

Ethical investing approaches: screening and best-in-class

Dr Quintin Rayer

*DPhil, FInstP, Chartered FCSI, SIPC, Chartered Wealth Manager
Head of Research and Ethical Investing at PI Investment Management*

Biography

Quintin has worked for actuarial and investment consultancy firms and a multi-national European bank, including wide experience in quantitative fund and risk analysis. He is a Fellow of the Institute of Physics, a Chartered Fellow of the CISI and a Chartered Wealth Manager. Quintin has applied skills gained from his Oxford University Physics Doctorate and while working in engineering to finance. He is the second UK graduate from the Sustainable Investment Professional Certification (SIPC) programme and joined [PI Investment Management](#) in January 2017, founding their ethical and sustainable investing proposition.



Introduction

Previous articles asked why ethical investment matters [1], gave an introduction to Sustainable (environmental, social and governance, or ESG) investing [2] and a short history of ethical investing [3]. This article outlines how ethical investors use screening and best-in-class approaches to achieve their goals.

Ethical investors wish to allocate funds to areas they feel deserve investment selectively and to avoid businesses or activities that do not. Typically, they seek to avoid the so-called ‘sextet of sin’, which generally refers to alcohol, tobacco, gambling, pornography, armaments and nuclear power [4]. Different investors may wish to avoid different or more sectors than these, including areas such as animal testing, the fur trade and child labour.

Exclusions or ‘screening’ is only one strategy of several. Investors can ask themselves whether they wish to:

- Avoid unethical companies, but accept investment in ethically neutral companies, which do neither good nor harm? This is known as negative screening.
- Invest only in ethical companies, avoiding both unethical and ethically neutral companies? Called positive screening.
- Actively seek to influence corporate behaviours for the better. Examples would include positive engagement or shareholder activism.

The answers an investor reaches regarding these questions and how they might be implemented leads to a range of investment approaches.

Investment approaches

Ethical investors focus on activities that are seen as desirable or else avoiding undesirable outcomes. Sustainability, using ESG factors [2], can provide a helpful framework when it comes to determining whether a business activity should be seen as having a positive or negative impact.

Ethical investing means different things to different people, and institutional investors may answer to several stakeholders that differ in the conclusions they have reached between themselves. Despite different approaches available, some investors may feel that none of the primary methods fit their requirements. The focus here is on screening, and ‘best-in-class’, but other approaches include tilting, or influence and engagement. These will be considered in a later article.

Screening

Screening appears to be the most usual approach with investments tested against several requirements. These seek to identify companies’ impacts as positive, negative, or ‘ethically-neutral’ (broadly doing neither good nor harm).

When considering screening, an investor must decide whether to avoid ethically-neutral companies (see Figure).

- Negative screening avoids companies deemed to be involved in unethical activities but invests in ethically-neutral companies.
- Positive screening only invests in ethically beneficial companies, avoiding both ethically-neutral and unethical companies.

A concern with screening is that it can generate portfolios with company size and sector biases, which could limit portfolio diversification.

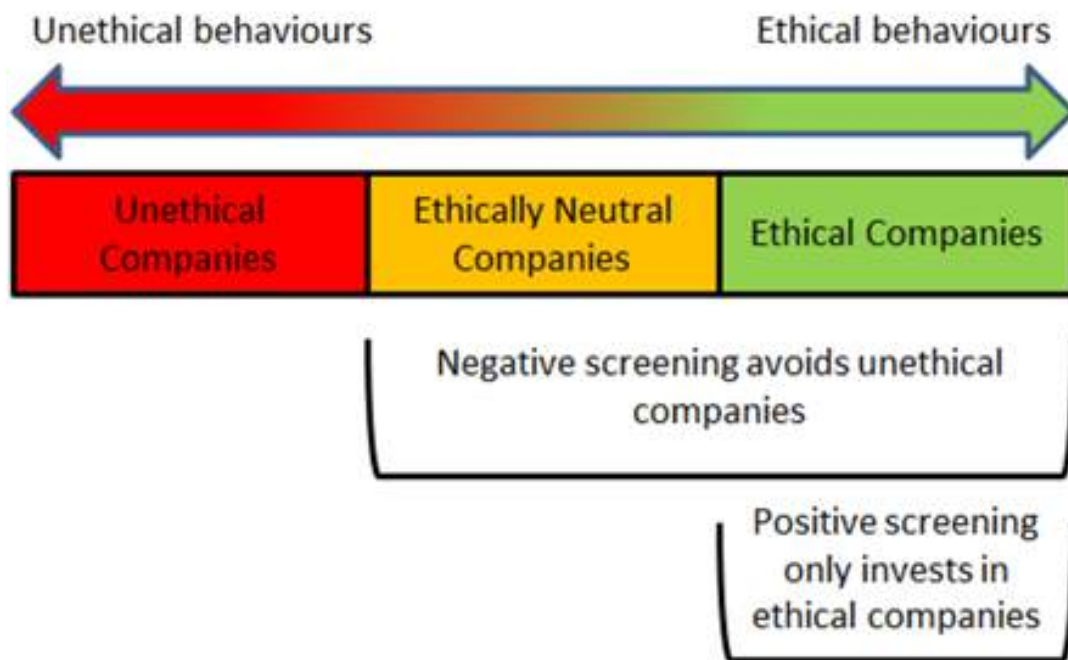


Figure: Positive and Negative Screening (reproduced from [5])

Best-in-Class

This approach includes companies and industries that are the best operators within the class considered, including the best companies within a sector. This can mean selecting the 'least bad' businesses in some sectors.

It can motivate companies in ethically-challenging sectors to improve. Consider a fictitious mining company against some different ethical investing strategies. Suppose the company has a weak record regarding environmental damage during extraction, pollution from refinery waste products, treatment of labour and indigenous peoples displaced or harmed by its activities.

Consider how different ethical selection methods might approach this company:

- Positive screening would exclude the company based on its sector or activities, which would likely be unacceptable. Management can take no action to make the company acceptable (apart, presumably, from winding the company's operations up), leaving them no motivation to improve.
- Negative screening would similarly exclude the company due to its sector or activities.
- Under best-in-class, the sector's 'least bad' companies can attract investment. By comparing with peers, management can improve their environmental and social record to be amongst the best in their sector and attract investment. In a competitive market environment, companies can be motivated by a 'race to the top'. This can generate real improvements for those affected by the company's activities, even if they will never be perfect.

For investors seeking to more actively engage, the best-in-class approach can provide benefits to those most affected by harmful company practices, but can mean a closer involvement with firms that not all will feel comfortable with.

How this helps Investors

By appreciating the approaches used by ethical fund managers when selecting companies, individuals who wish to invest ethically should be better placed to understand the strengths and weaknesses of techniques offered, helping them choose an approach best suited to their needs.

References

[1]

Q. G. Rayer, "Introducing Ethical Investing," *The Private Investor*, the newsletter of the UK Shareholders' Association, no. 199, pp. 12-13, April 2019.

[2]

Q. G. Rayer, "Introducing sustainable "ESG" investing," The Private Investor, the newsletter of the UK Shareholders' Association, no. 200, pp. 10-11, June 2019.

[3]

Q. G. Rayer, "A short history of ethical investing," The Private Investor, the newsletter of the UK Shareholders' Association, no. 201, August 2019.

[4]

C. Krosinsky, N. Robins and S. Viederman, Evolutions in sustainable investing: strategies, funds and thought leadership, John Wiley & Sons, 2012.

[5]

Q. G. Rayer, "Exploring ethical and sustainable investing," CISI, The Review of Financial Markets, no. 12, pp. 4-10, 2017.

Policy round-up

UKSA's Policy Director, Peter Parry, works closely with his ShareSoc counterpart, Cliff Weight. By working together the two organisations can achieve much more clout when lobbying for shareholder rights among government and private-sector organisations.

The close contact built up with the FRC in recent years is the result of this collaboration and this year's events with PwC are further evidence of the activity in the policy field.

Details of the upcoming PwC event can be found below, while on the adjacent page readers can find details of UKSA's and ShareSoc's combined response to a consultation on CMA recommendations.

The policy teams are currently working on a response to the Law Commission's review of intermediated securities, which is due to be submitted by 11 November. More news on this will be included in the next edition of TPI.



Environmental reporting – can investors help to save the planet...?

In May PwC ran a very successful event for us on environmental issues. A number of participants said that they would like a follow-up event – one at which they would 'be able to do some real work'. PwC has risen to the challenge and has developed a highly participative event which is scheduled for Wednesday, 27 November, starting at 2.00 p.m at PwC's offices at 7 More London Riverside (near London Bridge).

The event will consist of a short introductory panel session from a number of PwC's environmental experts. Attendees will then break into four groups. With help from the PwC experts, each group will be tasked with discussing one of four topics on a key environmental issue facing investors. The groups will then rotate, with each one discussing a second topic. The event will end with a plenary feedback session followed by a more general Q&A. This is a fairly specialised event which is likely to appeal to those with a strong interest in environmental and climate-change investment issues.

There are only 24 places available, so members who want to attend are advised to book as soon as possible. Bookings are now being taken by the UKSA Office (officeatuksa@gmail.com).