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ALL THAT GLITTERS IS NOT SUSTAINABLE

ESG INVESTMENTS HAVE MANY BRIGHT AND POSITIVE ASPECTS BUT THEY'RE ALSO OVERCAST BY SHADOWS THAT COULD TURN INTO RISKS FOR INVESTORS

The lack of agreed standards on the exact definition of environmental, social and governance (ESG) criteria makes it difficult to establish whether this self-styled strategy is really sustainable or, in terms of impact, mere window-dressing.

ESG responsibility certainly contains some undeniable strong points surrounding which, however, there is no lack of risks that should be borne in mind.

ESG: POSITIVE IMPACT ON PERFORMANCE

According to a meta-study of over 200 academic studies, called "Arabesque - From Stockholder to Stakeholder", funds which explicitly include ESG factors in their strategy tend to achieve better long-term performance in risk-weighted terms. For example, 90% of studies on the cost of capital indicate that this is reduced when companies have sound ESG standards. And 80% of studies show that stock price performance is positively influenced by the presence of good sustainability practices.

Some more precise data can be found in a study conducted by Banor Sim with the School of Management of Politecnico di Milano on the relationship between the performance of shares on the Stoxx Europe 600 index and ESG ratings from 2012 to 2017.

"The study shows that companies with a high ESG rating are also more efficient at increasing their sales and improving their operating margin", explains **Angelo Meda**, head of equity at Banor Sim. "This trend translates into overall returns about 16% higher (with similar volatility) than those of less virtuous companies".

In detail, the research shows from that 2012 to 2017 stocks with a high ESG score achieved a cumulative performance of 86.1% (13.2% annualised) compared with 70.9% (11.3%) for portfolios with a low ESG content. As regards yield volatility, however, no significant differences were found. In both cases, the annual standard deviation for performance was just over 11%.

It's worth analysing how the companies were selected. "For the first selection, we applied negative filters by excluding stocks linked to controversial businesses such as weapons production", continues **Meda**. "The study then followed the approach used by Professor George Serafeim of Harvard Business School, which adopts reporting standards for sustainability drawn up by the SASB [Ed's note: Sustainability Accounting Standards Board]. The SASB is a non-profit body that was set up with the aim of providing models to critically evaluate the ESG variables with the biggest impact for each sector of activity. And that's an important factor. Indeed, while a company's financial statements follow certain rules and are therefore standardised, the same can't be said for its ESG reports. There are several methods for drawing up an 'ESG statement'. But, for example, knowing that a bank has a very low environmental impact is not really a discriminant in comparison with another bank, because the second could also have the same relatively neutral impact on the environment", **Meda** points out.

"What's more significant, in this case, is the governance aspect, i.e. the investigation of the way these two banks are managed, their remuneration policies, the percentage of women in the workforce, how they handle disputes with customers. That's why we need to identify the most relevant ESG factors sector by sector: it's useful in enabling us to conduct a more effective analysis".

So Banor SIM advises against applying overly strict selection filters. "The research showed that this has a negative effect on the portfolio's risk/returns ratio, while rewarding companies that take sustainability into consideration has a positive impact", states **Meda**.

RISK LIMITATION AND POSITIVE IMPACT

Another result of the research is that applying ESG criteria when selecting financial instruments produces better results when integrated with other investment strategies. "Notably, over the same period a portfolio in which ESG screening and a basic value criterion such as the price-to-earnings ratio were applied at the same time would have outperformed a portfolio based only on the value criterion or only on the ESG criterion, by about one percentage point a year". This is very significant, because a company's ability to generate profits and cash flow is directly linked to the quality of its business. The sounder the company is, and the harder it would be for the competition to attack it, the better will be the returns on the assets invested and the greater its appeal.

"Therefore, in value investing, evaluating a company doesn't just mean carrying out financial due diligence by analysing its financial statements. It means evaluating the business of the companies in which you're investing, and so fully understanding both their tangible assets (such as buildings, plant and land) and their intangible assets (brand, reputation, customer loyalty, etc.), explains **Meda**. "In conclusion, an ESG analysis is an intrinsic and necessary factor from a value investing perspective. You can't engage in value investing without taking sustainability issues into account".

In the light of the above, in periods of strong market turbulence well-weighted ESG strategies have been shown to be more effective.

Lastly, but no less importantly, the advantages inherent to ESG investments include the possibility of directing your savings towards a sustainable economy that respects the environment, workers rights, and society: to play a part, in short, in ensuring our planet's future. This need is strongly felt by millennials, as witnessed by many surveys. One that stands out was conducted by Nuveen in 2018. It found that 92% of people born between 1980 and 2000 want their investments to be sustainable.

LONG-TERM STABILITY

"We believe that ESG investments can at last help investors, asset managers and individual companies to align their interests with a view to obtaining better portfolios and, in the last analysis, a better world", confirms **Riccardo Ambrosetti**, President of Ambrosetti Am SIM. He sees "expectations of long-term returns that are theoretically more stable and also better in qualitative terms" as being "the main driver of ESG-inspired investment choices".

Fashionability also acts in favour of investors' sensitivity to this type of investment. "A number of studies have shown that today over 60% of investors, both professional and retail, view ESG investments as strategic for their portfolios. And a similar percentage intends to increase the proportion of their investments dedicated to that category", continues **Ambrosetti**. "At the same time, asset managers can offer new investment solutions that are apparently better than previous ones at a time when investors are complaining about low yields and asking for new strategies. These products are very 'of the moment' and attractive: they show investment houses' commitment to building a better world by tapping into the fashion of safeguarding the habitat. They're easy to understand and they promise better results over the long term".

THE RISKS: A CONFUSED MARKET WITH LITTE ACTIVE MANAGEMENT

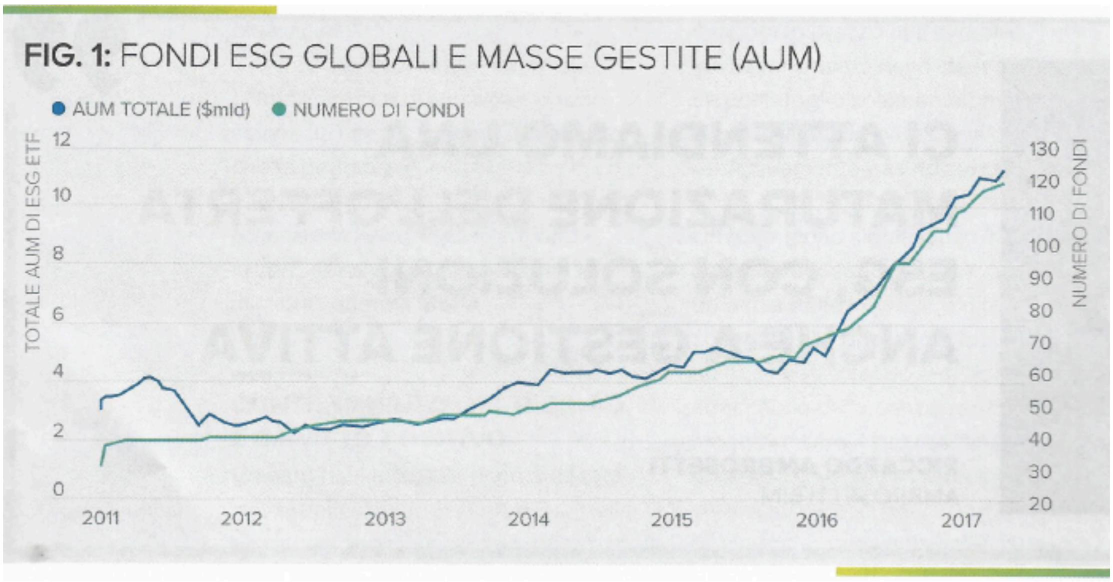
But, as mentioned at the beginning, the numerous positive aspects of sustainability are undoubtedly overshadowed by less positive aspects of the sector, which could turn into risks for investors.

“First”, asserts **Ambrosetti**, “the current offering is populated by long-only products that aren’t structured to actively manage exposure to the cyclical risk of the financial markets. Managers often merely make an initial ESG selection which they then fail to manage in a significantly active manner. So they miss potential opportunities for thematic rotation. Lastly, nearly all of the products on offer fail to adopt systematic approaches to investment decisions and in this they differ markedly from the most modern part of the asset management offering”. But all is not lost. On the contrary. “In practice, we expect the ESG offering to mature. It should consist of a range of solutions, including actively managed, flexible and absolute return, maybe event multi-strategy, solutions, and with a strong component of systematic decision-making. At that point we’ll have a mosaic that’s well-placed to fully satisfy investors’ expectations, and not just in the long term”, continues **Ambrosetti**.

THE RISK OF NOT CHOOSING THE RIGHT STRATEGY

In the meantime, however, there’s a real danger of not choosing the right strategy. This is explained by Mercer, a leading advisory company at the global level in the management of institutional investments. Mercer, which has over 9,000 billion dollars under advisory, monitors the global market of ESG investments and rates strategies on the basis of stewardship and managers’ integration of ESG aspects. “To date” says Luca De Biasi, wealth business leader at Mercer Italia, “we’ve assigned ESG ratings to more than 6,000 investment strategies. Of these, fewer than 15% obtained a high score.

GLOBAL ESG FUNDS AND ASSET UNDER MANAGEMENT



We found the most praiseworthy managers in infrastructure (more than 40% in that asset class have a high rating). In hedge funds, however, we find the lowest interest in sustainability (about 2%). The percentage of ‘good’ investors is higher in the stock market (over 20%) than in the bonds market (about 5%). Overall, most ESG opportunities seem to lie in real assets and in private markets. Infrastructure for clean energy or the cycle of water resources; the agricultural sector, with raw materials linked to energy and food cycles; wood, which could be a value in the transition to a less carbon-intensive economy. Investments of this type are substantially de-correlated from the market of traditional investments and so are able to produce diversification benefits for portfolios", states **De Biasi**.

THE BIGGEST RISK: NON-SUSTAINABILITY

But if we look more closely, the biggest sustainability-related danger is failing to include an ESG approach in portfolios. In the Global Risks Report 2018, presented at the World Economic Forum, the company highlighted the principal global risks. Three of the five most probable (extreme weather conditions, natural disasters and an inadequate response to climate change) and four of the five "highest-impact" risks (water-related crises, in addition to the three just listed) refer to ESG issues", explains De Biasi. He concludes that "maybe the biggest risk linked to ESG issues is to view them as marginal in investment decisions, compared with traditional financial issues. As non-traditional, long-term factors, ESG issues come within the scope of an expansion of the full set of risk factors for financial investments. That means they can be an important element in diversification, thanks to their decorrelation from traditional risk factors".