SUSTAINABLE TRENDS

Sustainable Insight
CAPITAL MANAGEMENT

EDITION 11 | QUARTER 1, 2016

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	ESG RATINGS	ESG fund ratings launched	*Consolidation among ESG data providers may accelerate*
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IN THE NEWS

ESG FUND RATINGS LAUNCHED

What happened?

Morningstar launched the first ESG ratings for funds in March. Its Sustainability Ratings will cover 20,000 investment products, with a scoring system ranging from one 'Globe' for the worst ESG performance to five for the best. Funds are bucketed using a percentile distribution.

MSCI soon followed suit. Its ESG Fund Metrics will cover 21,000 mutual and exchange-traded funds. Each fund will be given an overall score, a percentile ranking, and individual scores for E, S and G.

Reaction

Introducing fund-level ratings "democratizes ESG investing", said one wealth manager. But it may cause problems for asset managers, as some of the best-known stock funds score relatively poorly.

According to the Financial Times, "many of the world's largest equity funds are at risk of losing millions of dollars" as investors withdraw assets from investment products with poor ESG ratings.

What next?

The "battle to grade ESG investments" is heating up, said the Wall Street Journal.

An expected consolidation in the ESG data market could now accelerate.

As SICM noted in a recent paper, 100+ businesses now provide sustainability ratings and research, but it's likely that there will be "perhaps only a handful of providers eventually dominating."

> ***Many of the world's largest equity funds are at risk of losing millions of dollars.***
>
> *-The Financial Times*

IN THE NEWS

REGULATORS ACCUSED OF CLIMATE-RISK INACTION

What happened?

Investor groups accused the SEC of being "asleep at the wheel" over climate risk in Q1, the New York Times reported.

After issuing guidance in 2010 on how climate risk should be disclosed in filings, the regulator issued 49 letters to companies in the subsequent two years asking them to address the quality of their disclosures.

But it sent a mere three similar letters in 2012 and zero in 2013.

Reaction

The SEC "has been underreacting in the extreme," a US Senator told the NY Times. His comment echoes widespread concern that companies are not transparent enough about climate risk (see SICM's last quarterly for more.)

The wider issue is that defining materiality in the context of climate risk is proving tough. Former SEC Chair Mary Schapiro told the Financial Times, "It has to be concise and focused so the most decision-useful information is disclosed."

What next?

Expect much more on this in 2016 (see prediction 7 here). The Task Force on Climate-Related Disclosures aims to issue guidelines for companies by year-end. Meanwhile, the Sustainability Accounting Standards Board is mapping out industry-specific climate risks and has issued a working draft on the topic.

It also emerged in March that the FBI is now evaluating whether ExxonMobil should be investigated for allegedly misleading shareholders on climate risk.

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EXPLAINER

ARE WE GETTING THE MEASURE OF CLIMATE RISK?

Recent criticism of climate models highlights why it's far from straightforward to assess a company's climate risk exposure.

What's the issue?

We know the climate is changing. In fact, the latest NASA data suggests temperatures may be rising even faster than we thought. The problem for investors is that assessing an individual company's climate risk exposure remains extremely difficult.

Why?

A key reason is that researchers struggle to forecast climate impacts accurately. According to Lord Stern, "current economic models tend to underestimate seriously the potential impacts of dangerous climate change." Different models also tend to give a huge range of potential outcomes. For instance, estimates of losses from a 2°C rise in global temperatures vary from 0.2% to 2% of world GDP.

Is it just a problem with economic models?

No. The science that economic models rely on is also often imprecise. According to think-tank 2°, "there are huge uncertainties associated with [the physical risks of climate change] given the range of damage functions in climate impact models and uncertainty around [timing]." For example, estimates for changes in rainfall patterns vary by a factor of three across different models.

Why do we need better climate models?

More investors are incorporating climate risks into their decisions, for example via ESG ratings. In addition, the Financial Stability Board recently set up a Climate-Related Financial Disclosures task force, which will look into improving how companies report climate risks. Without more precise impact modelling, these disclosures may be of limited value.

What signs are there that things are improving?

Economists are starting to explore different types of models to replace existing approaches. Lord Stern describes the two front-runners – dynamic stochastic computable general equilibrium (DSGE) models and agent-based models (ABMs) – as "promising". But he also says economists need more help from scientists and engineers.

How about the scientific models?

There are encouraging developments here, too. UCLA researchers have announced a method for improving the way predicted changes in rainfall patterns are incorporated into climate change models. Their approach should reduce variations in precipitation across different models by about 35%. There are also several 'big data' initiatives that are providing more detailed insight into climate risk than ever before.

Such as?

Among the best known are Google's Earth Engine, which makes satellite imagery "available for the first time for global-scale data-mining." Its current projects include mapping global surface water, malaria risk, and deforestation. Another initiative, called Surging Seas, aims to provide "accurate, clear and granular information about sea level rise and coastal flood hazards."

What are the implications for investors?

Climate models will improve only incrementally. Consequently, assumptions and data sources – including ESG ratings – need to be continually evaluated to see whether they accurately reflect climate risk exposure. But there is a positive aspect to the uncertainty. As a recent academic paper points out, it isn't clear if markets are pricing climate risks efficiently. If they aren't, there will be opportunities for investors who can gain an edge in evaluating them.

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TIMELINE

GOING LONG: A NEW PARADIGM FOR CORPORATE GOVERNANCE?

Are we at the start of a paradigm shift in corporate governance that will curb the "powerful forces of short-termism afflicting corporate behavior"? Martin Lipton, a high profile corporate lawyer, thinks so. He believes leading institutional investors are redrawing the relationship between shareholders and companies to put the focus on sustainable value creation. We chart a year in the life of a nascent trend.

2015

April 2015
In a letter to business executives, BlackRock CEO Larry Fink criticizes excessive share buy-backs and dividends, which he says are made at the expense of investing in "innovation, skilled work forces or essential capital expenditures necessary to sustain long-term growth."

July 2015
Hilary Clinton unveils proposed tax reforms aimed at ending "quarterly capitalism" and discouraging "cut-and-run shareholders". Under the plans, capital gains would be taxed on a six-year sliding scale.

August 2015
Some of the world's largest asset managers attend the first of a series of secret meetings to develop a statement of best practice on corporate governance. Their aim is to get companies to focus on long-term value creation. Participants include JPMorgan Chase CEO Jamie Dimon, Warren Buffet, and representatives of BlackRock, Fidelity and Vanguard. The statement is expected to be released some time in 2016.

October 2015
Lawyer Martin Lipton writes of an emerging "new paradigm" in corporate governance, characterized by institutional investors engaging directly with companies on governance issues, rather than leaving activism to hedge funds or outsourcing to shareholder service companies. "We may well be approaching a peaceful end of the corporate governance war," he says.

2016

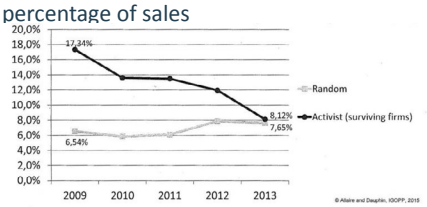
February 2016
In another letter to CEOs, Larry Fink keeps up the pressure on company executives to focus on the long term: "Many companies continue to engage in practices that may undermine their ability to invest for the future. Today's culture of quarterly earnings hysteria is totally contrary to the long-term approach we need."

February 2016
State Street Global Advisors sends guidelines to company boards outlining its views on governance and independent board leadership: "We want all companies we invest in to fully understand our expectation – that companies have … an effective board and independent leadership in place to convince us that their focus is on long-term value creation."

What's Next?
The stakes are high. According to Lipton: "Much of what is wrong with America today – slow growth, corporate scandals, inadequate investment in long-term projects, low wages, wide swings in the economy and rising inequality – is attributable to short-termism."

At the company level, the clear implication of the current debate is that companies with strong governance are more likely to align their strategies with long-term goals rather than short-term profits. If the long-termism movement gathers momentum, the perceived importance of governance as an investment signal could grow further.

In it for the short term?
Impact of hedge fund activism on company R&D as percentage of sales



Source: IGOPP, Allaire & Dauphin, 'Hedge Fund Activism: Preliminary Results and Some New Empirical Evidence' (2015); cited in Coffee & Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2015)

WORLDVIEW

FOOD SUSTAINABILITY: A GROWING CONCERN

Last year's Paris Agreement put food systems "on the climate change map", says the World Bank. In Q1 the sector has come further into the sustainability spotlight, with implications for businesses all along the field-to-plate-to-landfill value chain.

It's a complex area because the need to cut emissions from agriculture – which accounts for 19%-29% of global greenhouse gases – must be balanced against the fact that food production must rise by 70% in the next three decades to feed a forecast world population of 9 billion. At the same time, climate change is hindering our ability to grow food, especially fruit and vegetables. Left unchecked, its impact on agriculture could lead to over 500,000 deaths worldwide by 2050.

Solving the problem is likely to result in profound changes in the US and worldwide regarding where, what and how we grow – with potentially far-reaching economic consequences.

Food Production Threatened
Climate change is pushing the top edge of the US Corn Belt north of the Canadian border. Canada's wheat-zone is also heading higher. But experts say there will be a net loss in North American productive capacity as crops fail in the south.

Europe Bucks the Trend
In most regions emissions from agriculture are rising. But they've fallen in Europe since 1990 due to fewer livestock, smarter use of fertilizers, and better manure management.

Economic Opportunity
Smart farming' – such as using digital technology to apply water and fertilizers more efficiently – can boost agriculture profits by 18%. Meanwhile, the plan to cut food waste in the US could add 15,000 jobs and generate $100 billion of economic value.

Economic Threat
Coffee growing is no longer viable in parts of Nicaragua; some farmers are switching to cocoa. Bhutan is facing the loss of its #1 export, mandarin oranges, due to disease and climate change. It's not just a land-based problem: in the N. Atlantic, the distribution of some fish stocks is changing.

Waste not, want not
Cutting food waste is seen as key to addressing both rising food demand and agriculture's climate impact. Strategies for tackling the problem were unveiled in the US, UK and Italy in March.

Dietary Transition
Experts say a "global dietary transition" will have to take place. Plankton and insects are being touted to replace meat as a protein source. Businesses in Africa are taking a lead, exporting edible crickets (Kenya, Uganda) and larvae-based animal food (South Africa).

Degraded Land
A quarter of Asia's agricultural land is already highly degraded. By 2050, 45% of the region's irrigated rice output could be lost. Australia is also vulnerable: rainfall in its wheat belt has declined 20% in recent decades.

Sources: Asian Development Bank; Bloomberg; Business Insider; City Metric; Drinks Feed; European Environment Agency; Global Opportunity Network; Sustainable Brands; The Conversation; The Lancet; UN Food and Agriculture Organization; United States Department of Agriculture; Washington Post; World Bank

RESEARCH EYE

Journal of Sustainable Finance & Investment

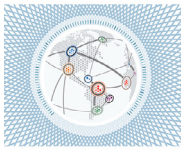
ESG and financial performance: aggregated evidence from more than 2000 empirical studies

Weight of evidence supports ESG:
One of the largest ever meta-analysis of the relationship between ESG factors and corporate financial performance confirms that sustainable factors matter. Most of the 2,200 research papers examined found that companies with positive ESG characteristics do better.

Sustainable Insight Capital Management

S is for Social

Social confidence:
Does analysis of social data on companies – the 'S' in ESG – help investors make better decisions? SICM's research shows the answer is a qualified yes. In fact, the influence of social factors on investment performance seems to be increasing. But particular care is needed when applying them to an investment process.



World Economic Forum

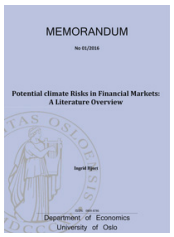
Global Risks 2016

The biggest global threat:
Climate change is the biggest global risk in terms of impact, according to the World Economic Forum. Its annual survey of experts ranked climate change at #3 in terms of likelihood, after large-scale involuntary migration and extreme weather.

Sustainable Insight Capital Management

Who are the ESG rating agencies?

Getting to know the ESG raters:
Investors are putting a lot of faith in ESG ratings. Yet how much do they know about how the ratings are calculated and who produces them? This SICM paper explains who the ESG rating agencies are, explores their commercial motives, and evaluates criticism of their methodologies.



University of Oslo

Potential climate risks in financial markets: a literature review

Mapping the extent of climate risk:
This study examines previously published research to try to identify "close to everything that may directly or indirectly impact financial markets as a consequence of climate change." It concludes that it still isn't possible to tell whether markets are correctly pricing climate risk.

THIS QUARTER... BY THE NUMBERS

Environmental

157
Size in sq. miles (407 sq. km) of the world's largest offshore wind farm, off the UK coast

90
Percentage of studies that show a non-negative relationship between ESG factors and company performance

41.8 billion
Value of green bonds issued in 2015, a record

5.3 quadrillion
Number of calculations per second the new Cheyenne computer dedicated to climate change can make

1.5 million
Number of cars removed from Delhi's streets during trial aimed at curbing pollution

Social

300
Number of contagious diseases to emerge or reemerge since the discovery of Zika in 1952

69
Percentage of middle- and high-school students reached by e-cigarette companies from one or more media sources

62
Number of people at the top of the global rich list who collectively own as much as the poorest half of the world's population

41 million
Number of children under 5 worldwide who are obese or overweight

1.2 million
Number of Wal-Mart workers to receive a pay rise in 2016

Governance

94.9
Percentage of Apple shareholders who voted against a proposal to force more board and senior management diversity

40
Estimated number of years for women to reach boardroom parity

18
Percentage of German companies planning to stick with quarterly reporting; the rest will go to semi-annual reports

12
Number of days it took UK top bosses to earn more than the average worker makes in a year

5
Number of Israeli banks put on an investment blacklist by the United Methodist Church pension board.

READING LIST

MSCI: '2016 ESG Trends to Watch'

READ HERE

RepRisk: 'Most Controversial Companies'

READ HERE

US Chamber of Commerce Foundation: 'Trash to Treasure'

READ HERE

OECD: 'Financing Democracy'

READ HERE

BP: 'Energy Outlook 2016 edition'

READ HERE

BMC Public Health: 'Simulating the impact on health of internalising the cost of carbon in food prices combined with a tax on sugar sweetened beverages'

READ HERE

Transparency International: 'Corruption Index 2015'

READ HERE

QUOTE OF THE QUARTER

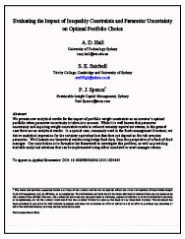
"Investors are desperate for clear and honest and comparable data about climate risk so that they can make decisions about where to allocate their capital."

-Mary Schapiro, former chair of the US Securities and Exchange Commission and member of the Task Force on Climate-Related Financial Disclosures (**More here**, subscription required)

Other SICM Research:

Sustainable Insights Weekly Newsletter, Edition 111

September 2015



Evaluating the impact of inequality constraints and parameter uncertainty on optimal portfolio choice

April 2015

Who are the ESG rating agencies?

February 2016

Diversification vs. Concentration: The Effect of Number of Stock and Active Share on Portfolio Risk

March 2015

Linking Climate Engagement to Financial Performance: An Investor's Perspective

September 2013

The Risks and Returns of Fossil Fuel Free Investing

September 2014

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