Hidden ESG gems: the "improvers" philosophy

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Kasper Elmgreen Head of Equity Investment Platform

> **"Our core belief is that ESG matters. It can significantly impact share price performance. Companies with better ESG fundamentals typically have a higher valuation in the market. They better manage ESG risks and opportunities. What is even more interesting, however, is that companies that improve their ESG profile typically experience a stock re rating that offers investors an opportunity for both positive ESG impact and improved risk adjusted return"**
>
> Kasper Elmgreen, Head of Equity Investment Platform

Traditional alpha opportunities tend to be found in underappreciated areas of the market where an expected improvement in fundamentals will lead to a re-rating of the stock. The same can be said for ESG investing: companies that embrace and improve their ESG profile will be rewarded by the market.

ESG Improvers: the road to responsible alpha

As ESG investing is increasingly relevant, it will be key for investors to be ahead of the curve. Indeed, being positioned in companies where ESG profiles are improving gives the opportunity to capture the ESG premium not yet fully priced in. Anticipating improving ESG dynamics and then reaping the potential rewards is what Amundi offers through its ESG Improvers philosophy. This approach seeks to deliver alpha to clients by investing in companies that have already embraced, or have committed to improve their ESG footprint.

A dynamic and forward-looking approach seeking tomorrow's ESG winners

Amundi has chosen to link ESG and fundamental investing. Investing only in highly ESG rated companies does not help to avoid businesses with weak fundamentals, nor it could replace an accurate analysis of corporate fundamentals. Historically, responsible investing has been based on – and driven by – pure assessment of ESG ratings, which tend to focus on what companies have already done. When moving from a snapshot in time (ESG rating) to a forward-looking approach, investors can evaluate the impact and the materiality of the ESG commitments of a company and the result will be greater analysis, deeper understanding of the fundamental drivers, and potentially improved performance. To unlock value from ESG improvement, a dynamic and forward-looking perspective is needed, through the following steps:

- Identifying the ESG drivers that are material to a corporate's ESG profile. For instance, the CO_2 footprint is more relevant to an energy company than to a telecommunication company.
- Identifying the financial impact of those drivers. To capitalise on this, a combination of both ESG and financial analysis is critical.
- Understanding how these drivers changed in the past, and assess how they will change in the future.

Such an ESG approach will allow investors to identify the companies at their early stage of their ESG rating migration which could be a source of value.

Portfolio construction: ESG winners and /or ESG improvers?

The ESG improvers philosophy blends ESG winners (quality companies with attractive valuations and strong ESG ratings) with ESG improvers (corporates portraying a solid fundamental investment case and an improving ESG trend). Choosing ESG Improvers, allows investors to benefit from the improvement in ESG ratings before a trend materialises and capture the potential premium. ESG winners act as a sound quality foundation, while the improvers offer an additional source of potential growth and return. Hence, it will be important to include both ESG winners and ESG improvers in portfolios to achieve the optimal risk-adjusted returns.

5 guiding principles for dynamic ESG investing

1. **Buy low, sell high:** extending the common investment philosophy to the realm of ESG will get rewarded by the market
2. **Best in class:** seeking ESG improvers through an all-inclusive approach across all sectors
3. **Fundamental approach:** go beyond static ESG ratings to include forward-looking qualitative assessment
4. **Materiality:** ESG improvement must be tangible and relevant, focusing on financially relevant factors
5. **Improvers and winners:** the potential return of ESG improvers, combined with the quality of ESG winners, can enhance the risk-adjusted return profile

Learn more on our ESG improvers approach here

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