WHY *clean money* MATTERS

Quintin Rayer explores why ethical and sustainable investing matters, the approaches used and how trustees can include it as part of meeting their fiduciary responsibilities

Although of fundamental importance, both ethical and sustainable investment can be seen as 'nice-to-have' but non-essential. Several approaches can be taken to move beyond common assumptions that it only involves avoiding investment in companies carrying out unacceptable activities (sometimes called 'sin stocks'). Pension trustees and other asset owners can benefit from awareness of different approaches that can be tailored to individual objectives. Charities, in particular, are likely to appreciate guidance on different areas and investment approaches.

Ethical investing matters

Human activities have generated threats, including climate change and its consequences. Lifespan is increasing, so demographics will affect healthcare and pension costs. Meanwhile, an expanding 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. Humanity needs them to end unsustainable behaviours and tackle future challenges, including environmental, climate change and social issues.

Financial markets help support and control corporate behaviour: markets reward ingenuity, efficiency, talent and productivity through the ability to raise funds. Farsighted companies tackling these problems will benefit, making them valuable investments. Businesses should target long-term sustainable returns. Immediate profits should not undermine future earnings.

The modern, technologically enabled world means failures are readily exposed by media, resulting in losses, adverse litigation, reputational damage and clients taking business elsewhere, with the potential to damage company value, share price and even survival.

Ethically orientated companies target long-term profits by addressing challenges and avoiding failures, while accumulating marketing advantages and loyal customers.

Sustainable investing

Companies are encouraged to promote environmental stewardship, consumer protection, human rights and support the social good. One focus is on environmental, social justice and corporate governance issues (ESG). In sustainable investing, funds are directed to 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 generation without compromising the ability of future generations to meet their own needs.

Investment approaches

Certain investors want their capital put to an ethically good use – not merely maximising gains but also causing benefit (or at least doing no harm) while generating decent returns. The commonest approach for those investors is to exclude sectors involved in unacceptable activities.

Exclusion is only one strategy. Some may avoid unethical companies but accept ethically neutral companies doing neither good nor harm (negative screening). Others target only ethical organisations (positive screening or impact investment), or actively seek to influence corporate behaviours for the better (engagement, or shareholder activism), leading to a range of approaches.

In impact investing, only ethical organisations are selected and less emphasis is placed on the need to generate competitive returns. The utility of the investment is assessed not just in terms of return but also its beneficial environmental or social impact.

Other approaches include 'best-in-class', in which the least-bad companies in a sector are selected, to encourage companies in challenging industries to improve. Consider a fictitious mining company against different ethical investment strategies. Suppose it has a weak record in environmental damage and treatment of labour. Both negative and positive screening would probably exclude the company, giving management no motivation to improve activities. However, under a 'best-in-class' approach, management can hope to attract investment by being better than their peers. In a competitive market environment, this can result in a 'race to the top', leading to genuine improvements.

> "Arguably, behaving unsustainably will cease to be an option"

A diluted approach is portfolio tilting, where the majority of a portfolio is invested conventionally (allaying underperformance concerns), with the remainder invested ethically. For those new to the area, they could consider having, say, 20% of their portfolio managed ethically and the remainder conventionally. As trustees and beneficiaries become more comfortable with the approach, the proportion invested ethically can easily be increased.

The price of conscience

Some investors fear that ethical portfolios are likely to underperform. Their argument is usually that ethical investment requires screening, reducing investment choices and diversification, resulting in worse returns, higher risk or both.

A counter-argument is that harmful corporate behaviours eventually lead to negative consequences, harming growth and share price, and that ethical companies enjoy a competitive advantage.

Research suggests that ethical approaches can outperform.

Figure 1 presents the results of studies of equity returns covering a range of ethical criteria over periods of up to 27 years, with statistically significant outperformance observed. The studies use long-short strategies (long 'ethical', short 'unethical'), extending to allowance for exposure to market risk and portfolio style tilts (size, value versus growth and momentum effects) by using the Carhart four-factor model.

Since investors will not generally be able to access a 'short' ethical strategy (and may not regard shorting stocks as ethical), only the performance of the long part of the strategy has been presented in *Figure 1*.

Of course, historical analyses can be challenged as offering no guarantee of future performance. Equally, future market conditions may change, and perhaps environmental, social and governance factors will become better addressed.

However, the results should give cause for thought to those who are tempted to assume that it is 'obvious' that ethical portfolios 'must' underperform the wider market.

FIGURE 1: Studies showing outperformance by ethical strategies

OUTPERFORMANCE PER YEAR	PERIOD ANALYSED	ETHICAL CRITERIA
1.3% to 4.0%	1995-2003	Environmental
2.3% to 3.6%	1992-2004	Environmental, Social
2.3% to 3.8%	1984-2011	Employment quality
3.5%	1990-1999	Governance
3.7% to 5.2% (estimated)	1990-2003	Governance

Sources: 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.

Implementation

Ethical strategies can be accessed through mutual funds. However, this is a complex area, because analysis beyond the usual investment due diligence is needed to confirm that the ethical strategies used meet the investor's needs. In this respect, trustees may benefit from support from asset managers with specific skills, qualifications and expertise in this area.

Trustees can help ensure that funds selected meet specific ethical portfolio objectives, particularly for investors such as charities or religious organisations that have specific requirements. Such matters can be extremely sensitive, particularly if inappropriate selections mean funds are found to have investments in companies with unacceptable activities. In this way, it will be clear that trustees are actively working to ensure they are making appropriate investment decisions on behalf of their ultimate beneficiaries, thereby demonstrating that they are seriously considering their fiduciary responsibilities.

DR QUINTIN RAYER is head of research and ethical investing at P1 Investment Management

ISTOCK