Feel-good funds hold their own

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It’s the ultimate feel-good investment, a fund that eschews tobacco, coal, alcohol, gambling, firearms and big pharma.

Supporters say that these funds are making the world a better place but critics believe that environmental, social and corporate governance strategies are little more than the latest sophisticated money-making marketing tool.

"To us it’s about buying everyday companies that do things well," says Ethical Partners Funds Management chief executive Matt Nacard.

"Most companies have the opportunity to improve things in terms of sustainability, supply-chain knowledge, and how they conduct their business. If they do that well, we think they can perform well too."

The data appears to support a view of outperformance for ESG-focused funds. A study in February of Morningstar’s 56 unique ESG-screened indexes found that 73 per cent (41 of 56) have outperformed non-ESG equivalents since inception.

"Morningstar's ESG-screened indexes have generally outperformed their mainstream counterparts," study author Dan Lefkovitz said. "They also exhibit superior exposure to measures of quality, financial health, and volatility – factors linked to a positive long-term investor experience."

The study's results were consistent with a range of other studies from previous years that found sustainable investing didn't hurt returns and that the filters tended to find companies with increased quality.

"I think long term it just makes sense," says Hamilton Wealth Management managing partner Will Hamilton. "If those boxes are ticked you should be able to get superior returns."

THB Asset Management chief executive Christopher Cuesta says his strong returns have been largely due in part to ESG considerations.

"Do ESG considerations add value to investment returns? It will take many years of scrubbing numbers to calculate an exact figure, and even then I assume the data will still be ambiguous," he says. "I personally believe that consideration of ESG factors does add value to investment returns.

"At THB, we believe there is a very high correlation between high-quality companies, good corporate citizenship and long-term shareholder value creation."

The money flowing into ESG-focused and sustainable funds in the past few years has been rising. Even last year, as the market fell, a record amount of capital was injected into sustainable funds, according to a report by Morningstar.

"It is investor-led and the fund managers are having to respond to the demand on the ground," Hamilton says.

"The problem domestically is we're really lagging. When I was in the UK talking to fund managers, it is so topical over there. We're lagging but just wait for it because we'll get a similar wave [of demand]."

The wave of demand has also created sceptics, however, with some investors believing investment firms aren't necessarily riding the ESG wave for all the right reasons.

Speaking at the Portfolio Construction Forum market summit in February, London-based LGM Investments chief investment officer Thomas Vester says many fund managers are just taking advantage.

"Wall Street, City of London, we’re all talking ESG and it’s not because we’ve become saved overnight and want to save the world," he says.

"It’s because it's where the assets are flowing in, it's where you can increase your margin a bit and it’s because maybe there are a lot of managers with bad track records that see a chance to get a new one."

He says that, while ESG was a positive, he believes clients need to ensure managers are using it properly.

"Don't get me wrong, I'm all for it, but I think that with ESG it will have to be much more about allocating in the right way," he says. "I think it's wonderful that it's here but let's raise the bar."

Goodments chief executive Tom Culver echoed Vester's thoughts on the approach of some funds to ESG investing.

"I do think a lot of companies are looking more at the bottom line," he says. "People are recognising there's a generational shift, but are these players getting involved for the right reasons?"

ESG can be used as more than a marketing tool, however, with many pointing to its value in weeding out dodgy companies.

"We think ESG generally is a good risk filter. Not many people are thinking about it that way but we do," says Ethical Partners investment director Nathan Parkin.

"We're a bottom-up stock picker so we're interested in how companies are running their business."

Yarra Capital Management's head of Australian equities research, Katie Hudson, says looking at a company's ESG can help avoid betting on the "blow-ups".

"For fund managers focused on the long term and prepared to research these potential risks, the rewards are apparent over time," she says.

"Not only can this process add significant value to portfolios – by highlighting likely winners – it also helps to identify risks that might not become apparent until disaster strikes. Avoiding blow-ups becomes much more likely."

Ethical Partners' Parkin says he is always trying to find companies that satisfied ethical filters. "Companies that are thoughtful about how they do business should have enduring franchises," he says.

"Companies like Orora are particularly strong across all the areas. Dulux are likewise very strong and ahead of the curve in terms of reporting and standards and also Bega Cheese."