Why ethical investment is crucial and not just 'nice to have'

By Quintin Rayer | July 27, 2017

In this article Dr Quintin Rayer of P1 Investment Management raises the question: “Why does ethical investing matter?”. This is the first in a series of posts that will explore different aspects of ethical investment approaches and issues such as performance.

Introduction

Although ethical investment can be seen as falling into the ‘nice-to-have’ but not essential category, it is actually of crucial importance. This can be seen by exploring the relationship between sustainability and finance, which, in turn, sets the background for ethical investing.

Unsustainable human activities have generated threats including climate change (associated with rising sea levels, extreme weather and flooding, for example) resulting in damage, loss of life, and disruption to food and fresh water supplies. As human life-span lengthens, so demographics will have an impact on healthcare and pension costs. An expanding proportion of a growing world population will demand improved living standards as less developed countries modernise. Proponents of responsible investment argue that behaving in an unsustainable manner will cease to be an option.

The role of companies

Corporations are ubiquitous and powerful, with a truly international presence. Humanity needs them to end unsustainable behaviours and tackle future challenges. These may include environmental challenges, climate change and social issues. Regrettably, part of industry's dynamism has been (and still can be) the externalisation of costs on to the environment, communities, employees or future generations [1]. Financial markets can help support and control corporate behaviour. Markets reward ingenuity, efficiency, talent and productivity through the ability to raise funds and by share pricing (which values companies). Companies making far-sighted investments tackling these problems will benefit in either the short or longer-term, making them valuable investments.

Since corporate activity is an essential part of human activity and development, sustainable investment also requires that companies generate economically sustainable long and short-term returns. This counters short-termism, in which immediate profits are made at the expense of damaging profitability at a later date.

The modern business environment

In today's environmentally and socially aware business environment, there is appreciation that:

» Companies taking environmental risks have historically caused disasters (e.g. oil spills, deforestation, mining pollution).

» The social costs of business practices can no longer be ignored, as in previous eras (for example, the slave trade). Public tolerance of unacceptable worker conditions has diminished (e.g., labour conditions in mines and child labour).

» Companies require effective governance to confidently develop, 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 high-risk behaviours and damaging scandals, potentially undermining reputations of entire industry sectors. For example, the LIBOR scandal undermining the reputation of banking and finance [2].

In the modern technologically-enabled world, environmental, social and governance failures are readily exposed by media and can rapidly achieve global coverage. Such failures can easily result in financial losses, adverse litigation, reputational damage and clients taking business elsewhere. This has the potential to cause enormous damage to a company's value, share price and ultimately even its long-term survival.

Thus ethically and sustainably orientated companies have the opportunity to target higher long-term profits by addressing necessary challenges while avoiding failures. At the same time they should accumulate marketing advantages and loyal customers as a result of their ethical behaviour.

Why this matters to advisers

Clients and advisers may be motivated by an increasing awareness of the challenges facing humanity (and other species) as a result of threats such as climate change, as well as many social issues. Global awareness of corruption also raises recognition of the importance of good governance.

Clients increasingly understand the importance of environmental, social and other ethical issues in society, and are willing to extend these considerations into ever-increasing aspects of their lives. Beyond the now-familiar 'fair trade' and ethical consumer decisions, a growing number of clients are using ethical considerations to guide their investments as well. In May 2017, according to the IMA (Investment Management Association), there were £13.8 billion of assets under management in the UK ethical funds sector, an increase of £3.0 billion since May 2016 [3].

Clearly, advisers will want to be able to better serve their clients by supporting them in this important and growing area.

References

[1] 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.

[2] BBC News, Libor scandal timeline, 2013. Accessed 19 July 2017.

[3] The Investment Management Association, Fund Statistics, May 2017. Accessed 20 July 2017.

This article was written by Dr Quintin Rayer, Head of Investment research at P1 Investment Management and also published on the DISCUS website.