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ESG INVESTMENT - A GUIDE

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What Is ESG?

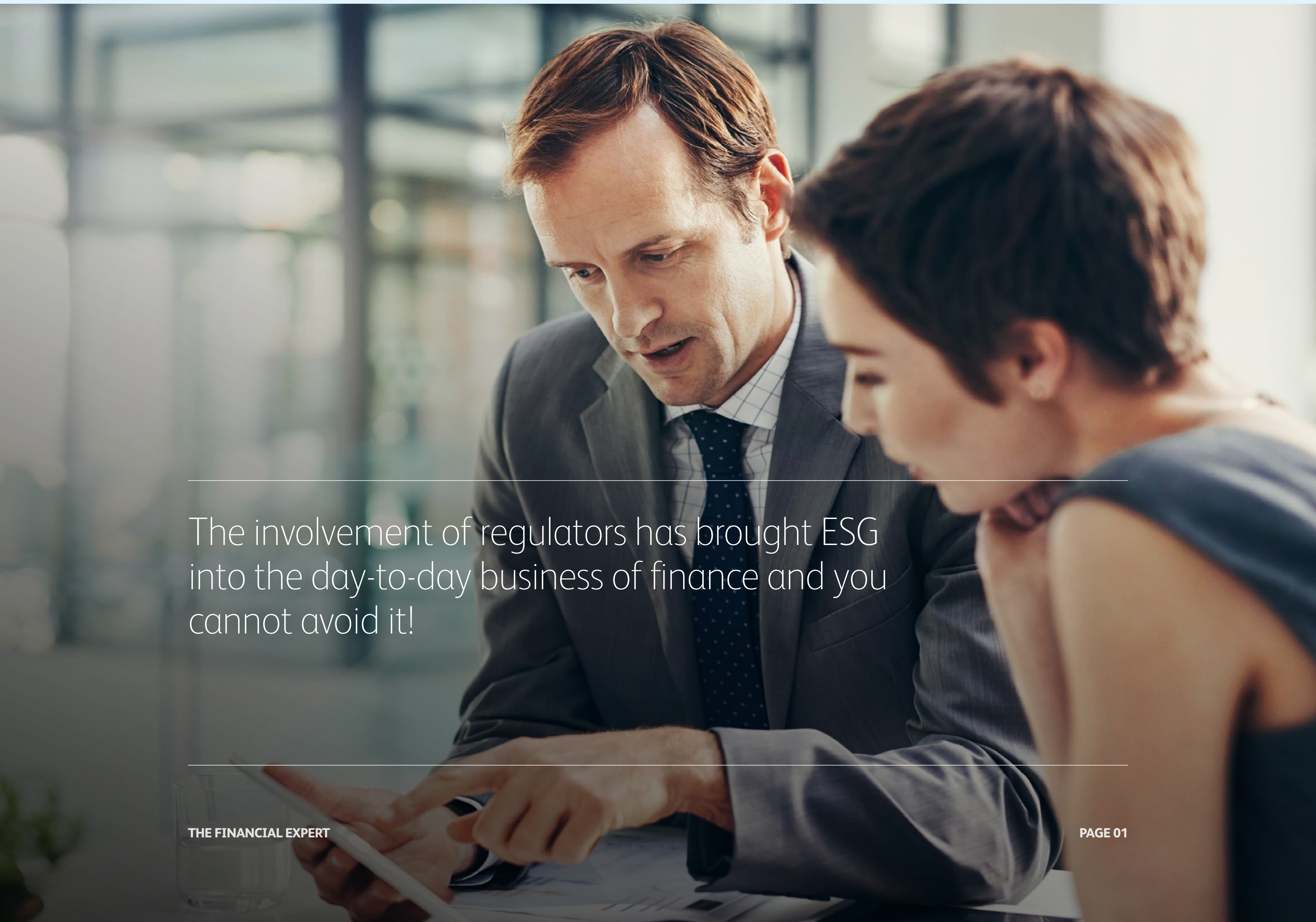
It used to be accepted that the main purpose of companies was to maximise profits and most investors were happy with that. Now, the majority of companies accept that they have broader responsibilities, and many investors have higher expectations. Formerly referred to as ‘responsible investing’, the term ‘ESG’ is now dominant and is derived from its three main strands – environmental, social and governance.

Do I Have To Know About This?

People often complain about the complexity around financial products and advice and could be forgiven for not wanting an ESG layer - with its associated jargon. However, the involvement of regulators has brought ESG into the day-to-day business of finance and you cannot avoid it! You will see it in the form of product choices presented to you and the documentation you receive.

Why Has ESG Become So Topical?

There had been a growing interest in the area over the last decade, but **the short answer is climate change**. As an existential challenge to humanity, it dwarfs all other considerations, important as they are. The evidence around climate change is now such as to have introduced a tremendous degree of urgency to the debate – and prompted greater actions by governments and regulators. It is also true that increasingly, more and more people want to ‘do right’ with their investments/pensions.



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So - What Is ESG All About?

A good place to start on ‘ESG is the UN Sustainable Development Goals; published in 2015 these were an agreed list of 17 Sustainable Development Goals, commonly labelled UNSDG. Represented graphically, the goals are

While they may seem rather aspirational, the Sustainable Development Goals provide an important point of reference for framing what is and is not consistent with ESG principles.

In short, it would not be prudent to invest on the basis that better returns are likely.

The Major Strands of ESG

Environmental

'Environmental' is the strand of ESG which attracts most attention. It addresses an investment's impact on the physical environment. At a time when climate change seems to be running out of control, the most pressing dimension of 'E' is of course greenhouse gas emissions and the quest for a zero-carbon world. But it should also embrace a much broader range of environmental issues – pollution of water, air and land, unsustainable use of scarce resources, habitat destruction, loss of biodiversity and so on.

Social

'Social' refers to impacts on people – employees, customers, suppliers, and those living near to a company's operations. There is a growing awareness that many of the goods we import from the developing world are made by workers whose pay and conditions are shockingly poor by our standards. In regions with weak rule of law, companies may also abuse local communities, through forced takeover of land and property for example. Closer to home, many businesses lack diversity among staff, and may be guilty of discrimination on grounds of race, gender or age. The past decade has seen the development of the 'gig' economy, where service workers must tolerate low earnings and uncertain conditions under the guise of being self-employed contractors.

A lot of companies – and entire industries – fall short in their treatment of people, and socially-driven investment looks to favour the companies which do better on this score.

Governance

'Governance' asks the question *'Is the company run in a way which is fair and just, conducive to good decision-making, and has proper regard to the interests of external investors?'* Examples of governance failures are all too easy to find. For public companies, potential red flags can include egregious executive reward packages, dominance by an insider shareholder, classes of shares with unequal voting rights, inadequate reporting, unbalanced board composition, and excessively long tenures by directors and chief executives.

Is ESG Likely To Mean Better Returns?

It may seem obvious that well-run companies which behave well towards their staff, suppliers and customers and do not damage the environment should perform better over the longer term. The past evidence in this regard is very mixed.

The industries on the wrong side of the trend – such as fossil fuel producers – will see higher costs, disappearing markets and progressive curtailment of their activities. However, the more unpopular the 'bad' companies become, the further their valuations will sink, and so might offer quite attractive returns for the few investors still willing to embrace them. A case in point is the tobacco industry, which provided stellar returns over the many years since it first fell from favour.

In short, it would not be prudent to invest on the basis that better returns are likely.

Will ESG Investing Lower Risk?

There is a greater basis for expecting ESG-compliant companies to be less risky. Some of the highest profile share price collapses of recent times have been associated with corporate wrongdoing. In 2015, Volkswagen AG shares halved in the wake of the 'Diesel-gate' scandal, which brought a total cost to the company in excess of €30bn. Looking to the future, investing though an ESG filter should help avoid those businesses which could lose most in the transition to a zero-carbon world.

That is not to say that risk reduction through ESG is guaranteed. Some of the more radical investment approaches can lead to high concentration in a small number of companies and sectors and the favouring of investments which demand has made expensive.

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ESG In Practice

Whether you seek out information on ESG or not, it will find you! From mid-2022, the documentation on every investment fund has to state which of three categories it falls into:

1) The fund promotes sustainability characteristics, among other characteristics; in this case it is classified as **'Article 8'** – commonly known as 'Light Green'

or

2) The fund has sustainable investment as its primary objective, in which case it is classified under **Article 9** – commonly known as 'Dark Green'

Investment products which do not qualify under Articles 8 or 9 will be classified under **Article 6**, which means that they do not claim any particular sustainability or ESG characteristics. That does not mean that they have not taken any account of ESG at all or even, possibly, to a significant degree; just that they have not gone quite far enough to warrant Article 8 status.

The introduction of this system of classification was needed to bring some order to a market in which most managers were claiming ever-greater ESG and particularly 'green' credentials – but not necessarily 'walking the walk'.

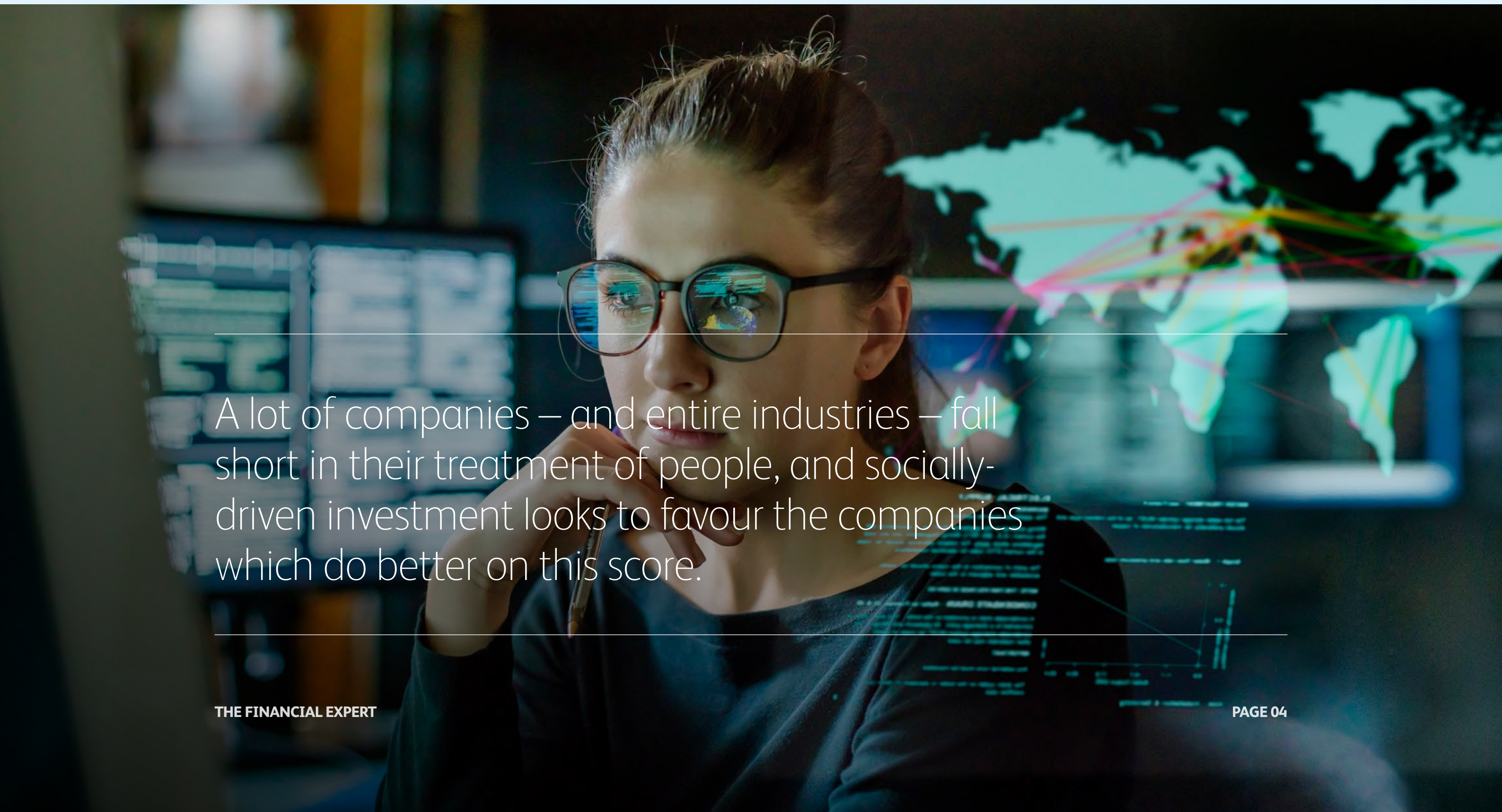
A Word of Caution – *You May Be Surprised*

The fact that a fund is classified as *Light Green* (Article 8) or *Dark Green* (Article 9) does not necessarily mean that it will meet every investor's reasonable expectations. Such funds may own companies involved in fossil fuel extraction or other activities which are damaging the planet - or which have come up substantially short under one or even a number of other ESG criteria.

In the first instance this is because many fund managers use systems of ratings which assess companies **within the sector in which they operate;** a sector-based approach leads, inevitably, to the ownership of the 'least bad' companies in all sectors including those which might be considered completely out of bounds – such as Energy, which is dominated by the big oil companies. So, a fund which you believe to be 'green' could own **Exxon** or **BP**.

The use of overall ratings based on scores derived separately under 'E', 'S' and 'G' can also lead to the inclusion of companies which surprise and disappoint investors. For example, a company which has failed badly under 'G' could have scored highly under 'E' and 'S' – with the total score being quite good.

So – outcomes may not be in line with your expectations; if you are very interested in ESG you may need to make further enquiries of your Financial Broker.



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