Environmental Finance
Sustainable Investment Awards
2020 Winner
Multi-asset manager of the year

ESG Portfolio Management

Investing with purpose and prudence

ESG Portfolio Management won *Environmental Finance*'s Multi Asset-Manager of the year award. Christoph Klein explains the firm's philosophy – and how its selection of sustainable companies and DAX put options helped it beat the pandemic crash

***Environmental Finance:* Please introduce ESG Portfolio Management: what is your investment philosophy?**

Christoph Klein, Managing Partner: We are a Germany-based asset manager of investment funds and segregated accounts. We offer the SDG Evolution Flexibel mixed fund, with an average equity holding of 30%, and the Mayence Fair Value Bond fund, which mainly invests in European investment-grade corporate bonds.

We fully embed the UN Sustainable Development Goals (SDGs) in our investment process, with every investment contributing to at least one of the seventeen SDGs, at the same time as doing no harm towards them. We have rather long lists of exclusion criteria for both corporates and countries.

ESG criteria are included in the security analysis and selection process alongside economic and financial quality, as they bear on risk and return. We see ESG implementation as extended risk management so that we and our clients can sleep at night, while generating positive SDG impact is a strong motivation to get up in the morning.

In addition, we measure the climate risks of our funds and publish the findings together with every fund's ESG quality and SDG impact in our monthly reports. Finally, we actively engage with issuers and use voting rights to enhance their ESG quality and SDG impact.

EF: How do you approach ESG evaluation?

CK: We use data from specialised ESG rating agencies and data providers as a starting point for our internal analysis. For every permitted sector and sub-sector, we invest in best-in-class companies – we aim for portfolio ESG ratings of AAA. We screen relevant news so that we do not overlook critical incidents and engage actively to improve investee companies' ESG quality. We are pleased to note that, in both the MSCI ESG fund analysis and the Morningstar sustainability ratings, both funds achieve the highest scores.

EF: What's the process by which you assess the impact of the funds' investments?

CK: Again, we use data from specialised ESG rating agencies and ESG data providers. As the SDGs are relatively new, methodologies are evolving and the impact data quality is improving. We are permanently on the lookout for further analysis, and recently published a report on the subject with the DVFA, Germany's association for financial analysis.[1]

▲ Christoph Klein

EF: Last year, you also published research showing the links between ESG factors and credit quality. What did the research find?

CK: While empirical credit quality research has focused on 'classic' credit ratios in the past, we found that adding at least one ESG factor improves quantitative credit rating models. In our study, we found the ESG factor "carbon emissions GHG mitigation score" delivered the highest additional explanatory discriminant power.[2]

Selecting this dynamic carbon emission factor fits well with the current political and regulatory attention towards climate change – not least in the EU Taxonomy, which starts with climate change mitigation and adaption. We believe this research bridges 'classic' quantitative credit research with current requirements and the latest developments in investment practice.

EF: How has the Covid pandemic impacted your portfolio, and how is it likely to influence portfolio positioning in future?

CK: Both funds outperformed during the crisis, supported by our ESG selection and our hedging strategy. Companies with the highest ESG scores and very positive sustainable impacts are often found in sectors such as healthy food, pharma and renewable energy. These companies performed on average much better than oil producers, which we exclude, and sectors which we avoid, given their high emissions, such as airlines, cruise travel operators and automobile producers.

We also routinely hedge against 'tail risks' by buying put options on the DAX index, which protect us from steep market falls. In March, these options helped us to mitigate losses stemming from the Coronavirus. During March, we sold our put options in seven steps, exploiting volatility spikes and panic selling in the market. On the morning of March 24th, we reached our long-term average equity allocation of nearly 30% and profited from the recovery. As we remain cautious, we bought new longer-dated DAX put options during April and reduced our equity allocation to 20%.

We expect major changes in the future. Many people consider changing habits, lifestyles and priorities. What does this mean for businesses, credit risks and equity prices? We assume that travel will be negatively impacted in the long run. Furthermore, many consumers are switching to healthier and locally sourced food options and consider social factors like working conditions in the supply chain when buying textiles. Also, reducing plastic waste becomes more important. As bad as Covid-19 is, many see it as it as a small issue compared with managing climate risks.

We will continue to invest in companies with obvious sustainable purpose and the highest ESG qualities. They are very often found in the education, healthy food, pharma, renewable energy and sustainable infrastructure sectors. Those companies tend to have more stable cash flows, lower debt levels and better credit quality, while their products and financials make them much more resilient. Furthermore, innovative leaders in these important fields are expected to generate increasing cash flows and healthy margins, leading to superior performance. They are the winners of tomorrow. ■

1 DVFA (2020), SDG Impact Measurement – A Brief Overview of Providers, Methodologies, Data and Output
2 University of Stuttgart Institute of Business Administration (2019), "Quantitative Credit Rating Models including ESG factors", Research Report No. 01/2019 ISSN 1864-0125