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Sustainable Investing: The Difference Between Growth and Value-Based Strategies

The term sustainability is used often in investing, yet there is confusion about the definition and the strategies that come under the "sustainable" umbrella. Two main categories are sustainable growth investing and sustainable value-based investing. Both strategies aim to generate returns, but they differ fundamentally in their approach and underlying principles.

Sustainable growth investing is growth-centric and often sector-specific, focusing on financial metrics and company performance. In contrast, sustainable value-based investing is ethics-centric, employing environmental, social and governance (ESG) factors to guide investment decisions that align with broader personal or societal values.

Sustainable Growth Investing

You are probably familiar with the concept of sustainable growth investing, which is the focus of the AAII Growth Investing approach and model portfolio. The methodology seeks companies with a history of solid but sustainable top-line growth and positive cash flow generation and those exhibiting high quality and future growth characteristics.

Sustainable growth investing does not inherently incorporate ESG criteria; it seeks companies with strong potential for long-term earnings growth, innovative product lines or leading market positions. The primary goal is financial performance and capturing growth opportunities, regardless of the company's ESG impacts.

In sustainable growth investing, the financial risks are predominantly viewed through traditional financial lenses, focusing on factors that can directly affect the potential for growth and the company's profitability.

Interest rate sensitivity is particularly significant for growth companies, which typically rely on debt to finance expansion, research and development (R&D) and other capital-intensive projects. Higher interest rates increase the cost of borrowing and can delay profitability for startups and technology companies.

Sustainable growth investing often involves a *concentrated portfolio* in sectors known for rapid growth, such as technology, health care and consumer discretionary. While this can offer substantial returns when those sectors are thriving, it also exposes investors to higher risk if the sector suffers a downturn.

The stocks of companies at the forefront of innovation and market changes can experience *higher volatility*. Their stock prices may be more sensitive to market sentiment, news and speculative trading, particularly in emerging industries. The high growth potential is often counterbalanced by the possibility of large swings in stock prices, influenced by both company-specific developments and broader market conditions.

Growth companies operate in dynamic markets and *must continuously innovate* to maintain their competitive edge. Broader economic factors—such as gross domestic product (GDP) growth rates, employment levels and consumer spending—play a crucial role in the performance of growth stocks. In times of *economic downturn*, consumers and businesses reduce spending, which can disproportionately affect growth-oriented companies, especially those in consumer-facing industries.

Companies focused on sustainable growth often face *regulatory scrutiny*, particularly in health care, biotechnology and renewable energy sectors. Regulation changes, political instability or geopolitical tensions can alter market conditions or directly impact business operations, potentially hindering growth.

Sustainable Value-Based Investing

Often synonymous with ESG investing, sustainable value-based investing involves making investment decisions based on ethical, environmental, social and corporate governance criteria. This approach is driven by personal values and the desire to contribute positively to society and the environment along with the desire to achieve financial returns.

Regulatory changes are crucial in shaping the landscape of ESG investing. These changes can significantly impact the operational and financial status of companies that are the focus of ESG-driven investment strategies.

Environmental regulations include carbon pricing mechanisms—such as carbon taxes or cap-and-trade systems—to encourage companies to reduce their carbon emissions; requiring a certain percentage of energy to be derived from renewable sources; and stricter regulations on waste management—including mandates for recycling and reducing plastic use.

Social regulations target improving labor conditions and enforcing fair wage policies; imposing stricter data handling and privacy guidelines; and requiring companies to report on diversity metrics or even meet

specific benchmarks for board composition or employment practices.

Governance regulations include enhanced standards for board responsibility, executive compensation and shareholder rights; stricter enforcement of anti-corruption laws; and changes in accounting standards that require more comprehensive disclosure of financial and nonfinancial risks, including climate and social issues.

Market-specific regulatory developments are another area of concern for sustainable value-based companies. In regions like the European Union (EU), specific regulations require financial market participants to disclose how they integrate ESG factors into their risk processes and investment decisions.

Companies anticipating and adapting to these regulations can often secure a competitive advantage, attracting ESG investors. Conversely, companies that fail to comply or adapt may face divestment from ESG-focused portfolios. ESG investors must stay informed and agile, adapting their investment strategies as regulations change to mitigate risks and capitalize on new opportunities.

Trends in Sustainable Investing

Emerging trends in sustainable growth and value-based (ESG) investing are reshaping the finance landscape, significantly influenced by technological advances and global policy shifts.

Sustainable Growth Trends

Technological advances continue to be a significant driver of growth in various sectors. In sustainable growth investing, the focus is on companies leveraging technology to create competitive advantages and achieve rapid growth. Some examples:

- Companies in sectors like technology, finance and health care use artificial intelligence (AI) and machine learning to innovate and improve efficiency, from algorithmic trading and personalized medicine to automated customer service.
- In the energy sector, advancements in solar panel technology, battery storage solutions and smart grid technologies propel growth for companies focused on renewable energy and energy efficiency solutions.
- Rapid advancements in genetic engineering, such as CRISPR and mRNA technology, are driving growth in the biotechnology sector. These technologies offer revolutionary treatments and potentially substantial returns for investors.

The shift toward digital operations across all sectors is a significant trend. Companies that are leaders in adopting digital technologies—like cloud computing, Internet of Things (IoT) and next-generation wireless technology—are often the focus of sustainable growth investing due to their potential to disrupt traditional industries and gain substantial market share.

Sustainable Value-Based Trends

Policy initiatives worldwide are increasingly focusing on sustainability, influencing the dynamics of ESG investing. Some examples:

- Many countries have committed to achieving net-zero carbon emissions by 2050 or sooner, boosting investments in renewable energy, electric vehicles (EVs) and energy-efficient technologies.
- Regions like the EU are implementing comprehensive sustainable finance regulations, which promote transparency and guide investment toward sustainable projects.
- Regulatory changes drive an enhanced focus on social issues, including labor rights and diversity practices, prompting companies to improve their practices and thereby attracting ESG investors.

ESG metrics are becoming integrated into the broader investment decision-making process. This trend is driven by increased availability of ESG data and investor demand for sustainability. Technological advances have made gathering and analyzing ESG data easier, allowing investors to integrate these metrics more effectively into their investing strategies. In addition, as societal awareness of environmental and social issues grows, investors increasingly demand sustainable investment options, encouraging fund managers to consider ESG factors in their portfolios.

There is a growing trend toward impact investing—investments made to generate a positive, measurable social and environmental impact alongside a financial return.

Convergence of Trends

Interestingly, there's a convergence where technological advances drive growth and are critical in addressing ESG concerns. As these trends continue to evolve, they shape the strategies of both traditional and ESG-focused investors, underlining the growing importance of sustainability in the global financial landscape. This convergence suggests that the future of investing will increasingly consider both financial returns and the broader impact on society and the environment. ■

—Adapted from AAII Growth Investing commentary by Wayne A. Thorp; see https://growth.aaii.com.