May 2016

ESG: A Brave New World of Investing

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Sustainable investing. Socially responsible investing. ESG (Environmental, Social, Governance) investing. Ethical investing. Call it what you will, but the bottom line is that investors are increasingly demanding a say in the types of companies in which their money is invested. That may be relatively simple for individual investors who are choosing their own stocks and bonds, but for institutional investors who employ investment consultants and/or money managers, the task is a bit more complex.

Socially responsible investing began in the late 19th century with the avoidance of "sin stocks" in portfolios owned by religious organizations. Many investors today still focus on exclusionary screens when it comes to making sure that their investment portfolio is socially responsible. However, the complicating factor is that what is socially responsible to one group may not be socially responsible to another. For instance, Catholic institutions may screen out stocks relating to abortion, while Quaker institutions may exclude companies that manufacture weapons, and health care organizations may eliminate tobacco-related stocks.

Whereas certain types of organizations may be required to use screening tools in order to remain true to their mission, the more modern approach to socially responsible investing tends to be inclusive rather than exclusive.

> *ESG is no longer merely about passive avoidance of companies in industries such as tobacco or firearms. Instead, the emphasis is on finding companies with certain quality attributes – e.g., environmental and product safety, workforce diversity, employee retention and strong corporate governance – that will have a positive impact on future shareholder value.*[1]

More than ever, investors are incorporating ESG factors into their portfolios as a way of taking advantage of opportunities and mitigating risk. The consensus view seems to be that companies that operate while being mindful of environmental (e.g., energy efficiency, pollution), social (e.g., stakeholder reputation, health and safety), and governance (e.g., board structure/diversity) issues are more likely to succeed than companies that don't take ESG factors into consideration.

The world is a different place than it was ten, fifteen, twenty years ago. Issues such as climate change and workplace diversity, virtually unheard of two decades ago, are now at the forefront of peoples' minds. Increasingly, investors want to invest the way they live. Someone who drives an electric car and brings his reusable shopping bags to Whole Foods to buy his organic, free range chicken is not likely to feel comfortable, for example, investing his money in a company that is known to pollute excessively. This brings us back to the concept of risk and opportunity. Companies that don't take ESG factors into account may be exposing themselves to risks (e.g., negative press, lawsuits), while companies that focus on ESG issues are opening themselves up to potential opportunities (e.g., developing new technology).

The attitude toward socially responsible investing has shifted dramatically. The Forum for Sustainable and Responsible Investment reports that $1 out of every $6 that is professionally managed in the U.S. is done so according to socially responsible strategies, which represents an increase of more than 75% since 2012.[2] Millennials in particular tend to place significant emphasis on ESG trends, and a 2015 Accenture survey estimates that $30 trillion in investable assets will pass from baby boomers to younger generations over the next few decades.[3] As such, sustainable investing is an issue that is here to stay.

When it comes to institutional investors, many institutions are facing pressure from trustees, donors, and other interested parties to adopt socially responsible investing practices. Reports of protests and sit-ins on college campuses calling for divestment from fossil fuels are widespread. In fact, a fund named "The Multi-School Fossil Free Divestment Fund" has been established, whereby rather than donating directly to a school, supporters make a donation to the fund in their school's name, to be held back until the school divests from fossil fuels. Should the school fail to divest within a certain period of time, funds that were earmarked for them are allocated among the remaining schools in the pool. While fossil fuel divestment is today's hot topic, the focus is just as likely to shift to other environmental, social, or governance issues in the future. As such, institutions must be prepared to deal with these issues.

Money managers are increasingly incorporating ESG factors into their investment process, not only because investors are demanding it, but also because they feel that considering these factors may ultimately strengthen their portfolios. For example, one well-known global asset management firm employs ESG analysts for each sector of the global marketplace. These analysts engage with companies to discuss ESG issues and ensure that ESG factors are integrated into investment decisions. This firm has successfully worked with several companies in their portfolios to help them improve their ESG profile. For instance, they engaged with Yum! Brands regarding a food supply chain issue that they identified as a potential risk, and the company directly addressed and rectified the issue that the manager identified. Similarly, the same firm encouraged Walgreens to add an anti-retaliation statement to their business ethics policy in order to help protect whistleblowers, and Walgreens incorporated it into their Code of Conduct. This particular firm is not alone in their approach – many money managers are realizing that socially responsible investing is not merely a passing fancy and are taking ESG factors into consideration throughout their investment process. These money managers are using their influence as investors in order to engage these companies and help them improve, which may result in a better bottom line for the company and better results for shareholders.

Just as money managers are increasingly asking ESG-related questions of the companies in which they invest, we at FIA are asking ESG-related questions of the money managers with whom we invest our clients' assets. Our research team has certainly noticed a trend of investment managers incorporating ESG principles into their investment process, whereas that was not the case several years ago. It can be more difficult to employ a socially responsible approach in certain asset classes, such as international, small cap, and certain segments of the fixed income markets, but managers in these spaces are beginning the work of addressing this trend. Although at this point in time it is somewhat of a challenge to build an entire portfolio of socially responsible strategies, given the recent surge in popularity of ESG investing, it seems reasonable to estimate that in five to ten years it will not be particularly difficult to find ESG focused investment managers with competitive performance covering the full spectrum of asset classes.

This is a complicated issue. Factoring ESG principles into portfolios is truly a brave new world of investing. However, with institutional investors facing increased pressure to invest in a socially responsible manner, companies facing increased pressure to build sustainable businesses that take ESG factors into consideration, investment managers facing increased pressure to incorporate ESG into their investment approach, and consultants facing increased pressure to address the ESG movement, socially responsible investing is certainly more than a passing trend. The world of investment management is doing its best to adapt to the ever-changing socially conscious landscape.

Sources:

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