ESG: WHY ACTIVE MANAGERS HAVE THE UPPER HAND

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Overview

The introduction of SFDR has been a welcome breath of fresh air for those of us committed to truly integrating ESG, as it should serve to prevent the cynical use of ESG terminology in marketing collateral.

But while SFDR will help remove the risks of greenwashing, it hasn't solved the issue faced by asset managers and clients when determining the right approach to responsible investing. How should asset managers integrate ESG? How can they differentiate themselves? How can clients distinguish between the various approaches taken by asset managers and what should they be looking for?

It is a significant challenge given there is not a unified 'one size fits all' approach to ESG across the industry.

I believe every asset manager has to integrate ESG in line with their own investment DNA. Authenticity is key and, as a result, there must be coherence between the ESG beliefs of a manager, its core values and investment beliefs.

The contrast between approaches that integrate ESG is perhaps greatest between active and passive managers. Competition between active and passive managers has always been fierce and the world of ESG is no exception, with passives increasingly eating into the lead active funds had established in this space.

While passives have developed their approach to ESG, I firmly believe active managers can add significant value over and above passives in two key areas:

- Identifying leaders and laggards
- Valuing ESG risks alongside other financial indicators

Key Points

1. Dispersion between the leaders and laggards in sectors is likely to be significant and requires analysis
2. ESG criteria cannot be isolated from the valuation of a company
3. Active and passive managers should collaborate to force change among companies

Identifying leaders and laggards

Since the 18th century, the world has seen several waves of innovation such as the industrial revolution, the electric revolution and the information revolution. The move to a sustainable economy and its implications can be seen as a fourth revolution which will similarly provide a strong new wave of innovation.

Sustainability will be a long-term driver for change in markets, countries, sectors and companies by generating opportunities for fruitful investment - but it also carries the risk of being trapped in depreciating assets.

I believe that active managers with a sustainability expertise, like Unigestion, have a better understanding of the dynamics of the transition than passive managers. Why?

ESG risks are complex and rapidly evolving and, I believe, require more than a simplistic decision to invest in a particular index. Active managers can decide which company to hold, what exposure to have to them, which businesses to avoid and when to sell.

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Our approach, for example, is to treat ESG in the same way as all investment risk: through a combination of systematic and discretionary analysis together with research and monitoring.

Passive managers cannot do any of this. They can only invest in companies that are constituents of an index, regardless of their quality, and only sell when the companies are no longer part of that index.

This issue is highlighted a 2021 study by environmental campaigning groups Reclaim Finance and Urgewald. The study analysed a sample of 29 leading asset managers and found that just a quarter implemented coal exclusion policies. The issue was even starker for the largest passive managers with less than 3% applying coal exclusion policies.

While some passive managers do not exclude these companies but instead compensate with strong engagement activity, I believe more work needs to be done by passive managers and indices to protect investors from the decline the coal industry faces, which will inevitably impact returns.

Active managers are also better placed to understand the key drivers that companies will use to integrate sustainability criteria into their operating models, and the impact these changes will have on their discounted cash flow models, risk and valuation channels.

At Unigestion, we have spent considerable time understanding how our transition to a more climate-friendly way of operating will affect the value chain of each sector. All sectors will need to adapt but solutions will be different. Some companies will choose to be more efficient in their output, others will reorganise their transportation plans, enhance the construction of their buildings, use more renewable sources of energy, or develop sustainable innovation.

The sustainability transformation offers companies growth opportunities, but with a high risk of disruption and, as a result, dispersion between the leaders and the laggards will likely be significant. Active managers are well equipped to play this dispersion but there is no room in passive management for such discretion.

Valuing ESG risk alongside other financial indicators

We believe that ESG criteria are not currently priced into the market in an efficient way. An active approach enables us to add performance and minimise risk to an investment portfolio.

One key advantage of active management is the ability to combine financial analysis with ESG considerations in order to define the right valuation of a company for the right level of ESG risk or opportunity.

Factoring these aspects into company valuations requires asset managers to combine financial analysis with ESG considerations.

There is a positive asymmetry of risk and return when integrating ESG in the investment process: the emergence of an ESG risk can devastate a company's share price and companies with high ESG scores are much less likely to experience such issues. They will have more robust and established risk management practices and fewer extreme events like fraud, mis-information and litigation. A lower level of negative events should lead to fewer stock-specific falls in their share prices. They should also be able to benefit from lower costs of capital, and demonstrate higher multiples ratios. So there is a logic that companies with good ESG scores achieve the highest valuations.

However, in our view, ESG criteria cannot be isolated from the valuation of a company.

Just as with other industry revolutions, we should be aware of the dangers of pricing in this transformation too quickly if we are to avoid a TMT boom and bust in the ESG space. In her book '*Technological Revolutions and Financial Capital*', the economist Carlota Perez argues that financial excesses and productivity explosions are "interrelated and interdependent". In fact, past market bubbles were often the mechanisms by which unproven technologies were funded and diffused — even if "brilliant successes and innovations" shared the stage with "great manias and outrageous swindles". Each of these revolutions was accompanied by bursts of wild financial speculation and followed by a golden age of productivity.

While ESG is here to stay and demands on how governments, society and corporates demonstrate progress within ESG are likely to increase, there are worrying signs of exuberance in some areas.

Look at Tesla. Is the difference between its valuation and those of old school autos really justified when companies such as VW and Audi expect electric cars to comprise the majority of their European car sales by 2030? The valuation spread will undoubtedly diminish; we may not know exactly when but there is an advantage for active managers in being able to assess that relative valuation spread.

Finally, when we take ESG factors into consideration in our portfolios, we need to make sure we control style exposures that could influence risk-adjusted returns and thus avoid potential draw-downs. This is important in ESG investing as these strategies can pick up unintended style correlations that can impact performance. For example, ESG scores often favour long technology stocks and short energy stocks and tend to be overweight quality, momentum and low volatility - styles that can be volatile in inflationary environments. Only active managers can counteract such issues by balancing sector allocations and factor exposures with ESG objectives.

Collaborate to drive change

An important part of our responsible investment duty lies in implementing an active ownership strategy toward the companies we own. We take the view that encouraging change is a better route to achieving our goals than an exclusionary approach alone. But how do you get companies to listen when you are not on the scale of multi-trillion dollar investment houses?

At Unigestion, we seek to punch above our weight when it comes to active engagement. While we can do this with smaller companies where we are a significant shareholder it can be more of challenge with larger companies, whose active shareholder engagement programmes typically favour only the largest shareholders. This is where passive managers have a huge role to play as they represent a significant proportion of the capital of companies in indices.

Our way around the problem for specialist asset managers like Unigestion is to engage in collaboration with our peers. We have joined several collaborative groups, including the Climate Action 100+ Initiative (where we have taken the lead on one of its engagements), the PRI-led Oil & Gas Collaborative Engagement and the Plastic Solutions Investor Alliance, and we seek to be actively involved in their work. By joining these important groups we can have a bigger impact than simply going it alone.

A good example of this type of collaboration was highlighted earlier this year when shareholders collectively forced ExxonMobil to accept two new non-executive directors onto its board. Collaboration is powerful and if we are to succeed in our aims to create a sustainable economy, all investors, whether active or passive, will need to do a lot more of it.

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