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Godfrey Pembroke Outlook

Most of us want to do good for the world. Socially responsible investing gives investors the opportunity to actively invest and contribute to a better tomorrow.

Socially Responsible Investing: How to leave a sustainable legacy

COVID-19 has raised the focus on social responsibility for consumers, corporates and governments, with the pandemic lifting interest in and awareness of environmental, social and governance (ESG) investing at every level. Almost 9 in 10 (89%) Australians would prefer to invest in a responsible investment option that considers ethical, social and governance (ESG) issues as well as financial returns.[1]

More investors recognise that leaving a legacy is no longer solely about passing money down to the next generation. Many want to do more with their money and invest in the future. Fortunately, successful and sustainable investing are not mutually exclusive. Investment options where you can put your money to good use both socially and environmentally, without sacrificing returns, have increased exponentially over the past decade. One route to investing sustainably, while simultaneously planning your estate efficiently, is understanding how to invest responsibly through strategies that align with your own values and the kind of legacy you wish to leave.

It's important that you always align your investment options to your financial goals. We recommend you speak to your financial adviser about a strategy that suits your investment style and values.

What is socially responsible investing?

Socially responsible investing (SRI) is an umbrella term that covers all approaches that consider ESG factors in portfolio selection and management. SRI tends to go by many names, including values-based investing, sustainable investing, ethical investing, and more recently, impact investing.

SRI is about considering factors that are important to you when deciding where to invest your money. These might be environmental, social, corporate governance and ethical factors, in addition to financial return.

[1]Responsible Investment Association Australasia, From values to riches 2020: Charting consumer expectations and demand for responsible investing in Australia.

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SRI favours investments in organisations that reduce, or do not contribute to, negative environmental and social impacts, and excludes those not aligned with a sustainable approach. Ethical investment is about knowing what your investments are funding, and choosing where to invest, based on this knowledge and your personal values.

While SRI has gained in popularity over the last decade or so, one of the most articulate early adopters of SRI was believed to be John Wesley (1703 – 1791), one of the founders of Methodism. Wesley's sermon 'The Use of Money' outlined his basic tenets of social investing – i.e. not to harm your neighbour through your business practices and to avoid industries like tanning and chemical production.[2] Some of the best-known applications of early SRI were religiously motivated, where investors would avoid 'sinful' companies, such as those associated with products such as guns, liquor, and tobacco.

The modern era of SRI evolved during the political climate of the 1960s. During this time, socially concerned investors increasingly sought to address equality for women, civil rights, and labour issues. Economic development projects started or managed by Dr Martin Luther King, like the Montgomery bus boycott and the Operation Breadbasket Project in Chicago, established the beginning model for SRI efforts.

Progress continued for SRI during the eighties, most notably through the effort to end the racist system of apartheid in South Africa, when individual and institutional investors pulled their money away from companies with operations in South Africa.

Fast forward to the present day, approaches to sustainability challenges are continually being embraced by socially responsible investors, focusing on a diverse range of issues, including tobacco stocks, mutual fund proxy disclosure, and other diverse focuses.

Current strategies for responsible investing

In the past, many SRI methodologies focused on exclusion based investing, with the purpose of avoiding companies that were considered to be in 'sin' industries like tobacco, gambling, or alcohol. While this method still exists, as SRI has grown in popularity there has been a distinct move towards screening investments using inclusionary factors, such as focusing on those companies who are better at managing sustainability-related issues.

There are several ways to evaluate if a company fits the criteria for responsible investing, with much of it being up to the individual investor's set of core values. There are a few general factors however that can be used to evaluate a company, with SRI today mainly encompassing the following seven strategies:

1. **Negative/exclusionary screening:** the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria,

2. **Positive/best-in-class screening:** investment in sectors, companies or projects selected for positive ESG performance relative to industry peers,

3. **Norms-based screening:** screening of investments against minimum standards of business practice based on international norms, such as those issued by the OECD, ILO, UN and UNICEF,

4. **ESG integration:** the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis,

5. **Sustainability themed investing:** investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture),

6. **Impact/community investing:** targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose, and

7. **Corporate engagement and shareholder action:** the use of shareholder power to influence corporate behaviour, including through direct corporate engagement (i.e. communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

What ties together these investing models and strategies is quite simple: while generally generating competitive returns, it so happens that they also positively benefit society as well in some way. And while taking these approaches was once an exception, it's now becoming the norm.

Responsible investment – large and growing quickly

SRI is already big, and it's only growing. According to the Global Sustainable Investment Alliance (GSIA), at the start of 2018, global sustainable investment reached US $30.7 trillion in the five major markets of Europe, the United States, Canada, Japan, and Australia and New Zealand - a 34% increase in two years from GSIA's last survey in 2016.[3]

In Australia, the size of the professionally managed investment market (TAUM) as at 31 December 2018 was AUS $2.24 trillion, according to the Australian Bureau of Statistics (ABS). Responsible investment strategies were applied across $980 billion of the TAUM, representing 44% of TAUM. Among this, the dominant responsible investment strategy was ESG integration, which represented 45% of AUM when taking both primary and secondary strategies into account.[4]

[2] John Wesley, The Use of Money (Sermon 50).
[3] Global Sustainable Investment Alliance, Global Sustainable Investment Review 2018.
[4] Responsible Investment Association Australasia, Responsible Investment Benchmark Report 2019.

Globally, momentum is building to better align finance with the world's sustainable development needs. Countries and regions around the world are setting out sustainable finance strategies that provide pathways and set frameworks to enable the finance sector to contribute more systematically to the transition to a more resilient and sustainable economy.

In March 2018, the European Commission presented its ten-point action plan to enable sustainable growth. And in March 2019, a ground-breaking initiative launched in Australia: the Australian Sustainable Finance Initiative (ASFI). Its goal is to redefine the financial system to better support economic, social and environmental outcomes.

Australian regulators and industry bodies have also supported ESG integration and reporting. In a speech delivered in 2017, Geoff Summerhayes, Executive Board Member of the Australian Prudential Regulation Authority (APRA), identified the need for investors to assess risks and declared "some climate risks are distinctly 'financial' in nature. Many of these risks are foreseeable, material and actionable now".[5]

The shift in views of the fiduciary duty of funds, shareholder activism and members demanding more alignment of their investments with their values has fuelled the impetus for funds and investors to seriously consider how they invest in terms of environmental and social factors.

How SRI can affect financial returns

A common concern surrounding responsible investing is that incorporating ESG factors into the investment process, or screening out certain companies, may compromise investment performance. However, recent research shows that assets under management using a responsible investment approach are outperforming mainstream funds over most time frames and asset classes.[6]

According to research from the Responsible Investment Association Australasia, at the end of 2018 responsible investment share funds outperformed mainstream Australian share fund benchmarks for all periods except the three-year period. International responsible investment share funds outperformed the Morningstar average mainstream international share fund over every time horizon, as did responsibly managed multi-sector funds against the mainstream multi-sector growth fund average.[6]

It's important to note however, that many of these investment options are still relatively new and most haven't been around longer than 10 years. This means their long-term performance is unknown at this stage.

Why choose socially responsible investments?

All businesses, and therefore all investments, have an impact on people and the planet, both positive and negative. SRI seeks to minimise the negative effects generated by business and promote positive impacts, ultimately helping to deliver a healthier economy, society and environment and underpinning a stronger investment outcome.

Different reasons fuel investors' appetite for SRI strategies. Some do it for moral reasons, choosing to completely avoid companies that do not align with their views. Others consider ESG factors from a financial risk standpoint. For example, if a company doesn't employ equal pay practices, there could be backlash and a high turnover rate which could, in turn, impact the stock performance.

You may choose to invest responsibly for a variety of reasons, including investing in-line with your personal values, supporting a cause you're particularly passionate about, or even facilitating social change as businesses alter their practices to attract your investment.

Ultimately, sustainable investing is about pioneering better ways of doing business and creating the momentum to encourage more and more people to opt into the future you're working to create. There's good reason to see SRI investing as a long-term way to help add value and mitigate risk in a portfolio, but to also look beyond traditional investment metrics and leave a sustainable legacy.

The future for SRI

In 2007, the European Investment Bank issued its first green bond, a EUR 600 million equity index-linked security, whose proceeds were used to fund renewable energy and energy efficiency projects. A year later, the World Bank followed suit, and by 2017, over US$155 billion worth of public and corporate green bonds had been issued, paving the way for the Seychelles government to issue the first ever 'blue bond' in 2018 — a US $15 million bond to fund marine protection and sustainable fisheries.

The success of these early sustainable financial instruments reflects the fact that investors are increasingly conscious of the social and environmental consequences of the decisions that governments and companies make. And as issues like climate change and global poverty become more immediate, and as COVID-19 continues to shape our world, people will increasingly call on the most powerful players to take action. The universe of potential responsible investments is already broad, and is set to grow significantly.

[5]Geoff Summerhayes, 2017. https://www.apra.gov.au/news-and-publications/australias-new-horizon-climate-change-challenges-and-prudential-risk
[6]Responsible Investment Association Australasia, Responsible Investment Benchmark Report 2019.

In one sense, nothing about what drives us to invest has changed. We invest because we are planning for the future, and hoping for a better, wealthier tomorrow. What has changed, perhaps, is our sense of what constitutes wealth and the legacy we wish to leave.

When considering investing your funds ethically, you must ask yourself which values you hold most important, and how you can evaluate companies to ensure you are investing in ways which align to your beliefs. What are the values you want to express through your saving, giving and investing?

There are a number of ways to take an SRI-style investing approach - whether investing in individual companies, or exchange traded funds, there are a number of options available to investors who wish to invest responsibly.

While historical performance doesn't guarantee future performance, ethical indexes have shown in the past that sustainability doesn't necessarily compromise returns. As a result, socially responsible investing is a trend on the rise, and while it may not be suitable for every investor, it may be something you wish to consider.

Most of us will have both short-term and long-term financial goals, but these may change over time and at certain moments in life. Your financial adviser can help you build a wealth plan that aligns with your values throughout your life and also sets the tone for the legacy you wish to leave behind.

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