UBS

# Sustainable investments

A brief look at some of the key questions

There's always a purpose behind financial investments. Perhaps it's performance. Or having investments which reflect your values as an organisation.

For many of our clients sustainable investing is a key part of their approach to defining their purpose, but what is sustainable investment and what approaches are out there? Will we give up performance if we invest in this way? Can we be confident that your investments aren't merely "greenwashed"? What is the Charity Commission's guidance on moving to a sustainable investment approach?

In this brief paper we look to unpick these key questions which we've been discussing with our clients for over a decade.

**What is sustainable investment?**

Sustainable investment (SI), Environmental, Social, and Governance (ESG) investing, Socially Responsible Investing (SRI) and various other terms are used interchangeably to describe one key approach, which is investing with the intention to perform comparably to traditional investments while at the same time having a positive impact on the environment and society. This could relate to the overuse of natural resources, rising levels of pollution or the effects of increasing urbanization.

Broadly speaking, sustainable investing contains three distinct approaches: exclusion, integration and impact investing.

*Exclusion*

Historically the principal approach involved excluding individual companies or entire industries from portfolios if their areas of activity conflict with an investor's values. This process, called exclusionary or negative screening, can rely either on standard sets of exclusion criteria or be tailored to investor preferences. For instance, a cancer charity may wish to exclude companies with 5% or more of sales generated from tobacco.

Exclusions can, however, be rather a blunt tool. I recall a discussion with a client which had formulated an investment policy which included no fewer than 15 exclusions. By the time all these had been excluded (with a very low tolerance threshold) the investible universe had materially shrunk. Following discussion with the trustees we discussed the advantages and disadvantages of this approach and they pared back their hard restrictions to those which had a clear inconsistency with their core charitable objectives and instead looked at a more integration and impact-based approach.

*Integration*

This approach combines environmental, social and governance (ESG) factors with traditional financial considerations to make investment decisions. It involves understanding how companies handle ESG risks that could entail significant costs or damage their reputations. It also involves assessing whether firms are well positioned to capture opportunities arising from major sustainability-related themes and trends which might give them a competitive edge.

*Impact*

Impact investments are investments made with the intent to generate measurable environmental and/or social impact that seek attractive financial returns. Because the link between capital invested and actual impact generated is more difficult to establish in the liquid public markets, in practice this means that impact investments tend to be private market investments. One notable exception to this rule is shareholder engagement, where investors may use their ownership stake in a company to drive measurable environmental and/or social change.

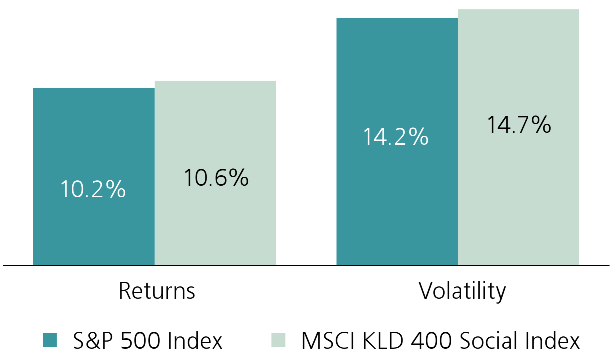
### Will I sacrifice performance?

One important myth to bust is that sustainable investing and impact investing in particular is not philanthropy. It is investing with the expectation of financial return.

Our view, and the view of the industry more broadly, is that there is no reason to sacrifice performance to invest sustainably. This is supported by academic research from the University of Hamburg and NYU Stern Business School and also when comparing the historical returns of sustainable investing indices and conventional indices.

The following chart shows that the MSCI KLD 400 Social Index and the S&P 500 index generated similar returns and volatility over the 29 years to November 2019.

*Average annual returns and volatility*




**Notes**

Performance is not guaranteed. The past performance of an index is not indicative of future results. An index reflects an unmanaged universe of securities and investors cannot invest directly in the index. Please always read in conjunction with the risk information at the end of the document.

Data from 30 April 1990 to 29 November 2019.

Investing involves risks, including the potential of losing money or the decline in value of the investment.

KLD (Kinder, Lyndenberg, Domini & Co) Research & Analytics. The MSCI KLD 400 Social Index is a capitalization weighted index of 400 US securities that provides exposure to companies with outstanding Environmental, Social and Governance (ESG) ratings and excludes companies whose products have negative social or environmental impacts. The parent index is MSCI USA IMI, an equity index of large, mid and small cap companies. The Index is designed for investors seeking a diversified benchmark comprised of companies w ith strong sustainability profiles while avoiding companies incompatible with values screens. Launched in May 1990 as the Domini 400 Social Index, it is one of the first SRI indexes. Constituent selection is based on data from MSCI ESG Research. (Source: MSCI, 2019)

The S&P 500 focuses on the large-cap sector of the market; however, since it includes a significant portion of the total value of the market, it also represents the market. Companies in t he S&P 500 are considered leading companies in leading industries. (Source: Nasdaq, 2019)

### How can I spot greenwashing?

As investors have become increasingly attuned to sustainable investment, so the number of investment managers purporting to invest with a sustainability lens has proliferated. Greenwashing is the practice of intentionally misleading investors or giving them a false impression about how well their investments are aligned with their sustainability goals.

This matters, because if the fund or portfolio which you're invested in is greenwashed then it isn't doing what you think it is. This could lead to reputational issues for both the investment manager and you as an investor.

You can take a couple of steps to control your risk on this front. The first is to ask your manager(s) to explain the approach taken. The response you should expect is one which evidences the process which they use and/or the positive impact which it has. Second, many managers now have third-party endorsements for their approach. Is this from reputable third parties? Are these endorsements current?

Ultimately, as with all matters related to the investment of your charity's assets, you should take care to ensure that you are conducting ongoing monitoring of your advisers and decide what matters to you as a body of trustees.

### What is the Charity Commission's guidance?

Earlier this year, the Charity Commission issued a Consultation on draft revised guidance to CC14 (Charities and Investment Matters: a Guide for Trustees). The revised guidance had the intention of providing greater clarity to charity trustees about adopting a responsible investing approach. In my view there were a number of shortcomings with the Consultation, which principally stem from the law in the area being rather long in the tooth.

The law is founded on the Bishop of Oxford case which sets out three justifications for investing ethically:

– Where investments in a particular type of business would conflict with the aims of the charity;

– Where certain investments might hamper the charity's work, either by making potential beneficiaries unwilling to engage with the charity or by alienating supporters or beneficiaries; and

– There is no significant financial detriment.

Given these hurdles to jump over, it's no surprise that many trustees have felt uncomfortable pursuing a sustainable investment approach. The Commission's well-intentioned Consultation has therefore been somewhat ham-strung by the inflexibility of the law.

However, a case is currently in the High Court which has been brought by two charities in relation to responsible investment. The decision in this case may enable the Commission to take a more expansive view of the circumstances in which a charity may invest ethically and thereby provide greater comfort to trustees who are looking to invest their asset sustainably.

We are watching this with interest …

### Trustees' approaches

While there is an investment rationale for sustainable investment and many charities have already taken the opportunity to invest their portfolios sustainably, it is hoped that the High Court case will provide a watershed moment as regards the legal framework for this approach. In the meantime trustees who are looking to move to a sustainable investment approach should review their investment policies and consider, in conjunction with their advisers, the approach to sustainable investing which is the most appropriate expression of their charity's purpose.

If you would like to discuss our sustainable investing offering or any other aspect or your investment portfolio can help you, please contact us.

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**Your capital is at risk. The value of investments may fall as well as rise and you may not get back the amount originally invested.**



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