How ESG can help planet and investors

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Environmental concerns have become a major issue.

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Over the past four years, I have watched as investing in environmental, social and governance (ESG) as a strategy has gone from being a niche issue to one that now attracts high levels of interest.

At all the major gatherings of international investors, it seems as if ESG is referenced in every session.

Essentially, ESG takes two forms. The most common approach is to try to exclude the negatives. Here you have a reliance on filtering to exclude "no harm" stocks in industries such as tobacco, gambling, weapons, alcohol and coal as examples.

Alternatively, there is the biasing angle — towards companies that positively promote their credentials in the areas of environment, social, and corporate governance practices.

Notably, Bank of England governor Mark Carney said recently that ESG was crucial to the pressing need to manage between risk, reporting and returns.

I would add that in active funds management in the UK and Europe, the allocation of capital by the funds management industry has taken on a societal view.

One argument I have often heard put in Australia is that there is no clear consensus on a definition for ESG.

Indeed, this is highlighted by the publication of more than 2000 studies completed on ESG yet none agree in a way that allows comparing “apples with apples”.

I think that’s because ESG, broadly defined, ranges from values-based screens that are negative to so-called impact investing, where the intention is positive action for change.

On top of that we have a profusion of ESG qualities (some social objectives, some financial objectives — and no agreement whether it is constraint versus an objective).

I wonder actually if this will ever be resolved and if we can ever have a practical “one size fits all” definition or approach with ESG.

Risks and rewards

Either way, ESG as an investment principle has become mainstream in the UK and Europe and it is growing in force in Australia by the day.

I estimate there are three reasons for the growth of ESG:

• Better data is available.

• The focus is investor-led and therefore the care factor has increased. For instance, Volkswagen shares fell 30 per cent in September 2015, as did BP in April 2010, on the back of their negative announcements.

• Climate change is widely accepted in Europe as real and it is no longer a left versus right issue.

I have been watching trends globally and noticed a time lag in many mainstream UK/EU investment issues coming to Australia.

Four years ago, the hot topic in the northern hemisphere was funds management fees, or MERs. I would say that issue took three years to become an issue of the same magnitude in Australia.

I have no doubt ESG will become as big an issue in Australia, but not just yet. Meanwhile, there are some risk issues that need to be taken into account:

• Greenwashing — or managers claiming they implement ESG but in practice it is in words only.

• Many managers are using ESG to justify increased fees. When it is part of a process, this cannot be justified.

• You cannot access ESG parameters through index products.

On the other hand, there are also some positives:

• Constraining an index should lead to increased risk. However, including best-in-class ratings has shown that in fact it decreases the portfolio risk. ESG therefore enhances risk controls.

• In Europe, demand is outpacing supply. Likewise, we have found this to be the case in domestic Australian asset classes.

• ESG leads to stewardship and therefore increased engagement and influence with companies. It is having the result of lowering portfolio turnover.

We have experienced increased demand from clients to invest with "do no harm" mandates and, as we have seen in Europe, I can only see this trend growing. Interestingly, wealth managers I have spoken to say the No 1 age bracket where there is demand for ESG principles is in the 60 to 75-year-old group.

You might well ask "why not millennials?" But it has to be taken into account that this cohort is only growing as an age bracket for investing.

Some areas such as climate change go beyond ESG and are now touching everyone. As climate change is forcing countries to transform, so too will it force companies to transform.

Where I believe many critics lose focus on ESG and sustainable investing is that understanding it is about responsible investing with increased risk criteria.

In the end, ESG is about moral capitalism. I believe that in this era, moral capitalism is about maximising the long term.

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