AXA Investment Managers

Your guide to responsible investing in three steps

December 2017

IT'S LITTLE SURPRISE THAT THERE HAS BEEN PLENTY OF CONFUSION ABOUT RESPONSIBLE INVESTING (RI). MUCH OF THE TERMINOLOGY AROUND THE CONCEPT CAN BE JARGON HEAVY AND AS A RESULT, MANY INVESTORS COULD BE FORGIVEN FOR NOT FULLY UNDERSTANDING OR ENGAGING WITH THE OPPORTUNITIES PRESENTED BY RI.

After starting out with the fundamental idea of investing in 'good' companies and sectors and avoiding 'bad' ones, RI has since evolved into a powerful way to make effective investment decisions. It can deliver sustainable, long term value for clients and create a positive impact on society using insights gleaned from environmental, social and governance (ESG) data. By incorporating these considerations into investment solutions across all asset classes investment managers can deliver positive measurable outcomes that are in line with clients' broader ESG objectives.

This approach has built significant credibility in an age when some firms can become winners almost overnight while seemingly powerful corporates fall by the wayside as a result of not addressing increasingly prominent trends such as technological disruption.

A striking example of this is the rapid rise of electric car manufacturer Tesla[1], which although launched a century later than Ford, has in its few short years of existence already temporarily outstripped (in terms of market capitalisation) what was for generations the world's most successful automobile producer.

The shift may seem sudden but illustrates the momentum that is building for products that are deemed more responsible and less harmful to the environment. And the wave of enthusiasm for creative innovation is not limited to the heavy polluters in industrial sectors, it is quickly moving into the financial world. Investors increasingly want to understand how a company is creating value. They therefore expect and demand details of how an organisation's activities are impacting the wider world.

The RI revolution

In the past, investors concerned about aspects of a company or sector, such as tobacco, arms or gambling often found that they were faced with limited investment options. The focus was almost exclusively on public equity-oriented strategies, in what were generally described as negative screening or ethical funds. This also created the perception that financial returns were limited.

But the RI universe has moved on significantly since the early days of such negative screening. Responsible investment strategies have grown both in number and sophistication, reflecting investors' appetite for investment products that address and respond to ESG issues. Through integrated and innovative fund management techniques, RI is opening up a new world of opportunities, and these will continue to improve as tools and measurement criteria within RI become more nuanced. Greater scrutiny on non-financial criteria can help asset managers to more effectively mitigate risk and therefore potentially enhance financial returns.

[1] For illustrative purposes only, no representation is made that AXA IM has or is invested in such security.

Why we believe RI is a compelling opportunity for investors

IN RECENT YEARS, THE INVESTMENT LANDSCAPE HAS WITNESSED DRAMATIC CHANGE AS THE MULTIPLE FACTORS THAT COMPANIES MUST ADDRESS TO DELIVER LONG TERM VALUE AND MITIGATE RISK HAVE BEEN REDEFINED. THESE INCLUDE HARD TRENDS SUCH AS REGULATION AS WELL AS SOFTER TRENDS WHICH ARE SHAPING CORPORATE AND SOCIAL BEHAVIOURS, AND EMERGING INVESTMENT OPPORTUNITIES.

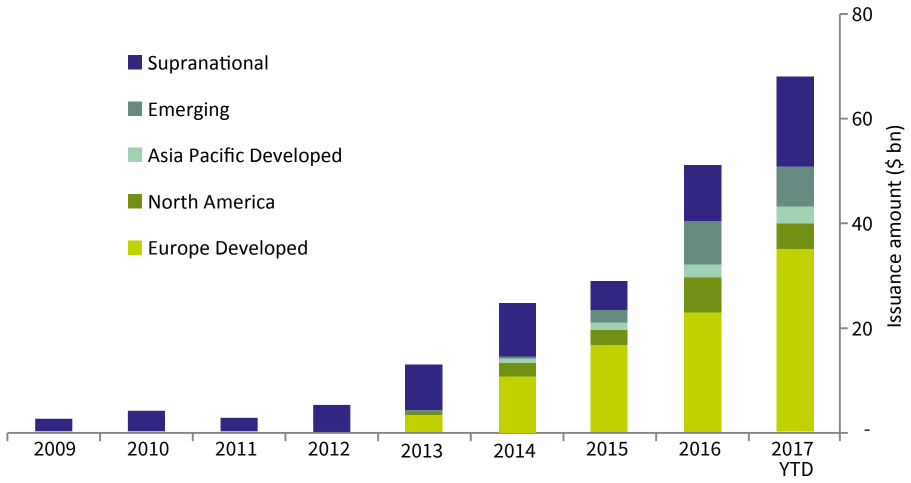
An effective tool to address regulatory change

COP21, the UN Climate Change Agreement signed in 2015 by nearly every country in the world, was a seminal moment in influencing corporate behaviour globally. At the national level, important initiatives such as the Energy Transition Law (Article 173) in France, which requires investors to disclose how they manage ESG criteria, have dramatically transformed the global investment landscape as it relates to RI. Around the world, regulations that include specific RI requirements are growing, as seen in pension fund legislation in the Nordics, Canada and South Korea[2].

These have been joined by a series of so-called 'soft trends' that are compelling companies and investors to place greater focus on ESG factors in their operations and communications, including the Financial Stability Board's move to increase transparency on climate-related financial risks (FSB TCFD[3]), and ratings agencies such as Standard & Poor's and Moody's committing to ESG benchmarking and measurement.

Launched in 2016, the UN's 17 Sustainable Development Goals (SDGs) are quickly becoming a norm in certain geographies, for example the Netherlands, where many Dutch pension funds have announced that their mandated investment managers must make reference to how their solutions will contribute to one or several of the SDGs all the while still ensuring market rate returns.

FIGURE 1: ANNUAL GREEN BOND ISSUANCE HAS GROWN IN VOLUME AND IN GEOGRAPHIC DIVERSITY



Source: Bloomberg New Energy Finance. Note. APAC is Asia Pacific, EMEA is Europe, Middle East and Africa, AMER is North, South and Central Americas.

A smart approach to increasing social pressure

This backdrop has been complemented by an increasing social conscience where an ever-rising number of consumers want to know that their purchasing power is having a more positive, and less destructive, impact on the world.

For example, 76%[4] of millennials said they regard business as a force for positive social change, according to a 2017 Deloitte survey. Similarly, a global study by consultants Mercer found that 81% of asset owners and 68% of asset managers view climate change as either a material risk or opportunity[5].

And as appetite grows for a new, sustainable approach so does demand for new instruments to meet these expectations. New financial instruments such as green bonds (see figure 1), green infrastructure or investment vehicles that target gender diversity, financial inclusion or healthcare are rapidly growing in volume and accessibility.

[2] Principles for Responsible Investment (PRI) Global Guide to Responsible Investment Regulation 2016.
[3] Financial Stability Board Task Force on Climate-Related Financial Disclosures.
[4] The Deloitte Millennial Survey 2017.
[5] Morgan Stanley Research 18 May 2016.

What RI approaches are available for investors?

GIVEN THE ENORMOUS SCOPE FOR RI STRATEGIES, IT CAN BE A DAUNTING TASK TO UNPACK ALL THE DETAILS AROUND THEM. THE RANGE OF RESPONSIBLE INVESTMENT OPTIONS CAN BE BROADLY CATEGORISED INTO THREE BUCKETS; SCREEN, INTEGRATE AND IMPACT. THESE THREE APPROACHES COVER THE FULL INVESTMENT SPECTRUM AND ALSO REFLECT THE INCREASINGLY REFINED INVESTMENT APPROACH EVIDENT IN RI'S ONGOING DEVELOPMENT.

1. ESG-embedded

This is the first step into the world of responsible investments. Various forms of screening create a starting point for embedding ESG. Initially designed to avoid ESG risks by excluding exposures that conflict with investors' principles and values such as controversial weapons, palm oil or coal, screening now goes much further than simple 'exclusionary' or 'negative' filters.

A focus on ESG scoring means the portfolio can be evaluated in terms of its exposure to both ESG risks and opportunities. Every bond and stock can receive an ESG score that is aggregated to form an overall ESG portfolio scorecard. This means investments can be viewed in a broader ESG context. Alongside the screening and scoring, an active approach towards stewardship through voting and engagement is an important part of the assets being deemed ESG-embedded. Active voting and engagement is an effective way of encouraging companies to move towards best practice, or initiating change on important issues at board level. ESG-embedded is where you can also start to report on key performance indicators (KPIs), such as carbon footprint, which form the basis of a clear ESG measurement framework.

2. ESG-integrated

These investments go a step further. This approach uses ESG analysis, including the ESG score outlined above, and incorporates this information into investment decisions.

ESG integration is perhaps the most complex of all RI approaches. While each company is analysed on an ESG basis, there are no perfect companies, so it is not a simple exercise in the same way as an exclusionary screen may appear in its bluntness.

In this case, companies are assessed on how they are positioned to handle both short and long term ESG risks - as well as opportunities. The expectation is that management teams taking decisions to address and minimise ESG issues are likely to be more competitive relative to their peers in the long term. This type of analysis will be very different depending on each company and the industry it operates in, and therefore results in placing companies on a sliding scale in order of preference, rather than creating a simple binary choice.

For example, Coca-Cola[6] is a company that you may not necessarily expect to appear in an ESG-integrated portfolio. Health concerns around obesity rates, water management and efficiency are all ESG issues that could affect the long term sustainability of the business. However, Coca-Cola is also an example of a company that has responded to ESG concerns around its core product and wider practices. Through a series of initiatives, such as increasing low or no-calorie products and developing its water risk management programme, it has retained trust and support from investors.

In this way, ESG integration is a world away from viewing companies in just black and white and is perhaps better considered as seeing investments in colour.

Used in conjunction with financial analysis, it aims to create a clearer, longer term picture of a company's future prospects. The ultimate aim of employing this approach is to create a portfolio of strong ESG holdings which are more likely to outperform their peers with lower ESG scores operating in the same industry. Using MSCI World Index as a basis, our research suggests that companies with better ESG scores generate a higher return on equity and lower stock specific risk, see figures 2 and 3.'

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3. Impact

The most recent phase in RI's evolution is impact investing. This takes the latest RI techniques and refines them to specifically target positive change. The approach should not be confused with philanthropy – rather, it has two clear objectives. Impact investments simultaneously seek to deliver competitive financial returns while at the same time producing positive societal impacts. Importantly, positive impacts must be measurable and quantifiable. In this way it seeks to harness the power of finance and direct it to solve complex social and environmental problems.

Impact investments can be used in a range of different projects, such as improving access to education and healthcare, expanding the reach of financial products to underserved populations, or reducing the effects of climate change. These are all examples of positive change that can be achieved - in conjunction with financial returns - through impact investing.

In order to deliver on both financial and societal criteria, target outcomes from these investments should be clearly identified from the outset and be specific and measurable.

Because of this strict criteria, the traditional area for impact investing has been in alternatives, like private equity. However demand is building for publically listed equities to play a role. In order to maintain integrity around impact investing, products and services should be considered that go beyond a simple analysis of a carbon footprint compared to a benchmark. Listed equity or fixed income portfolios will need to be constructed with a focus on holdings which can demonstrate that they are making a positive contribution either through quantifiable metrics or active engagement.

Ultimately, impact is the most forward looking segment of responsible investing. It seeks to create an investment virtuous circle by financing projects that promote a better society, in an environment where companies and industries, delivering long-term and sustainable value creation, can flourish.

A clear path ahead

In time, an ever increasing amount of ESG data will become available, which will demystify the sector even further. But for this to happen, improved consistency and a greater adoption of standardisation of ESG measurements is needed so it becomes an accepted financial analysis criteria.

Addressing the demand for disclosure and standardisation on metrics such as carbon footprint, water sustainability and gender diversity will set clearer targets for companies to reach.

At portfolio level, greater consistency on ESG standards will enable investment managers to be compared on a consistent basis so that regulation can be applied to asset owners and investors more systematically.

In essence a powerful measurement framework will provide the proof that including ESG criteria into financial decisions is adding value.

RI is evolving fast. Soon it will be possible to harvest vast ESG data sets for powerful insights, rivalling any other area of financial analysis. The next generation of investors will demand greater transparency and accountability, which will make RI the norm in asset management.

Momentum is only building and RI will in time become a mainstream form of investing. We see only one direction of travel – and there is no turning back.

To learn more about AXA IM's responsible investing capabilities, please visit our website:
www.axa-im-usa.com/en/responsible-investing

Glossary

'Aiming for A' coalition: A coalition set up in 2011 to undertake engagement with the largest global extractive and utilities companies. The coalition enables asset owners and managers to support these companies in their preparations for the low-carbon transition.

Carbon footprint: The amount of carbon dioxide released into the atmosphere as a result of the activities of a particular organisation, most often expressed as tonnes of CO2 emission per USD million of revenues.

Climate Bond Initiative: An investor-focused, not-for-profit organisation that works to mobilise bond markets for climate change solutions. The aim is to reduce the cost of capital for climate-related investments by developing a large and liquid market, while providing trusted standards and certification.

Conference of the Parties (COP): COP21, COP22, COP23: A UN conference on climate change that is held annually. The 21st conference (COP 21) was held in Paris in December 2015. The conference negotiated the Paris Agreement, a landmark global treaty on the reduction of climate change. The treaty lays out a framework to limit global warming to less than 2°C compared to pre-industrial levels. COP22 was held in Marrakech, Morocco in November 2016. COP 23 was held in Bonn, Germany in November 2017.

Corporate governance: The system of rules, practices and processes by which a company is directed and controlled.

Corporate Social Responsibility (CSR): Corporate responsibility involves the search for an effective 'fit' between businesses and the societies in which they operate. 'Corporate responsibility' refers to the actions taken by businesses to nurture and enhance this symbiotic relationship.

Energy Transition Law (French) – Article 173: In August 2015 France passed the Energy Transition Law, the first of its kind in Europe, came into full effect in June 2017. France has decided to provide a clear signal to institutional investors with this law by encouraging them to become truly engaged on the subject of RI and start considering how to better integrate ESG factors in their investments. The law reinforces the role of institutional investors in financing the transition towards a low-carbon economy and requires more awareness of long-term issues in investment decisions.

Engagement: The practice of shareholders entering into dialogue with management of companies to change or influence the way in which that company is run.

ESG: Environmental, social and governance issues that constitute the three pillars of Responsible Investments. E, S, and G are the three central factors in measuring the sustainability qualities of an investment.

ESG-embedded: These investments benefit from active stewardship, exclusion polices on controversial weapons, non-RSPO palm oil, derivatives on food commodities. The can also receive ESG scoring and footprint analysis.

ESG integrated: The incorporation of ESG factors and analysis into investment decisions.

EU Non-financial Reporting Directive: Large , public-interest entities (listed companies, banks, insurers) with more than 500 employees should disclose in their management reports relevant and useful information on the policies, main risks and outcomes relating to at least

- Environmental matters
- Social and employee aspects
- Respect for human rights
- Anti-corruption and bribery issues
- Diversity in the board of directors.

High Level Expert Group (HLEG) on sustainable finance: Set up by the European Commission to develop an overarching and comprehensive EU strategy on sustainable finance as part of the Capital Markets Union.

Extra-financial: Elements of a company's behaviour that may not be immediately apparent solely from an analysis of its financial data. Often ESG themes are associated with extra-financial factors.

Fiduciary duty: Fiduciary duties (or equivalent obligations) exist to ensure that those who manage other people's money act in the interests of beneficiaries, rather than serving their own interests. The most important of these duties are:

- **Loyalty:** Fiduciaries should act in good faith in the interests of their beneficiaries, should impartially balance the conflicting interests of the different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party.
- **Prudence:** Fiduciaries should act with due care, skill and diligence, investing as an 'ordinary prudent person' would do.

Source: Fiduciary Duty in the 21st Century, United Nations Global Compact, UNEP FI, PRI and Inquiry, September 2015.

Financial Stability Board (FSB): An international body that monitors and makes recommendations about the global financial system. It was established after the 2009 G20 London summit as a successor to the Financial Stability Forum.

Green bonds: A bond that is issued to raise capital for the development of environmentally friendly projects or assets.

Green washing: When a company, government or other group make a unsubstantiated or misleading claim about the environmental benefits of a fund or financial instrument.

Institutional Investor Group on Climate Change (IIGCC): A forum the provides investors with a collaborative platform to encourage public policies, investment practices, and corporate behaviour that address long-term risks and opportunities associated with climate change.

Impact investing: Focuses on financing businesses and projects that are designed to have intentional, positive and measurable impacts on society while simultaneously delivering financial market returns. As the societal impact is fully embedded into the business model, there need not be an inherent trade-off between impact returns and financial returns.

ESG Key Performance Indicator (KPI): A measurable value that demonstrates how effectively a company is achieving its ESG and impact objectives.

Low-carbon economy: An economy based on low-carbon power sources with minimal carbon emissions into the environment. It makes reference to a world where the temperature increase is contained below 2°C or 1.5°C.

2°C Scenario: An internationally agreed threshold to limit the rise in global temperatures to below 2°C from pre-industrial levels.

Negative screening/disinvestment: An investment approach that excludes some companies or sectors from the investment universe based on criteria relating to their policies, actions, products or services. Divestment refers to the sale of stocks, bonds or investment that conflict or are not aligned with specific ESG objectives, values or convictions.

Principles for Responsible Investment (PRI): The UN-supported Principles for Responsible Investment (PRI) initiative was launched in 2006. The world's leading proponent of responsible investment, the PRI is an independent organisation bringing together and supporting an international network of investors to put the six Principles for Responsible Investment into practice.

The six Principles are to:
- incorporate ESG issues into investment analysis and decision-making processes
- be active owners and incorporate ESG issues into ownership policies and practices
- seek appropriate disclosure on ESG issues from invested entities
- promote acceptance and implementation of the Principles within the investment industry
- enhance effectiveness in implementing the Principles
- report on activities and progress towards implementing the Principles.

AXA IM was an early signatory to the PRI in 2007.

Responsible investment: At AXA IM, we believe that responsible investment can deliver sustainable, long term value for clients and create a positive impact on society. We do this by incorporating environmental, social and governance (ESG) considerations into our investment solutions across all asset classes, with a view to achieve sustainable performance and positive measurable outcomes in line with our clients' objectives.

Task Force on Climate-related Financial Disclosure (TCFD): Set up to develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders.

UN 2030 Agenda for Sustainable Development: An agenda made up of 17 Sustainable Development Goals adopted by world leaders in 2015. The Goals encourage countries to establish national frameworks to end all forms of poverty, fight inequalities and tackle climate change. Each goal has specific targets to be achieved over the next 15 years.

United Nations Development Programme (UNDP): UNDP is the United Nations' global development programme. It works across 170 countries and territories, helping to achieve the eradication of poverty, and the reduction of inequalities and exclusion.

United Nations Environment Programme (UNEP): UNEP was set up in 1972 as an agency of the United Nations to assist developing countries in implementing environmentally sound policies and practices. Today, UNEP is the leading global environmental authority, setting the global environmental agenda within the United Nations system.

UN Global Compact: An initiative to encourage businesses worldwide to adopt sustainable and socially responsible policies and report on their implementation.

The UN Global Compact supports companies to:
- Do business responsibly by aligning their strategies and operations with Ten Principles on human rights, labour, environment and anti-corruption; and
- Take strategic actions to advance broader societal goals, such as the UN Sustainable Development Goals, with an emphasis on collaboration and innovation.

UN Environmental Programme Finance Initiative (UNEP FI): An initiative led by the UN that seeks to encourage the implementation of sustainability principles in financial institutions through the incorporation of ESG factors in risk analyses.

UN Guiding Principles (UNGP) on Business and Human Rights: A global standard for preventing and addressing the risk of adverse impacts on human rights linked to business activity.

The UNGPs encompass three pillars outlining how states and businesses should implement the framework:
- The state duty to protect human rights
- The corporate responsibility to respect human rights
- Access to remedy for victims of business-related abuses.

Design & Production: AXA IM Paris - 27-09871- Photos : GettyImages