SUSTAINABLE INVESTING

What you need to know

June 2023

FWU Life Insurance Lux S.A.

In this short, three-section white paper, we unpack 'sustainable investing' for you, and explain all the important aspects worth knowing. Read on to get to know more about the most important investment revolution of our time!

AN OVERVIEW

Up until around 10 years ago, investors possessed a very narrow mindset when it came to choosing their investments: it was all about the bottom line. The only thing that mattered was how a company was doing on its income statement and how its balance sheet looked; investors wanted companies to only focus on profits and rewarded those firms that did so with the most emphasis.

The famous economist – Milton Friedman – exemplified this view perfectly when he noted that 'There is one and only one social responsibility of business — to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.' So, what mattered first and foremost were the shareholders, who in turn also only wanted the company to focus on generating higher bottom lines.

Then, however, the financial crisis of 2008 came. Driven by an excessive, short-term focus on profits inside the banking sector, the entire global economy was brought to its knees, and many countries struggled with slow growth for years to come.

Arising out of this crisis, though, was an increasing sense that profits should not be the sole focus of a company; it could end up being detrimental to the wider economy and society, as the crisis of 2008 showed. Investors increasingly saw the need not just to look at how a company's revenue/income numbers were doing, but also look at companies in a wider context, increasingly asking themselves, for example, whether adequate risk controls were in place, even if high profits were being generated.

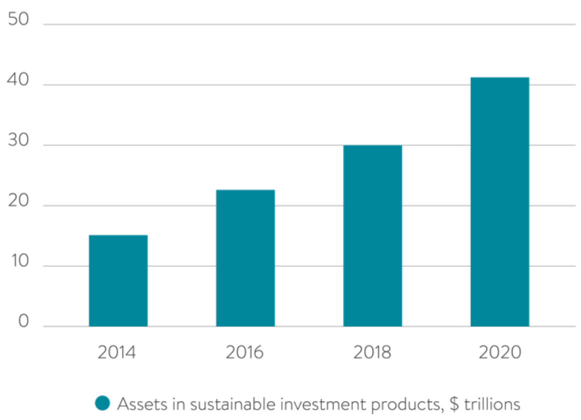
In the years that followed the Great Recession, changes throughout wider society also started to accelerate. The crisis had accentuated the rifts between upper and lower classes, leading to wider societal concern around inequality, and thus also labour rights and in general for a more employee-friendly form of capitalism. LBQT rights also started to be heavily championed in these years, leading to, for example, gay marriage being legalised in many countries, and overall, a much more accepting environment for people of different sexual orientations, with the intention to eradicate any form of stigma. Women's rights also saw a major push during this period, with, for example, the MeToo movement, whereby some of the previously unspoken discrimination and exploitation of women in the workplace was laid bare.

Arguably, however, the most important societal change over this period was the rising concern around climate change. While climate change had been known about for a while, what we have witnessed over the past 10 years, which has further accelerated over the last 5 years, is an increased urgency to act. Climate scientists have been vehemently sounding the alarm bells, as the evidence of manmade climate change became overwhelming throughout the 2010s. And given more and more extreme weather events in recent years, these concerns have accelerated even further.

So, taken together, the last decade has generated deep and structural societal change, which has led us in a direction of a more inclusive, fairer socio-economic system, with a strong sense of responsibility for the environment. Only by moving in this direction could our societies become sustainable on a long-term basis. Societies still based around profits at all costs, in which discrimination of all kinds was accepted, would simply not last.

These structural changes in society have, of course, also had a major impact on the investment world, which does not operate in a vacuum, but rather, mirrors and reflects these wider changes. This is where we get the rise of 'sustainable investing' i.e. investing with the above changes and new concerns taken into account, which in turn should also help us move societies onto a more sustainable footing. As a result, sustainable investing has started to grow tremendously, to the extent where soon it will become the norm, and the old ways of thinking will soon be forgotten.

Fig 1.: Sustainable investing is going mainstream… quickly.



Source: Bloomberg

SUSTAINABLE INVESTING IN PRACTICE – THE RISE OF ESG

We know that sustainable investing has grown massively in recent years, but the next question is how is this concept implemented by investors? This is where the ESG framework comes in, which stands for Environment, Social and Governance, and allows investors to form a much more holistic picture of a potential investment, going beyond just looking at traditional metrics of profitability.

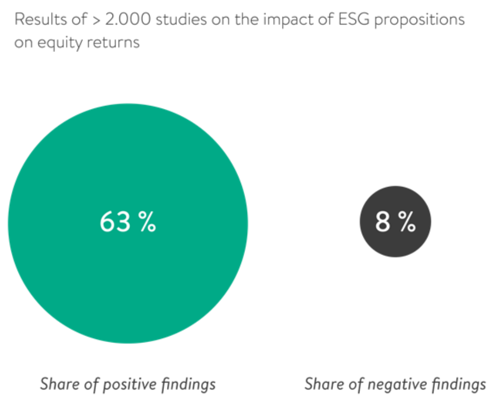
Each part of ESG constitutes its own pillar, so E, S and G are looked at and analysed separately. For example, by taking the (E)nvironment pillar, it forces the investor to think about what kind of environmental impact a company has, which ranges from simply ascertaining its carbon footprint to much more granular analysis, taking into account such things as its waste management policy, pollution levels, how it uses its water resources and whether it produces in potentially water-stressed regions. The aim is to give investors a thorough idea whether a company is taking responsibility for its impact on the environment, and in doing so whether it is taking risks or not.

What about the '(S)ocial' pillar? This is usually split into two sections: internal and external. The internal facet to the S pillar refers to how a company acts towards its internal stakeholders, most important of which are the employees. What investors look for here are things such as strong health and safety standards, adequate compensation levels, worker training programmes as well as non-discrimination policies. As for the external component to S, the best way to think of this is in terms of how the company engages with the local community it operates in, looking at for example if it is fulfilling its tax obligations to the best degree possible or whether it has community outreach and development programmes. Having all of this in place means the company is on a more sustainable footing and is guaranteed to continue to be able to operate in the future.

The final component of ESG – the (G)overnance pillar – is sometimes overlooked, but it is also critically important. It focuses investors into looking closely at the internal structures and culture of a company. More concretely, this means looking at aspects such as the composition of the board of directors, seeing if they are independent or not and if the CEO has too much power, or factors such as executive compensation – if this is extremely high and excessive, it tends to be a red flag. Importantly, through the G concept, investors can also see whether good risk control processes are in place throughout the company, by examining, for example, the audit function and/or gauging the risk management responsibility at board level.

So those are the basics of the ESG framework, which allows investors to 'operationalise' the sustainable investment concept. The next question, though, is whether incorporating these aspects will be detrimental to performance? It has been a much-discussed question in recent years, but the academic evidence is essentially conclusive that the incorporation of ESG criteria into an investment process does not have a negative impact on performance.[1] The vast majority of studies conducted on the topic have found that either ESG inclusion adds to performance, with only few studies showing a negative correlation to performance.

Fig 2.: ESG can add significant value for investors.



Source: McKinsey

1 See for example the follow 'meta' study: Friede, Gunnar, Timo Busch, and Alexander Bassen. "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Journal of Sustainable Finance & Investment 5.4 (2015): 210-233.

The fact that the inclusion of ESG can have a pronounced positive effect on performance makes absolute sense. Say, for example, a non-ESG investor was looking to buy a certain bank. The bank had a good-looking income statement, the balance sheet was fine, and the overall growth strategy looked highly promising. This investor would almost certainly want to buy stocks in this bank.

Now, however, say a sustainable investor with an ESG framework came to look at the same bank: he or she would, of course, see the same good numbers and strategy, but would also go several steps beyond. This investor would see, for example, using the G pillar, that the executives were paying themselves very large bonuses, while risk control functions are also not very important at board level, with few policies and processes defined throughout the firm. The culture appears aggressive and very short-term focused. And indeed, a few months later it turned out the bank was massively involved in facilitating money laundering in one of its branches, seeing the stock crash heavily.

The ESG-based investor, though, would have avoided this crash, as they would not have invested in the first place, given the low governance score. And thus, relative to the market and to other non-ESG investors, this investor will be better off. This is just one example and can apply across all three ESG components. For instance, if a company begins lagging in the E pillar, it is likely a sign it is increasingly neglecting its environmental responsibilities. ESG-based investors will tend to exclude this firm from their portfolios, as the risk of a major environmental scandal will heighten considerably, and with it the potential for a catastrophic drop in its share price.

The main message here, then, is that ESG incorporation will not have a negative impact on performance. Indeed, it can even have a marked positive contribution to performance through, for example, identifying key risks before they materialise and thereby avoiding big nasty surprises.

THE FORWARD QUANT SUSTAINABILITY APPROACH

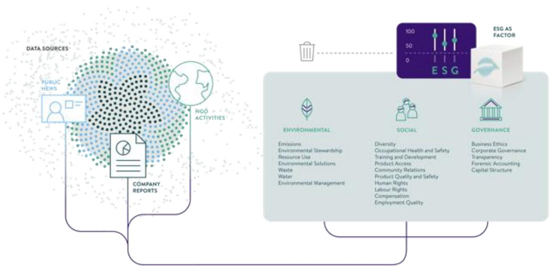
So, we have seen why sustainable investing has grown and how it has led to an ESG framework for investors, now let us have a brief look at how we incorporate sustainability into our Forward Quant funds. Investors in Forward Quant have two options when it comes to sustainable investing with us: they can either invest in the 'classic' Quant approach, which also contains ESG integration, or they can opt for full-fledged sustainable versions of our funds. We think the difference being between 'light green' funds and 'dark green' ones. There no longer is the option for no sustainability-related criteria being used in our products. We'll explain more below.

To start with, the foundation under all our funds, be that 'light' or 'dark' green', is the ESG framework highlighted above. In contrast to most other investors, however, we meld an ESG approach with Big data analysis. If you have followed our Quant funds for a while, or even if you have just briefly come across them, you will have noticed that we place a lot of emphasis on being 'objective' and 'data-driven' investors. And when it comes to implementing ESG we are no different.

In practice, this means we use algorithms to sort through reams of ESG data being produced on all companies in our universe. The data comes from three sources: from the reports from the companies themselves, from newspaper articles about the companies as well as reports from NGOs, which often report on company activities.

As you can see below, all of this data is then structured into each one of the three ESG pillars, and then subdivided into 'ESG topics', such as 'environmental management', falling under the E pillar, whereby we can analyse and measure such things as the number of environmental lawsuits a company is facing, or the amount of money being invested into resource efficiency initiatives. On S, we measure for example 'diversity', seeing to what extent women are represented at decision-making level as well as throughout the workforce, or 'training and development', where we ascertain how many hours of training a company provides per employee and the types of policies in place to monitor and promote this. On G, with the 'transparency' topic, we can see how open a company is being, about for example compensation structures for senior management as well as its reporting.

Fig 3.: The Forward Quant ESG process



Each one of these topic areas is, then, given a score from 0 to 100, with 100 being the best. All the scores per topic under each ESG pillar are added up, and the average forms the score for E, S and G. Once these three scores are defined, an average is taken, and the overall ESG score is determined!

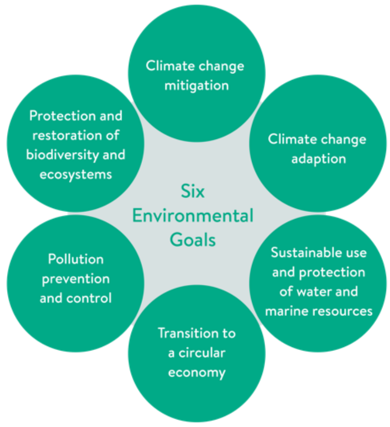
Subsequently, we cut down the investment universe. In both, the 'light' and 'dark' green versions of Forward Quant, this means we exclude companies with a score of less than 30, as these present the biggest risk from an ESG perspective. They are not the type of companies we want in our portfolios. Besides full ESG integration - as for the 'light' green funds - for the 'dark' green funds, Principal Adverse Impacts are also taken into account. Moreover, part of the investment is required to be sustainable as defined by the EU Taxonomy Regulation.

The EU Taxonomy refers to a policymaking effort in Europe that has identified the key areas where investment is needed to facilitate the energy transition. So, with the 'dark' green funds, not only is the idea to avoid companies proving unsustainable, but also to allocate capital to areas that are making a positive impact on the environment.

Being aligned to the Taxonomy means we invest in companies that helping in at least one of six critical sustainability areas, consisting of following: (1) pollution prevention and control (2) protection and restoration of biodiversity and ecosystems (3) climate change mitigation (4) climate change adaptation (5) sustainable use and protection of water and marine resources (6) transition to a circular economy.

At the same time, while every company we invest in must be contributing to at least one of these six areas, it also cannot do 'any significant harm' to any of the others. As you can see, this is an ambitious and exacting framework, and it allows to invest in a much more targeted sustainable way.

Fig 4.: The EU Taxonomy provides targeted areas for Forward Quant's sustainable investments.



Lastly, as we noted, on top of the EU Taxonomy, we also practice Principal Adverse Impact Analysis. This is not a particular way, or strategy, of investing, but rather a tool that allows us to garner better information on sustainability, which in turn can be relayed to our investors. It allows investors to see exactly how their capital is affecting key environmental and social factors . So, for example, this means being able to see what kind of carbon footprint is being left by the companies being invested it, what kind of water emissions they have, or how high their hazardous waste ratio is, and so on. The idea is that there should be no more 'sustainability unknowns', with the offer of full transparency.

CONCLUSION

The rise of sustainable investing should be seen as part of a wider societal transformation over the last decade: we are moving towards a more equitable and inclusive world, with an increasingly very strong sense of responsibility for the environment. The investment community is part of this change, and it is moving away from a pure profit-centred approach to investing to a much more holistic conception, which is seen through the rise of the ESG concept.

Through this concept, investors do not just look at immediate financial factors associated with a company, but place it in a wider context, seeing how it impacts the people and environment around it. Doing so helps foster increased social and environmental responsibility amongst companies, but crucially, also helps investors better identify risk, which in turn can also markedly help performance.

We at FWU are very much part of this process towards sustainability in the investment community, and if you do invest with us, you can be safe in the knowledge that we apply ESG criteria across all of our Quant strategies, underpinned by an innovative, machine-driven approach. If you wish to go one step further and be as sustainable as possible with your investments, this you can do with us as well, with targeted investment funds aligned with the EU taxonomy and with full sustainability transparency.

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**Light Green, for the purposes of this document, means External Funds promoting sustainable investments according to Art. 8 of the Reg. (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector ("SFDR"). For more details, please check the precontractual information of the respective product or the information available on https://www.forwardyou.com/en/products/reporting-center/.*
***Dark Green, for the purposes of this document, means External Funds promoting sustainable investments according to Art. 8 of the Reg. (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector ("SFDR"), which have a commitment to invest to a specific degree in Sustainable Investments according to both the SFDR and the EU-Taxonomy Regulation, and which take Principal Adverse Impacts into consideration. For more details, please check the precontractual information of the respective product or the information available on https://www.forwardyou.com/en/products/reporting-center/.*

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