THE REALITIES OF ESG INVESTING

Sustainable investing: why it is important, how will it help our planet and livelihood, and what it will do for our wealth, health and future.

ESG (environment, social and governance) investing, like cryptocurrency, has experienced a surge in popularity and attention over the past two years. Investors from corporate to retail have been abuzz with its importance, but it still has been met with varying response. It has been talked about enough that it's beginning to lose its luster – so why are we still struggling to grasp its significance?

Other interchangeable names for ESG investing include 'green investing' or 'sustainable investing' or 'socially responsible investing'. These alternative names for the themed investment highlights the objective of these investments. In that vein, however, the language to describe ESG investing can be regarded as both alarming and alienating. The vocabulary applied freely associates these themes to be synonymous with climate change and the environment – but the reality is that it is very much more than that.

If there's anything the pandemic has taught us, is that corporations would need to focus on other stakeholders, such as the workers of the company and other social aspects, like customer service. "The pandemic has also brought the vulnerability and interconnected nature of our societies and industries to the forefront of investors' minds and shown that sustainability considerations cannot be ignored," says Hortense Bioy, the global director of sustainability research at Morningstar.

As this is about investing, the fact is that it is overall difficult to assign monetary value to these ESG pillars, which has created a dissonance for investors to be able to grasp the tangibility of its importance. Research houses and fund management firms have taken the task to providing hard predictive data to chart projections for the future, especially with regards to the performance of their funds. This information will provide more solid research that ESG investing will bring better returns in the future – both for businesses, and the greater good of the planet.

ESG, MORE THAN JUST CLIMATE CHANGE

The three pillars of ESG are interlinked although we tend to only think about the environment, climate change and the 'green' movement when we hear of 'ESG' or 'sustainability'. The reality is each pillar is not easily measured to wholly assign its tangible value. For example, you may be able to count high employee turnover at a company, but what is it costing the company for that high turnover? It cannot all be answered purely with numbers.

"First and foremost, I think it's important to understand that ESG investing represents a spectrum of motivations and approaches," shares Bioy. She adds: "At the moment, there is a lot of confusion in the sustainable investing space because it is still early days and regulation has yet to bring some clarity and order to it. Countries are at different stages of their journey, some being more committed and supportive than others (e.g. Europe vs. US)."

The main skepticism applied to ESG investing is the possibility of investing to bring both financial returns and social impact. "The argument was that ESG investing would underperform financially as ESG considerations would compromise profits," says Ismitz Matthew De Alwis, executive director & chief executive officer of Kenanga Investors Berhad. "Another group argues that ESG isn't effective at achieving environmental or social change," he adds.

However, ESG investing helps accelerate ESG adoption among companies.

"ESG funds only invest in companies which meet their respective ESG criteria, contributing to the increase in awareness among investee companies on the importance to adopt ESG practices across their business operations," says De Alwis. "In order to attract new investments and to meet the expectation of institutional shareholders, companies must put together greater emphasis on identifying and managing the ESG risk associated with their business operations. This has catalysed ESG adoption among companies."

Ultimately, ESG investing provides a platform for investors to demonstrate their personal values and play a role in financing assets that are contributing positively to environmental and social causes, adds Chan Ai Mei, chief marketing & distribution officer of Affin Hwang Asset Management Berhad.

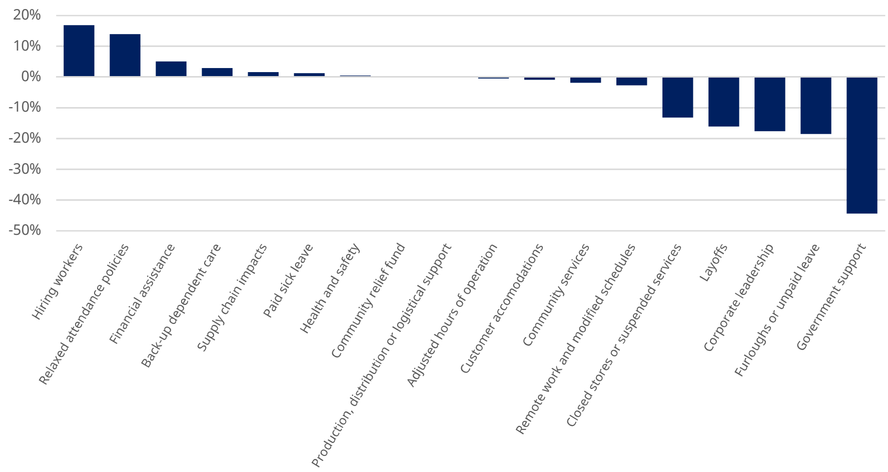
"ESG integration is the inclusion of material ESG factors on top of traditional financial metrics in the investment decision process," shares Chan. "For instance, companies with poor labour practices face increased risk of lawsuits, customer order cancellations as well as reputational damage," she adds.

Echoing Chan is Victor Wong, head of the regional ESG team at UOB Asset Management Sdn Bhd: "Some have viewed the 'S' in ESG as suffering from middle child syndrome – many have placed emphasis on the 'E' and 'G' but are neglecting the 'S' in ESG. However, we observe a pickup in the prominence of 'S' factors. With Covid-19, 'S' has been dragged into the limelight."

Wong gives the example of outstanding social issues in Asia and labour management, where the pandemic had exposed companies that were not prepared to face this challenge. One example he gave is as follows: At the beginning of the pandemic, a leading glove manufacturer saw its prices surge.

Re-writing social contracts: responsible "saint" companies will outperform the "sinners"

Figure 1: Sector-relative performance of companies announcing responses to COVID-19, since start-Jan



Source: Company announcements, JUST Capital, Schroders. Past performance is not a guide to future performance and may not be repeated.

Hortense Bioy

Ismitz Matthew De Alwis

Chan Ai Mei

Victor Wong

Claire Herbert

Koh Huat Soon

However in the same year, thousands of factory workers tested positive for the virus which resulted in major plant shutdowns and local government investigations into workers' housing conditions. Furthermore, the company was imposed with hefty bans from trading countries.

Claire Herbert, the ESG Manager of Asia Pacific at Schroders agrees: "During the early days of Covid-19, we analysed the relationship between companies' responses to Covid-19 and the equity market appraisal value. The results are telling: those hiring workers, relaxing attendance policies or offering financial assistance, for example, have been appraised positively."

A RISK MANAGEMENT TOOL

Picking the right investments is an art and a science – and a very big part of choosing the right investment requires the need to explore its risk.

"Some investors use ESG data to assess and manage ESG risks. This approach has become widespread among traditional investments as more investors have come to understand that material ESG issues may reflect hidden risks that traditional analysis may overlook," opines Bioy. This is especially true with risks associated with climate change, where investors use ESG information as a tool to identify companies that are sustainability leaders, or those seeking to improve their ESG practices to build competitive advantages.

This type of investing also demands active engagement from investors, gaining popularity among asset managers and owners to generate impact. "For example, through engagement, portfolio managers can encourage companies to commit to reducing their greenhouse gas emissions," Bioy adds.

"One of the key practices in ESG investing is to exercise shareholders' rights to influence corporate behaviour by voting in the AGM/EGM," says De Alwis, adding: "Many institutional investors publish their voting policies to promote better governance. Exercising voting rights is an effective and direct approach for asset managers to influence the direction of investee companies and to push for an ESG agenda. This puts pressure on corporate boards to demonstrate that they are adequately equipped to understand and oversee ESG issues, from climate change to human rights to social unrest."

"In sustainable investing, ESG considerations complement traditional fundamental principles in selecting companies and securities that are of a higher quality. Sustainable investments can add value to investor portfolios and

THE 3 PILLARS OF ESG

All companies, regardless of their sector or nature of business will have a part to contribute under at least one pillar, or more. Here's a (non-exhaustive) list of things included under the umbrella of ESG or sustainable investing:

1 ENVIRONMENTAL: Conservation of the natural world and its resources, includes: Carbon and greenhouse gas (GHG) emissions; natural resource depletion; air and water pollution; biodiversity; deforestation; energy efficiency; waste management and water scarcity

2 SOCIAL: Consideration of people and relationships, includes: Labour standards and working conditions; employee engagement; health and safety of employees/customers; equal opportunities; gender and diversity; customer satisfaction, data protection and privacy, community engagement and philanthropy

3 GOVERNANCE: Standards for running a company: Board diversity; business ethics and compliance; bribery and corruption; executive compensation and fairness; lobbying for policy change; political donations; whistleblower schemes

Malaysia's Climate Change-Related Agenda to ESG Investing

The Sustainability Accounting Standards Board (SASB) and Global Reporting Initiative (GRI) have charted the way in reporting sustainability goals. Other governing bodies like the UN Sustainable Development Goals (SDG) and the Task Force on Climate-related Financial Disclosures (TCFD) have contributed to regulating and achieving them.

The region has also seen a push in policy developments, with the publication of the first ASEAN taxonomy draft during COP26 to individual governments, setting out taxonomy standards and climate-related disclosure guidelines.

An estimated US$2 trillion (RM8.84 trillion) of infrastructure investment is needed – from resource extraction to electrification – over the next decade for Southeast Asia's sustainable transition. This was determined by a collaborative report written by Bain & Company, Microsoft, and Temasek.

"Bursa Malaysia is introducing a voluntary carbon market (VCM) as a platform to trade carbon credits for carbon emission offset purposes. Furthermore, the National Energy Policy, long-term low-emission development strategies (LT-LEDS) and carbon emissions price will be announced by the end of 2022," says Victor Wong, head of the regional ESG team at UOB Asset Management Sdn Bhd.

"Along with the carbon pricing policy, the Cabinet agreed to develop the Domestic Emissions Trading Scheme (DETS). On the financing front, BNM's 2021 Climate Change Principle-Based Taxonomy (CCPT) requires financial institutions to assess lenders and investees' climate change transition status. Such developments are expected to guide financial flows and capital allocation towards more sustainable outcomes," adds Wong.

are complementary to traditional investment concepts and financial performance yardsticks," says Wong.

He adds that the main objective is using sustainable investing as a risk management tool – one that enables us to limit the downside for investors by identifying and eliminating companies with ESG risks, such as pollution for an industrial company or data privacy concerns for a technology company. In many ways, having these ESG pillars prompts investors to interrogate a company and their practices further keeping them accountable to their performance and returns to the investor.

"Studies have shown that companies that manage their ESG risks well tend to perform better than their peers in the long run. This includes having better profitability and lower cost of capital," says Wong. A fund manager would be doing their job right by evaluating a company on its stance on climate change, employee treatment and board accountability. With the right foundation, these factors would aid in the identification of competitive companies that will do well in the long-term.

Organisations like the CFA Institute have been conducting research, discovering that companies with a strong ESG focus achieve better financial performance than those that place less or no emphasis on ESG, shares Wong.

He further adds: "The positive relationship between ESG and performance supports the philosophy that sustainable companies are more resilient, navigate risks well and are better prepared to meet future challenges."

COVID-19, HASTENING SUSTAINABLE INVESTING

ESG investments proved their resilience by retaining their performance throughout the past two years while riding through the volatile changes of life caused by the pandemic. This was exemplified by the growth of global sustainable assets which outpaced global assets under management, according to the Global Sustainable Investment Review.

"The reported sustainable investment assets stood at US$35.3 trillion (RM157 trillion) making up 35.9% of total assets, up from 27.9% in 2016," says Koh Huat Soon, regional head of research at Maybank Asset Management Sdn Bhd. He adds that Morningstar reported that ESG funds rose 29% globally in 2020.

De Alwis agrees adding that large funds with ESG criteria outperformed the broader market, according to a report published by S&P Global. "While ESG investing is often criticised to compromise profitability, S&P's analysis is evidence that such funds outperformed their peers and the broader market during the pandemic," he says.

At the heart of it, investors are often searching for long-term sustainable investments. De Alwis opines: "The pandemic was a wake-up call for investors to reiterate on the importance of sustainable business practices to avoid the risk of being financially impacted by such external events in the future."

This was further proven in 2021 being the record year for ESG investing in the US, with an estimated US$120 billion (RM530 billion) of inflow, more than double of US$51 billion (RM225 billion) in 2020.

On the local front, based on data provided by the SC, there were ten SRI (Socially Responsible Investing) funds (combination of unit trusts and wholesale funds) registered by end

2020. Since then, the number has risen to 56 funds as of 1 June 2022, with 29 launched in 2021 and 17 this year.

POLICY-DRIVEN BODIES AND REGULATORS

Regulators such as the SC and Bank Negara Malaysia (BNM) are laying out the frameworks for asset managers through guidelines that include '*Guidance Note on Managing ESG Risks for Fund Managers*', '*Principles-based Sustainable and Responsible Investment Taxonomy for the Malaysian Capital Market*' and '*Climate Change and Principle-based Taxonomy*'.

While we are still at a nascent stage for ESG-themed investments, it would be reasonable to expect a growth outlook for in the long-term.

"In the near term, the local ESG agenda remains very much driven by our regulators and large GLC (government-linked companies) funds such as the EPF, KWAP, PNB and Khazanah. For example, bank-backed local asset managers, being partly driven by BNM requirements on climate risk management for the financial sector, have embraced ESG more readily compared to the more resource-challenged smaller non-bank peers," Koh says.

Some early starts have been observed, with local asset managers integrating ESG considerations into portfolio management by requirements imposed on funds of GLC clients. "But as the ESG momentum built and having seen the impact of erosion on stock value for those falling short on ESG standards, asset managers increasingly recognise that the growing ESG tide is irreversible. ESG factors were driving investment returns in as much as operating and financial performance were," adds Koh.

CONCLUSION

What does this mean for Malaysian investors? Even if it may appear to be a current trend and hot topic, it's clear that ESG investing is here to stay. Incentivised with promising returns while also enforcing deeper research and understanding of the companies you invest in, it is always worth your while to take a holistic approach towards where you are putting your money's worth.

3 MEGATRENDS FACILITATING TRANSITIONS FOR BUSINESSES AND ESG INVESTING

Victor Wong, *head of the regional ESG team at UOB Asset Management Sdn Bhd*

ESG investing is soon going to be the map of our future as all facets of the environment, socially responsible matters and corporate governance are interlinked. These megatrends are slated to shape ESG investing for the long-term in Asia.

1 SUSTAINABLE TRANSITION AND CLIMATE CHANGE

Sustainable transition has far-reaching implications and is not limited to carbon intensive sectors such as energy, utilities, materials, and mining. As companies start to take into consideration climate-related risks, their business models will transition to start incorporating more ESG factors. Asset owners like sovereign wealth funds and pension funds are taking the initiative to ensure that the largest corporate greenhouse gas emitters take necessary action on climate change.

2 SHIFTING AWAY FROM COAL / ENERGY TRANSITION

With increasing climate awareness and mounting pressure, funding for coal projects is dwindling. Since the 2015 Paris Agreement, there has been a strong decline in the number of coal power plant projects – by 76%. Globally, the number of coal projects in development have rapidly fallen over the years – from 1,553 GW in 2015 to 482 GW in 2021.

Last year, the Asian Development Bank announced that they will conditionally cease funding of new coal-fired power plants, coal mining, and oil & natural gas production and exploration. This comes on the heels of Southeast Asian banks, development banks, and export credit agencies pulling their support from such activities. Without such support, we see countries within the region –that largely rely on coal-fired power generation for electricity – having to quickly transition away from coal-fired power generation, shifting towards greener and cleaner alternatives from renewables.

3 JUST TRANSITION / FOCUS ON SOCIAL

'A Just Transition' may become a new sustainable engine of growth in Asia. It is a framework developed by the trade union movement to encompass a range of social interventions to protect workers' rights and livelihoods, especially when economies are shifting towards sustainable productions.

We have also seen the pursuit of 'common prosperity' goals that target labour practices within the gig economies. In Asia, outstanding social issues on labour and Covid-19 management, especially for migrant workers, are being flagged out, suffering not just financial losses from bans and contract termination but also reputational risk.