Beyond climate: turning the SDGs into an investment strategy

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SDG-related listed equity indexes are within reach and can offer attractive financial and impact returns, write **Alexander Bassen, Mathieu Verougstraete** and **Sander Glas**

In 2020, the Global Investors for Sustainable Development (GISD) Alliance, convened by the UN Secretary General, created for the first time a common definition of sustainable development investing (SDI). The definition establishes a credible norm for investment products marketed as sustainable. Research by Alexander Bassen and others at the University of Hamburg now concludes that the definition's simple decision tree can be operationalised using existing sources of data.

Passive investment strategies that replicate sustainability indexes offer considerable opportunities for both institutional and retail investors interested in aligning their money with their values without necessarily compromising on financial returns.

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The Paris Agreement holds clear advantages as a framework for passive investment strategies. It rests on a common foundation of science, articulated by the Intergovernmental Panel on Climate Change (IPCC); and progress in its implementation can be measured using a single indicator, namely carbon dioxide (CO2) equivalent.

While the importance of the climate struggle cannot be denied, our failure to achieve other sustainability goals – environmental but also social – equally threatens our society, and as such the viability of companies misaligned with tomorrow's reality.

The UN Sustainable Development Goals (SDGs) may not offer the above simplicity of the Paris Agreement, but they can also be used in similar ways for passive investment strategies. The SDGs are the only globally agreed framework that cover both people and planet.

While the use of SDGs as an investment framework has been slower to materialise, we are increasingly seeing an interest in moving beyond climate-only. This interest is materialising from regulators (e.g. the proposed Social Taxonomy of the International Platform on Sustainable Finance) as well as investors (e.g. Taskforce on Nature-related Financial Disclosures).

With this in mind, we sought to understand the degree to which the SDGs could be translated into a listed equity index – using existing data solutions alone. Because an assessment of the firms' alignment with the SDI definition on a case-by-case basis is not feasible for passive investors with broad, diversified portfolios, it is necessary to rely on commercial solutions developed by major data providers.

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In this context, we analysed the suitability of numerous data providers of ESG and SDG measures to match the approach put forward in the SDI definition developed by the GISD Alliance. The approach follows a simple decision tree for determining whether an investment is aligned with the SDGs and the degree of adherence to this decision tree was used to generate an SDI, or sustainability, score for every company.

Based on this, we constructed hypothetical stock indices and compared their risk, return, and SDI performance with the MSCI ACWI benchmark, which encompasses stocks from 23 developed and 27 emerging markets. For all indexes we found similar risk-return profiles as for the benchmark but higher sustainability scores. We concluded that the optimal SDI value of constituents is around 15 [on a scale that ranges between the lowest score, 0, and the highest score, 20]. Beyond this threshold, the concentration of asset weights increases significantly, resulting in higher risk.

It is hopeful that this exercise was possible with the data already available – something which we could not have said as recently as a couple of years ago given the lack of SDG-related data at the time. That being said, there is considerable room for improvement. It would be desirable if data providers were to expand the coverage of their SDG-related measures, especially in developing country equities, and deepen their assessment on SDG alignment. The lack of data in developing countries should definitely not result in having sustainable financing flows bypass countries where the needs are the highest.

Much of the data is also behind significant paywalls, which limits its usage to sophisticated investors. Many promising approaches, of which some such as the World Benchmarking Alliance will be offered as a public good, are still being developed. While time will tell whether these approaches can fill the aforementioned gaps, they hold promise.

We hope that the research, which is now available online, will convince investors to develop impactful investment strategies that better integrate the SDGs. This obviously remains a work-in-progress area that will hinge on enhanced data and methodologies to measure the impact of companies on the SDGs. Yet, we should not allow perfect to be the enemy of good, since this research demonstrates that it is already possible to act now.

Prof. Alexander Bassen is the chair of capital markets and management at the University of Hamburg and was the principal investigator for the report. Mathieu Verougstraete and Sander Glas work in the UN's Financing for Sustainable Development Office of UN/DESA, where they coordinate the development impact work of the GISD Alliance.