Investing in the sustainable transition

As we move into ESG 3.0, investors will need to look further to find investment opportunities. An area of interest is companies in a process of sustainable transition.

Yuko Takano
Senior Investment Manager of Pictet's Positive Change strategy.

What innovation have you seen in responsible investing?

I feel we are going through a transition. ESG 1.0 was about exclusions, i.e. cutting some sectors out from portfolios for clients that wanted to invest according to certain beliefs. Then around the mid-2010s, asset managers started to launch strategies that were less about exclusions and more about finding innovative companies able to contribute to a sustainable future - that was ESG 2.0.

In my view, a weakness of this approach is the use of sustainability scores from MSCI or Sustainalytics, because these scores are backward looking and narrowly focused. Tech companies, banks or healthcare firms score very highly as they have much less environmental impact than industrials or oil companies.

Investors have piled into these high-scoring ESG names in recent years. They've been richly rewarded by markets but have ended up with very growth-oriented, tech-heavy sustainable portfolios.

Now, I think we are entering into the next phase – in part because of the market downturn. ESG 3.0 is really about going back to basics and conducting deep research on companies. Investors need to look beyond the leaders to find investment opportunities in less covered areas such as transitioning companies.

What do we mean by transition?

Transition is a shift towards improved impact or better ESG behaviour by companies.

In the energy sector, for instance, we are talking about firms that are shifting away from fossil fuels to energy sources with little or no carbon emissions.

There is also a fundamental shift happening in the social space, both in terms of diversity and how companies treat their employees. For example, at Walmart or Amazon, employee retention is a huge part of the investment case because it goes directly to the bottom line. Companies with high turnover rates find themselves having to re-hire and re-train employees at a huge cost, to the detriment of shareholder returns.

How do you invest in ESG 3.0?

Our objective is to invest in companies that are in the process of transitioning, and whose transition has not yet been fully appreciated by the market. We think there's a lot of investment opportunities in less preferred sectors like industrials, sometimes energy and utilities, because without those companies we won't really be making that sustainable transition.

We do our own research and make our own decisions. Even if rating agencies have become much better at providing different types of data and research, we are not wedded to their conclusions.

To me, this really is the realm of active fund managers because of all the fundamental research that is required. It really differs from a passive ESG fund. We have to understand a company, its risks and opportunities, and its potential for making a transition. Engagement is an important element of our strategy. We work with a selected number of companies that we can meet up to four times a year, to guide them towards this transition path.

"We have to understand a company, its risks and opportunities, and its potential for making a transition. Engagement is an important element of our strategy. "

What type of companies are you looking for?

First and foremost, we are looking for companies with robust balance sheets and the potential for high returns, because becoming more sustainable can take up a lot of capital. Second, we want to invest in companies where the environmental or social impact of products and services directly translates into operational improvements. And sometimes, those opportunities are not the most obvious.

Take electric vehicles. Apart from Tesla, we don't really see a lot of auto companies making electric vehicles in a profitable way - they either have a diversified product mix that includes other types of cars or they are benefitting from government subsidies. Those companies are basically sacrificing their margins and returns to produce electric vehicles. It is unsustainable in the long run as it will gradually erode capital.

On the other hand, we own an oil services company with which we engage a great deal. It has compression technology that is applicable not just to oil, but to liquefied natural gas (LNG) and then further down the road to hydrogen. Not only is this particular division more profitable than average for the firm, but it is also a good indication the company is well placed to survive the energy transition.

How do you ensure your voice is heard, as you engage?

I recently had a lunch with 20 wholesale clients, who in turn advise companies about their pension funds. They all cared about ESG because their clients do. Engagement is a two-way process. While we expect companies to work towards our ESG-related objectives, we also share our best practices and knowledge in the matter. Companies are eager to learn, especially on how they should report or what first steps they should take.

Not so long ago, my colleague Peter Rawlence was invited to an industry event by an energy company. We were one of only four partner investors at the event; the other three were giant global asset managers. We may hold a much smaller stake in the company, but they wanted us to sit at the table because they know that that we are an influential voice in the field of responsible investing. Companies really are starting to listen.

How do you measure something as complex as impact?

Impact measurement comes in many different forms. What we want to avoid is saying "by investing in the fund you saved X amount of CO2" or "you planted 10,000 trees", because there is no way of truly validating those numbers and they are meaningless to our clients. Instead, we look at impact figures at a company level for all of our portfolio companies. We track those key performance indicators (KPIs) and make sure that companies meet our targets. All that information is disclosed to our investors.

Overall, each company has different KPIs. We are dependent on companies' level of disclosure - which can also be one of our engagement objectives. This is a work in progress. We're still on this journey where more data becomes available every day.

For more information, scan the QR code or visit am.pictet.

PICTET
1805
Asset Management

Building Responsible Partnerships