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What to consider when developing a strategy for sustainable investing

Once an obscure, easily dismissed ideology sparked by a 2005 call to action from then United Nations Secretary General Kofi Annan, a recent report from Opimas revealed the value of global assets being managed with consideration for environmental, social and governance (ESG) factors has almost doubled every four years to hit US$40.5 trillion this year.

Underpinning this, the 2020 EY Global Alternative Fund Survey found 88% of investors worldwide are regularly questioning fund managers on ESG.

Investment houses are rapidly responding to this demand, and the number of products available has ballooned; for some firms it's something new they're integrating into their existing offerings, for others it's just business as usual.

AXA Investment Management (AXA IM) falls into the latter category, with more than 20 years' experience in responsible and impact investment.

The AXA IM Sustainable Equity strategy was launched in August 2014 in Australia and is managed by the firm's systematic equity team Rosenberg Equities, one of the first quantitative managers to fully integrate ESG considerations into all its portfolios.

Since inception, the strategy has recorded an annualized return of 12.92% net of fees[1] , and the team has achieved this by doing three key things, AXA IM Rosenberg Equities' chief investment officer Gideon Smith[01] explains.

Firstly, the team focuses on stocks with lower risk or less volatility than the market. They then target stocks with higher earnings quality that deliver a higher level of profitability and more sustained earnings. Finally, the team tailors the portfolio to improve its ESG positioning; emphasising stocks with better credentials and reducing or removing those without.

"When we build the portfolio, we're using a transparent and systematic, quantitative investment process," Smith explains.

"We're constantly adjusting the weights of stocks based on our assessment of their volatility, their quality and their ESG characteristics, and when we do this, we leverage a huge amount of proprietary data to do that analysis.

"The goal is to build a portfolio that provides drawdown protection when markets are falling and participation when markets are rising."

And that is exactly what it did during the COVID-19 volatility that wreaked havoc on markets earlier this year, with 2020 providing an acid test for the strategy.

"In the first quarter as the crisis took grip, markets fell precipitously, and the strategy did exactly what we'd hope for. That drawdown protection kicked in, and the strategy outperformed as those markets fell," Smith says.

When the markets recovered in the second and third, the strategy participated in the rally.

"Basically, the strategy did exactly what we would hope for – it kept pace with markets when they were rising and was resilient when they fell," he says.

The strategy in large part benefited from its many technology holdings, including Microsoft, Apple, Amazon and Facebook, and its holdings in pharmaceuticals such as Procter & Gamble and Johnson & Johnson. In fact, Smith and his team increased the strategy's exposure to technology as it looks to improve quality and lower risk.

At the same time, Smith says, exposure to financials has been reduced as risk profiles begin to deteriorate. It has also reduced allocations to the energy sector, with Smith saying it is the sector that remains most out of favour due to its weak earnings, above-average risk and poor ESG characteristics.

He adds that many of the trends that have emerged during COVID-19 were already evident to factor investors – they were just on the periphery.

"What we've observed is that the COVID crisis may have accelerated some of the trends that we've been observing in factor investing for some time, particularly with regards to the technology and consumer technology areas," Smith says.

Aware that they aren't typically the kind of stocks investors would associate with low-risk investing, Smith says these industries have become more defensive in nature, and therefore more attractive to low-risk investors.

"Pre-COVID these segments of the market started to deliver higher quality earnings, more consistent and predictable earnings, and that led to the stock price behaviour becoming less volatile… that has become more pronounced," he says.

Smith adds that the short-term volatility of several consumer technology stocks has been lower than in the past.

"Intuitively that makes sense; they're well positioned to withstand the COVID shock, and in some cases, they're going to be real beneficiaries of a more virtual, more digital world," he says.

And, while not typical of the Rosenberg Equities' team's style of investing, Smith says: "If these trends persist, we think these stocks will increasingly have a place in our portfolio."

The quote

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Watch the video on www.fsitv.com

But the AXA IM Sustainable Equity strategy is not the only one of its ilk out there, and they all do things differently, making it very difficult for financial advisers to know what's best for their clients.

Breaking down the options available, Smith places them into two distinctive buckets, saying it's important to distinguish between the two.

On one side, you have the highly thematic funds which might seek to target a specific issue or sector, such as gender diversity. On the other you have the more core-like offerings which, while primarily seeking to build a robust investment strategy, do also seek to integrate ESG considerations in their investment decisions.

It's the latter solutions that financial advisers should be focused on, Smith says.

"It's easy for fund managers to adopt a simplistic approach, excluding a few stocks or sectors and providing a little ESG polish to the final portfolio. But we're not sure that actually meets advisers' or their clients' needs or aspirations," he says.

If advisers consider just one thing, it should be how much commitment fund managers demonstrate to responsible investing; "Is ESG an afterthought or is it tightly coupled with their investment decision making?"

"In our strategy, when we're talking about targeting companies with higher earnings quality, we think that management diversity has a bearing on companies' profitability and their ability to deliver those earnings. Consequently, we build diversity metrics into our investment models and measures of quality," Smith says.

"We don't talk about responsible investing as something distinct or separate, for us responsible investing is simply investing." **FS**

1 Source: AXA IM, as of end of Oct 2020. Strategy Inception date: Aug 7, 2014. Past performance is not a guide to future performance.

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