> *Behaving in an unsustainable manner will cease to be an option*

STUDY ROOM

WHY ETHICAL INVESTING MATTERS

Dr Quintin Rayer explains why ethical is about more than paying lip service to corporate social responsiblity

Advisers may find that they face a dilemma with ethical investing, while advisers and clients often accept matters, they fear underperformance. Human activities have generated threats including climate change and its consequences; lifespan is increasing, so demographics will impact healthcare and pension costs; while an expanding world population demands improved living standards as less developed countries modernise. Behaving in an unsustainable manner will cease to be an option.

Corporations are ubiquitous and powerful; we need them to end unsustainable behaviours and tackle future challenges, including environmental, climate change and social issues. Financial markets help direct and control corporate behaviour; markets reward ingenuity, efficiency, talent and productivity through the ability to raise funds and by share pricing (thereby valuing companies). Companies tackling these problems will benefit in either the short or longer term, making them valuable investments.

APPROACHES TO ESG

Companies are encouraged to promote practices including environmental stewardship, consumer protection, human rights and supporting the social good. One focus is on environmental, social justice and corporate governance issues (ESG). In sustainable investing, funds are directed into companies with business practices capable of being continued indefinitely without causing harm to current or future generations, or exhausting natural resources (ie not 'unsustainable'). Sustainability is often defined as ensuring development meets the needs of the present without compromising the ability of future

IMAGE: GETTY

generations to meet their own needs.

ESG identifies three sustainable investing dimensions (see diagram).

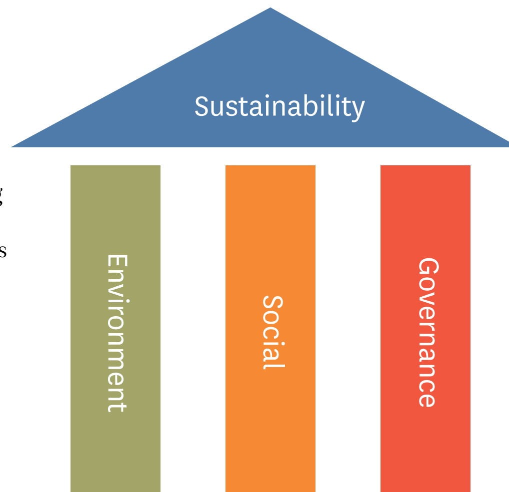
- Environmental, including carbon-intensity; forest and woodland degradation; pollution; use of scarce resources, including water and living creatures, additionally to minerals, oil and natural gas; toxic by-products from mining etc.
- Social, including corporate social responsibility (CSR); child labour; slavery; hazardous, exploitative and/or coercive working conditions; structures that reduce corporate tax bills to levels incommensurate with the profits and activities taking place in those countries; displacement of indigenous peoples.
- Governance; weak internal controls may let management ignore company policies, increasing risks of irresponsible behaviours, corruption and bribery. At board level, weak governance may mean that non-executives cannot control powerful executives, with possible damage to the company and owners' (shareholders') interests and increased risk of excessive executive remuneration.

IMPLEMENTATION STRATEGIES

Methods cover a range of strategies, including negative screening (avoiding unethical companies), positive screening (investing only in ethical companies), best-in-class (selecting least bad company), portfolio tilting (slanting a portfolio towards ethical investment) and engaging with companies to influence their behaviours.

Many of these strategies can be accessed through funds, although this can be a complex area since, in addition to the usual investment due diligence, analysis is required into the ethical strategies used to confirm they meet clients' needs. In this respect, advisers may benefit from support from wealth managers with specific skills and expertise in this area.

One 'light green' approach is portfolio tilting, where the majority of a portfolio is invested conventionally (allaying underperformance fears), while the remainder is invested ethically.



THE THREE PILLARS OF SUSTAINABILITY

IS PERFORMANCE BETTER THAN FEARED ANYWAY?

The argument that ethical funds must underperform generally proceeds as follows: Ethical investment requires screening, this reduces choices available for investment, reducing diversification and resulting in worse returns, higher risk, or both. An early example of the argument that less-diversified ethical portfolios increase risk was made in 1980. Additionally, some fund providers may only have a superficial commitment to ethical investing, which can cloud the issue.

Looking at risk, harmful corporate behaviours eventually lead to negative consequences, harming growth and share price. These can include sector emissions constraints, community opposition to projects, increased insurance premiums, decreased access to capital markets, damage to reputation and litigation threats. Essentially, unethical companies have risks not well reflected in share prices.

Ethical companies have a competitive advantage by avoiding the problems above, but also from a good reputation to attract customers, enhanced trust with similarly-ethical trading partners reducing costs and increasing business opportunities, the ability to attract the best staff, new revenue streams from novel environmental technologies and access to capital markets on better terms.

Academic studies suggest that various ethical approaches can indeed result in outperformance. The table outlines studies of long-only ethical strategies, which all generated positive alpha. These involve analyses of various time periods using differing criteria to define which companies are more (or less) ethical.

Such historical analyses can always be challenged on the basis that they offer no guarantee of future performance. Equally, market conditions may vary looking forwards, and perhaps several environmental, social and governance factors are now better addressed by companies.

However, they should serve to give pause for thought for those who are tempted to assume that it is 'obvious' that ethical portfolios 'must' underperform the wider market and help to allay the dilemma faced by advisers considering discussing ethical investing with their clients. ●

STUDIES SHOWING OUTPERFORMANCE BY ETHICAL STRATEGIES

Alpha, per year	Period analysed	Ethical criteria
1.3% – 4.0%	1995-2003	Environmental
2.3% – 3.6%	1992-2004	Environmental, social
2.3% – 3.8%	1984-2011	Employment quality
3.5%	1990-1999	Governance
3.7% – 5.2% (estimated)	1990-2003	Governance

Table: See below

The table presents the result of the following analyses: J. Derwall, N. Guenster, R. Bauer and K. Koedijk, "The eco-efficiency premium puzzle," Financial Analysts Journal, vol. 61, no. 2, pp. 51-63, 2005; A. Kempf and P. Osthoff, "The effect of socially responsible investing on portfolio performance," CFR Working Paper, no. 06-10, 2007; A. Edmans, "The link between job satisfaction and firm value, with implications for corporate social responsibility," Academy of Management Perspectives, November 2012; P. Gompers, J. Ishii and A. Metrick, "Corporate governance and equity prices," Quarterly Journal of Economics, vol. 118, no. 1, pp. 107-155, 2003; and L. Bebchuk, A. Cohen and A. Ferrell, "What matters in corporate governance?," The Review of Financial Studies, vol. 22, no. 2, pp. 783-827, 2008.

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