Approaches to Ethical & Sustainable Investing: Screening and Best-in-Class

By Quintin Rayer | October 26, 2017

In previous articles, Quintin Rayer 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 screening and best-in-class approaches are used to achieve ethical investment goals. Following articles will explore different methods and other aspects of ethical investment including performance issues.

Introduction

Ethical investors wish to allocate resources to areas they feel deserve investment and to avoid businesses that do not. Typically, avoiding 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.

Exclusions, or 'screening' is only one strategy of several. Do investors wish to:

- Avoid unethical companies, but accept ethically-neutral companies doing neither good nor harm? (Negative screening.)
- Invest only in ethical companies, avoiding both unethical and ethically-neutral companies? (Positive screening.)
- Actively seek to influence corporate behaviours for the better? (Positive engagement, or shareholder activism.)

These questions and their implementation lead to a range of investment approaches.

Investment Approaches

The focus is on activities that are seen as generating desirable or avoiding undesirable outcomes. Sustainability, using ESG factors [2], is helpful 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 stakeholders that differ amongst 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.

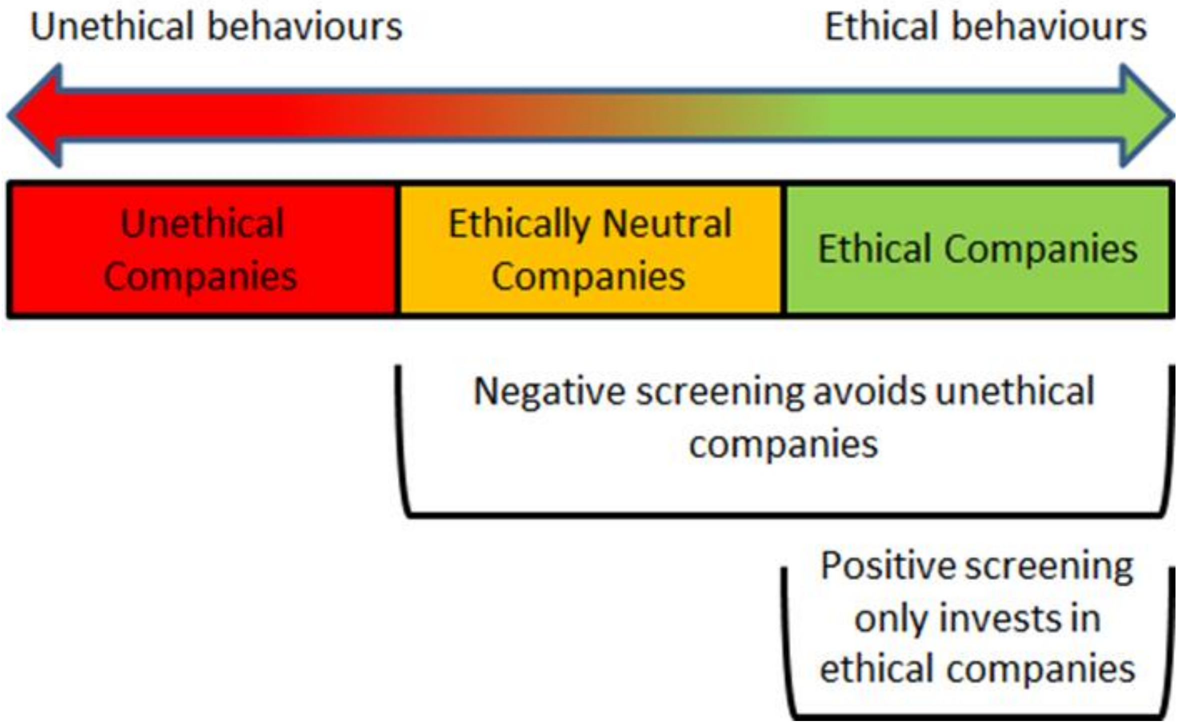
Screening

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

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

- Negative screening avoids unethical companies, 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, limiting portfolio diversification.



Best-in-Class

This 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. Regarding ethical selection approaches:

- Positive screening excludes the company based on sector, 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.

- 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, this can motivate companies in a 'race to the top', thereby generating 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.

Why this Matters to Advisers

A growing number of clients are using ethical investing. The IMA (Investment Management Association) reports there were £14.0 billion of assets under management in the UK ethical funds sector in July 2017, an increase of £4.3 billion since July 2016 [5]. By appreciating the approaches used by ethical fund managers when selecting companies, advisers will be able to support their clients better in this important and growing area.

REFERENCES

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