A guide to responsible investing

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Investment Platforms May 2022

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The value of your investments can go down as well as up and you may get back less than you originally invested. We don't offer advice, so it's important you understand the risks, if you're unsure please consult a suitably qualified financial adviser. Tax treatment depends on your individual circumstances and rules may change. Past performance is not a guide to future performance and some investments need to be held for the long term.

A guide to responsible investing

A lot of the time, investing can feel pretty abstract. You buy funds or shares through a computer or smartphone, and log in to your account to see how they're doing. All being well, their value goes up – and your wealth with it.

Responsible investing acknowledges that investing – abstract as it can seem – has a real-world impact. It's about choosing investments with the heart as well as the head, so performance and returns don't come at the expense of people and the planet. The aim is twofold – to make money for yourself, and make the world we live in better, if possible, too.

It's often thought that these two aims are incompatible. But sticking to your principles doesn't mean sacrificing your profits. It's important to remember that responsible investing doesn't look to **replace** traditional investing, but to **complement** it. And as we'll see later on, there is growing evidence that favouring responsible investments can, in some cases, actually lead to higher, not lower, returns.

In this guide, we'll explain what makes an investment responsible, look at the three main approaches, and discuss how to research responsible funds and shares. Responsible investing is also variously called 'ethical', 'ESG' and 'socially responsible' investing, and we've used these terms interchangeably throughout the guide. To help you get your head around all the lingo, you'll find a useful jargon buster at the end.

What makes an investment responsible?

Companies have an impact on the world. Responsible investing, simply, sets out to avoid those companies that have an adverse impact, and favour those that have a positive one.

When weighing up whether a company is suitable for a responsible portfolio, there are several different factors to consider. These are usually grouped under three main headings: environmental, social and governance (or ESG for short). To give you an idea of what each heading covers, here are some examples:

Environmental

Climate change
Deforestation
Plastic waste
Pollution
Resource depletion

Social

Child labour
Employee relations
Human rights
Modern slavery
Working conditions

Governance

Bribery and corruption
Executive pay
Board diversity
Political lobbying & donations
Tax affairs
Cyber security

The three main strategies for investing responsibly

Responsible investing is becoming increasingly popular, with today's investor able to choose from a wide array of responsible funds. But not every fund manager invests the same way. In this section we'll look at the three main approaches to responsible investing.

These three approaches aren't exclusive – many funds use them in combination. So always look 'under the bonnet' by doing additional research first.

ESG integration

ESG integration is a fairly straightforward way to introduce responsible investing to a portfolio. It simply means that when researching an investment, you consider ESG factors alongside the usual financial ones. To assess a company's ESG credentials, a fund manager will typically examine all the environmental, social and governance factors included in the table on page 3.

ESG integration can be a complex process, and lead to seemingly counterintuitive results. For example, it's possible that an oil and gas company is selected if ESG analysis concludes that their work in other areas, such as renewable energy, makes them a responsible player overall.

Socially responsible investing

To avoid the counterintuitive results that ESG integration can produce, socially responsible investing generally uses a form of 'screening'. That includes negative screening, which is a blanket exclusion of all companies within non-socially responsible sectors, such as oil and gas.

Positive screening, on the other hand, actively seeks out companies that meet socially responsible values, such as a strong gender diversity policy or track record in carbon emission reduction.

Impact investing

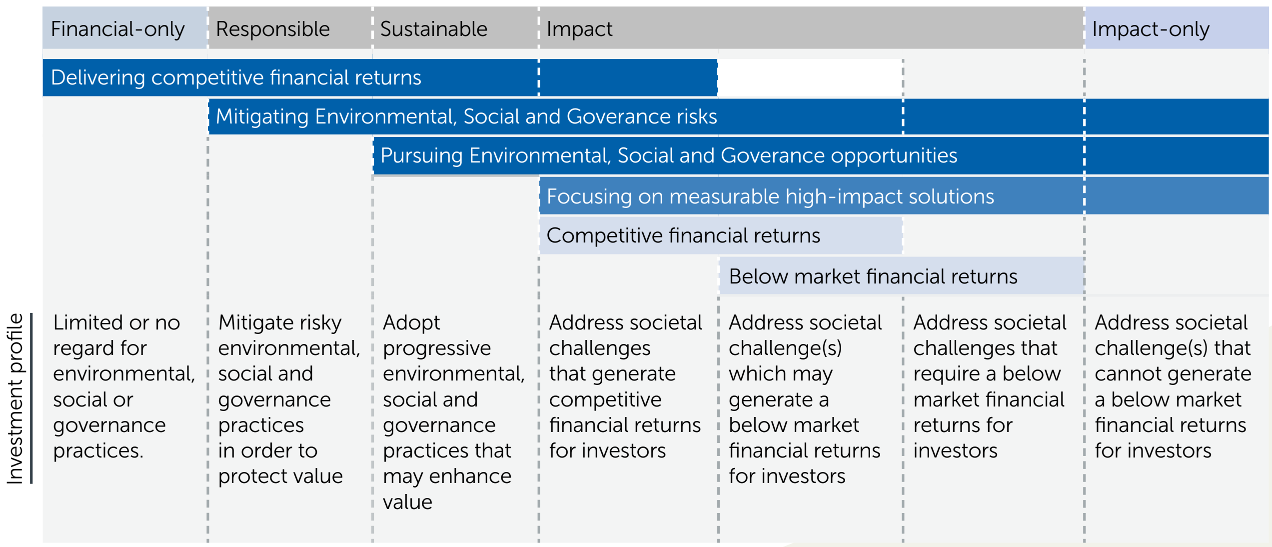
In contrast to the other two approaches, impact investing prioritises social outcomes over and above financial returns. It selects companies specifically for the positive, measurable effect they have on society or the environment, often following a specific theme – such as renewable energy, gender equality or water management.

Values or value?
Deciding how responsible your portfolio should be

Responsible investing has a spectrum. For some, financial returns will be the priority; for others, choosing ethical investments is the crucial consideration, and returns are secondary.

That's why there are different approaches to responsible investing. These range from the 'lightest touch', which seeks to avoid the biggest ESG offenders without sacrificing financial returns, all the way to impact investing, where the focus is largely on addressing societal and environmental issues.

In the following chart, you can see how different responsible investment styles balance the need for financial returns with responsible investing goals.



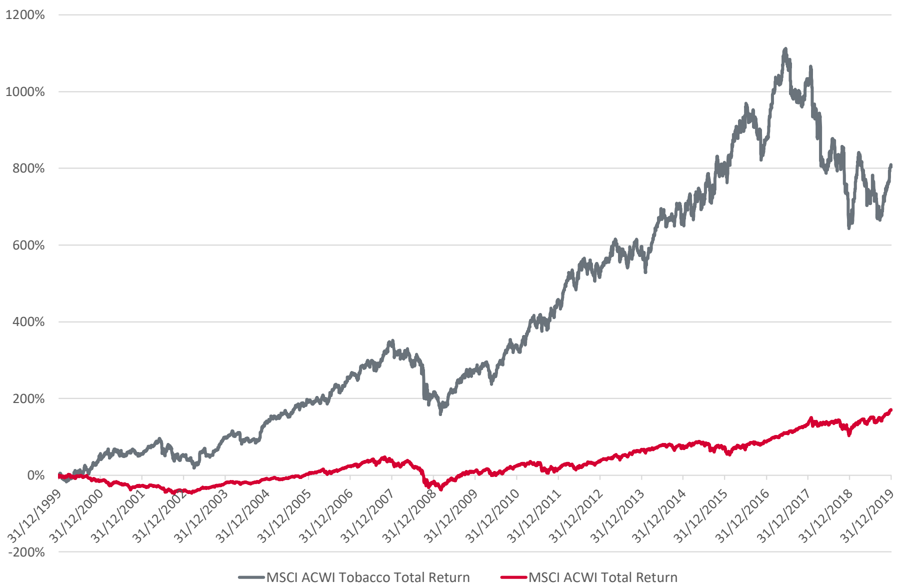
Source: Social Impact for Investment: Building the Evidence Base (2015) OECD
https://read.oecd-ilibrary.org/finance-and-investment/social-impact-investment_9789264233430-en#page20

Performance versus principles – a trade off?

Prioritising ESG factors over financial ones doesn't have to leave you with an underperforming portfolio. In fact, there's a growing consensus that taking a responsible approach can, in some cases, lead to higher returns.

This wasn't always so. In the past, when responsible investing employed an ethical approach, stocks that didn't meet the investor's values would be screened out. This made it difficult for an ethical fund to consistently outperform a non-ethical one – able to pick high-performing investments in non-responsible companies or sectors such as alcohol or energy.

For example, since 2000 through to the end of 2019, an index of tobacco stocks significantly outperformed the stock markets. This sector is often screened out as part of a socially responsible investing style.



Source: Bloomberg LP.

The past performance is not a guide to future performance and some investments need to be held for the long term.

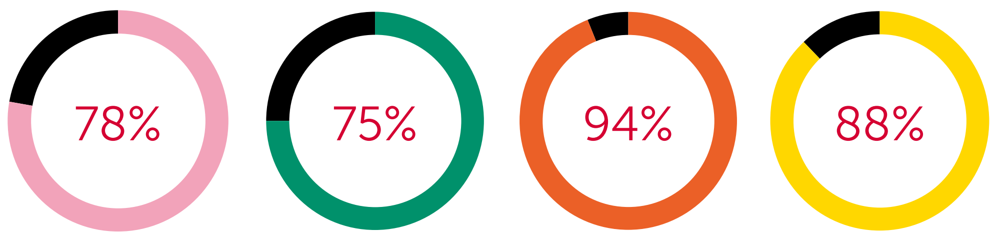
New approaches – stronger performance

But as explored on page 5, there are now different styles of responsible investing. Instead of simply applying blanket exclusions, they take a flexible approach – investing in companies with good ESG practices, and avoiding companies that don't.

To illustrate why this can improve returns, let's take the case of Volkswagen. In September 2015, the company's share price fell more than 30% in two days on the news that it had fitted devices to its cars to 'cheat' emissions tests. Before this happened, Volkswagen scored badly for company governance because of the composition of its board. So investors using ESG scoring systems would likely not have had the company in their portfolio. Similar examples are BP and BHP Billiton, who would have fared badly on ESG assessments before their disasters at Deepwater Horizon and the Mariana dam, respectively.

By employing a combination of screening (which can potentially lower returns) and ESG integration (which can potentially improve returns), taking a responsible approach doesn't have to mean foregoing performance.

As the following data from Blackrock shows, indices taking a responsible approach outperformed the broader stock markets during market sell-offs:



EM / energy downturn. 21 Jul 2015 - 11 Feb 2016.

Fed Policy reaction. 20 Sep 2018 - 24 Dec 2018.

COVID-19 crisis Q1 2020.

YTD 2020.

Source: BlackRock, as of May 11, 2020. For illustrative purposes only. This is a set of 32 globally-representative, widely analyzed sustainable indices and their non-sustainable counterparts. Indices are unmanaged and used for illustrative purposes only and are not intended to be indicative of any fund's performance. It is not possible to invest directly in an index.

But be aware of bias

It's important to note that a responsible portfolio is likely to show a bias towards certain types of companies. For example, European companies tend to score better on ESG metrics compared to US or emerging market companies. In a similar vein, technology companies tend to score better than energy companies. This means that in the short term, performance could vary from a mainstream index, such as the MSCI World – either for better or worse, depending on other factors such as the health of the underlying economy.

What to do before you begin choosing investments

Responsible investing is, by definition, subjective. There's no universal standard on whether an investment is ethical or not. It will come down to your personal values. A company considered problematic by some investors might be thought perfectly fine by others – and vice versa.

Perhaps the most important first step, then, is to ask yourself:

- What are your personal values?
- Which sectors and companies are you happy to invest in, and which do you want to avoid?

Doing this will help you choose investments in line with your principles.

How to choose responsible funds

Not sure you've the time, or confidence, to pick individual shares? You could opt for funds instead. Funds have the benefit of providing quick diversification, as well as the expertise of a professional fund manager with dedicated resources.

When picking a fund with a responsible mandate, you'll need to carry out a bit more research than usual. You'll need to look at how the fund is managed responsibly – and decide whether these standards meet your own. Knowing that a fund has a 'responsible', 'ESG' or similar label is a useful starting point, but this doesn't always tell the full story.

For instance, what is the fund manager's investment strategy? As we've discussed, there are different responsible investing styles, and you may prefer one to another. A manager may use a negative or positive screening approach similar to that described earlier, or may invest according to specific themes – for example, a dedicated gender diversity fund.

Be wary of 'greenwashing'

Another reason you should carefully consider a fund's management strategy is to avoid those guilty of 'greenwashing'. Greenwashing is when a fund markets itself as responsible, but includes non-responsible investments. You can spot a greenwashed fund by scrutinising its screening criteria, as well as the underlying investments it holds.

The increasing attention paid to responsible investing in recent years has prompted funds and companies to be more proactive at providing evidence of their responsible credentials. This means it's getting easier to tell the genuinely responsible investments from the fakes.

Should I choose a passive or active fund?

When choosing a responsible fund, one question you'll need to answer is: active or passive?

An active fund has a fund manager who aims to outperform the market, choosing investments based on their views and strategy. Typically higher charges.

A passive fund looks to mirror the performance of an index, such as the FTSE 100, and isn't actively managed. Typically lower charges.

Both approaches have their pros and cons. But when you're looking for a responsible fund, there are several additional factors to consider.

How consistently does it exclude non-ethical investments?

If you're sure you want to avoid certain companies or sectors, a passive fund may be more appropriate. That's because passive funds follow a defined set of rules, while an active investment enjoys greater freedom.

However, it isn't always that black and white. For example, if you want to avoid investing in tobacco, you could choose a passive fund that expressly avoids tobacco. However, the fund may also include holdings in a supermarket that sells tobacco products, or a paper company that produces cigarette cartons. Similarly, an active manager may also exclude tobacco products, but come to a different conclusion about what can and can't be included.

How does it assess an investment's ESG credentials?

To assess a company's ESG credentials, most passive funds enlist third-party data providers – such as MSCI and Sustainalytics – who award companies an ESG rating.

Though they seem objective, such ratings depend on subjective judgements. For example, one data provider may score Tesla highly because they produce electric cars; another may mark them down for perceived governance problems. A passive fund *can* give your portfolio a better ESG score in the round, but dig deeper and certain companies could be outliers.

Active managers will usually consult ESG rating agencies too. But they can also analyse the different issues a company faces, and draw their own conclusions from their data.

How much does it engage with the companies it invests in?

To truly tell how responsible a company is, it's important to engage with it directly. Passive and active fund managers do this in different ways.

A passive fund will often contain hundreds, if not thousands of companies – making it difficult for managers to engage with them all. They are also less flexible than active funds, and must invest in a company if dictated by the index it tracks. However, some of the world's biggest fund managers are passively managed, including Blackrock, Vanguard and State Street. This gives them the resources to engage with the companies they invest in. They can also vote down the re-election of board members that have failed to enact important changes – such as disinvesting in unethical companies.

Active funds, on the other hand, generally have a smaller number of holdings – making it easier to engage directly with companies. They are also more flexible than passive funds, enabling them to disinvest from unethical companies.

Cost

Responsible funds typically cost more than non-responsible ones. The premium for passive funds is fairly small (around 0–0.3%). However, it's larger for active funds, in which investing responsibly involves additional work.

There are three main reasons why responsible funds cost more:

Data

Assessing a company's ESG credentials requires extra research. Outsourcing this research to third-party data providers is an additional expense.

Engagement

It's important to liaise with companies to make a proper ESG assessment. This takes time and comes at a cost.

Reporting

A responsible fund needs to explain to investors the societal and environmental benefit it is delivering, which can also be expensive.

How to choose responsible shares

Building a portfolio of shares you've chosen yourself requires more research than buying a fund. But it also allows you 100% control over what goes into your portfolio – meaning you can be sure it aligns with your principles.

Once you've decided which sectors to avoid and include, one way to get started is by using a screening approach, as described on page 5.

Negative screening excludes companies that conflict with your personal values – for example, firms with poor records on animal testing.

Positive screening looks to actively include companies whose activities benefit society – for example, renewable energy companies.

How to assess a company's ESG credentials

So you've ruled out – and ruled in – certain sectors. The next step is scrutinising individual companies. Thankfully, you can divide this process up into the environmental, social and governance (ESG) factors we've described earlier.

It's worth noting that it's hard to find companies which do all three impeccably. There is no 'perfect' company, and all firms would do well to continually look to improve their standards. The good news is that ESG reporting is becoming more and more transparent – making your research easier – but keep in mind the reliability of this data is sometimes still questionable. Here is what you need to look at in each category.

Environment

What is it?

A company's impact on the natural world – including waste and pollution, resource depletion, greenhouse gas emissions, deforestation and climate change.

How do I research it?

These days, company reports have a greater focus on non-financial reporting. They usually include the company's greenhouse gas emissions – making it relatively straightforward to tell if a company has reducing their carbon footprint over time. This can be a good indication of how seriously they take wider environmental issues.

Social

What is it?

The well-being and rights of a company's people and communities – covering working conditions, conflicts, health and safety, employee relations and diversity.

How do I research it?

Social issues tend to be more intangible and harder to analyse than environmental and governance ones. But you can get an idea by reviewing a company's website and looking for reports or policies on social issues such as a Modern Slavery statement. You can also look at public information. This could include information such as reports on gender pay gap or health and safety records. Other sources could include HR awards won by the company, such as The Times Best Companies to Work For.

Governance

What is it?

A company's management and oversight – specifically executive pay, board make-up, diversity, tax strategies and any cases of bribery and corruption.

How do I research it?

For public companies, you can check the board structure, and the diversity of board members, by visiting its website. Additionally, company mission statements which mention ESG, or any dedicated ESG mission statements you can lay your hands on, can give you a helpful steer.

Finally: old-fashioned research

Once you're satisfied that a company's ESG credentials are sound, you can then get on with the more traditional work – researching whether it might be a good investment.

You can learn more about the nitty gritty of researching shares in our First-time investor guide, as well as on our website.

Owning a share also brings voting rights. You can use yours to influence company management for the better. If you grow disappointed with a company's ESG policies, and don't see them changing for the better, you may decide it's better to sell up.

What are the risks?

No matter how well-run a company, or impressive its ESG record, it still faces the usual risks. It can go out of business during challenging economic conditions if it isn't flexible enough to cope.

Investing responsibly, however, can help you avoid putting money into companies with looming environmental problems. As discussed on page 4, ESG rating agencies flagged the risks faced by BP and Volkswagen before their respective disasters in 2010 and 2015.

But it isn't absolutely foolproof. In 2020, the company Wirecard in Germany was embroiled in a case of corporate fraud that led to its eventual insolvency. But this governance risk wasn't uncovered by all ESG rating agencies.

So, while a responsible approach lowers your chances of investing in a bad bet like Wirecard, it doesn't remove the possibility completely.

The easy way to invest responsibly

Want to invest with the heart as well as the head? At AJ Bell, we offer all the resources a responsible investor could need. You've thousands of funds and shares, investment trusts and ETFs to choose from, along with extensive accompanying data and research. Want to narrow down your search? Our AJ Bell Favourite funds list includes our specialists' pick of ethical funds.

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The value of investments can change, and you could lose money as well as make it.

The information contained in this guide is based on our current understanding of ESG investing which may be subject to change.

We don't offer advice, so it's important you understand the risks. If you're not sure, please speak to a financial adviser.

Jargon buster

Corporate governance	The processes, procedures and frameworks that direct and control a company. Usually the responsibility of the company's board of directors.
ESG	Environmental, social and governance. The three central factors when assessing a company's responsible credentials.
ESG integration	An investment process that takes environmental, social and governance factors into account, as well as financial outcomes.
Ethical investing	A type of investment process which is guided by overarching values or beliefs rather than a strict focus on financial outcomes.
Green bond	A bond whose proceeds are used exclusively to fund environmentally friendly initiatives.
Green investing	Investing in companies specifically focused on making a positive impact on the environment.
Greenwashing	Giving the false impression that a company or portfolio is much more ethical or responsible than it really is.
Impact investing	An investment strategy that prioritises ESG concerns over financial returns.
Negative screening	The process of filtering out companies from non-responsible industries (such as tobacco, alcohol or arms).
Positive screening	The process of actively investing in industries or companies with good ESG practices, such as a strong gender diversity policy or track record in carbon emission reduction.
Principles for Responsible Investment	Six principles defined by the United Nations as a framework for fund managers to incorporate responsible investing into their process. You can learn more here: https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment
Responsible investing	An investment strategy in which environmental, social and governance (ESG) factors are a fundamental consideration, rather than focusing solely on performance and return. Encompasses different approaches such as ESG integration, socially responsible investing and impact investing.
Socially responsible investing (SRI)	An investment process that uses positive or negative screening to choose companies with good ESG credentials.
Stewardship	Actively engaging with companies to promote strong corporate governance. Aimed at fostering long-term value for shareholders as well as the wider economy.
Sustainable Development Goals (SDGs)	A set of 17 targets designed by the United Nations as a blueprint for addressing a range of social and economic problems. The SDGs are often integrated into responsible investment practices. You can learn more here: https://www.un.org/sustainabledevelopment/sustainable-development-goals/