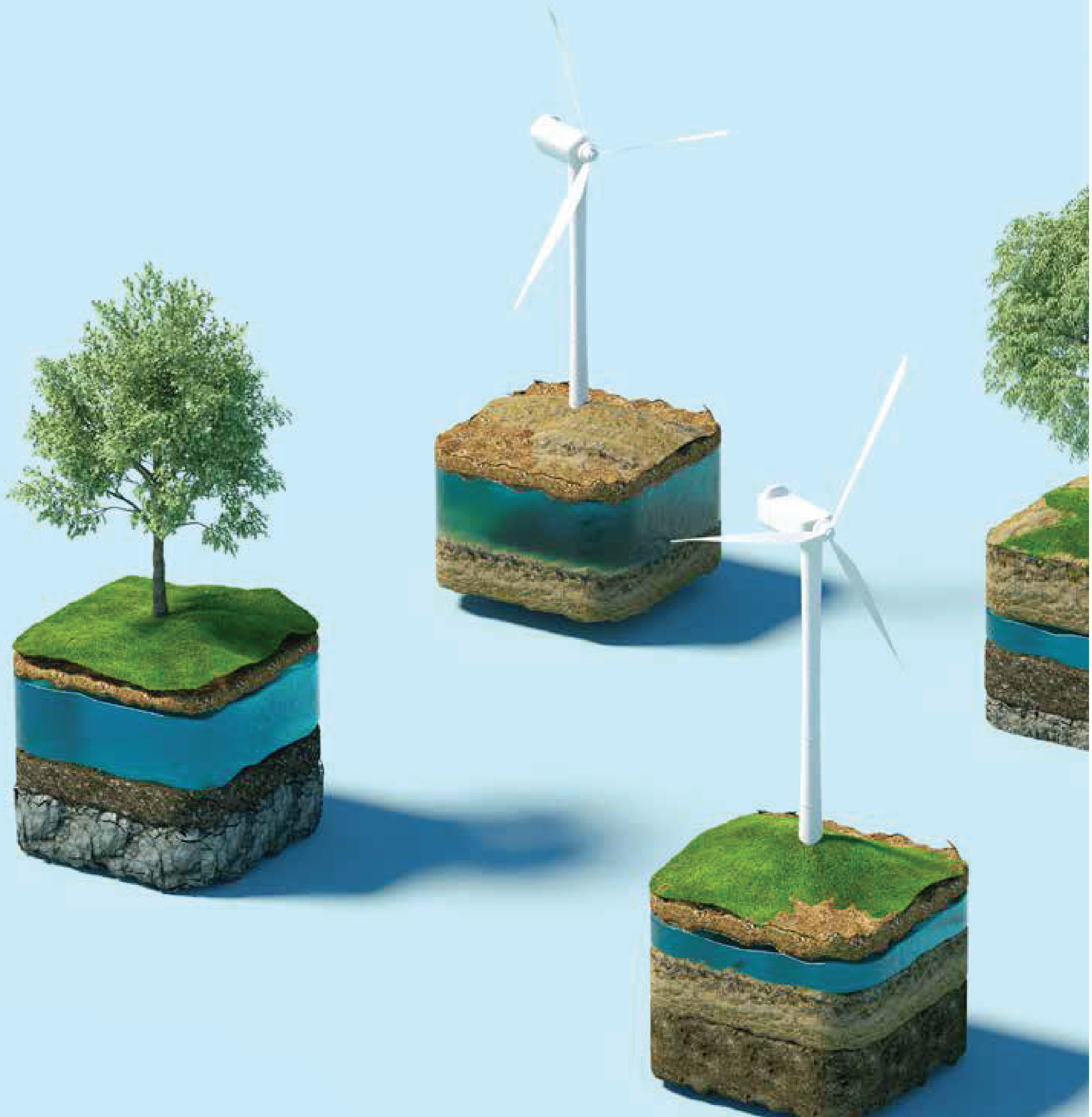
UNLOCKING VALUE WITH SUSTAINABILITY

THE ROLE OF DOUBLE MATERIALITY



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As sustainability gains momentum and changes the perceptions of many investors, we are entering a new paradigm where non-financial criteria are increasingly being used to make investment decisions. However, it may seem difficult to navigate this additional dimension if investors do not proceed with a clear idea of what they intend to achieve.

For decades, investors have relied on risk-return models to optimize their portfolio allocation. For a given financial risk budget, the objective was to maximize the financial performance of a portfolio that combines risky assets with different levels of risk, liquidity and yield.

Let's go back to basics: building a resilient portfolio is the objective of many investors. They want to optimize performance, while limiting the downside of adverse developments. Achieving this depends on factors that may positively or negatively impact the price of assets. Identifying these factors is essential, and traditional investors are used to analyzing multiple financial indicators when assessing the risk-return profile of an investment opportunity. Over the last few years, environmental, social and governance (ESG) criteria have gained traction among the financial community. This trend goes far beyond Socially Responsible Investment (SRI), which mainly focuses on ethics and governance.

The two facets of sustainability
Sustainability has two facets. The first is resilience, which relates to the impact of externalities on the value of assets. Resilience reflects the outside-in effect of non-financial factors on the value or the financial performance of an asset or a portfolio. Climate change may hit the value of an asset or the income expected from it, for example, or weak governance may have a disastrous impact on the valuation of a company. The second facet is the inside-out effect, which measures the consequences of an investment decision on ecosystems.

Non-financial criteria, despite their non-financial essence, can provide valuable

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information to increase the resilience of the portfolio, limiting its downside risk and increasing value creation over the long term.

When optimizing investment decisions, the concept of materiality is key to enhancing value creation over time. Including a non-financial, but material risk (e.g. reputational risk for a company strongly involved in deforestation in Brazil) is likely to be more efficient than including a financial, but non-material risk (e.g. interest rate risk when investing in very short-dated securities). Applying materiality to both financial and non-financial risks enhances the resilience of a portfolio. Combining outside-in and inside-out lenses delivers superior long-term value creation.

Adding a long-term view to value creation

More and more studies show a positive correlation between outperformance and strong ESG ratings. For skeptics doubting the value of environmental, social and governance considerations in investment decisions, this outperformance is due purely to more and more investors chasing after the same types of investments because of their ESG risk profile, thereby creating an ESG bubble.

But reality actually goes far beyond this. In fact, by integrating more information – especially relating to material non-financial risks - investors can select the companies that present a high-performance potential and avoid others that bear too high a risk. This may prove useful when dealing with a limited financial risk budget.

Resilience is one aspect of sustainability, and probably the easiest to comprehend for investors who are used to seeking financial performance. However, it is only one side of the coin; sustainability embeds a much broader concept. Outside-in and inside-out effects are strongly

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interconnected, and dealing with one while neglecting the other keeps investors locked into their usual short-term view of value creation.

Taking climate change as an example, resilience should lead to protecting the value of assets against both transition and physical risks. These two risks move in opposite directions, as the faster the transition, the higher the possibility of containing global warming. However, this only works to the extent that the transition is sufficiently early and orderly. Otherwise, transition damage – mainly stranded assets – and a significant increase in the severity and/or frequency of climate-related extreme events, may hit investors' portfolios.

Therefore, when addressing the inside-out effects of their investment decisions, investors may decide to exit some sectors that are not compatible with the Paris Agreement. They may also decide to put a best-in-class strategy in place aimed at limiting the adverse impacts of their investment decisions on the environment. By doing so, they actively contribute to a faster transition, which in turn protects their portfolio against physical damage - over a much longer time horizon. This loopback effect reintroduces the long-term horizon into short-term decisions.

Impacting the real economy: Combining best-in-class and engagement

In an ideal world, investees should be actively and directly involved in transitioning their business models to address environmental, social and governance challenges in a frictionless way. To support this transformational behavior, responsible investors can play an active role by engaging with investees.

Returning to the climate change example, a strategy combining engagement and decarbonization targets is best positioned to impact the real economy. Portfolio decarbonization should be carried out in an orderly manner, remaining exposed to all sectors needed to build a more sustainable world. It's not a question of exiting the energy sector to decrease the carbon footprint or the implicit temperature rise of a portfolio. Rather, investors should select the best companies within each sector committed to reaching carbon neutrality as soon as possible, supporting them in their pathway to decarbonization and engaging with them to speed up their process.

CONCLUSION

Sustainability should be considered holistically. It highlights the responsibility of investors in terms of building a sustainable world. Investors are becoming mindful of what they invest in when using the double materiality lens. Sustainability raises the question of how to generate returns not only on financial capital but also on nature and society. It opens the door to "multi-capital" thinking, which complements traditional investment and creates new opportunities.

IN A NUTSHELL

- Sustainability encompasses the double materiality principle
- The loopback effect of investment decisions reconciles short-term resilience with long-term impact and benefits value creation
- Responsible investors should seek to impact the real economy beyond building a resilient portfolio