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Sustainable Investing

There have always been investors keen to match their money with their morals, with sustainable (or responsible) investing being around since the 1980s. Although sustainable investment has remained a somewhat niche area for many years, this is now no longer the case.

As society becomes more conscious of environmental and social issues, such as climate change, human rights and diversity, we are now taking much more interest in how our money is invested. While generating good investment returns is still very important, today we are also increasingly focusing on how companies are generating those profits.

There is increasing evidence that companies who take environmental and social factors seriously may actually be better investment prospects compared to those that ignore these issues. Indeed, we have seen over the course of the COVID-19 pandemic that companies who boast strong sustainable investing credentials have tended to perform better those that do not.

More choice, less clarity

With a growing emphasis on sustainable returns, there has been a wave of interest in funds focused on sustainable investment. But wider choice potentially brings greater confusion, especially given there are different definitions of what sustainable investment means – not just by investors but by fund managers as well. Should a stock involved in the oil industry, for example, be excluded from a fund even if it is making big strides to clean up its act and investing in new technologies?

In this newsletter, we aim to decode the concept of sustainable investment and answer why some investors regard certain companies as sustainable while others do not. We will also highlight the different approaches taken by sustainably-managed funds.

What does sustainable investment mean?

There are many terms used to describe sustainable investment, such as green, responsible, socially-responsible and impact investing. These are often used interchangeably even though they can signify differences in the way an investment is managed.

Traditional ethical investing, for example, typically involves excluding companies from specific ‘sin’ sectors, such as those involved in the production and distribution of alcohol or tobacco. Impact investing, on the other hand, goes further and actively involves investing to make a positive social and environmental impact.

The E, S and G

Today, the common theme amongst responsible and sustainable investments is that they tend to focus to some degree on environmental and social standards as well as on how individual companies are managed (corporate governance).

These areas are generally regarded as the three pillars of responsible investing. This has led to another term to describe this topic – ESG investing. The range of factors that fall under these three pillars are highlighted below.

Environmental factors - How a company is addressing issues such as climate change, resource depletion, waste, pollution and deforestation.

Social factors - A company’s policies and record in relation to human rights, modern slavery, child labour, working conditions and employee relations.

Governance factors - A company’s record in relation to bribery and corruption, executive pay, board diversity and structure, political lobbying/ donations and tax strategy.

When a fund manager meets with a company’s board prior to making any investment, they may well quiz them on their ESG credentials. They will be looking for signs that the firm is doing the right thing by their employees, the industry regulator, the environment and their surrounding communities. For instance, this could mean making sure staff are paid a good wage, there is a sensible approach to corporate risk management so any fines for bad practice are unlikely, and asking what the firm is doing to reduce pollution and support local initiatives.

Once a fund manager takes a stake in a business, they can drive positive change within that company. As a major shareholder, for example, they can encourage the company’s management to become more sustainable or socially responsible. They can also use their considerable voting rights at shareholder meetings to either support or oppose plans put forward by the board. In this way, sustainably-managed funds can be a great option for today’s conscious investor.

The different approaches to investing more sustainably

Sustainably-managed funds are not all managed in the same way. Some may specifically exclude stocks from certain industries, such as those involved in arms manufacturing or the extraction of fossil fuels. Conversely, another fund manager may invest in companies from these 'sin' sectors on the basis that their ESG credentials are moving in the right direction. In other words, the fund manager will support firms who are making a conscious effort to improve how they operate from a sustainable or responsible perspective.

It is therefore important to know how a sustainably-managed fund is run, particularly if you wish to avoid certain stocks or industry sectors due to ethical, moral or religious considerations.

The four broad types of sustainably-managed funds

1. **Exclusionary** - As the term suggests, certain companies or even whole industries are excluded from the fund or portfolio. These may be based on ethical, values-based or religious concerns. Companies commonly excluded from these types of funds are those involved with tobacco, armaments or fossil fuels.

2. **Impact investments -** Impact funds make investments that aim to have a positive effect on the world in which we live. They target companies, for instance, that generate a positive and measurable social/environmental impact alongside a financial return.

   Impact investments intentionally contribute to social and environmental solutions, which differentiates them from other responsibly-managed funds.

3. **Sustainability-focused funds** - These funds invest according to certain sustainability criteria. The manager may consider companies based on their economic activities (what they produce/ what services they deliver) and their business conduct (how they deliver their products and services). It may be that the fund focuses on an explicit theme, such as climate change mitigation or pollution prevention.

4. **ESG Integration** - The managers of these types of funds systematically consider all material ESG factors when making investment decisions. As such, it is important to note this approach does not specifically prohibit any investments. They can invest in any business, sector or geography if the fund manager considers all the relevant environmental, social and governance issues. However, most asset managers have firm wide exclusions therefore certain sectors may be excluded even if they take the ESG integration approach. The precise ways in which these considerations are factored into the decision-making process may differ from fund to fund.

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Five points to remember when investing sustainably

1. Very few sustainable investing issues are straightforward. There are almost always ambiguous areas to explore and decipher.

2. There is no ideal size of company. Smaller businesses often lead change but, for our lifestyles to become more sustainable, bigger companies need to be encouraged to change too (and many of them are already doing so).

3. Larger companies tend to be more diverse than smaller companies and are more likely to do things that you may not necessarily agree with. Try to bear this in mind.

4. No one is perfect. Most companies have positive and negative attributes – no business is entirely ethical or unethical.

5. Sustainable funds are not all the same. Different fund managers have different policies and may – or may not – exclude companies involved in specific activities.

Sustainable investing is one of the key factors we, at Breed Elliott, consider when constructing the portfolio of funds we recommend that you hold in your investment account. If you would like to understand more, please speak to your financial planner at your next review meeting.

Market data

Market	Value at start of 2020	Current situation	Comments
Interest Rates (BOE base rate)	0.75%	0.25% at 31/12/21	The official bank rate is 0.25%.
House Prices (Nationwide)	House prices increased by 7.3% in 2020	House prices up 1.0% at 31/12/21	Annual house price growth up 10.4%.
UK Share Prices (FTSE 100)	7542.40	7364.84 at the close on 31/12/21	The FTSE 100 rose by 305.34 points in December.