2018: The year of the human?

Cyber crime, greater disclosure, fixed income, people and, of course, climate change. Welcome to what could make the headlines in ESG during 2018.

Responsible investing is not what it used to be. Gone are the days when ethically-minded investors simply sought to avoid companies selling guns, drilling for oil or distilling vodka.

Today, these people are using their cash to make an impact. Rather than avoid certain industries they want to help build a better world by supporting companies that are working to make a difference.

So ethical investing has evolved into environmental, social and governance (ESG) standards, which promote transparency, health and safety, diversity, protecting the planet and eradicating poverty.

Such standards are believed to improve risk management in portfolios and could generate sustainable, long-term returns.

We asked our panel of ESG experts what they are expecting to see in this market in the next 12 months. Here are some of the replies we received.

CLIMATE CHANGE

Climate change is likely to remain at the forefront of ESG-focused investors' minds in 2018 and Newton Investment Management expects to see more and more companies challenged on this issue.

"It is not just public companies which are being held to account on this topic, but investors themselves are also being challenged to disclose what they are doing in terms of identifying and taking action on climate-related risks and opportunities," says Rob Stewart, Newton Investment Management's head of responsible and charity investment.

"We have received a number of client and prospect queries on this matter, and this year, for the first time, asset owners will be asked in the PRI's annual survey to disclose how they are integrating climate thinking into their strategies."

Invesco Perpetual is another firm that believes the topic will remain in the headlines this year.

"From climate aware funds to carbon footprinting to climate resolutions, to public commitments on divestment or investment; climate change as an investment topic has become almost as common as corporate governance," Cathrine De Coninck-Lopez, head of ESG at Invesco Perpetual, says.

She points to commitments made by several investors at the Macron Summit in Paris in December to divest from carbon intensive oil and coal as one reason keeping this subject on the agenda. Other catalysts include companies committing to the Task Force on Climate-related Financial Disclosures (TCFD), with suggestions (but no firm evidence) that eventually this could become a legal requirement as part of European non-financial disclosures.

"Separately, local governments and cities have signed the 'One Planet Charter', committing to procuring green technology and energy," De Coninck-Lopez says. "Related to this, the European Bank for Reconstruction and Development, among others, has committed to increase financing to help facilitate this transition. In addition, in the UK, we have seen local authorities targeted by NGOs with a public register of those with the greatest fossil fuel investments."

FIRST STEPS IN SCENARIO TESTING CLIMATE CHANGE

Matt Moscardi, senior analyst and head of sector research at MSCI ESG Research, anticipates that investors will expand their view of portfolio climate risk from a company carbon footprint to macro exposures across asset classes. MSCI has found that at least 40% of each major asset class is exposed to countries at high risk to irreparable physical damage under a high warming scenario.

Moscardi says that institutional investors moving their portfolio to mitigate climate change has been a bottom up process, where you find out how much carbon companies emit and tilt the portfolio accordingly. This approach could be about to change.

"Spurred by the taskforce on climate disclosure, there's an emphasis on scenario modelling and a top down approach," he adds. "That is going to be huge this year. Investors are going to need to look at climate change not just from a company perspective but from an asset allocation perspective, too."

A SEARCH FOR QUALITY IN EMERGING MARKETS

China A-shares listing on the MSCI EM will expand the companies in the index by around 20%.

"This will prompt institutional investors and asset managers to look for high-quality companies in markets that are constantly shifting, evolving and tend to be opaque," Moscardi says. "There is a higher degree of information asymmetry and ESG helps penetrate that."

Indeed, around 15% of emerging market-domiciled constituents of the MSCI ACWI Index have ESG ratings that eclipse their country's ESG sovereign ratings, making them country outperformers that investors need to find.

THE ACCELERATION OF ESG INTO FIXED INCOME

Fixed income has historically lagged equities when it comes to ESG analysis adoption, but could this be about to change? In 2018, MSCI foresees that the "push" from asset owners eager to align their ESG frameworks across asset classes will coincide with the "pull" factor that ESG could add value to credit analysis.

"As more investors are looking to go multi-asset with their climate analysis, there is a lot of momentum in other asset classes," Moscardi says. "Clients are demanding ESG frameworks across fixed income because for a lot of them it is the biggest proportion of what they own."

LOOKING BEYOND SUSTAINABILITY DISCLOSURE

Investors will look to alternative data sources to balance the growing volume of corporate sustainability disclosure this year.

MSCI believes. 65% of a company's average ESG rating is driven by data sources beyond voluntary disclosure. "There is clear momentum for companies disclosing more and more," Moscardi says.

"On average about 35% of any rating is driven by voluntary disclosure," he adds. "So a third of the rating is what companies say, the rest is driven by these unique data sets and mandatory data sources. So when we talk about diminishing return on disclosure, more is not necessarily better.

"There has been a tripling in companies contacting us over the past three to four years and it is only going to get worse. There is a sense that we need to do something with this data and this year that will take centre stage."

THE YEAR OF THE HUMAN

MSCI anticipates that investors will look to invest in people, as artificial intelligence redefines work tasks to require higher-skilled human input. While good workforce data is hard to come by, MSCI has found evidence that companies with stronger human capital practices had better productivity growth than their peers.

"We have titled this year the year of the human because we have done a lot of research into AI and automation and how that is going to affect certain industries," Moscardi says. "One of the things that popped up for us was the need for high-skilled labour increases as you increase the use of automation.

"Sectors such as auto components have a person problem," he adds. "They cannot find enough highly-qualified people; they almost have a talent problem. The AI revolution is going to drive investor interest in the human element and how to invest in companies that are maximising their talent pool.

"Even with the limited data we have on human capital, there are intriguing results in that companies that place more emphasis on high-skilled talent actually saw higher productivity growth."

STANDARDISATION

Policy will be a big theme for Candriam's sustainable and responsible investment team this year.

The European High-Level Expert Group on sustainable finance published a report in July that set out steps to build a financial system that supports sustainable investment in Europe. Another report is due to published shortly.

The group wants to promote a sustainable finance strategy at a European level for long-term and sustainable growth, by making sure that the right tools, structures and legal systems are available.

"This is a step in the right direction," Solange Le Jeune, a senior SRI analyst at Candriam, says. "The markets within Europe are all very different. They have a different focus and different strategies, clients have different needs and objectives.

"It creates a blur and although the ultimate goal is always the same it is difficult to introduce, in practice terms, investment solutions," she adds.

"Having a strategy at the European level could help define things a bit more, be more acute and decide on the definitions and what you want to achieve. It could help maybe having a structure at the European level could help countries develop their own strategies in a consistent way and countries can make progress together.

"One of the things that we struggle with is understanding what sustainable finance and ESG means. So anything which can help define things, where the strategy is, what we need to achieve, where we want to go and the regulations that go with this can really help the market."

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>
> Matt Moscardi, MSCI ESG Research

PAY INEQUALITY

There has been a lot of talk about remuneration in the past few years, but the debate is no longer limited to the gap between an executive's pay and that of the company's average employee. The disparity between men and womens' compensation filled the conversation last year, a debate that will continue into 2018.

Legislation is scheduled for the UK to make companies report any gender pay gap that they have. Le Jeune believes that more and more developed world companies will gradually be forced to disclose more on this issue. She also expects to see investors pushing companies to disclose such data if they are not covered by legislation.

"I would see the gender pay gap and, more generally, pay inequality as a big governance theme in 2018," she adds.

Gender diversity and pay are also in Invesco Perpetual's ESG outlook. De Coninck-Lopez believes that workplace culture could come into sharper focus this year with human rights in the supply chain and gender diversity continuing to be high up the agenda for investors and companies.

"Social issues have historically been more difficult for investors to tackle as they are often not as tangible in terms of physical or monetary impact as, for example, an issue such as climate, but certainly these issues receive a lot of attention," she says.

CYBER SECURITY

Last year saw a number of high-profile hacking cases, most notably the WannaCry software which hit more than 10,000 organisations and 200,000 individuals. Then there was the Equifax attack, which exposed the personal data of some 143 million Americans. "The sheer scale of these incidents is perhaps an insight into the quality of global corporate IT systems and the extent of the challenge to update and protect critical systems and sensitive data," Newton's Stewart says.

Many businesses were unprepared for this risk. PwC's 2016 Cybercrime survey found that only 37% of the organisations surveyed had a cyber incident response plan.

"Companies are unlikely to be able to stop attacks, so a well-planned response is vital," Stewart adds. "To add to the issue, the hackers are able to act much more quickly than companies in defending themselves. Further, it isn't just the risk posed by external threats which companies need to consider, but the risk that intellectual property is subject to internal theft also. While this perhaps may not be front of mind when evaluating security gaps, for companies which rely heavily on R&D, this is a serious consideration.

"Research suggests a significant need to improve board-level, strategic understanding of cyber risks at companies, with research by EY revealing that 87% of board members and C-suite executives lack confidence in their organisation's level of cyber security."

HOLDING INDIVIDUAL DIRECTORS TO ACCOUNT

A number of corporate governance commentators are discussing the potential use of a currently underused section of the UK Companies Act for shareholders to hold individual company directors to account. Section 172 of the Act, 'duty to promote the success of the company', includes calls for directors to always act in the companies' best interests while having regard for its employees and the impact of the company's operations on the community and the environment. "We don't know exactly how this will play out yet as the legislation is quite open ended," Stewart says.

ONE TREND YOU MIGHT NOT SEE

Regardless of what happens in this space in 2018 Aon Hewitt head of responsible investment Tim Manuel does not expect to see ESG become a mainstream investment market just yet.

"What we saw in 2017 was people outside of that niche start to ask questions [about ESG]," Manuel says. "What is this? Why might it be important?

"I would love to think we will get more of that, but I'm not convinced that 2018 is when it is going to break into the mainstream," he adds.

"Regulation is likely to be the thing that pushes this topic beyond those natural adopters [in the defined benefit market]."

"The DC side is more interesting," he adds. "Member engagement comes through more strongly in DC schemes because they are more closely connected with the underlying investments in the scheme."

Only time will tell if some or all of these predictions will define ESG in 2018. *Portfolio Institutional* will be tracking the market, researching eight more features on the sector before the year's end, which might include some of the points made above.