ESG committee, of which Tytti is a member. From the start, the CEO or deputy CEO of IPM have been on the ESG committee. We believe it is important that management shows direct involvement in our ESG work. The committee meets on a regular basis, and among other things we go through GES's engagement lists. If a company is on the engagement list and they do nothing to improve for a year, then we exclude them from our portfolios. We, as in IPM, send them a letter, saying that we have been watching them closely, and that they have been excluded. We also send them a letter if they are re-included. It is worth noting sending a letter regarding a re-inclusion is not a very common practise among asset managers. A large US-based technology company once sent us a thank you note, saying that it was the first time they had heard any positive feedback. That is possibly a lesson for all of us. It is easy to complain about what companies do not do, but when they improve perhaps we should also make sure to let them know."

"In our investment process, engagement becomes digital. Here again, it is critical how we integrate this type of data into our quantitative process. Values for engagement in the model are set either to zero or one, depending on whether a company is included or excluded. When a company is excluded, our process finds a 'best-in-class substitution', so that the portfolio maintains the same risk profile as if the position had not been excluded. This goes for norm-based as well as engagement-based exclusions."

Stronger together

For Smith, one of the keys to successful engagement is the ability for investors to act in concert. "It is hard to get away from the fact that engagement is a resource-intensive activity. At Rosenberg, we are fortunate that AXA Investment Managers have a dedicated team engaging with companies. We also benefit from having a parent who is interested and engaged, and an 'activist' in their own right. We also work together with other investors where appropriate. It is important that we look for those opportunities to work together, where interests are aligned."

Kaasinen supports Smith's arguments for collaboration and elaborates on the risk that individual engagement could potentially generate. "Collaboration is important and impactful at the same time. Individual investors might lack resources, expertise, or leverage to influence companies. However, coming together, combining assets under management, expertise and resources opens up a world of opportunities and allows for better results. This is relevant not only on a practical level but also to ensure that messages and intentions are aligned. When talking to companies separately, how do investors make sure that one is not asking something, and another is asking something else, so that the company is caught in a cross-fire trying to please everyone? That would be messy. It is essential that the investors have some understanding or mutual view of what is desirable and what the priorities are. Engagement should not cause any harm or hinder the company in the management of these delicate issues."

Behind the scene: addressing PR issues

Beyond the debate of whether engagement enhances financial returns or only satisfies an ethical requirement, Tyszkiewicz brings up another important point that often remains behind the ESG scene. "Engagement from our clients' perspective is very size dependent. We have some larger clients such as the Swedish state pension AP7 for example, who are quite happy to catch a plane and go and sue Facebook. That is perhaps not quite typical for our clients, but it does happen. Most of our clients want to outsource engagement, as it is a labour-intensive job, as it has been already mentioned. The crucial point we hear from every single client is a need to know what is going on. They want to know very quickly from their fund managers or their data providers if there is anything in the portfolio that has an issue, so that they can prepare an appropriate answer. That is another thing that is not so often associated with ESG. Most investors will say they choose to integrate ESG because of altruism or to save the planet, or increasingly for financial reasons. Behind the scenes, however, lies the PR risk. It is crucial for large pension funds to avoid reputation-damaging headlines. Managers and data providers should, therefore, remember to get on the phone immediately if something happens, to enable their investor to answer the question that they are inevitably going to receive from their members or the press."

What are the trends in investors' policies?

"Policies vary widely, and in many cases, criteria are not very precisely stated. This is why SDGs are so interesting."

Richard Tyszkiewicz, bfinance

Answering a question from a guest, Tyszkiewicz gives an insight into how different institutions around Europe address ESG in their investment policies.

"It varies hugely," he starts. "I cover the Nordics, and it is fair to say the Nordics are ahead of the curve. I'm generalising of course, but it is especially true regarding the clarity of the demands included in the policy. That is particularly useful when we run a search, as it helps the managers to know what they are supposed to be doing. Interestingly, however, in some of the 'deep' ESG searches we have run, our client looks for managers to help them develop their policy, and not just manage their money. That is one of the additional criteria we put in place when we focus our search on ESG. It is not just about compliance with ESG criteria, but we also look for thought leadership, and the ability to help the investors develop their policies. Quite often, their starting point is a negative screening, and they need guidance to achieve something more sophisticated, along the spectrum that Gideon showed."

"Policies vary widely, and in many cases, criteria are not very precisely stated. This is why SDGs are so interesting. Many are also excited about the idea of a taxonomy put forward by the European Union, following the recommendations of the high-level expert group. These concepts are trickling down even into the UK, where asset owners, trustee panels and consultants are all being told that they have to start addressing ESG, and not just as an afterthought. In contrast, in the Nordics, there is often quite a long track record of looking at ESG issues, and the policies are more precise in their requirements. There is a strong local collaboration as well, so the level of knowledge is high. In other markets, in southern Europe for example, the clients we see are perhaps not as advanced. In Asia or the U.S., the investors are also a little further down on their learning curve."

Work in progress

Sharing more of the observations he can make about his clients' demand, Tyszkiewicz believes progress is still very much ongoing, especially when it comes to ESG in quantitative strategies,

"Clients are still learning about everything we are discussing today. The convergence of systematic and ESG trends is still happening, and it depends on where the client is along that thought process, not the least because of data scarcity. I know that one of the main index providers has produced some interesting studies on what we are looking at today, where they test factor-based portfolios, taking some away, or adding some new and seeing what effect ESG has. This is still far from the mainstream, however. Investors must first become more comfortable with the quality of the inputs going into these processes, the ability to measure performance and to implement it practically."

Given the preference of asset owners for pooled funds, the development of a common ESG ground seems to be a must for the market to take off. "Standardising and developing a taxonomy are crucial. If there are as many ESG policies as there are asset owners, that means asset managers can't cater to a wide enough audience. As long as that is the case, the take up of those strategies might be limited."

Do no harm to performance

For Nydahl the key to ensuring a successful path for sustainable investing in systematic strategies is the ability to demonstrate a positive impact on the investment results. "As Richard said, many investors still look at this trend in different ways, but so far, our main conclusion is that when we integrate ESG, it doesn't have to be a drag on returns. And as we said earlier, regarding the governance factor, we can often see a positive effect."

"Of course, as Gideon said, governance is closely linked to what we have looked at regarding the risk factor quality for many years. That being said, when portfolio managers take into account some of the sustainability elements, whether in a systematic or in a discretionary manner, they might have looked at such factors anyway, without calling it ESG. Therefore, the marginal impact of integrating new elements that come through ESG analysis alone is most likely harder to assess. Regarding systematic integration, we believe in an approach which includes both the human legwork and quantitative factors, and that is an approach we are very happy with."

Show me the data!

Stories bring strategies to life

For Smith, measurements and ratings provide useful guidance, but clients want to hear stories, which can be a challenge in the context of a quantitative strategy. "I am a systematic and quant investor at heart. Like many people, I want to find some nice quantitative value to capture my investment outcomes. Give me a metric, or an ESG score, or a number of sustainability globes, so I can measure myself against a benchmark. We can build portfolios this way, targeting and optimising the relevant metrics. More than that, we believe there is clear economic case for doing so and that this is an opportunity to add value for clients."

However, simple metrics may not make the case for some clients. "Bringing the strategy to life for clients is challenging. You can't get away from telling stories. So even though diversification is

Gideon Smith, AXA Rosenberg

key when building a portfolio, and we may own hundreds of positions, clients like to hear the story about two or three of our holdings and why they are 'sustainable'. Those examples bring the investment process to life for them, even though the holdings may only represent a small part of the portfolio. Hence we like to look at the biggest contributors along various ESG dimensions and build a narrative for our clients. That said, we try to stop short of attributing short term portfolio performance to ESG. Investors would like us to say: 'ESG added x basis points of alpha over this period.' But ESG is a forward-looking idea... it's about avoiding long-term risks, or pursuing opportunities that lie far ahead. These may not manifest themselves this quarter or this month, and therefore may not show in today's performance figures. It is sometimes hard to shift between a short-term performance perspective and long-term oriented investment views such as ESG."

An evolution from risk-avoidance to opportunity-oriented thinking

Stanghellini emphasises the development that investors at AP3 have gone through, going from risk-avoidance to opportunity-seeking. "A few years ago, we might have thought about selecting companies based on ESG to avoid risks, not being entirely sure if we would be getting better returns. We have moved on from there since, and we believe nowadays that exposure to good responsible companies generates better returns over the long-term." Smith shares this type of thought evolution. "Historically, we used to say 'we are not sure about the ESG, but for sure it helps avoid certain risks.' That is the rationale we presented. We have moved on from there now that we can demonstrate opportunities, such as the link between governance and earnings quality, or diversity and profitability."

Short- versus long-term mindset

"However, some of the risks and opportunities are truly long-term," Smith continues. "The negative screen for tobacco is a good example, given that it is easily integrated into a traditional investment case. We made the call to exclude tobacco firms two weeks before the FDA made their announcement, which was a nice story to tell. In reality, we think that these types of decision will play out over the next ten years. We don't know when the case will materialise in the asset prices. If a client asks me to show the cost or benefit of our tobacco screening this month, I'm not sure that's the right thing for them to be looking at. This highlights the real challenge of short- versus long-term thinking."

Closing the loop

The long term is where the line between sustainable and traditional investing is indeed blurred. To summarise the challenges this discussion highlights, pushing investors' time horizon further out in time and integrating ESG seems to be the same pursuit, or at least an essential aspect of making ESG an element of universal financial investment principles.

Tyszkiewicz proposes some evidence that the trend may already have started. "I have noticed something completely anecdotal, but it may be indicative of a trend: managers with two flavours of the same systematic product, one ESG, one non-ESG, who recently merged the two. It is statistically insignificant, but it seems interesting to me, in the sense that they have concluded that the ESG product was at least as good as the non-ESG one, so they stuck them together."

Data of the future

Tyszkiewicz brings up an interesting example of a new kind of data that could provide a complement to existing solutions and shows what technological innovation can bring to ESG analysis.

"I met an interesting company recently, which is using a different approach to get ESG ratings on companies by using an artificial intelligence platform, which is fed by Big Data. There's a couple of buzzwords for you. They take 75,000 different sources of information, and they deliberately avoid the official company publications. They look at press articles, news blogs and so on, sources that are supposedly curated to be of good quality. They don't see themselves as replacing the existing traditional ESG data providers like Sustainalytics, but as providing a different angle. That data is real time so that you can plug in your portfolio into their machine and it spits back real-time ratings. Of course, their backtesting shows alpha generation over time, but the system still has to be tested. It is interesting to watch the new solutions as they appear, especially as data is at the core of systematic investing."

Show me the rationale

Amidst the plethora of new data sets coming up, Smith voices some scepticism. "Regarding new data, as Stefan said, you need to consider the economic rationale behind it. Data providers often come to us with interesting new data sets. However, unless we can understand how the data connects to real economic concepts, we remain somewhat sceptical. You can find spurious correlations between any data. As Stefan mentioned earlier, the quality of information that's available in the ESG space is about as good as the financial data that was available 20 years ago. The amount of effort you need to put into cleaning, integrating and correcting much of that data is significant."

Tyszkiewicz stresses the difference in data availability in different markets, although according to Smith, in some areas, emerging market data can be as good as in developed markets. "Some of these data sets, for example when looking at media stats, provide as much information about emerging market companies as there are in developed market companies. So this can be an interesting alternative to traditional data." This presupposes the integration of languages other than English, Tyszkiewicz underlines.

Keeping engagement credible through accountability

Going back to engagement, for Kaasinen accountability is an important point. "Quality reporting is crucial to

ensure the integrity of the engagement process and making sure that it is not a tick-in-the-box exercise. Through engagement, investors should intend to change something. Engagement shouldn't be for the sake of engagement itself, or to avoid having to exclude companies. Investors should develop specific goals, to improve something in the company. ESG integration, in general, should be built around a goal; there is supposed to be a reason for it. With this in mind, you should be able to measure to what extent you have been successful in having an impact, or making progress. The process you choose for this, as well as the reporting, can look different depending on what suits your investment strategy, but you should report. The key is to have a goal and avoid box ticking."

"There is an increasing demand from our clients, who certainly feel the pressure from their clients respectively, to be able to show the measurable impact of ESG integration or engagement. It doesn't always have to do with portfolio performance, particularly when talking about engagement. They want to confirm that engagement produces results; that it is not all talk, but leads to concrete results. We have therefore developed indicators that show where companies are meeting milestones on their way towards reaching the ultimate goal, which we have clearly set at the beginning of the process."

"Generally, we can illustrate developments with the KPIs we measure all our engagement cases on, assessing the progress and the responses we receive from the company. We illustrate to what extent the dialogue has evolved, and we evaluate if the identified gaps are closing and the promises the company made are materialising or not. Our efforts don't always pay off, and we should be transparent about that too. Engagement is not all plain sailing, and it is not a golden arrow that always saves portfolios and the world. In fact, it is useful to recognise that sometimes engagement is not leading anywhere, and then it is time to let go. Such cases might lead to exclusions. As Stefan explained, if the confidence in the company is not improving, then the exclusion option is always available. There are two sides to the same coin, and they could be intertwined as well. Measuring the impact, knowing what you're trying to achieve, and then disclosing it, are good steps towards showing what is possible and what works specifically for you."

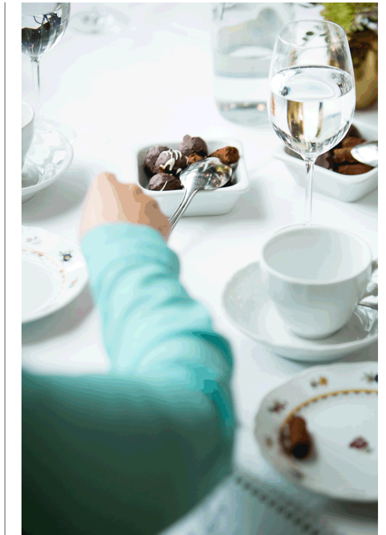
Transparency key in reporting practices

Kaasinen brings up PRI reporting as a useful tool in furthering accountability. "Most investors are PRI signatories by now. This means that at least once a year, they have to look back and put some statistics on what they have been doing concerning ESG. Beyond that, many investors have their own quarterly or annual responsible investment reporting. Quarterly reporting can be tricky, as we established earlier, given the long-term nature of sustainability. Telling stories about company engagements every quarter works of course. By doing so, an investor can keep the story alive throughout the year, but it is difficult to bring statistical evidence over such a short time span. Voting can be an exception to this, as it can illustrate efforts particularly during certain periods of the year."

"Transparency should be a key concern for investors. It is something that we are demanding from companies. A large part of engagement work is to get companies to be more transparent and report on specific issues. Hence investors should practice what they preach, be as transparent as they would like the companies to be and show the practical efforts they make."

Saving the Best for Last

"The more arguments for ESG investing appeal to the hard-nosed capitalists, the more hope I see for the planet."



Improved dialogue opens opportunities

With a smile, Kaasinen admits that she could talk about engagement all day, and she provides a short conclusion on how she sees engagement evolve. "Where is engagement going? First, I believe that the dialogue we have developed with companies has improved dramatically. The practice of investor engagement is so much more established nowadays, which means a world of opportunities is opening for constructive dialogues and the ability to have a real positive impact. This evolution does not apply to all companies or markets. There are still big differences between markets regarding the companies' willingness to enter into an open dialogue with investors about difficult questions, but I am optimistic."

Welcome weaknesses

"Another aspect", Kaasinen continues, "is that investors increasingly appreciate that issues are not always black or white. It has become also more acceptable for companies to make mistakes, as long as they have a structure in place to learn from those mistakes and can explain this process. Take an issue like child labour for instance. I would find it rather suspicious if a company in a high-risk sector says they have no child labour in their supply chain. That does not seem credible or might mean their due diligence simply isn't working. Personally, I believe that it can reflect better on a company if it transparently discloses that, for example, in the last year, they have identified ten instances of child labour in their supply chain, and then explain what they do to rectify the situation and to make sure it doesn't happen again. For me, as an investor representative, this behaviour is much more reassuring than pretending that there are no issues at all. Being open about challenges and shortcomings has become a key to building trust between companies and investors. On the other side, investors increasingly understand that they need to evolve beyond automatically blacklisting companies, by instead giving them a chance to improve their ESG management."

Avoid boxes

Smith shares some of the key messages he would like everyone to take away, as well as something he has learned from the discussion. "After this discussion, I hope that you have an appreciation for the work being done to integrate ESG, RI and SDGs into systematic investment processes. I believe that we've provided good examples of how we do that. The data is hard to work with, but the volume of information that is now available is allowing us to achieve much more than we ever able to."

"The message I want to leave you with is to be aware of the different approaches that are available and how they are described. At one end of the spectrum we have traditional investing. We then have ESG integration where ESG is considered as part of the investment decision in order to improve economic outcomes, but risk and return remain as the primary objectives. And then there is impact investing where, even in listed equity space, there is a broader objective to positively impact society. We see a blurring of the lines between all of these categories, and people can use the language carelessly in describing them. Understanding and identifying your own ESG and investment objectives, as well as what managers can offer is key."

Packaging attractive products

Smith's takeaway should allow him to fine tune his product offering to better match investors' needs. "What Richard said about making these frameworks and concepts accessible, stresses the idea that, unless we can package them up into the right vehicles that appeal to clients, it will be hard to get broad investment into the space. We already have the ESG integration ticked off. We can provide pooled funds that include that notion, but packaging SDG-focused strategies, picking themes and allowing people to prioritise their own impact objectives, that's something we want to do for our clients."

A comprehensive yet straightforward approach

Nydahl summarises IPM's ESG strategy in a few words. "As a systematic asset manager, we have a great opportunity to both provide the advantages of systematic investing and in parallel, to include ESG in an efficient and disciplined manner. Perhaps in doing so, we also avoid the potential danger of paying lip-service, for the lack of a better word, to ESG integration. At IPM, when we include a step in our investment process, in this case integrating ESG, it will not only be done in the way we say, but we also control that it is being done properly, today, tomorrow, the next day, and the day after that. We will apply a systematic approach, and I believe that investors will benefit from it long-term."

Last words of wisdom

Humbly, Tyszkiewicz chooses to conclude with a more philosophical point. "I will give you a fluffy personal last word."

"I am just a human being, and I am quite hopeful now. The more arguments for ESG investing appeal to the hard-nosed capitalists, the more hope I see for the planet. If the money, the 'big money' shifts into these products, it can generate real change, and that seems to be the direction we are heading towards."

about our partners

IPM was founded in 1998 with the objective of assisting institutional investors to improve their overall investment results by offering uncorrelated and innovative investment strategies applying analyses predominantly based on fundamental data

IPM is today recognised as a specialist asset manager focused on fundamentally driven investment strategies with a systematic implementation

IPM offers it asset management services to institutional investors globally and currently employs ca. 60 persons in its offices in Stockholm and London

IPM manages around USD 9 billion for institutional investors in its Global Macro and Systematic Equity strategies

AXA Investment Managers is an active, long-term, global, multi-asset investor. The firm works with clients today to provide the solutions they need to help build a better tomorrow for their investments, while creating a positive change for the world in which we all live. AXA IM is part of the AXA Group, a world leader in financial protection and wealth management.

Currently, AXA IM manages approximately €750 billion of assets, across 1,800 funds and mandates. The organisation employs 2,400 employees in 21 countries.

With more than 30 years in the asset management business, Rosenberg is the quantitative investment arm of AXA IM, currently managing close to €20 billion. Rosenberg employs 52 investment professionals and 26 technology experts.

Kungsgatan 8
111 47 Stockholm
For any enquiry, please contact:
Aline Reichenberg Gustafsson
+46 (0) 70 9993966
aline@nordsip.com

Photography *by* Binniam Halid
Cover image © Shutterstock

© 2018 NordSIP all rights reserved

GENERAL TERMS AND CONDITIONS

These are the terms and conditions which govern the use of *NordSIP Insights*, an online magazine edited and distributed electronically and owned, operated and provided by Nordic Business Media AB (the "Editor"), Corporate Number: 556838-6170, BOX 7285, SE-103 89 Stockholm, Sweden.

DISCLAIMERS AND LIMITATIONS OF LIABILITY

1. The Content may include inaccuracies or typographical errors. Despite taking care with regard to procurement and provision, the Editor shall not accept any liability for the correctness, completeness, or accuracy of the fund-related and economic information, share prices, indices, prices, messages, general market data, and other content of *NordSIP Insights* ("Content"). The Content is provided "as is" and the Editor does not accept any warranty for the Content.

2. The Content provided in *NordSIP Insights* may in some cases contain elements of advertising. The editor may have received some compensation for the articles. The Editor is not in any way liable for any inaccuracies or errors. The Content can in no way be seen as any investment advice or any other kind of recommendation.

3. Any and all information provided in *NordSIP Insights* is aimed for professional, sophisticated industry participants only and does not represent advice on investment or any other form of recommendation.

4. The Content that is provided and displayed is intended exclusively to inform any reader and does not represent advice on investment or any other form of recommendation.

5. The Editor is not liable for any damage, losses, or consequential damage that may arise from the use of the Content. This includes any loss in earnings (regardless of whether direct or indirect), reductions in goodwill or damage to corporate.

6. Whenever this Content contains advertisements including trademarks and logos, solely the mandator of such advertisements and not the Editor will be liable for this advertisements. The Editor refuses any kind of legal responsibility for such kind of Content.

YOUR USE OF CONTENT AND TRADE MARKS

1. All rights in and to the Content belong to the Editor and are protected by copyright, trademarks, and/or other intellectual property rights. The Editor may license third parties to use the Content at our sole discretion.

2. The reader may use the Content solely for his own personal use and benefit and not for resale or other transfer or disposition to any other person or entity. Any sale of Contents is expressly forbidden, unless with the prior, explicit consent of the Editor in writing.

3. Any duplication, transmission, distribution, data transfer, reproduction and publication is only permitted by
i. expressly mentioning Nordic Business Media AB as the sole copyright-holder of the Content and by
ii. referring to the Website www.nordsip.com as the source of the information provided that such duplication, transmission, distribution, data transfer, reproduction or publication does not modify or alter the relevant Content.

4. Subject to the limitations in Clause 2 and 3 above, the reader may retrieve and display Content on a computer screen, print individual pages on paper and store such pages in electronic form on disc.

5. If it is brought to the Editor's attention that the reader has sold, published, distributed, re-transmitted or otherwise provided access to Content to anyone against this general terms and conditions without the Editor's express prior written permission, the Editor will invoice the reader for copyright abuse damages per article/data unless the reader can show that he has not infringed any copyright, which will be payable immediately on receipt of the invoice. Such payment shall be without prejudice to any other rights and remedies which the Editor may have under these Terms or applicable laws.

MISCELLANEOUS

1. These conditions do not impair the statutory rights granted to the readers of the Content at all times as a consumer in the respective country of the reader and that cannot be altered or modified on a contractual basis.

2. All legal relations of the parties shall be subject to Swedish law, under the exclusion of the UN Convention of Contracts for the international sale of goods and the rules of conflicts of laws of international private law. Stockholm is hereby agreed as the place of performance and the exclusive court of jurisdiction, insofar as there is no compulsory court of jurisdiction.

3. Insofar as any individual provisions of these General Terms and Conditions contradict mandatory, statutory regulations or are invalid, the remaining provisions shall remain valid. Such provisions shall be replaced by valid and enforceable provisions that achieve the intended purpose as closely as possible. This shall also apply in the event of any loopholes.