Inefficiencies Inspire Sustainability

Original Article: "Why the Market Gets Sustainable Investing Wrong" by Wendy Cromwell, CFA
Viewpoint Author: Aaron Filbeck, CFA, CAIA, CIPM

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The full article may be accessed here.

Central Issue of the Paper

ESG, sustainable investing, impact investing, and socially responsible investing are popular buzzwords in the asset management industry. Everyone, from the asset manager to the individual investor, has different definitions for each of these phrases, some of which carry varying connotations depending on their views. In addition to definitional inconsistencies, the current structural state of the market has created inefficiencies and, therefore, pockets of opportunities for sustainability-driven investors. In her article, "Why the Market Gets Sustainable Investing Wrong," Wendy Cromwell, CFA identifies five of these inefficiencies and what investors might do to take advantage of them.

Approach Employed by the Paper

Market participants are heterogenous in that they take differing views on individual securities and have different time horizons for their investment portfolios. This is the basis of a fully functional market; it also can create opportunities for sustainability-focused investors who understand some of the inefficiencies it creates.

Cromwell identifies five of the inefficiencies, as well as the ways sustainable investors can exploit them:

1. **The market's focus on short-term growth.** Equity investor holding periods have shrunk substantially over the past few decades as investors have opted to focus on quarterly profitability metrics instead of longer-term corporate strategy. Sustainable investors have an opportunity to take a long-term view of companies and even engage with management to align corporate strategy with sustainable objectives while still creating shareholder value.
2. **Inconsistent, backward-looking ESG ratings.** While ESG rating providers offer a valuable service to investors, most ratings are based on company disclosures, which are backward looking. Additionally, different ratings providers emphasize different factors in their rating methodology, causing major differences in the final rating. Cromwell believes that by having multiple in-house specialists engaged in the analysis and the dialogue with company management, an active manager can derive differentiated insights and forecasting ability from their competitors.
3. **Emerging market (EM) indices' underexposure to structural development**. Capitalization-weighted EM indexes have experienced a drastic shift in terms of sector composition over the past

two decades. Approximately 44% of the FTSE Emerging Market Index consists of technology, consumer goods and services, health care, and industrials. These sectors have benefited from structural forces like greater inclusiveness, enhanced productivity, improved living standards, and better sustainability. However, over half of the index remains in legacy growth drivers, like natural resources and financials. In contrast, private equity investments have overwhelmingly allocated to investment opportunities in technology, health care, and consumer goods and services. If private equity allocations are providing insight as to where the opportunity lies, sustainable investors would do well to not hug pubic EM benchmarks, which are drastically under-exposed to these structural changes.

4. **Blind spots in climate risk analysis.** Regarding climate change, many investors focus on financial risks that might stem from climate-related policy, regulation, and legislation. However, Cromwell argues there is an even bigger climate-related risk being ignored: physical risks. Physical risks stem from companies that hold physical assets (such as real estate or power plants) in areas that could be negatively impacted by rising sea levels, drought, or extreme weather events. Investors who have a deeper understanding of physical asset risks may have more insight into which companies to avoid or to engage.
5. **An undefined impact investing universe.** Currently, the universe of publicly traded securities remains undefined regarding impact investing opportunities. While some organizations have made steps towards standardized definitions, none have been widely accepted. In the future, Cromwell expects companies that make a positive impact on society to be large economic growth engines. Active, sustainable investors have an opportunity to fight through the noise and identify these companies before everyone else.

Findings of the Paper

While this list is certainly not exhaustive, these five inefficiencies offer sustainable investors an opportunity not only to pursue sustainability objectives (such as engaging management) but also to avoid risks (sector composition in EM or physical assets risk) and enhance return (identify where the impact investment opportunities exist). Changes in societal attitudes, environmental research and regulation, and a shortening of investor time horizons all create market inefficiencies. These inefficiencies can create opportunities for investors with a long-term focus and a deep understanding of how value is created at the individual company level.