# Sustainable Income and Growth

Aiming to deliver sustainable income and sustainable outcomes.

For today's investor

AVIVA INVESTORS

# Sustainable Income and Growth

## Aiming to deliver sustainable income and sustainable outcomes.

Investors are constantly balancing their near-term needs with their long-term goals. They balance income and capital growth. They balance the prospects for total returns with the associated risks of an investment opportunity. And growing numbers aim to balance the desire for profits with the impact of their investments on society and the environment.

A strategy that aims to deliver sustainable income and growth therefore might appear to be contradictory, but our innovative approach to delivering multi-asset income shows how a focus on sustainability can serve to enhance investor outcomes.

## Natural income

Our Sustainable Income and Growth strategy targets a five per cent income yield distributed from natural income, meaning the dividends and coupons produced by the shares and bonds it invests in. Our strategy aims to do this by investing in a broad range of global asset classes including equities and real assets, allowing investors to maximise their exposure to growth asset classes long-term without sacrificing their desired level of income.

We concentrate on assets capable of generating sustainable cashflows, where environmental, social and governance (ESG) risks fall within considered parameters. We believe our focus on natural income reduces sequence-of-returns risk, the risk associated with price volatility and permanent loss of capital for investors drawing down units in retirement when markets have fallen, allowing them to leave their capital in place to grow long term.

## The integrated advantage

Traditional multi asset strategies have found it difficult to integrate Environmental, Social and Governance (ESG) considerations into their investment processes. This is largely due to their top-down view and therefore a reduced ability to influence and engage with stakeholders at the individual company level.

Our Sustainable Income and Growth strategy is constructed from the bottom-up, allowing it to be highly discerning when selecting investments for the portfolio. We consider ESG factors when assessing investment opportunities, and proactively seek to engage with the management teams and stakeholders of the portfolio's holdings.

## Finding sustainable income growers

Our bottom-up nature allows it to have a broad remit, evaluating over twenty-five thousand stocks and bonds globally included in the MSCI All Country World Index and Bloomberg Barclays Global Aggregate Bond Index. But while all investments that meet our thresholds are permittable, not all investments are beneficial. How we integrate ESG into our investment process is highlighted in four stages.

# 1 Our aims

## Increase confidence in long-term cash flows by excluding assets carrying elevated ESG risks

A bias towards companies with stronger ESG credentials means that we are more likely to avoid those whose business practices, and hence income streams, are unsustainable over the longer term. We use MSCI's ESG scoring, to filter out companies whose ESG score fall in the bottom 20 per cent. Some companies are simply not covered by MSCI, and while we don't want to exclude those due to lack of data, we aim to ensure that over 90 per cent of the portfolio's holdings are covered.

## Industry leading ESG rating

The MSCI's ESG scores provide a market-leading benchmark rating companies according to their exposure to industry-significant ESG risk. The ratings are constructed based on thousands of data points across 37 ESG 'Key Issues' divided into three pillars and ten themes.

| 3 Pillars | 10 Themes | 37 ESG key issues | |
|---|---|---|---|
| **Environment** | Climate change | Carbon emissions<br>Product carbon footprint | Financing environmental impact<br>Climate change vulnerability |
| | Natural resources | Water stress<br>Biodiversity & land use | Raw material sourcing |
| | Pollution & Waste | Toxic emissions & waste<br>Packaging material & waste | Electronic waste |
| | Environmental opportunities | Opportunities in clean tech<br>Opportunities in green building | Opportunities in renewable energy |
| **Social** | Human capital | Labour management<br>Health & Safety | Human capital development<br>Supply chain labour standards |
| | Product liability | Product safety & quality<br>Chemical safety<br>Financial product safety | Privacy & data security<br>Responsible investment<br>Health & demographic risk |
| | Stakeholder opposition | Controversial sourcing | |
| | Social opportunities | Access to opportunities<br>Access to finance | Access to healthcare<br>Opportunities in nutrition & health |
| **Governance** | Corporate governance* | Board*<br>Pay* | Ownership*<br>Accounting* |
| | Corporate behaviour | | |

*The corporate governance theme carries weight in the ESG rating model for all companies. In 2018, sub scores were introduced for each of the four underlying issues: Board, Pay, Ownership and Accounting.

## Robust proprietary scoring tool

Our proprietary ESG heatmap is a company-specific integration tool. It includes a range of material ESG data sources and analysis, including our internal governance rating, which is based on historic voting records. This is available to all investment teams through the Bloomberg platform.

Our heatmap draws together a wider range of metrics than those considered by MSCI. It is based on both external ESG data providers combined with internal ESG research including our own assessments of a company's ESG practices (through monitoring and engagement), which are also recorded in our in-house database. We use our heatmap and database to help identify investment risk and opportunities within the investment universe to inform decisions in the portfolio construction phase.

## 2 Reject unsustainable sectors where income generation could be threatened

We will not invest in sectors and industries where we believe prospects for long-term cash flow generation might be threatened, even if a company has a high individual ESG score.

### Controversial Weapons

Almost all types of controversial weapons have been subject to bans or restrictions by international treaties or conventions. Our screen will cover cluster munitions & landmines, blinding laser weapons, non-detectable weapons, and biological weapons, chemical weapons, nuclear weapons and civilian firearms in line with the Aviva Investors Baseline ESG Exclusion Policy.

### Thermal Coal

We focus on screening thermal coal assets and generation as they are fundamentally opposed to the general shift to a low carbon economy. Thermal coal not only accounts for two thirds of CO2 emissions from power generation, but also carries with it a significant financial risk should assets become stranded.

### Tobacco

Tobacco use has widespread societal impacts and costs including illness, costs of medical care, and loss of productivity – seven million people die annually from tobacco-related causes according to estimates from the World Health Organisation. From an investment perspective, tobacco exposure can also be viewed as a long-term risk as regulations and public sentiment move against it.

What this suggests is that the ESG filter should not detract from total returns over longer timescales; instead, it should increase certainty over future cashflows, by helping address environmental, regulatory and obsolescence risks.

> *"For a strategy to deliver a high, sustainable and if possible growing income stream to clients long-term, it must focus on the right sectors and the right corporate governance structures to deliver those outcomes."*

## 3 Enhance investor outcomes through optimisation of sustainability in portfolio construction

The Sustainable Income and Growth strategy aims to maximise long-term capital growth at a targeted five per cent level of income. To evaluate the degree of confidence we have that the underlying cash flows will be delivered, we assess a broad range of metrics and look for investments that can maximise income and long-term capital growth in a sustainable manner. ESG scores are a useful indicator beyond traditional economic and financial measures and form an integral part of our portfolio construction process.

Our optimisation framework blends income and capital growth expectations, and through our proprietary optimisation tool we maximise ESG scores at our targeted investment outcome. This allows us to construct a portfolio with an average ESG score significantly higher than the broader market and in turn gives us increased confidence that the fund can sustain its outcomes long term.

Our research shows that investors do not have to sacrifice investment outcomes when maximising ESG scores. Using our universe of sustainable income and growth investments, an efficient outcome frontier maximising ESG scores is broadly similar to an indiscriminate efficient frontier. While traditional portfolios place an emphasis solely on volatility as an indicator of risk, our model also allows for a deeper understanding through the integration of sustainability factors.

### Evaluating the impact of sensitivity to ESG factors: optimising outcomes along an efficient frontier


For illustrative purposes only. Source: Aviva Investors, as at March 2019

# 4 Active ownership & engagement in a changing world

Change is the only constant and investors should be responsible stewards of capital. Our bottom up approach allows us to proactively enforce positive change through engagement and intelligent proxy voting.

### Intelligent Proxy Voting

We consider voting to be an important part of the investment process and have had a formal and considered voting policy since 1994.

We vote against matters where we consider that the specific proposals are not in the best interests of our clients; where we have wider concerns with individual directors, strategy, oversight and reporting; or to reflect disappointing outcomes from prior engagements.

### Active Company Engagement

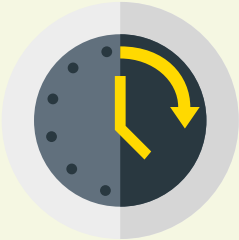
We consider active stewardship to be a fundamental responsibility as investors.

In 2018:

We engaged with 2,938 companies

Voted on 54,335 resolutions at 4,713 shareholder meetings

Worked alongside other investors and civil society organisations through more than 30 collaborative initiatives.



### Improved ESG practices over time

To us, active ownership means monitoring, engaging, and, where appropriate, intervening at a company level, on matters than can have a material impact on the long-term value of our investments.

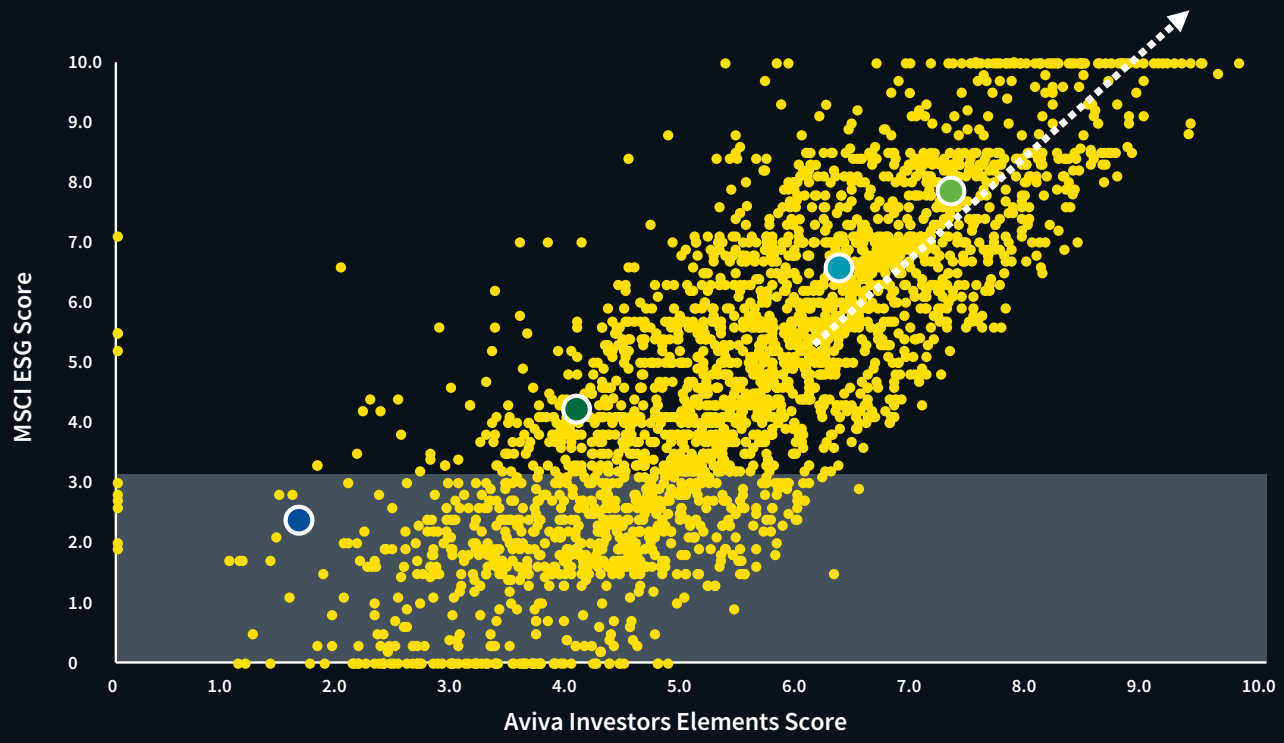
These matters might be environmental e.g. greenhouse gas emissions, social e.g. employee and board diversity or relate to governance issues e.g. human rights abuses taking place within outsourced activities or a corporate production line.

## Did you know?

**Aviva Investors are leaders in sustainable investment. In 2011, we were founding signatories of the United Nations' Principles for Responsible Investment.**

# Finding Sustainable Income Growers

1. Exclude assets carrying ESG risk
2. Reject unsustainable sectors
3. Enhance outcomes through portfolio construction
4. Active ownership and engagement




Source: Aviva Investors, MSCI, July 2019. Based on MSCI ACWI Index and holdings in Sustainable Income & Growth Model Portfolio, subject to change. Aviva Investors Elements scores are a proprietary ESG scoring system that ranks all companies on a scale from 1 (weakest ESG credentials) to 10 (strongest ESG credentials)

# Our heritage as responsible investors

**Responsible investment has been central to our values and investment philosophy for many years. We are proud to have been amongst the vanguard of investors leading market changing initiatives, including helping to author the world's first corporate governance code, the UN Principles for Responsible Investment and the Global Real Estate Sustainability Benchmark. We are making strong progress in embedding Environmental, Social and Governance (ESG) factors across our asset base, and have moved beyond simply establishing integration processes, to focusing on leveraging ESG insights to deliver better outcomes for our clients.**

**We have continued our efforts to help catalyse reform of our capital markets with the aim of tackling barriers to long-termism and sustainability. This included serving on the Financial Stability Board Task Force on Climate-Related Financial Disclosures and the EU High Level Expert Group (HLEG). Sustainability is a systemic issue and needs a system wide solution. We are confident that if all factors work collectively, together we can create a sustainable capital market that can better meet the needs of both long-term investors and society.**

## Key Risks

Investment and currency risk: The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested. Emerging market risk: Investments can be made in emerging markets. These markets may be volatile and carry higher risk than developed markets.

Credit and interest risk: Bond values are affected by changes in interest rates and the bond issuer's creditworthiness. Bonds that offer the potential for a higher income typically have a greater risk of default.

Illiquid securities risk: Some investments could be hard to value or to sell at a desired time, or at a price considered to be fair (especially in large quantities).As a result their prices can be volatile.

# Responsible investment highlights

## 2019

Voted on 61,876 resolutions at 5,382 share holder meetings

Engaged with 2,149 companies

Voted against 24% of management resolutions (incl 46% of pay proposals)

Published reports include:

- Plastic (not so) fantastic
- Why EU legislation could herald a boom in ESG investing?
- ESG and real assets: a matter of balance
- ESG: A keystone for stronger emerging markets

# About Aviva Investors


| Asset class | £m |
|---|---|
| Credit | 107,754 |
| Equity | 31,345 |
| Multi-asset and macro | 74,320 |
| Real assets | 47,915 |
| Solutions | 93,593 |
| **Total** | **354,927** |

**1,500+**
people

Source: Aviva Investors, as at 30 June 2020.

# Contact us

**Benelux**
Aviva Investors
WTC Amsterdam
H-Toren, 4th Floor Zuidplein 36
1077 XV Amsterdam
The Netherlands
Tel: +31 30 799 1150

**Germany**
Aviva Investors
An der Hauptwache 7
60313
Frankfurt am Main
Tel: +49 69 2578 26 0

**Italy**
Aviva Investors
Via A. Scarsellini, 14
20161 Milano
Italy
Tel: +39 02 27 75 306

**Nordics**
Aviva Investors
Strandvägen 7A
114 56 Stockholm
Sweden
Tel: +46 (0) 8 58610792/93

**France**
Aviva Investors
14 rue Roquépine
75008 Paris
Tel: +33 (0)1 76 62 90 00

**Luxembourg**
Aviva Investors
2 rue du Fort Bourbon, 1st Floor
P.O. Box 1375
L-1013 Luxembourg
Tel: (+352) 40 2820 261

**United Kingdom & Ireland**
Aviva Investors
St Helen's
1 Undershaft
London, EC3P 3DQ
Tel: +44 (0) 20 7809 6000

**Singapore**
Aviva Investors
One Raffles Quay
#27-13 South Tower
Singapore
048583
Tel: +65 6491 0560



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