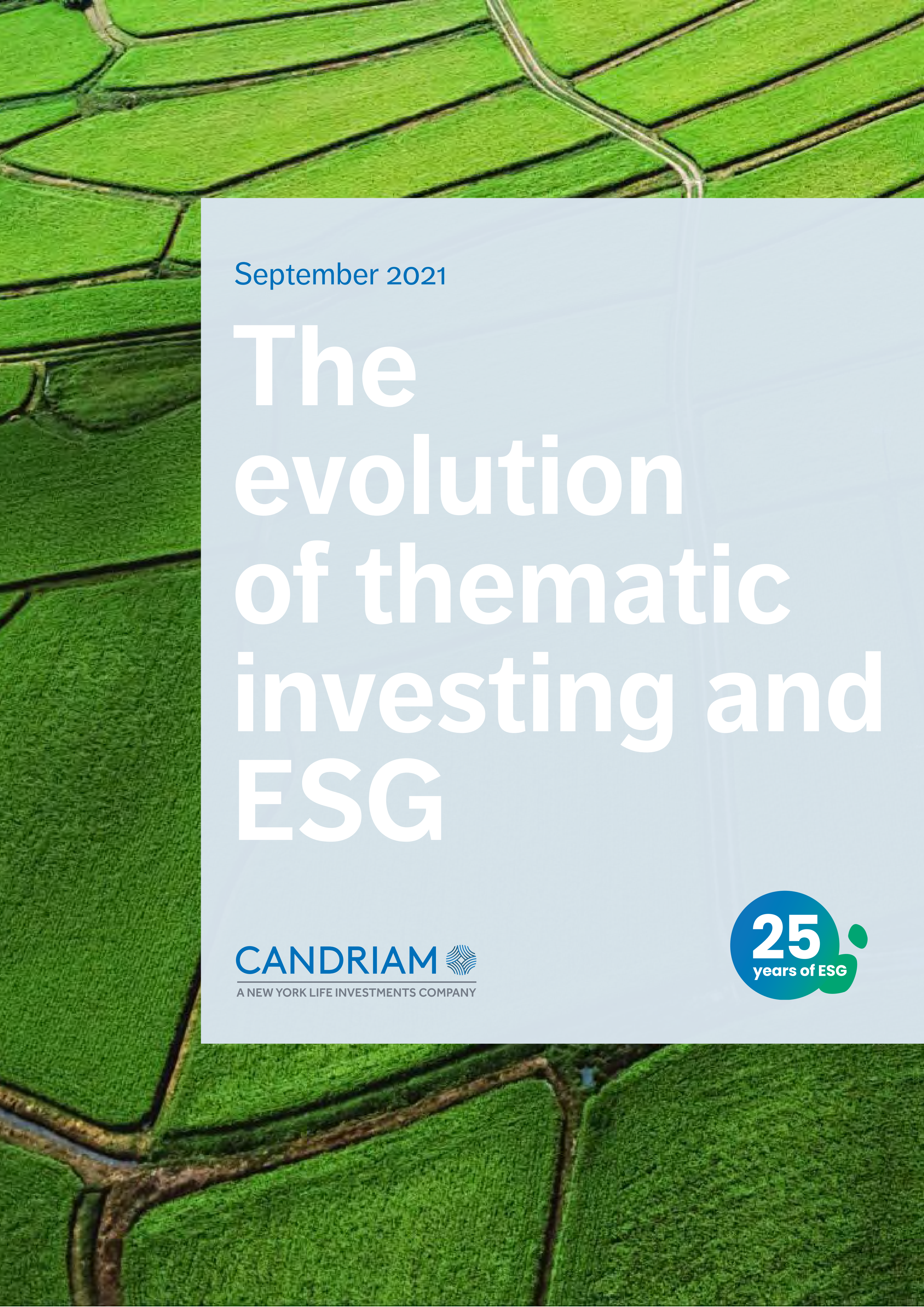

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The evolution of thematic investing and ESG

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

25 years of ESG

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Introduction

The investor community is increasingly recognizing the importance of environmental, social and governance factors in investment decisions, not only for risk mitigation, but for potential outperformance. In addition, there is growing demand to invest in ways that support sustainable industries as well as sustainable business models, as investors aspire to have a positive impact on society, or at the least, limit negative impacts.

Recently, we have also seen strong growth in thematic investing, which focuses on structural trends that transcend traditional sectors in order to access the "new normal" of the economy. While there are strategies that attempt to tie the thematic and the ESG approaches together, we believe that looking at opportunities through a more thoughtful ESG lens, considering externalities and positive and negative impacts, should allow investors to take advantage of growth areas in the market while also progressing towards clear ESG objectives.

Evolving nature of thematic investing

One could argue that thematic investing started off with sector investing, where an investor could make a bet on a particular industry they thought was poised for growth (for example, information technology in the late 90s and early 2000s). But thematic investing then grew to focus on broad macroeconomic trends that would benefit from structural changes in the economy, transcending traditional sector classifications and encouraging investors to capitalize on broader growth areas.

This is a more outcome-oriented type of investing where the objective is to take advantage of future growth potential over both the short and long term. Macro thematic strategies that have garnered much attention include themes such as robotics and automation, marijuana, gaming, and fintech. These all look at growth potential across multiple sectors, driven by structural drivers such as improving technology, lower development costs, and changing regulation.

However, what happens when an investor wants to look at thematic investing through an ESG lens?

Thematic investing through an ESG lens

The asset management industry is undergoing a fundamental change as the consideration of ESG factors is starting to be viewed as an intrinsic part of fiduciary duty.

With increased investor attention to ESG factors, modern economies are reaching a pivotal point in their development. The pressure is not only coming from investors that see opportunity in the structural changes occurring related to ESG factors, but also from the recognition of negative externalities that are driving change both at the consumer level and the regulatory level. New businesses are emerging, tapping into the need to decarbonize our economies, preserve ecosystems and harness the potential from everyone no matter race or origin.

So how could an investment strategy tie the thematic and ESG approaches together? With many investors recognizing that opportunities related to ESG, perhaps most notably in relation to the environment, many thematic strategies would typically look at opportunities in what may be referred to as the "green economy".

The green economy is commonly defined as being based on six main sectors: renewable energy, green buildings, sustainable transport, water management, waste management and land management. An ESG-themed strategy focusing on renewable energy, for example, could invest in companies that manufacture wind turbines, or solar panels, recognizing and trying to capitalize on the overall shift in the global power sector towards decarbonizing electricity supply.

Framework for addressing sustainability more broadly

However, if we look beyond just green economy sectors, we can see that there are larger sustainability challenges for society as a whole.

In 2015, the United Nations outlined these sustainability categories by putting forth a collection of Sustainable Development Goals (SDGs). These SDGs list objectives and specific targets to achieve in order to address climate change, end poverty, ensure equal opportunity to everyone, and restore our ecosystems. The SDGs are increasingly being adopted as a framework for companies to map their contributions to, as investors begin to recognize the many ways a company can contribute positively to these areas. Major corporations, like Coca-Cola, Dell, DuPont, GE or Pfizer[1] are already adopting the SDGs in their strategic planning.

1. http://www.businessfor2030.org/explore-by-company/

As an example of this mapping, we could view a company that makes semiconductors as a positive contributor to addressing climate change. Though they wouldn't be part of the traditional green economy sectors, they could be considered a contributor towards SDG 13 (Climate Action) because they have become a critical component in the electrification of cars as well as in the development of the related charging infrastructure.

Therefore, the "new normal" for the economy is to consider the contribution of companies' activities to major sustainability challenges, which is a more comprehensive view than focusing only on what sector the company operates in. These contributions can be multifold, offering plenty of opportunities for companies to deliver tangible support as the private sector innovates towards a broader range of solutions for major sustainability challenges.

Considering externalities: A multifaceted approach

However, even with a solutions-oriented approach grounded in the UN SDG framework, often we see that thematic investment strategies are missing the opportunity to incorporate a holistic and systematic ESG approach in their decision-making process. This kind of approach should take into account externalities of a business, which means looking at not only the impact of what a company produces, but also the way a company operates and conducts its business. The failure to consider the business alignment with sustainability challenges is what has led some environment-focused investors, for instance, to support oil producers due to their gains in environmental efficiency. The fact that a company seeks to improve its operational profile will not buy it a place in the major league of thematic outperformers if its products are hurting the theme in the first place.

In the previous semiconductor example, we recognized that a company producing semiconductors could be seen as contributing positively towards mitigating greenhouse gas emissions because its products were being used in electric cars, which lead to lower fossil fuel use and carbon emissions into the atmosphere. However, a more holistic approach would also analyze the company's use of hazardous chemicals in the manufacturing process as well as its chemical waste management practices.

A second case to consider is the manufacturing of photovoltaic (PV) cells to make solar panels. This provides a striking example of a sustainable product that raises many concerns in terms of operational sustainability, especially considering that many top PV cell manufacturers are based in countries with looser regulations around labor and environmental practices. While solar panels represent an undeniable solution to generate low carbon electricity, the manufacturing of these panels themselves consumes a significant amount of energy because of its use of carbon intensive coal, rather than renewable energy sources. The manufacturing of the panels also consumes a significant amount of natural resources, in particular, quartz that needs to be mined, then processed to make silicon, then polysilicon. These steps require highly toxic chemical compounds that can be handled differently depending on the safety and environmental standards of the country as well as the degree of scrutiny the companies are subject to. In other words, the corporate champions of tomorrow do not only need to make great products that solve sustainability challenges to stay relevant. As customers and regulators increasingly demand enhanced transparency and more sensitivity to controversies, the way companies manage their stakeholders becomes critical to their success.

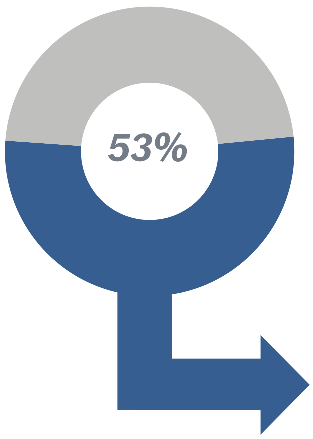
ESG investors have long thought of corporate success as encompassing more than just investor returns. ESG investors have also looked to companies as providers of social goods, and saw that these goods – racial equality, a clean environment, healthy customers – could be priced as well. This multifactor lens, initially carried by ESG investors, is now moving mainstream.

The "values-driven" consumer

The general public is starting to demonstrate that they are viewing companies through this multifactor lens – perhaps without even realizing it. Research has shown that consumers who would be considered "values-driven" consumers, represent over half the population. A "values-driven" consumer is defined as someone who took actions such as boycotting a brand, divesting from a company in their portfolio, or changing the type of products that they buy or use, in reaction to something they've seen in the news or an experience in their personal lives. Examples could include a consumer no longer using plastic straws based on concerns about plastic in the oceans, or buying an electric car because of concerns about global warming. This segment of consumers has been steadily increasing across all age brackets in recent years. Importantly, research indicates that approximately 50% of "values-driven" consumers are open to ESG investing and their level of social responsibility is high, which is reflected in their investment attitudes.

The rise of “values-driven” consumers

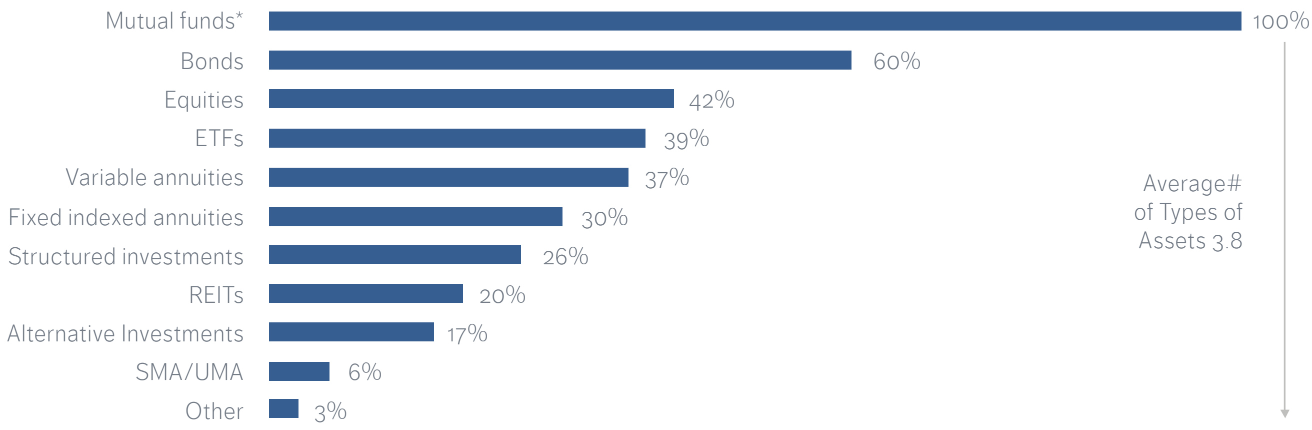
"Values-driven" consumers represent over half of the random population



“Values-driven” Consumer definition:

By becoming aware of and concerned with broader issues, “values-driven” consumers will take actions in their personal lives, such as:
• Boycotting a brand
• Divesting from a company in their investment portfolio (selling shares of a company)
• Changing types of products they buy or use (e.g. stop using plastic straws or purchasing an electric car)

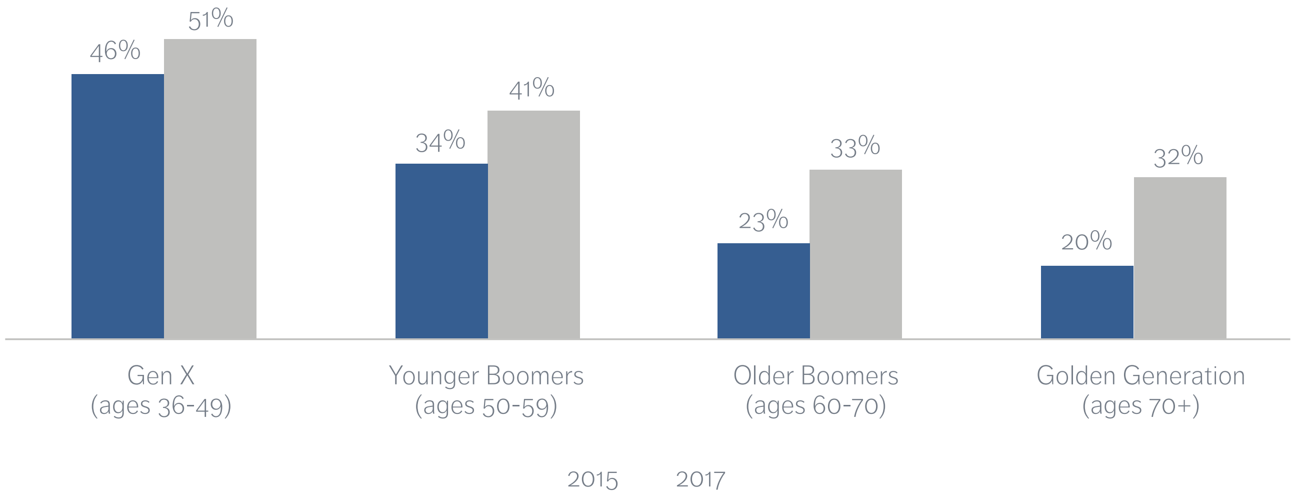
“Values-driven” consumers' portfolios are highly diversified



Source: New York Life Investments and RTi 2019 Research Study
Base: Random (503), Values Driven Consumer (266)
S4a. Which of the following types of assets do you own in any of your accounts?
*To qualify for the study respondents must have a mutual fund or SMA/UMA account

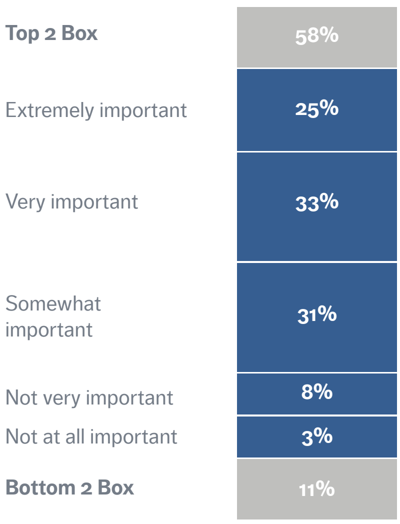
"Values-driven" consumers' impact has been steadily increasing

Consumers who actively consider company values when making a purchase



Source: Forbes - Millennials Call For Values-Driven Companies, But They're Not The Only Ones Interested, May 23, 2018.

Importance of investment behavior reflecting what is good for society



This research indicates that consumers, and ultimately investors, recognize the importance of pricing in externalities and how these align with their own values. These value-driven consumers, and ultimately investors, are instinctively taking the multifaceted view of an ESG investor.

Materiality in ESG investing

The sheer quantity of data available to investors integrating ESG factors has also created new challenges for investors to pick the right factors based on their financial materiality.

Derived from its use in corporate financial reporting, ESG materiality invites investors to apply the same approach in defining the ESG factors that will ultimately make it into their valuation and risk assessment models. Regulation and customer preference provide two powerful forces driving such materiality, with both alternating in driving and reinforcing the other. The “G” (Governance) can for instance respond to strengthening accounting requirements, but could also proceed from investors’ desire to see a clear distinction between chairman and CEO roles. The “S” (Social) did receive a significant boost under the dual pressure of investors’ call for more inclusive corporate policies after the tragic events of 2020 and a renewed emphasis on human capital management brought in by the COVID-19 pandemic. As for the “E” (Environmental), the U.S. rejoining of the Paris Agreement in 2021, and the attention of the Biden administration to climate change has highlighted the opportunity for innovation and investment in this area.

The operational, stakeholder-driven perspective is the right level to ensure that investors do not end up piling into bad companies making good products. Doing so could expose these investors to unsuspected reputational risks, as well as the risk of backing underperformers once the market starts to price in different dimensions of corporate sustainability.

Potential for outperformance

There is now a growing body of academic research pointing to the financial benefit for companies in developed markets to incorporate ESG considerations within their business. For instance, Garcia and Orsato (2020) reviewed the performance of 2,165 companies from developed as well as emerging economies and concluded that a statistically significant relationship exists between ESG performance and financial performance[2].

Tracking corporate performance of 180 US companies over an 18 year period, Eccles, Ioannou and Serafeim (2014) found that companies that voluntarily adopted sustainability policies outperformed those that adopted no such policies both in terms of stock market and accounting performance[3].

A similar study was conducted by Zhao, Guo, Yuan, Wu, Li, Zhou, & Kang in 2018. They focused on Chinese power companies and showed that good ESG performance could indeed improve financial performance. Since then numerous other studies focusing on specific sectors or regions have been conducted with similar results[4].

2. Garcia, A. S., Orsato, R. J. (2020). Testing the institutional difference hypothesis: A study about environmental, social, governance, and financial performance. Business Strategy and the Environment, 1-12.
3. Eccles, R.G., Ioannou, I., Serafeim, G. (2014). The impact of corporate sustainability on organizational processes and performance. Mangement Science, vol 60(11), pages 2835-2857.
4. Zhao, C., Guo, Y., Yuan, J., Wu, M., Li, D., Zhou, Y., Kang, J. (2018). ESG and corporate financial performance: Empirical evidence from China’s listed power generation companies. Sustainability, 10(8), 2607.

Conclusion

These studies, and others, have already highlighted the significance of ESG factors in assessing corporate performance. We posit that investors can further enhance their potential return by combining material ESG factors with sustainability-based investment thematics aligned with UN SDGs. Such thematic alignment does not have to remain the purview of a few narrow investment strategies but can be applied to diversified strategies, provided that the stock and bond selection considers companies' contribution to these themes.

Taking it one step further, a multifaceted ESG approach that considers externalities should look at not only what the company produces, but how they operate. This stakeholder-driven perspective can ensure that investors do not end up piling into bad companies making good products. Furthermore, it can help protect against reputational risk and ensure that clear progress is made towards the investors' ESG objectives.

This holistic analysis of ESG factors is an approach that is integral to New York Life Investments and CANDRIAM's commitment to ESG investing. CANDRIAM's experience running responsible investing portfolios for over 25 years demonstrates our conviction that investment opportunities and risks can't be fully evaluated using traditional financial measures alone: considering a company's ESG practices is key to ensuring a complete view of each company's prospects, and potentially lead to better risk-adjusted returns.

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