AD2030: the future of sustainable investing

Mike Fox, Head of Sustainable Investments at Royal London Asset Management, reflects on how sustainable investing has changed over the last decade and considers how it might develop over the next 10 years.

The world has certainly changed over the last 10 years. The cliché for taking readers back in time is to reference Apple products. In May 2010, the original iPad had just been launched, while consumers were looking forward to the new iPhone4, still a month from market.

The biggest change for me has been a silent revolution: the acceptance of sustainable investing. This reflects two developments. First, there is now strong evidence that integrating sustainability into investment decisions can enhance returns. Second, more consumers are considering not just what a product does, but the environmental and social context in which it has been produced. Such considerations are now increasingly a factor in their investment choices.

Some commentators attribute this increased awareness to the emergence of 'millennials'. There is some truth in this: this generation now outnumbers baby boomers as adult consumers for the first time. However, older people can be just as passionate about sustainable investing, not least as they consider their legacy to their children.

There is an ongoing societal shift towards understanding the importance of environmental, social and governance (ESG) factors, which form the bedrock of sustainable investing.

It started with G

The emergence of these factors as mainstream investment considerations is rooted in the avoidance of bad. The global financial crisis highlighted how woefully bad corporate governance was. After 2009, it became clear how little active engagement shareholders had with the companies they owned. Such destruction of capital couldn't be allowed to happen again, so corporate governance became more mainstream.

Within this, there has also been a shift from negative to positive governance effects. As an example, considering the optimal composition of corporate boards from a gender and ethnicity perspective shows that companies and investors are starting to realise the positive gains that effective governance can bring. There's a lot further to go as some big tech companies demonstrate. However, you can't overstate the importance of good corporate governance.

Over the last three years or so, there has been a sharp increase in awareness of environmental and social factors, and their influence on investment returns. Whether in plastics, carbon footprints, data or long-term social effects, there is a clear alignment of the big issues of the day with sustainable themes. Sustainable investing has moved into the mainstream for very good reason.

One thing that hasn't changed over the last decade is that sustainable investing must demonstrate its ability to deliver above market returns to be successful. You can be as sustainable as you want but, if you're not also delivering good investment returns, you won't be serving your clients' interests.

Looking forward

The point of looking back isn't to ruminate on the past, but to seek clues about what might happen next. Whatever some fund managers may think, however, we don't have magic powers to divine the future. So, rather than engaging in 'futurology', I'll consider how current trends are likely to develop.

Here are two bold predictions. First, 10 years from now, all investing will be sustainable. Second, all investors will be sustainable. Given only around 1.5% of investments are classed as sustainable at present, how can I make such claims?

The first prediction is rooted in the idea that you can't optimise the 'risk-return' trade-off without considering the potential

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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.

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, as I've already said, it's clear 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 wind farms. 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 happened last year. The International Energy Agency believes the next two decades will see offshore wind farms meet all of our energy needs.

Beware greenwashing

While it's exciting to consider a 100% sustainable investment landscape by 2030, this will involve challenges. First, most sustainable factors aren't binary – given companies will have an incentive to overstate their ESG credentials, how will fund managers differentiate between genuine claims and greenwashing? They 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. 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, they may appear similar, but there will come a point where the overlay isn't enough.

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.

Second, when should investors buy the future-tech companies that will make up the indices in 2030? 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. Sustainable investing is still about striking a balance between risk and return to protect your investors. Tech IPOs are definitely not low risk.

Predictions

Here are some forecasts for 2030:

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 the current explosion in ESG/sustainable investing will lead to problems. There are too many funds being launched with marketing that is too 'creative'. There will be a challenging period, perhaps after a diligent journalist exposes untrue claims about a fund's ESG processes or impact? 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 take all marketing at face value and do your due diligence.

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Royal London Asset Management

55 Gracechurch Street,
London EC3V 0RL

020 327 25950
bdsupport@rlam.co.uk
institutional@rlam.co.uk
www.rlam.co.uk

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