Sustainable investing AD2029

Mike Fox, manager of Royal London Asset Management's sustainable fund range, outlines how sustainable investing might develop over the next decade.

In earlier articles, I described the sustainable investing landscape and looked back at how the sector has changed over the 10 years since we launched the Royal London Sustainable Diversified and Sustainable World Trusts. As a reminder, we think of sustainable investing in two ways: products and services that help the transition to a more sustainable society, and companies showing leadership in managing the environmental, social and governance (ESG) issues they face.

This time, I look at how the sector might evolve over the next decade. Full disclosure from the outset, however: whatever some fund managers may think, we don't have magic powers to divine the future. So, rather than engaging in 'futurology', I'll consider how current trends could develop.

This may sound unambitious, so I'll start with two bold predictions. First, 10 years from now, *all investing will be sustainable*. Secondly, *all investors will be sustainable*. Given only around 1.5% of investments are classed as sustainable at present, how can I make such claims?

Gaining an edge

The first prediction is rooted in the idea that you can't optimise the 'risk-return' trade-off without considering the potential impact of sustainable factors on risk and return. ESG leaders and laggards have different levels of risk – most corporate scandals arise from poor management around ESG factors.

Conversely, returns will be greatly enhanced by identifying products and services that solve society's problems. In simple terms, wind power offers better long-term sustainable potential than fossil fuels; likewise, companies that find a cure for lung cancer are likely to have longer-term viability than companies that sell tobacco products.

The second prediction is based on demographics and the rise of millennials as consumers. However, it's clear from the last few years that a general societal shift is also underway. In a decade, I believe every product and service will have to detail its ESG impact, like food labelling today.

It's clear that ESG and sustainability aren't a fad and the investment industry will respond to these changes. Nonetheless, surely growing from 1.5% to 100% is too ambitious, even over a decade? Looking at UK power generation, I would suggest otherwise.

When I started investing in 2003, there were no commercially-viable windfarms. The vast majority of electricity generation came from fossil fuels, with the remainder coming from nuclear. Yet, in 2017, the UK recorded its first full 'coal free' day since the Industrial Revolution and our first coal-free week came earlier this year. The International Energy Agency believes the next two decades will see offshore windfarms meet all of our energy needs. The world is changing rapidly.

Beware greenwashing

While it's exciting to consider a 100% sustainable investment landscape by 2029, this will involve challenges. First, will fund managers fall foul of greenwashing? Most sustainable factors aren't binary – given companies will have an incentive to overstate their ESG credentials, how will investors differentiate between genuine and spurious claims? Fund managers will need to develop new skills regarding sustainable factors, not unlike assessing which companies comply with the spirit of accounting standards, not just the letter.

This should be easier for managers with a track record in sustainable investing. It's hard to explain, but years of experience have taught me many of the pitfalls. There's a real difference between companies that are truly sustainable and fully integrate ESG factors in their businesses, and those which overlay ESG as a secondary consideration. For a time,

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they may appear similar, but there will come a point where the overlay isn't enough.

To illustrate this, consider how the internet has changed the retail sector. For a while, retailers that set up a website and operated a 'bricks and clicks' strategy looked like they could benefit from the internet. Slowly but surely, however, their businesses have been exposed as 'old school', while the pure internet-only business model of Amazon has triumphed. Similarly, playing at sustainability won't cut it over the longer term.

Other challenges

This raises two interesting questions about the shift to 100% sustainable investing. First, how will passive funds that replicate indices respond? Indices tend to be weighted to the industries of the past, whereas forward-thinking investors should be thinking about investing in the industries of the future. How should fund managers approach oil & gas supermajors, for example?

Should we reward them for higher capital expenditure as they attempt to re-orientate their businesses towards renewables, battery technology and electric vehicles? Or would it be better to accept that the world has discovered all the oil it needs for the future, stop all E&P expenditure and run off the current assets. On a discounted cash flow basis, the shares would soar, yet the business would be signing its own death warrant. However, sustainable fund performance would be impacted by not owning these companies.

Secondly, when should investors buy the future-tech companies that will make up the indices in 2029? One might imagine that sustainable investing is all about buying tech IPOs to get early exposure to the winners. However, I'm a fund manager, not a venture capitalist, and many of our fund's investors can't afford to speculate like that. Instead, by taking low-medium risk and investing well, I may achieve medium-high returns. Tech IPOs are *definitely not low risk*.

Take Amazon. At its IPO in 1997, its market capitalisation was less than $500m. We didn't buy it until 2013, by which time it was worth around $125bn and the world leader in environmentally-positive cloud computing. But we sold it last year at around $1tn. For our funds, it would have been irresponsible to buy it at IPO or for years afterwards – aside from ESG factors, the risk was simply too high. Sustainable investing is still about striking a balance between risk and return to protect your investors.

The big reveal

As no-one will remember this article, I can afford to make some punchy predictions for 2029:

1. Only electric vehicles will be sold as new, although petrol cars will survive for a few years.
2. Smoking will disappear from society.
3. Power generation will be 100% from renewables and nuclear.

A less happy prediction is that there could be a point in the next few years when the current explosion in ESG/sustainable investing leads to problems. There are simply too many funds being launched with marketing that is too 'creative'. I'm not predicting a future mis-selling scandal. However, I believe there will be a challenging period, perhaps after a diligent journalist exposes untrue claims about a fund's ESG processes or impact. For a period, this could cast a shadow over all sustainable funds.

Advisers can protect themselves by properly understanding sustainable investing; identifying managers that have established a sustained record of performance in different market conditions; and who have with a clear and repeatable investment process. As ever, don't believe the marketing hype and do your due diligence.

Find out more about our range of sustainable funds at rlam.co.uk/sustainable.

Contact us

For more information about our range of products and services, please contact us.

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