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WEALTH MANAGEMENT

KEY GUIDE I JULY 2021

ESG investing

Introduction

BUILDING A PURPOSEFUL PORTFOLIO

Investing for the future has taken on new meaning in a world of climate emergency, health crisis and growing awareness of how our actions might affect current and future generations. Environmental, social and governance (ESG) concerns now underpin many investment strategies, to minimise harm to the world and its people while also generating returns.

Profits in polluting sectors and companies reliant on weak labour practices are at risk from greater regulation, making them less attractive investments in the longer term. ESG investing aims to future-proof portfolios by backing solutions to finite resources and universal human rights. But navigating these noble aims can be tricky for investors confused by jargon and junk messaging about supposedly ethical credentials.

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INVESTING WITH PURPOSE

Investing in line with environmental, social and good governance (ESG) practices is a rapidly growing area of the investment fund market. UK investors transferred almost £1bn a month on average into responsible investment funds in 2020, a total of £12.4bn – 43% of all the money invested in 2020. Equity funds made up the highest proportion, taking on average £510m a month.

UK investors now have £71.9bn in responsible investment funds, growing 66% over 2020 (versus 7% across funds overall).

- Almost 60% is invested in equity funds.
- 20% is in bond funds.
- 20% in mixed asset funds.

Sustainability is a theme for 66% of responsible investment funds under management, 72% exclude certain types of investments and 42% do both.

Why now?
Three factors are behind the move to ESG: a bigger role by organisations such as the Principles for Responsible Investment, better ESG performance data and investor tools, and demand from 'millennial' investors, now aged 24 to 39, mid-career, and inheriting the reality of climate change and social unrest (87% of high net worth millennials invest based on a company's ESG record). A new driver has also been the Covid-19 pandemic.

Performance
Ethical investing was once positioned as a choice of principles over returns. A shift in global policy and advances in technology mean responsible funds now consistently outperform non-ethical equivalents. So one of the traditional arguments against investing with conscience has all but disappeared.

Analysis of 140 ethical funds last year found on average in the 12 months to July 2020:

- ethical funds had grown by more than 4%;
- investments not in the ethical category shrunk nearly 1.5%.

Over the past five years, ethical investments achieved growth of just over 41% versus 32% for those not listed as ethical.

Over 10 and 15 years ethical funds have returned 134% and 202% respectively, beating the average non-ethical fund returns of 103% and 155%.

Example – Returns on £10,000

Using the growth figures above, an investment of £10,000 would have yielded the following returns:

	Ethical	Non-ethical
12 months	£10,400	£ 9,850
5 years	£14,100	£13,200
10 years	£23,400	£20,300
15 years	£30,200	£25,500

Source: Moneyfacts

Pandemic influence

The coronavirus pandemic has also focused minds, with more investors looking at ESG factors for the kind of legacy they want to leave, and sustainability of returns. Ethical funds have performed particularly well during the pandemic, benefitting from:

- a lack of exposure to oil stocks, which plummeted due to the drop in the oil price as air travel stopped; and
- heavy investment in technology companies, which boomed during the lockdowns and the pivot to working remotely, now emerging as a long-term trend.

Planning point

ESG-designed or not, consider how changes to the way we will live and work in the future will affect your portfolio. For reliable, long-term returns, beware of overexposure to sectors likely to lose out from weaker demand for their products such as fossil fuels, or tobacco.

DEFINING ESG INVESTMENT

ESG investing is about choosing to consider the treatment of the planet, people and management structures in order to receive financial returns in a way that is aligned with personal ethics and concerns about the world.

This may mean:

- avoiding certain sectors;
- excluding specific companies; or
- picking a theme with personal importance and investing in projects trying to achieve particular goals or change.

ESG investing lets investors align the way they use their money with their principles, often as part of a lifestyle of ethical consumerism that considers the supply chain of everything we use, from plastic waste to modern slavery.

Future-proof investing

Global sustainability challenges are forcing us to rethink traditional ways of working and living. Companies that once looked like solid and stable investments now face new risks to their profits, including from:

- food shortages;
- drought;
- rising sea levels and floods;
- conflicts over resources and land;
- data privacy.

ESG investing is considered a way of future-proofing returns by investing sustainably, choosing industries concerned for both people and the planet, in order to make long-term returns.

EXAMPLE - Electric vehicles

Cleaner energy electric vehicle (EV) sales are expected to grow 29% a year over the next decade. Add in remote updates to EV functionality and entertainment, and investors get dual returns: consumer demand for less harmful products, and software subscription deals.

Socially responsible investing

Socially responsible investing (SRI) is a type of investing 'for change'. Investors back causes and companies actively trying to make a positive impact on the world, sometimes called

impact investing. For example, increasing access to affordable education globally, or reducing consumption of single use plastics.

SRI investors may filter companies or industries they will invest in, by:

- environmental stewardship;
- consumer protection;
- human rights;
- racial and gender diversity.

SRI investing views financial returns as a secondary consideration, after the investor's ethical priorities.

Sustainability
Sustainable investing supports economic growth while reducing pressure on the environment and increasing good social and governance practices. The aim is to ensure short-term goals do not compromise long-term aims, and to speed up fixes to global problems like inequality and the climate emergency.

Sustainable investing backs a transition to a global economy that is:

- Climate-neutral – activities that do not create greenhouse gases.
- Climate-resilient – able to prepare for and respond to hazardous climate changes.
- Resource-efficient – uses Earth's limited resources sustainably with minimal environmental impact.
- Fair.

In sustainability-themed investing, investors back projects aligned with wider targets, like the UN Sustainable Development Goals, which include clean energy, gender balance and sustainable agriculture.

Green investing
Green investments are environmentally focused, aimed at protecting the Earth's ecosystems from human-caused damage, and repairing the damage done so far. This may include alternatives to fossil fuels, or companies shunning rainforest-depleting palm oil production.

Planning point

Investing using specific, public criteria, such as the UN Sustainable Development Goals, can make it easier to filter companies in which to invest, and keep ESG aims on track.

YOUR VALUES

Matching investments to your values means deciding what is most important to you. You may need to compromise to achieve all of your goals. Consider which causes you care about most, for example:

Environmental	Social	Governance
Conservation of the natural world	*Consideration of people & relationships*	*Standards for running a company*
Climate change and carbon emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committee structure
Biodiversity	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Community relations	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labour standards	Whistleblower schemes

Source: CFA Institute

Then key questions you will need to address include:

1. How would I feel about investing in a good company in a bad sector?

2. Will I only invest in companies where ESG considerations are their primary aim?

3. How much weight will I give to companies trying to improve their ESG ranking?

4. Will I sell current investments that go against my ESG stance?

5. Am I willing to sacrifice investment returns to stick rigidly to my principles in some cases?

A rough idea of what you want to achieve to start with is fine. Your financial adviser can help you weigh up the pros and cons of each option to find the right balance for you.

Intergenerational planning
The pandemic has made a larger number of investors look at ESG criteria more closely in the context of intergenerational planning and wealth transfer. In a recent survey from Prudential, 61% of participants said they now care more about the environment and the planet than they did before Covid-19. One in five are more worried about ESG issues now they have children or grandchildren.

The report found an increased appetite for ESG investing among:

- 60% of millennials;
- 44% of Gen X;
- 35% of baby boomers; and
- 45% of all investors now only want to invest in sustainable companies and funds.

However more than a third (36%) of UK adults admit they do not know where their current investments, including workplace and private pensions, are invested.

Generational divide
While interest in ESG investing has increased across the board, a generational divide exists over priorities when it comes to choosing investments.

Climate change is a more pressing issue for older high net worth individuals, with 55% ranking it their top ESG issue. Social and governance issues ranked lower; only 9% put diversity among their top three ESG concerns.

Younger investors in the 18 – 34 range, however, prioritised social issues.

- 45% said diversity should be companies' top priority;
- 64% judged companies by their responses to Covid-19; and
- 60% were concerned by unequal financial and social hardship caused by the pandemic.

Planning point
Let your adviser know of your sustainability preferences which they will integrate into your suitability assessment. Advisers will soon need to disclose all the ESG-related features of the products they propose and be able to show regulators they have done so.

This divergence of opinion in ESG investing has the potential to cause friction for intergenerational financial planning. Your adviser can guide you on how best to find compromise for children or grandchildren.

DECIPHERING ESG FUND OPTIONS

Picking individual companies based on your ESG principles can risk having all your investment eggs in one or two baskets. A more well-rounded approach is with a portfolio including a range of companies that fit certain ESG criteria.

Last year a record number of sustainable European funds launched, totalling 3,196. Finding your way through them may sound daunting. Your adviser can help you decide which is suitable for you. A single fund may cross over into several categories but the main ESG fund styles to pick from are:

- ESG as a factor – using criteria to judge a company's performance over the long term.
- Active stewardship – fund managers pressuring companies on positive improvements.
- Sustainability-themed – picking a sector's most sustainable companies, or ones that could profit from demand for sustainable goods and services.
- Impact investing – designed to have a measurable positive impact on the world.
- Negative screening – excluding companies on ethical grounds, such as tobacco companies or those involved in animal testing.
- Passive – trackers, such as exchange traded funds, that follow a specially designed index, for example one that includes the top 50 clean energy companies.

Which strategies your fund manager chooses will determine their fund's holdings (companies or bonds they invest in) with at least the largest ten holdings usually listed on the fund's fact sheet.

Ratings

Independent ratings can help you judge the ESG credentials of a particular fund. MSCI ESG Fund Ratings, for example, is an easy to use online search box that scores funds on a scale from CCC (laggard) to AAA (leader), based on:

- holdings of the fund;
- ESG track record (holdings with a positive/worsening rating year on year); and
- exposure to holdings with worst-of-class ESG ratings.

Specialist indices

Specially designed ESG indices are used by fund managers to structure their ESG funds and measure performance. They are also tracked by passives, like exchange traded funds, to invest in certain ESG themes, companies and sectors.

Popular specialist ESG indexes include the S&P Global Clean Energy Index, and the MAC Global Solar Energy Index. The broader MSCI USA Extended ESG Focus Index is the largest in the sector globally, tracked by $15.5bn of investors' money in exchange-traded funds (ETFs).

Passive investing typically costs less in fees and charges than actively managed funds.


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Investment risk
All investment carries some kind of risk. As a general rule, the less risk taken, the lower the return. However, as a fast growing sector, ESG investing can pose greater risks in exposure to technologies and projects that are:

- experimental;
- untested over the long term; and
- yet to make a profit.

> **Planning point**
> Diversification is the key to managing risk in a portfolio but especially ESG, where market leaders are still rising and falling rapidly. You should avoid overexposure to any one ESG theme, government policy, region, asset class or company.

The counter argument is that old-style industries like coal and oil could leave you stuck with loss-making investments in the not-so-distant future, which is also a risk to consider.

Look for companies with diversified income streams, a competitive advantage, or who are market leaders. Find fund managers with a proven track record of beating competitors.

Working with your financial adviser you will need to weigh up your ESG principles against your risk profile and clearly measure your attitude to risk and capacity to lose some or all of your investment.

Measuring performance
Fund performance is typically measured in investor returns after fees and can be compared to its peers, a benchmark or an index. These figures will be found on the fund's fact sheet. Returns remain an important success metric for most ESG investors. How a fund has met certain environmental, social or governance goals can be harder to measure.

Fund managers and individual companies may take a hybrid approach, reporting short-term performance balanced against the potential for long-term reward – both financial and in terms of positive change – by applying ESG principles.

Reports from your fund manager may quantify work on the ESG aims of the fund by, for example:

- the times they voted in AGMs to push companies to meet UN Sustainability Goals;
- how much their holdings have cut capital spending on carbon-creating activities;
- the growth in the number of women on the boards of companies the fund invests in.


Credit: Vanatchanan/Shutterstock.com

The specific positive or negative performance factors a fund manager reports on will depend on the type of ESG strategy they have chosen to invest in. Your financial adviser can chase any clarifications you may need on this.

PITFALLS
While ESG investment is experiencing a positive surge, as with every strategy, there are some key issues that investors should bear in mind.

Greenwashing
To cash in on the 'green pound', and jump on the bandwagon of demand for ethical investments, some companies are rebranding as ESG-focused in a way that's not entirely honest. Some ESG funds take a liberal view of what they allow to make it easier to achieve returns. This 'greenwashing' can make it hard for ordinary investors to choose genuine ESG investments.

Greenwashing can be cynical marketing, or it can be an oversimplified view of a company or sector that fails to take into account hidden ESG risks. Examples include:

- Fishing, once seen as 'green' versus meat, is the largest contributor to ocean plastic.
- Soybeans are the second largest driver of deforestation after cattle, a fact largely hidden from investors in ETF indexes.
- The Australian government found modern slavery of Uyghurs in the supply chains of at least 82 well-known global brands.

Ask to see details of an ESG fund's core investment philosophy (how it picks companies to invest in), process and method of measuring and reporting its ESG principles.

1. Do ESG criteria run like a vein through everything the investment does?

2. Does the fund manager do their own research or rely on third party ratings?

3. Has the fund voted against a company's management at AGMs to protect ESG?

4. Is the fund house signed up to the UN Principles of Responsible Investment?

If you are investing in the shares of a single company, their annual report should demonstrate how much of their ESG activity is measurable and written down.

Worthy but worthless

Remember, just because a company, project or fund is marketed as ESG or ethical or sustainable doesn't necessarily mean it will turn a profit or achieve anything worthwhile. ESG investing may increase the focus on metrics beyond pure financial gain, but decisions about where to invest should still be grounded in sound logic on the likely success, however measured, of the strategy being advertised.

Example – renewable energy but moribund strategy

Philip has been hearing about a renewable energy company from a family friend. It sounds good value. On investigating it further with a view to investing, he discovers the company hasn't made any money for about 20 years. His adviser also points out that it may be cheap only because it is so far behind its competitors with no explanation of how it plans to catch up. Philip decides to investigate more dynamic options in the same field.

You should ask the same clear headed questions of an ESG-focused company or fund as any other potential investment:

- What is it doing better than its rivals?

- What growth has it achieved and what is it doing to achieve more?

- What problem is it solving and how is it measuring its success at that?

- Is it good value for money?

Planning point

In short – there is no need to let your sense-check guard down just because a fund or company is labelled ESG. Don't just believe the hype, ask for proof of results.

The value of investments and the income they produce can fall as well as rise. You may get back less than you invested.

Past performance is not a reliable indicator of future performance.

Investing in stocks and shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and your financial circumstances.

HOW WE CAN HELP

We can help you to understand how to translate the values that are most important to you into a suitable ESG investment portfolio that reflects your principles, financial goals, attitude to risk, and capacity for loss.

- We can work with you to create a financial plan based on your wishes to build and pass on long-term, sustainable investment returns to your children and grandchildren.

- We can also discuss the advantages and limitations of different ESG investing styles.

- Laws and regulation around climate change and sustainability are changing rapidly. We can advise on the impact of these changes on your portfolio and keep you up to date with any future opportunities.

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