NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

Lunch Seminar
January 2020

insights

For investment professionals only
Not for public distribution

NordSIP Handbooks are published by
Big Green Tree Media AB
Kungsgatan 8
111 47 Stockholm
+46 70 9993966

Editor-in-Chief
Aline Reichenberg Gustafsson
aline@nordsip.com

Director, Strategic Relations
Kim Hansson
kim@nordsip.com

Economics Editor
Filipe Wallin Albuquerque
filipe@nordsip.com

For advertising or other sales-related enquiries
email: sales@nordsip.com

FOR INVESTMENT PROFESSIONALS ONLY
Please read important Terms & Conditions on the last page of this document

Photographic Credits: Binniam Halid for NordSIP ©
Featured image: Shutterstock ©

© 2020 NordSIP all rights reserved

MENU

amuse-bouche

easy as pie 5

who is who? 6

starter

Easy impact: a normal investment 10

Hydropower in Nepal 12

The golden mean in impact investing 13

main course

Building the future: from exclusions to impact 16

Bringing impact to the forefront of the financial industry 18

Reducing Negative Impact: Can investors engage and exclude at the same time? 20

Showing off externalities 22

dessert

Risk, correlations & asset allocation buckets 23

coffee

about our partners 26

amuse-bouche

easy as as pie

Event in Nordics, where sustainable investing has become mainstream, the word ***impact*** sounds a little intimidating.

Those for whom impact is the most unattractive don't even believe that investors can generate positive impact without sacrificing returns. For some others, impact remains a far-away promise, something an investor may achieve in the long-term, but “we are not there yet.”

Investors need to see proof, a track-record of positive impact. Then, they ask for terms that are equivalent to traditional investments. Finally, they may wish for the same liquidity terms and legal structures. And even then... institutional portfolio managers may struggle as they wonder which investment bucket they should allocate this impact investment from.

What then, we asked the managers we met, can make for an investment that is not so difficult? Can we find impact investments that are just normal? A no-excuse product that investors can just buy and direct capital towards solving global issues?

Institutions need to get used to the idea by dipping their toe into investments that can fit into their allocations easily. Once they see the positive effects of their investments, they may be tempted to take another more daring step. To help us break down the barriers to impact one constraint at a time, we assembled expert managers and engaged investors to discuss ***Easy Impact***.

Aline Reichenberg Gustafsson, CFA
Editor-in-Chief
NordSIP

your experts

James Tomlins, CFA

Fund Manager

M&G Investments

James Tomlins joined M&G in June 2011 and was appointed fund manager of the M&G European High Yield Bond Fund later that year. In January 2014, he became co-manager of the M&G Global High Yield Bond Fund, after two years as deputy manager on the fund. James has also managed the M&G Global Floating Rate High Yield Fund since its launch in September 2014 and is co-fund manager of the M&G (Lux) Floating Rate High Yield Solution, launched in August 2017 and the M&G (Lux) Global High Yield ESG Bond Fund, launched in October 2017.

James has more than 10 years experience in high yield credit. He was previously an analyst and then a fund manager at Cazenove Capital Management. Before Cazenove, James was at KBC Alternative Investment Management; in the three years prior to that, he worked at Merrill Lynch Investment Managers. James is a CFA charterholder. He graduated with an MA in history and PgDip in economics from the University of Cambridge.

Gunnela Hahn

Head of Responsible Investments

Church of Sweden

Gunnela Hahn is Head of Responsible at the Church of Sweden since 2008. She has built up and continuously developed the RI structures and content, not least the climate adjustment of the overall portfolio. Previously she worked eight years as an RI analyst at Folksam Insurance Group. She was one of the founders of Swesif, the Swedish Sustainable Investment Forum, and served for many years on the board. She has also served on the board of Ekobanken.

In the past, Gunnela worked as an environmental consultant for private companies as well as various public institutions. For the past ten years, she has served on the board of a major public healthcare provider. Her educational background is in international economics and business administration with environmental specialization and science.

Kärim Chatti

Investor Relations Manager

Triodos Investment Management

Kärim joined the Business Development and Investor Relations Team in June 2019. He has over ten years of experience in the financial industry. In his last position before

joining Triodos Investment Management, he worked as Market Head Germany at ResponsAbility Investments AG (Zurich). Previously, he worked at UBS Bank AG, Donner & Reuschel

Privatbank AG, HSH Nordbank AG and Bertelsmann Foundation. His professional experience covers the sectors of finance, wealth management, impact investing as well as philanthropy.

Kärim holds a master's degree in political science from Bonn University.

Easy Impact

T-House
Stockholm

6 November 2019

Easy impact: a normal investment

“Yes, you can invest in impact investing, and you can do so without being a 'dark green' investor or sacrificing returns. Impact investing is a normal investment,” starts Kärim Chatti, Investor Relations Manager at Triodos Investment Management (Triodos IM).

“We typically offer a standard rate of return with standard fees, standard fund struc¬tures, investing in a range of impact strategies in developed and emerging markets.”

Prior to joining Triodos IM, Chatti spent five years at ResponsAbility Investments, based in Zurich. He joined the Swiss impact investor from UBS where he had worked in the field of sustainability, ESG or impact. “When I joined UBS many, many years ago, the team was called values-based investing (VBI). That turned into sustainability, into ESG, then into impact, and now it is mainstream,” Chatti explains.

Triodos IM has over 30 years of experience as a globally active impact investor and is a whol¬ly-owned subsidiary of Triodos Bank. With over 180 employees and €4.6 billion in AUM at the end of June 2019, Triodos IM has carried out more than 750 investments across the globe.

Impact and Scalability

“How we invest reflects the world we want to live in. This message is carved in our company’s DNA. It is why the DNA of Triodos IM is 100% impact,” Chatti explains.

The main feature that distinguishes Triodos IM from its competitors is its scope, according to Chatti. “We invest throughout Europe, but also, for example, in South East Asia and Africa. We invest in emerging markets and in the developed world. That is the main difference between Triodos IM and ResponsAbility,” he explains. “They only invest in emerging economies, whereas we invest in both. As a result, impact investing has a broader scope and implementation at Triodos IM, when you consider our products and funds.”

“This scalability is a key pillar of our approach,” Chatti continues. Its broader scope allows Triodos IM to deploy more resources and to reach more people, thus achieving higher impact, he argues. “Take the case of our renewable energy strategy. Together with our colleagues from Triodos Bank we have invested EUR 2.25 billion in more than 500 re¬newable energy projects. The wider scope has allowed us to reach 2.5 million households.”

Renewable Energy in Emerging Markets

Nevertheless, as Chatti explains, there is value in focusing on Emerging Markets and doing so does not mean compromising on scalability. “1.7 Billion people worldwide have no access to electricity, and most of them live in emerging economies. The demand for electricity is grow¬ing by 25% every year. We need more invest¬ments to satisfy this enormous demand.”

Triodos IM can draw on the lessons learned from the investment opportunities created by its wid¬er scope when it goes into emerging markets. “To satisfy this need for electricity in emerging markets, we are launching a fund specifically aimed at energy generation in this region, building on the experience of Triodos Green Fund and Triodos Renewables Europe Fund. Contrarily to these two funds, the new fund will be 100% targeted at emerging markets.”

“Being in the market for so long has given us enough experience to know where to invest and how to hedge risks. (..) there is a low correlation between such an investment opportunity and listed equities or bonds.”

“One of the most important features of renewable energy in emerging markets is scalability,” Chatti explains. “It's not a niche offering. Demand from investors and energy needs on the ground allow us to build a large, scalable, stand¬ard energy fund. The fund already has a full pipeline of projects to invest in.”

A Mainstream Investment

Being in the market for 35 years gives Triodos IM a leadership position in renewable energy invest¬ments. “Our new fund will build on existing portfolios. It will have a Luxembourg, SICAV structure. It will be open-ended, and liquidity will be monthly. Its target return is 3% to 4% in euros, which is a conservative assumption,” Chatti describes, to illustrate how mainstream such an impact investment vehicle can be.

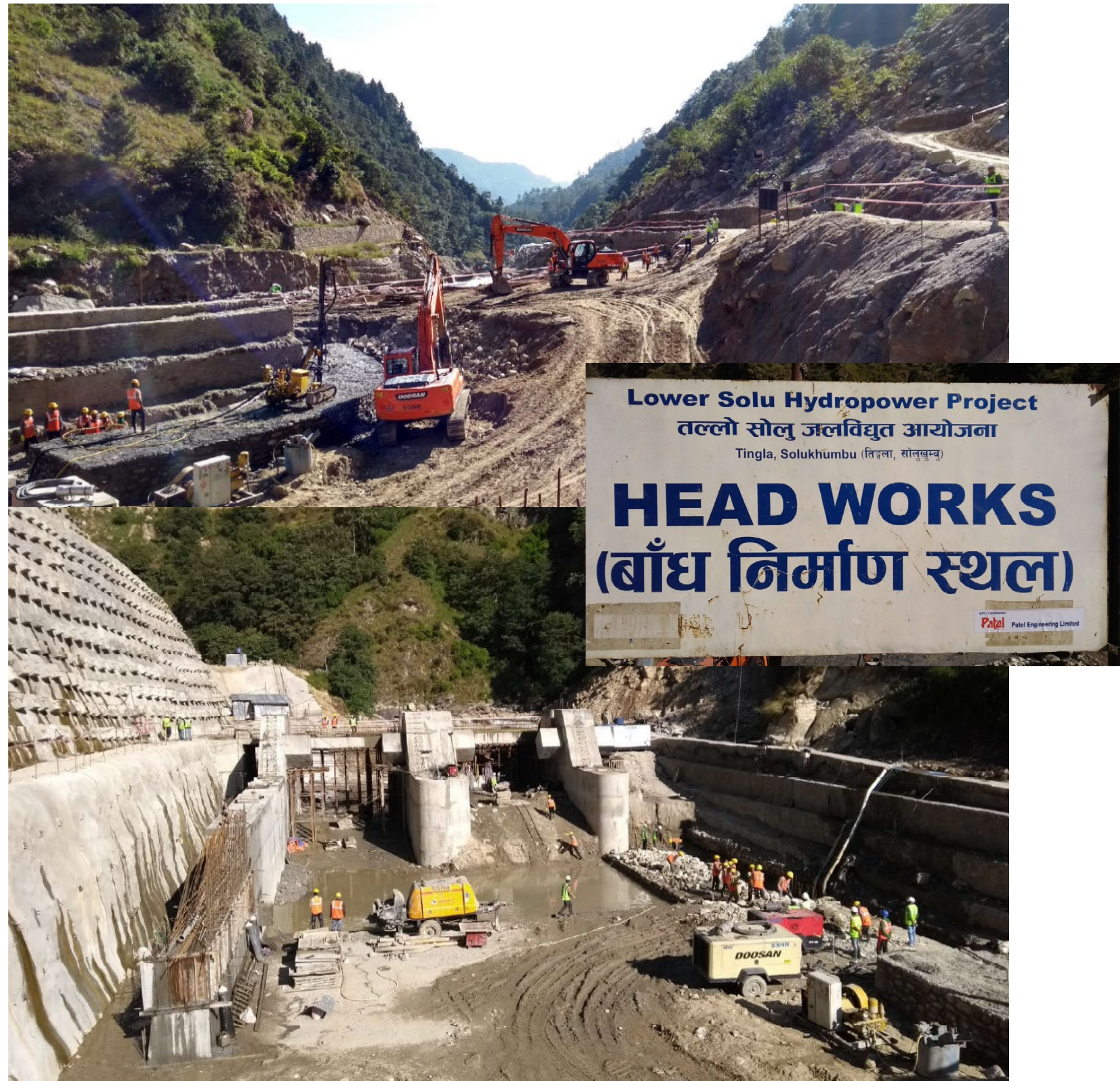
In setting up the new fund, Triodos IM can also draw on the existing partnerships it has estab¬lished over many years. “As a pioneer in the renewable energy sector, Triodos IM has a broad network of partners such development finance institutions, local developers and other funds. Building on this network allows us to build a scalable investment fund that mobilises the capital needed to address this important global challenge.”

Chatti is also confident about the risk profile of the new fund. “Being in the market for so long has given us enough experience to know where to invest and how to mitigate risks. Investing alongside the DFI's further reduces risks given their preferred creditor status. Finally, there is a low correlation between such an investment op¬portunity and listed equities or bonds.”

Hydropower in Nepal

"A good example of the type of investment that could be part of the portfolio of the new fund is the hydropower plant project in Lower Solu, Nepal," Chatti continues. "The region does not have enough electricity. There are 40 million people, and the grid's present capacity only reaches 700 megawatts. Every day there are power outages for 18 hours. The region is also prone to earthquakes. Not only does the damage from these natural disasters further erode the country's already limited in¬frastructure, but the poor capacity also under¬mines post-disaster assistance efforts, ultimately increasing the damage, as was the case with a massive earthquake in April 2015."

"Bringing electricity to the people of Nepal is extremely important to ensure the functioning of schools and hospitals, but also to sustain com¬panies, large and small," Chatti argues. "This power plant in Lower Solu will add at least 82 megawatts to the grid. That's more than 10% of the current capacity."



The golden mean in impact investing

"Responsible investing is like politics. There is an inherent combination of ideology and practicality that requires trade-offs. If you want to get things done, sometimes you have to make compromises on your ideology to have a genuine impact in the world," says James Tomlins, fund manager at M&G Investments a British investment manager with £341 billion in AUM at the end of the first half of 2019.

"Ideally, in politics, you would want someone in the middle, who is principled, but accepts the fact that sometimes you have to make compromises to get things done," the fund manager explains. "I find that this is very much true in investing as well."

This trade-off is particularly important in sustainable investing, Tomlins argues. "You can have the purest principles when it comes to sustainable and responsible investing, but the purer you are, the more constrained you are, and the less impact in actual financial terms and client terms you're likely to have."

Practical Impact

"A lot of theory has dominated the responsible investing space," the fund manager explains. "This focus on principles is particularly visible in equity investments, but also in the private debt space where there are excellent self-selecting funds and strategies with project-by-project approaches."

"However, I work in the public liquid credit market, where none of these philosophies works in a 'pure' way," Tomlins argues, referring to his experience with the M&G Global High Yield ESG Bond Fund to illustrate the need for compromise. "We have taken what we think are the workable parts of these philosophies, applied them to a market to generate returns, but also to find some ESG improvements and sustainable impacts."

"M&G's Global High Yield ESG Bond Fund is a SICAV Luxembourg vehicle. Dealing, pricing and liquidity for the fund are daily and the fund invests in the public credit market," the fund manager says.

Screening Laggards

"Our strategy is not necessarily constrained to a small investment universe, but we do apply screens. We start with the global high-yield investment universe consisting of 3,144 issuers. We then screen out fairly traditional sectors and UN Global Compact violators," Tomlins explains. "This includes exposure to weapons or the defence industry, alcohol, nuclear energy, adult entertainment, gaming, thermal coal, and tobacco but also anyone deemed to be failing to comply with standards of human rights, labour, environment and anti-corruption."

The fund manager illustrates this point with some examples. "Petrobras, the Brazilian oil company, is excluded from this portfolio because of its historical problems with corruption. Another interesting case is the Ball Corporation, a US packaging business. Their focus on metal packaging is appealing from a recycling and environmental standpoint. They are one of the few US companies that take ESG very, very seriously. Unfortunate-

ly, they have a small aerospace division that sells equipment to the F-22 fighter jet program in the US," Tomlins notes. "Despite their ESG commitment, they are excluded from the portfolio due to their participation in the weapons industry." The exclusion criteria create other subtle considerations for the fund, according to the fund manager. "While a supermarket is eligible, a duty-free retailer would be excluded if significantly more than 10% of its sales came from alcohol and tobacco goods."

Despite the vast range of these screens, Tomlins argues that the screening process actually has a relatively limited impact on the investment universe. "The only sectors that significantly constrain us are the aerospace and defence and the gaming industries because of their size."

Impactful Rebalancing

"The most important step in our approach, and by far the most impactful, is the ESG rebalancing step of the portfolio construction," the fund manager argues. "This is where we spend the most time and where we believe most of the impact and value for the end investor is."

"At this stage, we score every single remaining business in our potential investment universe using a combination of internal and external resources," says Tomlins. "While we hope to use more internal resources in the future, for now, data from providers such as MSCI help us appreciate where companies stand from an ESG perspective."

These scores are the crux of the rebalancing process, according to the fund manager. "We exclude the bottom scoring businesses from an ESG perspective. We then take that capital, and re-weight it to channel it towards the better scoring businesses in a sector-neutral way." Rebalancing is where much of the trade-off occurs, according to Tomlins. "This rebalancing takes out quite a large chunk of the market, but it also generates a much better ESG score for the portfolio."

The effectiveness of this exercise is clear, according to the fund manager. "As a result of this process, the portfolio will always have a much higher ESG score than the market average. Based on MSCI scores, we score roughly 6/10 for this portfolio, whereas the high yield market, on average, scores approximately 4/10." Tomlins is forthcoming in acknowledging that a higher improvement would be better. But he claims this is a feature of the high yield market. "We want to score 8/10,

9/10 or 10/10, but in this market, less than 5% of issuers score better than 8/10. A best in class approach for high yield would generate incredible concentration issues."

Sharing Expertise Through Engagement

Another way in which the fund uses the ESG scoring is in its corporate engagement activities with portfolio companies. "We want to improve the ESG performance of our businesses and help them improve their scores. This does not mean sending e-mails and questionnaires to every single business in the market, which would inevitably be ignored," the fund manager warns.

"Our approach is much more targeted because we want to see results from engagement. We are not trying to get Unilever from AAA to AAA+. We are trying to talk to private businesses who may have minimal experience of disclosure and engagement, and cooperate in identifying issues to help them improve their business practices."

"We experienced an interesting engagement case with Iceland supermarket operating in the UK," the fund manager says illustrating M&G's engagement efforts. "It's a private business. The only public funding they have is from the debt market, and we are a large holder of their bonds, which gives us very good access. They announced that they wanted their products to be plastic- and palm oil-free over the next two years. Given its positive environmental impact, we were very supportive of that ambitious goal, but we felt we needed to have a conversation about this transition."

M&G was able to benefit from the expertise of its Head of ESG in palm oil substitutes. "Businesses need to be very conscious of the net impact of the substitutes because they can be more harmful than palm oil. Sometimes, the optimal solution from an environmental impact can be sustainable palm oil, where more attention is paid to supply chains, and making sure the plantations are not encroaching on virgin rainforests."

Given its privileged relationship as a large debt holder, M&G was able to engage with the Icelandic supermarket and have a conversation. It shared its expertise and helped them understand the issue a little bit better and help "bring out better corporate behaviour."

Engagement also requires coordination across teams and portfolios. "We try to be as coordinated and strategic as possible. Conversations are logged in internally, tracked and reported on," Tomlins says. "We sit down with our colleagues from equities and private debt and work out cross-holdings, where there might be an issue and try to triangulate between us. These conversations allow us to identify where M&G might have the most potential bargaining power as a capital provider, and where we can have the biggest impact in terms of corporate behaviour, which gives us a target list."

Returns, Biases and Impact Assessment

"An important concern for investors coming into the impact sector is the perception that they have to forego returns to achieve meaningful impact," Tomlins continues. "In my experience, it is not the case. In fact, there is increasing evidence that this approach enhances returns. It's an extremely effective risk management and flagging tool, particularly for ESG downside risks."

Another issue that Tomlins is keen to address is the potential introduction of unforeseen biases. "Risk-wise, one concern is that the selection process we apply to narrow our investment universe to impactful securities may introduce biases in credit rating, region, and sector," the fund manager acknowledges. "Broadly speaking, there is no inherent bias introduced by credit rating. If we wish to be in BB, there are enough BB-rated credits to choose from. We are not necessarily skewed towards or against CCC-rated bonds. Likewise, by region, there is no major impact in the portfolio between the traditional fund and the ESG fund. Sector-wise, as I noted, with the obvious exceptions of gaming and aerospace, again, the process introduces no major biases, so from an investment perspective, there is no inherent reason why returns should be different from a non-ESG focused fund – there is no need to sacrifice returns in order to "do good" in the global high yield market."

Building the future: from exclusions to impact

"In the old days, the Church only did exclusions, focusing on a couple of sectors. However, they were not very ambitious. These screens were quite limited, which led to a lot of criticism," recalls Gunnela Hahn, Head of Sustainable Investment at the Church of Sweden. "Following a review of its policy, the Church of Sweden decided to shift from a negative to a positive approach. The Church moved from avoiding companies with detrimental activities to focusing on opportunities worth investing in."

"At the end of a thorough review process, what we understood was that, fundamentally, the Church wanted to invest in the future," Hahn explains. "The Church is very involved in human rights and climate change, pushing for tougher politics in Sweden and abroad. It made sense to move towards sustainable and impact investing. But this was a new way of thinking, and it was challenging for investment managers to interpret the new policy and to build products, since about half of the global index MSCI World was excluded."

"Before joining the Church of Sweden eleven years ago, I worked for the asset management departments of Folksam and KPA," Hahn says. "So the first thing I did was to produce an interpretation tool for the Church's investment policy. It was very square so that all the asset managers could understand how to interpret the guidelines in every sector."

"That is still the basis for our investments, and it remains valid. So much so that I hear from others in the investment community that they look at our policy to get some guidance," she recounts. "But at the same time we want to make an impact and create real value for societies because that is what we value in an investment. And of course, we want to have good financial returns as well."

Real Impact

"As investors for a sustainable future, our approach is to try to create value that will drive positive change, such as supporting the SDGs," Hahn says. "However, it is not always easy to identify real impact. Every economic activity has an impact, both negative and positive. Considerations about the time horizon of the impact are also important. How will a given investment help improve our societies and generate stable returns in the short, medium and long term?"

Nevertheless, sometimes the decision is easy, she argues. "When we look at fossil fuels, we conclude they don't belong to a climate-resilient and sustainable future, so we exclude them. There is also a big risk of stranded assets tied to fossil fuels. To truly identify the investments in corporations and projects that will have positive impact, we need to be willing to ask tricky questions and have serious conversations to see whether our interlocutors have the necessary knowledge and insights about the operations, their complexity and effects on the real economy."

Pragmatic Impact Across Asset Classes

Asked about the often-contradictory conclusions one might reach about the profile of a company, Hahn agrees that pragmatism is critical. "If we were very narrow in our interpretation of what is impactful, we wouldn't invest in almost anything at all. We have to keep in mind the proportionality of the problem versus the big picture." Nevertheless, Hahn is encouraged by recent developments. "The investment opportunities have improved a lot since I started twenty years ago. Then, there was not much to choose from in the public, listed equity space, where we are focused. Today, it is still more difficult than in the private equity space where investors can influence the target companies to a greater extent. But we've seen significant improvement. Hopefully, the new agenda set by the Paris Agreement and the road map created by the SDGs will guide us to more and better sustainable investment opportunities yet."

The bond market is another very appealing market where there is still room for improvement, according to Hahn. "We do as much as we can in the fixed income market. We invest in a green bonds fund, and also develop various investment products that can suit larger institutional investors. To do that, we work with for instance Triodos, the European Investment Bank, FMO or IFC. We are a small actor, but if we could mobilise a broader part of the community of institutional investors, we could make a real difference."

Another way that Hahn believes investors could move the needle in fixed income markets is by focusing on increasing transparency for the 99% of bonds that are not marked "green". That would allow investors to more easily assess whether they make for appropriately sustainable investments regardless of the presence of a "green" label, or lack thereof. "If we could just raise the transparency and sustainability reporting bar it would have a huge impact, maybe more than trying to tweak rules in the green bond space," she argues.

Hurdles to Impact Growth

According to Hahn, one of the main obstacles facing institutional investors on a quest to make impactful investments is manpower shortage. "I work full-time with sustainability, and we manage SEK10 billion. That ratio, one person per 10 billion, is rarely seen elsewhere. Institutional investors need to hire more sustainability specialists," the head of sustainable investments argues. "Consider due diligence, for instance. It takes time. It needs new resources and new competencies that you just don't find at the big banks, insurance companies or pension funds. At the same time, they could have hundreds of people working on compliance. Investors need to either invest in the field by hiring impact teams, or perhaps share resources with others."

Cooperating with Development Finance Institutions (DFIs) could allow impact investors to overcome staffing issues, according to Hahn. "Partnering with those who have the expertise has been the way forward for the church. We don't have the competence. My background is not the impact space or private equity. That's why we can invest with FMO or EIB. They have the expertise and track record."

For Gunnela Hahn, it is not necessary for the Church of Sweden to engage with any of its investments on their own. "For some time, we did a lot of engagement, but then realised that we had a very concentrated portfolio of around 400 holdings that score very well on ESG metrics," she explains. "Engagement is especially worthwhile for us when there is a real problem that nobody else attends to, and presently we have not identified such a situation. Again, having limited resources, we have to prioritise. Given the quality of our holdings, we rely on the engagement of our fund managers. However, we do involve an external engagement service provider to keep track of our holdings. In case we see a need for action, we would also ask other asset managers to join us in engaging with the company."

Bringing impact to the forefront of the financial industry

As the discussion opens for questions and reflexions from the audience, **Filippa Bergin**, Sustainability Expert and responsible for Business Development at Ekobanken, wonders what can be done to shift more investments to impact. "We're standing before one of the biggest economic transformations that we're ever going to see, and all of these investments are at risk," Bergin argued. "If there was one thing that you think would shift the perspective amongst investors, what could we do to make impact investing more easily accessible for the wider industry? How can we shift the onus from impact investors having to defend themselves to having the rest of the investment industry justifying their choices instead?"

From Niche to Mainstream

According to **Gunnela Hahn**, the focus should be on making the substance of impact investing easier to understand. "Having worked for 20 years, I feel that this is still a niche market. Perhaps, we should just scrap the whole concept of 'impact' and 'sustainability' and instead focus on clarifying that it is about good long-term value creating activities that provide solutions to the problems we face on this planet," she said.

"When we talk about impact we generally focus on the positive side, and tend to forget the negative one. The cost of pollution to air, soil and water, for instance, is seldom paid by the polluter, but handed over to society. But we still lack a tool to analyse all these external costs, externalities, caused by economic activity. With a price on a company's externalities, we could better assess its true value. Some companies have introduced a voluntary shadow price on carbon dioxide emissions or natural capital for this reason. But despite various initiatives on the market during the last decade on how to integrate the externalities, it has not become mainstream."

"Something else that would lighten the burden of all investors would be the adoption of a tool that could clarify which companies or assets are at risk of being stranded. That would be a leap in the right direction," she argues. "Riverside and beachfront hotels will inevitably suffer from increased flooding due to climate change. And technological disruptions such as electric cars or renewable energy is already changing business-as-usual. However, there is still no mainstream tool to capture the risks and expected costs of such stranded assets. The Church of Sweden addressed that problem two years ago, and we developed a toolbox with Stockholm Environment Institute and SEB."

Impact Framework and Legislation

"I think one of the missing elements is a digestible, measurable impact framework," **James Tomlins** adds. "Ideally, we'd need a universal taxonomy, but I think the EU taxonomy is an important initiative and a necessary first step. We need to define the terms, how to measure them, and how to report them. Once this process has been scaled and applied across the world, the conversation becomes far easier."

However, the fund manager says, these changes cannot happen in a vacuum. "We also need top-down legislation. At the institutional level, the discussion about fiduciary duty has already moved from economic returns to environmental and social impact. This is probably why the institutional space has moved faster than the retail space."

Consumer-Led Paradigm Shift

Kärim Chatti turns the argument around and suggests that the industry should pay more attention to what clients want, in the manner that consumer demands have driven much of the paradigm shift in the retail industry. "What moves the needle in the retail industry? The consumer. When the consumers complain, the retail industry reacts immediately," he argues. "In my opinion, the consumer should also be driving change in the impact space. Consumers should be deciding where their savings and their pension are invested and how easily a portfolio can be adjusted."

"Unfortunately, investing is not typically a catchy topic that consumers want to read page after page," Chatti adds. "That is a problem. Pension investments do not catch consumers' interest as much as what they eat, or what groceries they buy."

"I agree, but I think asset managers have a duty to educate their clients, because financial customers don't have the resources to learn about all of these issues," **Hahn** replies. "Asset managers also need to dispel the myth that sustainability or impact is costly. They need to show asset owners that it is a good means to reduce risk and increase opportunities to create long-term sustainable value." Hahn also argued that the argument will benefit when more accurate metrics can point to the triple bottom line of the investment.

"I think we are getting there in the Swedish market," says **Cecilia Kellner**, Senior Portfolio Manager and Sustainability Strategist at Nordea Life & Pension. "In Sweden, the media and NGOs have played a crucial role, asking about where pension savings are invested. We, as asset owners, and our clients are exposed to these changes in media coverage and we react to it."

"But, more importantly, most asset owners, like ourselves, have formal requirements on sustainability that the asset managers have to comply with to attract investments," Kellner argues. "That goes for Swedish asset managers as well as global ones. If they want us as a client, their product has to be aligned with our sustainability criteria. Often, they do come up with a solution."

"In Sweden, the media and NGOs have played a crucial role, asking about where pension savings are invested"

Reducing Negative Impact: Can investors engage and exclude at the same time?

"When we speak about impact, shouldn't we insist on reversing the burden of proof, as Filippa suggested earlier?" remarks **Magnus Emfel**, Finance Engagement Manager at WWF. "It's obvious that reducing negative impacts is fundamentally important if we want to save the planet and maintain economic stability. It is more attractive, however, to measure and disclose positive changes. The EU taxonomy, for instance, focuses on defining what is 'green' and 'good' but doesn't help investors to appraise and navigate negative impact. How do you invest with impact by reducing in a meaningful way the negative effects of economic activities?"

"To a degree, almost every economic activity we do has a negative impact, because we use natural resources to produce goods and services," **Hahn** explains, before pointing to a few different paths to minimising that harm. The common denominator is the need to create the necessary incentives to drive change. "On the one hand, we can mainstream engagement on these issues so that we discuss them with companies in our conventional portfolios to reduce their negative impact. Introducing new metrics and models for accounting is another way. But we also need legislation to reduce negative externalities."

"To a degree, almost every economic activity we do has a negative impact, because we use natural resources to produce goods and services."

Ultimately, Hahn notes that the focus should be on maintaining a dialogue among stakeholders about the outcomes to be reached. "Reducing negative externalities is part of wider conversations about the modernisation of the economy, energy efficiency and energy transition and how to become more circular in the way we use natural resources," she says.

"I hear from a number of asset owners that we work with around the world that the most responsible thing to do is to stay invested, engage and have an influence on a given company or sector. By analogy, could they argue, if you exclude them, you don't rally contribute to the necessary reduction of emissions and pressures on nature," **Emfel** argues.

For Hahn, exclusions can be made contingent upon certain criteria, which may trigger a company to act. At M&G Investments, engagement and exclusions do not have to be mutually exclusive forms of intervention either. "We have examples where we have engaged with excluded companies and explained how they can improve and no longer be excluded," says **James Tomlins**.

He also warns about the dangers of superficial exclusions, particularly in the context of the energy transition. "We like Total, both from a credit perspective and because it has one of the best environmental scores, due to its efforts to transition from fossil fuels to renewables. A pure exclusions policy would preclude us from investing in Total because they still have operations in coal. But they are transitioning out of it. We choose to focus on the journey that a company is on and how far they are along their transition process."

This is not a trivial issue for investors. "We also need to ask ourselves whether it is better to invest at the point of transitioning or post-transition. Do we want only to do good or prevent things from worsening?" Tomlins asks, acknowledging that the answer is contingent on the approach followed by each investor.

"We can engage without owning," **Kellner** confirms. "We can exclude fossil fuels but engage with fossil companies and have a dialogue where we tell them that, while we don't own the stock today, we may invest if the conditions change. I do find it hard to engage with oil companies that are still planning new exploration projects, and increasing their fossil fuel production."

Instead Kellner suggests the focus should move up the value chain. "In the same context as the consumer-led movements we talked about earlier, it may be easier to engage with the consumers of oil, such as car manufacturers, than with the energy companies themselves. If investors help the automotive industry on the journey towards electric cars, the energy companies will experience the economic pressure from this shift."

"It is important to be very careful with engagement, because it very often turns into greenwashing," **Hahn** warns. "Doing it well is time consuming and costly, but if you have a trustworthy process, and you can show that you have set targets, then it can work."

""We have examples where we have engaged with excluded companies and explained how they can improve and no longer be excluded."

"The Church of England is leading a great initiative with some other large investors called the Transition Pathway Initiative (TPI)," Hahn continues. "Instead of divesting, the organisation engages with companies in energy intensive sectors to help them to reduce these problematic activities and operation. This way the investor can still make money from owning these stocks, but when the problematic activity inevitably comes to an end, we haven't lost money."

"Whenever we invest, we express our view of the world, I believe," adds **Irene Mastelli**, Director Advisory at **Phenix Capital**. "Excluding energy companies is akin to expressing a view against owning oil reserves with the intention to extract and, eventually, to burn them. Taking this view may cause investors to exclude companies that might be part of the energy transition."

"For example, coal makes for an easy case, in my opinion," Mastelli adds. "The coal industry is dying and many coal companies are going bankrupt. I don't want to invest in something that I believe is clearly going to die. It may be replaced by natural gas and other forms of energy that are more economical, let alone also more environmentally friendly."

"Investors will never get away from having a view of the world and, in this case, about how the energy transition will unfold. BP or Total may still be around in 10 years, doing other things. We need to take that into account but while we don't know what they will do, we may choose to stay away."

Showing off externalities

"One of the issues facing investors in the energy transition is that externalities tend to be invisible," adds **Filippa Bergin**. "Externalities are almost invisible for an institutional investor, and completely invisible for retail investors, who are the buyer of the product. Information about the positive externality exist, sometimes, but companies tend to be less forthcoming with their negative ones."

"I used to be the sustainability manager at Åhlens and, in my office, we had a funny picture of ICA selling bananas," Bergin remembers. "Nowadays everybody buys organic bananas, but they weren't selling very well at first and that is why we put up this pictue. The issue was not that there was something wrong with organic bananas, but people didn't know enough about the non-organic banana and therefore didn't understand the need to shift to organic ones."

"Increasing information about the organic banana did nothing for sales. Increasing awareness about the negative externalities of every other product that is on the market is what did it. In the same way, if asset managers and investors also disclosed information about the negative externalities of non-impact strategies that would make a bigger difference than focusing on the positives."

Emfel agrees. "Those who have signed up to UNEP FI's Principles for Responsible Banking have agreed to disclose the positive as well as the negative impacts of their products. This is very welcome, and it will be very interesting to see - I suspect that the negative disclosure can be much more powerful than the positive."

dessert

Risk, correlations & asset allocation buckets

Typically, the word "impact" triggers a debate about the notion of risk and return. Many investors fear that positive impact can only be achieved through sacrificing return. Others argue that impact reduces risk and therefore the ratio of risk/return remains consistent with the market. One aspect that is often overlooked is the correlation (or lack thereof) which impact assets exhibit against other asset classes and more specifically the equity market.

Asked about the evidence of low correlation from her portfolio and her long-term experience as an impact investor, **Hahn** says: "We don't report information about correlation. However, I do know that we have several investments in microfinance, for instance, and these show no correlation with the rest of our assets. It was great during the financial crisis. The default rate of microfinance loans is so low that they make for extremely resilient investments with a lot of social and environmental impact. In these frontier and emerging market countries where investments are really needed, this resilience is underestimated. We had a 69% return for a fixed income product in microfinance!"

According to **Chatti**, another issue facing impact investments is how asset owners compartmentalise their investments. "I have spent a lot of time, throughout my career, discussing with asset owners where to fit microfinance in their asset allocation. Is it an alternative investment, or is it fixed income?" According to Chatti, impact often gets stuck in a niche investment bucket, which makes it problematic to grow the scale of investments. "There's a big pool of money and impact investing should tap into it by getting out of these niche investment buckets."

Hahn agrees: "We have these buckets with asset classes, and when we define them, the resulting framework is not necessarily prepared to handle new investments that belong to the future, such as green infrastructure and blended finance."

This compartmentalisation can be extremely constraining according to the Church of Sweden's sustainability expert, who recognises the issue. Investors seek to mobilise capital towards positive impact, but they hit a hurdle that is difficult to overcome. "They want to invest, but they can't fit it into their buckets," Hahn comments.

"It's important to understand the position that portfolio managers find themselves in," Chatti retorts. "Even in the investment arm of a large insurance there is no 'blended finance portfolio manager'. There are, however, managers for the fixed income portfolio who do not want to have to handle risk he does not understand. They want to go home early and have a good night's sleep. It's a natural human reaction."

"We have got to make it easy for investors," **Tomlins** adds. It may be worth rethinking the industry's focus on uncorrelated assets, he explains. "A high correlation to an existing market is actually becoming an advantage right now. We all know that there is value in low correlation and that diversification is attractive. But it can pigeonhole an investment, which is often the bigger constraint. Providing an investment opportunity that fits well within the existing asset allocation framework of an asset owner has the potential to help them deploy much more capital."

coffee

about our partners

M&G is one of the largest investment managers in Europe with approximately €200 billion in fixed income, €78 billion in equities and €30 billion in real estate.

M&G naturally allocate long-term capital to responsibly-managed businesses and has been financing impact investments on behalf of its clients since the 1930s.

Today, M&G has approximately €25 billion invested in impact assets across public and private fixed income, with a proven track record of consistent returns, and a measurable social and/or environmental impact.

Triodos Investment Management is a globally active impact investor and a wholly-owned subsidiary of Triodos Bank.

Triodos Investment Management invests to generate social and environmental impact alongside a healthy financial return. We focus our investment activities across several overarching themes: Energy and Climate, Financial Inclusion, Sustainable Food and Agriculture.

Triodos Investment Management has a 30-year track record in impact investing, with 750+ investments across the globe. Today, the firm counts €4.6 billion of AUM, entirely invested in impact strategies in all asset classes.

NORDSIP

NORDIC SUSTAINABLE INVESTMENTS

Written, edited, designed and published by
Big Green Tree Media AB
Kungsgatan 8
111 47 Stockholm
For any enquiry, please contact:
Aline Reichenberg Gustafsson
+46 (0) 70 9993966
aline@nordsip.com

Cover image © Shutterstock
Photos, Binniam Halid
© 2019 NordSIP all rights reserved

GENERAL TERMS AND CONDITIONS

These are the terms and conditions which govern the use of NordSIP Insights, an online magazine edited and distributed electronically and owned, operated and provided by Big Green Tree Media AB (the "Editor"), Corporate Number: 559163-7011, Kungsgatan 8, 111 43 Stockholm, Sweden.

DISCLAIMERS AND LIMITATIONS OF LIABILITY

1. The Content may include inaccuracies or typographical errors. Despite taking care with regard to procurement and provision, the Editor shall not accept any liability for the correctness, completeness, or accuracy of the fund-related and economic information, share prices, indices, prices, messages, general market data, and other content of NordSIP Insights ("Content"). The Content is provided "as is" and the Editor does not accept any warranty for the Content.

2. The Content provided in NordSIP Insights may in some cases contain elements of advertising. The editor may have received some compensation for the articles. The Editor is not in any way liable for any inaccuracies or errors. The Content can in no way be seen as any investment advice or any other kind of recommendation.

3. Any and all information provided in NordSIP Insights is aimed for professional, sophisticated industry participants only and does not represent advice on investment or any other form of recommendation.

4. The Content that is provided and displayed is intended exclusively to inform any reader and does not represent advice on investment or any other form of recommendation.

5. The Editor is not liable for any damage, losses, or consequential damage that may arise from the use of the Content. This includes any loss in earnings (regardless of whether direct or indirect), reductions in goodwill or damage to corporate.

6. Whenever this Content contains advertisements including trademarks and logos, solely the mandator of such advertisements and not the Editor will be liable for this advertisements. The Editor refuses any kind of legal responsibility for such kind of Content.

YOUR USE OF CONTENT AND TRADE MARKS

1. All rights in and to the Content belong to the Editor and are protected by copyright, trademarks, and/or other intellectual property rights. The Editor may license third parties to use the Content at our sole discretion.

2. The eader may use the Content solely for his own personal use and benefit and not for resale or other transfer or disposition to any other person or entity. Any sale of Contents is expressly forbidden, unless with the prior, explicit consent of the Editor in writing.

3. Any duplication, transmission, distribution, data transfer, reproduction and publication is only permitted by

i. expressly mentioning Nordic Business Media AB as the sole copyright-holder of the Content and by

ii. referring to the Website www.nordsip.com as the source of the information provided that such duplication, transmission, distribution, data transfer, reproduction or publication does not modify or alter the relevant Content.

4. Subject to the limitations in Clause 2 and 3 above, the reader may retrieve and display Content on a computer screen, print individual pages on paper and store such pages in electronic form on disc.

5. If it is brought to the Editor's attention that the reader has sold, published, distributed, re-transmitted or otherwise provided access to Content to anyone against this general terms and conditions without the Editor's express prior written permission, the Editor will invoice the reader for copyright abuse damages per article/data unless the reader can show that he has not infringed any copyright, which will be payable immediately on receipt of the invoice. Such payment shall be without prejudice to any other rights and remedies which the Editor may have under these Terms or applicable laws.

MISCELLANEOUS

1. These conditions do not impair the statutory rights granted to the readers of the Content at all times as a consumer in the respective country of the reader and that cannot be altered or modified on a contractual basis.

2. All legal relations of the parties shall be subject to Swedish law, under the exclusion of the UN Convention of Contracts for the international sale of goods and the rules of conflicts of laws of international private law. Stockholm is hereby agreed as the place of performance and the exclusive court of jurisdiction, insofar as there is no compulsory court of jurisdiction.

3. Insofar as any individual provisions of these General Terms and Conditions contradict mandatory, statutory regulations or are invalid, the remaining provisions shall remain valid. Such provisions shall be replaced by valid and enforceable provisions that achieve the intended purpose as closely as possible. This shall also apply in the event of any loopholes.