An introduction to ESG investing (for advisers with ethically minded clients)

By Quintin Rayer | August 23, 2017

In a previous article on ethical investment, Quintin Rayer outlined "Why ethical investment is crucial and not just 'nice to have'". In this follow-up article he introduces the concept of sustainable investing and its focus on 'ESG' factors. Following articles will explore different aspects of ethical investment approaches and issues such as performance.

Introduction

Although distinctions can be made between ethical investing, socially responsible investing, and so-on, in this article the term 'ethical' investing will generally be used interchangeably with these other terms (for definitions of these terms see [1]).

Companies are encouraged to promote practices including environmental stewardship; consumer protection; human rights and to support the social good [1], [2]. One focus is on Environmental, Social Justice and Corporate Governance issues (ESG).

In sustainable investing, funds are directed towards companies with business practices capable of being continued indefinitely without causing harm to current or future generations, or exhausting natural resources (i.e. not 'unsustainable'). Sustainability is often defined as ensuring development meets the needs of the present without compromising the ability of future generations to meet their own needs [3].

What is ESG investing?

The three key dimensions of sustainable ESG investing are:

1. **Environmental.** Including carbon-intensity; forest degradation; pollution; usage of scarce resources; mining activities which generate toxic by-products; intensive agricultural methods and so on.
2. **Social.** Including corporate social responsibility (CSR); child labour; modern-day slavery; hazardous and exploitative working conditions, including 'zero hours' contracts; aggressive corporate taxation reduction methods; and displacement of indigenous peoples.
3. **Governance.** Weak internal corporate controls may let management circumvent company policies, increasing risks of irresponsible behaviours, corruption and bribery. Weak governance may mean that non-executive directors do not hold executives in check, with possible damage to the company as well as the owners' interests, and increased risk of excessive executive remuneration.

Outsourcing and externalisation

Companies may outsource production to countries or other companies operating without meaningful sustainability practices. A company might claim ethical operations, while not looking too deeply into its suppliers' practices. Best practice requires companies to scrutinise their resource chains and monitor the entire production process, from origin through to ultimate disposal of products after use.

Companies may also externalise costs of production [4]. Companies consume resources and create waste products. Ideally all costs associated with resources consumed and waste product disposal during manufacture would be included in the price of goods created; including disposal after use.

Externalising production costs also applies to forcing labour to subsidise activities, and saving money with potentially health-damaging practices or inadequate wages. Failure to invest in appropriate governance and management structures can result in company staff undertaking activities boosting earnings, but with the tab ultimately being picked up by society or taxpayers. The company saves money on management and governance, while the taxpayer pays the cost of dealing with problems that may arise as a result. The company externalises these costs to the taxpayer when it should pay them itself.

What do ethical investors want?

Having identified some concerns motivating ethical investing, investors want, broadly speaking, to see capital put to an ethically good use. Not merely maximising investment return, but also causing benefit (or at least doing no harm) while generating a decent return - 'doing well while doing good'.

Why this matters to advisers

Clients increasingly understand the importance of environmental, social and other ethical issues in society. A growing number of clients are also using ethical considerations to guide their investments. The Investment Management Association (IMA) reports there were £13.8 billion of assets under management in the UK ethical funds sector in May 2017, an increase of £3.0 billion since May 2016 [5].

Clearly, advisers will want to be able to support their clients by appreciating the key ethical factors in this important and growing area.

References

[1] C. Krosinsky and N. Robins, Sustainable investing, the art of long-term performance, London: Earthscan from Routledge,2008.
[2] C. Krosinsky, N. Robins and S. Viederman, Evolutions in sustainable investing: strategies, funds and thought leadership, John Wiley & Sons, 2012.
[3] G. Bruntland, "Our common future, from one earth to one world: an overview by the World Comission on Environment and Development," 1987.
[4] J. Porritt, "The world in context: beyond the business case for sustainable development," Cambridge: HRH The Prince of Wales' Business and the Environment Programme, Cambridge Programme for Industry, 2001.
[5] The Investment Management Association, Funds Statistics, May 2017. Accessed 20 July 2017.

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