Sovereigns and ESG
Is the Future Already Here?

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1. Executive summary

Recent editions of the Invesco Global Sovereign Asset Management Study have clearly shown how sovereigns are continually intensifying their efforts to incorporate environmental, social and governance (ESG) considerations into investment decisions.

This trajectory is being driven by factors including ongoing research into the positive link between ESG and corporate financial performance; improvements in the quality and quantity of ESG data; greater support for ESG at the highest policymaking levels; and heightened awareness of ESG-related risks, particularly with regard to climate change.

There is good reason to believe that sovereigns will need to intensify their commitment to ESG integration even further in the years ahead.

This is because of ongoing developments such as (among others) the emergence of a worldwide regulatory framework and potentially decisive moves to standardise reporting, disclosure, metrics and definitions around ESG.

We argue that the momentum behind ESG is becoming urgent, most obviously with regard to the threat posed by global warming; that the case for ignoring this reality is becoming untenable; and that sovereigns, not least given the significant power that they wield over capital markets, should therefore act now.

2. Introduction

This white paper seeks to address two vital questions about how sovereigns deal with the ever-growing incorporation of environmental, social and governance (ESG) considerations into investment decisions. The first: why are more and more sovereigns conspicuously stepping up their efforts to embrace ESG? The second: why are they likely to have to step up their efforts even further in the very near future?

The context for our analysis is supplied by recent editions of the Invesco Global Sovereign Asset Management Study (IGSAMS), an annual report whose findings are derived from interviews with representatives of sovereigns worldwide[1]. Three editions in particular, IGSAMS 2017, IGSAMS 2019 and IGSAMS 2020, underscore the escalating demands that sovereigns are facing – and responding to – in light of the pace and scale of developments in the ESG arena.

IGSAMS 2017 highlighted a disparity between those sovereigns still to commit to ESG and those pressing ahead with such an approach. Many of those in the former camp suggested that they would reassess their stance only when presented with proof of ESG's positive long-term impact on portfolio performance; despite their lengthy investment horizons, some lamented a detrimental effect on short-term returns; and others exhibited an incomplete grasp of the viable strategies, often viewing negative/exclusionary screening as the be-all and end-all.

IGSAMS 2019 revealed the substantial extent to which the landscape changed during the intervening two years. More sovereigns rallied to the ESG cause, while the leaders in this space further honed their thinking. The long-held assumption that ESG criteria have an adverse bearing on performance all but collapsed under the weight of evidence; ESG data steadily improved in both quantity and quality; and less restrictive strategies, foremost among them those that look to include rather than exclude, became more popular.

The latest edition, IGSAMS 2020, has now highlighted how ESG-related risks are increasingly influencing sovereigns' thinking. Focusing specifically on climate change, it underscores how the immediate challenges – and, indeed, the immediate opportunities – that ESG poses are earning greater recognition among many sovereigns.

All this is encouraging, because the pressure to adapt is mounting as never before – not least in a regulatory sense. Countries all around the world are contributing to an emerging global framework for ESG, with Europe retaining its position at the vanguard. Perhaps the most ambitious initiative so far, originally outlined by the European Union (EU) in 2018, is the Sustainable Finance Action Plan, whose promotion of an economy that fully acknowledges the value of ESG is already revolutionising attitudes towards capital flows, risk management and transparency[2].

Meanwhile, additional pressure comes from the desire to pursue an ESG-aware philosophy across portfolios. ESG has maintained a firm foothold in the equities sector and is now increasingly implemented in other asset classes – including fixed income, which was once described as "the neglected child of responsible investing" but has recently witnessed notable progress. Even some of the United Nations (UN) Sustainable Development Goals (SDGs), which were designed for corporate or direct finance investors rather than for the mainstream, still defy meaningful measurement and do not yet constitute an investable framework – further fuelling attempts to introduce more uniformity in terms of reporting, disclosure, openness, metrics and definitions.

There are many reasons, then, to believe that sovereigns must keep up and even augment their efforts to integrate ESG. As innovation in this sphere edges from the incremental towards the radical, the fundamental task for sovereigns is to determine where on the curve they stand now and where they may need to be very soon – and, crucially, how they might get there.

"There are many reasons to believe that sovereigns must keep up and even augment their efforts to integrate ESG."

The beginnings of a global framework for ESG
The Principles for Responsible Investment (PRI) first published its *Global Guide to Responsible Investment Regulation in 2016*. The accompanying map hinted at the development of a worldwide framework for ESG-aware investing – a vision that, as we explain in this paper, is now being realised in earnest.

UK
The Stewardship Code is overseen by the Financial Reporting Council (FRC). The code is supported by Conduct of Business Rule 2.2.31, which requires funds managed for professional clients to disclose the nature of their relationship to the code, or the alternative strategies in place. The FRC publishes statements of commitment to the code on its website and announced that in 2016 it would begin publicly ranking signatories based on the quality of their disclosures against the code.

Canada
Ontario Pension Benefits Act, Reg. 909 requires pension funds in Ontario to disclose in their investment policies "'information about whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated."

Brazil
Resolution Nr. 3,792/2009 Article 16, § 3rd., VIII requires pension funds to disclose in their investment policies if social and environmental responsibility is factored into investment policies.

South Africa
Johannesburg Stock Exchange's (JSE) listing rule mandates the adoption of the Institute of Directors' King Code which requires integrated reporting.

Source: PRI: Global Guide to Responsible Investment Regulation, 2016.

Pension Fund Regulations
Stewardship Codes
Corporate Disclosure Guidelines

UK
The Occupational Pension Schemes (Investment) Regulation requires pension funds' Statement of Investment Principles to cover "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments."

Norway
The Government Pension Fund's mandate commits the fund to upholding principles based on the UN Global Compact, the OECD Principles of Corporate Governance and the OECD Guidelines for Multinational Enterprises, as well as considering environmental factors in management of the real estate portfolio. The fund is also subject to an exclusions list.

Sweden
The National Pension Insurance Funds (AP Funds) Act notes that environmental and ethical considerations must be taken into account without compromising returns.

European Union
Pending transposition into member state law, the revised Occupational Retirement Provision Directive (IORP II) will require European occupational pension funds to disclose how they consider ESG issues in their investment approach through a Statement of Investment Policy Principles and establish risk management processes for emerging ESG issues.

South Korea
The Financial Services Commission's Green Posting System (2012) requires firms to post their greenhouse gas emissions and energy usage. Companies listed on the Korean Stock Exchange (KSE) must include this information in their annual reports.

Kazakhstan
Stock Exchange (KASE) listing rules (2009) must include information on social and environmental liabilities and corporate governance structure.

South Korea
The National Pension Act of Korea requires the National Pension Scheme to consider ESG issues and declare the extent to which they are taken into account.

Germany
Insurance Supervision Act, Occupational Pension Schemes requires pension funds to disclose to scheme members if and how ESG issues are taken into account.

Singapore
In 2016, Stewardship Asia launched Singapore's Stewardship Principles (SSP) for Responsible Investors. It references ESG issues as appropriate topics for engagement.

India
Business Responsibility Report regulation is set out by Securities and Exchange Board of India (SEBI) with National Stock Exchange of India (NSE) and Bombay Stock Exchange (BSE) responsible for its implementation.

Japan
The Principles for Responsible Institutional Investors considers stewardship and ESG integration. It is overseen by the Financial Services Agency (FSA) which encourages adopters to publicly disclose adoption of the Principles on their own websites. The FSA also collates signatories to the code on its own website. They have established the "Follow up council" to monitor implementation.

3.1. 2017: a polarised picture

The enduring reluctance of some sovereigns to incorporate ESG considerations into their investment decisions was one of the most striking findings of IGSAMS 2017. As the study remarked, this disinclination could be seen as running counter to historical expectations. It appeared at odds with the risk-reduction objectives and ethical awareness inherent in many sovereigns' mandates; it also seemed contrary to many sovereigns' capabilities, as defined by scale, reach and long-term orientation.

IGSAMS 2017 noted how those sovereigns already recognised as ESG pioneers – particularly in Europe, Canada, Australia and New Zealand – had stayed at the forefront. The events of the preceding 12 months, which saw a number of sovereigns continue to blaze trails in showcasing the power of ESG, very much chimed with this conclusion.

For example, the New Zealand Super Fund announced plans to enhance its carbon footprint, insisting that it should be able to boost returns for the same risk or achieve the same returns with less risk. Sweden's AP7 pension fund sold its investments in energy companies that it claimed violated the Paris Agreement on climate change. The French government's investment arm, the Caisse des Dépôts et Consignations, officially dismissed coal as "a 19th-century energy".

By contrast, other sovereigns were playing a waiting game. This was especially true of those in the US and emerging markets. As IGSAMS 2017 observed: "The role of ESG is unclear for many sovereigns... Uptake of ESG practices appears to be less broad than initially anticipated."

The overall polarisation was most starkly illustrated by dividing respondents into two groups – the first encompassing the West but not including the US, the second encompassing the rest of the world. More than 90% of those in the first group said that they integrated ESG into their investment processes, compared with just 32% in the second.

So what were the arguments behind the latter's unwillingness to climb aboard the ESG bandwagon? By and large, late adopters' hesitancy was rooted in two long-interlinked issues: performance and diversification.

The debate over whether it "pays to be good" had already been raging for years when IGSAMS 2017 was published, and for a time – rightly or wrongly – research indicating that it might pay to be bad was in vogue. One widely cited study (see panel below) calculated that $10,000 invested in a fund comprised of "sin" stocks would have grown to $33,655 between August 2002 and the start of 2015, while the same amount invested in a fund comprised of socially responsible stocks would have grown to just $26,788 during the same period.

It was also routinely posited that taking ESG factors into account must inevitably shrink the investment universe to a detrimental degree. With negative/exclusionary screening the dominant strategy, rigid regimes might eliminate more than two thirds of the available market. Such an approach was hugely removed from that of funds made up of stocks from sectors such as alcohol, gambling, pornography and armaments – which, given their reliance on consistent consumer demand rather than the vagaries of the economic cycle, might serve as ultra-defensive buffers during market storms. In 2015, in another story that captured plenty of column inches, CalPERS, the US's biggest public pension scheme, was found to have sacrificed $3 billion in returns as a consequence of blacklisting tobacco companies since the turn of the millennium. On balance, the message often seemed to be that vice would trump virtue; but this narrative, as we explain next, would soon be turned on its head.

"By and large, late adopters' hesitancy was rooted in two long-interlinked issues: performance and diversification."

Vice versus nice

In 2015 London Business School published a comparison of the historic performance of two US mutual funds: one with its focus on "sin" stocks, and one with its focus on socially responsible investments. The former was found to have clearly outperformed the latter during a sample period from August 2002 to the beginning of 2015. As responsible investment strategies grew in sophistication, research painting a more pro-ESG picture soon began to proliferate.

Source: Dimson, E, Marsh, P, and Staunton, M: Responsible Investing: Does It Pay to Be Bad?, 2015; data from Morningstar, August 2002 to end of 2014; chart shows cumulative value of $1 invested. Past performance is not a guide to future returns.

3.2. Today: a new normal?

Whereas IGSAMS 2017 exposed a dichotomy in sovereigns' perspectives on ESG, IGSAMS 2019 detailed growing signs of convergence. It reported that ESG had become "a front-of-mind issue for many respondents, occupying significant asset-owner time and resources", with more than half of the sovereigns surveyed having ESG policies in place. Although implementation was still most prevalent in the West, both Asia and the Middle East witnessed an uptick in ESG adoption during the intervening years. Broadly speaking, in spite of the challenges presented by global events during 2020 to date, this positive trajectory has continued since.

Why has the landscape changed so substantively in so little time? We first need to revisit the perceived hurdles mentioned in the previous section – performance and diversification – and explore how thinking around these concerns has become more nuanced since IGSAMS 2017.

Evidence of ESG's capacity to enhance performance has existed for years. Published in 2015, one of the most well known analyses, a review of more than 2,000 empirical studies of the relationship between ESG and corporate financial performance, stressed "the business case for ESG investing" and "the ESG opportunities... in many areas of the market"[3]. Numerous additions to the literature have queried the real-world relevance of pro-"sin" research. Even so, many sovereigns have been awaiting data whose objectivity and quality might better explain the risk/return trade-offs that ESG adoption can bring. This has now begun to arrive in several guises, including further studies, more transparency, improved disclosure and the more refined use of factors – quantifiable characteristics that can help clarify patterns of risk and return across all asset classes.

In turn, these innovations have led to a more enlightened understanding of the strategies that can be used to invest responsibly. Maybe most importantly, they have shed light on the prospective shortcomings of negative/exclusionary screening, its automatic narrowing of the investment universe and its dilution of the advantages of diversification. Like other investors, sovereigns are now more likely to accept that it is possible to include investments on ESG grounds – just as it is possible to rule them out – and that efforts to sift out the worst performers can be accompanied by efforts to sift out the best or the most promising.

They are also more likely to accept that active ownership is key to achieving positive change. Investing in companies with poor ESG performance can represent an attractive proposition – not only in terms of returns but in terms of the greater good – if dialogue and engagement can be used to persuade them to reconsider their policies and practices. As Bank of England Governor Mark Carney said in a speech at the UN Secretary General's Climate Action Summit in September 2019: "Sustainable investment... needs to do more than exclude incorrigibly brown industries and finance new, deep-green technologies. [It] must catalyse and support all companies that are working to transition from brown to green." Given their long-term horizons and the enormous sway that they now exercise over capital markets, sovereigns may have an unrivalled ability to influence the behaviour of the entities in which they invest.

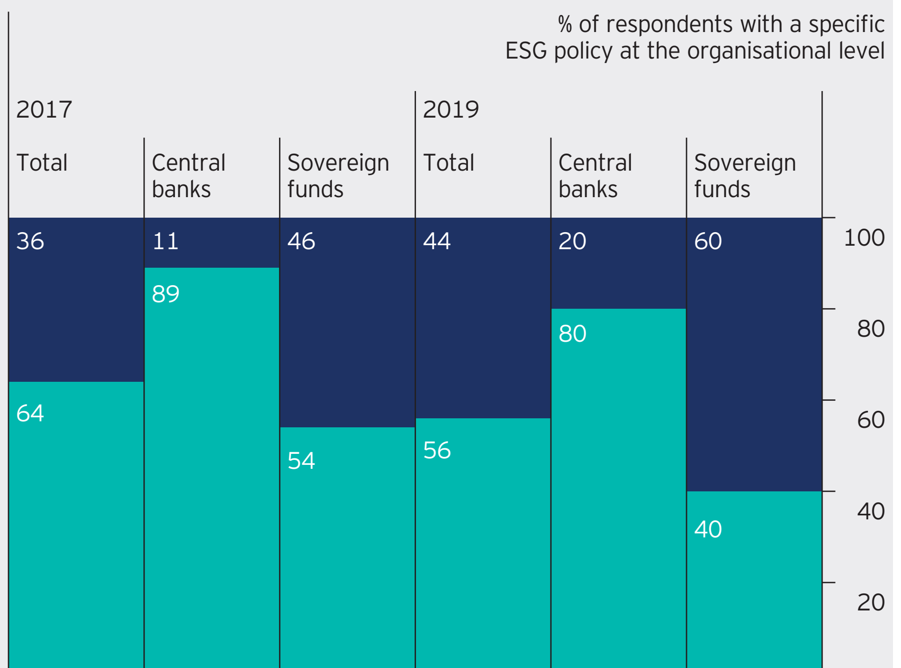
It is barely a decade since the fashionable view was that institutions subject to social norms had a fiduciary duty to invest in "sin" stocks such as alcohol and tobacco, irrespective of the wider repercussions of these products, if such stocks were found to deliver higher returns to those of their more virtuous counterparts. It seems fair to suggest that a decisive shift has taken place and that the prevailing outlook now is very different.

Today many more institutions, sovereigns among them, feel that their fiduciary duty involves encouraging investee companies to immerse themselves in ESG and that this is central to the sustainability of returns and the minimising of risk over the long term. Moreover, as we will see next, the years ahead appear set to cement this transformation even further.

"Sovereigns are now more likely to accept that it is possible to include investments on ESG grounds... and that active ownership is key to achieving positive change."

An unfolding transformation

The chart below shows the number of IGSAMS respondents with a specific ESG policy at the organisational level, as reported in 2017 and 2019 respectively. The figures illustrate IGSAMS 2019's finding that sovereigns have "intensified their focus on ESG, added or deepened dedicated ESG teams and... moved beyond initial scepticism (in some cases) to integrate their interpretation of ESG into broader investment policies and processes".



Source: Invesco Global Sovereign Asset Management Study 2019; sample size – 113 (central banks – 53; sovereign funds – 60).

4. New momentum, new challenges

We now come to the question of why sovereigns are likely to further intensify their commitment to ESG in the near future. While the points touched on in the preceding chapter are pertinent here, it is imperative, above all, to appreciate the bigger picture – or, to put it another way, the global picture – in the form of a high-level, international groundswell of support for ESG.

In 2015, two years before IGSAMS 2017 revealed a split in sovereigns' attitudes towards ESG, more than 190 nations signed the Paris Agreement. The same year saw the UN launch its 17 SDGs, covering all three components of ESG in a "shared blueprint for peace and prosperity". Faced with international calls to action, politicians, businesses and investors alike have since increasingly acknowledged the roles that they can play in achieving the targets enshrined in these milestone initiatives.

So have regulators. With sustainability an essential constituent of more and more financial and fiscal decisions, a worldwide framework for ESG is now rapidly taking shape. In 2016, when it first published its Global Guide to Responsible Investment Regulation, PRI unveiled a map showing the application of ESG-centric directives and requirements in settings ranging from South Africa to South Korea, from Canada to Kazakhstan and from Brussels to Brazil: we can now see that this snapshot, as featured in chapter 2, was just the start of a trend that has gained momentum ever since.

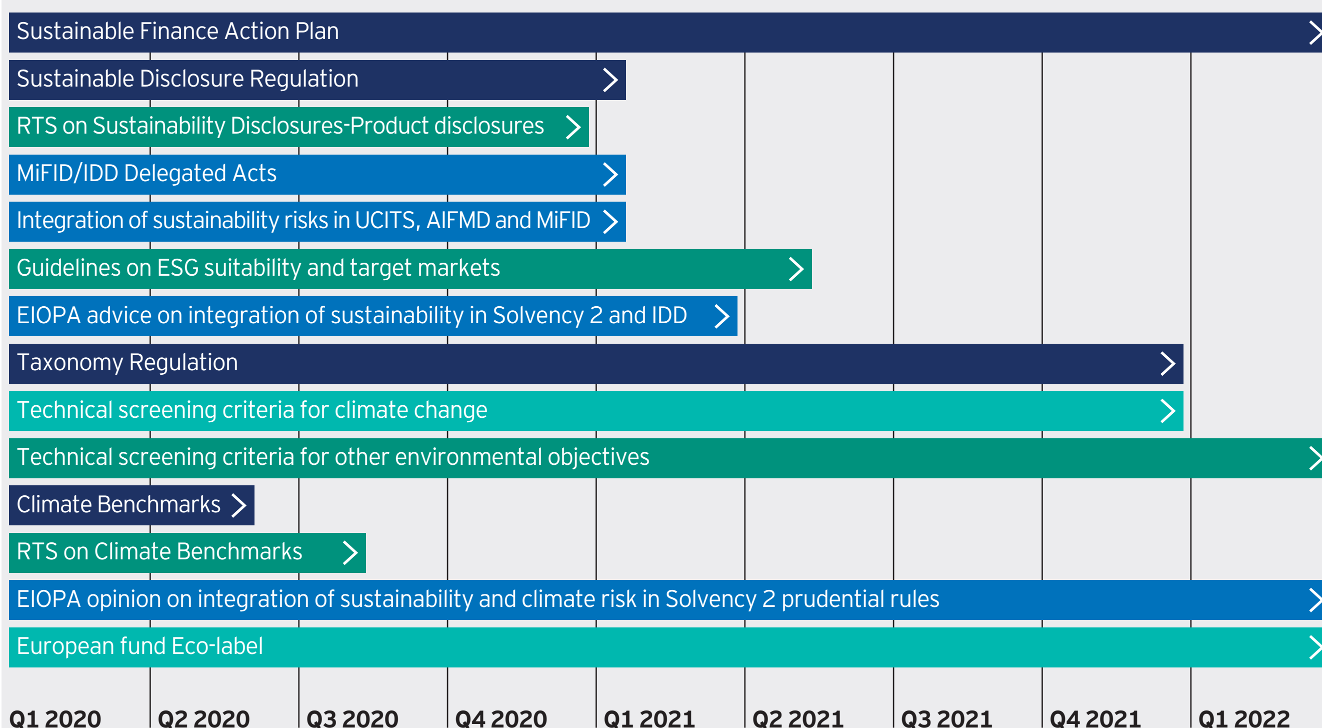
The renewed pressure to adapt is at present most manifest in Europe, where the **EU Sustainable Finance Action Plan** offers a far-reaching roadmap for generating the $180 billion in private capital thought necessary to fund sustainable growth in the EU each year. It is designed to reorient capital flows towards sustainable investment; to manage financial risks arising from climate change, resource depletion, environmental degradation and social issues; and to foster transparency and long-termism in financial and economic activity. The timeline for implementation is deliberately pressing.

Pressure from all sides
Whether it comes from policymakers or peers, regulators or the public, sovereigns – like all investors – find themselves under growing pressure to integrate environmental, social and governance issues into their investment processes. Here we take a closer look at some of the main sources of the wider groundswell of support for ESG.

- Final
- Draft rules
- Consultation
- Under development

Regulation and policy
Europe has traditionally led the way in advancing the cause of ESG, and its latest proposals maintain this theme. The overall message is hard to ignore – and other regions are likely to follow suit.

The chart below shows an array of regulatory programmes either under way or under consideration within the EU.



Source: Invesco, as at February 2020.

Moreover, the European Commission (EC) is already working on a follow-up, the Sustainable Finance Strategy, which will take into account the new political priorities under the European Green Deal, an EC initiative that sets out the EU's policy roadmap for achieving climate neutrality[4] by 2050[5].

In tandem, the EU has rightly inferred that a lack of reliable and comparable ESG information hinders the greater mainstreaming of ESG across the financial sector. It intends to address this issue by updating its Non-Financial Reporting Directive, which governs what companies are required to report in relation to ESG. Mindful of the growing sophistication of investors' needs, the EU is especially keen to formulate a reporting standard that would be much more detailed than the existing principles-based comply-or-explain rules. An initial consultation closed in June 2020[6], and revised legislation is expected in early 2021.

The mainstreaming of ESG is also obvious in the work of the **Task Force on Climate-related Disclosures** (TFCD), an industry-led body that promotes the development of financial risk disclosures around climate change[7]. The TFCD has earned the backing of hundreds of organisations in the public and private sectors, including a number of central banks and governments, since its founding in 2015. Introducing its 2019 Status Report, chairman Michael Bloomberg referred to "the power of transparency to spur action on climate change through market forces", adding: "Progress must be accelerated. Today's disclosures remain far from the scale the markets need to channel investment to sustainable and resilient solutions, opportunities and business models."

The European Green Deal

The European Commission's European Green Deal strategy sets out the sustainability-driven policy changes that the EU plans to introduce with a view to achieving climate-neutrality by 2050. Significantly, one of its key goals is to enshrine climate neutrality in law.

The initiative also encompasses broader environmental issues, including the impact of food production, the challenge of preserving biodiversity and the further greening of the financial sector. The various components are illustrated below.

Source: European Commission; Invesco.

Many sovereigns are already prominent backers of TFCD principles. They include the members of the **Network for Greening the Financial System** (NGFS), which has identified climate-related disclosure as a cornerstone of financial resilience, and the **One Planet Sovereign Wealth Funds Working Group,** which encourages the integration of climate-change analysis into the management of large, long-term, diversified pools of assets[8]. **The International Forum of Sovereign Wealth Funds** has also intensified its focus on climate change and other ESG issues. IGSAMS 2020 underscores the appetite for progress.

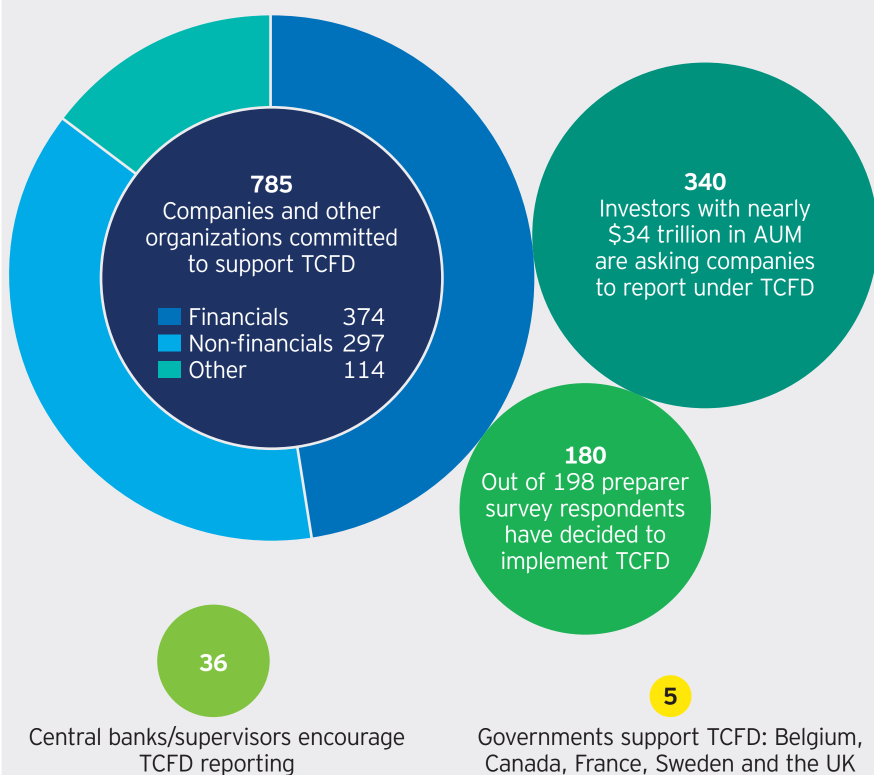
So what does all this pressure actually mean for sovereigns? The critical takeaway is that simply ignoring ESG is no longer an option: there might still be scope to endorse it or reject it as preferred, but the choice has to stem from a firm and convincing understanding of the issues at hand. While even EU legislation may not be legally binding for sovereigns[9], the mere existence of initiatives such as the Sustainable Finance Action Plan speaks volumes for the expectations that now surround responsible investing. In keeping with a broader network effect, the more widespread ESG's adoption – even among non-sovereigns – the more out of touch and behind the curve sovereigns might appear if they do not at least reflect the spirit of the regulations. In short: ESG is well on its way to becoming a "must have" rather than a "nice to have".

4. New momentum, new challenges

The Task Force for Climate-related Financial Disclosures

Established in 2015 by the G20's Financial Stability Board, the TCFD continues to gain powerful backing for its bid to encourage greater transparency in companies' climate-related disclosures. According to its 2019 Status Report, more and more firms are "putting significant effort and thought" into implementing its recommendations – and investors of all kinds are welcoming this shift.

The illustration below breaks down the TCFD's global support, which includes a number of central banks and governments.



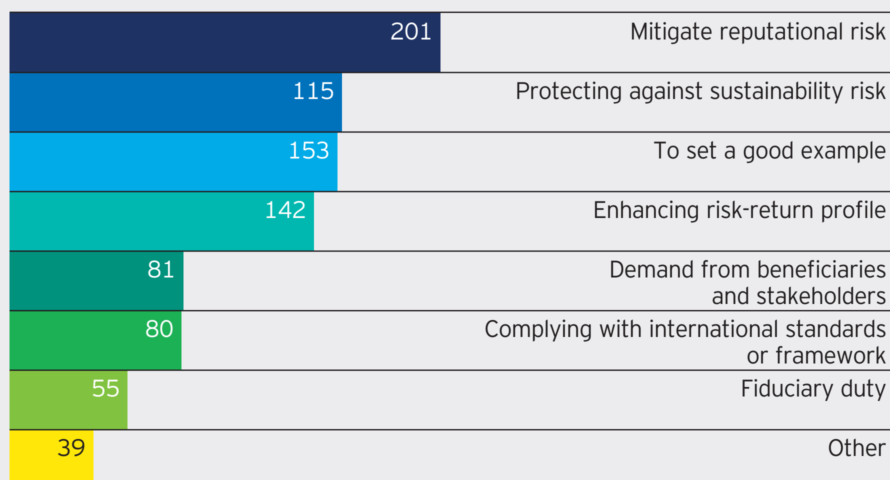
Source: Task Force for Climate-related Financial Disclosures: 2019 Status Report.

"With sustainability an essential constituent of more and more financial and fiscal decisions, a worldwide framework for ESG is now rapidly taking shape."

The Network for Greening the Financial System

The NGFS was established by eight central banks and supervisors in 2017. By late 2019 it comprised 46 members and nine observers. Describing itself as a "coalition of the willing", it is a voluntary forum that aims to share best practice, develop climate/environment-related financial management and support the transition to a sustainable economy.

The chart to the right details central banks' reasons for engaging in socially responsible investing (SRI) – a term synonymous with ESG. The results are based on a survey of 25 central banks, which were asked to rank their motivation (from one to eight) for each of their portfolios – 38 in all – in which SRI plays a role.

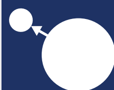


Source: Network for Greening the Financial System: A Sustainable and Responsible Investment Guide for Central Banks' Portfolio Management, 2019.

One Planet Sovereign Wealth Funds Working Group
The One Planet Sovereign Wealth Funds Working Group argues that sovereigns are "uniquely positioned to promote long-term value creation and sustainable market outcomes". It was established in 2017 by the Abu Dhabi Investment Authority, the Kuwait Investment Authority, the New Zealand Super Fund, Norges Bank Investment Management, the Public Investment Fund of the Kingdom of Saudi Arabia and the Qatar Investment Authority.

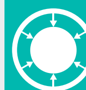
The group aims to accelerate the incorporation of climate-change issues into sovereigns' investment processes through a framework built around three key principles:

Alignment
Build climate-change considerations, which are aligned with sovereign wealth funds' investment horizons, into decision-making



Ownership
Encourage companies to address material climate-change issues in their governance, business strategy and planning, risk management and public reporting to promote value creation

Integration
Integrate the consideration of climate-change-related risks and opportunities into investment management to improve the resilience of long-term portfolios



Source: One Planet Sovereign Wealth Funds Working Group: Framework Companion Document 2019.

4.2. Level playing fields

As remarked in an earlier Invesco white paper[10], a burgeoning industry normally witnesses the gradual evolution of recognised standards. Research has shown that the number is usually small enough to facilitate both convenience and adherence, enhancing efficiency and reducing costs in almost any setting[11]. Yet this has not happened with ESG – until now.

The EU Sustainable Finance Action Plan exemplifies a new determination to bring about a level playing field. Its core proposals – including developing sustainability benchmarks and establishing a taxonomy for sustainable economic activities – are geared towards the entire investment chain. If it works as hoped then bold, sweeping, unifying legislation could follow around the world. As the European Commission commented after hosting a conference entitled A Global Approach to Sustainable Finance, which featured contributors from (among others) Morocco, Japan, India, Hong Kong and China: "A coordinated international approach is a precondition for unlocking the considerable potential of sustainable finance worldwide."

Yet there is another level playing field to strive for: the ability to invest responsibly across all asset classes. IGSAMS 2019 reported "a more general breakout from [ESG's] starting point in equities", noting sovereigns' willingness to apply an ESG methodology "across portfolios in a manner that has not been seen previously". This ties in with both the use of more sophisticated strategies – that is, those that go beyond negative/exclusionary screening – and the emergence of investment vehicles that explicitly seek outcomes linked to the Paris Agreement and the SDGs.

The arena of fixed income shows what can be done. Labelled "the neglected child of responsible investment" at a 2014 PRI-hosted event, the sector was dubbed a "sleeping giant" just a few years ago[12]. Now many investors are adamant that their exposures to bonds, like their exposures to equities, should take sustainability concerns into account.

Green Bonds are structured like normal bonds but feature substantial ESG requirements – in relation, for example, to energy efficiency or the management of resources. The World Bank issued what is now thought of as the first Green Bond a little over a decade ago. Today the market is exhibiting signs of exponential growth and experiencing what Environmental Finance editor Peter Cripps has called "an unprecedented flurry of innovation and experimentation", with new products such as sustainability bonds, climate bonds, SDG bonds and transition bonds (intended to aid the move to a low-carbon economy).

Such progress reflects a recognition that ESG-aware investment processes in this space – as in others – are likely to be rewarded in the marketplace with lower funding costs, capital appreciation and better risk-adjusted returns over the longer term. Moreover, this philosophy can be employed in multiple areas of fixed income, including sovereign debt, corporate credit and senior secured loans. Even municipal bonds are naturally aligned with many environmental and social objectives, including those in the SDGs.

We observed earlier that active ownership is central to bringing about positive, ESG-led change. This applies to fixed income as much as it applies to equities, despite the absence of proxy voting in the former. For instance, Invesco Fixed Income (IFI) uses regular meetings with issuers to discuss ESG matters and, where appropriate, to encourage better sustainability-related behaviour from the firms and entities in which it invests.

Does the quest for these level playing fields mean that sovereigns should be embracing ESG as never before? It might be useful to rephrase the question: all things considered, what other course of action could there be? As the authors of a recent MSCI study advised: "Acting today could make the difference tomorrow."

Waking the "sleeping giant"
Recent developments in the fixed income sector underline a growing resolve to apply an ESG-aware philosophy across all asset classes. Here David Todd, Head of Global Corporate Credit Research at Invesco Fixed Income, explains how ESG integration is fast becoming a norm in this space.

Fixed income was branded "the neglected child of responsible investment" only a few years ago. What has changed?
Fixed income has certainly been something of a late developer in terms of ESG, at least in comparison with equities. But the scale of its potential contribution to the cause has been understood for some time.

Now we're really starting to see that contribution. There's a wider recognition that what has worked well for equities can work well with other asset classes – and there's a fundamental appreciation that this simply has to happen.

What sort of analysis do you carry out when integrating ESG into fixed income investment decisions?
It varies. It's important to remember that this is a very diverse sector that encompasses many forms of asset. Geographical, structural and regulatory differences make for many levels of data availability, management engagement and general ESG awareness.

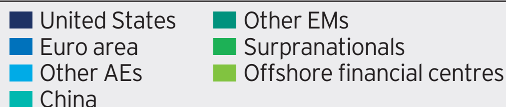
At IFI, for example, the application of ESG principles across fixed income represents an ongoing strategic effort. Although we maintain much the same underlying approach to ESG integration, we take different paths to arriving at an ESG-based assessment depending on the asset class.

But the crucial point is that ESG analysis can be extremely relevant to all forms of fixed income. For instance, countries can issue bonds that mature over the course of half a century or more, so their action or inaction with regard to ESG issues such as climate risk could impact on their ability to meet their future obligations. Using ESG metrics when assessing corporate bonds enhances the evaluation of credit risk and therefore ratings migration potential. In municipal debt, ESG research allows us to identify issuers that provide clean, affordable, attractive services, and we've been incorporating ESG factors into our analysis of senior secured loans for some years now.

So this has basically become an essential element of what we do. And a key goal is to look beyond "best in class" assets and explore the whole opportunity set for the most attractive investments from a risk-and-reward perspective. This is how we stay true to clients' specific ESG objectives.

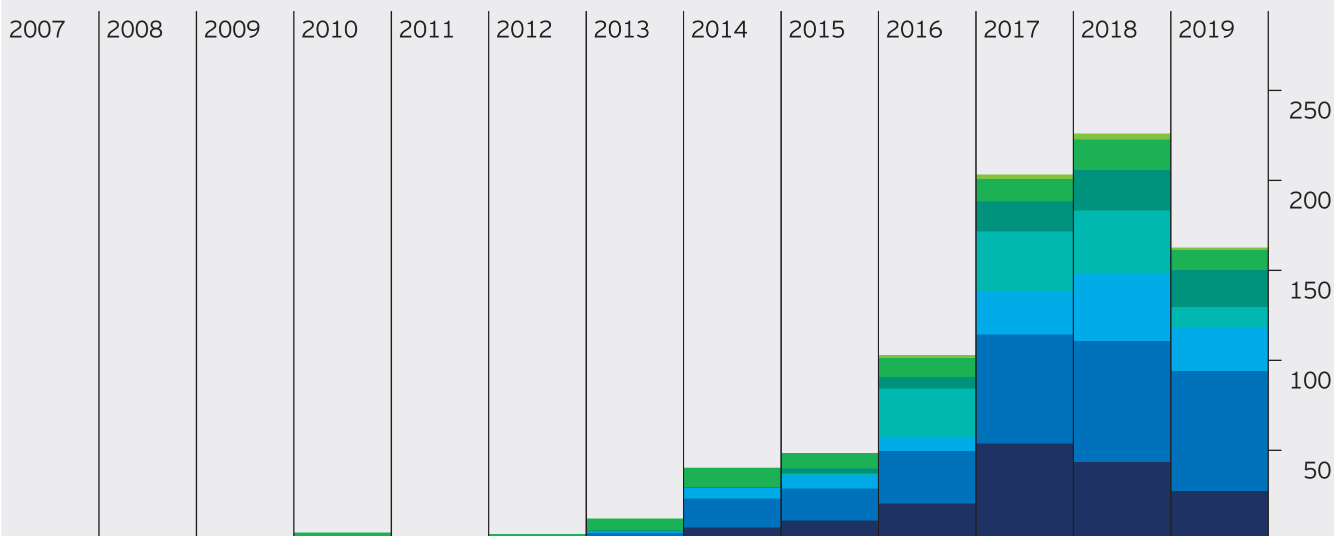
What about the importance of active ownership?
Again, this is something that for a long time was mainly associated with equities. But there's no doubt that directly engaging with the companies we invest in can be highly effective in steering them towards better ESG policies and practices.

We find that the vast majority of management teams welcome dialogue on ESG matters, not least because they acknowledge that investors ultimately decide an issuer's cost of funding. And it's not merely a case of establishing ESG-oriented goals – it's also a case of attaining them, which means that engagement has to be target-driven and ongoing. It all supports long-term thinking, which is obviously in keeping with sovereigns' mandates and general orientation.



The growth of Green Bond issuance
According to a study by the Bank for International Settlements, Green Bond issuances rose from less than $50 billion in 2014 to almost $230 billion in 2018. There was little activity prior to 2014. The recent rapid rise underscores ESG's fast-growing integration in the fixed income arena.

- United States
- Euro area
- Other AEs
- China
- Other EMs
- Surpranationals
- Offshore financial centres



Source: BIS: Green Bonds: The Reserve Management Perspective, 2019; AEs = advanced economies; EMEs = emerging market economies; figures in billions of dollars.

5. Conclusion

At Invesco we have stated on many occasions that ESG investing is a journey, not a race. This idea still holds true today. Yet it is impossible to overlook the fact that the speed of travel is increasing – even in the face of a global pandemic – and that investors of every sort, sovereigns among them, must react in kind.

If we examine the obstacles to sovereigns' incorporation of ESG into their investment decisions, as reported by IGSAMS 2019 respondents, we find six that are most commonly cited. In ascending order, these are lack of internal resources, impact on returns, monitoring, paucity of regulatory support, limited choice of investments and, above all, quality of data/ratings.

Now let us compare these with the primary drivers of change discussed in this paper. We have growing empirical evidence of a positive relationship between ESG and corporate financial performance; we have near-universal backing for ESG at the highest policymaking levels; we have unprecedented moves towards a worldwide regulatory framework for ESG investing, underpinned not just by milestone initiatives such as the Paris Agreement and the SDGs but by ESG's concomitant entry into the world's collective conscious; and we have relentless advances in data analytics, factor-driven strategies and product innovation as a whole.

This brings us back to the fundamental task that we articulated in introducing this paper: every sovereign must determine where on the curve it stands now and where it might need to be very soon. In other words, as a sovereign, are you ready for the future of ESG or do you fear that it has already arrived sooner than you expected? Do you perceive that new hurdles to adoption and adaptation are sprouting up or that longstanding barriers are being lowered?

The answer surely falls somewhere between the two extremes. The future of ESG is still crystallising, but it is doing so more swiftly – and maybe more decisively – than ever before. The pressure to move with the times might be unparalleled, and some sovereigns could initially struggle to do so; yet the long-term gain should comprehensively outweigh the short-term pain. Innovation very seldom comes without disruption: it is what lies beyond that justifies any early turbulence.

We believe that the momentum behind ESG is becoming urgent and that the case for ignoring this reality is becoming untenable. It is hard to deny that the time to act is now. But what sets sovereigns apart from other stakeholders in meeting the challenges posed by these circumstances?

Perhaps the first key distinction is that many sovereigns are already well equipped to adjust to these new normals. Although some say that they lack internal resources, as mentioned above, many have added or expanded their own dedicated ESG teams – some during the past few years. They are likely to consider ESG across their investment processes; to train their staff in implementing responsible investing; to appreciate how ESG strategies, parameters and data quality might affect the size of the investment universe and the level of returns; and to use dialogue and engagement to improve the policies and practices of the entities in which they invest.

Second, it should not be forgotten that sovereigns occupy a powerful position at the heart of the financial nexus. To quote Scott Kalb, one of the few foreigners to have served as chief investment officer of another country's sovereign wealth fund, they are "a new and dynamic class of institutional investor… with larger assets under management, scalable resources, few liabilities relative to assets… [and the] capability to be very long-term investors with strong balance sheets"[13]. If such exceptional potency can be successfully channelled towards ensuring the greater good, as circumstances now patently require, then the benefits may be uniquely widespread and long-lasting; and this, ultimately, is what the future of ESG should really entail.

"We believe that the momentum behind ESG is becoming urgent and that the case for ignoring this reality is in many ways becoming untenable."

6. References and suggested further reading

References

[1] IGSAMS defines five kinds of sovereign, each determined in the first instance by its objectives. They are investment sovereigns, liability sovereigns, liquidity sovereigns, development sovereigns and central banks.

[2] Although skewed towards environmental concerns, the Sustainable Finance Action Plan features a number of measures that underline the need to give thought to every element of ESG.

[3] See Friede, G, Busch, T, and Bassen, A: ESG and Financial Performance: Aggregated Performance From More Than 2,000 Empirical Studies (2015), which concludes that "approximately 90% of studies find a non-negative ESG-CPR relation".

[4] An economy or society is said to be climate-neutral if it has net-zero greenhouse gas emissions.

[5] Invesco responded to an initial consultation, which featured more than a hundred questions covering multiple aspects of the financial ecosystem and various ESG issues. Given the complexity of the matter, the timescale for subsequent steps is at present unclear.

[6] Invesco participated in this consultation and at the time of writing is finalising a separate paper on this issue.

[7] In July 2020, as a supporter of the TFCD, Invesco published its inaugural Invesco Climate Change Report. Underscoring our belief that climate change is a top-of-the-agenda issue both for society and for our clients, it includes an explanation of our own approach to governance and strategy, including how ESG principles are integrated across the business; an assessment of a significant part of our listed equities and corporate fixed income holdings in respect of emissions intensity, temperature alignment and climate scenario analysis; and an examination of climate change at an operational level, including metrics covering investment and regulatory risk. See Invesco: 2019 Invesco Climate Change Report, 2020.

[8] Invesco is proud to be part of the One Planet Sovereign Wealth Funds Working Group.

[9] EU regulations apply only to financial market participants. This means that in most cases, as government bodies, sovereigns would not be directly subject to them. However, it is interesting to note that sovereigns – led by, among others, the Norwegian Sovereign Wealth Fund and France's Caisse des Dépôts et Consignations – are in large part spearheading the drive for change. Since many of the proposed innovations are intended to help the creation of new products and services, sovereigns are likely to be not only beneficiaries but maybe even early adopters.

[10] See Hasselgren, U, Saynay, B, and Stein, H: Lost in Translation: In Search of Authenticity in ESG Integration (2018).

[11] See, for example, Bongers, C: Optimal Size Selection in Standardisation: A Case Study (1982), which proves this rule of thumb in – believe it or not – the world of concrete piles.

[12] his prescient comment came from Archie Beeching, who at the time was PRI's senior manager of fixed income and infrastructure.

[13] Kalb served as deputy chief executive and chief investment officer of the Korea Investment Corporation from 2009 to 2012, during which time the fund diversified across an array of asset classes and increased assets under management from $19 billion to $50 billion. He made these remarks during a speech at the CFA Institute's annual conference in 2015.

Suggested further reading

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- PRI: Global Guide to Responsible Investment Regulation, 2016
- Task Force on Climate-related Financial Disclosures: 2019 Status Report
- Von Ditfurth, M, and Hoepner, A: Sustainable Factor Investing, 2017

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