ROYAL LONDON

IS IT WORTH MAKING A DIFFERENCE?

Do ESG considerations make a difference to returns when investing in Britain's biggest businesses?

EXECUTIVE SUMMARY

This analysis aims to dispel the myth that investing sustainably might have a negative impact on performance and returns, by comparing the performance of sustainable companies over the past five years, with the performance of the FTSE 100 as a whole during the same time period.

Our analysis found that, based on data from the past five years, investing sustainably can pay off.

Key findings

- The cap-weighted index that we created for the purpose of this analysis, based on 54 UK listed companies that have passed RLAM's sustainable criteria, returned 10.2% per year on average over the past five years, compared to the FTSE 100 which returned 9.5% per year on average over the same time period.
- As market weighted indices tend to be concentrated in a small number of the largest companies, we also looked at the average performance of companies in our sustainable index, by looking at what would happen if you split your £100 equally across all 54 companies. This was compared to £100 split equally across the entire FTSE 100, and £100 split equally across every company that didn't pass the criteria used by RLAM's sustainable funds.

  Over five years:

  - the average return of sustainable companies (as per RLAM definition) in the FTSE 100 was 14.7% per annum
  - the average return of FTSE 100 companies was 10.3% per annum
  - the average return of the stocks that did not pass our sustainable criteria was 8.6%

Companies which make the RLAM sustainable grade

The companies which meet RLAM's sustainable funds' criteria come from a broad spectrum. While pharmaceutical giant AstraZeneca and environmental leader Unilever were obvious choices, some less obvious choices also made the cut. While a chemical company like Croda might not seem a classic example of a sustainable investment, its focus on sourcing raw materials from sustainable sources, and the wider environmental benefits its products provide stood it in good stead.

Another, perhaps surprising example of a sustainable company was Diageo. Although it is ultimately a manufacturer of alcoholic drinks, it has made remarkable efforts to build a socially beneficial business model, thanks to initiatives on water efficiency and its work with local communities. In addition, it boasts one of the most diverse leadership and management teams in the FTSE 100.

Conclusion

This analysis shows that companies that take into consideration the impact that they have on the society and the environment around them have been rewarded for it in the past five years. Savers who opted for investments that value sustainability have been rewarded too.

INTRODUCTION

In a globalised world with instant access to information and news, issues about inequality, the environment, deprivation and social need feel 'closer to home' than they used to, and people are increasingly driven to make a personal contribution to address these challenges. On a daily basis, people recycle used goods and waste and give time and money to charities; the consumer goods market also allows the expression of social and environmental preferences, with product labels such as Fairtrade.

The fund management industry is starting to follow these societal changes too and there is increasing evidence to show that making decisions factoring in environmental, social and governance considerations, doesn't have to mean you need to compromise on returns. In some cases, it's quite the opposite.

RLAM'S APPROACH TO SUSTAINABILITY

The investment process used by RLAM's sustainable funds selects companies that meet one of two criteria: they must provide products and services that benefit society or be a leader in managing their environmental, social and governance (ESG) impacts when compared with their peers. These funds also avoid investment in tobacco or arms companies.

THE FTSE4GOOD APPROACH

The FTSE4GOOD uses a 'best in class' approach, whereby it selects companies that score better on ESG issues when compared with their sector peers. The FTSE assigns companies a score between 0 and 5, based on publicly available information. A company with a score of 3.1 or more may be included in the index.

The 50 largest UK companies passing this process are then selected for the FTSE4GOOD UK50, all of which are members of the FTSE 100. Certain companies, which produce tobacco, weapons systems, parts for 'controversial' weapons and coal are automatically excluded. Companies which score below 2.5 may be at risk of deletion from the index.

WHICH COMPANIES MAKE THE GRADE?

To figure out what these two models of sustainable investing mean in practice, we looked at how they apply in the real world.

Of the 100 companies which make up the current FTSE 100, 31 passed RLAM's sustainable funds' criteria and also featured in the FTSE4GOOD UK 50. This included household names like *National Grid*, *GlaxoSmithKline* and *Tesco*. Lesser known firms included cleaning and catering contractor *Compass Group* and property investment firm *LandSec*.

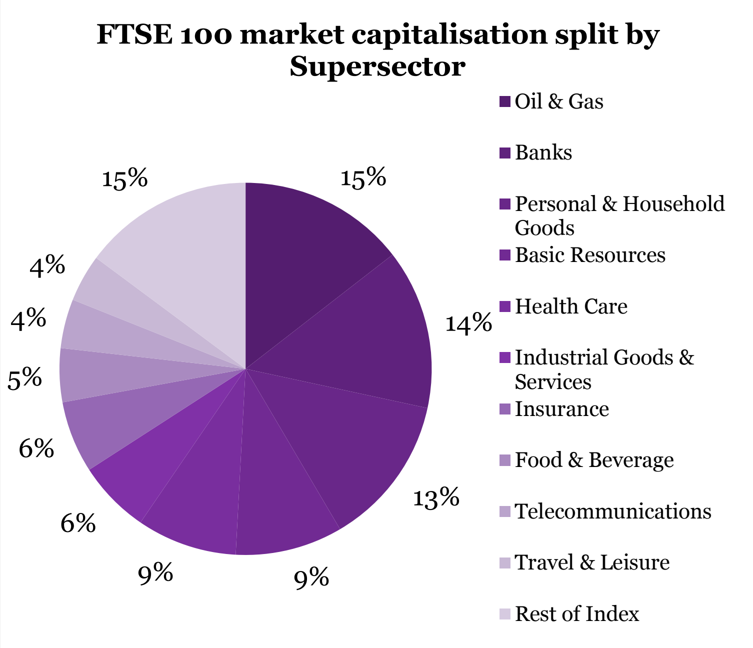
Another 19 firms make up the FTSE4GOOD UK 50 but didn't pass RLAM's sustainable funds' investing criteria, with big names like *RBS* and *Royal Dutch Shell*. Perhaps surprisingly, a number of mining companies including *Anglo American*, *BHP Billiton*, *Fresnillo* and *Rio Tinto*, along with online gambling giant *Paddy Power Betfair*, made the cut.

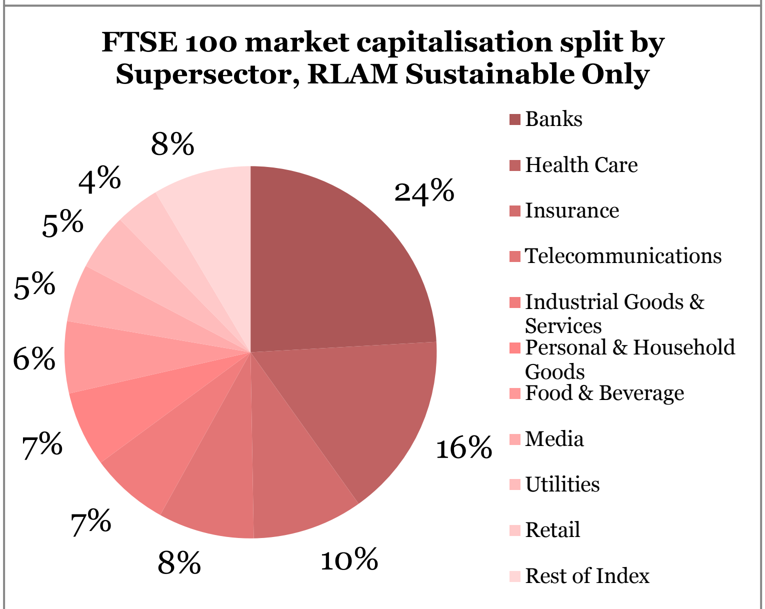
Meanwhile another 23 firms passed the criteria of RLAM's sustainable funds but either weren't of sufficient size or, due to criteria, weren't included in the 4GOOD index. These included *Rentokil, RSA* and chemicals firm *Croda*.

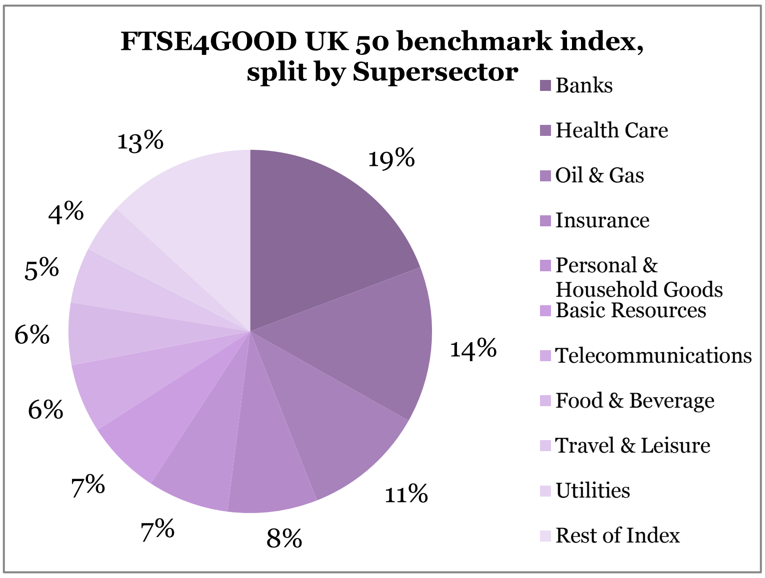
We also broke the index down into its constituent ICB Supersectors, and looked at how much of the index (by market capitalisation) was made up of each Supersector, both for the normal FTSE 100 and for the two approaches to sustainable investing.

For both sustainable approaches, health care firms and banks become the two largest constituents while utilities firms also made it into the top 10 Supersectors.

However, there are some clear disparities between the two as oil & gas and basic resources (which includes mining stocks) don't feature at all when the RLAM sustainable investing approach is applied, but take 3rd and 6th spots for the FTSE4GOOD UK 50. Only three industrial goods & services firms are in the FTSE 4GOOD



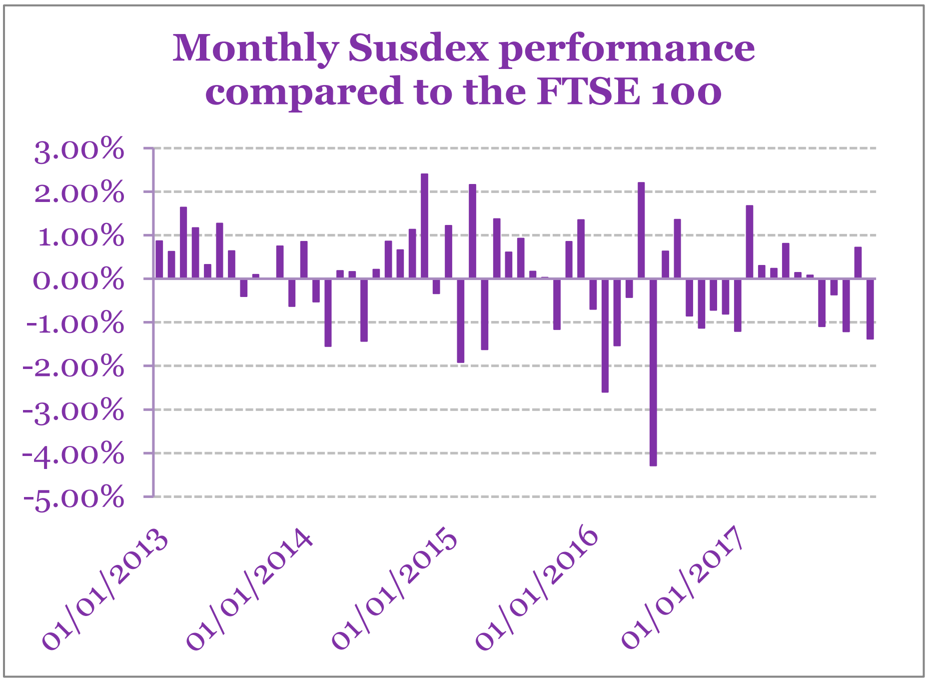




index, excluding businesses such as *Ferguson* and *Worldpay Group*.

HOW DOES INVESTING SUSTAINABLY IMPACT ON PERFORMANCE?

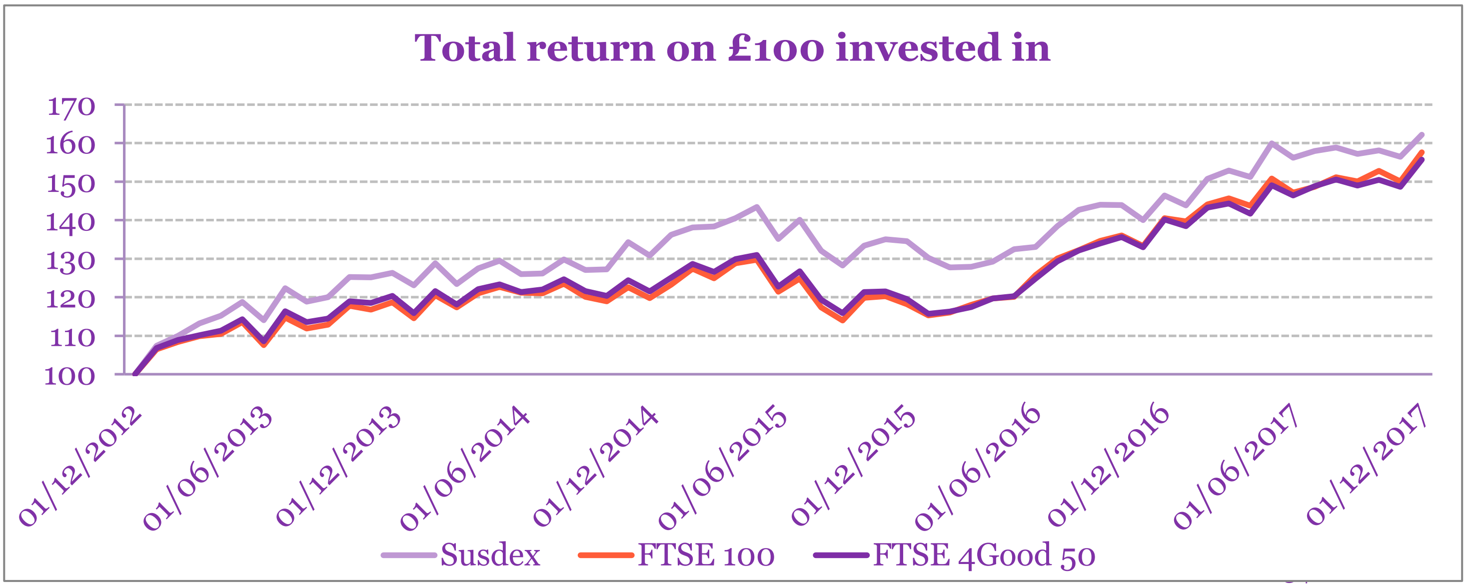
When it comes to investing, sustainably or otherwise, for most people it is performance which matters most. To understand what choosing to invest sustainably means for investment returns, we decided to look at what would happen if you'd invested in the 54 stocks within the current FTSE 100 which passed the criteria used by RLAM's sustainable range of funds. This was compared to the FTSE4GOOD UK 50 and FTSE 100, over the past five years.



To do this, we constructed a new 'cap-weighted' index from the 54 companies selected. Like the FTSE 100, each of the 54 stocks was included in proportion to how large the overall companies' market capitalisation was. In short, the larger the company, the more of our Sustainable index or "*Susdex*" they made up.

We then compared the performance of our Susdex to the performance of the FTSE 100, and the performance of the aforementioned FTSE4GOODUK 50 (which also includes ESG factors in deciding the weight of the stocks within the index), over the last five years. The headline numbers showed that:

- Over the past five years, the sustainable index we created returned **10.2% per year** on average, with a total return of **62.1%**
- Over those same five years the FTSE 100 returned **9.5% per year** on average, with a total return of **57.6%**
- Over the same period, the FTSE4GOODUK 50 returned just **9.3%** a year on average, delivering a total return of **55.7%**
- In **36** of the last 60 months, the sustainable index performed better than the FTSE 100, while the FTSE4GOODUK 50 performed better than the FTSE 100 during only **31** months.

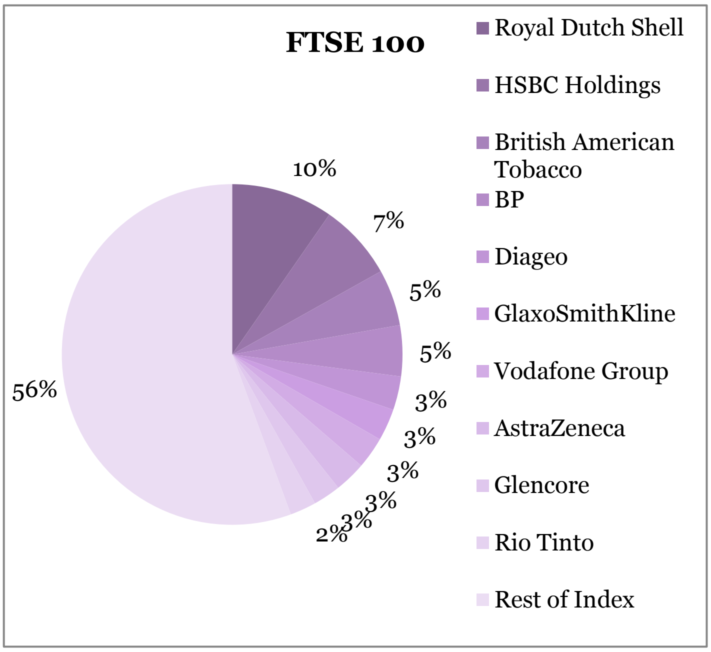


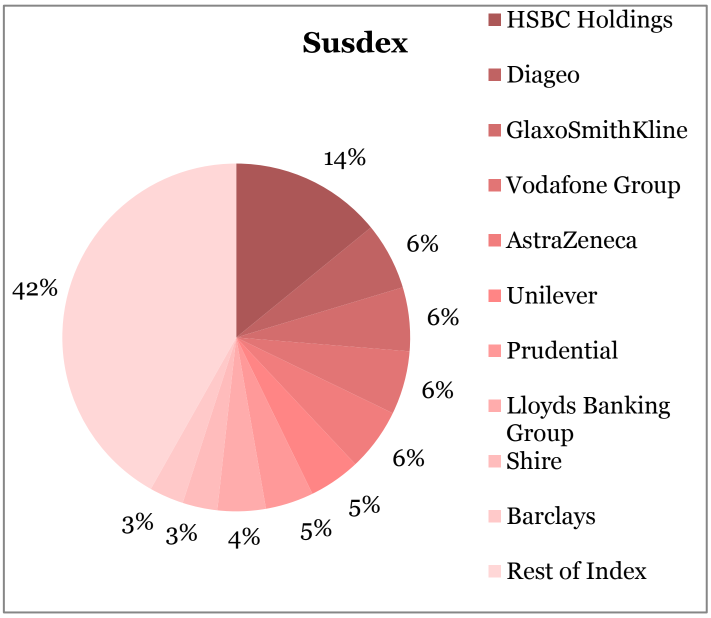
The initial figures suggest that companies in the FTSE 100, meet the criteria used by RLAM's sustainable range of funds, have outperformed. To try and understand why, we looked at whether outperformance was a consistent feature across the companies in the Susdex.

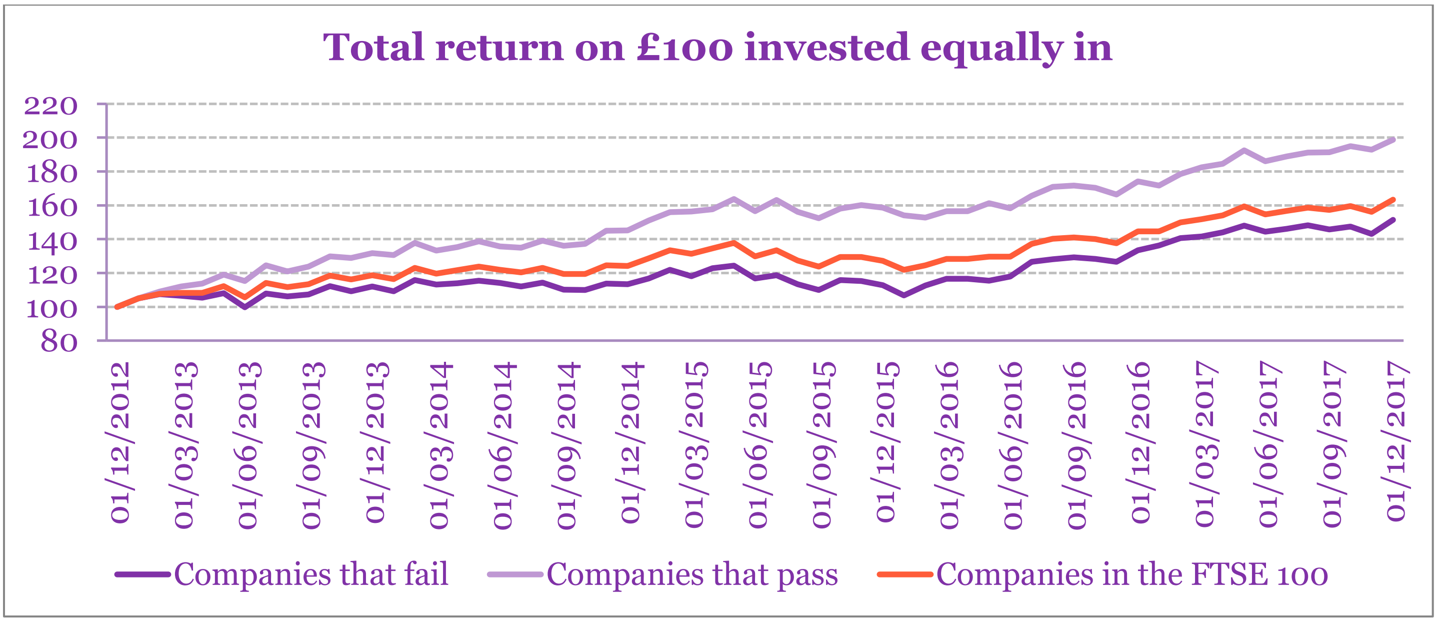
Market weighted indices are usually fairly concentrated in a small number of the largest companies. This means a £100 investment in the FTSE 100 would put roughly £10 into *Royal Dutch Shell* shares and roughly £3 into *Vodafone*, but just pennies into a smaller firm like *easyJet*. The returns of these larger stocks have a much greater impact on overall performance.

At the end of December 2017, the UK's top ten largest companies made up 44% of the total FTSE 100. The top twenty are an even greater proportion, making up nearly two thirds (63%) of the total size of the FTSE 100. Eleven of these top 20 companies passed the criteria and made it into our sustainable index of 54 firms. At the end of December, these 11 firms made up nearly 60% of the Susdex.

Therefore, to identify the average performance of companies in our sustainable index, we looked at what would happen if you split your £100 equally across all 54 companies. This was compared to £100 split equally across the entire FTSE 100, and £100 split equally across every company that didn't pass our criteria. It is impractical to track the changing make-up of the FTSE4GOODUK 50 over time, so it was omitted from this second analysis.







The headline numbers showed that:

- Over the past five years, investing equally across the stocks which passed the criteria of RLAM's sustainable funds returned **14.7% per year** on average, with a total return of **98.8%**
- Over the past five years, investing equally across the stocks which failed RLAM's sustainable funds' criteria returned **8.6% per year** on average, with a total return of **51.4%**
- Over those same five years, investing equally across all the constituents of the FTSE 100 would have returned **10.3% per year** on average, with a total return of **63.3%**
- In **38** of the last 60 months, the companies that passed RLAM's sustainable investing criteria performed better than the FTSE 100, while the average company that failed our criteria only performed better than the FTSE 100 during **24** of the last 60 months.

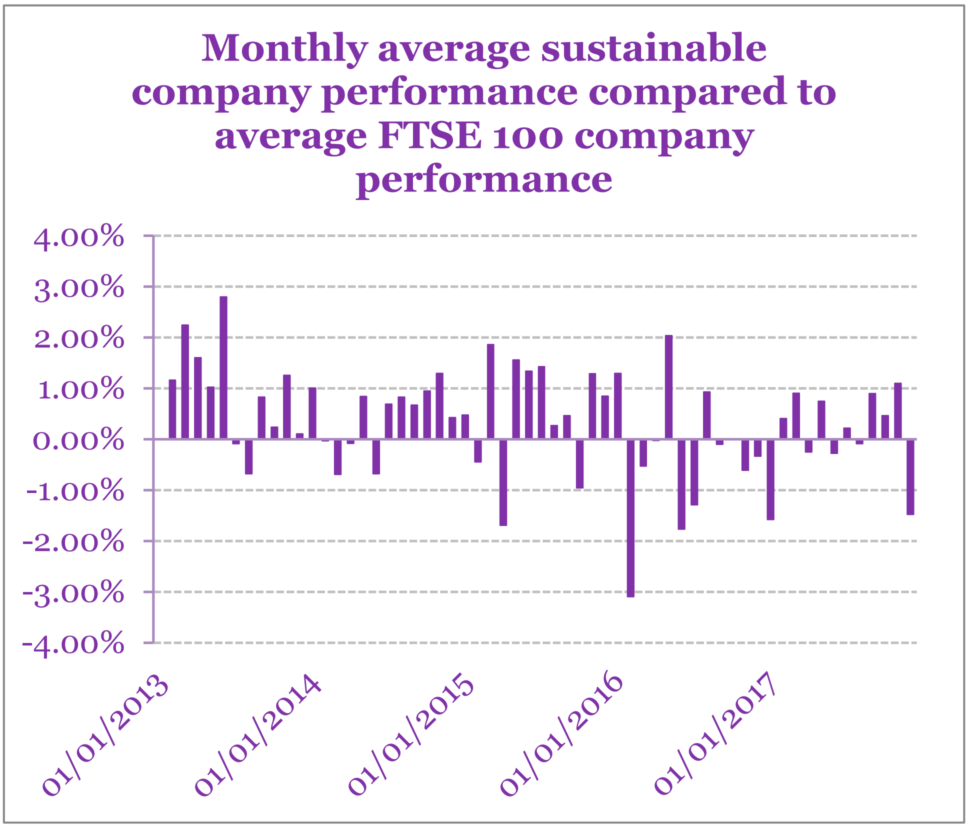
Over the past five years, the average performance of a company in the FTSE 100 that passed RLAM's sustainable criteria delivered an annual return of over 4% above the return of the average FTSE 100 company.

Comparing the results from two sets of analysis, the figures seem to back the classic theory that smaller companies have the potential for greater long term returns.

The equal split assessment of the FTSE 100 returned **10.3% per year on average,** compared to **9.5% per year on average** for market weighted version.

Meanwhile, the average performance of companies within the Susdex was **14.7% per year** when a £100 was divided equally, compared to **10.2% per year** when split according to how large each company was.

Whichever way we looked at this, over the past five years, sustainable companies have outperformed the wider FTSE 100 by a significant margin. The approach to sustainable investing of RLAM's sustainable range of funds, with its emphasis on the tangible benefits to society, strong governance, and a clear focus on the good ESG performance, has trumped the FTSE4GOOD UK 50. Over the last five years, investing sustainably would have delivered the goods.



WHAT MAKES A SUSTAINABLE COMPANY

Below are a few examples of companies which are either particular leaders in their fields or are firms which we believe, despite first appearances, are strong arbiters of sustainability.

Croda

Innovative chemicals - Over 70% of the firm's raw material comes from sustainable sources, with the next best competitor managing just 16%, and their top 25 products by volume of sales met *11.3/12 Principles of Green Chemistry* standards.

The products they create are not just environmentally conscious during sourcing of materials and manufacture, but offer a wider benefit. 60% of all new products in 2016 delivered some form of sustainable benefit, while some of the new adjuvants produced by their crop sciences business are rapidly reducing the need for pesticides sprayed on crops.

Diageo

Clear as water - As a manufacturer of beverages, use of water is at the heart of what Diageo does. However, aside from the water that goes into their products, Diageo has been very progressive on its water efficiency, setting itself tough targets. It has also guaranteed access to safe water and sanitation for more than 10 million people through its 'water of life' project.

Diageo is also fairly progressive on boardroom diversity, 42% of its board are women and when it comes to executives, that number rises to 47%. This is also filtered down into the business, where 28% of the firm's leaders are women. While its core product remains alcoholic beverages, Diageo has made strides to tackle alcohol related issues with 300 programmes launched in over 50 countries.

AstraZeneca

Curing societies - For us, AstraZeneca is a classic example of a company whose products offer a long term net benefit to society. The firm is constantly developing a range of immuno-oncology treatments to help the body fight a range of life changing diseases, while it also tackles cardiovascular, metabolic and respiratory diseases.

While each compound undergoes a rigorous trial procedure, once out in market a successful drug can help people not only to live longer, but live better. As populations around the world age and more of us suffer from the effects of cancer, the products which pharmaceutical leaders like AstraZeneca deploy will provide lasting benefits.

Unilever

Best in class – Unilever is one of the best examples of a company which incorporates sustainability at the very heart of its business model. Most of the company's products meet basic societal needs and care is taken to minimise the environmental impact from sourcing to consumption. In particular, commitments on packaging should not simply help reduce creation of waste but, given the global scale of the firm, actively help to reduce some demand for new raw materials. Business lines like water purifiers will make a real difference to demand for the plastic bottles that until now have been the only way many communities have consumed fresh water.

METHODOLOGY

When doing this analysis and writing the report, we wanted to investigate, in clear terms, what impact two different methods of investing sustainably could have had for a UK saver choosing to invest in the FTSE 100. We chose the FTSE 100 as the most well-known equity investment index in the UK, and because it offered us a chance to analyse its performance and composition using two different measures of sustainability, the process used by RLAM's own sustainable funds and a market standard from FTSE Russell, the FTSE4GOOD UK 50.

The following points highlight what data was used and how performance was measured. If you have any questions not raised in this methodology, please direct any enquiries to: pressoffice@royallondon.com

- **How performance was measured** – Performance was measured using Bloomberg data, looking at the monthly gross total return (including dividends) of the FTSE 100, FTSE4GOOD UK 50 and the 54 companies which made up the Susdex, from 31/12/2012 to 31/12/2017.
- **What about fees and charges** – As we chose to compare the performance of two existing indices and a third index created for the purpose of this analysis, the performance figures do not include the impact of fees, charges or taxation that an investor would incur in.
- **Analysing Supersectors and constituents by market capitalisation** – For the FTSE4GOOD UK 50, we used the index weights from the latest available factsheet from FTSE Russell at the time of the analysis, and then grouped these by ICB Supersector. For the FTSE 100 and the RLAM Susdex, we used the market capitalisation for each company as of market close on 28th December 2017, and then grouped these by ICB Supersector.
- **What 54 companies made up the Susdex** – While we are unable to provide further detail behind the specifics of the RLAM sustainable investing criteria, 54 companies in the FTSE 100 passed the process used by RLAM's sustainable team at the time the analysis was carried out, however the list of companies was not back-dated to reflect changes to it over time.
- The inclusion of these companies in the index we created **does not** guarantee that RLAM's sustainable team currently or in future intend to invest in any of these companies, and does not guarantee that they will continue to pass this process in the future. RLAM's sustainable range of funds are not limited to the FTSE 100 and invest across a range of different asset classes, market capitalisations and geographies.
