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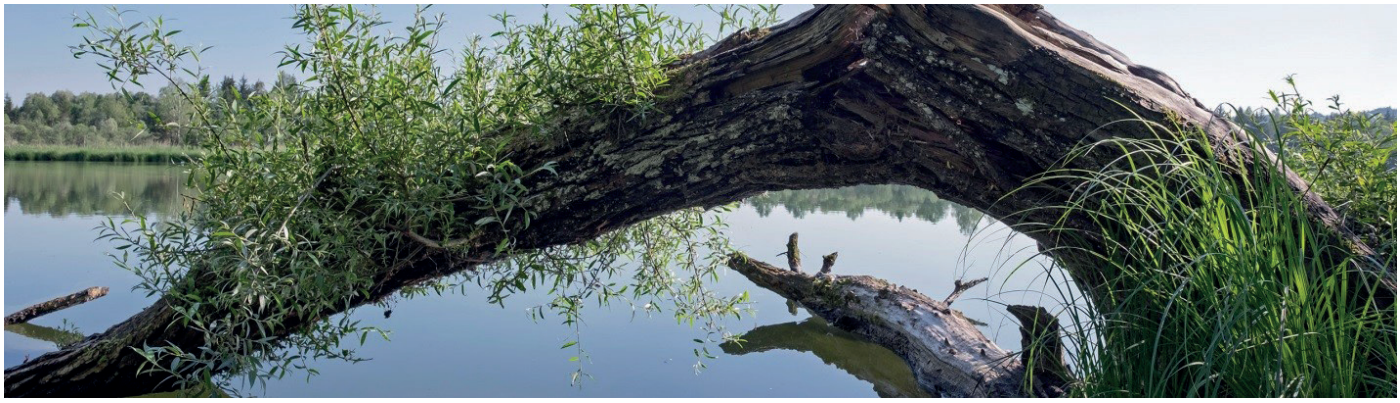
Momentum for Institutional Investors to pick up on Sustainable Investment

Topic of the month March 2017

With the integration of environmental, governance and social criteria (ESG) into the investment process, sustainability has gained momentum and is becoming increasingly important for large asset owners in developed countries. Those leading the way have clearly understood that both financial and ESG factors are essential to protecting one's reputation, to complying with growing international and national regulation as well as to enhancing their risk-return profile.



What Drives Sustainable Investment among Institutional Investors?

There are three main areas of concern that drive institutional investor appetite to factor ESG into their investment strategy and decision-making process: reputation, regulation and improved risk-return profile.

Following the financial crisis, regulators and civil society alike increasingly pressured investors and financial institutions to demonstrate their commitment to sound investment practices and more transparency. Specifically for pension funds, an industry where the public has the right to request for the investment disclosure of their own money, not following sound investment practices became a potential **reputational** risk.[1]
To standardize the new investment practices several international codes and standards were developed by well-known institutions to define global principles that guide investors in factoring ESG considerations into their investment decisions. The voluntary adoption of these codes and standards, pre-dominantly the two most widely used standards United Nations Global Compact Principles (UN GCP) and United Nations Principles for Responsible Investments (UN PRI), has been a driving force in shaping today's sustainable investment market. As of 2016, more than 1'600 investment institutions have endorsed the UN PRI representing USD 60 trillion in AuM.

Alongside the development of international codes and standards, countries have started to adapt their own **regulations** requesting for the institutional investors to take into account specific environmental or social risks when managing and reporting their assets. An example for such a regulatory change was the banning of direct investments into companies with ties to cluster munition (Belgium 2007, France 2010, Switzerland 2012, the Netherlands 2013)[2].

2015 was a milestone for sustainability with unprecedented commitment by the international community to international agreements, including the Sustainable Development Goals (SDGs) and the Paris Agreement on climate change action. In the wake of these recent agreements regulatory developments are expected to materialize in the near future as governments will have to live up to their commitments.
In this context, the UK asset owners' "Aiming for A Coalition" is advocating and filing resolutions for improved management and disclosure of climate risks and opportunities within the companies they own. Last year, Sweden's national AP pension funds have also agreed to coordinate the way they report the carbon footprints of their investment portfolios.[3] Furthermore, the European Parliament has voted to include environmental risk factors in pension fund directives while in Switzerland, seven major public pension funds* (AuM CHF 150bn) established the Swiss Association for Responsible Investments (SVVK) in 2015, planning to extend their fiduciary duties to include ESG criteria in their investment process.

In today's low-interest rate environment institutional investors are increasingly having trouble generating the returns they need to meet their obligations. Maximum return for their beneficiaries and shareholders has long been a contentious issue, which investors have cited as a reason for not incorporating ESG into investment processes.
However, it has repeatedly been shown that considering ESG criteria in the investment process does not compromise return. Investing in top ESG performers may even result in improved financial performance in the long run because the consideration of ESG-factors in a portfolio **reduces the exposure to potential financial, reputational and regulatory risks**, which are likely to have a material financial impact on the performance of a company in the long-run.
Nowadays, it is essential to factor in ESG criteria for holistic risk management – in addition to traditional valuation criteria. Obviously, there is no guarantee that a top ESG performer will not be affected by ESG issues. However, the risk of material financial impact is significantly reduced in case of a company that is well prepared for such shocks. The ESG performance of most publicly listed companies is assessed and reviewed on a regular basis by dedicated rating agencies.

How Can Institutional Investors Implement Sustainable Investments?

There are different ways for institutional investors to implement a sustainable investment strategy. These range from negative screening to positive, more inclusive, approaches.

- The *norm-based approach* tackles reputational risk in areas that are controversial from an ESG perspective. The screening process hence focuses on whether a company is involved in ongoing controversies (e.g. labor rights issues) that constitute material or reputational risks. Going forward, as part of this approach, investors should also consider direct investments in companies where they have enough influence or control to upgrade the ESG management (engagement)
- By applying the *exclusionary screening*, investors avoid investments in companies linked to certain controversial activities such as the manufacturing of weapons, nuclear power or genetically modified organism (GMO)

- On the positive side, the *best-in-class approach* identifies companies that perform well in terms of ESG criteria within a peer group by assessing their ability to successfully manage ESG issues such as CO2 emissions and labor standards. It thereby helps to identify sustainability related risks and opportunities. As more and more investors consider the best-in-class approach, it will also have a positive impact on the sustainability of the economy as a whole as it encourages companies to improve their ESG performance. When setting up ESG-related frameworks, investors are often confronted with a trade-off between rigorous ESG criteria and diversification objectives. Unlike the exclusion approach, the best-in-class strategy does not exclude any industry and, hence, does not compromise the diversification of a portfolio.
- Last but not least, *thematic investments* provide a good opportunity to strengthen the sustainability footprint of a portfolio. Impact Investment, for example, can be applied as a form of alternative investment, while at the same time offering attractive diversification benefits in addition to social impact. Another example are green real estate investments, through which a portfolio's carbon footprint can be improved. With climate change representing the major global challenge of our time, sustainable real estate can make a major difference to this pressing issue as approximately one third of global CO2 emissions stem from the real estate sector.

Turning a symbolic commitment to ESG into practice is not easy. However, in light of increasing stakeholder demand for meaningful action, there is little choice. Institutions that get out in front of the growing movement will be the first to benefit from ESG investing: lower risk, better returns, and—last but not least—a more sustainable world.

Sustainable Investment at Credit Suisse

A growing number of institutional clients, charitable foundations and individual clients are seeking to combine financial returns with positive social and environmental impact. We offer various solutions including sustainability portfolio checks, advice on investment guidelines and additional services such as workshop and trainings on ESG topics as well as thought leadership publications.

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Footnote and References:

1) *In Switzerland, more than 70% of the population want their investment schemes to consider sustainability criteria (gfs Zürich/RobecoSAM 2014)*
2) *List not exhaustive, read more in PAX 2016 Report on Investments in Cluster Munition*
3) *https://cib.bnpparibas.com/sustain/sustainability-the-new-driver-for-institutional-investors_a-3-97.html*