GREEN DOLLARS

Quintin Rayer discusses ethical and sustainable investing, and how they can enable trustees to meet their fiduciary responsibilities

Ethical investment can be seen as 'nice to have' but non-essential. However, it is of fundamental importance, as is the more recent concept of 'sustainable' investment. Several approaches are outlined below, moving beyond common assumptions that either ethical or sustainable investment only involves avoiding investment in companies carrying out unacceptable activities. In practice, ethical investors can benefit from awareness of different approaches. Finally, implementation is discussed.[1]

ETHICAL INVESTING MATTERS

Unsustainable human activities have generated threats including climate change, resulting in environmental damage, loss of life, and disruption to food and fresh water supplies. Increasing lifespans mean healthcare and pension costs will be impacted. An expanding proportion of a growing world population demands improved living standards as less-developed countries modernise. Arguably, behaving unsustainably will cease to be an option.

Corporations are ubiquitous and powerful, spanning the globe. Regrettably, part of industry's dynamism can entail externalising costs to the environment, communities, employees or future generations.[2] Financial markets help support and control corporate behaviour; markets reward ingenuity, efficiency, talent and productivity through the ability to raise funds. Far-sighted companies tackling these problems will benefit, making them valuable investments.

Since corporate activity is an essential part of human activity and development, businesses must also generate economically sustainable long- and short-term returns. Immediate profits should not be made at the expense of future profitability.

In today's business environment, there is an appreciation that:

- Companies taking environmental risks have caused disasters (e.g. oil spills, deforestation, mining and pollution).
- The social costs of business practices cannot be ignored. Public tolerance of unacceptable worker conditions has diminished (e.g. labour conditions and child labour).
- Companies require effective governance to confidently develop and meet legal and ethical requirements, and be accountable to stakeholders, including owners and shareholders. Corruption facilitates losses and sub-optimal decision-making. Poor oversight encourages risk-taking and scandals, potentially undermining reputations of entire industry sectors.

In the modern, technologically enabled world, environmental, social and governance failures are readily exposed by the media, rapidly achieving wide coverage. Failures can easily result in losses, adverse litigation, reputational damage and clients taking business elsewhere, with the potential to damage a company's value, share price and even its long-term survival.

Ethically and sustainably oriented companies can target higher long-term profits by addressing necessary challenges while avoiding failures. At the same time,

KEY POINTS

WHAT IS THE ISSUE?
Ethical investing is becoming increasingly important, with sustainable investing providing a useful framework. Sustainable investing includes several approaches that can be tailored to individual trust or client objectives.

WHAT DOES IT MEAN FOR ME?
Understanding different ethical investing approaches helps you guide clients towards solutions fitting their requirements. Charities, in particular, are likely to appreciate guidance on different areas and investment approaches.

WHAT CAN I TAKE AWAY?
Better appreciation of ethical investment approaches will help you support your clients and, in the process, you will have made an active contribution to fulfilling your fiduciary duties.

they should accumulate marketing advantages and loyal customers.

SUSTAINABLE INVESTING

Here, little distinction is made between ethical, socially responsible and sustainable investing.[3] Companies are encouraged to promote environmental stewardship, consumer protection and human rights, and support the social good.[4,5] One focus is on environmental, social justice and corporate governance (ESG) issues. In sustainable investing, funds are directed into businesses with practices capable of being continued indefinitely without causing harm to current or future generations, or exhausting natural resources. Sustainability is often defined as: ensuring development meets the needs of the present without compromising future generations' ability to do so.[6]

ESG identifies the following sustainable investing dimensions:

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

Companies may outsource production to countries or other companies lacking meaningful sustainability practices. They might claim ethical operations, while not looking too deeply into their suppliers' practices. Best practice requires companies to scrutinise their resource chains and monitor the entire production process, from origin to ultimate disposal of products after use.

Companies may externalise production costs.[2] As companies consume resources and create waste products, ideally all costs associated with resources consumed and waste disposal during manufacture would be included in the price of goods created, including disposal after use.

Similar arguments relate to labour and saving money with health-damaging practices or inadequate wages. Failure to invest in governance and management structures can result in company staff undertaking activities that boost 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.

INVESTMENT APPROACHES

Broadly, investors want to see capital put to good use: not merely maximising investment gains, but also causing benefit (or at least doing no harm), while generating decent returns.

Ethical investors wish to allocate resources to areas deserving investment and avoid businesses that, directly or indirectly, do not. They typically avoid the so-called 'sextet of sin': alcohol, tobacco, gambling, pornography, armaments and nuclear power.[5] Different investors may wish to avoid other or more sectors than these.

Exclusions, or 'screening', is only one strategy of several. Consider investment through the following:

- avoiding unethical companies, but accepting ethically neutral companies doing neither good nor harm (negative screening);
- investing in ethical companies only, avoiding both unethical and ethically neutral companies (positive screening); and
- actively seeking to influence corporate behaviours for the better (engagement, or shareholder activism).

Other approaches include 'best in class', in which the 'least bad' companies in a sector are selected to encourage companies in challenging sectors to improve, and engaging to influence their behaviours.

A weaker, or diluted, approach is portfolio tilting. The majority of this type of portfolio is invested conventionally, allaying underperformance fears, while the remainder is invested ethically.

IMPLEMENTATION

Ethical strategies can be accessed through funds, although this can be a complex area. In addition to usual processes, due diligence and analysis of ethical aspects is required to confirm they meet client needs. In this respect, trustees may benefit from support from wealth managers with specific skills, qualifications and expertise in this area.

Trustees can help ensure that the funds selected meet specific social- or ethical-portfolio objectives, particularly for clients such as charities or religious organisations. Such matters can be extremely sensitive, particularly if inappropriate selections mean funds are found to have investments in companies with unacceptable activities. Trustees, with advice, can play a valuable role in guiding their clients to help avoid such outcomes.

In this way, it will be clear that trustees are actively working to protect their clients from making inappropriate investments, thereby demonstrating that they are seriously considering their fiduciary responsibilities.

1 For further discussion, see Q G Rayer, 'Exploring Ethical and Sustainable Investing', *Review of Financial Markets*, Chartered Institute for Securities and Investment (12, 2017), pp4–10
2 Jonathon Porritt, *The World in Context: Beyond the Business Case for Sustainable Development*, Cambridge: University of Cambridge Programme for Industry (2001)
3 For brevity, the term 'ethical investing' is used, except where a useful distinction can be drawn
4 Cary Krosinsky and Nick Robins (eds), *Sustainable Investing: The Art of Long-term Performance*, London: Routledge (2008)
5 Cary Krosinsky, Nick Robins and Stephen Viederman (eds), *Evolutions In Sustainable Investing: Strategies, Funds and Thought Leadership*, John Wiley & Sons (2012)
6 Gro Harlem Brundtland, *Our Common Future, From One Earth To One World: An Overview By The World Commission On Environment And Development* (1987)

DR QUINTIN RAYER IS A CHARTERED FELLOW OF THE CHARTERED INSTITUTE FOR SECURITIES AND INVESTMENT, A CHARTERED WEALTH MANAGER AND HEAD OF RESEARCH AT P1 INVESTMENT MANAGEMENT