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ADAM GILLETT: We've shown that if people see a threat as urgent and as big as COVID, then we can completely change the way that we act and behave and function as a society almost overnight.

SPEAKER 1: Welcome to the PODfolio. Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolios.

LOK MA: Hello, and welcome to this episode of the PODfolio podcast with your host, Lok Ma. Sustainable investing, now that's a theme that's run right through quite a few of our previous episodes, but it's now time to go in depth into what's arguably the hottest of the investment hot topics right now. And not just in a talky sense, but in terms of taking some real action, as well. So I'm delighted to welcome to the show Adam Gillett, our head of sustainable investment at Willis Towers Watson. So welcome to the show, Adam.

ADAM GILLETT: Hi, Lok, thanks for having me.

LOK MA: And also Shahrazad Khan, who is a sustainability specialist with a range of advisory clients. And so welcome to the show as well, Shaz.

SHAHRAZAD KHAN: Hi Lok, great to be here.

LOK MA: So now let's just kind of set the scene, a bit. And looking back on a very eventful 2020, two of the major themes have got to be COVID and climate change. And I think it's interesting to see the interaction between these two. And I've come across a couple of statistics that I found quite intriguing. I just want to run those by you. The first one is that in the first half of this year, global carbon emissions were 9% down on the year before because of the lockdown.

And then the second statistic is that if we want to keep climate change under control, we need to try to halve our carbon output by 2030. So even with much of the world coming to hold people not traveling, factories shutting, all of that barely made a dent compared to what we need to do over the long term. So am I right to feel kind of a little bit daunted by the size of the task that's facing us?

ADAM GILLETT: I think you're absolutely right to feel daunted, to be honest, Lok. It's an enormous task. So tackling the climate crisis, the crisis of inequality, biodiversity collapse, and many more. It's an enormous and really urgent challenge. And the extent of the change that we need to make is completely broad across all areas of our society, financial systems, economies, and really, really deep and fundamental, too. So yeah, it's a pretty big challenge.

To your stat, so just a halving in context, halving in a decade, then that's about 7% a year. So it's doable, but it's going to be really, really tough. And it might sound a bit flippant to talk kind of interesting lessons from COVID or something like that because it's been so traumatic and really, really horrendous for nearly everyone around the world. But I think COVID has taught us a couple of things that give me some cause for optimism.

Not that I'm the biggest cheerleader for optimism, you'll find, I'm afraid. But there are some causes for hope through it. And the first is that I'd say that we've shown that if people see a threat as urgent and as big as COVID, then we can completely change the way that we act and behave and function as a society almost overnight. And so if we can recognize things like the climate crisis, biodiversity collapse, and inequality as the urgent and enormous threats that they are, then there's hope that we can make these completely fundamental changes to how we organize ourselves.

And the second point I'd make with that, is that for me, I think 2020 has been a bit of a watershed moment for a lot of people. Watershed in terms of recognizing and realizing the extent of these crises and how important and how urgent they are, and that our systems are actually pretty vulnerable and pretty interconnected. And once you've had that watershed moment, that watershed realization, you can't unlearn it, you can't unrememeber it.

And hopefully once you're down the sustainability path as Shaz and I have been for a while, like our passion only grows. The urgency with which we act only grows. And so I think that there's hopefully going to be a whole band of people that have recognized the scale of these challenges through 2020 and are now absolutely determined to act on that.

SHAHRAZAD KHAN: Yeah, just to add to that and kind of echo what Adam's been saying, I think there is always a need for optimism. We can all clearly empathize with people such as yourself, Lok, who are discouraged. I mean, half the world's population were basically staying put, at some point. And that has barely impacted emissions. Unfortunately, the reality is that fossil fuels are just so embedded within our lifestyle choices that even when we are being couch potatoes doing nothing, there is a huge amount of carbon even in the most sedentary of lifestyles.

And so the problem of emissions is not going to be changed in one year, five years, or even 10 years. You already know the stat that we're expecting a tripling of the economy by 2050. So that means we will need three planets. There are going to be 10 billion people in the world, all aspiring to a middle income lifestyle, probably worse if the Kardashians are anything to aspire to.

So we simply know that consuming at this rate is not going to be possible. So as Adam says, unless the reduction in emissions reflects structural and permanent changes in our economic systems, in our transport systems, in our energy systems, i.e. The way we live and consume, then emissions won't reduce. Governments know this. And on the positive side we can be encouraged if not by the rhetoric, then actually by the policy announcements coming out both here in the UK and abroad.

LOK MA: Yeah, and Shaz, when you talk about being a couch potato while still consuming resources, I think it's very much guilty as charged at this end. Let's talk about the role that we play in the investment world in all of this. Our topic, of course, is sustainable investment. So can you just first of all explain the differences between some of the terms that people use in this area? So you know, we've got things like ESG, we've got sustainability, and also stewardship. Adam, are these all talking about slightly different things?

ADAM GILLETT: They are to an extent. And there are an awful lot of terms and even more acronyms in this area. What we say and how we talk about it is to use sustainable investment, sustainability is the umbrella term if you like, the overarching concept. And some of the big pillars within that would be things like ESG and stewardship. So environmental, social, and governance factors, for some people is almost synonymous with the subject. But it's a huge part of it. And then similarly, stewardship.

So being an active owner, engaging with your underlying assets, engaging at a system level is another huge component of sustainability, of sustainable investment. So there's almost an alphabet soup of acronyms out there, huge number of terms. But I guess for shorthand and for simplicity, we'll stick roughly with sustainability and sustainable investment to talk about the broad church of everything that goes on under this banner.

LOK MA: And I mentioned COVID at the beginning of this episode. What kind of lessons is COVID taught us about ESG investing, Shaz?

SHAHRAZAD KHAN: So it has taught us that ESG investing is very much here to stay. We've all been watching the investor flows this year into ESG funds, with the recent stat that's caught many people's attention from Morningstar. That over the first three months of this year, there was more invested in ESG funds than in 2018 and '19 combined. So really, investors that were already trying to increase their exposure to companies scoring well on ESG will have been justly rewarded.

If nothing else, from a supply demand perspective, i.e. the momentum effect of all these investors piling into those stocks. But then also, and we as a firm, WTW, believe this, from the actual ESG performance that's led to more resilient risk and return profiles over the period. So investors have done very well for basically these reasons.

Another really important thing that ESG investing has kind of taught us this year is about the visibility of companies, particularly for the end investor. So that means pension scheme members for most of our clients. So we'd already been seeing a lot of grassroots interest from members. They want to know what's in their pension pot, i.e. looking under the hood, and once they find this out they want to know whether these companies are actually aligned with their values and beliefs.

The great news is the crisis has showcased the role that these good businesses can play. Particularly in how they've taken care of their employees, especially the lower and more insecurely unemployed. As well as those that have taken efforts to contribute to public health outcomes, whether that be supplying supplies to key workers, offering discounts to the NHS like we saw with Deliveroo, or actually the senior executives of those companies forgoing bonuses over the period, and setting a really good example to the other employees within their company.

ADAM GILLETT: I certainly agree that this year the spotlight has really been on the S of ESG. And maybe that's been the unloved one of the trio up till now. So people have be really comfortable with G, governance, for a long, long time. E, which has almost been synonymous with climate change for people, has been right at the top of the agenda for the last couple of years. But S has certainly come into its own this year, inclusion and diversity workers rights.

The whole idea around a health pandemic and how people are responding to that mental health, Black Lives Matter huge, huge movement as well. And so I absolutely agree that

that's kind of got its moment in the sun. And I really hope that it continues to get the attention that it really deserves going on.

LOK MA: And just to be clear with our listeners because I've been caught out by this. The S in the ESG, the one that's getting more of the limelight now, that stands for the social aspect, not sustainability or stewardship, which also starts with an S. So I often get confused with that. So can I just ask you maybe to give an example of good practice? And then perhaps another example of bad practice in this kind of social context, in a way that affects a company's performance, both in an operational sense and in the market performance, as well. So Shaz, should we start with you?

SHAHRAZAD KHAN: So if you really want to link S issues to company performance, then we know, for example, employee satisfaction, i.e. how happy you are to be at work, will impact your productivity. So those of us who are lucky enough to still have a job at the moment will definitely have taken note of how our employers have treated us.

Even for the largest and most successful global companies, a really key link between social risks and performance is sometimes the sharp and sudden reputational damage that can come about from discovering a part of your supply chain has perhaps not been so well looked after. So fixing then on this year, the really great companies that stand out in setting really good examples to their employees and to the wider company market, was an example from Tesco. So they provided all employees with 12 weeks of fully paid leave. And that's to all employees who were vulnerable because of pre-existing health conditions, who were pregnant, or over 70. So we've really seen management quickly change tacks and rectify situations where they haven't been doing as well, as well as those companies who wish to set an example to others really using this is an opportunity to do so.

ADAM GILLETT: And not to add too much negativity to a lot of really good positive actions and examples from companies that there certainly been, but there have been a few major missteps. And they've certainly got into press headlines, as you'd expect. So Shaz mentioned supply chain management. I think that's one that's really come under the spotlight recently, particularly in areas such as fashion and food retail. A couple of high profile names that saw an awful lot dropped from their share price overnight on that front.

And then I also think that the human rights management, workers rights, I think is going to become increasingly important, and rightly so. And so that was an example not too long ago about a pretty horrendous example, actually, of violating a culturally important heritage site over in Australia. Won't take too much googling to give away the name on that one. But I think it just demonstrated, and as the company admitted, just not really understanding the issues and thinking through the issues as well as they might have done. And I think the spotlight on those kind of practices is only going to become sharper. That's going to be a really good thing.

SHAHRAZAD KHAN: And just to add to that, I guess, because often we sit in a very different part of the world. Their company HQ can often be very far removed from the places where the primary commodity is being mined, or where the factory workers are sitting. And so even if you know that your direct team, your direct business unit has got nothing to do with the scandal that you're hearing about on the part of the world, employees can often feel a lot of shame working for that company. Which of course, leads to poor productivity, and in the worst cases, turnover.

I mean, I say worst cases, but I think it's actually quite a heroic act to leave your company on the basis of your values and principles. So that's something that people really need to be aware of in this very global world we live in, what's happening in another part of the world can directly impact employees all around the world.

LOK MA: All right, and thank you both for these examples. So let's kind of dive into the details now of sustainable investment, and look at the evidence that's available. First of all, is the data showing that ESG friendly portfolios have done better or worse during the crisis?

ADAM GILLETT: So I'm going to give a short answer, briefly popping off my consultant fence, and say, yes. And then I'll jump back on to say that, it's a short horizon. The COVID pandemic certainly isn't over, and so you can't draw too much into it. But there's an awful lot that's been written about how well ESG has done, and I think quite rightly.

And you'd expect that. It kind of makes intuitive sense that those companies that are understanding their employees and their supply chains best are mindful of their impact on the environment, or set up in with that sustainability mindset have best navigated this crisis. And so I think it's been, again, a good case study into some of those issues about whether ESG pays off or not. And I think it's helped build the case, which is overwhelmingly strong in my opinion, on that.

What I would also do is kind of look out to the future, because really that's what people are interested in. What's the future performance? What's the future risk return, risk and opportunities, out there? And there's an awful lot of talk about a green recovery, a building back better, building back greener. And so I think there's an awful lot of opportunities there for sustainability tailwinds, for green tailwinds, and the investors that position themselves intelligently now to take advantage of those trends are going to reap the benefits for years to come.

LOK MA: And this next question, I think Adam, is maybe putting you on the spot a little bit more as well. In the last episode we had on inclusion and diversity, we talked about how a strong I&D culture could add something like 20 basis points a year to the total portfolio return. Is there an equivalent figure that you could possibly kind of give us roughly for ESG friendly investments?

ADAM GILLETT: I love how you've caveated that for me pretty well in advance. I'll add a few that obviously, I don't know.

LOK MA: Not just sitting on the fence, but this is like super sitting on the fence, right?

ADAM GILLETT: Absolutely. So I would say that there's a few things that you could look to. But it's got to be material and it's going to be meaningful. I would personally put it a bit higher than that I&D figure, that culture figure. Some of my more intelligent colleagues than me, from our Thinking Ahead Institute did a fantastic piece of work on long horizon investing and on the long horizon premium a couple of years ago, that pointed to between 50 basis points and 1 and 1/2 available there depending on your set up in your governance.

And long horizon investing is kind of a huge part of sustainability, and for some people it might be synonymous. So that gives a good order of magnitude. There were some studies out there about stewardship, there are some studies about ESG company performance, relative performance. But I'd maybe also go back to that future point, thinking where are the most risks and opportunities out there in the future, in the coming five years, 10 years.

And for me so many are sustainability related. How we're good active managers going to find an edge and find something they can exploit to deliver alpha. For me, sustainability, understanding ESG, stewarding assets, has got to be a huge part of that. And similarly, for asset owners positioning their portfolios for the big risks and opportunities, to kind of thematically and systematically take advantage of. For me, that's sustainability orientated. So I've danced around it, but I have given you some numbers.

LOK MA: Oh, I will take that, actually. I mean, it is interesting because you've mentioned at the beginning of this, being maybe pessimistic about some things. This seems like a very optimistic view of sustainability investments, actually, I was thinking as you were answering. Whether it takes a pessimist or an optimist to do what you do, to be full time working with in this particular area. Well, I haven't got time to go into that, I'm just going to throw it out there.

SHAHRAZAD KHAN: Well, no politician ever got elected not in the back of a campaign of negativity.

LOK MA: That is very true. That is very true. But anyway, I mean what we're saying is the financial impact is very much material in the context of that total portfolio return. So let's talk about how to do this in practice. So in terms of how you build ESG into the way that you pick your stocks to invest in, people have been talking about excluding the naughty stuff, say, for some years, things like tobacco, and weapons, and what have you. And what do you think about that sort of approach?

SHAHRAZAD KHAN: Yes, so exclusions have been common for a very long time now. Interestingly, they actually began in the US many decades ago. So lots of faith based institutions, i.e. churches, had accumulated a lot of money and wanted to invest it in such a way so as to avoid the so-called sin sectors. So adult entertainment, alcohol, gambling. Exclusions have definitely evolved since then as they've come across to Europe and just globally, as data around company activities and how companies generate their revenue has really improved.

So we've seen lots of exclusions about some of the stuff we've mentioned already. So the climate focused ones on coal, fossil fuels, and then social concerns like gambling, labor rights violations, et cetera. There are also the more kind of snazzy exclusions that people talk about less, but are still considered important by some investors. So things like animal testing, or fur, or even genetic engineering.

So however you want to call it, exclusions, divestment, negative screening, they're all really variations used to describe removal of certain companies or sectors from your portfolio. And we, WTW, definitely believe that such approaches are a really valid part of the investor toolkit and should be used where relevant, necessary, or helpful.

So many active managers will exclude companies already, whereas index or passive indexation manages, we've yet to see them include exclusions as standard. But there are certainly interesting conversations going on as to whether the kind of common controversial weapons or worst human rights violators should actually be taken away from the mainstream indices as the default setting.

We actually believe that it can make sense in particular to combine exclusions with strong stewardship priorities. So particularly where exclusions can have greatest impact is where removing the very worst companies from your portfolio that usually contribute disproportionately to negative outcomes away from your opportunity set. So for example, we all know that 100 companies that produce 2/3 of the world's global emissions. So in that sense, if you want to just exclude a very small handful of the thermal coal companies from your portfolio, that can have a really great tailwind for your emissions profile.

Specifically, I guess for the DC space, we have seen a lot of interest in exclusionary funds that kind of map to a stronger expression of member values. And reducing exclusions for social or values based reasons is quite different to the kind of financial case that a lot of people talk about. So some people excluded tobacco in the late 90s, and were kind of very resentful, if you like, of the returns they then lost out on. Whereas investors who would have recently excluded fossil fuels, in particular oil, from their portfolios, will have done really well over the past year.

So you can see that there's a balance and lots of different reasons why investors apply exclusions. So going back quickly to the DC case, you have to recognize that what matters to an individual differs quite dramatically. And trustees can't really provide a solution that caters to all member needs. So to make that kind of decision as to what funds to offer their members, trustees will often seek member feedback or consensus, but they're also trying to capture the broader public sentiment around particular issues. So overall, I think it's a difficult challenge for trustees as they try and understand and reflect the priorities of these different stakeholders when they're thinking about adding these kind of values based products to the fund range.

LOK MA: Thank you, Shaz. And what we've just been talking about is how you invest maybe across a market with an eye on the ESG factors. And then more recently, I think we've seen the development of these positive impact investments. So instead of just trying to exclude the stuff that causes harm, you're kind of consciously making investments that would actually do good as part of that business. And can you give us a few examples of these? And both in terms of, again, the investment characteristics, but also the wider impact, as well.

ADAM GILLETT: Sure, I can take this one. And I think that this has been one of the big recent trends, as you say, people increasingly thinking about and aware of the importance of investment's impact on the real world. And where if a positive-- trying to make that a positive impact. Which sounds very simple, but is probably much harder to do in practice.

And what I would like to echo from Shaz's comments, is that for most investors, the financial thesis is absolutely paramount to this. So investing is absolutely great sense on a risk return basis. But have this added tailwind, this added benefit, of having a positive societal or environmental impact.

And I think there are a whole range of options here for people. We've invested in a lot of them, and I think that they can come up across all different types of assets. There are some really cool ones in alternative credit, at the moment, that we've spent quite a bit of time on recently. And that's providing people with alternative financing, smaller scale financing, for things like installing solar panels on domestic roofing, that's that kind of stuff. And I think that those are quite interesting funds, quite interesting developments as the energy supply becomes decentralized and democratized.

Then I think you can look to real assets, and this is somewhere that's really, really rich for these kind of impact investments. And so whether that's investing in real assets like buildings or infrastructure. There was a fund that we recently invested in, which is a forestry fund in the UK, which is brilliant. There's an awful lot of talk about, nature based solutions, reforestation, and so that's great.

And then another fund which kind of takes a look across the whole spectrum of solutions that you need to electrify our grid and to provide electric charging infrastructure for cars and so forth. And I think that that just plays into the fact that there are so many different opportunities. Because the scale of our change is going to be enormous. And picking out the ones that can make most financial sense, give the best risk to [INAUDIBLE] to investors.

And then I think it even extends into listed assets, so in areas like public equities and so forth. It's been a huge upswelling of strategies that are really focused in a space, trying to A, invest in companies that give really great products and solutions to these kind of sustainability challenges. But also trying to apply their own stewardship to help those companies realize their full potential. And to help those companies improve their impact on society and the environment. So a real wide range of strategies that are out there, all asset classes, and I think that they provide some really fantastic diversifying, risk adjusted return opportunities, as well.

LOK MA: Thank you for those examples. And a reminder for our listeners, actually, that in episode 7 of our podcast on weird and wonderful opportunities, we also talked about some other examples of positive impact investments, as well. Now we've talked about the positive case for ESG and sustainability. And I just wanted to kind of flip this around a little bit. So let's just pretend that I don't actually care much for this ESG stuff, beyond complying with any new regulations that I have to. What could I stand to lose with that kind of attitude? Is it just that extra bit of return I'm giving up on that, Adam, you've tried to quantify? Or are there actually potentially other dangers to be aware of, as well?

SHAHRAZAD KHAN: So the really big one, I think, is reputational risk. No one likes the hypocrite. So if you are a pension scheme, often you can look to your sponsor for guidance, obviously for funding. But then also, if you go on any of their websites you'll normally see a huge dedicated portal focusing specifically on sustainability and the business priorities around that.

So if you're making loads of business actions, near you It really only makes sense to replicate or extend these to the way in which you're designing your scheme and setting investment strategy. Particularly reputations are called into question when you begin to compare yourself with other peer schemes. So for example, we saw a couple of years ago when the UK government's environmental audit committee actually sent a letter to the 25 largest schemes here in the UK, naming, shaming, and also faming them on their actions thus far around climate.

Given their agenda and the pace of change around sustainability, the area is also very fast moving. So if you fall behind now, it's very difficult to try and keep up. And so we just recommend that all investors look to integrate sustainability to the fullest extent possible, as soon as possible.

LOK MA: All right, guys, I'm just going to warn you. I've barely got started on this topic. I think ESG and sustainability is such a huge topic. I kind of want to devote the right amount of time to it. So I think what's best is probably we're going to pause here, and kind of conclude this is part one of our discussion. So for our listeners, can you please now go on to part two of my conversation with Adam and Shaz?

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