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Sunny days may last a long time

Seeking alpha

Padma Iyer

The trillion-dollar question for wealth builders is how long the alpha in sustainability-related investments will last.

Alpha is the holy grail of investing. It is the excess return of your portfolio over the wisdom of the crowd, or the average market performance. So high alpha is highly coveted, and investors can never have enough of it.

Since the beginning of the pandemic, sustainability-correlated exchange-traded funds and sectors with a direct or indirect link with the environment, social and governance (ESG) factors (health, clean energy, technology) have had a good run. ESG, in fact, has been the winning horse in the alpha stakes.

A report from the Bank of America says ESG funds globally are growing three times faster than non-ESG funds.

"ESG has been one of the fastest-growing segments in the world and every study indicates that the amount of money going into it is unprecedented," says Bhanu Singh, head of Asia Pacific portfolio management at Dimensional, which manages $800 billion in assets globally, including $45 billion for Australia and New Zealand clients.

"We have been running socially filtered strategies since the 1980s for various clients, covering things like tobacco or alcohol exclusions or sharia law," says Singh. "For the past 15 years, we've been applying environmental sustainability strategies. Our primary focus is greenhouse gas emissions. We manage to lower emissions intensity exposure for clients in these strategies by about 75 per cent or more."

Industry is rushing to provide new products to whet investor appetite for sustainability-correlated investment vehicles, Singh says. And investors are going into it primarily because they are eager to align their values with their investments, but also because of the high performance of ESG products.

"But there is no simple correlation between lower carbon footprint and high performance," he says.

The market will ensure that alpha opportunities are taken advantage of.

So how long will the ESG trend last?

Customised portfolios will continue to benefit, Singh says. "The trend of incorporating client preferences is here to stay. Customised portfolios are here to stay."

Chris Berkouwer, portfolio manager of Robeco Sustainable Global Stars Equity, agrees about the long-term horizon for sustainability portfolios.

"Historically, sustainability investing mainly focused on companies having proper governance practices," Berkouwer says. "However, over time environmental concerns and, on the back of the COVID-19 crisis, social issues too, really cemented ESG as a core part of investment decision-making. We believe this tipping point in favour of ESG investing has sufficient stickiness to enjoy a long-term tailwind.

"Recently, much of the debate has been whether doing good equals losing money, as if there is a natural trade-off between the two," he says. "Interestingly, the short answer is no. In fact, there is a growing body of academic evidence suggesting a positive relationship between sustainability investing and financial performance. ESG has evolved from being a force only protecting against downside risk to one that also drives excess performance, or alpha. For example, global ESG funds have outperformed category peers on a three-, five- and 10-year basis, according to Morningstar."

ESG is widely believed to be in its early stages. How ESG thinking affects individual businesses is yet to be seen.

Investors should be watching how businesses position themselves, says Pablo Berrutti, a senior investment specialist for Stewart Investors, Sustainable Funds Group. "Over the long run, it is hard to imagine a scenario where sustainability issues become less important," he says.

"Whether driven by consumer demand, regulation, environmental constraints or technology, these shifts are structural in nature. However, in our view, rather than treating it as a theme, we believe the best way to find opportunities is by understanding how companies are positioned for these changes from the bottom up."

American Century Investments chief investment officer Victor Zhang would like to see ESG issues as important inputs into fundamental analysis – the evaluation of intrinsic asset values to determine the factors behind their future prices – to reduce risk and accentuate upside potential. "Ultimately, we believe integrating material ESG factors into fundamental analysis contributes to better investment decisions," he says. However, ESG will continue to evolve, with different issues assuming importance.

"Global events in recent years have accelerated the shift in mindset toward sustainable investing – and more specifically in impact investing. Investors increasingly look to align their investments with their values," Zhang says. "These impact investments can help drive the transition to clean energy, increase access to clean water, provide quality education, improve health and wellbeing, and foster innovative solutions that alleviate poverty or inequality.

"We have seen particular demand from clients across regions for investment solutions that address climate change, focused on issues like clean energy and carbon transition. We have also seen interest for products that can create positive social impact, and in response, we have recently launched a healthcare impact strategy in Australia that addresses issues such as access to medicine and innovative treatments for diseases."

Dugald Higgins, head of responsible investment and real assets at Zenith Investment Partners, makes a distinction between investing in exchange-traded funds, and active management of investment portfolios.

"For ETFs, utilising an index with a defined set of rules gives clarity on which securities are included or excluded," he says. "In addition, ETFs' daily disclosure of all portfolio holdings means investors can see exactly what's held by the ETF at any point in time.

"However, lack of regulatory disclosure and uniformity means ESG data isn't always robust or comparable and can also suffer from lags, creating potential challenges for indexing," Higgins says. "It also typically measures current activities, not transitional activity. For investors seeking to have a more material impact, select active managers more likely to result in greater real-world impact." AFR

Clean energy investments are increasing (above left). Top: Pablo Berrutti, of Stewart Investors, Sustainable Funds Group. Above: Victor Zhang, of American Century Investments. Below: Bhanu Singh of Dimensional.

Industry insight

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Investors are looking to feel and do good with their investments. In Australia, the asset flows in sustainable funds increased 66 per cent in 2021 over 2020.

In 2020, ETFs attracted a record $20 billion from investors looking to conveniently access baskets of securities with one trade. Tying this together are ethical ETFs, offering well-intentioned investors a convenient way of accessing ethical investments.

But are they getting what they signed up for? Greenwashing has become a popular term and unfortunately, an oft-discovered occurrence with ethical funds.

It refers to professionally managed investments, like ETFs, that are doing something different to what they claim on the box — calling themselves out as sustainable to reel in investors, but actually signing deals with a coal baron who has a cigarette in one hand, and an armament in another.

Let's take a look at the largest sustainable ETF in Australia and see if they pass the test according to Morningstar's sustainability metrics. When we look at sustainability, we look at the ESG ratings of all the underlying holdings, and then take a holistic view of the fund. Although this is a point-in-time snapshot, it's a litmus test for whether they are staying true to their word.

Betashares Global Sustainability Leaders ETF (ASX: ETHI) sits at the top of the pile when we look at size, with a bronze medallist rating from our analysts. Our analysts give ratings from negative to bronze, silver and gold based on their belief in the fund's ability to outperform their benchmark over the long term.

Looking at the underlying assets, the ETF is overweight technology, financial services and healthcare and differs from the MSCI world index by around 85 per cent.

This makes sense — entire sectors have been excluded, including fossil fuels, gambling, tobacco and armaments. Using these criteria, the investable universe is brought down to just over 200 securities from 6000. We give it a five globe sustainability rating — the highest on our scale, and we believe that it is delivering on its ESG premise.

So our analysts think ETHI passes the sustainability test — but does it pass the investor test? Ultimately, we invest to reach financial goals, and financial goals require returns.

A common misconception is that if you are delivering on your ESG premise, the price you pay is through performance. In a study done by Sustainalytics (ESG Better Minus Worse), now a Morningstar company, we took the 10-year period between 2009 and 2019 and created a hypothetical portfolio of global stocks.

These stocks were divided up into three groups based on our ESG scoring methodology that looked at a number of environmental, social and governance factors. The top-rated category came in at .76 per cent monthly return, the middle at .78 per cent and the lowest at .75 per cent, indicating that investing using ESG factors has not hurt investor returns.

We believe that over the long-term, companies with sustainable competitive advantage — or a moat — can protect and grow their earnings.

ETHI has a higher weighting towards these companies than the benchmark — 43 per cent of the fund is invested in companies with a wide moat (businesses that our analysts believe can out-earn their costs of capital over the next two decades).

Although not an indicator of future performance, investing in high-quality companies has served ETHI well in the past — outperforming the Morningstar Global ex-Aus Index on a one-year, three-year and since-inception basis.

And so that's all impressive — but is ETHI in good company?

When I look at our coverage and the active funds that have been awarded a medallist rating by our analysts and also have a five-globe sustainability rating, it is in unexpected company.

When we look at sustainability, we look at the ESG ratings of all the underlying holdings, and then take a holistic view of the fund.

ETHI is the only fund that is marketed as an ESG investment.

The rest? Property and infrastructure funds. There are three funds that join ETHI: Vanguard Australian property securities (ASX:VAP), SPDR S&P ASX 200 Listed Property (ASX:SLF) and VanEck Australian Property (ASX:MVA).

These funds are invested 98-100 per cent in real estate, a sector that for the most part, stays within the bounds of what would classify as an ESG investment across the board.

We spoke about greenwashing before, but this is almost the opposite. No marketing spin or ethical labels to stay true to. Although an investor cannot fill their portfolio with one asset class and call it a day, this is a reminder that in investing, it is important to look past the label.

Investors conscious and concerned about ethical investing do not need to stick to investments that are labelled to attract their funds, instead understand the underlying investments.

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