WARNER MATTHEWS ASSET MANAGEMENT

Warner Matthews Diaries – Third Quarter 2021

Asset Allocation Musings:

It appears as if we are in the final innings of an elaborate cricket match, at times it felt like the end was a mirage. I am of course referring to the Covid pandemic. Much has been written about, spoken about and analysed meticulously over the last 18 months. I for one will be glad when front page headlines return again to more mundane story lines. Enough said, move on and think about what the issues are that will be more pervasive, potentially more damaging and stir up as much fear for the next generation. The pandemic has helped transform the role of Environmental, Social and Governance (ESG) to the front pages and caught the attention of all generations.

In this issue we deal exclusively with the various monikers attached to responsible investing and how we see it through our own investment lens. Coming up with an appropriate song for the Green Revolution was hardly going to challenge this scribe's limited musical memory bank. I thought about the flower-power generation, their free-spirited ways and intuition to treat each other and the planet they lived on with respect. Perhaps they were the forefathers for today's equivalent eco-warriors? In the end, I selected a song I heard on the radio recently, Joni Mitchell's Big Yellow Taxi, whose undertones touched on the growing tentacles of city life that were blighting the natural settings around it.

From Backwater to Front of Mind – the ESG Revolution – a potted history

The concept of ESG investing has its origins rooted back to the 1800s when religious groups such as the Quakers and Methodists established set guidelines for how their members should invest. Fast forward to the 1960s at a time of expansion in the mutual fund industry, investment managers started to reflect the growing awareness of the social issues of the day such as civil rights. In the 1970s onwards, a new breed of investor, activist by name, began to appreciate their role (as shareholders) to influence board decisions in the companies they invested in. This included putting pressure on companies that invested in places like South Africa that had introduced apartheid. From the 1980s to this day, environmental issues have hit the headlines, from oil spills in the Gulf of Mexico, to the deforestation of the Amazon rainforest and other man-made disasters. This was the precursor to global warming and climate change and the way investors began to look at the causes and search for solutions. Fast forward to the new millennium and the global financial crisis of 2008/09. This episode revealed how interconnected the world had become and questioned the environmental benefits of globalisation. Finally, bringing us to the present, the Covid-19 pandemic and the digital transformation, which optically looks better for the world we live in, but casts a darker cloud over the influence the new digital behemoths possess and their practices.

How to navigate the options

Every year appears to create a new investment fad within the ESG space. There are no universally agreed definitions so the interpretation by fund managers can be blurred. If you are finding it as hard to keep up as we are, here is a precis of what's out there and what the nuances are. As you will see there's a degree of overlap:
Socially Responsible Investing (SRI): regarded as the original green innovator funds, managers focused on ethical, moral and value based criteria. Funds often excluded sin industries (tobacco, weapons, gambling). Managers tended to use shareholder engagement as a technique to promote dialogue and persuade companies to improve practices.
ESG: often viewed as the one size fits all, the data from the three subsets are often analysed using traditional financial metrics to understand the risks and opportunities a company faces. Some funds apply ESG factors once "offensive" industries have been excluded. Some focus on best in class ESG scores in each industry, including best in worst categories.
Impact Investing: historically used to refer to private investments in companies with environmental or social good embedded in the mission of the company. Now used more broadly by fund managers to generate financial returns but whose intention is to invest in companies that do good.
Environmental/Green: another broad term to refer to investments with an environmental focus, often incorporating levels of "green" depending on positive and negative screening of the underlying investments. Under this umbrella are funds that screen for carbon emissions / net zero carbon targets / biodiversity and the like.
Ethical: investing in a manner which reflects the ethics or values of an investor, it is a similar philosophy to SRI and Impact Investing.

Looking for Authenticity in a Growing Market

From its humble origins when The Global Reporting Initiative was introduced in 1997 to when ESG was first mentioned in 2006 United Nation's Principles for Responsible Investment (PRI), to the United Nations Sustainable Development Goals Framework (SDG), this market is evolving quickly. The cynic in me has always mistrusted the fund management industry's ability to take a "hot" investment fad and tailor it to their needs. The latest set of legislation that was introduced in March (EU Sustainable Finance Disclosure Regulation (SFDR)) should in theory mitigate this criticism. It has introduced a regulatory framework for funds to better understand the ESG status of their underlying investments and will require the fund managers to report on the sustainability characteristics of their investments. This framework then baskets funds into categories (Article 8 = light green, Article 9 = dark green) ranked by their commitment to ESG factors and avoids potential greenwashing risks.

The universe is growing very rapidly, roughly $340bn flowing into ESG funds in the past 2 years according to Emerging Portfolio Fund Research ($1.65trn in total). With a universe so large you need some basic tools to plot the right path. There are attributes we look for in distinguishing whether a fund is a truly dedicated ESG product or one paying lip service to the underlying cause. Firstly, does the manager/team or investment company have a heritage in running ESG funds, if so are the investment professionals running dedicated portfolios. Secondly, do they have an inbuilt team that sits within the team to help research potential investments? We are sceptical when separate teams enforce buy-lists or rely upon 3rd parties to do the fundamental research. Data collation and interpretation is a key component. Thirdly, do they practice what they preach? This can be two distinctive traits; are the individual managers living and breathing what they preach for themselves and do they actively engage with investee companies to create change – this can be more nuanced than just disclosing shareholder voting patterns. Fourthly, be wary of persistent sector and geographic biases that come from ESG scores. Just because Europe scores better than Emerging Markets doesn't mean you should ignore the latter. Ditto technology will score better than oil & gas, but that shouldn't equate to investing only in the leaders in the technology field. Finally, don't discount passive funds/ETFs that won't necessarily have an active "voice" in terms of engagement with underlying holdings. If you are clear about what you want to invest in, there's normally an ETF that is tailored to your requirements.

Amalgamating this into an acronym, we focus on the *5Ps*…philosophy, process, people, price and performance.

Does ESG related investing come at a price?

One the most prominent issues plaguing the industry is whether investing in this space comes at the expense of financial returns. There has been a lot of conjecture over this point in the last 20 years or so and the answer tends to ebb and flow with different market cycles. As always it is open to interpretation, there are different types of fund that don't naturally tie in with an obvious benchmark. Empirical evidence has begun to debunk the myth. Morningstar sampled 745 European ESG funds against their non-ESG peer group and showed that almost 6 out of 10 funds delivered better returns over the last decade. However, the the Covid-19 "years" supported companies that were deemed "quality", namely high profitability and low capital expenditure. ESG characteristics are similar to those in the quality franchise. Add into this the power of momentum investing and you have the perfect storm – a powerful thematic combined with supportive fund flows pushing up prices of those companies that are deemed ESG friendly to the industry. How long will this last no one knows, but ESG investors should be aware of the hidden risks.

View from an Expert

Investors should align themselves to issues that matter to them. They should seek out ESG strategies that assist their priorities with an expectation that returns should not be diluted for their beliefs..

Charlie Thomas CIO of EdenTree Investments.