Beginners guide to responsible investing

Russell Investments

Socially responsible investing (SRI) has been around for a long time. Centuries ago, responsible investing found its origins in Jewish and Islamic regulations that targeted investments in industries deemed sinful.

In the 18th and 19th centuries, responsible investing started in the US with the Methodists and Quakers shunning investments in the slave trade. In the second half of the 20th century, responsible investing was also used to protest the Vietnam War, 'dirty' energy, and apartheid in South Africa. Environmental, social and governance (ESG) is a closely related term that was coined more recently in 2005.

Since then, SRI has generated significant traction, and now is an integral component of any well-structured investment policy. Traditionally, investments in companies deemed to be participating in 'sin' activities were avoided by socially responsible investors. SRI now covers a much broader range of criteria, involving issues such as corporate governance, human rights, corruption, and the environment. While simply not holding controversial stocks is still the most common style of SRI, it has developed with more intricate strategies.

With the increasing attention SRI investing has received in recent years, there has also been greater confusion around the correct thought process needed to decide why and how one might invest responsibly. In this article, we look at what SRI is, and some of the motivations for incorporating SRI strategies when investing.

What is SRI?

Investors with SRI strategies primarily consider non-financial company information when deciding how much (or whether not) to invest in a particular security. This information is usually around how much a company adds (or detracts) to society.

There are many names for SRI strategies which include:

- ESG investing
- Values-based investing
- Sustainable investing
- Ethical investing
- Impact investing

While each term has a slightly different definition, we use SRI as a term that refers to any and all of the above styles of responsible investing.

Why might an investor make an ESG investment?

There are two reasons an investor might make SRI a part of their investment strategy. Investors might take a 'values' approach, in which they account for their personal belief set when constructing their portfolio. Alternatively, investors may aim to use SRI strategies to improve the performance of their portfolio through a 'value' approach.

Values

The traditional form of SRI has a focus on avoiding investments in firms that don't align with societal values and ethics. This is an attempt by investors to ensure that their portfolio constituents are consistent to their personal beliefs. A clear distinction is drawn between "good" and "bad" investments from a moral and ethical perspective. Consequently, it is of no great concern if the returns achieved from good investments do not match those from other investments, given their redeeming social characteristics. This is known as a values-based SRI strategy. A values-based SRI strategy has the objective of ensuring that the investors portfolio is aligned to their personal beliefs or ethics.

For example, an investor who also strongly believes in addressing environmental issues may decide to consider a firms track record before investing in it. This investor might exclude polluting companies from their portfolio, or have larger investments in companies that produce clean energy. This investor would not be too concerned with the effect of this decision on their portfolio performance, as they would be investing in accordance to their personal beliefs.

Value

Incorporating information on SRI factors when trying to improve investment performance is known as a value-based SRI strategy. Often, this is implemented using firm ESG scores.

Some investors consider a stock's ESG profile to be useful information when trying to predict its returns or estimate its riskiness. These investors may believe that ESG investments, defined in a broader sense, can be expected to generate better returns, and that stocks with good ESG scores are 'cheap' relative to those with poor scores. Alternatively, some investors may believe that certain ESG themes are overpriced. This would mean that stocks with good ESG scores are 'expensive' and may generate inferior returns in the future. Both strategies are value-based approaches.

An example of this is an investor who is choosing between two companies to invest in. Overall, both companies are similar and operate in the same industry, but one has several corporate governance concerns, including the CEO hiring their friends in top positions, taking an excessive salary and has arranged for a 'golden parachute' in case they get fired. This investor might consider this company to be riskier than the other and invest less money in it.

Creating an ESG framework

Before engaging in an SRI strategy, an investor should clearly identify why they are doing so. They should frame whether they are making the investment on a values- or value-based framework.

If the investment is a values decision, the investor must identify what they are explicitly looking to avoid, and how it should be measured. Certain values criteria are more easily measured – for example, an investor looking to avoid tobacco investments would simply exclude any securities in the tobacco industry from their portfolio. Other definitions are less black and white – for example, an investor looking to exclude carbon from their portfolio, could exclude firms that extract fossil fuels, but also firms that rely heavily on fossil fuel energy in operations. These definitions must be clearly identified by investors when they create their strategy.

When making a value decision, investors should understand what their beliefs are. Do investors believe that investing in high scoring ESG firms will improve returns? Will investing in positive firms reduce investment risk? Or does the investor believe that sin industries are more likely to outperform? Is this strategy only going to generate returns in the short run? Ideally, research should be the basis of forming such a values-based belief.

In reality, a typical investors decision to adopt an SRI strategy is a combination of both values and value approaches. In the simple scenario where both are aligned, the strategy of the investor is clear. In the more complicated case where the values of an investor contradict their belief in ESG investment value, investors must make a call – is sacrificing returns worth incorporating their personal beliefs, or vice versa?

ESG in the investment industry

The industry has also moved to accommodate the shifting demand for SRI investments. Over time, more and more SRI products are being offered by money managers to investors. Sometimes, the SRI products are marketed simply as investment solutions that satisfy the demands of the socially conscious investor. At other times, these products promise that due to their strategy, investors can expect to see better investment performance.

It is still too early to make a confident decision on whether ESG improves investment performance. Because ESG investing is still a trending phenomenon the impacts of ESG on the performance of financial securities is not yet understood with clarity. We know that excluding poor ESG scoring stocks reduces the diversification of an investment portfolio. We also know that good corporate governance is a prerequisite for good company performance; Similarly, poor environmental and social practices can cause a serious dent in the performance of a company. Whether or not ESG investments generate a consistently superior (or inferior) return depends on whether ESG factors are already, and properly, factored into the price of a stock. Indeed, many academic studies find contrasting evidence on whether ESG adds or detracts from returns. As a result, investors must ensure that they are able to separate the true product offering from a marketing spin.

This is not to say that SRI and ESG products have no importance – they can be used to satisfy the demands of values-based investors that wish to avoid controversial investments. Often, these values-based motivations are excluded from the ESG discussion, which tends to instead focus on whether ESG factors can improve portfolio performance.

Common ESG strategies

There are three broad options open to investors who wish to embrace SRI investing:

- Adopt an engagement strategy and join with other investors in entering into a constructive dialogue with company management. Various parties offer this service for little cost.
- Invest in an "active SRI" product where securities are excluded or included based on their specific characteristics.
- Invest in a "passive ESG" product whose stocks are chosen to meet particular SRI criteria. This is

an enhanced-passive strategy where securities weights may be positively or negatively tilted based on their ESG scores.

- Invest in a product which targets a particular SRI theme, such as sustainability or water.

There are a limited but growing number of products available in the market using these strategies. Russell Investments actively conducts research within both the values and value spheres of SRI, and has products available for investors with SRI mandates.

For more information on Russell Investment's research on SRI and ESG, please see: https://russellinvestments.com/nz/about-us/responsible-investing

\

IMPORTANT INFORMATION

Issued by Russell Investment Management Ltd ABN 53 068 338 974, AFS Licence 247185 (RIM). This document provides general information for financial advisers only. It has not been prepared having regard to any investor's objectives, financial situation or needs. Before making an investment decision, an investor must obtain advice from a financial adviser and consider whether this advice is appropriate to their objectives, financial situation or needs. This information has been compiled from sources considered to be reliable but is not guaranteed. Model Portfolio performance results described in this document are hypothetical and have been provided for illustrative purposes only. The hypothetical performance results do not reflect actual results to investors which could differ substantially. Past performance is not a reliable indicator of future performance and the performance described here is of a theoretical model. Any potential investor should consider the latest disclosure document of the Managed Portfolio (''Disclosure Document'') in deciding whether to make or continue to hold, an investment in the Managed Portfolio. The Disclosure Document can be obtained by contacting a financial adviser or the platform operator(s) offering the Managed Portfolios. RIM is part of Russell Investments. RIM is the issuer of the Russell Investments Funds and Russell Investments ETFs mentioned in this document. RIM or its associates, officers or employees may have interests in the financial products referred to in this document by acting in various roles including trustee, investment manager, broker or adviser, and may receive fees, brokerage or commissions for acting in these capacities. In addition, Russell Investments or its associates, officers or employees may buy or sell the financial products as principal or agent. Neither RIM, Russell Investments or its associates, officers or employees guarantees the repayment of capital, the performance of any Russell Investments products or any rate of return referred to in this document.

Copyright © 2020 Russell Investments. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments.