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Avoiding the 'ethical' trap

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As with acquiring any new skill, an investor or fund manager's first steps in ethical, sustainable and responsible investment will likely be the most challenging. At times it may feel akin to landing in a parallel universe, but upon digging deeper, it will likely become apparent that this area is more grounded than most.

One of the challenges of this field is its jargon, which has evolved over several decades and is often interpreted differently. Financial advisers, for example, typically refer to this entire area as 'ethical', fund managers generally prefer 'ESG' (environmental, social and governance) and others, including myself, prefer 'SRI' ('sustainable and responsible investment') as it points towards solutions.

The new frameworks, standards, codes and rules that are being developed by the EU, British Standards Institution, Financial Conduct Authority (FCA), Investment Association and the Financial Reporting Council should help sort out labels, taxonomies and more. But these will take time. In the meantime, setting out the sequence of events may help.

A brief history

The term 'ethical' emerged in retail investment in 1984 with the launch of the Friends Provident Stewardship funds. Their aim was to meet the needs of clients who wanted to stay true to the firm's Quaker origins, avoid South Africa's apartheid regime, support 'decent' companies and encourage progress.

Four years later, Jupiter Ecology was launched with an emphasis on environmental issues and opportunities. Broader sustainability themes started gaining momentum in the 1990s, alongside new corporate governance codes.

The 'responsible ownership' agenda emerged around the year 2000, alongside new pension disclosure requirements.

Recognition of the benefits of integrating ESG risks and opportunities into investment analysis – and focusing on the valuable role investors can (or should) play in addressing environmental or social challenges – have both flourished over the past few years.

Therefore, although different, these strategies typically agree on more than they disagree on and commonly aim to address related financial and societal challenges.

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ESG in 2019

Fast forward to this year and 'ESG', 'stewardship' and 'impact' approaches are making the headlines.

'ESG' generally relates to additional research that improves management of environmental, social and governance risks.

'Stewardship' indicates responsible ownership strategies where asset owners steer companies, through voting and engagement, towards practices that will benefit both parties in the longer term.

'Impact', meanwhile, refers to stock selection that explicitly aims to deliver environmental and social benefits such as reduced carbon emissions.

The primary focus of almost all such funds is to generate competitive financial returns – although benchmarks and combinations of issues and approaches vary (the exception being some impact funds may make trade-offs if they have both impact and financial objectives).

The most common thread through this area is 'sustainability' – because to ignore it is quite literally unsustainable.

Regulation

The Paris Climate Agreement, UN Sustainable Development Goals and increasing regulation underscore this and are being taken increasingly seriously.

For instance, the Department for Work and Pensions last year directed pension trustees to consider ESG issues – particularly climate change – as part of their fiduciary duties.

The FCA is currently working on its "climate change and green finance" plans and the European Securities and Markets Authority is consulting on MiFID II amendments that may make ethical or ESG fact finding obligatory.

Earlier this month, input/output operations per second (IOPS) also indicated that pension trustees should regard ESG factors as "material" or, in other words, financially relevant as opposed to optional.

Assuming the proposed MiFID II changes proceed, and keeping materiality in mind, advisers will soon have to update their fact-finding processes. There are two main schools of thought on how best to do this.

Many advisers indicate their clients are happy to invest in a fund or portfolio that covers the basics. Typically, this means avoiding tobacco and armaments, and investing in companies with sound environment and social practices.

Others use detailed supplementary questionnaires that list issues for clients to select from. Both have pros and cons.

Building client portfolios

The route we often suggest is a combination of the two, whereby clients select their preferred SRI styles.

We have identified seven: Negative Ethical (avoidance of non-ethical funds), Balanced Ethical ('best in sector' led), Faith-based, Sustainability, Social or Environmentally themed and ESG Plus.

It is also important to consider responsible ownership-related corporate activity, as clients often like to know more about fund management companies themselves.

Adopting such techniques will also help intermediaries avoid the trap of thinking this area can be reduced to a binary ethical/not ethical issue, which can be very misleading.