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Marketing Material

Normative judgments

How assessing norm violations in a portfolio context could help avoid risks.

- The most prominent norm violations typically relate to breaches in human rights, environmental responsibility and business ethics.
- The sectors most prone to norm violations are energy, consumer staples and materials.
- Among sub-sectors, severe incidents include bribery in pharmaceuticals, environmental destruction in metals and mining and money laundering at banks.

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A global survey released at Davos in January 2020, found that 56% of people believe that capitalism, as it exists today, does more harm than good in the world.[1] Moreover, the survey found that companies can become trusted if they contribute to communities, deal fairly with suppliers, pay a decent wage and partner with external organizations and governments on key issues. This has proved particularly poignant given the unfolding Covid-19 crisis. Indeed, the current crisis should increase the momentum of integrating social aspects into investing according to environmental, social and corporate-governance (ESG) aspects, an area that has often been overshadowed by the responsibilities of integrating the multiple dimensions of climate risk. This should eventually mean better data capture in terms of scope and depth as it relates to social issues. This goes to the heart of our norms-based ESG screening.

One of the early steps to incorporating ESG criteria into the investment process has been to identify and measure the scope of corporate involvement in controversial sectors such as coal or tobacco, which has typically led to engagement or outright divestment. When it comes to screening for norm violations, a more nuanced approach is required. As a starting point, the UN Global Compact and its ten principles provide a good foundation.[2] This typically means understanding and assessing whether or not a corporate's conduct of business is in compliance with, or in breach of, human rights and labor standards. It further extends to such issues as whether a company is working against all forms of corruption and whether it is promoting environmentally friendly technologies.

To address these norm issues, we subscribe to four leading ESG data providers in the market (MSCI, Sustainalytics, ISS-Oekom and ISS-Ethix). All ESG providers screen and assess ESG controversies involving the impact of company operations, products and services as well as governance practices. However, they apply different methodologies, which may result in different criteria being included and ultimately leading to a variety of assessed severities.

Furthermore, some providers may take a more conservative stance against certain factors. For example, ISS-Oekom's assessments more heavily rely on corruption cases compared to those of other data providers. Such signal discrepancy creates material challenges when it comes to aggregating multiple signals from these providers. However, we value the diversity in assessments, which has led us to devise a proprietary methodology to derive an objective and reliable cross-vendor measure to overcome these challenges.

1 Edelman 2020 https://www.edelman.com/trustbarometer
2 www.unglobalcompact.org

This methodology seeks to re-confirm the severity of any given controversy across vendors. It assigns an agnostic score from 0 (no controversy) to above 90 (worst controversies) which then translates into the classical DWS scoring and letter rating schemes. A to D label the corporates with either no, low or manageable risks; E labels the corporates with severely controversial violations, and F labels the most controversial violations.

The norm violations against human rights, labor rights and the environment are taken most prominently within this methodology, as we believe they may have far more impact on society and local community with long-lasting negative effects. Our norm methodology considers not only the company's operations itself, but also incidents within the corporate's supply chain. It therefore examines norm violations that are occurring some distance away from the corporate and not under its direct control. Typical examples of remoteness to a corporate's operations include forced labor, child labor, discrimination as well as general labor standards in the supply chain. In the current crisis it relates to support mechanisms for employees, customers, contractors and suppliers such as working from home, paid sick leave and community relief funds.

When examining the results from our analysis and categorization, we find that sub-sectors most affected by severe ESG controversies are within healthcare, materials, energy, financials and consumer staples. In this respect, the most affected sub-industries are pharmaceuticals, metals-and-mining, oil, gas and consumable fuels, banks and tobacco companies. However, within these sub-industries the areas of severe norm violations vary substantially. Human rights and environmental issues are most pronounced in the oil, gas and consumable fuels, metals-and-mining and tobacco sub-industries while the banks and pharmaceuticals sub-industries are more affected by incidents relating to business ethics.

From the identified controversies in the metals-and-mining sub-industry, the two most prominent areas of violation are environmental and human-rights issues, with 61% and 52% "E and F" exposure, respectively. Key failures relate to assessing environmental impacts and, specifically, the contamination of air, soil and water. This has been most acute in mining operations in emerging-market countries where environmental protection laws are typically weaker compared to the developed world.

The most severe controversies in the oil, gas and consumable-fuels sub-industry, in descending order of importance, relate to human-rights, environmental and business-ethics issues. In this sub-industry 35% of laggards[3] had one or several severe controversies related to human rights; 20% were exposed to environmental controversies like systemic oil spills and shortcomings in their remediation. A growing area of risk relates to accessing gas and other natural resources in the Arctic.

Severe controversies in the pharmaceuticals sub-industry cover human rights, environmental issues and business ethics in equal measure. Regarding human rights, we have seen incidents related to the quality and safety of several products. Examples of business-ethics violations relate to allegations of bribery in pharmaceutical sales as well as in fixing generic drug prices. We have also seen cases where environmental impacts and biodiversity loss are not being addressed.

In banks, there are severe controversies in human rights. However, these are related to Israeli banks, which are contributing to the proliferation of West Bank settlements by providing loans and mortgages for local construction activities, and consequently violating human-rights[4] obligations.[5] The second most prominent area of incidents within the banking sector relates to business ethics. Some examples of severe cases are in money laundering, unfair lending practices, overcharging customers or breaking consumer protection rules.

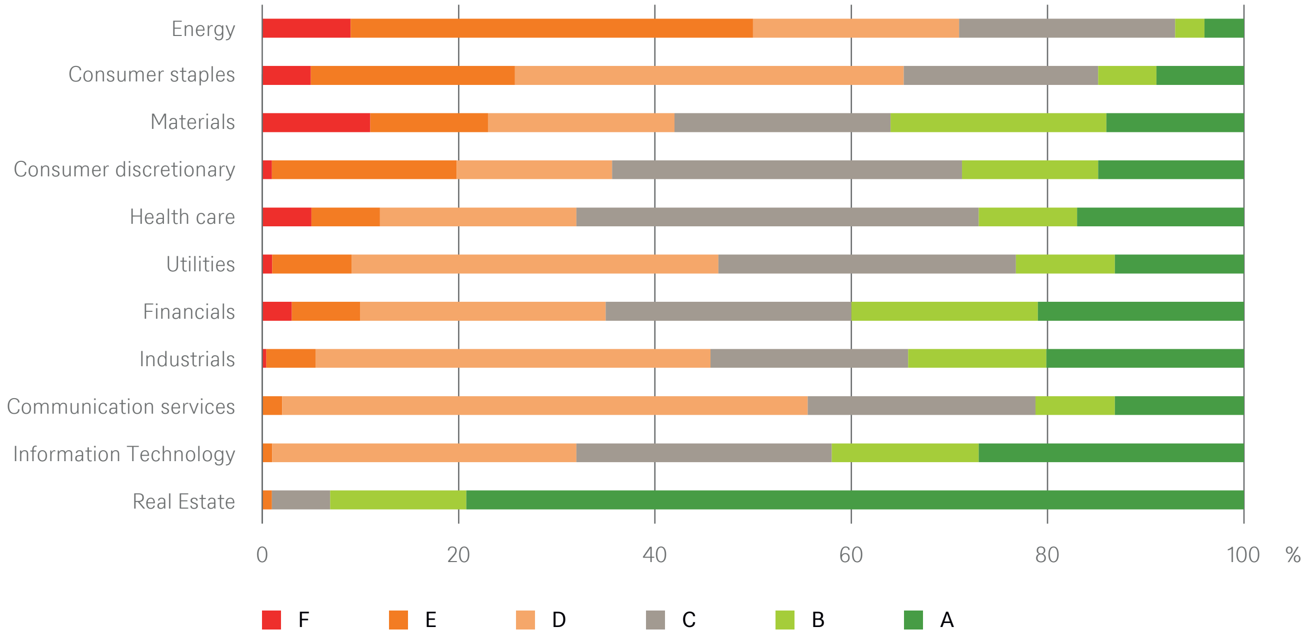
From a sub-sector perspective there are also some positive examples. We identify equity real-estate investment trusts, water utilities, software, healthcare technology and biotechnology, thrifts and mortgage finance with the lowest degree of norm risk currently.

In order to enhance our sector-allocation process and to take ongoing asset-repricing risk into account, we aim to fully incorporate norm risks into our fundamental research and portfolio-management processes. Indeed, by identifying the norm leaders and laggards, we are able to avoid exposure to severe controversies while maintaining sector weights in portfolio allocations. This has never been as important as it is in today's challenging times.

[3] We consider those companies rated E or F according to our methodology as laggards
[4] As defined by the United Nations
[5] See, for example, United Nations Human Rights Council report as of 2/12/20: https://www.ohchr.org/EN/HRBodies/HRC/RegularSessions/Session43/Pages/ListReports.aspx

ESG LEADERS AND LAGGARDS IN MSCI AC WORLD INDEX SECTORS

Energy, consumer staples and materials are most prone to norm violations.



A–D refers to no, low or manageable risk, E to severe violations, F to most controversial violations
Source: DWS Investment GmbH as of 02/2020

GLOSSARY

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

Investors increasingly take environmental, social and governance (ESG) criteria into account when analyzing companies in order to identify non-financial risks and opportunities.

The MSCI AC World Index captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

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