Sustainable investing: from niche strategy to a flight-to-quality?

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COVID-19 has wrought havoc around the world. How have markets valued environmental, social and governance factors during the pandemic? Here, HSBC Global Research's Ashim Paun offers analysis of two sustainable investment stock screens compared with an equity benchmark. Outperformance is found during the current crisis and over the longer term.

The pandemic has brought widespread global disruption to communities and societies. Lockdowns implemented by governments everywhere – coupled with oil price volatility - have brought massive economic upheaval and huge swings in financial markets.

Before considering stock market impacts, an understanding of sustainability factors is important in understanding how companies and sectors are exposed to this crisis. Social factors associated with the pandemic deal mostly with the effects and include healthcare resilience and access to medicine, automation of tasks in the workplace, job security for gig workers and aspects of inequality. Environmental effects to consider include the emissions that come from less air travel, working from home, online deliveries, and temporary lower industrial activity, as well as potentially more on-shoring of production and agriculture.

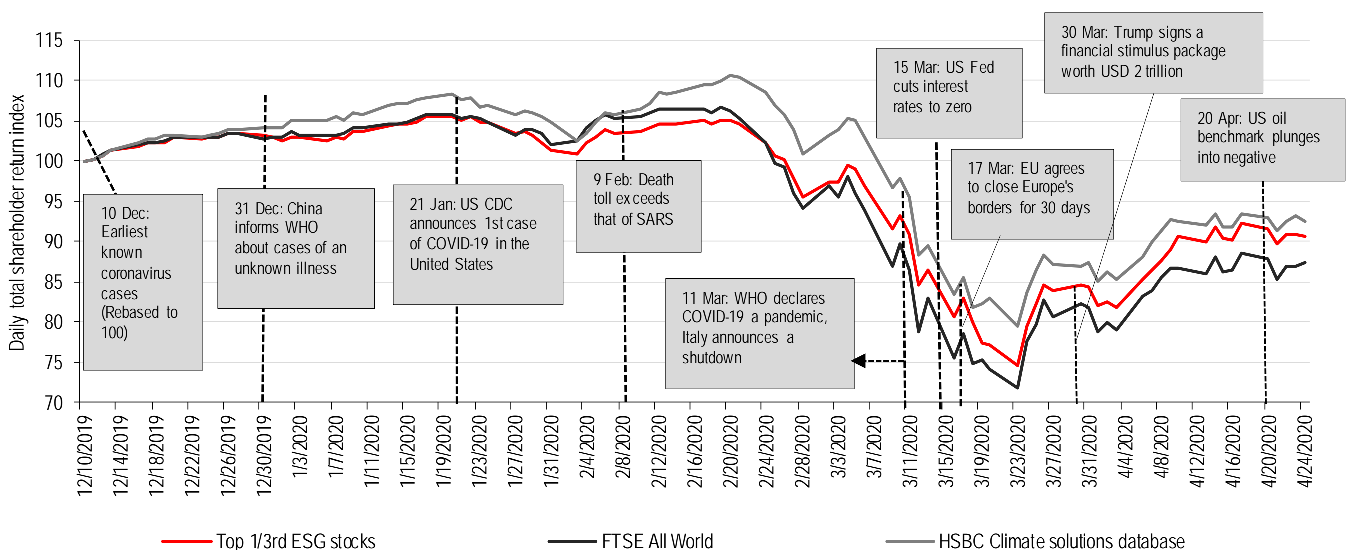
An analysis of the environment must also consider the causes of the pandemic. The COVID-19 virus is an example of a deadly zoonotic infection (one that is passed to humans from animals). We have had others, including SARS, Ebola, HIV and previous influenza variants. The Centre for Tropical Veterinary Medicine at Edinburgh University found that, during the 20th century, the proportion of infectious diseases which can be transmitted from animals to humans grew, with 75% of emerging pathogens found to be zoonotic. Many zoonotic viruses have been transmitted to humans via consumption of wild animals and through the parallel wildlife trade. So the pandemic raises renewed questions over how we treat and interact with nature.

Short-term sustainability outperformance

These factors raise a broader question for investors – how do markets value sustainability during such a crisis? In research notes which HSBC Global Research has published recently for its global investor client base, two sustainable investment stock screens were compared with a global equity benchmark (the FTSE All World Index).

The first screen was a portfolio of approximately 600 Climate Stocks. Companies from across developed and emerging markets with at least 10% of their revenue from climate themes were included. (These climate revenues were derived from HSBC's Climate Solutions Database (HCSD) – a proprietary tool which analyses corporate revenues against a detailed taxonomy of climate themes and products.) Additional criteria for inclusion in the portfolio included a minimum market capitalisation of USD500m, and a minimum free float market capitalisation of 10%.

On a global basis, these Climate Stocks outperformed the benchmark by 5.1% over four-and-a-half months from 10 December 2019 through to 24 April 2020. (There are material regional differences, with double-digit outperformance of Climate Stocks in APAC and LatAm, but underperformance in North America.) A second portfolio included approximately 210 High ESG-Rating Stocks, again from developed and emerging markets. Companies with a market capitalisation in the top 20% of FTSE AWI constituents were considered, as larger companies typically disclose more and often face greater scrutiny on sustainability issues. From these large caps, the portfolio was then constructed from those registering in the top third in terms of environmental, social and governance (ESG) scores, according to the scoring methodology of research provider Refinitiv Eikon.



Again, outperformance against the benchmark during the pandemic period - of 3.7% - was found. (On a regional basis, this outperformance was more pronounced in Europe and Asia).

And the long-term?

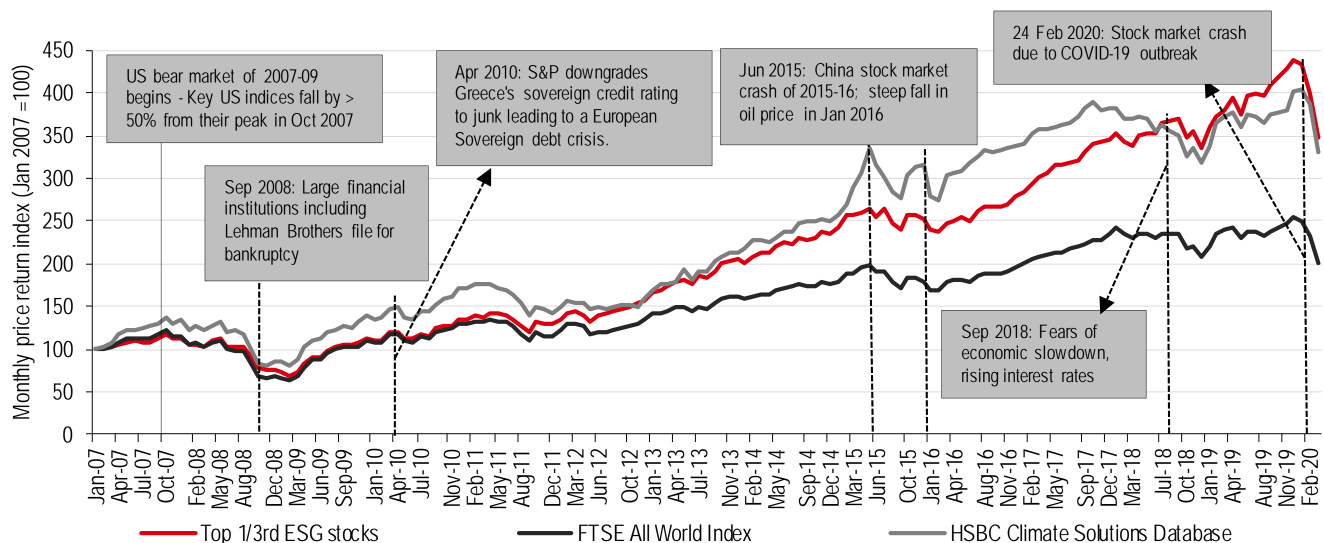
But what about over a period of many years? Many investors believe that long-termism is at the core of responsible investment. Here, the analysis was even more compelling. Both the climate and the high-ESG portfolios have outperformed since 2007 – a period covering the financial crisis of 2007-9, the subsequent sovereign credit crisis, stock market downturns in 2015 and 2018 and the current pandemic.
Since January 2007, the high-ESG portfolio outperformed the global equity benchmark by 75% and Climate Stocks outperformed by 66%.

In absolute terms, the high-ESG portfolio grew by 248%, while our Climate Stocks grew 232%, compared with growth of c100% growth from the FTSE AWI.

We also find significant long-term outperformance across Europe, the Americas and particularly in the APAC region. The table on the next page captures this.

Factoring in risk

A final question which HSBC considered was the volatility of the sustainable investment stock screens – how should investors think about the risk-adjusted returns of these sustainability screens?



There are a number of measures of risk-adjusted returns used by investors. One is the Sharpe ratio - which allows an understanding of how much excess return the holder of a riskier asset should expect to receive compared with a risk-free asset, such as a US Treasury. The excess return essentially should compensate for the risk taken on by investing. This ratio uses standard deviation to measure volatility – and therefore risk – experienced during the period an asset is held for.

A second measure, the Sortino ratio, also measures risk-adjusted returns but factors in only negative, or downside, volatility. Some risk analysts prefer to look at Sortino over Sharpe, because Sortino's view of a portfolio's risk-adjusted performance is designed to ignore positive volatility, which would generally be seen as a benefit (since most would welcome unexpectedly high returns) and should not therefore be 'penalised' in standard deviation calculations.

Either way, the higher the Sharpe or Sortino ratio, the better the returns have been relative to the risk that has been taken on.

The analysis found strong risk-adjusted performance for the sustainability screens. The average Sharpe ratio values for the High ESG-Rating Portfolio and Climate Portfolio since 2007 are, at 1.5 and 1.3 respectively, considerably higher than the corresponding value of 0.7 for the global equity benchmark. Meanwhile, the average Sortino ratio values for the High ESG and Climate screens over this period, of 3.7 and 3.4 respectively, were also substantially higher than the FTSE AWI at 1.7. Material risk-adjusted outperformance is also found across regional markets.

From niche strategy to the mainstream

In analysing such findings, further questions are raised about the factors that can drive such outperformance, as well as broader investor psychology. At HSBC Global Research, our long-held, core ESG conviction is the simple idea that issuers succeed long-term, and hence deliver shareholder returns, when they create value for all stakeholders – employees, customers, suppliers, the environment and wider society. Consequently, a key part of ESG is looking at how issuers serve society, and what this may mean for the future. When crises manifest, particularly with social and environmental causes and implications, as with COVID-19 and (arguably and partially) oil price dynamics, then we believe this idea is ascribed greater weighting by investors, who view ESG as a defensive characteristic.

	Relative performance from 10 Dec 2019 - 24 Apr 2020	Relative performance from Jan 2007 to Mar 2020	Average (2007-Mar 2020) Sharpe ratio (Portfolio/Benchmark)	Average (2007-Mar 2020) Sortino ratio (Portfolio/Benchmark)
HSBC Climate Solutions Database rel FTSE All World	5.10%	66.14%	1.3/0.7	3.4/1.7
Environment & Land Use Management, rel FTSE All World	2.40%			
Low Carbon Energy Production, rel FTSE All World	9.60%			
Energy Efficiency & Energy Management, rel FTSE All World	2.10%			
Capital Deployment & Financial Products, rel FTSE All World	2.50%			
HSBC Climate Solutions Database Regional performance				
HSBC Climate Solutions Database Europe, rel FTSE Europe	5.30%	39.20%	0.9/0.3	2.7/0.8
HSBC Climate Solutions Database North America, rel FTSE North America	-2.20%	23.24%	1.1/0.8	2.6/1.9
HSBC Climate Solutions Database Asia, rel FTSE Asia Pacific	12.40%	149.02%	1.1/0.5	3.9/2.2
HSBC Climate Solutions Database Middle East & Africa, rel FTSE MEA	9.40%			
HSBC Climate Solutions Database Latam, rel FTSE Latam	15.10%			
ESG				
ESG vs FTSE All World Index	3.70%	74.55%	1.5/0.7	3.7/1.7
Americas ESG vs FTSE Americas	0.04%	96.06%	1.5/0.8	3.1/1.9
Europe ESG vs FTSE Europe	8.55%	105.08%	1.0/0.3	2.3/0.8
Asia ESG vs FTSE APAC	6.92%	64.33%	1.2/0.5	4.6/2.2

Lastly, and at a more structural level, we think investors should assess how well companies they own manage ESG risks and opportunities, embedding this in valuation. ESG data can be a useful starting point to analysis, but correlation does not equal causation. Investors should instead use ESG analysis to consider whether estimated earnings growth levels are still realistic, what does increasing volatility mean and should risk premia be altered, how companies have used earnings, and what are the trough multiples from previous crises. And what are the best-case, worst-case, and highest-likelihood scenarios. In our view, this is the pathway towards deeper integration of sustainability factors into investment management.