What next for ESG? Looking through the noise

Whilst ESG-integrated (the process of considering environmental, social and governance factors in investment decisions) portfolios have been around in various guises for many years, it took a global pandemic to truly throw ESG into the limelight. The strong performance of stocks in oft-highly rated sectors such as clean energy and technology saw many portfolios with an ESG focus significantly outperform their more traditional peers; products with sustainable overlays also enjoyed a period of strong performance for much the same reason. In early 2022, this came to an abrupt end, with a combination of rollercoaster geopolitics and soaring inflation proving particularly challenging for ESG. Understandably, this has led clients to question the longevity of such strategies as markets adjust to a world of higher rates and increasing investor-led scrutiny of sustainable products.

To answer this question, we must first understand the drivers of recent underperformance, of which rising interest rates have undoubtedly been the most significant drag. On average, sustainable themes are naturally more interest rate sensitive. Relatively early stage companies (i.e., those looking to tap into emerging themes, such as alternative energy) are capital hungry entities. Companies borrow to fuel growth, and the interest paid on the loan becomes a liability on the balance sheet. When rates rise, this liability increases and a company's overall value falls. Those companies with low or no borrowing needs – more mature, cash generative companies in sectors such as energy and consumer staples – do not see the same increase in debt repayment liabilities. The inverse relationship between rates and company valuations has continued to bite even as central banks have approached the end of their recent hiking cycle, as resilient economic growth continues to defy expectations and point to rates remaining 'higher for longer'.

Alongside the rates narrative, market sentiment has soured in the face of an increasingly hostile political backdrop. Across the developed world, not least in the UK, governments scrambling to ease the cost of living have been watering-down environmental pledges. As a result, we find ourselves in a position where politicians are doubling down on old world industries, rather than the new technologies that the majority of scientists and CEOs agree we need for a more sustainable economy. This won't last forever. New tech is increasingly cost competitive (just look at how sharply the price of solar panels has fallen), and as the saying goes, money talks. But in the meantime, negative sentiment has persisted.

So, what next - are we witnessing the slow death of ESG? Far from it. Whilst painful for investors, we view the last two years as a critical step in the maturation of ESG as an investing style. Gone are the days of buying stocks at lofty valuations for the sole reason that they reside in a sector with favourable ESG characteristics. In its place is a greater recognition of the opportunities on offer across the entire value chain. Take the offshore wind industry; where once a typical portfolio may have held the turbine installer/manufacturer in isolation, increasingly we see investments in the company that manufactures internal components, lays the connecting electrical cable, or mines the raw materials. This more holistic view of the investable universe is a win-win from both a valuation and diversification perspective.

The macroeconomic outlook for more rate sensitive assets is improving, too. As I write this article, UK inflation has just fallen to its lowest level in two years, with a similarly

positive story in the US. The Bank of England and Federal Reserve are both on pause, and confidence is growing that central banks are done raising rates. In response, we've seen the first signs of positive momentum for many of the most beaten-up sectors, including beleaguered renewable infrastructure assets. Fears of a global recession still linger, and the impact of higher rates is yet to be fully felt. If growth slows, company balance sheets will be affected; however, integrating ESG is a tried and tested method of tilting a portfolio towards strong management teams with the experience to navigate turbulent times.

Last but not least is the growing recognition that our planet is changing more rapidly than ever before. We are currently on a pathway that will fall hopelessly short of what scientists say needs to happen to avoid dangerous warming. 2023 looks set to be the warmest year on record – the warmest eight years have all been since 2015. Last month, some parts of the UK experienced the wettest October on record, while there are areas of southern Europe still suffering from drought. As these effects become more visible, the demand for more sustainable products, services, and investments will grow. Even after a historically challenging year for clean technology stocks, the International Energy Agency (IEA) expects global renewable capacity additions to increase by over 100 gigawatts, the largest absolute increase ever and equivalent to the entire installed power capacity of Germany and Spain combined. While investors have been fixated on short-term stock price moves, the transition continues apace. It is a powerful reminder to look through the noise in order to see the long-term structural trends.

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Email: **dfm@whitechurch.co.uk**

Phone: **0117 452 1207**