NEVER WASTE A CRISIS: SUSTAINABLE STRATEGIES AFTER COVID-19

By David Harris

In uncertain times like these, investors are looking for solutions for their ever-changing investment strategies. The COVID-19 crisis could be a boon for smart sustainability strategies…

It was Rahm Emanuel, President Barack Obama's Chief of Staff, who argued in the aftermath of the last great period of market turmoil in 2008 that 'you never want a serious crisis to go to waste'.

As policy makers and financial institutions around the world make dramatic and costly moves to address the current crisis, many are also taking aim at the crises of the future.

As the market turmoil caused by the COVID-19 pandemic necessitates institutional investors to review their asset allocations and mandates over the coming months, we expect them to embrace invention in the form of climate and sustainability-tilted smart beta strategies, or what we refer to as Smart Sustainability. This is set to accelerate the already explosive growth of sustainable investing.

Photo: Archive FTSE Russell

David Harris

Smart beta strategies offer investors a low-cost means of taking a view on factors they believe will generate outperformance over time. Rather than simply tracking an index based on market capitalization, smart beta strategies use a series of pre-determined rules to tilt investment towards stocks based on particular factors such as value, quality, volatility, momentum, or yield.

The approach started to emerge after an earlier market crash. In the dot-com bubble of the late 1990s and early 2000s, tech stocks raced ahead of the wider market before collapsing spectacularly, badly burning many investors, including those that were passively tracking well diversified benchmarks.

That lesson ultimately led to the first factor indexes getting serious attention from institutional investors. These were typically 'value'-focused indexes, using fundamental factors to influence the weight of securities in the index based on objective and consistent rules that are not influenced by market over-exuberance. This had the effect of reducing returns on the way up, but providing considerable downside protection when markets fell.

Over the 15 years or so since smart beta products first saw widespread market acceptance, their popularity has exploded. Assets in factor funds rose from $ 565 billion to $ 1.2 trillion in the last five years, according to Morningstar data. Our annual survey of the market last year found that, for the first time, more than half (58%) of asset owners reported allocating assets to smart beta strategies, and more than three quarters (77%) of European asset owners expressed interest in applying ESG considerations to smart beta, up from 55% in 2018.

> *We expect institutional investors to embrace invention in the form of climate and sustainability-tilted smart beta strategies.*

Indexes and benchmarks that capture sustainability considerations can help push us toward a more sustainable global economy by encouraging better corporate ESG practices and disclosures.

More recently, another investment approach has also exploded in popularity: the integration of climate risk and other environmental, social and governance (ESG) factors. Investors increasingly accept that incorporating data on an issuer's ESG performance into investment analysis can help to reduce risk and improve returns.

These two trends have come together. We are finding that over the last couple of years a growing number of institutional investors have taken the opportunity to integrate certain sustainability parameters—usually climate related but sometimes other ESG measures as well—when they have awarded new smart beta mandates. Over the last couple of years this has become a majority, the new normal, for new asset owner smart beta mandates. This trend will benefit from the apparent relative outperformance of sustainability indexes during the recent COVID-19 sell-off.

The COVID-19 pandemic will inform us of the issues that investors choose to focus on. Social considerations have, in the past, garnered less attention than environmental and governance concerns, but that could change. Resilience will be a growing concern. To date, it has mostly been considered in regard to the low-carbon transition and exposure to physical climate hazards such as flood and drought; issuers' resilience to a wider range of disruptions will be a priority.

Many sustainable smart beta strategies employed to date have focused on climate change. Certainly, the impacts of global warming and of the policies needed to reduce greenhouse gas emissions will be a major driver of performance for a growing number of companies. But we expect investors to also seek to increasingly reflect other factors in new smart beta mandates, including Sustainable Development Goals strategies.

The latest Gates Foundation annual assessment of global progress toward the UN Sustainable Development Goals (SDGs) is less than encouraging. According to Bill Gates, the goals are still far out of reach as he lamented the world is nowhere near improving fast enough to meet them. The same could be said for investors—when it comes to addressing SDGs in their investments, there's still much progress to be made.

The SDGs might appear the logical next step for investors looking to take ESG to the next level, as they lay out 17 global goals spanning environmental, social and development issues—representing the closest we have to a global sustainability strategy.

The SDGs may offer the framework for identifying many of the issues that really matter to employees, stakeholders, companies, and investors alike. The goals can also bring a sharper focus to climate, gender, employment and job creation, urbanization, and, importantly, the role of financial markets in sustainable global growth and development.

There are some questions as to how they should best be used—are they a measurement tool for impact investors? A framework for identifying areas for shareholder engagement? Or a tool for identifying future investment risks to global portfolios?

These are the questions that characterize the early stages of SDG adoption in investment strategies.

Should investor SDG adoption continue to grow, there's a good chance the ultimate answer is that the SDGs will be suited for all of these uses. Because just as a broad range of tools, indexes and investment products has been developed to support the rise of ESG integration, the same will likely be done to support SDG adoption. An initial challenge is the ability to obtain meaningful company level data related to specific SDGs, in particular when you are working with a large global universe. However, new techniques for collecting and processing large amounts of data are providing exciting opportunities to clear this hurdle.

While still in their nascent stage, the future for SDG-aligned indexes looks promising. Indexes and benchmarks that capture sustainability considerations can help push us toward a more sustainable global economy by encouraging better corporate ESG practices and disclosures.

Indeed, the growth in investor allocations to investment strategies linked to social and environmental objectives – many of which will be aligned to the SDGs – has been spectacular. Data collected by the Global Sustainable Investment Alliance shows that in 2018 global assets in 'sustainability themed' and 'impact' strategies reached approximately $ 1.5 trillion, up from around $ 500 billion in 2016.

Ultimately, the contours of the post-COVID global economy have yet to come into sharp focus. But what is clear, is that investors are taking a hard look at how they expect to generate returns in the new normal; smart sustainability strategies and the SDGs are likely to become an increasingly popular method of their doing so. «

This article was written by David Harris, Head of Sustainable Business, London Stock Exchange & FTSE Russell.