FEEL-GOOD FUNDS HOLD THEIR OWN

Investment Environmental, social and corporate governance fund management strategies are more than a marketing tool, writes **William McInnes**.

Clockwise from top: Matt Nacard and Nathan Parkin believe ESG doesn't mean sacrificing returns; Tom Culver says people using ESG need to make sure they're doing it for the right reasons; Christopher Cuesta says his strong returns have been largely due in part to ESG considerations.
PHOTOS: NIC WALKER, CHRISTOPHER PEARCE, JAMES BRICKWOOD

It's the ultimate feel-good investment, a fund that eschews tobacco, coal, alcohol, gambling, firearms and big pharma.

Supporters say these funds are making the world a better place but critics believe that ESG (environmental, social and corporate governance) is little more than the latest sophisticated money-making marketing tool.

"To us it's about buying everyday companies that do things well," says Ethical Partners Funds Management chief executive Matt Nacard. "Most companies have the opportunity to improve things in terms of sustainability, supply-chain knowledge, and how they conduct their business. If they do that well, we think they can perform well too."

The data appears to support a view of outperformance for ESG-focused funds. A study in February of Morningstar's 56 unique ESG-screened indexes found that 73 per cent (41 of 56) have outperformed non-ESG equivalents since inception.

"Morningstar's ESG-screened indexes have generally outperformed their mainstream counterparts," study author Dan Lefkovitz said. "They also exhibit superior exposure to measures of quality, financial health, and volatility – factors linked to a positive long-term investor experience."

The study's results were consistent with a range of other studies from previous years that found sustainable investing didn't hurt returns and that the filters tended to find companies with increased quality. "I think long term it just makes sense," says Hamilton Wealth Management managing partner Will Hamilton. "If those boxes are ticked you should be able to get superior returns."

THB Asset Management chief executive Christopher Cuesta says his strong returns have been largely due in part to ESG considerations. "Do ESG considerations add value to investment returns? It will take many years of scrubbing numbers to calculate an exact figure, and even then I assume the data will still be ambiguous," he says. "I personally believe that consideration of ESG factors does add value to investment returns.

"At THB, we believe there is a very high correlation between high-quality companies, good corporate citizenship and long-term shareholder value creation."

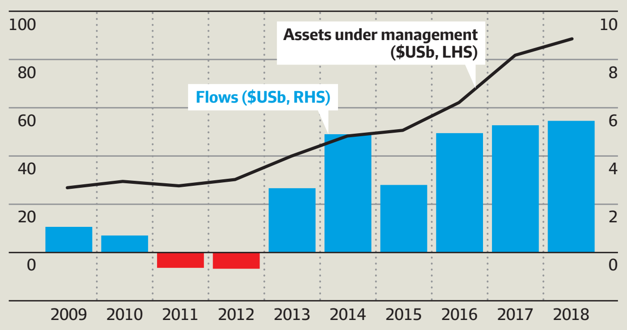
The money flowing into ESG-focused and sustainable funds in the past few years has been rising. Even last year, as the market fell, a record amount of capital was injected into sustainable funds, according to a report by Morningstar. "It is investor-led and the fund managers are having to respond to the demand on the ground," Hamilton says.

"The problem domestically is we're really lagging. When I was in the UK talking to fund managers, it is so topical over there. We're lagging but just wait for it because we'll get a similar wave [of demand]."

The wave of demand has also created sceptics, however – some investors believe investment firms aren't necessarily riding the ESG wave for all the right reasons.

A decade of growth

Sustainable fund flows*



*As at Dec 31, 2018. SOURCE: MORNINGSTAR

Speaking at the Portfolio Construction Forum market summit in February, London-based LGM Investments chief investment officer Thomas Vester said many fund managers were just taking advantage. "Wall Street, City of London, we're all talking ESG and it's not because we've become saved overnight and want to save the world," he said.

"It's because it's where the assets are flowing in, it's where you can increase your margin a bit and it's because maybe there are a lot of managers with bad track records that see a chance to get a new one."

He said that, while ESG was a positive, he believed clients needed to ensure managers were using it properly. "Don't get me wrong, I'm all for it, but I think that with ESG it will have to be much more about allocating in the right way," he says. "I think it's wonderful that it's here but let's raise the bar."

Goodments chief executive Tom Culver echoed Vester's thoughts on the approach of some funds to ESG investing.

"I do think a lot of companies are looking more at the bottom line," he says. "People are recognising there's a generational shift, but are these players getting involved for the right reasons?"

ESG can be used as more than a marketing tool, however, with many pointing to its value in weeding out dodgy companies.

"We think ESG generally is a good risk filter. Not many people are thinking about it that way but we do," says Ethical Partners investment director Nathan Parkin.

"We're a bottom-up stock picker so we're interested in how companies are running their business."

Yarra Capital Management's head of Australian equities research, Katie Hudson, says looking at a company's ESG can help avoid betting on the "blow-ups".

"For fund managers focused on the long term and prepared to research these potential risks, the rewards are apparent over time," she says. "Not only can this process add significant value to portfolios – by highlighting likely winners – it also helps to identify risks that might not become apparent until disaster strikes. Avoiding blow-ups becomes much more likely."

Ethical Partners' Parkin says he is always trying to find companies that satisfied ethical filters. "Companies that are thoughtful about how they do business should have enduring franchises," he says.

"Companies like Orora are particularly strong across all the areas. Dulux are likewise very strong and ahead of the curve in terms of reporting and standards and also Bega Cheese." SI

Beware all those great market stories when investing

Portfolio

Giselle Roux

The investment world is replete with great stories. Fund managers, brokers and online channels all have nicely worded and often convincing tales on the merits or otherwise of individual companies.

Inevitably there is an agenda behind the presentation. That is, the writer represents their view based on why they are holding, or not holding, a security. By default, it is rarely an unemotive, independent, assessment though one does not doubt the inherent belief.

When hearing counterarguments, it gets more useful. The current investment opinion appears to be increasingly divided on the broader outlook.

A starting base is global economic growth. While the measured correlation of gross domestic product growth and equity market momentum is low, corporate earnings inevitably have varying degrees of attachment to economic cycles.

Even if a fund manager suggests it selects stocks with no reference to this cycle, the holdings will usually paint enough of a picture to judge their attitude on expected conditions. Anticipate, therefore, that any stock story is framed with a particular outlook in mind.

The second factor is the valuation of overall regions or sectors of the global equity market.

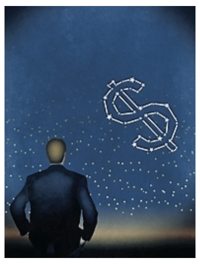
The mantra for some years has been the US is expensive with respect to history and relative to other regions. That has done little for any manager skewed away from the US given the persistent outperformance of the S&P500.

The argument rests on the determinants of this US equity cycle – a juicy combination of "disruptor" companies, corporate tax cuts, buybacks and credit growth. Expect those overweight the US to stick with this backdrop and hardly likely to make a case for other regions.

Similarly, sectors such as financials or energy tend to get a short shift based on an entrenched view on interest rates, policy and variable oil prices. Digging up a counter case to these positions can raise issues that otherwise don't see the light of day.

As the plot unfolds, the global conditions and regional valuations are expressed in stock examples, and the most interesting ones sit on the extremes of opinion.

One category bound to attract attention are the very high price to earnings equities, some with a patchy track record of an accounting profit and negative cash flow. In this bucket are companies such as Netflix or Tesla, along with a host of lesser known names.



Colourful storylines on stocks are highly digestible but should not be the basis on which to allocate investment assets. ILLUSTRATION: KARL HILZINGER

In these cases, it can truly be the story that has to support the attitude to this investment, given there is little by way of historical data or the current financials to underpin the case. It might start with sizing up the addressable market.

For example, is the group aiming at a local or global footprint? Which current service or product is it disrupting and are those participants neglecting to adapt their business model?

Each requires a stab at a forecast that inevitably is a set of "what if?" assumptions. Then imagine how they will charge for these services and what costs will be incurred.

The tale has not come to an end – what capital will be required to achieve the company's ambitions? How will it fund its expansion? Will that include dilutive equity at some stage?

Rather obviously, there are many potential scenarios that could emerge, with the investor focusing on their opinion of the most likely outcome. It goes without saying that a credible scenario can be construed on both the buy and sell side for these companies.

Another category is a less exciting, but apparently predictable, group. Staid consumer brands may be slow growth, and detractors will prognosticate on their long-term demise given changes to consumption patterns.

That has not yet proven to be a universal cause for concern, as some have been adept at refreshing brands and reducing costs. Recently Kraft-Heinz muddied the water with an unexpected hit from accounting irregularities, flat revenues, goodwill impairment and a cut in the dividend. No less an investment guru as Warren Buffett was caught on the wrong side of this trade.

High-profile fund managers can be given a status that encourages investors to believe they are infallible. Every investment philosophy has limitations and blind spots.

Confirmation bias, where one only listens to supportive opinion on already entrenched views, is one of the inherent dangers in investment markets.

Colourful storylines on stocks are highly digestible but should not be the basis on which to allocate investment assets. SI

Giselle Roux is chief investment officer at Escala Partners.