

Sector rotation hurts, but green investors hold their breath for COP26

After winning fame for "Most Underperforming Asset" over the last few years, commodities are now putting a smile on the face of fossil fuel investors. After months of frustration from lockdowns, the reopening of the economy unleashed a hoard of heavy pocketed avid buyers. Industrial activity also resumed at full throttle.

So much so that the imbalance in supply and demand, amplified by supply chain bottlenecks, naturally drove prices higher in everything from furniture and food to cars and particularly energy. China and India are already experiencing power outages since coal reserves are depleting and domestic utilities are reluctant to import overpriced combustible.

One could have thought that renewables would have benefited from the trend amid ESG bashing and massive green bills in the pipeline, but the chart below tells another story. The iShares Global Clean Energy ETF is down 22.91% YTD, while the S&P Oil & Gas Exploration & Production ETF is up 67.35% and natural gas futures twice as much.

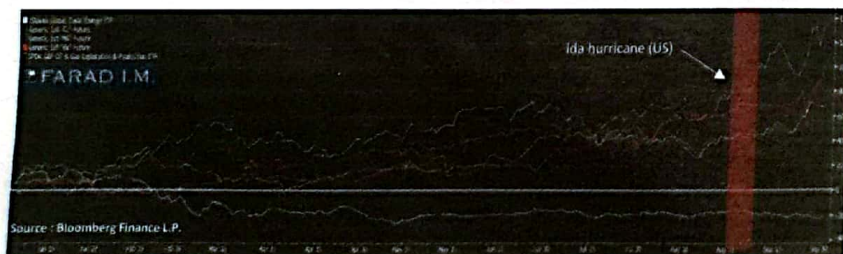


Figure 1 : Investors give prominence to dirty energy – oil (orange), gas (yellow) and coal (red) – over renewables (white)

After taking profit from an amazing rally last year, investors swapped renewable for dirty energy as reflation narratives outweighed environmental awareness. Ironically, other contributing factors to the surge in dirty energy price rally were depleted reserves from hot summer months and Ida hurricane disturbing the supply chain in the United States. As highlighted in the Intergovernmental Panel on Climate Change (IPCC) from the United Nations, anthropogenic carbon emissions are fueling a vicious circle where more pollution yields more intense weather conditions, which yields more energy consumption to cool down or stay warm, which yields more pollution... Nature is not helping nature to recover, but maybe we could.

Who knows, another warning from COP26 on the greatest challenge of our times may just be the inflection point? From October 31st to November 12th, eminent officials will meet at COP26 in Glasgow to discuss technical issues including: carbon market mechanisms, financial help policies for vulnerable countries, nature-based solutions to tackle climate change and other items of the "Paris rulebook". Governments have targets, but what they need are action plans. There is no doubt that achieving carbon neutrality will be a tortuous journey, but COP26 may well be

a first step on that path. It is also worth noting that ESG investing has been channeling money to reduce supply from coal mine and oil wells, but demand is slower to react. If rising dirty energy price is a short-term negative for companies' margins and consumers' purchasing power, it is a long-term net positive because it will naturally incentivize demand to look for a cheaper and cleaner alternative - name it solar, wind or hydro energy. We have seen earlier that recently dirty energy has outperformed green energy, a legitimate question would thus be: do ESG labeled stocks perform better than their non sustainability friendly peers? A meta-study of 1,000 research papers published between 2015 and 2020 showed a positive relationship between ESG and financial performance - measured as ROE, ROA and stock price - for 58% of the "corporate" studies. The conclusion is essentially the same for corporations involved in mitigating climate change. On the other hand, "investment" studies focused on risk-adjusted attributes showed that only 33% of ESG-friendly investments delivered better performances than their conventional counterparts, but this relationship rises to 43% for investment in firms particularly engaged in reducing carbon emissions.

In other words, over the past five years, empirical evidence have showed that sustainability initiatives at corporate level tended to improve financial performance thanks to improved risk management and innovative spirit. Therefore, ESG integration, as an investment strategy, has produced relatively higher return than simple negative screening approaches. However, these findings need to be considered cautiously given ESG data shortcomings. The implementation of Sustainable Finance Disclosure Regulation (SFDR) will be key

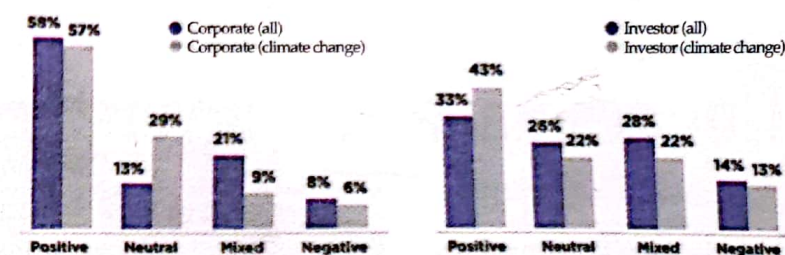


Figure 2 : Relationship between performance of firms/investors integrating ESG factors based on 245 studies from 2016 to 2020 (T. Whelan et al, "ESG and financial performance", 2021).

to harmonise ESG terminology. Going forward, as Sustainable Investment becomes the new norm, more stringent processes will be required to sort the wheat from the chaff (T. Whelan et al, "ESG and financial performance", 2021).

Generally speaking, over the last three years, the main ESG global equity indexes continue to outperform their non-ESG peers. For instance, the MSCI World ESG Leaders index (white) has outperformed the traditional MSCI World index (dotted orange) by 453 bps (135 bps YTD). As far as fixed income is concerned, we can reiterate our observation made three months ago, the relationship is blurrier over the same timeframe. Indeed, there is a slight over performance of non-ESG corporate bonds if we compare the Bloomberg Barclays Green Bond Index (13.36%) and the Bloomberg Barclays MSCI Global Aggregate ESG (+13.83%) to their non-ESG equivalent (14.46%). However, the relationship is reversed if we consider another benchmark, because the JP Morgan ESG EMBI Global Diversified index outperforms its non-ESG homonym by 121 bps. A possible explanation is that ESG fixed income strategies tend to include more growth firms' corporate bonds, which have underperformed value firm's this

year in anticipation of a more hawkish monetary policy globally. Let us recall, however that performance showed can differ dramatically depending on the reference date and the benchmark selected (Source: Bloomberg Finance L.P., 30/09/2021).

With a view to assessing and fostering clients' commitment to sustainable investing, FARAD Investment Management has developed an internal proprietary ESG scoring system, called GreenEthica Sustainable Scoring System (GSSS). This report aims to provide a reliable and objective way to assess the main ESG portfolio metrics with a comprehensive focus on its alignment to the 17 Sustainable Development Goals ("SDGs"). Thanks to GSSS, FARAD IM can produce a synthetic sustainability report with selected key ESG metrics to unveil the real sustainability profile of a portfolio and to compare it in relative terms with a benchmark. Thanks to this easy-to-read ESG dashboard, investors can visualise their quantified contribution to the achievement of the 2030 Agenda for Sustainable Investments of the United Nations.

Mathias TALMANT
Junior Portfolio Manager
FARAD Investment Management S.A.