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An investor's guide to

SUSTAINABLE INVESTING

In association with

Aberdeen Standard Investments

BM BROOKS MACDONALD

PICTET 1805

Guide edited by **John Lappin**, leading industry commentator

What exactly is ESG?

ESG stands for environmental, social and governance and describes an approach to investing which takes each of these factors into account when selecting assets and constructing investment portfolios.

As an investor you may wish to know when and how these factors are taken into account particularly as an increasing number of asset managers are adopting an ESG approach.

It can take the form of funds and investment solutions which are explicit about taking a sustainable approach and may well be labelled as such using terms such 'sustainable', 'ethical' or 'impact'.

At the same time, many fund managers are including ESG in their thinking and approach to investing overall. This aspect of ESG is generally known as 'ESG integration'.

Much of this latter change has been driven by institutional investors such as pension funds where scheme trustees, working on behalf of scheme members, are concerned about sustainability.

However, this is not a matter of focusing on ESG instead of financial performance. Fund managers are now much more likely to believe that ESG can help drive returns and allow them to manage risks because the companies selected are often better run and less likely to suffer from reputational damage due to scandals and governance failings.

The subject goes right to the heart of what investing is or could be for. If you invest to grow or manage your wealth or income then ESG factors are important. But if you wish to invest for a wider purpose, investing for "good" for example, then ESG considerations will be paramount to you.

In this guide, we will take a brief look at what each letter means and some other important terms, consider the regulations and the global context and suggest a few things you may want to talk about and questions you may want to ask your financial adviser or planner if you are interested in the concept.

Laurent Ramsey

Managing Partner and CEO, Pictet Asset Management

ESG as an investment

The environmental products and services industry is already firmly in the ascendancy. It is currently worth some USD2 trillion and is growing at an annualised 6 to 7 per cent – double the rate at which the world economy is expanding. The number of patents filed for environmental technologies have more than tripled over the past decade to some 20,000 per year, according to the World Intellectual Property Organisation.

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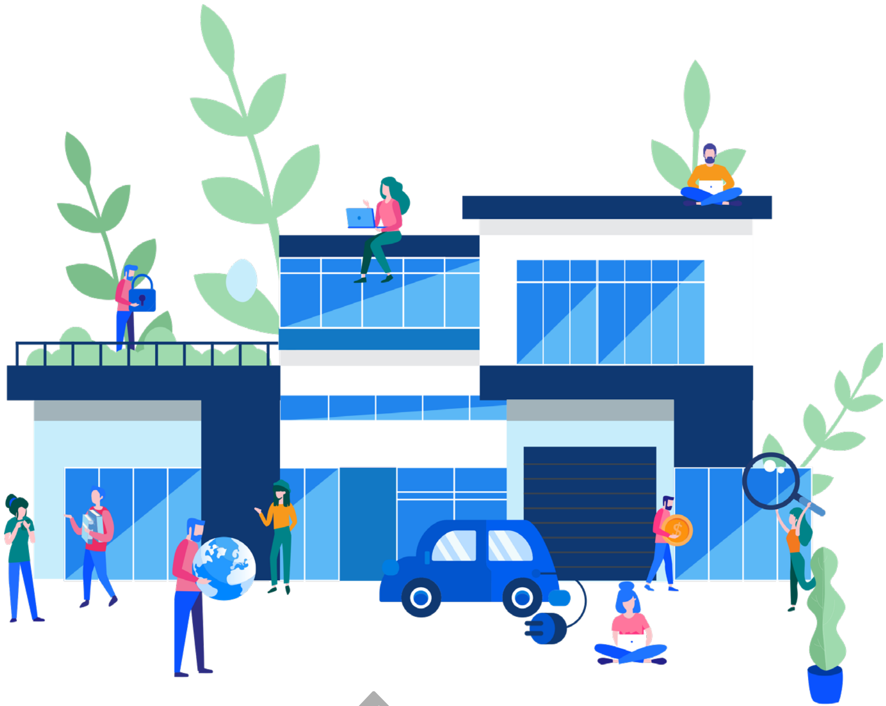

Section 1
ESG definitions

The environmental, social and governance factors are often deployed together and to some extent can overlap with each other.

The three letters do provide a very good starting point to the ESG approach. So below, we look at the definitions for each and then consider some of the other terminology in the next section.

Environmental

The environmental criteria include everything from focusing on a firm's carbon footprint to examining a company's approach to managing pollution, reducing the use of single use plastics and helping with conservation. A fund manager can exclude companies who fail on these criteria but also encourage them to perform better on these measures.

It also covers firms which are devising solutions to environmental challenges such as the renewable energy sector or firms seeking solutions to waste management or supplying clean water. It could even include investing in established energy firms where they are moving to renewable energy. If this is an area of concern to you, then the key is to work with your adviser to really understand what kind of approach a fund manager is taking.

Social

Social factors are what is broadly described as a company's business and societal relationships so, for example, whether a company's approach to working conditions shows a high regard for its employees' health and safety. It may involve asking whether stakeholders including employees, customers, suppliers and local communities' interests are taken into consideration.

Governance

The Governance criteria are likely to appeal to the broadest group of investors, simply because they are fundamental to a firm's operation. Those focusing on governance will want to know that a company uses the appropriate accounting standards, fully meets the required standards for selecting board members, fully manages conflicts of interest and is transparent about all these and other management practices. We think it is an increasing issue in the United Kingdom given recent corporate failures.

Other significant terms to look out for

Screening

When creating ESG-based portfolios, fund managers will often apply screening which will remove certain stocks from those they select from. A very strict screening process could inhibit financial performance, but most managers assert that it can help drive performance and that screening means they are screening out risky investments as well.

Overlays

An ethical or ESG overlay may be applied across a wide range of portfolios and indeed across the complete fund group to remove or reduce exposure to certain types of investments.

Tilts

An ESG tilt will position a portfolio to be overweight in certain types of stocks and underweight in others. It could weight a portfolio to a certain type of stock. We have seen one fund, weighted to firms with a better gender balance, for example.

Thematic ESG investing

This refers to specialist investment strategies within ESG. Themes might include water and waste management, energy efficiency and climate change mitigation solutions. Social themes could include supply chain management, while governance themes could include diversity on the board of a company.

Socially Responsible Investing

This is an investment strategy which seeks to consider both financial returns and social good but is increasingly replaced by ESG to describe the approach more generally. It can involve a best in breed approach to various sectors.

Stewardship and Engagement

This is where a fund manager will talk to the company and engage with it sometimes using votes at the Annual General Meeting to encourage or sometimes disapproving of certain measures or actions.

It has been used to encourage oil and mining companies to consider their carbon footprint for example.

Impact investing

The World Bank definition of Impact investing runs as follows – it involves investments made into companies, organisations, vehicles and funds with the intent to contribute to measurable positive social, economic and environmental impact alongside financial returns. There is a debate about how much emphasis there is on returns. At one stage, impact carried a suggestion that it was philanthropic and that returns were secondary. We think this is changing rapidly with an at least equal focus on performance. Once again it is something to talk about with your adviser or planner.

An ESG approach to bonds and other investments

While ESG is often seen as primarily an approach to investing in equities, it's also being adapted to the bond market as well. There are two main characteristics to this approach. The first is investment in credit labelled as ESG or green and used to fund investment in these areas.

The second involves an ESG approach towards general bond investing which uses many techniques such as screening and tilting. ESG-minded bond managers believe that ESG strengthens the financial evaluation of their investments in credit.

A similar approach can be taken to other assets such as investments in infrastructure, or property.

Mary-Therese Barton

Head of Emerging Market Debt, Pictet Asset Management

On research on bonds

Advisory services and rating agencies have responded to the growing demand for sovereign-based ESG analysis. And that's likely to grow as investors see direct evidence of a relationship between how sovereign states rank on various ESG criteria and how their bonds perform.

Integration

ESG integration means appling much of the thinking and techniques of ESG to broader investment analysis and stock selections. Many big fund management groups are doing this now.

Cindy Rose

Head of ESG Clients and Products, Aberdeen Standard Life

On integration

There is an opportunity to make these businesses accountable. You need to ask about two things. Do you integrate ESG into your fundamental investment processes. If not, you don't have to ask anything else. If the answer is yes, you need to know how, the process, the time horizon, the implications.

Section 2
ESG in the UK

Although elements of ethical investing have a very long history in the UK stretching back to the 19th Century with religious foundations and philanthropy in the lead, the concept has undergone a radical transformation in the last five years or so.

It has moved from a concern purely for activist investors out into the mainstream.

ESG is now firmly embedded either as a speciality within many asset management firms or sometimes applied across the full range of investments, funds and solutions. Clearly firms have their own methods of organisation, but ESG teams are frequently consulted and work with other fund management teams through analysis and advice.

ESG can now help asset managers in their approach to equities, bonds and credit markets and infrastructure. It also straddles both passive and active investment where the larger passive managers investing in various indices can exercise influence through engagement with company boards.

We have also seen a rise in asset managers styling their approach as “impact investing.”

It has come at a time when many businesses are also promoting their ESG credentials in terms of corporate responsibility, their attitude to the environment and more. Managers want to be able to distinguish between firms with a genuine commitment to ESG and business performance and those where an ESG approach is at best a nice-to-have.

It has come a long way since early 1984, when the UK saw the launch of the first explicitly ethical fund the F&C Stewardship Growth Fund while the 1990s and 2000s saw the launch of many more green-tinged funds.

Yet they remained a relatively specialist area. Things are starting to look very different first with the embrace of the acronym ESG which really came of age with the publication of six principles for responsible investing by the UN in 2006 (included later in this Guide) and which have been built on since then.

Yet it is the last five years that have seen dramatic developments with a much wider incorporation of ESG ideas.

At the same time, it remains important to distinguish between philanthropy, impact investing and broader ESG-style investing demanded by pension funds and increasingly investors in the retail market. It does not necessarily involve a trade-off between doing good and achieving returns. It also provides tools to manage downside risks.

Clearly, ESG does not operate in a vacuum from real world economic and market events.

Some of these disciplines have allowed fund managers to avoid certain high-profile corporate reverses and even business failures. A few have even gone public to say the ESG approach has seen them steer clear of problem stocks including those that had a previously unblemished reputation with the wider public.

Section 3
Big changes in regulation

There has been a great deal of focus on global events but there have also been important changes in a host of UK regulatory bodies. We take a brief look at this below.

Perhaps the most high-profile proponent has been Mark Carney, the Bank of England Governor. He has a nuanced view – worried about climate change and concerned that if we move too swiftly it could have financial implications for asset prices.

But other regulators are also concerned.

The Prudential Regulatory Authority wants banks and insurers to start publishing more information about their strategy for climate change.

The Pensions Regulator is asking that employer pension schemes consider ESG factors. The Financial Reporting Council is demanding that institutional investors consider similar issues.

One key change being asked for by the European Union is that financial advisers across the EU be required to ask clients about ESG as part of the suitability process. Obviously with the UK's future relationship with the EU up for debate, it isn't clear this will become a requirement from the Financial Conduct Authority, but a lot of experts believe that the UK will not want to fall behind, so even if the UK and EU rules diverge elsewhere, they believe this is likely to be a requirement.

All these powerful regulators are demanding more action, more transparency and better management of these kinds of risks. They are not suggesting that they would force investors to only invest this way. But when you do invest, you, your adviser and the asset managers should be better equipped and have access to a lot more information and these ESG related regulations will begin to have an impact.

Ben Palmer

Investment Director and Head of Responsible Investment Research, Brooks Macdonald

On government and regulatory influence

Clearly governments want to support sustainability. That will help some business, and it will create headwinds for others and more broadly we would say that positive ESG factors can act as instructive indicators of a company's longer-term outlook.

As for the regulator, as part of the Europeans Commission's Action Plans on Sustainable Finance, draft rules have been published on how investment firms should take sustainability issues into account when advising clients. The European Commission believes advice can play a central role in reorienting the financial system towards sustainability.

Ben Palmer

Investment Director and Head of Responsible Investment Research, Brooks Macdonald

On suitability

Advisers need to start thinking about how they are going to engage with new ESG requirements now. Changes to MIFID II will make it mandatory for firms providing investment advice and portfolio management to introduce questions into their suitability assessment to identify ESG preferences, offer products and services that correspond to those ESG preferences and report to the client on how their ESG preference has been taken into consideration.

Section 4

Real world developments that may change the ESG debate

We take a look at some developments that may influence the context of ESG investing below.

1 Norway divests from most oil exploration

The US$ 1 trillion (£770bn) Norwegian Sovereign Wealth fund backed by Norway's politicians is taking its investments out of many oil explorers and producers partly driven by concerns about being overexposed to the oil price.

The report

2 BP and Glencore agree to look at 'stranded assets'

Shareholders have campaigned for global firms to consider their carbon footprint particularly associated with new mineral finds and to consider how they transition away from CO2 intensive mining and oil. Two FTSE giants Glencore and BP have agreed to do so.

Share Action's website concerning BP

Church Commissioners' press release regarding Glencore

3 The Investment Association consults on ESG terminology

The trade body for fund managers in the UK is exploring ways to describe ESG investing so that investors and their advisers can better understand what it means including standard definitions.

IA launches first industry-wide consultation on sustainability & responsible investment

4 Members of big pension funds such as the Legal and General Master Trust default fund are beginning to show support

L&G recently assessed its members' opinions on ESG with 60 per cent supporting a move towards using ESG factors though members also said they did not want to sacrifice performance. The firm has now applied an ESG tilt within the default fund used for auto-enrolled workplace pensions.

L&G master trust default goes green due to member demand

5 Many of the world's corporate reporting bodies are cooperating to create global reporting standards for firms to demonstrate progress towards meeting the UN's Global Development Goals.

A new report from the International Integrated Reporting Council is aiming to identify how corporate reporting can illustrate which specific Sustainable Development Goals (SDGs) are relevant to a company's business model to help investors. It is all quite technical, but it does give advisers and fund managers the chance to get to grips with this technical information.

The Sustainable Development Goals and the future of corporate reporting

6 Demand growing for more 'social' information

We are seeing other important moves on standards. The International Organisation for Standardisation has completed work on a human capital reporting standard ISO 30414. These standards apply to all sorts of things from electronic devices to financial planning. It looks like there will be more information to empower investors.

7 EU aims for action on plastics

Last year, the EU began to set out plans to restrict single use plastics focusing on the top ten items found polluting Europe's beaches. It has now beefed up a 2011 directive to increase regulation. Single use plastic has also entered public consciousness in the UK with Collins Dictionary making it word of the year in 2018! In the UK there is some talk of taxing single use plastics.

EU directive

'Single-use' has been named word of the year 2018

8 Economists win Nobel Prize for work on climate change in 2018

William D. Nordhaus who has advocated for a carbon tax and Professor Paul M. Romer who believes that governments can make a key contribution to climate change jointly won the Nobel prize for economics in 2018.

2018 Nobel in Economics Is Awarded to William Nordhaus and Paul Romer

Laurent Ramsey

Managing Partner and CEO, Pictet Asset Management

On the Nobel award

The Laureates Paul Romer and William Nordhaus have, respectively, devoted their careers to understanding why the world economy grows and whether it can continue to do so without causing irreparable harm to the planet, issues that cut to the heart of sustainability.

The Nobel jury and the UN's climate change panel delivered a clear message to investors. Without the investment community's commitment to the cause, the battle to protect the world's natural resources will be lost.

Investors matter because they have the power to withhold or withdraw capital from businesses that fail to take their environmental responsibilities seriously.

On the asset classes covered

At ASI, we integrate the consideration of key, material ESG related risks and opportunities of assets into our investment processes for equities, fixed income, real estate, private equity and infrastructure. We undertake this type of assessment because it helps us make better informed investment decisions for our clients around the globe. We look at our investments and do not separate ESG related issues from financially related issues, but look at these holistically, since all material issues impact our investments. As part of our stewardship platform, we undertake rigorous engagement with our holdings as well as vote our proxies, whereby upholding our active investor perspective.

Cindy Rose

Head of ESG Clients and Products, Aberdeen Standard Life

Section 5
The global context - the UN and more

We do not have space to cover all the details of the UN initiatives designed to drive global development and wellbeing, but they do underpin much of the work towards ESG with a huge emphasis placed on the role of the global investment industry.

The ESG definitions rely on what are called the Six Principles for Responsible Investment created in 2006 with signatories from some of the hundreds of the world's biggest institutional investors.

We list them below:

1 We will incorporate ESG issues into investment analysis and decision-making processes.

2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.

IN 2015/2016, the UN put together its 17 Global Development Goals, which are influencing a lot of ESG thinking.

These are - No Poverty. Zero Hunger. Good health and wellbeing. Quality education. Gender equality. Clean water and sanitation. Affordable and clean energy. Decent work and economic growth. Industry, innovation and infrastructure. Reduced inequality. Sustainable cities and communities. Responsible consumption and production. Climate action. Life below water. Life on land. Peace and Justice with strong institutions. Partnerships to achieve the goal.

What may be of most interest is that the website of the Principles for Responsible Investing group makes a strong investment case as well as what might broadly be called a humanitarian one.

It suggests the SDGs can help fund firms identify and minimise risks to their investments and identify firms that are managing the transition to lower carbon technology better but also coming up with positive solutions.

Managers say that new sources of information are allowing them to develop and hone their approaches. We think this is an important context, but most investors will want to know what exactly an investment firm is going to do too.

Section 6

Are you the sort of investor who might be interested in ESG?

We have suggested briefly the sorts of investor or saver who might be interested in ESG just to prompt a few thoughts from you. Obviously you will ultimately know best!

You may be a typical investor but would like to talk about how you might secure returns without investing in firms with a poor record on pollution or social or governance failures.

You may want performance first but want to know if you can embrace ESG without sacrificing any gains.

You may want to know about how ESG can help you avoid, reduce or manage risks.

You may want to discuss how fund managers can encourage better behaviour with better engagement with the firms they invest in.

You could be very committed to ESG and want to find specialist managers and be prepared to sacrifice a little performance.

You may want to discuss how ESG is impacting on the investment industry more generally to understand why ESG techniques are increasingly underpinning mainstream funds and approaches.

Section 7

Some questions to ask

We also considered a few questions and very brief answers below but our intention is to help inform a discussion you might have with your adviser.

? Am I sacrificing performance or not?

Most fund managers would argue that you do not have to unless you have a very tightly defined universe of stocks. Your adviser can talk about this further in terms of evidencing this.

? How does it fit when I am building a portfolio or when I have started to take an income?

ESG puts great emphasis on the reliability and sustainability of its stocks but your adviser's help will be crucial in understanding how it fits into a portfolio appropriate for you.

? What if I have particular concerns say for example the treatment of animals?

You can source funds that should be able to help you avoid these concerns. Many ethical funds avoid firms with a poor record in these areas.

? What if I want to invest in companies that are trying to improve their record?

A host of managers engage with firms in this way including for example distinguishing between the oil majors who have or have not embraced renewables.

? Does it fit all types of securities?

In general, yes with different approaches to shares, bonds and, for example, infrastructure.

? What if I want to invest philanthropically?

That is a very different approach where generally the return is less of a concern. It could involve a portion of a portfolio where you may have built up wealth and want to put something back. It is very important to be clear from the outset what you are aiming to achieve.

? Is it generally the younger generations investing this way?

Actually, advisers and fund managers say that while there can be more demand from younger generations, all ages are increasingly expressing concerns and interest.

Ben Palmer

Investment Director and Head of Responsible Investment Research, Brooks Macdonald

On changing generations

We are heading into an unprecedented period of intergenerational wealth transfer and as baby boomers increasingly pass their wealth the rate of transfer will only increase, beginning a trend that will continue to develop for many years. It is also clear from investor studies that the percentage of clients who want to reflect their values around sustainability and responsibility in portfolios is growing, and pleasingly there is also a growing body of evidence disproving the old belief that reflecting these principles will inherently be detrimental to investment returns.

? Does ESG investing involve a different kind of advice?

Actually no. All the other good things about financial advice, planning and investment apply. Your adviser will talk to you about your attitude to risk, your existing assets and your goals in life to help create a financial plan and recommend an investment solution. ESG should be complementary to this.

? What if I only want to invest in say the E, the S or the G?

Funds are likely to be available to do this, but it is important to talk to your adviser to understand what you are trying to achieve overall and then factor your particular concerns into your plan.

Section 8

Useful links

- The EIRIS Foundation: campaigning for better environmental information
- Investopedia definitions
- The Morningstar section on ESG investing
- The UN's Development Programme's sustainable development goals
- The UN Principles for Responsible Investing
- UN PRI investor tools (generally aimed at fund firms)

Aberdeen Standard Investments

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Brooks Macdonald

Our Responsible Investment Service (RIS) is designed for clients with the dual objective of responsible investment and return generation in line with defined risk profiles. We offer two distinct Responsible Investment strategies: **Avoid** and **Advance** and the service is available via professional advisers both through our Bespoke Portfolio Service and on select platforms.

RIS is integrated into our centralised investment process. This ensures that same level of due diligence, monitoring and accountability is applied across all investments. This is extremely important as the Responsible Investment Service is designed to offer the core expertise of Brooks Macdonald, while additionally meeting your responsible investing requirements.

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Pictet Asset Management

We are convinced that Environmental, Social and Governance (ESG) considerations can help us make better long-term investment decisions for our clients.

For decades, sustainability has been central to our way of thinking. Since the Pictet Group was founded in 1805, we have aimed to ensure the prosperity of our clients over the long term. In doing so, we have instinctively considered the interests of future generations.

Pictet Asset Management believes in responsible capitalism and takes an enlarged view of the economy and its interactions with civil society and the natural environment.

Consistent with our fiduciary duty to act in the best interests of our clients and our adherence to the UN Principles for Responsible Investment (UN PRI), we are committed to integrating material ESG criteria in our investment processes and ownership practices with a view to enhance returns and/or mitigate risks. We also aim to embed ESG in our risk management and reporting tools in order to maintain high standards of transparency and accountability.

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The Adviser Home Investor's Guide to Sustainable Investing is intended to appeal to investors wanting to understand more about ESG. It does not constitute advice or guidance and all investors should discuss the subjects raised with their financial adviser or planner.

Past performance is not a guide to the future

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