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GIBBS DENLEY

FINANCIAL PLANNING

Guide to **ESG** investing

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Investing that considers more than the bottom line goes back centuries. But the movement has evolved and it's gradually becoming more popular among investors.

ESG investing means that when making investment decisions, environmental, social and governance (ESG) factors are taken into consideration. The decision to consider ESG can be for ethical or financial reasons, or both.

According to the Investment Association, 26% of all UK assets are invested using a responsible or sustainable strategy, though the depth of these strategies will vary significantly. The UK Sustainable Investment and Finance Association (UKSIF) explains ESG can be attractive to investors that want:

1. To profit from companies and activities that avoid causing harm
2. Investments that are more likely to perform well over the long term
3. To reduce the financial risk of poor environmental, social or corporate governance behaviours
4. To speed up solutions to global crises such as inequality or climate change

What is ESG investing?

ESG investing can track its routes back to the 18th century when the Quakers effectively banned members from investing in the slave trade as it was incompatible with their ethics.

Values and ethics do still play a role in ESG investing for some investors but the movement has come a long way since the 18th century. Today, ESG investing looks at applying non-financial factors as part of the process to identify risk and growth opportunities broken down into three broad categories:

1. **Environmental:** This category deals with the conservation of the natural world and may look at issues such as carbon emissions, deforestation, energy efficiency and use of raw materials.
2. **Social:** This factor considers people and relationships, areas that are focused on may include human rights, labour standards, customer satisfaction and data protection.
3. **Governance:** Finally, governance assesses the standards for running a company, such as executive remuneration, lobbying, audit committee structure and political contributions.

As you can see, ESG investing can cover a huge range of areas and issues. An ESG investment wouldn't consider every factor but focus on particular areas.

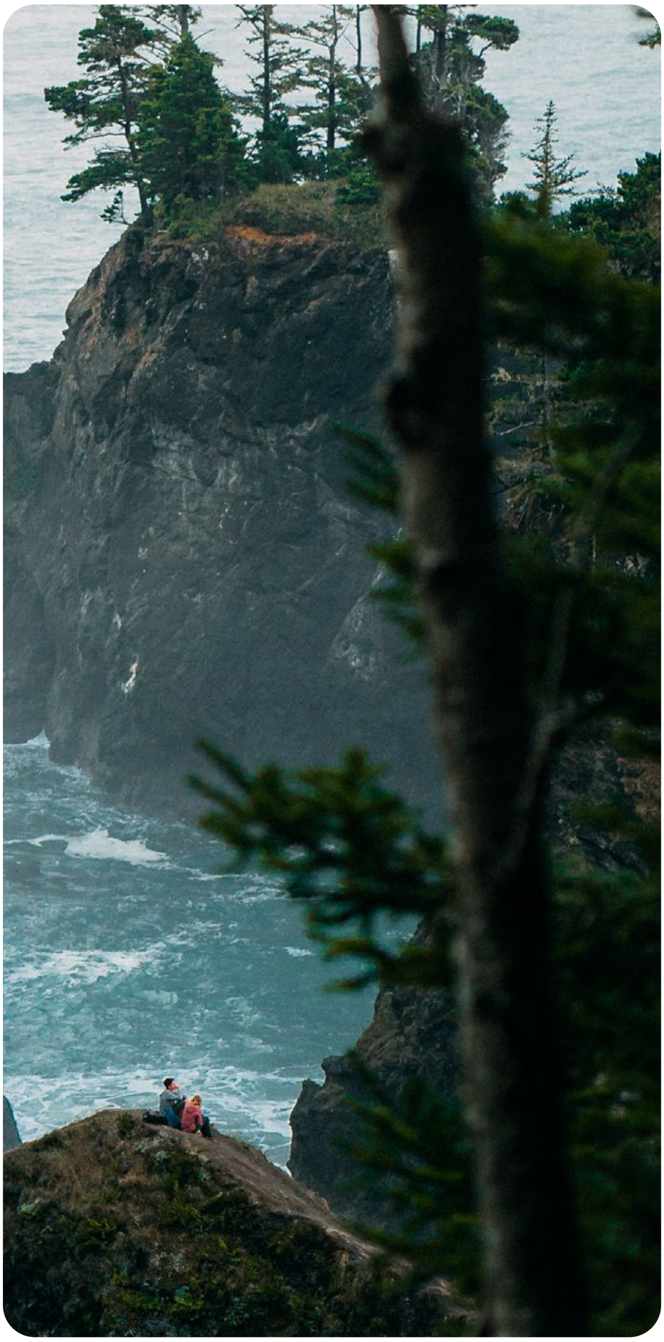
Measuring the size of the ESG market can be difficult as different terms and criteria can be applied. What someone may consider to be a sustainable investment, may not meet the criteria of another investor. However, research indicates that it's a market that's growing fast. Figures suggest the use of ESG data to drive investment decisions has doubled in the last four years to $40.5 trillion globally in 2020.

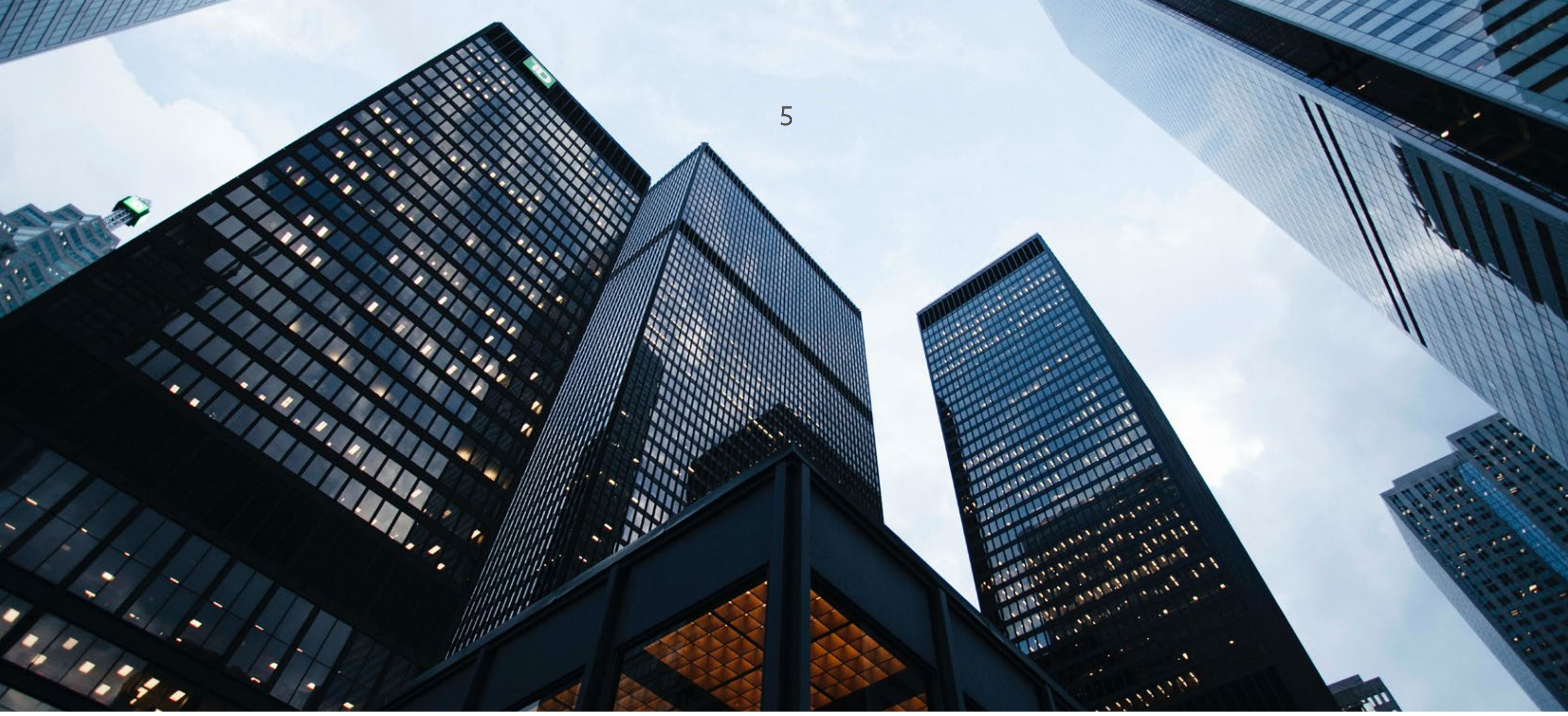
So, how are these ESG factors reflected in investment strategies? There are three main ways:

1. **Negative screening:** This strategy goes back to the origins of ESG investing. You actively avoid investing in companies that don't align with your values or whose operations you believe will harm performance over the long term. For instance, you may choose to avoid investing in companies that are involved in industries with high carbon emissions or have a poor track record of data protection and privacy.

2. **Positive screening:** Rather than avoiding investment opportunities, you'd actively look to invest in firms that meet ESG criteria. You may do this by diverting a portion of your investment portfolio to investment opportunities that meet certain standards or operate in specific industries, for instance, renewables.

3. **Engagement:** Finally, engagement seeks to change the behaviour of businesses by using shareholder power to encourage firms to improve their ESG credentials. This is a strategy that is more often used by institutional investors rather than individuals.





Why would you make ESG part of your investment process?

Now you know what ESG investing involves, why make it part of the investment process? There are two key reasons, to make your investments reflect ethical values and to support long-term financial performance.

Reflecting ethical values

Reflecting personal values in the investment decisions we make is part of a wider trend. When you're shopping, you may choose to purchase Fairtrade items or consciously shop with a local business to support the community. For some investors, ESG investing is an extension of this kind of thought process.

Investors that want to consider ethics will consider more than the returns they receive but want to know that their money is also having a positive impact on the world. That's not to say the financial returns aren't important, you'd still invest to achieve returns. Think of it as having a double bottom line, one that looks at the financial return and the other focusing on the positive impact.

2019 research from Triodos Bank found 66% of investors would like to support companies that contribute positively to society and the environment. A rise of 11% compared to a year earlier.

It's a trend financial advisers are seeing too, some 88% of UK advisers predict sustainable investing will increase dramatically over the next year, according to a survey from ESG Clarity. This research also highlighted some of the most common ESG areas investors wanted to focus on:

- The impact of climate change (31%)
- Air and water pollution (17%)
- Waste management (15%)
- Consumer privacy and data security (10%)
- Energy efficiency (6%)

If these areas, or others, are a concern, you may want to reflect this in the way you invest money. One of the important things to remember here is that ESG covers a vast range of different factors and it can be difficult to find investment options that perfectly align with your ethics. As a result, there may be points where you need to compromise, having priorities in mind can help focus your ESG investments to what's really important to you.

Supporting financial performance

A common misconception is that ESG investing means sacrificing financial performance. However, ESG processes can support identifying investment risks and opportunities to create a portfolio that reflects your long-term goals.

ESG investing looks at how companies operate and their place in the wider world which can deliver financial benefits. For instance:

- Consumer privacy and data security are becoming a growing concern among customers. Businesses that breach data security rules can face hefty fines and lose consumer trust. A firm that consistently fails on this ESG criteria could find their short-term profits are harmed as well as long-term prospects, affecting investors.
- Climate change is another key issue that could affect businesses. As governments around the world impose stricter measures to reduce carbon emissions or improve air quality, businesses operating in the fossil fuel industry that aren't adapting to invest in other technologies or change the way they work could face falling behind, again affecting investors.

By looking at a broader range of information when investing, ESG investors can identify potential risks and opportunities that may have been overlooked if ESG criteria weren't considered.

Research does indicate that considering ESG can support investment performance over the long term.

A recent study published in the Financial Times found close to six in ten sustainable funds delivered higher returns than equivalent conventional funds over the past decade. The research suggests that ESG criteria can drive investment performance in some areas. As a result, ESG investing could add value from a purely financial perspective.

However, while ESG can be useful for supporting long-term investment performance, it can't provide guarantees. All investments carry some risk and values can fall. ESG investments are no different, so it's important to understand risk and consider your investment objectives when making decisions.

The challenges of ESG investing

There are benefits to including ESG criteria in your investment, but as with any financial decisions, there are challenges and drawbacks too. For some investors, incorporating ESG makes sense, but it's still important to be aware of how the drawbacks can affect investments.

1. It's subjective

If you want to incorporate ESG so your investments better reflect your values, keep in mind this is a highly subjective area. What you'd consider a crucial part of ESG may not align with what others would consider essential. If you're investing through a fund, you'll likely need to compromise in some areas. Even if you're investing directly in businesses, the complex nature of business today may mean even a 'good' investment doesn't perfectly match your views.

2. It can cost more and be time-consuming

As you delve deeper into how a business operates and their activities, this takes more time. As a result, investing through ESG funds can mean your fees are higher than investing through a traditional fund. Always make sure you understand what fees and charges you'll face before investing.

3. Greenwashing is an issue

Businesses need to demonstrate how they meet ESG criteria but, in some cases, these can be overstated and at times criteria or statements can be ambiguous. With no standardisation across the industry, defining what an ESG investment is can be difficult and links back to the challenge of subjectivity.

4. Missed opportunities

Depending on the ESG investing approach you take, it could mean missing out on opportunities. If you choose to negatively screen out businesses involved in the fossil fuel industry, you may miss an opportunity for growth or exclude certain funds that may suit you.

5. Measuring the impact

Finally, you can keep track of investment returns relatively simply and can compare these to benchmarks. But if you want to measure the non-financial impact of your investments this is far more difficult to quantify.

Understanding your investment position

While you may be considering ESG factors when investing, it's still important to understand your financial position to select investments that are right for you and your goals.

Even when you're looking at the sustainability of your investments, the usual things you should consider when investing still apply. An investment that matches your values or scores well against ESG criteria isn't necessarily right for you even when these are important. You should ensure investments consider your position alongside these, with factors such as those below playing a role too.

- Investment goals
- Investment time frame
- Diversity of other assets
- Risk profile

With so many different pieces of information to pull together, investing can be complex whether you want to make ESG part of the process or not. We're here to help you select a portfolio that considers the above and more to guide you towards your aspirations and goals. Please get in touch to discuss your investments.

Don't forget your pension

If you're considering ESG investing, it's probably your investment portfolio that first comes to mind. However, remember your pension savings are likely to be invested too. Even if you're saving for retirement through a Workplace Pension, you'll still have some control over the investments.

Pension providers will typically offer a range of different funds for you to choose from, with many offering an ESG option, as well as a different risk profile. As with other investments, it's important to consider risk and goals before changing your pension investment to reflect ESG factors.

ESG jargon buster

Investing is filled with jargon and if you're considering incorporating ESG, you'll encounter some more. Getting to grips with some of the terms used can help you when reviewing your own investments.

Engagement

An investment strategy where you invest in companies with the aim of improving their behaviour and policies. This is typically a strategy that's used by institutional investors, such as pension funds, rather than individual investors.

Green funds

These are funds that invest in companies and technologies seen as being positive for the environment.

Impact investing

This focuses on investing in companies that have a positive, tangible social impact through its activities, such as providing solutions for renewable energy.

Negative screening

A responsible investment strategy that excludes investing in certain companies due to their activities, this could include fossil fuels or tobacco, for example.

Positive screening

A responsible investment strategy that specifically invests in companies that meet certain ESG criteria, such as environmental, technology and education.

Responsible investments

A phrase that can be used to refer to an investment strategy the incorporates ESG factors into the decision-making process.

Socially Responsible Investment (SRI)

Another term that is used to describe investments that are chosen to deliver both financial returns and a positive social impact.

If you'd like to discuss your current investment portfolio and ESG factors, please get in touch. We're here to help you understand what your investment options are and how they can help you towards goals.

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Please note: This guide is for information only and does not constitute financial advice.

The value of your investments, and any income from them, can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance.