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Is your ESG capital at extra risk?

Many ESG funds have performed remarkably well this year. This achievement has increased awareness about the role investments can play in combatting climate change and protecting biodiversity. However, investors should be mindful that there can be more risk to some ESG funds than meets the eye.

Interest in the sector persisted even at the peak of pandemic volatility, with net inflows into ESG funds of $71.1bn worldwide between April and June. There are, of course, many sustainable funds – from actively managed impact funds to passive trackers. But it is worth looking more closely at what has driven their strong performance.

Earlier in the year, sceptics might have highlighted the absence of oil and gas stocks. Now they are pointing at another factor – the part played by big tech.

Rise of big tech

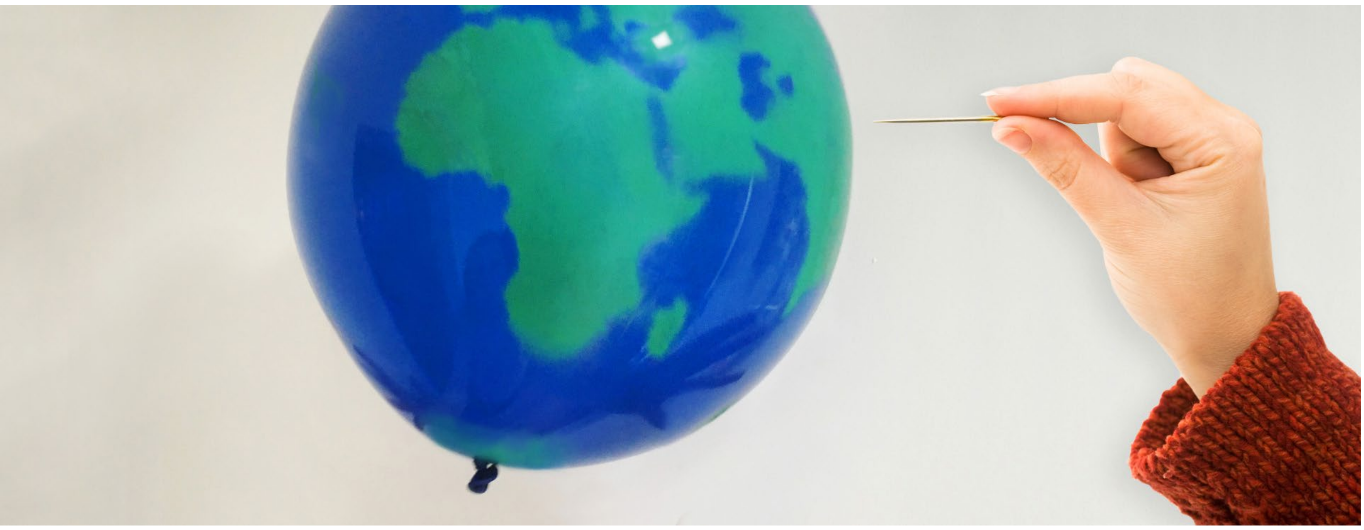
A recent Bank of America Global Fund Manager Survey showed 80% of respondents believed being long US tech was the most crowded trade of all time. This crowding can be exacerbated further in ESG funds as the jaws widen between investment in large and small-cap stocks.

ESG disclosure tends to be greater in larger companies (and especially tech), funnelling some ESG funds towards the large-cap end of their investible universe, exposing them to concentration risk. Enhanced corporate disclosure can also see funds forced to tilt towards the US and Europe, leaving them underweight Asia and Emerging Markets.

We have all watched in awe at the rise of Tesla – as shares surged nearly 500% this year to the beginning of September, leaving the company worth more than twice as much as Toyota ¬– at Apple surpassing the FTSE 100 in size or even at Snowflake's recent IPO, which saw shares soar over 160% on their trading debut.

The success of many ESG funds is not disaggregated from the staggering ascent of tech. A glance at some of the most successful active ESG funds across the market shows many powered by the same few names – Amazon, Apple, Adobe, Alphabet, Microsoft. These companies have been able to demonstrate strong management of ESG risks and opportunities. And, fortuitously, they have exhibited a level of immunity to Covid-19, entrenching their competitive positioning.

Is the alpha that your chosen ESG fund has generated a reflection of the significant flows into this one part of the market? What happens if recent trends reverse, if a



vaccine or antiviral is developed and a semblance of normality returns to our lives? The often-perceived diversification benefits of ESG funds can lead to an unintentional doubling up of risk.

Quality of research

If there are issues about the breadth of portfolios, there are concerns, too, about the breadth of research.

The 'E' of ESG can often be easier to achieve for less capital-intensive big tech businesses. Their bulging balance sheets allow for well-publicised carbon-offsetting and sustainable investment initiatives. This can boost their overall ESG ratings, but a good manager should look beneath the headline scores. Poor governance and stakeholder management can lead to significant costs and reputational harm, which should be weighed up alongside any environmental upside. Wirecard's recent scandal highlights these complex issues and exemplifies the need for engagement and thorough due diligence. The company had been given a median overall ESG rating by some of the most widely used ESG and risk data providers and was owned by some ESG funds, despite some well-flagged governance issues.

Why ESG matters

The penalty for companies failing to meet ESG criteria is rising – they face additional regulatory burdens, higher costs of capital and reduced investor interest. The ESG hurdles are getting higher, too. The UK has committed to carbon neutrality by 2050. Comprehensive change will be required. A truly sustainable business recognises the major long-term threats to its continued success and develops a credible plan to address them. Good ESG analysis must therefore be central to the evaluation of businesses.

Choose carefully

As ESG becomes ubiquitous in mainstream investing, the concern is that the specialist funds that have done so well this year will lose their edge. Research suggests nearly 40% of institutional investors now incorporate ESG into their investment process – over twice as many as last year. Morningstar noted 125 new sustainable funds were launched worldwide in Q2 2020 alone. These new funds add to a number of repackaged traditional funds to create an increasingly wide choice.

For those tasked with recommending funds the job is becoming harder. These funds should be assessed carefully to ensure investors obtain the outcome they desire, without unintended exposure to undesired risks – whether that is from under-diversification or insufficient research.

Another approach to adding ESG funds to a conventional portfolio is to choose an investment manager that has embedded ESG analysis into their core investment process. This is the approach that we have taken at JH&P as we believe it allows us to ensure all of the investments we make are in firms whose business models are sustainable.

To discuss our approach of building diverse portfolios around directly held, carefully researched sustainable businesses, call Chris Macklin on 020 3817 3401 or email CMacklin@jameshambro.com.