# On the Minds of Investors

September 2019

## How is ESG affecting the investment landscape?

Environmental, social and governance (ESG) factors are non-traditional metrics that can affect a company's performance.


### WHY ARE INVESTORS PAYING MORE ATTENTION TO ESG FACTORS?

#### Environmental and social policy changes

Governments have committed to carbon emissions targets. The Paris Agreement was established in 2016 within the United Nations Framework Convention on Climate Change by 196 state parties to combat climate change and prevent global temperatures from rising by more than 1.5 degrees by 2030. **Exhibit 1** shows that many governments are way off this target. The grey bar shows total estimated emissions based on current policy by country/region and the green bar shows the target emissions based on the Nationally Determined Contributions (NDCs), which form part of the Paris Agreement. As a point of reference, the blue dot shows carbon emitted by the same country/region in 2017 (latest full year data available). Government Policy is trying to shift quickly to get back on track, although this is not being seen within all countries. Initiatives include spending on climate-friendly projects, influencing behaviour through taxes and regulation.

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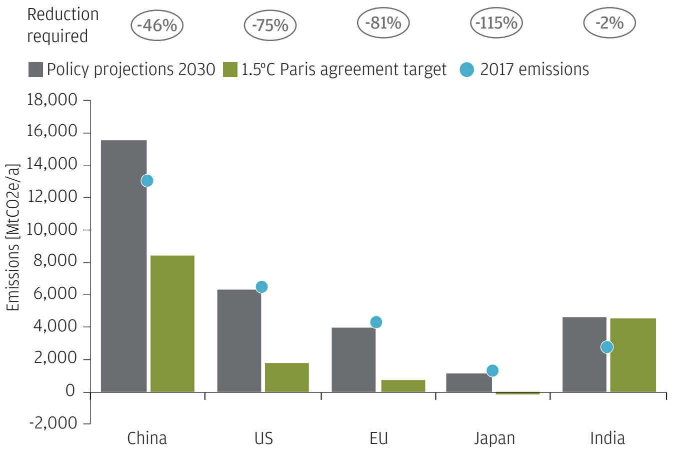
**EXHIBIT 1: CARBON EMISSIONS BY COUNTRY AND/OR REGION BASED ON CURRENT POLICY PROJECTIONS VS EMISSIONS NEEDED TO BE COMPATIBLE WITH PARIS AGREEMENT BY 2030**

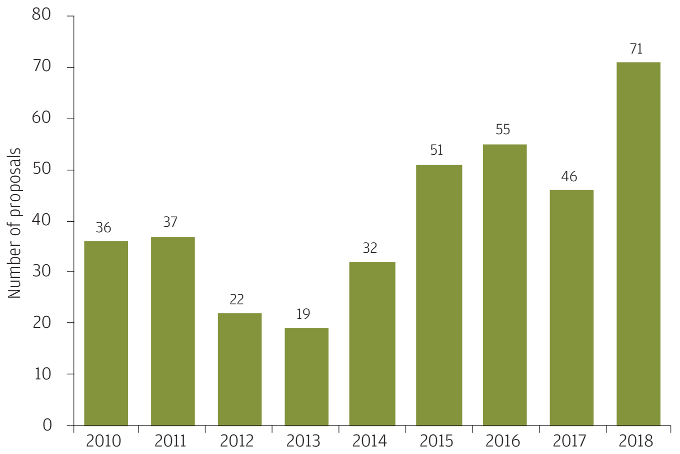
Global sustainable investing assets across region




Source: Climate Action Global Tracker Proxy Preview, J.P. Morgan Asset Management. Data as of 29 August 2019.

**EXHIBIT 2: US CORPORATION- SHAREHOLDER RESOLUTIONS ON CLIMATE CHANGE**

Voted on or pending by year




Source: Climate Action Global Tracker Proxy Preview, J.P. Morgan Asset Management. Data as of 29 August 2019.

Many new regulations focus specifically on the role capital markets should play in delivering a solution. In March 2019, the EU Parliament and Council introduced new regulation to ensure consistency, disclosure and transparency by financial market participants and financial advisors across EU member states. The regulation sets out how ESG risk and opportunities must be integrated in their processes, as part of their duty to act in the best interest of clients.

Further detail was provided in June 2019, when the European Commission's Technical Expert Group (TEG) released its final recommendations for a "taxonomy" of environmentally sustainable activities. The main report set out technical screening criteria for 67 economic activities that can make a substantial contribution to climate change and mitigation. Asset Managers that market products as environmentally "sustainable" will need to explain and disclose information on how they relate to the 67 activities.

The current US administration has pulled out of the Paris Agreement, but it may be wrong to assume that climate change is not a domestic priority. **Exhibit 2** shows that the number of US shareholder resolutions with climate change as a key theme has been steadily increasing. Given that most climate experts agree that the next ten to twenty years will be crucial in limiting climate change we expect to see government policy ramp up in the near term as the threats to the environment increase.

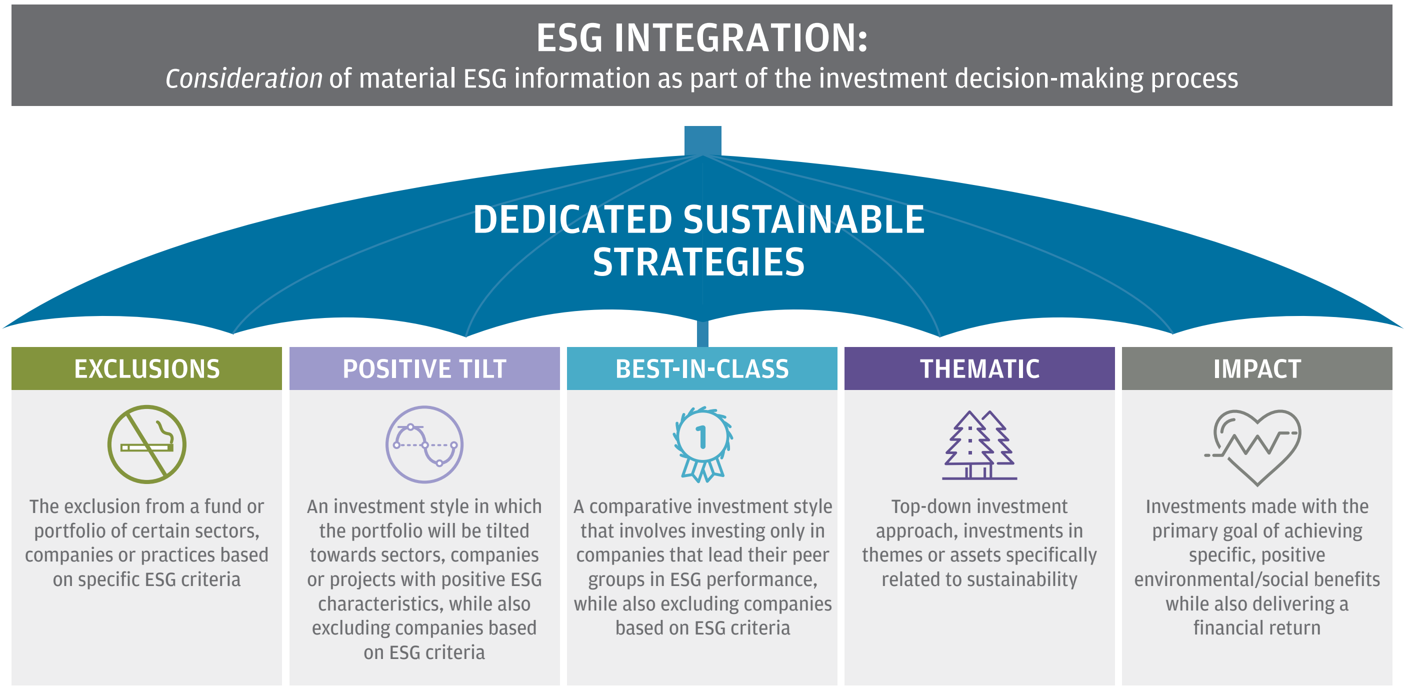
In addition to climate change, social issues are affecting government policy. One of the corollaries of the slow growth in this expansion has been lacklustre real wage growth, particularly in low- and middle-income households. We suspect that social policies, such as living wages and on-the-job training, will become an increasingly important component of government policy in many developed world countries.

As such, understanding how ESG-related government policy will affect corporate earnings is increasingly crucial to appropriately valuing a company's stock.

## Social attitudes

ESG factors are influencing consumer and investor behavior. The recent aversion to single-use plastics is one example of how increasing awareness can have a notable impact on consumer behavior. In addition, savers are keen to see their savings put to work in a way that accords with their social values. In a recent survey, 87% of millennial respondents indicated the importance of ESG in investment decisions.

**EXHIBIT 3: HOW CAN ESG INFORMATION BE INCORPORATED INTO STRATEGIES?**




Source: J.P. Morgan Asset Management. As of 30 September 2019.

## HOW CAN ESG BE INCORPORATED INTO INVESTMENT DECISION MAKING?

**Exhibit 3** from our upcoming Q4 *Guide to the Markets* shows the different ways in which ESG factors can be considered, or screened, when investors are making decisions. These are J.P. Morgan Asset Management classifications that seek to conform to global industry standards and align as much as possible with potential regulations.

**ESG integration** is the broadest category and is defined as "the explicit and systematic consideration of ESG issues in investment analysis and investment decisions". Investors consider ESG factors when making their investment decisions in the same way they would consider other traditional variables, such as product demand, that might affect a company's outlook. It is at the investor's discretion to determine the materiality of these ESG factors and whether the price of the asset is reflecting this additional risk.

**Dedicated ESG strategies** are investment processes that are more rules-based and may invest in themes specifically related to sustainability.

- **Exclusion** strategies apply restrictions on the ability of a fund manager to buy assets related to industries such as weapons, tobacco, thermal coal extraction, unconventional oil and gas extraction, alcohol and adult entertainment. Alternatively, fund managers may be able to invest only in businesses that have signed up to the UN Global Compact on sustainable and socially responsible policies.
- **Positive tilt** strategies exclude the industries noted above and then award a larger allocation within a portfolio to stocks with higher ESG scores. The ratings can be developed in-house by investment teams or sourced from third-party ESG research providers.
- **Best-in-class** strategies build on the exclusion processes by ranking the remaining companies in the investment universe within their sectors and then selecting the most sustainable companies within a given sector. This process attempts to reward ESG leaders in an industry, while also avoiding large portfolio skews toward sectors more associated with strong ESG practices or better disclosure.
- **Thematic** and **impact strategies** are built according to specific forward-looking sustainability goals.

**Exhibit 4**, from our upcoming Q4 *Guide to the Markets*, considers the assets under management (AUM) of the top 400 asset managers. We estimate that roughly USD 30.7 trillion (47% of total AUM) includes some form of ESG integration or certain types of exclusion-based screening. However, less than USD 10 trillion (12% of total AUM) is in dedicated investment strategies.

**EXHIBIT 4: VALUE OF ASSETS CONSIDERED TO BE MANAGED SUSTAINABLY**

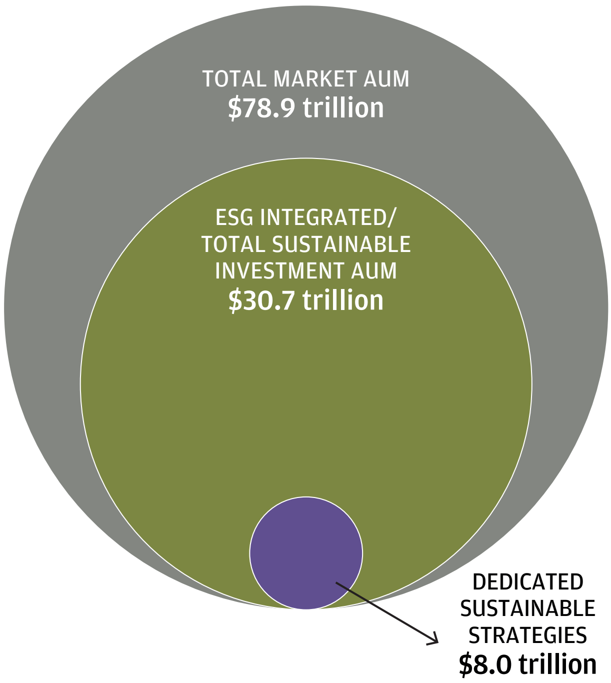
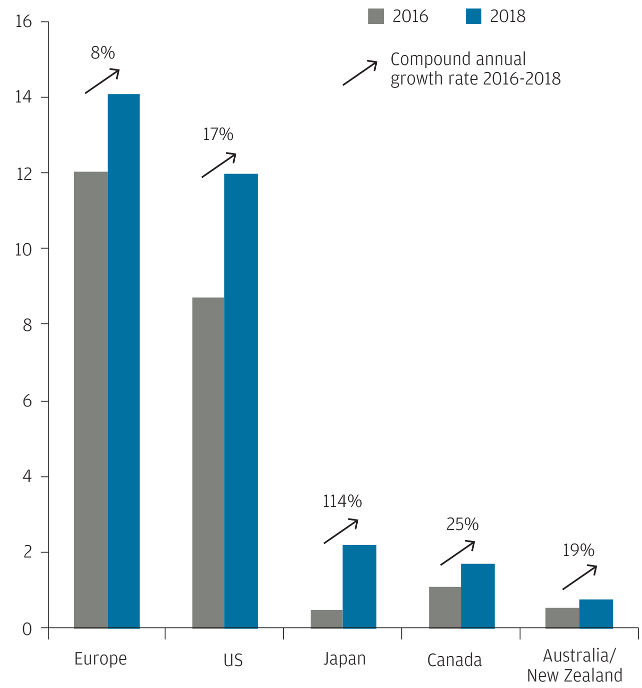



**EXHIBIT 5: SUSTAINABLE INVESTMENT ASSETS UNDER MANAGEMENT**

USD trillions




Source: (All charts) Global Sustainable Investment Alliance (GSIA), Investment & Pensions Europe (IPE), J.P. Morgan Asset Management. Total market assets under management (AUM) represents the AUM of the top 400 asset managers in 2018, and comes from IPE. ESG integrated/total sustainable investment AUM is the total sustainable investing assets in five major markets (Europe, US, Japan, Canada, Australia and New Zealand), and comes from GSIA. Dedicated sustainable strategies represent a part of the total sustainable investment AUM, and includes norms-based screening, positive/best-in-class screening, sustainability themed investing and impact/community investing as defined by GSIA.

Past performance is not a reliable indicator of current and future results. Data as of 30 September 2019.

**Exhibit 5** showcases the growth by region over the past two years. While traditionally Europe has been at the forefront of ESG inclusion in the investment process, the growth in Japan and the US is noteworthy.

## WHAT IS THE PROCESS FOR RATING AN ASSET BASED ON ESG FACTORS?

With investors increasingly scrutinising companies according to ESG criteria, managements are becoming more adept at providing data on the performance of their firm. 85% of companies in the S&P 500 now report on ESG issues, up from just 20% in 2011.

The influence and importance of ESG rating agencies has also increased. MSCI and Sustainalytics are the two most prominent players. They both analyse the ESG-related business practices of thousands of companies globally, and provide research, materiality frameworks, a benchmark in which to compare industries and companies, and an overall score.

It is worth noting that individual agencies' ESG ratings can significantly vary (the correlation among their scores is just 0.53). This is due to a combination of factors including methodology, quantity and quality of the underlying data, subjective interpretation of a company's ESG disclosures and lack of standardization. As a result, the rating agency scores can end up biased toward countries, industries or companies that have better disclosure.

Some asset management firms build their own proprietary tools to produce in-house scoring systems that can account for these limitations.

## SUMMARY

Environmental, social and governance factors are becoming a higher a priority for governments and savers alike. Investors have a range of strategies they can deploy, ranging from ESG-integrated, whereby ESG factors are considered alongside traditional metrics in the investment process, to impact investing, in which a specific sustainable goal is at the heart of the investment process. At a minimum, understanding how preferences and policies are changing is necessary to mitigate risk. Increasingly, savers are seeking more than financial returns—they want to be a force for change.

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