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The Journey of Sustainable Investing

A multi-asset approach seeking returns and a better future

February 2019

Maria Municchi, a fund manager in the M&G Multi Asset team, discusses the development of sustainable investing over time, and explains how we incorporate it with our long-standing multi-asset approach in a new investment strategy.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

From exclusion to impact

What we think of as sustainable investing has developed significantly over many years.

Decades ago, ethical investing became a guiding principle for many investors. It was often rooted in the underlying religious beliefs of certain institutions or their benefactors. The concept of excluding investments in particular types of companies was based on the desire to avoid gaining benefit from activities contrary to the tastes of the investor. Exclusions-based investing is a way of avoiding negative externalities, or the unchosen costs and effects felt by being associated with a company. A typical exclusion would have been producers of alcohol or tobacco products, or munitions, or companies involved in gambling.

As this concept developed over time, a company's attributes regarding **environmental** and **social** impact or its general approach to good **governance**, its ESG characteristics, were evaluated. An ESG-pedigree was considered alongside prospective returns. This approach encourages not only avoidance of undesired exposures but also a focus on selecting the best available among the potential candidates for investment.

Latterly, sustainable investing has extended to incorporate consideration of the positive impact or contribution an investment is expected to make. Companies are assessed on what they are explicitly doing to address the major environmental and social challenges the world is facing, as well as the scale and materiality of that impact. This approach allows investors to build investments in companies delivering attractive financial returns, but also positive externalities; benefiting society and the environment.

"Democratising" sustainable investing

Asset owners increasingly want to commit their funds to investments that aim to achieve attractive financial returns, at the same time as generating good outcomes and avoiding harmful or detrimental effects.

The nature of some of the asset classes may make them less accessible for some investors, perhaps due to the large scale required for each individual asset or because of limited liquidity. Examples might include green bonds where the universe is relatively small, or green infrastructure, which may be less liquid and involve a longer time commitment.

However, investing collectively and for the long term may significantly reduce those challenges. Scale and commitment can help facilitate investing in asset classes that previously may not have been possible.

Adopting this sustainable approach can offer all types of investor, from individuals to large institutions, the flexibility to select specific types of investments and pursue their objectives, both financial and impactful.

What is the objective?

- Flexible and diversified asset allocation to benefit from and withstand variations in markets
- Integrate ESG principles and add assets expected to help make a positive impact
- Aim to provide an attractive financial return

ESG and positive impact

The first steps to investing responsibly and sustainably can be targeted relatively simply by applying an **ESG screen**. Many investors will already be familiar with exclusions-based investment criteria. These tools can have the benefit of reducing ESG risk, otherwise known as reducing the experience of negative externalities.

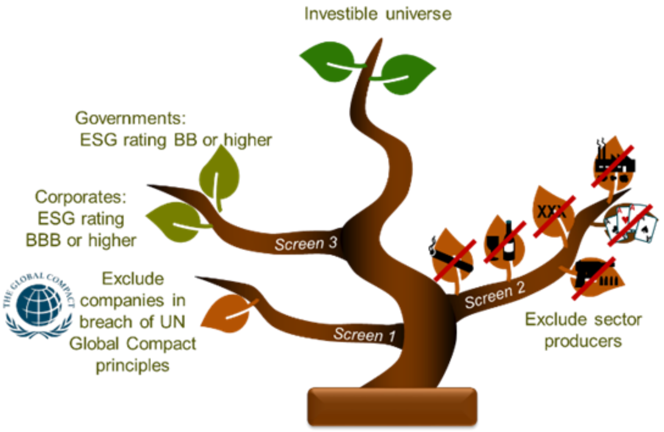
In our sustainable multi-asset strategy, we apply **ESG screens** on three levels.

Screen 1: whether a company is in breach of the UN Global Compact principles on human rights, labour, environment and anti-corruption;

Screen 2: whether a company is a producer in certain sectors: tobacco, alcohol, controversial weapons, gambling, pornography or thermal coal;

Screen 3: as MSCI is a main third-party data provider for ESG ratings, we screen corporates for an MSCI ESG rating of at least BBB, and government issuers for an MSCI ESG rating of at least BB.

Please note that MSCI ESG ratings are not the same as credit ratings.



Source: M&G, illustrative, February 2019

An investible universe is identified after these screens have been applied and we select from these eligible securities.

A second, and we believe even stronger, contributor to achieving success in multi asset sustainable investing, is incorporating positive impact features into the strategy. Positive impact holdings are intended to increase the experience of positive externalities.

Candidates for investment within the **positive impact** component of the fund should first be assessed using the three-factor, **triple-i**, analysis.

Investment – the quality and viability (opportunities and threats) of the business and the risks

Intention – the company culture and intentions and alignment of the management to long-term goals

Impact – the material impact and contribution their activities make to specific United Nations Sustainable Development Goals (UN SDGs).

The 17 UN SDGs are a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity. Its timeframes run to 2030 and the SDGs cover areas such as climate change, economic inequality, innovation and sustainable consumption among other priorities.

Source: M&G, illustrative, February 2019

Positive impact investments may include mainstream instruments such as listed equities, sovereign, supranational bonds and corporate and convertible bonds from impactful companies. Less well-known instruments may include green and sustainable bonds and green infrastructure.

In our multi-asset sustainable funds, we believe positive impact assets should represent approximately 20% of the total portfolio.

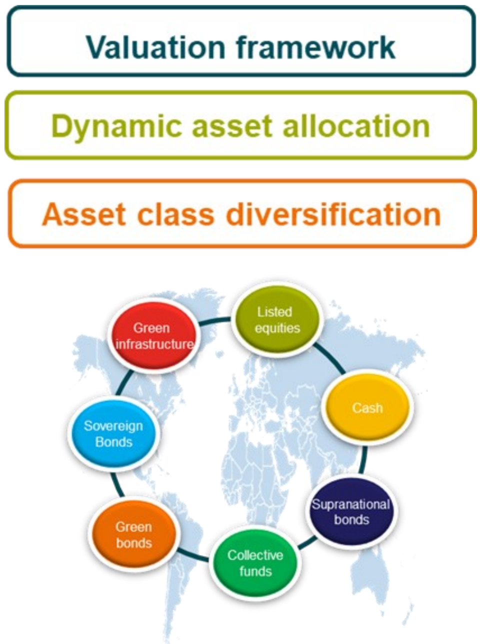
Why take a multi-asset approach?

Valuation is key, so taking a multi-asset approach allows an investor to capture value across a wide range of asset classes, diversifying risk at the same time. Access to different types of sustainable investments with different risk/reward characteristics may be able to reduce the overall volatility of returns. This is because one asset class may provide some offset should another asset class suffer from market weakness.

At M&G, we believe that the best way to invest a multi-asset strategy is to determine an initial strategic asset allocation. This should be based on detailed analysis of the essential underlying fundamentals of each economy, market and asset class. That analysis seeks to identify the real yield conditions of asset classes relative to their fair value, We call this measure of fair value 'neutrality'.

A separate tactical assessment, which builds on that fundamental assessment, can capture how behavioural factors can influence the pricing of assets relative to their fair value. We aim to identify such behavioural events, known as 'Episodes', as part of our process and the divergences they create form the basis of our tactical, or dynamic, asset allocations.

In addition to mitigating the financial risks, providing the broadest potential universe of accessible asset classes may also increase the overall sustainability of the portfolio from an ESG and impact perspective. For example, compared to equities, green infrastructure may offer a steady income and lower volatility while making a positive contribution to renewable energy generation.



The sustainable way ahead

Sustainability is now a key item on the agenda of governments, institutions, corporates and private investors, large and small. Private investment choices have a huge role to play in driving change and helping to tackle the world's future challenges, potentially with enormous effects on the well-being of future generations as well as ourselves.

Being able to align our financial and sustainable goals is now possible, and this strategy provides an ideal opportunity to contribute towards a more sustainable future.

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