DAVY | DWS

Davy Horizons PLC ESG Insight Series – DWS

Davy Horizons. **Helping you define sustainable solutions.**

Overview

On Wednesday 30th March, Davy Horizons launched our inaugural PLC ESG Insight Series event.

- This series provides the latest capital market perspectives for PLCs as they grapple with evolving shareholder demands for non-financial disclosure.
- We look from the ESG lens of the global asset managers, the core institutional shareholders that are becoming one of the most vocal stakeholders. Driven by end investor demand for more sustainable investments and societal pressure, they are accelerating at a pace ahead of sustainability regulation.
- Davy Horizons' objective is to provide practical insights into how they are configuring their investment portfolios to incorporate all non-financial metrics across the Environmental, Social & Governance verticals.
- Critically, we look at how ESG criteria are now becoming key determinants of their individual sector criteria to buy, hold or exclude company's equity or debt instruments from their portfolios.

At the webinar, we were delighted to be joined by Dr. Francesco Curto, Global Head of Research at DWS Group, one of Europe's largest asset managers with assets under management (AUM) of c.€928bn across equities, fixed income, alternatives etc. Importantly, Francesco has been a very active global equity investor for the last 25 years, having previously built out the CROCI (cash return on capital invested model) at Deutsche Bank's Global Valuation Group. Francesco is a financial returns focused investor, now challenged with incorporating non-financial or ESG criteria as key drivers of DWS's investment portfolios.

This report is an overview of the key insights and perspectives provided by Dr. Curto, on how DWS are evolving sustainability and integrating ESG in their portfolio assets.

Highlights

- Investors have moved away from just seeking maximisation of financial returns to saying they want to understand how financial returns are achieved and how sustainable the capital is? Sustainability means that you really understand the economic impact but also the societal and environmental impact.

- Non-financial reporting must have a defined standard that is trusted by everybody and independently audited, like financial reporting.

- 34.5% of DWS's total assets under management (AUM) is already Net Zero committed. The end objective is to put 100% of the assets across regions in scope by 2050. From that top-down basis, all portfolio holdings, such as individual company shareholdings, need to be to be Net Zero aligned.

- DWS is moving away from exclusions and divestments to engagement for change. If organisations like DWS want to be a positive driver, we need to engage with companies and with the world to transition together.

- It is critical that companies' sustainability objectives and targets are clearly aligned with science. Disclosure starts with CDP reporting, then Science Based Targets Initiative SBTi. For DWS, Scope 1 and Scope 2 data are fundamental but, in certain industries like automobiles and energy, Scope 3 data are most important.

- The portfolio manager needs to be able to see what a company is going to be doing, by when and how credible its pathway is. This is where the SBTi framework is very valuable.

- We need certain sectors today like cement, oil and gas, and materials. DWS uses the SBTi's Sectoral Decarbonisation approach to work with those companies that truly realise the extent of challenge and are doing something about it. That will allow DWS to buy companies that may only be cutting emissions by 20% or 30% within their portfolios.

- Sustainable Finance Disclosure Regulation (SFDR) is very important because it is about putting some standards in the world of ESG and Sustainability, but it is still evolving. It is based on three clearly defined buckets — Article 8, 9 and and a pool of six funds. The bulk of DWS's clients want Article 8 or sustainable funds. Currently, for these funds, they have to divest many sectors — this is not DWS's decision, it is regulatory driven for certain sectors and industries. At the end of 2021, €200bn of assets were held by DWS in Article 8 funds.

- If you assume that the economic life of assets invested today and returns are not going to change because of climate, then that is the wrong assumption. Companies need to start taking all these factors into consideration and begin the transition today — those companies are going to be the leaders and it is just a matter of time before the market recognises this.

- The biggest risks for companies are doing nothing, delaying or waiting. We need this journey of decarbonisation to start as soon as possible.

End investor

One thing that is very clear is that the ultimate investor has moved from just the maximisation of financial return to wanting to understand how their capital is having an impact on the world. We must all provide for that, so that they can make the correct decision.

Non-financial reporting

Non-financial reporting must learn from the evolution of financial reporting and have a standard that is trusted by everybody, and that standard needs to be audited by an independent party. Currently, the investment management industry is being tasked with defining what is good ESG? What is good sustainability? This does not work. We are conflicted. We cannot decide what is good sustainability and then implement it. We need something that does that for us. ESG rating agencies and third-party data providers are also currently conflicted as they are defining risk and at the same time selling risk analytics.

Net Zero

DWS is founding member of the Net Zero Asset Managers (NZAM) initiative. NZAM now has 236 global asset managers with c.$57.5trn in assets, including DWS, Ballie Gifford, Blackrock, BMO and Fidelity. All have committed to achieve Net Zero alignment by 2050, in line with the Paris Agreement. This means that all their constituent portfolios need to be Net Zero by 2050 and, from that top-down basis, all individual holdings, such as individual company shareholdings, need to be to be Net Zero aligned. DWS's first stage commitment is for 35.4% or EUR 281.3 bn of its total AUM in scope to be managed towards Net Zero. The end objective is to put 100% of the assets across regions in scope by 2050.

Engagement for change

DWS are adopting a barbell approach and are working with those companies that are transitioning to a sustainable future. We are moving away from exclusions and divestments to engagement for change. One of the key issues that we realised in the past last few years is that if we were holding an equity that has some "dirty assets" and we ask that company to divest, these divested assets keep on operating but we lose the power to proactively engage for change. Typically, these disposed assets end up being sold to private equity funds with very poor disclosure and, if anything, our experience has been that the CO2 emissions of these assets keeps on increasing. If organisations like DWS want to be a positive driver, we need to engage with companies and support them to transition together. Our approach is also multi-faceted; while climate is critical, it is intertwined with biodiversity, oceans and fresh water. The oceans take away 40% of CO2 emissions, so the health of the ocean is vitally important.

Based on science

As an asset manager, when we evaluate the pathway for those sectors and companies in transition, the economic life of their exposed assets needs to be modified to really calculate the true level of profitability, which is consistent with the path to Net Zero. Our starting point is with CDP reporting and then SBTi. It is critical that objectives and targets are clearly aligned with science and the GHG protocol, and the SBTi provides the reference for DWS's Net Zero ambitions. However, if you look at the portfolio of c.10,000 companies that DWS invests in, the majority of them may not be disclosing to SBTi. This means that, at the moment, we are working with the classic data providers to provide us with data inputs.

The practical challenge for portfolio managers is that they have an overall target of say 1.5 °C or 2.0 °C for their portfolio and they need to see the level of emissions that each individual company has. The portfolio manager also needs to be able to see what a company is going to be doing, by when and how credible its pathway is. This is where the SBTi framework is very valuable — it is complementary to normal financial reporting, defining the credibility of the measure in moving towards the decarbonisation target.

For us, Scope 1 and Scope 2 data are fundamental but, in certain industries like automobiles and energy, Scope 3 is the most important. Scope 3 is the area where we see the greatest data challenge. Currently, in the absence of comprehensive data from the companies, we are working with lots of different sources and data providers, cross referencing to ensure our decision making is correct. We are also engaging with the companies directly and hopefully the regulators will provide proper frameworks that help us all.

We need to operate within a framework that is neatly defined, otherwise we spend most of the time interpreting data rather than doing the right thing. The biggest risks are doing nothing, delaying or waiting for disclosure regulation to evolve. We need this journey of decarbonisation to start as soon as possible.

Hard to abate sectors

We recognise that we need to invest in every sector — each one is functional for global economic activity. While it might be easy to own the technology sector, we still need sectors like cement, chemicals and other materials. We use the SBTi's Sectoral Decarbonisation approach to define what companies are best in class within the same sector. It is about working with those companies to be the best, in terms of strategy implementation to transition to Net Zero within their respective sectors. In the end, we may find that certain sectors just cut the emissions by 20% or 30% and that is fine. We want to work with those companies that realise the challenge and are doing something about it. That will allow us to buy companies that may be cutting emissions by 20% or 30% within our portfolios.

The investment management industry needs to facilitate the transition in capital rather than just ticking the box and stating that its invested capital is very clean and that it doesn't care about what is happening outside — ultimately, that risk will come back to us. For pension funds, the biggest long-term risk is climate change so, while we can maximise our returns today by excluding certain industries in the short term, in 20 years' time we will still have the same issues.

EU Sustainable Finance Disclosure Regulation

SFDR is very important because it is about putting some standards in the world of ESG and Sustainability, but it is still trial and error. The EU has attempted to come out as regulator and put an ESG standard in place based on three clearly defined buckets. The first are light green funds, also known as Article 8 funds, which have environmental or social characteristics. The second are dark green funds, or Article 9 funds, which invest specifically in highly-rated environmental and social companies. Lastly, investments classified as Article 6 are traditional products that are not focused on sustainability.

The bulk of DWS's clients, which include pension funds but also other financial institutions that distribute their products, now want Article 8 or sustainable funds that do "no significant harm". At the end of 2021, DWS had €200bn of assets in Article 8 funds. For these Article 8 funds, it must divest or exclude many holdings — this is regulatory driven. As a result of this shift, there are a lot of constraints on its ability to invest in certain sectors.

The SFDR will evolve further and if you are in the hard to abate sectors, the challenges are there, but we need to make the regulators aware of the full implications of some of these standards. With SFDR, we have already seen some of the shortfalls and we will probably see a rebalancing going forward, with a bigger shift towards engagement for change rather than exclusion.

Conclusion

The story of this discussion is that it is a complex world which is evolving — we do not have certainties with data, regulation and lots of things. But, one thing is very clear, we have moved from investors just seeking maximisation of financial returns to those saying they want to understand how they are achieving that financial return. Is there child labour being used in the supply chain? Are lakes and mountains being destroyed as a result of this? How sustainable is this capital? Sustainability means that you really understand the economic impact but also the societal and environmental impact.

While the regulatory backdrop will continue to change, companies need to prepare for this now — they should not delay. If you take the fundamental principles of how to become sustainable from the economic frameworks available today, then you are already leading the way. The evolving reporting and regulatory issues will be resolved eventually.

If you assume that the economic life of assets invested today and returns are not going to change because of climate, then that is the wrong assumption. Companies need to start to take all these factors into consideration and begin this transition today. The biggest risks are doing nothing, delaying or waiting. We need this journey of decarbonisation to start as soon as possible. Companies that start to recognise this today will be the future leaders — it is only a matter of time before the market also recognises this.

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