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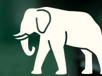

Stewart Investors
Sustainable Funds Group

Active versus passive investment in achieving sustainable development

Growing investor concerns about climate and societal crises have contributed to the burgeoning demand for 'sustainable investment' funds that take into consideration environmental, social and governance (ESG) factors. According to Morningstar, sustainability funds attracted USD20.6 billion[1] of new assets globally in 2019, almost four times higher than the previous year. This should be a positive development, as more capital should, in theory, be channelled into helping resolve some of the world's greatest challenges. However, this may not necessarily be the case as not all sustainability funds are created equal.

The biggest differences occur between active and passive funds, and more specifically, in how they assess ESG factors, and how they engage with companies. Passive investing typically uses quantitative ESG data, procured from third-party providers, to either exclude companies or tilt a portfolio towards more 'sustainable' companies, or a mixture of both. Active investment involves picking individual stocks and bonds based on an assessment of their underlying fundamentals, and either uses qualitative or quantitative ESG analysis, or often both.

Many questions remain about the validity of ESG metrics, including a lack of standardisation in the data, and the overall scoring methods being used. For example, in 2018 three well-known and highly regarded services came up with completely different ratings for Tesla on ESG issues. FTSE rated Tesla as the worst car maker globally based on its metrics, MSCI ranked it the best and Sustainalytics was roughly in the middle. Moreover, it is common to find that the top-rated businesses on ESG issues also tend to be larger, developed market companies, suggesting the data is skewed to large capitalisation firms that have more formalised policies and more transparent disclosure.

Using quantitative ESG data can be beneficial in some circumstances, but placing too much emphasis on 'ESG by numbers' can be a risky strategy. It also is unlikely to fulfil the desired outcome of shifting capital toward more productive purposes. A quick glance at the constituents of the Dow Jones Sustainability World Index, BlackRock iShares ESG ETFs or the FTSE4Good Index, reveals the familiar names of Apple, Google's parent Alphabet, and Bank of America. These businesses offer useful products and services, but are they really the most sustainable businesses in the world?

To invest in the highest quality companies that both contribute to and benefit from sustainable development, there needs to be room for qualitative judgements, on more nuanced areas such as:

- Are the products and services useful, and making a valuable contribution to society?
- Is the company genuinely trying to improve its approach to sustainability rather than just greenwashing?
- Is the company able to navigate sustainability headwinds and tailwinds (e.g. changing consumer preferences or regulations)?
- How is the company's corporate governance? In other words, how does it treat various constituents – shareholders, employees, customers?

It is not easy to find answers to these questions in ESG data alone, and it is difficult to ascertain when investing in hundreds and sometimes thousands of companies. Genuinely active investment managers, with high active share and more concentrated portfolios, should be better placed to assess these grey areas and therefore make more considered and conscious judgements.

Engagement is another important difference. For passive funds the approach to engagement can be limited by the breadth of their portfolios and is often conducted by groups that are separate from the investment team. In these cases the highly diversified nature of passive funds can work against effective stewardship. Long-term active investors that hold stocks for five years or more have the opportunity to build relationships over time helping them to influence corporate policy and encourage better practices.

Proxy voting also provides an opportunity for investors to encourage businesses to improve their ESG performance. Research finds that active investors are more likely to hold management to account by voting against them on proxy ballots, versus passive investors who are more likely to vote in line with management. For example, BlackRock, Vanguard and State Street, the three largest passive firms all supported doubling the pay of the CEO at California utility PG&E Corp even after its stock plummeted over the USD30 billion liability from maintenance problems linked to the California wildfires. The firm has since filed for bankruptcy, becoming one of the largest utility bankruptcies in history, and one of the first to be tied directly to climate change. Even worse, recent research found a number of large passive investors have repeatedly voted against resolutions related to the environment or climate change at annual shareholder meetings even as they publicly call on companies to consider climate risks.

It seems that when it comes to sustainable investment, there is an argument that you get what you pay for, with passive funds offering a cheaper, simpler product, versus active funds that can provide more in-depth and considered analysis. All sustainability funds, regardless of whether they are active or passive, need to be clear and transparent about how they are delivering on their sustainability promises, lest the industry once again finds itself the subject of criticism for failing to meet clients' needs and expectations.

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[1] Source: https://www.morningstar.com/articles/961765/sustainable-fund-flows-in-2019-smash-previous-records

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