Asset Management

THREE REASONS TO INVEST RESPONSIBLY

By James Rich, Chairperson of the Sustainable Investment Committee

Responsible investing has evolved in recent years from an aspirational approach offered only by a handful of niche managers to an increasingly mainstream offering with growing adoption among asset owners and managers alike. In addition to generating competitive returns, many investors now seek to do more with their money by making a positive impact on society, the economy or our environment. At Aegon Asset Management, we believe responsible investment practices, such as ESG integration and aligning with long-term sustainability trends, can help improve investment decision-making abilities, identify attractive investment opportunities and ultimately aid in the pursuit of better outcomes.

Improve decision-making

Integrating ESG factors into the research process can help manage risk and uncover opportunities

Identify opportunities

The secular shift towards sustainable business practices, products and services presents investment opportunities

Pursue better outcomes

Responsible investment practices may add value and contribute to a more sustainable world over the long term

Reason 1: Improve decision-making to better manage risk and uncover opportunities

Consider a situation in which a company is at risk of losing its largest customer to a competitor due to that customer's concerns over product safety issues. While the current financial condition of the company may be stable, as a bond holder, would you incorporate the social risk of this situation in your fundamental credit outlook? Similarly, if new regulation forces a company to dispose of environmentally sensitive waste in a more expensive way, as an investor, would you consider the effect of higher expenses on the company's profit margins? In both situations, social and environmental factors could be material enough to deteriorate credit fundamentals, thus lowering bond and equity valuations.

At Aegon AM, we believe environmental, social and governance (ESG) factors are a meaningful component of sound, fundamental credit analysis that can help to better manage risk and uncover opportunities. Analyzing ESG factors can provide insight into a company's business practices that could pose a risk, or an opportunity, from an environmental, social or governance perspective. As depicted in Exhibit 1, companies across various industries can exhibit ESG-related opportunities and risks. Furthermore, by combining ESG factors with traditional financial metrics, investment managers can identify situations where ESG factors may affect an issuer's fundamentals and, ultimately, its security prices.

While integrating ESG factors help uncover and mitigate risk, we believe the real value in ESG integration is in accurately parsing out what really matters from all the noise. ESG-specific information available to investors today—from ESG research firms, credit rating agencies, consultants and issuers themselves—is vast, complex and often contradictory. To sort through it all and make better-informed investment decisions, we believe it is crucial to conduct an independent assessment of ESG factors in conjunction with traditional financial metrics. Seasoned research analysts apply their deep understanding of an issuer's financial condition with ESG information to identify the potential economic effect that ESG issues may have on the issuer's ability and willingness to meet debt obligations.

Although ESG integration is typically thought of as a risk mitigation tool, it can also provide upside opportunity for investors. For example, an issuer that provides strong creditor protections in its debt documents may have a solid governance regime in place, which may result in outperformance of its securities' relative to industry peers. A fundamental, research-driven investment process should be structured to capture both upside and downside alpha.

Exhibit 1: Examples of ESG-related risks and opportunities

	Risks	Opportunities
Environmental	An independent energy company with a history of flaring/venting a relatively high proportion of associated gas in its Permian Basin operations.	A technology company utilizing renewable energy to power its data centers.
Social	A mining company involved in controversies related to human rights violations over the proper treatment of local indigenous peoples.	A financial services company with a high rate of lending to underbanked communities as well as small and medium enterprises.
Governance	A protein producer with executives and/or controlling owners that are involved in numerous bribery and corruption scandals.	A metals company with a board that has an independent majority, has split the roles of CEO and chair and has a fully independent chairman.

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Reason 2: Opportunities driven by long-term sustainability trends

We believe a secular shift toward sustainability is underway: an evolution of business practices, products and services. Al Gore, Chairman of Generation Investment Management and former US Vice President, even refers to sustainability as the next revolution and the "single largest investment opportunity in history." Furthermore, sustainability, once more of a burden for some industries imposed by government regulations, has become a competitive advantage for other companies.

The secular shift toward sustainable business practices, products and services will create interesting investment opportunities and should not be ignored. Combatting climate change is just one example. Sustainability efforts extend to a myriad of other objectives too, from selling healthier, unprocessed foods to utilizing recycled materials as inputs to improving access to affordable healthcare to enhancing the quality of education.

For example, while some may debate the cause of global warming, the increasing focus on combating climate change globally is clear. Utilities are investing in wind and solar power and deemphasizing their past use of fossil fuels. As outlined in the US Energy Information Administration's annual report for 2019, electricity generation from renewables is expected to continue to increase (Exhibit 2).

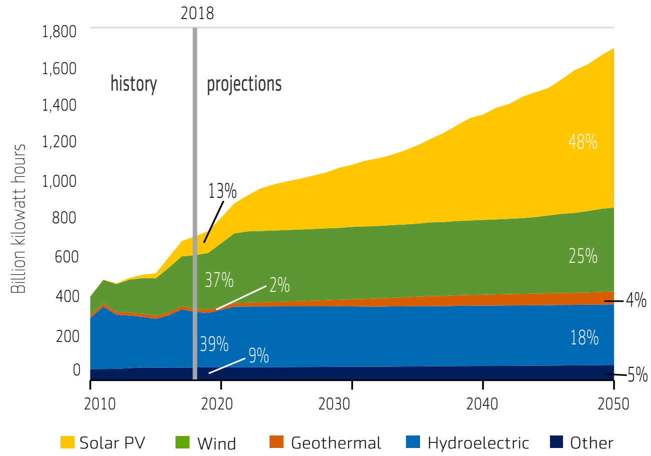
In addition, auto manufacturers are racing each other to create affordable, low-emission cars as global emissions standards are driving hybrid and electric vehicle growth. Currently, hybrid and electric vehicles are approximately 5% of global light vehicle sales volume with expectations for that figure to grow to 30% by 2030 (Exhibit 3). Moreover, China is adapting its central policies in an attempt to reduce greenhouse gas emissions from its large manufacturing sector. Technology companies are building mile-long data centers to help customers to cut costs and reduce their carbon footprint. Likewise, the list of public and private organizations working to fight climate change continues to grow.

The United Nations' Sustainable Development Goals (SDGs) provide a good starting point for defining what sustainable means. These 17 goals were agreed to in 2015 by all 193 members of the UN, with a scheduled achievement of all 169 underlying targets by 2030. The extensive efforts by public and private organizations globally in recent years to support them is evidence of a global sustainable megatrend that will likely change the shape of the global economy in the decade to come.

Further, the investment opportunity is massive: a study released by the UN indicates that nearly $4 trillion of private investment is needed annually to achieve the SDGs by 2030. However, only $1.4 trillion is currently being invested, suggesting an additional $2.5 trillion of investment is needed annually. (Exhibit 4).

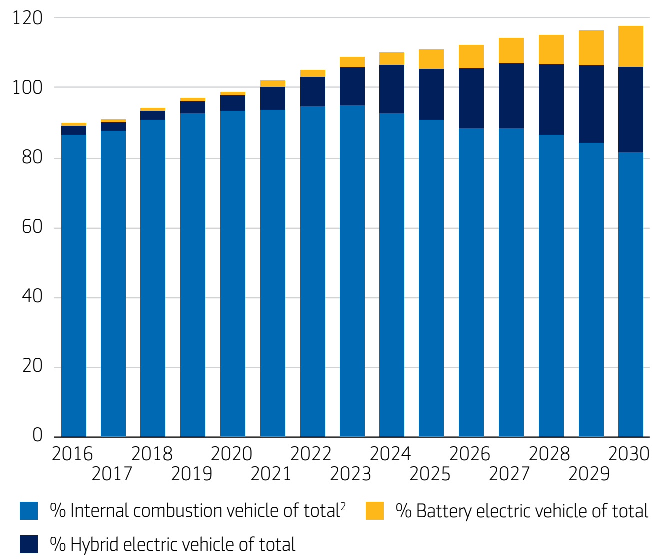
Issuers that support this sustainable megatrend, through the products and services they sell or the business practices they employ,

Exhibit 2: Renewable electricity generation



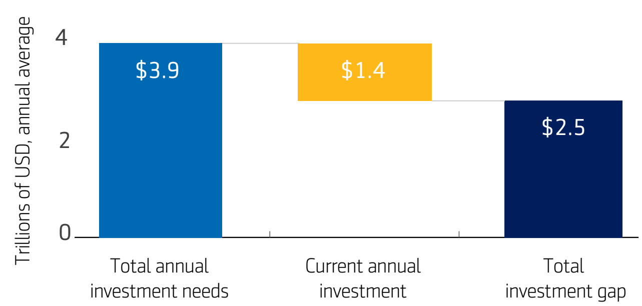
Source: US Energy Information Administration (EIA) – Annual Energy Outlook 2019.

Exhibit 3: Hybrid and electric vehicle growth is expected to accelerate (millions of units)[1]



Source: Aegon AM US using publicly available BCG estimates.[1]Units of global light vehicles. [2]Includes mild hybrid electric vehicles.

Exhibit 4: Estimated annual investment gap in key UN Sustainable Development Goals



Source: United Nations Financing for SDGs - Breaking the Bottlenecks of Investment from Policy to Impact report as of June 2018.

will likely be rewarded over time. Supporting the sustainable megatrend will likely give such issuers an advantage over their competitors that don't, offering them a better chance at long-term success. We believe there's value in aligning portfolios with this megatrend by investing in these issuers in an effort to generate better returns.

Reason 3: Pursue better outcomes

While competitive financial returns are one desired result of investing alongside the secular sustainability shift, a simultaneous benefit is the positive impact it can have on the global economy, environment and society. Actively choosing to invest in sustainable issuers may help to lower their cost of capital and reduce the return hurdle required for the continued development of their sustainable products, services and business practices. This has the follow-on effect of encouraging issuers to continue their sustainable ways because the market rewards them for doing so. On the other hand, actively choosing to avoid unsustainable issuers may have the opposite effect: It raises issuers' cost of capital and ultimately discourages them from continuing their unsustainable ways. Not only does investing responsibly benefit issuers, but we believe responsible investing can provide opportunities to generate alpha.

Many investors also erroneously believe they can only make an impact through equity investments given equity shareholders have control over the issuer. However, we are finding ample opportunities to make an impact through debt investments. While lenders don't have a vote in the company's strategy, they still have the ability to "vote" with their investments. Actively choosing to invest in a sustainable issuer lowers their cost of capital regardless of whether the investment is through the equity or debt of the issuer.

By investing sustainably, we believe investors can both achieve their financial objectives and make a contribution towards a more sustainable economy, environment and society.