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What is Responsible Investing?

ESG Ethical Sustainable Responsible Impact

...Confused? Well you're not the only one. These terms are often used interchangeably and seem to mean different things to different people.

In many ways that's not surprising as the field of responsible investing has developed in a disparate fashion over many years, with little collaboration between the various fund managers and investors. Times are changing, however, and what used to be a niche area has become mainstream in a short space of time. Where investments and social/environmental aspirations used to be very separate things, they are now quite rightly becoming aligned. The importance of investing both sensibly and responsibly is increasingly seen as a non-negotiable requirement by investors and fund managers alike. The investment industry is racing to catch up, to provide funds that cater to a range of responsible investing expectations and in some cases simply to articulate the good practice that they already had in place but didn't necessarily tell us about. But we'll come on to that. First, let's rewind a bit, take a look back at where we have come from, and try to make sense of some of that jargon.

Responsible investing is nothing new. Whilst the origins of the language are slightly hazy, governance considerations (the G in ESG) seem to have first been formally taken into account in the mid 1800s, when greed and incompetence took hold during the railway boom in the UK (an early example of an 'investment bubble'), and investors suffered widespread and significant losses.

Wary of a repeat performance, investors insisted on some sort of formal check on companies, and the company audit was born, allowing investors to start to incorporate corporate governance into their analysis before investing. Responsible investing has evolved significantly since then. Fast forward to today and many of the factors incorporated in this way of investing align to very normal societal concerns – climate change, social justice and corporate responsibility for example. Broadly speaking, these types of concerns can be grouped into three categories: environmental concerns (E), social factors (S) and corporate governance issues (G).

Despite the importance of ESG in our everyday life, there is still surprisingly little consensus on language in the investment industry. This may, in part, be due to the fact that there is little in the way of regulation or common standards in this space. There are, however, some standards starting to emerge, and we welcome the Investment Association (IA)'s efforts in this regard. The language we will adopt throughout this brochure is in line with the IA's framework. We have defined some common terms below so that you can refer back to them as you wish. Please be aware, however, that other providers may use the same words to mean slightly different things. If in doubt, it's always worth asking them (or us) to clarify.

Responsible Investing

An umbrella term used to incorporate many aspects of non-traditional investing, including environmental, social, governance and ethical components. It is often focused on avoiding unnecessary risks, and should not usually involve having to accept lower returns.

ESG Integration

ESG stands for Environmental, Social and Governance. ESG integration involves looking at these factors as a fundamental part of the research and/or investment process and making sure that the expected return of an investment is high enough to fully compensate for the environmental, social and governance risks which you are taking on. Again, this is largely about risk mitigation and should not involve having to give up returns.

Stewardship

The responsible management of money to create long term value for the investor. This incorporates many aspects of investing, but is now usually taken to include ESG factors, recognising that "value" is not a purely monetary term.

Exclusions

Also known as "negative screening", this involves identifying an area, or areas, in which you are not comfortable investing and setting rules to exclude them from the portfolio. Examples might be tobacco, gambling or controversial weapons, like landmines. A fund may have one or multiple exclusions, and they may be applied for just the fund in question or across all funds which a company manages. Applying exclusions to a portfolio may result in returns which look slightly different to the wider market at times, particularly if the exclusions are extensive, but the evidence to date suggests that in the long term returns do not need to be sacrificed as long as the screening is applied skilfully.

Ethical Investing

Investing in line with an investor's personal ethical beliefs and standards. This usually involves using negative screens to eliminate investments which do not tally with the investor's beliefs. Ethical investing is personal, as everyone will have slightly different ethical preferences and beliefs, but examples might be a blanket ban on investing in companies which generate more than a certain percentage of their revenues from activities related to gambling or from tobacco products because the investor feels strongly about how these issues impact society.

Sustainable Investing

Here, ESG analysis is used to capture opportunities, rather than just avoid risks, actively seeking companies with positive ESG products, processes or services which may make them more profitable, or better placed to take advantage of emerging trends. Managers who run these types of funds will actively seek out companies who are innovating in order to improve environmental, social and/ or governance outcomes. An example might be a company operating in the renewable energy field, or one who is reducing the cost of healthcare to make it more affordable for all. Of course, investments must also stack up from a financial perspective, but these types of companies are often well-positioned for the future. There is little data on this form of investing, but early studies suggest that investing in this way should enhance returns for investors over the long term.

Impact Investing

Investing with the express intention of generating a positive impact on the environment or society. Note that this may be (although is not always) at the expense of some monetary return. An example could be investing in social housing, or in companies which offer employment in areas where unemployment is high.

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