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INNOVA ASSET MANAGEMENT


# INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS AND THEIR CLIENTS

## EMBRACE ESG BUT ACKNOWLEDGE THE CHALLENGES

Much of the world has now formally backed a roadmap to **net zero carbon emissions**.

But for investors that path remains strewn with contradictions spanning the impact of new technology and geo-political tensions.

More than $US84 trillion of assets are now being managed to net zero commitments based on signatories to the three largest initiatives, according to Barclays[1].

It will take a nuanced approach to ensure that environmental, social and governance (ESG) factors don't have unintended consequences that can damage those very goals.

Many developing nations such as India are still highly reliant on fossil fuels and change will take time. China has announced its own path to carbon neutrality by 2060 but many of its actions seem contrary to this as it struggles with a major transition that will affect more than one billion people.

If traditional power companies don't have capital investment, the living standards of large portions of the developing world will be worse off. It would be irresponsible to simply focus on the developed world to the detriment of the developing world.

While the mining industry and fossil fuels producers are often demonised, they must be part of the solution, which means investors must work with them. The mining industry will also be needed to provide the raw materials needed in the green evolution such as lithium for batteries and copper for electric vehicles.

There are few places in the world that have an electrical grid infrastructure that can cope with 100% electric vehicle usage, which could counterintuitively lead to increased use of coal to generate electricity.

If every vehicle on the road was electric and powered by wind and solar energy, the grid would be shut down each evening when drivers come home to plug in their cars to recharge them.

Carbon emissions aren't the whole story – other greenhouse gases are far worse (like nitrous oxide and methane). Transport captures the bulk of attention

[1] *Barclays ESG Special Report Research - Net zero investing: The other 'tragedy of the horizon' (18 October 2021).*

when it comes to carbon, but **animal-based agriculture** is just as bad. Yet few people are prepared to embrace a vegetarian lifestyle.

Divesting fossil fuel producers and other companies is a simplistic answer – one that results in investors having no voice to encourage change.

While Australia's Government has been criticised for the vague nature of its plan to reach net zero by 2050, the reality is it will require significant innovation and new technology.

Australia's CSIRO sees a large role for hydrogen power and has produced a 116-page **National Hydrogen Roadmap** to encourage further development of a local hydrogen industry.

Perhaps tapping into geothermal energy – the energy contained in super-heated granite deep in the ground – could be another possible (and radical) energy source which would require the mining and drilling industries expertise.

While the environmental aspect of ESG is currently getting the most attention, the social and governance factors are equally important.

The strongest research shows that companies that are conservative and good stewards of capital, as well as companies that are gender diverse, tend to outperform.

The other ESG factors have yet to show the same long-term boost to portfolio performance, although it should be noted that the track record is short, investors define ESG in significantly different ways, and outperformance isn't necessarily the biggest reason to embrace ESG.

Innova incorporates ESG factors into our core portfolio offerings if we believe they will lead to superior return outcomes while managing our portfolios to strict risk benchmarks.

However, we are also building ESG-specific portfolios that will take this further. They will encapsulate out philosophy that ESG factors should coalesce to create a better world, both environmentally and socially.

They will focus on more than reducing the impact of economic activity on the environment and help improve the lives of those living below the poverty line.

We can do this by investing in companies with sustainable practices that will lead to a higher standard of living of the populace – something that can't be achieved with a simple negative screen that cuts out fossil fuels.

ESG is here to stay and will make the world a better place to live (regardless of its impact on returns). But, like other components of investing, it can't be a 'set and forget' strategy or a simplistic approach, with the way ESG is implemented set to take many twists over the coming decades.

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Dan Miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios since 2010. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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