

RESPONSIBLE INVESTMENT QUARTERLY

Q3 2020



Your success. Our priority.

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01 Foreword



Iain Richards

Head of Global Responsible Investment Policy

As we moved through Q3 2020 a pervasive sense of change was evident in every aspect of responsible investment. ESG (environmental, social and governance) fund flows have remained strong even when mainstream equivalents have struggled through a volatile year (and yes, the old laws of supply and demand remain true in terms of ESG and the effects being seen in the market).

One area where growth in supply has, in part, been responding to demand is in the bond market. By way of a case study, in this quarter's report we look

more closely at Spain, which is already one of the world's leading markets for green bonds. More widely, the all-time total cumulative issuance of green, social and sustainability bonds reached \$1.1 trillion by the end of the quarter. Issuance this year jumped from \$173 billion at the end of Q2 to \$334 billion by the end of this quarter.¹ This again is seeing some interesting effects in the market in terms of both pricing and post-pricing spreads.

Investors have also continued to fund responses to Covid-19 through the bond market, with the total reached by the end of the quarter standing at around \$90 billion.²

An area of particular interest to us, given our involvement in developing the ICMA (International Capital Market Association) Social Bond Principles, has been the growth in social bond issuance, which almost doubled in the third quarter to \$80 billion. To put that in context, the total raised through social bonds between 2009 and 2019 was \$30 billion!³

Similarly, the scope of client enquiries in pursuing ESG interests is expanding. Asset classes and regions that were once thought to be too difficult for responsible investment approaches are now a key focus. In the past we have looked at some of these, including what is possible in high-yield

strategies. This quarter we look at another example, emerging markets, and share insights from the investment team on the relevance and role there is for responsible investment approaches in these markets.

Change has also been an ongoing topic in our research work. Although there is much focus in the world today on batteries and electric vehicles, there are limits to what this technology can achieve. Given the needs of industry, transport, society and the challenges of climate transition, hydrogen has been a particular area of interest for us, and we explore this in more detail in this publication. It was not surprising for us, therefore, to see this reflected when Ursula von der Leyen, President of the European Commission, gave her state of the union address in September. Hydrogen was first on her list of the projects with the biggest impact for the NextGenerationEU funding, and she spoke of creating new European hydrogen valleys to modernise industry, power vehicles and bring new life to rural areas.⁴

This is not just "blue sky" thinking. During the quarter, for example, we saw Sweden begin a pilot-testing operation for a unique fossil-free steel project,⁵ which aims to replace coal with hydrogen to produce clean steel.

This is not a one-off project, with Q3 also seeing the signing of an agreement for a \$5 billion world-scale green hydrogen-based ammonia production facility powered by renewable energy.⁶ We also saw the completion of the “world’s first and largest” hydrogen fuel cell power plant.

While much of the RI debate on a post-Covid world focuses on the importance of maintaining the “E” of ESG, the pandemic has equally underlined the importance of the “S” (inclusive growth focus, which is again critical for recovery packages). So what is the potential impact of the pandemic on investment? To help answer this, our Global Head of Research shares his insights on some key aspects of the investment implications later in this report.

The quarter also offered a chance to take further stock of the 2020 proxy season, which in many respects had been dominated by considerations arising out of Covid-19, which were touched on in our Q2 report.

Perhaps most interesting in the context of change, however, have been the ongoing developments in the US where regulators continued to focus on interventions around proxy voting. Notable have been the Securities and Exchange Commission’s adoption – despite criticisms – of rules impacting proxy voting advisors which require them to inform clients when companies issue written statements about proxy research. One dissenting SEC Commissioner, Allison Herren Lee, observed that the rules would harm the governance process and suppress the full exercise of shareholder voting rights.

The SEC also adopted changes to “modernise” the rules on shareholder proposals that raise the bar for shareholders submitting them. It facilitates corporate access, as well as influence over proxy advisory services and the US Department of Labor’s proposals that appear to try and disincentivise public pension funds from exercising their proxy voting rights, despite them being assets of the fund.⁷

Overall, during the 2020 proxy voting season 50 shareholder resolutions received majority support (12% of the total). Although governance issues continued to dominate the proposals, the US did continue to see a focus in shareholder resolutions on environmental and social issues. As the potential materiality of the risks arising out of climate change become

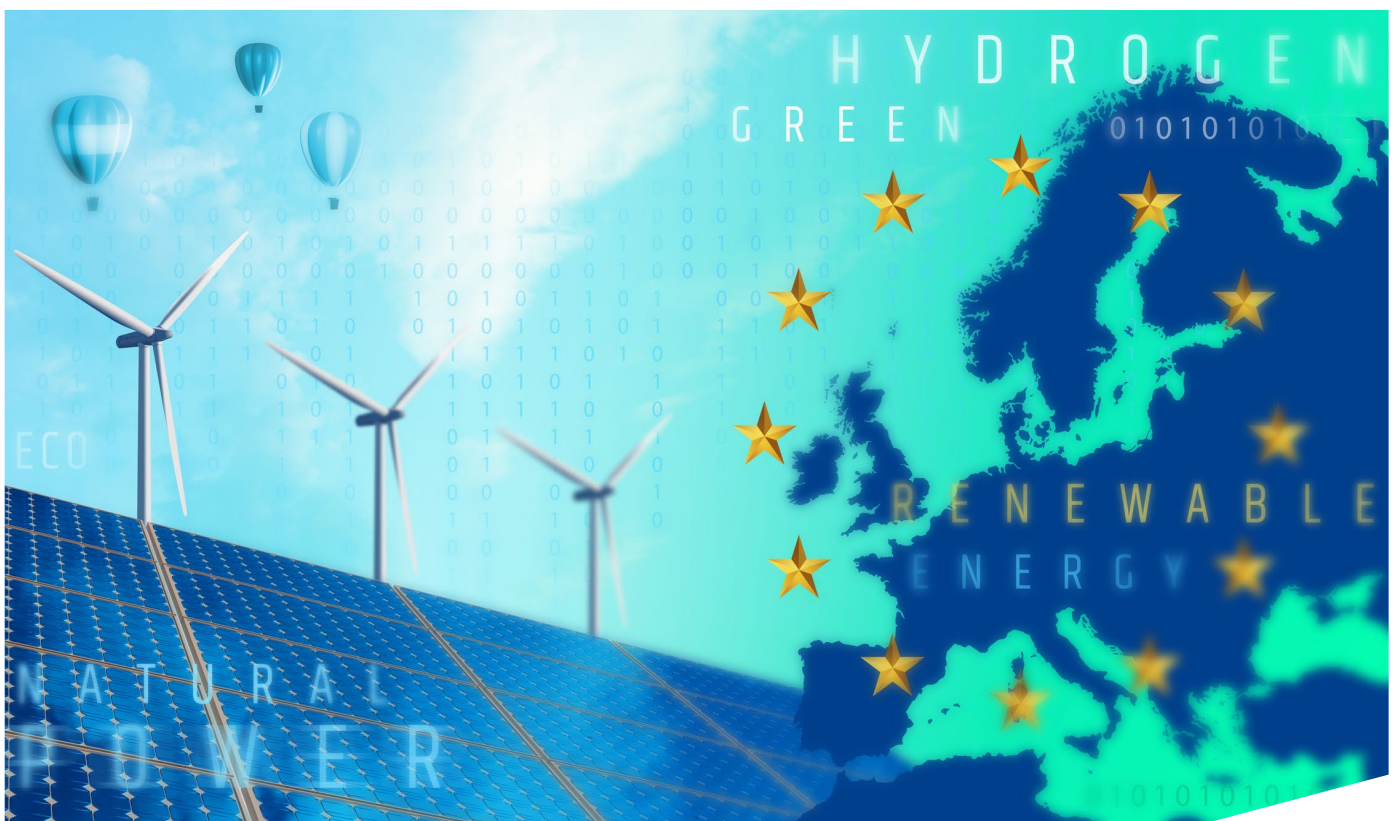






Figure 1: EU sustainable finance reforms

Regulatory Theme	 Sustainability Risk Integration	 Adverse Impact on Sustainability Factors	 Disclosures	 Suitability and Product Governance
Change requirement	Integrate sustainability risks into investment decision-making and risk management process across all current strategies	Identify and mitigate the adverse impact of investment decisions on external sustainability factors within equity and fixed income strategies	New pre-contractual, website disclosures and periodic reporting to demonstrate the integration of sustainability risk, consideration of adverse impacts, ESG factors and compliance with the criteria for environmental sustainability	Sustainability preferences to be gathered from clients and included in portfolio management services and product governance fund manufacturing
Scope	Segregated accounts Pooled funds	Segregated accounts Pooled funds	Segregated accounts Pooled funds	Segregated accounts (suitability) Pooled funds (product governance)
Deadline	10 MARCH 2021	TBC (expected Q1 2022)	10 MARCH 2021 – 1 JANUARY 2022	TBC (expected Q3 2021)

Source: Columbia Threadneedle Investments, 2020.

ever more apparent – for example, BP’s £13.9 billion asset write-down at the end of Q2⁸ – this is perhaps unsurprising. It also reflects moves being made elsewhere by, for example, prudential regulators to require consideration of these risks by asset owners.

As part of this we saw a notable and welcome focus on facilitating improved disclosure, not least around the adoption of Sustainability Accounting Standards Board (SASB) and Task Force on Climate-Related Financial Disclosures (TCFD) standards. This comes alongside signs of improving disclosure among issuers on both the SASB and TCFD.

Over and above all of this, a range of legal and regulatory changes have taken effect (or are soon to) in

the investment world. By this stage few will be unaware of the EU’s Sustainable Finance Reforms, although many have yet to unravel it all, and indeed in many respects it remains incomplete. Leaving that and specialist requirements aside, for example the EU’s green taxonomy, key aspects of the reforms will touch almost every EEA-domiciled fund, whether pooled or segregated, and whether client or balance sheet assets (Figure 1).

And finally, we were very pleased with the UK government’s announcement on 9 November that it will outline plans to launch the UK’s first green gilts. This is something we at Columbia Threadneedle have long advocated, and it is terrific news for the UK economy, our society and the investor community.⁹

Source:

- 1 Morningstar, September 2020.
- 2 Bloomberg and Columbia Threadneedle Investments, September 2020.
- 3 Columbia Threadneedle Investments analysis, September 2020.
- 4 https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_20_1655
- 5 Reuters, Sweden’s HYBRIT starts operations at pilot plant for fossil-free steel, 31 August 2020.
- 6 IFRF, Air Products announce \$5 billion renewable hydrogen to ammonia project in Saudi Arabia, 16 August 2020.
- 7 SEC, SEC Adopts Amendments to Modernize Shareholder Proposal Rule, 23 September 2020.
- 8 Reuters, BP wipes up to \$17.5 billion from assets with bleaker oil outlook, 15 June 2020.
- 9 FT.com, Rishi Sunak to announce UK’s first green gilts, 9 November 2020.



H_2

Hydrogen

zero emission

02 Hydrogen: significant opportunity or hot air?



Natalia Luna

Senior Thematic Investment Analyst,
Responsible Investment

Over the past year or so we have noticed a remarkable focus on green hydrogen as a clean alternative to traditional fossil fuels. Hydrogen is the most abundant molecule in the universe and its qualities have been known for a long time. So, what is driving all this hype and why the attention now?

There are, in fact, two key explanations: firstly, climate change is accelerating; and secondly, renewable energy costs have fallen dramatically.

Since the Paris Agreement in 2015 governments have turned their attention to climate change and committed themselves to achieving emissions reduction targets that will lead to carbon neutrality by 2050. The Covid-19 pandemic has accelerated the urgency surrounding climate change policies and many governments have now announced net zero emissions targets. As policymakers look for ways of cutting emissions there are some sectors where electrification is not practical and “green” hydrogen is a feasible alternative.

The cost of renewable energy makes a big difference because green hydrogen is produced by electrolysis, splitting water into hydrogen and oxygen. When the electrical input comes from a renewable source the hydrogen has no carbon footprint. Therefore, it can play a pivotal role in decarbonisation.

Currently, around 66 countries have net zero emissions targets, out of which around 20 have unveiled hydrogen roadmaps. We expect more to follow.

The cost of green hydrogen has fallen significantly recently. The renewable energy used in electrolysis accounts for about 70% of the cost and has fallen in price by approximately 70% in a decade.¹ Additionally, the price of an electrolyser has declined by about 60% in the same time.² It is reasonable to expect that these price falls will continue, adding to the appeal of green hydrogen.

Problems with green hydrogen

However, even after the decline in renewable energy costs, green hydrogen remains expensive when compared with other forms of hydrogen (see “Not all hydrogen is ‘green’” panel) and fossil fuels. Currently green hydrogen is seven times more expensive than fossil fuels. It also takes a lot of

Not all hydrogen is “green”

While hydrogen is a colourless gas, it is categorised by colour. Grey hydrogen is made from fossil fuels, so therefore its production emits CO₂. Blue hydrogen is grey hydrogen paired with carbon capture and storage that captures the majority of carbon emissions. By contrast, green is produced by the electrolysis of water. As long as renewable energy is used, it is a zero-emission energy source.



Energy transition: a major accelerator of renewable energy growth

As green hydrogen production scales up, so it will become an additional factor driving the construction of renewable energy-generating capacity. Producing 1GW of green hydrogen requires 2GW of renewable energy. According to Bloomberg estimates, for the world to hit its optimistic target of limiting climate warming to 1.5 degrees above pre-industrial levels, green hydrogen might grow to account for 24% of global energy needs. In this case, renewable energy capacity would have to increase by 20 times – reaching about 60,000 TWh, up from less than 3,000 TWh today.⁹ Looking to the longer term, hydrogen could also have a role in energy storage and heating. With modest investment, gas power plants could be converted to hydrogen power plants to generate green energy when the sun is not shining and the wind isn't blowing. Large-scale batteries can efficiently balance renewable energy over short periods of around six to eight hours, but longer-term solutions are required. Clear policy support could lead to higher earnings for European utilities from 2024-25, with valuation multiples rising in anticipation before then. Outside Europe these trends are not likely to become commercial until 2030.

power to produce – it is estimated that renewable energy generating capacity would need to increase by roughly seven times in the next 30 years to meet anticipated demand.³

Beyond that, hydrogen is hard to store and transport. Its low density makes it considerably harder to store than fossil fuels, and in order for it to replace natural gas in the global economy, three to four times more storage infrastructure would have to be built. Meanwhile, pipelines and power plants would require retrofitting because hydrogen can escape through existing infrastructure. It is estimated that around 70% of energy used to produce green hydrogen is effectively lost.⁴

Such considerable practical difficulties mean that, generally, where electrification is possible it will be the more efficient and competitive option. Therefore, green hydrogen can fill the gaps where electrification is not possible, ie trucking, shipping, seasonal energy storage and heavy industry.

To make hydrogen fulfil the hype, policy support and carbon pricing are essential. This will help to drive investment, promote the use of hydrogen and render it more cost competitive. Europe is at the forefront of policy support. This summer the EU unveiled its "Vision 2050" strategy which aims to grow the share of

hydrogen in the bloc's energy mix from less than 2% currently to 13%-14% by 2050.⁵ The strategy has very ambitious targets for installing electrolyser capacity, scaling up renewable energy and building hydrogen infrastructure by 2024, 2030 and 2050 respectively (see "Energy transition" panel). Moreover, the investments required are estimated to be up to €470 billion. The strategy also contemplates introducing supportive policy measures and regulation in the next year to set up a regulatory framework that creates demand for hydrogen. Given the EU has the most highly developed hydrogen policy landscape, this is expected to bring the most opportunities in the near term.



Transport: Rapid transition for heavy vehicles, autos may follow

When it comes to transport, hydrogen fuel cells and batteries are likely to prove complementary technologies. While hydrogen fuel cells have a relatively long range, short refueling time and low weight, batteries are less expensive and have more established infrastructure. This means hydrogen fuel cells are suited to long-range, heavy forms of transport such as aviation, buses, heavy duty trucks, shipping, taxis and trains. Batteries, by contrast, are more appropriate for cars and vans. In aviation hydrogen prototypes are being developed; in lorries and shipping prototypes are already in use. On buses and light rail, hydrogen fuel cell products have already been approved for use, and for space travel and passenger cars, fuel cells are in operation. Improvements in energy efficiency, scale and safety could change the status quo in the major market of road transport.



Resource management: *Hydrogen is key, but it's not a quick win*

While hydrogen could account for as much as 17%-38% of energy demand in industrial applications by 2050,¹⁰ it's currently not cost competitive. Demand towards the higher end of this range will only materialise if policymakers give green hydrogen strong policy support, leading to lower hydrogen costs and a higher cost of carbon. There is a strong logic for hydrogen to be used, especially in steel making, which makes a sizeable contribution to global greenhouse gas emissions. Car makers such as Toyota and VW are looking for lower carbon steel. But significant capital expenditure will be needed over a long period. Other opportunities for decarbonising industrial production with hydrogen exist in cement, chemicals, fertilisers, oil refining and mining.

A major role in decarbonisation

Higher carbon prices are crucial to making green hydrogen competitive with other fuels. By 2030 blue hydrogen could be competitive with grey hydrogen at a unit cost just below \$2/kg if we see carbon prices increase to \$80/tonne of CO₂, according to an estimate from IEA/McKinsey.⁶ For its part, the European Commission estimates a carbon price of €55-€90 per tonne of CO₂ is required versus the current EU allowance price of about €30.⁷ To achieve higher carbon prices, carbon taxes will be crucial, and the EU's proposal to tighten its Emissions Trading Scheme and introduce a carbon border tax in 2021 could drive prices higher in the next decade.

Looking forward, hydrogen has a material role to play in the 30-year decarbonisation evolution. It is likely to account for a substantial proportion of the future energy mix (estimates range from around 10% to 24%). Sizable investments will be made across transport, power and industrial processes. Policy support and higher carbon prices will bring scale and required infrastructure, reducing costs and creating opportunities in electrification, renewables, the hydrogen supply chain and green mobility. However, adoption will vary by geography and application. While heavy transport applications may provide lower hanging fruit, most industrial applications will require both green hydrogen price declines and higher carbon prices. Those regions

such as Europe with the strongest policy frameworks will take an early lead.

Source:

- 1 Kepler Cheuvreux, *All About Hydrogen*, September 2020/Goldman Sachs, *Carbonomics, The rise of clean hydrogen*, July 2020.
- 2 BNEF, *Hydrogen Economy Outlook*, March 2020.
- 3 Kepler Cheuvreux, *All About Hydrogen*, September 2020.
- 4 Bloomberg, 2020.
- 5 A hydrogen strategy for a climate-neutral Europe. European Commission. 8.7.2020. https://ec.europa.eu/energy/sites/ener/files/hydrogen_strategy.pdf
- 6 Hydrogen Council, *Path to hydrogen competitiveness: a cost perspective*, 20 January 2020.
- 7 The EU Allowance is the main currency in the EU Emissions Trading Scheme.
- 8 EU Commission *Hydrogen Strategy*, BNEF, *Hydrogen Economy Outlook*, March 2020.
- 9 Bloomberg, *Hydrogen Breaks Through as the Hottest Thing in Green Energy*, 24 September 2020.
- 10 BNEF, *Hydrogen Economy Outlook – Key Messages*, May 2020.



Climate change and carbon: *Uptake of supportive policy expected*

As countries around the world commit themselves to achieving carbon neutrality, green hydrogen becomes essential to hitting climate targets. The EU is a frontrunner and its hydrogen strategy will play a significant role in setting the industry on a path to the required scale and cost-competitiveness. What the US and China do to follow could become real game changers on establishing a global hydrogen economy.



03 Why responsible investment has greater potential in emerging markets



Young Kim

Senior Portfolio Manager,
Emerging Markets



Kyle Bergacker

Senior Thematic Investment Analyst,
Responsible Investment

An interview with **Young Kim** and **Kyle Bergacker** looking at the case for ESG integration, company selection and data analysis

Q: What is the case for environmental, social and governance (ESG) integration in emerging markets?

YK: The emerging markets universe of the MSCI Emerging Market Index (EMI) has 26 countries, and I would argue that ESG matters far more in them than in developed markets. There is more room for companies to improve and for investors to influence change, for the good of society and investors themselves. That means greater potential for alpha generation and having a positive impact.

KB: I agree. Emerging markets tend to rely more on natural resources and have

more labour-intensive manufacturing businesses. So there's naturally more opportunity for improvement.

YK: ESG standards are beginning to matter more. Consider the growing populations, rising middle class, urbanisation and expanding energy consumption. Clearly you need to improve regulation and governance for these economies to grow in a responsible way. Countries like China and India are jumping ahead in terms of renewable energy adoption. India has a target of generating 57% of its energy from renewable sources like wind and solar by 2027.¹

Q: Does empirical research show the potential for adding value through ESG integration in emerging markets?

KB: Many emerging market-related academic papers show just that. For instance, a researcher from the University of Waterloo, Canada, published a paper a few years ago showing that the MSCI Socially Responsible Investing (SRI) Index not only ranked higher in terms of mean return than most emerging market portfolios, but also was less vulnerable to negative shocks.²

Q: How do you find the companies that represent “quality” in terms of ESG and are making improvements?

YK: Step back and you see a huge spectrum of “quality”, defined in terms of both ESG and investment generally. I would argue a lot more so than in developed markets. The quality businesses look after the interests of investors, employees and society; they manage capital responsibility and have good corporate governance. Well-run businesses can take market share away from competitors like state-owned enterprises that aim primarily to provide employment and aren’t as competitive.

Additionally, there are family-run businesses. Studies show they generally outperform. They tend not to have great corporate governance, but often the families’ interests are aligned with investors’ interests in terms of long-term growth and avoiding risk.

There are bad players as well, of course. The situation is improving but loose regulations and unstable policy environments mean that bad practice does still persist.

Q: What role does data analysis play in selecting companies?

KB: Our models act as a first screen. They allow Young to focus his research with greater intensity. He might look at a company that the models are indicating as lower quality but decide it is improving and that is not being picked up by the models quite yet. Young has a great opportunity to generate alpha by engaging with these companies to uncover hidden value. That’s where our most fruitful dialogue happens.

Q: Is there enough data disclosed to build your model?

KB: Yes. Columbia Threadneedle’s proprietary responsible investment ratings model draws on more than

250 million data points. Other complementary models we have in development draw on more than three billion data points. The data covers about 90% of the MSCI EMI and tells us if a company is making a real socioeconomic impact or not. Even if a company doesn’t publish a data point, data can be obtained via machine learning approaches; for instance, gallons of water used, or hazardous waste emitted. While there is still typically less data produced by companies in emerging markets, corporate disclosures are growing quickly in response to pressure from governments and large investors like sovereign wealth funds and pension funds.

Q: Can you give examples of investment themes you like?

YK: FinTech is exciting because it increases financial inclusion. There are huge benefits in moving from cash to digital transactions, and this transition is happening quickly in some emerging markets. You will likely have heard about Alipay and Tenpay, China’s payments duopoly. Some more examples in Brazil, StoneCo and PagSeguro,³ both enable digital payments. Digital payments are the first step towards digital banking.

Turning to renewable energy, countries such as China and India are adopting these technologies on a massive scale. Companies in solar and wind have large numbers of potential consumers. Furthermore, China has poured billions of dollars into support for electric vehicles and leads the industry worldwide.

KB: I would add the opportunities in education companies. There is a big appetite for online education services that give children in rural areas more opportunity.

Q: Does engagement make a difference?

YK: Engagement is important for sourcing data from companies and helping them to improve ESG practices. We make our views known and help

companies to improve performance. Say, for instance, you are Coca-Cola and water is a key input. Obviously, reducing wastewater improves your income statement and increases free cash flow. Collaborating with companies helps them to achieve a double win – in terms of ESG performance and financial performance.

Q: Why is now a good time for ESG investing in emerging markets?

YK: A lot of policy makers are taking action, setting renewable energy targets as well as introducing stewardship codes. We feel that with the right team and tools there is an opportunity to influence change and be at the forefront of change. We believe it is a great time to dive in and invest in emerging markets using an ESG strategy.

Source:

- 1 [The Guardian, India plans nearly 60% of electricity capacity from non-fossil fuels by 2027, 22 December 2016.](#)
- 2 [Weber, Olaf, and Ang, Wei Rong. "The Performance, Volatility, Persistence and Downside Risk Characteristics of Sustainable Investments in Emerging Markets."](#)
- 3 [Mention of specific companies should not be taken as a recommendation to buy.](#)



04 Country head focus – Spain



Rubén García Paéz
Country Head

With an ambitious climate law and inaugural sovereign green bond both in scope for 2020, Spain is placing finance at the heart of its drive for a green economy. The quixotic withdrawal of renewable energy investment incentives seven years ago belongs to the past.

After a troubled history, Spain is successfully rebuilding its credentials in the fields of green finance and responsible investment. Gradually it is making headway, becoming a leading issuer of green bonds and introducing new standards that have sparked growth in responsible investment funds.

The country certainly has a reputation to rehabilitate. In 2013-14 Spain's renewable energy boom came to an abrupt halt when the government withdrew investment incentives and made retrospective cuts to guaranteed subsidies. The move generated a wave of litigation from both domestic and foreign investors.¹

But that episode now appears to be in the past, as Spain places finance at the heart of its policy drive to build a green economy. The immediate priority? Tackling climate change, with a climate law expected to be introduced before the end of this year. The law will ban all new coal, oil and gas extraction projects with immediate effect, end direct fossil fuel subsidies and ensure that all new vehicles are emission-free by 2040. Financial institutions must also play their part, making public from 2023 the decarbonisation objectives of their loan and investment portfolios.²

There are other positive signs, too. The European Investment Bank has agreed to provide up to €385 million in financing to Alfanar, a manufacturer of electrical construction products, for 21 wind farms. This will be one of the biggest wind power projects in Spain.³

Prepping a sovereign green bond

In addition to the climate law, Spain is planning to issue a sovereign green bond, also possibly by the end of the year. The government has also indicated that it plans green bond issuance totalling around €10 billion over the next few years.⁴

The move would come hot on the heels of Germany's first ever sovereign green bond launch in September 2020⁵ and would put Spain in the company of other EU countries such as France, the Netherlands and Belgium which have previously issued sovereign green bonds.

Spain is already one of the world's leading markets for green bonds, ranking in the top 10 of countries worldwide for issuance in 2019,⁶ with activity led by the country's corporate sector. The early pioneers of green bond issuance in Spain were non-financial corporates such as energy companies Abengoa Greenfield and Iberdrola. The latter is a repeat issuer of green bonds, and in 2017 became the first Spanish green loan borrower. The first public sector deal came the same year, with a €600 million green bond from Adif Alta Velocidad, the state-owned railway infrastructure manager.⁷

Since then the City of Madrid has become a repeat issuer of social and green bonds,⁸ with proceeds used to finance social development projects and environmentally sustainable projects. And in September 2020 energy generation company Ecoener issued Spain's first mixed green bond, funding both hydroelectric and wind power projects.⁹ The country's planned sovereign green bond would give further impetus to the market, serving as a valuable benchmark for future green bond issues.

Responsible investment standards

Turning to responsible investment, Spain's domestic fund managers have been making steady but significant progress, launching large numbers of funds which follow environmental, social or governance (ESG) criteria. Excluding international assets, 49% of total assets under professional management by domestic institutions in Spain are run according to ESG criteria.¹⁰ In 2018, assets managed with ESG guidelines in Spain reached €210 billion.¹¹

This growth has in part been spurred by rules setting out minimum standards for ESG funds. Since 2014 fund managers wishing to market

retail funds in Spain using an ESG or responsible investment label must follow a minimum set of requirements outlined by INVERCO, the Spanish Association of Collective Investment Schemes and Pension Funds. Under these rules, funds using such a label must commit to selecting their underlying investments based on both financial and non-financial analysis, displaying warning messages in fund marketing and outlining a fund's ESG criteria in its prospectus.

Among occupational pension funds the rules are even stricter: all pension funds must disclose whether they take ESG criteria into account within their investment portfolios. These stricter rules are in part credited with a wider adoption of ESG criteria among Spanish institutional investors compared to retail investment managers.

Some individual investment institutions are also helping drive change. Pension Caixa 30, the biggest pension fund in Spain with around €6 billion in assets, has been one of the pioneers of ESG investment. The pension fund has stated that it wants to increase its use of ESG performance benchmarks to cover up to 90% of its investment portfolio within the next few years, up from a level of 33% in 2019.¹² What's more, it is looking to introduce

fee structures with its asset managers that encourage ESG and carbon footprint reduction strategies, a trend that if widely adopted would spur further growth in the sustainable investment market in Spain.¹³

Looking ahead, Spain should benefit from the recently introduced EU Taxonomy Regulation, which is designed to encourage private investments into green projects. Under the proposed legislation EU-listed companies with more than 500 employees and larger fund managers will have to calculate and publish what proportion of their business meets new green standards, a move that should encourage more companies and fund managers to adopt green initiatives.

This legislation, combined with Spain's own planned climate law and its ambitions in the green bond market, look set to accelerate changes in the country's ESG investing and green finance landscape. After the loss of credibility caused by the withdrawal of renewable energy investment incentives, the country appears to be back on a path to developing a mature green bond market, moving ESG criteria to the centre of its investment industry.

Source:

- 1 *Responsible Investor*, ESG Country Snapshot: Spain's quixotic journey, 5 September 2018.
- 2 Spain unveils climate law to cut emissions to net zero by 2050, *Climate Home News* <https://www.climatechangenews.com/2020/05/18/spain-unveils-climate-law-cut-emissions-net-zero-2050/>
- 3 *European Investment Bank*, Spain: Climate action - EIB to finance construction of 21 wind farms, 1 August 2019. <https://www.eib.org/en/press/all/2019-207-climate-action-eib-to-finance-construction-of-21-wind-farms-in-spain>
- 4 *Green Finance for Latin America and the Caribbean*, Spain will issue in 2020 green bonds aimed at financing projects with environmental purposes, 10 January 2020.
- 5 Euractiv, Germany raises €6.5 bln from first-ever green bond, 3 September 2020.
- 6 2019 Green Bond Market Summary 2019, Climate Bonds Initiative https://www.climatebonds.net/files/reports/2019_annual_highlights-final.pdf
- 7 2019 Green Bond Market Summary 2019, Climate Bonds Initiative https://www.climatebonds.net/files/reports/the_green_bond_market_in_europe.pdf
- 8 Sustainable debt, *Community of Madrid* <https://www.comunidad.madrid/en/inversion/relacion-inversores/deuda-sostenible>
- 9 Hydroelectric power plants and wind farms continue to grow thanks to green bonds, *Societe Generale* <https://wholesale.banking.societegenerale.com/en/insights/clients-successes/clients-successes-details/news/hydroelectric-power-plants-and-wind-farms-continue-grow-thanks-green-bonds/>
- 10 Sustainable and Responsible Investment in Spain, page 28, *Spainsif* https://www.spainsif.es/wp-content/uploads/2019/12/AF_Spainsif_Report_2019_web_pxp.pdf
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- 13 Jordi Joffra, Caixa 30, *UBS* <https://www.fpecaixa.info/documents/eng/20190618%20Responsible%20Investor.pdf>





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COVID-19



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12pm

05 Covid-19's impact on investing



Kirk Moore

Global Head of Research

When it comes to evaluating which companies may flourish and which may struggle following the disruption of Covid-19, studying underlying business models is more revealing than reviewing traditional sectors.

Conventional industry classifications were already becoming less insightful as company business models evolved. For example, is Amazon a technology company, a retailer or both? Now, Covid-19 will alter long-term customer behaviour and change the nature of their transactions.

For asset managers, having different perspectives and debating different

views within their research teams often delivers the greatest insights.

In looking at the long-term implications of the pandemic we have split business models into three groups, identifying how the shifts in consumer behaviour resulting from Covid-19 are likely to impact their recovery prospects. Broadly speaking, the three categories are:

- **Negative impact** – business models not expected to recover to pre-Covid-19 levels, for example traditional retail.
- **Unchanged** – business models expected to recover to pre-Covid-19 levels, for example pharmaceuticals.
- **Positive impact** – business models expected to exceed pre-Covid-19 levels, for example internet retail.

Without a doubt, the pandemic is a significant turning point and will have a long-term impact. Depending on when a vaccine comes to market and how widely it is adopted, Covid-19 is still likely to alter people's behaviour for years to come, changing how consumers interact with companies. But it is not just a company's relationship with its ultimate customer that is impacted. Supply chain resiliency and flexibility has become more critical than pure efficiency.

Those companies with the means to not be locked into current infrastructure, or able to pivot quickly, could gain share. To a certain extent the crisis has accelerated long-term trends that were in place beforehand. If there were three areas that were important to understand before the crisis, they were technology, healthcare and the financial ecosystem. As the pandemic accelerates existing economic and social trends it has magnified the importance of these three themes. Technology and healthcare will be key sources of future sustainable growth. And understanding financial liquidity is critical, because readily available capital greases the global economy. The soundness of the financial system is critical for all businesses in order to identify potential pain points, key investment risks and opportunities.

A spotlight on social issues

Discovering opportunities and challenges that the market has overlooked would not be complete without responsible investment or environmental, social and governance (ESG) research, particularly because the pandemic has highlighted social issues. ESG is a non-financial measure of a company's quality that complements financial analysis.

It reveals how well a company has thought about elements of its operations, including the quality of the management and rigour of the governance structure. It signals how well it is likely to be able to grow organically, as well as how adaptable and innovative it is likely to be.

After Covid-19 social issues will be more important, with major implications for businesses. It is important for both traditional and responsible investment professionals to engage companies and learn about how they are responding to the heightened sensitivity towards social issues. For example, in a recent engagement call with a company the management outlined their detailed plans around keeping employee health and wellbeing a priority at this time.

The path to recovery

Rarely has there been a greater need for analytical insight. The path to recovery will necessitate one or multiple vaccines coming to market, which we expect on a limited basis by the end of this year and broader availability during 2021. Over the next two years companies will have to endure a testing environment.

For example, we believe that the most likely path of recovery for the US economy is U-shaped, with a possible re-emergence of the virus later in the year, a 6%-8% decline in US GDP growth in 2020 and eventual economic recovery in 2022. Our equity researchers anticipate US aggregate revenue and net income to recover faster than the economy as larger cap companies with exposure to durable growth outpace the broader economy, with levels returning to fourth quarter 2019 figures by the middle of 2021. However, the estimates from our credit teams highlight that the recovery is not expected to be even across all business models, with those identified as being negatively impacted by Covid-19 struggling to recover over the next three years.

In the European high-yield market the additional leverage typically found on corporate balance sheets amplifies the importance of correctly assessing how different business models will be affected over the longer term.

The scale of the demand shock seen in cyclical or particularly exposed sectors is likely to stretch liquidity and increase leverage this year. However, following an unprecedented wave of state-backed liquidity measures, most companies have the financial

flexibility to respond by restructuring and reshaping where necessary. As such, businesses with strong market positioning in sectors that are likely to (at least partially) recover have the potential to emerge from the crisis with leaner cost bases and sound cash generation.

Independent research

This is also a time of great change in people's behaviour, the interaction of consumers with businesses and the nature of transactions. Some of the long-term impacts such as more working from home and using less office space are well known, but how that ripples out through different business models and across supply chains is not.

This pandemic is a big moment for economies; a rare event that truly deserves to be described as a crisis. Analysing its impact on different business models with a laser focus is where one can discover value. Covid-19 is a true game-changer that presents active investment managers with a challenge – as well as the opportunity – to discover the varying effects and position portfolios accordingly. More than ever independent research will drive consistent investment returns.

STEWARDSHIP IN ACTION

Columbia Threadneedle Investments views an integrated, joined-up approach to stewardship as an integral part of its responsible approach to investment. We vote actively at company meetings, applying our principles on a pragmatic basis. We view this as one of the most effective ways of signaling approval (or otherwise) of a company's governance, management, board and strategy. We classify a dissenting vote as being where a vote is cast against (or where we abstain/withhold from voting) a management tabled proposal, or where we support a shareholder-tabled proposal not endorsed by management. While analysing meeting agendas and making voting decisions, we use a range of research sources and consider various ESG issues, including companies' risk management practices and evidence of any controversies.

Our final vote decisions take account of, but are not determinatively informed by, research issued by proxy advisory organisations such as ISS, IVIS and Glass Lewis as well as MSCI ESG Research. Proxy voting is effected via ISS. Although we subscribe to proxy advisors' research, votes are determined under our own custom voting policy which is regularly updated. The RI team assesses the application of the policy and makes final voting decisions in collaboration with the firm's portfolio managers and analysts. Votes are cast identically across all mandates for which we have voting authority. All our voting decisions are available for inspection on our website seven days after each company meeting.

In prioritising our engagement work, we focus our efforts on the more material or contentious issues and the issuers in which we have large holdings – based on either monetary value or the percentage of outstanding shares. There are

many companies with which we have ongoing engagements, as well as a number that we speak to on a more ad hoc basis, as concerns or issues arise. We actively participate in several investor networks, which complement our approach to engagement. Along with other investors, we raise market and issuer-specific environmental, social and governance issues, share insights and best practice. We do not make use of third party engagement services.

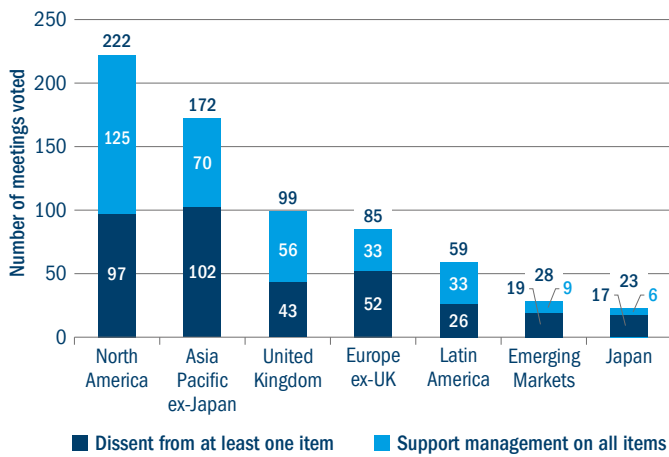
The significant impact of Covid-19 on companies' ability to operate continues to be a main topic of engagement. Our approach to active stewardship remains unchanged: we continue to engage with companies to better understand their management of financial and non-financial risks and how they generate sustainable long-term returns. Companies' response to and management of Covid-19 will be a core part of this analysis going forward.

06 Voting Q3

Between July and September 2020, we voted at 688 meetings across 41 global markets. This compares to 3,886 meetings voted across 57 global markets in the second quarter.

Of the 688 meetings, 531 were annual general meetings, 13 combined annual/special, 136 special, four court, and four written consent meetings. We cast at least one dissenting vote in 356 meetings (52%).

Figure 1: Meetings voted by region

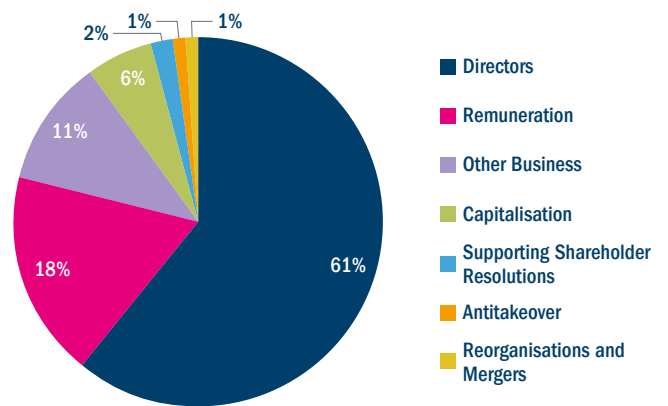


Source: Columbia Threadneedle Investments, ISS ProxyExchange, 30 September 2020.

We voted in 41 separate markets in the third quarter. Most meetings were voted in the US (211), followed by United Kingdom (96) and India (72).

The majority of the voting items that we did not support throughout the quarter related to directors followed by remuneration and non-salary compensation-related proposals.

Figure 2: Proportion of dissenting votes per category



Source: Columbia Threadneedle Investments, ISS ProxyExchange, 30 September 2020.

07 Engagement highlights

Between July and September we engaged with the 44 issuers¹ listed below, some on multiple occasions.

Specific sustainability focus

AVEVA, British American Tobacco, Compass Group plc, Domino's Pizza Group, Equinix Inc, Future plc, Hershey Co, Intercontinental Hotels Group, ITV plc, Nucor Corp, Sherwin-Williams Co, Sika AG, SSP, Stock Spirits plc, TJX Companies Inc, Wood Group

Environmental, social and governance discussions

Albemarle Corp, Anheuser Busch Inbev, Apple Inc, Brown-Forman Corp, Compass Group, Honeywell International Inc, McKesson Corp, Tyson Foods Inc, Union Pacific Corporation, Visa Inc

Specific environmental focus

Amazon.com Inc

Specific social focus

Tyson Foods Inc, Ubisoft

Specific governance focus

Avon Rubber plc, Cubic Corp, DS Smith, FirstGroup, Hays plc, Imperial Brands, Informa plc, Irish Continental Group Plc, Knorr Bremse, Palo Alto Networks Inc, Pearson plc, Restaurant Group plc, Stagecoach, Tate & Lyle, Ted Baker plc, WM Morrison

Case studies

The case studies overleaf describe company engagement over the past quarter:

¹ The mention of specific stocks should not be taken as a recommendation to deal.

Company:	Albemarle, Inc.
Location and sector:	US, Industrials
Topics:	<i>Sustainability and strategy</i>
Why did we engage?	We sought to assess contributing factors for the company's historically low third-party ESG risk scores. Our hypothesis was that the company was performing better than reported and, given the importance of its lithium products to battery technologies, we discussed the company's sustainable outcomes for the environment.
How did we engage?	The RI team met alongside our fundamental equity analyst and engaged with Albemarle's investor relations team and senior sustainability staff.
What did we learn?	ALB products are increasingly important to solving global environmental challenges. The lithium business segment provides significant exposure to electric vehicle and stationary energy storage solutions. 50% of FY2019 revenues derived from products with a positive impact on lowering water usage and greenhouse gas emissions. A significant investment in, and commitment to managing, climate and toxic material risks mitigates ESG concerns.
What was the outcome?	At our encouragement, management committed to disclose greenhouse gases and water targets in spring 2021. CDP and TCFD reporting frameworks are also under consideration.

Company:	Imperial Brands
Location and sector:	United Kingdom, Tobacco
Topics:	<i>Corporate governance, strategy, intervention</i>
Why did we engage?	Since mid-2019 we have been involved in a long-term engagement with Imperial Brands, both unilaterally and through the Investor Forum.
How did we engage?	The UK equities and RI teams met the company's new chief executive officer and senior independent director.
What did we learn?	The new CEO will complete a review of the business and present an updated strategy at a capital markets day in Q1 2021. Remuneration is a focus for the board: balancing the shareholder experience and motivating a new management team. Any changes to pay structures throughout the organisation will align with the updated strategy and associated KPIs.
What was the outcome?	While we continue to monitor the company, our period of intensive engagement has ended, having achieved many of our objectives including changes to senior management, the dividend policy and financial disclosures.

Company:	Knorr Bremse
Location and sector:	Germany, Construction Machinery and Heavy Trucks
Topics:	<i>Corporate governance</i>
Why did we engage?	We participated in the company's IPO in late 2018. Since then we have met the company on a regular basis to discuss its corporate governance. During the summer the CEO left unexpectedly.
How did we engage?	The European equities and RI teams held a conference call with the chairman of the supervisory board.
What did we learn?	We discussed the reasons for the CEO's departure and how the hiring process will work as a replacement is recruited, and the importance of alignment between the individual and Knorr Bremse's long-term strategy. The company has a decentralised structure; the short-term operational impact is minimal.
What was the outcome?	We requested further engagement with independent members of the board to fully assess the company's approach to corporate governance.

Company:	McKesson, Inc.
Location and sector:	US, Healthcare
Topics:	<i>Corporate governance</i>
Why did we engage?	Since 2018 we have engaged with McKesson on governance and executive compensation having urged change and casting dissenting votes on pay for several years. We met with the company in this instance to discuss recent governance and compensation enhancements and the company's response to the US opioid crisis as a pharmaceutical distributor.
How did we engage?	The RI team conducted a video conference with investor relations, senior legal and ESG staff alongside our fundamental equity and corporate credit analysts.
What did we learn?	Material changes in executive compensation structure have been installed, quantum of pay is now in line with peers, and incentive metrics are firmly linked to achievement of financial results. Board overhaul is nearly completed, and the board's compliance committee focused on opioid litigation and risks, led by a capable director with legal and government regulatory experience. The company's opioid controls system leverages analytics to drive illegal drug purchasing activity and detect issues early.
What was the outcome?	While prior CTI engagement has helped shape a new compensation structure and encourage governance changes, we continue to engage on key risk items. We supported two shareholder proposals on governance mechanisms and lobbying payment policy, and continue to monitor ongoing opioid litigation and potential for material regulatory actions on the industry.

Company:	Tyson Foods, Inc.
Location and sector:	US, Consumer Staples
Topics:	<i>Corporate governance</i>
Why did we engage?	As one of the largest protein companies in the world, Tyson Foods' meatpacking facilities became Covid-19 hotspots which drew worldwide concerns around employee and product safety. Our engagement sought to assess effectiveness of the company's actions to safeguard employees, food products and the firm's brand reputation.
How did we engage?	A video call was held between Tyson investor relations, the senior vice president of health and safety, the RI team and CTI fundamental equity and corporate credit analysts.
What did we learn?	The company's actions to protect employees were considerably more extensive than reported, with more than \$350 million spent on programmes, tests and physical barriers in facilities resulting in infection rates below local averages. The company had conducted thousands of employee virus tests, hired a chief medical officer and contracted more than 500 nurses and physicians for facilities.
What was the outcome?	The company acknowledged they weren't prepared for the virus, but rebounded spectacularly, and we noted their particular responsibility to employee safety so products, brand and the workforce remain intact. We continue to monitor reported infection rates and will review aggregate investments in safety and results at year end.

Company:	Ubisoft
Location and sector:	France, Interactive Home Entertainment
Topics:	<i>Corporate governance, social risk management</i>
Why did we engage?	Following allegations of workplace misconduct, two executives unexpectedly left the business and a third was demoted. We met the company to discuss its immediate response to the allegations and a mid- to long-term remediation plan.
How did we engage?	The RI team held a conference call with Investor Relations alongside members of the European equities team.
What did we learn?	Workplace misconduct and company culture is an acute, material social risk for Ubisoft and the industry. In the past this may not have been appropriately managed. Since the scandal there have been positive changes: all employees must complete mandatory training on harassment, and an anonymous, independent whistleblowing line has been established. Multiple investigations are ongoing, and an external consultant has been hired to review the human resources function.
What was the outcome?	We requested further engagement with independent members of the board and will continue to monitor the situation as the external consultant completes its review.

Company:	Wood Group
Location and sector:	United Kingdom, Oil and Gas Equipment and Services
Topics:	<i>Sustainability, strategy</i>
Why did we engage?	As a long-term investor, we engage with management on a regular basis.
How did we engage?	The UK equities team met senior management to discuss strategy, financials and sustainability.
What did we learn?	There has been a significant shift in the company's revenues: oil and gas has fallen from 85% to 32% in less than four years, while increasing exposure to renewable energy and green infrastructure is a strategic focus.
What was the outcome?	The company is taking leadership in providing solutions for the energy transition. The engagement caused it to be upgraded from a Transition name to an Advanced Contributor within our developing Social Outcomes assessment framework, aligning with our Regeneration and Infrastructure theme.

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