Sustainable investing: An unstoppable trend

Growing commitment to sustainability is rapidly driving a reallocation of capital among asset owners and investors. BY GENEVIEVE CUA

The Global Sustainable Investor Alliance reports a rise in sustainable assets from US$30 trillion in 2018 to US$35 trillion in 2020. ILLUSTRATION: PIXABAY

INTEREST in sustainable investing has surged in recent years – with good reason. Today, asset owners and investors are likely to heed the environmental and social impacts of their capital, and institutions which advise and invest on clients' behalf are just as vigilant, if not more so.

This is because climate change can no longer be dismissed as a remote threat. Already, extreme weather events are causing extensive damage to livelihoods and lives. Signatories of the Paris Agreement in 2015 vowed to cap the rise in global temperatures to 1.5 deg C, but based on the latest data, far more more drastic action is needed to keep this target within sight.

In the social sphere, issues such as labour policies and income disparity also have a bearing on economic and political risks. Covid-19 in particular has accentuated social issues such as workers' welfare and unequal access to vaccines.

The upshot is that a growing commitment to sustainability is rapidly driving a reallocation of capital among asset owners and investors, who increasingly recognise the power of private capital to drive change. Data from the Global Sustainable Investor Alliance's (GSIA) biennial report records a rise in sustainable assets from US$30 trillion in 2018 to US$35 trillion in 2020.

In the mutual funds space, Morningstar reports steady inflows into funds focused on environmental, social, and governance (ESG) issues, hitting a cumulative US$2.3 trillion in assets as at end-June. The data reflects all funds that claim to have a sustainability objective or use ESG criteria in their security selection.

Large institutions with long-term portfolio objectives such as sovereign wealth and pension funds are increasingly adopting the ESG discipline in investments.

For its part, Prudential, as a life insurer, asset owner and manager, sees itself as a long-term steward of customers' assets. It incorporates ESG factors into investment decisions, alongside traditional financial analyses. Pulse by Prudential, an app with health and wealth components, is part of the group's ESG strategy to raise access to health and financial security.

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Andrew Chen, acting head of investment, Prudential Singapore

Walking the talk

But sustainable investing is by no means limited to institutions. It has a place as well in individuals' long-term retirement portfolios for a number of compelling reasons. One is alignment with investors' values. Younger investors in particular seek to invest sustainably.

Yet another big reason is risk management. Morningstar says in a paper that ESG factors "come down to the bedrock of investing: risk".

It notes: "A company that ignores these risks or commits a misstep could incur significant economic costs that jeopardise its ability to earn long-term, sustainable profits."

Says Andrew Chen, Prudential Singapore's acting head of investment: "How well companies identify, address and mitigate ESG risks or unsustainable practices in many cases can influence their competitive advantage, particularly given the increasing awareness and focus of consumers and governments around the world.

"If a company is viewed to be unwilling to reduce its ESG risks or unsustainability concerns, investors may move capital towards those that are stronger from an ESG perspective. This can add up to material implications for sectors, countries and asset allocation in portfolios."

Regulatory risk also looms large. Major economies have rolled out emissions standards and carbon pricing mechanisms, as well as incentives for energy efficiency.

For asset managers and advisers, greater scrutiny is also being placed on sustainability disclosures in the effort to weed out greenwashing, or the practice of making funds or investments look greener than they actually are.

In Europe, the Sustainable Finance Disclosure Regulation (SFDR) came into effect this year, which will make sustainability reporting mandatory and force asset managers, insurers and pension funds to disclose how they consider ESG risks in their investments. In the US, regulators are mulling sustainability disclosure requirements. And the Monetary Authority of Singapore is to set out expectations for disclosure standards for retail funds that claim to have an ESG objective by 2022.

Mr Chen says there are well establ-ished frameworks to help investors and advisers make investment choices aligned with their sustainability goals. He says the fund categorisation set up under the SFDR is among the most stringent.

Managers can also be differentiated through third-party accreditation for their ESG products, as well as how they convey their ESG strategy. "This can help to distinguish between those who added the ESG consideration as an afterthought from those who have a coherent strategy with ESG as an important factor," he says.

On top of regulatory risk are the reputational and valuation risks arising from heightened shareholder activism and even litigation. The past few months alone have thrown up high-profile cases. In June, a coalition of heavyweight investors with a combined US$17 trillion in assets called on some of the world's highest-impact companies to disclose environmental data.

Shareholder activism has also forced the hands of oil giants Exxon and Chevron, driving them towards greener strategies. Exxon was forced to give up two director seats in a shareholder revolt; and in Chevron's case, a majority of shareholders voted in favour of a proposal for the group to cut carbon emissions.

But quite apart from risk management, the drive towards sustainability also throws up investment opportunities.

Opportunities abound

Climate trends are almost unanimously cited by asset managers as a megatrend set to potentially last decades. This has surfaced myriad opportunities in areas such as renewable energy, energy efficiency and agricultural technology, among many others.

Does ESG deliver outperformance? While debate continues unabated on this, the short-term evidence appears positive. MSCI ESG Research found that the MSCI ACWI ESG indexes finished 2020 at least as well as the parent index, and most outperformed during the slump and rally of 2020. "ESG characteristics played a leading role in outperformance during the slump, rally and the whole year," it said.

It is important to note that the "sustainable" label encompasses a range of approaches. Here are some:

- Negative or exclusionary screening: This comprises the avoidance of sectors such as coal, tobacco and munitions.
- ESG integration: This is defined by GSIA as the explicit and systematic use of ESG factors in financial analyses. Assets invested via this approach grew 43 per cent between 2018 and 2020, to US$25.5 trillion.
- Best-in-class: Selection of investments based on positive ESG performance relative to peers.
- Thematic: Investments based on specific themes or solutions.
- Impact: Investments with intentionality; typically requires measurement and reporting on impacts.

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