

GUIDE TO ESG & RESPONSIBLE INVESTING

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A growing number of investors are embracing ESG (environmental, social and governance) factors, which have become an integral part of the investment process for many. So what are ESG factors and why are they important?

ESG STANDS FOR ENVIRONMENTAL, SOCIAL & GOVERNANCE

These are factors that help investors to assess whether a business is sustainable.

Environmental relates to the company's impact on the planet and its approach to climate change mitigation.

Social addresses the company's policies and their impact on their employees, customers, suppliers, and the community.

Governance focuses on business practices, board structure and independence.

Together, ESG factors are inputs to "responsible" investing, which is based on generating sustainable long-term returns by investing in financially stable, well-run businesses with strong ESG credentials.

● THE EVOLUTION OF ESG AND RESPONSIBLE INVESTMENT

Responsible investment might seem to be a concept that has entered our consciousness relatively recently. In fact, it goes back much further¹ in the early nineteenth century, the Methodist Church decided to prohibit investments in undesirable industries such as arms. Over time, a growing number of charities and churches pursued similar strategies, until eventually the first sustainable mutual fund – the US-based Pax Fund – was launched in 1971.

Over five decades later, investors have become increasingly mindful of environmental and human rights issues, and aware of their impact on investment returns. By the end of 2021, UK investors had a total of £89 billion in responsible investment funds, according to the Investment Association.

“BY THE END OF 2021, UK INVESTORS HAD A TOTAL OF £89 BILLION IN RESPONSIBLE INVESTMENT FUNDS, ACCORDING TO THE INVESTMENT ASSOCIATION”

● ADDING VALUE AND MAKING A DIFFERENCE

Responsible investment used to be widely regarded as a “fringe” issue that focused primarily on a negative screening process: “bad” companies were cut from the investment universe using non-financial, ethical criteria. It was understood that, by reducing the number of potential investment opportunities, the investor was likely to sacrifice performance in order to maintain their principles.

More recently, however, attitudes to ESG investment have evolved. ESG considerations have moved into the mainstream to become a fundamental part of the research process that can add significant value by identifying well-run businesses that are positioned to deliver sustainable returns over the long term and avoiding businesses whose processes pose a risk to society, the environment, and share price performance.

According to the Investment Association², 47% of total assets integrated ESG factors to their investment processes during 2021.

Corporate scandals are not only disruptive but can also cause lasting harm to a company's reputation – and its share price. In comparison, companies with positive business practices are well positioned to deliver sustainable profits over the long term, which is likely to prove beneficial for shareholders.

“COMPANIES WITH POSITIVE BUSINESS PRACTICES ARE WELL POSITIONED TO DELIVER SUSTAINABLE PROFITS OVER THE LONG TERM”

Instead of denoting “good” or “bad” companies, ESG factors are used to identify quality and sustainability. They focus on tangible factors, examining not only whether a company pursues sustainable business practices, but also whether it has sustainable finances. They help not only to uncover possible risks, but also long-term investment opportunities. They build conviction and reduce portfolio risk by assessing possible vulnerabilities to the company's business and financial stability.

● LOOKING FURTHER,

DIGGING DEEPER

These days, companies are expected to be transparent and accountable. They are expected to demonstrate good corporate governance and to deliver sustainable long-term value for shareholders. ESG analysis helps by digging deeper into the company and the sector in which it operates. If a company has sustainable business practices, it is well positioned to generate sustainable profits in the long term.

● INTEGRATING ESG IN THE INVESTMENT PROCESS

An “ESG” fund is an investment portfolio in which ESG factors are embedded into the process of research and stock selection. An increasing number of investment funds have a “sustainable” remit – this might involve a focused mandate concentrating on the environment, water, or renewable energy, or a

more generalised approach.

However, more and more fund managers are embedding sustainability into their investment process, regardless of their investment objective, as they recognise the benefits of an integrated ESG approach. Many investment managers have embraced the opportunity to engage with companies by questioning management, encouraging them to improve their ESG practices, and focusing on businesses that apply sustainable processes.

“The green agenda has risen in prominence ... investment managers have committed to support the transition to net zero emissions”
- The Investment Association Annual Survey, 2020-21



● NOT ALL ESG APPROACHES ARE EQUAL

ESG investing has come a long way, but there is still more to be done, particularly with regard to consistency of standards. Different investment managers will follow different processes – as yet there are no established standards for evaluating potential ESG investments or for measuring ESG performance, although regulatory authorities are working towards these goals. For now, therefore, two ESG funds from different providers are likely to have very different approaches to ESG, even if they invest in the same market with the same objective.

● PROFIT AND PRINCIPLE

An ESG investment approach provides investors with the opportunity for their investments to reflect their personal

principles and priorities, without having to compromise on long-term returns.

A successful sustainable or ESG investment approach does not focus on sustainable behaviour at the expense of strong investment returns – it ranks these considerations alongside them.

● HOW TO INVEST

As interest in ESG and responsible investment has grown, so has the number and variety of available investment products for investors seeking capital growth, income, or a balance between the two. From equity funds to fixed income or multi asset products, whether you are focusing on the domestic UK market or taking a more global perspective, there is more choice than ever before in ESG and responsible investment.

79% of financial advisers report growing interest in ESG from their clients.- FE fundinfo 2022 Financial Adviser Survey⁴

¹Morningstar [The history of sustainable investing \(morningstar.in\)](https://www.morningstar.in)

²ISA [Investment Management Survey 2021-22 full report.pdf \(theia.org\)](https://www.theia.org)

⁴FE fundinfo, [Building better advice - 2022 FE fundinfo Financial Adviser annual survey](https://www.fe-fundinfo.com)

contact

We hope you found the information in this guide useful and informative. If any of the points are of interest, or you would like to discuss your own situation in more detail, please do get in touch.

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