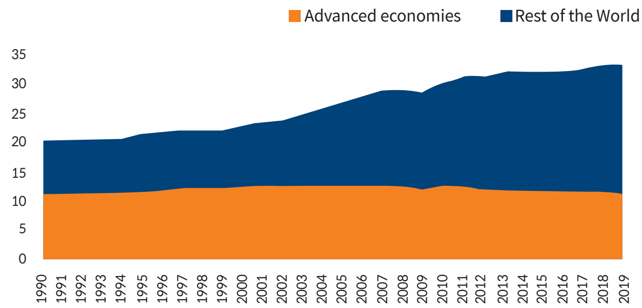
ESG investing – A noble investment strategy that may score on performance and morals

MIRAE ASSET Mutual Fund

The imbalance in the ecosystem is increasingly visible with the rising number of disasters, such as wildfires, floods and droughts, with the latest being the Covid-19 pandemic. This has called for seriously evaluating the impact of our actions and choices on the planet. These issues are mainly stemming from the drastic climate changes that are primarily happening because of heavy emissions. For instance, as seen in the chart below, carbon emissions have steadily increased (especially in countries other than the developed ones) over years.

Energy related CO2 emissions (in giga tonne)



Source: International Energy Agency (IEA)

Apart from the issues related to climate change, the focus on other factors, such as the impact of businesses on the society and the quality of management, is also on the rise. These issues could affect the profitability, growth and sustainability of businesses in the form of huge financial implications and loss of public trust.

Companies sensitive towards tackling these issues – in other words, those that take into consideration the environmental, social and governance (ESG) factors while conducting their businesses – are steadily becoming investors' preferred choice.

Broad ESG factors

Environmental

- Climate change and carbon emissions
- Pollution
- Biodiversity
- Waste management

Social

- Data protection and privacy
- Customer satfiscation
- Gender and diversity
- Human rights

Governance

- Board composition
- Bribery and corruption
- Lobbying
- Whistleblower policies

For illustration purpose

Environmental factors – The consistently rising ill-effects of global warming in the form of melting glaciers and the subsequent rise in sea levels, receding forest cover, water pollution and waste management are some of the important factors that can be considered while investing.

Social factors – The way in which a company pays attention towards society and customers also reflects its business strategy. For instance, a responsible company regularly invests towards protection of data and privacy of its customers, as it invests towards its business expansion.

Governance factors – A competent and experienced management goes a long way in the growth prospects of a company. Further, a company's various internal policies, such as whistle-blower policy and insider-trading policy, highlight its seriousness towards conducting its business in a fair and transparent way.

Organisations score on morals and long-term sustainability

As various stakeholders, such as investors, employees, customers and governments, are increasingly focusing on ESG factors, organisations that conduct business on these principles earn loyalty and trust of these stakeholders, potentially resulting in more sustainable and profitable growth. ESG is mainly about taking long-term business decisions based on diverse factors rather than mere financial metrics.

Firms with ESG focus also come under the good books of regulators and market intermediaries. In India, the Securities and Exchange Board of India (SEBI) has mandated the inclusion of a Business Responsibility Report (BRR) as a part of the annual report for the top 1,000 listed companies. A BRR is a disclosure of adoption of responsible business practices by a company to all its stakeholders. Given that companies garner funds from the public, a BRR comes in handy to keep a track on the business practices of companies. Further, major domestic stock exchanges – National Stock Exchange and Bombay Stock Exchange – have also become partners of the United Nations – backed Sustainable Stock Exchanges Initiative, committing to promote sustainable investing through improved ESG disclosure requirements of listed firms.

Companies with robust ESG mandates demonstrate better operational performance. Such companies are usually less exposed to various risks, such as environmental or regulatory risks. If a company implements its ESG standards and processes properly, it can lead to long-term sustainability and high levels of investor confidence.

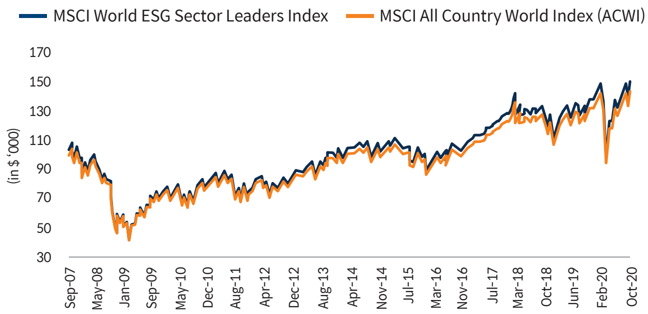
Investors score on performance

Investors might think that investing in companies with a higher ESG score might mean sacrificing on returns. But that may not be the case. In fact, such companies have performed well across the return periods and market phases.

Global performance

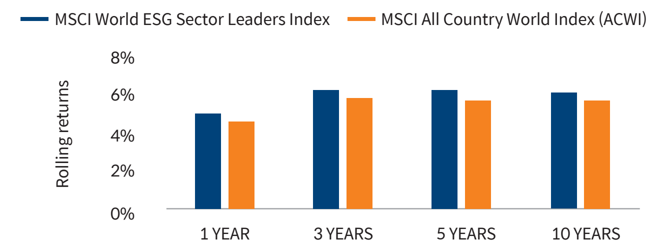
Let us consider the ESG performance on the global front. As seen in the chart below, MSCI World ESG Sector Leaders index (representative of the ESG theme) has outperformed MSCI All Country World Index (representative of general equity) since inception. If an investor had put in $100,000 in the ESG index since inception (September 28, 2007), it would have grown to about $150,000 as on October 12, 2020. A similar amount invested in the general equity index would have grown to around $143,000.

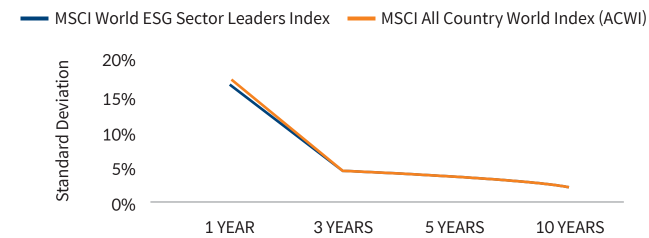
Growth of $100,000: MSCI World ESG Sector Leaders index vs MSCI All Country World Index



Source: Bloomberg

Rolling returns and volatility comparison between ESG vs general equity

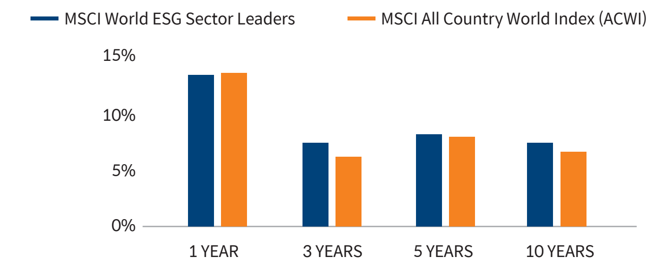




Source: Bloomberg

Note: Data based on average daily rolling returns for the period ended October12, 2020

Point-to-point returns comparison



Source: Bloomberg
Past performance may or may not be sustained in future.

Market phase analysis

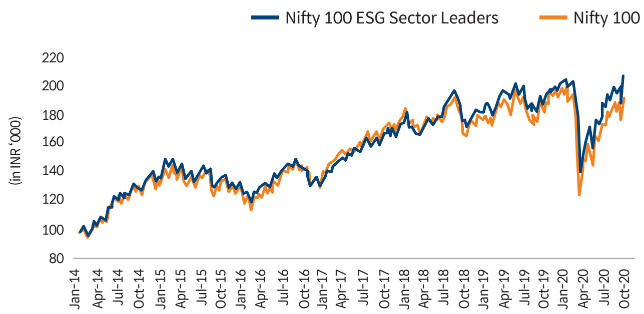
Market phases	MSCI World ESG Sector Leaders	MSCI All Country World Index
Sub-prime crisis (January 2008-March 2009)	-42.10	-42.56
Sharp bounce-back post sub-prime crisis (April 2009-December 2010)	82.20	81.50
Eurozone crisis (January 2011-June 2013)	4.64	2.72
Post-Eurozone crisis (July 2013-February 2015)	12.30	12.01
Chinese slowdown (March 2015-February 2016)	-0.13	-0.14
Global liquidity (March 2016-December 2017)	15.84	18.10
Mixed global scenario (January 2018-December 2019)	6.66	4.98
Covid-19 crisis (January 2020-October 2020)	0.05	0.05

Source: Bloomberg

Domestic performance

On the domestic front too, ESG theme (represented by Nifty 100 ESG Sector Leaders index) has beaten general equity (represented by Nifty 100 index) over the long term. If an investor had put Rs100,000 in the ESG index since inception (January 1, 2014), it would have more than doubled to Rs 207,000 as on October 12, 2020, a compound annual growth rate (CAGR) of 11.4%. A similar amount invested in the general equity index would have grown to around Rs192,000, implying a CAGR of 10.2%.

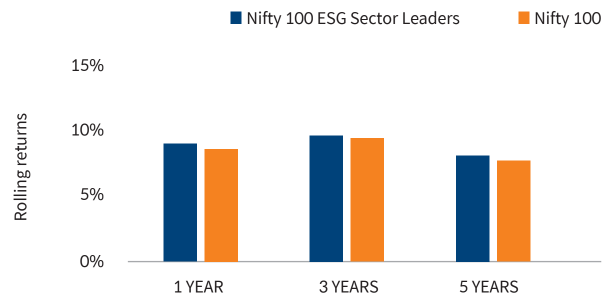
Growth of Rs 100,000: Nifty 100 ESG Sector Leaders index vs Nifty 100 index

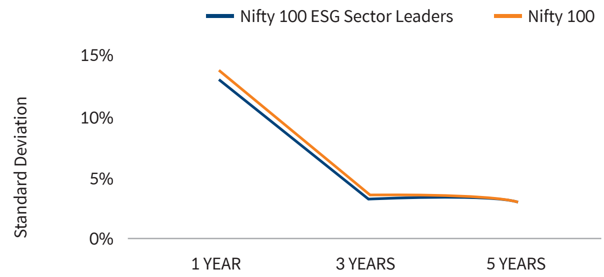


Source: Bloomberg

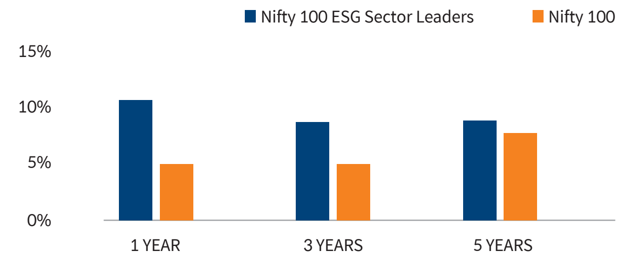
Further, if we consider the rolling-returns performance of domestic ESG index and general equity index, a similar trend can be witnessed. Another important point to be observed is that even though the ESG theme is outperforming general equity, it is doing it with lower volatility. As far as point-to-point returns performance is concerned, the ESG index has beaten general equity index over all the periods analysed (1, 3 and 5 years). In various market phases, too, ESG has mostly performed better.

Rolling returns and volatility comparison between ESG vs general equity





Source: NSE
Note: Data based on average daily rolling returns for the period ended October12, 2020



Source: NSE

Market-phase analysis

Market phases	Nifty 100 ESG Sector Leaders	Nifty 100
Chinese slowdown (March 2015-February 2016)	-0.21	-0.21
Global liquidity and domestic reforms (March 2016-December 2017)	21.83	24.83
Mixed domestic and global scenario (January 2018-December 2019)	7.82	6.11
Covid-19 crisis (January 2020-October 2020)	0.04	-0.02

Source: NSE
Past performance may or may not be sustained in future.

Passive play, may be a better alternative for investors

Although an investor can take the active route for putting his money in these funds, it may be better off to consider the passive fund route in the current market scenario. Further, considering the dip in the outperformance of actively managed funds vis-à-vis their benchmarks – often called alpha – the passive route might be a better option, as it also comes at a lower cost. Passive funds, such as exchange traded funds (ETFs), have lower expense ratios compared to active funds, ranging between just 0.05% and 1% for equity-oriented ETFs. The tracking error for ETFs is also very low; they mirror an index more closely, as they do not have to keep funds for liquidity. ETFs can be transacted at intraday prices, enabling investors to buy or sell at the desired index/market levels. In addition, their transparency is high, as portfolio is disclosed in real time as against monthly disclosure in case of active equity funds. As they are traded on stock exchanges, investors get the flexibility to buy/sell them at their convenience.

Source: CRISIL Research

Make it a part of the core portfolio

Globally ESG investments have gained significant traction in a short span compared with other categories, with total global assets under management (AUM) of funds following the ESG route reaching $1 trillion in second quarter of calendar 2020.

While ESG funds are at a very early stage in India, they seem to have a bright future, given the theme's strong financial and moral connect. Their exponential growth globally and increasing acceptance and awareness could propel the growth of ESG funds domestically.

Investors can look at investing in this category of funds, as a part of their core strategy to get exposure to companies on a long-term sustainable growth path. These funds could turn out to be wealth generators in the long term and relatively less volatile during periods of market stress, compared with other equity categories. However, investors should first gauge their individual risk profiles and financial goals before investing in these funds.