GIC

THINKSPACE

PERSPECTIVES ON

Sustainability in Practice - A Long-Term Investor's View

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*The **International Forum of Sovereign Wealth Funds** (IFSWF) is a global network of sovereign wealth funds (SWFs) that meets, exchanges views on issues of common interest and facilitates an understanding of SWF activities and the **Santiago Principles**. GIC is a Board Member of the IFSWF.*

This article captures key takeaways from a recent GIC-IFSWF webinar on Sustainability in Practice – A Long-Term Investor's View. The session featured four senior members from GIC's Sustainability Committee, namely Liew Tzu Mi (Chief Investment Officer, Fixed Income), Rachel Teo (Head of Futures Research Unit, Senior Vice President, Economics & Investment Strategy), Boon Chin Hau (Head Of Asia And Emerging Markets, Managing Director, Infrastructure), and Shang Thong Chie (Head Of Enterprise Strategy, Senior Vice President).

The growing focus on sustainability presents new investment opportunities, while exposures to climate change and other sustainability risks will play a key role in long-term performance. Sustainability is thus integral to GIC's mandate, which is to protect and grow the reserves under its management over the long term. In this article, GIC shares how sustainability is being integrated into its portfolio, investment strategy and process, and operations, the challenges faced and how these are managed.

HOW GIC APPROACHES SUSTAINABILITY IN ITS PORTFOLIO AND OPERATIONS

GIC has three key beliefs that anchor and guide its sustainability efforts:

- Companies with strong sustainability practices will offer prospects of better risk-adjusted returns over the long term, and this relationship will strengthen over time as externalities get priced in. Sustainability integration is thus imperative to the resilience of GIC's portfolio.
- A holistic and long-term approach is needed as there may be inherent conflict between different sustainability objectives, especially in the shorter term. One key example is the conflict between environmental and social sustainability, especially in the emerging markets.
- It is more constructive to engage and support companies in their transition towards sustainability, rather than adopt a blunt divestment approach.

GIC's sustainability approach is aligned to its O-D-E framework, which encompasses both investment and corporate processes. ***O*** for Offence is about investment opportunities, ***D*** for Defence is for risk management, and ***E*** for enterprise excellence is about corporate practices and culture.

Offence

As regulators and consumers act on ESG issues, businesses rethink operating models and technologies improve, new investment opportunities will emerge. GIC seeks to capture these through multiple means, including adapting its investment processes, focusing on themes arising from the global transition towards a lower-carbon and more sustainable economy, and greening its real assets.

Defence

As sustainability presents disruptive risks over the longer term, investors need to be proactive in understanding the risks and positioning their portfolio ahead of these. Besides negative screening, GIC conducts stress testing for its portfolio against various climate scenarios. Bottom-up investment teams also incorporate climate change risks in their investment process, and actively engage companies in their transition towards sustainability. This is done through the proxy voting process, engaging companies on their sustainability plans, and supporting them to improve their ESG reporting.

Enterprise Excellence

How the organization operates is equally important. GIC's efforts include sustainable procurement practices, ensuring sound governance, fostering a diverse and inclusive corporate culture, and giving back to the community. GIC will also be carbon neutral by end March 2021.

ASSESSING THE IMPACT OF CLIMATE CHANGE RISK ON THE PORTFOLIO

Climate change is a key concern for long-term investors like GIC given the impact of both physical risks and transition risks on the value of physical assets and companies over time. Assessing and factoring this in both top-down and bottom-up investment processes is key to ensuring a resilient portfolio.

For top-down strategic asset allocation, GIC looks at how long-term capital market assumptions are affected by climate change drivers and in different climate change scenarios. External environment assessment and scenario planning analysis are important building blocks in the asset allocation process. This also highlights areas where there are heightened risks, such as energy and utilities, and help to focus more in-depth analysis and research into those places. These analyses are used to look into strategies that can make the portfolio more climate resilient.

For bottom-up company analysis, GIC equips the investment teams with tools, analysis and research to better understand, identify and assess climate change related risks and opportunities. Some examples include:

- ***Climate value at risk dashboard*** which shows how companies would be affected by a comprehensive set of climate related drivers such as carbon costs and physical risks under different scenarios.
- ***Carbon dashboard*** which shows carbon intensity at the company level, and allows the analysts to compare it with the company's peer group and assess the impact of carbon pricing on its profit margins.

INTEGRATING SUSTAINABILITY IN GIC'S PORTFOLIO AND INVESTMENT PROCESS

GIC does not adopt a top-down blunt divestment approach, instead it believes it is much more constructive to focus on specific companies, understand their markets and business practices, and support them in their transition plans.

Investment teams are well-aware of the market and reputational risks involved in investing in companies with poor sustainability practices. GIC also does not target a certain size or volume of sustainability investments. When evaluating individual investments, they do so holistically, by integrating sustainability factors, alongside other drivers of long-term value, to make better-informed decisions.

One recent example was GIC's investment in a US utility company called Duke Energy. The company's commitment to retire its coal power plants and invest in cleaner generation sources in the coming years was one of the key factors for the investment, and GIC's capital will help the company accelerate their transition plan towards renewable energy. This nuanced and holistic approach to investing and working alongside businesses to support their stated sustainability goals, creates long-term value for the company and the planet, while driving returns for GIC's portfolio.

As all of GIC's investments are screened for their ESG characteristics, additional due diligence will be conducted for those that are exposed to such risks, and long-term valuation and risk models will be adjusted accordingly. With this, the investment teams are better able to engage with investee companies to discuss specific mitigation actions. In situations where negligence towards ESG risks have led to negative implications or where there is no willingness or viable pathway for the entity to transition, GIC will not invest or divest these positions.

GIC also engages with its portfolio companies and fund managers on sustainability issues. While the specific issues of engagement will vary depending on the company, asset type and sector, the constant underlying premise is to protect and enhance long-term value. For listed companies where GIC has voting rights, GIC exercises those rights and engages with management before and after voting to explain the decisions. For private companies in which GIC has significant positions, GIC conveys its views on sustainability related topics through dialogues with the company's board, senior management, and other like-minded shareholders. GIC also discusses and shares best practices with its investment partners.

However, there is no one size fits all assessment criteria or industry standard, as the ESG impact by asset class, sector, company, and market will differ. Two key challenges to highlight are:

- *Materiality*: what are the metrics, risks and opportunities that matter to the company's long-term financial prospects. For example, what matters to an oil-and-gas producer is very different from what matters to a consumer goods company. Investors need to have a clear view of these so that they are better able to guide the companies to the most important issues.

- *Comparability*: Today, there's a real "alphabet soup" of reporting and disclosure standards. This is challenging for companies because every investor will ask for slightly different metrics, while investors will find it hard to compare companies that use different standards.

Notwithstanding, by coming together as investors and portfolio companies, the hope is to learn from and support one another on this sustainability journey. Over time, this will likely improve the way we all look at these systemic sustainability issues.

OTHER ESG ISSUES THAT COULD POTENTIALLY DISRUPT BUSINESSES AND INVESTMENTS OVER THE LONG TERM

Like climate change, the S part of ESG could also pose disruption risk to economies and markets. The COVID-19 crisis has magnified the vulnerabilities and awareness of rising social inequality, specifically those who have limited or no access to healthcare, jobs, social safety nets, and technology. In addition, as a result of the safety measures and supply chain onshoring, the push to technology and automation could lead to more job displacement, particularly for lower skilled workers, further widening the social divide.

GIC's research indicates that of all the 10 social issues in the SASB materiality framework, employee engagement, diversity and inclusion is one of those that really matter for the company's financial performance, with economic equality an important driver of the *Diversity*, *Equity* and *Inclusion* practice in the S in ESG. Economic inequality (defined based on three dimensions – income, wealth and access to opportunities due to a person's socio-economic background, gender or ethnicity) has an impact on macroeconomic growth, inflation, political stability and policies. For example, higher income inequality is associated with weaker GDP growth especially for middle- and high-income countries, while rising economic inequality can result in poorer human capital quality due to limited access to credit, education and healthcare. Economic inequality is positively correlated to indicators of political stability, as social unrests and protests during crises periods are often a reflection of the underlying economic inequality in these societies.

As such macro factors matter for investment performance, investors need to pay attention to economic inequality risks.

INTERNALISING SUSTAINABILITY IN THE ORGANIZATION

Enterprise excellence is mainly about inspiring and getting the buy in from the whole organization on why sustainability is integral to GIC's purpose and core values, and then equipping them with the knowledge and resources to make more responsible decisions. In the organization, GIC tries to do this in three ways.

First is through campaigns. Just recently, GIC completed its "sustainability month" programme, where webinars and workshops were organized featuring thought leaders from its global network of partners and fund managers, as well as GIC's in-house experts. It also gamified the experience where people were divided into teams and able to set themselves 'sustainability' challenges such as saving energy or reducing waste in the home.

Next is about integrating the right corporate processes to build the right culture. This includes setting out clear expectations for sustainable business practices to our business partners, vendors and service providers, encouraging good governance, environmentally and socially conscious practices and behaviour, and reducing our carbon footprint across our global offices.

One key area of focus has been on fostering a diverse and inclusive culture in GIC. For instance, deliberate efforts have been made to adequately and appropriately consider diversity in the hiring process and performance management conversations. GIC also believes in empowering their people to contribute their time, effort and expertise to help the communities where they live and work. Through sustainable social programmes such as Differently Abled, GIC Sparks & Smiles, and GIC X Change, GIC seeks to promote inclusion within and outside of GIC as well as deliver long-term social impact.

Given its global footprint and networks, GIC also actively engages with external organizations such as IFSWF, [FCLTGlobal](#) and [World Economic Forum](#), as a way to share insights and advocate long-termism in the community, sustainability and good corporate governance.

CONCLUSION

As a responsible steward, GIC aims to deliver good risk-adjusted returns and do in a way that will also drive positive outcomes for society over the longer term. To do that, GIC needs to maintain a resolute focus on its mandate, which is to protect and grow the reserves under its management. That is why being vigilant about the risks and opportunities arising from ESG factors is critical. Next, GIC must stay focused on the long term. Having this mindset allows GIC to look beyond short-term headlines and position for longer-term trends. Likewise, engagement to improve companies' sustainability practices and focus them on a transition pathway will create long-term value. Third, GIC needs to continue building capabilities and partnerships. This means constantly working on getting better at what it does, staying informed on market shifts, and expanding its networks of like-minded partners to exchange best practices with.

> **GIC DOES NOT ADOPT A TOP-DOWN BLUNT DIVESTMENT APPROACH, INSTEAD WE BELIEVE IT IS MUCH MORE CONSTRUCTIVE TO FOCUS ON SPECIFIC COMPANIES, UNDERSTAND THEIR MARKETS AND BUSINESS PRACTICES, AND SUPPORT THEM IN THEIR TRANSITION PLANS.**
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Lastly, as sustainability is a space that is still evolving, there is a lot to learn from different partners in the industry, to uncover blind spots and improve the ways of doing things. While companies are all at different stages of discovery, the sustainability journey ahead remains a long one.