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STRATEGY

In this report:

Malaysia: ESG – A new mega trend in investing

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Summary

- ESG is the acronym for "environmental, social and governance". As more investors embrace "responsible investing", the degree to which a company observes or fails to observe these non-financial standards in its operations, is increasingly being scrutinised and taken into consideration by the investment community in their investment decision making.

- We believe ESG investing is a mega trend in investing that can only get more prominent each day. The key driving force behind ESG investing is no longer confined to conscience and philanthropy, but has extended to practicality. It has gathered so much momentum in recent years that fund managers who ignore it may risk missing the boat, potentially resulting in underperformance of their portfolios, as the writing has been on the wall for a while.

- We believe ESG investing is increasingly becoming "mainstream". A case in point is the rapidly rising number of signatories of the Principles for Responsible Investment (PRI), an initiative started in 2005 by an international network of investors and backed by the United Nations, to promote the incorporation of ESG issues into investment practices across asset classes. From a humble beginning of only 100 signatories representing US$6.5 trillion of assets under management in April 2006, the number has grown tremendously to 3,300 signatories representing US$103.4tril of assets under management as at March 2020.

- We hold the view that despite potentially reduced returns (lower earnings and cash flow) for a company that observes high ESG standards, its market valuations may not fall, and may rise instead. As more investors embrace ESG investing, they raise the weighting of ESG-compliant stocks in their portfolios. This bumps up the demand for ESG-compliant stocks which pushes up their prices based on the simple law of supply and demand. The market effectively prices in an "ESG premium", as reflected in its willingness to accept a higher P/E multiple or a lower discount rate in valuing ESG-compliant companies.

- The local benchmark ESG index, i.e. the FTSE4Good Bursa Malaysia, has underperformed its benchmark index the FBM Emas persistently. We believe the key reason is the under-representation of glove stocks in the index. We hold the view that over a longer time horizon, it shall outperform its benchmark index as more investors take to ESG investing, and as the index further expands its constituents, enabling it to better represent and capture ESG-compliant stocks.

- A conservative way to play the ESG theme in Malaysia is to construct a portfolio that tracks the FTSE4Goold Bursa Malaysia Index. On the other hand, one could maximise returns by cherry-picking the constituents of the index based on their fundamentals, i.e. their growth prospects and potential headwinds, against their valuations. Our top BUYs within the constituents of the index are **Tenaga Nasional, Maybank, Axiata Group, Malaysia Airports** and **Malayan Cement**.

Exhibit 1: Constituents of FTSE4Good Bursa Malaysia Index

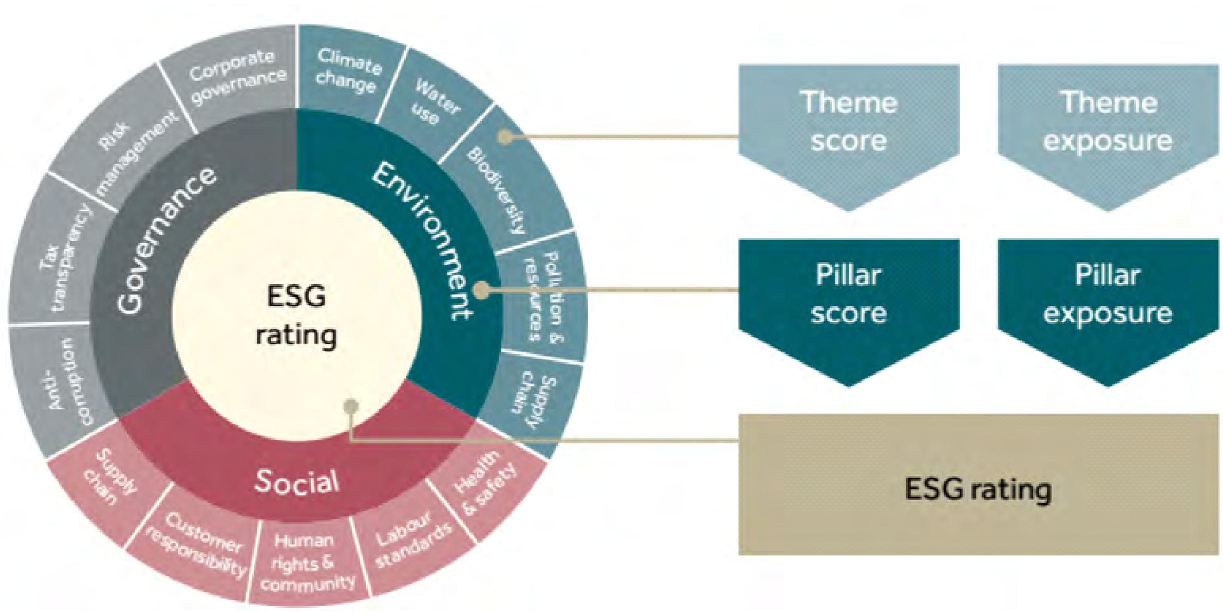
Source: Bursa Malaysia, FTSE Russell, AmInvestment Bank

ESG defined

- ESG is the acronym for “environmental, social and governance”. As more investors embrace “responsible investing”, the degree to which a company observes or fails to observe these non-financial standards in its operations, is increasingly being scrutinised and taken into consideration by the investment community in their investment decision making.

- In its ESG ratings model (see Exhibit 2), FTSE lists five themes under the “environmental” pillar, i.e. climate change, pollution & resources, water use, biodiversity and environmental supply chain; five themes under the “social” pillar, i.e. labour standards, health & safety, human rights & community, customer responsibility and social supply chain; and four themes under the “governance” pillar, i.e. corporate governance, risk management, tax transparency and anti-corruption.

Exhibit 2: ESG Pillars and Themes



Source: FTSE Russell

- Under the environment criterion, a company is assessed in, among others: its main sources of energy and the corresponding carbon emissions (clean and renewable naturally rank higher than fossil and nuclear); how it uses water and natural resources; how it treats animals (including product testing on animals); how it handles hazardous waste, toxic pollutants and contamination (such as oil/chemical spills); and its contributions towards the conservation of natural resources and biodiversity, or conversely, environmental degradation and biodiversity loss (such as depletion of aquatic populations from overfishing).

- Under the social criterion, a company is examined for, among others: if its employees are fairly remunerated, and their working conditions, safety and health are taken care of fully; if it is engaged in child labour or forced labour abuses directly, or indirectly in its supply chain; if its suppliers hold acceptable ESG standards; if it commits a percentage of its profits to charity and volunteer work to help the community; if it pays adequate attention to product safety, or if its product is safe – for this very reason, companies engaged in the production of tobacco and alcoholic products, firearms and weapons, nuclear power and gambling are generally deemed "unsocial", and hence not ESG-compliant.

- Meanwhile, among the requirements under the governance criterion for a company include: if it puts in place within the organisation proper checks and balances (including separation of power between the board of directors and the management), internal controls and risk management; if it adopts anti-bribery and corruption practices (particularly in dealings with government officials); if it uses accurate and transparent accounting methods; if various stakeholders are allowed to be heard on deciding important issues affecting the company; and if conflicts of interest are adequately managed and addressed.

Embracing ESG investing

- We believe ESG investing is a mega trend in investing that can only get bigger each day. The key driving force behind ESG investing is no longer confined to conscience and philanthropy, but has extended to practicality. It has gathered so much momentum in recent years that fund managers who ignore it may risk missing the boat, potentially resulting in underperformance of their portfolios, as the writing has been on the wall for a while.

- We believe ESG investing is increasingly becoming "mainstream". A case in point, is the rapidly rising number of signatories of the Principles for Responsible Investment (PRI), an initiative started in 2005 by an international network of investors and backed by the United Nations, to promote the incorporation of ESG issues into investment practices across asset classes.

- From a humble beginning with only 100 signatories representing US$6.5 trillion of assets under management in April 2006, the number has surged to 3,300 signatories representing US$103.4tril of assets under management as at 30 March 2020. The signatories comprise investment managers, asset owners and professional service providers, including prominent names such Fidelity International, The Vanguard Group, PIMCO, BlackRock, CalPERS, Invesco Ltd, Harvard University Endowment and Aberdeen Asset Management.

The debate

- A discussion on ESG investing will not be complete without quoting Nobel laureate economist Milton Friedman. In response to the prevailing mood of philanthropy during his time, the most prominent advocate of free markets in the 20th century, in his article *The Social Responsibility of Business Is to Increase Its Profits* published in *The New York Times Magazine* in 1970, argued that a corporate executive's actions in the name of social responsibility reduce the corporation's profits and (hence) the price of its stock. These actions go against his or her direct responsibility as an employee/agent of the owners of the business, which is to make as much money as possible while conforming to the rules of the society.

- According to Friedman, the social objectives could take the form of: 1) preventing inflation by refraining from increasing the price of the product; 2) improving the environment by incurring costs on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by the laws; and 3) reducing poverty by hiring the hardcore unemployed instead of better qualified available workers.

- He likened the corporate executive's actions to the imposition of taxes and deciding on how the tax proceeds shall be spent, what is the role of a government elected through a political process. He labelled "the doctrine of social responsibility" as an attempt to replace "market mechanisms" with "political mechanisms" as the appropriate way to determine the allocation of scarce resources to alternative uses.

- Since then, views conflicting to those of Friedman on social responsibility have started to emerge. A good example is a paper analysing the relationship between employee satisfaction and long-run stock returns authored by Alex Edmans and published in the *Journal of Financial Economics* in 2011. In the paper, the finance professor at Wharton School, University of Pennsylvania, claimed that a value-weighted portfolio of the "100 Best Companies to Work For in America" had outperformed industry benchmarks by 2.1% from 1984 to 2009. Arguably, these were the companies which were most socially responsible in terms of their willingness to "incur costs on staff welfare beyond the amount that is in the best interests of the corporation or that is required by the laws" (putting it in Friedman's writing style).

- **While we share the first part of Friedman's argument, i.e. that social responsibility/ESG practices in operations reduce the profitability of a company, we disagree with him on the second part of his argument, i.e. the resulting reduced profitability decreases the stock price, and hence valuations of the company**. Our main contention is that, as far as valuations of a company are concerned, "returns" (as reflected in earnings, cash flow, etc) are only half the equation, with the other half being a "factor" (such as P/E multiple, cash flow discount rate) to be decided by the market based on the market's perception on the company's prospects and risks.

- We are of the view that despite potentially reduced returns (lower earnings and cash flow) for a company that observes high ESG standards, its market valuations may not fall, and may rise instead. There are plenty of tell-tale signs that more investors are taking to ESG investing. When they do so, they raise the weighting of ESG-compliant stocks in their portfolios. This bumps up the demand for ESG-compliant stocks which pushes up their prices based on the simple law of supply and demand. The market effectively prices in an "ESG premium", as reflected in its willingness to accept a higher P/E multiple or a lower discount rate in valuing ESG-compliant companies.

The reality

- Using the S&P 500 ESG Index as an example, it has actually outperformed its benchmark S&P 500 consistently. In fact, the outperformance has been more prominent on a 1-year and 3-year basis, vs. 5-year and 10-year (Exhibit 3), which could be a testimony for the increasing recognition of the "ESG premium" by investors.

- Closer to home, however, the FTSE4Good Bursa Malaysia has underperformed its benchmark index the FBM Emas persistently, on all 1-year, 3-year and 5-year basis. We believe the key reason is the under-representation of glove stocks in the FTSE4Good Bursa Malaysia index, i.e. only Top Glove and Hartalega, during a time when the Malaysian market has been driven predominantly by glove stocks. We hold the view that over a longer time horizon, it shall outperform its benchmark index as more investors embrace ESG investing, and as the index further expands its constituents, enabling it to better represent and capture ESG-compliant stocks.

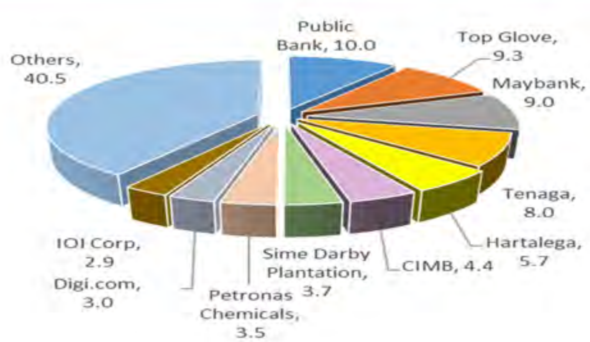
Exhibit 3: Relative Performance* — S&P 500 ESG vs. S&P 500

*As at 11 Nov 2020 Source: AmInvestment Bank, S&P Global

Exhibit 4: Relative Performance* — FTSE4Good Bursa Malaysia vs FBM Emas

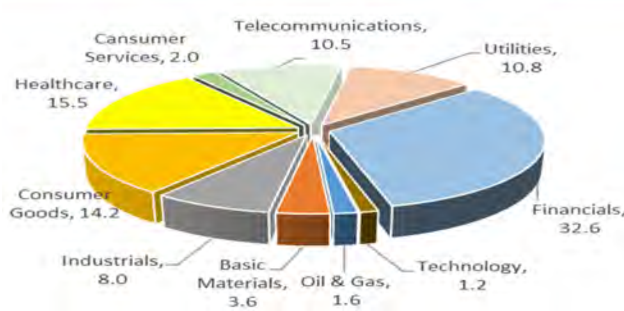
*As at 30 Oct 2020 Source: AmInvestment Bank, FTSE Russell

Exhibit 5: Top 10 Constituents of FTSE4Good Bursa Malaysia Index* (%)



*As at 30 Oct 2020 Source: AmInvestment Bank, FTSE Russell

Exhibit 6: FTSE4Good Bursa Malaysia Index's Weighting by Sector* (%)



*As at 30 Oct 2020 Source: AmInvestment Bank, FTSE Russell

Top ESG picks

- A conservative way to play the ESG theme in Malaysia is to construct a portfolio that tracks the FTSE4Goold Bursa Malaysia Index. On the other hand, one could maximise returns by cherry-picking the constituents of the index based on their fundamentals, i.e. their growth prospects and potential headwinds, against their valuations.

- Our top BUYs within the constituents of the index are **Tenaga Nasional** (which is growing its renewable energy generating capacity to 1,700MW by 2025), **Maybank** (supporting low-carbon businesses and transactions), **Axiata Group** (carrying out corporate social responsibility programmes in various developing countries where it operates), **Malaysia Airports** (pursuing a "green airport" strategy characterised by the use of affordable clean energy, recycling and reuse of resources and waste, low carbon emissions and sustainable transport systems) and **Malayan Cement** (processing waste including schedule waste from various industries in Malaysia and reuse the end product in its cement production and rehabilitating quarries to preserve biodiversity) (Exhibit 7).

Exhibit 7: Top Buys in FTSE4Good Bursa Malaysia Index

	Recomm.	Price	FV	Upside	Mkt Cap	FYE	EPS (sen)		EPS growth (%)		P/E (x)		P/B*	ROE*	NDPS*	DY*
		(RM)	(RM)	(%)	(RMmil)		FY20F	FY21F	FY20F	FY21F	FY20F	FY21F	(x)	(%)	(sen)	(%)
Malayan Banking	BUY	7.69	8.40	9.2	86,446.1	Dec	58.6	65.2	(20.2)	11.3	13.1	11.8	1.0	8.5	50.2	6.5
Tenaga Nasional	BUY	11.34	13.95	23.0	63,998.4	Aug	69.1	89.8	(18.8)	29.8	16.4	12.6	1.0	8.3	44.9	4.0
Axiata Group	BUY	3.30	4.50	36.4	30,239.8	Dec	5.7	9.5	(48.6)	64.8	57.5	34.9	2.0	5.6	9.5	2.9
Malaysia Airports	BUY	5.33	6.64	24.6	8,843.5	Dec	(12.3)	23.2	nm	nm	-43.5	23.0	1.0	6.5	0.0	0.0
Malayan Cement	BUY	1.90	3.37	77.6	1,614.4	Dec	(30.9)	8.0	(17.7)	(125.9)	-6.1	23.7	0.7	2.9	0.0	0.0

** FY21F*
Source: AmInvestment Bank

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