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Insurers Guide to Sustainable Investing: What, Why, and How ? - Ch. 4

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

25 years of ESG

About the authors

Marie Niemczyk

Head of Insurance Relations

Marie Niemczyk is Head of Insurance Relations at Candriam. In this role she monitors the factors impacting insurers' asset management - including market, regulation and accounting-related matters – and works to ensure these insurance-specific requirements and objectives are integrated into investment solutions and strategies.

Prior to joining Candriam in 2018, Marie was Insurance Strategy & Development Director at AXA Investment Managers in Paris. Previously, Marie held several positions with Fidelity in London, Frankfurt and Paris. Before that, she was an Economist with EY in London. She started her career in 2004 as a Research Associate with The Advisory Board Company in Washington D.C..

Marie has an M.Sc. from the London School of Economics, a B.A. from Swarthmore College, and holds IMC and SII qualifications.

Kristof Woutters

Global Head of Pension and Insurance Relations

Kristof Woutters is Global Head of Pension & Insurance Relations at Candriam. In this function, Kristof is responsible for giving strategic advice to pension funds and insurance companies. This often involves the design of advanced investment solutions that take into account specific client needs and respective regulatory frameworks, such as SFDR, SRD II, IORP II, Solvency II, IFRS, etc. Kristof has over 25 years' of experience in the investment management industry. He is a regular speaker on various investment or pension & insurance topics at seminars and events and he is an active member of numerous associations in this field.

Prior to joining Candriam Investors Group in 2000, he worked as Senior Consultant at Pragma Consulting, an independent institutional investment consulting company specialised primarily in advising pension funds and financial institutions world-wide.

Kristof earned a master's degree in commercial engineering at the University of Leuven (KUL, Belgium) and an additional master's in economics from the University of Groningen (RUG, the Netherlands).

David Czupryna

Head of ESG Development

David holds the position of Head of ESG Development at Candriam. David's role is to deliver Candriam's unique blend of sustainability credentials and market wisdom to investors and market participants. Before that, David led the growth of sustainable investment strategies in several European countries at Sycomore Asset Management and in Northern Europe at Erste Asset Management. David started his career in finance with BNP Paribas in London on the equity derivative structuring desk in 2007.

David holds an MBA from the University of Cambridge specializing in finance and strategy as well as Masters degrees in political science from the Free University of Brussels and the Catholic University of Louvain.

4. Who Can Benefit? Sustainability and Financial Performance

#SpeedRead	
	• *There is extensive evidence, both academic and practical, that investing Sustainably does not necessarily sacrifice financial performance.* • *Many studies at the individual security level and at the fund level have shown that Sustainability can often potentially improve return/risk profiles.* • *Sustainable investment strategies are diverse, and insurers must be careful in their selection.*

Research and practical experience have refuted the myth that Sustainable Investing inevitably means sacrificing performance. Many empirical studies have been conducted; a 2015 review[1] analysed more than 2,000 such studies. More than 90% of the studies demonstrated that ESG-friendly stocks perform in line with or outperform non-ESG stocks. The authors of this comprehensive review of the academic evidence concluded that sustainable strategies that focus on companies with good ESG practices were investing in "better" companies. They remarked that "the business case for ESG investing is empirically well-founded" and stated, "We clearly find evidence for the business case for ESG investing."

At the fund level, a study[2] examining how funds behaved in 2018 showed that 63% of sustainable funds concluded the year in the top half of their respective categories. Looking specifically at sustainable equity funds, the study found that this category performed better than their conventional equity counterparts in the volatile and negative stock market of 2018. We will devote a separate section to ESG performance in meeting the investment challenges of Covid.

It is important to examine the methodology of a strategy, and not to generalize. Of course, Sustainable Investing strategies are as diverse as other approaches. Not all will perform the same, nor will they always outperform. But across the board, they have proven their potential to enhance return/risk profiles. This generally applies across investment geographies and market capitalisations, as illustrated by the case study on Sustainability in emerging markets presented in the Box.

1. Gunnar Friede, Timo Busch, and Alexander Bassen (2015), "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," Journal of Sustainable Finance & Investment, 5:4, 210-233.
2. Morningstar, "Sustainable Funds U.S. Landscape Report," February 2019.

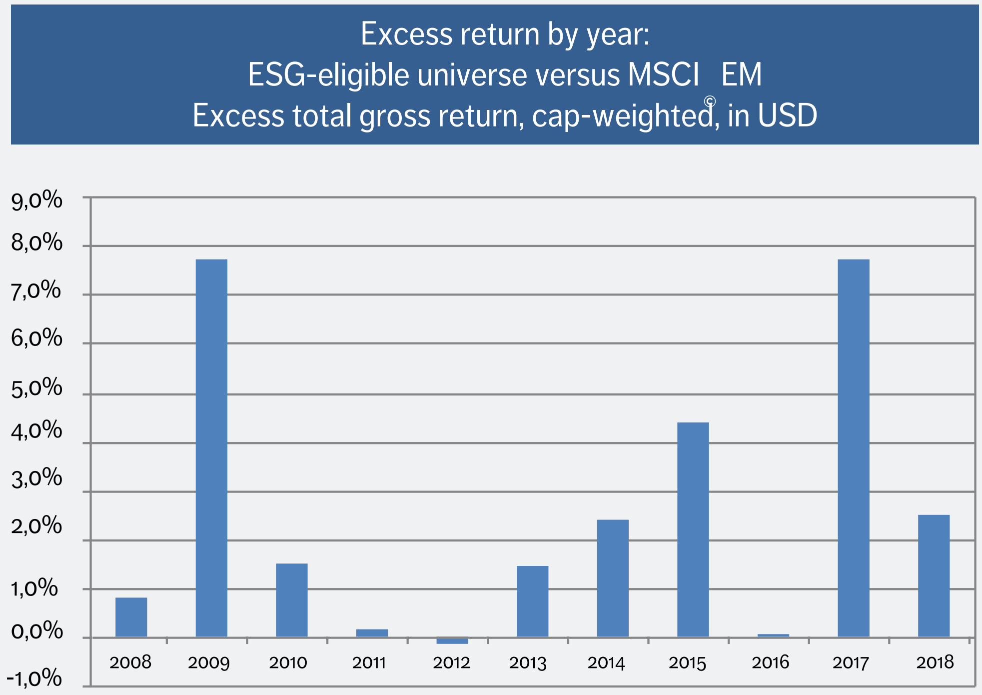
#InFocus: Sustainability and Performance in Emerging Market Equities

Emerging Markets are particularly interesting when examining Sustainability and investment performance. If ESG risks, particularly poor governance, are more pronounced in Emerging Markets, then correctly avoiding these risks should lead to significant improvements in risk-adjusted performance. Meanwhile, these higher ESG risks, plus reduced access to data, make Sustainable Investing more complex in Emerging Markets. The key question remains: can incorporating ESG factors in Emerging Markets investing pay off in practice?

We conducted a long-term study of ESG factors in Emerging Market equities. Given that ESG ratings vary by provider and investor, recognize that this study covers one specific approach. The Candriam engineering team compared the performance of the Emerging Markets ESG-eligible universe (approx. 700 stocks), as determined by Candriam's in-house ESG analysts, to the MSCI© Emerging Market Index (approx. 1,150 stocks) between 2008 and 2018. The universe of ESG-eligible Emerging Market stocks outperformed the MSCI© EM Equity Index by an average of 2.4% p.a. on a gross basis – with a similar risk.

Figure 4-A

ESG-eligible universe versus MSCI© EM



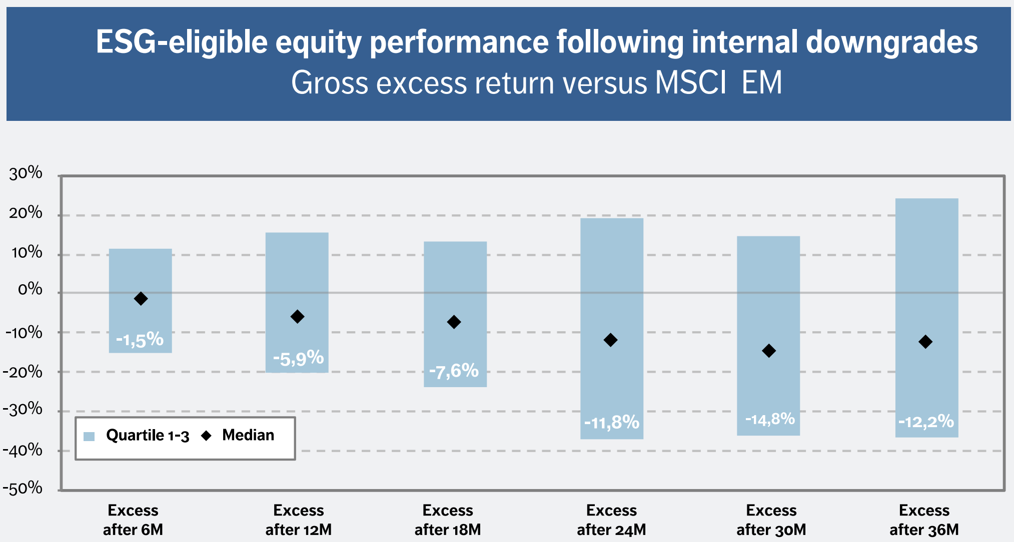
Sources: Candriam ESG Team and Financial Engineering Team, MSCI (Weight) © 2019 MSCI Inc. All rights reserved; Factset Prices (Gross Total Return). Data from April 2008 to October 2018. Past performances of a given financial instrument or index or an investment service, or simulations of past performances, or forecasts of future performances are not reliable indicators of future performances. Gross performances may be impacted by commissions, fees and other expenses. Performances expressed in a currency other than that of the investor's country of residence are subject to exchange rate fluctuations, with a negative or positive impact. The MSCI EM Index is mentioned for informational purposes only. The strategy does not consist of replicating this index.be impacted by commissions, fees and other expenses. Performances expressed in a currency other than that of the investor's country of residence are subject to exchange rate fluctuations, with a negative or positive impact. The MSCI EM Index is mentioned for informational purposes only. The strategy does not consist of replicating this index.

We analysed the consistency of the gross excess returns of the ESG-eligible universe across sectors, regions and sizes. In terms of sectors, ten of the 11 sectors generated a positive excess return. The ESG-eligible universe achieved a positive excess return in all four geographical regions. ESG-appropriate companies also outperformed the index in all three market cap categories.

We also asked what it means for the future performance of a company if it is no longer considered ESG-eligible. The study showed that when a company fell out of the ESG-eligible universe, this was followed by negative excess returns for time horizons beyond one year and up to three years after the company concerned has been removed from the list of sustainable companies. The lowest point was reached in the 30th month, with a (median) excess return of -14.8% (gross). The effects of an ESG-downgrade lessen beyond this time horizon.

Figure 4-B

Performance following ESG downgrades from ESG-eligible to ESG-excluded



Sources: Candriam ESG Team, MSCI (Weight) © 2019. All rights reserved; Factset Prices (Gross Total Return). Past performances of a given financial instrument or index or an investment service, or simulations of past performances, or forecasts of future performances are not reliable indicators of future performances. Gross performances may be impacted by commissions, fees and other expenses. Performances expressed in a currency other than that of the investor's country of residence are subject to exchange rate fluctuations, with a negative or positive impact. The MSCI EM Index is mentioned for informational purposes only. The strategy does not consist of replicating this index.

5. What About Covid-19? – The Potential Impacts for Sustainable Investing

#SpeedRead	
	• *It is too early to draw definitive conclusions on Covid-19 and Sustainable Investing. However, we can take inventory of the evidence so far.* • *Several studies show that during the crisis, Sustainable Strategies have been relatively resilient.* • *Sector allocation may explain part, but not all, of this resilience.* • *The attributes of companies with strong ESG characteristics, notably good stakeholder management, strong governance, capacity for innovation, and adaptability, likely also played a role.*

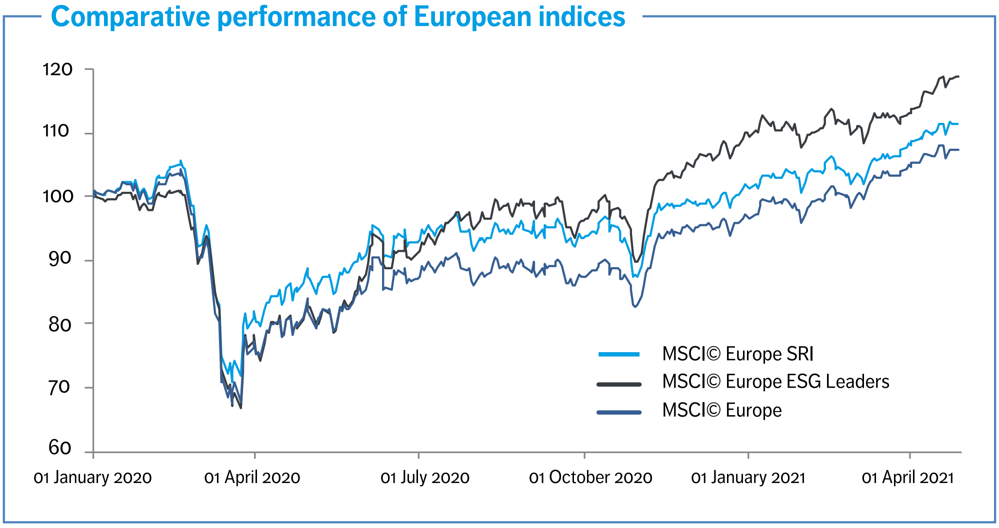
With the Covid-19 crisis still underway, it is too early to draw definite conclusions regarding its long-term impacts on Sustainable Investing. It is nevertheless informative to take an initial look at the performance of ESG strategies during the crisis so far, and at what the crisis has taught us so far about Sustainability as a predictor.

5.1. Performance During the Crisis

The effect of Covid-19 on companies and securities is particularly intriguing because it can be considered the first global, large-scale test of Sustainable Investing. While many Sustainable Investment Strategies demonstrated resilience during the 2008-2009 Global Financial Crisis, at the time they were more of a niche investment. Sustainable Investments have grown threefold since then.

Broad market indices and fund returns show that the performance of Sustainable Strategies during the Covid crisis has, on average, been more robust.

Figure 5-A



Sources: Candriam, Bloomberg, 29/01/2021.

Figure 5-B

ESG fund performance in the depth of the crisis

Performance-ranking of 203 ESG Fonds in their respective Morningstar categories	
	13/02/2020 - 12/03/2020
1^{st} quartile	39% of ESG funds rank in the 1^{st} quartile of their Morningstar category
2^{nd} quartile	27% of ESG funds rank in the 2^{nd} quartile of their Morningstar category
3^{rd} quartile	23% of ESG funds rank in the 3^{rd} quartile of their Morningstar category
4^{th} quartile	11% of ESG funds rank in the 4^{th} quartile of their Morningstar category

Source: Morningstar

5.2. Drivers of ESG Performance During the Crisis

What explains the relative resilience of Sustainable strategies so far in the crisis? It is certainly too early to conduct a formal attribution analysis. However, what appears clear is that Sustainable strategies tend to display a number of characteristics that are logically sought-after attributes in times of stress.

A first factor that is often mentioned when trying to explain the performance of Sustainable strategies in the crisis is sector allocation. A sector that is often pinpointed in this argument is energy – indeed, it is often argued that strategies that take into consideration ESG factors have performed relatively well because they underweight energy. And in fact, the energy sector did suffer significantly during the early Covid financial market crisis.

Analyses show that the average outperformance of Sustainable investments on an aggregated basis is still material even after adjusting for sectors. It is not as simple as avoiding the energy sector. Many sustainable strategies still invest in energy forms such as natural gas and lower-emitting fossil energy. In many sectors there are dispersions within the industry, between companies with good versus unsustainable ESG ratings. Further, the weight of energy in most indices is actually not that high. The energy sector is less than 3% of the MSCI World index.[3] Sector allocation does not explain the overall performance of Sustainable strategies.

Factors beyond sector allocation are demonstrably at work. Sustainability considerations at the company level are clearly relevant. The Covid crisis seems to point for example to certain Social, or S-factors, such as good management of employees and suppliers. Good long-term relationships with staff can support business continuity processes in times of crises. In sectors such as food distribution this can be a differentiator. Investors are increasingly pushing for greater transparency in these areas, especially with regard to working conditions and health insurance. Good relationships with suppliers, too, can be supportive in times of stress, notably to maintain supply chains.

The fact that investors have sought out companies with strong ESG ratings in the crisis also makes sense when thinking about the implications of good Governance. Companies with good Governance are often characterized by healthy balance sheets, financial caution and proactive risk management. In the eyes of many investors, these features help reduce risk, especially during market turmoil.

Companies with strong ESG elements frequently display adaptability and the capacity to innovate – both attributes which are particularly in demand in crises. Certain Sustainable companies develop new solutions, for example to mitigate climate change or facilitate the circular economy. Others evolved their processes to meet ESG criteria. This demonstrates innovation, flexibility and adaptability.

Hence, the crisis sheds light on the potential added value of analysing Sustainability risks and opportunities. It also illustrates why it is interesting to examine company's alignment with global Sustainability trends In fact, structural Sustainability trends such as digitalisation and the search for health and wellbeing have been further reinforced by this crisis.

3. Source: MSCI, January 29 2021

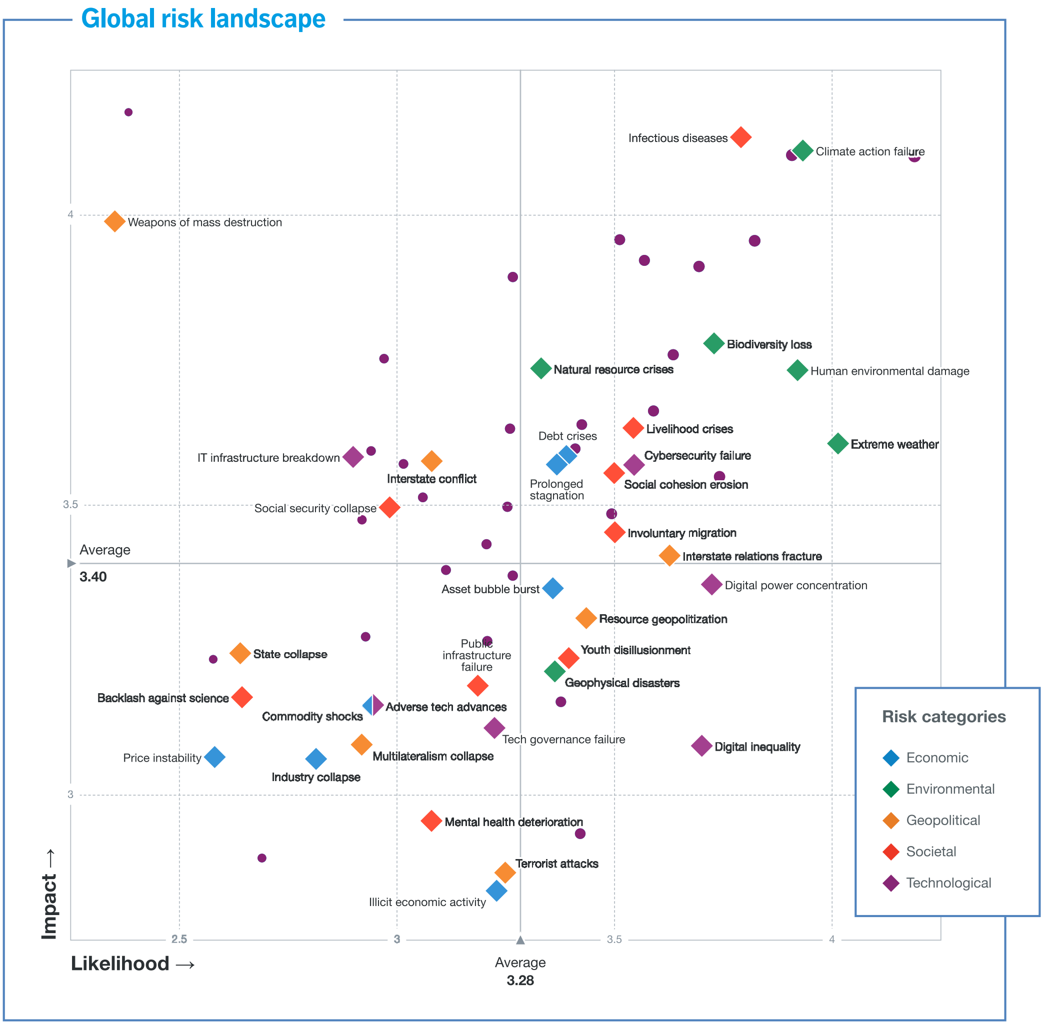
5.3. Peering into the Future

While it is too early to draw long-term conclusions on the impact Covid-19 will have on Sustainable Investing, we have gained insights from the crisis that should support the use of ESG in analysing investments.

So far, we are seeing that on average, issuers with good ESG ratings have been relatively resilient. The crisis illustrated the potential added value of exposure to structural sustainability trends. The evidence so far could also supports a more ESG-aligned perspective on what constitutes good, and financially successful, employee and supplier management. The international community is learning that massive, drastic remedies against exogenous shocks can be deployed relatively quickly, and that changes in human activity can have tangible consequences for the environment.

In the most recent World Economic Forum Global Risk Landscape, published after the onset of the crisis, climate action failure ranks almost as high as infectious diseases in terms of impact, and even higher in likelihood. These are followed by other environmental risks, such as human environmental damage, biodiversity loss and extreme weather. The fact that many environmental risks rank close to the risk of infectious diseases, may add to the growing understanding of the environmental urgency and further support regulatory initiatives to mitigate climate change and other environmental issues.

Figure 5-C



Source: World Economic Forum, Global Risks Report 2021, 16th Edition.

6. Conclusion: High Stakes

Sustainable Investing has become indispensable.

The stakes for insurers are high --- to ensure the resilience of investments in the face of rising Sustainability risks, align practices and portfolios with increasing regulation, and protect their company and brand against reputational damage.

Capturing the new opportunities offered by Sustainable Investing will be key to the long-term earnings potential of insurance assets and the competitive position of insurers. It is vital for insurers to build significant in-house know-how or to carefully select their external partners. For outside expertise, companies must carefully select partners that are both true Sustainable Investing experts to support the insurer in the implementation of Sustainable Strategies which fit their portfolio and individual circumstances.

The goal is simple -- to make Sustainable Investing a source of potential added value.

€140 B
AUM as of
31 December 2020

570+
Experienced and
committed professionals

25 years
Leading the way in
sustainable investing

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