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SUSTAINABLE AND ACTIONABLE

A study of asset-owner priorities for ESG investing in Asia

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About the research

Sustainable and actionable: A study of asset-owner priorities for ESG investing in Asia is an Economist Intelligence Unit report, sponsored by Amundi. Dewi John is the author and Jason Wincuinas is the editor. It is based on in-depth interviews conducted with 15 executives at asset-owner firms and finance professionals at academic or advisory organisations, as well as extensive desk research and historical analysis.

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- Jamie Allen, founding secretary-general, Asian Corporate Governance Association (ACGA)
- Choi Jinsuk, director investment planning team and investment strategy group, Korea Investment Corporation (KIC)
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- Stefen Shin, senior financial institutions relationship officer, investment operations, AIIB
- Feng-Ching Tsay, director-general, Bureau of Labor Funds (BLF) Taiwan
- Srikanya Yathip, deputy secretary general, Government Pension Fund (GPF) Thailand
- Eddie Yue, deputy chief executive, Hong Kong Monetary Authority (HKMA)

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Executive summary

The world's top 100 asset owners (AOs) represent about US$19trn in assets under management. The largest, and potentially most influential, proportion is in Asia—more than a third of the total. Out of the top 20 largest funds, three out of the first five and nearly half of the total are in Asia.

How do asset owners in Asia approach that scale of responsibility?

The Economist Intelligence Unit carried out interviews with some of Asia's largest asset owner firms, development banks, sustainable investment organisations and influential industry advocates to determine how they saw the growth of environmental, social and governance (ESG) investing in Asia, as well as the AO role in it. In parallel, we review the latest research on ESG investing in the region to give an overview of sustainable investing in Asia. The main findings include:

- There has been a significant change in the awareness, uptake and impact of ESG in Asia over the past three to five years. This has been driven by: uptake by large asset owners such as Japan's Government Pension Investment Fund (GPIF) and the Thai Government Pension Fund, which are not only transforming their own approach but proselytising among other investors in the region; the policies of national and multilateral development banks; and regulatory action by governments and exchanges.
- AOs are motivated by an increasing recognition that their investment decisions have material consequences for their environment and the lives of their beneficiaries. What's more, there is growing awareness that integrating values or ethical considerations into investment approaches does not necessarily result in a negative impact on financial returns or performance. Rather, ESG is an integral component of prudent risk management.
- In terms of financial return, "governance" seems to be the most important ESG factor for most AOs, given its demonstrable link to optimising risk-adjusted returns. Capital allocation, in social and environmental themes, tends to be made within a framework of first identifying companies or assets that fit a good-governance profile and fulfil a returns-based role within portfolios. China is an exception, where a government focus on environmental issues has pushed this factor to the fore.
- As in other regions, ESG investing began with a negative screening approach. While the method is still used, the dominant ESG approaches are now engagement and, in particular, integration. Although commonly seen as late adopters, Asian AOs are applying this throughout their portfolios, rather than asset class by asset class.
- While progress is accelerating, challenges remain. Interviewees cited concerns about thin and poor-quality data preventing informed investment decisions; a fragmentary regulatory environment across the region, and a dragging perception in the broader market that ESG was about values (or ethics) rather than financial value (or returns). However, all participants agreed that these issues were being addressed and progress continues to be made.

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Introduction: Everything to play for

The ability of asset owners (AOs) in Asia to change the face of investing has never been greater. The top 100 AOs globally own US$19trn of assets (see table). That's about 35% of the entire world's capital. Within the top 100, the largest region in terms of assets under management (AUM) is Asia-Pacific (36%).[1]

These large AOs fall into broad categories: pension funds (US$36.4trn in AUM in 2016), insurance company general accounts (US$23trn in 2015), sovereign wealth funds (US$7.5trn), investment consultant outsourced CIOs (US$1.69trn in 2017), with the rest being single family offices, endowments and foundations, and multi-family offices.[2]

Alongside this, estimates for total AUM being managed using one or more environmental, sustainable or governance (ESG) investing strategies globally was US$23trn in 2016, and about US$526bn in Asia.[3] While Asia has historically been seen as a laggard in ESG terms, that is changing.

This report looks beyond the headline figures to see how major Asian AOs and other market participants view ESG investing in their region, their role in it and its future.

[1] Willis Towers Watson, "The Thinking Ahead Institute's Asset Owner 100", https://www.willistowerswatson.com/en-GB/press/2018/11/thinking-ahead-institute-reveals-the-most-influential-capital-on-the-planet
[2] CFA Institute, "The Seven Kinds of Asset Owner Institutions", https://blogs.cfainstitute.org/investor/2018/02/20/the-seven-kinds-of-asset-owner-institutions/
[3] Oliver Wyman, "Driving ESG investing in Asia", https://www.oliverwyman.com/our-expertise/insights/2018/jun/driving-esg-investing-in-asia.html

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Top 20 asset owners
(in US$ m)

Rank	Organisation	Country	Total assets	Primary category
1	Government Pension Investment	Japan	1,443,554	Pension fund
2	Government Pension Fund	Norway	1,063,456	Pension fund
3	China Investment Corporation	China	900,000	Sovereign wealth fund
4	Abu Dhabi Investment Authority	UAE	828,000	Sovereign wealth fund
5	National Pension	South Korea	582,938	Pension fund
6	APG	Netherlands	564,508	Pension fund
7	Federal Retirement Thrift	US	531,489	Pension fund
8	Kuwait Investment Authority	Kuwai	524,000	Sovereign wealth fund
9	SAMA Foreign Holdings	Saudi Arabia	514,000	Sovereign wealth fund
10	Hong Kong Monetary Authority Investment Portfolio	Hong Kong	456,000	Sovereign wealth fund
11	SAFE Investment Company	China	441,000	Sovereign wealth fund
12	GIC Private Limited	Singapore	359,000	Sovereign wealth fund
13	National Social Security	China	341,361	Pension fund
14	California Public Employees	US	336,684	Pension fund
15	Qatar Investment Authority	Qatar	335,000	Sovereign wealth fund
16	Canada Pension	Canada	283,454	Pension fund
17	Central Provident Fund	Singapore	269,133	Pension fund
18	PGGM	Netherlands	262,290	Pension fund
19	Temasek Holdings	Singapore	230,310	Sovereign wealth fund
20	Public Investment Fund/ Sanabil Investments	Saudi Arabia	230,000	Sovereign wealth fund

Source: Willis Towers Watson

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Why has ESG taken off?

On one level, this is a trivial question: the environmental and social consequences of not doing it are—and are increasingly being shown to be—catastrophic. Mark Konyn, chief investment officer at Hong Kong-based insurer AIA, says the group's "approach to ESG is underpinned by our purpose-led promise of enabling healthier, longer, better lives that relates to sustainable investing, targeting long-term outcomes".

Eddie Yue, deputy chief executive of the Hong Kong Monetary Authority (HKMA), says his organisation has adopted an ESG framework "because we believe climate change risks must be tackled on a global basis and across different sectors of the economy. Clearly how the banking system and the investment community operate will have profound impact on the way in which the risks are managed and reduced." Choi Jinsuk, the director of the investment planning team and investment strategy group at the Korea Investment Corporation (KIC), concurs, saying "ESG is kind of mandatory for a public fund, considering its external effects."

That frames the overall context of "why", but not "why now?" One thing that does help explain this is that it's becoming increasingly apparent to Asian investors that certain ESG risks—particularly the environmental aspect—are a more pressing risk in their region than elsewhere. And that is borne out in terms of dollars; according to a joint report by the UN and the Asian Development Bank, between the years of 2007 and 2016, natural disasters in the Asia-Pacific region wrought an average of US$76bn a year in estimated damages, a level about twice that recorded in the previous decade.[4]

Tackling this comes at a cost. The Asia Investor Group on Climate Change conducted analysis and found that aggregate annual losses for companies in Asia exponentially increase as global temperatures rise—from US$16bn to US$221bn depending on the climate model used (the study used 1.5°C, 2°C and 3°C average temperature rises). However, the same study also claimed that Asia in particular had a greater opportunity to offset such losses via technology, referencing existing low-carbon patents already owned in the region. Savings were "estimated at US$181bn for 2°C and US$440bn at a 1.5°C scenario".[5]

One aspect of our adoption of ESG principles has been the realisation that only one group can mobilise the market, and that is institutional investors.

Srikanya Yathip, deputy secretary-general, GPF Thailand

[4] UN ESCAP, the Asian Development Bank and the UNDP, "Transformation towards sustainable and resilient societies in Asia and the Pacific", https://www.adb.org/sites/default/files/publication/410761/sdgs-resilience-transformation.pdf
[5] CWR, Manulife Asset Management and Asia Investor Group on Climate Change, "Are Asia's Pension Funds ready for Climate Change?", http://www.chinawaterrisk.org/wp-content/uploads/2019/04/Are-Asian-Pension-Funds-Ready-For-Climate-Change-CWR-MAM-AIGCC-Report_FINAL2.pdf

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Asia, therefore, has much at stake and a huge amount to lose if the necessary transition is mishandled, but an immense amount to gain if companies respond in the right way. What constitutes an efficient influence? Srikanya Yathip, deputy secretary-general of the Thai Government Pension Fund (GPF) has no doubt: "One aspect of our adoption of ESG principles has been the realisation that only one group can mobilise the market, and that is institutional investors."

This is, explains Makoto Okubo, sherpa, insurance and retirement income work stream, Asia-Pacific Financial Forum (APFF), largely because of the long-term nature of many institutions' investment goals: "Life insurance is a unique business—our pay-back is in 20 or 30 years, therefore long-term growth is more important than the next quarterly report. We don't need to be profitable at every moment. That gives us the ability to take a really long-term outlook—something that fits well with an ESG strategy."

Regulation can also be a driver. Richard Sheng Ruisheng, director of the group ESG office at Chinese insurer Ping An, emphasises that the company's ESG policy is motivated by both "our own corporate commitment to making the lives of our customers and the conditions of society better; and also it is driven by the central government's increasing commitment to sustainable environmental planning and development".

Lastly, although an early prompter for ESG development, has been the role of investors outside of the region. "Over the past decade, it's been primarily institutional investors outside of Asia, investing into the region, that has driven asset manager adoption of RI [responsible investing] practices," says James Robertson, head of Asia (ex-China and Japan) at the Principles for Responsible Investment (PRI), an investor initiative founded in partnership with the UN. However, he says, "local asset owners have been far more engaged over the past two or three years and are starting to ask similar questions and have similar expectations of their managers."

Asian corporations responding to regulatory requirements in global markets also have an effect, as Christine Loh, chief development strategist at the Hong Kong University of Science and Technology, explains: "As the EU's requirement [comes] into play, it will drive supply-chain companies to sort out their own footprint in order to be able to report to their buyers."

This spring-board effect hasn't just happened from outside Asia to within, but from one Asian country to another. Srikanya says that GPF's new CEO visited the Government Pension Investment Fund of Japan (GPIF), which is the world's largest asset owner. This triggers a conversation on ESG, and the realisation "that we need to be leading in this area. GPIF and Nippon Life have been very influential on our approach," she adds.

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Ultimately, however, ESG investing still comes down to the bottom line. While there's still some way to go on this (see the Challenges section), there is a growing realisation that what distinguishes ESG investing from its predecessor, "ethical investing", is that the former creates a framework for sustainability not just at the planetary level, but at the corporate level too. As Feng-Ching Tsay, director-general of Taiwan's Bureau of Labor Funds (BLF), explains: "Although our priority is the best economic interests of our scheme members, we also recognise that, increasingly, non-financial issues such as social and environmental factors have the potential to impact the share price, as well as the reputation of companies," adding, "it is now widely recognised that ESG can have a meaningful impact on risk-adjusted returns."

It is now widely recognised that ESG can have a meaningful impact on risk-adjusted returns.

Feng-Ching Tsay, director-general, BLF Taiwan

In a 2017 keynote interview at the ten-year anniversary event for the publication *Responsible Investor*, Hiromichi Mizuno, chief investment officer of Japan's GPIF, put the "why now" question into even more straight-forward terms: "I just see no point in [having] our grandchildren receive pension benefit in a world [where] they cannot play outside."[6]

[6] Interview with Hiromichi Mizuno: https://www.youtube.com/watch?v=rGPj5r6HOyE

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What's happening

Development of a concept

The term ESG was popularised in about 2005, when the then UN secretary-general Kofi Annan invited a number of heads of large financial organisations to a conference, supported by the International Finance Corporation and Swiss government, outlining ESG for the first time in these terms.[7] This produced the *Who Cares Wins* report released that year.[8] And since 2006, it has seen further development with the launch of the UN-backed PRI.

This has been brought into sharper focus by the 17 Sustainable Development Goals (SDGs) set by the UN General Assembly in 2015 around themes from clean oceans to zero hungar. "There's a reason there are 17 goals—they are all interconnected," says Heike Reichelt, head of investor relations and new products at the World Bank. "Things are never purely environmental or social," she adds.

Nevertheless, environmental concerns sit front and centre in the SDGs, with the Paris Agreement on climate change being held within months of the rolling out of the former. There are clearly synergies between the two sets of objectives, and an inaugural conference in Copenhagen in April 2019 looked at how "to align the climate and SDG processes, and stimulate action from stakeholders at the global, regional and country levels to maximise co-benefits".[9]

The SDGs have proved to be far more than window dressing, instead helping frame concrete investment objectives for institutional investors. "There is a lot of discussion about matching between ESG and SDGs," says KIC's Mr Choi.

"Life Insurance Association of Japan (LIAJ) selected eight priorities regarding the 17 UN SDGs, which includes the promotion of ESG investment," says Mr Okubo "These were the eight goals we thought were most closely aligned with our function as the life insurance sector—for example establishing sustainable social security systems, and the promotion of the empowerment of women."

Gathering momentum

ESG has markedly picked up pace over the past half-decade. The role of AOs and asset managers in organising themselves has played a major role. "Looking back, a number of local and regional stakeholders helped lay the foundations for the progress we are

[7] UN Global Compact, Federal Department of Foreign Affairs Switzerland and International Finance Corporation, "Investing for Long-Term Value, Integrating environmental, social and governance value drivers in asset management and financial research", https://www.scribd.com/fullscreen/16876744?access_key=key-mfg3d0usaiuaob4taki
[8] The Who Cares Wins conference in 2005 brought together institutional investors, asset managers, analysts, consultants, government bodies and regulators. It looked at ESG drivers in asset management and financial research. See: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/publications/publications_report_whocareswins2005__wci__1319576590784
[9] Sustainable Development Goals Knowledge Platform, "Climate and SDGs Synergy Conference", https://sustainabledevelopment.un.org/climate-sdgs-synergies2019

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beginning to see now," says Mr Robertson. He cites the influence of Sustainable Investment Forums in Japan, South Korea and China, which have helped build up local capacity and awareness. In Hong Kong, the Association for Sustainable & Responsible Investment in Asia was established in 2001, to promote corporate responsibility and sustainable investment practices in the region, working alongside leading non-profits like the Asia Corporate Governance Association (ACGA) to drive progress.

The Thai GPF is spearheading efforts to form a network in Thailand, involving the stock exchange, the regulator, the social security fund and fund managers. "We want to develop an ESG ecosystem throughout the Thai investor community," says Srikanya, citing initiatives such as a national responsible investor conference in October 2018, and another, in June 2019, with the OECD, focused on knowledge sharing. "There is a strong emphasis on developing collaborative engagement with others: we are much stronger when we act collectively ," she says. "Regulators have been supportive, and many investors have their own policy, but we are trying to get everyone together to have a consistent approach. Alongside this, we are developing our network outside of Thailand in order to learn from their successes, and their failures," Srikanya adds.

We are much stronger when we act collectively.

Srikanya Yathip, deputy secretary-general, GPF Thailand

Countries adopting stewardship codes, such as Malaysia and Japan, have also been important. In 2019 the HKMA published its own policy[10] around sustainability, including incorporation of ESG factors in its credit-risk analysis and requiring external managers of the Hong Kong equity portfolios to comply with the Principles of Responsible Ownership.

Multilateral development banks such as the Asian Infrastructure Investment Bank (AIIB) have also driven the ESG market. With regard to infrastructure, Courtney Lowrance, principal environment specialist (operations) at AIIB, says "the most effective way to do this is to use our own investment portfolio as a proof-of-concept to the market." Once a track record is established over the next 12-18 months, the bank hopes to open the fund to other investors. Interrelated initiatives include working with index providers to develop an ESG enhanced infrastructure index for Asian emerging markets, and expanding ESG ratings coverage of Asian issuers.

[10] HKMA press release, "HKMA introduces key measures on sustainable banking and green finance", https://www.hkma.gov.hk/eng/key-information/press-releases/2019/20190507-4.shtml

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Case study: Japan stewardship

Japan is an example of how one or two large investors can change the investment landscape and stimulate others to change their outlook. This is principally the case with insurer Nippon Life following on the Government Pension Investment Fund (GPIF) example.

"In 2012, GPIF in Japan wasn't looking at [ESG]," says Jamie Allen, founding secretary-general of the Asian Corporate Governance Association, "then Japan got the stewardship code, and GPIF got right behind it." As a result, "in 2014-16 funds invested in ESG assets grew faster in Japan than anywhere else", as reported in *The Economist*.[11] According to Oliver Wyman, a management consulting firm the rate of growth was 6,771%,[12] between those years.

GPIF then signed up to the Principles for Responsible Investment in 2015; and from March 2016 to the same month in 2017, sustainable investment reached ¥136.6trn (as disclosed by 32 Japanese-headquartered institutional investors). The combined total in the previous year was about ¥56.3trn, which was more than twofold growth from 2015.[13]

Government action accelerated this further: "There is a working group on SDGs, chaired by prime minister [Shinzo] Abe in 2016, and the entire public and private sectors collaborate to promote SDGs," says Makoto Okubo of Asia-Pacific Financial Forum (APFF). That high level of influence means it's much harder for corporate leaders to ignore ESG factors in their outlook or reporting.

"What GPIF is doing is influential, because it's very visible to others who are looking to integrate ESG. They can see how GPIF is working with its external managers, and this will definitely catalyse the markets," says the World Bank's Heike Reichelt.

[11] *The Economist*, "The craze for ethical investment has reached Japan", https://www.economist.com/finance-and-economics/2017/11/23/the-craze-for-ethical-investment-has-reached-japan
[12] Oliver Wyman, "Driving ESG investing in Asia", www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2018/june/driving-esg-investing-in-asia.pdf
[13] Japan Sustainable Investment Forum, "Third Sustainable Investment Survey in Japan Total Sustainable Investment Balance in Japan Exceeds ¥136,595 Billion", http://japansif.com/180103en.pdf

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How it's being done

Different strokes

There are various approaches to ESG investing, and innumerable sub-variants. The main ways of going about this, however, are:

- **Negative screening:** excluding companies or sectors from investment consideration because of their business activities or other environmental or social concerns.
- **Positive screening/best in class:** selecting investments with favourable ESG aspects, generally by pre-determined quantitative factors.
- **Thematic investing:** investing in companies within a specific sector or industry theme, such as energy efficiency or clean water.
- **Corporate engagement:** applying shareholder leverage to influence corporate behaviour, including through direct corporate engagement, filing or co-filing shareholder proposals, and proxy voting.
- **Integration:** the incorporation of material ESG issues into the investment philosophy and process, ideally including security selection, portfolio construction and portfolio risk management.
- **Impact investing:** targeting social or environmental objectives along with measurable financial returns (sometimes called ESG 2.0). It's still early days with this approach. According to Mr Allen, in Hong Kong it "has been largely motivated by family offices".

Eliminate the negative

Sustainable investing began with screening out "sin" stocks. "As a fundamental first step, AIA relies on exclusion of certain sin stocks such as tobacco manufacturing and cluster munition," says Mr Konyn, with external investment managers mandated to abide by the group's investment exclusion list. "And our shareholders hold us accountable," he adds.

Screening can be done through individual security selection or via indexing—an approach Taiwan's BLF uses, as its customised benchmark ESG index excludes some sin sub-industries and companies with significant ESG controversy from its investible universe.

Indices and positive screening

Indeed, the creation of appropriate indices has been an important ESG driver in the region. Japan's GPIF uses S&P Carbon Efficient Indices to reduce exposure to high-carbon companies in a systematic way, while maintaining a risk-return profile similar to that of their benchmarks.[14]

[14] S&P Dow Jones Indices, "TalkingPoints: Institutional Carbon Efficiency: Exploring the Tools Japan's GPIF is Using to Achieve Green Objectives", https://www.arx.cfa/up/post/6296/talking-points-institutional-carbon-efficiency.pdf

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Taiwan's BLF has also used passive investment strategies in its domestic equity investments since 2011 by tracking different socially responsible investing (SRI) indices, says Mr Tsay. The Taiwanese pension fund has collaborated with US-based financial services provider, MSCI, to build a customised ESG index for its foreign equity investments.

While some (unsurprisingly, active managers) say that passive investing and ESG are incompatible, ESG-themed exchange traded funds (ETFs) have been around since 2005. Although, at US$11bn, assets in such funds are relatively small, they are expected to rise considerably, according to the *Harvard Business Review*.[15] And, even in "conventional" ETFs, it's possible for investors to engage with those companies in which they are invested through proxy voting services, as mentioned earlier.

It's not just the creation of bespoke indices where ESG factors are highlighted in benchmarks, as PRI's Mr Robertson explains: "The inclusion of China A shares into MSCI EM [emerging markets] indices last year has been important. As part of this process, MSCI has decided to do ESG ratings for all companies listed in the indices. This inclusion is a key milestone."

Accentuate the positive

Investors have gone from a "leave well-enough alone" approach to actively engaging with the companies in their universe. "The approach has gone from negative screening, to 'hey, we have this thing called a vote. Maybe we should use it'," says Jamie Allen, founding secretary-general of the ACGA. "It's gone from being reactive to shaping how companies behave. Where voting has been effective, it's been in a negative way—using your 'against' vote."

Voting is increasingly recognised as an important way that AOs can assert their influence—especially for those large institutions that hold a significant part of their domestic market—and PRI has issued guidance to steer them through the process.[16] Those that don't have the weight to influence decisions by themselves can pool their resources through proxy voting services such as Institutional Shareholder Services (ISS) and Hermes EOS, which have a presence in the region.

AIA is one company that finds engagement a beneficial approach, regardless of asset class. "Active engagement with investee companies is an effective means of improving awareness of good ESG practice and management across our markets, and particularly in emerging market economies," says Mr Konyn. "Stock exchanges and banks have a key role to play here in respect of both disclosure and bond issuance."

[15] *Harvard Business Review*, "The State of Socially Responsible Investing", https://hbr.org/2019/01/the-state-of-socially-responsible-investing
[16] PRI, "Engagement and voting practices", https://www.unpri.org/listed-equity/engagement-and-voting-practices-in-listed-equity/2725.article

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BLF's domestic investment in-house team has gone from "low-level participation (such as attending stockholders meeting and voting) in the past, and has continued to move towards medium participation, such as dialogue with the company's CEO or CFO, putting forward a proposal in the shareholder meeting, etc," says Mr Tsay.

Engagement to integration

The market is progressing to a full integration of ESG principles into portfolio management. "ESG integration is going far beyond labels to a completely different kind of investment approach, looking at ESG throughout the investment process," says Ms Reichelt.

Over time, people have realised that if these risks are material and fundamental, ESG shouldn't just cover 5-10% of your assets in an ESG fund; it should be how you run your entire portfolio.

Jamie Allen, founding secretary-general, ACGA

"Over time, people have realised that if these risks are material and fundamental, ESG shouldn't just cover 5-10% of your assets in an ESG fund; it should be how you run your entire portfolio ," says Mr Allen. "So our investors have gone from running a dedicated proportion of their portfolios under ESG principles to something that covers the entire portfolio."

The Thai GPF is developing an ESG framework that integrates all areas, says Srikanya, with the OECD invited to review and hopefully endorse the fund's approach: "Once this has been done, we'll disseminate this information so that others can more easily apply it."

ESG will be part of the due-diligence process for all of the Thai GPF's new investments. With existing assets, it will be part of the auditing process, and each asset will receive an ESG score, says Srikanya, adding that the fund is also looking at portfolio carbon exposure targets for five and ten years.

AOs are also using their influence to see that these principles are not just implemented in their own portfolios, but extended more

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widely. Mr Yue says that the HKMA is using its influence to "request external managers integrate ESG factors in their investment process with a view to promoting ESG integration in the wider asset management industry," in particular through compliance with the Hong Kong stewardship code.

This, as Ms Reichelt notes, represents a fundamental shift, requiring changing systems, such as how you report to investors: "This is a change in mindset and takes time, but creates a virtuous circle: because investors have more information, they can dig deeper and ask more questions, which in turn provides more information."

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ESG in theory

Value and values

What's different about an ESG approach versus other responsible or ethical investment approaches is that the former attempts to also make a positive contribution to financial returns—or, as a bare minimum, not be a drag on returns. The goal is to get value (positive returns), while supporting good governance and social or environmental values. The question then is, does it work?

The available research on ESG investing has a degree of ambiguity. For example, one recent meta-study of socially responsible approaches—*Is it Worth Being Good?*—concludes "despite many attempts in which various methods were used, so far there is no firm evidence to support or reject" whether ESG is good for performance.[17] Another best-practice review, by economist Gregor Dorfleitner et al, found "mixed evidence" of ESG outperformance in relevant stocks and funds.[18]

However, a 2011 Harvard Business School study found that 90 "high-sustainability" companies outperformed an equal number of low-sustainability ones over an 18-year period,[19] while index provider MSCI looked at the relationship between ESG factors and volatility, finding that companies with high or upgraded ESG ratings generally saw lower volatility.[20]

Probably the most wide-ranging study, by Gunnar Friede et al, reviewing about 2,200 individual studies, concluded that "the business case for ESG investing is empirically very well founded". About 90% of studies reported a non-negative relationship between corporate financial performance and ESG: "More importantly, the large majority of studies reports positive findings."[21]

The bottom line is still the bottom line

Yosuke Matsunaga, director and senior managing executive officer at Nippon Life, explains that, as an AO, his company must ensure "that investment results in profit—this is the biggest issue." As an insurance company he believes that "given the nature of the life insurance industry, we have always—when investing and managing assets—emphasised

[17] Tomasz Jedynak, "Is it Worth Being Good? – The Efficiency and Risk of Socially Responsible Investing in Light of Various Empirical Studies", http://e-finanse.com/archives/?page=wpabstracts&tab=attachments&task=download&type=attachment&id=941
[18] Gregor Dorfleitner, Sebastian Utz and Maximilian Wimmer, 26th Australasian Finance and Banking Conference 2013, "Where and when does it pay to be good? A global long-term analysis of ESG investing", https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2311281
[19] Robert G Eccles, Ioannis Ioannou and George Serafeim, Harvard Business School, "The Impact of Corporate Sustainability on Organizational Process and Performance", https://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf
[20] MSCI, "Foundations of ESG Investing", https://www.msci.com/documents/10199/03d6faef-2394-44e9-a119-4ca130909226
[21] Gunnar Friede, Timo Busch and Alexander Bassen, *Journal of Sustainable Finance & Investment*, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies", https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917

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the perspective of the public good." But at the same time, "implementation and the execution of ESG investing and financing is a way to help society transform to a more sustainable society—profitably."

Breaking down ESG

All ESG factors are not created equal, at least, not in terms of their financial impact. For example, one Barclays credit study found a small but steady performance advantage from ESG. This was strongest for governance—with issuers experienced fewer downgrades—and weakest for social.[22]

There are also regional variations, depending on how developed the market framework and participant engagement is. The Dorfleitner study found that Japanese firms, which could be identified as having "a strong corporate social performance", showed significant positive returns that reached as high as 20% (over a 60-month period). However, "in Asia Pacific and Japan…the environment-ranked portfolios generate negative abnormal returns in the long run. This holds especially true for the Asia Pacific region, which may be attributable to a lower general appreciation on environmental issues there."

Why it works, and why it doesn't

One potential reason for the stronger financial performance of firms with better ESG integration is that they enjoy a lower cost of capital, an effect seen in the MSCI study cited previously.[23] In addition, "investment in improving responsible employee relations, environmental policies, and product strategies contributes substantially to reducing firms' cost of equity… firms with socially responsible practices have higher valuation and lower risk."[24]

But that in itself presupposes a market structure where regulation and participants favour corporations acting in a sustainable manner over those that don't. ESG outperformance isn't a natural phenomenon. Companies that treat workers badly and have activities that result in environmental destruction can "get away" with it because they are more "efficient" in a narrow sense, as detailed in the Dorfleitner study. That, in reality, is no more than dumping their inefficiencies at no cost on the broader market and society. As soon as those "efficiencies" are recognised as a social cost, and regulators and market participants act accordingly, the company's financial performance suffers.

[22] Barclays, "Sustainable investing and bond returns", https://www.investmentbank.barclays.com/content/dam/barclaysmicrosites/ibpublic/documents/our-insights/esg/barclays-sustainable-investing-and-bond-returns-3.6mb.pdf
[23] Dan S Dhaliwal, Oliver Zhen Li, Albert Tsang, and Yong George Yang, *The Accounting Review*, "Voluntary Nonfinancial Disclosure and the Cost of Equity Capital: The Initiation of Corporate Social Responsibility Reporting", https://aaapubs.org/doi/abs/10.2308/accr.00000005?journalCode=accr
[24] Sadok El Ghoul, Omrane Guedhami, Chuck C Y Kwok and Dev R Mishra, *Journal of Banking & Finance*, "Does corporate social responsibility affect the cost of capital?", https://www.sciencedirect.com/science/article/pii/S0378426611000781?via%3Dihub

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What the data and the theory show is that where Asian markets have not factored in ESG concerns, ESG itself didn't pay—at least in financial terms. That, however, is changing as a result of changing market structure and demand.

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G over S plus E

"The G in ESG is what investors are most focused on," says ACGA's Mr Allen, and, in general, this does seem to be the case.

The strongest link between performance and ESG factors is with the last factor—and so governance sits at the core of most, although not all, investors' ESG processes. "The 'governance' side is seen to be the traditional side of financial and management integrity," says Ms Loh. "The social aspect is much harder, so I would say environmental reporting is what is new and developing."

Mr Yue believes ESG assessment "is highly situational and project specific", and so the HKMA doesn't adopt any one-size-fits-all approach. "Rather," he says, "we tend to identify ESG factors which are relevant to a project."

While Srikanya agrees that the weightings of E, S and G depend on the nature of the business, she says, "the most important aspect overall is governance." Mr Konyn sees this as fundamental and aligned with principles of good risk management: "Good governance is a core underpinning of our ESG analysis, and often is indicative of sound practices more generally. Transparency, accurate reporting and clear purpose allow us to explore a company's approach to social or environmental issues."

First, we have to be satisfied that a company is being run to a standard we can invest in.

Makoto Okubo, sherpa, insurance and retirement income work stream, APFF

Given investors' fiduciary duty to meet return objectives, this is no surprise. "First, we have to be satisfied that a company is being run to a standard we can invest in ," says Mr Okubo. "For example, if a company is doing fantastic work environmentally or socially, but is badly run, we could not invest in it: it presents too great a risk of a loss. We're not a government agency, so are not in a position to write off losses in that way. In return terms, G tends to contribute more than E and S. So we may identify, first, well-governed companies and then, among them, select ones that are beneficial environmentally and socially."

Ms Lowrance says that the weights assigned to E, S, and G at AIIB will vary across sectors and industries, but that "governance is over-weighted because of its strong links to credit strength," adding that the bank is mapping E, S, and G factors according to PRI's ESG in Credit Ratings Initiative, "which will help us understand those factors which are most suitable for ESG integration."

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Governance is over-weighted because of its strong links to credit strength.

Courtney Lowrance, principal environment specialist (operations), AIIB

Taiwan's BFL has found that "good ESG performance does not guarantee profitability," says Mr Tsay, and "as a pension fund manager, the BLF always puts first the economic interests of the plan in providing retirement benefits." However, he qualifies this: "we have come to believe that the ESG factors can help identify companies positioned for strong long-term performance."

BLF's foreign ESG benchmark index puts the same weight on each of the three factors. However, domestically, "governance has a significant effect on improving investment performance and is easy to adopt and evaluate in the investment process," says Mr Tsay.

Mr Sheng at Ping An attributes this to the fact that the social aspect is harder to quantify: "For the market to shift its mindset and recognise the benefits of investing in social good will take time but it will take its course… we are strong advocates of the S aspect and see great potential in this space."

Chinese exceptionalism: E to the fore

While governance is the driving force for most, China takes a different approach, with an investment ecosystem more closely defined by top-down goals, driven by regulations. Here, E comes out top.

"China needs to be seen from an overall national policy perspective," argues Christine Loh, chief development strategist at the Hong Kong University of Science and Technology. She adds that "its development of the concept of 'ecological civilization' and its incorporation in 2012 in the Communist Party Constitution was a very major move. The Chinese national constitution was also amended in 2018."

"'G' is a predominant aspect for western investors," says Richard Sheng Ruisheng, director of the group ESG office at Chinese insurer Ping An, whereas environmental protection is part of national strategy. He adds that "China's environmental protection legislation is comprehensive and law enforcement is also very strict. For example, the China Securities Regulatory Commission will use environmental compliance as a necessary condition for corporate IPOs. Thus, the risk and opportunity regarding E prevail in China."

However, governance issues are moving more centre stage. "While it may not have been held on the same pedestal in China, it has always been part of financial and legal considerations when making [an] investment decision," says Mr Sheng. "Its importance is rising among domestic investors, as businesses scale and start to see the ROI [return on investment] of good governance."

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Asset classes

BFL's Mr Tsay believes "ESG investment is a universal value, and should not be distinguished between asset classes and regions." However, he also makes the point that "ESG strategies are often viewed as more problematic with illiquid investments: the more developed the investment market is, the more investment targets are provided, the higher the liquidity, and the more fully the information is disclosed."

AOs in the region are employing diverse strategies to navigate the various asset classes. At Ping An "research and experience highlight three asset classes compatible with ESG investments strategy: equity, fixed income and M&A [merger and acquisition] projects," says Mr Sheng. Meanwhile, Ms Lowrance highlights the "important differences between equity and fixed income asset classes that affect ESG strategies. These include time horizon, engagement opportunities, and emphasis on downside risk versus upside."

ESG also helps us take a more holistic approach in research methods

Richard Sheng Ruisheng, director of group ESG office, Ping An Group

Equity

Listed equity is the most developed market, with a history of corporate engagement, a variety of ESG indices and so on. It's where most investors began their ESG journey, and where there is the greatest experience.

"In equity, we can adjust forecasted financials or company valuation models for the expected impact of ESG as the basic strategy," says Mr Sheng. "ESG also helps us take a more holistic approach in research methods, for example the potential of deploying quantitative models enriched with ESG factors alongside factors such as value, size, momentum, growth and volatility."

Green bonds

The next most developed market is fixed income—particularly green bonds (GBs). These have very much taken off in Asia and, as a specifically ESG-compliant asset, it's worth looking at them in some detail.

GBs are corporate, project and sub-sovereign bonds that finance climate-change solutions. The World Bank owns the distinction of issuing the first branded as a "Green Bond" in 2008, however, a year earlier the European Investment Bank launched a "climate awareness" bond, which is now widely seen as the original GB. "Green bonds have sparked an increased desire to find out what the money is being used for," says Ms Reichelt

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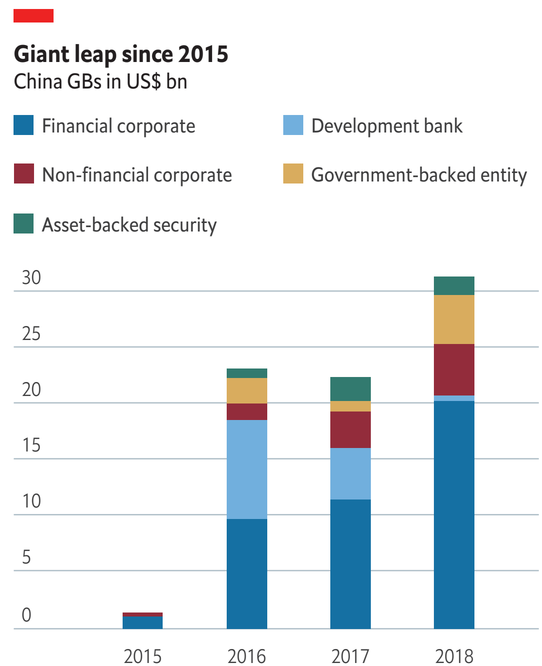
GBs should offer the same yield as conventional equivalents by the same issuer, as "credit exposure arises from the same balance sheet…Green bonds are, therefore, a genuine investment vehicle as opposed to a form of philanthropy,"[25] according to the CFA.

There can be explicit links between SDGs and particular GBs, making them ideal instruments for investors such as Nippon Life, which use the SDGs to orientate their ESG strategies. As Ms Reichelt explains: "We link our bonds to the SDGs, and investors can come to us and say, for example, 'we have these four SDGs in our investment strategy. Can you please give us some [project] examples?' We're not issuing project finance bonds, so the risk that investors take is World Bank risk—AAA-rated—and we engage with them on how we use the funds overall."



Source: Climate Bonds Initiative

National take up of GBs

China is a global leader in GBs, with US$31bn of issuance and 18% market share in 2018, just 2 percentage points behind the US. There are currently 69 Chinese issuers, including the world's second largest—the Industrial Bank of China. The country's GB guidelines, from the People's Bank of China in 2015, were one of the first to be published.[26]

One potentially negative aspect of the market is the decline in external reviews, with Chinese entities issuing GBs on the onshore interbank market less likely to be externally reviewed. "This represents a challenge for the market in terms of pre- and post-issuance transparency," points out the Climate Bonds Initiative.[27]

"Opinions over the issue of verification fall into two camps: one, that you need a standard and a stamp for something; the other that you can use this as an opportunity to find out more about the issuer—ask for more transparency," says Ms Reichelt. "The external verifications

[25] CFA Institute, "Handbook on Sustainable Investments: Background Information and Practical Examples for Institutional Asset Owners", https://www.cfainstitute.org/en/research/foundation/2017/handbook-on-sustainable-investments
[26] Climate Bonds Initiative, "Green Bonds, The State of the Market 2018", https://www.arx.cfa/up/post/6736/cbi_gbm_final_032019_web.pdf
[27] Ibid

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At the end of the day, it's the investor's decision as to what standards they expect.

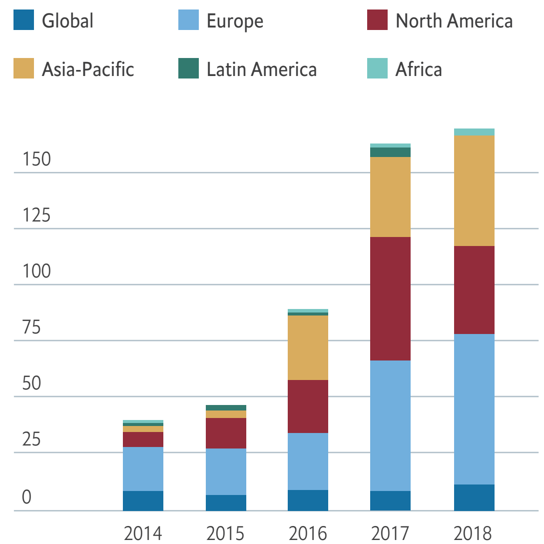
Heike Reichelt, head of investor relations and new products, World Bank

and second opinions should be regarded as additional resources. They are also helpful, because these external reviewers have a wider view across the market, and it's good for investors to be able to judge what's available. At the end of the day, it's the investor's decision as to what standards they expect."

Issuance from other emerging markets is small but growing, with 85 debut issuers in 2018. Thailand issued its first GB in 2018, from commercial bank TMB Bank (US$60m). "In the early days, ESG bonds were issued largely by international organisations or European corporations, recently we see many more issues by Asian corporations," confirms Mr Matsunaga of Nippon Life.

Malaysia revised its Islamic Securities Guidelines in 2014, laying the basis for the first green sukuk, a sharia-compliant bond, issued in 2017. Sukuk issuance almost doubled from US$755m in 2017 to US$1.4bn in 2018.

A greener bond world
in US$ bn



Source: Climate Bonds Initiative

For the ASEAN GB market, Indonesia issues the largest share, at 39%. The Philippines entered the market last year, when its Securities and Exchange Commission approved the country's "Guidelines on the Issuance of Green Bonds".

South Korea issued its first GB in 2013, from the state development bank Export-Import Bank of Korea, while Taiwan debuted the following year, and US$1.2bn worth of GBs had been issued by 2018. It's worth noting that non-financial firms dominate issue volumes,

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at almost 80% of the total, which is a good indicator of a maturing market.[28]

In May 2019 Hong Kong became the first Asian signatory to the Green Bond Pledge, and the territory's government kick started issuance with up to HK$100bn (US$ 12.8bn) in sovereign GBs.[29]

Financial institutions, including commercial banks and real-estate investment trusts, dominated the Asian market, "representing more than half of Asia-Pacific issuance volumes in 2018."[30] "This is very much a function of how financial markets work, as intermediaries start by trading among themselves," says Stefen Shin, senior financial institutions relationship officer at the AIIB. "Green Bond issuances from companies other than financial institutions will take longer to grow—but that is the tipping point we want to get to."

Infrastructure

Infrastructure is a key area for AIIB. "We have three thematic pillars: sustainable infrastructure, cross-country connectivity and private capital mobilisation," says Ms Lowrance. Mr Shin adds: "We are helping kick start emerging market infrastructure as an asset class through capital markets, encouraging institutional asset managers to allocate to this in a long-term sustainable fashion, rather than sporadically."

Mr Okubo concurs that the market needs development: "We are close to Asia and Asia is growing, but we are not invested heavily in Asia yet," he says: "There are constraints: first, bankable projects are rare. There are market issues, regulatory issues. APFF is tackling these issues to promote infrastructure financing in the Asia-Pacific region. But it's a long process."

Private equity

Private markets are examples of the problem of illiquidity, and relative lack of data, Mr Tsay referred to previously. "Overall, ESG is still not a very well understood concept in PE [private equity]," says PRI's Mr Robertson, "although some PE firms have joined the PRI and are seriously putting it into practice."

Individual practice varies. Srikanya says that the Thai GPF is not planning any new PE exposure, but is auditing existing holdings: "As an example, we are invested in the Holiday Inn in Phuket, and we have been engaging its management about environmental factors, such as reducing the amount of plastics used—working with them to be a good hotel operator."

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[28] Ibid
[29] Climate Bonds Initiative press release, HKSAR Government signs the Green Bond Pledge: First signatory from Asia", https://www.climatebonds.net/resources/press-releases/2019/05/hksar-government-signs-green-bond-pledge-first-signatory-asia
[30] Climate Bonds Initiative, "Green Bonds, The State of the Market 2018", https://www.arx.cfa/up/post/6736/cbi_gbm_final_032019_web.pdf

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Property

Sustainable benchmarks are available for listed real-estate equities, such as the MSCI Green Buildings Index, which is a bucket for companies that derive at least 50% of revenue from green-building construction, management and/or equipment supply. The Global Real Estate Sustainability Benchmark is another source for related data. The organisation tracks ESG performance of assets and provides uniform data to capital markets, with the goal of making these types of investment vehicles standard and digestible for investors.

"In relation to any real-estate investment assets which an AIA business unit is considering acquiring, a minimum requirement would be a green certification accredited by an industry-recognised green building association such as the US Green Building Council," says Mr Konyn.

Buildings we invested in directly have ratings in green building standards.

Eddie Yue, deputy chief executive, HKMA

The importance of certification is reinforced by the HKMA's Mr Yue: "Most of the buildings we invested in directly have ratings in green building standards by various green certification organisations." He adds that "many of the buildings have seen an upgrade in green certification under our ownership."

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Case study: Ideal outcomes, catch-up or leapfrog?

A combination of take-up by major investors, such as Japan's Government Pension Investment Fund, and regulatory pressure, for example China's environmental targets, has led to an increased acceleration over the past half-decade, and this is expected to continue. "The number of and sophistication of discussions we've been having is like chalk and cheese compared to where we were three years ago in the region," says James Robertson, head of Asia (ex-China and Japan) at the Principles for Responsible Investment (PRI). "So you'll begin to see big players starting to speak more about this and do more over the next couple of years, and that can really help drive local markets."

This could see Asia catapult from laggard to leader: "How long will it take for Asia to catch up?" asks the World Bank's Heike Reichelt. "In terms of volume, it may already be there…It's hard to say whether Asia needs time to catch up with Europe and North America—there is potential for significant growth; it could very well leapfrog the other regions."

While problems such as supportive regulation, transparency and sufficient data on which to base investment decisions remain, these are being tackled. The iterative process of environmental, social and governance (ESG) investing and reporting, for example, creates its own solution. As Nan Luo of the PRI says: "This is a journey, and it will take time. Many of these challenges will be addressed with actions taken by key players: for example, investors would have clear demands for ESG data, and the new regulatory requirements will greatly drive progress as well."

Over the course of the research, interviewees referred to "tipping points", in which ESG would get to a level where it became both self-sustaining and a key component of the broader market. If it's not there yet, it seems very close.

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Challenges

Although progress is significant, those promoting and investing in ESG strategies still encounter problems. It's clear from the interviews with AOs in Asia that the same issues reoccur across the region.

Perception: Value or values?

First, perception is still an issue. "There have been many misperceptions around ESG," says Mr Robertson. "The ones we hear most often are that ESG is about values rather than value." This implies accepting a diminution of portfolio return value in exchange for upholding a given set of social or ethical values, "whereas we approach responsible investment primarily from a risk management and long-term performance perspective. Linked to this is the misperception that there is a trade-off—you have to sacrifice returns to implement ESG." Indeed, KIC's Mr Choi says there remains "a great deal of concern about return internally" around ESG.

That's an issue more specific to SRI than ESG, says BFL's Mr Tsay: "In years past, SRIs had a reputation for requiring a trade-off: because they limited the universe of companies that were eligible for investment, they also limited the investor's potential profit."

"Many investors have yet to see the value and necessity of ESG risk control," agrees Mr Sheng at Ping An. "Many treat ESG criteria as a burden, rather than tools to help their businesses grow sustainably. Consequently, it could limit our options when we seek ESG investment opportunities."

The good news is, a lot of progress has been made combatting these misperceptions.

James Robertson, head of Asia (ex-China and Japan), PRI

While this persists, says Mr Robertson, "the good news is, a lot of progress has been made combatting these misperceptions."

Regulation

This is an area where Asia is perceived to lag. "Regulatory guidance is a lot more developed in Europe, and we've only begun to see regulators get involved over the past couple of years," says Mr Robertson. "We need a stronger voice from regulators and policymakers. This is starting to change, but it does take time—engaging and consulting stakeholders and market practitioners is a key part of this process."

"In the current environment, there has yet to be a clear regulatory framework for insurance funds concerning ESG investments," says Mr Sheng, although "it's moving to the right direction, as we note that regulators are increasingly encouraging investment funds to engage in ESG investments."

That said, one study postulates the less developed regulatory framework found in

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much of Asia could eventually work to its advantage, as "they lack the layers of complex regulations to be found in many developed markets. This provides an opportunity for regulators in emerging markets to 'leapfrog' developed markets by pushing for ESG information to be included in required and voluntary disclosures."[31]

Data

According to the Sustainability Accounting Standards Board (SASB), "Investor satisfaction with the quality of ESG data is very low, despite high levels of corporate sustainability reporting." The facts and determinants of ESG-related metrics can be wide and varied. However, the SASB report concludes that "much of ESG disclosure is binary". Investors get limited use and report they are still looking for "comparable, consistent, reliable data".[32] Like grey, green has many shades.

Mr Yue reckons this is a widespread problem—although not one limited to Asia. "Investors around the world have found that the lack of good quality ESG data with [a] sufficiently long track record poses some difficulty in investment decision-making. ESG investment is also hampered by the lack of objective measurement in each of the factors leading to difficulties in ESG research and comparison."

Nan Luo, head of China for the PRI, agrees that the availability and quality of data in China

By 2020, all Chinese listed companies will be required to disclose ESG information on [a] mandatory basis.

Nan Luo, head of china, PRI

"is quite poor at the moment, which is one of the biggest barriers investors face when putting this into practice". However, she adds that listing requirements are addressing this: "By 2020, all Chinese listed companies will be required to disclose ESG information on [a] mandatory basis , which will mean a big improvement to data after this deadline." Mr Robertson says that Hong Kong, Singapore and particularly Thailand have been leading the way, "but it does take time for corporates to develop strong reporting practices, and exchanges need to support through guidance, training and other resources".

For some, it's not simply the paucity of data available, but the quality of that which is out there. "I think a lot of the MSCI scoring doesn't mean anything," says the ACGA's Mr Allen. "When I compare the scoring of different companies, it's hard to see where one company scores above another: it just doesn't seem to make intuitive sense."

[31] IFC and The Economist Intelligence Unit, "Sustainable investing in emerging markets: Unscathed by the financial crisis", http://www.eiu.com/report_dl.asp?mode=fi&fi=554794840.PDF
[32] ACGA, "Meeting with Sustainability Accounting Standards Board", https://www.acga-asia.org/news-detail.php?id=94

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Although data are important, says Ms Reichelt, "you have to start somewhere. If investors don't have the quantitative data they need, they can look at a company's policies, for example." Mr Allen concurs, making the point: "Investors have to do their own analysis. The value of this data is something to compare your own views to, rather than being something definitive."

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Conclusion

Ultimately, what drives ESG investing among Asia's AOs is still the quest for returns, which is why—albeit with caveats (such as China's emphasis on the environment)—governance is still the determining factor of the three tenants of ESG.

As has been the case in other regions, a minority of Asia's AO investors began their ESG journey with negative screening. And that screening, both positive and negative, remains important, but engagement and, in particular, integration are the key approaches that AOs in the region see growing and ever greater promise with—irrespective of asset class.

Today, the ability of Asia's AOs to influence and change investing across Asia and the world has never been greater. And while ESG integration is gaining in prominence as an investment approach, so is another kind of integration—that between AO goals and information exchange. Thailand's GPF expresses having learned from Japan's GPIF and is in turn advocating for ESG approaches further among its peers. And as long as competitive markets and like-minded regulations keep pressure on AOs to achieve returns in both value and values, best practices are likely to continue jumping borders and pushing wider and deeper ESG engagement across the region. ESG growth in Asia has accelerated in recent years, and nothing in our recent research indicates it is about to slow.

The ability of Asia's AOs to influence and change investing across Asia and the world has never been greater.

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