Resilience in Sustainability Funds

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The COVID-19 pandemic has been described as a stress test for equity funds. But funds with a sustainability focus have shown resilience amidst the turmoil in global markets. Paul Schofield, the lead portfolio manager of the Allianz Global Sustainability Fund shares his insights on the environmental, social and governance (ESG) space and why these values can no longer be ignored in the investment realm.

QUESTION 1
How has the fared in the aftermath of the coronavirus-related financial crisis? Why is this the case?

At a high level, my personal belief is that the COVID-19 pandemic in and of itself may probably not have huge issues on ESG investing; it may highlight some areas and downplay others. The trend for ESG has long been established and has been increasing year on year. ESG is just one tool in the toolbox that investors may use when analysing companies. We do not believe COVID-19 will change that; the trend was already in place and it is only going one way.

However, the focus has shifted a little. The Governance element of ESG was always the easiest one to talk about, everyone understood this and were comfortable that good corporate governance is a 'good thing'. In the last few years the clear focus of ESG was the E, the environmental benefits. In particular, climate change was the area the clients had a particular connection with. The S, the social part of the equation has always been the difficult one to discuss with people and COVID-19 has helped to highlight some of the social factors a little more.

The need to get the economy back and firing means working conditions, for example, will need to be managed closely across the world. Companies will have to convince its employees, trade unions and regulators that workers will be kept safe. This will be much discussed going forward. Topics will include healthcare, access to medicine, education and health and safety which were areas that were less discussed pre- pandemic.

Now with all this having been said, the performance of ESG funds and indices may be to their wider adoption and for about the last 6 or 7 years including 2020 (as of September) outperformed their non-ESG peers. This level of resilience has helped us and our peers enormously. This performance has translated into flows where significant flows into Sustainability funds have flown in the face of significant outflows from active equities more generally as investors get more and more comfort that they do not forgo returns by investing in this way and in fact, incorporating ESG into your investment process may be performance enhancing.

QUESTION 2
Walk us through the investment process of Allianz's sustainability strategy. How are stocks selected and what quantitative/qualitative factors are they ranked against before they are included in the portfolio?

The Allianz Global Sustainability strategy invests in a diversified mix of companies on the global stock market that aims to generate long-term outperformance and a positive, measurable impact on society. The investment process is a collaborative effort, consisting of four stages: SRI Ratings; Idea Generation, Team Stock Selection and Portfolio Construction.

[1] *Proprietary SRI Ratings on over 4,000 companies.*

[2] *Global listed companies with a market cap over $1bn USD and a $10mn average daily turnover.*

The strategy takes a 'Best in Class' approach to SRI, seeking to own companies which outperform sector peers on ESG criteria. ESG performance is assessed using AllianzGI's proprietary SRI Ratings model. The strategy also aims to avoid stocks with reputational risks, excluding stocks with significant revenues from coal, tobacco, alcohol, weapons, gambling and/or pornography.

The model ranks stocks as Best in Class, Average or Worst in Class. Thereafter, using bottom-up fundamental analysis, the PMs construct a concentrated, diversified and long-only portfolio of c.50 stocks with superior financial and ESG performance.

The team analyses all potential investments from the bottom up, considering stocks in terms of their quality, growth and valuation characteristics. The focus is on high quality companies generating returns sustainably above the cost of capital, with a clear growth trajectory, on reasonable valuations. These stocks tend to be excellent franchises, operating in sectors with low competitive intensity and high barriers to entry. The valuation discipline is based on reverse discounted cash-flow analysis.

The strategy invests primarily (at least 75% of portfolios) in companies that are considered 'Best in Class' according to our SRI ratings. It can also invest up to 25% of the portfolio in 'Average' rated stocks that have demonstrated a commitment to improving ESG performance. This flexibility incentivises the portfolio managers to engage with investee company managements in order to press for continued ESG improvements. We believe that superior ESG performance may ultimately translate into share price appreciation. As a result, this mechanism is an important source of alpha for the strategy, as well as positive, societal impact. The strategy cannot hold any worst-in-class rated names.

QUESTION 3
Research from Morningstar showed that the majority of ESG-centric funds outperformed their conventional counterparts this year. Why is it so important to also assess the ESG component of a stock today and how does it contribute to fund performance?

ESG factors are important drivers of investment performance. An investment process which takes these into account should be better able to identify both the associated competitive advantages and potential downside risks.

For example, from a quality perspective, an industrial company with fewer injuries and fatalities than its peers should produce material cost savings over time. This is because the company will be subject to fewer stoppages in work, fewer legal penalties and, assuming a safe environment is more attractive to employees, lower staff turnover. Similarly, companies that are improving their ESG performance should be rewarded by the market as their quality improves.

Equally, the long-term ESG parameters within which management must operate may have a bearing on how a company grows over time. By identifying longer-term risks, such as increasing environmental regulations or opportunities such as the evolving demand trends of millennial consumers, better insight can be achieved on the growth assumptions used for evaluating holdings.

Many academic studies now show a positive correlation between good ESG risk management and financial performance. Allianz Global Investors has synthesized this into a white paper called 'ESG in Equities'. The white paper uses recent, publicly available studies written by academics and financial services providers to analyse the financial materiality of Environmental, Social and Governance (ESG) factors for listed equity as an asset class.

QUESTION 4
We are approaching the tail-end of 2020. What's your broad outlook for markets ahead and what your investment strategy ahead? Any sector preferences?

COVID-19 has accelerated the technological change disrupting the old economy, driving increasing returns for the winners at the expense of the losers. There is also great conviction in the power of the US Federal Reserve to backstop the financial system and the equity market through unlimited asset purchases.

We believe technological disruption is set to continue. It will pay to be on the right side of these trends as has been shown in recent years. Similarly, COVID-19 has brought forward many behavioural changes that were likely to happen anyway.

However, we should be careful in assuming that everything that has changed in recent months will stay this way. Many behavioural changes have been forced rather than voluntary. Thus far, monetary authorities around the world have reacted quickly and aggressively to support markets, but such actions may bring new risks further down the road, particularly as they come in combination with huge fiscal deficits.

Against this uncertain backdrop, we believe the portfolio's focus on quality stocks with sustainable growth at reasonable valuations makes it well-placed to navigate the months and years to come. A quality mindset means the portfolio may have a bias towards resilient, financially sound companies. At the same time, we are not chasing market momentum for stocks without the long-term earnings growth to substantiate their valuations. A truly active approach may prove more necessary now than ever.

QUESTION 5

There has been significant growth and demand for ESG investment solutions over the years. Do you expect this trend to continue especially following the impact of COVID-19 that has highlighted issues surrounding sustainability?

With the spread of COVID-19 globally, we have seen research that suggests that the evolution of the coronavirus (and others we have seen in the past like SARS, Ebola, avian influenza, etc.) may be associated with environmental changes or ecological disturbances, such as agricultural intensification and human settlement, or encroachments into forests and other habitats. In addition, experts suggest that virus epidemics are often triggered by events such as climate change, flooding and famines. In other words, in order to decrease the likelihood of future pandemics, politics must follow the roadmap to a more sustainable economy and society, and continue to fight climate change. This requires a longer term perspective, and with this in mind, it is important to note that investing sustainably means to reflect on the individual investment horizon.

We believe the COVID-19 crisis has driven individuals to be more interested in responsible investing on the back of (social) media attention to topics such as (impacts of) urbanisation, inequality etc. The interest is across all generations – not just millennials - with people wanting to know how their money is being invested and how this contributes to society, going beyond pure financial value generation.

Tapping into ESG

The Affin Hwang World Series – Global Sustainability Fund ("the Fund") which feeds into the Allianz Global Sustainability Fund ("Target Fund") was launched back on 14 September 2020.

Chan Ai Mei, Chief Marketing & Distribution Officer of Affin Hwang AM said, "We are proud to introduce our first ESG solution to investors as discussions surrounding sustainability, climate change and diversity are brought to the fore. Changing demographics and trends coupled with the unprecedented impact of the COVID-19 pandemic have only accelerated the adoption of ESG by both businesses and the investing community in their decision-making."

"Our belief is that good governance ultimately leads to better financial performance, with industry research showing positive correlation between ESG and stronger returns over the long-term. The new Fund will provide an avenue for investors to buy into global quality stocks with sustainable growth, whilst investing according to their own principles and beliefs," Ai Mei said.

The Base Currency of the Fund is in USD. The Fund is offered in four (4) currency classes, namely USD Class, MYR-Hedged Class, SGD-Hedged Class and AUD Hedged-Class. The minimum investment amount is $5,000 for all listed currency classes.