MARKET INSIGHT

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THE COMBINED FUTURE OF FINANCE AND SUSTAINABILITY

FLORENCE ANGLES
HEAD OF RISK MANAGEMENT

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Is growth sustainable? Since the 1970s, society has been aware that we are living in a world with finite resources. This scarcity of raw materials is inevitably causing a loss of economic momentum, which is in line not only with a Newtonian mechanistic outlook, but is conversely in keeping with the law of entropy and, more specifically, the second law of thermodynamics[1]. Growth is sustainable, then, only if it preserves natural capital and incorporates environmental and social aspects alongside its economic dimension. This form of growth is none other than sustainable development, in other words a development "that meets the needs of the present without compromising the ability of future generations to meet their own needs"[2].

Sustainable development has been a major focus since the 1987 Brundtland report and the Rio Earth Summit in 1992, creating 380 million jobs and $12,000 billion of value by 2030[3]. For partisans of weak or strong sustainability, innovation plays a central role and is inseparable from sustainable development. This is known as eco-innovation, an important strategic source of competitiveness for companies, allowing them to cut costs, offer new avenues for growth and boost their credentials by improving their image with customers. Sustainability is transcending national borders to become an international phenomenon. On 8 March 2018, the European Union unveiled its action plan for financing sustainable growth. The EU roadmap has three objectives: redirecting capital flows to a more sustainable and inclusive economy, incorporating sustainability in financial risk management, and promoting transparency and sustainable investing. Europe currently has an annual investment shortfall of nearly EUR 180 billion, to achieve its objectives by 2030 the European Commission is seeking to overhaul the financial sector, so that this major promoter of economic development helps to support sustainable development. By prioritising environmental, social and governance (ESG) criteria in financing and investment decisions, finance and sustainability combine to produce sustainable finance.

Sustainable finance encompasses socially responsible investing (SRI), green investing, social finance and responsible investing more generally. It is not a recent phenomenon. The SRI movement began in the US, driven by religious congregations seeking to exclude certain sectors, such as alcohol, tobacco and gambling, from their investments. The first funds emerged in the 1920s and were centred on what is known as a negative selection approach, consisting of eliminating sectors considered to be immoral. The most acclaimed of these funds, the Pioneer Fund, was launched in 1927 in Boston. The crisis in 1929 hindered the development of this "ethical" investing, and it wasn't until the 70s that there was a resurgence of interest in SRI, against the backdrop of the Vietnam War and the Watergate scandal. The first SRI fund, the Pax World Fund, was created during this period, adopting a best-in class approach consisting of retaining every sector and giving priority to socially responsible companies. The approach aimed to combine financial performance with ESG or non-financial criteria. In Europe, with the exception of Sweden, this type of investing was late in arriving, appearing in the 1980s and 1990s following the Brundtland report, "Our Common Future", and the emergence of sustainable development. Switzerland, with its highly developed financial sector, may have a competitive edge in this field. Considered initially to be a niche sector, certain Swiss financial institutions have had a foothold in sustainable finance for many years, and have patiently awaited stronger enthusiasm for this type of investment from private and institutional clients. According to the Swiss Sustainable Investment Market Study 2018, by Swiss Sustainable Finance in collaboration with the University of Zurich, in the space of 10 years, sustainable investment has grown sharply in Switzerland, increasing from 33 billion in 2007 to 391 billion in 2017, 86% of which is accounted for by institutional investors and 14% by private investors. The most popular asset classes are equities (28%), real estate investments (22%) and sovereign bonds (17%). (chart 1)

This trend can only progress further and further, with the expansion of sustainable development and growing demand from institutional investors. The Geneva financial marketplace, which became the home of the sustainable financial centre world headquarters when it was chosen as the location for the secretariat of the FC4S (Financial Centres for Sustainability), will be able to demonstrate its expertise in this field.

Sustainable finance is an international phenomenon with influences and power spread across the globe. However, it will only influence retail investors if it offers an attractive risk/return trade-off, or one that is at least comparable with that of traditional financial products. Although we don't yet know enough about this particular aspect but there is room for improvement in the data available in terms of consistency, quality, coverage and frequency. BlackRock claimed in a recent study that ESG criteria can be applied to most asset classes without sacrificing the risk-adjusted return. (chart2)

From an academic point of view, a 2018 publication named "The Sustainability Footprint of Institutional Investors", by professors Rajna Gibson Brandon and Philipp Krüger, from the Swiss Finance Institute and the University of Geneva, reveals that sustainability reduces risk and results in higher returns in the long term[4]. Sustainable investments therefore seem to perform just as well and incorporate other factors of interest to socially-engaged investors concerned about their environment

and society in general. As sustainable financial products cover more asset classes and geographical regions each year, they are becoming an increasingly essential component of the investment universe.

Sustainable development is therefore a new societal project requiring significant amounts of financing. This will only be possible with the support of the financial sector. Major initiatives are under way aimed at changing the rules of the finance game to alter its DNA and introduce the notion of sustainability into its genes. Sustainable finance is a response to the recent economic and ecological crises and a way of ending the all too short-term view of profit. By focusing on concepts such as transparency, responsibility and sustainability, banks are unquestionably gaining the trust and interest of current and future clients. Is this groundswell therefore an opportunity for them to adapt and transform themselves in order to cater more to the needs of their ecosystem and so include all stakeholders as the rules of good governance demand?

“Major initiatives are under way aimed at changing the rules of the finance game to alter its DNA and introduce the notion of sustainability into its genes.”

1. Reference to the works of the economist Nicholas Georgescu-Roegen.

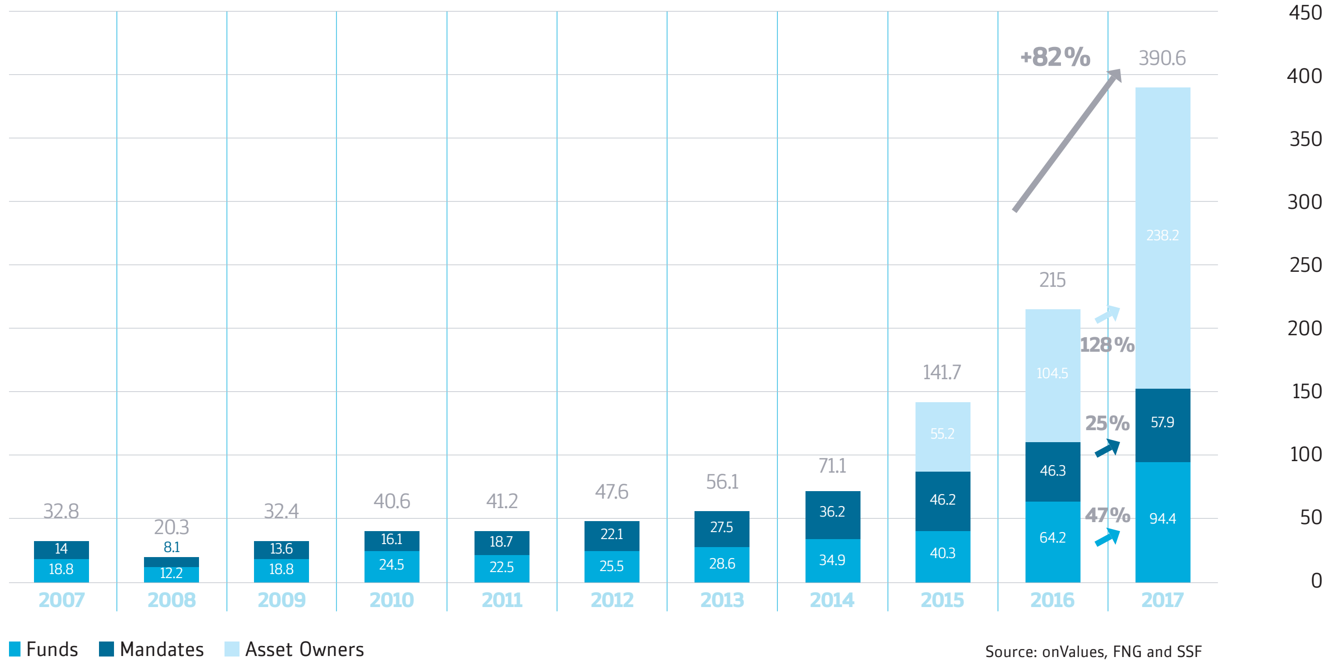
2. 1987 Brundtland Report, "Our common future", produced by the United Nations World Commission on Environment and Development.

3. 2017 Report "Better Business, Better World", published by the United Nations Business and Sustainable Development Commission.

4. For more information see https://www.bafu.admin.ch/bafu/fr/home/themes/economie-consommation/dossiers/magazin2017-2-dossier/die-rendite-stimmt.html

1

DEVELOPMENT OF SUSTAINABLE INVESTMENTS IN SWITZERLAND (IN CHF BILLION)



Source: Swiss Sustainable Investment Market Study 2018, Swiss Sustainable Finance, page 6.

2

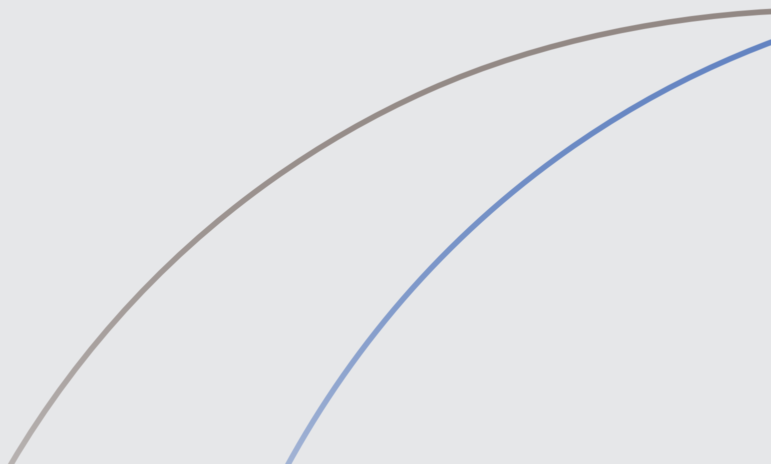
No sacrifice required?

Comparison of traditional and ESG-focused equity benchmarks by region, 2012–2018

	US		World ex-US		Emerging markets	
	Traditional	ESG Focus	Traditional	ESG Focus	Traditional	ESG Focus
Annualised return	15.8%	15.8%	10.5%	11.1%	7.8%	9.1%
Volatility	9.5%	9.6%	11.4%	11.6%	14.4%	14.3%
Sharpe ratio	1.62	1.60	0.88	0.92	0.51	0.61
Maximum monthly drawdown	-13.9%	-13.8%	-23.3%	-22.6%	-35.2%	-33.0%
Price-to-earnings	19.4	19.5	17.2	17.1	13.3	13.7
Dividend yield	2.1%	2.1%	3.2%	3.2%	2.7%	2.8%
Number of stocks	620	293	1,011	419	831	288
ESG score	5.2	6.6	6.5	7.9	4.4	6.2

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from MSCI, April 2018. Notes: the data cover the period from 31 May 2012, to 28 Feb. 2018. Returns are annualised gross returns in US dollar terms. Number of stocks, price-to-earnings ratio and dividend yield are monthly averages. Indices used are the MSCI USA Index, MSCI World ex-US Index, MSCI EM Index ('Traditional' columns) and MSCI's ESG-focused derivations of each (example: MSCI USA ESG Focus Index). The MSCI ESG Focus indices use back-tested data. They are optimised to maximise ESG exposure within certain constraints (example: a tracking error of 50 basis points and maximum active weight of 2% for each index constituent in the case of the USA ESG Focus). See important notes on the back page.

Source: Global Insight May 2018, «Sustainable Investing: a 'why not' moment», BlackRock Invest-ment Institute (equity snapshot).



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