

ESG: Playing the long game

It's fair to say that it has been a challenging start to the year for ESG investments, coming off from the high of 2020 which saw strong performance and rapid inflows, into what has been one of the most powerful market rotations in recent history. Whilst any amount of underperformance is never desirable, when the potential for future gains is as high as it is for ESG investments, short-term setbacks such as these can be embraced, as we look ahead to the possibility of future rewards.

The market rotation we have described, began towards the end of 2020 following the vaccine news. We began to see a shift away from highly valued growth companies, largely technology stocks, which performed well during the pandemic, in favour of more economically sensitive shares, such as banks, airlines and energy, which are set to benefit the most from an improving global outlook. To put this into context and to highlight how powerful this rotation has been this year, at the time of writing, European bank and energy sectors have risen 20% and 13%, respectively, in little over two months since the start of the year.

The rotation picked up steam this year, as rising expectations for economic growth and inflation sparked

a sharp sell-off in US government debt, which also weighed on the stock market, as higher borrowing costs are typically considered bearish for expensive portions of the equity market because they reduce the value of future cash flows. Inevitably, this had a particularly sharp effect on the COVID winners from last year, which were trading at elevated levels.

So what does all this mean for ESG investments?

ESG funds invest in high quality companies, whose shares are highly valued compared to their earnings, given their strong growth prospects. Coupled with the exclusions of 'sin stocks', which is often the case with ESG funds, this leads to a bias towards sectors such as Technology and Healthcare and away from the more cyclical sectors such as Energy, Financials and Industrials. Therefore, when these sectors, which are naturally underweighted in ESG funds, perform well, as we are currently seeing, it is inevitable that ESG-orientated investments will underperform.

We are seeing a similar story playing with Sharia investments, considered a subset of socially responsible investing. Sharia-compliant funds are governed by the requirements of Sharia law and the principles of the Islamic religion, which means they often incorporate negative screens to exclude the same controversial sectors as ESG funds, which do not adhere to Sharia principles. At the same time, there is a focus on high quality companies with values aligned to ESG criteria. Unsurprisingly, this gives rise to a similar growth bias for Sharia investments and has resulted in a parallel pull back in performance in recent months.

With this said, it is important to remember the value in holding such high quality companies, which was made clear during the market sell-off in February and March last year. Companies with strong balance sheets, sound corporate governance practices and strong management teams proved the most resilient during this period of market stress, and ultimately, were able to withstand one of the toughest years for financial markets. The pandemic highlighted the many dimensions to ESG risk, including financial as well as reputational, which have the potential to cause significant damage to a business if not taken seriously enough.

When we think about the actual sustainability themes that many of these companies are aligned to: decarbonisation, water management, digitalisation, enabling healthier lifestyles and so many more, we see that these are key areas that businesses and institutions more broadly, are paying closer attention to now, more than ever, and that these issues will only move further up their agendas.

Governments and policymakers worldwide are already beginning to place ESG considerations centre stage in their decision-making, helping to guide investors towards cleaner investments. More recently, the UK announced plans to join the green bond market in its Budget, whilst the Bank of England also committed to start buying green bonds. Across the Atlantic, recently elected US President, Joe Biden, highlighted that ESG matters were a priority when immediately after his election, he announced the US would be re-joining the Paris Climate Agreement, as well as putting forward a number of ESG-friendly policies focused on limiting emissions and protecting workers, providing domestic support for electric vehicle production and broad research and development for clean technologies.

The US regulatory authorities are also stepping up and beginning to take action against companies who

are not aligning their businesses to address ESG matters. The US Securities and Exchange Commission (SEC) has created an enforcement unit to hunt for possible misconduct in companies' climate risk and ESG disclosures, which is a huge step forward for the US in catching up to the regulatory bodies in Europe who have already placed several ESG-related requirements on businesses.

It is also easy to see how Sharia investing could also be a beneficiary of these key developments taking place in the ESG space. While both forms of investing were founded on faith-based principles, ESG has come a long way since then, gaining huge traction in the industry in recent years, while Sharia investments have stayed somewhat out of the limelight despite the overlap of the social and environmental issues being addressed. It is becoming more important today for investors to holistically assess the impact of their investments, which is about not just looking at what companies are producing, but also how they are run, including the well-being and welfare of their employees and the wider community, which are all issues addressed through both ESG and Sharia investments.

So for us, it is clear that there is a vast amount of investment opportunity in this key growth area, which is very much here to stay. However, it is also important to understand the natural biases within these investments and to be aware that, just like any other investment theme or style, there may be periods when it is out of favour in the market, as we are currently experiencing. But in our view, and much of the market's for that matter, this period of underperformance will only be temporary.

Whether it will be for another 1 month, 3 months, 6 months or longer, we believe is irrelevant, and should not cause a rush for the exit, but could in fact represent an attractive entry point for investors wanting to increase their sustainable investing exposure. If fund launches are anything to go by, this is also the general consensus of our peers. Fund houses across the board have seen the direction of travel for ESG investing and are quickly realising that they need to have some form of ESG offering in their arsenal if they are to remain competitive.

So for now, it may be a case of holding on tightly and letting the storm clouds pass over, because what lies ahead, in our opinion, is most certainly more bright skies for ESG investing.

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