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Amundi
ASSET MANAGEMENT

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Looking for hidden ESG gems: a new frontier for responsible investing with "improvers"

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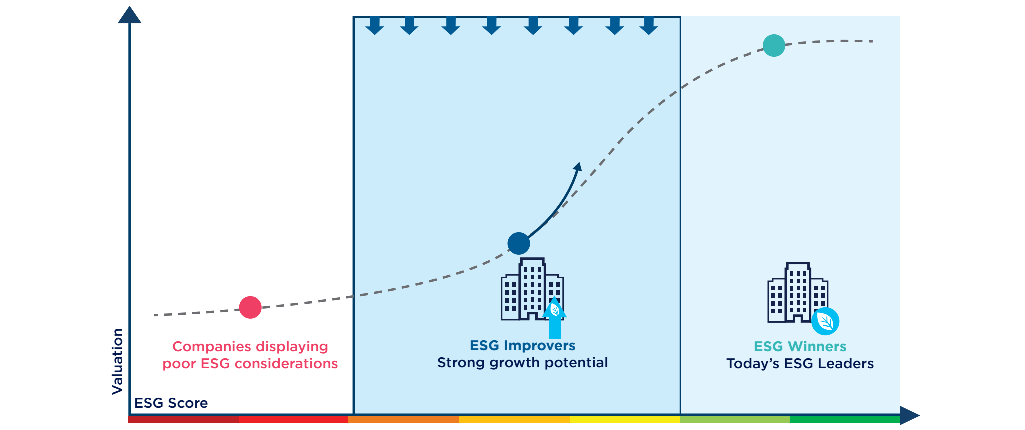
Dear client,

The ongoing Covid-19 crisis and the resulting market turmoil have confirmed a pre-existing trend within equity investing: the increasing relevance of integrating ESG criteria and sustainability into the investment decision. We believe doing so will add value both in terms of being able to deliver better risk-adjusted return, but also in terms of helping to put focus on - and ultimately improve - important ESG parameters for companies and society.

ESG equities have proved resilient throughout the crisis, both in terms of flows and performance. On flows, ESG equity funds – including active and passive worldwide open-ended funds – have experienced net inflows both in 2019 and so far this year, while non-ESG equity funds have seen net outflows. On performance, ESG criteria have proved to be a source of outperformance both over the long term and recently.

With ESG investing becoming increasingly relevant, it will be key for active investors who look to generate excess returns to detect those opportunities where the ESG premium is not yet priced in fully. A way to do it, in our view, is moving from a static best-in-class approach to a dynamic and forward-looking one, seeking tomorrow's ESG leaders. ESG winners are quality companies with attractive valuations and strong ESG ratings, while ESG improvers are corporates portraying a solid fundamental investment case and an improving ESG trend, but not yet an ESG leader. A combination of the two, in our view, will allow investors to benefit from the improvement in ESG ratings before a trend materialises and the premium is established. Hence, it will be important to include both ESG winners and ESG improvers in portfolios.

Figure 1. The link between ESG and valuation



Source: Amundi as of 18 August 2020.

For both ESG winners and improvers, in our view excess return will be generated by detecting the most material drivers impacting the ESG credentials - and ultimately rating - at the single-stock level. This requires active bottom-up analysis to detect the material drivers as well as their sustainable improvement.

To us, ESG analysis should go hand in hand with fundamental analysis in order to assess the sustainability and profitability of each corporate's business. This will be especially relevant in the aftermath of the Covid-19 crisis, when many public funds will be available to drive an economic renaissance and policy authorities could increase scrutiny over how those funds get invested. New elements of the governance pillar may get fresh investors' attention (e.g., CEO pay-gap ratio, company attention towards employees health, diversity management, etc.), while the environment pillar has already been on the radar of ESG investors for sometime and the S one is gaining attention as a result of the crisis.

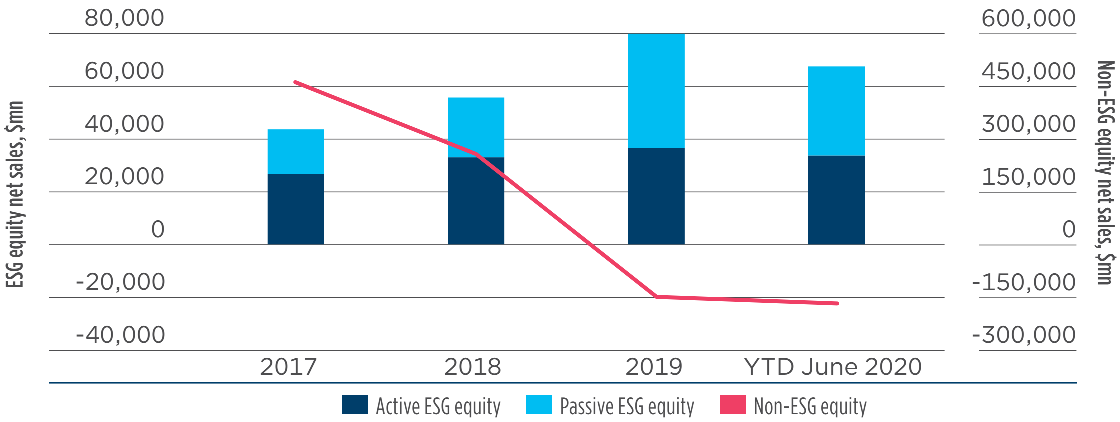
We believe that Europe will play a crucial role in the trend towards ESG investing, as it is home to most global ESG leaders and has the most advanced ESG framework globally, both due to pressure from regulatory requirements and to the shareholder community promoting ESG. However, there is still a huge dispersion of ESG scores across both sectors and countries, offering opportunities for ESG improvement and for active managers scouting those companies that can benefit the most from this trend.

ESG equity investing in the wake of the Covid-19 crisis

"There are steady asset inflows into responsible companies which have not been derailed by the crisis and involve both active and passive ESG equity funds."

The ongoing Covid-19 crisis is likely to bear long-term consequences on equity investing, reinforcing the ESG vs. traditional non-ESG equity divide, with the former enjoying large structural demand. Such trends emerge from the 2020 fund flows data available thus far, which show significant outflows from non-ESG equity funds, as investors have de-risked portfolios in the wake of the pandemic-related market sell-off. However, strong market volatility has not derailed the large structural demand for ESG equity funds, which have proved resilient, enjoying consistently strong inflows. To put it simply, **there are steady asset inflows into responsible companies which have not been worn away by the crisis and involve both active and passive ESG equity funds.** For reference, the year-to-date ESG equity funds inflows have already beaten the inflows recorded in 2018 as a whole.

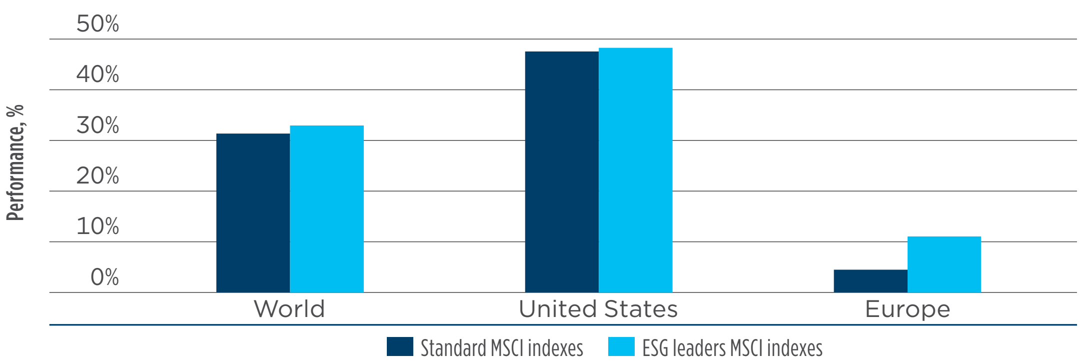
Figure 2. ESG vs. non-ESG equity funds flows



Source: Amundi on Broadridge data as of 18 August 2020 on worldwide open-ended funds.

From a financial standpoint, ESG criteria have proved to be a source of outperformance. Over the past three years, the ESG leaders MSCI indexes have all outperformed their respective non-ESG index on a total-return basis.

Figure 3. ESG vs. non-ESG indexes, three-year total-return performance



Source: Amundi on Bloomberg data as of 18 August 2020.

"We see the 'S' (social) one taking some shelf space, due to stronger short-term focus, larger impact from the crisis, and the reallocation of financial resources from governments."

While investors have been aware of the merits of investing responsibly for a long time, the current crisis is likely to increase the focus on ESG principles, that should play a critical role in the emergence from the crisis. Indeed, the current global economic recession is the first one of the ESG-investing era. While in previous downturns, the solution to the crisis came from economic textbooks, with the political will, together with monetary and fiscal stimulus providing a path to recovery, **this time both governments and corporates will have to focus even more on the human component of the recovery,** with factors such as rising inequality, healthcare, remote learning access, remote working, and access to primary goods and services for the most vulnerable share of the population.

We believe that **ESG investing will be a structural force for asset managers going forward.** With reference to its three pillars, **we see the 'S' (social) one taking some shelf space**, due to stronger short-term focus, larger impact from the crisis, and the reallocation of financial resources from governments. Looking ahead, **how companies behave today will have long-lasting financial implications on their businesses.**

Historically, many companies have been managed purely for the benefit of shareholders. Today, they are increasingly managed in the **interest of a wider audience of stakeholders** beyond shareholders, including employees, customers, suppliers, and governments. **Corporates that fail to consider their wider responsibilities will face reputational damage in the short term and fundamental headwinds in the longer run that could weigh on their financial performance.**

With ESG set to become a structural trend for equity markets, it is important to acknowledge that the three pillars – environmental, social, and governance – are not mutually exclusive, but **can be inherently linked.** For instance, poor social awareness can have negative environmental fallout. This could be observed in some emerging economies, where, as a result of poor employment conditions and low wages, people focus on satisfying their primary needs and cannot make environmentally conscious decisions. This is an extreme example, but even small changes in one of the three pillars can have a knock-on impact on the others. As a result, **we believe in a comprehensive and fundamental approach which takes into account all three pillars.**

A **holistic approach** will allow investors to capture structural and cyclical trends across industries. While the social pillar is gathering increasing attention, it does not mean that investors should reduce their focus on the other two factors. For investors to fully embrace ESG, **it will be key to invest in a portfolio that is constantly improving its ESG footprint. ESG investing is dynamic, and, as such, needs to be managed in an agile way to take advantage of market trends at any given point in time.**

"We see growth opportunities in areas such as nutrition, with consumers increasingly demanding healthy alternatives to traditional food and beverages."

Looking ahead, we see continued **strong traction for the de-carbonisation trend in the energy and utilities sectors,** moving towards more eco-friendly power production. On **energy**, we see the integrated oil companies increasingly focussing on natural gas over oil with some of them also making significant investments in renewable energy. **Utilities** are increasingly moving towards green electric power generation. Such move has been welcomed by financial markets based on their recent performance.

Outside of the environment-only perspective, the move towards smart mobility, smart factories, and smart cities is generating growth opportunities in areas such as information technology, capital goods, and transportation, which are set to benefit from those trends. In the consumer space, the recent crisis is a health crisis which has re-focused consumers on the importance of health and healthcare. As such, **we see growth opportunities in areas such as nutrition, with consumers increasingly demanding healthy alternatives to traditional food and beverages.**

Opportunities from ESG improvers for fundamental investors

"ESG trends are more prolonged, giving investors time to assess and allocate only when they are comfortable with the trajectory of the company."

One positive outcome of investor's increasing focus on ESG is that they may push companies towards embracing ESG principles on a larger scale. **A risk possibly emerging from such a trend is that of an ESG bubble,** as investors crowd into the highest ESG-rated companies. Such a risk could be mitigated by targeting a wide range of corporates that are not yet ESG leaders**. There may be good opportunities for investors in being ahead of the curve, by identifying companies that will be tomorrow's ESG leaders.** ESG implementation tends to be a slow-moving dynamic and makes it possible for investors to extract value from companies that are embarking on an ESG-improvement journey.

If we think about a traditional value investor for example, they need to invest early as share prices can move fast. ESG trends are more prolonged, giving investors time to assess and allocate only when they are comfortable with the trajectory of the company. Investing in ESG-improvers will have a positive fallout on our world in our view. In addition, these companies could benefit from the tidal wave of assets waiting to be invested in strong ESG stewards.

To unlock value from ESG improvement, a dynamic and forward-looking perspective is needed, through the following steps:

- Identify the **most material ESG drivers** for each business;
- Understand the **financial impact** of those drivers; and
- Detect how those drivers will **evolve** in the future.

Companies can be mapped based on their ESG score. ESG improvers are the ones that display some potential to become the ESG leaders of tomorrow. **In this trajectory, valuations will adjust, as shown by the United Nations' Principles for Responsible Investment, MSCI and others. Identify the companies at the early stage of this ESG rating migration will be a source of value for investors, in our view.**

We believe that ESG investing will not only support absolute returns but will also help enhance risk-adjusted returns. On one hand, there is empirical evidence to suggest that buying the **ESG leaders is an effective strategy to enhance a portfolio's information ratio.** On the other, more recent research incorporates the ESG-momentum dimension, which points to further improvement of potential returns.

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We believe that an optimal portfolio will combine both features, with the ESG leaders acting as a sound quality foundation, while the improvers will offer an additional source of potential growth and return.

While quantitative results confirm the attractiveness of including ESG principles into any investment decision, there is also evidence of sectors - and even single corporates – that have been rewarded thanks to their improving ESG profile. This is the case of the utilities sector, where those names that have adopted a pro-active stance towards the use of renewables in power production have performed well. Another example is the capital goods sector, where companies exposed to the 'smart factories' theme – specifically, to the automation theme – have performed well given the strong growth potential of the stocks involved.

"ESG investing is not a panacea to save bad fundamental businesses."

There is a strong link between ESG and fundamental investing. ESG investing is not a panacea to save bad fundamental businesses, nor it could replace an accurate analysis of corporate fundamentals. Historically, responsible investing has been based on – and driven by – pure assessement of ESG ratings. The problem with such approach is that these ratings provide only a static and backward-looking snapshot of a company's ESG

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footprint, **while they do not capture its potential ESG improvement.** To do this, investors need to focus on dynamic and forward-looking analysis, which translates into:

- **Identifying the ESG drivers that are material to a corporate's ESG profile.** For instance, the CO2 footprint is more relevant to an energy company than to a telecommunication company.
- **Identifying the financial impact of those drivers.** To capitalise on this, a combination of both ESG and financial analysis is critical.
- **Understanding how these drivers changed in the past, and assess how they will change in the future.**

When moving the ESG analysis from current simple snapshot in time to a forward-looking approach, a natural integration between the ESG and the financial analysis is required. The result will be greater analysis, deeper understanding of the fundamental drivers, and potentially improved performance.

"The understanding by active managers of key ESG drivers within a specific company or sector will dictate their engagement agenda, engaging on the issues that can impact both ESG and financial performance."

Having a fundamental approach allows investors to understand the underlying ESG dynamics of each investment case and of how it interacts with the financial parameters. In addition, this can facilitate **engagement,** with investors opening a dialogue with the corporate management and potentially influence their decisions. This is something that active managers have been doing for a long time but it increasingly includes ESG topics as well. Today, instead of pressing the management only to improve shareholder returns, investors also influence management to make responsible decisions towards all stakeholders, with the goal of improving returns in a sustainable way. **The understanding by active managers of key ESG drivers within a specific company or sector will dictate their engagement agenda, engaging on the issues that can impact both ESG and financial performance.** Only by doing this, investors could avoid the risk of a box-ticking exercise resulting in some sort of 'ESG washing'.

Table 1. Ten guiding principles for dynamic ESG investing

Buy low, sell high Extending the common investment philosophy to the realm of ESG will get rewarded by the market	**Integrated analysis** Good ESG principles is not a solution for bad fundamentals; ESG and financial analysis should be combined
Best in class Seeking ESG improvers through an all-inclusive approach across all sectors	**Active alpha** Returns are driven by the performance of the single corporates owned
Fundamental approach Go beyond static ESG ratings to include forward-looking qualitative assessment	**Engagement** A focused and bottom-up approach, coupled with corporate engagement, will ensure high influence level
Materiality ESG improvement must be tangible and relevant, focusing on financially relevant factors	**Sell discipline** Monitoring evolving ESG dynamics and valuation upside to ensure the appropriate exit strategy
Improvers and leaders The potential return of ESG improvers, combined with the quality of ESG leaders, can enhance the risk-adjusted return profile	**Investing for a better world** ESG leaders will allow investors to get a sustainable portfolio, while improvers will help live in a sustainable world

Source: Amundi as of 18 August 2020.

"Europe being ahead on this race does not necessarily mean that it should stop pushing ahead, as there is an opportunity to move towards a more sustainable world for all regions."

Europe as an ESG-investing leader

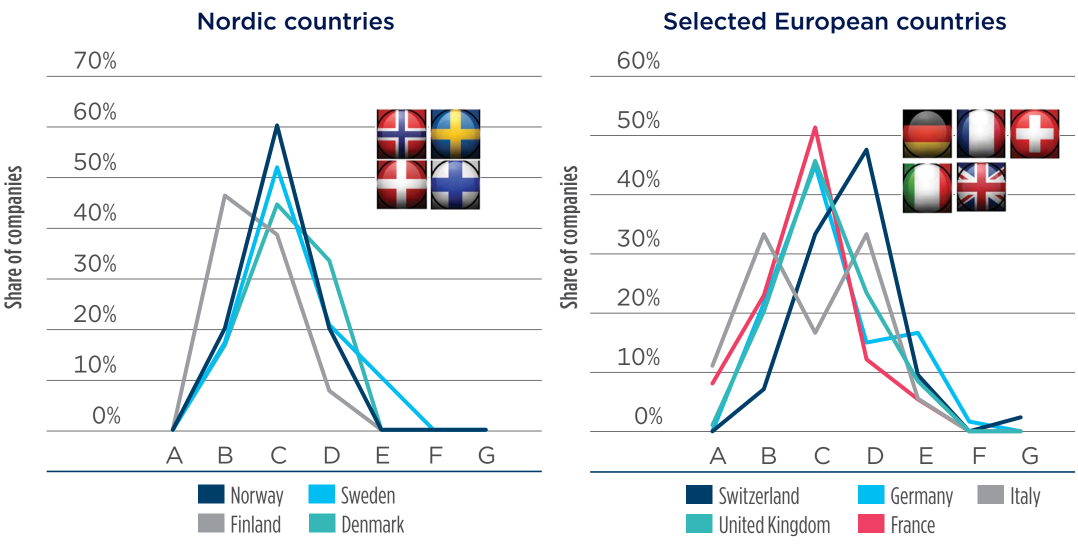
Historically, both many investors and corporates have invested with the only goal of gaining the highest possible return on (financial) capital, under the assumption that other forms of capital, such as human or environmental capital, were unlimited. Today, it is assumed that non-financial capital is limited as well and has to be managed carefully and sustainably.

Going forward, both investors and corporates will make decisions based on the best possible outcome from both a financial and an ESG standpoint**. Much progress has already been registered on this but the race is not over yet. Today, while the United States and Japan have made good progress, Europe is leading this process, as it has a more socially-aware approach of policy formation in terms of labour rights, education policies, healthcare policies, and social security policies.**

On environmental topics, Europe stands ahead in terms of climate policies, renewable energy and de-carbonisation. Governance is also generally strong. However, the distribution of ESG ratings is uneven across European countries, with the nordics being ESG leaders with a high number of highly-rated companies, while the rest of Europe shows a more diverse ESG profile, with more room for improvement. **Europe being ahead on this race does not necessarily mean that it should stop pushing ahead, as there is an opportunity to move towards a more sustainable world for all regions.**

This can be a fertile ground for active managers able to detect investment opportunities across regions and sectors, and to play the dynamic evolution of ratings.

Figure 4. Distribution of ESG ratings across European countries



Source: Amundi as of 18 August 2020.

Definitions

- **Alpha:** The additional return above the expected return of the beta-adjusted market return; a positive alpha suggests risk-adjusted value is added by the money manager compared with the index.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Beta:** Beta is a risk measure related to market volatility, with 1 being equal to market volatility and less than 1 being less volatile than the market.
- **Information ratio:** A measure of portfolio management's performance against risk and return relative to a benchmark or alternative measure.
- **Value style** means purchasing stocks at relatively low prices, as indicated by low price-to-earnings, price-to-book, and price-to-sales ratios, and high dividend yields. Sectors with dominance of value style: energy, financials, telecom, utilities, real estate.

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