A guide to E, S, and G in investment

Environmental, social and corporate governance factors in investment processes

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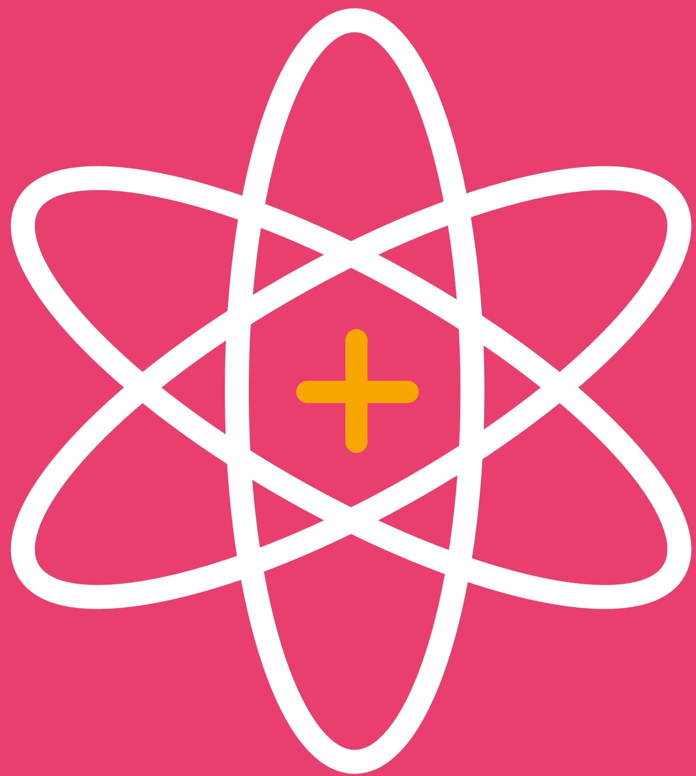

What are E, S, and G?

> *Investors are now expected to incorporate environmental, social and corporate governance (ESG) factors into their investment processes.*

"ESG" has become one of the most frequently used terms in investment. But what are E, S and G factors? And how are they relevant to investors?

ESG is an umbrella term used to cover a wide range of factors that traditionally were regarded as "non-financial" or "extra-financial" and did not form part of standard financial analysis of investment opportunities. However, there is now widespread acceptance that these issues can affect financial performance, especially over the longer term.

Investment managers now typically include ESG issues in investment analysis, to varying degrees. They use a variety of approaches and a range of quantitative and qualitative information. ESG-related matters are also frequently the subject of votes at company AGMs and often feature in investors' dialogue with investee companies. Although equities were previously the main focus for ESG considerations, there is a growing understanding that these factors can, and should, be applied to all types of investment.

Historically, governance issues – particularly those relating to executive remuneration – have received the most attention, but environmental and social issues are now also prominent. Climate change, in particular, is a topic of major concern and social issues came to the fore during the Covid-19 pandemic.

Examples of ESG issues:

E — *Environmental*

- Biodiversity
- Climate change
- Energy efficiency
- Pollution
- Resource depletion
- Waste management

Learn more

S — *Social*

- Community relations
- Diversity and inclusion
- Fair pay
- Human rights
- Labour standards
- Product safety

Learn more

G — *Governance*

- Board composition
- Bribery and corruption
- Compliance
- Executive remuneration
- Lobbying
- Succession planning

Learn more

Please note these are just examples of the types of issues covered, not an exhaustive list.

Examples of financial impact from ESG factors.

Wirecard, which provided electronic payment services, filed for insolvency in June 2020 following an accounting scandal in which **€1.9bn** went missing.

Almost **£2bn** was wiped off the value of Boohoo in just three days in July 2020, when worker exploitation in its suppliers' garment factories was highlighted.

The share price of **Ørsted**, a renewable energy leader, went **up by 29%** in the first nine months of 2020 when energy was the worst performing sector. In contrast, the **BP** share price went **down by 52%** in the same period.

The stock of Equifax, a credit agency, plunged **18%** in value in September 2017 when it revealed a massive data breach.

The US energy company PG&E filed for bankruptcy in January 2019, citing potential fines of around $30bn following safety failures linked to Californian wildfires. The bankruptcy settlement agreed in June 2020 requires PG&E to pay around $13.5bn in cash as part of an overall settlement of **$25.5bn**.

The impact of ESG factors

How might ESG issues affect company performance?

Poor ESG practices can impact on companies' financial results in various ways, including:

- misaligned interests and insufficient oversight of management (eg inappropriate pay structures, lack of board diversity);
- fines or litigation costs for compliance failures (eg unethical business practices, breaching pollutant limits);
- increased costs from new legal and regulatory requirements (eg higher environmental standards);
- reputational damage for failing to meet societal expectations (eg human rights, executive pay);
- vulnerability to shortages or price rises of key inputs (eg water, energy); and
- exposure to changing weather patterns (eg supply chain disruption, crop failures).

Conversely, good ESG practices are likely to reduce a company's exposure to such risks. They can also be a source of competitive advantage and new business opportunities, including:

- opportunities to develop new products and services (eg renewable energy, electric transport);
- gain in market share from changing consumer preferences (eg desire to reduce waste); and
- scope to reduce costs through improved efficiency (eg energy, raw materials).

Moreover, some investors view high ESG standards as indicative of sound management practices more generally.

How could ESG affect investment performance?

Analysis of ESG issues tends to focus on individual companies, but overall portfolio exposure is relevant too. Investors may want to consider:

- How might ESG factors affect a company's financial results and thus the level and volatility of its dividends and share price?
- How might ESG factors affect a company's financial results and thus its ability to service debt?
- To what extent are ESG risks and opportunities reflected in the current market price of a company's shares and debt?
- Does a given portfolio of securities have an elevated exposure to certain ESG risks due to a concentration of companies in particular geographies or industry sectors?
- What is the overall exposure to ESG risks across the whole portfolio?

In practice, these questions are usually considered by investment managers on behalf of asset owners, although asset owners retain an oversight role.

Data and techniques for analysing ESG factors are undergoing rapid development, although the availability and quality of data are still concerns. We expect to see an increasing focus on portfolio-level analysis, particularly in relation to climate risk.

Bringing ESG to life

On the following pages we give two examples for each of E, S and G that we have covered recently in our Quarterly Investment Updates.

E
for Environmental

Corporate lobbying: BHP feels the heat

At a glance:

- BHP has faced increasing criticism for its membership of industry groups whose lobbying is not aligned with the Paris climate agreement.
- At its autumn 2019 AGMs in the UK and Australia, 27% of shareholders backed a shareholder resolution calling on it to suspend such affiliations.

27%

of BHP shareholders backed a shareholder resolution calling on BHP to suspend affiliations with industry groups whose lobbying is not aligned with the Paris Climate Agreement.

BHP's own policies are supportive of climate action. At the same time however, it belongs to groups such as the Minerals Council of Australia, which are seen by investors as impediments to the transition to a low carbon economy. Aberdeen Standard was among those who voted in favour of the shareholder resolution.

BHP is not the only one. Climate think tank InfluenceMap released a report in October 2019 highlighting the gap between companies' stated position on climate change and their influence on global climate policy. Of the 50 most influential companies worldwide, it concluded that 33 had a negative net impact on climate policy. It was particularly critical of Chevron, ExxonMobil and BP, with BHP also on the list. Certain corporates' lobbying on climate policy may be one reason why the 2019 international climate talks, COP25, made little progress.

Following the 2019 AGMs, BHP published a review of its industry association memberships. After its previous such exercise, in 2017, BHP quit the World Coal Association. This time though, the company decided against leaving any industry groups, saying it believes it can better influence change from within. However, it has been saying this for several years and a growing number of investors appear dissatisfied with the stance.

With the recent wildfires in Australia and California, public support for climate action rising and an increasing number of investors seeking to align their portfolios with the Paris climate targets, BHP and other companies are surely feeling the heat. The pressure is only likely to rise in the future.

> *This is a strong signal to BHP that Australian investors have woken up to the impact of anti-climate lobbying by its members, and the long-term risks it poses to their portfolios.*

Brynn O'Brien
Executive Director, Australasian Centre for Corporate Responsibility (ACCR)

The EU Taxonomy - will it end "greenwashing"?

At a glance:

- The EU Taxonomy came into force in July 2020 as the result of the European Commission's Action Plan on Financing Sustainable Growth.
- It is a classification system designed to help identify environmentally sustainable business activity.
- From 2022, it will be mandatory for investment products marketed as sustainable in the EU to have an accompanying statement as to whether, and how, the EU Taxonomy has been used.
- Requirements for company reporting are also expected to follow in 2022.

In March 2018, the European Commission launched an Action Plan on Financing Sustainable Growth. This included developing a classification system, or "taxonomy", to help with assessing what environmentally sustainable business activity might look like – something that is subject to much debate.

In order to be aligned with the EU Taxonomy, an economic activity must make a substantial contribution to at least one of six environmental objectives, and avoid significant harm to the others. These objectives relate to climate change, water use, managing waste, pollution and protecting ecosystems. The activity also needs to meet minimum social and governance safeguards.

Initially, technical screening criteria are being developed for the climate change objectives, identifying activities consistent with net zero emissions in 2050. Criteria for the other environmental objectives will follow later.

The exact implications for the UK are currently unclear. Although the taxonomy itself will form part of the EU law we retain, the regulations that require its use do not. However, the UK Government has committed to ambitious action on sustainable finance, so we'd be surprised if we do not see something broadly equivalent applying in the UK.

In any case, we expect the EU Taxonomy to influence investment products outside the EU. All investment managers seeking to market their products in the EU must comply and this will likely influence their offerings elsewhere.

We view the taxonomy as a positive step to help investors understand how sustainable investments really are and to navigate the sea of ESG products. It should enable managers with credible, robust practices in this area to stand out and address investor concerns about "greenwashing" (where products that are labelled as "green" are not substantially so).

The EU is leading the way in tackling this challenging area and its impact is likely to be widespread.

> *The adoption of the Taxonomy Regulation today marks a milestone in our green agenda. It creates the world's first ever classification system of environmentally sustainable economic activities, which will give a real boost to sustainable investments.*

Valdis Dombrovskis
Executive Vice-President of the European Commission for An Economy that Works for People

S
for Social

Advent of social bonds

At a glance:

- Social bonds are similar to their better-known sibling, green bonds, except that their proceeds are used to finance projects addressing social issues.
- Social bond issuance rocketed in 2020, with $46bn issued in the first half of the year, compared to $19bn of issuance in the whole of 2019.
- We expect to see demand and supply for social bonds continue to grow as long-term social megatrends progress.

What are social bonds?

The proceeds from the sale of social bonds are used to finance projects addressing social issues. Examples include funding for basic infrastructure for sanitation, affordable housing or food security.

It's important to note that this is not about charity. The purpose of these bonds is to generate an acceptable financial return whilst at the same time having a positive social impact. Current issuance remains modest and relatively niche. Should the market grow as anticipated though, social bonds may well become attractive to fixed income managers seeking diversification for their more mainstream portfolios.

What's driving the rise in popularity?

In the whole of 2019, social bond sales amounted to $19bn. For the first six months of 2020, the figure was $46bn. The Covid-19 pandemic has generated a flood of "Covid-19 bonds" funding, for instance, vaccine research and hospital medical equipment or providing loans to generate or maintain employment opportunities impacted by the global economic shutdown.

Historically, the lack of clear aims for social bonds had hindered their take-up by impact investors, particularly compared with green bonds, which target environmental challenges. The pandemic has changed that, with more recently-issued social bonds having clear and measurable targets.

Where there's an unmet investment demand, there are usually bankers and fund managers ready to meet it. We expect to see a similar trajectory for social bonds as we saw for green bonds, with increasing diversity of issuers and indices in time allaying investors' concerns about choice and concentration.

What is "social-washing"?

Social bonds may be subject to "social-washing", a term used to describe capital claiming to fund social objectives actually being used for other purposes. Many new issues are self-labelled and may not be properly vetted or adhere to industry standards such as the Social Bonds Principles developed by

Sustainable Debt Issuance

Source: Bloomberg as at 3 July 2020
** 2020 issuance to date*

the International Capital Market Association (ICMA). Therefore, before investing in social bonds, investors should ensure that their asset managers will be closely scrutinising these matters.

Will demand for social bonds endure?

Covid-19 created an immediate need for emergency social funding, and we expect to see demand and supply for social bonds continue to grow. Managing food security, addressing ageing demographics and growing health-driven consumer preferences should provide ample opportunity for further issuance, beyond the kickstart provided by Covid-19.

Corporate Human Rights Benchmark

At a glance:

- In March 2020, a group of major investors wrote to 95 companies challenging their record on human rights due diligence.
- These companies were identified by the Corporate Human Rights Benchmark (CHRB) as being particularly poor in ensuring that workers are being treated fairly.
- Companies with robust internal processes and strong stakeholder relationships may be better placed to navigate the potential pitfalls of a crisis.

A group of more than 170 major investors, with combined assets under management of around $4.5tn, has jointly written to companies challenging their record on human rights due diligence. These companies, including Starbucks, Costco and Carlsberg, were identified by the Corporate Human Rights Benchmark (CHRB) as being particularly poor in ensuring that workers are being treated fairly.

In its 2019 report, the CHRB reviewed 200 of the largest listed companies in four sectors that it considers as having the highest risk of negative human rights impacts (agriculture, clothing, extractives, and information and communications technology manufacturing). Human rights due diligence is just one of a number of factors assessed; the others include public disclosure of human rights policies, processes and practices; and how the companies identify, prevent, mitigate and account for the most severe risks to people in their businesses and supply chains. While due diligence was the factor for which the largest number of companies achieved the lowest score of zero, the failure to demonstrate good (or even half-decent) practices across these metrics was widespread.

In recent years, human rights in business has been in the spotlight. Businesses that do not take decisive action to safeguard their employees and the workers in their supply chains (or those that simply fail to disclose their practices) are likely to come under fire from consumers and investors.

This issue is particularly pressing at times when businesses are having to make difficult decisions about their employees – the media has seized on actions that are arguably ill-judged in the wake of Covid-19, such as failing to provide adequate protective equipment or social distancing measures for staff. The pandemic has exposed the reputational risks that can arise from poor human rights practices. Companies with robust internal processes and strong stakeholder relationships may be better placed to navigate the potential pitfalls of a crisis.

> *Human rights due diligence is at the heart of any good approach to managing human rights risks, yet the 2019 Corporate Human Rights Benchmark identified 95 companies that do not do enough in this area. We are delighted that this diverse group of international investors has come together to call for immediate action from these companies.*

Camille Le Pors
Corporate Human Rights Benchmark Lead at World Benchmarking Alliance

G
for Governance

Shareholder revolt over executive remuneration

At a glance:

- At the September 2019 AGM, Ryanair shareholders voiced their displeasure over CEO Michael O'Leary's pay.
- Nearly 50% voted against adoption of the remuneration report.
- Although this vote was non-binding, the company committed to consulting with its investors following the vote.

50% *Nearly 50% of shareholders voted against the adoption of the renumeration report at the September 2019 AGM*

Ryanair shareholders voiced their displeasure over CEO Michael O'Leary's pay, with nearly 50% voting against adoption of the remuneration report at the September 2019 AGM. The objection centred around the 10 million share options granted to O'Leary, which could see him earn at least €99m if Ryanair earns a €2 billion profit or if the share price reaches €21 over the next five years (at the time, it was around €12).

Unsurprisingly, the sop of a reduction in pay and bonus by half to only €1m didn't quite cut it with investors. They questioned whether the bonus offered to O'Leary was justified, particularly considering the number of publicly reported issues the company was facing at that time (ie pre-Covid-19), such as strikes over pilot pay, the grounding of its Boeing 737 MAX fleet and the impact of volatile oil prices.

Michael O'Leary accepted a 50% pay cut for 2021, in keeping with trends for executive pay due to the effect of Covid-19. However, shareholders raised objections over his remuneration reward in 2020, questioning a bonus of around €450,000 for O'Leary (over 90% of the maximum he could have received) in a year when staff had been furloughed and the company was receiving government support.

Whilst generous bonus awards are not new, in recent years they have become less acceptable to shareholders. According to a report produced by the High Pay Centre, the median pay package of FTSE 100 CEOs fell by 13% between 2017 and 2018.

Although the Ryanair vote over remuneration was non-binding, at least the company committed to consulting with its investors following the vote.

Pay ratio reporting

At a glance:

- Large publicly listed UK companies must now disclose the ratio between the CEO's total pay and the total pay for the 25th percentile, median and 75th percentile employees.
- As a result of Covid-19, some senior executives have made charitable donations or taken substantial pay cuts, ranging from bonus waiver to a 100% reduction in salary.
- Moderating excessive pay packages while aligning pay with longer term goals can improve long-term financial returns for investors.

3 working days

The time that FTSE100 CEOs need to work to match the average worker's entire annual salary.

From 2020, large publicly listed UK companies must disclose the ratio between the CEO's total pay and the total pay for the 25th percentile, median and 75th percentile employees, with supporting explanation for the ratios. This, at a time when FTSE100 CEOs only needed to work for the first three working days of 2020 to match the average worker's entire annual salary.

Excessive executive remuneration has been a key focus for shareholder revolts at AGMs in recent years. Investors increasingly appear to feel that pay increases granted to senior executives are disproportionate and not sufficiently justified. As well as being a lightning rod for staff discontent, this is considered by many to be a potential sign of serious governance issues. The new pay ratio reporting will provide shareholders with further tools to scrutinise CEO pay.

The pay issue has been particular pertinent in the current climate, when many people are struggling financially due to the economic impact of Covid-19. Some senior executives have made charitable donations while others have offered (or agreed) substantial pay cuts, ranging from bonus waivers to a 100% reduction in salary, thus sharing (to some extent at least) in their employees' financial pain. Other executives are likely come under pressure to do the same, particularly if they are cutting jobs to reduce costs. We expect shareholders will object if pay packages are not adjusted to reflect firms' evolving operating environments.

Looking to the longer term, shareholders may see an opportunity to re-align executive remuneration levels and ensure incentives are refocused on those areas most important for the company's future prosperity. For example, CEOs may not necessarily be rewarded just for reducing costs, but also for delivering on sustainability targets and improved supply chain resilience.

Many executives have seen their overall pay fall in 2020, for example, through failing to meet performance targets or via coronavirus-induced salary cuts. Will shareholders seize the opportunity to address longstanding remuneration concerns? Moderating excessive pay packages while aligning pay with longer term goals can improve stakeholder relations and protect the business against future upheavals, thus improving long term financial returns for investors.

Related resources on responsible investment

Where can you go to learn more?

LCP's Quarterly Investment Update

Each quarter, LCP produces a commentary on topical ESG matters. This provides a briefing for trustees on recent developments and highlights companies in the news which they may want to discuss with their investment managers. For example, do the trustees hold shares in the companies mentioned and, if relevant, how did the manager vote at the AGM and what other action is it taking? Or, does the manager hold companies likely to be impacted by the same or similar ESG issues?

To sign up to our updates, please speak to your usual LCP contact or complete this form.

Responsible investment hub

We've gathered many of our resources into one easy-to-access hub so you can find what you need, when you need it.

We have reports and publications to help you understand the key RI issues, checklists and action plans to help guide you, case studies for examples of how others have achieved their goals, and much more.

Click here to visit our hub.

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