ACUMEN
FINANCIAL PARTNERSHIP LTD

KEY GUIDE

# ESG investing

# Introduction

## BUILDING A PURPOSEFUL PORTFOLIO

The debate on environmental and social issues and the scale of concern about environmental change have escalated in recent years and now permeate many areas of life, including the asset management industry. Climate change and the vulnerabilities exposed by the Covid-19 pandemic have undoubtedly pushed sustainability concerns to the front of the investment agenda.

The asset management industry has launched a flurry of new environmental, social and governance (ESG) funds while also adjusting the investment strategies of existing funds. What was once considered a niche investment area has gained growing attention not just in the UK but globally as well, with ESG-type funds seeing such large inflows that Bloomberg suggests that assets under management could exceed US$50 trillion by 2025, approximately one-third of the projected assets under management globally.

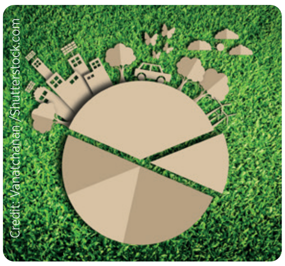
In this guide, we start with explaining what ESG involves and then look at the questions you should ask yourself if you are considering an ESG investment. We introduce the range of different investment strategies that are available, what factors to consider when selecting funds and the pitfalls to avoid.

# Contents













Credit: Vanatchanan / Shutterstock.com

# ESG defined

ESG stands for 'environmental, social responsibility and governance' and is a relatively new term that is being used to describe investment strategies that take these factors into account. In simple terms, ESG considers factors other than strictly financial criteria when evaluating companies to determine whether they are acceptable investments.

In the investment industry, the expressions ‘ethical investment’, ‘environmental investment’, ‘green investment’, ‘responsible investment’, ‘socially responsible investment' and ‘sustainability’ are all used in relation to ESG.

As ‘sustainable investment’, ‘responsible investment’ and ‘ESG investment’ are often used interchangeably the table below shows definitions of sustainable and responsible investment by three major bodies. Other labels exist but a common theme underlying these particular terms is an emphasis on how ESG issues are factored into investment strategies.

| | |
|---|---|
| United Nations | The UN describes responsible investment as an approach that considers environmental, social and governance (ESG) issues when making investment decisions and influencing companies or assets and sustainability as the positive or negative effect of investment activities on people and the planet. |
| Investment Association | In November 2019, the Investment Association issued a Responsible Investment Framework for UK investment funds, which demonstrates the increasing importance of this area. The term ‘responsible investment’ was selected to reflect the broad range of approaches that can be adopted and provide a common language that can be used to provide greater clarity in time to investors and advisers. |
| Eurosif | Sustainable and responsible investment is a long-term investment approach which integrates ESG factors in the research, analysis and selection process of securities within an investment portfolio. |

| Environmental | Social factors | Governance |
|---|---|---|
| This considers how a company's activities impact on areas such as climate change, depletion of natural resources, pollution, deforestation and bio-diversity. | This takes account of the impact that companies have on the societies in which they operate in areas such as working conditions, human rights and employee relations. | This looks at how a company manages itself in areas such as bribery, tax evasion and executive remuneration as well as how it undertakes internal control. |

Sustainable investors, and increasingly, traditional investors, consider ESG issues when making investment decisions. Examples of ESG factors are shown below.

| Environmental factors | Social factors | Governance factors |
|---|---|---|
| • Climate change and carbon emissions<br>• Air and water pollution<br>• Biodiversity<br>• Deforestation<br>• Energy efficiency<br>• Waste management<br>• Water scarcity | • Customer satisfaction<br>• Data protection and privacy<br>• Gender and diversity<br>• Employee engagement<br>• Community relations<br>• Human rights<br>• Labour standards | • Board composition<br>• Audit committee structure<br>• Bribery and corruption<br>• Executive compensation<br>• Lobbying activities<br>• Political contributions<br>• Whistleblower schemes |

*Source: Environmental, Social and Governance Issues in Investing: A Guide for Investment Professionals. CFA Institute.*

## ESG INCORPORATION

ESG incorporation means considering ESG issues alongside fundamental analysis and incorporating these into sustainable investment strategies.

Individual investment funds may place more focus on one area within ESG than another and approach how they select investments differently. For example, they may concentrate on specific areas such as climate change or renewable energy or take a more general investment approach and exclude companies that do not match up to their standards for working conditions.

Examples of different strategies are shown below.

| Best in class | Engagement and voting | Norms-based screening |
|---|---|---|
| Selecting companies for investment that are leaders in their industry in terms of environmental, social or governance criteria. | Actively engaging with companies on ESG issues to influence their behaviour and encourage positive outcomes. This can involve voting on important sustainability topics. | This looks at how a company manages itself in areas such as bribery, tax evasion and executive remuneration as well as how it undertakes internal control. |
| **Exclusions** | **Sustainability themed** | **Impact investing** |
| Avoiding investments in companies or industries that are harmful to the environment or society like oil, coal, weapons, tobacco, etc. | Investing in themes contributing to the development of sustainability, such as sustainable agriculture, green buildings, reducing carbon emissions, promoting gender equity and diversity. | Investing with the intention to generate positive, measurable, environmental or social impact, alongside expected financial returns. |

*Source:Eurosif*

These strategies involve screening potential investments to find those that meet the criteria the investment fund is following. Screening for ESG criteria can typically take two forms – negative screening or positive screening.

| Negative screening | Positive screening |
|---|---|
| • Portfolios are constructed to avoid areas of investment that are considered to have significantly adverse effects on people, animals and the environment.<br>• Fund managers screen potential investments against negative or avoidance criteria, using their own research and screening tools.<br>• This screening typically results in a larger than normal percentage of the portfolio being invested in smaller companies. | • Funds implement this approach by either using positive sector selection or choosing the best in sector.<br>• Positive sector selection chooses companies that operate in sectors likely to benefit from the global shift to more socially and environmentally sustainable forms of economic activity, such as renewable energy sources. This approach is known as 'investing in industries of the future' and gives a strong bias towards growth-oriented sectors.<br>• Best in sector often chooses companies for the environmental leadership they demonstrate in their sector, regardless of whether they fail the negative criteria applied by ethical investing funds. For instance, an oil company that is repositioning itself as an energy business focusing on renewable energy opportunities would probably be considered for inclusion in a sustainability fund but would be excluded from an ethical fund. |

## ESG INVESTING

ESG investing is about choosing to consider the treatment of the planet, people and management structures in order to receive financial returns in a way that is aligned with your personal ethics and concerns about the world. Investors can align the way they use their money with their principles, often as part of a lifestyle of ethical consumerism that considers the supply chain of everything we use, from plastic waste to modern slavery. This may mean:

- avoiding certain sectors;
- excluding specific companies; or
- picking a theme with personal importance and investing in projects trying to achieve specific goals or change.

ESG investing does not just include equity investment, it also extends to bond and multi-asset portfolios. There are both actively managed ESG funds and passive ESG index tracker funds available.

Whilst the growth of ESG funds may seem like something new, these types of funds have been around for many years. The last few years, however, have seen the assets under management in ESG funds grow substantially. New funds keep being launched and existing funds are changing their investment strategies to incorporate ESG factors into their deliberations.

As we become more conscious of environmental issues such as climate change, investors are taking a greater interest in where their money is invested and although good investment returns are still very important, we are also increasingly focusing on how companies make their profits and the impact they have on the environment and society.

**Misconceptions**

The UN-supported organisation PRI has identified three common misconceptions about responsible investing. These misconceptions and their views are shown below.

| | |
|---|---|
| It involves investing in a specific investment strategy or product | Responsible investment does not necessarily require investing in a specific strategy or product. It simply involves including ESG information in investment decision-making and stewardship practices, to ensure that all relevant factors are accounted for when assessing risk and return. Exactly how an investor practices responsible investment varies. |
| It leads to lower investment returns | Responsible investment does not require sacrificing returns; it should, in fact, enhance risk and return characteristics. Investors apply a range of techniques to identify risks and opportunities that might remain undiscovered without the analysis of specific ESG data and broad ESG trends. |
| It is the same as sustainable, ethical, socially responsible and impact investing | There are many terms associated with the plethora of investment approaches that consider environmental, social and governance issues. Most lack formal definitions, and they are often used interchangeably. A key to understanding how responsible investment is broader than these concepts is that where many make moral or ethical goals a primary purpose, responsible investment can and should also be pursued by the investor whose sole focus is financial performance. |

*Source: Principles for Responsible Investment*

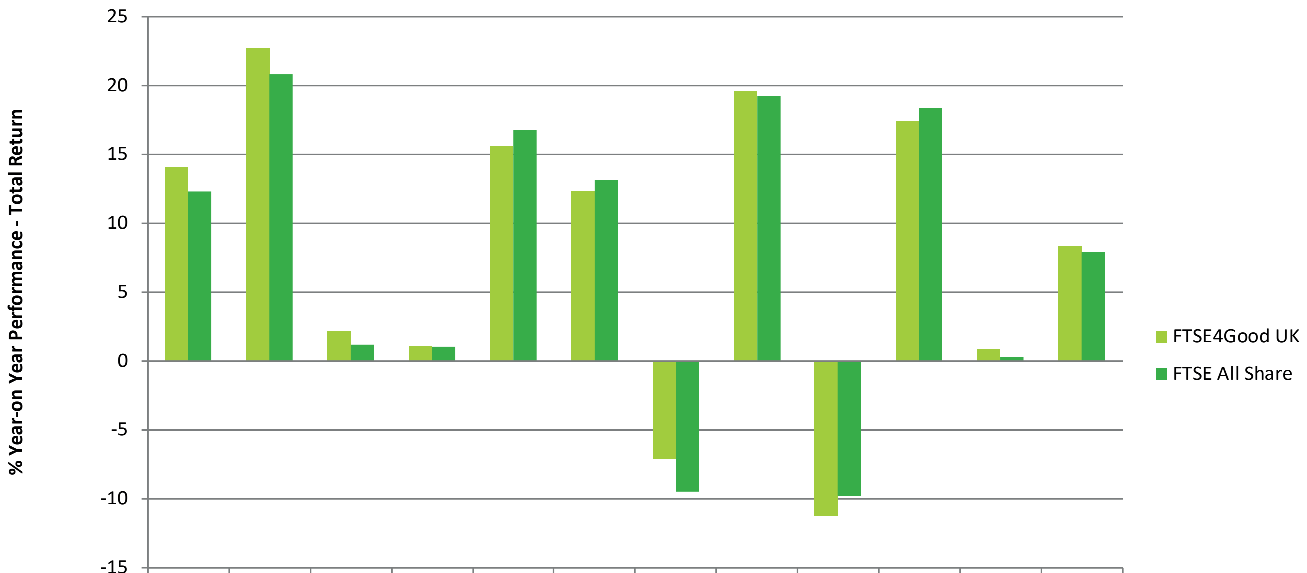
*Note: Principles for Responsible Investment (PRI) is a UN-supported organisation whose role is to encourage the take up of responsible investment practices. It defines responsible investment as a strategy to incorporate ESG factors into investment decisions and active ownership that complements traditional financial analysis and portfolio construction techniques.*

**ESG investment performance**

According to PRI there is growing recognition in the financial industry and academia that incorporating ESG factors into investment analysis and decisions better manages risks and improves returns.

Specially designed ESG indices are used by fund managers to structure their ESG funds and measure performance. They are also tracked by passives, like exchange traded funds, to invest in certain ESG themes, companies and sectors.

As an example, one such index is the FTSE 4Good UK Index which tracks the performance of companies in the FTSE All Share Index that demonstrate good sustainability practices. The FTSE All Share Index tracks the performance of close to 600 companies whilst the FTSE 4Good UK Index tracks just over 200 of those companies. Interestingly, those companies account for close to three-quarters of the total market capitalisation of the FTSE All Share Index and the average dividend yield on both indices is approximately the same.




| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| FTSE4Good UK | 14.1 | 22.7 | 2.1 | 1.1 | 15.6 | 12.3 | -7.1 | 19.6 | -11.3 | 17.4 | 0.9 | 8.3 |
| FTSE All Share | 12.3 | 20.8 | 1.2 | 1 | 16.8 | 13.1 | -9.5 | 19.2 | -9.8 | 18.3 | 0.3 | 7.9 |

**Source: FTSE Russell**

It is calculated in the same way as the FTSE All Share Index and so it is useful to compare the relative performance of the two indices to gain some idea of what ESG investing might mean. The chart on page 4 shows the year-on-year performance of each.

Past performance is not a guide to future performance.

The value of investments and income from them can go down as well as up, and you may not get back the original amount invested.

As more and more companies strive to improve their adherence to responsible standards in the near future we could reach a point where the majority of companies that make up the main indices are ESG compliant.

## YOUR VALUES

Ethical investing was once positioned as a choice of principles over returns. A shift in how we think about the environment, global policy changes and advances in technology has allowed ESG funds to move centre stage, meaning that one of the traditional arguments against investing with conscience has all but disappeared.

Matching investments to your values means deciding what is most important to you but remember, you may need to compromise to achieve all of your goals. Consider which causes you care about most.

Here are some of the key questions you should ask yourself when considering ESG investment:

1. Am I willing to sacrifice investment returns to stick rigidly to my principles in some cases?
2. Will I sell current investments that go against my ESG stance?
3. Will I only invest in companies where ESG considerations are their primary aim?
4. How much weight will I give to companies trying to improve their ESG ranking?
5. How would I feel about investing in a good company in a bad sector?

This will help you develop a rough idea of what you want to achieve which is a good starting point. Your financial adviser can help you weigh up the pros and cons of each option to find the right balance for you.

You may also want to take into account how your children or grandchildren view what matters for the future – your current investments may well be their legacies.

**Investment risk**

All investment carries some kind of risk. As a general rule, the less risk taken the lower the return. However, as a fast growing sector, ESG investing can pose greater risks in exposure to technologies and projects that are:

- experimental;
- untested over the long term; and
- yet to make a profit.

The counter argument is that old-style industries like coal and oil could leave you stuck with loss-making investments in the not-so-distant future, which is also a risk to consider.

Working with your financial adviser you will need to weigh up your ESG principles against your risk profile and clearly measure your attitude to risk and capacity to lose some or all of your investment.

**Finding funds**

Lipper Refinitiv has usefully portrayed the range of funds available as a spectrum that includes funds that negatively screen out unsuitable investments at one end to ones that positively screen at the other end.

**Planning point**

Diversification is the key to managing risk in any portfolio but especially in ESG, where market leaders are still rising and falling rapidly. You should avoid overexposure to any one ESG theme, government policy, region, asset class or company.

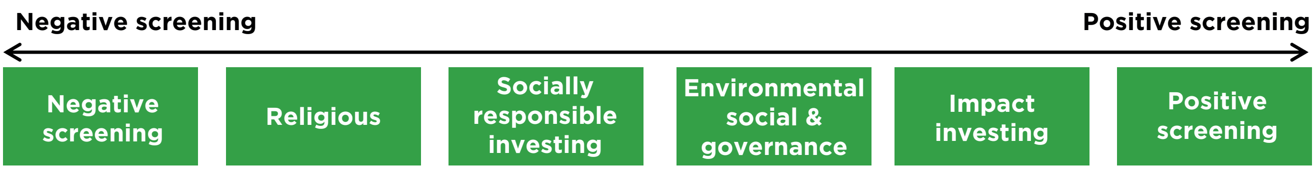
You should notice that ESG is just one of the categories despite it being used as a generic term. The type of funds that would generally fall under each category are shown in the table that follows.

An ESG fund can adopt any of the different styles and therefore it is important to drill down into how a fund will analyse, filter and select suitable investments to determine its approach.

| | |
|---|---|
| Negative screening | • Excludes companies involved with areas such as armaments, tobacco, fossil fuel energy and similar activities. |
| Religious | • Religious principles determine acceptable assets such as Islamic funds and faith-based funds. |
| Socially responsible investing | • Social impact is part of the overall screening process where acceptable investments must meet defined social criteria. |
| Environmental, social & governance | • Material environmental, social or governance factors feature in the screening process. |
| Impact investing | • Funds aim to achieve a positive impact on the behaviour of companies. |
| Positive screening | • Positive screening criteria identify suitable investments such as best in class, positive tilt or thematic. |

## FUND LABELS

As interest continues to rise in sustainable and responsible investment, regulators worldwide have expressed concerns that customers find it difficult to identify products that meet their sustainability preferences.




*Source: Lipper Refinitiv*

In the UK, the FCA has introduced rules surrounding the investment labels that funds can use to help investors navigate the sustainable investment market. They have introduced four sustainability investment labels that fund providers can adopt from mid-2024 provided that their funds meet specific criteria.

| | |
|---|---|
| **Sustainability impact**<br>Invests mainly in assets that focus on sustainability for people or the planet. | **Sustainability focus**<br>Invests mainly in assets that may not be sustainable now, with an aim to improve their sustainability. |
| **Sustainability improvers**<br>Invests mainly in solutions to sustainability problems with an aim to achieve a positive impact for people or the planet. | **Sustainability mixed goals**<br>Invests mainly in a mix of assets that either focus on sustainability, aim to improve their sustainability over time, or aim to achieve a positive impact for people or the planet. |

Source: https://www.fca.org.uk/consumers/identifying-sustainable-investments

The label means that investors will have access to clear and simple information on what that goal is and the approach to achieving it and receive annual updates on progress towards it.

Not all funds will fall into one of these categories. If a fund doesn't include a label but is making sustainability claims, then from December 2024 investors should have access to clear and simple information explaining how it's invested and why it doesn't have a label. Some funds may not include one of these labels because the fund is based outside of the UK. Many of the funds used by UK investors are based in Europe where new rules are due to come into place in the second half of 2024.

There are also anti-greenwashing rules to ensure that sustainability-related claims are fair, clear and not misleading and consistent with the sustainability profile of the fund.

**ESG fund selection**
It is important to recognise that an ESG approach by necessity restricts the available investment universe compared to traditional funds and makes the stock selection process more complex. Integrating ESG analysis into the stock selection process is necessarily more research intensive than the processes undertaken by traditional investment funds and requires a substantial research capability.

Given the range of different ESG investment strategies it is important to understand how a fund approaches the selection process and then whether that fits with your values.

- For you, it is important to understand what your personal ESG values are and which type of ESG strategy may best fit with your requirements - for example, would negatively screening out energy companies or positively screening for companies addressing our energy reliance be more appropriate? This simple example should emphasise that ESG investing can mean different things to different people.

- The fund should adhere to its ESG philosophy, considering how it implements its selection process, the experience of the fund management team in that area and the performance that the fund has achieved.

Ask to see details of an ESG fund's core investment philosophy (how it picks companies to invest in), process and method of measuring and reporting its ESG principles. Some key questions to bear in mind are:

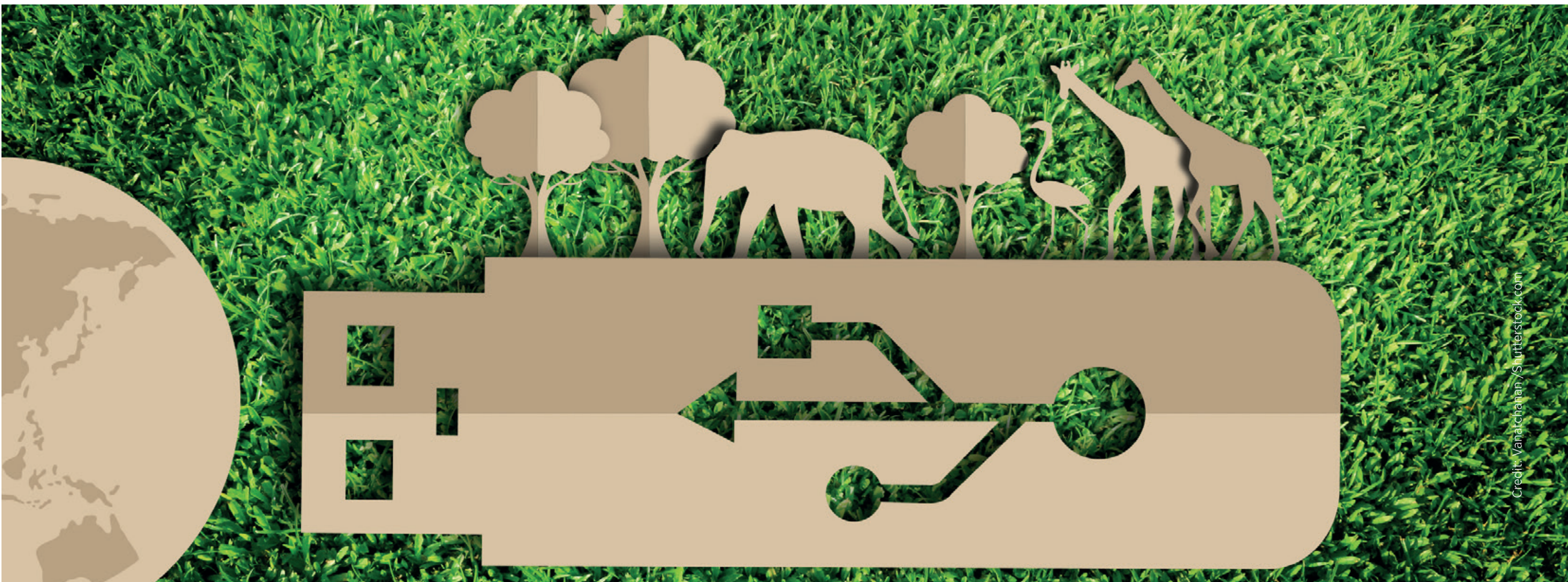
1. Do ESG criteria run like a vein through everything the investment does?

2. Does the fund manager do their own research or rely on third party ratings?

3. Has the fund voted against a company's management at AGMs to protect ESG?

4. Is the fund house signed up to the UN Principles of Responsible Investment?

If you are investing in the shares of a single company, its annual report should demonstrate how much of their ESG activity is measurable and written down.



**Fund ratings**
Independent ratings can help you judge the ESG credentials of a particular fund. Several ratings agencies provide their analysis of the ESG credentials of a fund including agencies such as Morningstar, Lipper and MSCI.

MSCI ESG Fund Ratings, for example, is an easy to use online search box that scores funds on a scale from CCC (laggard) to AAA (leader), based on:

- holdings of the fund;
- ESG track record (holdings with a positive/worsening rating year on year); and
- exposure to holdings with worst-of-class ESG ratings.

Both fund labels and fund ratings aim to help investors choose responsible investment products. An important difference between the two is that the fund manager takes the initiative to obtain a label, whereas the rating organisation unilaterally rates a fund, irrespective of whether the fund manager asks for the rating.

ESG ratings do not certify a fund's ESG process; instead, ESG ratings generally aim to "score" the sustainability of a fund's' portfolio with a rating.  Ratings agencies will look at the significant ESG risks and opportunities affecting an industry and assess how these translate into financial risks that may impact on a company's bottom line. An example from MSCI helps to illustrate this.

Climate change is causing more severe droughts and floods and so is affecting water access globally. The semiconductor industry is fundamental to the global digital economy but is water-intensive and relies on a large, steady and ultrapure water supply, used to rinse particles and chemicals from chip surfaces. Taiwan, for example, has the largest share of world production of semiconductors but its chipmakers are concentrated on a water-stressed and drought-prone island.

So, to determine whether a maker of semiconductors risks running out of the water it needs to make chips, investors may consider whether the company operates in a locale that requires it to conserve water. They also might consider the prospect of regulation on water usage, potential conflicts with the community and whether management is taking steps to address those concerns.

Water constraints add yet another important consideration for investors evaluating this critically important industry.

Fund labels and ratings can help investors see whether a fund fits well with their ESG requirements but it is important to recognise that this is just one part of the investment decision-making process.

**Fund performance**
Fund performance is typically measured in investor returns after fees and can be compared to its peers, a benchmark or an index. These figures can be found on the fund's fact sheet and through fund rating agencies such as Morningstar or Lipper or through other sites such as Trustnet.

Returns remain an important success metric for most ESG investors, but how a fund has met certain environmental, social or governance goals can be harder to measure. Reports from your fund manager may quantify work on the ESG aims of the fund by, for example:

- the times they voted in AGMs to push companies to meet UN Sustainability Goals;

- how much their holdings have cut capital spending on carbon-creating activities;

- the growth in the number of women on the boards of companies the fund invests in.

The specific positive or negative performance factors a fund manager reports on will depend on the type of ESG strategy they have chosen to invest in. Your financial adviser can obtain any clarifications you may need on this.

## PITFALLS
While ESG investment is experiencing a positive surge, it is important to remember there are some key issues that investors should bear in mind.

### Greenwashing

To benefit from the surge in demand for ethical investments, some companies are rebranding as ESG-focused in a way that's not entirely honest. Some ESG funds take a liberal view of what they allow to make it easier to achieve returns. This 'greenwashing' can make it harder for ordinary investors to choose genuine ESG investments.

In Europe, for example, the European Securities and Markets Authority reported in February 2022 that it had observed a mismatch between what fund managers are telling ESG clients and their actual investment allocation strategies.

Greenwashing can be cynical marketing, or it can be an oversimplified view of a company or sector that fails to take into account hidden ESG risks. Examples include:

- Fishing, once seen as 'green' versus meat, is the largest contributor to ocean plastic.
- Soybeans are the second largest driver of deforestation after cattle, a fact largely hidden from investors in ETF indexes.
- The Australian government found modern slavery of Uyghurs in the supply chains of at least 82 well-known global brands.

Fund rating agencies are increasingly undertaking in-depth analysis of the disclosures made by funds to identify those that fail to meet their criteria to be classed as sustainable investments. Morningstar, one of the leading fund rating agencies, removed more than 1,000 European funds from its list at the end of 2021 for failing to meet ESG criteria leading to significant outflows from those funds.

### Example – renewable energy but moribund strategy

Philip has been hearing about a renewable energy company from a family friend. It sounds good value. On investigating it further with a view to investing, he discovers the company hasn't made any money for about 20 years. His adviser also points out that it may be cheap only because it is so far behind its competitors with no explanation of how it plans to catch up. Philip decides to investigate more dynamic options in the same field.

### Worthy but worthless

Remember, just because a company, project or fund is marketed as ESG or ethical or sustainable doesn't necessarily mean it will turn a profit or achieve anything worthwhile. ESG investing may increase the focus on metrics beyond pure financial gain, but decisions about where to invest should still be grounded in sound logic on the likely success, however measured, of the strategy being advertised.

### Asking questions

You should ask the same clear headed questions of an ESG-focused company or fund as any other potential investment:

- What is it doing better than its rivals?
- What growth has it achieved and what is it doing to achieve more?
- What problem is it solving and how is it measuring its success at that?
- Is it good value for money?

### Planning point

In short – there is no need to let your sense-check guard down just because a fund or company is labelled sustainable, responsible or ethical. Don't just believe the hype, ask for proof of results.

The value of investments and the income they produce can fall as well as rise. You may get back less than you invested.

Past performance is not a reliable indicator of future performance.

Investing in stocks and shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and your financial circumstances.

### HOW WE CAN HELP

We can help you to understand how to translate the values that are most important to you into a suitable ESG investment portfolio that reflects your principles, financial goals, attitude to risk, and capacity for loss.

- We can work with you to create a financial plan based on your wishes to build and pass on long-term, sustainable investment returns to your children and grandchildren.
- We can also discuss the advantages and limitations of different ESG investing styles.
- Laws and regulation around climate change and sustainability are changing rapidly. We can advise on the impact of these changes on your portfolio and keep you up to date with any future opportunities.

ACUMEN
FINANCIAL PARTNERSHIP LTD

**Acumen Financial Partnership Ltd**
4a Swordfish Business Park
Higgins Lane
Burscough
Lancashire L40 8JW
tel: 0151 520 4353
fax: 0151 526 3399

Shield House
Nateby Technology Park
Cartmell Lane
Nateby
Preston PR3 0LU

email: info@acumenfinancial.co.uk
Web: www.acumenfinancial.co.uk