The rise of passives in ESG investing: It's risky business

We have long been advocates of active investing over the alternative of investing passively into the market via an exchange-traded fund (ETF) or index fund. The recent rise in demand for investments that contribute towards positive Environmental, Social and Governance (ESG) factors has been met by a rapid increase in supply of both active and passive investment options. For us, there is a clear danger in going passive in a market which relies on the integrity of the companies it invests in to keep driving change. What's more, the traditional benefits of holding passive over active investments are not as apparent as they once were.

There are numerous merits to active investing, the main one being the more hands-on approach of managers who are more active in monitoring the stocks they invest in, looking at price movements on a daily basis and seeking out profit opportunities. It involves deeper analysis by teams of experts, often specialists in their sectors, and grants greater flexibility to adapt portfolios to changing market conditions. The importance of this flexibility and ability to be nimble with your investments was more than evidenced this year during the COVID-induced market sell-off in Q1, highlighting the importance of active risk management in volatile markets.

Benefits such as these are what contribute to the higher price tag, although recently, the charges on actively managed funds have come down significantly, meaning that the relative value in holding ETFs is weaker today than it has been in the past.

The argument for active investing only strengthens when considering ESG investments.

When investing in an ETF, you are essentially locked in to holding small shares in companies across the entire market, warts and all! Whilst there are providers such as MSCI who have developed SRI screens to overlay their existing investment processes, they are relying on a quantitative tool which gives a single score to companies based on their ESG practices. There is no human element to this process. The danger is, that if a company stops behaving ethically (Boohoo being the most recent example) but remains in the index, then passive investors have to keep owning it as it may be some time before the ESG score is updated. This lack of control of where your money is actually being invested may not be suitable for clients with specific ESG requirements.

All the developments that have taken place within the world of ESG investing and the reasons why it has grown so much over the past few years including: techniques for measuring and quantifying impact, mapping companies to the UN Sustainable Development Goals (SDGs), growth in green bonds, engagement… are all areas that we believe require a human element and specialist teams. Unfortunately, the margins on passive investments tend not to allow for this.

Don't get us wrong, ETFs are a cost-effective and efficient way to fill in a gap in your portfolio and allow for greater short-term liquidity, which we do make use of in several of our own portfolios. However in terms of a long-term investment, we believe active is the way to go, especially with ESG.

With the rise of ESG ETFs, we see a strong danger that fund managers are just trying to meet the growing demand by rolling out suites of products to appeal to cost conscious investors who may not fully understand the limitations of the ESG screening processes being used. The pressure is on active managers to remain competitive in their pricing to avoid such ESG ETFs taking over and wiping out the years of progress that has been made in developing and enhancing this market.

If you are going to take away one thing from all this, we believe it should be that ESG investing is not about putting your money in the market and forgetting about it, which is something that suits many passive investors. It is about earning a return from your investments whilst driving positive change in our environment, society and corporations, which we believe, requires everything but passiveness.

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