Quarterly investment briefing
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First Actuarial LLP

Discussion topic – ESG

Environmental, Social and corporate Governance (ESG) issues have not historically been a major driver of trustee investment decision making, mainly because of the need to put the financial interests of scheme members first. However, we would expect that trustee boards would prefer to invest in companies that are not damaging to the enviroment, benefit society as a whole and take corporate governance issues seriously.

In a review of fiduciary duties of investment intermediaries, the Law Commission laid out guidance for trustees on ESG investments[1]. This guidance explicitly stated that there is no legal impediment to trustees considering all financially material ESG factors. In other words, trustees are free to take ESG factors into account if there is an investment case for doing so.

An important subset of ESG aware investment is addressing climate change risks. Early in 2016, the Financial Stability Board set up a Task Force to assess the implications of climate change risk. The Task Force released its findings in June 2017.

In this briefing, we discuss the implications of the Task Force's recommendations and the investment case for ESG focussed funds. We also highlight the options available for those seeking an ESG focussed investment.

[1] https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/

Investment Case 1: "Green" investments mitigate the risks associated with transitioning to a low-carbon economy

The Task Force identified 'transition risk' in moving to a low-carbon economy as a potential source of disruption for the financial system. A University of Cambridge study estimates that transition costs leading to shifts in market sentiment could lead to 45% losses in an equity investment portfolio[2].

The Task Force report aims for climate change risks to become mainstream considerations in investment decisions within two to three years[3], assisted by better climate change related public disclosures by firms. The sooner these disclosures become the market norm, the sooner climate related risks will be "priced in" to company valuations. So, if the Task Force's recommendations are adopted, the risk of financial disruption is a pressing one.

The impact of the risk posed by climate change can, however, be mitigated by investing in companies that are likely to benefit from the shift to a low-carbon economy. In particular:

- Companies such as those involved in the production of renewable energy that stand to benefit from climate change driven tax breaks, subsidies and demand.

- Companies involved in the production of materials that help reduce emissions of more polluting sectors. For example, manufacturers of lightweight materials for the aircraft industry may fall into this category.

[2] https://www.cisl.cam.ac.uk/publications/sustainable-finance-publications/unhedgeable-risk
[3] https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf

Investment Case 2: Companies that look strong on ESG grounds are less likely to get caught in a scandal

Scandal can have a lasting detrimental impact on a company's share price. The Volkswagen emissions scandal, which broke in October 2015 and wiped out 30% of the company's market value in a week, is a case in point.

Source: Datastream

There were, however, warning signs and some ESG focussed investors avoided Volkswagen's losses. For instance, MSCI scored Volkswagen poorly on ESG criteria and dropped it from its ESG Leaders Index in May 2015. This was five months prior to the scandal becoming public.

There is of course no guarantee that a fund manager will be able to avoid investing in all companies that get caught up in scandals. However, we believe that those funds who favour well governed companies are likely to do better in this regard.

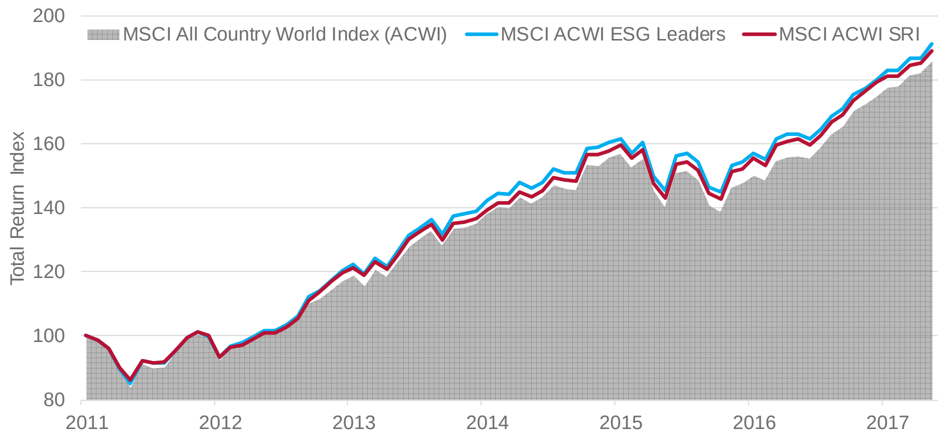
Investment Case 3: Companies that score well on ESG criteria are more likely to offer sustained growth and capital gains

Companies that score well on ESG criteria are likely to:

- Use resources efficiently
- Have labour policies that attract and retain the best staff
- Have corporate governance that encourages best practice

The Task Force's drive to improve disclosure is likely to make it easier for markets to distinguish between companies on ESG criteria. Thus, these factors, along with being potential drivers of long term growth, will also become increasingly important drivers of share price movements.

A number of ESG focussed indices have outperformed the global equity market in recent years, supporting the above investment cases. Indeed, the two indices plotted below have consistently outperformed the global equity market by around 0.5% pa.



Source: Datastream

Accessing ESG funds

With the investment case for ESG focussed funds compelling and demand for such funds strong, the fund management industry has made a somewhat bewildering array of ESG funds available.

The approaches taken by ESG focussed funds do, however, fall broadly follow three categories. A good starting point for selecting an ESG focussed fund is therefore to consider which approach best suits your objectives, beliefs and management fee constraints.

Category 1 – "Exclusionary"

Under this approach certain stocks are excluded from a portfolio. These exclusions are usually based on the sector in which the company does its business (e.g. tobacco, arms or coal).

These funds are suitable for investors who have good reason[4] to avoid certain sectors. With indices containing such exclusions already being available, this approach can often be implemented passively at relatively low cost.

Category 2 – "Tilts"

Under this approach the manager tilts their portfolio away from, but does not exclude, companies who score poorly against ESG criteria. They will also tilt their portfolio towards those who score well in these criteria.

[4] *In addition to financial reasons, "good reasons" include concerns that scheme members share about investing in a particular sector. The Law Commission guidance, referred to earlier, covers such "non-financial" decision making factors*

This approach is suitable for those who believe that companies that score well on ESG criteria will perform more strongly in the long term.

Under this approach, the scoring and weighting of companies is often implemented on a quantitative, rules based approach. As such, it can also be achieved at a relatively low cost

Category 3 – "Impact investing"

Under this approach, investments are made with a specific intention of improving society or the environment. The range of improvements targeted by funds is very broad and includes the provision of clean water, energy and healthcare to the developing world and supporting social enterprises in the UK.

The investment case for funds that target the reduction of carbon emissions is particularly strong given the mitigation they offer against climate change risk. The investments such funds make in renewable energy production, as well as materials and technology that reduce energy consumption, could perform particularly strongly if climate change risks become "priced in" over time.

These funds are by nature actively managed and higher management fees are typically charged.

In summary, there is a broad range of ESG focussed funds available and a broad range of financial justifications for investing in them.

For those trustees looking for an ESG focussed fund, there is likely to be a suitable option available.

Small print

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