The price of conscience: arguments for ethical out-performance

By Quintin Rayer | Feb 22, 2018

Previously, Quintin Rayer introduced sustainable (environmental, social and governance, or ESG) investing, looking at different approaches [1], [2] including fund selection [3]. This article is the first of two considering the 'price of conscience', challenging the view that ethical investments may underperform. Here, logical arguments to expect ethical out-performance are explored, a future article will review studies of actual performance.

Introduction

One may question how ethical investments compare with conventional counterparts, with concerns about underperformance, often clouded by worries that 'ethical' or 'green' labels have been applied for marketing advantage.

Investors often perceive that ethical investing reduces the number of companies available for portfolios, with the smaller 'opportunity set' reducing diversification possibilities, resulting in worse returns, higher risk, or both. This article proposes counter-arguments challenging this perception by exploring risks, and whether sustainable investing can give competitive advantage [4], [5].

Sustainable investing and risk

Proponents of sustainable investing argue that unethical corporate behaviours increase risk [6], [5]. Companies' harmful actions eventually lead to negative consequences for them, with a detrimental effect on growth and profits, leading to underperformance. Essentially running risks that are not 'priced in' by markets. By excluding these companies, an investor removes unrewarded risk from their portfolio.

Such practices can increase the likelihood of litigation against the company, cause reputational damage, or make customers take business elsewhere. Other risks may include:

- Poor industry standards stimulating government regulation, increasing business costs to all companies in that sector[7]. Firms with least invested in meeting standards will be harder hit, as they are forced to improve.
- Environmental issues, such CO2 emissions restraints or carbon permit trading. Companies investing in appropriate technologies are better placed to avoid redesign costs, while those continuing harmful practices may require investment or higher ongoing business costs.
- Ethical behaviour gives a company a 'licence to operate', as a valued community asset, avoiding resentment about activities[5]. Community opposition can upset projects and damage brands. Oil-spills can cause reputational damage lasting decades.
- Poor sustainability records can increase insurance premiums, or increase the cost of capital. Investor concerns can increase the cost of debt and lower share prices.
- Unethical supply-chain partners can tarnish brand reputation.
- Energy usage reduction and waste minimisation increases efficiency and reduces costs.

Other business risks relate to emissions and waste discharges (especially affecting companies in mining, oil, gas and forestry sectors); balance sheet risks from historical liabilities; and business sustainability risk. Companies may face the intrinsic lack of sustainability of their activities. Examples include coal mining, especially high-sulphur coal producers.

Competitive advantage

Ethical companies can build a good reputation, bringing financial rewards. Businesses can earn legitimate profits, contributing to society, avoiding coercive, exploitative or illegal practices. Internationally, some countries have lesser standards of human rights, labour, bribery and the environment [8].

A trustworthy reputation attracts customers and business partners, creating economic opportunities [9]. Staying within the letter of the law is insufficient to protect reputation: not everything immoral is illegal. An organisation's ethical climate helps protect it from illegal staff conduct since strong moral principles help limit abuses by staff tempted to circumvent regulation. Additionally, companies with stronger ethical reputations should command higher PE ratios for their stock and be able to borrow at lower rates in bond markets.

A 2010 study [10] concluded that positive CSR strategies, although initially perceived by analysts as being value-destroying, are now seen as value-creating. Analysts are now more likely to recommend a stock 'buy' for strong CSR firms.

Other sources of competitive advantage include [5]:

- Attracting, retaining and motivating top talent.
- Anticipating changes in regulatory and business environments ahead of competitors.
- Generating revenue growth through new products, services and technologies.
- Increasing customer and investor loyalty.
- Improving relations with regulators, local suppliers, communities and key stakeholders.
- Strengthening innovation and adaption within the corporate culture.

How this helps Advisers

Clients increasingly wish to invest ethically and often have specific concerns in mind. Younger people may give this a higher priority than older generations with twice as many 18 to 34-year-olds feeling their pensions should be invested ethically, compared with those above 45 [11]. The Investment Association reports £15.0 billion assets in the UK ethical funds sector in November 2017, a yearly increase of £3.0 billion [12].

Advisers will wish to be confident that selecting ethical funds to meet clients' needs is unlikely to be detrimental to portfolio performance. Of course, selection of the most suitable ethical funds is a complex area, and advisers are likely to wish to access the skills of wealth managers who can support them in this important and growing field.

Advisers must be confident that the wealth managers they choose to support the ethical and sustainable investing requirements of their clients have the necessary skills and commitment. By using the services of firms like P1, that have met certified environmental

management standards such as ISO 14001 and who are signatories of CDP, advisers can demonstrate to their clients, and thus reassure them, that they are providing them with a service that best meets their ethical requirements.

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