Allocation insight

5.7.2018

Responsible investing – for future returns

This time, in addition to portfolio positioning, our allocation insight focuses on responsible investing, which increasingly impacts investors' allocation and thus investment returns. In recent years, institutional investors, particularly in Europe, have placed responsible investments higher on the agenda, and an ever-growing share of the world's investment assets is managed with sustainability aspects in mind. At the same time, responsible investment methods have evolved, the supply of information has improved and the range of responsible investment products has expanded. That said, the topic is still surrounded by challenges and misconceptions.

Perhaps the most common misconception about responsible investing is the disparity between sustainability and return. It is true that many of the so-called sin stocks, such as tobacco companies, have been good choices in terms of returns over the past decades. However, the conception of disparity between sustainability and return has recently been challenged in academic research. According to several research results, responsible companies generate better returns on average and are less risky, measured by value fluctuation (e.g. Kumar et al.[1]).

Environmental risks are a very concrete example of the impacts of sustainability on investors. The prices of emission rights have tripled in five years, and this is directly reflected in the income statements of companies with high emission levels, making investing in cleaner production more attractive (Figure 1). Similarly, the financial risks pertaining to energy companies' fossil reserves are obvious and may materialise if governments end up limiting the use of these reserves through legislation. In other areas of sustainability, the cause and effect relationship is more difficult to discern, but research results support the notion that sustainability is financially profitable. Edmans, Li and Zhang[2], for example, have studied the positive link between employee satisfaction and equity return. The impact of good governance on profitability on a broader scale is also well-documented.

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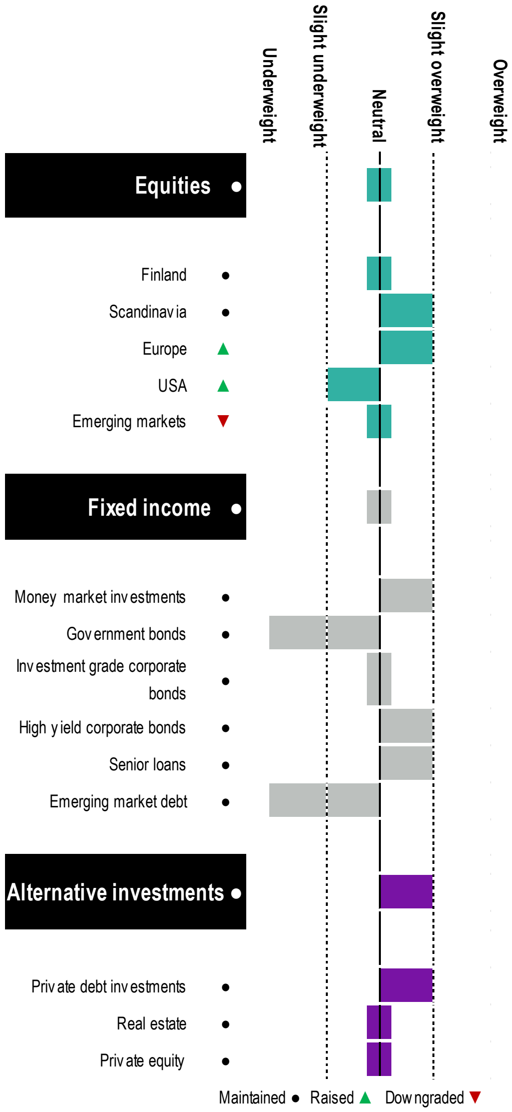

[1] N. C. Ashwin Kumar, Camille Smith, Leïla Badis, Nan Wang, Paz Ambrosy & Rodrigo Tavares (2016): ESG factors and risk-adjusted performance: a new quantitative model, Journal of Sustainable Finance & Investment, DOI: 10.1080/20430795.2016.1234909.
Available at DOI: http://dx.doi.org/10.1080/20430795.2016.1234909

[2] Edmans, Alex and Li, Lucius and Zhang, Chendi, Employee Satisfaction, Labor Market Flexibility, and Stock Returns Around the World (February 21, 2017). European Corporate Governance Institute (ECGI) - Finance Working Paper No. 433/2014. Available at SSRN: https://ssrn.com/abstract=2461003 or http://dx.doi.org/10.2139/ssrn.2461003

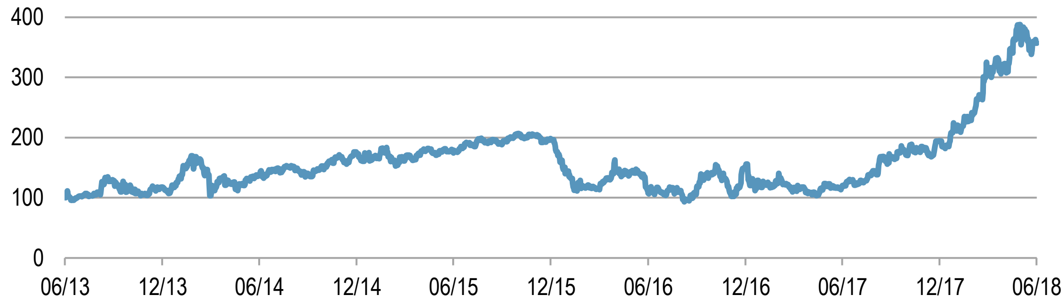

Figure 1. Indexed price development of emission rights 29 June 2013–29 June 2018. Source: Bloomberg.

Definition, demarcation and information supply as challenges

The main challenge in responsible investing is related to defining and measuring sustainability. In environmental matters, the perception is much the same worldwide, but when it comes to social (e.g. gender equality) and good governance issues, different cultures may have very divergent notions about responsible operations. In Asia, for example, corporate social responsibility is understood to have a broader meaning than in the western world, which is reflected in the decision-making of Asian companies. On the global market, an investor who looks at the world through European glasses easily falls into the minority, hence the importance of taking into account cultural differences for a realistic risk analysis.

In addition, an orthodox investor will quickly come up against challenges in demarcation. If, for example, companies manufacturing weapons are excluded from the investment universe, should the same approach be applied to the bonds of countries that acquire these weapons? After all, public debt is also used for many good purposes, such as to finance education and healthcare. A more down-to-earth investor will eventually come to the same conclusion as an investor who charts risks: what matters is that things are moving in the right direction, not orthodoxy in the present moment.

The third key challenge is related to the supply of information. Large companies typically have more resources for reporting and communicating on sustainability issues, which is why they typically receive better sustainability scores from different parties carrying out sustainability analyses. Less extensive reporting does not, however, automatically mean that smaller companies are less responsible than larger ones. In the case of small companies, the portfolio manager's legwork, attentiveness and active dialogue with company management are therefore all the more important.

Sustainability as part of investment analysis and allocation decisions

In its investment operations, Mandatum Life extensively charts the financial risks pertaining to the investments, a significant proportion of which are linked to sustainability. Sustainability analysis is thus a natural part of investment analysis. The cornerstone of the analysis is continuous and high-quality supply of information. In company-specific sustainability analysis, establishing the carbon footprint of our investments and regular monitoring of the investments, we co-operate with the Canadian company Sustainalytics and the Swedish company ISS Ethix. In the monitoring, we strive to identify the companies' sources of revenue, with the aim of avoiding companies that engage in controversial business or breach international norms. As part of the investment process, we participate, on a case-by-case basis, in investors' joint engagement processes to rectify identified problems. In the investment process, comprehensive risk analysis plays an essential role, enabling us to select the risks that we can accept to bear. One of the focal areas in investment analysis is assessing and taking into account climate risk, an area in which we have achieved good results (Figure 2). This year, we published an investor's guide on managing climate risks together with WWF and Sitra. The guide can be downloaded on our website (link, only in Finnish).

As in investment analysis in general, sustainability analysis is about the total assessment of risks and opportunities. We can say with great certainty that the weight of the factors related to the sustainability of investment operations and investments will increase. This development is driven by, among other things, company-level rules and norms, the transition taking place in energy production and industry due to climate change, changing purchase behaviour, transfer of wealth to the next generations and the growing emphasis on professional investors' social responsibility. Being at the forefront of this development increases the probability of avoiding unfavourable risks and leads to better investment returns in the long run.

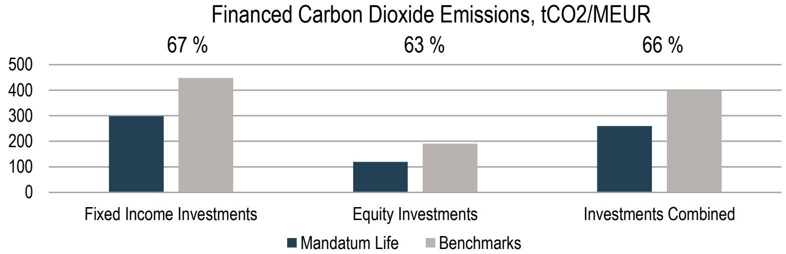

Figure 2. Carbon footprint of unit-linked assets managed by Mandatum Life (tonnes of carbon dioxide per invested million euros). The percentage indicates the carbon footprint in relation to the relevant benchmark indices. The measurement is based on holdings as per 30 June 2017 and on companies' emission data from 2016. Source: ISS Ethix, Mandatum Life

Positive vibe on the equity markets despite political uncertainty

Political uncertainty has weighed down the markets during the summer. The US trade policy rhetoric has escalated further towards both Europe and China. US trade is currently burdened by the import duties imposed by the US and the counter duties imposed by its trade partners on US products. So far, however, trade policy measures have had little impact on companies' confidence.

The ECB announced in its June interest rate meeting that it would end its bond purchase programme at the turn of the year. Purchases will be reduced after September. The announcement was largely in line with market expectations. At the same time, President Draghi said that the ECB would keep its key interest rate unchanged until the summer of 2019, which postponed market expectations of the first interest rate hike and dragged market rates down in Europe.

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When the US central bank, in turn, said that it would continue on its interest rate hike path, the appreciation of the dollar gained new momentum. On a monthly level, the change in the USD/EUR exchange rate is not particularly large, but intra-month movements have been stronger, and the development of the exchange rate is likely to be a key driver of investment returns also going forward. For a patient investor, however, the key economic factors are on track: global economic growth is expected to continue and companies' earnings performance looks good as we enter the Q2 reporting season. The technology sector is still largely responsible for the US equity market rise in the early part of the year, which is why all eyes will be on technology companies' reports. Considering the high valuation levels in the sector, there is no room for major disappointments.

Developed market equities reduced, western markets increased

The equity market valuation level is higher than average, but justifiable as earnings growth continues. Solid growth figures are expected from the Q2 earnings season beginning in July. However, with high earnings growth expectations, there is no room for disappointments. In addition to earnings growth, the relatively attractive return expectation compared to fixed income investments speaks in favour of making equity investments.

Emerging markets are suffering from an appreciated dollar and uncertainty related to trade policy, which has also been reflected in stock prices. Therefore, during June, we have gradually reduced the weight of emerging markets and increased the weight of European and American equities. The Amundi Global Low Carbon fund that invests in low-carbon companies and the Mercer Global Sustainable Equity fund that emphasises sustainability in its company selection form an essential part of our allocation solutions' equity investments

In fixed income investments, we favour corporate bonds and underweight government bonds

In fixed income investments, the focus is on Nordic corporate bonds, which offer better return potential than continental Europe. However, there is reason to be selective, in particular when it comes to higher-risk high yield investments. Due to the low return level, we underweight government bonds. The interest rate risk of fixed income investments, measured by duration, is more moderate than the market index, which we wish to use to prepare for a gradual rise in interest rates due to a tightening central bank policy.

In June, we acquired Chinese yuan-denominated dim sum bonds. Dim sum bonds have a low correlation with, for example, euro zone and US bonds, which is why they improve the diversification of fixed income investments. We examined in more detail the role of dim sum bonds in building a portfolio in our May allocation insight. The weight of dollar-denominated investments of fixed income investments is approximately 21 per cent. We actively regulated the dollar hedging ratio in June, which has resulted in better returns on fixed income investments. At the end of the month, the dollar hedging ratio was about 50 per cent and the open USD exposure was some 10 per cent of the value of the fixed income investments.

With return expectations on fixed income investments at a low level, we recommend that our customers also include in their portfolio alternative investments which offer better return levels due to, among other things, the liquidity premium paid for limited liquidity. In our allocation solutions, this recommendation has been taken into account by replacing a portion of the fixed income investments with alternatives. In alternative investments, we favour direct debt investments, real estate and real estate development projects. We have made capital investments selectively.

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