SUSTAINABLE FINANCE: A RISING TREND IN THE INVESTOR COMMUNITY

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As per a review by Global Sustainable Investment Alliance in 2022, US$ 30.3 trillion is invested globally in sustainable investing assets. There has been a 20% jump in the assets under management since 2020 in the non-US markets!

In India too, ESG (Environment, Social & Governance) focussed funds' AUM grew from US$ 330 million in 2019 to US$ 1.3 billion in 2023. That is nearly four times jump!

Increasing number of investors are considering ESG parameters in their investment strategy. However, most retail investors remain novice to this concept.

What is Sustainable Finance?

Sustainable Finance is a form of investing where **Environmental, Social and Governance factors are taken into consideration** in the investment evaluation. Such financing may be specific to a project or may be directly to a company that ranks high on the three factors.

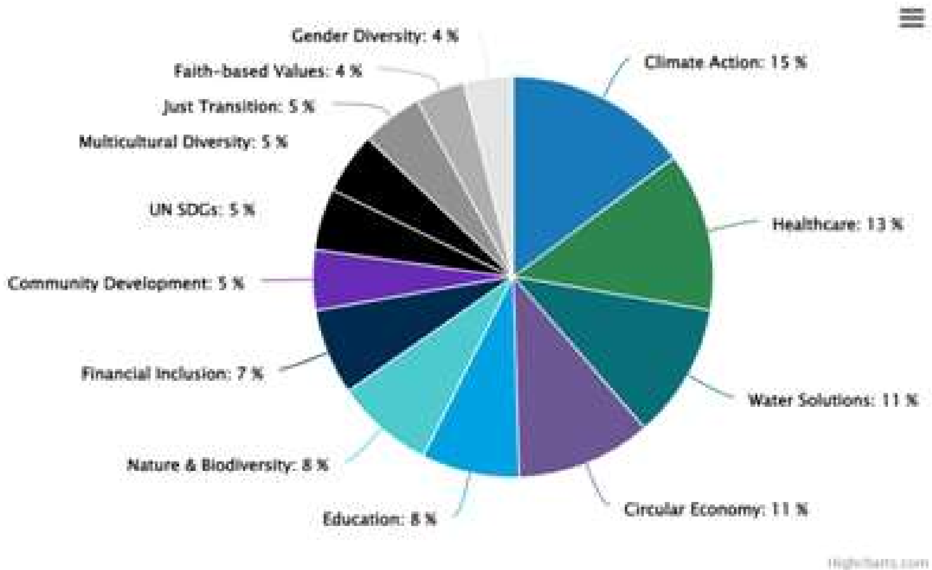
Environmental considerations might include climate change mitigation, use of sustainable inputs, preservation of biodiversity, pollution prevention, waste reduction and management, circular economy and the like.

Social considerations could refer to investment in human welfare, skill development, upliftment of local communities, managing diverse stakeholder interests, influencing public policy, and promotion of human rights.

Governance considerations are by far the most important and most popular. It involves consideration of risk management systems, internal controls, management structures, employee relations, executive incentives, amongst others. In fact, good governance plays a fundamental role in ensuring the inclusion of social and environmental considerations in the organisation.

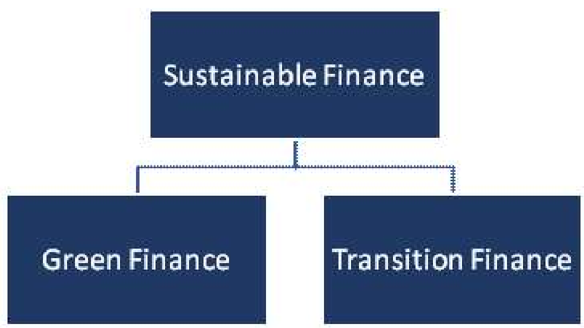
Here is a graph of top sustainable investing themes in the global markets:

Top Sustainable Investing Themes Ranked



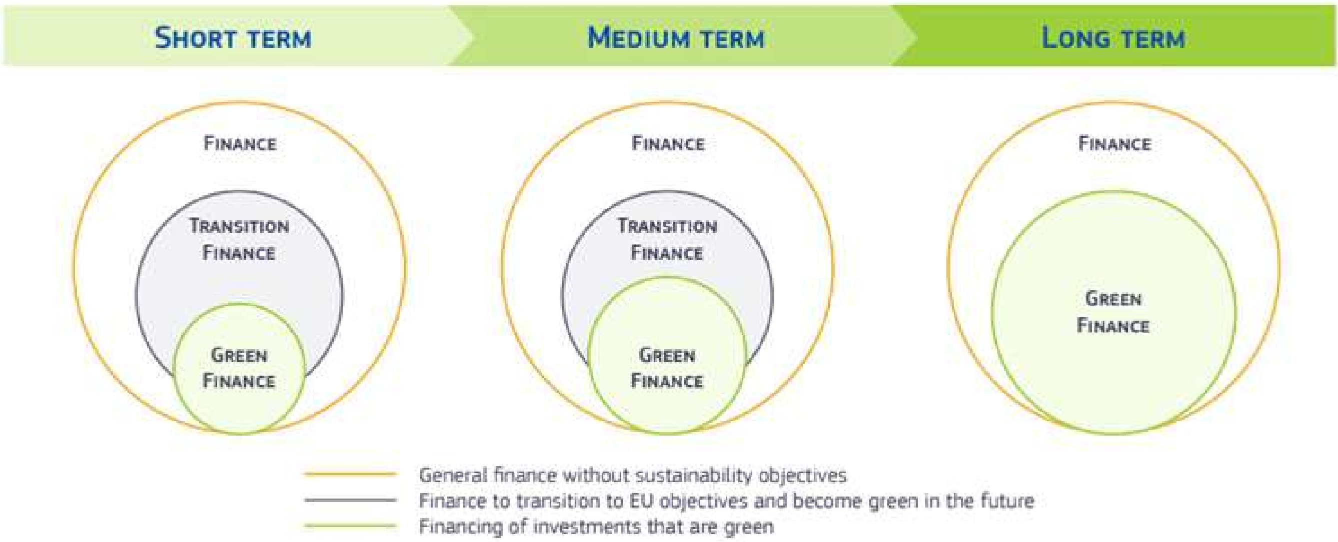
Source: Morgan Stanley Institute for Sustainable Investing, January 2024

Sustainable finance is not just about financing what is already environment-friendly today (green finance) but also what is transitioning to environment-friendly performance levels over time (transition finance).



For instance, power generation as a sector is widely criticised for adversely affecting the environment. However, companies in this sector are now focusing on renewable sources of energy and even willing to invest in carbon capture technologies. Investments in these companies, which are not inherently sustainable, also fall within the ambit of sustainable finance since they support transition to a sustainable economy.

Transition finance also means investing in companies and projects required to meet the net zero goals under the Paris Agreement. To give you some context, in 2015, 196 countries (including India) signed the Paris Agreement to limit the increase in global average temperature to well below 2°C above pre-industrial levels and pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels. This would not be possible without significant investments in alternate technologies, infrastructure development and its underlying research. Hence, transition finance plays a very important in the modern context. The European Union's sustainable finance agenda succinctly highlights how transition finance would be larger in size in the short term, but gradually decrease in the longer term as companies would be expected to have transitioned to greener methods of operation.



Many people believe that ESG investing is philanthropic. And investors considering such opportunities are interested in impact alone and not in the financial returns. This is a myth! A company investing in an organisation-level climate mitigation project is actually guarding itself from adverse physical and transition risks that could translate into crores of rupees in future. A company building strong relationships with its suppliers, distributors, neighbouring communities and employees is making itself a more amenable environment to work in – which though not quantifiable, contributes greatly to the company's P&L and its very survival. A company instating control mechanisms to check implementation of ESG policies, is mitigating risks, including frauds and even elevating its credit standing. Most businesses knowingly or unknowingly incorporate some or the other ESG parameter in their operations. But companies that rank high on this parameter are in a good position to create greater value in financial returns and otherwise.

The Indian Scenario:

Out of more than 2500 mutual fund schemes that exist in India, only about 11 are sustainability-focused. The market is concentrated with the top five sustainable funds accounting for approximately 87 percent of overall sustainable fund assets, with the largest fund accounting for 45 percent. Active funds account for 97 percent of overall sustainable fund assets, with some investing passively or through funds of funds.

Top three indices that track ESG performance in India include S&P BSE ESG Index, Nifty100 Enhanced ESG Index and MSCI India ESG Leaders Index.

Index	Description
S&P BSE ESG Index	Launched in 2017, S&P BSE ESG Index includes companies within and outside S&P BSE 100 Index. The sector weightage is similar to that of S&P BSE 100 Index, where companies within each sector are picked in descending order of their S&P DJI ESG Score (a popular ESG rating). The weightage is also adjusted for floating market capitalization.
Nifty100 ESG Index	A new addition in 2023, the index combines a company's free-float market capitalization and its modified ESG risk score. This results in a portfolio with similar sector exposure to the Nifty100 but tilts the weightage towards companies with better ESG performance.
MSCI India ESG Leaders Index	In existence since 2013, the index targets 50% coverage of the free-float adjusted market capitalization of each sector within the underlying MSCI India Index. The weights are subsequently adjusted for the companies' MSCI ESG Rating.

How are companies evaluated?

It is often difficult to evaluate a company on ESG parameters. A lot of ESG information is qualitative. Even the information that can be expressed in numbers, may not be comparable across sectors or peer companies of different size and structure. However, investors have developed different mechanisms which take them close enough to identify good ESG investment opportunities.

The SEBI Circular dated July 20, 2023, identifies six strategies for ESG-focused mutual fund schemes.

1. Exclusion:

   Exclude securities based on certain ESG related activities, business practices, or business segments. The strategy should specify:

   i. ***the characteristic/ type of exclusion (Adverse impact, Controversy, Faith)***

   ii. ***threshold or condition for exclusion, and***

   iii. ***reference, where applicable, to any law/ regulation/ third-party standard/ guideline/ framework used in the establishment or evaluation of the criterion.***

   This is a form of negative screening where companies are selected by a method of elimination. The criteria could be exclusion of carbon intensive sectors like coal, mining, oil and gas, or exclusion of companies involved in weapon development, animal testing, corruption or other controversies. Funds may also set thresholds linked to revenue or sector of the company for usage of water or release of emissions. ICICI Prudential has a fund using this strategy. It excludes companies from sectors like alcohol, tobacco, gambling, and fossil fuels, while focusing on those with strong ESG practices within the remaining universe.

2. Integration

Explicitly consider ESG related factors that are material to the risk and return of the investment, alongside traditional financial factors, when making investment decisions.

This means that in addition to its other financial and non-financial parameters, the fund must also consider ESG factors while determining its risk-adjusted return. This requires integration of ESG considerations into existing decision-making processes. Implementation may be done by assigning weights or scores to select ESG parameters that the fund considers important for active investments. The Axis ESG Integration Strategy Fund deploys this strategy.

3. Best-in-class & Positive Screening

Aim to invest in companies and issuers that perform better than peers on one or more performance metrics related to ESG matters. The details/specifics of the metrics should be disclosed.

Like most traditional active funds, this strategy involves shortlisting the best performing companies in the space. Comparison across companies is done using ratings and ESG scores. Invesco India ESG Equity Fund deploys this strategy in practice.

4. Impact investing

Seeks to generate a positive, measurable social or environmental impact alongside a financial return and how the Fund Manager intends to achieve the impact objective. The fund should seek a non-financial (real world) impact and evaluate if that impact is being measured and monitored.

In this case, the fund would normally have a social or environmental objective, such as conservation of forests in a region or upliftment of a tribal community. The primary objective here would be achievement of impact, while also earning a financial return in the process.

5. Sustainable objectives:

Aim to invest in sectors, industries, or companies that are expected to benefit from long-term macro or structural ESG-related trends. Describe the focussed objective including rationale for focussing on that objective.

This strategy focuses on specific trends and technologies in the ESG space. For instance, the fund could focus on automobile companies which are currently transitioning to 'Electric Vehicles'.

6. Transition or transition related investments:

Aim to invest in companies and issuers that support/facilitate environmental transition and just transition. The investment should generate a positive and measurable social and environmental transition.

As explained before, many industries are inherently carbon intensive and may need to transition to alternatives which are more sustainable. For instance, cotton-based textiles companies which are inherently water-intensive are switching to alternate forms of fabrics which use lesser water. Similarly, coal-based power plants are shifting to solar and wind energy to produce electricity.

Most structural ESG initiatives come with a longer gestation period, and hence investors generally invest in these companies for longer horizons. This supports rigorous screening and active identification of opportunities that are most value creating.

Is it really worth investing in ESG assets? What are investor views on this?

As per a report by Morgan Stanley, more than three quarters (77%) of global investors are interested in sustainable investing. 57% say their interest increased in the last two years and 54% anticipate increasing their sustainable investments in the next year. While most investors see financial returns as their primary interest, more than 70% believe that strong ESG practices can deliver good financial returns.

In fact, if we evaluate the annual returns (CAGR) for some of the top ESG-focused mutual funds in India, we can see that ESG bets have outperformed the Nifty in most instances. It is true that these investments come with a high-risk profile and strategies may differ from fund-to-fund, but these thematic bets are capable of earning active returns beyond the market performance.

Returns	Nifty	SBI Magnum Equity	Axis ESG Integratio n	ICICI Pru ESG Exclusiona	Quant ESG Equity
1-year	23.72%	25.14%	27.49%	40.30%	50.25%
3-year	13.73%	14.54%	11.71%	17.99%	36.12%
5-year	15.36%	16.68%	NA*	NA*	NA*

However, returns from passive funds have not been so impressive. Here is a comparative of per annum returns for S&P BSE 100 ESG Index and its benchmark S&P BSE 100 Index.

Returns	S&P BSE 100	S&P BSE 100 ESG
1-year	27.28%	21.39%
3-year	19.32%	17.90%
5-year	16.82%	16.87%

Further, just like any other market, the ESG market has seen its ups and downs. According to the Morningstar analysis, India saw an outflow of INR 1,060 crores in sustainable funds in the first half of 2023. While the initial fund launches attracted significant interest and flows, they were not consistent after the initial fund launch period. The primary reason behind this outflow has been rally in defence and energy stocks (which are generally excluded out of ESG funds) after the Ukraine-Russia conflict. Further, with rising greenwashing allegations on larger global funds, investors seem to have adopted a wait and watch approach until clear guidelines are released.

So yes, it's a mixed bag.

It might take more time and awareness for this concept to really make it to a retail investor's IPS. As Ashwin Patni, Head of Products & Alternatives, Axis AMC puts it, “Individual investors may not be able to appreciate what fund managers are attempting to do in the same way that they do with conventional equity funds. Different AMCs have their own individual approach. What we need is awareness and conversations around the theme, and the approach for these products.” While the concept matures, investors have definitely found an evolving category that is definitely worth exploring.

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