The green frontier: Diversified and defensive

Andrew Cole explains why investors should still focus on environmental investing in these challenging times

In times of market turbulence, it is important for investors to maintain a sense of perspective. The next few weeks and months will be volatile and unpredictable. The coronavirus outbreak is proving to be a major challenge for governments and central banks, who have yet to find right mix of policies to contain, and ultimately overcome, its economic effects. We're confident they will and that markets will eventually recover.

In the meantime, investors should try to resist the urge to take drastic action. A more rewarding approach, experience tells us, is to focus instead on the trends that will power portfolios over the long run.

One such trend is environmental change and humanity's response to it. Tellingly, equities that score well on sustainability appear to have been holding up better than the broader market in recent weeks. The MSCI ACWI SRI index – which gives exposure to companies with outstanding environmental, social and governance (ESG) ratings –outperformed the benchmark MSCI ACWI by 1.7 percentage points between the start of the year and March 16.

In our view, corporations, consumers and governments are increasingly recognising the need to do more to protect our planet and limit our environmental impact. We expect such efforts will strengthen further in the future.

For investors, this presents risks to manage, and opportunities for capital growth. One indicator of the extent of the problem is the Planetary Boundaries framework, developed by scientists and economists at the Stockholm Resilience Centre. The model quantifies a set of boundaries, which, if breached, would endanger the environmental conditions that have been instrumental to human prosperity over thousands of years. Of the nine areas included in the framework, four have already exceeded their boundaries, including climate change and loss of biodiversity.

As the world sits up and takes notice, companies that waste resources and pollute will become increasingly risky investments. Conversely, the prospects for businesses who are developing innovative solutions to environmental challenges facing our planet will brighten. We estimate that the global environmental products industry is already worth some $2.5 trillion, and can grow by about 6-7 per cent per year – more than double the pace at which the world economy as a whole has been expanding in recent years.

The economic benefits and investment potential manifest themselves in various ways such as precision agriculture, renewable energy, smart cities, energy efficiency, and pollution control. Within each segment, the set of opportunities is very wide. Renewable energy, for example, is not just about producing power in a clean way – be that from solar, wind or water – but also about transmitting and storing that energy and reducing the environmental footprint of batteries.

Crucially, an environmentally-friendly approach often comes with efficiency gains. For example, sensors which measure pressure inside water pipes can identify leaks as soon as they happen or even predict them in advance, thus saving time and money on repairs. Improving efficiency will become an ever bigger priority as businesses recover from the current economic slowdown. Furthermore, given the focus on the environment, some of the fiscal stimulus may well be targeted towards projects in this area.

Technology will play a key part in the green revolution. Global environmental technology patents tripled between 2010 and 2015, according to WIPO data. Successful green tech – such as smart meters or high-tech recycling plants – is readily being embraced by corporates, consumers and governments.

Investments focused around the environment can also have defensive characteristics – a reassuring trait in the current market environment. Naturally, this segment includes industries which are traditionally considered defensive, such as utilities and water management. These defensive holdings should dampen market volatility while providing steady cash flow, especially when global economic growth is weak. Conversely, there is limited exposure to cyclical and consumer driven sectors.

At Pictet Asset Management, we have been investing in thematic equities for a quarter of a century, and our experience testifies to the long-term potential of such an approach. We believe that adding the Pictet-Global Environmental Opportunities fund to a multi-asset portfolio can boost returns over the long-term, improve diversification and also offer the benefit of some defensive characteristics during short-term market volatility.

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