INVESTMENT INSIGHTS

Martin Grosskopf, MBA, MES
VP & Portfolio Manager
AGF Investments Inc.

How Themes Can Help Make the Most of ESG Investing

A day rarely goes by without an article or research paper on climate change, sustainability or some other topic related to environmental, social or governance issues.

For institutional investors, it's a veritable golden age of ESG investing, with more investment dollars flowing to these strategies, more money managers embracing the themes, and more companies and governments taking action to help build a better world. For instance, over 1,800 signatories representing approximately $70 trillion have signed on to the Principles for Responsible Investment, pledging to incorporate ESG issues into their investment practice.

But therein lies the problem: With the pledges to integrate ESG into investment strategies so prevalent, is there a better way to benefit more directly from the world's transition toward sustainability, one that produces dependable rates of risk-adjusted return?

At AGF Management Ltd., Martin Grosskopf, portfolio manager and director of sustainable investing, focuses on four broad sustainable themes: energy and power technologies, waste management and pollution control, water and wastewater solutions, and health and wellbeing.

"These four macro themes evolved over the 25-year life of the strategy, and we redefined them as time went on and certain themes became more robust," he said. "Each of these macro themes is important from the concept of sustainable development, and that's really what the origins of the strategy were.

"They provide a lens to track significant changes in society and the market, and where there's environmental and societal pressure on industries to improve their performance," he added. "It's really enabled us to identify those high-growth areas that result and the companies that are best positioned for it."

Identifying such companies is one thing. Analyzing them and investing in them is another.

Grosskopf, who has a background in environmental science, said he and his team, which also includes professionals with experience in environmental and social analysis and management, use both internal and external resources to help determine whether a company is a fit for the strategy. But sometimes that's not enough.

IDENTIFYING TOP PERFORMERS

"We do find that in some cases there are data inadequacies, especially with small or mid-cap companies," he said. "They don't necessarily report on everything that we'd like to see them report on, so we need to make estimations. For example, it could be water use that the company doesn't necessarily report, and we would have to estimate what we think their processes would consume in water to come up with a measure on that."

Narrowing the large — and growing — ESG universe to four macro themes is a good start, but with more than 4,000 publicly traded companies in the U.S. alone, additional effort is necessary to identify the top performers. And it's not a simple exercise of screening out certain factors, which is what early-stage ESG investing was often about.

Grosskopf subdivides the four macro themes into about 15 sub-themes, which gives him the opportunity to focus more narrowly on companies that meet his criteria. "For example, autonomous and electric vehicles is a sub-theme for us, and we will look across that entire value chain at companies that we think have good and growing exposure," Grosskopf explained. "And that would be everything from companies producing lithium or cobalt to companies that are suppliers that could be doing batteries or electronic components, semi-conductors that are going into electric vehicles, all the way to the manufacturers. For us, that would be the value chain."

From there, the team digs into the company's fundamentals, looking at factors such as short- and long-term margins and where the company is in its own business life cycle. Those factors influence what Grosskopf looks for in terms of ESG.

"For earlier-stage companies, the ESG factors and financial characteristics that we apply would be different from an incumbent," he said. "For example, you can't apply the same metrics to a company like Tesla — as an emergent company in the auto industry — that you would to GM or Toyota."

And then, of course, there are the companies.

"Whether it's water, waste, energy, healthy living, we've got to be really excited about why the company is offering the product and what the growth prospect is," Grosskopf said. "We would never own a company that we think is in an area that is going to be challenged due to changes in society over the next 10 or 15 years. So we wouldn't own a company because it ranks highly on ESG factors if we don't really like the product positioning."

According to Grosskopf, that is one factor that sets AGF apart from other managers as the field gets more crowded. "ESG is part and parcel of why we're selecting the companies vs. it being an add-on, which is true of many products coming into the marketplace," Grosskopf said. "We're looking at ESG factors from a risk perspective, but the opportunity side is as — or more — important to us. We're interested in companies that are providing the solution."

Because of that approach, the strategy has a high active share, meaning it doesn't closely mirror the benchmark that it is measured against, the MSCI World index. Grosskopf said the challenge is structuring a strategy that provides diversification and unique positioning but still tracks relatively well against a conventional benchmark.

He said the strategy can be customized to cater to clients with a specific ESG focus or interest. In addition, an allocation to ESG can address different objectives for different plan sponsors.

ADDRESSING THE SKEPTICS

"We find a lot of different applications. For some clients there has been a decision to make an allocation to ESG or sustainability products," he said. "In other cases, it is for diversification and to provide access to themes that conventional managers would not focus on."

Despite the well-developed work around the ESG themes, the deep analysis of companies under consideration and the strategy's long-term nature, Grosskopf said he still faces skeptics.

"It's one thing to be a skeptic, it's another to completely ignore the investment opportunities that are emerging," he said. "If you think of vehicles, the entire capital spend within the industry is moving away from diesel and combustion toward hybrid and electric. For skeptics, my case is simply that you need to have exposure here."

"Working with companies on the environmental and social impact issues of their operations provides you with a wealth of insight in terms of how these issues play out within industries," he said. ■

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