What is the cost for doing good?

In challenging environments, the choices we make matter both to ourselves and to the wider world.

Sustainability is an increasingly important theme for both investors and companies. Across the globe, firms are expected to adopt and demonstrate more socially responsible behaviour, and investors are increasingly keen for their financial assets to have a positive impact on our society and environment.

Whilst this theme has featured widely in the media of late, Partners Wealth Management has been researching the subject for several years. As an independent advisory practice, able to access the whole sustainable investment universe, we can help clients understand the options and reach their ideal solution.

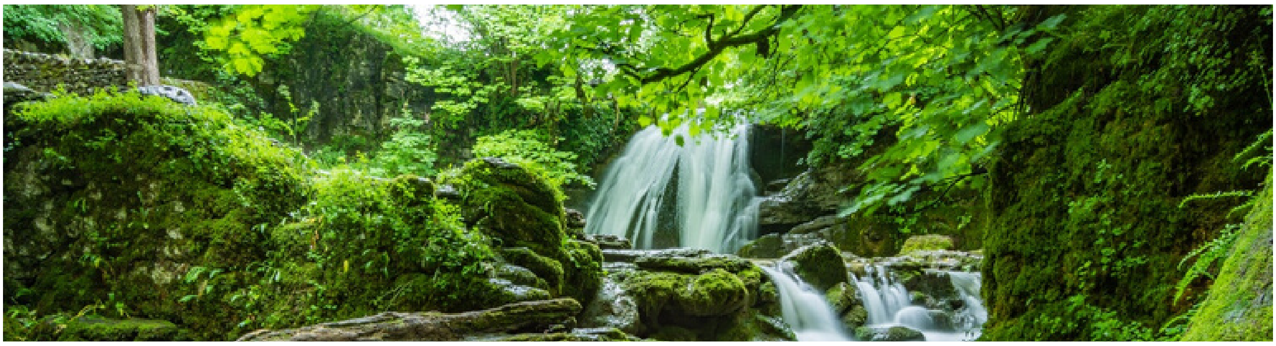
We found that whilst many clients wanted exposure to the market, they felt under-equipped to step onto a sustainable investment path. Our analysis showed that several key questions consistently needed addressing for clients to take the first step. One of the practical issues that concerns many clients is the relative performance of these sustainable portfolios. In short, what is the cost for doing good?

What has become clear anecdotally and summarised in “Sustainable Reality, Analyzing Risk and Returns of Sustainable funds” (Morgan Stanley, 2019) was that *“there was no financial trade-off in returns of sustainable funds and that they demonstrate lower downside risk”*. There are several factors for this which will be covered in this article but between 2017 - 2019 the price of doing good was not a cost at all but in reality, a rebate. Not bad. For reference, the report was published in the summer of 2019, five months before the COVID-19 pandemic began.

What goes up, must come down?

That was all well and good but how would these portfolios perform in a bear market? Sustainable equities tend to be (although not exclusively) growth stocks which typically do better in bull markets. This, coupled with the more global nature of sustainable stocks and the associated currency risk, could lead to increased downside volatility.

The nature of COVID-19 has been unprecedented both economically and for financial markets. It has been atypical both in the steepness of the decline and the effect it has had on various sectors of the economy.



To gain better insight into how sustainable investments have reacted to such challenging market conditions, we spoke to four Discretionary Investment Managers who run both sustainable and standard investment portfolios. Each investment house has a unique investment philosophy which it applies to both its sustainable and standard portfolios. In each case we found that their sustainable portfolios had out-performed both in the downturn and also over the last 12 months (data to 31 March 2020).

Some of these factors were obvious, *"The inherent underweight exposure to the traditional energy sector and energy servicing companies has benefitted relative returns since the start of the year as energy companies have been impacted by the fall in oil prices",* (Ben Palmer, Brooks Macdonald). The huge falls in the price of oil were not only a function of a severely contracting demand but also the Russia-Saudi oil price war, (currently resolved with a 10% cut in oil production) and one other factor, storage. *"I think the dramatic moves we have seen in the oil price have been primarily driven by the demand shock and fears around a lack of storage,"* (Ben Matthews, Heartwood Investment Management)

This time, in this recession it may not be the case that those sectors which have fallen furthest will recover most quickly. The energy sector is going through a transition to low-carbon and oversupply. This, coupled with peak storage, may well mean that a material recovery in prices may take a considerable amount of time. Oil companies are undeniably part of the problem in addressing climate change. But the reality is that these companies will also need to be part of the solution.

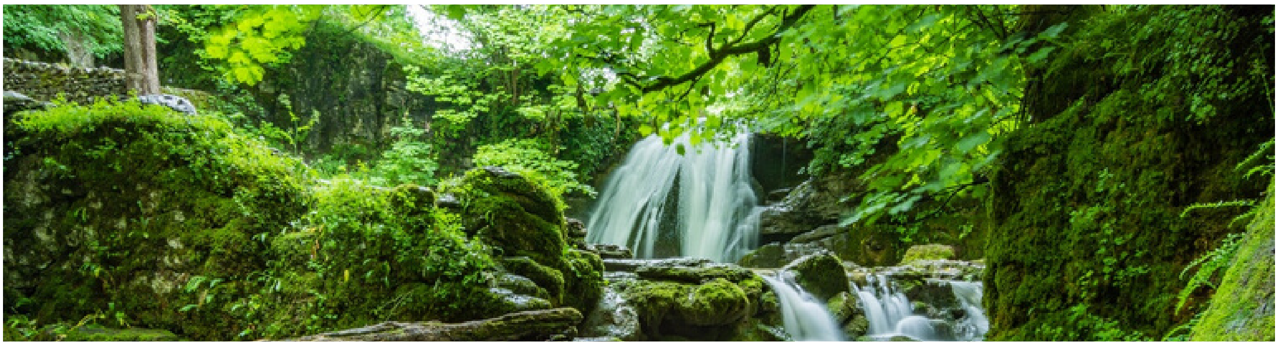
"Looking to the medium to long term, there is the usual noise of the adverse impact of a cheaper oil price on the outlook for renewables and the shift to a lower carbon global economy. There is no doubt that the oil and gas sector have a role to play in the energy transition and it will be interesting to see if the commitment and intentionality that had been displayed before this crisis is upheld. But two factors that are strongly in favour as to why a cheaper oil price will not materially impact renewables, is that non-renewable energy projects will offer much lower returns with a distressed oil price, as well as oil companies being left with stranded assets in the future.

Secondly, the extreme volatility in the oil price that we have seen this year, but also in 2015, illustrates the need for energy production to be diversified and shift to a more stable solution, which renewable energy supplies." (Mike Meyers, Psigma Investment Management)

Do no wrong

The inherent avoidance of sectors that have been particularly hard hit during the COVID-19 pandemic is one factor for sustainable portfolios out performance, but it is not the whole story.

Sustainable portfolios place a greater emphasis on ESG (Environmental Social and Governance) factors when selecting companies. Environmental, energy use, pollution, compliance with government environmental regulation. Social, looks at the company's



business relationships, both with suppliers and employees and the local community. COVID-19 has brought into sharp focus the quality of these relationships for all business owners and employees. The post COVID-19 business world will be partly defined by how we treated each other. Governance looks at how well a company is run, how transparent it is and how agile. Clearly more agile companies have been able to pivot and deal with COVID-19 better.

“We have long argued that sustainable companies should have lower declines due to lower incidence of controversies and occupational mishaps; greater loyalty from customers, employees and even shareholders; and often more conservative balance sheets. And, though the opportunity to test these hypotheses has been unfortunate, the evidence so far seems encouraging”. (Ula Caroto, Cazenove Capital)

“During the current pandemic, investors have concentrated on balance sheet strength, robust business models and adaptability. These characteristics are strongly aligned to businesses that show strong ESG characteristics which is a core focus of the Responsible Investment portfolios”. (Ben Palmer)

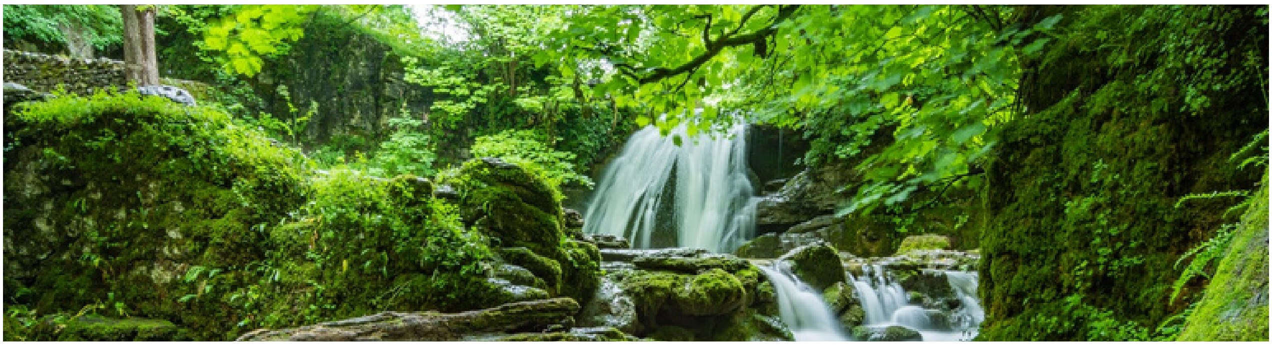
“Clearly ESG and Sustainability is becoming a growing dynamic in market performance as more money transitions to ESG/Sustainable mandates. This will be supportive of companies that are well positioned to deal with future environmental challenges, as well as those that are contributing positively to society supported by strong corporate governance”. (Ben Matthews)

What goes down, must come up?

Sectors avoided by sustainable portfolios have been particularly hard hit during the pandemic, whilst sectors favoured by sustainable portfolios such as healthcare and technology have done relatively well. The shape of the recovery and which sectors will fare best is of course still unknown, however, COVID-19 has given us all an opportunity to reflect and the time to consider what *‘new normal’* we would like to have.

"We feel that sustainability funds look for companies which have strong relationships with all stakeholders i.e. employees, suppliers, environment, regulators and communities, and thus, should thrive in a post-COVID world when stakeholders will look favourably on those companies that stood by them in a time of crisis. Most of us agree, the post-COVID world will be very different to the one we are used to. And, since sustainable investing is also about identifying future themes and companies with sustainable business models, arguably, sustainable fund managers are best placed to recognise the changes the world is going through and to take advantage of from an investment standpoint." (Ula Caroto)

“We believe the longer term structural growth drivers for sustainability will remain in place and there is an opportunity for global governments to leverage their economic recovery programmes into the sustainability agenda, as recently outlined by the EU”. (Ben Palmer)



"Firstly consumer preferences have shifted and continue to shift meaningfully – society is more engaged with environmental issues than in the past. Secondly government policy globally has been taking note of this, as well as scientific evidence around climate change, and are implementing policies to promote green energy production and drive economies towards carbon neutral (Paris Treaty Agreement)". (Ben Matthews)

A final thought

The nature of COVID-19 has provoked a massive political, societal and economic change over a short period of time. At the time of writing, according to the World Health Organisation (WHO), the global death toll from the disease is over 300,000 and globally countries have provided over $4 trillion of economic stimulus. That equates to ten times more than global expenditure on climate change which WHO estimates will kill 250,000 annually between 2030 and 2050. This, in turn, begs the question. What is the cost for not doing good?

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