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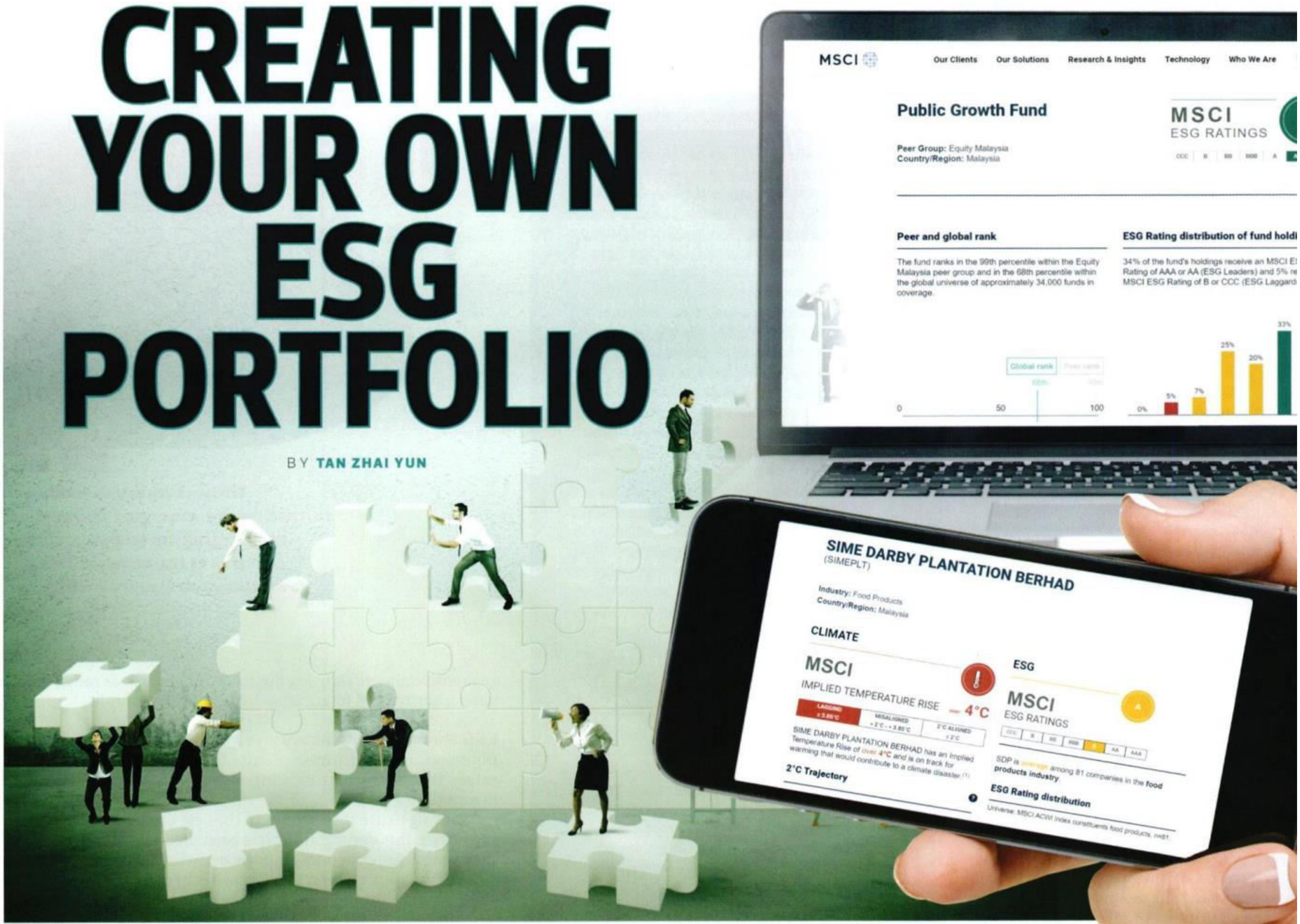
CREATING YOUR OWN ESG PORTFOLIO



BY **TAN ZHAI YUN**

Investors in Malaysia who want to create a diverse portfolio of stocks that adhere to environmental, social and governance (ESG) principles are likely to face some roadblocks at the moment.

ESG funds that comprise global and developed-market equities are easy to find. But the same cannot be said for those that hold regional or emerging-market stocks.

When it comes to a purely Malaysian ESG fund, there are only four (excluding wholesale funds) on the Securities Commission Malaysia's (SC) List of Sustainable and Responsible Investment (SRI) Funds. Of these, two are sukuk funds, one is a bond fund and the fourth is an equity fund. According to industry players, global ESG bond funds or green bond funds are relatively harder to find.

Meanwhile, investing in digital assets has its share of pitfalls. Plenty of studies have pointed out how the mining of cryptocurrencies guzzles huge amounts of energy. Investors may also be concerned about the use of these digital coins in illegal activities and struggle to understand the governance of this decentralised asset class.

What about investors who want to create a portfolio of ESG stocks themselves? They can rely on the analysis of service providers like MSCI or local brokerage houses, which are increasingly including ESG analysis in their research reports.

Even then, there is no standard method of analysing or reporting on ESG-related information. And analysts may not share the same view on, for example, whether a plantation company is doing enough to prevent illegal deforestation in its supply chain. Also, companies may use different reporting standards, which makes comparison difficult.

This is not to say nothing is being done. There has clearly been a shift towards ESG investing. Two robo-advisers in Malaysia have launched ESG portfolios over the past year. And of the 28 SRI funds on the SC's list, 18 were launched in 2021.

According to data provider Morningstar, inflows into ESG funds hit a record US$3.9 trillion (RM16.3 trillion) by the third quarter of last year. Full-year inflows into sustainable funds in Malaysia stood at US$263 million, according to Morningstar, which is 1.6% of the Asia ex-Japan universe.

But according to the financial planners that *Wealth* spoke to, there is still low demand for ESG investments.

"Despite the hoo-ha about ESG currently, if you look at the size [of some of the ESG funds in Malaysia], it is still quite small. The demand is not there yet. If you look at the available funds in Malaysia, you will find yourself limited by the options," says Felix Neoh, director of financial planning firm Finwealth Management Sdn Bhd.

Of the 28 SRI funds on the SC's list, 18 are global while four cover Asia-Pacific or Asean. Up to 16 are equity funds, five are mixed-asset funds and three are fixed-income funds. Four of the funds did not have their product highlights sheets available online. Most of the SRI wholesale funds feed into global equity funds.

Investors who want to create their own portfolio of ESG funds will have to do plenty of research themselves.

"How do you define whether a company is ESG-compliant? This is one of the issues raised by the US Financial Industry Regulatory Authority. There is no standard definition, so how do you do the classification? You can imagine how tedious [the research process] can be," says Neoh.

Of course, one can rely on service providers such as Sustainalytics, MSCI or even the FTSE4Good Bursa Malaysia Index as a reference. But even then, the ESG scores for companies may differ between providers. "There are some qualitative aspects that are very difficult to quantify," Neoh points out.

Some analysts may give a company high ESG ratings even if it hasn't achieved a huge reduction in carbon emissions, for instance, because they have confidence in the commitment of the management team. The company is only removed from the investment universe if it has not changed after a predetermined period of time.

Ultimately, many investors in Malaysia are still focused on returns. "Usually, when I show them the options of funds available [for ESG], they will ask me how I think it will do [in terms of returns]," says Ian Wong, partner at IPP Financial Planning Group, adding that it has been mostly his high-net-worth or fresh graduate clients who are curious about these funds.

"I think ESG is the future, but it's a bit too early for us to draw any real conclusions now. If a fund only has two years under its belt, I can't tell how good it is. So, I'll have to base it on the general [performance] of the fund house and how it is doing against the benchmark."

The majority of investors that Wong spoke to are taking a wait-and-see approach to ESG, even as many Malaysian companies — particularly those in the plantation, glove and manufacturing sectors — have been hit by sanctions due to allegations of forced labour. "I'm not getting the feeling from people that they link [these events] to ESG," he says.

A parallel, however, can be drawn with the shariah investing landscape. The definitions are more developed and it has a bigger investment universe. "When we look at our recommended funds list, we can probably find a shariah equivalent of that fund," says Wong.

That is what's needed for ESG investing to take off. But it will take time, he believes, as companies in developing countries may not have as many resources as those in developed countries to transform.

On a side note, investors who want to have an ESG approach to fixed deposits could look at the financial institution's financial reports to see who it lends to, says Neoh. Some banks, for instance, have stated that they would not lend to coal mining companies or those engaged in deforestation.

The burden on investors to do their own research is exacerbated by the risk of greenwashing. The lack of standardised reporting could lead many to call themselves green funds, but without any supporting data.

According to reports, Morningstar removed sustainability tags from more than 1,200 funds recently because they used "light or ambiguous ESG language". The good news is that a taxonomy for sustainable finance is being introduced by the EU and other jurisdictions to tackle this form of greenwashing. ∎

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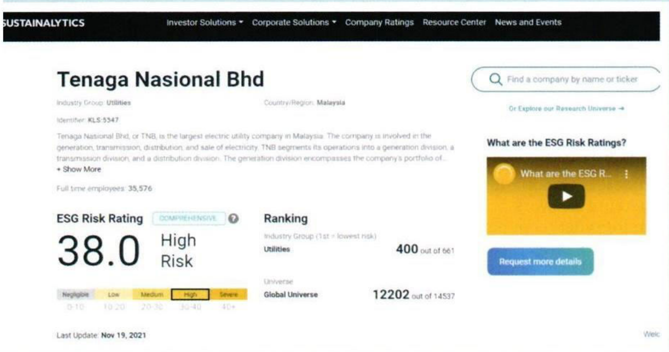
Analysing information from multiple sources

"Among the key material indicators to look for is a company's carbon footprint, its goals on carbon emissions, disclosures on biodiversity, water usage, use of renewable energy, human rights practices, alignment to the UN Sustainable Development Goals, and controversies if there are any, and the resolutions." > *Anand*



The simplest way for investors to create a portfolio of stocks and bonds that are compliant with environmental, social and governance (ESG) principles is to utilise the information provided by third-party service providers.

But it is expensive to subscribe to these services, observes Koh Huat Soon, regional head of research at Maybank Asset Management Sdn Bhd, and it could go against the spirit of ESG investing, which calls for investors to be agents of change through active management.

Technically, one could just pick stocks from the FTSE4Good Bursa Malaysia Index. But there are only 80 constituent stocks to choose from. "So, while it is possible to create a diversified portfolio of Malaysia-only ESG stocks, the potential returns may be compromised due to the small pool of investment choices and liquidity issues, if the portfolio is very large," he says.

Small-cap stocks are difficult to include due to a lack of documentation and reporting. To build a robust Malaysian ESG portfolio, fund managers will have to go beyond information provided by third-party service providers and do their own evaluations, Koh believes. This, of course, would incur additional costs and resources.

"Investors can understand what key ESG risks are applicable to their companies of interest and ask [the management] the right questions about those risks." > *Koh*

Another challenge investors would face is choosing from the variety of ESG strategies and interpretations. The taxonomy for ESG-related information is still evolving and companies tend to disclose information differently.

"What is material and sustainable to one is not sustainable to another, as some believe in negative screening and others in traditional investing that includes ESG principles," says Anand Pathmakanthan, regional head of equity research at Maybank Investment Banking Group.

A look at the ESG funds in Malaysia show that many have shariah-compliant screening and rely on the ESG methodology of their external investment advisers. Their product highlights sheets generally do not go into detail about the strategies they employ.

There are exceptions, however. Areca Dynamic ESG Fund, for instance, uses positive screening while Maybank Global Sustainable Technology Fund focuses on governance, the management team's commitment to change and issues such as data transparency, under the social pillar.

"Investors may find it challenging to compare the multitude of ESG funds available in the market, given that each fund has a unique ESG investment strategy and focus. Furthermore, domestic SRI funds still have a short investment track record, which makes it harder to assess the credibility of the ESG investment strategy." > *Ng*

"Investors may find it challenging to compare the multitude of ESG funds available in the market, given that each fund has a unique investment strategy and focus. Furthermore, domestic SRI funds still have a short investment track record, which makes it harder to assess the credibility of their ESG investment strategy," says David Ng, deputy managing director and chief investment officer at Affin Hwang Asset Management Bhd (AHAM).

"Another major risk is greenwashing. With the lack of standardised reporting, ESG offerings in the market can be easily hyped up through effective marketing."

There is momentum in the market to tackle these issues. For instance, regulators such as Bank Negara Malaysia and the Securities Commission Malaysia are working on a taxonomy and guide to help financial institutions and companies become more sustainable.

What can investors do?

To begin the information-gathering process, investors should read the annual report and sustainability report of companies and ascertain how dedicated the management and board are to their sustainability commitments.

"It is a particularly positive sign if there is a committee at the board level to drive ESG or sustainability initiatives," says Anand.

Summaries of ESG information can be found on websites such as Refinitiv, MSCI, Sustainalytics, Ecovadis, Factset, Arabesque and even Yahoo! Finance.

"Among the key material indicators to look for is a company's carbon footprint, its goals on carbon emissions, disclosures on biodiversity, water usage, use of renewable energy, human rights practices, alignment to the UN Sustainable Development Goals and controversies, if there are any, and the resolutions," he says.

Koh suggests looking at literature provided by standard setters, such as the Sustainability Accounting Standards Board, which identify the material risk factors of various industries for free. "Investors can understand what key ESG risks are applicable to their companies of interest and ask [the management] the right questions about those risks."

If the stock is a constituent of ESG-related indexes, it is a good indicator. As for bonds, investors should find out whether it is a green or sustainability-linked bond used by companies to transition to low-carbon business models.

"Also, read analyst reports on the company. There are increasingly more interpretations on ESG or sustainability issues by buy-side and sell-side firms, and these should be scrutinised for more granular details, especially for forward-looking conclusions that cannot be obtained from ESG indexes or external ESG research firms," says Anand.

Investors also have to determine their strategy when building the portfolio. The general strategies for ESG investing include negative screening, where certain sectors or companies with low ESG ratings are excluded; positive screening, where the best-in-class are selected; and ESG integration, where ESG factors are considered in the analysis.

An important point to consider, in Koh and Anand's opinion, is that the most rewarding investments can sometimes be the modestly rated companies with promising ESG potential. By investing in these companies, investors are indirectly encouraging them to improve their ESG performance.

A stark example would be the decision to invest in utility companies that are fossil-fuel driven. "In the past decade, European utilities have transformed to be renewable-energy-driven. This has led to significant improvement in their enterprise value, and it could not have been captured with a specific screening," says Anand.

So, what would make an ESG investment in a fossil-fuel-based company valid? What needs to be seen is "its commitment to decarbonise, its quality of disclosure and commitment, its execution plan and whether it is moving in the right direction for the climate transition", he says.

Greenwashed companies are difficult to avoid, but analysts and fund managers can engage with their management and ask them the tough questions. Compared to investors doing it themselves, this is where relying on the expertise of analysts and active fund managers could make a difference.

"We believe that continued engagement with our investee companies to better align the type of information disclosure and communicating our expected level of ESG best practices has dual benefits. It can improve their business practices and [make them] an attractive company worth investing in," says Ng.

AHAM adopts ESG integration as its primary ESG strategy. This means it includes ESG factors in its investment decision-making process that could have a material financial impact, and it applies to all of its internally managed funds. This strategy, in a way, saves ESG-minded investors from having to create a portfolio of ESG-specific funds from scratch.

"This is a more dynamic approach as it enables us to access a wider investable universe, while driving ESG adoption in the investee companies via regular engagement and dialogue," says Ng.

Both Maybank and AHAM use third-party ESG rating service providers and companies' public disclosures, on top of their own research and engagement with investee companies. Interestingly, this could sidestep criticisms about overreliance on ESG rating providers.

"We don't rely solely on a single source of data precisely due to the lack of comparability and, sometimes, opaqueness in their methodologies," says Ng. E

Thorny issues for cryptocurrencies

The biggest conundrum that ESG investors may face when it comes to cryptocurrencies is the high energy use in mining them. The mining process requires high-performance computers to verify transactions made on the blockchain. If the energy is generated by fossil fuels, this results in high carbon emissions.

The Cambridge Centre for Alternative Finance estimates that Bitcoin mining consumes 125TWh of electricity annually (as at Feb 17), which is equivalent or exceeds the electricity used by entire countries, according to various reports. This could add pressure to the electricity grids.

But Aaron Tang, country manager of digital asset exchange Luno, points to a voluntary survey by the Bitcoin Mining Council (BMC) late last year that suggests that 59% of Bitcoin miners use renewable energy. The BMC is a voluntary global forum of some of the biggest Bitcoin mining companies in the industry, according to its press release.

There have also been innovative miners who use wasted or stranded energy to power their operations, he says.

The problem is that investors would not know whether the cryptocurrency they buy is powered by renewable energy, given the lack of information. According to reports, miners have been moving to places where energy is the cheapest, which are mostly countries that still rely on fossil fuels.

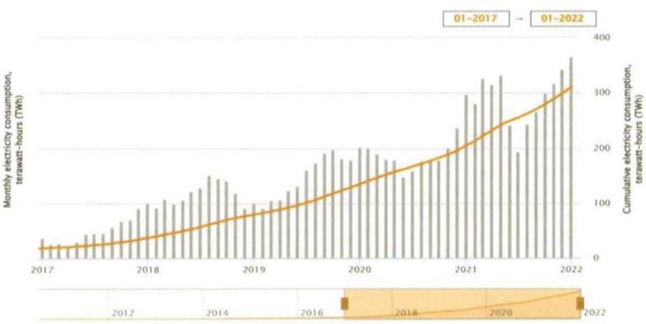
"I guess something investors can do is look at crypto mining organisations that have a good mix of renewable energy or consider that a lot of Bitcoin mining today already uses renewable energy," says Tang.

Another important point is that not all cryptocurrencies are the same. Some cryptocurrencies use the proof of stake (POS) model, which uses less energy, instead of the proof of work (POW) model to verify transactions.

POW, which is used by many cryptocurrencies including Bitcoin, uses a consensus mechanism that requires computers to solve complex mathematical problems. Miners compete to solve the same problems, which incentivises more energy use on computing power.

CAMBRIDGE CENTRE FOR ALTERNATIVE FINANCE

Total Bitcoin electricity consumption



In the POS model, validators "stake" their own cryptocurrencies to get a chance to validate new transactions. The network rewards validators who are most invested, and other validators have to verify that it is accurate. Unlike in the POW model, validators are not pushed to invest in powerful computing equipment that are energy-intensive just to compete.

Last year, Ethereum announced its intention to shift to a POS model. The Ethereum Foundation estimates that this can reduce its energy use by up to 99.95%, according to a research article by law firm Katten Muchin Rosenman. Other cryptocurrencies that use the POS model include Cadano and Solana.

On a more fundamental level, many people may find the environmental footprint of cryptocurrencies unacceptable because they do not see the value of this digital asset, Tang suggests. It could be different if one believes that cryptocurrencies are very beneficial in offering a faster and more secure way of transactions.

"For instance, if you compare Bitcoin mining to people watching YouTube, it could be possible that people are consuming more energy watching YouTube than by mining Bitcoin. But most people understand the value that comes from watching YouTube, whether it is for education or entertainment," he says.

However, the Cambridge Centre has estimated that a single transaction of Bitcoin could have the same carbon footprint as 680,000 Visa transactions or 51,210 hours of watching YouTube, according to *The Guardian*.

Meanwhile, non-fungible tokens (NFTs), which have taken off in the past year, are mostly bought and sold on the Ethereum blockchain. According to a report by The Verge, the energy used to produce an NFT is equivalent to two months' worth of electricity used by an EU resident.

But it is important to note that the Ethereum network is still likely to be running whether or not NFTs are minted, observes Tang.

The 'S' and 'G' problems

As for concerns about cryptocurrencies being used for illegal activities, Tang points to a recent report by blockchain monitoring firm Chainalysis that shows the illicit use of cryptocurrencies was just 0.15% of the total transaction volume in 2021.

This is against the backdrop of a growing use of cryptocurrencies for ransomware payments in the past year. The Colonial Pipeline in the US, for instance, paid US$4.3 million in cryptocurrency to hackers due to a ransomware attack. Fortunately, the US Department of Justice was able to seize Bitcoin valued about US$2.3 million from the perpetrators.

According to research done by Katten Muchin Rosenman, the total damages caused by ransomware were estimated to be US$20 billion in 2020. However, crypto ransomware only accounted for about 2% of the total amount.

"Every transaction of Bitcoin is recorded on the blockchain. People have tried to obfuscate the money trail, but with regulations coming up, players like us also have to do Know Your Customer and anti-money laundering procedures. So, it is becoming increasingly difficult for people to use Bitcoin to do bad stuff," says Tang.

The decentralised nature of cryptocurrencies, meanwhile, is something that ESG investors may have to wrap their heads around. There is no central decision-making body for cryptocurrencies. Instead, it is supported by communities of miners, software developers and other actors, according to a report by MSCI, which recommends that investors get involved in the development of cryptocurrency protocols or engage with other actors to understand this asset class.

Investors can also read the white paper of the cryptocurrencies to understand their governance structure, Tang suggests.

There are, however, some inbuilt governance mechanisms in cryptocurrency networks. Whenever a change is suggested for a cryptocurrency, it needs to be approved by the miners of the network.

"Basically, all the computers on the Bitcoin network have a certain period of time to show whether they support or reject the proposal. It can go into tens of thousands of people. There is no forcing of anyone to adopt or reject a change. For instance, in the past, when two factions did not agree on a change, they forked the cryptocurrency, which resulted in Bitcoin Cash," says Tang.

So, what should ESG investors do? Going for the most widely known coins such as Bitcoin and Ethereum is a good bet, he says, due to all the studies that have been done on the cryptocurrencies. Their track record is also public information.

Ultimately, cryptocurrencies are still a new asset class. More transparency and disclosure would be helpful for ESG investors. Tang expects this to come from individuals or cryptocurrency companies, while regulators continue to monitor these digital currencies. E

ESG through ETFs — easier but not without challenges

The big global exchange-traded fund (ETF) providers already have a diverse suite of ESG ETFs for investors. Since ETFs generally involve lower fees and are easily accessible via robo-advisors, would it be fair to say that investors who want a diversified ESG portfolio should opt for this investing method instead?

According to Wong Wai Ken, country manager for StashAway Malaysia, these providers have challenges of their own as well.

In Malaysia, two digital investment managers or robo-advisors have rolled out ETF portfolios in the past few months. MYTHEO's Global ESG portfolio, which invests in 11 ESG ETFs offered by BlackRock and US-based asset manager Nuveen, was launched last October. The ETFs mainly track indexes of developed-market and US companies, comprising small, mid and large-cap stocks. It has one ETF tracking large and mid-cap companies in emerging markets.

StashAway launched its responsible investing portfolio and environment and cleantech thematic portfolio in January. The ETFs in these portfolios are issued by the likes of BlackRock, Amundi and VanEck. The responsible investing portfolio covers developed and emerging-market equities as well as conventional and green bonds, while the thematic portfolio focuses on themes such as clean energy and waste management.

Neither portfolio has ETFs that specifically cover Malaysia.

"The [ESG] screening has been done by the ETF issuers, so that makes our job one degree easier. The next challenge is to match those ETFs to conventional ones. It is relatively easy to find an ESG alternative to an S&P 500 ETF. But once we go down to certain geographies or sectors, it becomes difficult," says Wong.

For instance, to hedge inflation, one might look at sectors such as commodities and energy that could do well, he says. The Australian market is a good proxy for the former, but ESG ETFs tracking that market are rare. "So, for that, we have to rely on the underlying Australia ETF already having high MSCI (ESG) ratings."

Opting for a clean energy ETF could sidestep the ESG concerns that come with a conventional energy ETF, but their risk-return profiles are very different, he adds. The technology sector is also an outperformer at this time. However, ESG alternatives for certain tech funds like the KraneShares CSI China Internet ETF are tough to find.

"The matching process is not the easiest, and this is just in equities in the best-case scenario," says Wong.

It is even more limited in the fixed-income space. StashAway invests in a global green bond ETF, but it is unable to represent the entire bond space.

Because of these challenges, StashAway's responsible investing portfolio is not a complete ESG replica of its general investing portfolio. Some of the ETFs that it invests in are not strictly branded as ESG but have high ESG ratings by MSCI.

But according to the firm's back-testing results, the returns are roughly the same, says Wong. "When we isolate the ESG factor, there is an outperformance of 2% from the benchmark [conventional portfolio]."

StashAway chose to rely on the ESG ratings by MSCI because the service provider is well known in the credit rating space and is widely used, he says. There have been criticisms on the subjectivity of ESG evaluations by different service providers, with an article by Bloomberg singling out MSCI for being too lax with its ratings.

But Wong believes that MSCI is on the right path as it encourages businesses to think of ESG as a risk management issue.

"I think if you talk about risk management, businesses are more inclined to report [on ESG issues], especially if it is to avoid fines, write-offs, boycotts or public relations nightmares. I think asset managers will also see that businesses that avoid controversies are better performers," he says. E