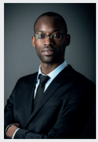
investment insights

MONTHLY INTERVIEW

APRIL 2018

RESEARCH ANALYSIS

ESG, AN INNOVATIVE APPROACH INCORPORATING RISK



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HOW ARE ESG CRITERIA INCORPORATED IN THE EUROZONE EQUITIES?

Today, the question is no longer about deciding whether or not extra-financial criteria should be incorporated into investment choices. Rather, the question is about how to do so. Indeed, ESG has become a groundswell as its analysis takes into account external environmental, social and governance-related factors that are likely to limit exposure of assets to certain long-term risks (regulatory, operational, reputational and financial). It is difficult to show how overweighting stocks with the best ESG scores provides protection against these risks. However, underweighting or excluding the worst ones corresponds to this vision of risk. This requires looking at factors in detail and studying sub-criteria beyond average ratings. These sub-criteria can be faint signals that are forerunners of difficult periods ahead.

WHAT IS YOUR ESG METHODOLOGY?

The Amundi group's extra-financial analysis assesses companies based on granular criteria that are generic (greenhouse gas emissions, Board of Directors structure, occupational health and safety, etc.) and specific (green cars, access to medicines, etc.). All these criteria are incorporated into environmental (E), social (S) and governance-related (G) pillars by taking sectoral issues into account. The overall rating summarises the issuer's ESG vision.

Rating: The ratings, whether they concern the criteria, pillars or the final ESG rating, range from 'A' to 'G', with 'A' representing the best rating and 'G' the worst.

The universe of eurozone equities is mostly made up of securities rated 'B', 'C' and 'D' that represent 90% of the universe's weighting. This good overall rating nevertheless hides sharp disparities that become clear when studying companies by criteria. Because of this, our conviction at CPR AM is that each stage of rating (criteria, pillars, overall rating) conveys important information. Analysis of the criteria identifies issuers' strengths and weaknesses. Indeed, an issuer can be efficient in greenhouse gas criteria yet not have an audit and internal control structure of a sufficient level of quality for detecting problems relating to the production process. The overall rating provides a summarised vision of an issuer's ESG performance, like the ratings of credit-rating agencies that provide a summarised vision of credit quality. All other things being equal, an issuer with a poor overall rating, like 'F', has low scores for the different ESG criteria. In this way, we have developed at CPR AM an exclusion-based approach in two parts:

The first part consists in excluding issuers rated 'F' or 'G' depending on the overall ESG rating. Those rated 'G' represent firms that are not compliant with the Amundi group's normative exclusion policy (trading in chemical and biological weapons and in anti-personnel mines, which are forbidden under the Ottawa and Oslo conventions).

The second part involves excluding issuers rated 'F' or 'G' in material generic criteria. In this way, an issuer that has a 'C' ESG rating but is rated 'F' for material criteria will be excluded from the investment universe.

The materiality of this criteria is determined based on analysis of information ratios of each one of them, after excluding issuers rated 'F' or 'G' in the criteria under consideration.

The generic criteria used in the universe of eurozone equities are as follows:

- Energy consumption & CO2 emissions
- Structure of the Board of Directors
- Audit & Control
- Rights of shareholders
- Health and safety

Cross-section correlations between generic criteria bring out the fact that the chosen criteria are not correlated and are therefore a source of diversification.

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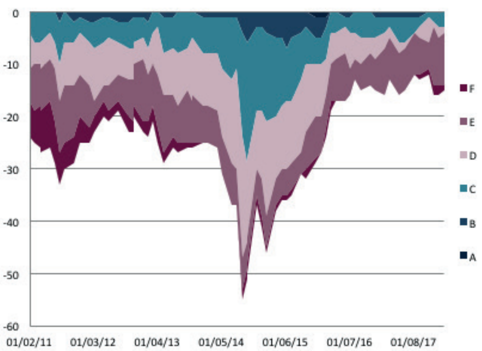
WHAT TYPE OF STOCKS ARE EXCLUDED?

Our ESG approach excludes 10% of the initial universe. Graph 1 shows that exclusions concern both virtuous issuers and others who are less so. The ones that are most concerned are issuers rated 'C' or 'D' (50% of exclusions).

NUMBER OF ESG SECURITIES EXCLUDED



Source: Research CPR AM

At a sectoral level, these exclusions generate bets on consumption and financial stocks.

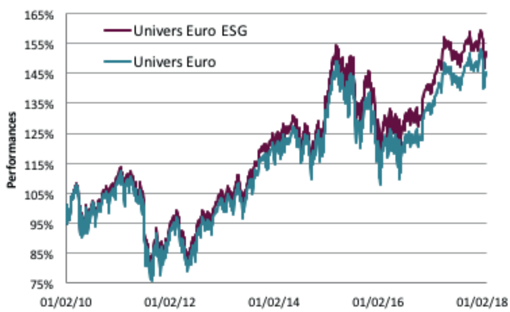
WHAT IMPACT IS THERE ON THE RISK-RETURN PAIRING?

The back test of the strategy from 2010 to 2018 shows that our approach generates a positive risk-return pairing that is close to the initial euro universe weighted with market capitalisations. The annualised performance of the strategy is 5.22%, versus 4.66% for the euro universe, with a tracking error of 1.01%.

The outperformance of the ESG universe comes mainly from selection bets brought about by exclusion of the worst issuers and not sectoral bets. Indeed, the performance of the euro universe after application of sectoral bets relating to our ESG methodology generates an annualised performance of 4.83%, which is only 0.17% above the universe, the remaining 0.39% of outperformance being explained by our ESG approach.

In conclusion, our exclusion-based ESG methodology using material criteria is a pragmatic approach that excludes securities that are not especially virtuous or that show weaknesses. It generates a positive risk-return pairing. Given these good results, we have applied this approach to other geographical regions for equities and are working on setting it up for credit.

SIMULATION - ABSOLUTE PERFORMANCE, EXCLUDING FEES



Source: Research CPR AM

The figures refer to simulations of past performance; past returns are no guarantee of future returns.