Although sustainable investing has gathered much interest in the last year, it is actually a style of investing that has been around for some time. With two of the funds in the RLAM sustainable range, the RL Sustainable World Trust and the RL Sustainable Diversified Trust, having reached their 10 year anniversaries this year, this is a good time to reflect on past developments and also look to the future.

Perhaps the most interesting trend we have noticed in the last 10 years has been the increasing acceptance of sustainable investing as a style of investment, alongside other well-known styles such as value, growth and income. This has resulted in the RLAM sustainable funds being considered as part of mainstream portfolios, as well as for sustainable investors. This reflects two changes. First, there is strong evidence that integrating sustainability into investment decisions enhances investment returns. This can be seen in the long-term performance of our funds. Secondly, consumers are considering not just what a product does, but the environmental and social context in which the product has been produced. As consumers come to make investment choices, it is highly likely that sustainable considerations will be a factor in the products they decide to buy. Ten years from now it is possible that investors will look back and ask why it was ever a debate as to whether sustainability is relevant in an investment context.

Another interesting development has been how we invest to support a more sustainable society. Ten years ago sustainable investing was quite small and mid-size company orientated. Investments tended to be in companies with a particular product that had a social or environmental benefit to it, a cog in a bigger sustainable agenda. Today our funds are more large company orientated. This is because many of the big social issues we face today, such as energy transition and electrifying transportation, need companies to solve them. Take cloud computing for example, which we think is much more environmentally friendly than traditional on-premises IT. To be a participant in this industry, a company has to build more than 30 data centres around the world, each the size of a football pitch. This requires a huge amount of money. Equally, the transition to a low carbon energy network needs a huge investment in renewable energy, which only large companies can afford. So the move from small and mid-size company investments, to a more large company bias has been another change we have seen in the last 10 years.

The final development has been the move from equity to equity and debt. Ten years ago, sustainable investing, including our product range, was mainly equity orientated. Equities have been the traditional starting point for sustainable investing, given the extra benefit of shareholder rights and influence, which debt investors do not get. Alongside this, there has historically been a lack of debt issuers with an explicit social or environmental benefit to them. This has, however, changed quite noticeably. ‘Green bonds’ have made the headlines, but even away from these there has been a sizeable increase in debt issuance from sustainable entities. The ability to work across equity and debt is very useful in being truly flexible in meeting investor requirements.

In summary, much has changed in the last 10 years. Investor acceptance of sustainable investing, a more sustainable society, and more relevant products means that sustainable funds can serve an ever increasing investor base. This leads us to believe that we are still in the early days of sustainable investing.
Corporate governance and sustainable investing

An interview with Sophie Johnson, Corporate Governance Analyst

Q What is your role?
A My role is to provide detailed governance analysis on current or potential investments in the funds, engage with companies on governance and social issues, and oversee proxy voting across both our domestic and international shareholdings.

Q What is corporate governance and why is it important?
A In essence, corporate governance is about how a company is run, from the Board of Directors at the top to the processes and procedures that filter down a company. As investors we cannot get first-hand knowledge of the internal workings of a company, but we want to know that our investments are being properly overseen by their directors. One of the most important but often controversial conversations we have with companies is around CEO succession planning. If something unforeseen were to happen to the CEO, is there a plan? If not then we start getting worried!

Q Is there evidence that good corporate governance results in better outcomes for investors?
A Yes. Particularly in markets where governance standards are more fluid. Market research shows that over longer time periods, companies that have good governance outperform and are more stable. It’s often hard to quantify on an individual basis, as much of what we do involves avoiding the very poorly governed companies or working with others to promote and encourage them towards high standards.

Q How can you tell a well governed company from a bad one?
A There’s no straightforward answer to this question. Despite having governance codes and best practice standards, each company and market is different and needs to be reviewed on its own merit. Not ticking certain boxes is not necessarily a sign of a poorly governed company; rather there are certain red flags we look for. By being discerning on this front we have avoided investing in a number of companies that have subsequently suffered from corporate scandals and accompanying falls in share price. There is a lot of work behind the scenes with companies getting them to improve their practices with a view to avoiding potential issues, but the problem is it can be hard to prove the absence of something!

Q How do corporate governance standards vary around the world?
A Corporate Governance Codes outline best practice, and whilst there are many similarities across markets, we also have to take into account local laws and customs. As an example, in the UK a Board of Directors is required to be majority independent, the CEO and CFO sit on the Board and there is an independent Chairman overseeing the Boardroom. In the USA however, it is very unusual to see a CFO on the Board – two thirds of the Board should be independent and the CEO and Chairman roles are often combined. In Europe there are jurisdictions that mandate a number of employee representatives to be on the Board, and in Japan you will still likely see only one or two independent directors. When assessing a company we have to consider what we think of as best practice for the market, our minimum standards and whether the company meets our threshold.

Q Do you have any examples of companies with outstanding corporate governance?
A Croda, a UK speciality chemicals company, consistently outperforms its peer group on both governance and wider ESG grounds. They meet the high UK governance market standards, there is a high degree of transparency and communication with shareholders and they have a very strong internal culture. This then shows through in their leading approach to a number of environmental issues.

Q What is your view of pay and the controversy it creates?
A Pay is always controversial and what I spend the majority of my time on. Our view is that if a company or CEO has truly performed exceptionally then they may well deserve to be paid in accordance with that. That being said, a large number of companies maintain incredibly complex pay schemes that routinely pay out regardless of underlying performance or the shareholder and employee experience. We look for companies to implement sensible, straightforward structures that are tied to both financial and non-financial performance, and show alignment with their workforce.

Q What are the key issues you are talking to companies about?
A While boardroom independence and remuneration tend to make the headlines, one of the most interesting issues we speak to companies about is their culture. An FRC report from 2016 detailed just how important corporate culture is in driving long-term business success and protecting value. A company with a strong culture is one that responds better to crises, adapts and grows with its workforce and they are often the best governed. This is a wide ranging topic that influences pay, diversity, risk management, employee engagement and retention among others.
What is a sustainable company?

One important question we are often asked is, what is a sustainable company? This enquiry often comes from there being many different definitions and terminology being used. Here are some key points to think about when considering sustainable investment:

- Sustainable and ethical are not the same – sustainable investing is about positive investment choices, ethical is about avoiding certain areas. Sustainable funds look to support the transition to a healthier, cleaner, safer, more inclusive society. Ethical funds look to avoid certain areas such as armaments and tobacco. They are two sides of the same coin however, with many areas avoided by ethical funds failing the positive test that sustainable funds apply.

- The products and services of a company – the starting point for considering if a business is sustainable is looking at its products and services. There are industries and companies, such as healthcare and technology, that have a long history of catalysing social and environmental improvement, and industries such as oil & gas and mining, that have been problematic. Often a simple look at the products and services of a company can give a good indication as to its sustainability.

- Environmental, social and governance (ESG) standards – alongside looking at the products and services of a company, a thorough examination of how a company manages the ESG risks and opportunities it faces is also a good indication of how sustainable it is. Good ESG management tends to correlate highly with positive social impact.

In summary, an understanding that sustainable investing is about positive investment choices, rather than avoidance, and a focus on products and services as well as ESG standards in a business, will help define what ‘sustainable’ means.

Company snapshots

We are often asked why we invest in the companies we do. There is no single definition of sustainability, and the judgement as to whether or not a company is sustainable is often subjective. Here are some snapshots of companies we own, to help you understand why we think them suitable.

**ADIDAS**

Not only is Adidas an ESG leader, but its products bring a benefit to society in that they facilitate sport, exercise and health. Adidas is spearheading the industry’s efforts in product stewardship through reduction of resource use throughout the supply chain and sourcing of sustainably produced materials. Demonstrating that sustainability really is integral to the business, Adidas articulates sustainability as a pillar of its strategy and key to contributing to its lasting economic success.

**ALPHABET** (the parent company of Google)

Alphabet is approved on the basis of its products and services. As a provider of information search and knowledge via its Google website it creates products that are socially useful and have the power to transform society in how we interact and share information and knowledge. The Android operating system, which is in the majority of smartphones globally, has been fundamental to the roll out of mobile telephony in developing countries. Alphabet’s model of supplying the operating system for free, in return for being the default search engine from which it can derive advertising revenues, has allowed mass market low cost mobile phones to be sold in developing countries.

**ANSYS**

Ansys, a provider of computer aided engineering (CAE) software, is approved on the basis of its products and services. CAE software aids the development of simulation technology that can be used by engineers in the design and manufacturing processes to reduce environmental impacts. Its products facilitate real-time analysis of operational data, which helps increase machine efficiency and reducing operational costs.

**CSX**

CSX is approved on the basis of its products and services. Rail transportation is significantly more environmentally friendly than road and air. Rail’s share of energy consumption is less than 2% despite a market share of 8.6%. In the US, one train can haul the equivalent of 400 trucks. As a leading provider of rail freight services in the US, CSX has a benefit to society.

**ROCHE**

Roche is deemed suitable for the sustainable funds due to its role in the creation of medicines to treat disease and illness. Roche is a leader in genetic medicine in the main due to its ownership of Genentech, a US based biotechnology company. The company is a leader in cancer treatment, which is the second leading cause of death globally. As genetic medicine develops, through gene editing and gene therapy, we expect Roche to be at the forefront of this.

**Unilever**

The primary case for inclusion is centred on the sustainable business practices of the company and its ESG leadership. Unilever is widely regarded as a leader in its industry with respect to environmental and social issues. The company makes strong efforts to minimise its environmental impact throughout its product life cycle, from raw material sourcing to packaging.
Our current equity themes

Themes can and do change over time. We think it’s important to have the flexibility to evolve as society evolves too, ensuring that at all times we are investing in the most relevant themes and the ones most likely to deliver strong investment returns. Our current themes include:

- **Industry 4.0**
  Steam was industry 1.0, electricity 2.0, and the computer 3.0. Industry 4.0 is data and using it to bring together the physical and digital worlds to enhance the efficiency of a range of existing industries.

- **Agriculture and naturalness**
  Demands on food production will continue to grow as demand for protein is linked to rising wealth, particularly in developing countries. The current system, based on the use of chemicals to enhance production, needs to be changed for smarter, more natural methods of food production.

- **Artificial intelligence and cloud computing**
  The exponential growth in the amount of data in existence, and in computing power, is allowing data to be used to make better decisions in areas such as healthcare diagnosis and energy usage.

- **Electric/autonomous vehicles**
  Transportation remains one of the major sources of pollution due to the use of combustion engines. Cars are also the source of many deaths and injuries. Electric and autonomous vehicles offer the opportunity to move transportation into a cleaner, safer future.

- **Next generation medicine**
  The current healthcare system is based on diagnosis methods and drug treatments that are slow and often ineffective. The ability to extract more accurate and timely health information from our bodies, and the ability to obtain our individual genetic profile, offer the opportunity to significantly enhance the standard of healthcare.

- **Social infrastructure**
  Areas such as water and electricity still require significant investment in the future for developing countries to be fully connected and also improve the way they are delivered in developed countries. Other areas such as social housing are relevant to this theme too.

- **Energy transition**
  The way we have historically extracted energy from the sun is via fossil fuels. Renewable energy, such as solar, offers the opportunity to extract energy directly from the sun in a cleaner more sustainable manner.
 Perhaps the largest issue of the day is climate change and its impact on the environment. Although climate change is a somewhat complicated issue, one key contributing factor is the emission of carbon from burning fossil fuels, primarily oil, gas and coal. This has led many investors to ask how they can support the transition to a cleaner energy mix.

In a historical context the planet has only used fossil fuels in the last 150 years. Previous to that windmills, waterwheels and other such inventions meant that society was essentially fossil fuel free. However, the amount of energy produced by wind and water was not sufficient to support human endeavour and the desire to create new industries. This meant as society industrialised, a more intensive form of energy was needed: fossil fuels. It is possible to take a view that the use of fossil fuels has, up until recently, been a social positive as it has enhanced the economic and human welfare of most people on Earth. We would not be able to commute, store food or communicate over long distances without it. Like all good things, if taken too far this can become a negative and that is where we are now. An overdependence on fossil fuels has begun to have important consequences, from climate change to air pollution. It is now time to go back to where we started and harness more energy from renewable sources.

The good news is that technology has moved on significantly from windmills and waterwheels. Wind turbines and solar panels offer increasingly affordable and scalable alternative sources of energy. It is those companies involved in these areas we are investing in.

Orsted, a Danish company, is the world leader in offshore wind energy. There is a significant opportunity in Europe and the USA for Orsted to design, construct and operate large wind farms. SSE is the UK leader in renewable energy with a target of trebling renewables output by 2030. These are highly credible companies for investors who want to support the transition to a low carbon energy mix to invest in and they are both owned by our sustainable funds.

Engagement

Engagement with companies on strategic, governance, and environmental and social risk management issues forms a core part of our stewardship responsibilities. It is an activity that all of our clients have come to expect from us as a long-term asset manager. In the last six months we have engaged with six companies owned by the sustainable funds, on issues such as remuneration, the environment and labour relations. Here are two examples of the work we have been doing:

**SSE plc (Scottish & Southern Electricity)**

We held a meeting with Alistair Phillips-Davies, the CEO of SSE to gain further insights into how the company’s strategy was pivoting towards both renewable energy and the further electrification of power networks. As part of this, we broke down their key sustainability targets, with the CEO noting that their target of trebling renewables output by 2030 was covered by their existing offshore wind pipeline, suggesting that they may be able to go further in the renewable energy space. We also discussed the potential for incremental improvements to their hydro-electric generation capacity.

It was also encouraging to hear that their sustainability strategy was already resonating with its largest business customers, and we came away convinced that its twin focus reinforced its position as an environmental leader within the utilities sector. As further evidence of this, a couple of weeks later the company announced that it was closing the last of its legacy coal-fired generation capacity.

**HSBC Holdings Plc**

Along with a small group of other investors, we joined a round table discussion with HSBC’s CEO John Flint and a number of specialists at the bank to discuss the company’s approach to sustainability. We came away with a better understanding of both the opportunities and risks facing the bank, including their $100bn green financing target and the decision to tie measurable sustainability and culture metrics into the CEO’s long-term remuneration. We used the opportunity to raise our own questions on how engrained sustainability was in the bank as a whole, including the reaction of staff to HSBC’s decision to opt for a low-carbon equity default within their own pension scheme. Overall, while the size of HSBC means that it is exposed to a broad range of ESG risks, we came away with a stronger conviction that the bank has both the policies and reporting in place to manage many of these.
Our fund range

Our funds are designed to work both as single funds and as a suite. We range from 100% fixed income to 100% equity, with three mixed asset funds grading upwards in between. The aim is to ensure that whatever your risk profile, income or capital requirements there will be a fund to match your objectives, all within the same RLAM sustainable investment process.

We also offer a segregated, bespoke, service for institutional clients with their own requirements. We can tailor asset allocation, with both equities and fixed income, either UK or Global, and embed sustainability criteria to match exact specifications.

For illustrative purposes – reflects approximate percentage asset allocation, weightings may vary.

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

Source: RLAM and FE as at 30 June 2019.

All fund performance shown is based on the C Acc share class, which is the clean share launched post RDR except for Sustainable Diversified Trust which is C Inc share class.
For further information about our sustainable investment capabilities, please contact us.

**Royal London Asset Management**
55 Gracechurch Street
London EC3V 0RL
020 7506 6500
institutional@rlam.co.uk
bdsupport@rlam.co.uk

The views expressed are the author’s own and do not constitute investment advice.

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