Investors' Chronicle

Investing explained

Sustainable investing

Sustainable investing has entered the mainstream in recent years, and amid global efforts to overcome climate change there's little sign of it losing pace. Yet for investors there are a myriad of metrics, definitions and benchmarks to navigate if you want to understand how sustainable your holdings may be.

What is sustainable investing?

Sustainable investing does not match an exact definition, with many phrases often used interchangeably to refer to products and approaches that allow people to invest in line with their beliefs and values.

ESG (environmental, social, governance) investing is centred on the three core principles, often backed up with data, while responsible investing and ethical investing are more tailored to suit an individual's beliefs and morals. The ambiguity means there is room for interpretation and different contexts when discussing sustainable investing, according to Mark Fitzgerald, head of product specialism, Europe, at Vanguard.

“There have been efforts to impose some structure on these terms,” he says. “In particular, the Investment Association breaks ‘responsible Investing’ down into three broad categories; ‘sustainability focus’, ‘exclusionary’ and ‘impact’. “‘Sustainability focus’ is defined as an investing approach that aims to achieve a particular sustainability goal, such as climate change mitigation, or reducing pollution,” he says.

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What’s in this guide?

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Sustainability metrics

Determining the returns of an investment is one thing but calculating the real-world impact an investment has made is nuanced, complex and frequently imperfect. Often, it starts with companies reporting their climate-related data, such as carbon emissions, as well as their objectives and strategies to become more sustainable. New regulations in the UK have mandated more companies to report their climate metrics, but the area is still emerging.

James Hewitson, head of wealth management at HSBC UK, says that two major metrics can be used to paint a general picture of how sustainable an investment opportunity is – climate risk and a carbon intensity index score.

Climate risk is a "metric used to measure how resilient a company is against issues and risks associated with climate change", Hewitson says. Asset managers are more commonly placing climate risk alongside traditional investment risks.

The second metric Hewitson uses is the Carbon Intensity Index – a value assigned to a company that describes the volume of carbon emissions against the company's revenue. "Most companies have to report what their score is as part of the framework, and from that, fund managers can see if they are on target, transitioning, or off track," he says.

The industry is still trying to agree on a standardisation of metrics and how they are reported. "These metrics are published on fund factsheets so customers can make an informed decision," Hewitson says.

Jim Henning, principal investment consultant at Dynamic Planner, points towards the value of governance metrics. "There is evidence that well-run companies with high-quality corporate governance are more likely to be managing overall business risks upstream and downstream more effectively than those that have poor governance metrics," he says.

Meanwhile, social metrics around supply chain, product safety and packaging waste are more "financially material" risks, Henning adds.

Metric minefield

Sustainability data is nascent, meaning that scores, profiles and metrics are often inconsistent, imprecise and sometimes subjective. As a result, it is hard for individual investors to accurately interpret the metrics correctly. An incorrectly labelled investment could result in 'greenwashing', where an investor decides on an investment that appears greener than it is.

"Customers will need to delve deeper into the reports around the scores to ensure they understand exactly what they mean, and to avoid the risk of being exposed to greenwashing," Hewitson says.

Likewise, investors must be careful about companies making unsubstantiated claims around their sustainable credentials or progress. Global brands and banks are regularly accused of misleading customers and investors about their green credentials or ambitions.

As such, analysis as to how funds are being managed from a sustainability lens is "vital", Henning says, alongside "thorough risk analysis" to ensure it is suitably diversified and in line with individual preferences and objectives.

"The good news is that regulations are driving increased disclosure and transparency," Henning adds, while bodies such as the UN's Principles for Responsible Investing seek to reshape the financial system to be more environmentally and socially conscious.

Current climate reporting rules mean UK-listed companies must report annual global greenhouse gas emissions from their business activities, known as Scope 1 emissions. Companies must also report emissions from their energy consumption (Scope 2). Scope 3 emissions, which result from a company's actions, such as those relating to supply chains, are disclosed on a voluntary basis. These emissions can be difficult for a company to quantify, but many large companies have done so. Scope 3 emissions are important because for many large companies these are the largest part of their carbon footprint.

Sustainable funds

Broadly, there are three main ways to invest sustainably: ESG, impact and thematic.

ESG covers a variety of approaches:

- Negative screening - will typically exclude fossil fuel extracting companies and 'sin' stocks such as tobacco, arms makers, gambling companies and sometime alcohol companies
- Tilting or positive screening, to intentionally invest in companies based on good ESG scores. Under this approach, corporate engagement, or the actions taken by asset managers to promote positive change, “plays an important role in shifting the behaviour of invested companies”, Hewitson says, influencing them to adopt more sustainable business practices.

Impact investing aims to deliver intentional, direct and positive environmental and/or social impact. Such investments seek to deliver financial returns alongside environmental and social change by focusing on high-impact solutions. The targeted outcome of the investment is publicly disclosed beforehand.

Thematic investing focuses on growth areas and trends, by seeking out companies or sectors that align with specific sustainable outcomes. Hewitson says that HSBC’s thematic approach aligns themes with the UN Sustainable Development Goals, for example.

The two easiest (and free) tools available to investors for assessing the sustainability credentials of funds are from Morningstar and MSCI. Morningstar has a ‘sustainability’ tab for most funds in which it displays various ESG “pillars”, one of which is an environmental score. MSCI has an ESG fund tool which is more detailed and displays the weighted average carbon intensity of the fund holdings and records how many of the fund’s holdings are green vs fossil-fuel-based.

Sustainability as a performance driver

The long-running debate among investors on whether sustainability acts as a performance drag or driver is nuanced, but market data provider Refinitiv claims that ESG-labelled funds have outperformed their conventional counterparts over three and five years.

In the larger context, ignoring ESG risks "can undermine a company's long-term value", Vanguard's Fitzgerald says. However, ESG investing is not a single strategy, and approaches are continually adapting to a changing landscape.

"Our research shows that, historically, no single approach to ESG investing has produced statistically significant positive or negative alpha," he says.
"The most important consideration in selecting an approach is therefore unique to each investor.

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