MULBERRY BOW

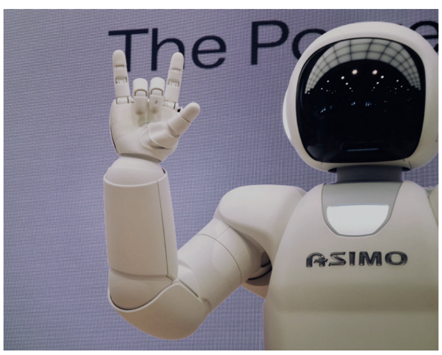
The New Normal

How Sustainable Investing is Changing the Way Investors Deploy Capital

A White Paper by Gosia Rosa, Partner
January 2020



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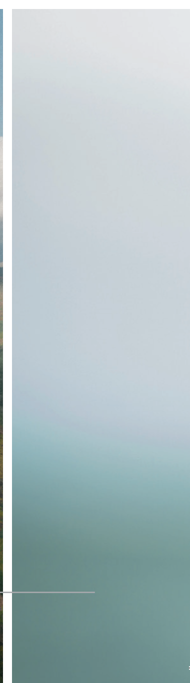

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Foreword by Andrew Toll, Mulberry Bow

Many moons ago, when I was studying for a degree in Environmental & Business Management, the concepts of sustainable development and corporate social responsibility were relatively new. As I navigated my way through various investment exams on my way to becoming a Chartered Financial Planner, coverage of sustainable investment within the study guides was noticeably light, a single page at best. Until very recently, most advisers overlooked sustainable investment, not because they didn't support it, but because there was limited information available to base informed investment decisions on.

Fast forward to present day and the idea of sustainable investing, once favoured by a minority of passionate supporters, has firmly entered the mainstream. Regardless of the type of investor you are, it is now possible to find, within the myriad of sustainable investment solutions, an approach aligned to your values, investment objectives and risk appetite.

Even the most demanding investors are increasingly catered for. Can't decide whether to use your money to support animal rights or clean energy? You can now invest in the US Vegan Climate Exchange Traded Fund, which launched back in September 2019, and which will track a cruelty-free and fossil fuel-free US Vegan Climate Index (VEGAN).

In a world where information can spread globally at the click of a button and where corporations and governments are (sometimes) held accountable for their actions, why shouldn't we start to scrutinise how our money is invested and where, so that it reflects the values we try to incorporate into our daily lives?

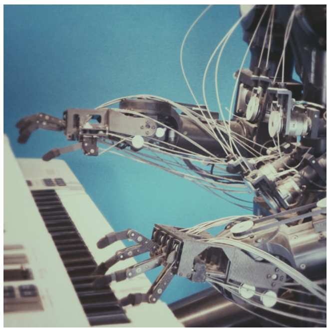
It is important to note that we believe that board of directors should still focus, first and foremost, on the long-term profitability of the companies the shareholders have entrusted to their stewardship (while operating within the law). That fundamental principle of capitalism could easily get obscured when considering some of the issues discussed in this white paper.

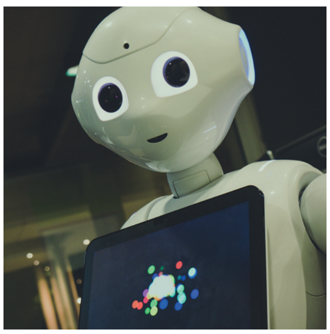
This paper is not designed to replace professional advice and you should not regard it as a means to induce you to engage in any particular investment activity. Instead, it is designed to give you an overview of sustainable investing, encourage reflection on different approaches and provide the knowledge needed to start a meaningful conversation with your friends, family or trusted adviser.

The first part of this paper will give you an overview of how the area of sustainable investment grew to become what it is today. We will then explain distinct approaches and the key themes that investors have been focusing on, so that you can understand the scope and nature of possible opportunities within the sustainable investment landscape.

The second part is a discussion piece. We will look at common myths that plague the area and evaluate the latest literature, which provides vast evidence in support of the sustainable approach. We will focus on ESG-based investing in particular, which is becoming the approach of choice for many sustainable investors.

Finally, we will provide you with practical tips on how you might start forming an investment strategy that is in line with your values, but still achieves the financial returns you are aiming for. With a little work at the outset, you can have your cake, eat it and feel good about it!
Let's get started...





Executive Summary

Society is becoming increasingly aware of the social and environmental challenges facing the world today, including global warming, pollution, income inequality and water scarcity. Improved access to information has given consumers a deeper appreciation of how various corporations either contribute to these problems or help tackle them. Over the past couple of decades, this awareness has started to gradually affect not only the choices that consumers make about the products and services they buy, but also about which companies they support through their financial investments.

Sustainable investment, from a niche pursuit, expanded its reach. A further boost was provided when the concept has broadened, from focusing on corporate social responsibility towards the much wider Economic, Social and Governance (ESG) factors. Many finance professionals and private investors are now considering the analysis of the company's ESG factors as a helpful tool to help distinguish well run companies from their badly run peers. The expectation is that the latter will be less well prepared to deal with future challenges and benefit from new opportunities.

Whilst investment decisions should not rely solely on how well the company scores on the ESG characteristics, there is mounting evidence suggesting that companies capable of achieving higher scores on ESG characteristics (especially governance) are likely to financially outperform their peers, particularly over the long term.

The area of sustainable investment is not free of its challenges. Some companies view ESG as a "greenwashing" exercise for their PR department, rather than a key part of leadership. Weak boards may also hide behind ESG to avoid or mitigate criticism. The terminology is full of jargon which puts people off. Information on companies' ESG scores and other sustainable credentials is inconsistent. Much of the data is submitted on a voluntary basis and incomplete, which limits the extent to which companies can be meaningfully compared with each other. With proper structuring, issues with portfolio diversification can be mitigated, but there remain gaps in the availability of sustainable investment products. Finally, availability of passive sustainable investment products is still limited, which means that many sustainable investors who have a clear vision of the impact they want to achieve are limited to investment opportunities that incur higher professional management fees.

Despite these drawbacks, there are many advantages to sustainable investment. Without sacrificing financial returns, investors can use their money to achieve a positive impact for the society and/or the environment. Money has the power to transform corporate practices over time. When millions of individual investors choose to direct their money towards causes that they care about, the corporate world takes notice and adapts. Thus, every time an investor selects a stock for their portfolio, they endorse and promote a vision of the world that the company asserts, for better or worse.

If any of the ideas in this paper pique your interest, why not get in touch.

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1. Sustainable Investment: Origins, Evolution and Current Approaches

Even a casual look at the financial press reveals sustainable investing getting a lot of attention. The idea that individuals are morally accountable for the impact of their investments is hardly new, dating all the way back to the Quakers and their ban on investments connected to the slave trade. Until recently, however, it had tended to be restricted to the beliefs of an individual or a defined group. The activists of the 60s and 70s gave momentum to the notion that **corporations and countries have a responsibility towards society and that this responsibility is shared by those who support their activities by investing in them**. Ever since, the number of investors who actively look for investment opportunities aligned to their ethical values has been steadily growing. In the 90s, sustainable investment was still considered niche and focused mainly on excluding investment in companies with questionable practices, using quite basic "negative screening". Investors for whom ethical considerations were a top priority favoured targeted investments into specific companies with a demonstrably "clean" focus (e.g. wind farms), while the majority stayed clear of anything with an "ethical" angle, either because the thought of investing ethically never really occurred to them, or because they believed that applying "moral" filters during investment selection would jeopardise financial returns.

In the 2000s, the growing awareness of the power of the financial market to influence corporate behaviour pushed sustainable investment into the mainstream. High-profile examples, including Nike's exploitation of sweatshops or the Deepwater Horizon oil spill, have focused public attention on the environmental and social costs suffered as a result of poor corporate practices, as well as the **potential opportunities of using the financial market as a tool to direct resource-rich corporations to help tackle "big" issues**. Investor demand for sustainable investment solutions continued to grow steadily, as did the volume and the scope of legislation with an environmental angle[1]. Eventually, the financial industry took notice. The number of sustainable investment products has rapidly expanded, and whilst there are still some gaps, it is now possible to create a broad, balanced portfolio made up of a variety of sustainable investment products, across various asset classes.

1 – Including, among others The Paris Agreement 2015; The United Nations Framework Convention on Climate Change; United Nations Sustainable Development Goals and the UN Guiding Principles on Business and Human Rights

New Kid on the Block? The Timeline of Values-Based Investing

18TH CENTURY	1960s - 1970s	1970s	1980s	2000s
Quakers exclude all investments with links to the slave trade	Equal rights legislation and environmental campaigns put a spotlight on responsible corporate practices	Investors blacklist the apartheid regime in South Africa - first significant example of the exclusionary approach	The World Commission on Environment and Development publishes its mission "to unite countries to pursue sustainable development together"	Sustainable Development Goals (SDGs) are published and are embraced as the key framework

From CSR to ESGs –
An Acronym Shift that Represents Real Progress

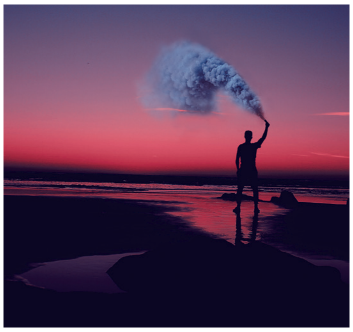
SOCIALLY RESPONSIBLE INVESTING		SUSTAINABLE INVESTING
Focuses on Corporate Social Responsibility and moral/ethical values rather than the risk/return profile of the investment	→	Uses a combined approach to look for financial returns, whilst considering moral/ethical objectives
Mainly employs exclusionary or "negative" filters		Broader method which employs inclusionary filters/positive screens, ESG factors, active engagement and other tools

As sustainable investment began to become more mainstream, **thinking shifted from focusing mostly on corporate social responsibility towards the much broader Economic, Social and Governance factors (commonly referred to as ESGs)**. Today, selecting sustainable investments often relies on the use of ESG factors as a benchmark. This broader outlook, and especially the assessment of corporate governance (how well the company manages itself) has found favour with many investors, including those who are motivated purely by financial returns. After all, factors such as board composition, accounting, ownership and executive remuneration have long been incorporated into the traditional financial analysis and investors intuitively understand how they might impact future performance of the company. **Expanding the analysis to include ESG factors is increasingly seen as a way to deepen the due diligence and look for potential risks and opportunities before they are correctly priced out by the markets**. It can of course be combined with a "negative" screening process.

Sustainable Development Goals to Guide Us All?

One of the most significant developments in this area was the United Nations' announcement of the 17 Sustainable Development Goals, designed to galvanise public attention around specific, agreed objectives, in order to secure a better future for everyone. To date, 193 countries pledged to contribute to the realisation of the SDGs by 2030. Since their publication, the SDGs have become a frame of reference for many sustainable investors and are commonly referenced when selecting investments for a sustainable portfolio.

Source: United Nations[i]



Approaches to Sustainable Investment, in a Nutshell

Sustainable investing is an umbrella term, meaning any investment that does not lead to the exhaustion of resources. There are various approaches, which are not mutually exclusive. **The most common methods of creating a more sustainable portfolio are described below:**

NEGATIVE/EXCLUSIONARY SCREENING

EXCLUSIONARY SCREENING			
How does it work?	**Why is it used**	**Popularity**	**Examples**
Excluding certain industries, companies or countries based on specific predetermined criteria (for instance, choosing not to invest in big polluters, gambling companies etc).	Primarily for moral/ ethical reasons.	Oldest and most commonly used sustainable investment method.	An investor excludes all companies involved in production or trade of tobacco from her portfolio. An investor instructs his portfolio manager not to purchase bonds from a specific country due to its human rights abuses. An investor sells all his stock in companies producing nuclear power.

For many decades, exclusionary screening was the only method available to investors who were concerned about the moral impact of their investments. It adopts a simple principle of excluding investments that an investor considers unacceptable or controversial, from a religious or ethical point of view. Perhaps owing to this apparent simplicity, exclusionary screening remains at the core of the majority of global sustainable assets. It can be applied on its own or combined with other methodologies.

Exclusionary screening is not without its challenges. First, identifying which investments to exclude may not be as easy as it seems, particularly when commingled funds and supply chains are concerned. If you feel strongly about child labour, how far down the supply chain do you look? Would you invest in a company that never employed minors in its clothing factories in the Philippines, but obtained its fabrics from undisclosed sources?

Second, using exclusionary filters is likely to have an impact portfolio performance, however the impact does not have to be negative. For example, a recent paper by JP Morgan established that “the MSCI world tobacco index has outperformed the MSCI World Index in 11 out of the last 16 years. [...] On the other hand, the S&P 500 Fossil Free Fuel Index TR (Total Return) for the five-year period ending April 30,2018, has earned annual returns of 8.43% compared to 8.495% earned by the S&P 500 Index.”[ii]

Finally, many investors, particularly those who are new to sustainable investing, like the reassurance of being able to compare how their sustainable investments fare in comparison to the broader world indices. Application of exclusionary filters may make it more difficult to compare the performance of an investor’s portfolio with the benchmark. Having said that, there are strategies that can minimise this problem, such as using separately managed portfolios. Like many of the challenges that come with sustainable investing, it may be much more of an issue if you are not prepared to compromise.

INTEGRATION OF ESG FACTORS

ESG Integration			
How does it work?	**Popularity**	**How is it applied**	**Examples**
Systematic analysis of companies' ESG characteristics as part of the traditional financial analysis.	Second most popular sustainable investment approach globally, and seemingly on the. It appeals to a broad range of investors, including those who are exclusively focused on financial returns.	Mostly used for public and private equities, but increasingly more common in fixed income and other investment products.	A publicly traded company introduces a new product. Sustainable investment analyst in a global asset management team has concerns over the safety of the product and possible corrupt practices in bringing the product to the market. The company is given the rating of 1 out of 5 (the worst score) for ESG and it is no longer deemed suitable for inclusion in long-term sustainable portfolios. Sustainability advisory team at an investment bank becomes aware of grave employment relations issues affecting a retailer. As a result, the retailer's score on ESG factors is negatively affected and it is removed from the bank's sustainability fund.

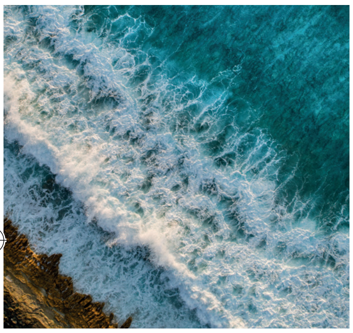
EXAMPLES OF "SIN STOCKS" USED IN EXCLUSIONARY SCREENING

- Adult entertainment
- Alcohol
- Animal testing
- Arms
- Firearms
- Fossil fuels
- Gambling
- Nuclear energy
- Payday loans
- Private prisons
- Stem cell research
- Tobacco

Integration of Environmental, Social and Governance (ESG) factors into an investment analysis is the second most popular approach to sustainable investment globally and arguably far more likely to become a global norm than negative screening. It is commonplace in Canada, Australia and Europe (particularly in France and Germany), but less entrenched in the US. In the US, the use of ESG integration is predicted to become widespread over the coming decades, owing to the expected transfer of wealth to women and the millennials, who are more inclined to see sustainability of their investments as a critical factor. **Some investment houses, in response to this meteoric rise, are applying ESG to all portfolio selection**.

As part of the ESG analysis, an investment is assessed not only by using the traditional financial tools, but also by breaking down the business to calculate the company's exposure to environmental, social and governance risks, which may (in the long-term) affect the company's finances. This information advantage is widely believed to support improved stock selection. According to Robeco, for investors with a long-term investment outlook, **ESG analysis can offer a strategic advantage by acting as an early warning system, and "spotting risks and opportunities before they are reflected in spreads, or picked up by the ratings agencies"**[iii]. Asset managers apply ESG analysis because they believe it offers a strategic advantage, not out of the goodness of their hearts.

We will look at ESG in greater detail in the second part of this white paper.



POSITIVE SCREENING

POSITIVE SCREENING		
How does it work?	**How is it applied?**	**Examples**
Rather than using ESG to screen out the “bad”, this approach seeks out companies with positive ESG performance relative to peers and/or benchmark. Companies committed to responsible business practices and those whose products and services make a positive contribution to the environment or the society are over-weighted, to maximise portfolio’s exposure to companies with strong ESG considerations.	Mostly used in equities.	An investor allocates a proportion of her portfolio to companies which outperform their peers on certain ESG measures, using data obtained from the MSCI KLD 400 index. A foundation which is currently focusing on maximising returns to fund their charitable giving instructs their investment manager to stop excluding tobacco companies from their investment portfolio, but instead allow a tobacco company which is pioneering the use of safer cigarettes and is making serious efforts to protect children from picking up smoking, which makes this particular company stand out from its industry peers in terms of ESG credentials.

Positive screening starts with an assessment of a group of companies, which aims to score them on a variety of ESG characteristics. Which criteria will be used and how they will be weighted will depend on the specific sector that the company sits in. Following the scoring, investors will positively select those companies which have ranked highest compared to their peers. For instance, an investment manager may create an equality-focused fund and include only those companies which score within the top 30% of their peer group for factors such as board composition and equal pay.

ESG ranking is commonly combined with financial analysis, so the final list of qualifying companies will typically comprise only those which not only have strong ESG credentials compared to the benchmark, but have also passed the hurdle of the financial screen.

One advantage of this approach is that it is well suited to near-passive investment approaches requiring low tracking error in relation to the standard broad market indices. However, investors who are particularly concerned about achieving specific social or environmental outcomes might find this approach insufficient, because the final portfolio based on positive screening may differ little from a typical “non-sustainable” portfolio. It may also include companies (e.g. big oil or cosmetics firms that test on animals) that the investor feels are unacceptable.

In future, “passive or near-passive portfolio based on custom designed ESG or sustainability-designed indices”[iv] might allow investors to achieve their impact objectives without the cost linked to “active” investment management, should that be their preference.

Common Strategies Used in Positive Screening

TILTING STRATEGIES

Companies with strong ESG characteristics are given preference within the portoflio. At the same time, exposure to ESG risks is minimised by under-weighting companies which underperform on ESG factors relative to peers/benchmark.

MOMENTUM STRATEGIES

Investment is focused on companies whose ESG scores are improving.

NORMS-BASED SCREENING:

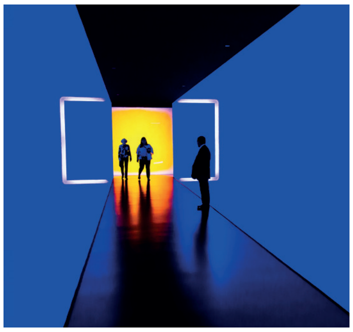
NORMS-BASED SCREENING		
How does it work?	**How is it used?**	**Examples**
Investments are screened on the basis of meeting minimum standards of business practice. Companies which fail to adhere to global norms on environmental protection, human rights, labour standards anti-corruption etc are excluded from the portfolio. [2v]	Norms-based screening is often integrated into the overall investment analysis. Investors can use norms-based screening on its own, to exclude companies from their portfolio. They can also use screening results to engage management in a dialogue, in order to encourage improvement in business practices.	A company is found to have breached Principle 5 of the UN Global Compact (Abolish child labour). An investor initially engages the company to encourage it to implement stricter checks to ensure minimum working age requirements are met. When dialogue fails to improve corporate practices, investor blacklists the company from his portfolio.

The advantage of applying norms-based screening is that it is not a particularly controversial approach, so it may be well suited to investors who are new to sustainable investing. On the other hand, investors with a clear vision of the environmental or social impact they want to achieve are likely to find that the company's adherence to a set of international norms is an absolute minimum and does not sufficiently qualify it for inclusion in their sustainable portfolios. For this reason, norms-based screening is often combined with other approaches, such as corporate engagement and shareholder action.

THEMED INVESTING:

THEMED INVESTING			
How does it work?	**Popularity**	**Common themes**	**Examples**
Investment in themes or assets targeting specific social or environmental causes, for instance clean energy, water, education or healthcare.	Small in absolute terms, but growing rapidly.	Most commonly, thematic investors focus on Sustainable Development Goals (see notes on this above) when selecting a theme for their investments.	An investor invests money directly into the equity or debts of a company which produces water desalination equipment. An investor invests into a mutual fund which focuses on clean energy.

2 – Global norms are set out in international initiatives and guidelines such as the OECD Guidelines for Multinational Enterprises, the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, the UN Global Impact and, more recently, the Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework'.



Sustainability-themed funds focus on social and environmental issues, such as water distribution, green energy, pollution, health care or climate change. Many thematic funds offer a diverse portfolio of companies from a variety of sectors, which are considered “best in class”, thanks to the role they might play in dealing with major challenges facing humanity.

This type of approach is attracting more and more attention, with investor demand growing steadily year on year, especially for certain themes. One such theme is water distribution, with a growing number of investors actively looking for viable projects, predicting that the rapid increase in the use of water (more than twice the rate of the global population growth in the last century[vi]) is likely to produce profitable investment opportunities. Trends in the spotlight include vertical farming, lab produced or plant-based “meat” and using AI to reduce crime (inc. cyber crime).

Thematic approach allows investors to move away from a geographical focus. Naturally, allocating a significant proportion of the portfolio to a specific theme, whether that’s green energy, or self-driving cars may increase concentration risk.

IMPACT / SOCIAL INVESTING

IMPACT / SOCIAL INVESTING			
How does it work?	**Popularity**	**How is it applied?**	**Examples**
Investing in companies or funds with the explicit intent to produce social, environmental and/or community benefits, while generating financial returns. Impact targets focus on defined, measurable and verifiable improvements in areas such as health, community empowerment or fair trade.	Small in absolute terms, but demand is increasing and is expected to continue growing as wealth gradually transfers to women, younger generations (and tech billionaires!).	Most commonly used in private equity and private debt, via direct investments or through funds. Slowly appearing in other asset classes, such as listed equities. It’s not normally categorised by sector or theme.	An investor invests money directly into the equity of a small business which has a clear mission to help the local community with no access to traditional banking benefit from the use of a digital payment applications. An investor instructs his portfolio manager not to purchase bonds from a specific country due to its human rights abuses. An investor uses a microfinance platform to lend money to a number of small, local, fair trade, agricultural start-ups in developing countries. Elon Musk seeks to democratise space travel.

COMMON SUSTAINABILITY-THEMED INVESTMENT AREAS		EXAMPLES OF IMPACT / COMMUNITY INVESTMENT OPPORTUNITIES
– Water	– Cogeneration	– Community development
– Solar energy	– Waste heat recovery	– Education
– Wind energy	– Agriculture efficiency	– Heath and wellness
– Enery storage	– Organic foods	– Microfinance
– Smart grid	– See developed to boost agricultural yields	– Renewable energy
– Technology substitution	– Reforestation	– Climate change
– Broadband	– Carbon sequestration	– Natural resources
– Energy-efficient buildings	– Rail transport	– Conservation
– Smart lighting	– Transport logistics	– Small business finance
– Waste to energy	– Electric vehicle loans	– Sustainable agriculture
– Greenhouse gas capture	– Resilience infrastructure	– Sustainable consumer products
– Recycling	– Flood protection	– Fair trade
– Energy-efficient products	– Desalination	

Impact and community investors are typically motivated by a desire to use their investments as a way to achieve specific societal and/or environmental outcomes, but in contrast to philanthropists, they pursue their goals through investing rather than via outright donations.

Impact investing is starting to attract headlines and it is expected to rise significantly in absolute terms. An estimated $48 trillion of wealth in the US is expected to be transferred to Generation X and millennials over the next 25 years[vii] and 45% of millennials consider social responsibility as one of the key factors in making investment decisions[viii]. The massive scope of the impending intergenerational wealth transfer in the US is expected to provide a significant boost to impact-focused projects.

One of the challenges linked to this investment approach is establishing clear outcomes, which tends to lead to the focus moving from the big picture to what can be measured. While some societal and community impact opportunities lend themselves to a quantitative approach, other projects are harder to assess based on results, without resorting to oversimplification.

Another downside is the expected return on investment. Some impact investments achieve market rates, but many do not, or lead to losses. For some, that's a price worth paying. Many impact investors are consciously choosing to direct money towards specific projects that are not yet adequately financed by the usual sources and they are willing to sacrifice returns in order to advance specific causes they are passionate about. **Unlike in philanthropy, investors continue to own the asset and expect some financial return, even if it is below the market rate**. Often, they reuse returns from one investment to fund subsequent projects. To protect their future financial wellbeing, many impact investors keep the core of their portfolio unchanged, but allocate a small proportion of their wealth to specific impact projects. Many believe "big issues" like curing cancer will be solved through a combination of impact investing (for instance early stage innovation in drug development), government-funded research and charity-funded research.

CORPORATE ENGAGEMENT AND SHAREHOLDER ACTION:

CORPORATE ENGAGEMENT AND SHAREHOLDER ACTION		
How does it work?	**How is it used**	**Examples**
Using shareholder power to influence corporate behaviour. May include direct engagement with management/boards, filing shareholder proposals or using proxy voting to champion best practice and ESG improvements.	Whilst sometimes used on its own, shareholder engagement is often used by sustainable investors in conjunction with other approaches, such as ESG integration. Government-linked institutional investors, such as teachers' pension funds, can be particularly active.	A shareholder approaches the company board directly to voice her concerns over the gender composition of the board and a perceived inequality of pay across all levels within the company. When private discussions prove ineffective, the shareholder requests a copy of the shareholder register and proceeds to contact other shareholders to obtain their support. A portfolio manager working for an institutional investor is concerned about environmental impact at a mining company. He enters a dialogue with the company's Head of Investor Relations to lobby for improvement.

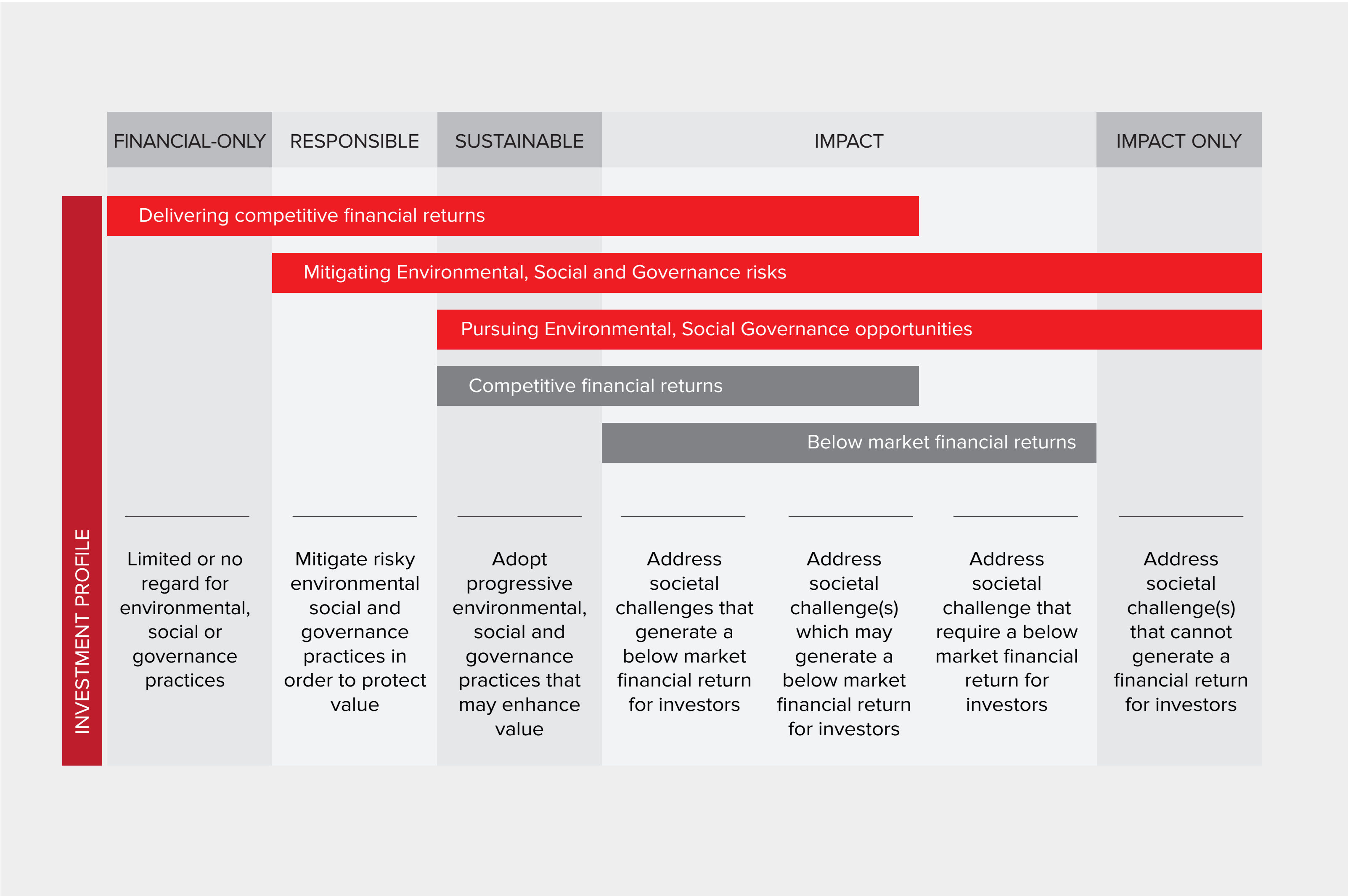
Shareholder engagement can include a variety of ways of using investor influence to encourage companies to make improvements. This could be through meetings, writing letters, proxy voting or social media activity. Whilst some individuals engage in shareholder engagement personally, it is often done through asset managers / institutional investors who act as intermediaries, particularly for large cap companies. Activist shareholders may also use proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis to help promote their agendas.

Over recent years, shareholders' voices have become louder and bolder on sustainability issues. A recent Deloitte survey suggests that nearly 75% of public companies in the US have been subject to shareholder activism, though not all activism related to a sustainability issue, of course. Nearly 50% of the surveyed companies admitted to making at least one major business change (such as share repurchase, management or board change, divestitures, or performance improvement initiatives) as a result of shareholder activism[ix].

Shareholder activists can have a tremendous amount of influence relative to the small percentage of shares they owe (generally three to five percent[x]). Some choose to exert their influence discreetly, others are more confrontational and tend to broadcast their views more publicly. Shareholder engagement can and often does have a positive influence on the bottom line. Shareholders are increasingly communicating directly with the boards on topics such as board composition, executive compensation or growth strategies. Their insights can help direct companies towards a better course of action and in some cases, prevent more aggressive activism and consumer boycotts.

Same Same But Different

While some of the approaches to sustainable investing may appear similar, they all occupy a distinct space on the spectrum of capital. The graph below[xi] is a helpful representation of the impact of different sustainable investment approaches on the likely financial returns.



Source: G8 Social Impact Investment Taskforce, Asset Allocation Working Group (2014).

2. A Closer Look at ESG

A Multi-Trillion Dollar Industry on Steroids

Warren Buffett is investing in solar and wind energy. Bill and Melinda Gates have made a public commitment to direct more than 50% of their income into socially responsible investments. Bill Gates, Mark Zuckerberg, Jeff Bezos and Jack Ma are throwing their weight behind Breakthrough Energy Ventures, a new fund focusing on low-carbon energy. Sir Richard Branson has invested in Memphis Meats, a company whose mission is to bring clean meat, grown from animal cells, to the mass market.

But it's not just the big names who are hopping onto the sustainability train. Starting as a niche pursuit for the idealists, sustainable investment has now firmly entered the consciousness of the masses. Whilst the financial industry press has been busy debating various approaches for years, the conversations have now moved to Jo Blogg's dinner table. Increasing numbers of investors consider ESG factors as part of their investment selection[xii]. The growing appetite for sustainability-related solutions is also starting to influence asset manager selection, with more investors considering the manager's capability to offer products focusing on ESG factors[xiii]. The Finance industry, as well as corporations eager to secure investment, will continue to respond to investor demand. As a result, t**he business landscape is continually shifting toward increased ESG disclosure and sustainable corporate practices.**

5, 4, 3, 2, 1... Lift Off!

It feels like we are on the cusp of sustainability going mainstream, but already the value of assets which are managed sustainably has rocketed from $1 trillion in 1995[xiv] to approximately $20 trillion today. **Globally, over a quarter of all professionally managed assets are now being managed sustainably[xv]. In Europe, more than half of all investments are managed sustainably[xvi]** .

The UK is considered a frontrunner for sustainable and responsible investment. Within the UK, €2.0 trillion's worth of assets are being managed through ESG integration, €2.2 trillion through exclusionary screening and €2.84 trillion through voting on sustainability grounds at annual general meetings[xvii]. Interest in ESG in the UK has picked up even more since October 2019, when new pension regulations[xviii] were implemented, which require trustees of pension funds to consider the impact of non-material factors including ESG as part of their investment process. UK consumers are also increasingly likely to pay a premium for an ethical version of a financial service or product, particularly when it comes to current accounts and savings accounts.

Demand from individual investors has certainly contributed to the surge in popularity. Nevertheless, **it is the weight of institutional investors that has allowed for such a rapid growth**. In-house sustainability departments, responsible for gathering ESG data and guiding investment decisions, are now ubiquitous in banks and asset management houses. ESG screening activity worldwide has increased by 150% in the last 18 months[xix] and 82% of companies in the S&P 500 now report on ESG issues[3].

The "Green" economy is also booming. It represents around 6% of market capitalisation, with around 3,000 global listed companies having exposure to green economy[xx]. The value of green economy, estimated at around US $4 trillion, is approximately the same as that of the fossil fuel sector and it's set to overtake fossil fuels shortly, as renewable energy sources account for over half of all new electricity capacity being added worldwide. The amount of energy produced from wind and solar sources is estimated to shortly match the amount of energy that is currently being obtained from the US shale oil.[xxi]

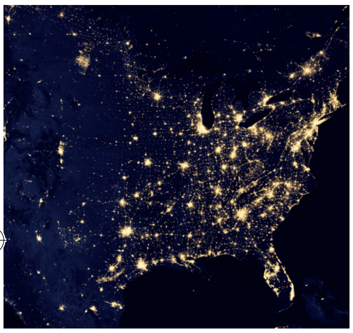
EXAMPLES OF ENVIRONMENTAL ISSUES ASSESSED IN ESG ANALYSIS	EXAMPLES OF GOVERNANCE ISSUES ASSESSED IN ESG ANALYSIS	EXAMPLES OF SOCIAL ISSUES ASSESSED IN ESG ANALYSIS
– Climate change & carbon emissions	– Board composition & diversity	– Customer satisfaction
– Air & water pollution	– Audit committee structure	– Data protection & privacy
– Biodiversity	– Bribery & corruption	– Gender diversity
– Deforestation	– Executive compensation	– Employee engagement
– Energy efficiency	– Lobbying	– Community relations
– Waste management	– Political contributions	– Human rights
– Water scarcity	– Whistle-blower schemes	– Employment relations
– Recycling solutions	– Accountability of management to shareholders	– Human rights
		– Health, safety & equality standards
		– Pay equality

Who Cares?

Investment professionals and those specialising in forecasting trends have noticed that the subject of sustainable investment holds particular appeal for two social groups: **millennials and female investors** [xxii].

Millennials are twice as likely to purchase a brand because of the company's environmental and/or social impact. They are also nearly twice as likely to invest in companies or funds that target specific sustainable outcomes[xxiii] and to pay a premium for financial products and services with strong ethical credentials. Younger investors frequently talk about the importance of supporting companies who have a positive impact on society and the environment; their personal responsibility to invest ethically and consciously; and the need to secure their own future whilst giving something back[xxiv]. Under 35s are twice as likely to sell an investment due to unsustainable corporate behaviour[xxv].

When it comes to female investors, 65% of women (as opposed to 42% of men) judge an investment's success based on social, political and environmental outcomes[xxvi] and 90% of women believe making a positive impact on society is important[xxvii]. Whilst less widely reported, clients of a "family office" are also more likely to favour sustainable investment, perhaps because they are more exposed to the subject than other clients[xxviii], though they are also known for adopting a more long-term outlook.



To Bond or Not To Bond?

Another area which has seen rapid growth is green bonds, lending to "green economy" companies. Whereas in the past sustainable investment has been primarily restricted to private equity, green bonds have recently grabbed investors' attention. Assets in green bonds more than doubled between 2015 and 2016[xxix].

While they remain a relatively niche choice for private investors, they are increasingly being considered as part of a broader portfolio thanks to their solid financial performance in the past. In recent years, Multilateral Development Bank (MDB) debt has achieved good risk-adjusted returns. Even ignoring the positive impact that can be achieved through investment in MDB debts, including MDB debt as part of a core holding may be useful to investors for whom impact is secondary to maximising long-term risk-adjusted returns. For long-term investors, returns from MDB debt could mirror those from investing in the US Treasuries. At present, some believe MDB debt enjoys the best risk/reward profile of AAA debt. It has been granted the highest possible credit risk rating since 1959 and it is achieving healthier yields than many developed market government bonds[xxx].

Another reason why sustainable bonds are gaining momentum is that with the introduction of ESG ratings, it is easier than before to measure and grade countries, using such criteria as transparency, political stability, respect for democratic values and the rule of law. This facilitates the process of country allocation for government bonds[xxxi]. Green bond "credits" can also be granted to specific projects, such as installation of a wind turbine, expansion of a water purification plant or construction of a solar power facility, which helps to ensure a greater degree of diversification.

Diversify or Die

Historically, one of the biggest challenges in terms of creating a sustainable portfolio was that with a limited range of investment products, portfolios focusing on sustainability lacked diversification. With fewer stocks that passed the criteria for inclusion into a sustainable portfolio, stocks were more closely correlated. While this in itself did not necessarily result in lower returns, it could. For example, if you chose to heavily invest in solar panel companies and the solar power industry went through a difficult period, your investments were likely to suffer more than if you had spread your bets across several sectors.

As demand for sustainable investment solutions grew, the range of opportunities broadened. While it's true that the market remains less diverse, geographically, it is now global and broad enough to allow for geographically diversified portfolios. US, Japan and Europe are all well represented, and in countries that are currently under-weighted (like China), exposure to sustainable investment products is improving fast[xxxii]. Even investors who want to focus on the narrower market of "Green Economy" are able to achieve a reasonable degree of geographical diversification.

The Green Economy is further diversified by company size and by ICB Sectors[4]. While its sector diversification is smaller than for the general economy[5], there is diversity in terms of types of companies within the sectors, and a significant variety in terms of the type of environmental challenge that is being addressed. Investors focusing on energy efficiency are particularly well catered for, with investment opportunities ranging from building insulation and cloud technology[6], to solar, large hydroelectric, lithium batteries and development of lightweight materials. Investor demand for financial solutions focusing on energy efficiency is particularly high, partly due to the concern about CO2 emissions, but also because investors are able to intuitively grasp that energy efficient products are not only better for the environment, but also more cost effective in the long run.

4 – Industry Classification Benchmark (ICB) is a globally utilized standard for the categorization and comparison of companies by industry and sector. ICB Cyclical sectors (ICB industrials) and defensive sectors (ICB utilities) are the two largest sectors within green economy. Technology ICB sector is third biggest and a key growth area.

5 – Cyclical sectors (ICB industrials) and defensive sectors (ICB utilities) are the two largest sectors within green economy. Technology ICB sector is the third biggest and a key growth area.

6 – Cloud computing technologies can reduce CO2 emissions by up to 90% according to the report "Cloud Computing Sustainability; The Environmental Benefits of Moving to the Cloud" published by Accenture 2010.

While some of the biggest companies within the green sector draw most of their revenues from "green" sources (for example Tesla or Waste Management Inc), there are also many companies where only a proportion of their revenues is green. These include Microsoft (due to its cloud infrastructure and video conferencing revenue stream); Amazon (with its cloud infrastructure segment) and Siemens (thanks to a number of its divisions, including renewable energy equipment, water treatment equipment and high efficiency power infrastructure).

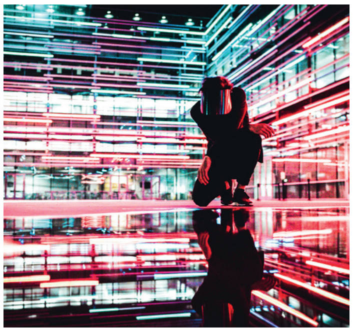
Overall, there certainly remain some product gaps within the sustainable investment chain, which are particularly pronounced in emerging markets. Having said that, **sustainable investment opportunities are now so broad that while it may not be possible to achieve comparable degree of diversification across all asset classes, sectors and geographies, with careful structuring, an investor focused on sustainability will be able to mitigate significant concentration risk.**

A Price of Conscience?

While it's true that the sustainable investing market has undergone a true revolution in recent years, it seems that how opportunities are perceived, both by investors and by some finance professionals, has not quite caught up. One of the biggest misconceptions is the enduring perception that investing sustainably will reduce diversification to an unacceptable level. Investors hesitant to get behind sustainable investing are concerned that applying any type of screening to the investment process will decrease the amount of businesses within the investment pool, which will lead to missed opportunities, increase concentration risk and inevitably hurt financial returns.

However, this assumption could only be true if the quality of companies integrated into a sustainable portfolio was the same as of those that were being excluded, so that the only meaningful result was reduced diversification of the portfolio. That is not how modern sustainable investment works. **Whatever the type of screening applied, companies selected into a sustainable portfolio are "qualitatively" different from the average company within the traditional global market and it is precisely this difference that can give a sustainable investor competitive advantage.**

Most investors intuitively grasp that bad corporate practices may result in adverse consequences for the company involved. This could include legal disputes, damage to the brand, increased insurance costs, wasted resources, higher running costs, issues with obtaining capital, issues with attracting and retaining quality staff, consumer boycotts and disruption to the business. When corporate misbehaviour is particularly serious, customers, investors and strategic partners may be irrevocably lost. The recent Volkswagen scandal is a striking example of how things can go very, very wrong. In October 2018, Volkswagen announced that its practice of distorting emission test results has already cost it nearly $33 billion[xxxiii].



Information Advantage

As important as the increased diversity of sustainable investment solutions is availability of better information to evaluate them. Historically, investing sustainably was, to some extent, a leap of faith. Critical infrastructure now exists to allow investors to accurately track, measure and report on non-financial risks and opportunities of a growing number of listed companies. ESG data and analytics are widespread and becoming more prevalent year on year. Disclosure standards are being refined. New market indices focusing on sustainability are being created. New investment frameworks designed to evaluate non-financial risks and opportunities are being introduced. At human level, more investment professionals understand the area of sustainable investment and have access to knowledgeable peer networks and quality data, which enables them to offer sustainable investment solutions to clients.

Performance

The belief that sustainably screened investments are doomed to underperform the broader market is partly a result of short-termism, which is arguably all too common throughout today's investment market[xxxiv]. Perhaps a more understandable source of scepticism about performance is that historically, ethically-guided investing was dominated by two types of approaches: exclusionary screening and targeted impact investing. However, exclusionary screening and impact investing no longer represent the breadth of the modern sustainable investment market. As a result, historical studies focusing on financial performance don't always provide an accurate reflection of the relative financial performance of sustainably managed assets.

The reality is that **whilst there are some approaches to sustainable investing which are more likely to produce below market returns (such as impact and community investing), there is now mounting evidence to suggest that sustainable investing in general (and ESG investing in particular) does not negatively impact financial performance, over a long-term investment window and that it may in fact enhance it.**

A number of studies suggest that investments which use ESG factors to inform valuation deliver outperformance compared to traditional approaches. The impact of each of the ESG factors on company valuation is not equal. High scores for Governance are associated with the biggest positive impact on corporate financial performance. On the other hand, the positive link between high scores for Social factors and stakeholder returns has been weakest[xxxv].

Studies have shown that companies scoring highly on corporate governance factors[xxxvi], treatment of employees[xxxvii] environmental sustainability[xxxviii], employee relations[xxxix], innovation management and supply chain management[xl] outperform their peers and deliver better results to shareholders. The positive association between ESG integration and corporate performance[xli] has been found repeatedly in multiple studies, particularly over the long-term[xlii].

There has also been a crop of smaller scale studies examining particular areas of sustainable investing in more detail. For instance, in studies focusing on exclusionary screening, correlation between adopting exclusionary screening and positive financial returns is less pronounced. Evidence suggests that the effects are likely to be neutral, i.e. applying exclusionary screening does not tend to result in portfolio overperformance or underperformance. Conversely, studies focusing on the Best in Class approach suggest that investments following this methodology outperform the benchmark[xliii]. Other smaller scale studies have also produced interesting insights. Investigations into emerging markets concluded that the positive impact of adopting ESG factors (particularly governance) on corporate financial performance is even more significant in these locations than in the global market[xliv]. Other studies have found direct link between ESG disclosure and higher share prices[xlv] and reported a 2.7% increase in stock returns for companies who engaged with their stakeholders with the aim of improving ESG scores[xlvi].

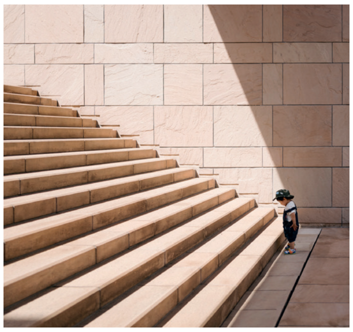
As with most areas of research, individual studies can from time to time produce data that does not support the overall trend. However, the overwhelming evidence is that sustainable corporate practices have a material, and positive influence on financial performance . A research paper commissioned by Mercer found a positive relationship between ESG factors and financial performance in 20 out of 36 studies, with only three studies showing a negative correlation . Research undertaken by Oxford University and Arabesque Partners concluded that 80% of the reviewed studies found positive correlation between prudent sustainability practices and investment returns . Perhaps the most comprehensive research project undertaken so far, encompassing 2,250 separate studies spanning a period of over 40 years concluded that ESG incorporation resulted in outperformance in 62.6% in cases and underperformance in only 10% of the cases, with neutral effect in the remaining cases.[xlvii]

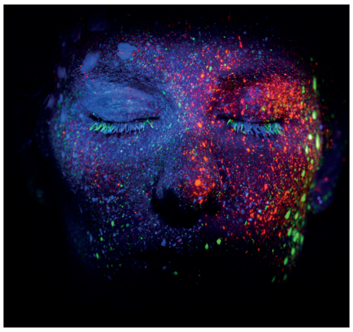
Avoid the Losers

Intelligent use of ESG to inform investment analysis can give investors an edge[xlvii]. Why might that be? In the broadest sense, many factors which are evaluated as part of the ESG analysis are simply sensible corporate behaviours and practices that distinguish well run companies from their badly run peers. In this sense, paying attention to non-financial factors of a company is simply a way to enhance the standard due diligence process undertaken as part of the traditional investment analysis.

Companies with solid governance standards, transparent ESG disclosure and good/improving ESG scores are less likely to be involved in major negative incidents, which reduces the inherent investment risk. In this sense, using data obtained from ESG analysis can be a helpful tool to structure a portfolio to avoid “losers”. There is evidence that this strategy works, with research indicating that sustainable equity funds achieve equal or median returns compared to traditional funds, but with reduced volatility[xlviii]. Companies with high ESG scores benefit from lower cost of debt and higher credit ratings[xlix]. Lower cost of capital[l] reduces the cost of doing business, which increases competitive advantage and results in higher profit margins.

But it’s not just about reducing risks. Proponents of the sustainable investment approach argue that companies scoring highly on ESG characteristics are the ones who are aware of the opportunities resulting from increased environmental regulation and changing consumer preferences. Increased awareness of these issues allows them to adjust their strategies in order to take advantage of them. It has also been argued that the need to tackle the various social and environmental challenges that the world is facing today is a driver for innovation and creativity. Investors who subscribe to this belief can use the best in class approach to sustainable investment to select the most resilient and adaptable companies, those prepared to commit the necessary resources to “future-proof” themselves, with the expectation that they will outperform their competitors.





Challenges

Investing sustainably allows investors to use the forces of the financial markets to help solve the world's biggest problems, while achieving attractive returns. That doesn't mean that the area of sustainable investment is free of any issues. There are a number of challenges that still need to be addressed, mainly around consistent terminology, quality of data, availability of products and human factors.

Comparing Apples to Oranges

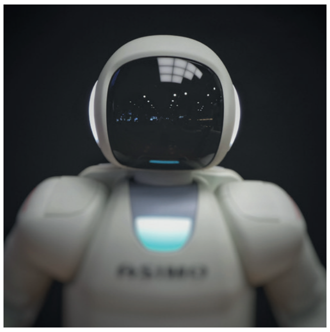
Many approaches to sustainable investment rely on allocating accurate ESG scores to companies, in order to judge whether, and to what extent, they should be included in a fund or an investment portfolio. However, identifying which ESG factors are relevant and should be taken into consideration can be challenging, given that the relative importance of each ESG characteristic varies from sector to sector. For instance, environmental regulation will have a significant effect on the energy and transport industries, and less so on banking, where governance factors will matter more. Even once the set of relevant material ESG characteristics has been identified, the assessment should be regularly repeated, so that it can adequately represent the changing dynamics of the investment landscape. This can require substantial time and resources, especially given the long-term investment window that sustainable investment is particularly suited to, though costs should reduce if it becomes the global norm.

Labels

Sustainable investing is many things to many people. For instance, not all investments classified as sustainable would meet the needs of an impact-focused investor. This can be viewed as a strength, because it allows investors with different values and different agendas to participate. The downside is that with no universally accepted taxonomy of products and services, it can be difficult to obtain the level of clarity that investors want. It is not unusual for both investors and investment professionals to use such terms as sustainable investing, impact investing or ethical investing interchangeably, where in fact they describe quite different things. To avoid misunderstandings, the process that the investor will have to go through to create a coherent investment strategy is bound to involve more soul-searching and more effort. Only when the investor has identified where on the spectrum of impact versus financial returns they sit (see Spectrum of Capital graph on page 15) and which issues they want to contribute to addressing (be it climate change, social diversity, local issues or something else entirely) can they have a meaningful conversation with their investment adviser about specific products or opportunities.

Big Data Small Data

Another major issue is the quality of data. With a little perseverance, anyone can now take advantage of the deluge of information covering corporate ESG performance, consult various standards and tools for assessing ESG factors[7] and check market indices which focus specifically on sustainable investing[8]. The issue, however, is that ESG data, levels of disclosure and methods for evaluating performance lack consistency. As a result, it is currently impossible to accurately compare all investment products globally in terms of their sustainable credentials. Availability of ESG information varies widely and can be limited for certain sectors, asset classes[9], themes[10] and geographical locations[11]. Furthermore, because a large proportion of ESG data is provided on a voluntary basis, corporate disclosure, especially for unlisted companies, is often only partial and inconsistent. This may act as an advantage to those companies who have cottoned on to the benefits of providing comprehensive ESG disclosure, as they are more likely to be selected into sustainability funds than smaller companies. The latter may be just as well governed and as environmentally friendly but may not have the desire or the resources to regularly compile ESG disclosures. Overall, there is a significant amount of ESG data available, but it's not globally available or consistent, so it's not easy to interpret.



Improving the Data

Sustainability related data is becoming more systematic, objective, quantitative and financially relevant[li]. In June 2019, the EU has published Guidelines on Reporting Climate-Related Information[lii]; The TEG Report on EU Taxonomy[liii]; The TEG Report on EU Green Bond Standard[liv] and The TEG Interim Report on EU Climate Benchmarks and Benchmarks' ESG Disclosures[lv]. Together, these guidelines are expected to lead to a more consistent use of terminology, improved reporting standards and improved methodologies for assessing the credentials of investment products. Similar moves have been reported in the US, where a number of projects aimed at improving the quality of sustainability-related information[12] are under way[lvi].

DIY?

Individuals who want to invest sustainably without obtaining advice from a qualified financial professional should be vigilant and carefully investigate the credentials of the particular investment and fund manager that they are interested in. That's because it may be challenging to evaluate a fund manager's abilities and **some unscrupulous managers have been known to inflate the green credentials of their fund (greenwashing)**, to take advantage of the public's growing interest in the area.

Being Human

Finally, while the data available to investors is continually improving, the human factors remain a challenge. On the advisor side, **risk-averse service providers may have little desire to change the status quo**, which means that investors who may benefit from taking up sustainable products are not being educated about them. Additionally, **experts working with sustainable products bring their own assumptions and biases**, which can distort the presentation of the data. Where no clear guidelines are available, analysts have to make their own subjective judgments, on issues such as which ESG factors are most relevant for a given company and how broad the analysis should be (for instance, should you look at the company itself, or investigate its supply chain as well). Traditional practices within the finance industry make the work of analysts dealing with sustainable investment even more challenging. **Backwards looking, risk-oriented analysis, which lends itself well to traditional financial analysis, is not particularly well suited to sustainable investments, which can lack the data on past performance**. On the investor side, faced with the confusing new universe of sustainable finance, many potential investors are overwhelmed and end up taking no action.

7 – These include, among others: Securities and Exchange Commission; Global Reporting Initiative; Sustainability Accounting Standards Board; UN Global Compact. Corporate Human Rights Benchmark; CDP; Climate Disclosure Standards Board; Greenhouse Gas Protocol; Financial Stability Board- Tas Force on Climate-related Financial Disclosures; Climate Bonds Initiative; Green Bonds Assessment; B-Corp and benefit corporations; Industry specific standards; Montreal Pledge.

8 – Most notably: Bloomberg Professional Service; Sustainalytics; Trucost; Thomson Reuters; RobecoSAM; IW Financial; VIgeo Eiris; South Pole Carbon; Morningstar's Sustainability Ranking; Dow Jones Sustainability Investing World Index. MSCI Global Sustainability and ESG Indexes and FTSE4Good Index series.

9 – Particularly outside of public equities

10 – ESG data for carbon and water tend to receive far more attention than other themes

11 – Data for developing countries is quite patchy

12 – Including an initiative supported by the Financial Stability Board to encourage standardisation of financial formation relating to the environment

3. From “Why?” to “Why Not?” and “How”

LOOKING FORWARD

The past two decades have seen a true transformation in the area of sustainability. The efforts to bring forth meaningful change have shifted from mostly political activity (subsidies and regulation) to economics. Increased consumer awareness, new technologies and stricter regulation have had a major impact on the risk and opportunities assessments for many, if not all, industries. **With an estimated $90 trillion required by 2030 to reduce global warming to manageable levels, the investment landscape will see some big winners and some big losers**. Investors who want to capitalise on this trend can now benefit from the opportunity to align their portfolios, before sustainability-related risks and opportunities have been fully priced in by the global investment markets. Complete disregard for non-financial ESG risks of an investment could cost you the Earth in more ways than one.

Growing awareness of social and environmental challenges, coupled with an increased sense of personal responsibility and consumer power, has meant that investors are questioning the impact of their investments and changing their investment approach. Personal beliefs and values, which were historically reflected in behaviours such as recycling or choosing free-range chickens, are now being expressed through the investment markets. This is a rational development, as **financial markets are capable of greater impact than an individual, regardless of how many times he or she brings a canvas bag to the supermarket**.

While impact investors are still a minority, they are very vocal about the need to stop companies from externalising the true cost of their unsustainable practices onto their own staff, the wider community and the planet. As sustainable and impact investment becomes more widespread, companies are under increased pressure to improve their practices in order to be able to raise funds. In turn, as companies are becoming more transparent about their practices, consumer consciousness increases, more investors choose to buy from or invest in sustainably-run companies and sustainability-focused businesses outperform their peers. It’s a virtuous circle.

Sustainably managed investments are growing at a significantly higher rate than total professionally managed assets and while it’s impossible to predict the future, further growth seems inevitable, with an acceleration likely. Even in Asia, where sustainably managed assets currently account for less than 1% of all professionally managed assets[lvii], sustainable investment is gathering pace. In time, if the current trends continue, sustainable investment could become the norm, globally.

Philanthropy is Dead. Long Live Philanthropy

The rise of sustainable investment is having a noticeable impact on traditional philanthropy. Ideas are cross-pollinating. Financially successful individuals who want to leave a legacy can now take advantage of better data and tools that allow them to measure the impact of their contributions and facilitate the decision on where best to direct funds.

Perhaps even more significantly, **a proportion of assets that would have traditionally be given away is now being directed towards outcome-oriented sustainable investment endeavours**. The focus is increasingly shifting towards collaboration, impact and sustainable philanthropic initiatives that can self-fund in future.

Traditional philanthropy can still be a good way to leave a legacy in a tax efficient way and there are some interesting developments in this space, such as Donor Advised Funds (DAFs), which allow donors to place money in a charitable trust or account and invest those monies while deciding which good causes will benefit. Increasing numbers of wealthy individuals are however starting to see philanthropy as only one part of their broader strategy, which also includes some form of sustainable initiatives.

You

On an individual level, disinvestment is unlikely to have an impact on stock prices or save the world's environmental and social problems. Having said that, the current trend of millions of investors wanting to fund businesses that have a positive impact is driving the direction of the market. Over time, the continual process of re-allocation of capital towards more sustainable businesses transforms business practices across industries. Civic action may have put social and environmental issues on the agenda, but without capitalism, it will not resolve them.

Whether you, as an investor, decide to actively include sustainable funds into your portfolio, chances are that as time goes by, a growing proportion of your assets will meet the criteria of sustainable investment. **If your assets are managed professionally, in house sustainability teams which are now commonplace, are undoubtfully already using some type of ESG methodology**. Some asset managers go a step further, like Schroders who have just purchased a majority stake in BlueOrchard (a pioneer in microfinance and impact investing) in order to strengthen its sustainability offering[lviii]. Many of the popular index-linked funds (including BlackRock and Vanguard) are also, to some extent, sustainably managed, through shareholder engagement. Clearly, sustainability considerations should not be the only element of stock selection, but it seems likely that eventually they will form part of due diligence of all professional investment firms.

No Good Deed...

It goes without saying that not all sustainable investments are created equal. For example, a broad-based index representative of SRI Investing outperformed the S&P 500 from 1990 to 2014, on a gross of fee basis[lix]. However, some of the socially responsible, sustainable and impact funds which are actively managed may in fact underperform the benchmark, once professional fees have been taken into consideration. This is true for many active managed investments, regardless of whether they boast sustainable credentials or not.

It is possible for low-fee passive or enhanced passive investments to incorporate ESG analysis. One way to do that is to follow one of the socially responsible / sustainable investing indexes, such as the MSCI Emerging Markets Custom ESG index, which screens out tobacco, controversial weapons and companies with homogenous boards. Dimensional's Sustainability Portfolios (which target lower C02 emissions) are another example of how ESG criteria can be incorporated into passive or near passive investment solutions. **The rise of sustainable investment goes hand in hand with the shift away from fee-heavy active management towards passive solutions which track indices**. As soon as institutional investors (such as huge pension funds) switch to passive investing, they ask for their portfolios to incorporate ESG analysis[lx]. The market for low fee sustainable investment is continually expanding, so it is expected that in time, investors who favour the low fee passive approach, but are committed to aligning their investment decisions with their values, will be increasingly well catered for.

Low fee passive investments with a focus on sustainability may be appealing to some investors, but they are unlikely to meet the needs of someone who is primarily motivated by the desire to use their finances in order to maximise impact. Other investors may feel that true peace of mind can only be achieved once they have satisfied themselves that they are not personally profiting from investments that go against their deeply held beliefs. In these circumstances, a bespoke portfolio, created following a detailed discussion with an investment professional, might be more appropriate, even if it incurs higher fees. This will give the investor a more active role in stock selection, to ensure that no compromises are made and that their investment choices are truly aligned with their values.

FAQs

I'M INTERESTED. WHERE DO I START?

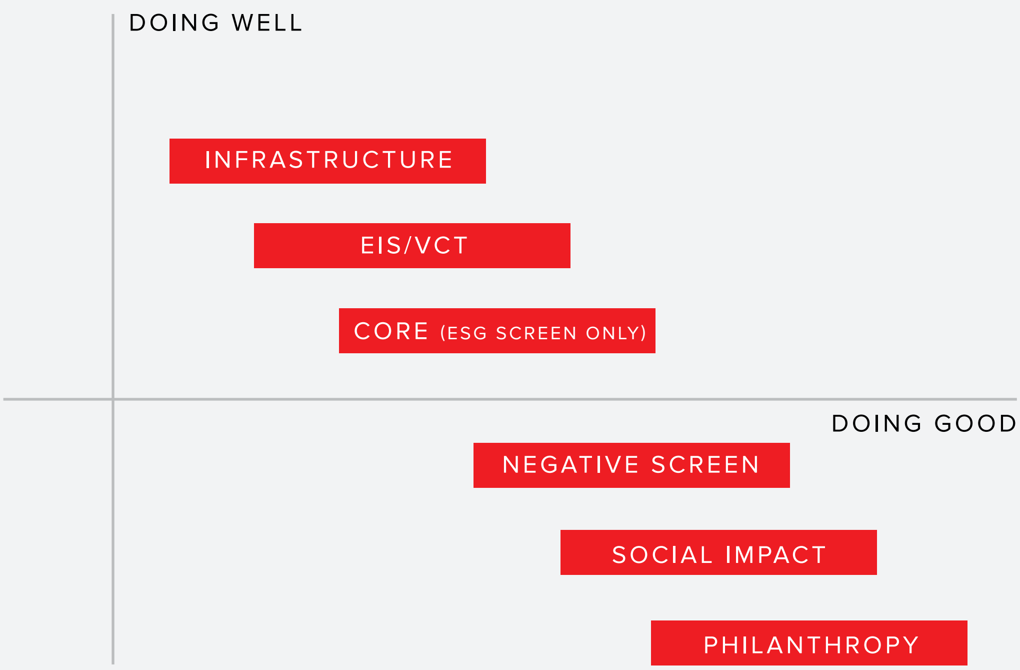
With sustainable investment, even more so than for other areas of investment, there is no one approach that is suitable for everyone. It's not only investors' aims, net worth and appetite for risk that determine which investment solutions will be most suitable, but also deeply held personal values. In response to investor demand, an entire suite of sustainable and impact investment products has been developed, so it's important to take time to assess which investment products meet individual needs.

First, define your key investment beliefs. For many investors, the process of articulating their values and peeking behind the statistics of their portfolio is the beginning of the long process of reconciliation between investment choices and personal values.

Whether you care about global warming, plastic pollution, women on the board, quality of public transport, employment conditions or affordable housing, there will be investment options available. Early on, you also need to decide where you sit on the spectrum of achieving impact versus investment returns. Once this process of self-reflection is completed, it will be significantly easier for you and your financial adviser(s) to identify appropriate investment solutions and work out how considerations of sustainability can be incorporated into your overall portfolio.

The most important thing in getting started is... getting started. Make some decisions and then review/refine/repeat.

The graph below is a high-level visual representation of a client's sustainable investment philosophy. It shows where different types of investments within the client's portfolio sit on a spectrum of financial returns (doing well) versus impact (doing good).



WHICH APPROACHES MIGHT SUIT INVESTORS JUST STARTING OUT?

The most common approach to sustainable investing, i.e. exclusionary screening, is arguably the easiest to implement, but it may not be the "best" approach for many investors if it is implemented on its own, whether someone's primary motivation is achieving impact or financial returns.

For investors who want to maximise impact, excluding certain companies from a portfolio is unlikely to feel sufficient. Impact-driven investors tend to favour impact or community investments in areas that are personally important to them, rather than simply excluding "sin stocks". An alternative to impact investments may be to look for broader sustainability-themed investment opportunities which contribute to meeting one (or more) of the Sustainable Development Goals published by the United Nations. SDGs have been adopted by 193 countries, are widely considered to produce a hugely positive impact if met and are relatively easy to use in portfolio selection (with data relating to SDGs available for many companies).

Investors who decide to go down the exclusionary route out of moral considerations would also be well advised to examine what stocks are excluded and what the rationale for exclusion is, as there is great discrepancy between different sustainable funds in terms of what is and what is not excluded. For instance, some investors might be comfortable with investing in nuclear power, if their primary objective is to reduce CO2 emissions. Others might be perfectly happy to support breweries. If that's the case, paying a premium for sustainability stocks which have excluded alcohol or nuclear, two of the most commonly excluded sectors, wouldn't make much sense.

For those who prioritise returns, focusing on best in class businesses and ESG factors, particularly Governance, is likely to be a more effective approach than excluding "sin stocks". ESG analysis is the most common framework used to evaluate funds in terms of their sustainability credentials. Funds which incorporate ESG analysis into their stock selection processes are widespread and easily accessible.

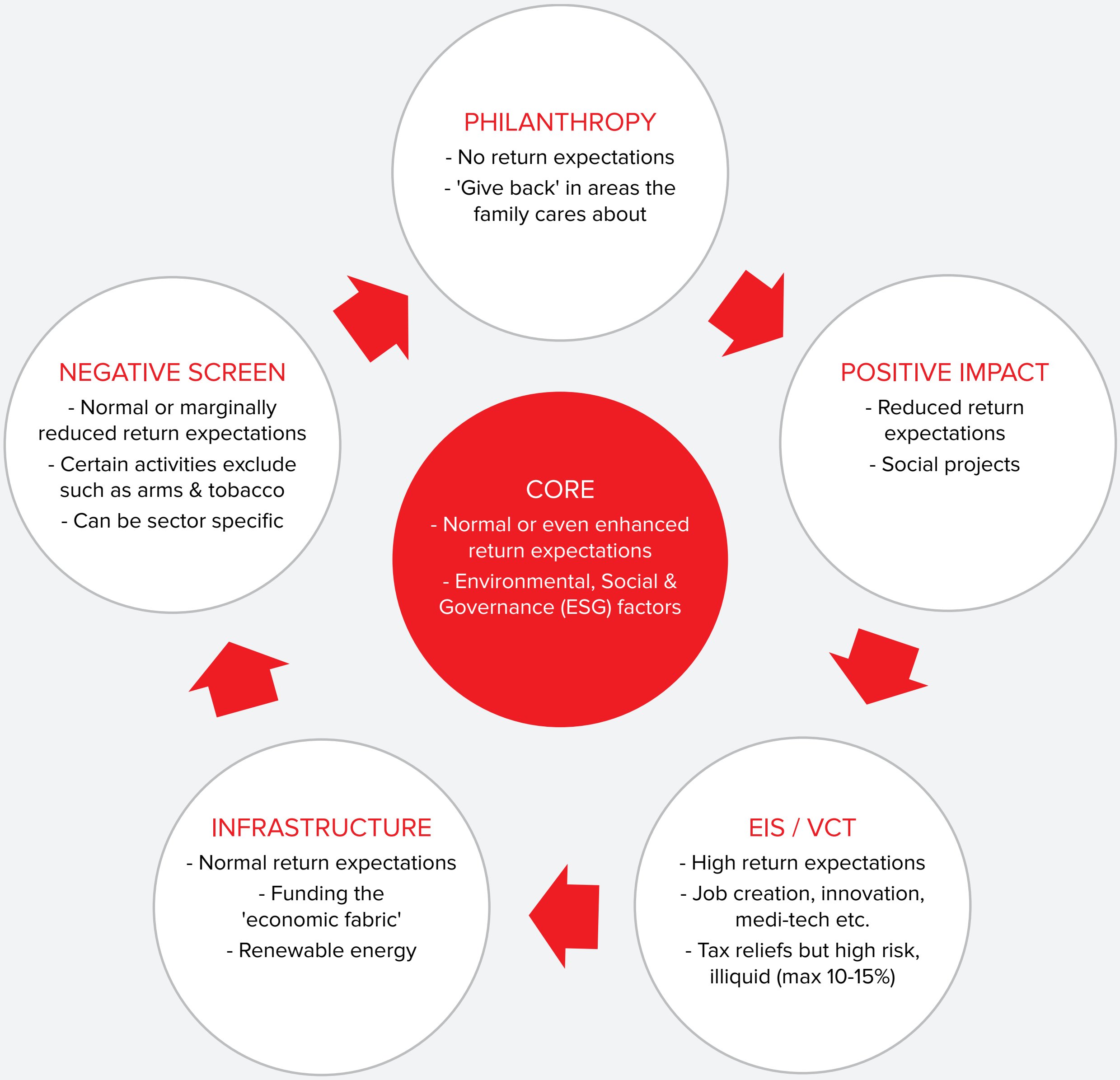
One interesting approach to incorporating an element of sustainability into a portfolio is portfolio tilting, in which the core of the portfolio is invested in a traditional way, with the rest allocated to investments with a green/ethical focus. This "light-green" approach may appeal to investors who are keen to invest more sustainably but are reluctant to make drastic changes and want to watch the area develop further before fully embracing it.

Another strategy that may appeal to budding sustainable investors with a particular interest on environmental issues is the approach called "green alpha". This consists of building a portfolio that is 20% more sustainable than the benchmark, with a 20% lower footprint for water use, CO2 emissions, waste and energy use + exclude sin stocks[lxi].

Finally, model portfolios might be a good starting point for an investor new to sustainability. These are pre-packaged asset allocation models[lxii], which help time-poor investors to invest in line with their values, whilst leaving the hard work linked to ESG analysis to institutions.

WHAT PERCENTAGE OF MY PORTFOLIO SHOULD BE INVESTED SUSTAINABLY?

In terms of the proportion of one's assets that it is wise to invest sustainably, it depends on the aims, level of wealth, risk appetite and the sustainable investment approach chosen by the individual investor. **It is now possible to go 100% sustainable, but for many investors, a hybrid approach may be more appealing**. It's also important to remember that many of the sustainable investment approaches are not mutually exclusive, so it's possible to create a portfolio that combines two or more sustainable investment strategies, often alongside traditional investments in a global market. An example of a blended sustainable investment portfolio is shown below.



WHAT ARE THE BIGGEST BARRIERS STOPPING PEOPLE FROM INVESTING SUSTAINABLY?

Sustainable investment is conceptually complicated and riddled with jargon. It also needs a period of self-reflection, with the investor considering some difficult questions. What is my money for? Can I afford to allocate some funds to an investment that will achieve an important social or environmental goal but that might bring below market returns? Are there any industries and companies that I am currently unknowingly investing in that I would never consciously choose to support? Have I got the knowledge to distinguish genuinely sustainable investment opportunities from financial products carrying the sustainable label thanks to the overenthusiastic efforts of the marketing department? A trusted professional adviser can help you successfully navigate these challenges, but it is also possible to be self-directed in this area, if you have the time and financial knowledge.

CAN I STILL INVEST SUSTAINABLY WHEN MARKET CONDITIONS ARE TOUGH?

A large proportion of sustainable investment opportunities are best suited to a long-term investment horizon. In this context, temporary market fluctuations are not particularly relevant. In addition, some studies suggest that investors applying certain sustainability criteria to their portfolio are able to weather bad market conditions better than conventional investors, with the best in class approach in particular able to deliver some outperformance compared to the benchmark[lxiii].

AS ADVISERS, WHAT FUTURE CHANGES ARE YOU KEEPING AN EYE ON?

There is an ongoing consultation[lxiv] which is being conducted by the UK's Prudential Regulation Authority, to determine whether all banks and insurance companies should appoint a senior executive responsible for managing risks relating to climate change. The FCA (Financial Conduit Authority) is also undertaking a consultation[lxv] to identify measures which would enhance "green" financial products and improve the way in which financial industry is dealing with environmentally-related financial risks. If these measures are successfully introduced, this will give a further boost to the area of sustainable investment in the UK.



JARGON BUSTING

Active investment – refers to a portfolio management strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index or target return.

AUM (Assets Under Management) – refers to the total market value of investments managed by a financial services company.

Best in Class approach to investment – the composition of portfolios by the active selection of only those companies that meet a defined ranking hurdle established by environmental, social and governance criteria.

Bond – a certificate issued by a government or a public company promising to repay borrowed money at a fixed rate of interest at a specified time/ An insurance policy held by a company, which protects against losses resulting from circumstances such as bankruptcy.

Broad market indices – serve as a benchmark for measuring the performance of the stocks or portfolios, such as mutual fund investments.

Commingled fund – portfolio consisting of assets from several accounts blended together.

Concentration risk - the level of risk in a portfolio arising from concentration to a single counterparty, sector or country.

Corporate engagement – the practice of shareholders entering into discussions with company management in order to influence or change the way in which that company is run.

Donor Advised Funds – a philanthropic fund held within a charitable organisation, which allows donor to donate and receive immediate tax relief, but defer the decision of which cause to support (and invest the monies in the meantime).

Enhanced passive investment – a fund that seeks to enhance the returns of an index by using active management to modify the weights of holdings for additional return.

Equities – Stock and shares that carry no fixed interest.

ESG integration – analysis of all material factors in investment analysis and investment decisions, including environmental, social, and governance (ESG) factors.

Exclusionary screening – process of screening specific assets out of an investment universe or strategy.

Green alpha – the premium that quantifies what proportion of total ungeared differential returns from an individual asset investment can be attributed to sustainability and energy efficiency initiatives.

Green bond – bond specifically earmarked to be used for climate and environmental projects.

Greenwashing – practice of making an unsubstantiated or misleading claim about the environmental benefits of a product, service, technology or company practice.

ICB (Industry Classification Benchmark) – globally recognised standard, operated and managed by FTSE Russell, for categorising companies and securities across four levels of classification.

Multilateral Development Bank – international financial institution chartered by two or more countries for the purpose of encouraging economic development in poorer nations.

Norms-based screening – screening of investments according to their compliance with international standards and norms.

Passive investment – investment strategy that seeks to avoid the fees and limited performance of frequent trading. Buying a security to own it long-term.

Portfolio diversification – practice of spreading investment over a number of asset types to help reduce the risk of market volatility.

Portfolio tilting – investment strategy that over-weights a particular investment style. An example would be tilting to small-cap stocks or value stocks.

Positive screening – rather than excluding companies, investors select companies that set positive examples of environmentally friendly products and socially responsible business practices.

Proxy advisory firms – provide services to shareholders (in most cases an institutional investor of some type) to vote at shareholder meetings of, usually, quoted companies.

R&O analysis – identification of what could go wrong and what might go right with a company or organization.

Securities (in the investment portfolio) – tradable financial assets, such as equities or fixed income instruments that are purchased in order to be held for investment.

Shareholder activist – shareholder that uses an equity stake in a corporation to put pressure on its management.

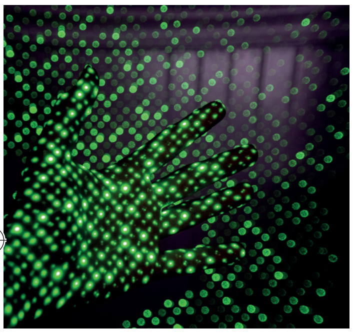
Stock selection – active portfolio management technique that focuses on advantageous selection of particular stock rather than on broad asset allocation choices.

Sustainable investment – broad term for investment approaches that consider environmental, social and governance (ESG) factors and their impact.

Tracking error – difference between a portfolio's returns and the benchmark or index it was meant to mimic or beat.

Valuation – estimation of the worth of something, especially one carried out by a professional valuer.

Volatility – liability to change rapidly and unpredictably, especially for the worse.



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