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Has sustainable investing passed crisis test?

Early signs of greater resilience in funds that focus on stakeholders

By **LAURA DU PREEZ**

● Sustainable investing is having its "moment" in the midst of the coronavirus crisis. The investment trend is gaining momentum and its advocates say there are signs that it may fare better in bear markets than strategies with no stakeholder focus.

Morningstar and Schroders report that the funds of global managers that have embraced sustainable investment are attracting new investment as the environmental, social and governance (ESG) issues they address in their investment processes take centre stage during the crisis.

Disaster management, continuity planning, employee treatment, biodiversity, supply chain management and health and safety are factors sustainable investors look for in the companies in which they invest, Dan Lefkovitz, a strategist for Morningstar's Indexes group, told a webinar for investment professionals recently.

He noted that sustainable funds in the US had record inflows during the first quarter of the year despite it being an awful period for markets generally.

In SA, the crisis has thrown into sharp focus high levels of unemployment, inequality and poverty and is exposing the essential services needed to sustain life, Jon Duncan, head of responsible investment at Old Mutual, told an Asset TV webinar for financial advisers.

Retirement fund consultants say they expect the pandemic to shift the sustainable investment focus from governance issues in South African companies to how they are dealing with pressing social issues.

Sustainable investing is also in the news because stock market indices with an ESG focus fared better than traditional indices through the recent market falls despite many detractors previously arguing that investing responsibly means giving up on returns.

Managers promoting sustainable investing argue that it has moved well beyond screening out companies that are, for example, involved in weapons, tobacco or alcohol.

Katherine Davidson, portfolio manager and global sector specialist at UK-based manager Schroders, told a webinar for Batseta members recently that sustainable investing offers much potential for investors who are able to do it intelligently to earn market-beating returns.

Companies that focus on the long-term wellbeing of their stakeholders, including employees, suppliers, customers, communities, regulators, the environment and shareholders, have been shown to have more persistent returns and profitability, she says.

The investment opportunity arises because most investors in the market do not price these shares efficiently, she says.

Analysts typically take short-term views and few investors take non-financial factors into account — no-one models the improved innovation and lower risk of strikes in companies that treat their staff well, she says.

Investing more sustainably in the green economy need not cost you in investment growth. Picture: 123RF.com Belchonock

What is sustainable investing?

● Responsible investing is a voluntary commitment to integrate environmental, social and governance (ESG) issues into everything you do when you select and hold investments, says Jon Duncan, head of responsible investments at Old Mutual. Sustainable investing is a bit more intentional — it recognises the interplay between financial markets and the social and environmental systems and seeks out returns from activities that do not compromise the needs of future generations, he told an AssetTV ESG masterclass.

If you believe the biggest economic opportunity we are seeing globally is the transition to a green economy — low-carbon, resource-efficient and socially inclusive — sustainable investing will win out, he says.

Investors persistently underestimate these companies but they can deliver above-market returns, she says.

In addition, these companies' share prices are less volatile, Davidson says.

Schroders found that the top 20% of US shares ranked on ESG factors by research specialist Sustainability outperformed the broader S&P500 shares over the first quarter of the year.

According to Lefkovitz, 89% of Morningstar's 57 ESG-screened indices performed better than their broad-market equivalent indices over the past quarter.

Morningstar's ESG-screened indices weight companies in the parent index based on how they manage ESG issues. Some companies, like those manufacturing controversial weapons, are excluded.

Morningstar also found that ESG indices lost less relative to other market benchmarks during downturns over the five years to the end of 2019 and were less volatile. It attributed this to the ESG indices giving more weight to companies that are competitively advantaged and financially healthy.

Locally it is early days for Old Mutual's World Leader ESG Index Fund but it has also outperformed the MSCI world index over the past quarter and since its inception about 18 months ago.

Professional investor website Citywire found in its analysis of seven global managers that in most cases their ESG funds performed better than their non-ESG versions over the three and five years, too.

Francis Marais, head of research at Glacier, says a lot of the research indicates that there is a positive correlation between corporate performance and ESG, but company performance does not always translate into share price performance.

Marais says testing the performance of ESG funds is difficult as funds' performance varies over time, managers have different definitions of ESG, managers who apply ESG well may not necessarily get their analysis of the fundamentals of the company right, or the fund costs may be high.

One thing is for sure: your manager should assess the companies on which they invest on ESG principles, he says.

Marais notes that ESG funds have been very focused on technology companies and quality stocks, which did not perform as badly as the rest of the market over the past quarter.

Many also avoided or down-weighted shares in the energy sector, which typically score poorly on ESG factors and were hit by the oil price crisis, and financial services companies, which were hit by the economic fallout of lockdowns.

But Lefkovitz says energy is a small portion of the overall equity market and an analysis of how the indices performed shows that while sector positioning helped, more of the performance came from the shares that were included.

Davidson says Schroders also found the top 20% of ESG-rated shares in the US outperformed the broader market when sector bias was neutralised.

Marais says for ESG to work for you, you have to have a long time horizon. Despite that he says it is a worthwhile theme, which he thinks will have a positive future.

Davidson says it is very hard to prove empirically that funds with a sustainable focus do not give up on returns because it is hard to quantitively capture a sustainable investment approach.

"We think about good sustainable investing as good fundamental investing — a myriad of factors that influence a portfolio over time rather than something you can independently strip out."

She says the best evidence you will find is in the performance of individual funds like the one she manages.

The US-dollar denominated Schroders ISF Global Sustainable Growth returned 8% a year between its inception in late 2010 and the end of March — more than two percentage points higher than its benchmark MSCI all country world index, according to its fund fact sheet.

Over the past year it returned -2.2% against the index's -11.3%.

Davidson says sustainable portfolios can underperform over the short term when, for example, value shares rally. But beyond these cycles, sustainable companies' stronger relationships with their stakeholders should result in better returns, she says.

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