Dutch Pension Industry €1.5 trillion ESG 'Green Swan' Accelerating for European Take-off

The €1.5 trillion Dutch pensions industry, the largest in the European Union, and the fourth biggest in the world, is driving forward in adopting ESG (environmental, social and governance) principles to colour all its investments green across asset classes and markets. The sheer size and concentration of capital represented by this ESG firepower, means these institutional investors could emerge as a leading 'Green Swan,' a powerful game-changing force that positively shifts the balance in the greatest existential challenges facing humanity, such as Global Climate Change, investment specialists at a recent AXA Investment Managers' online media roundtable concluded.

In his book: '*Green Swans: The Coming Boom in Regenerative Capitalism*,' John Elkington, described as the "Godfather of Sustainability," says that if Nassim Taleb's 'Black Swans' are problems that take us exponentially towards breakdown, then Green Swans are ESG solutions that take us exponentially towards breakthrough.

Elkington identifies the European Commission's Green Deal as a potential Green Swan. The EC's plan is designed to attract at least €1.0 trillion worth of public and private investment over the next decade and to turn Europe into a climate neutral economy by 2050, which will require massive investment in clean energy technologies. The total Dutch pension funds investment base, however, is half as big again as that being commanded by Brussels and is larger than the GDP of the Netherlands itself, the fifth-ranking economy in the Eurozone.

Hanneke Veringa, AXA IM Country Manager Netherlands, said the Dutch institutional approach to ESG investing is built on two pillars: the IMVB, International Responsible Business Conduct covenant, which predominately addresses social issues, and the National Climate Agreement, the commitment of the financial industry to the goals of the Paris Global Climate Change Accords.

AXA IM research indicates the group of largest Dutch pension funds, led by the giant civil servant (ABP) and health workers (PGGM) retirement plans, which together account for around 50% of the sector's total assets under management, are most advanced in implementing and reporting on these ESG covenants across their investment processes. The institutional investment industry's progress in agreeing ESG objectives and developing the performance benchmarking and application of big data and artificial intelligence analysis and quantitative investing methodology to equities and fixed income and other asset class portfolios, means smaller Dutch schemes now increasingly have access to the toolkits and resources necessary to accelerate the expansion of their green signatures, she added.

In contrast to the Dutch consensual approach, AXA IM and its parent the French AXA Group, Europe's largest insurer, are subject to France's Energy Transition Law, the regulatory framework around the adoption of measures to combat climate change within companies and other organisations. Within these parameters the insurer has achieved a 31% reduction in its carbon footprint over the last five years (2014 – 2019). The United Nations Sustainable Development Goals (UN SDGs) are also increasingly becoming the mainstream global standard for communicating on ESG investing and AXA has targeted a selection of seven grouped under: Climate Change and the Environment (SDG 13, 14, 15), Health and Disease Prevention (3), Social Inequality and Inclusion (1, 5, 10) to guide its investment management processes.

SDGs have increasingly become a mainstream Global Standard to communicate about ESG

AXA Group's Corporate Responsibility strategy targets a selection of 7 SDGs

Covid-19 Spurs ESG Investment Integration

Jeroen van der Put, Board Member at the Central Beheer APF pension fund, said in his 30 years as an institutional investor, he had never seen such a clear strategic investment outlook as that based on the huge worldwide political capital committed to the UN Sustainable Development Goals programme out to 2030. The engagement of the Dutch pensions sector with this global ESG vison is already substantial and rapidly extending further, he added.

“ESG investments have proved to be a relatively safe area to be in during the Covid crisis… and the companies that are not centred on sustainable development goals in coming years will have a lot of problems…Over the last 10 years there’s also been a lot of research showing it’s very important to take ESG as a risk factor into account and when you really get into this area it doesn’t have to cost return. Over the recent coronavirus period you could say that there’s more belief that ESG investing really adds to return,” Van der Put noted.

He added that the pending ‘Big Bang’ Dutch pension reforms, which will transform the retirement system in the Netherlands from a defined benefit approach, based on a proportion of previous working salary, to a pooled defined contribution structure, where an individual’s pension income is dependent on investment outcomes, could also be a ‘Green Swan.’ The reforms may boost the adoption of ESG investing as individual pension plan members demand their money is only invested in an ethical way and where it makes a positive impact, for example in the fight against Global Climate Change.

“With the new pension reforms we will see a complete shift, with all the (investment) risks completely on the plates of the (pension scheme member) participants. So that means they will be more involved in their pensions and that will be very interesting, for example in equities, as they will say it’s important to implement ESG policies because your investments always have an impact,” Van der Put said.

The reforms package will also allow Dutch pension funds to reset the composition of their portfolios, for example switching out of ultra-low yield sovereign debt and opting for more riskier, but also higher yielding assets, notably corporate bonds, better matched to cashflows for future pension payments than the present liability-driven investment structures. Recent AXA IM research concluded these regulatory changes could result in a seismic shift in the allocation of over a third of those assets, or more than €500 billion, between fixed income asset classes.

Van der Put said he expected Dutch institutions to increasingly focus on ‘green bonds’ in their fixed income investments, but the big question is whether there would be a difference in returns compared with ‘brown bonds,’ or non-ESG integrated debt.

“It’s really interesting what’s happening in this area because you’ve got companies that issue a green bond and also a non-green bond and the question for me is, will there be a difference in return? If the green bonds have slightly lower returns because they’re a bit more expensive to issue, institutions will take this issuance, but what happens when the difference in investment performance is too large between these two forms of debt?…..It will show what the premium is that people are willing to pay for ‘green,’” he concluded.

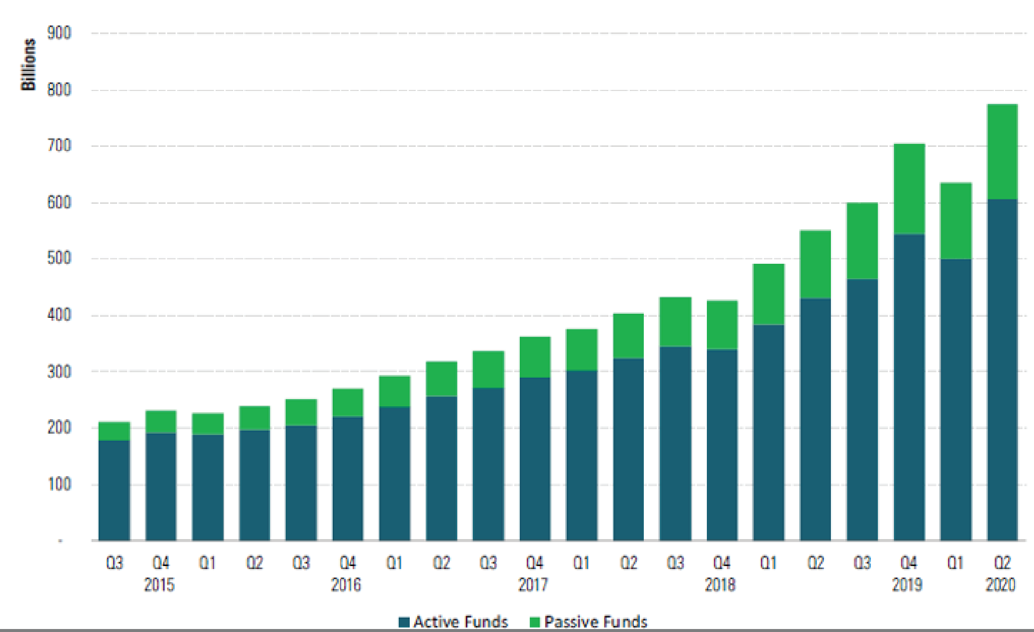
Investment Flows into European ESG Funds Hit Record High in Q2

Hortense Bioy, Director of Sustainability Research at ratings agency Morningstar told the news conference that investment flows into European sustainable open-ended funds and ETFs hit a record high of €54 billion in the second quarter of 2020. That was double the inflows registered in the tumultuous first quarter of this year, when sustainable fund flows declined, but not to the extent of the large outflows from their non-ESG counterparts. The volume of assets in ESG funds also hit a new peak of €774 billion at the end of June.

“We’re seeing growing interest in ESG issues from both institutional and retail investors, especially in the wake of the Covid-19 crisis. The disruption caused by the pandemic has really highlighted the importance of building sustainable and resilient business models, based on multi-stakeholder considerations. Another contributing factor to the strong inflows in Q2 was the continued growth of the sustainable fund universe in terms of number of products,” she said.

Sustainable fund assets hit new highs

Exhibit 7 Quarterly European Sustainable Fund Assets (EUR Billion)



Source: Morningstar Direct, Morningstar Research. Data as of June 2020.

Despite the Covid-19 crisis, the number of ESG funds is growing with over 200 new vehicles launched so far this year, including 50 passive funds, bringing the total in Europe to 2,703 at the end of the second quarter, and encompassing funds that have been ‘repurposed’ or ‘renamed’ with a green label.

“Asset managers are literally greening their mainstream funds. They typically do that by divesting from ESG laggards, adopting best-in-class ESG strategies, reducing exposure to companies with the highest carbon footprints, or completely divesting from fossil fuels. Some are even switching to a sustainable thematic strategy, like climate change, for example,” Bioy said.

The research analyst added that Morningstar is often questioned over whether the repurposing and rebranding of funds represents ‘greenwashing,’ but said she is careful when using the term because there is no real market consensus on what ‘green’ actually is and that investors also have a responsibility to do their due diligence and “look under the bonnet” at the investment product they are being offered.

“Investor engagement and divestment can both influence companies, but in different ways… Divestment can, for example, raise the cost of capital for companies with bad ESG credentials and that can provide an incentive for management to improve their ESG performance. Engagement is also a very powerful tool; it’s a big piece, and a new piece of the ESG story…Transparency is key though; asset managers need to disclose more about their engagement activities, the ESG outcomes they’re looking to achieve and how successful they are in achieving those outcomes, because investors need to be able to hold these managers accountable,” Bioy concluded.

Quantitative Analysis will own the Future of ESG Investing

To build an institutional quality ESG investment portfolio requires the ability to process a large amount of data to incorporate in investment processes and to be able to manage multiple constraints. Quantitative managers are really well-placed to score well in these three dimensions and that is why 'quants' could own the future of ESG investing, putting billions of euros of listed equity to work on sustainable goals, Paul Flavier, CEO of AXA Rosenberg, told journalists.

"It's important to recognise that we (quant managers) can arbitrate between risk and return. Today it's fair to say that ESG is more seen as a risk dimension, or constraint. Maybe in the future it will shift to more of an 'alpha-generating' (market-beating) source of return…On the ESG side we have to learn to be investors first and quant second…and managers already have the ability to select some sustainable development goals and target them quite precisely in the portfolio," Flavier said.

He added that the Covid-19 crisis has accelerated the acceptance that corporates have a socially responsible role to play, in addition to their commercial and financial objectives. Secondly, the pandemic has exacerbated the valuation discrepancies between the best-in-class and the worst-in-class on the ESG front, with companies scoring well being rewarded in their valuations compared with their failing peers. The third by-product of the crisis is that carbon-intensive equity sectors such as energy and transportation have been hit more severely than carbon-light sectors like technology and health. But Flavier said simply moving investments out of carbon-intensive industries into more sustainable sectors to achieve 'energy transition' targets should not be investors' primary strategy.

"Investors should not be just lured by reducing the carbon intensity of their portfolios. When you shift from carbon-intensive to carbon-light sectors you haven't really done anything, because what really matters is also being able to have an influence on those industries which are contributing the most to the energy transition. It's important to also look at different metrics when you're judging the carbon impact of a portfolio -- not just intensity -- such as the absolute levels of CO_2 within one industry and which companies are the best-in-class and who is the worst-in-class," he said.

AXA Rosenberg research has identified links between some ESG metrics and the price and valuation of investment assets, which are becoming useful as input into the analysis of future corporate earnings, particularly a company's carbon footprint as a measure of liability.

"This (the carbon footprint metric) is something that seems to be working and becoming more and more established financially, with the market really anticipating its outcome. So if you're a carbon-intensive business and you do nothing about it, you're going to be heavily penalised by the market. I wouldn't be surprised if going forward we will see sell-side analysts using this metric as part of their valuation methodology," Flavier said.

He added that it was also important to understand the interaction between ESG and traditional financial metrics and distinguish the respective contribution between these variables when building a sustainable portfolio, as investors often tend towards a 'size bias' with high quality names, larger market caps and low volatility stocks.

Asset managers also need to be fluent in the emerging field of 'natural language processing,' which AXA Rosenberg is using for plain text analysis to complement its numerical data and capture what companies are fundamentally really saying in public statements about their ESG-related activities, Flavier said.

The quant manager incorporated the various elements of its ESG processes into an equities investment product launched last year called ‘Green Opportunities, which is composed of three tiers: The first excludes companies with a very negative ESG impact and, on the other side, also pushes in businesses with a very high positive impact. In the middle-tier, corporate engagement is the key factor.

“So you have these three brackets in your portfolio, divestment or inclusion, forcing in the best-in-class, and then engaging with everybody in the middle, and that gives you a nicely balanced approach to ESG investing,” he added.

Dutch Market has Critical ‘Green Swan’ Mass

Paul Flavier said that from the perspective of a French asset manager, the Dutch institutional investment market is emerging as the anchor and leader for innovation in ESG investing in Europe.

“The Dutch market is very large with sophisticated players, so it has critical mass. I think these pension funds could lead European industry and asset owner groups in proposing an ESG investment framework that people can gravitate towards, creating a convergence of language so we all know what we’re referring to with terms like ‘net zero,’ ‘Paris-alignment,’ or ‘energy transition stage.’ We’ve seen some of this initiative in the Institutional Investors Group for Climate Change proposals put forward in July, but the Dutch pension funds are really well-placed to be the anchor point for the creation of a set of very pragmatic and concrete definitions for asset owners and asset managers. The size, sophistication and ESG focus of the Dutch market means it has a very important role to play,” Flavier concluded.