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The Art of the Possible: What Charities / Funeral Trusts Can and Can't Achieve with ESG

The demand for ESG (environmental, social and governance) investing shows no sign of abating. In 2019, $17.1 trillion poured into ESG-focused products, a 42% increase on 2017, according to the Wall Street Journal. In the first quarter of 2021, flows into ESG mutual funds and ETFs reached $21.5 billion, twice as much as the first quarter of 2020. Whether due to greater social awareness following the COVID-19 pandemic, the adverse weather phenomena that increasingly dominate the news cycle or growing concerns about corporate governance, people are more attune to sustainability issues and want to use their purchasing and investing power to support companies that genuinely care about the future of our planet and society.

As The Guardian reported last year, just under half of all UK employees now pay into employer schemes or private pensions in which they make a choice about how their money is invested . This represents a sharp increase from 2012 when it became mandatory for employers to automatically enroll workers in a workplace scheme. Most people with a private pension or an ISA now decide as to how their money is invested, and many are prioritising sustainability. The financial industry has responded by setting up funds labelled as sustainable, climate, transition or ESG.

How companies of all shapes and sizes, including charities/funeral trusts, invest their money is of increasing importance to their customers, employees and investors. ESG investing refers to how companies perform on key responsibility metrics and standards for potential investments, and first came to prominence in 2004 thanks to a report titled "Who Cares Wins", which was a joint initiative of financial institutions at the invitation of the United Nations (UN).

Exclusions: A Simple, Blunt Tool

Contrary to conventional wisdom, ESG investing is about a lot more than just combating climate change. Environmental criteria – the "E" in ESG – measure how a company impacts the environment.

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Social criteria gauge how it manages relationships with employees, suppliers, customers, and communities. Governance examines its performance on leadership, executive pay, internal controls, audits, and shareholder rights.

When it comes to ESG investing, one of the simplest but bluntest approaches is to apply "exclusions" to one's investment portfolio. This means deliberately avoiding investments in companies, industries or sectors that may negatively impact the environment or society, such as those related to fossil fuels, weapons or tobacco. Exclusions have evolved over time, as more and more investors have realised that negative behavior by companies around ESG issues can have a detrimental effect on not only the world around us but also shareholder value.

Determining what companies or sectors to exclude largely boils down to an act of conscience on the part of the investor. Many use the principles contained in the UN Global Compact as a benchmark for what is considered unacceptable business practices. Some financial firms, including MSCI, Bloomberg and Morningstar, have developed ESG ratings and scoring systems. One of the biggest challenges for investors is discerning between companies that are genuinely committed to ESG and those that are simply seeking to "greenwash" their brand.

Big regulatory changes are coming in that should make this easier. At the end of May, the Financial Conduct Authority brought into force a raft of new rules designed to protect consumers and investors by ensuring that the sustainable products and services they are sold are accurately described. There has also been regulatory moves in the past year to ensure that fund managers and portfolio managers include product labels to help consumers understand what their money is being used for as well as naming and marketing requirements so products can only be described as having positive outcomes on the environment and/or society when those claims can be backed up.

A More Holistic Approach

Exclusions, while a very useful tool, are often used as a blunt final straw and typically don't reduce the investable universe that much. A more holistic approach is to combine exclusions with "positive" investing – i.e., investing in companies and/or sectors that are doing good.
There are various ways of doing this. One is to take the market cap index and re-weight it by ESG ratings, allocating more capital to companies with better ratings. Another is to actively seek out companies that are improving the world while at the same time providing an investment return.

So-called "impact investors" may seek to support renewable energy, electric cars, microfinance, sustainable agriculture, or other seemingly worthwhile causes. An alternative approach is to actively identify companies within industries that are big carbon emitters but could have a big impact if they de-carbonise their businesses.

All three of these approaches require a heavy onus on what is often called "active" stewardship, which entails engaging directly with the companies you invest in, with a view to driving positive change and safeguarding the long-term health and value of these companies. Active engagement with issuers on ESG matters can help investors make sustainability a key part of their strategies in ways that go far beyond what portfolio construction and management alone can achieve.

Active stewardship is often an important fund selection criterion for ESG investors. Charities, in particular, will want to know that their fund manager is actively on top of current controversial topics.

But active stewardship can even be a feature of passive equity funds, making it perfectly accessible to all investors. While these might not perfectly align with your own priorities, you should be able to find some that provide a close enough fit. This approach will set you back a lot less in management fees. As Morning Star notes, passive investment strategies can harness the power of ESG stewardship through an overlay approach:

"Identifying the riskiest issuers in an ESG context and actively engaging with them across a benchmarked index is an emerging method by which systematic investors combine active ownership with passive strategy exposure."

Ultimately, there is no one-size-fits-all solution to ESG investing, but there is a growing wealth of options out there for today's increasing socially and environmentally conscious investors. It is just a matter of finding the right fit for you.

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