HEALTH WEALTH CAREER

SUSTAINABILITY IS GATHERING MOMENTUM

A THEME AND AN OPPORTUNITY FOR 2019

In a sense, sustainability is nothing new.
It has a lot of overlap with the concept of long-term investing, which was famously espoused by Benjamin Graham and David Dodd following the Great Depression (side by side with the concept of value investing).[1] However, the context has changed. With vastly greater numbers of people living on the planet today, resources that were once practically inexhaustible are either now exhaustible and unreplenishable (oil and gas, for example) or inexhaustible only if managed with restraint (forestry).

In response to this change in context, we have observed investor demand, strategy availability and regulatory engagement on sustainable investing all gradually rising for more than a decade. All three increased significantly in 2018, and none look to be abating anytime soon. Sustainability is gathering momentum.

[1] Graham B and Dodd D. *Security Analysis*, McGraw-Hill: New York, 1934.

WHAT DO WE MEAN BY "SUSTAINABILITY"?

In its simplest form, sustainability is literally "the ability to sustain." The most widely accepted definition is that "which meets the needs of current generations without compromising the ability of future generations to meet their own needs."[2] The 2015 UN Sustainable Development Goals, driven by the population, consumption and resource challenges we face, are based on this definition and make the connection between "people, planet and prosperity."[3]

At Mercer, we believe an investment approach that includes environmental, social and corporate governance (ESG) factors and broader systemic issues — for example, climate change and sustainable development — along with active ownership (stewardship) is more likely to lead to sustainable investment outcomes, such as a greater ability to sustain pension payments. In practice, this can mean investors focusing on Mercer's higher-ESG-rated strategies and/or allocating to sustainability-themed strategies, where the emphasis is on companies that explicitly provide solutions to social and environmental challenges.[4]

[2] World Commission on Environment and Development. *Our Common Future*, 1987, available at http://www.un-documents.net/our-common-future.pdf.

[3] United Nations Development Programme. "UN Sustainable Development Goals," available at https://www.undp.org/content/undp/en/home/sustainable-development-goals.html.

[4] For more information on how we think about sustainability and responsible investment, see our recent paper, *The ABC of ESG*, available at https://www.mercer.ca/content/dam/mercer/attachments/north-america/canada/ca-2019-the-abc-of-esg-environmental-social-governance.pdf.

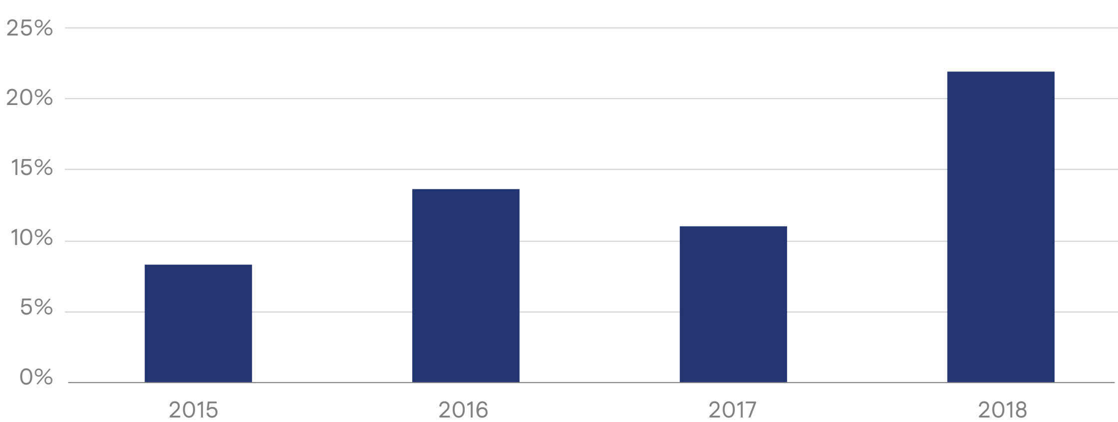
INVESTORS ARE BUYING INTO SUSTAINABILITY

We have witnessed an emerging preference among our client base for selecting investment strategies that Mercer rates highly for the way they incorporate ESG factors into their idea generation and investment processes.

In 2016 and 2017, the number of client searches resulting in an allocation to a strategy highly rated for ESG grew meaningfully, whereas the total assets being allocated each year didn't change much — with just a higher number of clients allocating to these strategies. In 2018, however, this changed, and we saw the total level of assets allocated to highly rated ESG strategies jump from around 11% (of total Mercer client search assets) to around 22%. This increase was the result of much larger allocations being made.

ESG integration is a core part of sustainability, and with more than one-fifth of assets in 2018 being allocated to strategies highly rated for ESG, it appears increasingly relevant to investors.

FIGURE 1: ALLOCATIONS TO STRATEGIES HIGHLY RATED FOR ESG
PERCENTAGE OF ALL MERCER CLIENT SEARCHES



Source: Mercer

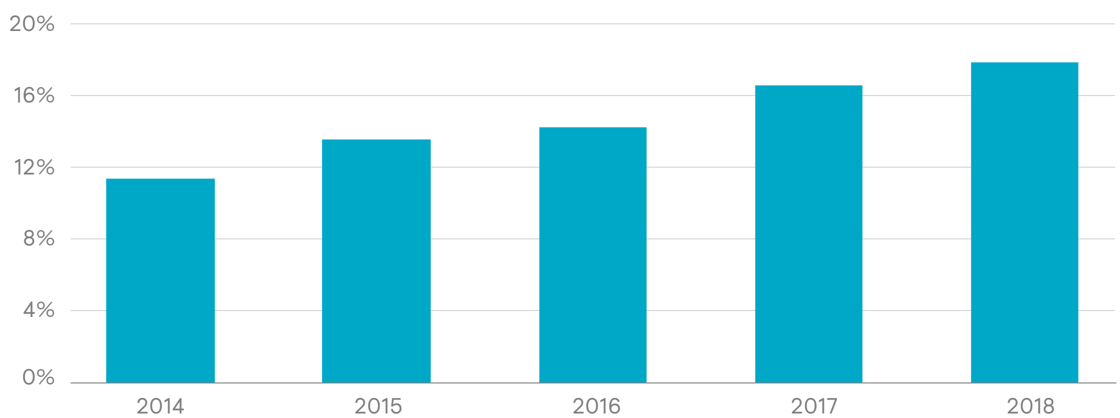
Over and above this broad trend, we have also seen an increase in searches that are explicitly focused on sustainability, often with clients engaging Mercer's specialist Responsible Investment Team. Mercer clients have allocated more than US$5 billion in assets in the last three years as part of searches with an explicit focus on sustainability — approximately $1 out of every $13 in assets where Mercer has been involved in a manager selection.

ASSET MANAGERS ARE CATERING TO DEMAND

At the same time, the number of strategies for which asset managers are incorporating ESG factors into their decision-making, valuations and investment processes continues to rise.

It is difficult to say whether this is a response to or a driver of client demand (we suspect both). Either way, this means there is now a broader opportunity set for investors prioritizing ESG, and that opportunity set is growing.

FIGURE 2: NUMBER OF STRATEGIES HIGHLY RATED FOR ESG
AS A PROPORTION OF ALL STRATEGIES RATED BY MERCER



Source: MercerInsight

REGULATORS ARE MOVING IN CONCERT

We have seen some challenges for sustainable policymaking — most commonly, for environmental policy. These challenges may relate to how financial costs are addressed, a topic most recently in the limelight due to the "*gilets jaune*" protests in France following a proposed increase in fuel taxes. Or there may be disagreement over the need for policy action altogether — such as the US withdrawal from the Paris Agreement on climate change mitigation in 2017.

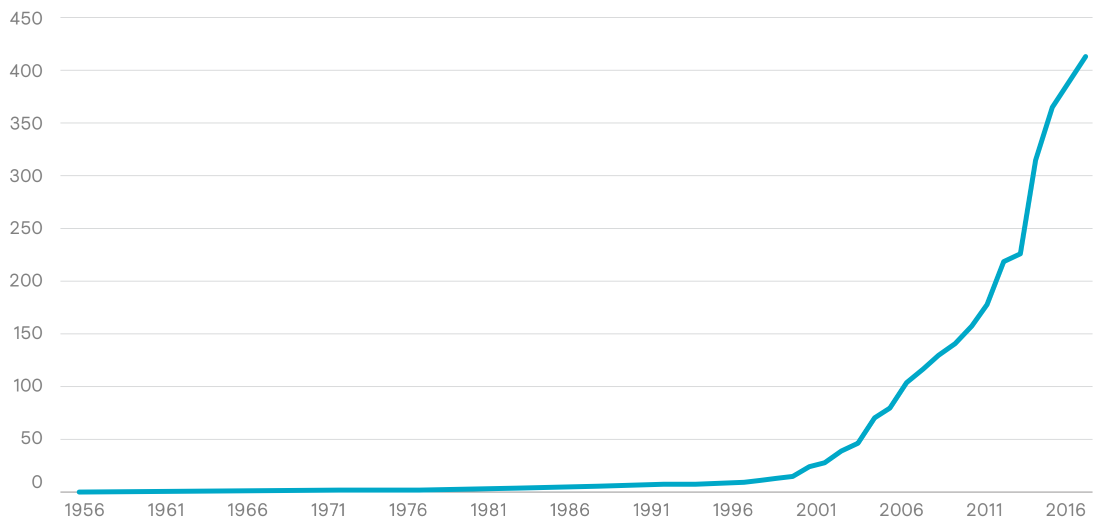
However, these appear to be the exceptions to the broader trend, which has been a steady rise in sustainable policies in recent years.

In many countries around the world, including those in the European Union and the G20, governments are demanding that asset owners, investment managers and investee companies, to varying degrees, incorporate ESG factors into their decision-making, and, with increasing frequency, this explicitly includes climate change.

Stewardship codes are increasingly being set to govern the interactions between investors and investee companies. This is a relatively recent phenomenon, with the first stewardship code appearing in the UK in 2010. Since then, however, several other countries have followed suit, with legislation such as *The Principles for Responsible Institutional Investors* in Japan,[5] which encourages institutions to set policies and disclose actions taken to contribute to the sustainable growth of investee companies.

[5] The Council of Experts on the Stewardship Code. *The Principles for Responsible Institutional Investors (Japan's Stewardship Code)*, 2017, available at https://www.fsa.go.jp/en/refer/councils/stewardship/20170529/01.pdf.

FIGURE 3: CUMULATIVE NUMBER OF POLICY INTERVENTIONS
COUNTING INDIVIDUAL REVISIONS SEPARATELY



Source: PRI Regulation Map

This chart comes from PRI's 2016 *Global Guide to Responsible Investment Regulation*, which looks at the world's 50 largest economies and identifies ESG regulation targeting pension funds, stewardship codes, ESG integration requirements for the wider investment chain and corporate disclosure guidelines, both voluntary and mandatory.

MERCER VIEW

Sustainability can feel like a loaded term, but for us, it merely involves being aware of what is expected to happen in the broader world in the years to come and what that might mean for you as an investor; it is about understanding the impacts of actions taken today and the potential risks and opportunities they might create. This can be achieved through the selection of strategies highly rated for ESG or allocating to dedicated thematic sustainability strategies.

The confluence of these three highlighted trends, along with the pace of change evidenced so far, leaves us in little doubt that sustainability is gathering momentum. Sustainable investing may not yet be mainstream, but it could well be headed in that direction.

As with any emerging trend, the question investors have to ask themselves is, "Can the momentum be sustained, and if so, is there a potential cost associated with playing catch-up at a later date?"

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Wealth and investment require sophisticated solutions. We offer research and advice on how to assess risk and design investment strategies while keeping in mind the need to optimize throughout changing times. Along with more than 140 manager researcher with in-depth knowledge of the complexities and ever-changing factors that impact investment, Mercer's consultants can help you make effective decisions that align with your business needs and ensure more rewarding futures for your employees.

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