

# Update on Sustainable, Responsible Investing (SRI)

ECB Bond Market Contact Group

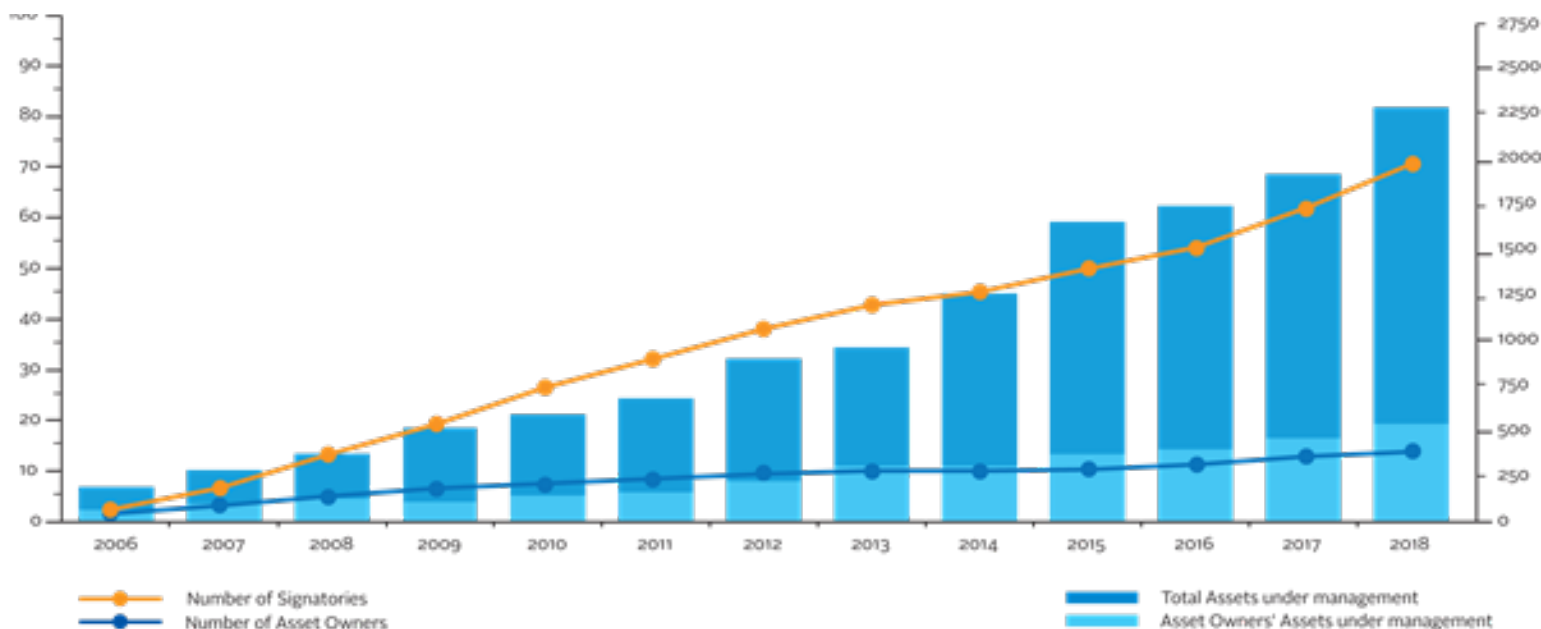
---

12 June 2019

## Drivers for ESG: an irreversible trend

*Muzinich & Co*

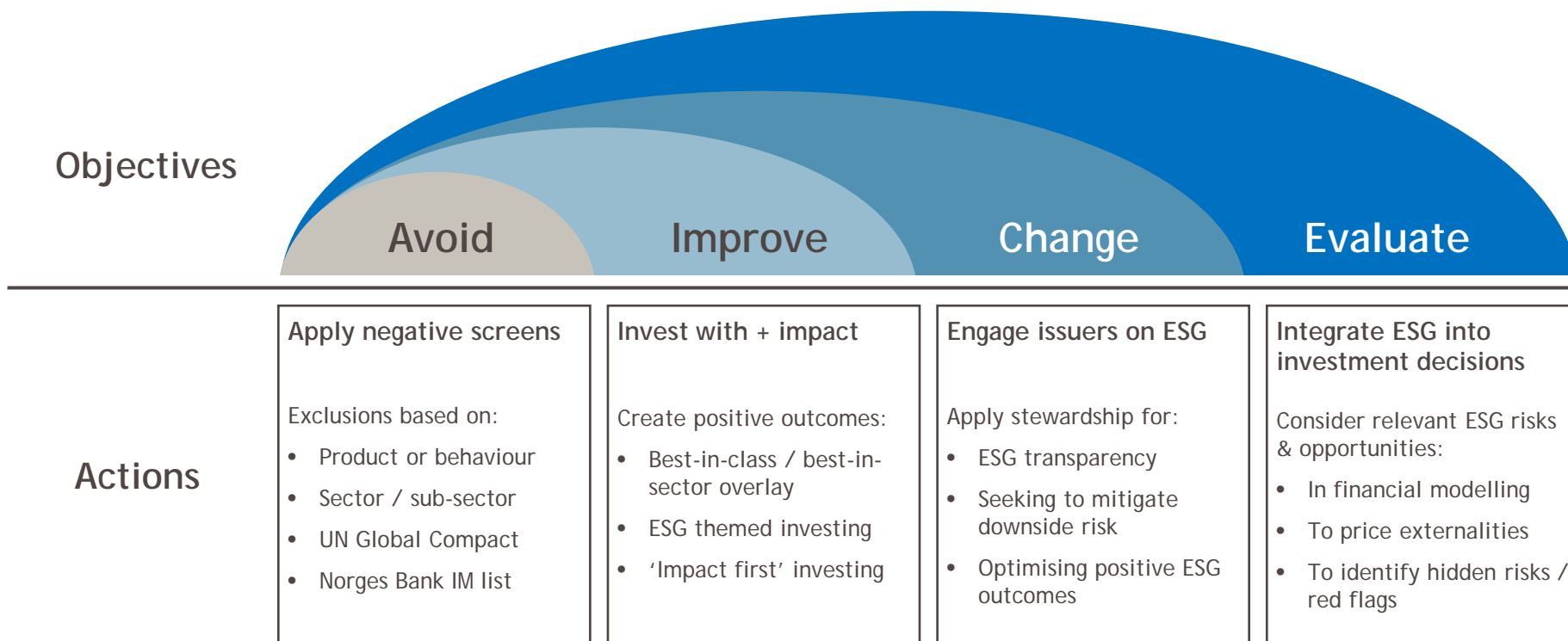
- General concerns about sustainability
- Wealth transfer to gen. Xers & millennials
- Institutional demand for RI as best practice
- Investor buy-in for ESG 'business case'
- Better corporate reporting → availability of ESG data
- Rapid growth in ESG policy instruments



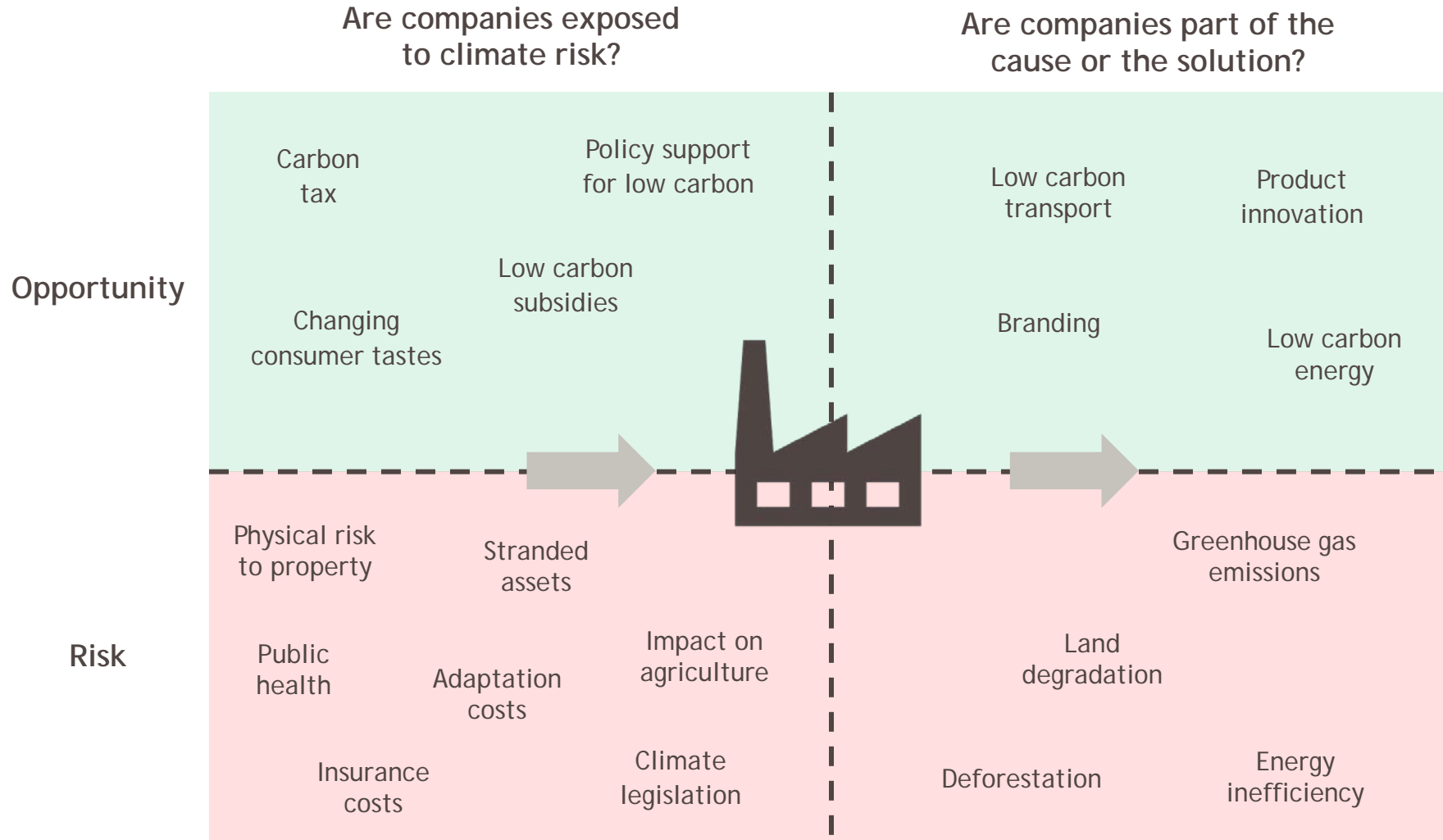
Source: UN-supported Principles for Responsible Investment (PRI) website as of 5 April 2019

Muzinich views and opinion for illustrative purposes only, subject to change and not to be construed as investment advice.

# ESG objectives and actions



# Addressing climate change as investors



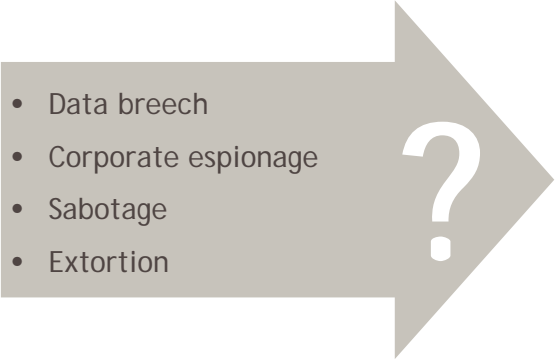
## Overcoming the ESG data gap and low correlations between ESG rating providers

- Rating correlations: 0.9 - credit rating agencies | 0.32 - MSCI / Sustainalytics
- Largest ESG data gaps: high-yield / private companies
- Muzinich commissions c. 20 new ESG ratings per annum
- Results of new ratings are shared with all Sustainalytics subscribers
- Lack of ESG data can be both a challenge and an opportunity (particularly for active managers)

### Example: cyber security

#### Cyber security risks

- Poor understanding of risks
- Under investment in infrastructure
- Poor accountability

- 
- Data breach
  - Corporate espionage
  - Sabotage
  - Extortion

#### Financial outcome

- Litigation costs
- Revenue loss
- Unexpected capex

# ESG analysis, ratings and certifications



## Proliferation of types and providers of ESG information available to investors

### Types of ESG information available:

- Asset management certifications and fund ratings
- ESG data, ratings, rankings
- Specialist & bespoke thematic and sector research
- Sell-side research incorporating ESG elements
- Thematic product (e.g. green bond certification)
- EC 'green taxonomy' and 'ecolabel'
- ESG (custom) benchmarks

### ESG data providers



### Responsible investing standards, certifications etc.



### ESG themed research



## Responsible investing, returns and fiduciary duty

*Muzinich & Co*

*“Failing to consider long-term investment value drivers – which include environmental, social and governance issues – in investment practice is a failure of fiduciary duty.”*

UN-supported Principles for Responsible Investment

- Freshfields (2005) *A legal framework for the integration of ESG issues into institutional investment.*
- Deutsche AM (2016) study of 2,000 papers – 90% non-negative correlation ESG and corporate performance
- ESG should not be seen as a ‘barrier’ but rather a ‘duty’ of investors
- Policy makers play a key role to:
  - Clarify the status of ESG integration in relation to fiduciary duty
  - Strengthen implementation of legislation and codes to refer to ESG
  - Clarify expectations of trustees’ competence relating to ESG
  - Harmonise legislation on ESG globally
- BUT... in the US policy makers are not necessarily progressing

Sources: UNPRI (2015) Fiduciary Duty in the 21<sup>st</sup> Century.

Freshfields (2005) A legal framework for the integration of ESG issues into institutional investment.

Deutsche Asset and Wealth Management (2015) ESG and Corporate Financial Performance: Mapping the global landscape.

Muzinich views and opinion for illustrative purposes only, subject to change and not to be construed as investment advice.

## Network for Greening the Financial System

*Muzinich & Co*

### Key recommendations for central banks (NGFS members)

- 1) Integrate climate-related risks into financial stability monitoring and micro-supervision
- 2) Integrate sustainability factors into own-portfolio management
- 3) Bridge the data gaps
- 4) Build awareness and intellectual capacity and encourage technical assistance and knowledge sharing
- 5) Achieve robust and internationally consistent climate and environment-related disclosure
- 6) Support the development of a taxonomy of economic activities



### Central banks as regulators

- 1) Carbon reduction mechanisms: cap & trade or tax
- 2) Harmonise ESG regulation globally
- 3) Clarify investor (fiduciary) duties on ESG
- 4) Ensure executives' accountability for climate risk
- 5) Innovation – positive incentive loans, green CLOs etc.
- 6) Green supporting factor / regulatory capital

7) Tax incentives

8) Innovation (e.g. equity tranche on green CLO)

### Central banks as investors

1. Integrate ESG into investment decisions
2. Apply ESG tilt to bond buying
3. Soft engagement (messaging to corporates)








## Appendix

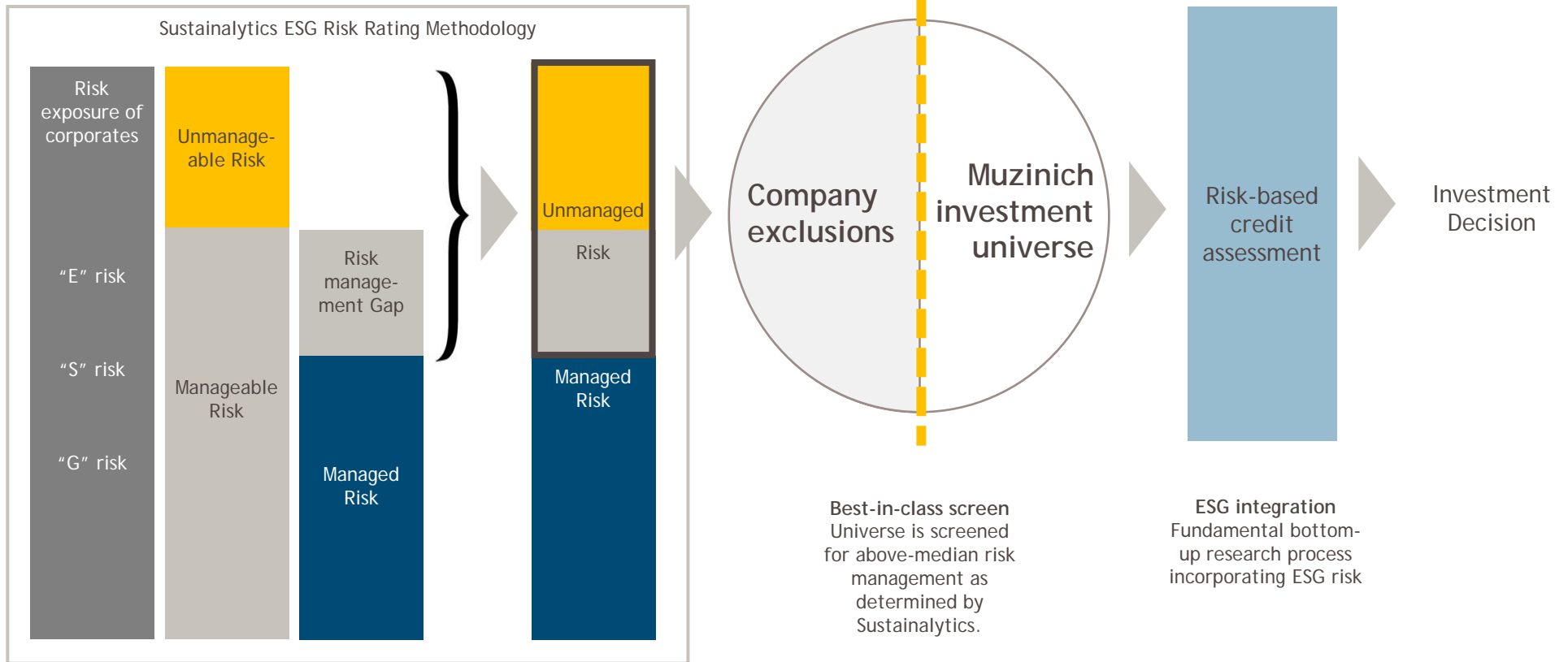
---

# Negative screening



Zero-tolerance 	Industry 	UN Global Compact 	NBIM 	Custom screens 
<ul style="list-style-type: none"> <li>• Production of controversial weapons (e.g. cluster munitions)</li> <li>• Evidence of child labour in company operations</li> </ul>	<ul style="list-style-type: none"> <li>• Adult entertainment</li> <li>• Alcohol</li> <li>• Conventional weapons</li> <li>• Fur &amp; specialty leather</li> <li>• Gambling</li> <li>• Military contracting</li> <li>• Nuclear power generation &amp; services</li> <li>• Tobacco</li> </ul>	<p>UN Global Compact requires companies to follow ten principles encompassing:</p> <ul style="list-style-type: none"> <li>• Human rights</li> <li>• Labour standards</li> <li>• Environment</li> <li>• Anti-corruption</li> </ul> <p>Specialist ESG research provider determines compliance quarterly.</p>	<p>Determined on a name-by-name basis by Council on Ethics. Criteria:</p> <ul style="list-style-type: none"> <li>• Controversial weapons</li> <li>• Tobacco</li> <li>• Mining and energy companies using coal</li> <li>• Human rights and environmental</li> <li>• Gross corruption</li> <li>• Human rights contraventions</li> <li>• Severe environmental damage</li> </ul>	<p>Muzinich provides options for clients to determine custom screens for separately managed accounts.</p>
<p>Threshold: Zero-tolerance for involvement</p>	<p>Threshold: &gt;5% revenues derived from related criteria</p>	<p>Threshold: Zero-tolerance for non-compliance</p>	<p>Threshold: Zero-tolerance for names on list</p>	<p>Threshold: Determined with client</p>

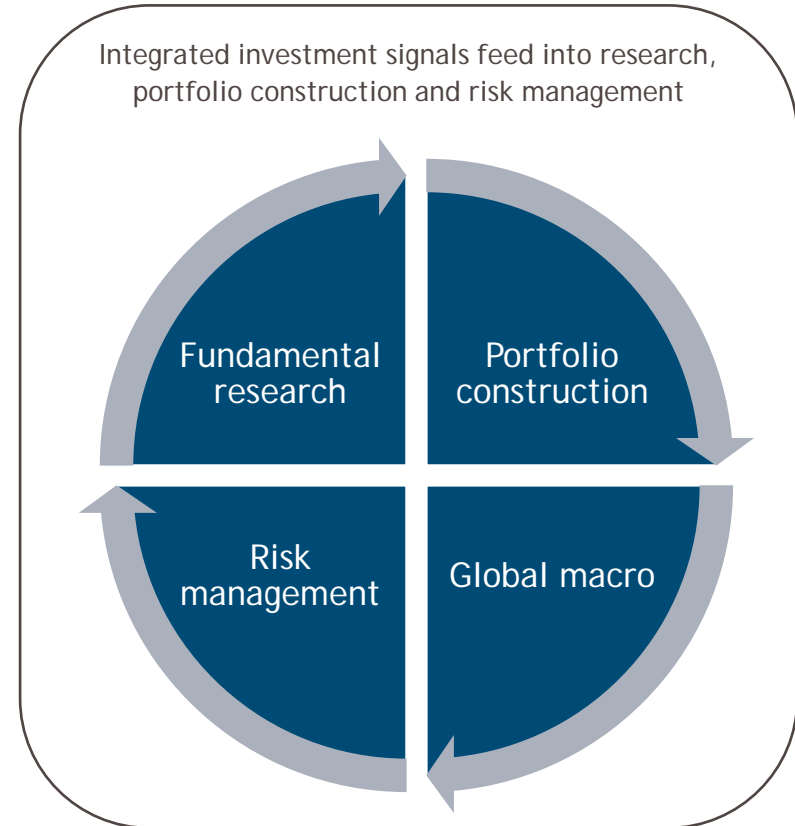
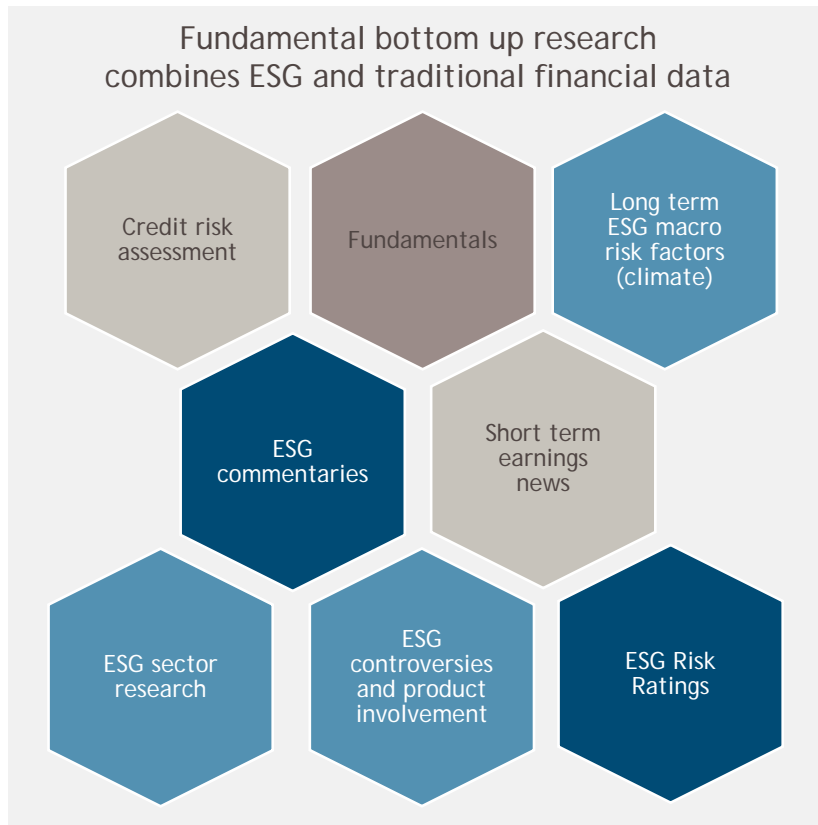
# Best-in-class: identify ESG leaders



Source: Sustainalytics.

Muzinich views and opinion for illustrative purposes only, subject to change and not to be construed as investment advice or an invitation to engage in any investment activity.

# Integrating ESG into credit assessments



## Engaging & monitoring issuers on ESG

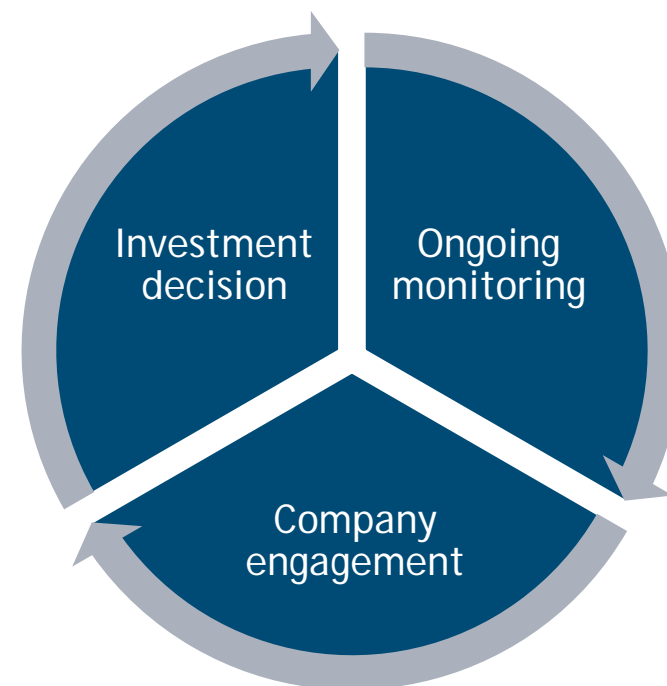
*Muzinich & Co*

### Why does Muzinich engage on ESG?

- Actively manage downside risk
- Encourage transparency on material ESG issues (hidden risks)
- Drive positive change relating to specific ESG issues
- Communicate rationale for not participating on ESG grounds
- Part of ongoing cycle of monitoring and research

### How does Muzinich engage on ESG?

- Engagements done by investment team directly or via banks
- Investment team raises concerns about ESG verbally in meetings with issuers, at roadshow events and other opportunities
- Automatic engagement whenever not participating on ESG grounds
- Feedback from engagements shared among investment team members



## Addressing climate risk at Muzinich



Trucost is a leading provider of specialist environmental research and data. Muzinich has access to:

- Carbon emission reporting at portfolio level
- Detailed company level carbon assessments
- Stranded assets assessments
- Green/Brown revenue share for corporates
- Alignment with 2 degrees warming scenarios
- Private company carbon footprint modelling



### Incorporating climate risk into research

- Muzinich analysts will be able to conduct carbon intensity and “carbon value at risk” assessments across holdings
- 2 degrees scenario analysis gives forward looking insight into corporate climate transparency and readiness

### Reporting portfolio carbon intensity

- Muzinich able to report to clients on
  - portfolio carbon footprint
  - portfolio preparedness for 2 degree scenarios and climate policy shifts
- Muzinich will further integrate portfolio carbon intensity into investment decisions to reduce climate risk exposure

### Muzinich as a firm

- Muzinich is undertaking a full greenhouse gas emissions assessment of its own operations including:
  - CO<sub>2</sub> emissions / US\$m
  - Estimated damage cost equivalents
  - Impact ratios

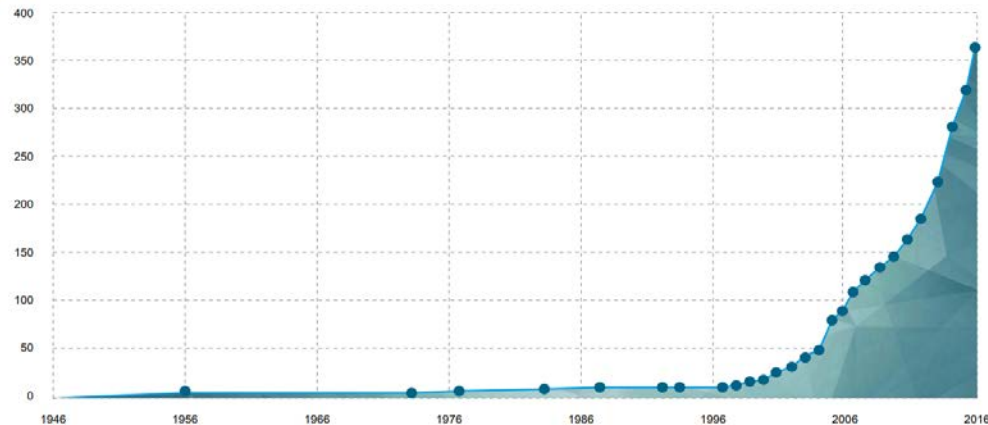
# Mainstreaming ESG - the role of the official sector

## Policy overview

- Almost 300 individual policy tools or initiatives\*
- Over half since 2012
- Requirements grouped into:
  - Asset owners: insurance & pension regulation
  - Asset managers: disclosure & stewardship codes and
  - Investees: corporate disclosure on ESG (climate)
- Paris Climate Agreement (2015)
- UN Sustainable Development Goals (2015)

## Policy activity

- Network for Greening the Financial System
- FSB - Task Force on Climate-related Financial Disclosures
- EU - High-Level Expert Group on Sustainable Finance
- French Article 173 of French Energy Transition Law
- CRISA code (SA), Ontario Pension Benefits Act (Can)
- De Nederlandsche Bank & Hong Kong Monetary Authority signed Principles for Responsible Investment (2019)
- Banque de France 'ESG charter'

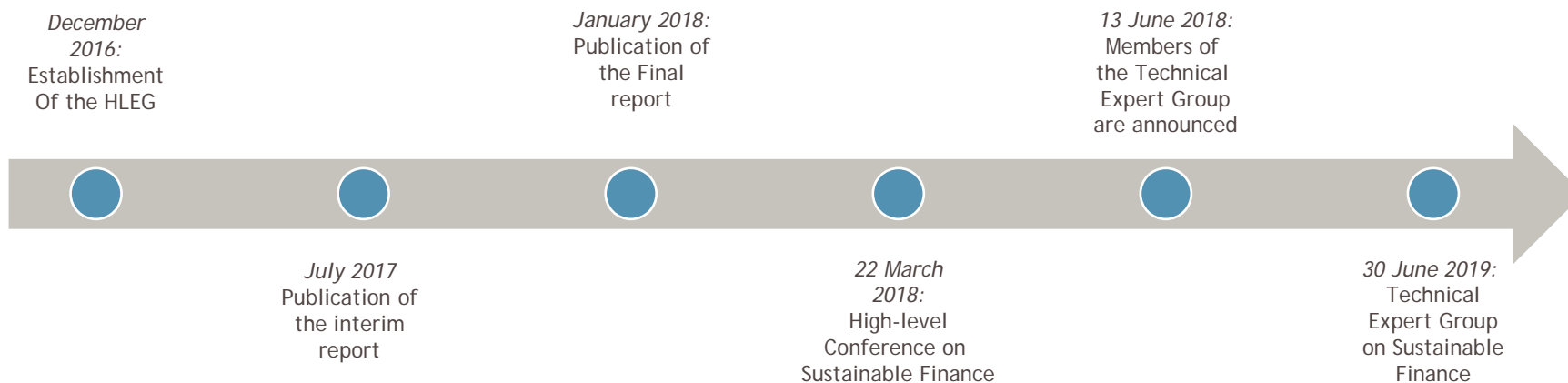


\* Source: PRI (2018) Global Guide to Responsible Investment Regulation. Data shows the cumulative number of ESG policy interventions per year. Source: PRI (2016) The Global Guide to Responsible Investment Regulation.

## European Commission: Sustainable Finance Action Plan

High-Level Expert Group on Sustainable Finance (HLEG) established to advise on:

- 1) **Sustainable taxonomy:** develop a universal classification system for sustainable economic activities
- 2) **EU Ecolabel:** criteria for labelling of sustainable retail financial products
- 3) **Green bond standard:** to address barriers and promote 'additionality' of green bonds
- 4) **Promoting sustainable finance:** mapping investment gaps for sustainable projects
- 5) **Investment advice:** MiFID II Directive to include ESG considerations in investor and insurance distributors advice
- 6) **Clarification on investor duties:** with regards to ESG and fiduciary duty
- 7) **Low-carbon benchmarks:** amend benchmark regulation, create new category of low-carbon benchmarks





## Important Information

*Muzinich & Co*

### FOR PROFESSIONAL AND INSTITUTIONAL CLIENT USE ONLY - NOT FOR RETAIL USE OR DISTRIBUTION

This document has been produced for information purposes only and is not intended to constitute an offering, advice or recommendation to purchase any securities or other financial instruments. The investment strategies and themes discussed herein may not be suitable for investors depending on their specific investment objectives and financial situation. Investors should conduct their own analysis and consult with their own legal, accounting, tax and other advisers in order to independently assess the merits of an investment.

The views and opinions expressed should not be construed as an offer to buy or sell or invitation to engage in any investment activity, they are for information purposes only, are as of the date of publication and are subject to change without reference or notification. Certain information contained in this document constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events, results or the actual performance of the securities, investments or strategies discussed may differ materially from those reflected or contemplated in such forward-looking statements. Nothing contained in this document may be relied upon as a guarantee, promise, assurance or a representation as to the future.

Past results do not guarantee future performance. The value of investments and the income from them may fall as well as rise and is not guaranteed and investors may not get back the full amount invested. Diversification does not assure a profit or protect against loss. Changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely. Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity. All data herein is reflected in U.S. Dollars, unless stated otherwise.

All information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Nothing contained herein is intended to constitute investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. Historic market trends are not reliable indicators of actual future market behavior.

Certain information contained herein is based on data obtained from third parties and, although believed to be reliable, has not been independently verified by anyone at or affiliated with Muzinich & Co.; its accuracy or completeness cannot be guaranteed.

No part of this material may be reproduced in any form or referred to in any other publication without express written permission from Muzinich & Co.

Issued in Europe by Muzinich & Co. Limited, which is authorised and regulated by the Financial Conduct Authority FRN: 192261. Registered in England and Wales No. 3852444. Registered address: 8 Hanover Street, London W1S 1YQ.