rosan helmsley
WEALTH MANAGEMENT

KEY GUIDE I JULY 2022

ESG investing

Introduction

BUILDING A PURPOSEFUL PORTFOLIO

The debate on environmental and social issues and the scale of concern about environmental change have escalated in recent years and now permeate many areas of life, including the asset management industry. Climate change and the vulnerabilities exposed by the coronavirus pandemic have undoubtedly pushed sustainability concerns to the front of the investment agenda.

The asset management industry has launched a flurry of new environmental, social and governance (ESG) funds while also adjusting the investment strategies of existing funds. What was once considered a niche investment area has gained growing attention not just in the UK but globally as well, with ESG-type funds seeing large inflows in both 2020 and 2021.

In this guide, we start with explaining what ESG involves and then look at the questions you should ask yourself if you are considering an ESG investment. We then look at the range of different investment strategies that are available, what factors to consider when selecting funds and the pitfalls to avoid.

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ESG defined

ESG stands for 'environmental, social responsibility and governance' and is a relatively new term that is being used to describe investment strategies that take these factors into account. In simple terms, ESG considers factors other than strictly financial criteria when evaluating companies to determine whether they are acceptable investments.

In the investment industry, the expressions 'ethical investment', 'environmental investment', 'green investment', 'responsible investment', 'socially responsible investment' and 'sustainability' are often used interchangeably and so can be quite confusing. These strands are often brought together under the label ESG.

Environmental	Social responsibility	Governance
This considers how a company's activities impact on areas such as climate change, depletion of natural resources, pollution, deforestation and bio-diversity.	This takes account of the impact that companies have on the societies in which they operate in areas such as working conditions, human rights and employee relations.	This looks at how a company manages itself in areas such as bribery, tax evasion and executive remuneration as well as how it undertakes internal control.

As this guide explains, ESG covers many different factors and individual investment funds may place more focus on one area than another and approach how they select investments differently. For example, they may concentrate on specific areas such as climate change or renewable energy or take a more general investment approach and exclude companies that do not match up to their standards for working conditions.

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 your personal ethics and concerns about the world. Investors can 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. This may mean:

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

ESG investing does not just include equity investment, it also extends to bond and multi-asset portfolios. There are both actively managed ESG funds and passive ESG index tracker funds available.

Whilst the growth of ESG funds may seem like something new, these types of funds have been around for many years. The last few years, however, have seen the assets under management in ESG funds grow substantially. New funds keep being launched and existing funds are changing their investment strategies to incorporate ESG factors into their deliberations.

As we become more conscious of environmental issues such as climate change, investors are taking a greater interest in where their money is invested and although good investment returns are still very important, we are also increasingly focusing on how companies make their profits and the impact they have on the environment and society.

Misconceptions

The UN-supported organisation PRI has identified three common misconceptions about responsible investing. These misconceptions and their views are shown opposite.

Principles for Responsible Investment (PRI) is a UN-supported organisation whose role is to encourage the take up of responsible investment practices. It defines responsible investment as a strategy to incorporate ESG factors into investment decisions and active ownership that complements traditional financial analysis and portfolio construction techniques.

ESG investment performance

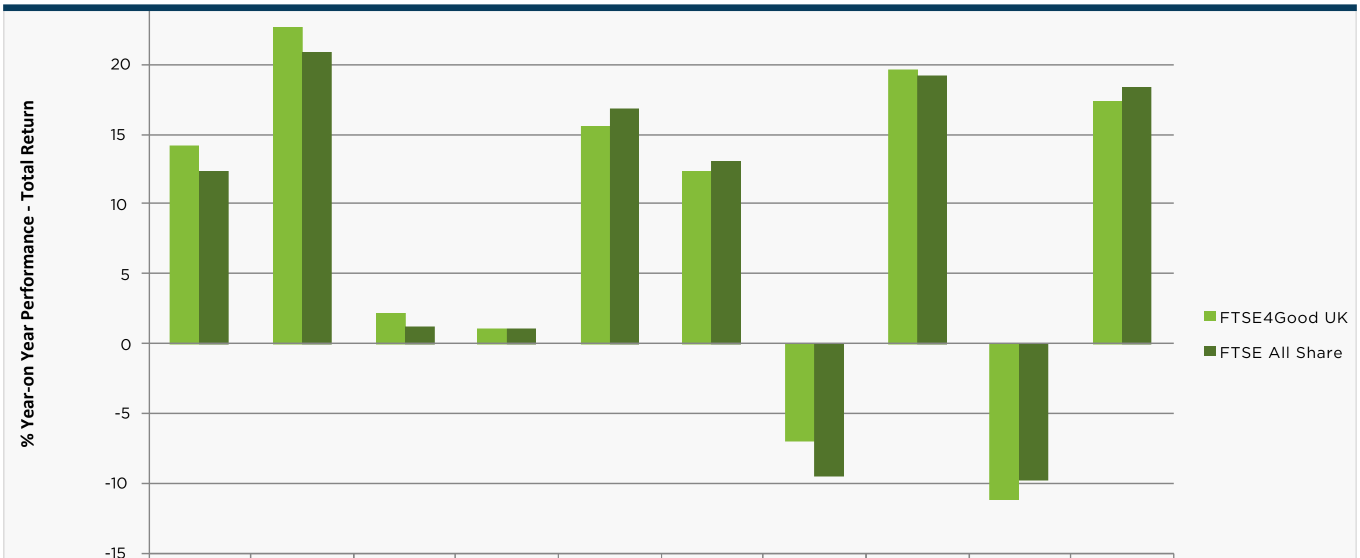
According to PRI there is growing recognition in the financial industry and academia that incorporating ESG factors into investment analysis and decisions better manages risks and improves returns.

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.

As an example, one such index is the FTSE 4Good UK Index which tracks the performance of companies in the FTSE All Share Index that demonstrate good sustainability practices. The FTSE All Share Index tracks the performance of just over

It involves investing in a specific investment strategy or product	Responsible investment does not necessarily require investing in a specific strategy or product. It simply involves including ESG information in investment decision-making and stewardship practices, to ensure that all relevant factors are accounted for when assessing risk and return. Exactly how an investor practices responsible investment varies widely.
It leads to lower investment returns	Responsible investment does not require sacrificing returns; it should, in fact, enhance risk and return characteristics. Investors apply a range of techniques to identify risks and opportunities that might remain undiscovered without the analysis of specific ESG data and broad ESG trends.
It is the same as sustainable, ethical, socially responsible and impact investing	There are many terms associated with the plethora of investment approaches that consider environmental, social and governance issues. Most lack formal definitions, and they are often used interchangeably. A key to understanding how responsible investment is broader than these concepts is that where many make moral or ethical goals a primary purpose, responsible investment can and should also be pursued by the investor whose sole focus is financial performance.

Source: Principles for Responsible Investment



	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
FTSE4Good UK	14.1	22.7	2.1	1.1	15.6	12.3	-7.1	19.6	-11.3	17.4
FTSE All Share	12.3	20.8	1.2	1	16.8	13.1	-9.5	19.2	*-9.8*	18.3

Source: FTSE Russell

600 companies whilst the FTSE 4Good UK Index tracks just over 200 of those companies. Interestingly, those companies account for close to three-quarters of the total market capitalisation of the FTSE All Share Index companies and the average dividend yield on both indices is approximately the same.

It is calculated in the same way as the FTSE All Share Index and so it is useful to compare the relative performance of the two indices to gain some idea of what ESG investing might mean. The chart on page 4 shows the year-on-year performance of each.

Past performance is not a guide to future performance.

The value of investments and income from them can go down as well as up, and you may not get back the original amount invested.

As more and more companies strive to improve their adherence to responsible standards in the near future we could reach a point where the majority of companies that make up the main indices are ESG compliant.

YOUR VALUES

Ethical investing was once positioned as a choice of principles over returns. A shift in how we think about the environment, global policy changes and advances in technology has allowed ESG funds to move centre stage, meaning that one of the traditional arguments against investing with conscience has all but disappeared.

Planning point

Consider how changes to the way we will live and work in the future will affect your portfolio or choice of investments. For reliable, long-term returns, beware of overexposure to sectors likely to lose out from weaker demand for their products such as fossil fuels, carbon intensive industries and other polluting industries.

Matching investments to your values means deciding what is most important to you but remember, 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

Here are some of the key questions you should ask yourself when considering ESG investment:

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

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

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

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

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

This will help you develop a rough idea of what you want to achieve which is with a good starting point. Your financial adviser can help you weigh up the pros and cons of each option to find the right balance for you.

You may also want to take into account how your children or grandchildren view what matters for the future – your current investments may well be their legacies.

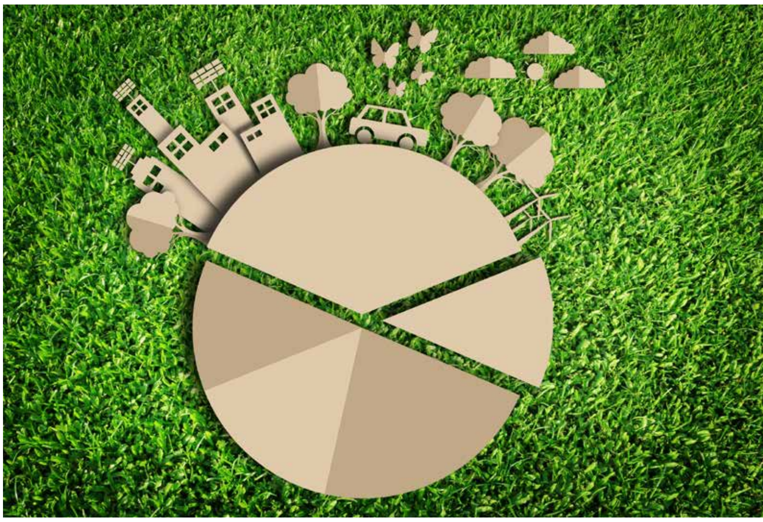
Investment risk
All investment carries some kind of risk. As a general rule, the less risk taken the lower the return. However, as a fast growing sector, ESG investing can pose greater risks in exposure to technologies and projects that are:

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

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.

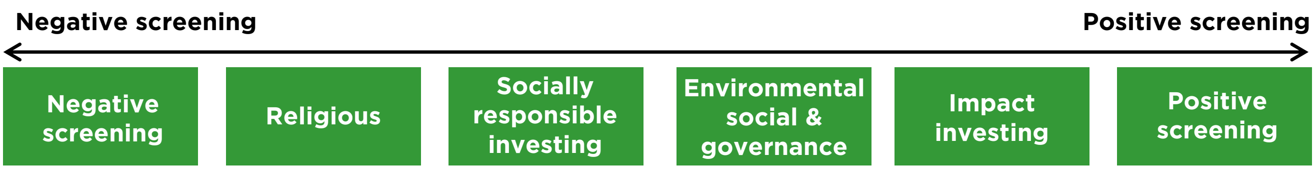
Working with your financial adviser you will need to weigh up your ESG principles against your risk profile and clearly measure your attitude to risk and capacity to lose some or all of your investment.

Finding funds
Lipper Refinitiv has usefully portrayed the range of funds available as a spectrum that includes funds that negatively screen out unsuitable investments at one end to ones that positively screen at the other end.



You should notice that ESG is just one of the categories despite it being used as a generic term. The type of funds that would generally fall under each category is shown here.

Negative screening	Excludes companies involved with areas such as armaments, tobacco, fossil fuel energy and similar activities.
Religious	Religious principles determine acceptable assets such as Islamic funds and faith-based funds.
Socially responsible investment	Social impact is part of the overall screening process where acceptable investments must meet defined social criteria.
Environmental, social & governance	Material environmental, social or governance factors feature in the screening process.
Impact investing	Funds aim to achieve a positive impact on the behaviour of companies.
Positive screening	Positive screening criteria identify suitable investments such as best in class, positive tilt or thematic.



Source: Lipper Refinitiv

An ESG fund can adopt any of the different styles and therefore it is important to drill down into how a fund will analyse, filter and select suitable investments to determine its approach.

Screening

Investment funds 'screen' companies to determine if they are acceptable investments to include within the fund portfolio. Two main approaches are used in ESG funds - negative screening and positive screening

ESG fund selection

It is important to recognise that an ESG approach by necessity restricts the available investment universe compared to traditional funds and makes the stock selection process more complex. Integrating ESG analysis into the stock selection process is necessarily more research intensive than the processes undertaken by traditional investment funds and requires a substantial research capability.

Given the range of different ESG investment strategies it is important to understand how a fund approaches the selection process and then whether that fits with your values.

- For you, it is important to understand what your personal ESG values are and which type of ESG strategy may best fit with your requirements - for example, would negatively screening out energy companies or positively screening for companies addressing our energy reliance be more appropriate? This simple example should emphasise that ESG investing can mean different things to different people.

- The fund should adhere to its ESG philosophy, considering how it implements its selection process, the experience of the fund management team in that area and the performance that the fund has achieved.

Negative screening	Traditional ethical portfolios are constructed to avoid those areas of investment that are considered to have significant adverse effects on people, animals or the environment. Such screening exercises, combined with conventional portfolio management techniques, typically result in a larger than normal percentage of the portfolio being invested in smaller companies.
Positive screening	At the other end of the spectrum are funds that employ positive screening to identify suitable investments for inclusion in a portfolio. Funds can implement this approach by either using positive sector selection or choosing the best in sector: **Positive sector selection**: chooses companies that operate in sectors likely to benefit from the global shift to more socially and environmentally sustainable forms of economic activity, such as renewable energy sources. This approach is known as 'investing in industries of the future' and gives a strong bias towards growth-oriented sectors. **Best in sector:** often chooses companies for the environmental leadership they demonstrate in their sector, regardless of whether they fail the negative criteria applied by ethical investing funds. For instance, an oil company that is repositioning itself as an energy business focusing on renewable energy opportunities would probably be considered for inclusion in a sustainability fund but would be excluded from an ethical fund.

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. Some key questions to bear in mind are:

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.

Fund ratings

Independent ratings can help you judge the ESG credentials of a particular fund. Several ratings agencies provide their analysis of the ESG credentials of a fund including agencies such as Morningstar, Lipper and MSCI.

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.

Fund 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 can be found on the fund's fact sheet and through fund rating agencies such as Morningstar or Lipper or through other sites such as Trustnet.

Returns remain an important success metric for most ESG investors, but how a fund has met certain environmental, social or governance goals can be harder to measure. 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;

Credit: Vanatchanan /Shutterstock.com

- the growth in the number of women on the boards of companies the fund invests in.

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 obtain any clarifications you may need on this.

PITFALLS

While ESG investment is experiencing a positive surge, it is important to remember there are some key issues that investors should bear in mind.

Greenwashing

To benefit from the surge in 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 harder for ordinary investors to choose genuine ESG investments.

In Europe, for example, the European Securities and markets Authority reported in February 2022 that it had observed a mismatch between what fund managers are telling ESG clients and their actual investment allocation strategies.

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.

Fund rating agencies are increasingly undertaking in-depth analysis of the disclosures made by funds to identify those that fail to meet their criteria to be classed as sustainable investments. Morningstar, one of the leading fund rating agencies, removed more than 1,000 European funds from its list at the end of 2021 for failing to meet ESG criteria leading to significant outflows from those funds.

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.

Asking questions

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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Rosan Helmsley Ltd, 1000 Cathedral Square,
Cathedral Hill, Guildford, Surrey, GU2 7YL

01483 90 40 40 | www.rosan-ifa.com