SIMMONS CONSULTING *Spotlight 4th Oct 2021*

A Brief Guide to Environmental, Social and Governance (ESG) Criteria

ESG – How it is Transforming Wealth Management?

Sustainability is an important measure of a company's credibility, whether the industry is food production, travel, or fashion.

It has become increasingly relevant to the investment process, as companies aim to operate more ethically, and consumer appetite for sustainable investing has risen.

The wealth management industry has adapted accordingly, responding to the increased demand for, and availability of sustainable investment choices.

But does this mean compromising on performance? Or are ESG factors an integral component of a company's desirability as an investment?

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ESG criteria refers to certain standards by which a fund manager or investor might assess a company for inclusion in a portfolio.

These criteria are explained as follows:

Environmental

Determines how a company interacts with the environment, for example by:

- Limiting waste,
- Reducing pollution,
- Producing solutions for clean energy
- Encouraging conservation,
- Avoiding animal cruelty.

Social

Determines how a company interacts with the community, for example by:

- Treating employees fairly,
- Upholding consumer rights,
- Dealing ethically with suppliers.

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Governance

Looks at a company's leadership structure, for example:

- Executive pay,
- Internal processes and controls,
- Diversity at senior levels.

An ESG strategy aims to apply a positive screening process to the companies selected for investment.

This is just one of the metrics that a fund manager will take into account, along with profitability, growth potential, and market share. Even where ethical or sustainable investing isn't a primary aim, a company's ESG score can provide insight into aspects of a company that won't be apparent from its balance sheet.

Demand

Demand for socially responsible investing has increased in recent years, particularly amongst younger investors. The reasons for this are varied, for example:

1. The impact of carbon emissions and the effect on climate change.
2. Commitment to ethical practices and a distaste for companies that pollute or carry out human rights abuses.
3. Increased coverage in the news and social media of environmental issues.
4. Social media, activism, and corporate shaming when companies behave unethically.
5. A desire not to support or be affiliated with socially irresponsible companies. A company known to pollute and waste resources could face fines, sanctions, or shortages, which can all affect shareholders' profits.
6. A wish to influence businesses, and the wider corporate world to act more sustainably.
7. A belief that socially responsible companies have the greatest potential to grow and produce long-term profits.
8. An interest in the business sectors at the forefront of sustainable investments, such as technology and healthcare.

The wealth management industry has had to adapt to meet consumer demand for more socially responsible investing, without compromising on growth potential, diversification, or ease of access.

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Transparency

With demand for socially responsible wealth management firmly established, the next step for a wealth manager is to research companies to invest in.

This is now easier than ever, as several organisations now measure ESG factors across the UK and overseas markets.

The idea is to allocate a numerical value to each company's ESG credibility. This can be assessed in different ways, but aims to establish how a company is performing in terms of Environmental, Social and Governance factors. Criteria may be weighted differently depending on the impact and the specific industry.

There are several advantages to ESG scoring:

- It adds transparency and depth to the analysis of a company.
- It can help to demonstrate consistency in the process of choosing stocks.
- It creates a snapshot that can be used to quickly narrow down the list of companies.
- Having the information in the public domain could encourage companies to operate more ethically to improve their score.

However, there are some possible disadvantages:

- The score doesn't tell the whole story, and should be regarded as a starting point.
- Ratings companies measure criteria differently and could come up with different scores for the same company.
- ESG scores could be used by some wealth managers as an easy way to tick the 'green' box without carrying out full due diligence.

Wealth managers now have an abundance of data to allow them to fully research and analyse the companies they are considering buying. ESG scoring can form part of this picture, providing the overall process is robust.

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Availability

With higher levels of transparency, there are now a multitude of sustainable investment options available. Wealth managers (and indeed individual investors) can choose from:

- Company shares
- Sector-specific funds
- Multi-asset funds
- Index tracking funds for low cost exposure to ethical companies
- Investment trusts

These assets can be combined to create a diverse portfolio that can hold its own against a 'standard' fund.

Investors have even more choice, and can take an active or hands-off approach depending on their preference. Some investors wish to actively trade shares, while others prefer to delegate the daily management to a professional. In today's market, there is an investment option for every portfolio level, price point and management style.

ESG investments are no exception, and have gradually made their way into the mainstream.

Profit and Growth Potential

Investing in line with personal values is important to many investors, but equally, most want to make money as well.

Traditional ethical investing involved excluding companies based on their business area, for example, tobacco, gambling, or weapons manufacture. As the choice of investments is naturally narrower, portfolios can become less diverse, more volatile, more expensive, and may not perform as well.

ESG investing aims to view companies holistically and include them on their merits. This includes ethical credentials *and* performance potential.

The Covid-19 pandemic created an unprecedented environment, where technology and healthcare businesses thrived, while the travel and transport industry ground to a halt. The impact on sustainable funds throughout 2020 has been substantial, as these are the funds best placed to benefit.

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The economy is cyclical, and no doubt when restrictions are lifted, commuting and low-cost flights will pick back up again. But recent performance has demonstrated that ESG funds are no longer niche or a second-best alternative. The wealth management world is now embracing sustainable investing as a fully mainstream option.

Please don’t hesitate to contact me to find out more about socially responsible investing.

Thank you

Chris Simmons