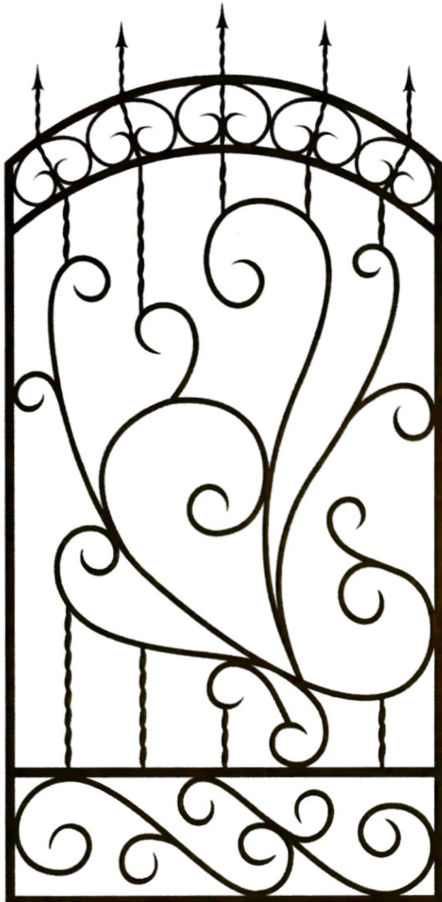
SUSTAINABLE STRATEGIES



THE GATEKEEPER'S DILEMMA

HOW TO ASSESS ESG FUNDS

A small pool of funds and idiosyncratic subclasses can make selecting ESG strategies a tricky task. But should the process be any different from picking traditional products?

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I have spent a large part of my career leading manager research and multi-manager portfolio model teams in both asset management and wealth management settings.

As a product of assessing hundreds of boutiques and teams I have developed a methodology for deconstructing investment processes and portfolios in quantitative and qualitative terms. This allows me to evaluate relative and absolute 'goodness', discipline, transparency and systematic risk management.

In this field there is almost an embarrassment of riches, with thousands of managers and tens of thousands of strategies in the universe. Any given category of substance has dozens, if not hundreds, of competitive options.

If a strategy under due diligence does not seem to be standing up to scrutiny, just move on to the next one. If a thesis is not playing out, sell and move on to the next one.

THE DILEMMA

But what if the gatekeeper – a research director, a fund-of-funds manager, a consultant – faces an asset space where there are only a few options, or perhaps only one?

This is a critical challenge for research- and advice-driven firms that have the task of evaluating managers and building globally allocated solutions for an environmental, social and governance (ESG) mandate.

Not only is the population of managers fairly concentrated, there are subclasses within the population that make peer groups even smaller. Religious and other types of sub-mandates may introduce portfolio and process idiosyncrasies that make peer grouping more challenging. Do gatekeepers need a new methodology to address this space?

A number of firms have been coming to market with new ESG-oriented strategies, so it is easy to anticipate a future where asset categories will see at least dozens if not hundreds of options.

What about right now, though?

Gatekeepers see new strategies with little or no track record in traditional investment terms and little evidence to demonstrate skill in ESG terms. Only the passage of time or an extraordinary amount of deep analysis and extrapolation can address that.

BACK TO BASICS

In my view, the solution begins with dismantling the mythology around portfolios and performance going back to the early days of socially responsible investing.

The quantitative evidence we can tease out of general manager and fund databases and a number of academic studies do not support the widely held conclusion that performance is different, and in fact worse, than traditional asset management.

Speaking in gatekeeper terms, if an ESG strategy is underperforming against a reasonable peer group, consider that it might be an artifact of a traditional style bias or just poor money management and not intrinsic to ESG itself. The expectation should be market performance with market risk, neither more nor less.

There is nothing about ESG that should necessitate quarantining such strategies in a bubble universe of their own. Short of buying the entire market in cap- or float-weighted proportions, any portfolio manager first makes a series of headline decisions to reduce the selection universe to securities that have a reasonable likelihood of satisfying portfolio criteria.

That reduction may be based on size, industry and sector, or financial ratios. How is the byproduct of that top-down process intrinsically different from eliminating companies based on environmental performance, human rights track record, or executive compensation policies?

A FAIR COMPARISON

Most ESG security selection factors are no more esoteric than long-pursued fundamentally researched criteria. Does looking at workplace safety produce materially different selection results than considering employee satisfaction surveys? Are sustainable supply chain considerations wildly different from looking at cost of inputs and resource utilization efficiency in manufacturing?

ESG is part of the language of fundamental security analysis. ESG-driven decisions will introduce biases in portfolios just the same as favoring companies with low debt-to-equity ratios or regular dividend increases.

Why not evaluate and compare ESG strategies on the same basis as their traditional stylistic peers? Judge them first as traditional portfolio managers and then overlay that coverage with robust analysis to be certain they approach ESG with the level of thoughtfulness and authenticity in sustainability terms that clients require.