NLP Financial Management Ltd

Investment Team Report

July 2020

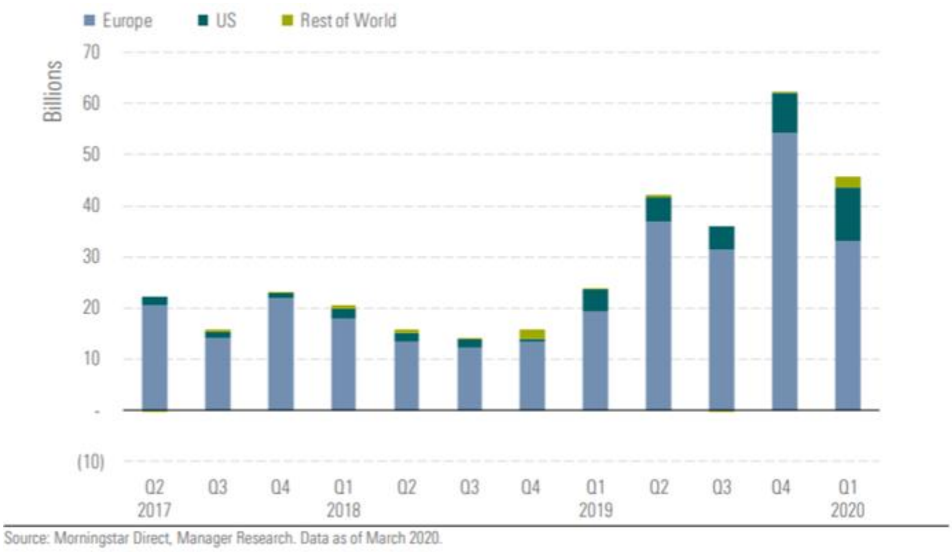
Sustainable Investing: Providing Resilience in Uncertain Times. A study of the performance of sustainable funds during the Coronavirus crisis.

At the turn of the year sustainability was at the forefront of political and corporate discussions, which looked to drive a permanent shift in decision making for the upcoming decade and beyond. There is no doubt that the speed of technological innovation over the last 20 years has enabled developed and developing economies to generate economic growth. However, the trade-off has been the longer-lasting impact on the environment and society as a whole, where the damage is already evident.

Thankfully, 2019 appeared to be the year where people started to wake up and register this very real threat on the future of the planet. Governments worldwide are now working to reduce the pace of change and construct a framework for providing solutions to the biggest challenges facing our society. Together with governments, the investment industry has a crucial role to play in financing these initiatives. The opportunity to invest in companies which strive to make a difference has grown exponentially over the years, but had largely been ignored due to the belief that it would forfeit returns. Research has not only proved this to be a myth, but that investing in companies with a sustainable approach can even enhance returns.

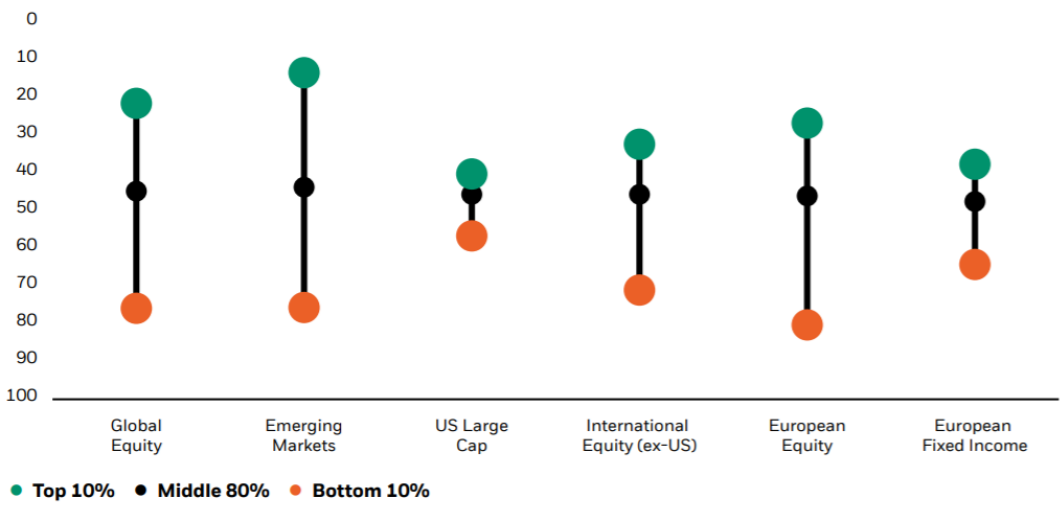
Sustainability has been rapidly picking up momentum in the investment industry, with an increased emphasis of asset managers on the integration of ESG into the investment process. However, the COVID-19 crisis has gripped economies globally and the government response has been unprecedented, as they turn away from longer-term sustainable projects and focus on putting out the very immediate fires. The initial fear was that this would slow the move to sustainable investing, yet the results thus far suggest the opposite. Sustainable funds have exhibited resilience during the outbreak of the pandemic and subsequent market crash. A Morningstar report shows that in the first quarter of 2020 the global sustainable funds universe attracted over 45 billion dollars, compared with an outflow of over 380 billion dollars for the overall fund universe. This can be seen in Figure 1 below.

Figure 1 – Quarterly Global Sustainable Fund Flows (USD Billion)



The performance of sustainable indices has also been relatively strong compared to their peers, with a study from BlackRock showing 94% of sustainable indices have outperformed their broad market counterparts for Q1 2020. Beyond indices, Morningstar report that open-ended funds that score in the top 10% of Morningstar's sustainability ratings have significantly outperformed low-scoring peers. Within the global equity sector, funds that rank within the top 10% on sustainability on average ranked in the top 29th percentile for their Q1 2020 returns, while those in the bottom 10% on sustainability rank towards the bottom 76th percentile on performance, as seen in the below chart.

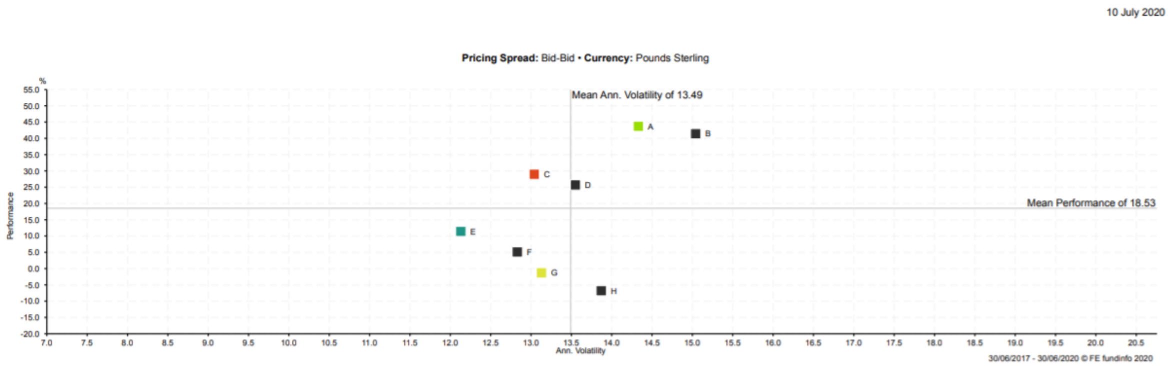
Figure 02: average peer group performance ranking, Q1 2020
Comparing funds with highest and lowest sustainability rankings within peer group.



Source: BlackRock, Morningstar as of May 11, 2020. Past performance is not an indicator of future results. Peer comparison shown is for illustrative purposes only and does not purport to compare all funds in the same investment universe nor does it compare all characteristics of the funds.

Whilst short-term outperformance is certainly encouraging, we are only concerned with delivering consistency over the long-term. We found that investing in ESG (environment, society, governance) leaders versus the traditional "old economy" stocks can not only generate excess returns, but that this can be achieved with lower volatility. Over a 3-year period to the end of June 2020, investing in the MSCI "ESG Leaders" indices versus the traditional regional indices would have given on average an extra 4.35% return with annualised volatility that is 5% lower. This is best illustrated on the below chart.

Figure 3 – MSCI ESG Leaders vs. Traditional MSCI Equity Indices



Key	Name	Performance	Volatility
A	MSCI USA ESG Leaders TR in GB	43.71	14.33
B	MSCI USA TR in GB	41.43	15.04
C	MSCI ACWI ESG Leaders TR in GB	28.97	13.04
D	MSCI ACWI TR in GB	25.69	13.55
E	MSCI Europe ESG Leaders TR in GB	11.42	12.13
F	MSCI Europe TR in GB	5.11	12.83
G	MSCI UK ESG Leaders TR in GB	-1.29	13.13
H	MSCI United Kingdom TR in GB	-6.80	13.87

Source: FE Analytics, 10 July 2020

The MSCI ESG Leaders indices (represented by the coloured squares above) is comprised of the highest environmental, social and governance scores in each sector of the parent index (shown above by the black squares), and targets 50% sector representation vs the parent index. For this example, we have selected the US market (A & B), World Index (C & D), Europe (E & F) and the UK (G & H), and in every instance the ESG leaders index has outperformed the traditional equity market with lower volatility.

There are a number of contributing factors to the outperformance of sustainable investing in recent years, and whilst COVID-19 has caused unforeseen disruptions to the global economy, we believe that it has actually accelerated the tailwinds for sustainability. The oil price has shown wild swings in recent months and fell to the lowest on record at one point during the crisis, adding pressure on oil-dependent economies and the companies themselves to diversify and invest in renewable energy sources. The majority of sustainable funds will avoid investing in traditional energy companies due to the harmful nature of the industry, and the Sustainability portfolio has benefited from having zero exposure to oil & gas. We believe that there is a long-term structural growth opportunity in alternative energy sources, and this portfolio will continue to profit as governments move further away from fossil fuels.

The pandemic has also shone a spotlight on the need for healthcare investment, as companies work together to find both a vaccine and treatments for COVID-19. Our Sustainable portfolio has an overweight to healthcare companies, which has boosted the performance through the crisis, and our underlying funds are actively allocating to companies which are directly tackling the virus. The technology sector, which has already proved to be a disruptor for a number of years as the economy shifts towards digitisation, has shown resilience in share price performance as many companies are providing solutions to the heightened demand for remote connectivity and communication. COVID-19 has materially changed the way companies operate, and we feel that our fund managers in this portfolio are well positioned to take advantage of this trend.

In addition to these factors, the sustainable investing world has been able to display resilience in the face of economic turmoil as the companies are typically far more financially robust. Forming the G of ESG, governance is a crucial analytical tool for fund managers when looking at which companies to invest in. if a company has poor corporate governance practices, it will not be sustainable in nature. This portfolio will inherently have a bias to companies with higher quality balance sheets, more conservative accounting practices and a fairer treatment of staff. These businesses have seen much more resilient share prices this year as the market believes they will not only survive the crisis, but also thrive versus their competitors.

At NLP Financial Management we believe that the impetus remains firmly with the industries and companies which continue to invest in positive change. We launched our Sustainability Portfolio almost two years ago to give investors the opportunity to fund these solutions personally. We have identified funds which can deliver an attractive return profile whilst adhering to our ‘safe-hands’ approach.

So far, the results have met these expectations. For 2019 the Sustainability Portfolio delivered 17.8% total return (gross of fees) compared to the MSCI UK Index which was up 16.3% with significantly lower volatility. Despite the difficult start to the year, the portfolio fared much better on the downside versus the market and has outperformed on the upside, losing only 0.27% for the year to the end of June versus -17.7% for the wider market. We are confident that there will remain significant tailwinds for sustainable businesses for the foreseeable future and believe the direction of travel for investing in a sustainable manner is gathering significant momentum, even in the face of the disruptions caused by COVID-19.

Charlie McCann - On behalf of the Investment Committee

NOTE: This material has been written for information purposes only and must not be considered as financial advice. Past performance is not a guide to the future performance. Changes in rates of exchange may also cause the value of investments to go up or down.

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