Invesco and ESG

The incorporation of environmental, social and governance factors into our investment process

A brief history of ESG

From the first trading in derivatives on the Amsterdam Stock Exchange in the mid-sixteenth century all the way to the present day, capital markets were generally approached as a means to invest and earn a return. These exchanges were used and grew in popularity due to self-interest – we wanted something, whether to hedge, protect a position or save for a rainy day. A market itself is amoral, with no interest or judgment on the transactions or participants. Very slowly, over time, the purpose of investing began to change.

Around the time of the Civil War, the idea of philanthropy as an active endeavor started to take hold. It should be noted that philanthropy is completely different from charity – philanthropy attempts to cure the causes of societal problems, while charity treats the pain caused by the problems. The wealthy financier George Peabody began endowing museums and libraries in the US (and building low-income housing in London) during the 1860s. His activities were noticed by other titans of industry like Andrew Carnegie and John D. Rockefeller, who also believed that with the blessing of great wealth came a responsibility to give back through the creation of targeted permanent foundations. From the late 19th century and all through the 20th, wealthy families set up namesake foundations in the US and abroad. As examples, the Ford, MacArthur and Gates Foundations have together awarded many billions of dollars in grants since opening their doors.

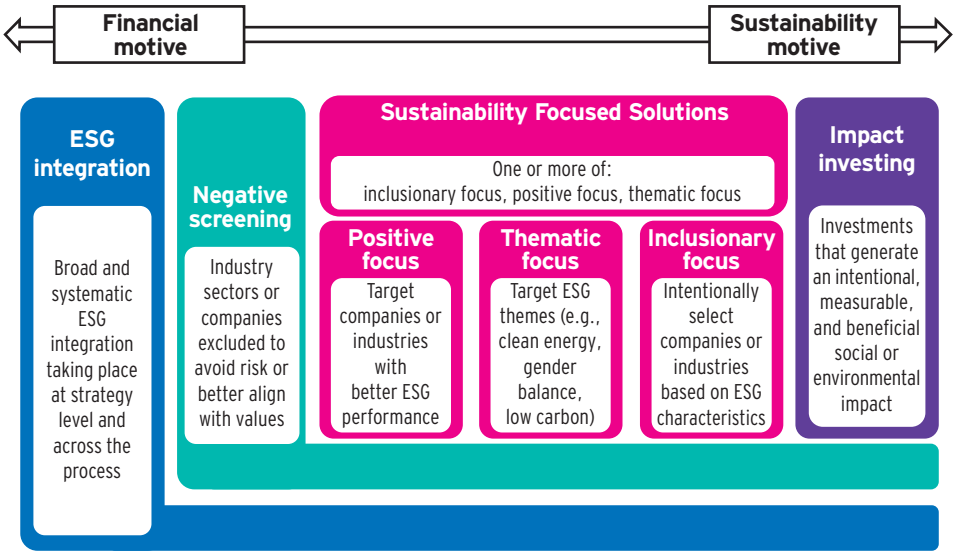
One could argue the advent of using environmental, social and governance (ESG) principles in investing was a natural outgrowth of activism on the part of individuals and foundations. If pressing certain companies to be better "citizens" is worthwhile, why not dramatically expand the universe of companies? Meet ESG. The term didn't even exist as we now know it until a landmark study sponsored by the United Nations (UN) was published in 2004,[1] but since that time, the embracing of ESG practices has snowballed. In the past 15 years, ESG assets have grown from a negligible amount to an estimated $30 trillion[2] – about one-third of all investments globally. Notably, a large portion of this growth has occurred in the last few years. According to Morningstar,[3] the number of mutual funds that consider ESG principles to be relevant in investment analysis quadrupled (from less than 20 to 81) during 2018, then exploded to 564 in 2019 with assets increasing nine-fold. Sustainable ESG funds (which use a stricter adherence to ESG principles) have exhibited similar popularity with investors. From 2010 through 2014, just 27 sustainable ESG funds were launched, compared to 164 from 2015 through 2019. Perhaps most demonstrative of the recency of this growth, these funds recorded net inflows of $21.4 billion last year, four times the result from 2018.

With major financial exchanges deeply committed to their own ESG initiatives, this movement is likely to continue – current expectations estimate an additional $20 trillion[4] in assets to ESG-focused investments in the next two decades.

How we view ESG investing

ESG investing is not a "for it" or "against it" decision. At Invesco, we view ESG investing as a process that exists along a two-part continuum. The first part is integration, where asset managers can choose to embed ESG principles within all areas of investing and corporate behavior. At the other end is a focus on products, with two more distinct tiers of increasing ESG engagement for investment analysis and process. The first (and most limited) is a focus on sustainability by using an exclusionary solution, where negative screening is applied to weed out "undesirable" companies or industries based on certain criteria. Positive screening can also be utilized to identify companies with positive or improving ESG factors. In this sustainability solution, socially responsible outcomes are part of the overall investment objectives, and as such, a fund is dedicated to taking these actions. The second is thematic investing, where preferred industries (like clean energy) are identified and funded. The most direct type of ESG investing strategy is called impact investing. Although currently the smallest piece of the ESG pie, these assets have the greatest intentionality for societal or environmental outcomes. With impact investing, the ultimate goal is measurably contributing to the improvement of society and/or the environment, with a secondary objective of earning a positive financial return.

ESG Investing Spectrum



Source: Invesco Ltd.
For illustrative purposes only.

We believe in ESG principles, so these are part of the overall corporate strategy at Invesco — included in designated product offerings, utilized when creating client-centric solutions and embedded in our corporate interactions with the world.

Process to product to behavior

To truly integrate ESG into a corporate culture, it must represent more than just a series of product offerings. Converting from the traditional practices of conducting business takes time, effort, and initially, considerable resources. ESG principles need to be part of the corporate strategy, but also present in all product decision-making processes. In our view, this includes, but it is not limited to:

- **Research** – This function will not only incorporate ESG activities into its reporting but also assess impact. A company with a number of initiatives but poor results will not usually warrant an investment.
- **Data collection** – If one is going to base investing or corporate decisions on the ESG principles of others, supporting data is essential. However, not all data you might want will be readily available from the source, so third-party providers may be needed.
- **Proprietary information** – A true ESG investor will not stop at third-party ESG data, because it wouldn't necessarily tell the whole story about a company. Using measures that are unique to your industry or region might reveal valuable information about a company's true practices.
- **Portfolio construction** – Once all data is collected, members of the various investment teams will perform their analyses. After a holistic assessment of all the ESG and performance yardsticks, a decision will be made.
- **Shareholder services** – How a company treats shareholders (and supports proxy voting) is often telling. Are voting opportunities carefully explained and communicated well in advance? Is the process of initiating shareholder proposals and votes fair and clearly outlined? Is the platform robust and intuitive?
- **Transparency** – It is one thing to say you support ESG, but you can't be afraid to prove it. Quarterly and annual reporting to investors should be straightforward and complete, with all supporting data to paint a clear picture of the company's activities and results.

To be truly engaged with ESG principles, each must be woven into the fabric of how a company behaves, how it engages with its various audiences and how it is governed by shareholders.

ESG applied to product development – exclusionary

Asset managers are in the business of providing financial products and services to investors. ESG products exist on a continuum because there is no "one size fits all" in financial ESG strategies. At Invesco, this has been a mantra for decades. Pre-packaged strategies do not effectively address the needs of traditional or ESG-focused investors.

The oldest (and most limited) type of sustainable ESG investing is exclusionary or negative screening. This method is generally acknowledged to have gained momentum toward the end of apartheid via non-investment in South African companies from investors abroad.

By screening out companies or industries that are viewed as contrary to any of the ESG components, strategies can be made available that satisfy certain investment goals while maintaining flexibility. Commonly used screens will remove companies producing tobacco, alcoholic beverages and firearms, but screens are customizable to one's beliefs and goals. Some may object to stem cell research, adult entertainment or gambling. And as we've seen in the news, there are individual companies that otherwise are good citizens, but become targets due to the behavior of their CEOs or executive team.

A common variation of the screening strategy examines the total sales of a company – what percentage of total sales is comprised of undesirable products? As an example, if firearms equal 70% of Company A sales, ESG-conscious investors may look elsewhere. However, a company in an undesirable industry might make the cut due to its ongoing ESG efforts, like an energy company transitioning to a greater focus on renewables.

ESG applied to product development – sustainability-focused solutions

A more dedicated ESG strategy for product development focuses on sustainability. In using this metric, a company must codify socially responsible investing objectives and follow them. Again, transparency is key, and the criteria used to implement the sustainability strategy must be clearly and completely described and disclosed.

To successfully implement sustainability-focused solutions, we believe an asset manager needs:

- To document and detail the exclusion screens used by the fund investment teams to create portfolios, which can include:
  - Specific companies or industries being targeted as undesirable
  - Specific characteristics being sought or avoided
  - Companies that have demonstrated ESG best practices
  - Screens based on multiple exclusion factors or strategies
  - Specific demonstrated sustainability themes
- To offer funds that are active investors and participate in targeted engagement

ESG applied to product development – impact investing

This is the smallest category of ESG investments at about $500 billion, as measured by assets under management.[2] Some consider this category to still be in its infancy, but it has very ambitious goals that are resonating more and more with investors of all ages.

The primary intention of an impact investment is to generate a measurable and beneficial social or environmental goal, with a secondary goal of generating a financial return. Forbes describes impact investing as combining "both the rigorous analytics of traditional investment and the heart of philanthropy.[5]" While this may be muddying the waters a bit, the basic premise is we are all realizing there is more to capitalism than just profit. An example of impact investing could be a fund that builds wells in locations where water is scarce or invests in a business that purchases local crafts from impoverished areas for resale to global audiences.

One of the main reasons that impact investing is still a relatively small ESG segment is because these opportunities are most commonly found through private markets and thematic strategies that target one or more of the UN's 17 sustainable development goals.[6] These goals promote the following:

1. No poverty
2. Zero hunger
3. Good health and well-being
4. Quality education
5. Gender equality
6. Clean water and sanitation
7. Affordable and clean energy
8. Decent work and economic growth
9. Industry, innovation and infrastructure
10. Reduced inequality
11. Sustainable cities and communities
12. Responsible consumption and production
13. Climate action
14. Life below water
15. Life on land
16. Peace and justice strong institutions
17. Partnerships to achieve the goal

What about returns?

It is widely believed that in order to invest in a socially responsible way, one must accept underperformance. A growing body of data suggests that this is not true, but there are also logical arguments supporting the idea that ESG returns will improve and outperform over time. Companies that pursue a strategy embedding ESG principles will be able to hire the best people, increase customer loyalty and be successful in new markets. Transparent and strong corporate governance will likely reduce risk while increasing potential as customers further engage with companies viewed as friendly to society. Here is a list of academic and industry studies that we have selected as good examples to show the positive correlation between ESG and returns:

- According to a 2015 study of 2,200 studies published by the *Journal of Sustainable Finance & Investment*, 90% of previous studies show a non-negative correlation between ESG investing and corporate financial performance.[7]
- JUST Capital (founded by Paul Tudor Jones) found that companies in their top quintile (as measured by ESG criteria) have 18% to 22% lower volatility, 6% lower beta, 5% shallower drawdowns, nearly half the quarterly earnings-per-share volatility, and 4.5% higher ROIC than bottom-quintile companies.[8]
- Reports by others, including sell-side brokerage firms, also report that companies in their top quintile (for ESG factors) outperformed those in the bottom quintile by more than 25 percentage points from Jan. 2014 through June 2018, with less volatile stock prices.[9]
- An industry analysis of S&P 500 stocks with high environmental scores (from 2005 through 2017) found outperformance of low-ranked counterparts of as much as three percentage points per year (and ESG adherence is indirectly proportionate to earnings risk).[10]
- Per Bloomberg, the nine largest ESG funds outperformed the S&P 500 Index in 2019, and seven of these outperformed their market benchmark over the past five years.[11]
- MSCI found that companies with higher ESG ratings recorded a higher average return on invested capital and were valued at a premium over top-performing peers with lower ESG ratings.[12]
- A Harvard Business School study of more than 2,300 firms found that firms with good performance on material sustainability issues outperformed firms with inferior performance on material sustainability issues historically from 1993 - 2013. Although past performance is no guarantee for future results, this study also shows that investments in material sustainability issues can be value-enhancing for shareholders.[13]
- Looking at the week of February 24 – 28, 2020, as well as year-to-date February 28, 2020, Morningstar found that during the COVID-19 related market downturn, sustainable equity funds overall fared better than their traditional peers and the same for passive sustainable equity funds compared with traditional market indexes.[14]

Invesco study also confirms recent ESG outperformance

The Invesco Quantitative Strategy team recently published a study that clearly shows the outperformance of ESG stocks in the aftermath of the COVID-19 market collapse.[15] Following an extended bull market, the spread of the virus in early 2020 and the associated containment measures by various governments caused a severe equity market correction starting mid-February. Soon thereafter, crude oil prices collapsed as a price war between major global producers began. As volatility spiked, certain credit markets dislocated around liquidity concerns. While the crisis period is short-lived so far, the market reaction is dramatic. The team not only shows how ESG scores generally offered outperformance but also how securities exhibiting ESG features (like carbon intensity, corporate governance, tax transparency and human capital management) have held up compared to securities with poor ESG scores.

Invesco and ESG – an integrated approach

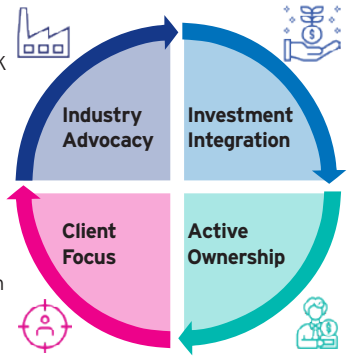
ESG integration is an ongoing strategic effort, and investment teams will vary in their level of ESG integration. We are presently working to apply these principles into all of Invesco's assets under management. As noted earlier, there is little value in providing pre-packaged, one-size-fits-all strategies to ESG-focused investors. All are different, with differing time horizons, levels of risk tolerance, return expectations and commitment. Invesco has the depth of products and, combined with a deeply consultative approach, we believe is uniquely positioned to seek to deliver purposeful outcomes for nearly any investment objective.

ESG investing is a fundamental commitment at Invesco. We're a trusted partner to our clients, both on ESG product strategies and as part of our mission to deliver an investment experience that helps people get more out of life. We adopt and implement ESG principles to align with our fiduciary responsibilities and have strengthened our position through industry advocacy, leadership and innovation.

The starting point for our company-level ESG research is the analysts and fund managers, who will look at a variety of factors. These will differ per asset class, sector, geography and company and will typically be one component of an overall investment view. Based on this initial view, where the fund managers and analysts wish for more detailed ESG information, our Global ESG team can provide proprietary analysis. Crucially, while there is global, centralized support, decisions are ultimately made by our investment managers and analysts – the individuals who know their asset classes and sectors best.

While our first socially responsible investment product was launched over 30 years ago, we became a signatory of the UN-backed Principles for Responsible Investment in 2013 and have since achieved an A+ in Strategy and Governance for three consecutive years. This rating demonstrates our extensive efforts in ESG integration, active ownership, investor collaboration and transparency. We're also disclosers to and investor member of the Carbon Disclosure Project, and in 2019 we became supporters of the Task Force for Climate-related Financial Disclosure (TCFD) with our inaugural Climate Change report published in Q2 2020. The table below lists the different ways Invesco is committed to ESG goals:

Invesco is committed to being a responsible investor through four key approaches



Industry Advocacy

- Lead investor in Climate Action 100+; largest investor to sign COVID-19 ICCR open letter; Stewardship Code Signatories in UK (Tier 1 status) and Japan
- Investor partners of CDP, SASB, IIGCC, Climate Bond Initiative, FAIIR
- Members of ACGA (Asia), UKSIF, CII (US), RIA (Canada), Italian SIF
- Participant in UK PRA/FCA Climate Financial Risk Forum; UK Investment Association SRI Committee; PRI Taxonomy committee

Investment Integration

- 90% of AUM integrating minimum ESG levels
- Investment approaches vary from Broad-based ESG integration, Asset Based Integration, Combined ESG Strategies, Thematic, Positive Screening, Value-Based Screening, Negative Screening
- Leveraging a host of tools and vendors providing ESG research to global investors
- Pilot Scenarios: 1.5 and 4-degree climate scenarios by Vivid Economics on a pool of global Eq and FI instruments

Client Focus

- Global ESG team of 14 people and external, dedicated resources
- Invesco diversity means investment strategies will vary in their approaches to implementation of ESG
- Capability to manage ESG solutions tailored to client through customized portfolios and products
- Knowledge transfer and through leadership

Active Ownership

- Engaged with 1,000+ companies on ESG topics in 2019 – through core investment teams and targeted by Global ESG team
- Operate a propriety global proxy voting platform called Fund Manager Portal Echo – voting applied to ETFs
- Vote on 10,000 companies per year
- Individual and collective ESG engagements

We aim to develop industry-leading ESG investing practices fully aligned to our purpose of helping people get more out of life

Source: Invesco ESG team as of March 2020.

In addition to being a champion of responsible corporate behavior, we also offer a variety of products along the ESG continuum, as shown below:

	ESG Integration and Engagement	Exclusions	Sustainability Focus	Impact Investment
Equities	✓	✓	✓	
Fixed Income	✓	✓	✓	✓
Real Estate	✓			
Quantitative Strategies	✓	✓	✓	
Alternatives	✓	✓		
ETFs	✓	✓	✓	

Invesco as of August 31 2020.

Closing remarks

At Invesco, we believe ESG principles need to be part of a corporate strategy as well as embedded in product decision-making. From our first foray into ESG products more than 30 years ago to today's commitment, we have woven ESG principles into the very fabric of how we behave, engage with our various audiences and are governed by shareholders. This is accomplished not by compromising our dedication to client-centric solutions – ESG is an enhancement to our approach. In our view, ESG is not a passing fad, but a tsunami of truth on how business can partner with its constituents for the next century and beyond.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

The opinions referenced above are those of the author as of Sept. 21, 2020. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.

Sources:

Source 1: The Global Compact (2004) Who Cares Wins: Connecting Financial Markets to a Changing World.

Source 2: Global Sustainable Investment Alliance (2018) Global Sustainable Investment Review.

Source 3: Morningstar Research (2020) Sustainable Funds U.S. Landscape Report.

Source 4: Merrill A Bank of America Company (2019) Why ESG Matters – now more than ever.

Source 5: Forbes (2018) Impact Investing, Just A Trend Or The Best Strategy To Help Save Our World?

Source 6: United Nations (2020) Sustainable Development Goals.

Source 7: Journal of Sustainable Finance & Investment, Volume 5, Issue 4 (2015) ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies.

Source 8: JUST Capital (2017) JUST companies exhibit lower investment risk.

Source 9: The Motley Fool (2019) Does ESG Investing Produce Better Stock Returns?

Source 10: Bank of America Merrill Lynch (2019) ESG From A to Z: A Global Primer.

Source 11: Bloomberg Green (2020) The Biggest ESG Funds Are Beating The Market.

Source 12: MSCI (2018) Enhancing Economic Value With ESG.

Source 13: Harvard Business School (2015) Corporate Sustainability: First Evidence on Materiality.

Source 14: Morningstar (2020) U.S. Sustainable Funds Weathering Coronavirus Correction Better Than Most Funds.

Source 15: Invesco (2020) How have ESG objectives behaved during this year's market turbulence?

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