



Nothing to fear

Sustainable investing trade-offs

Mirza Baig

Sustainable investing, and the supposed trade-offs involved, have been a topic of heated debate. But trade-offs are a fundamental part of all types of investment; the key is to be clear about one's objectives.

This paper explains:

- why all investments entail trade-offs
- the importance of having clear objectives
- some of the trade-offs pertaining to specific sustainable approaches.

Trade-offs are part of everyday life. We make choices on how we work, what we consume, how much money we save and how we utilise our spare time.

Trade-offs are also a fundamental tenet of investing. Every investment decision is predicated on optimising and managing the inherent trade-offs between risk, return, liquidity, volatility and other considerations.

Trade-offs, then, should not be thought of as something that must be avoided at all costs. But we need to understand where trade-offs exist, assess their relative importance, and decide on a course of action based on a clear sense of our goals, needs and preferences.

What does this mean for sustainable investing?

First, we need to move beyond the polarised debate that suggests, on the one hand, that sustainable investing inevitably conflicts with pos-

itive investment performance, and on the other, that sustainable investing is always and everywhere aligned with positive performance. As with most things, the truth is more nuanced.

Start with clarity about the terms of the discussion. After all, sustainable investment is an umbrella term encapsulating a hugely diverse set of approaches. Each will have its own trade-offs on risk, liquidity, beta and, in some cases, returns.

While not intended to be exhaustive, the following examples explore some sustainable investment approaches and the trade-offs in expected investment outcomes they might entail.

Environmental, social and governance (ESG) integration

This approach is designed to deliver enhanced risk-adjusted returns through a holistic approach to research, valuations, asset selection and portfolio construction. It involves assessing a variety of financially material factors such as the quality of management, stability of supply chains, exposure to physical climate risks, or growth opportunities linked to sustainable solutions. It does *not* involve binding constraints or fixed allocations to sectors, regions or any other factor.

Trade-offs

There is no expected trade-off with investment performance,

as ESG integration is fully aligned with the core investment and return objectives, and parameters of a given strategy.

Sustainable thematic investing

The aim here is to identify long-term sustainability themes that will support specific technologies and solutions, enabling investors to pick winners of the future and benefit from earnings growth and multiple expansion.

This approach includes taking significant exposure to themes like artificial intelligence, the circular economy, climate adaptation, urban migration or meat-free alternatives.

Trade-offs

Thematic strategies target alpha based on high-conviction investment opportunities associated with a theme. This will potentially come at the expense of increased risk and volatility, due to factor and sector concentration relative to the benchmark.

Sustainable funds

These are funds designed to deliver sustainable objectives alongside traditional performance goals. They can either focus on specific issues, like healthcare provision, or direct capital towards a broad category of companies deemed sustainable, such as businesses whose operations are aligned to the UN Sustainable Development Goals (SDGs).

There is a broad spectrum of sustainable funds ranging from highly focused impact-orientated strategies all the way to index funds with sustainability tilts, with each strategy designed to deliver a specific balance of sustainable and return outcomes.

Companies typically eligible to be held in sustainable funds may benefit from structural and regulatory tailwinds, with business models that are expected to deliver long-term growth. However, their relative performance in the short-to-medium term will be a function of various factors, including the macroeconomic backdrop, such as the interest rate environment, and the extent to which 'excluded' sectors and companies are considered in favour by the market.

Trade-offs

Depending on its profile, a sustainable fund can mirror or materially diverge from its benchmark's expected returns and volatility. Sustainability criteria that put tighter restrictions on the investable universe will most likely result in greater dispersion in performance outcomes—positive or negative—against an unconstrained benchmark, in exchange for a sharper focus on sustainable outcomes.

Net-zero strategies

Climate and the pursuit of net-zero goals is the dominant theme in sustainable investing. Net-zero strategies can focus on real-world decarbonisation, portfolio-level decarbonisation, or a combination of the two. They typically gear investments towards climate-solutions providers, companies with low-carbon footprints and those with robust climate transition plans, while avoiding high-emitting companies.

Trade-offs

Over a multi-decade horizon, climate factors will fundamentally define investment outcomes, so there should be no trade-off. However, in the near-to-medium term, a misaligned policy environment can lead to a breakdown between net-zero goals and investment performance.

Therefore, efforts to forcibly decarbonise portfolios faster than the broader economy may result in a trade-off in performance until there is a policy correction. A key consideration is whether the targeted pace of portfolio decarbonisation is aligned with a science-based trajectory, or adjusted and softened to take account of the policy environment and maturity of critical technology.

Private markets

Sustainable private asset strategies have two significant advantages over public-market funds. First, a direct investment in assets is the purest way to capture and measure sustainability impact, if true impact is what investors are after.

Second, private markets offer exposure to critical technologies to deliver the energy transition and meet the SDGs on a scale not available in public markets.

However, private-market strategies cover a broad range of asset classes, with different risk, return and cash-generation characteristics. The key factors they have in common is reduced liquidity relative to public markets and a longer duration of investments.

Private market strategies can also require initial investment and active management to realise longer-term benefits, for example, investing in real estate to improve energy efficiency, or investing in research and development in private companies. These investments create a temporary hit to performance and bring with them a temporary active management cost, with the goal of enhancing returns over the longer term.

Trade-offs

Due to private markets' long holding and performance periods, sustainability objectives anchored in long-term thematic trends should complement rather than



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conflict with performance goals. The trade-off is in being prepared to make the initial capital outlay or take active management risks in the short term.

Key considerations

As this summary suggests, sustainable investing covers a hugely diverse set of strategies, each with their own sustainability, return and risk profiles. That means sustainability goals can either improve risk-adjusted return expectations or push up risk and volatility—and potentially drive periods of underperformance—depending on the asset class, sustainability objectives, binding investment parameters and macroeconomic backdrop.

But it is important to emphasise trade-offs are not inherently negative, provided they are clearly understood and actively taken.

The legitimacy of sustainable investing does not depend on the presence or absence of trade-offs. Instead, as with other investment trade-offs, like the level of risk or the time horizon, it is for clients to determine their choice of sustainability strategies based on their preferences, needs and investment goals. Or, to put it another way, trade-offs are nothing to be scared of. **FS**