Sustainable (or ESG) investing: Are we on the same page?

By Daniel Soon

THE world has seen a significant increase in investor interest in sustainable investing, also known as ESG (environmental, social and governance) investing.

Asset managers have responded to this interest and demand with a proliferation of ESG-labelled investment products. As investors, we find ourselves inundated by numerous terminologies.

Terms like sustainable investing (SI), responsible investing (RI), socially responsible investing (SRI) and impact investing, are often used interchangeably, but they're not the same. In the course of my work, I've witnessed how industry professionals and investors (myself included), grapple with the onslaught of ESG jargon. Hence, it should not come as a surprise that retail investors are equally confused, if not more so.

ESG investing may mean different things to different investors.

Let's say investor A refers to it as investing in companies that score high on ESG metrics. Investor B may refer to it as investing in companies that make the world a better place, while investor C refers to it as investing with ESG analysis embedded within the investment process. They're not wrong, but they're not exactly on the same page either.

Such misconceptions have persisted and unfortunately hindered meaningful discussion on the merits or suitability of the various ESG investing approaches.

In this article I will provide a framework that serves as a starting point for both investors and investment professionals who have yet to embrace ESG, to take the discussion forward.

If the goal is to arrive at a conclusion on whether a certain type of investing approach works for you (it could be SI, SRI, impact investing or none of those), then the first step is to obtain a map so you know where you are.

RI and Italian cuisine

Personally, working from home has meant more time in the kitchen and my mind has certainly wandered while peeling one garlic clove too many.

■ The cuisine: At the top of the hierarchy, let's begin with RI, which is the practice of incorporating ESG considerations into investments. RI is an approach to investing much like Italian cuisine is an approach to preparing food.

■ The dishes: Like the dishes that characterise Italian cuisine, the terms ESG investing, SI, SRI, and impact investing represent various investment approaches that fall under the umbrella of RI. These approaches, in one way or another, incorporate ESG considerations.

■ The ingredients: Exclusions, screening, ESG integration, voting and engagement, active ownership, are examples of building blocks (ingredients) that are applied in the different investment approaches (dishes).

How do the various investment approaches differ? While these investment approaches are similar as they incorporate ESG considerations in one way or another, what sets them apart is how that's being done. I will focus on the key objectives relating to each investment approach in an effort to differentiate.

Socially responsible investing (SRI)

SRI investors seek investment returns but wish to avoid companies that are not aligned with their personal values and/or are deemed unsustainable for the society. For example, an SRI fund may avoid investing in companies in the alcohol, gambling, or tobacco industries. "Exclusions" is thus a key feature.

A sub-set of SRI would be ethical investing or values-based investing, with an emphasis on aligning one's investments with their own moral beliefs and ethical values.

Sustainable investing (SI) or ESG investing

SI investors seek to improve the risk-return of their investments by taking into account financially material ESG information. The systematic analysis of ESG issues in the investment process is called "ESG integration", which is a key feature of this approach.

For instance, equity analysts applying SI will explicitly incorporate ESG information about a company as part of their fundamental analysis process (e.g. How is a manufacturing company dealing with its hazardous waste? Should health and regulatory risks be priced in?).

The industry is still finding a way to achieve consistency and alignment amid demand for ESG investing. ILLUSTRATION: PIXABAY

This is done with the aim of helping them make better-informed decisions regarding the investment risks and opportunities relating to the company's stock price.

Best-in-class investing

Investors here seek investment returns by allocating their portfolio to companies that are top performers in terms of meeting certain ESG criteria. A key feature here would be the use of proprietary ESG scores to determine the most sustainable companies to be included.

Impact investing

Impact investors seek investment returns in order to generate positive, measurable social or environmental objectives as an outcome alongside investment returns. An example of traditional impact investing would be an investment into a hospital project to provide healthcare services in underserved rural areas, with social impact metrics tracked, such as the number of patients treated.

More recently, thematic impact investing – via allocations into public equity and bond markets – has gained momentum as another form (albeit less direct) of impact investing. Impact measurement and reporting are key features.

Just as olive oil is an ingredient to many dishes beyond *aglio e olio* (like focaccia bread, caprese salad, and more), do note that the ESG building blocks can be applied across multiple investment approaches. Take for example: while exclusions are a key feature in SRI, it is also commonly applied across SI and best-in-class investment approaches.

Making it easier to differentiate

In practice, unfortunately, the investment approaches outlined above may not be as clearly defined. Investors should look beyond product names and glossy marketing material to understand what an ESG-labelled product entails to avoid being greenwashed.

Greenwashing makes false or misleading claims about the environmental benefits of a product. In the asset management context, it seeks to tell investors that the investment product or firm is doing more to adopt ESG or sustainability than it really is.

According to Robeco, an asset management firm specialising in sustainable investing, investment strategies that merely apply an exclusion policy should not be considered sustainable. Applying our analogy, that would be akin to the attempt to label every dish that contains olive oil as Italian.

As asset managers continue to offer ESG solutions to meet rising investor demand, the industry is still finding a way to achieve consistency and alignment.

Fortunately, the CFA Institute is currently developing a global industry disclosure standard to provide greater product transparency and comparability for investors by enabling asset managers to clearly communicate the ESG-related features of their products. With these efforts and continued investor education, we're more likely to all be on the same page.

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