E and S Themes Drive ESG Growth

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Governance factors remain highly relevant from a risk and return perspective, but the delta for growth in environmental, social, and governance (ESG) factor integration (or sustainable investment adoption) will continue to be more a function of the environmental and social trends that are reshaping industries and business models.

Changing consumer preferences, disruptive technologies, and the shifting regulatory environment have presented companies with a mix of risk and return opportunities across a number of industries.

For example, based on its analysis of global sector exposures to sustainability issues, UBS, in its April 2015 Global ESG Analyzer, highlighted the energy- and transportation-related sectors as being most exposed to ESG risks. These risks are primarily related to CO2 regulations, new forms of mobility, and innovative technologies.

Certainly many companies in these industries are adapting to these risks to neutralize the effects on revenues, but profitability and return on capital are under threat. At the other end of the spectrum, consumer-related industries are considered to be more favorably exposed to ESG issues, as sustainability trends such as organic products and health awareness are net positives.

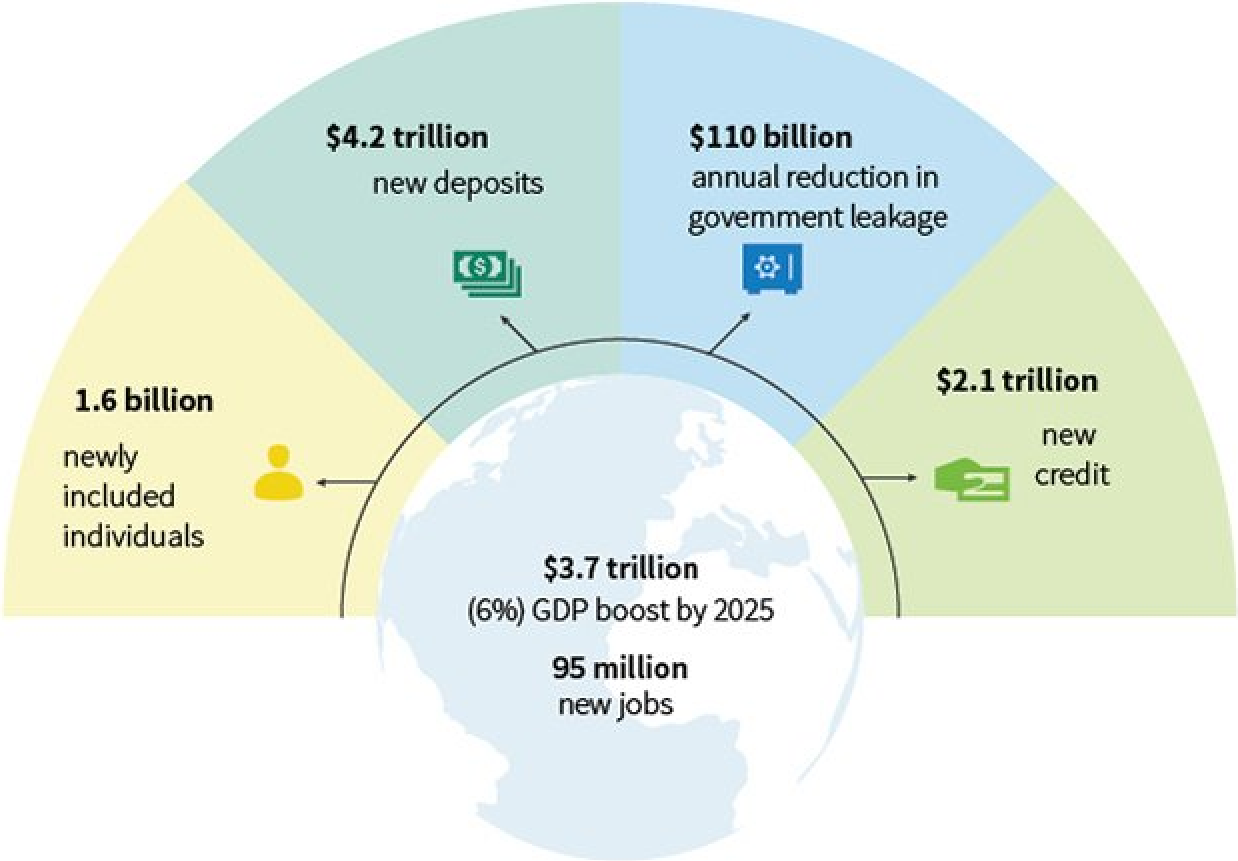
While risk mitigation remains a key objective of sustainable investing, longer-term thematic-oriented return opportunities are emerging across a wide range of industries. These themes are broadly tied to shifting demographics, climate change, resource scarcity, and improvements in quality of life—particularly in developing economies.

The financials, technology, and telecom sectors are not traditional areas of focus for investors pursuing ESG objectives, but the growth of digital finance (where these sectors intersect) is proving to be a compelling sustainable investment theme.

The proliferation of mobile devices and rising demand for banking services among lower-income populations have facilitated the creation of innovative payment platforms with high levels of adoption among the “underbanked” demographic. This is particularly important in emerging markets, where most people and small businesses transact exclusively in cash and do not participate in the formal financial system.

According to a recent study by the McKinsey Global Institute, nearly 80% of adults in emerging markets own a mobile phone, but only 55% have a financial account. McKinsey estimates that 1.6 billion people out of 2 billion without bank accounts—more than half of whom are women— could be assimilated into the system via digital finance. The graphic below shows how digital finance is affecting emerging markets.

Digital Finance Impact in Emerging Markets



Source: McKinsey Global Institute, as of September 2016.

The ability to accept wages, subsidy payments, and remittances or initiate tuition, medical, and rent payments from the palm of the hand is both convenient and empowering. From a macroeconomic perspective, rising loan demand and deposit growth are favorable outcomes of the migration to digital. Economic gains can potentially be achieved through productivity gains and lower costs from reducing cash transactions and brick-and-mortar branches.

Among developing economies, McKinsey sees the most potential for low-income countries in Africa and in India, where digital finance could increase gross domestic product (GDP) growth by 10% to 12%. Although less significant, the estimated 4% to 5% estimated growth benefits for middle-income countries, such as China and Brazil, are also compelling.

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