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NEWTON

Investment Management

A SUSTAINABLE APPROACH TO MULTI-ASSET INVESTING

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Catherine Doyle, investment specialist on our Real Return team, asks **Philip Shucksmith**, co-lead manager of the Newton Sustainable Real Return Fund, to comment on the growing interest in sustainable investing.

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Catherine Doyle: There is a lot of talk about sustainable investing at the moment. Do you think it is genuinely becoming more mainstream?

Philip Shucksmith: Attitudes towards sustainability, and our knowledge and understanding of the environment, have come a long way since the 'save the world' idealist movements of the 1960s. For example, there is now widespread consensus that the rise in global temperatures we are seeing can predominantly be explained by the sharp rise in man-made carbon dioxide and other greenhouse gases in the atmosphere. This understanding was demonstrated by the 2015 Paris Agreement at which 195 countries agreed to an ambitious pact to limit carbon emissions.

Against this backdrop, there are also clear demographic drivers of the rise of sustainable investing. According to research conducted by Morgan Stanley, 86% of millennials (broadly defined as those born between the early 1980s and 2000) say they are interested in socially responsible investing.[1] In the Schroders Global Investor Study 2016, which surveyed 20,000 end investors in 28 countries, the millennial generation ranked environmental, social and governance (ESG) factors as equally important as investment outcomes when considering investment decisions.[2]

CD: What are the big sustainability issues, and how do you integrate such considerations in the investment process?

PS: The most commonly agreed set of issues to address are highlighted by the 17 UN Sustainable Development Goals, which aim to end poverty, protect the planet and promote peace and prosperity. In this context, corruption and bad governance are the root causes of much of the world's poverty and injustice, and are areas that can most readily be addressed by investors. As a bare minimum, we will not invest in any companies that violate the UN Global Compact Principles, which require companies not to engage in unlawful practices such as bribery.

1 https://www.morganstanley.com/ideas/millennial-sustainable-investing
2 http://www.schroders.com/en/media-relations/newsroom/all_news_releases/schroders-global-investor-study-2016-millennials-put-greater-importance-on-esg-factors/

Many of the biggest stock blow-ups have occurred as a result of weak governance, often exhibited by a culture of corrupt practices or a lack of accountability to shareholders in the board structure, which investors have been prepared to overlook because the returns appeared so attractive. Conversely, we believe it stands to reason that companies with honest corporate cultures and strong governance should be all-round better businesses and, in turn, better risk-adjusted investments.

These days, an investor wishing to help protect the planet need not see a trade-off with economic activity. For example, we see the move towards more sustainable forms of energy as creating some very attractive investment opportunities. These include companies which build and operate wind and solar assets, and businesses which build out the transmission infrastructure to modify the grid to adapt to renewable energy. As electric vehicles gain traction, it is possible to gain exposure to their supply chain, through investments in battery and semiconductor manufacturers, as well as chemical companies that supply the lithium used in the batteries.

CD: What are the advantages of an active approach, and can this really be achieved across the multi-asset spectrum?

PS: It is possible to do elements of this passively, such as by deciding to exclude certain companies in the oil & gas sector. However, such an approach can have unintended consequences. For example, certain renewable-energy businesses would officially be classified as oil & gas companies because of their legacy assets. However, investments in one such company have enabled it to build one of the largest offshore wind portfolios in the world. A passive approach, which would naturally be biased more towards historic data, may miss out on such a forward-looking opportunity.

It is possible to invest sustainably across the multi-asset spectrum by ensuring that analysts carefully research sustainable factors. In European corporate debt, for instance, a high proportion of sub-investment-grade companies are privately owned, meaning there is often limited public disclosure. In many cases, these may be small companies that are doing all the right things but have not put resources into producing a glossy sustainability brochure. A passive approach would immediately discount this type of investment, although it is likely that companies will improve their sustainability data over time.

CD: Do you have to sacrifice some performance in order to satisfy sustainable criteria?

PS: In short, we would argue that the answer is no. Since the 1970s, academics and investors have published over 2,000 separate studies looking at the relationship between ESG criteria and corporate financial performance. In 2015, a meta-study was published, combining the findings of these previous studies.[3] The aggregated evidence makes a strong case for sustainable investing by highlighting how a large majority of the studies have shown positive financial effects of positive ESG credentials, and that the ESG impact on financial performance appears stable over time.

Taking oil as an example, it is certainly true that there have been periods when investors have made a lot of money from the sector. However, viewed from a multi-decade perspective, oil companies have generated very average returns on invested capital, and research suggests that excluding fossil fuels from a portfolio has had little impact on overall returns over the long term.[4] Conversely, the businesses that have been able to generate supernormal profits over sustained periods of time have been those with sustainable competitive advantages.

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

3 ESG and Financial Performance: Aggregated evidence from more than 2,000 empirical studies, Journal of Sustainable Finance & Investment (Friede, Busch & Bassen), 2015
4 The impact of ethical investing on returns, volatility and income (Zhang and Li, Warwick Business School), 2016

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