Asset Management

Responsible Investment
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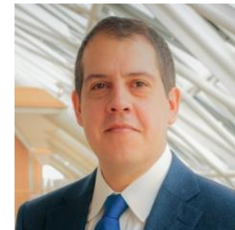
AEGON INSIGHTS

Sustainable Development Goals: Taste the Rainbow

I started working with ESG investors almost 20 years ago. Back then, getting portfolio managers just to consider material ESG risks before investing was counted as a big win. After a stint at an ESG data provider, I took a detour into the development finance industry, where investment mandates were far more focused on positive environmental and social impact.



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It was while working at the World Bank Group that I learned the challenges of measuring, monitoring, and reporting impact, while also trying to prove 'additionality' (the input we brought to an investment project which could not have been obtained from commercial sources of finance). This remains an area of huge effort for development banks.

When I returned to work in asset management in 2019, I was shocked to read some of the claims of impact and contributions to the Sustainable Development Goals (SDGs). I had always believed that these goals were something which governments, rather than companies or investors, signed up to. Furthermore, I saw their relevance as primarily relating to developing countries, where solvency rules limit the ability of institutional investors to making meaningful investments. I wondered how investors could be achieving this level of impact and how I could have missed it.

Looking at corporate disclosures, we see a rush of companies reporting activities in alignment with the SDGs, regardless of how (in)significant those activities might be or how other activities might be actively negating any positive impact claimed. You can therefore find mining companies reporting capacity-building programs with local and national governments as 'implementing' SDG 16 (peace, justice and strong institutions), while at the same time settling large guilty plea agreements for bribery in multiple countries. One tobacco company claims its ESG strategy is aligned with SDG 3 (good health and wellbeing), because they are committed to 'offering adult smokers a range of potentially less harmful products'.

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Rainbow[1] washing, the term coined to name this phenomenon of questionable SDG-related claims, is rife in corporate disclosures. Investors interested in finding ways to contribute to the SDGs therefore needed more objective measures to identify impact. A popular investor approach to measuring 'alignment with' or (worse) 'contribution to' the SDGs is to measure the alignment of corporate revenues to each goal. The idea is to identify an economic activity (a product or service) that contributes towards an SDG and then measure the revenues a company obtains from those activities as 'alignment' or 'contribution' to that goal. With this approach defining which products and services contribute to which SDGs becomes a critical piece of the puzzle. Unfortunately, for investors eager to demonstrate the positive impact of their portfolios, loose definitions are very tempting, leading to some questionable logic.

To illustrate, it might make sense to say a food company is 'contributing to' SDG 2 (end hunger, achieve food security and improve nutrition, and promote sustainable agriculture). The trouble is that there is little consistent disclosure in the sector about the nutritional value and affordability of their products or their clients' income levels. A blunt research approach trying to cover thousands of companies in a cost-effective manner might therefore conclude Skittles[2] are 'contributing to' SDG 2, and its associated revenues for Mars Inc are 'aligned' to that goal. To be a little less provocative, you might consider Danone's food revenues to be 'aligned' to this goal, but should we count their developed market revenues as contributing equally to SDG 2 as their revenues in emerging markets? In other words, are the yogurts they sell in France contributing to SDG 2 as much as those they sell in Africa? And were the people able to buy their products hungry in the first place? Are their products affordable to those targeted by SDG 2?

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Another issue to consider is how those 'contributing' activities are conducted. After all, it is great to contribute towards ending hunger, but you may well be hindering progress against SDG 13 (climate action) if you are achieving this by growing mangoes in greenhouses in the Netherlands using fossil fuels. To be fair, most methodologies do attempt to cover potential negative impacts by incorporating metrics such as carbon emissions, pollution or major labor or human rights controversies, summarizing negative performance as negative contributions to the SDGs somehow.

Here again though, we can quickly run into the blunt research problem. How do we quantify the negative contribution of a slave labor involvement controversy towards SDG 8 (decent work and economic growth) and balance that against a company's positive contributions? How do we consider a company's positive or negative contribution to gender equality in their operations – through their board diversity, gender pay gap, opportunities for women, education offered? How consistent are such metrics? How often are they measured and disclosed? If they are estimated, how reliable are the estimation models, how accurate?

There are similarities between these SDG-contribution methodologies and the approach taken by the EU taxonomy for sustainable investments. The EU taxonomy seeks to identify economic activities positively contributing to one of six environmental objectives, while demanding compliance with technical screening criteria that seek to address how those contributions are made.

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[1] 'Rainbow' is a reference to the colours of the SDGs in their popular graphic, see [THE 17 GOALS | Sustainable Development (un.org)]

[2] Skittles are multicolored fruit-flavored candies first made in the UK in 1974. In 1994, New York ad agency D'Arcy Masius Benton & Bowles coined its popular tagline 'Taste the Rainbow'.

‘Do no significant harm’ requirements also demand demonstration that the activity is not contributing negatively towards another environmental objective. Notably however, the EU taxonomy calls for companies to measure and report their alignment with the taxonomy according to a prescriptive regulation; it distinguishes between the ‘eligibility’ of an activity and its ‘alignment’ with the taxonomy including all its requirements; and most importantly it requires disclosures beyond the revenues associated with those activities, such as capital expenditures. Arguably, these additional requirements make the EU taxonomy a more solid methodology, more firmly rooted in objective and mandatory corporate disclosures, even if investors can still question the accuracy of those disclosures and cannot obtain them easily from non-EU companies.

Considering all this, at Aegon AM we have been a little reticent about making claims of contribution to the SDGs for our sustainable equity and corporate bond portfolios. Our approach in identifying sustainable or impactful investments has always been more holistic and cognizant of the qualitative nature of the information we are analyzing. Of course, it is always possible to build thematic strategies based on revenue data, but this only gets us to the ‘eligible activity’ standards of the EU taxonomy, not its alignment standard. Weighing different impacts for companies remains more of an art than a science until we have consistent disclosures based on proper accounting standards. These would enable us to create reliable ESG metrics with which we can build algorithms to drive quantitative sustainable investment solutions.

> ***The SDGs are well-suited for comparisons of the sustainability of sovereign issuers, after all they are fundamentally sovereign commitments.***

We also believe sustainable investment opportunities can be found well beyond corporate securities. For example, there has been almost no discussion of a taxonomy for sustainable sovereign investments, despite sovereign bonds constituting a significant proportion of institutional investor portfolios. Ironically this is where SDG-alignment is far easier and more credible to claim. The SDGs are well-suited for comparisons of the sustainability of sovereign issuers, after all they are fundamentally sovereign commitments. Comprehensive and reliable data sources, such as the World Bank, have allowed us to build a model that tracks each country’s relative progress towards each SDG. We can then attach weights to each SDG target according to its salience for the country’s relative income level, such as climate action being more important in developed markets while no hunger being more pressing for developing countries. The model results act as an important input for our analysts to propose a sustainability categorization of each country, which is then debated in our Sustainable Investment Committee. With these well-researched and discussed opinions, we can build a unique and diversified portfolio of the most sustainable sovereign issuers, confident in the fact that these issuers demonstrate the most progress towards the most important SDGs for their income class, and therefore giving our clients confidence that their capital is being directed towards positive SDG progress.

The SDGs remain an important reference framework and an inspiring, unifying vision for the world’s sustainable development. Investing with impact can and does contribute towards the SDGs but there are limited shortcuts we can take to ensure proper impact measurement and reporting. We should all be aiming to work towards these laudable goals, but we need to make sure that in trying to taste the rainbow we are not merely rainbow washing.

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