# Impact

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## Dilemma's in responsible investing

Responsible investing seems to be in vogue. Perhaps it's just our bubble, but newsfeeds and timelines are full of company, journalist and analyst reports highlighting one or several angles of how societal trends and issues build (or destroy) shareholder and stakeholder value. Climate change, biodiversity loss, circularity, human rights and plastic waste. There seems to be more and more focus – thankfully – on these matters from all actors in society; whether regulators and policy makers (introducing the EU Green Deal and associated EU Sustainable Finance Action Plan), civil society groups, businesses, NGOs, investors and concerned citizens and consumers.

But what exactly is responsible investing, or its closely associated approaches such as sustainable investing or impact investing, and what does it mean when practitioners aim to base investment decisions on more than just financial risk and return considerations. In a world that's increasingly more data driven and quantitative, how can you make capital allocation choices when values are to be included, measurements are methodologically nascent and ESG thematics[1], and their underlying correlations or causalities, are yet to be completely understood.

The interplay of an external environment that – rightfully – expects more of the financial sector, and the way the sector has historically operated, poses dilemmas for asset managers and asset owners when it comes to responsible investing. This paper is an attempt to define some of these dilemmas, offer insights from investment professionals and set out some of the ways choices can be made.

[1] ESG stands for Environmental, Social and (Corporate) Governance and is an umbrella term used in the investment industry to refer to all sustainability factors when looking at company investments. There is a long history of including more than financial return in capital allocation decisions, with various terms used throughout its evolution.

## Starting at first principles

At a.s.r. asset management we invest all assets according to the principles and rules set out within our Socially Responsible Investment (SRI) policy. This document contains the guardrails in between which portfolio managers can make their decisions when it comes to choosing the securities we hold, whether it's listed or private equity, listed or private corporate debt, or sovereign bonds. It describes the evolution of our thinking and the way we try to operationalize our approach in the investment process through various tools such as screening, engagement, exclusions or targets. It defines our investable universe and portfolio construction.

However, the pace of change in the real economy is unprecedented. There are many studies and observations describing rapid technological development, socio-economic trends, a Fourth Industrial Revolution or the compounding effects of globalization and knowledge transfer. To stay on top of current and emerging salient issues that might affect company performance or influence stakeholder expectations is practically infeasible when knowledge doubles every 12 months[2]. Even when basing investment decisions within a theoretical framework, such as the Planetary Boundaries model, the Doughnut Economics model, or the Sustainable Development Goals framework, trade-offs and choices are inevitable. Moreover, this growing complexity can come at the expense of focusing on the G of ESG, which can leave space for those with the intent to wilfully deceive and defraud investors and customers[3].

It is therefore important to choose and prioritize thematic areas where you can create the largest positive impact or reduce negative impact, when keeping in mind the boundaries of capabilities of your organization. Something you might have to embrace the trade-off and use data to avoid binary choices where possible.

> Take a cornerstone of our worldview: weapons. Since its first iteration in 2007, our policy has always been 'no involvement in weapons'. That means no offensive weapons, no defensive weapons and no dual-use products that could be used against humans, not even key parts that are needed in the production of weapons. We have continuously excluded large weapons manufacturers, but also companies that sell weapons for recreational use. No weapons means no weapons. But fast forward to 2020 and the definition of weapons has evolved, alongside company transparency and the capacity of analytics to capture the nuances within disclosure.
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> Is a manufacturer of a supercomputer now a weapons manufacturer, when that product is used for testing sophisticated delivery systems? But the twin of that product is used for Covid-19 vaccine development? And how do you classify that manufacturer when the development of supercomputers is dwarfed by its development of renewable energy solutions?
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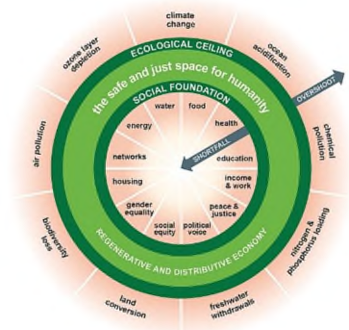
> The choice is often binary – invest or don't invest.

a.s.r. is a Dutch insurance company and while we are a global investor, the money we are entrusted with to invest on behalf of our clients is predominantly Euro-denominated and set aside for the long term to cover our clients' financial position and insurance claims. Our strategic asset allocation and investable universe reflects this. We cannot be all things to all people.

[2] According to the Knowledge Doubling Curve theory we should quickly come to a point where knowledge doubles every 12 hours
[3] See the Steinhoff accounting scandal in 2017 or the more recent situation with Wirecard

## Making strategic choices

The principle of maintaining focus applies to both the financial and the 'non-financial' side of investing. There are seventeen Sustainable Development Goals, with 169 targets underneath them. There are nine (or ten) boundaries identified within the Planetary Boundaries concept, and there are an additional thirteen social boundaries identified through the complementary Doughnut model. Focusing on all potential impact areas becomes practically unfeasible and would dilute the effort.




Instead, we have chosen three thematic areas that fit our business and our operating environment, and we aim to align our investment approach as much as possible to these areas. These are:

- Climate change and energy transition
- Vitality and (sustainable) employability
- Financial self-reliance and inclusiveness

This does not mean we do not consider other topics within our investment process. Far from it as we have recently demonstrated by signing and committing to the Finance for Biodiversity Pledge[4].

> One of our thematic focus areas is *climate change and the energy transition*, and we seek a positive role through our investments whether through exclusions, screening or engagement on the public side, or direct finance through the private markets.
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> One critical component of the energy transition is battery storage and the electrification of transport. Various critical raw materials are needed, in large quantities, to support this shift in production. Materials such as cobalt and lithium are often found in places (or under the control of regimes) where human rights, labour rights and environmental protection are not fully respected or enforced.
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> Is a leading manufacturer of electric vehicles creating more problems in its upstream supply chain than it seeks to solve downstream? Or should it deserve some leeway for pioneering a new industry that could enforce better standards to its suppliers and deliver net positive benefits in the long term?

There is a minimum bar, which we believe is already quite high, and which we keep raising. And we believe – where there is an absence of proactive betterment within the sector – this low bar is being raised for us as well. Legislation such as the *Principle adverse impacts statement* as part of the EU Sustainable Finance Disclosure Regulation (SFDR) as well as the *Do No Significant Harm* (DNSH) criteria as part of the EU Taxonomy for Sustainable Activities will raise the measurement and disclosure requirements for the broad agenda of ESG topics[5].

As such, making a strategic choice where to focus – while not ignoring compliance-driven transparency – should create more

[4] https://www.asrnl.com/news-and-press/news/ook-asr-staat-op-tegen-natuurverlies

[5] Both reporting obligations include a long list of indicators – the draft Delegated Act under the SFDR has a table of 50 separate indicators – ranging from carbon emissions and intensity, biodiversity impacts, gender pay gap, human rights policies and other entity- and product-level requirements

choice for clients, deeper and more meaningful impact in the real economy, and less confusion in investment committees and teams.

## The importance of data

However, underpinning everything discussed thus far is data. Without data no insights are generated and ESG cannot be included, in any real meaningful, comparable and systematic sense, into investment decision making.

For public companies, there exist various disclosure requirements depending on the company's home country or share listing(s). Companies are required to measure, manage and disclose a variety of sustainability risks and impacts, ranging from greenhouse gas emissions to remuneration policies and gender diversity.

For an institutional investor with a large portfolio in listed equities and bonds, covering hundreds or even thousands of companies, it becomes impractical to mine individual company reports and publications in search of these data points. Commercial ESG data providers are therefore often used to source, aggregate, analyse and provide this type of data to investors, often using slightly different methodologies or approaches[6].

This has in turn given rise to other proprietary models developed by some of the larger global asset managers, combining fundamental company research with a combination of 'feeds', in an attempt to generate the most valuable ESG insights and analysis (either to minimize credit risk or select the best quality companies to invest in).

Independent assurance on company reporting, or certification, can also help in this quest for quality insights. But the ideal would be to take data collection out of the realm of self-reporting completely, and make it forward looking instead of compliance driven and ex-post. Think here of satellite imagery to assess emissions, track deforestation rates or pollution patterns. But also using scientific or crowd-sourced analysis and Artificial Intelligence to complement fundamental company research.

> Some dilemmas are a result of the way the financial system itself functions.
>
> While we aim to assess risk, return *and* impact in all our investment decisions, is it in the best risk and return interests of our customers to completely exclude all fossil fuels in 2020, or build down over time towards 2050?
>
> Given that if we limit our investable universe further, by tightening our exclusions (an act of active management) we create more tracking error against a benchmark. On the flipside, by making an early decision on this sunset sector we can indirectly promote the energy transition. It remains a balance.

Investments are driven by expectations of future earnings, not past performance. This opens the door to innovation, and that's the topic of our next white paper on impact measurement. Watch this space.

[6] A recent paper found low levels of correlation between the large ESG data providers, compared to their credit rating cousins. *Aggregate Confusion: The Divergence of ESG Ratings* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533

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