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In praise of choice

Mike Fox – Head of Sustainable Investments

Sustainable investing continues to evolve rapidly. After glacial change over the first decade and a half of my sustainable investment career, the last four years have seen a staggering shift as the sector initially went mainstream and then became the 'next big thing' in asset management.

This was catalysed last year as the pandemic showcased the benefits of sustainable investing, leading to record-breaking inflows. While much of this was driven by increased awareness of environmental, social, and governance (ESG) issues, some undoubtedly stemmed from the positive impact of Covid-19 on the sector's performance.

Technology made life in lockdown feasible, facilitating remote working and ecommerce, while the healthcare sector delivered Covid-19 treatments and vaccines with unprecedented speed. In addition, to boost economic activity, governments focused fiscal spending on environmental initiatives, such as transport infrastructure and renewable energy – the 'Green New Deal'. This all aligned with sustainable investing themes.

Meanwhile global industrial demand cratered, driving down the prices of oil and other commodities and augmenting the relative performance of funds with no exposure to these sectors. Likewise, the weakness of many financials stocks was a positive for performance as banks tend to perform poorly against sustainable metrics.

This year we are seeing some of these factors unwind. Despite this more challenging environment, which is impacting the relative performance of sustainable funds, inflows continue to be strong. Investors and advisers increasingly understand that sustainable investing doesn't have to mean weaker performance: indeed, over the longer term, we believe that considering a wider range of risk factors is likely to improve returns.

At times of rapid change, it can pay to step back. While many developments have undoubtedly been positive, others have arguably been less so. The sheer number of new funds being set up may involve compromises in standards. We have also launched two new funds, with the RL Global Sustainable Equity Fund and RL Global Sustainable Credit Fund complementing our existing funds. However, with so many new managers entering the sector, there must be a risk that 'me too' funds, with poorly designed investment processes, deliver sub-optimal results.

Also, some marketing by newer entrants is questionable. For example, while they are important societal aspirations, I'm not convinced that the UN's Sustainable Development Goals (SDGs) are relevant investment metrics – it feels like they are being used to 'virtue signal' to investors rather than being a meaningful framework for investors to catalyse change.

You might therefore think that I would be happy that there are efforts to impose more structure on the sector. However, I'm ambivalent about this. While no one would oppose regulation that applies clear standards and helps investors to make informed choices, more prescriptive frameworks could ultimately disadvantage investors.

In 2019, the UK's Investment Association introduced its Responsible Investment Framework as "the lack of a common language has been a significant barrier to date to the promotion and growth of responsible investment." Following widespread consultation with the industry, the IA's framework introduced clarity and consistency "to make it easier for all savers to understand the opportunities available to them". This is clearly good for investors.

Two recent related pieces of legislation, the Sustainable Finance Disclosure Regulation (SFDR) and EU Taxonomy Regulation, are more moot. I'm broadly happy with the SFDR as it will give investors more transparency, yet asset managers will have the choice of how to classify particular funds according to standardised categories. However, the Taxonomy Regulation feels more prescriptive, imposing an inflexible structure that may not be so positive.

At its heart is an apparent assumption that diversity is bad. This seems surprising as other sectors, such as global equity funds, thrive with diverse approaches offering investors a range of solutions. Instead of diversity and choice in sustainable investing, this more directive approach risks over-concentrating funds on limited parts of the market, leading to potential bubbles. The flexibility that allows active managers to steer away from excessively hyped investments is at risk of being ironed out to the detriment of investors.

It's not hard to set up a new fund and buy the top 50 sustainable stocks according to an external data source. However, at RLAM we prefer to take a more informed approach based on a rigorous investment process that has delivered strong returns across a variety of market conditions, supported by in-house fundamental research, risk management and high standards of reporting.

Within this, we weight equally a stock's sustainable score against its financial metrics – stocks with very compelling sustainable credentials can be terrible investments. Equally, very good sustainable companies that we identify early through diligent research are driven up by weight of money and it's right to take profits. Selling at the right time is an important element in delivering good investment returns.

It will be interesting to see if UK legislation follows a similar approach to the EU. To some extent, fund managers will be to blame if it does as we will have failed to define our funds clearly enough, to the point that third-party regulation is required.

Choice is generally considered a good thing. In asset management, as well as reducing the risk of bubbles, it also helps advisers to better match their clients' values and principles. Educating and empowering investors, while maintaining a diversity of investment approaches, would be a credible alternative.

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

A version of this article recently appeared on FTAdviser.com.

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