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ROYAL LONDON
ASSET MANAGEMENT

Growing pains in sustainable investing

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Mike is Head of Sustainable Investments and co-fund manager of the Sustainable Leaders, World and Diversified trusts as well as the Global Sustainable Equity fund. He has managed the Sustainable Leaders Fund since November 2003. Prior to this, Mike worked as a Deputy fund manager at the Co-operative employee pension fund for two years and as an investment analyst covering the utility, support services and media sectors. Mike originally trained and qualified as a Chartered Accountant with Ernst & Young in Manchester. Mike has won five Fund Manager of the Year awards, in 2015, 2017, 2019, 2020 and 2021. Mike has spent the majority of his career assessing environmental, social and governance issues and how they influence investment decisions. He is a specialist in sustainable investing and one of the few fund managers in this area with such long tenure.

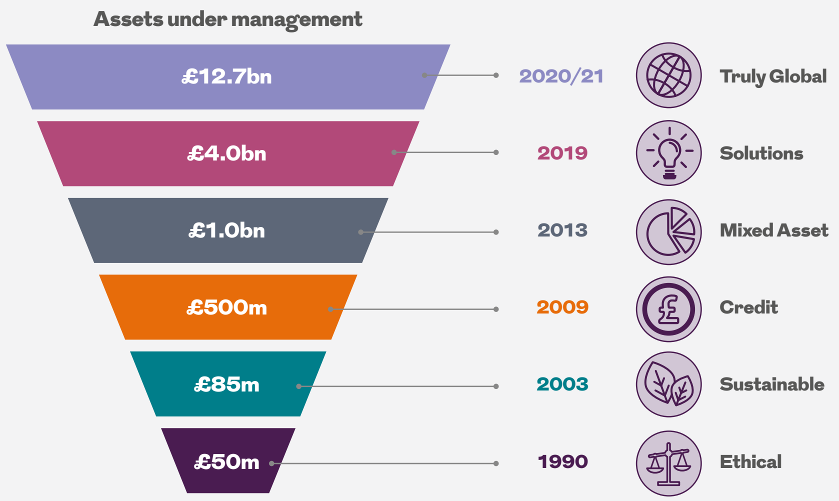
> “I remain firmly convinced that sustainable investing offers the best potential of doing good for society, while deriving reasonable investment returns.”

While retaining a very positive longer-term view on sustainable investing, we expected 2021 to be a challenging year – as presaged by the performance of our sustainable funds during November 2020 as the ‘Covid-19 reopening’ trade played out. However, as of early December, the funds have had a strong 2021, although this masks periods of strong out and underperformance, rather than a consistent trend.

There are several reasons for this, but in summary we tend to favour more growth-oriented sectors and stocks (such as technology, healthcare and high-end engineering); and the long-term prospects for those companies and industries badged as ‘growth’ have accelerated due to the pandemic. Conversely, many companies and sectors regarded as value (leisure, retail, oil, etc.) have seen their prospects worsen.

We retain our long-term positive view of the prospects for sustainable investing: while we don’t invest thematically, our conviction in the broad themes that we see across most of our investments has only strengthened, such as technology (specifically digitisation, cloud computing and ecommerce) and healthcare. However, we believe that 2022 could be a more challenging year for sustainable investing. As I will explain, this is partly market-related (valuations are much higher), but also reflects the ‘growing-up’ process that sustainable investing is going through.

Sustainable investing at RLAM
Product evolution



Source: RLAM as at 31 October 2021. AUM covers the sustainable fund range and segregated mandates.

There are three broad areas of concern for us:

1. **Regulation:** we see the regulatory burden increasing for sustainable funds – some of this is already in place, but we see it gaining traction in 2022. Of course, we're in favour of well-conceived regulation that is beneficial for end-clients – for example, the regulations introduced recently by the UK's Investment Association that requires sustainable fund managers to be able to demonstrate and report on sustainable effects. We're more concerned about the taxonomies introduced by the European Union – the definitions of what is 'sustainable' are very narrow and this could create asset bubbles, which would certainly not be beneficial for end-clients. Managers should be able to operate within parameters, but these are narrowing and that will make sustainable investing harder.

2. **Ability of thematic sustainable funds to outperform:** we believe that the 'low-hanging fruit' has been picked in the rush to sustainable investing that we've seen over the last few years and some of the newer entrants will struggle to outperform. In particular, those funds that have adopted a low-intensity sustainable investment process by adopting broad themes (such as low carbon or following the UN's Sustainable Development Goals (SDGs)) may struggle, as the short-cuts have been arbitraged away. I believe that we're entering the period of sustainable investing 2.0, which will require more heavily resourced and granular investment processes. Clients will benefit from asking managers detailed questions about their investment processes and how much in-house resource is available – in my view, those who rely mainly on external data will likely find the going tougher from here.

3. **Sustainable stocks are more expensive now:** perhaps all equity managers feel like this after 18+ months of stocks recovering from the initial impact of Covid-19, but trends such as digitisation and ecommerce have driven up the valuations of the biggest stocks in the world and sustainable funds are more expensive than at any time that I can remember.

   The year ahead will be a good test of the theory that 'prospects for sustainable businesses have been enhanced by the pandemic, but this will more than compensate you for the higher valuations that you have to pay to own them'. Without going into detailed investment maths, we will need to be comfortable that these higher-valued stocks will grow for longer – say for five or more years, rather than three or four. I'm not particularly uncomfortable about this, but companies will have to deliver to justify their high valuations. I anticipate that companies that don't hit investors' expectations (even for understandable reasons) will face a backlash and extended period in the doghouse. Such situations really test fund managers as we have to recalibrate our thinking on a stock, yet not overreact – it's usually right to hold and take the short-term pain, but where there is a clear break with our investment thesis, we have to face the facts.

So, 2022 looks like a year for regulation, wider dispersion in the performance of sustainable funds and volatility. I'm generally an optimistic person, but you wouldn't necessarily be able to guess from this outlook!

In my view, most people don't realise how early we still are in the adoption of sustainable investing. The Investment Association believes the scale of assets that is managed sustainably is still well under 10%. So while investors may feel that the sustainable ship has sailed and that they don't want to be last to the party, this is not the case. I remain firmly convinced that sustainable investing offers the best potential of doing good for society, while deriving reasonable investment returns.

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