

Pension plans confident ESG investing is re-firing its engine

- *Despite setbacks in 2022, appetite for ESG investment amongst pension plans remains robust with powerful tailwinds expected thanks to the evolution of capital markets*
- *Plans are demanding a strong focus on real world outcomes and accountabilities as well as financial returns*
- *Equities most popular asset classes used in Net Zero strategies as they permit strong stewardship and proxy voting*
- *External manager selection criteria are becoming more stringent*

London, 1 December 2023 – Last year's savage bear market hit a broad range of investment strategies, and ESG was no exception. However, underperformance is seen as a temporary setback, not an irreversible trend. ESG investing remains central to long term value creation in this era of global warming and social inequality, according to a new report published by CREATE-Research and the largest European asset manager, Amundi.

The report is based on responses to a survey from 158 pension plans globally, managing €1.91 trillion of assets. It aims to shed light on how ESG investing will evolve after the exceptional events in 2022.

Appetite for ESG amongst pension plans remains strong despite market decline in 2022

2022 saw rising global inflation and the Russian invasion of Ukraine that roiled capital markets. ESG investing suffered in the resulting market falls, reminding investors that it is not immune from market trends. 63% of those surveyed experienced ill-timed sector bets, as energy stocks gained the upper hand over decarbonisation goals, and 53% are concerned about the political backlash against ESG in the US, the world's biggest fund market.

However, the consensus is that as a strategy, ESG will be marked by periodic setbacks due to a larger dynamic that has little to do with ESG investing per se. Most survey respondents (79%) believe that ESG factors will not hurt performance in the long term.

As a result, appetite remains strong and ESG investing will continue to deepen its roots in the pension landscape. Over the next three years, 53% of respondents expect the share of ESG investing in their active portfolios to rise, and 49% expect a rise in their passive portfolios.

Vincent Mortier, Amundi Group Chief Investment Officer said: *"Even the most casual markets observer will know that 2022 was a difficult year, but despite the hit to ESG strategies, it's encouraging to see such optimism from institutional investors. This year's survey reveals a positive picture and robust appetite for ESG from pension plans, and we should not underestimate the power of this group to move the needle when it comes to making an impact."*

ESG should not be considered philanthropic finance

A distinctive feature of the evolution from socially responsible investing to ESG investing is dual emphasis – making money while also making a difference for wider society. One respondent said: *“we want to see clear evidence that our ESG investments do well financially and do good socially.”* For their portfolios to achieve this duality, our respondents have highlighted two sets of goals.

The first set is about investment basics: minimising risks linked with ESG factors (57%), enhancing returns from related opportunities (53%), seeking double bottom line benefits via societal and environmental as well as financial returns (51%), and reducing portfolio volatility (34%). Notably, only 14% are prepared to achieve ESG goals at the expense of portfolio returns.

The other set is about secondary issues, such as tackling trade-offs between the E, S and G pillars (49%) and reducing operational and reputational risks (34%).

Professor Amin Rajan of CREATE-Research, who led the project, highlights: *“ESG investing has evolved – we are now seeing a more robust version coming into view with a strong focus on real world outcomes and accountabilities as well as financial returns. This shift marks a defining moment in the next stage of ESG investing and one that signifies its firm place at the heart of pension portfolios.”*

Changing ecosystem of capital markets and climate policy action driving ESG investing

There are several forces driving ESG investing amongst pension plans including the changing nature of capital markets and climate action policy.

Capital markets are evolving, and profits are no longer the sole focus. Companies must promote the interests of shareholders as well as employees, customers, and communities. The dominant avenues used by pension plans to enhance stakeholder interests are stewardship and proxy voting (68%), investing in best-in-class companies with high or improving ESG scores (56%), integration of ESG factors in the investment process (52%), exclusion of companies with poor ESG ratings (41%) and impact investing (35%).

Climate action policy is another powerful tailwind. Two recent policy game changers include the Inflation Protection Act in the US and the ‘Fit for 55’ programme in the EU. Further impetus is likely from industry collaborative ventures such as Net Zero Asset Owner Alliance and Net Zero Asset Managers Initiative. Currently, one in every two pension plans has a net zero strategy and a further one in four reports ‘work in progress’.

Monica Defend, Head of the Amundi Investment Institute, said: *“In the last 12 months, we’ve seen a raft of new regulatory and policy initiatives announced across the world, such as the IRA in the US, and the RePowerEU Plan and Net Zero Industry Act in Europe. Governments and regulators have an important role in driving forward ESG investing. From increasing*

transparency to helping markets price in risks and opportunities, we expect to see policymakers continue to progress the ESG agenda.”

Equities and bonds favoured over alternatives for achieving net zero goals

When it comes to which asset classes are best suited to achieving the net zero climate goal by 2050, 50% favour equities. This is because equities permit strong stewardship and proxy voting, offer ready liquidity and can readily target ‘pure play’ ESG business models like renewable energy, as well as hard-to-abate sectors, such as cement and steel.

Bonds are the second preference (41%). As ever more pension plans advance into their run-off phase due to ageing demographics, green, social and sustainability-linked bonds have become attractive.

Alternative assets come third (38%). In order of importance, the emphasis is on green infrastructure, green buildings, private equity and private debt. Private equity is well positioned to buy the worst ESG laggards and improve their green credentials both with and without tax incentives.

Advances in ESG investing most evident in thematic investing and manager selection criteria

With investors progressing up the ESG learning curve, trade-offs between the individual ESG pillars have become evident and a more granular approach has gained traction.

Within each pillar, favourite themes have emerged. In the environmental area climate change and carbon emissions is the most popular (63%), followed by biodiversity (48%), then water scarcity (42%) and waste management (36%). In the social pillar it is employee engagement and labour standards (57%), human rights (42%), and data protection and privacy (32%). In the governance pillar they are executive compensation linked to ESG outcomes (61%), diverse board composition (57%), an independent audit committee structure (46%) and zero tolerance towards bribery and corruption (40%).

As pension plans advance on their ESG journey, the list of criteria for selecting external managers for ESG investing has grown. Criteria can be divided into qualifiers and differentiators. The first set covers investment basics that give a manager baseline credibility. It includes a value-for-money fee structure (58%), followed by core ESG values embedded in corporate culture (56%). The second set commands more weight as it includes value creation activities like a track record in delivering clients’ ESG goals (67%) as well as in stewardship and proxy voting (65%). The set also includes a deep and broad talent pool (63%), followed by widely admired thought leadership content (57%).

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¹ Source: IPE "Top 500 Asset Managers" published in June 2023, based on assets under management as at 31/12/2022

² Amundi data as at 30/09/2023

³ Boston, Dublin, London, Milan, Paris and Tokyo