Sustainable Investing in a bear market
“Will sustainable investing survive the bear market, or is it simply wiser to retreat to tried-and-tested strategies?”

This is a looming question in many investors’ minds, given that momentum around sustainable investing has thrived in a long bull market.

**EARLY EVIDENCE SHOWS RESILIENCE IN ESG STRATEGIES**

Early evidence has shown some form of resilience in terms of ESG strategies, which look at companies with strong environmental, social and good corporate governance practices.

Refinitiv’s analysis of the performance of the 34,340 equity funds relative to their Lipper-assigned benchmark from 31 January 2020 to 31 March 2020 showed that the average relative performance of the analysed ESG funds (+0.43%) was higher than that of conventional funds (-0.65%).

Data from Morningstar also showed that more than half of ethical and sustainable funds beat the MSCI World index. The MSCI World stock index fell by 14.5 per cent in March, but 62% of global environmental, social and governance-focused large-cap equity funds outperformed the global tracker.

Based on Bloomberg data, ESG funds are also outperforming ‘sin stocks’ in slumping markets. In past economic slowdowns, ‘sin stocks’ have been resilient, but this year, the coronavirus and lockdowns in cities around the world have significantly impacted the alcohol and gambling sectors. The S&P 500 Index hit its highest relative to the vice group in March.

ESG funds have benefited from owning shares of companies with strong business models that through their sound management of environmental and social issues have a degree of resilience that helps in time of crises.

ESG funds that have had exclusions against oil and gas sectors have also benefited in recent days from the lack of exposure in their holdings.

**Fig. 1 ESG investing show resilience**

<table>
<thead>
<tr>
<th>Performance Related to 100</th>
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<tbody>
<tr>
<td>31-Dec</td>
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<tr>
<td>MSCI Europe ESG Leaders</td>
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Source: Refinitiv, MSCI, Standard Chartered
Fig. 2 Investors are showing appetite for ESG solutions

One year and Year-To-Date flows into ETFs relative to total assets

<table>
<thead>
<tr>
<th>Flows as % of Assets</th>
<th>Top 25 US ESG</th>
<th>YTD</th>
<th>1-Year</th>
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<tbody>
<tr>
<td>69.6%</td>
<td>8.6%</td>
<td>25.6%</td>
<td>1.9%</td>
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WHAT CONTRIBUTES TOWARDS THIS RESILIENCE?

ESG investing has been used as a tool for risk management, focusing on companies with best-practice operations across material environmental, social and governance aspects of the business. Companies with higher ESG scores tend to be of higher quality, experience lower volatility and be relatively large. This can make them more resilient when markets fall. In the face of a downturn, clients tend to liquidate riskier assets first hence a higher quality portfolio should, in general, be better protected during severe drawdowns.

A study comparing over 10,000 funds between 2004 and 2018 found that sustainable funds had 20% less downside risk than traditional funds, and were more resilient in years of turbulent markets, such as 2008, 2009, 2015 and 20181.

As a bear market increases earnings stress, it forces analysts and investors to understand the underlying drivers of value creation, such as corporate governance structures, employee and customer loyalty and operational efficiency, which are among the factors considered in ESG evaluation.

THE IMPORTANCE OF MATERIALITY

While the case is being made for the importance of ESG factors, it is important to understand that not all ESG factors are equal, hence the concept of materiality is important.

Materiality refers to “a measure of how important a piece of information is when making a decision”. Material “E, S, G” factors differ based on industries and can influence financial fundamentals.

Take, for instance, airlines—its material ESG factors would include fuel efficiency, carbon emissions and health and safety practices, which would have a bigger impact on bottom line and consumer expectations, as compared to issues such as child labour.

As investors investigate the materiality of ESG factors, they should consider:

- **Sustainability impact**: understanding how an asset is positioned with regard to sustainability and whether it contributes either negatively or positively to extra-financial value creation. This may range from a reduction in Greenhouse Gases Emissions to a decline in accident rates or an increase in diversity of a workforce.

- **Financial impact**: whether these ESG factors influence financial value creation or destruction.

LOOKING FORWARD TO THEMES THAT ARE HERE TO STAY – BEAR OR BULL MARKET

While sustainability is a broad area, a couple of key themes stand out for investors to watch.

Climate change – considering the costs of climate risks and transition risks

Traditional approaches to risk management which consist of extrapolating historical data and on assumptions of normal distributions are largely irrelevant to access future climate-related risks. The damage inflicted by climate change, for instance through increasingly volatile weather patterns, has risen quickly and we have seen the costly impact in both Australia and California early this year. According to Moody’s Analytics, the economic damage from the Australian bushfires is likely to exceed the record USD 4.4bn set by 2009’s Black Saturday blazes2.

The Bank for International Settlements, often described as the central bank for the world’s central banks, has warned that climate change may spark ‘green swan’ disasters, which are extremely financially disruptive events that can trigger a systemic financial crisis3.

In its 2019 report4, the Climate Disclosure Project (CDP) revealed that 215 of the biggest global companies reported almost USD 1trn at risk from climate-related impacts, with many likely to hit within the next five years. Over 80% of companies see significant climate-related impact on their operations, including extreme weather patterns, rising global temperatures and increased pricing of greenhouse gas emissions. Around USD 500bn of costs are rated as likely to virtually certain, with a potential USD 250bn in losses are due to the write-offs of assets.

Regulation is another aspect that will impact companies, with a report5 from Refinitiv estimating USD 4trn worth of carbon taxes to be paid by firms, which could translate to a hit of revenue of as much as 13% for companies. This is based on a USD 75 per tonne global carbon tax, a level the IMF has said is needed to limit temperature increases to about 2 degrees. This would have significant impact on companies in sectors including construction materials, utilities, metals and mining and airlines.

\[\text{~USD 4trn} \quad \text{carbon tax to be paid} = \quad \sim 13\% \quad \text{of revenue}\]

2 Source: Economic impact of Australia’s bushfires set to exceed $4.4bn cost of Black Saturday.
5 Source: The financial industry should prepare now for a “Carbon Correction”, Refinitiv, Jan 2020.
**Climate change – opportunities in transition and financing transition**

Moving beyond understanding and mitigating risks, climate change can also be an investment opportunity. In the CDP report\(^6\) highlighted above, climate business opportunities were calculated at USD 2.1trn, nearly all of which are highly likely or virtually certain. The potential value of sustainable business opportunities almost 7x the cost of realising them.

Investors interested in capturing opportunities should look at sectors that will aid or benefit from the transition to a low carbon economy. This includes companies providing goods and services that will enable the transition, such as makers of electric vehicles and renewable energy providers, and the businesses that make their operations more resilient to climate change by decarbonising them, including some fossil fuel companies. Interestingly, fossil fuel companies report more opportunities than risks from the low-carbon transition.

Based on the report, companies in the financial sector see the most potential revenue from potential new sustainable products & services, followed by manufacturing, services, fossil fuels (USD 141bn) and the food, beverage & agriculture industries.

In addition to the role of renewables and energy-efficient measures, the rise of the circular industrial economy is another important theme in addressing climate change as this looks at addressing emissions associated with making products.

The circular economy refers to an economic system aimed at eliminating waste and the continual use of resources. This regenerative approach contrasts with what most of us are familiar with, in terms of a “take, make, dispose” model of production. This is spurring new industries and businesses focused on recycling, reusing and repurposing, including areas such as designing out waste, keeping materials in use, and regenerating farmland.

A paper by the Ellen MacArthur Foundation\(^7\) shows that when applied to four key industrial materials (cement, steel, plastic and aluminium), circular economy strategies could help reduce emissions by 40% in 2050. When applied to the food system, the reduction could amount to 49% in the same year.

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\(^7\) Source: Ellen MacArthur Foundation, Completing the Picture: How the Circular Economy Tackles Climate Change (2019).
Opportunities within the investible Sustainable Development Goals

The United Nations’ 17 Sustainable Development Goals (SDGs) are among the most ambitious projects humanity has attempted and within those goals, Standard Chartered’s Opportunity 2030 report examines the opportunity for investors to contribute to three of the most tangible, infrastructure-focused SDGs in 15 of the world’s fastest growing economies.

SDG 6: Clean water and sanitation

Globally, 3 in 10 people do not have access to safe drinking water. 6 in 10 people do not have access to safe and clean sanitation facilities, affecting their health and livelihoods. Worldwide, nearly 1,000 children die due to preventable water and sanitation-related diseases.

SDG 7: Affordable and clean energy

Clean and renewable energy sources are crucial for combating climate change. 840m people worldwide are still living without access to electricity, even with rapid modernisation. >1 in 10 people worldwide still lacking a safe and reliable power supply.

The social impact of this can be significant, given that access to electric lighting helps children pursue educational opportunities and hence increases one’s ability to find employment.

SDG 9: Industry, innovation and infrastructure

Infrastructure is vital for countries to achieve sustainable and inclusive economic growth. Transport infrastructure is particularly essential for boosting trade and productivity, increasing income levels and decreases poverty. In addition, it helps facilitate climate action, with investments in sustainable transport infrastructure reducing CO2 emissions and benefitting public health through improved air quality.

USD 3.674trn investment is required in transport infrastructure in the world’s emerging markets by 2030, with the greatest investment opportunities in China (USD 2.31trn).

Enabling internet access is another large opportunity. ~3.8 billion people globally (including 80% of the population of the least developed economies) do not have access to the internet.

16% of the population lack access to mobile broadband networks.

As investors brace themselves for a bear market, there remains opportunities in the sustainable investing space that they can investigate, and future proof their portfolios for the structural shifts in society continue towards sustainability.

~USD 125.4bn of the private sector investment needed in water and sanitation in the world’s emerging markets by 2030.

The markets in Asia offer the greatest investment opportunities, led by:
- **China**: USD 26.1bn
- **India**: USD 19.2bn

~USD 4.226trn of the private sector investment needed in generation and transmission of electricity in all Emerging Markets by 2030.

The greatest opportunities reside in Asia, led by:
- **India**: USD 701.5bn
- **Indonesia**: USD 147.5bn
- **Bangladesh**: USD 73.9bn

USD 1.642trn investment is required in transport infrastructure in the world’s emerging markets by 2030, with the greatest investment opportunities in China (USD 2.31trn).

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9 Source: UN SDG 6: Clean water and sanitation.
10 Source: UN SDG 9: Building Build resilient infrastructure, promote sustainable industrialization and foster innovation.