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Thinking about sector allocation in new ways

Why ESG quality is such an important driver for investors and performance across companies, sectors and sub-sectors.

_ Increasingly, the integration of environmental, social and corporate-governance criteria help us identify potential investment opportunities and risks.

_ From a sector perspective, energy and materials pose some of the highest climate-transition and norm-based risks.

_ Potential opportunities are most evident in the technology and renewable energy sectors, as well as among some industrial companies.

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In this article, we examine some of the potential risks and opportunities of different sub-sectors to relevant environmental, social, and corporate governance (ESG) dimensions. This brings together work we have previously outlined. We therefore only provide a brief introduction to our approach, for measuring climate-transition risk (CTR rating), exposure to controversial behavior (norm rating) as well as the exposure to Sustainable Development Goals (SDG rating). Interested readers should check previous issues of the Quarterly for further details on our methodologies.[1] We go on to describe how the results increasingly help drive our asset-allocation decisions, as well as help to explain performance across companies, sectors and sub-sectors.

The purpose of our norm rating is to show whether or not a corporation's conduct of business is in compliance with or breaches international norms such as the United Nation's (UN) Global Compact. This rating assesses the overall severity and frequency of incidents related to operations, products or services and governance practices. Our climate-transition-risk rating (CTRR) assesses which corporations are more likely to successfully manage the transition to a carbon-free world. Last but not least, our SDG rating assesses the net contribution to the UN-defined SDGs. We identify companies with revenues positively linked to SDGs and apply a control-risk mechanism which is designed to identify "true" leaders. The latter is achieved by removing securities with any severe issues either in ESG quality, as measured by our proprietary DWS SynRating, or by any norm violations or controversial sector involvement.

Through this assessment we seek to identify sectors and sub-sectors that are facing higher risks and/or opportunities according to these three dimensions. Since 2018, we have been integrating global ESG trends into our DWS CIO View. By including ESG information, we aim to reduce our investment risk, explore business areas with growing demand and put investment flows to work for financial return but also to make important contributions to society. We consider this step as a valuable addition to our investment process by considering ESG impacts into our asset allocation and portfolio construction. It allows us, among other things, to optimize a portfolio that not only reduces climate-transition, financial and reputational risks, but also tilts investments towards entities that promote the low-carbon transition and contribute positively to the SDGs.

[1] Availabe at https://www.dws.com/en-us/insights/cio-view/cio-view-quarterly/q3-2019/climate-transition-risk-and-asset-allocation/

When analyzing the results from our in-depth sector and sub-sector analysis based on the combined risks of these three dimensions, we came to the conclusion that the sub-sectors that tend to present the highest risks are in consumer discretionary, energy and materials. These three sectors tend to have the highest number of true CTRR laggards and often violate international norms. By contrast, we found that the sectors with the highest share of "true SDG leaders" and "providers of climate solutions" are in the technology, renewable-energy and industrials' sectors.

In the consumer-discretionary sector, the automobile sector suffers from some instances of poor business ethics, a legacy of the diesel-gate scandal and high climate-transition risk via traditional internal-combustion-engine-based car models. However, over the long term, we believe the sector provides opportunities to climate solutions thanks to its growing emphasis on electric vehicles, which contribute to SDG number 13 (Climate Action).[2]

In the energy sector, we found that all sub-sectors have a high proportion of climate laggards and companies are exposed to severe norm-controversial behavior. These are typically related to environmental risk and human rights' abuses. Finally, within materials, metals and mining as well as construction materials possess excessive climate-transition risks as well as severe norm violations for example from emissions and waste, water stress and local communities. Therefore, we expect the need for key inputs such as water and energy to physically and financially constrain the construction of new operations in this sector.

In order to enhance our asset-allocation process in light of ongoing asset-re-pricing risk, we aim to reduce exposure to climate-transition and norm risk, as well as capture low-carbon and SDG investment opportunities. Besides identifying where high levels of climate-transition and norm risk have a tendency to reside, we have also been able to identify sectors, sub-sectors and individual securities where climate change and exposure to the SDGs could offer some of the most opportunities.

We have found that such opportunities are concentrated in the information technology, utilities and industrials sectors. Within IT, all three sub-sectors have a high proportion of SDG leaders. Furthermore, IT products are typically deployed for energy-efficiency purposes and are associated with SDG13 (Climate Action); the same also applies to certain devices in the semiconductor sub-sector. In the utilities sector, we identified water-utility entities and a small portion of the independent power companies that are focused on renewable parks while in industrials the sub-sectors electrical-equipment, building products and railroads are well positioned.

Within the framework of this analysis we concluded, that these three facets have historically shown relative outperformance against the broader market as of August 2020. By constructing portfolios as subsets of the MSCI AC World EUR Index according to the climate-transition-risk rating, norm rating, and SDG rating, we found that it is possible to get some indicative results.

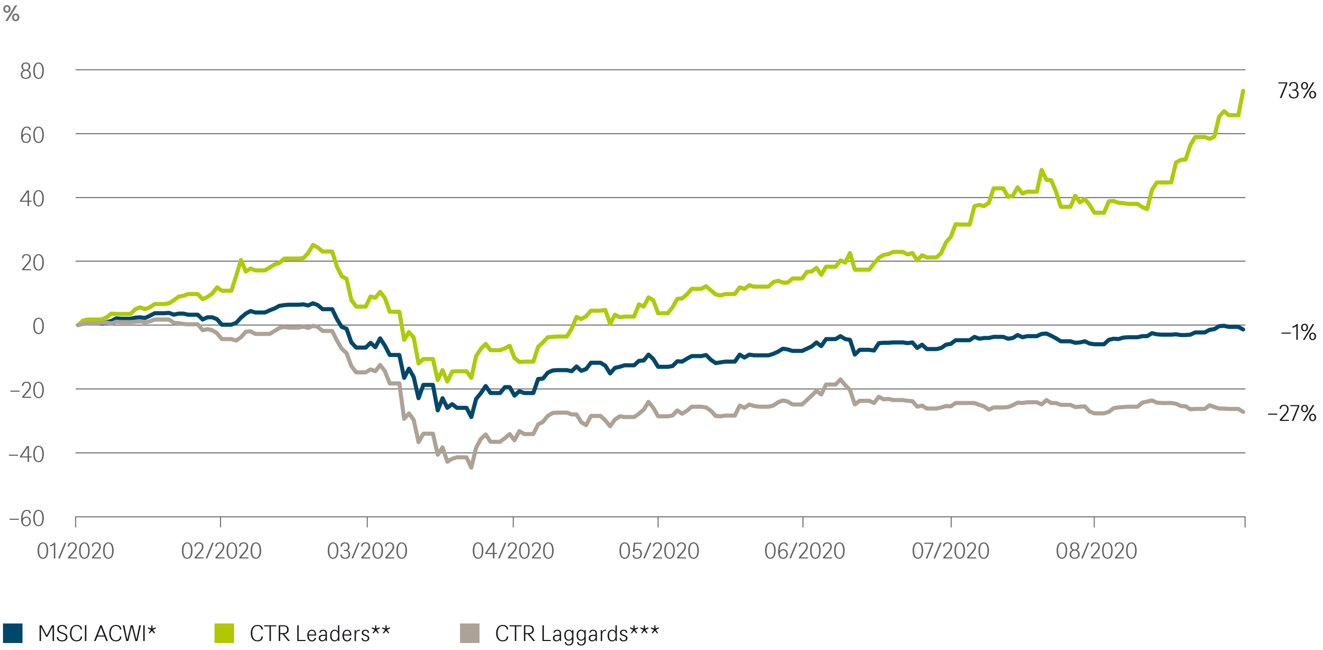
As an example, we found that the outperformance was highest with respect to climate transition, where the climate-solutions portfolio outperformed the climate-risks portfolio by 73% in the year to date (ytd). The climate-risks portfolio consisted mostly of energy, utilities and materials companies, while the climate opportunities portfolio was exposed heavily to information technology and industrials. The norm-risks portfolio underperformed the broad market by 2%. The SDG opportunities portfolio outperformed the market by 14% ytd, driven by significant overweights in health care and information technology (IT) at the cost of underweighting almost every other sector (except real estate). These results should be taken as indicative only, but are consistent with our view that it can be valuable to take a granular look at various ESG components.

So, what does all this mean? Well, our analysis shows that global investors are increasingly integrating ESG information into their investment decisions. This in turn may have supported the performance of different sectors and sub-sectors during the first eight months of 2020. Furthermore, we believe it also illustrates the usefulness of a formal framework when evaluating issuers against a consistent set of criteria in deriving a global outlook for a sector allocation. By integrating ESG information in general and climate transition, norms and SDG information in particular, we aim to reduce our investment risks, capture investment opportunities and facilitate efforts to improve environmental and social challenges the world faces.

2 https://www.dws.com/insights/cio-view/cio-view-quarterly/q2-2020/sustainable-success-stories/

CLIMATE-CHANGE LEADERS VS. CLIMATE-CHANGE LAGGARDS

In the year to date, companies rated best (A or B) with regards to climate-transition risks strongly outperformed the broader market, while the worst rated ones (E or F) lagged behind.



* MSCI All-Country World EUR Index
** Climate-transition-risk rating A-B
*** Climate-transition-risk rating E-F
Sources: Bloomberg L.P., DWS Investment GmbH as of 8/31/20

GLOSSARY

Consumer discretionary is a sector of the economy that sells non-essential goods and services.

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 (EUR) Index captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries. The values are normally shown in US dollars, here converted into euros.

PERFORMANCE / Overview

Performance in the past 12-month periods (%)

	08/15 – 08/16	08/16 – 08/17	08/17 – 08/18	08/18 – 08/19	08/19 – 08/20
MSCI AC World EUR Index	7.9%	9.7%	13.8%	5.4%	7.3%

Source: Bloomberg Finance L.P. as of 8/31/20

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