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INVESTMENT MANAGERS

MANAGER POINT OF VIEW

Sustainability investing beyond Covid-19

In the face of coronavirus lockdown and resulting economic malaise, multiple data shows the sustainability sector is outperforming the wider market. Yet not all ESG investment managers are the same. Many continue to invest in poor ESG-rated industries while others do not – and some strategies are therefore proving to be more resilient.

Jens Peers, CEO & CIO of Mirova US and manager of the Mirova Global Sustainable Equity Strategy, reveals why his strategy has held up well against global equity indices during the crisis and suggests why some ESG strategies outperform over the long term.

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Investing in sustainability

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Some ESG funds have outperformed during Covid-19 lockdown. Do you think the current crisis will accelerate ESG trends in companies and the industry?

There are many ways to look at ESG and there are many methodologies too. So it's difficult to say whether this is an ESG company or not, right?

But if you look at the big providers of ESG ratings, including the MSCI, Sustainalytics and ISS, they all use the same data, but they all get to different conclusions. This makes it difficult to say those are really good ESG companies or not.

On average, the ones that score well on most of those methodologies have actually done very well during the COVID-19 crisis. That's also translated into the performance on average of the ESG focused equity strategies like ourselves.

But there are also many others that have done very well during the crisis. Our performance was already very good going into the crisis, and it's been very good during the crisis as well. And there are a few reasons for that.

First, by having a longer-term view, taking things into account like climate change, governance and lower risk, you don't tend to invest in companies within the fossil fuel sector that have underperformed. Likewise, we don't tend to invest too much in banks in general either, because many banks still cause systemic risks.

And we avoid those companies that take irresponsible risks with their balance sheet by taking on too much debt. On average, that means ESG managers do quite well during a crisis.

So will it lead to extra demand?

Yes, in a way it will because, until now, ESG investing was mainly considered by people that genuinely cared about the world. The people that are okay with the world or just focusing on performance in their portfolio said, ok, fine, but you cannot be good for the world and create performance at the same time and, therefore, I'm not going to invest in that way.

What we are seeing right now is that people are more aware of the fact that ESG strategies actually can generate good performance. And for that to be accepted more broadly, you need more and better ESG managers.

Many of our competitors also have good performance, so there's choice. And if you have a choice between two well-performing strategies and one has a good ESG profile and the other one does not, which one are you going to choose?

Well, many people now certainly go more for the one with a better ESG profile. So to cut a long story short, yes, I think that demands will certainly pick up from here.

> *"What we are seeing now is that people are more aware of the fact that ESG strategies can actually generate good performance."*

We've also seen that during the crisis, ESG strategies have actually seen inflows while the non ESG strategies on average have outflows. We've had the same where, throughout the crisis we've seen our assets increased from that point of view against some of our competitors that don't take an ESG approach

What's going to drive performance going forward?

Well, if you look at the long-term potential recovery from here, I think it'll probably go in two phases. There'll be a relief rally – and to large extent, we've seen a bit of that already. Of course, there's a risk that some of those strategies might underperform a little bit.

So we've had that already and it'll end if that relief rally is basically driven by those sectors and stocks that have underperformed the most during the crisis. Once that reverses, it is possible for some of these strategies that they may not necessarily benefit in the early days of the recovery rally.

However, when things are just normalized again after that, that's where the quality of your research will start to show again. I believe the long-term trends will pick up again, in terms of driving performance, and that's when things should actually begin to normalise.

What might some of the winning investment themes look like in a post Covid-19 world?

It's the billion dollar question, right? My view is that the world is still ageing and we still have urbanisation and climate change – even though we've seen that the quality of the air and the CO2 emissions have actually been lower, because there's a lot less economic activity as well. But those long-term themes are still going to be very important.

There are a few things, however, that we believe will change. We think we're going to see an acceleration of the digitalization of our economy. Many people are now used to doing video conferences, working from home and ordering things online, but also businesses that have not actually started this online, are starting to think about that a lot more too. It will certainly help a lot of the companies that we have in the portfolio with their businesses.

"One of the main reasons we've outperformed in the first quarter, during the Covid-19 crisis, is because we don't want to invest in companies that take irresponsible risks."

The second one that's very important is supply chain management. We've seen that Wuhan is probably the global production centre for many different industries, including many basic components for pharmaceuticals and the car manufacturing industry. Centralizing all your production centres into one specific city may actually lead to very important disruptions in your supply chain management, so it's something that companies will have to start thinking about as well. Companies that have a wider distribution or sourcing network compared to others will continue to benefit.

Furthermore, globalization from an emerging markets point of view could be under some pressure. The poorer countries, as well as the bigger industrialized companies, are going to focus more on local production and local consumption, going forward.

Why do you think the Mirova Global Sustainable Equity Stretegy has proved so resilient during the Covid-19 pandemic crisis?

Because of the thematic choices that we make, the strategy has a few biases in terms of sectors and styles. From a style point of view, we have a small growth bias and a significant quality bias.

Indeed, one of the main reasons we've outperformed in the first quarter, during the COVID-19 crisis, is because we don't want to invest in companies that take irresponsible risks. We are significantly underweight in companies with high levels of debt, and in a crisis, those debt levels are obviously bad for performance.

Secondly, we have no classic energy or fossil fuels, which has been one of the worst performers, year to date, as well as during the crisis. The oil price war between Saudi Arabia and Russia has obviously pushed this sector down as well.

Another sector that was significantly hit was real estate. That's also a sector to which we have no exposure at this point. We're now looking at a few names because valuation opportunities are certainly there in that sector.

And we've been significantly underweight financials. Financials have also been a very poor performer during the COVID-19 crisis. We also don't have aviation, tourism or luxury goods in the portfolio, and those are all sectors that were very badly hit during the crisis too.

Which sectors have contributed positively for the strategy?

We've been a bit overexposed to IT. It's quite neutral relative to the real tech companies, but they have been a reasonably good performer.

The biggest overweight position that we have is in healthcare, which has also contributed quite positively. Looking at companies in our top 10, the likes of Danaher and Thermo Fisher have testing equipment, including testing for COVID-19. We have Gilead in the portfolio as well, which was the first company that had a drug against COVID-19 in phase three trial, and it has been a fantastic performer since the beginning of the year.

We have with Terumo and Coloplast, two companies in the portfolio that supply hospitals with difference treatments; Ecolab is a company that makes chemicals for hygiene, including hand sanitizers, which is very topical right now.

From a thematic and ESG point of view, we believe Microsoft is a big player on cloud computing. One of the bigger risks for Microsoft on the environmental side is carbon emissions. It also announced this year that it will offset all the carbon emissions it's ever made, so it's a very positive signal from that point of view.

Meanwhile, MasterCard and Visa are two plays on digital payments. Visa is a more neutral company; MasterCard is also company that increasingly uses its information to create positive impacts.

Elsewhere on our top ten list, we've Orsted, which is the biggest offshore wind operator in the world. Then there's Eaton, a company that's focusing on energy efficiency and low carbon solutions for electronics and the industrial world.

Why aren't you invested in a company like Tesla, for example?

Tesla is a difficult one to get through all the steps in our investment process. It's a very thematic stock obviously, I mean there's no doubt that our economy will be electrified going forward. Many of the products that have used fossil fuels in the past, like eating, but also transportation, like cars, will actually move to more electric solutions rather than using fossil fuels directly.

And Tesla has been a fantastic company from the point of view that it has been a very important disruptor. It has changed the whole automotive industry. If you look at all the research and development spending now, it's happening in two areas in the automotive industry: electric vehicles and self-driving car. But also in terms of barriers to entry, competitive advantages, and so on, Tesla ticks all the boxes.

Where I do have a bit of an issue is on valuation and governance. Tesla is not actually a very well-run company. It's been a company that had great vision from Elon Musk but has very poor social practices and governance around the management team. It's improving, but it's not to the standard that I would like it to see. And on valuation, I would say it's priced to more than perfection. Obviously, it's gone down quite significantly now as well.

So, on balance, I'm not invested in Tesla at the moment for those two reasons. And those reasons sort of exemplify the philosophy of the strategy. Because it's important to construct a portfolio around the things you really believe in. Many people construct the portfolios around the benchmark and want to get exposure to every sector, every region in that benchmark. That's not what we do.

We only invest in companies we like, and we like them because they have a very good structure and the right products to benefit from important long-term trends. I think it's really important to construct your portfolios around the things that you'll believe will create that sustainable, long term future.

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Additional Notes

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