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Investment opportunities in social equity

Introducing the Aviva Investors Social Transition Global Equity strategy

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Key takeaways

The poor treatment of workers can lead to a financial and regulatory backlash, while social inequality hinders economic growth directly and indirectly by increasing the probability of financial crises, poor public policy decisions and social unrest.

Regulation, consumer demand and productivity gains could provide consistent tailwinds to companies that respect human rights, promote decent work, act as responsible corporate citizens and provide responsible access to health, education and finance.

Our Aviva Investors Social Transition Global Equity strategy invests in solutions companies and transition leaders across those themes, seeking to deliver long-term capital growth and contribute to socially equitable economies.

Our capital allocation is complemented and bolstered by macro stewardship and company engagement to accelerate the transition to a socially equitable economy and ensure the companies we hold benefit from those changes.

Introduction

The last few decades have seen rising inequality within countries: globally, 630 million workers live in moderate or extreme poverty.[1] Yet inequality can impede growth and fuel social unrest.[2] A study by the Organisation for Economic Cooperation and Development (OECD) across its 38 member countries showed a one per cent increase in inequality lowers GDP by 0.6 per cent.[3]

COVID-19 exposed existing fault-lines of inequality in societies, contrasting poor health-and-safety conditions for low-paid workers in meat-processing facilities and care homes with the rise in tech-enabled remote working for white-collar workers. Across sectors, an increase in organised labour attempted to claw back some of the power lost to capital and companies over the past decades.[4] There is now a wider debate about the nature of work, importance of social equality and resilience of the social fabric.

We believe markets will increasingly price in the risks and opportunities related to social trends. Policy is already shifting, with regulators mandating that companies provide more information on their treatment of workers and better manage human-rights risks and impacts across their supply chains.

In addition, consumers are becoming more connected with social issues. They increasingly want to spend money with companies whose operations, products and services are aligned with their own values.[5] In our view, companies putting consumers' interests first will see benefits over the long term.

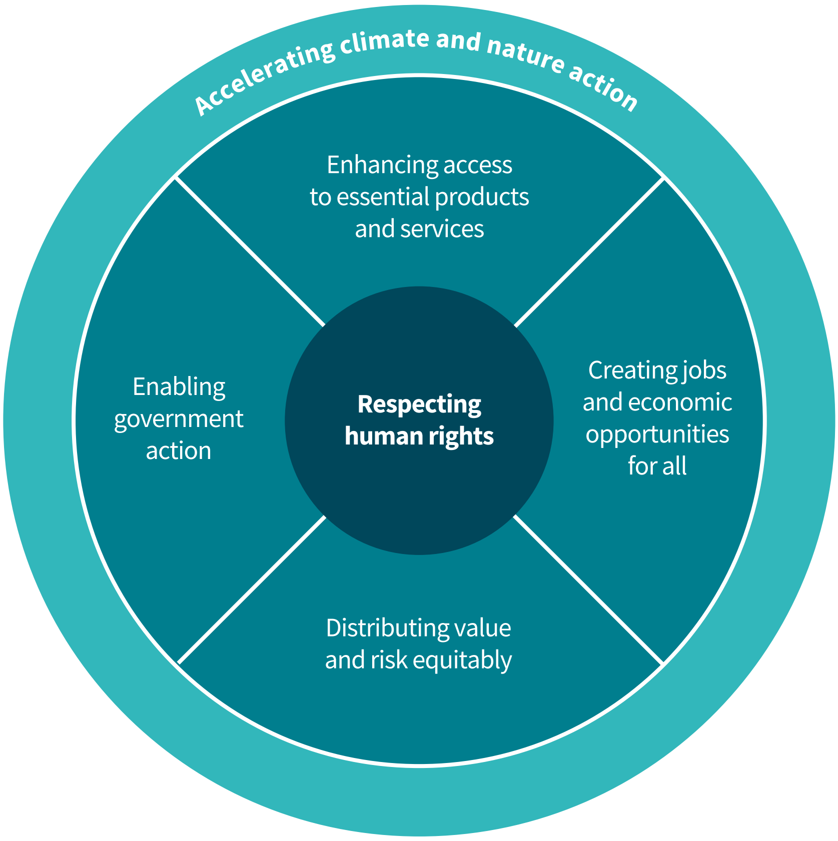
There is a wider debate about the nature of work, importance of social equality and resilience of the social fabric

Finally, companies that treat workers well in their own organisations and supply chains typically benefit from increased engagement and productivity (see '*Global megatrends: How climate, nature and social change will reshape economies*').[6]

In a recent report, the Business Commission to Tackle Inequality (BCTI) and the World Business Council for Sustainable Development (WBCSD) recommended a course of action starting with respect for human rights, which is the baseline requirement of creating a level playing field, alongside access to essential products and services, equal opportunities, equitable distribution of value and risks and enabling government action (Figure 1).[7]

Human rights is the baseline requirement of creating a level playing field

Figure 1. **Key areas for business action to tackle inequality**



Source: Aviva Investors, BCTI, WBCSD, May 2023.[8]

In this paper, we will set out the investment case for tackling social inequity and highlight opportunities to invest in companies that protect and support social equality, as well as those providing solutions to improve people's access to education, health and finance.

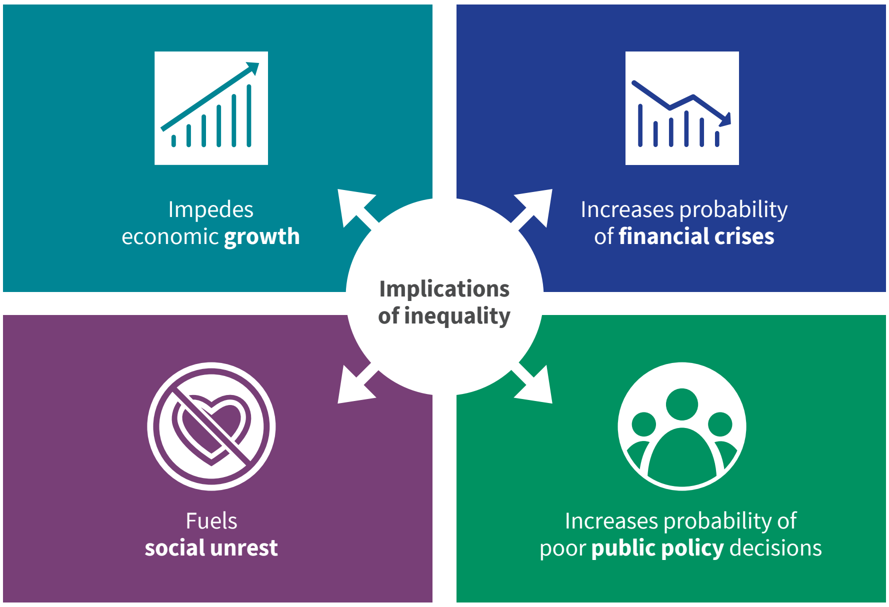
Mitigating social risks – a case for better people management

Social inequality creates macro- and micro-level risks for companies out of step with the public and policymakers on their treatment of people – employees, customers, people in their supply chains and local communities.

Macro-level risks

At a macro level, social inequality and an unstable business environment can limit companies' ability to grow, restrict their customers' spending power and disrupt supply chains. It hinders economic growth directly and indirectly, increasing the probability of financial crises, poor public policy decisions and social unrest (Figure 2). The sum of these possibilities constitutes a systemic risk to economies.

Figure 2. **Implications of inequality**



Source: Aviva Investors, from Dabla-Norris, et al., 2015.

Growth: Several IMF studies have demonstrated that widening income inequality has a negative effect on growth, undermining drivers such as productivity and consumer spending.[9]

In countries with higher levels of income inequality, parents' earnings are an important determinant of their children's earning potential. Lower-income households are generally more vulnerable to economic shocks and less able to invest in long-term strategies to boost resilience, such as health and education. The OECD and others have argued this underinvestment impacts long-term labour productivity.[10]

Since middle- and lower-income households spend a higher proportion of their incomes than wealthier groups, an increasing concentration of incomes can reduce aggregate demand, undermining economic growth.[11] According to the BCTI/WBCSD report, closing the living-wage gap worldwide could generate an additional $4.56 trillion a year through increased productivity and spending.[12]

Financial crises: Evidence suggests the rising influence of the rich and stagnant incomes of the poor and middle class have a causal effect on financial crises.[13] A prolonged period of higher income inequality in advanced economies was a contributory factor to the global financial crisis, intensifying leverage and overextending credit against a backdrop of declining mortgage underwriting standards and financial deregulation.

Social unrest: Social unrest is a function of the erosion of social cohesion, which topped the World Economic Forum's ranking of the global short-term risks that deteriorated most during the pandemic.[14] Social cohesion can erode as citizens lose confidence in institutions.[15] Any potentially resulting social unrest may impact the normal functioning of the economy, as shown during the French *Gilets Jaunes* movement in 2018 and 2019.[16]

Public policy: In unequal economies, public policy can often be skewed to the benefit of the elite, who tend to have more political influence. As a result, there may be a public backlash to policies that promote economic liberalisation and greater globalisation (as seen in recent years in the US and across Europe).[17] Simultaneously, the effectiveness of policies to increase the provision of public goods (such as health and education) may be limited if they are designed to sustain the interests of the already powerful.[18]

Micro-level risks

At a micro level, companies with poor pay and working conditions can exacerbate disparities in society, particularly where they impact already vulnerable groups. They are coming under scrutiny for this reason. When food delivery company Deliveroo had its initial public offering on the London Stock Exchange in 2021, some investors refused to participate, citing low wages and poor working conditions as a concern. The IPO was subsequently described as "the worst in London's history" and Deliveroo shares have since underperformed the wider FTSE 250.[19] Working conditions in the broader sector have also drawn scrutiny from lawmakers and policymakers across Europe.[20]

Poor treatment of workers in companies and their supply chains can also lead to a backlash from regulators. In 2018, non-government organisations used French consumer law to denounce the gap between Samsung France's claims to be "one of the most ethical companies in the world" and grave human rights violations in its supply chains. Samsung France was indicted in 2019 for misleading advertising.[21]

Companies with poor pay and working conditions can exacerbate disparities in society

To mitigate those risks, companies must cultivate mutually beneficial relationships with four key stakeholder groups: workers, supply chains, customers and local communities (Figure 3), particularly as regulation and consumer demand increasingly support the fight against social inequality.

Figure 3. **Company stakeholders**

Source: Aviva Investors, June 2023.

Investment opportunities in companies

Popular myth suggests the "S" in ESG is intangible, meaning it can't be measured, which in turn makes it difficult to link to alpha. While it is sometimes challenging to precisely measure intangibles – such as brand value, customer loyalty and customer data – it is possible to analyse them. This is not a new concept, but an increasingly pertinent one.

In 1975, an estimated 17 per cent of the S&P 500's value was attributable to intangibles; in 2020, this had risen to 90 per cent.[22] Intangible elements are critical to fundamental equity analysis as they can fuel a company's future cashflows, which drive value and ultimately share prices. Using company stakeholders, we explain how this works below:

90%

Of the S&P 500's value was attributable to intangibles in 2020

Workers

Fundamental shifts towards a knowledge-based economy have resulted in a greater reliance on the workforce as a driver of innovation and economic growth. Companies that cultivate internal talent should be better positioned to outperform as, if management invests correctly in human capital, the returns can be significant. A 2015 meta-analysis of 92 academic papers concluded "there is sufficient evidence of human capital materiality to financial performance to warrant inclusion in standard investment analysis".[23]

A study of Australian companies by the Melbourne Institute of Applied Economic & Social Research on the relationship between training expenditure and profitability found firms that increased investment in training in one year reported significantly higher profits the next.[24]

Meanwhile, research in the *Journal of Occupational and Environmental Medicine* showed companies scoring highly on health and wellness delivered shareholder returns of 333 per cent between 2001 and 2014, compared to 105 per cent for the S&P 500.[25]

A study conducted by Alex Edmans in 2012 concluded "companies listed in the '100 Best Companies to Work for in America' generated 2.3 to 3.8 per cent higher stock returns annually than their peers from 1984 through 2011", (see '*Global megatrends: How climate, nature and social change will reshape economies*').[26,27,28]

Supply chains

Companies that invest in improving worker conditions in their supply chains can benefit from lower reputational and operational risks, as well as increased productivity. This feeds through to more sustainable margins and lower financial risk.[29]

In an assessment of the International Labour Organisation's (ILO) Better Work Programme, researchers found stronger labour standards made a positive difference to worker performance by increasing productivity and lowering turnover. Improvements in working conditions also enhanced suppliers' ability to retain and obtain buyers, increased sales value and profitability, and reduced inspections and auditing.[30]

Figure 4. **The case for sustainable supply chains**

Supply chain sustainability business value drivers

Managing risks	Realising efficiencies	Creating sustainable products	Building a culture of responsibility
• Minimise business disruption from environmental or labour problems • Protect company's reputation and brand value • Gain greater access to capital, financing and insurance	• Reduce cost of material inputs, energy, transportation • Increase labour productivity • Develop strategic supplier relationships for optimisation	• Innovate to meet evolving customer and business partner requirements • Gain access to new markets • Increase pricing power • Improve customer loyalty	• Attract and retain engaged employees • Build strong relationships with external stakeholders, including government • Gain greater access to capital, financing and insurance

Legal compliance, governance, management and transparency

Source: Aviva Investors, BSR, December 2010.[31]

Customers

How a company treats its customers, and how customers perceive a company's social practices, can drive revenue growth – which can positively feed through to share prices.

Between 1997 and 2003, the top 20 per cent of companies in the American Customer Satisfaction Index earned nearly double the returns of the Dow Jones Industrial Average, while the 2021 Edelman Trust Barometer found customers are 4.5 times more likely to buy if a brand addresses human rights and 3.5 times more likely if it addresses economic inequality.[32,33]

Local communities

How a company affects communities can have a direct impact on its share price. It can also draw the attention of governments, buttressing or impeding the company's social licence to operate, which can either bring additional revenue opportunities or the risk of significant costs.

ETP was forced to halt its Dakota Access Pipeline, announced in June 2014, after the Standing Rock Sioux tribe's successful campaign and legal action against the project, which crossed their ancestral lands. The company saw a 20 per cent fall in its share price between August 2016 and September 2018 and incurred huge costs.[34]

Delivering returns through socially positive investments

By managing these risks and opportunities, the Aviva Investors Social Transition Global Equity strategy aims to deliver on the following dual objective:

1 To provide clients with long-term capital growth

2 To support the transition towards a more socially equitable economy

The strategy seeks to outperform broader global equity markets, as measured by the MSCI All Country World Index, by two per cent per annum gross of fees over three-year rolling periods. The portfolio is not constrained by a benchmark, which we believe should mean performance better reflects stock-specific fundamentals rather than momentum in a given area or investor sentiment, as well as being more resilient over market cycles.

We aim to achieve our dual objective by investing in solutions companies that help tackle inequality through products and services that provide or improve access to health, education and finance. We also invest in companies transitioning their business activities towards a more socially equitable economy by respecting human rights, promoting decent work and demonstrating responsible corporate behaviour.

Investing in firms that support social equity presents significant investment opportunities

Beyond the moral imperative to act and need to mitigate social risks, investing in firms that support social equity presents significant investment opportunities.

Solutions

Given the importance of social issues and potential impact on economic growth and stability, we see opportunities in companies that improve access to basic resources for underserved communities, focusing on areas with the clearest gaps in public provision: access to education, healthcare and finance (Figure 5).

Figure 5. **Investment themes in solutions**

For illustrative purposes only and not intended as an investment recommendation.
Source: Aviva Investors, UN Sustainable Development Goals, June 2023.

We consider companies that generate revenues above a minimum threshold in one of the three areas above, offering products or services that address a clear social need for a specific group or underserved population. They must also commit to increasing their reach to the target group and be transparent about their efforts. Qualitative analysis is a core part of understanding and assessing each company's approach and potential to align with the SDGs mentioned in Figure 4.

Qualitative analysis is a core part of understanding and assessing each company's approach

Looking at the examples in Figure 4, Coursera is a certified B-Corp, meaning it has a legal duty towards shareholders, but also to deliver positive social impact – which it does through reducing barriers to education. Invitae is a young company whose mission is to "democratise genetic testing". Finally, serving 124 million micro-borrowers, Bank Rakyat Indonesia has an important role to play in empowering marginalised sections of the population to access financial and economic tools and resources.[35]

These themes should help tackle social inequality because improved access to health, education and finance can create a stronger labour market. Healthier people able to work, higher levels of educational attainment and increased social mobility can create a wider pool of talent for companies. According to the BCTI/WBCSD report, wide-scale investment in employee upskilling alone has the potential to boost global GDP by $6.5 trillion by 2030.[36]

Companies addressing needs in underserved markets often face initial difficulties, as customers can be riskier and more difficult to reach. However, the addressable market is generally large, creating top-line growth opportunities over the medium term.

As an example, diagnostics company Qiagen has teamed up with the World Health Organization to provide a low-cost latent tuberculosis test to help meet its goal of eradicating the disease by 2035. Qiagen also played a vital role increasing access to testing during COVID-19 and is benefiting from the expansion of its installed base, including its new syndromic testing platform QIAstat-Dx. We think both factors are underappreciated drivers of future top-line growth. As these technologies scale, we see scope for Qiagen's operating margins to catch up with more profitable peers.

Transition

As discussed earlier, rising economic inequality and the pandemic legacy, as well as the need to transition to a net-zero and nature-positive world, mean companies must urgently tackle social inequality. This is even more crucial as regulation and consumer expectations are shifting towards demanding greater equality and respect for human rights.

In fact, human rights and labour standards underpin 90 per cent of the targets in the SDGs – the 17 global goals that provide a roadmap for the global community to build a more just and sustainable world. By shifting how they conduct their business and operations to bolster support for human rights and decent work, companies can help ensure a smooth and just transition to net zero – and reap the benefits.

90%

Of the targets in the SDGs are underpinned by human rights and labour standards

As discussed above, treating key stakeholders well also creates significant opportunities for firms to improve their productivity and customer satisfaction and ensure sustainable revenue growth.

We select companies demonstrating three essential behaviours that are the cornerstones of a transition to a more equitable and just society:

Figure 6. **Three essential behaviours**

1 Respect for human rights

All companies must have a robust human rights due-diligence process to identify and manage human-rights risks and impacts in their value chain.

2 Promoting decent work

Companies must provide work that is safe, secure and well paid, which enables different groups to feel included and flourish.

3 Responsible corporate behaviour

Companies must ensure their products and services do not cause harm; demonstrate responsible corporate tax behaviour; and ensure their lobbying activities don't undermine policy efforts to address inequality.

Source: Aviva Investors, June 2023.

PayPal is a good example of a company demonstrating these behaviours. It recently conducted a human rights assessment in partnership with human rights organisation Article One, scored 100 per cent on the Human Rights Campaign's Corporate Equality Index 2021 and ranks first in its industry on the JustCapital ranking.

During the pandemic, PayPal created the Financial Wellness Initiative, aimed at improving the financial security of its lowest paid workers. It has invested in various practices to ensure financial crime compliance, protecting customers from fraud and data security breaches, and is a leader in the way it uses transaction oversight to flag issues such as human trafficking and banning transactions related to the sale of firearms and ammunitions.

At firms like PayPal, human capital is the key driver of product innovation. The company believes one of the main reasons employees come to work is because of its values.

A bespoke risk model to identify transition leaders

For transition companies, we have developed a proprietary social transition-risk framework to assess companies' impact on people. It is a multi-step process consisting of analysing layers of different types of data to build a better picture of companies in the investable universe.

We will only invest once we feel comfortable a stock meets the dual mandate of potentially delivering strong long-term returns and contributing to a socially equitable economy.

Five buckets of businesses

The investment themes have led us to identify companies across five types of business (Figure 7). Some firms address several of these themes, each of which is influenced by different social considerations that, in turn, shape important financial metrics.

1 In **sustainable production**, we look for companies focused on delivering high-quality products which provide evidence of increasing the transparency of opaque supply chains and commit to source products and services responsibly.

2 In the **just energy transition**, we focus on companies that place as much emphasis on the transition of the workforce as on the energy transition, including investing in direct employees, contractors and suppliers and working with communities to ensure the benefits of the energy transition are shared equitably.

3 Human capital drives value creation, particularly in the tech sector. Strong people management, training and engagement are key. In the **technology transition**, we aim to invest in technology service providers that demonstrate leadership on those behaviours.

4 In the shift from **ownership to usership**, a key component of the net-zero transition, we look for product quality and safety, best practice in labour standards and robust diversity and inclusion policies.

5 Finally, **responsible access** covers solutions companies improving access to health, education and finance. We select companies that stand out for the quality of access to their products and their affordability, but also those focused on customer welfare and regulatory alignment. Governments and regulators often hold the power to support companies that improve access to goods and services and inflict significant financial penalties on those that exploit vulnerable customers.

Figure 7. **Five buckets of businesses**

Portfolio theme	1 Sustainable production	2 Just technology, energy transition	3 Technology transition	4 Ownership to usership	5 Responsible access
Example portfolio holding	NXP	sse	RELX	Halozyme	QIAGEN
Key social considerations	Product quality, supply chain management, materials sourcing	Community relations, employee health and safety, legal and regulatory, environmental	Data security, competitive behaviour, employee engagement	Product quality and safety, labour practices, diversity and inclusion	Access and affordability, customer welfare, regulatory relationships
Key financial considerations	Operating margin sustainability	Sustainability of excess returns	Earnings growth durability	Top-line growth durability	TAM expansion/ penetration versus short-term profitability

Transition → Solution

Note: These are current holdings in the portfolio. The information about specific securities should not be construed as a recommendation to buy or sell any securities.
Source: Aviva Investors, June 2023.

Leveraging our influence to maximise value

By investing in these companies, we can drive a larger impact throughout the value chain via our bespoke engagement programme, which entails company-level engagement and macro stewardship.

> We can drive a larger impact throughout the value chain via our bespoke engagement programme

Company engagement

Our engagement focuses on two areas that are essential building blocks to a more equitable economy. The first is ensuring companies address their adverse impacts on people through human rights due diligence. The second is implementing living wages across the value chain. This is important both for enabling workers to afford a decent standard of living and for the wider business benefits associated with a well-paid workforce. We track companies' progress over time to determine which warrant further engagement and potential escalation.

We escalate our engagements by voting at AGMs in ways that support our asks, including voting against directors or in favour of specific resolutions. We may ultimately divest from any company that does not make sufficient progress within a three-year period. While we aim to invest in companies demonstrating leadership in their management of social risks and opportunities, all companies have significant areas for improvement. Our escalation pathway shows a clear consequence if they fall short in their actions.

Company engagement also provides a positive feedback loop into our investment process, influencing position sizing and company holdings. Over time, we believe this will allow the strategy to consistently maximise strong returns and positive social outcomes.

Macro stewardship

We actively engage with governments, policymakers, NGOs, academics and other key stakeholders to try to correct market failures – a practice we call macro stewardship (see *AIQ: The macro stewardship edition*).[37]

In a social equity context, we continue to support strengthening the Corporate Sustainability Due Diligence (CSDD) proposal within the European Commission and use the Glasgow Financial Alliance for Net Zero (GFANZ, which we helped found) to campaign for a just transition to net zero. Those least responsible for climate change are disproportionately affected by its impacts, while substantial economic benefits will arise from the transition to a green economy. We need to ensure these benefits are shared widely across society.

Encouraging governments and supranational institutions to accelerate the transition to a socially equitable economy, tighten standards and implement regulation is important to incentivising companies to adopt behaviours that can drive investment returns and support social equality.

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Key risks

Counterparty risk

The strategy could lose money if an entity with which it does business becomes unwilling or is unable to meet its obligations to the Fund.

Currency risk

The strategy is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.

Derivatives risk

Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred.

Derivatives are instruments that can be complex and highly volatile, have some degree of unpredictability (especially in unusual market conditions), and can create losses significantly greater than the cost of the derivative itself.

Emerging market risk

Investments can be made in emerging markets. These markets may be volatile and carry higher risk than developed markets.

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), and as a result their prices can be volatile.

Sustainable investing risk

The value and income from the strategy's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the strategy will achieve its objective and you may get back less than you originally invested.

Sustainability risk

The level of sustainability risk to which the strategy is exposed, and therefore the value of its investments, may fluctuate depending on the investment opportunities identified by the Investment Manager.

Important Information

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