



Why responsible investing is good for people and the planet

Investment managers are increasing their focus on environmental, social and governance issues and playing a critical role in the transition to a low-carbon future

As the focus on environmental, social and governance (ESG) standards becomes increasingly important for investors around the world, the case for sustainable investing has never been stronger.

What once simply meant investing in entities that were sustainable over the long term and could grow their earnings has developed to encompass a much broader definition of sustainability in that business models must be able to continue without incurring disruptions from ESG issues, says Chris Iggo, chief investment officer at AXA Investment Managers.

"A good example is a business that is a heavy carbon emitter; increasingly it will be penalised for those carbon emissions either through taxation or regulation to the point where it will become less profitable and therefore the business will be unsustainable," he explains.

While there are a number of ESG risks investors need to think about, it is also creating opportunities for investors to support companies that are contributing to a sustainable future. "An example would be a renewable energy company, which is helping shift the economy to a low-carbon world," says Iggo.

While some institutional investors, such as endowment, charitable and pension funds, have long incorporated non-financial considerations into their investment policies, responsible investing is now becoming far more mainstream.

"There are two things driving this," says Iggo. "People do want to invest in assets that are good for people and the planet, but there is also a sense the world is moving this way and therefore some companies are going to be rewarded for doing the right thing. And there are other companies that are going to be punished for not doing the right thing, which will increase their cost of capital and make it harder to generate a good economic return."

While ESG concerns are wide-ranging, the issue that is drawing the most attention is climate change and the potential cost of not reducing carbon emissions. A number of countries have committed to achieve net-zero carbon emissions by 2050 and those government commitments mean they are likely to pressure businesses to reduce carbon emissions while implementing policies to transition to a low-carbon economy.

"Not only do governments have the power to impose regulations and taxes to help achieve that, they also have the fiscal power to subsidise new

technologies and encourage the energy transition," says Iggo.

"It's also very measurable. We can look at a company and measure its carbon footprint today and we can assess how that's going to look going forward based on the plans that company has to transform itself. The UK, US and Chinese governments all have target dates when they want to achieve net-zero economies, so there's huge pressure on companies to be compliant towards those universal targets."

Against this backdrop, investment managers can also play a critical role in helping the world transition to a low-carbon future. For starters, fund managers can measure the carbon intensity of their investment portfolios by measuring the carbon footprint of all the com-

panies a particular fund invests in, enabling managers to adjust their portfolios' carbon footprints accordingly.

For example, AXA Investment Managers has committed to exit all its coal investments in Organisation for Economic Co-operation and Development countries by the end of this decade and in the rest of the world by 2040.

"That's a big source of capital that coal companies can no longer tap, which means they can't fund their businesses as easily as they did in the past. But equally asset managers can also play a more venture-capital role by investing in companies that are developing new technologies such as electronic vehicle batteries," says Iggo.

In addition, investors have a role to play in engaging with businesses and marshalling them in the right direction on sustainability issues, no matter if they are investing in equities or bonds. AXA Investment Managers' stewardship and engagement strategy, for instance, seeks to protect client investments by holding businesses to account on issues that could significantly impact the value of that business, and therefore investor returns, over the longer term.

Growth in sustainable investment also means asset managers have to weigh ESG considerations, including climate, inequality and biodiversity, alongside more traditional investment metrics, such as a company's financial statement and balance sheet.

"Incorporating that information into the investment decision is already happening and it's becoming embedded into the traditional investment process even for funds that don't class themselves as ESG," says Iggo.

"It's a necessary process to go through to establish the value of a corporate asset, because if you ignore all this then suddenly that asset could get devalued through some kind of fine or increased tax burden or whatever it might be and, if you're not aware of those risks through a

detailed study of the business, then as an investor you're going to underperform."

Any concerns investors might have that they are forfeiting potential returns in favour of more sustainable but less profitable investments is also being contradicted by an increasing body of research showing incorporation of ESG factors can lead to better investment performance.

"That trade-off just doesn't exist," says Iggo. "Think about the auto sector. Some car companies are much further advanced in developing new electronic vehicles, for example, so you can still have the same allocation to autos but within that you can pick the best-in-class companies. They're likely to be the ones that have done more in terms of changing their business model and this means they're more profitable and the return to investors will be better as a result."

AXA Investment Managers is already leading by example on sustainability. It has pledged to reduce its carbon exposure to net zero by 2030 across all its investment portfolios. And 90 per cent of its assets under management meet the criteria set out under articles 8 and 9 of the European Union's new Sustainable Finance Disclosure Regulation.¹

"Our culture has undergone a massive change to put sustainability at the heart of everything we do, from research to our entire investment process," says Iggo. "As a responsible asset manager, we actively invest for the long term to help our clients prosper and to secure a thriving future for people and the planet."

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¹As of 31 December 2020, assets under management within Equities, Fixed Income and Multi-Asset stand at €587 billion out of which €460 billion are applicable under the SFDR

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CHINA

The risks and rewards of investing in China

China represents a red-hot ticket for investors after weathering the coronavirus storm better than many economies, yet questions remain and not just over whether it can sustain growth

Nick Easen

The one thing investment professionals around the world are good at is following the money. It's why all eyes continue to focus on China. When foreign direct investment in the world's second-largest economy surged recently, at its fastest rate in over a decade, it peaked interest among wealth and asset managers. That's because China has navigated the coronavirus pandemic well and is now seeing a strong recovery.

This is likely to be highlighted by its leaders when China's Communist Party turns 100 this year; ironically their celebrations may well tout the success of capitalism. The country's financial markets have deepened, diversified and matured of late, their size and liquidity are now more enticing to global investors, just in time to make the most of record annual growth. Output has leapt 18 per cent year on year in the first three months, the fastest rate since records began in the early-1990s.

"In the last few years, China has made great progress in reforming its equity and bond markets, while enhancing access for foreign investors," says Arne Staal, chief executive of FTSE Russell. "Reform of China's domestic capital markets has also paved the way for greater foreign ownership of mainland Chinese companies."

The investment case is strong partly because many global investors are hugely underweight when it comes to China and their participation is surprisingly low. This is true for both global equity and fixed-income markets; the numbers are stark.

The Chinese economy makes up 16 per cent of the world's GDP. Its share of global manufacturing is close to 30 per cent, the same as the combined shares of America, Japan and Germany. China also accounts for 14 per cent of all global exports, yet it only makes up 5 per cent of the world's equity markets.

"Right now, as an investor you cannot afford not to have exposure to China," says Ronald Chan, chief investment officer at Chartwell Capital. "Managers must look beyond the Western media headlines about the country and apply perspective, as well as logic, to investing."

Already, cool-headed institutional investors have been increasing their exposure. Chinese markets are being added to some of the major global equity and bond indices. "It feels like investors are jumping on a bandwagon right now," says Mark Williams, chief Asia economist at Capital Economics.

The country's inclusion in the FTSE Russell, MSCI, Bloomberg Barclays Global Aggregate and J.P. Morgan GBI-EM Global Diversified indices, to name a few, should not be ignored. This is expected to drive hundreds of billions of dollars of inflows.

Let's also not forget that China was the only major economy to expand in 2020, albeit by a little more than 2 per cent, driven by a surge in industrial production rather than consumer spending, during a year that was fraught with economic paralysis elsewhere and global lockdowns.

At the same time, China has refused to rely on "helicopter money", unlike the United States and others. This Asian behemoth has not resorted to a demand-side stimulus either, which has been deployed by some developed economies. Its orthodox monetary policy is in contrast to what

investors are observing in many industrialised nations.

"COVID-19 has seen global central banks and governments engage in a synchronous monetary and fiscal easing that has exacerbated the scarcity of safe, decorrelating yield," says Alan Siow, portfolio manager at Ninety One.

Many industries in China have also been exhibiting high and sustainable growth over a long period. The Chinese ecosystem of industrial sectors is increasingly deep and sophisticated, from solar panels to COVID testing kits, representing growth opportunities not widely available in many other markets. The country has also set a growth target of at least 6 per cent this year.

"The investment case for China is strong. There is tremendous potential for investing in this Asian giant as part of a well-constructed total portfolio," says Nikesh Patel, head of investment strategy at Kempen.

Turning to the \$16-trillion bond market, a ten-year Chinese government bond offers yields of more than 3 per cent. A US equivalent will generate close to half as much. When interest rates are rock bottom around the globe, it is not surprising overseas investors are piling into China.

"Northbound trading volumes between Hong Kong and mainland China are also good indicators of foreign capital flows and have increased tenfold since 2017," Chan at Chartwell Capital points out.

“The West needs to cast off its stereotype of China as an unsophisticated work horse and simply the world's factory. The country is diverse

"The West needs to cast off its stereotype of China as an unsophisticated work horse and simply the world's factory. The country is diverse and like Europe there is abject poverty in rural provinces, yet sophistication and dynamism across hundreds of Chinese cities. Shenzhen now rivals Silicon Valley as an innovation hub, with energy driving new products and solutions, as well as creating new markets. In terms of patent applications, China had over four times more than the United States in 2019."

The Year of the Ox, the Chinese zodiac sign that is known to be strong and tenacious, inspire confidence, yet hates to be challenged, is a good analogy for China in 2021. To date, the country's bank-financed economic model has been reliant on strong exports and capital investment. This is unsustainable in the long term, yet China has shown stubbornness in its shift to a more consumption-led economy.

"There are also a whole range of additional risks with China, even more so and magnified when compared to other emerging markets," says Patel.

From the persecution of ethnic minorities in Xinjiang province to civil liberties violations in Hong Kong or sabre rattling over Taiwan, China is feeling the pressure. A wave of sanctions imposed by the UK, European Union and Canada has ripple effects.

"You now have hyper-specific issues like forced labour and human rights abuses of the Uighur Muslim population. This isn't just contained to Chinese equity and fixed-income markets, there are large global companies that have questions to answer here," Patel adds.

"ESG – environmental, social and corporate governance – reporting is not mandatory in China. Engagement efforts are often neglected by companies. There's also a very high degree of state interference in ESG matters of policy and a huge discrepancy between the interest of the Chinese government and both shareholder and stakeholder interests."

This is why a group of socially conscious and religious investors, as well as other funds, have recently ramped up pressure on Western companies such as Zara owner Inditex, H&M and Hugo Boss that source from China. They want transparency and accountability on whether supply chains deployed forced labour or lead to human rights abuses.

At the same time China denies all accusations of abuse. There are also concerns to do with legal standards and the stability of the country's property market. For many managers, the country can still be opaque.

"Investors need to separate the differences between politics, economy and the company. These three things don't correlate with each other all the time," says Colin Liang, head of China at RWC Partners.

"Investors find it hard to fully understand how China works under a one-party system, both politically and economically. Investors are often confused with China's policies domestically and abroad. Many private companies, as opposed to state-owned enterprises, are also very much immune to changes in GDP growth, money liquidity or any US-China conflict."

China also faces long-term issues. There's a high debt burden with growing corporate bankruptcies, poor productivity, the support of flagging state-owned enterprises and its ageing population. Beijing's apparatchiks can also change the rules on a whim. Investors looked on wide-eyed when Chinese regulators took a swipe at Alibaba with a \$2.8-billion fine for violating antitrust laws, a company that in the past has received extensive government favour and support.

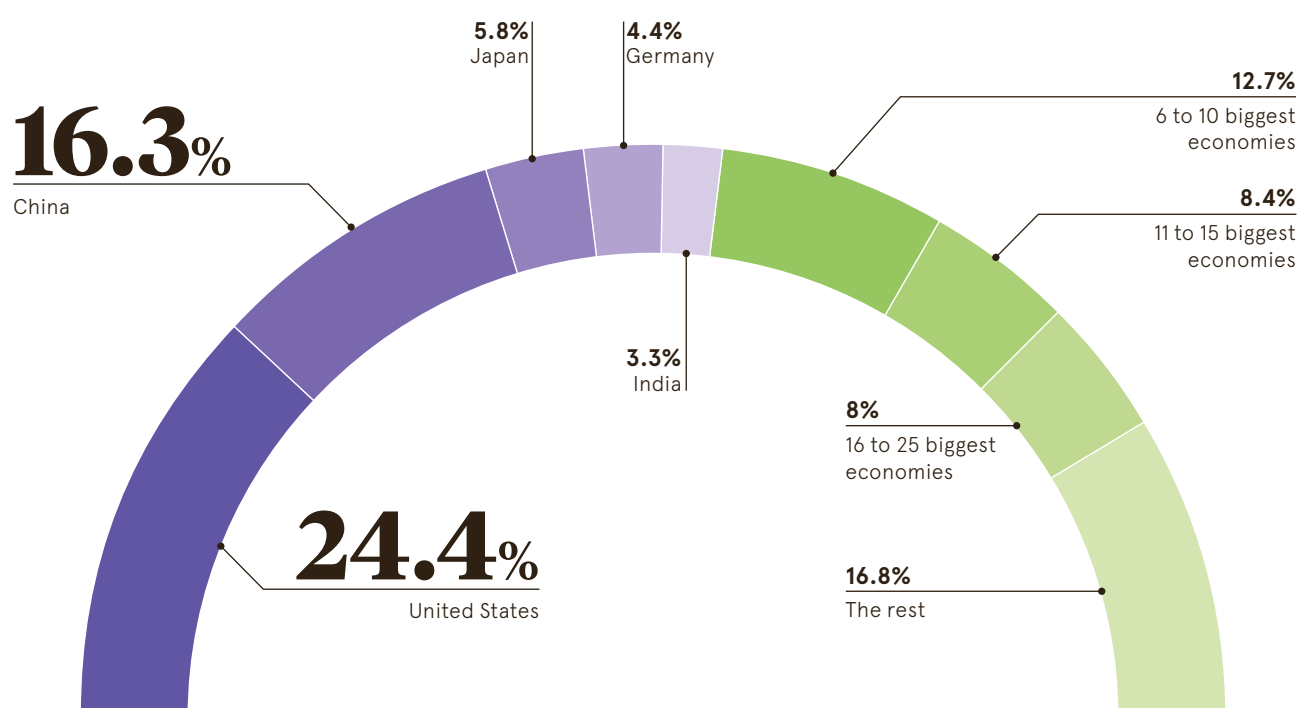
"Investors should be aware that China's markets don't operate to the same rules as major markets elsewhere. Regulators have aligned some rules as part of a push to join global benchmark indices. But it's the unspoken rules that catch foreign investors out. Many firms aren't run for the benefit of shareholders or with a purpose of maximising profit," explains Williams from Capital Economics.

"Some of the biggest listed firms are state controlled and explicitly used as policy tools. But private firms also have to do the state's bidding. It doesn't matter how big or successful. In fact, the bigger a firm is, the more it has to follow the leadership's bidding. Just look at what has happened to

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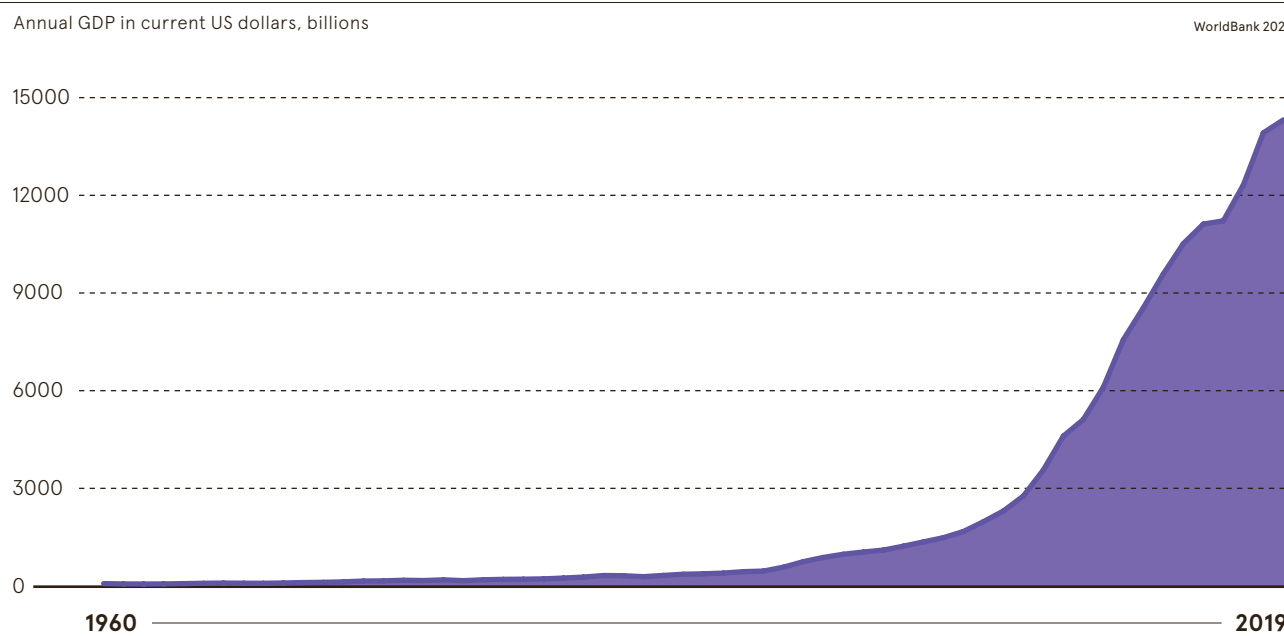
Ant Financial, Alibaba and its chief executive Jack Ma.”

There is certainly a lack of understanding among global investors beyond large and commonly owned stocks. Yet cutting through the opaqueness of information can play to an investor's advantage. “There is an undisputed need for local knowledge. Investing blindly through an index or tracker will give you exposure to volatility and the full suite of highs and lows that China offers,” says Chan.

The key piece of advice is to do significant homework and really understand the risks associated with onshore or mainland China investments. This involves using an investment process that combines both a top-down comprehension of the macroeconomic and political themes and trends with a bottom-up knowledge of the company, sector and wider marketplace.

“However, I don't think the Chinese market will be sufficiently open and welcoming to Western standards of institutional due diligence to make it mainstream in the

CHINA'S GDP HAS SOARED OVER THE PAST 40 YEARS



coming years; I don't think onshore China will become mainstream until the 2030s,” says Kempen's Patel.

Besides monitoring diktats from President Xi Jinping or macroeconomic trends, ESG factors are a significant concern for global investors in the lead up to COP26, the United Nations climate summit in Glasgow. China is improving, albeit from a low basis and disclosure is getting better. Many internal policies in Chinese are now laid out in English. Regulators in Beijing are also pushing better practices, if only to clear the smog-laden skies that consume many cities. The country has also committed to peak carbon by 2030.

“ESG is a growing pain. Headlines and horror stories persist in the global media on China's environmental record, however China is cleaning up its act. The one key difference that Chinese policymakers have over their Western counterparts is control of more levers. When China says it is going to do something, it usually can and will,” says Chan.

“It's pledged to be carbon neutral by 2060 and is currently investing dramatically in core industries to support this. China is the largest market for renewable energy, so you will see a tsunami of investment in this sector. Coal contributes to 65 per cent of China's energy generation, but it is expected that solar, hydro and wind power will quickly take over in the coming decades.”

CHINA'S STOCK EXCHANGES ARE SMALLER THAN THOSE IN THE US

Market	Market capitalisation
NYSE	\$29tn
NASDAQ	\$10tn
Shanghai	\$4.7tn
Shenzen	\$3.5tn
Hong Kong	\$4.5tn

Investopia 2020

“China's consumption market is expected to double in size and reach a scale similar to the United States. Chinese brands are already capitalising on this opportunity, with strong national brands such as Midea and Haier emerging in China,” says Wenchang Ma, portfolio manager at Ninety One.

Shifts in demographics don't lie either. China is set to report its first population decline since 1949. A significant moment when you consider that its workforce could drop by 0.5 per cent each year to 2030, with a higher burden for elderly care. Education and technological progress may not compensate for this slump and shift in population. This is likely to temper any gear change for China to overtake America as the world's largest economy.

“Let's also not forget China has been climbing the technology curve, trying to capture higher value in the industrial supply chain. China won't succeed in every segment, but leaders in certain fields will be able to do that. R&D spending has also been increasing across the board. Cloud-based solutions, high-end manufacturing and specialty materials are examples where China has excelled,” says Liang at RWC Partners.


“China is also never slow to adopt new innovations, either new products such as electric vehicles or new business models in ecommerce. We expect rampant business innovation will continue and champions will continue to emerge from new areas.”

That's the thing. China never fails to surprise. For good or bad, wealth and asset managers should be ready. ●

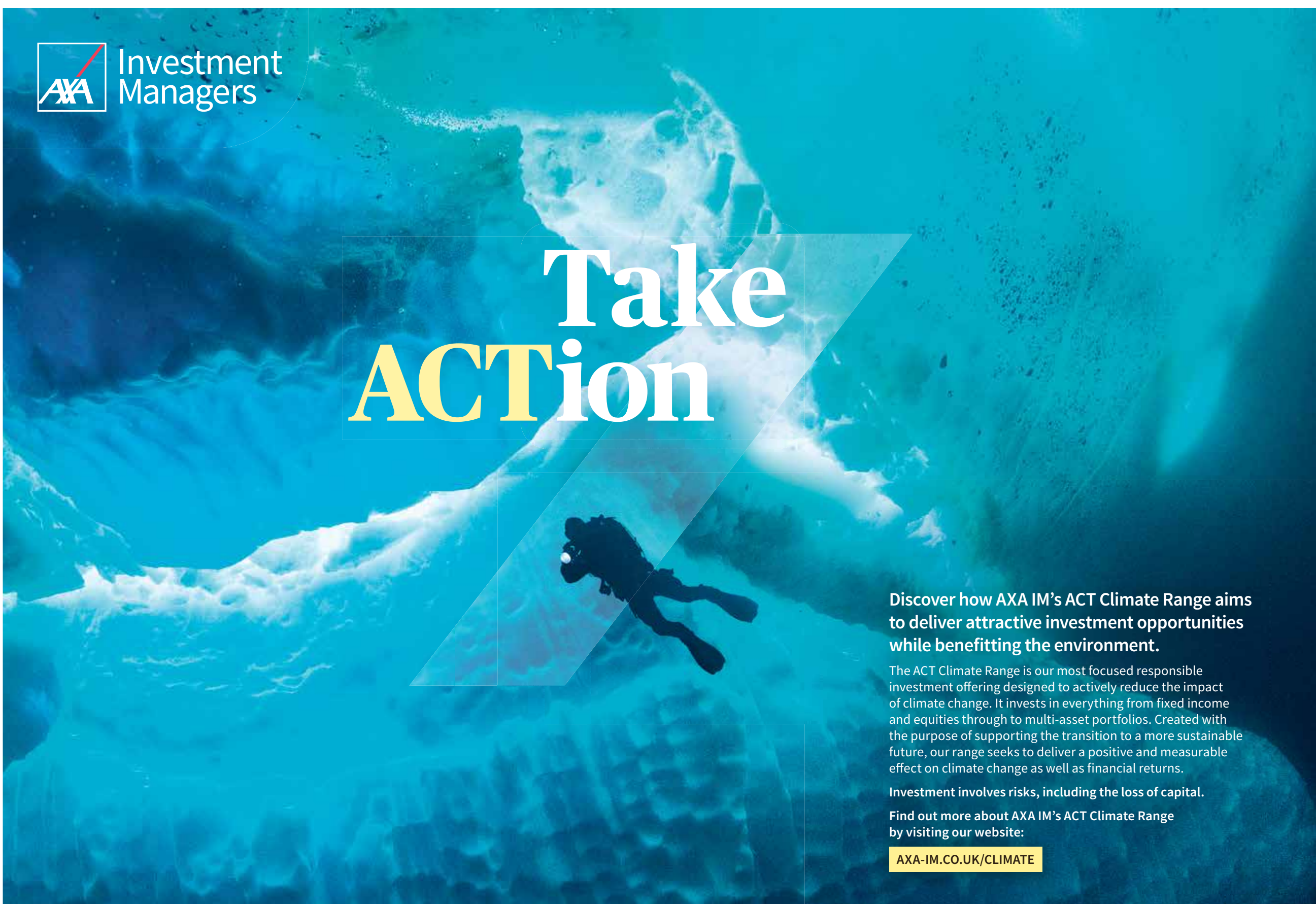
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Looking to the future, wealth and asset managers should focus on the megatrends. Urbanisation, domestic consumption and the explosion of the Chinese middle class will continue to be in focus. The population with more than \$10,000 annual disposable income is expected to grow from 280 million to 680 million by 2030. Chinese millennials and Generation Z are also becoming more discerning consumers.

President Xi's dual-circulation strategy is part of this story. This involves China still being part of international circulation, which involves competitive global exports and trade, however there is a move to improve domestic circulation. This involves building a vibrant home-grown economy with less dependence on imports. Investors hope this will bode well, at least for local demand.



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