Socially responsible investing

A guide for charity trustees

Rathbones
Look forward

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What is socially responsible investing?

You've probably heard the terms ethical, sustainable and impact investing, which are popular descriptions of investment approaches that consider social, environmental and governance factors as well as financial returns. What do these terms mean and what might you consider when defining your charity's investment policy? How might your approach to investment better align with your charity's mission?

In the broadest sense, these terms reflect a common ambition to use investment capital to respond to a wide range of social and environmental problems.

You can find a glossary at the end of this publication, but for the sake of clarity within the guide, we use the term socially responsible investment (SRI) to refer to the approaches introduced above, unless another more specific description applies.

A new approach?

SRI is nothing new. It dates as far back as the 1700s, when religious groups such as the Quakers refused to support companies involved with the slave trade, or other activities in conflict with their values. Since then, various approaches have evolved to enable investors to consider non-financial factors in their investment decision making.

When investing responsibly, asset managers can consider both positive and negative social and environmental factors. They may evaluate the risks of continuing to invest in companies failing to respond to global concerns and identify opportunities in those working to address them. Additional ethical criteria may be incorporated in an investment strategy to reflect the specific values or mission of each investor.

The value of investments and income arising from them may fall as well as rise and you might get back less than you originally invested.

A sense of responsibility

Responsible investing can seek to encourage greater corporate accountability and transparency, improve environmental stewardship and protect human rights.

While more traditional negative screening excludes certain products, services, or activities, some SRI managers apply a 'best-in-class' approach. This allows them to invest in the broadest range of sectors, but only in those companies with the strongest policies and practices with respect to social and environmental issues.

For example, they may still be able to consider a company involved in producing energy from fossil fuels if it is also working towards being more environmentally sustainable, investing in low-carbon energy and demonstrating high standards of corporate responsibility. Such an approach enables shareholders to retain their voting rights, allowing them to influence a company's direction.

Environmental, social and governance (ESG) screening and sustainability analysis can identify companies conducting their operations or providing products and services in keeping with the need for a more sustainable economic system.

Thematic investing identifies companies working to solve specific global challenges, often by developing innovative technologies. Examples include organisations addressing the needs of ageing populations; recognising resource scarcity; producing energy from renewable sources; or improving the water value chain through better distribution, management, treatment and analysis or irrigation.

Impact investing tips the balance of ethical and financial returns in favour of a measurable social or environmental change. Unlike a simple grant or philanthropic investment, there's still an expectation of a financial return, although market performance may be less important to impact investors. These investors view the potential for increased social or environmental returns as adequate compensation for the risk of lower investment returns.

The spectrum of investment today

Financial only

Traditional
No positive or negative screening

Responsible
Focus on avoidance

ESG leadership
Best in class ESG management, balancing positives and negatives

Sustainability features
Promote sustainability development

Thematic
Solve a social or environmental challenge

Impact first
Trade-off between financial and social returns

Philanthropy
No focus on financial returns

Impact only

Source: Graphic modified from Bridges Ventures' Spectrum of Capital

Why invest responsibly?

In the past, ethically-minded investors simply avoided sectors that conflicted with their values. The most obvious examples are industries involved in the production or promotion of tobacco, armaments, pornography, alcohol and gambling.

More recently, many investors have sought to apply a more encompassing approach that looks further into the social and environmental repercussions of a company's activities. How can their investments be more socially responsible and what are the risks of continuing to invest in companies failing to adequately respond to global concerns about sustainability?

Increasingly, investors are seeing the long-term performance and reputational benefits of their investments achieving higher standards of social and environmental performance and good corporate governance.

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Gaining momentum

As well as realising that a socially responsible approach may actually enhance rather than detract from investment performance, investors around the world are increasingly looking to ensure that their values are reflected in their choices. Extensive media coverage of social and environmental issues and their prevalence in global current affairs provides ethically-minded investors with the information they need to apply pressure for change, while also limiting the opportunities for companies to conceal their actions.

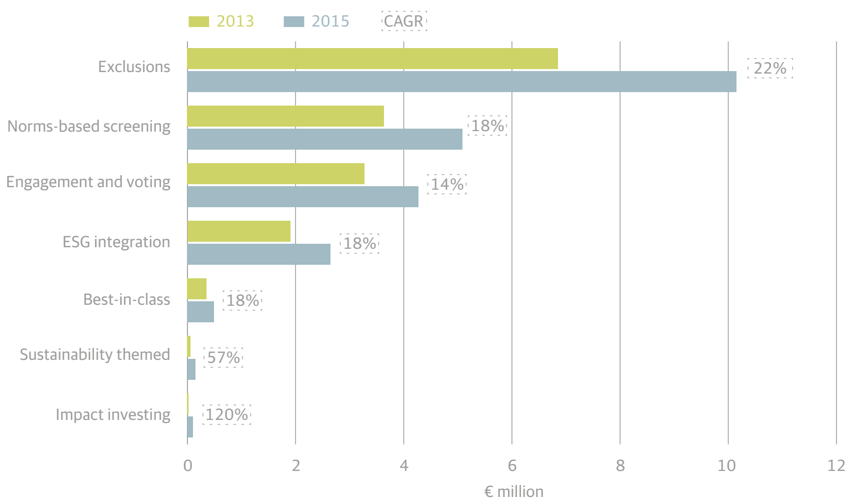
According to a 2016 report by the US Forum for Sustainable and Responsible Investment, more than a quarter of global assets under management are screened on SRI criteria, representing nearly $23 trillion. In the US, the market expanded by 33% over the preceding two years to $8.7 trillion.[1]

The broader significance of the growth of SRI and the expectation of investors that ESG factors should be incorporated into investment decisions is reflected in the number of organisations signed up to the Principles for Responsible Investing (PRI), backed by the United Nations. Launched in 2006, PRI has established six core investment principles for investors to act in the best long-term interests of beneficiaries and "better align investors with broader objectives of society".[2]

The aim is to create a more sustainable global financial system capable of generating better long-term, risk-adjusted investment returns. By March 2018, these principles had more than 1,800 signatories from 50 countries representing $70 trillion of assets under management, and the membership continues to grow.

Amount invested in SRI strategies in Europe

Impact investing was the fastest-growing strategy between 2013 and 2015 with a 120% compound annual growth rate (CAGR).



Source: Eurosif European SRI Study 2016, www.eurosif.org/sri-study-2016/

Measuring investment returns

One of the biggest questions surrounding SRI has been how the potential returns compare with more traditional 'financial returns only' investment strategies. Can an investor really maintain or even improve performance when they align their portfolio with their values?

Encouragingly, the long-term financial performance of ethical portfolios has defied mainstream scepticism. Independent research that aggregated evidence from more than 2,000 empirical studies shows SRI strategies have often matched or exceeded the returns of comparable mainstream investments.[3]

Morgan Stanley's Institute for Sustainable Investing arrived at this conclusion in a performance study published in 2015. It also noted that comparable or improved financial performance could be observed over time across all asset classes on both an absolute and a risk-adjusted basis.[4]

Morgan Stanley reported that the MSCI KLD 400 Social Index had outperformed the S&P 500 on an annual basis since its inception in 1990. Similarly, a 2014 data review of the 190 highest-quality SRI performance studies conducted by the Smith School of Enterprise and the Environment at Oxford University found that companies operating at a high level of sustainability significantly outperformed their counterparts over a 20-year data period.

ESG driving returns

More and more companies will need to incorporate sustainability into their products and operations over the short term, requiring investment capital to finance this transition.

Investors are recognising the competitive advantages for companies adopting a greater focus on sustainability, for example through greater innovation and ESG risk management, and are allocating capital accordingly.

The Morgan Stanley Institute for Sustainable Investing estimated that by 2050, business opportunities for companies exhibiting high standards of sustainability are expected to be between $3 trillion and $10 trillion a year, representing up to 4.5% of global GDP.[5] Its analysts calculate that, in terms of future performance, sustainable companies are more likely to effectively manage diverse business risks and limit the volatility of cash flows.

Similarly, a National Bureau of Economic Research paper on the impact of corporate sustainability on financial performance calculated that $1 invested in 90 large US 'high sustainability' companies in 1993 would, by the end of 2010, have outgrown the same investment in 90 'low sustainability' counterparts by more than 64%.[6]

In addition to the evidence of outperformance Morgan Stanley uncovered in 2015, the bank also observed that 54% of investors still considered the choice between sustainability and financial gain to be a trade-off.[7] The lingering perception that investing in line with your values is incompatible with financial gain needs to be dispelled, particularly where it is coupled with doubts that SRI can change the world.

Despite the evidence of strong performance, SRI is still considered an under-realised opportunity. Increasingly, individual investors are expressing interest in SRI strategies, which indicates the potential for continued growth.

Investment decisions are more informed today because of the improving quality and accessibility of information and reporting standards. Groups such as the Sustainable Investment and Finance Association (SIF), Investor Responsibility Research Center (IRRC), Global Reporting Initiative (GRI) and Sustainability Accounting Standards Board (SASB) have worked to improve reporting standards and corporate transparency for investors to assess progress and impact.

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"Investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments. This is on both an absolute and risk-adjusted basis, across asset classes and over time."

Source: *Sustainable Reality*, Morgan Stanley, March 2015

Making a difference

To what extent can pressure from investors encourage governments and companies to change their behaviour and have a positive impact on society and the environment? The evidence is encouraging and there have been significant developments at an international level.

For example, the investment community contributed to the Paris Agreement on climate change in 2015 and continues to support this important initiative. In August 2016, a group of 130 investors responsible for $13 trillion of investments called on the G20 to ratify the agreement within the year and accelerate investment in clean energy and financial risk disclosure. Signatories also took the opportunity to remind G20 governments that the transition to a low-carbon economy is "inevitable and already under way".[8]

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Engaging investors

Meanwhile, long-term investor engagement with the UK government on the issue of human trafficking helped generate support for the Modern Slavery Act 2015. Investors exerted further pressure for the inclusion of a transparency in supply chain clause, which requires companies conducting business in the UK with an annual turnover of £36 million or more to investigate and report annually on the activities of their labour and service providers. The first of these reports was published in 2017 and is helping to encourage a 'best-in-sector' response among companies subject to the requirement.

Investor pressure is also supporting the global drive to improve well-being and reduce the spiraling public health costs of obesity and other diet-related diseases. In advance of the introduction of the 'sugar tax' in the UK in 2018 for example, concerned investors encouraged food and beverage companies to reduce the amount of sugar in their products on both health and financial grounds. More generally, food manufacturers are responding to responsible investor demands for healthier choices with long-term programmes of product reformulation.

Across a wide range of issues, investor engagement has been central to a process of recognition, action and meaningful change. In response to this pressure, companies are implementing new levels of standardisation and transparency to improve their standing against ESG-driven benchmarks.

Looking ahead

Despite concerns that the recent populist surge in international politics could threaten global sustainability ambitions if governments become more protectionist, investors, consumers and companies have continued to push for positive change in pursuit of a more sustainable world.

For example, after President Trump announced that the US would withdraw from the 2015 Paris Agreement on climate change, American businesses reaffirmed their commitment to creating a low-carbon economy. Around 1,000 businesses and investors, representing more than $5 billion in managed assets, wrote an open letter to the president to express their concerns that his administration would reverse the commitments made by the preceding government.[9]

The implications of Brexit and political turmoil in Europe make it harder for investors to gauge the extent of any possible disruption to EU-wide sustainability programmes. However, the evidence of cross-party consensus and increasing investor pressure for solutions to social and environmental problems suggest sustainability trends can survive beyond periods of political uncertainty.

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A paradigm shift

It is becoming more apparent that further advances in sustainability and corporate responsibility will be driven by the private sector regardless of the changing perspectives of individual governments.

A generational shift is also becoming increasingly evident, with a growing investor base of millennials demonstrating a strong appetite for sustainability through their investment and consumer choices. Increasing numbers of female investors are also helping to propel a behavioural shift as women are more likely to base their investment decisions on sustainability.[10]

Making headway

All this points to a shift that should continue to progress, with donors and beneficiaries expecting more as time and engagement go on. If the quality of those identifying the opportunities currently presented by SRI and the level of output from such investment houses is anything to go by, then there's a strong likelihood of significantly increased value-driven socially responsible investing in the future.

With evidence of sound financial performance and resilience in the face of extreme political change, it's no longer a question of why should you apply a socially responsible investment policy to your portfolio, more a case of why wouldn't you?

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Charity Commission guidelines

According to Charity Commission guidelines, trustees of any charity can decide to invest ethically, even if the investment might provide a lower rate of return than an alternative investment, as long as you are able to justify why it is in your charity's best interests to do so.[11]

The law permits the following reasons:

– a particular investment conflicts with the aims of the charity;

– the charity might lose supporters or beneficiaries if it does not invest ethically; or

– there is no significant financial detriment.

As a trustee, you must ensure that you can justify any decision you take about adopting an ethical investment approach. You must be clear about the reasons why certain companies or sectors are excluded from, or included in, your portfolio.

You should also evaluate the effect of any proposed policy on potential investment returns and balance any risk to financial returns against the risk of alienating support or damage to reputation. This cannot be an exact calculation but you will have to assess the risk to your charity.

Designing and implementing an ethical investment approach can be challenging. That is why many charities choose to outsource the process to a professional investment manager with the required skills, resources and experience.

Ethical investment strategy case studies

An environmental charity with aims to protect wildlife and the environment decides to adopt an ethical investment policy.

It decides to avoid investing in companies that have a poor environmental record (for example, recent cautions or convictions for pollution offences).

The trustees could go further and apply greater integration of climate change considerations across the investment portfolio. This would involve reducing exposure to industries whose activities are misaligned with a 2°C pathway – such as coal mining or those operating coal-fired power plants with unabated emissions, and increasing exposure to industries and companies which are contributing to climate change mitigation and adaptation – for example, renewable energy, energy efficiency and avoiding deforestation.

They could also include a requirement to include active engagement and stewardship on environmental, social and governance issues to address relevant concerns and drive positive change.

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An environmental charity with aims to protect wildlife and the environment decides to adopt an ethical investment policy. It decides to avoid investing in companies that have a poor environmental record.

A charity established with the aim of educating the public in the causes and prevention of heart disease decides to adopt an ethical approach to the investment of its funds by choosing to exclude investment in tobacco.

This would exclude companies involved in the production of cigarettes and tobacco products (such as cigarettes, cigarillos, cigars, snuff, tobacco). It would also exclude companies involved in wholesale or major distribution and sale of tobacco product. The trustees may also wish to extend the definition for reputational risk reasons and exclude companies involved in the sale of tobacco products, such as major supermarkets.

From a more positive investment perspective, they could look to invest in companies that promote healthy living and wellbeing through their products and services. This might include companies involved in producing and reformulating food products, running gyms, establishing community sports initiatives or making sports equipment.

A charity with a broad mission covering a range of sectors may decide that the most appropriate ethical investment approach for them is not to apply an exclusionary strategy.

Their decision is to apply a positive emphasis on those companies that adopt the best policies and practices, with strong ESG performance, while avoiding those with poor environmental, social and ethical standards.

Key points

– A solid understanding of the latest trends associated with socially responsible investing (SRI) can help charity trustees align their organisation's core values with an appropriate investment strategy.

– The long-term financial performance of ethical portfolios has defied mainstream scepticism. Independent research shows that SRI strategies have often matched or exceeded the returns of comparable mainstream investments.[11]

– More companies are acknowledging the long-term competitive advantages of achieving higher standards of social and environmental performance and corporate governance.

– Pressure from investors can encourage governments and companies to change their behaviour.

Glossary

Best-in-class/ESG leadership. A means to balance positive selection and avoidance screening. This approach looks within specific industries to identify and invest in companies displaying strong environmental, social and ethical standards, while avoiding those where there is evidence of significant or repeated ESG failings. It can be used to broaden the range of eligible investments – and thereby increase diversification – by allowing investment in major investment areas that may otherwise be excluded.

CSR. Corporate Social Responsibility is an approach to business which seeks to identify and minimise any negative impacts on society and the environment, while promoting responsible corporate behaviour. It is a broad term that can encompass topics such as corporate philanthropy, management of human rights risks, employee and community relations, health and safety, or environmental management.

Engagement. The process of working with organisations, industry bodies or policymakers to address issues of concern and bring about positive change. It encompasses many approaches, for example: informal dialogue; meetings with senior management; public statements; collaboration with other investors; and tabling or voting on resolutions at company AGMs.

ESG. Relating to environmental, social and governance factors.

ESG investing. An approach which incorporates environmental, social and governance factors into the evaluation of investments. It often seeks to identify risks and opportunities associated with ESG factors that a purely financial analysis may miss. For example, the risk of work stoppages or labour disputes due to poor employment practices.

Ethical investing. The application of specific ethical, values-based or religious considerations relevant to the individual or organisation within the investment approach. It can include both positive and negative screening approaches.

Impact investing. Investing with the intention to generate measurable social and environmental benefits alongside a financial return.

Impact first investing. A subset of impact investing, sometimes called social impact investing or social enterprise investment. It often involves an acceptance of lower financial returns or increased risk in return for an expectation of significant social and/or environmental returns. For example, a favourable interest rate on debt issued by a small community organisation working to rehabilitate ex-offenders.

Negative screening/avoidance screening. Choosing not to invest in companies or sectors that are fundamentally at odds with your values or those of your organisation. It can relate to specific activities of concern (such as tobacco or armaments) or aspects of corporate behaviour (breaches of human rights standards for example).

Positive screening. Choosing to invest in companies that are aligned with your values or those of your organisation. It can also involve investment more broadly in companies committed to responsible business practices or those which provide products and services that address environmental or social challenges. It can relate to specific activities of interest (such as renewable energy or affordable housing) or aspects of corporate behaviour (such as good employment practices or responsible supply chain management).

Responsible investing (RI). An approach which emphasises long-term value creation and the avoidance of harm to society and the environment. It usually focuses on ethical and ESG factors rather than sustainability themes. Responsible investing can also be used as an umbrella term to refer to any investment approach which takes non-financial factors into account.

Socially responsible investing (SRI). A broad term used to refer to investment approaches which combine financial considerations with ethical, ESG and/or sustainability considerations. It can refer to any combination of negative screening, positive screening, thematic investment, engagement, ESG integration and best-in-class investment. Investors may be motivated to adopt an SRI approach due to ethical or values-based considerations and/or a belief that it can enhance financial returns or guard against risks.

Sustainable and responsible investing. An alternative to 'socially responsible investing' as an expansion of the SRI abbreviation, used more commonly in Europe and North America. It refers to the same approaches as 'socially responsible investment' (see above).

Sustainable Development Goals (SDGs). A global framework which aims to end poverty, protect the planet and ensure prosperity for all by 2030. Adopted by world leaders at a UN summit in 2015, the SDGs consist of 17 top-level goals and 169 underlying targets. These cover issues such as nutrition, poverty, biodiversity and climate change, with many goals interconnecting. It is widely recognised that achieving the SDGs will require combined action from governments, investors, companies and civil society.

Sustainable investing. Another broad term. It originally applied to investment approaches that focused on particular sustainability themes (such as climate change or water security). Now it tends to be used interchangeably with SRI (see above).

Thematic investing. An approach which aims to identify investments that help solve a social or environmental challenge. It often concentrates on pure-play or highly focused investments where financial returns are directly linked with a social or environmental challenge and its solution. For example, investing in a renewable energy company to address the challenge of climate change. This approach often, but not always, places less emphasis on negative exclusions or ethical concerns.

Traditional/non-impact. An investment approach which seeks to maximise financial returns without any explicit or intentional regard for ethical, ESG or sustainable factors.

About Rathbones

Rathbones is a leading provider of investment management services, advice and training to charities of all sizes throughout the UK. Stewardship is at the heart of our investment approach.

As a part of the charities and specialist services team, Rathbone Greenbank Investments offers dedicated ethical and sustainable investment expertise. As specialists, we know how to balance financial objectives with ethical, social and environmental concerns. For us, ethical investment is not one strategy among many. It is ingrained in every aspect of how we manage money.

We are one of the most experienced teams in this field and have been pioneers in driving change in business and society through ethical investment.

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If you would like to find out more about how we could work with your charity on socially responsible investing, please email victoria.hoskins@rathbones.com or call 020 7399 0000

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