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Sustainable Funds Showed Their Mettle In Tumultuous Q1

By **Jeff Schlegel**

FOR THE MOST PART, EQUITY FUNDS GOT CLOBbered in the first quarter. But equity funds in the sustainable investing category got clobbered a little less. While that moral victory doesn't quite assuage the awful feeling associated with losing a good chunk of change in the markets, it does speak to the viability of this particular investment approach, says Morningstar analyst Jon Hale.

In a recent report, Hale looked at how 206 U.S.-listed sustainable equity open-end mutual funds and exchange-traded funds performed versus their respective categories during the pandemic-fueled market rout. These 206 funds include all actively managed and index-based funds, as well as green-sector funds of various types.

He notes that sustainable, or environmental, social and governance (ESG) funds aren't an asset class, per se. As such, they're grouped together with conventional funds within Morningstar's standard categories.

Hale reported that the first-quarter returns of 70% of sustainable equity funds ranked in the top halves of their respective categories and 44% ranked in their category's best quartile, while 11% finished in their category's worst quartile.

"Based on first-quarter returns, sustainable funds were substantially over-represented in the top quartiles and top halves of their peer groups," Hale wrote.

Next, he analyzed 26 sustainable equity index funds (mainly ETFs) versus conventional index funds across the U.S market., non-U.S. developed markets and emerging markets. This group includes funds that mimic traditional market indexes while tilting toward companies with better ESG assessments, and excludes products focused on specific themes such as gender diversity, low carbon and other areas. It also left out a few ESG growth and value indexes.

Among U.S. stock index funds, Hale found that 10 of the 12 sustainable funds in the large-blend category had smaller losses than the iShares Core S&P 500 ETF (IVV) in the first quarter. The average ESG passive fund returned a negative 18.5% versus a 19.6% drop in the IVV.

Those returns are net of fees, an important consideration given that the dozen ESG passive funds have an average expense ratio of 0.16%. IVV's expense ratio is 0.04%.

The best-performing U.S.-focused sustainable index fund last quarter was the IQ Candriam ESG U.S. Equity ETF (IQSU) that tracks a proprietary index developed for fund sponsor IndexIQ by European sustainable asset manager Candriam. That fund lost a tad more than 16%.

Sal Bruno, IndexIQ's chief investment officer, posited that the fund's relative outperformance was helped by its focus on higher-quality companies that he believes should be more sustainable over the long haul.

"It didn't underperform and you didn't sacrifice anything by investing according to your conscience," he said. "You were pretty much in line with the market, if not a little bit better."

The IQSU fund launched in December, and its net expense ratio is 0.09%.

ESG Drivers

Among non-U.S. developed markets in the foreign large-blend category, all 11 passive sustainable funds did better in the first quarter than the iShares Core MSCI EAFE ETF (IEFA). That group of 11 funds lost an average of 21.3% compared to IEFA's loss of 23.5%.

As with all of these comparisons, the results are net of fees: the 11 funds have an average expense ratio of 0.34% while the IEFA fund charges 0.07%.

Among emerging markets, all three sustainable funds in this group topped the iShares Core MSCI Emerging Markets ETF (IEMG) with an average return of negative 22.8% versus IEMG's return of negative 24.4%. The average expense ratio for these three funds is 0.30%, while IEMG has a fee of 0.13%.

Hale noted that sustainable funds in general benefitted during the first quarter from less exposure to energy stocks—the quarter's worst-performing sector—versus the market indexes.

To a lesser extent, sustainable-focused funds also got a slight boost from overweight positions to technology stocks. Hale noted these funds tend to be overweight in information technology, the quarter's best-performing sector.

"Perhaps the biggest reason for their outperformance is that sustainable funds appear to have benefited from selecting stocks with better ESG credentials," Hale wrote, adding that companies that meet various ESG criteria are better positioned to weather environmental challenges while treating their stakeholders well and governing themselves in an ethical way.

"Many such companies are proving to be more resilient during the sudden crisis in which we now find ourselves," he said.

Perhaps, but the slight relative outperformance by ESG funds in the first quarter wasn't exactly eye popping, a point that Hale acknowledged.

"Given the magnitude of the stock market decline in the first quarter, the actual difference between the returns of sustainable funds and conventional funds may seem trivial," Hale said. But, he added, this is a relatively new sector that has come of age since the 2008-2009 market crash, and the Covid-19 crisis gave it a chance to show what it's got.

"Yes, sustainable investing is about delivering competitive financial performance on an ongoing basis, aided by the insights of ESG analysis, but it's also about helping companies move toward a more long-term stakeholder-centric model of corporate behavior," Hale said. FA

[IQSU: IQ Candriam ESG U.S. Equity ETF]
[IVV: iShares Core S&P 500 ETF]
[IEFA: iShares Core MSCI EAFE ETF]
[IEMG: iShares Core MSCI Emerging Markets ETF]

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