ESG Investment in Asia

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Introduction

The demand from our clients to visibly embed environmental, social and governance (ESG) considerations into their investment decisions has never been higher. The area of greatest advance in this trend has been across the Asia-Pacific region. That makes the publication of this document particularly timely, although I expect it to remain highly relevant for years to come.

Sir Douglas Flint, Chair of Standard Life Aberdeen's board, has many years of experience leading business in Asia. In this paper he sets out the vast scale of the investment opportunity waiting to be grasped. He also frames the responsibilities of investors in shaping the future for the people of Asia by incorporating ESG considerations into investment decisions.

We recently launched the Social Capitalists index of 135 countries. This measures economic dynamism and the sustainability of the growth, as well as the development that is achieved. In a world that appears to be embracing political populism over globalisation, the conclusions of this work are certainly eye-opening. The index shows that globalisation can work and that no trade-off need exist between strong economies and robust and sustainable societies.

Of all the ESG issues that we analyse, climate change rightly receives the most attention. Water stress is particularly aligned with climate risk, and is frequently underestimated by politicians and investors alike. This paper explores some options to redress this imbalance by highlighting how Asia can embrace the management of water resources through disclosure and transparency to improve the sustainability of development in the region.

Finally, Aberdeen Standard Investments (ASI) is proud to be a strategic partner of the Asian Infrastructure Investment Bank (AIIB). This relationship has been established in order to help build a template for investors to participate in the sustainable development of infrastructure assets. The use of debt in funding this development is likely to be significant and this paper explores how our partnership will focus on long-term ESG factors in infrastructure investment decision-making.

Euan Stirling
Global Head of Stewardship
and ESG Investment

The future of sustainable finance – catalysing ESG investing in Asia

Sir Douglas Flint
Chairman
Standard Life Aberdeen Plc

It is worth starting with a broader perspective to highlight the criticality of sustainable finance in Asia. From a global perspective, the world's economies and the global financial and investment communities that support them are facing three existential threats that cannot be resolved without co-ordinated actions and unprecedented levels of investment. These deal with climate change, social inequality leading to unrest, and unsustainable production and consumption.

Without investment in the infrastructure to build the sustainable economic and social ecosystems required to address these issues, the world faces future migration patterns it is completely unprepared to deal with, either financially or socially. For Asia, this is particularly critical. The region contains some of the most pressing developmental issues in the world:

- a significant number of people still living at a subsistence level
- insufficient and inefficient energy, transportation, water supply, sanitation and logistics infrastructure to meet the accelerating population growth and urbanisation
- according to the World Health Organization, 70% of the most polluted 100 cities in the world.[1]

It is estimated that developing Asia has $20-30 trillion worth of infrastructure investment needs over the next 15 years. The region must therefore attract significant private capital to fund its development.

- First, issues of sustainability are now recognised to be of global importance. Influential asset owners are demanding change and are actively allocating capital to managers who incorporate ESG standards into their investment processes. Regulatory pressures are building for greater transparency and tackling pollution. This changing landscape is reflected in the number of Asia-based signatories to the UN Principles for Responsible Investment (PRI), which grew 26% between 2016-2018.
- Second, there is growing evidence that ESG integration does not hurt investment performance. What used to be seen as a trade-off between generating attractive returns, reducing risk and doing the right thing, is now increasingly aligned. Performance of selected sustainability indices is largely on a par with the benchmark indices over different investment horizons.
- Third, asset managers are increasingly and properly called on to demonstrate their social contribution and impact. They can do so by actively advancing a holistic cross-asset-class appraisal of ESG factors through engagement, insight and influence. Further, they can not only generate better long-term outcomes for their clients, the environment and wider societal stakeholders, but also promote better capital allocation. ESG is a journey, not a destination – and engagement is the mode of transport. At ASI, ESG analysis and proactive, substantive engagement are now integral to our investment process.

Asia represents a prime opportunity for responsible investors to allocate private capital to large-scale sustainability-linked projects. More broadly, there is growing recognition that failure to address the three core risk areas creates significant long-term portfolio risks – and not just in companies with high exposure to climate change or carbon. For example, many businesses will be challenged by competition for natural resources, concerns over deforestation, recycling, management of energy use and waste management solutions.

We believe, as a consequence, investors around the world will more broadly apply ESG investment principles. Technological advances and greater transparency will not be reversed. Increasing frequency of the costs and ramifications of climate change will act as a reminder. Lastly, as individual investors gain access to tools to play a more active role in their investments, they will be in a position to express their preferences without necessarily having to sacrifice returns to achieve them.

We see the relatively low ESG engagement in Asia as both a challenge and an opportunity. The ability to have meaningful impact through ESG investment is far larger in Asia than in developed markets. Beyond managers incorporating ESG analysis in their investment processes, it is also clear that demographics and the growing democratisation of savings will play a role in further driving assets towards ESG strategies. Younger generations are entering the markets with different priorities from older generations. These changing preferences, combined with technology, will increasingly place greater control in the hands of the investor – and will further impact asset allocation for the good.

As Asian asset owners co-finance the region's development, they can also drive the growth of sustainable investment by making ESG a prerequisite for all investment decisions. They can do so by promoting adoption of the recommendations of the Task Force on Climate-related Financial Disclosures, targeting new investments through ESG compliant mandates, and expanding their issuance of green bonds.

By incorporating ESG principles into their Asian investment strategies, there is the opportunity to build a market ecosystem that will benefit investors, issuers, the people of Asia, and the rest of the world.

70%

of the most polluted 100 cities in the world are in Asia

[1] All statistics are taken from the UN's "Asia-Pacific Sustainable Development Goals Outlook" (2017). https://www.adb.org/sites/default/files/publication/232871/asia-pacificsdgoutlook-2017.pdf.

Beyond GDP – the Social Capitalists index

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Political Economist

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The most successful societies blend strong economies with healthy environments, inclusive social policies, representative political institutions and fair legal frameworks. To recognise this, last year we launched an innovative indicator of national progress. The Social Capitalists index of 135 countries measures the extent to which they are persistently economically dynamic and making progress on meeting UN Sustainable Development-aligned ESG goals.

Our results are a testament to the benefits of more open economies and societies, a message that risks being lost amidst the wave of political populism that is sweeping through the developed world and some prominent developing economies.

Not only have the vast majority of developing countries converged on US and broader developed country living standards over the past decade – a distinct improvement since the '80s and '90s – but in many cases this has been accompanied by strong progress on sustainable development objectives. This reveals the supposed trade-off between strong economies and strong societies to be a false one.

It also highlights the benefits of globalisation at a time when support is dangerously low. Without globalisation, much of the poverty reduction in developing countries over the past 20 years would not have been possible. This is a good news story that deserves to be celebrated. Moreover, stronger absolute and relative growth is helping to provide resources and build political coalitions to support the ESG goals that will make future growth more sustainable.

Based on economic growth data for the past five years and ESG scores in our global ESG index, we identified numerous countries that are exceeding both their development-adjusted growth and ESG benchmarks. The vast majority of these 'Social Capitalist' countries are developing economies and can be viewed as hunting grounds for the places that will generate both global economic and sustainable development leadership over the next 20 years.

Although two of the most prominent developing economies – India and China – do not make the 'Social Capitalist' grade, both have been persistently economically dynamic. Additionally, recent developments suggest that their governments are placing more weight on broader measures of progress. If China is to become a 'Social Capitalist' it will need to improve the transparency and representativeness of its political and governance institutions in particular. In India, the focus should be on environmental indicators and social equality.

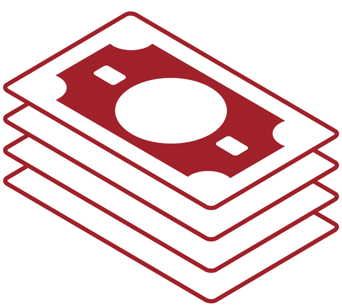
Conversely, the majority of developed economies – particularly in the Eurozone – have outperformed their ESG benchmarks, but failed to generate robust economic growth over the past five years. The danger is that this persistently weak economic growth will amplify existing populist pressures and eventually undermine support for broader sustainability goals.

If developed countries' commitment to open economies and societies were to weaken further, it would inevitably weigh on their own growth prospects. It would also damage the prospects for further catch-up growth in developing countries. At a time of enormous productivity, demographic, social and environmental challenges this would prove especially counterproductive. The task then is to identify country-specific political and policy solutions that can reconcile each of these objectives.

Exceptions to the pattern of weak economic performance and strong ESG performance among the developed economies include countries like Portugal, Ireland and Sweden, which have performed well across both dimensions. Meanwhile, Japan stands out – contrary to general wisdom – as an economy that has been more economically dynamic than most, with the country's shrinking population masking relatively healthy productivity performance. Abenomics has not been the failure it is sometimes made out to be.

Although most countries' ESG scores have been on a rising trend over time, there is a lot of room for improvement. Most countries are not doing enough to reduce greenhouse gas emissions and limit the damage from climate change, nor improve air quality. And while income and other inequalities between developed and developing countries have been shrinking, disparities within countries are high and have risen over recent decades. Addressing these is important for gaining broad-based buy-in for growth-enhancing reforms.

The Social Capitalists index can be used in a number of useful ways. For policymakers, it can be a benchmark for assessing absolute and relative national performance. Investors, meanwhile, can use it as a screen to support asset allocation decisions and product development.



Water as an unpriced risk

Andrew Mason
Senior ESG Manager

The need for water and the management of this resource dates back to the earliest civilisations. Today, the management of this resource has never been more important as global populations continue to grow, with ever more increasing demands for water-intensive resources and services. If global steps are not taken to manage water quality, efficient allocation across uses and users, and to adjust for the risk of climate change, this largely unpriced resource could represent the ultimate 'tragedy of the commons'.

According to the UN, roughly 1.2 billion people currently live in areas of physical water scarcity, with this number potentially increasing to 3.5 billion by 2025.
This risk is particularly prevalent in Asian markets. A recent report published by China Water Risk highlighted the following.

- Asia has limited water resources to develop. Neither China nor India have sufficient water to ensure food and energy security. They will also be unable to develop under the current export-led economic growth model.
- Significant systemic risk is caused by the clustering of 280 large cities in 10 major Asian river basins.
- Climate change threatens already scarce water resources. For example, rivers draining from the Himalayan glaciers are expected to decline over the next 50 years.

Despite these risks, the report goes on to identify the lack of focus among financial institutions in the region on water risk. In particular, the risks presented by assets clustered in areas that currently or could face water risk in the future. A recent report by the Leadership Group on Water Security in Asia exemplifies the scale of the challenge. Asia is home to half of the world's population but has the least fresh water per person of any other continent, excluding Antarctica. Its population is expected to increase by almost 500 million in the next 10 years, with 60% of this growth among urban populations – the very people who are clustered around water risks.

Governments and investors have been taking steps to address these risks. China's economic stimulus package continues to invest in ecological projects, including reducing water use and water pollution. It has also taken more punitive measures through the Ministries of Environmental Protection and Finance to prevent the worst water polluters from accessing finance. The UN announced its Water Action Decade in 2018, launching a number of projects, while the UN's Sustainable Development Goal (SDG) 6 targets clean water and sanitation for all people.

Through industry initiatives such as the Principles for Responsible Investment (to which ASI has been a long-term contributor), and the Ceres Investor Network, the investment community has sought to address the challenges posed by water. The Investor Water Toolkit produced by Ceres deserves special note as a resource available to all investors seeking to act on water risk. Research providers are also supporting this drive and highlighting areas requiring action. For example, the Carbon Disclosure Project reported that, of 783 companies it assessed in 2018, only 29% had set water targets or goals.

Measurement of water by companies and investors still lags behind the well-established mechanisms that are in place to measure greenhouse gas (GHG) emissions in efforts to address climate change and global warning. I believe this is driven by a number of factors. First, GHG present a global impact – an emission in Delhi can ultimately have an impact in Dublin. The same cannot be said for a lack of rainfall in Delhi compared to a rainy Dublin. Unlike climate-focused initiatives such as the Paris Agreement, this regional emphasis affects the ability to create a global consensus on tackling the issue. Regional variations also impact the ability to aggregate total impacts. A company can combine its total emissions in Delhi and Dublin to represent its total global emissions. A company which aggregates its water use cannot represent its regional impacts. Nor does it represent the water intensity of individual assets versus areas of operations.

For investors and their investee companies to fully understand the use of this resource, volumetric water benefit accounting must be applied. This is based on three key areas:

- identify shared water challenges in a local context
- define water stewardship project activities
- gather data and calculate volumetric water benefits.

Building upon these cornerstones, companies can create a representative, replicable standardised approach to water that can be used to reflect water stewardship or the lack thereof. Many companies have started to apply these types of indicators and I would highlight BHP's inaugural water report, published in 2018, as an example of best practice. In addition to the key areas already identified, the company also details areas such as tailing dams, which could ultimately impact its operations, and water, sanitation and hygiene (WaSH).

ASI continues to engage with investee companies to understand how they are managing these risks, and what opportunities exist in this space. This includes technologies that improve water usage or improved methods to desalinate water. At a portfolio level, we are exploring means to measure water resilience and, as part of industry groups, we will continue to seek greater disclosure from investee companies. Although largely unpriced to date, we do not believe that this will or should be the case over the longer term.

Table ES-1 - Contributions to Water Stewardship Outcomes, Shared Water Challenges, and SDG Targets per Water Stewardship Activity Category

Water Stewardship Outcomes		(1) Sustainable Water Balance	(2) Good Water Quality Status	(3) Good Water Governance	(4) Important Water-Related Areas (IWRAs)	(5) Safe Water, Sanitation, and Hygiene for All (WaSH)	N/A
Shared Water Challenge		Water quantity	Water quality	Water governance	Important water-related ecosystems	Water, sanitation, and hygiene (WaSH)	Extreme weather events
SDG Target(s)		6.1, 6.4	6.2, 6.3	6.5, 6A, 6B	6.6, I3	6.1, 6.2	11.5, 13.I
WS ACTIVITY CATEGORY	Land conservation and restoration	✓	✓		✓		✓
	Water supply reliability	✓		✓			✓
	Water access	✓	✓	✓		✓	
	Water quality		✓		✓	✓	✓
	Aquatic habitat restoration	✓	✓		✓		
	Water governance	✓	✓	✓	✓	✓	✓
	Catalytic activities	✓	✓	✓	✓	✓	✓

Source : World Resources Institute 2019.

The Asian Infrastructure Investment Bank (AIIB) mandate: infrastructure development coupled with ESG sustainability

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Investment analyst - ESG, Fixed Income

AIIB's role in sustainable infrastructure

It is estimated that developing Asia has some $20-30 trillion worth of infrastructure investment needs over the next 15 years. The region needs to attract significant private capital to fund these development needs. Asia represents a prime opportunity for responsible investors to allocate private capital to large-scale sustainability-linked projects.

The Asian external credit market, which has more than doubled in size over the past five years, will be a key channel to funding Asia's infrastructure investment needs. At nearly $1.3 trillion and still rapidly growing, Asian credit will soon exceed the $1.4 trillion US high-yield market.

The spectacular growth and evolution of the external Asian credit market, combined with Asia's ongoing needs for sustainable infrastructure development, present exciting and unique opportunities for investors. Formed in 2016, the AIIB has a mission to improve social and economic outcomes in Asia. The AIIB invests in infrastructure and other productive sectors, and is also focused on capital market development in order to support its mission. In December 2018, AIIB announced the ESG Enhanced Asian Credit Managed Portfolio to catalyse ESG investment strategies in emerging Asia. By incorporating ESG principles into its Asian credit portfolio, AIIB has taken a leadership role to build capacity for sustainable investment, an ecosystem that will benefit investors, issuers, the people of Asia, and the rest of the world.

ASI commends AIIB for taking this leadership role and we are excited about our strategic partnership to develop sustainable capital markets for infrastructure investment in Asia. Together we seek to improve the standards and raise awareness for sustainable investment in Asian credit.

Our approach to ESG in emerging market debt

ESG integration is core to ASI's philosophy of making long-term investments principled on comprehensive fundamental analysis. Understanding each investment's ESG factors is integral to fully assessing the risk/reward of each investment to produce better client outcomes.

We are pleased that the investment community is catching up to our view that generating attractive returns, reducing risk and doing the right thing is not a trade-off. MSCI has shown that emerging market stocks with better governance ratings have outperformed weaker ones since 2013. Barclays identified a positive correlation between ESG ratings and credit ratings for debt issuers.[2] UBS has noted that companies with better ESG scores benefit from lower credit spreads when controlled for the impacts of other factors such as ratings and duration.[3]

[2] Sustainable investing and bond returns. Barclays. 2016.
[3] ESG: A green light to change global corporate credit? UBS 2019.

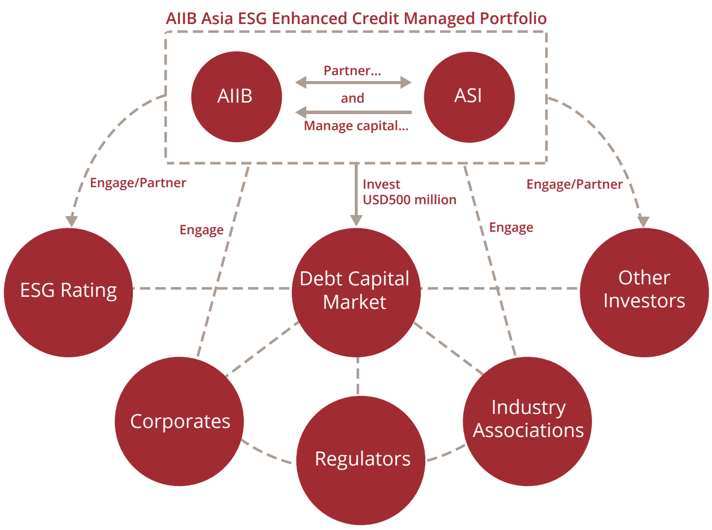
Many new to ESG investment may focus solely on the best-scoring companies or on exclusion lists. We believe both are short-sighted; the opportunity to make a greater positive impact and greater economic return lies in helping less advanced companies along the earlier parts of their journey to sustainability. Most importantly, you cannot have an impact without having a seat at the table. Exclusions eliminate the possibility of driving for positive change and this is precisely where we see the opportunity in Asian credit.

Why we are excited about the AIIB Asian ESG Enhanced Credit Managed Portfolio

At ASI, we are excited about the AIIB mandate because the project joins together two essential pieces of Asia's development puzzle: sustainability and infrastructure investment. It also helps to make the Asian credit markets part of the long-term solution. Home to half of the world's population, Asia is facing critical developmental needs. The World Health Organization notes that nearly 70% of the world's 100 most polluted cities are in Asia. In a 2017 study of access to healthcare, The Economist noted that five of the world's 10 bottom scoring nations are in South Asia.[4]

Goal 9 of the UN's SDGs is to "build resilient infrastructure, promote sustainable industrialization and foster innovation". Across emerging Asia, the poor will benefit the most from such improvements, including better access to healthcare, education, and mobility. Importantly, those benefits will also positively contribute to other SDGs such as eliminating poverty (SDG 1) and achieving food security (SDG 2). The development of sustainable infrastructure is critical to support economic growth and improve living standards across Asia.

As Asia addresses its need for sustainable development, the AIIB is to be commended for taking a leadership role at this critical juncture to help shape the future of the region. Emerging Asia will offer a tremendous opportunity for responsible investors to allocate private capital to projects that positively impact millions of people and help Asia take significant steps forward.



> "Given the growth of Asian sustainable assets under management, there is a significant opportunity for harnessing the debt capital markets to achieve sustainable development goals. We are particularly excited about this potential in Asian emerging markets."

Courtney R. Lowrance
AIIB

[4] http://accesstohealthcare.eiu.com/wp-content/uploads/sites/42/2017/06/AccesstohealthcareinAsia-Pacific.pdf.

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