Responsible Investment: Seeing the full picture

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What separates environmental, social and governance (ESG) investing; impact investing; ethical screening; and socially responsible investing (SRI)? While they are all unique approaches to investment, there are some areas that overlap. **SUSHEELA PERES DA COSTA** shares insight on how to navigate this complex landscape and get responsible investment governance right.

When British American Tobacco joined Lockheed Martin – one of the world's largest sellers of cluster munitions – in the Dow Jones Sustainability Index in 2017, Regnan received enquiries from perplexed investors. Many mainstream investors had just announced they were divesting from these stocks given their incontrovertible harms. How could these be among the world's most sustainable companies?

The short answer is that many different objectives and processes operate in the world of responsible investment.

The first and most important distinction to understand is a conceptual one – the difference between *value* and *values*.

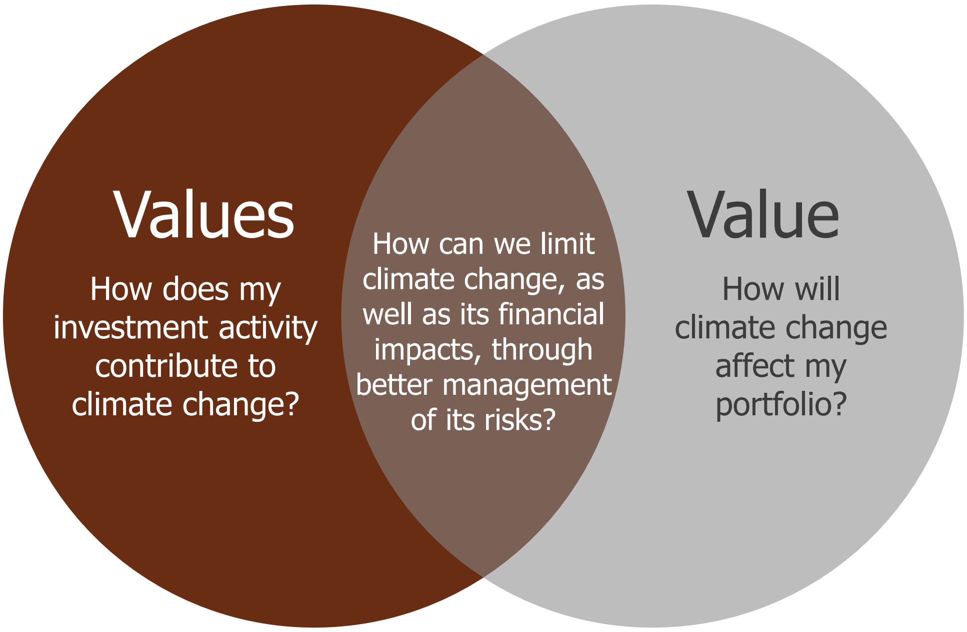
Values-based investing means including extra ('values' related) rules when investing. There are many ways to do this. It can include restricting decision making or limiting the investible universe based on a set of values, or using an investment process that gives these factors extra weight. These values may be important for members, trustees or stakeholders. Screening (ethical screens), divesting and tilting all fall into this category.

Value-based investing is different. While it covers some of the same social or environmental information as values-based investing, it uses this within its ordinary investment process to improve performance. In essence, it uses ESG to gather a more complete picture of a business' value drivers and to make better predictions about how it will perform.

There is no one right motive or method – many investment strategies involve a combination of both value and values methodology.

IMPROVING INVESTMENT PERFORMANCE – UNDERSTANDING THE IMPACT ON LONG-TERM VALUE

The idea that ESG analysis could improve investment performance is newer. It has grown with the realisation that, on average, 50 per cent of the underlying value of a company today is attributable to intangible value. Another way to think about this is the 'invisible infrastructure' a company relies on: its brand and reputation with its customers, its employee efforts and ingenuity, how efficiently it is organised for effective risk management.



Markets are not good at processing this kind of qualitative information. Share prices often get a sudden boost when a company announces large scale reductions in staff numbers, ignoring what this means for future performance, when fewer staff might mean unhappier customers, sluggish innovation, problems with products or compliance. A company's impact on employees, local communities or the environment can also mean future profits may be hindered by regulation, a poor reputation affecting sales, or from problems in securing funding.

It is worth noting that many funds are already taking climate change risk into account in their portfolio. While climate change presents wide ranging risks over the long term, it is one of many ESG factors that funds need to consider.

VALUES OR VALUE – HOW TO CHOOSE?

Both strategies are legitimate and serve different purposes. Values strategies are more likely to arise from community, member or stakeholder feedback, or trustee beliefs; while value strategies owe their popularity to their financial potential and/or fiduciary lens.

Since it is a fiduciary's responsibility to monitor *all* risks – including long-term risks that financial markets tend to ignore, the real choice is whether or not to apply a values strategy *on top of* the value strategy.

VALUES VERSUS VALUE: THE LITMUS TEST

Good investment governance means trustees must know what the different strategies mean. The first step is to ask the following questions:

Q – Is the impact *of* the investments the main focus?
Yes = values basis

Or, is the main focus the impacts of these issues *on the* investments?
Yes = value basis

Following the tragic deaths of more than 1,100 people in the collapse of a garment factory in Bangladesh in 2013, Regnan received two very different client calls.

One rang to check that its values-based ESG research took account of how responsibly Australian companies managed their supply chains. The other call, from a client of Regnan's value-based ESG research, wanted a second opinion on their own analysis, which predicted little impact from this issue for Australian retailers.

New regulation, changes to consumer behaviour, or security of supply were unlikely to become problems for the Australian retailers Regnan reviewed. It was corporate responsibility that would drive many Australian retailers to support improved health and safety practices in their supply chain.

Importantly, there was no contradiction in Regnan saying "yes" to both clients. Regnan's analysis recognised that the *impact of* retail industry practices on people working in the garment supply chain was significant. However, this impact was asymmetrical; the *impact on* Australian retail companies of labour conditions in their supply chain was not.

Many providers claim their approach does both simultaneously. This is possible (though rare) with a disciplined approach that handles each strand separately. Just as often, this claim is a combination of spin and wishful thinking. Fortunately, it is easy to test.

When considering strategies, products, frameworks or providers, funds should ask for examples of responsible investment decisions that were made; drill down on the *reasons* for these decisions (for example, a decision to sell down a stock) and focus most on the cases where value and values angles *differ* (such as the garment factory example, above). Then consider:

- Do the reasons include a statement of a clear moral position? If such a statement is vague, weak or ambiguous, it is likely that the values are not a driver of decisions.
- If the rationale given is an economic one how robust is the risk analysis, returns impact or business case that underpins it? If the goal is enhancing investment performance, mere mention of these isn't enough – the analysis must stand up to professional scrutiny.

PRACTICAL APPLICATIONS

Where a strategy is only about investment performance, it will integrate ESG information into its financial analysis, rather than using a rule to apply directly within the portfolio.

In contrast, because values-based funds are *supposed* to make decisions independent of financial matters, they need clear-cut policies. But there are different ways in which these rules can be applied – even where they apply the same thresholds and boundaries (e.g. in the tobacco example above).

Responsible Investment strategies may mix and match any of the following:

- Acting on fundamental features (e.g. what industry the company is in), or act on corporate behaviour (e.g. fines, recognition as a 'leaders').
- Exclude 'bad' companies or industries, or build a portfolio of only the 'good'.
- Adjust holdings or adjust portfolio weightings.
- Judge companies relative to others (e.g. the most responsible tobacco company) or in absolute terms.

Responsible investment strategies are as varied as their clients. Best practice fiduciaries need to be apply care and diligence to understanding the responsible investment approach, and determining its suitability to the objectives. Effective investment governance requires knowing how well internal investment teams and external fund managers understand ESG impacts on long-term value, as well as any 'values' to be applied. It is also critical to securing the best retirement outcomes for beneficiaries.

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Regnan was established to investigate and address environmental, social and corporate governance (ESG) related sources of risk and value for long term shareholders in Australian companies.

Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors in S&P/ASX200 companies.