

Tackling inequality through ESG and active ownership

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Executive summary

- Social factors have traditionally played third fiddle to their environmental and governance counterparts in many approaches to responsible, sustainable investing.
- The COVID-19 pandemic and its far-reaching impacts have challenged this norm by highlighting the persistence of social and economic inequality in the 21st century.
- The tragedy of George Floyd, whose death during a police arrest sparked anti-racism protests around the world, has further underscored this enduring scourge.
- These crises represent an opportunity to promote socially responsible investment solutions that help address inequality-related issues through the prism of ESG.
- Active ownership is vital to ensuring that the necessary organizational responses transcend mere box-checking and are genuinely geared towards the greater good.
- If properly devised and implemented, socially responsible solutions square moral and fiduciary duties by potentially enhancing both ESG performance and financial performance.

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“Is it possible to frame inequality in ESG terms? Yes, because every organization can promote social policies and practices that recognize such issues.”

Introduction

“If the misery of our poor be caused not by the laws of nature, but by our institutions, great is our sin.” - Charles Darwin, Journal of Researches, 1839

Investors' thinking around environmental, social and governance (ESG) considerations tends to follow a particular pecking order. Governance, which to some degree influences the other two elements, usually comes first. Environmental, especially in light of the existential threat posed by phenomena such as climate change, normally comes second. Social, which covers how organizations interact with a broad range of stakeholders, more often than not brings up the rear.

This hierarchy might not alter dramatically anytime soon, but today the S of ESG is undoubtedly earning more attention. The COVID-19 pandemic has further crystallized the importance of the greater good, posing new and highly pertinent questions about entities' relationships with clients, employees, suppliers, communities and, crucially, society in general.

In addition, the case of George Floyd, the African-American man who died during a police arrest in Minneapolis, Minnesota, has re-exposed what has been called “the pandemic within the pandemic”: inequality. It has challenged the notion, supposedly forged during the fight against the virus, that humanity is a collective that strives to find shared solutions to shared problems.

Is it possible to frame inequality - and even racism - in ESG terms? Yes, because every organization can promote social policies and practices that recognize such issues. Investors have a potentially enormous part to play in bringing about the desired transformation, given their ability to allocate capital responsibly and to exercise the power of active ownership in pursuing outcomes whose benefits extend far beyond the bottom line.

In this paper we examine how ESG integration can help tackle inequities and imbalances that have existed for decades and which have been thrown into sharp focus by the extraordinary events of recent months. We reflect on the growing chasm between “haves” and “have-nots”; we explain how fiduciary duty links to the fundamental idea of doing the right thing; and we outline the roles of data, direct engagement and dialogue in shaping equality-aware investment decisions.

We should stress that we do not intend for this to be any kind of political treatise. Nor do we pretend for an instant that asset managers should be looked upon as the world's moral and ethical guardians. Our purpose is simply to explore how investors can contribute to the cause of positive, lasting change in the face and wake of unprecedented and all-pervading societal upheaval.

Q&A: Pandemic, protest... and progress?

Colin Meadows is Invesco's Head of Global Institutional and Private Markets and Digital Wealth.

In this interview, he discusses how recent events have drawn renewed attention to the S of ESG. He also considers the financial sphere's willingness to confront inequality, as well as Invesco's own commitment to diversity and inclusion.

You wrote a very powerful blog post in the wake of George Floyd's death, arguing that a nation derives strength from diversity and that a corporate culture such as Invesco's shows how multiple perspectives can help achieve common goals. What kind of reaction did your article generate?

It was really encouraging. There was a tremendous outpouring of support from colleagues around the world, which reinforced my belief that society as a whole can finally come together to make this situation better.

So what should happen next?

What makes me especially optimistic is that there seems to be a real willingness to push forward. These things often start and then flame out, but right now - maybe because we've been in lockdown and can't look away - this has everyone's attention. There's already a shift towards thinking less about protests and more about what people can specifically do to effect change - and, as I said in my post, the business world has a massive part to play here.

We know from a wealth of evidence and from our own experience that diversity, inclusion and equality lead to positive outcomes. Simply put: a company that's truly diverse tends to outperform a company that isn't diverse at all or that merely pays lip service to diversity.

So we have to spread this message. We have to establish diversity, inclusion and equality as norms throughout the corporate world. And we have to encourage businesses to foster the same thinking through their engagements with society.

“When we’re able to make a direct connection between diversity and positive outcomes, we have an irrefutable economic case for equality.”

Countless businesses have supported the Black Lives Matter movement. Is this part of the answer?

It’s a terrific start. One of the things that give me optimism that this time is different is the vocal commitment of allies across the business world. Now the hard work of moving from commitment to action must begin.

This is why I think ESG can be such a powerful vehicle for eradicating inequality. It gives us an authentic basis for comparison and improvement. When we’re able to see that certain things are correlated with stock outperformance, when we’re able to make a direct connection between diversity and positive outcomes, we have an irrefutable economic case for equality.

Raphael Bostic, the first black president of a US Federal Reserve Bank, recently wrote that systemic racism “is a yoke that drags on the American economy.”¹ How significant is it that someone in such a position should publicly express that sentiment?

It’s hugely significant. It shows that these conversations, however uncomfortable they might be, have to take place openly and that these are issues that must be addressed at every level.

One of the key points Raphael underlined is that injustices can be economic as well as moral. He wrote that many of our citizens “endure the burden of unjust, exploitative and abusive treatment by institutions” - and we have to recognize that this includes financial institutions.

We know there are racial disparities in access to capital. We know these disparities have an impact on members of minority communities, on people at the margins of society and on the economy as a whole. And we know we all need to think differently about how we tackle the problem.

So what steps has Invesco taken?

First, as an asset manager, we recognize our responsibility to create investment solutions that align with our clients’ values around diversity, inclusion and equality. To give you just one illustration, we manage a solution that very much takes diversity into account in investing on behalf of one of the biggest public pension plans in the US.

Since 2005 through Invesco Private Capital Partners, this solution has invested more than \$800 million in emerging venture capital and private equity fund managers raising their first, second or third institutional funds. Crucially, over 70% of these funds have managers who are women or members of minorities, which is way above the average figure of around 20%.²

We use diversity metrics such as ethnicity, minority representation and gender to identify these managers, who have to be involved in high-level decision-making. As well as reflecting the framework of the pension plan’s mandate, this is an approach that’s part of our own ethos. The team responsible for this solution has been doing this for around 15 years and was one of the very first of its kind, and we’ve seen the positive impact and the broader multiplier effect over a significant period of time.³

Second, as a corporate entity, we recognize our responsibility to promote diversity, inclusion and equality within our own company. We have a global initiative that includes a women’s network, an LGBT network and a black professionals’ network, plus many others.

We don’t claim to be perfect. We know there are many ways in which we can still improve. What matters is that we acknowledge we’re on a journey that reflects that of society at large.

Does this also tap into the notion of diversity of thought?

Absolutely. Diversity of thought is imperative, because it helps us make better decisions. Some years ago, when consultancies like McKinsey first began pushing this idea, there was a realization that not everybody should have an MBA and that companies should recruit from grad schools, medical schools, law schools, the military... I was a beneficiary of that process myself.

I sincerely believe a diverse company is a stronger company - just as I believe a diverse nation is a stronger nation, which is what we need to prove now. These issues have existed for a very long time, not just in America, but today - maybe for the first time in my life - it feels like we can bring about real and lasting change.

“There is clear evidence that the gap between haves and have-nots persists - and in some ways is even intensifying - in the 21st century.”

Inequality and the responsible allocation of capital

Haves, have-nots and difference-makers

Economic inequality underpins many enduring disparities, most notably with regard to the treatment of and opportunities available to minorities. Despite progress in furthering the overarching cause of diversity and inclusion, there is clear evidence that the gap between haves and have-nots persists - and in some ways is even intensifying - in the 21st century.

For instance, according to the World Bank, 20% of the US population holds 46.6% of the nation's wealth.⁴ More broadly, data shows that the gulf between the richest 10% and the poorest 10% in OECD countries widened during the period from 1995 to 2008 and that the fall in disposable income following the global financial crisis was most severe among the latter group.⁵

As seen since the emergence of COVID-19, the impact of such inequities is not confined to wages, saving rates and other financial considerations: it also encompasses matters such as health. For example, a Public Health England report found membership of a black, African or minority ethnic (BAME) demographic to be a “major risk factor” during the pandemic - a situation attributed to dynamics including urban living, overcrowded households, deprived neighborhoods and higher-risk jobs.⁶

Going forward, there is a danger that the divergence between haves and have-nots could worsen yet further. Even symmetric shocks have asymmetric aspects, and the repercussions of the coronavirus have inevitably hit some harder than others. As William & Mary economist Peter Atwater recently wrote in the Financial Times: “What COVID-19 has done is create a tipping point where, for many, chronic underconfidence has turned to hopelessness.”

So how can businesses make a difference? How can they reduce income disparity, encourage social mobility and promote prosperity? How can they contribute to making the world a fairer, less discriminatory place? And why should they?

The straightforward answer is that they can do so through their policies and practices. Like their attitudes toward environmental and governance issues, their attitudes toward social issues can take more account of the greater good. And investors - longer-term, active owners foremost among them - can play a substantial role in steering them in the right direction.

The Gini coefficient is a statistical measure of distribution intended to represent the income or wealth distribution of a nation. The measurement ranges from 0 to 1 with 0 representing perfect equality.

A snapshot of inequality

The George Floyd case has made the US the main focus of renewed concerns over inequality. Below are five key findings from recent research into inequities in American society.

- 1 The highest-earning 20% of US households accounted for 52% of all national income in 2018. Half a century earlier, in 1968, the figure stood at 43%.⁷



- 2 Income inequality is higher in the US than in any other G7 nation. The US had an income inequality Gini coefficient of



- 3 The difference in median household incomes between white Americans and black Americans increased from \$23,800 in 1970 to \$33,000 in 2018.⁹



- 4 The richest 5% of US households had 114 times more wealth than the second quintile (i.e. one tier above the lowest) in 1989 - and 258 times more in 2016.¹⁰

114X
1989

258X
2016

- 5 Middle-class incomes have grown at a slower rate than upper-tier incomes during the past five decades. The former increased by 49% between 1970 and 2018, the latter by 64%.¹¹

Middle-class income growth 49%

Upper-tier income growth 64%

“Striving for equality is about more than doing the right thing: it is also about acting in the best interests of an entity and its stakeholders - shareholders included.”

Squaring moral duty with fiduciary duty

Historically, although acknowledged as consonant with “the right thing to do,” ESG was routinely dismissed as contrary to many of the exigencies of business. The basic argument was that the greater good, while a noble ideal, could never be a comfortable bedfellow of shareholder primacy.

Today, in the era of responsible investing and stakeholder capitalism, we know that this is not so. ESG has repeatedly been shown to enhance performance, and we already have evidence that it has contributed to firms’ resilience during the virus-sparked downturn.¹² But why, moral duty aside, should companies and investors strive for equality specifically?

First, the business case for ensuring that everyone is granted a voice is manifest. There is a demonstrable link between diversity and financial performance, as highlighted in a McKinsey & Company study that concluded: “That this relationship continues to be strong suggests that inclusion of highly diverse individuals - and the myriad ways in which diversity exists beyond gender - can be a key differentiator.”¹³ Our own series of papers on diversity and inclusion has explored how multiple perspectives generate productive ideas, better decisions and a corporate culture that is more a mosaic than it is a melting pot.¹⁴

Second, equality can be a gateway to untapped opportunities. According to a 2018 report by Morgan Stanley, investors missed out on up to \$4.4 trillion in revenues in 2012 by failing to back US businesses owned by minorities and women - thereby not only foregoing returns but squandering a chance to “advance the next generation of leading companies and emerging industries while creating jobs and economic growth.”¹⁵

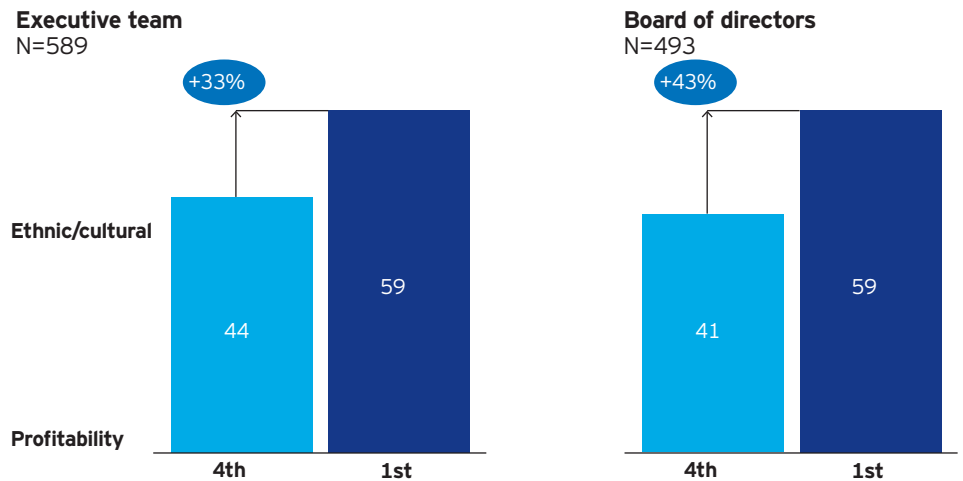
Third, the elimination of inequality is obviously essential to longer-term stability. Most pointedly in the US, where protests in the aftermath of the death of George Floyd have been widespread, escalating civil unrest could have increasingly serious economic and societal consequences.

So it is not difficult to square moral duty with fiduciary duty. Striving for equality is about more than doing the right thing: it is also about acting in the best interests of an entity and its stakeholders - shareholders included. For asset managers, as with any element of ESG, the responsible allocation of capital can be fully aligned with an obligation to protect and grow clients’ wealth.

Why it pays to give everyone a voice

Published in 2018, McKinsey & Company’s Delivering Through Diversity underscored the link between diversity and financial performance. It found companies in the top quartile for executive teams’ ethnic/cultural diversity are 33% more likely to have industry-leading profitability.

Likelihood of financial performance* above national industry median by diversity quartile (%)



Source: McKinsey & Company: Delivering Through Diversity, 2018
 * Average economic profit margin, 2011-2015, and average EBIT margin, 2011-2015

“ESG is about being accountable. It’s about what businesses really believe in and whether they truly meet the expectations society has of them.”

Q&A: Values and voices

Dr. Henning Stein is Invesco’s Global Head of Thought Leadership.

Here he discusses the importance of ensuring that everyone’s voice is heard – both within organizations and across society – and warns that, as awareness of inequality increases, companies should expect to face more pressure to align their values with those of the communities with which they engage.

How does the notion of equality resonate with you personally?

First of all, I’m sure it means many different things to many different people. When I first spoke about the death of George Floyd with my colleagues, for example, I said I obviously couldn’t know how it feels to be a person of color in America.

But I do know what it’s like to be a gay Jew who’s married to a Muslim. I know what it’s like to be “different.” And I know what it’s like to be a member of a progressive congregation whose synagogue was once bombed in retaliation for endorsing the black civil rights movement.

On the other hand, I also know what it’s like to be relatively privileged. I grew up in a household that gave me the kind of familial support and financial backing that can lead to opportunities many people don’t get.

So I’ve seen something of equality – and, by extension, inequality – from both sides of the fence. This doesn’t make me an expert, but it does mean I can draw on my own life experiences in trying to develop a rounded understanding of these issues. I think I appreciate what it means to have your voice heard.

Is inequality an ESG issue?

Yes, because ESG is about being accountable. It’s about what businesses really believe in and whether they truly meet the expectations society has of them. Above all, it’s about values.

Now, the fact is that no business is perfect in this respect. Some are more proactive than others, but there are always occasions when events in the wider world remind us all that we can do more to align our values with those of the communities in which we operate.

The Paris Agreement on climate change, for example, has propelled environmental considerations high up companies’ agendas. Numerous corporate scandals have underlined the importance of good governance. And now events have turned the spotlight on to inequality – and we need to respond to that.

Ultimately, ESG gives us a chance to transform a negative into a positive. And in this case every organization has the power to help tackle inequality through its social interactions.

What sort of corporate philosophy would qualify as genuinely “positive” in this regard and how might investors identify it?

We have to look beyond superficialities and find out if a company really believes in giving everyone a voice. It’s very easy to fly a gay pride flag on your website one day and a Black Lives Matter flag the next, but what does any of this really mean? Okay, you’re showing support, which is great, but what are you actually doing?

We still see something similar in relation to environmental considerations. There are businesses that talk the talk but don’t walk the walk, which is why we have to be alert to the risk of “greenwashing.”

The same kind of disconnect can apply to a company’s social behavior – so here, too, we have to dig deeper. For example, we could try to establish whether a business channels funds or resources to social initiatives that advance the fight against inequality. We could invite a firm’s managers to articulate their stance on these issues. We could talk about how inequality links to structural topics such as education, opportunities and wage levels.

Do you think this will become a “new normal” in terms of due diligence?

I really hope so. There are many companies that espouse change, but there are far fewer that actually achieve it. We need to distinguish between those that are just quick to signal their virtues and those that are sincerely committed to embedding the necessary values. So here, again, it’s about accountability.

As asset managers, we should support these values if they’re already evident. And we should try to instill them if they’re lacking but there’s a willingness to improve. It’s the same for any aspect of ESG.

Should we see the fight against inequality as another facet of an asset manager’s fiduciary duty?

Yes, because we know equality translates into performance and stability. As active owners, we have every reason to help further this cause – and, quite frankly, how could anyone think otherwise? As was famously said about the same struggle more than half a century ago: “If you’re not a part of the solution, you’re a part of the problem.”

“Socially responsible solutions increasingly form a substantive part of the overall ESG conversation, whereas in the past they might have amounted only to an afterthought.”

Socially responsible solutions

Demand and distinctions

One reason why S has traditionally lagged E and G may be that it has lacked a catalyst for universal recognition. The twin tragedies of COVID-19 and George Floyd could prove pivotal in this respect: history may yet record 2020 as the year when organizations and investors truly grasped the importance of inequality in particular and social concerns more generally.

It is too early to say whether this means that S will remain a focus within the mainstream over the longer term. Yet our experience of late - especially with institutional investors - is that it increasingly forms a substantive part of the overall ESG conversation, whereas in the past it might have amounted only to an afterthought or even elicited no discussion at all.

In tandem, organizations and investors are steadily expanding their social focus. While familiar subjects such as gender diversity and wage disparities might have dominated previously, today the full extent of an entity's social obligations is more likely to enter the reckoning - as are the many stakeholders that these obligations encompass. Demand for socially responsible solutions therefore looks set to rise further.

As this shift unfolds, it is important to note that such solutions, broadly speaking, can be divided into two distinct camps. Some revolve principally around financial materiality; others aim to deliver returns while also having a more far-reaching social impact.

The debate around wages offers an illustration of the first approach. With the European Commission consulting with trade unions and employers in a bid to establish a fair minimum wage, EU businesses that are already committed to paying a “living wage” are better placed to cope with regulatory change and its associated costs; a well compensated workforce is also more likely to be satisfied, loyal and productive. In this instance, a socially responsible solution is geared mainly towards a business's long-term profit and performance.

An obvious example of the second approach would be investments in entities that have “progressive” agendas. These might include companies that are high achievers in racial equality. In this instance, although usually still contingent on financial parameters, a socially responsible solution is geared towards realizing a more stakeholder-conscious outcome.

Anatomy of a socially responsible investment platform

Although the S of ESG is now enjoying arguably unprecedented attention, Invesco has been devising socially responsible solutions for a number of years. One example is the designing of a bespoke investment platform in collaboration with Amalgamated Bank, whose mission is to provide banking resources to non-profits, unions, political organizations, social impact enterprises and others that further economic, social, racial and environmental justice.

Crucially, we did not first build the platform and then discuss what it could achieve for Amalgamated. Quite the opposite: we first discussed what Amalgamated wanted to achieve and then built the platform.

This solution thus represents a highly customized, ground-up synthesis of a preeminent socially responsible institution's objectives and Invesco's capabilities. It will provide foundational, broad market index strategies with high ESG exposure, as well as theme-specific strategies solely focussed on a particular issue - for example, social equity, gender balance or climate change.

Due to launch in late 2020, the platform will undoubtedly evolve further. Social equity metrics are still a challenge, and many large providers of data have yet to fully incorporate them in their gathering and analysis of data - which is why we are currently working with niche providers that specialize in themes such as racial equality.¹⁶

Foresight and flexibility will be necessary to drive continued improvement. “How the most innovative and effective socially responsible strategies look now might not be how they look in two or three years' time,” says Chris Paoletta, of Invesco's North American Institutional Management team. “So we have to stay open-minded. It's about skating to where the puck is going rather than where it has been.”

Having been involved in its creation, Paoletta believes that the platform reflects a nascent determination among institutional investors to address social issues directly. “It feels like we've arrived at a pivot point,” he says. “This is becoming a bigger part of organizational culture. It's a subject of emotion and passion, and that's what can really change things.”

Active ownership as a force for social change

Data is the lifeblood of almost every ESG investment decision. It most patently underpins stock-picking methodologies that rely on negative screening/exclusion, which is still one of the most popular means of responsible investing.¹⁷ However, as with any aspect of ESG, it can tell us only so much.

For a start, many social factors can be tricky to measure. It is possible to capture some in data, but even then the rules around disclosure vary from one jurisdiction to another. As a result, there has been comparatively little pressure to prioritize such matters. While initiatives such as the EU's Non-Financial Reporting Directive are now bringing more transparency to some companies' ESG policies and practices¹⁸, there is invariably scope to dig deeper.

Relatedly, headline figures often serve as a helpful signpost at best. As Harvard Business School academics Boris Groysberg and Deborah Bell memorably remarked in a study of board membership composition in 2013: "Diversity is about counting the numbers. Inclusiveness is about making the numbers count."¹⁹ In keeping with how we view ESG as a whole, we believe that investing to combat inequality is very seldom about numbers alone and that the key to success instead lies in applying the power of active ownership.

Imagine, for example, that data shows a business to have a workforce that is 50% BAME and to be a supporter of Black Lives Matter (BLM). Should we accept this information at face value? We would argue that only direct engagement and dialogue might reveal that there is zero BAME representation at management level and that the support for BLM goes no further than a token message on the firm's Twitter feed. As with environmental and governance facets, first-hand scrutiny is frequently necessary to separate those entities that are merely swift to parade their putative virtues from those that are genuinely dedicated to positive change.

Does this mean that those found wanting should be completely disregarded? No, because excluding companies on the basis of set ESG criteria can be surprisingly complicated²⁰ and also limits choice, as a consequence of which investment decisions might not be aligned with clients' interests.²¹

A vital function of active ownership is therefore to encourage more social awareness in such organizations - whether through direct engagement, dialogue or a third potent tool, proxy voting - and thus direct their endeavors more towards the greater good.²² For inequality, as for any ESG consideration, close stewardship can make the difference between window-dressing and impact; between box-checking and meaningful outcomes; between signaling and doing.

“Close stewardship can make the difference between window-dressing and impact; between box-checking and meaningful outcomes; between signaling and doing.”

Socially responsible solutions in fixed income

ESG investments, not only those that aim to tackle inequality, are most readily associated with equities. It is only a few years since the UN-backed Principles for Responsible Investment described fixed income, by contrast, as “the neglected child of responsible investment” and “a sleeping giant.”

With COVID-19 and the death of George Floyd shedding fresh light on vulnerabilities within local, regional and national systems, the giant is stirring like never before.²³ Invesco’s innovative approach to municipal bonds illustrates how ESG can be used to encourage the provision of affordable, attractive and equitable public services.










Our research aims to identify ESG-related risk factors across this varied asset class, enabling our analysts to compare issuers and recognize best-in-class opportunities within a specific sector. We focus on risks that could have a material effect on an issuer’s willingness and ability to meet its debt obligations.

We also use direct engagement and dialogue. These allow us to learn more about how municipalities view various risks and how they intend to address them over time.

Municipal bonds often shine brightly when viewed through the lens of ESG. This should come as no big surprise, since local and regional authorities ought to have ESG objectives at the heart of their programs.

As shown below, many of their aims are naturally aligned with the UN Sustainable Development Goals (SDGs). These include quality education (SDG 4), gender equality (SDG 5), economic development initiatives (SDGs 8 and 9) and reduced inequality (SDG 10).

Municipal bond alignment with Sustainable Development Goals

State and local governments	K-12 and higher education	Utilities	Not-for-profit healthcare
<p>Examples include bond proceeds used to:</p> <ul style="list-style-type: none"> ■ Increase supply of affordable housing ■ Finance environmentally friendly projects, including clean water, reduction in GHG emission, and protect open space ■ Promote economic development initiatives focused on promoting high-tech capabilities to create higher-paying jobs 	<ul style="list-style-type: none"> ■ Inclusive and quality education for all are the goals of public schools districts (K-12) and higher education institutions ■ Quality education can help reduce inequalities and achieve gender equality 	<ul style="list-style-type: none"> ■ Providing clean water and sanitation services are the primary missions of municipal water and sewer systems ■ Debt issued by public power agencies to reduce GHG emissions as well as increase share of renewable energy 	<ul style="list-style-type: none"> ■ Not-for-profit healthcare sector provides services to ensure healthy lives and promote well-being for all
  	  	 	

Source: Invesco

“This is the perfect time to maintain the pressure and push for real change, because ‘business as usual’ isn’t an option.”

Q&A: Crisis, culture and commitment

Cathrine de Coninck-Lopez is Invesco's Global Head of ESG.

Nikki Gwilliam-Beeharee is Invesco's Director of ESG Research.

Cathrine and Nikki reflect on the recent, crisis-driven rise of the S of ESG and how this is likely to reshape investment thinking. They also discuss the critical role that active ownership can play in enhancing both ESG performance and investment performance.

Is S finally catching up with E and G in terms of wider recognition among organizations and investors?

CCL: It's certainly moving up agendas in light of recent events. I don't think it will rank alongside E and G in the near future, as these things always take time, but the good news is that it's entering the conversation more and more. Even if it stays at number three, it's becoming more common to talk about these issues - and that's encouraging.

NGB: Environmental topics in particular have obviously earned much more in the way of headlines and attention during the past few years. They've earned a lot more in the way of capital flows, too, because it's relatively easy to put a number on them and identify what the focus should be. But social topics have always been there - they're structural and underlying - and I think we've all been reminded recently that social and economic inequality presents an enormous and urgent challenge.

Can social and economic inequality be framed in terms of risk and opportunity?

NGB: Every element of ESG is about risk and opportunity. Social and economic inequality is no exception, and we believe it's going to impact a wide range of investments.

Say, for example, a company is paying the minimum wage in a country where there's a concerted push to raise the minimum. That's going to mean a big change in costs for the company. Or look at the debate around tax levels, which has intensified during the pandemic and is likely to mean another big change in costs in some sectors. So we can see that inequality relates directly to financial materiality at a company level.

Then there's the question of having a social impact. We think this is the perfect time to maintain the pressure and push for real change in this respect, because "business as usual" isn't an option. A time of crisis presents a chance to accelerate the adoption of responsible, sustainable business models in all we do. So we can look at responsibility and sustainability in terms of investment discount or costs, but we can also look at them in terms of a premium.

CCL: How companies behave in times like these can tell us a lot about their overall corporate culture. Issues such as employee welfare, access to healthcare and supply-chain sustainability are all core social considerations that have become especially important during the pandemic.

Responses to the George Floyd tragedy and the subsequent civil unrest have also been significant. For example, as a direct result of how they've reacted to the situation, we've downgraded some states on our proprietary ESG framework for municipals.

Why is direct engagement so important in effecting positive change?

CCL: Lack of disclosure can be an obstacle, which is why it's hard for investors to play their part in addressing these issues on the basis of data alone. If we look at measures of equality in the US, for example, the relevant information has to be supplied to the government by companies but often isn't made public.

So transparency is a problem. But for an asset manager like Invesco, which prides itself on being an active owner with extensive research and engagement capabilities, it's a problem that can be overcome.

If you meet with the companies you invest in, as an active owner should, you have a lot more scope for obtaining the insights you need to make informed decisions. You also have a lot more scope for constructive dialogue around improving ESG policies and practices.

Proxy voting is important as well, because annual general shareholder meetings offer a chance for investors to express their approval of or dissatisfaction with the entities they own. Voting underscores the relationship between how an organization conducts itself and whether its institutional owners choose to buy or sell its shares. It's one of the ways in which investors are best able to make their voices heard.

Why do you favor engagement over exclusion?

NGB: The problem with labelling investment opportunities "good" or "bad", with practically nothing in between, is that you rule out any hope of bringing about positive change. A company might fall short on headline measures, but what if the data conceals a real willingness to do the right thing? Again, this is where direct engagement and active ownership can be so powerful.

CCL: If we dig deeper, establish a relationship and use our power as active investors, we can turn a "bad" company into a "good" one over time. That represents a situation from which everyone benefits, because it's a process that encapsulates the goal of combining enhanced ESG performance with attractive investment performance.

“If we want to do the right thing, if we want to align ESG performance with investment performance, we need socially responsible solutions.”

Conclusion

As has been observed on many occasions since the tumultuous first quarter of 2020, extraordinary events demand extraordinary responses. Turmoil compels us to reassess our outlook and to redefine what is possible. As Milton Friedman wrote more than half a century ago: “Only a crisis - actual or perceived - produces real change.”²⁴

There is no mean irony in referencing Friedman here, given his near-immortal standing as the arch-proponent of shareholder primacy. It was Friedman, after all, who famously railed against “the cloak of social responsibility and the nonsense spoken in its name”, thereby cementing for the better part of half a century the notion of pursuing profit above all else.²⁵

Yet this doctrine has dramatically fallen out of favor in recent years.²⁶ The global financial crisis in particular brought an epochal change in thinking; and today other crises are having a similar effect, this time in relation to the very thing that Friedman was so determined to resist.

So we might reasonably infer that Friedman was entirely right about crisis but utterly wrong about social responsibility, for we are now witnessing a growing willingness to make the fight against inequality a central component of how organizations and investors attempt to work for the greater good. If we want to do the right thing, if we want to deal with shared problems and achieve common goals, if we want to align ESG performance with investment performance, we need socially responsible solutions.

In this paper we have explored why interest in these solutions is increasing, how they can be devised and implemented and why they should benefit multiple stakeholders - investors included. As we have seen, active ownership is essential if such solutions are to proliferate at the expense of virtue-signaling gestures that constitute little more than box-checking and window-dressing.

We stressed at the outset that asset managers are neither politicians nor moral guardians. We in no way wish to portray ourselves as perfect, omniscient role models. The fact is that we, too, have much to learn and improve upon as the story of socially responsible investment solutions continues. But we can at least be certain of this much: it is our duty, both as fiduciaries and as members of the collective known as humanity, to further this cause.

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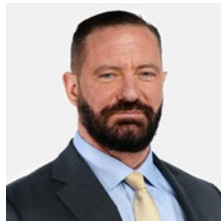
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- 1 Federal Reserve Bank of Atlanta: "A moral and economic imperative to end racism", June 12, 2020.
- 2 Invesco, 2020.
- 3 Our own experience has shown that private equity and venture capital firms that are themselves diverse are more likely to invest in underlying companies that are also diverse. This leads to a natural "trickle-down" and encourages diversity, inclusion and equality more broadly and at a number of levels.
- 4 World Bank Development Indicators, as at June 9, 2020.
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- 7 US Census Bureau: Income and Poverty in the US: 2018, 2019.
- 8 These figures, published in 2018, are based on the OECD's own calculations.
- 9 These figures were published in 2020 by the Pew Research Center, which analyzed data from the US Census Bureau.
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- 12 Bloomberg: "BlackRock joins Allianz, Invesco saying ESG outperformed", May 18, 2020, and Financial Times: "Why ESG investing makes fund managers more money", July 9, 2020.
- 13 McKinsey & Company: Delivering Through Diversity, 2018.
- 14 Broad Diversity as a Driver of Meritocracy, 2018; Diversity of Thought and the Search for Best Ideas, 2019; and Mosaic Versus Melting Pot: Reassessing the Relationship Between Diversity and Corporate Culture, 2019.
- 15 Morgan Stanley: The Growing Market Investors Are Missing: The Trillion-Dollar Case for Investing in Female and Multicultural Entrepreneurs, 2018.
- 16 This approach sometimes involves trade-offs in terms of coverage and geographic focus, but it is important to start somewhere.
- 17 Global Sustainable Investment Alliance: Global Sustainable Investment Review 2018, 2019.
- 18 European Commission: "Non-financial reporting: EU rules require large companies to publish regular reports on the social and environmental impacts of their activities", February 2020.
- 19 Groysberg, B, and Bell, D: Dysfunction in the Boardroom: Understanding the Persistent Gender Gap at the Highest Levels, 2013.
- 20 Consider, for instance, the exclusion of investments in a specific country. Does this mean avoiding those companies listed within said country or those with revenue exposed to it? What about indirect exposure via supply chains or logistics? Such an approach is rarely as clear-cut as it first appears.
- 21 One likely corollary of introducing such limits would be the exclusion of appropriate capital-generating investments.
- 22 Active Managers Council: Sustainable Investing Is an Active Process, 2020.
- 23 The use of ESG to enhance fixed income returns is one of the key themes explored in the Invesco Global Fixed Income Study 2020.
- 24 Friedman, M: Capitalism and Freedom, 1964.
- 25 New York Times: "The social responsibility of business is to increase its profits", Sept. 13, 1970.
- 26 Perhaps the most notable acknowledgment of the substantive shift that has taken place came when Business Roundtable, an association of leading US CEOs, included "a fundamental commitment to all stakeholders" in its formal definition of a corporation's purpose. See, for example, Business Roundtable: "Redefined purpose of a corporation: welcoming the debate", Aug. 25, 2019.

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