Smart data and smart integration

Data has become the cornerstone of ESG investing and the basis of fully informed investment decisions. However, the diversity of information also makes it quite difficult to navigate the data jungle. How can this information be optimally used for ESG investments? Dennis Haensel brings light into the data darkness in an interview with the person behind the DWS ESG Engine – Carsten Keil – and with the head of DWS Investment Specialists - Oliver Plein.

Q: **Dennis: Oliver, analysts and portfolio managers are using a whole lot of data already. Why is ESG-related data so important now?**

OLIVER Portfolio Managers use a whole set of fundamental metrics like valuations, sales or profitability metrics to have a very comprehensive view of the opportunities and risks of a stock. But now you have to imagine that this is just the surface of the data, like an iceberg. But by far the largest part of the iceberg lies beneath the surface, the so-called non-financial information, and that is the ESG-related data that can provide incredibly valuable insights into the companies. Because if you include this data, then at the end of the day you see that companies that you think are extremely sustainable at first glance are perhaps not when you examine them closely. Just as companies that you actually think are ESG laggards turn out not to be that bad when you take into account all available data.

Q: **Dennis: How do I get access to that kind of information about a company? How are these data points generated?**

OLIVER Companies are publishing more and more data, either on a voluntary basis, because the market or investors require it, or for their own reputational reasons, or because they are forced by regulators to comply with certain requirements. And this has led to the emergence of a complete new industry in recent years. There are large market providers such as MSCI, for example, which have been building up a comprehensive database since the beginning of the new millennium. But, beyond that, there are still many providers that are specialised in certain aspects of ESG, whether in the area of reputation, climate, ESG opportunities, ESG risks, regional specifics, different coverages of market capitalisation. A huge industry has developed here that enables us to make more informed investment decisions with this valuable data.

Q: Dennis: Carsten, now that we've talked about the data that is available, how do we take it into account and what information do we provide to clients?

CARSTEN ESG is really a very complex topic and, as we have already heard, there is a lot of data in the market. Our core idea is always that we want to bring the best that can be done in the ESG area to the customer. That's why we don't rely on just one data provider. We look at what's on the market and buy from a variety of data providers. To briefly name a few providers, there is MSCI, which is a well-known index provider that has also been active in the field of ESG research for some time. ISS has also now developed a very strong foothold in the ESG area with the acquisition of ETHIX and Oekom. Then there is Trucost, which is now part of Standard & Poors and is very far ahead in the area of climate data. And Sustainalytics which has been acquired by Morningstar; its data goes into the fund valuation area. Our last addition to the portfolio suite is Arabesque who with their product, S-Ray, have dedicated themselves to a very new approach which essentially uses Artificial Intelligence. The core idea there is to use modern quantitative models to collect data, structure it and select the relevant factors.

What is and what isn't sustainable is a very subjective matter, which means that the various data providers use different definitions of sustainability and different methods and assessments.

Q: Dennis: Why do we use data from so many providers? Wouldn't one or two of those you've mentioned suffice?

CARSTEN That's a valid question which we hear quite often. What is and what isn't sustainable is a very subjective matter, which means that the various data providers use different definitions of sustainability and different methods and assessments. But we don't call that ‚bad'. We see that as diversity and we try to make the most of that diversity by looking at a range of data providers and then arriving at some kind of consensus.

OLIVER If you rely on only one data provider as an asset manager, then that can of course lead to a certain alignment of portfolios, because – as Carsten already pointed out – there is a certain degree of subjective assessment. This means, for example, that in the portfolio management perhaps an inappropriate restriction will occur or that certain stocks are not at all sustainable when you look at the data from several resources. And of course investment decisions which are based on the analysis of several providers are more comprehensive and more reliable because then you look at a very broad and balanced picture, with the possibility of cross-validation and confirmation.

Q: Dennis: It makes sense to work with several data providers but how do we combine the information in order to arrive at a conclusion? How do we get an objective result that allows the portfolio managers or even our clients to actually manage their investments?

CARSTEN We have created a proprietary software solution at DWS, our so-called ESG Engine. You might think of it as a big data vacuum cleaner – which absorbs the multitude of data that was mentioned earlier. This multiplicity of data is now machine processable and we are able to produce a whole set of ESG signals. These ESG signals can be both positive and negative, identifying both the leaders – those companies that make a positive contribution to the environment – and the laggards – the ones that have a negative impact by, for example, not managing their risks in terms of water or CO_2 properly. And so we have a way of bringing all these positive and negative signals together in a rating that we can then use to manage our portfolios.

OLIVER These ratings and evaluations are integrated into our portfolio management system so that our portfolio managers don't have to dig through hundreds of thousands of different data points themselves. And this is independent of whether we are talking about special ESG strategies or traditional portfolios. The non-financial information is available to all portfolio managers for their risk assessment.

Q: Dennis: If an analyst or portfolio manager sees a bad rating and therefore a potential risk with a company, what happens?

OLIVER That's a very important question, especially in view of the new disclosure regulation, where asset managers are required to provide information about sustainability risks in their portfolios. And that's why it's also a very important issue for us. Our designated ESG funds consciously avoid these risks and completely exclude ESG laggards. ESG laggards can, however, still be present in actively managed products – which look for broad performance opportunities in the investment spectrum. Here, of course, under sustainability risk, we look at the extreme laggards that are F-rated. And if a company has an F-rating, it is blocked for the time being and further steps will have to be taken. What do these steps look like? Well, first a review by an internal committee takes place to see how the result of the risk analysis is incorporated into the investment decision. And then, on the advice of the committee, there is an active dialogue with the company's executives about the strategy and the business model and the analysis from our ESG engine and our experts. Is an improvement plan perhaps already in place and have measures been initiated? In this way we exert a positive influence on the company as an active shareholder.

In addition to the classic ESG integration, that is, the consideration of sustainability risks, we have added our Smart Integration approach. If, for example, we see further potential in a company despite the sustainability risks – based on discussions with these companies – then the pros and cons for this stock are weighed up in a specially created committee and then a partially binding recommendation is made to the portfolio manager.

Q: Dennis: Let's make this a little more transparent. Who is part of this committee?

OLIVER The committee consists of experts from our CIO office who have taken on the topic of ESG integration on the platform, and also includes Carsten Keil's ESG engine team. We have representatives from relevant risk functions, experts from the respective asset classes, and Compliance. The committee is headed by Petra Pflaum, our CIO for Responsible Investments.

The committee is made up of a very comprehensive range of members, because various perspectives are necessary to assess whether we are actively managing these sustainability risks in our traditional products. It is very important – and this applies to all products and not just to dedicated ESG strategies – that the sustainability risks are always set in relation to fundamental factors but also to the general development prospects or the exercise of voting rights, both ex ante and ex post.

And as a result of this review, it may be that the given restriction is being lifted within the ESG Engine; that further investments, i.e. acquisitions, are no longer permitted; or that the company is to be removed from our portfolios. However, this would only be the very last resort: if we have exhausted all the possibilities of engagement to support the company.

Q: Dennis: As there are so many different ESG facets, can you briefly describe which ones are explicitly considered by the committee or in this process?

OLIVER We look in particular at the serious ESG risks and at the companies that a) have a high climate change risk or b) have serious and confirmed violations of international sustainability standards, such as the well-known UN Global Compact.

CARSTEN I can perhaps flesh this out a little bit, based on three ESG signals that we're using here. The first signal is the question of whether a company has anything to do with controversial weapons. These are biological and chemical weapons, which have been outlawed since the 1970s, but also weapons systems such as cluster bombs and anti-personnel mines, which were only outlawed later and are still produced by individual companies. And we're trying to identify and tag such companies within our process.

> There are various risks that may not show up in data, but where press releases about possible damaging processes in companies already lead to so-called reputational risks, where assets have already been forfeited or prices started to suffer. And these risks should be avoided.

A second signal is direct violation of a sustainability guideline, such as the UN Global Compact. Here we look at things that do not seem acceptable at all from the point of view of a sustainable investor. For example, child labour or forced labour, a lack of regard for trade union and assembly rights, or the destruction of nature and, often related to that, the destruction of societies. An example is a dam bursting due to neglected safety standards or the contamination of water due to inadequate filter systems. What we're doing is trying to assess a broad spectrum of environmental risks, responsibility risks, and also business ethics risks that fall into the realm of corruption, accounting fraud and market manipulation and so on. Because such risks can translate very quickly into direct economic risks. For example, criminal proceedings against the company or claims for damages that could result in substantial payment demands being made on the company. Ultimately, of course, this has a negative impact on profit margins. And with that, you always have to ask yourself whether these risks are worth taking.

OLIVER The topic of reputation risks is also important from a portfolio point of view because, as already mentioned by Carsten, there are various risks that may not necessarily show up in data, but where a lot of information or press releases about possible damaging processes in companies already lead to so-called reputational risks, where assets have already been forfeited or prices already started to suffer. And these risks should of course be avoided as much as possible.

CARSTEN The third signal in this series is one that has been discussed strongly and very negatively in public and therefore brings with it corresponding reputational risks for asset managers: climate risk. Which companies make a negative contribution to the carbon balance of the planet, whether by emitting unacceptably high amounts of carbon dioxide into the atmosphere in their production, or extracting fossil fuels that are later burned? Or, for example, manufacture products such as gasoline-powered cars that also have a negative impact on the carbon balance of the planet. And if you now refer to the negative things – as I have just done – it is also important to look at the positive side. There are also companies that are pioneers in the development of a carbon-free planet, such as, for example, manufacturers of wind turbines. These are the companies that have a potential opportunity in the area of climate.

Q: Dennis: Let's get back to the source: the data. How do we calculate the climate risks with the available data?

CARSTEN We look at the carbon dioxide that the company either emits in the production of its goods or that is emitted to supply the energy with which the goods are produced. But also the carbon dioxide emitted in the consumption of these goods. And finally we also look at the carbon dioxide that is reduced by the use of products. This may seem nonsensical at first but, for example, a company that builds wind turbines reduces the use of electricity generated by burning coal. These purely quantitative considerations that I have just mentioned can also be supplemented by qualitative ones – we look at how the company is oriented towards the future. Of course, you don't really know that, that's why a qualitative orientation is always supported by quantitative, reliable statements such as, for example, what is the ratio between green and brown investments?

Q: Dennis: Can we think of this as assigning an exact climate transition risk to each individual issuer?

CARSTEN That's exactly right, every issuer has a valuation in terms of climate transition risk but to be fair it affects some sectors more than others. For example, in the energy or coal sector transition risks are higher due to their business model than, for example, in a traditional financial sector company where the only thing that matters is whether there is climate finance or climate sensitive finance in the portfolio. Or what car fleet I run, or whether I have green office buildings or not. But the dimension is much lower than in the energy sector. But yes we assign a climate risk to each company.

Q: Dennis: What are the newest additions of investment signals that our customers can already use?

CARSTEN I would like to name two. One is that we define climate transition risks – which we in the past only determined for companies – for countries, too. And this is of course very important from an asset management point of view because there are sovereign fixed income portfolios or asset portfolios in which government bonds are mixed with corporate bonds and equities. And we need a consistent investment model in order to properly reflect the climate transition risks. A second signal that we have been focusing on is water risk. Here we look at the impact that water can have on a company's operations – for example, an increase in water costs due to water scarcity.

Q: Dennis: Oliver, let's come back to DWS's Smart Integration approach. We talked about the different ESG risks. Why are you focusing on climate risks and norm violations?

OLIVER I think it's important to emphasise here that Smart Integration is an extension of ESG integration and so it's applied to all our actively managed products. We are looking in particular at climate risks because that is certainly the most significant ESG trend globally and represents a significant risk for investors, whether it's through extreme weather events or indeed through a reassessment of assets in terms of decarbonisation.

Let's just take the example of a large energy company that still has a lot of unmined fossil energy reserves in the ground. If a country now decides overnight that no more carbon should be emitted, then these assets would have to be de facto depreciated down to zero. In addition, climate change can lead to companies losing market share to other companies that are more efficient, or to the acceleration of climate protection measures.

The second point is the violation of international norms. This can very quickly lead to asset losses, especially through the reputational damage that Carsten and I have already mentioned. It is not uncommon that reputational damage results in sometimes heavy price losses in portfolios. This can happen for many reasons: human rights violations or violations of workers' rights, child labour, slavery, corrupt business practices, bribery, lack of data or product security. It could start with the interruption of the product production process, if, say, central suppliers fail to deliver their goods and the assembly lines are at a standstill within a few days. Then there are general reputation risks, loss of confidence from the stakeholders and the market, leading to fines or a possible withdrawal of the so-called 'Licence to Operate.'

> If we were to simply go and invest in companies that no longer emit CO_2, this would of course mean that relatively little would be achieved for the world`s climate. Instead, we should enter into dialogue with companies that emit a lot of CO_2 and support them with our fiduciary function on the way to emitting less CO_2 in the future.

Q: Dennis: We are able to see and measure these risks and are integrating them into our investment process as well. But what are the results?

OLIVER Smart Integration is an extension to the classic exclusion of certain sectors that are controversial, such as tobacco, coal or palm oil. It is also important to look ahead and to say that if we disinvest, we will also forego the possibility of active participation, be it through stewardship responsibility or by contacting the issuer. For example, if we were to simply go and give the bulk of the money to companies that no longer emit CO_2, this would of course mean that relatively little would be achieved for the world's climate. Instead, we should enter into dialogue with companies that emit a lot of CO_2 and support them with our fiduciary function on the way to emitting less CO_2 in the future. And with this Smart Integration approach we have consciously decided against automated exclusions for all portfolios, but rather said that we rely on a combination of reliable, robust research, active dialogue with the companies, the detailed analysis of the committee and a final qualitative and quantitative assessment.

Q: Dennis: I understand that we look at the data and start the engagement process, but what happens if we observe a bad rating on an investment?

OLIVER If an issuer received an F-rating – and after extensive discussions with the company and discussion within our committee can remain in the portfolio – they subject to mandatory active influence because they have a higher risk potential.

Q: Dennis: Unfortunately our engagement with companies does not always result in positive developments or a change of direction. What happens if we don't see any progress? Do we use exclusion as a last resort?

OLIVER You're absolutely right. If there is no positive development or the counterparty doesn't react at all then the company risks being excluded from our investment universe. If it comes to that, the portfolio managers – especially if we're talking about large positions in companies – would be given enough time to reduce these positions in a market-friendly way.

Q: Dennis: Final question on that topic. Do we report these results?

OLIVER Yes, that's quite important, because transparency plays an essential role in disclosure regulation. We report on the results, on the discussion points, our engagement policy, we have non-financial reporting and we report on our proxy voting so that our investors know exactly how we voted and why and that our dialogue with these companies was active.

Q: Dennis: Great. We heard that we apply the Smart Integration approach for our whole active range of products within EMEA. But what about the dedicated ESG strategies that use the ESG Engines data. Can you briefly explain the difference?

OLIVER On the one hand we have the mainstream products to which we apply our so-called ESG integration, supplemented by the Smart Integration process we have just described. These are the mainstream products that have to disclose sustainability risks. And then we offer our so-called dedicated ESG strategies, which follow much stricter standards than the mainstream funds. Here we apply special ESG standards, whether exclusion criteria and a best-in-class approach or positive and negative lists.

Our ESG engine is very flexible. The requirements of institutional investors can be included individually, we can create individual ESG filters but also, as with Smart Integration, cover individual areas of standard portfolios or, as with dedicated ESG funds, include opportunities and risks in our investment decisions.

Dennis: Thank you, Carsten and Oliver, for the detailed information about the data we use and how we apply the knowledge we derive from it in our investment process.

In the German ESG Buzz podcast series, experts provide answers on the topic of sustainable investing. The moderator Dennis Haensel is Global Head of the ESG Investment Solutions & ESG Advisory Team.

www.dws.com/de/loesungen/esg/esg-basics/

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