SUSTAINABLE STRATEGIES

Revisiting the classics

Mark D. Sloss
CHIEF EXECUTIVE, REGENERATIVE INVESTMENT STRATEGIES

Regenerative Investment Strategies chief executive Mark D. Sloss explains the origins of sustainable investing and the impact of divestiture

It really feels like the market for sustainable and responsible investing has come full circle.

The roots of this style of investing can be traced back to a variety of religious movements and values, as well as societal and environmental concerns. Portfolios have been built by first eliminating businesses rooted in traditional vices such as gaming, alcohol and tobacco, or those with exposure to bigger issues, such as South African apartheid.

The economic motivation on the part of investors may have been not to profit from certain businesses and business practices, or it might have been a more active effort to deprive those businesses of access to capital, but it amounted to the same thing – divestiture.

The remnants of this approach linger in many environmental, social and governance (ESG)-oriented strategies today, with baseline exclusions that might involve weapons, tobacco, and egregious environmental and human rights threats. But exclusion as the principal engine of ESG investing has given way to more inclusive processes that are prioritizing best-of-class companies according to a range of sustainable business factors.

DEBUNKING MYTHS

As mentioned in previous columns, there is a persistent mythology surrounding ESG that divestiture comes at the cost of increased risk and reduced return from a more limited opportunity set. The numbers do not support this, and neither does the reasoning. Short of full index replication, most investment processes, fundamental and quantitative, incorporate some funnel or screen that either re-weights, or outright excludes, securities that do not exhibit favorable attributes.

With that largely debunked, the new reasoning behind the assumption of poor performance is not so much about limiting the universe, but limiting the universe by non-financial factors. This is a similarly bogus assertion, since many investment processes incorporate non-financial factors that may be indicators of the potential for financial outperformance or recognition of off-balance sheet risk. Many ESG managers and academics worked to identify non-financial ESG factors that have economic significance to tease out even more sources of alpha. A new generation of strategies was born, geared toward inclusivity and best-of-class companies and securities.

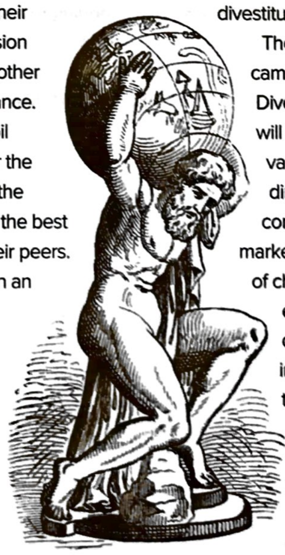
But did they overcorrect?

The holdings of a number of these portfolios end up nearly indistinguishable from their non-ESG counterparts because exclusion has been set aside for weighting and other schemes to favor ESG factor performance. A manager might own an integrated oil company, but will show preference for the one with the best safety track record, the largest investment in renewables and the best environmental track record among their peers. 'ESG-ness' becomes relative and often an industry-specific call while absolutes are put aside.

A significant and growing number of investors, however, find themselves dissatisfied with this evolution. Weighting and optimization, best-of-class and other inclusive methodologies, leave these investors troubled that they are unable to fully align their investments with their views and values. Advocacy and engagement are insufficient to offset the disagreeableness of certain companies or securities, and they find ownership tantamount to support and approval for bad ethical, societal and environmental practices. Rummaging around in the investor's toolbox, they have reached in and pulled out divestiture. What was old is new again.

A LEVER OF CHANGE

Most prominent among the divestiture-oriented strategies right now are the fossil-fuel-free portfolios. They are devoid of most traces of the hydrocarbon economy, eschewing oil, coal, natural gas, pipelines, drillers and other companies that are principally in the supply chain of extracting, transporting and burning hydrocarbons. There are partial-measure portfolios as well, 'carbon optimized' or 'low carbon,' which will satisfy some investors but are largely ignored by those who see divestiture as the tool of choice.



The impact investment divestiture campaigns alone create is debatable. Divestiture in efficient liquid markets will do little to move the needle on valuation. But, with consumer and direct public action, regulation, competition and other forces in the marketplace, divestiture becomes a lever of change. The levels of sophistication, expectation and action around divestiture have climbed with ESG investors. Whether or not it is a myth, they are no longer satisfied accepting anything less than market-performing investments, and they want their portfolios to reflect their ideals. Divestiture is very much back on the table.