R & A stock selection: Sustainability

Philosophy, approach and implementation

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Introduction

The topic of sustainability has experienced an enormous upswing in recent years and has become an indispensable guide for the actions of governments, companies and investors in large parts of the world. According to surveys, the corona pandemic has increased the ESG focus among companies ("E" stands for environment, "S" for social and "G" for governance). That the general public is becoming increasingly interested is shown in the number of Google searches for the term "ESG," which has quadrupled in the last two years.

There is more agreement than ever among the leading countries on sustainable development. With the election of Joe Biden as the US President, the world's second largest greenhouse gas emitter has recommitted itself to the goals of the Paris Agreement, i.e. limiting global warming to well below two degrees compared to the pre-industrial era. China, the largest emitter of pollutants with a population of over 1.4 billion, committed last fall to carbon neutrality by 2060, and the EU (the global number three in greenhouse gas emissions) is on track to achieve carbon neutrality by 2050 based on the Green Deal and ambitious interim targets for 2030. Therefore, progress on sustainability targets at the global level is clearly there, though the path to achieving the targets undoubtedly will be challenging.

In the corporate world, the importance of ESG has increased sharply in recent years, especially in Europe, which has been an early mover in this respect, but with some delay now also overseas. Among publicly listed companies, there is an exponential growth in ESG reporting, with environmental issues often at the forefront, given their quantifiability and global significance. In selected industries, the energy transition is leading to drastic changes. Well visible in everyday life is the increasing electrification of mobility. In a similar vein, energy producers are undergoing a sustained transformation. The energy mix of electricity suppliers steadily moves towards renewables, and European oil and gas producers, such as France's Total and the UK's Shell, aim to significantly reduce their core business in the long term and increasingly turn to the production and distribution of wind and solar power.

Introduction (cont'd)

ESG in the investment world has evolved in tandem with the trends in society, governments and at the corporate level. Over the past five years, the volume of capital market investments managed according to ESG criteria has increased by around 30% annually, with an ever larger number of sustainable index funds (ETFs/exchange traded funds, which track indices of sustainable investments) becoming available. Even if growth slows somewhat in the coming years, at least one-third of global capital market investments will be made on the basis of ESG criteria by 2025, according to Bloomberg. These trends mean that sustainable investing is in the process of becoming mainstream.

The fact that sustainable capital market investments do not have to come at the expense of returns is now well documented in scientific studies. Due to the large and growing amounts of capital invested on the basis of ESG criteria, companies with a good ESG ranking may even be able to lower their cost of capital (i.e. get more favorable conditions for equity and bond financings).

Ethical schools and ESG in practice

Ethics is the scientific examination of questions of morally right behaviour. Among the important schools of thought are virtue ethics, deontology and consequentialism. Depending on the axiomatic starting point, very different conclusions arise with regard to morally correct actions. From antiquity (e.g. Aristotle) we know virtue ethics, whereby the virtue of the decision maker – for example courage, strength and honesty – stands in the centre. In deontology, with Kant an important representative, the fulfilment of duty is in the foreground. Consequentialism (developed, among others, by the utilitarian Jeremy Bentham) focuses on weighing the consequences of actions for all concerned (utilitarians, for example, may come to different conclusions than duty ethicists with regard to unborn life). It is thus obvious that morally right actions, also those of companies, cannot be clearly defined. This helps to explain that moral concepts change over time and tend to be different among cultures.

In investment practice, ESG (Environment/Social/Governance) analysis is most often based on a mixture of absolute criteria (attributable to virtue and duty ethics) and a consequentialist best-in-class (i.e. relative) approach. Absolute exclusion is applied to companies that violate the principles of the UN Global Compact (such as Volkswagen in the wake of the diesel scandal) or are active in the areas of controversial weapons, tobacco products or coal are excluded (see, as an example, the sustainable index family ESG-X of the index provider Stoxx).

In the best-in-class approach, on the other hand, companies that rank best compared to sector peers are selected, with the idea that this will motivate companies to adapt their behaviour even in sectors that are weak in terms of ESG (such as the energy sector). This takes advantage of the fact that many companies strive for a top ESG assessment which in turn might lower capital costs.

UN Global Compact as a basis for analysis

The term sustainability originally comes from forestry. As early as the early 18th century, people spoke of the "sustained use" of forests in the sense that a forest is managed sustainably if only as much wood is removed as can grow back, so that the forest can regenerate again and again.

Sustainability has historically been defined rather narrowly in terms of natural resources. In the last twenty years, the term has become broader, including not only the environment but also social and governance aspects. Responsible companies, therefore, consider the current and future needs of all stakeholders.

With the UN Global Compact, the United Nations has created a basis for the ESG assessment of companies. The Compact sets out principles and sustainable development goals (SDGs). While the Global Compact serves as the basis for most ESG analysts, other criteria are often included in the analysis. In addition, the data used and not least their interpretation differ.

Based on our introductory considerations, it is therefore hardly surprising that analysts often arrive at very different ESG assessments, in much the same way as there are buy and sell recommendations for most stocks. For example, the correlation between the ESG ratings of Sustainalytics and RobecoSAM (two leading providers of ESG analysis) is only about 0.6. It is not unusual for one team of analysts to rate a company as an ESG leader while another gives the same company very low ESG scores. This outcome is indeed quite different from credit ratings of companies and their bonds. The correlation of Standard & Poor's and Moody's ratings is a near-perfect 0.9. This stems from the fact that ratings reflecting the default risks of companies and bonds are based on actual default data. Naturally, a similar calibration possibility does not exist in the ESG area.

Europe leads the way in sustainability

RobecoSAM produces annual ESG ratings of thousands of companies worldwide. The ratings are published in the form of a ranking for each industry and show how a company is positioned within its industry. The table shows which countries and regions have how many companies in the top 15% of their industry.

Europe's companies are global leaders in terms of ESG. 168 (i.e. 37%) of the 457 companies analysed in Europe are in the top 15%. These 168 companies represent 38% of the global top-15%, although they account for only 18% of the analysis universe.

The corresponding shares are significantly lower in North America and in Asia (Japan/Pacific, Emerging Asia), with high divergences among countries. In China, just one out of 119 companies analysed makes it into the top selection, while Thailand (20 out of 35) and Taiwan (18 out of 80) perform very well.

RobecoSAM Sustainability Yearbook 2019: The industry's best

	Universe	Top-15% share	Top-15% share	World share: Universe	World share: Top-15%
Europe	457	168	37%	18%	38%
North America	710	88	12%	27%	20%
Japan/Pacific	569	76	13%	22%	17%
Emerging Asia	556	84	15%	21%	19%
Other	307	23	7%	12%	5%
Subtotal	2599	439	17%	100%	100%
Germany	57	17	30%	2%	4%
France	70	34	49%	3%	8%
Switzerland	33	11	33%	1%	3%
Austria	7	1	14%	0%	0%
China	119	1	1%	5%	0%
Taiwan	80	18	23%	3%	4%
Thailand	35	20	57%	1%	5%
Hongkong	31	2	6%	1%	0%
Brazil	41	12	29%	2%	3%

Notes: Top-15% in the respective industry. Top-15% share = top-15% number/universe. RobecoSAM, own calculations

ESG in R & A stock selection

Within the framework of our quality select approach, we aim to compile lists of stocks and portfolios that clearly outperform in terms of ESG criteria. Depending on the analysis universe, it must be taken into account that the average is already high (e.g. in Europe), while it is lower in other universes (e.g. USA, but also in samples of smaller and younger companies). We take into account both absolute (such as signing the UN Global Compact, violation of Global Compact guidelines) and best-in-class criteria. It is possible that we classify a violation of UN Global Compact rules as temporary and thus may not exclude the company from our recommended lists (even though we label the company accordingly). We also tend to give more weight to a company's future prospects (for example, if a utility is pursuing a credible strategy toward renewable energy) compared to its current (or past) ratings.

Sustainability indicators R & A equity lists

	Sustain-alytics rank*	Robeco-SAM rank	UN Global Compact sign.**	R & A Sustain-ability Index**
Shares Europe	90	91	86%	100%
thereof long-term favourites	88	83	92%	100%
Benchmark (Stoxx 600)	*80*	*56*	*54%*	*70%*
Shares USA	82	76	24%	80%
thereof long-term favourites	81	81	35%	76%
Benchmark (S&P 500)	*52*	*42*	*13%*	*48%*

Note: *Median (Max. = 100). **Share of companies. R & A Sustainabilty Index: Sustainalytics > 60 or RobecoSAM > 60 or MSCI ESG rating A/AA/AAA or UN Global Compact signatory (and not excluded in the Stoxx-ESG-X). Source: Sustainalytics, RobecoSAM, UN Global Compact, index providers, own calculations.

R & A Sustainability Index

To show how our portfolios perform in terms of ESG, we use the R & A Sustainability Index. The index contains the companies that are either among the peer-group sustainability leaders (RobecoSAM or Sustainalytics rank, MSCI ESG rating) or have signed the UN Global Compact. The company must also not be excluded from the Stoxx ESG-X indices.

The table shows that our equity lists perform very well in terms of ESG criteria, especially when compared to broad market indices. Almost all companies in the Europe equity list are represented in the R & A Sustainability Index, while the US equity list scores much better in terms of ESG than the average S&P 500 company.

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Data sources in charts or tables that are not specifically mentioned are either companies or index provider.

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