



Ethical, SRI, ESG or Impact Investing?

(But more importantly does it work?)

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The Investment industry doesn't make it easy. Consultants, intermediaries, and managers bandy these terms around as though interchangeable in what really can be a highly subjective field.

The key element is that an investment strategy based on any of the above seeks to achieve investment results, while at the same time meeting other requirements in terms of the underlying nature of the investments.

In Ireland, Ethical funds were originally driven by demand from religious and charitable bodies and at their most straightforward simply looked to avoid exposure to companies or investments that operated in certain areas for example tobacco or armaments. This is often labelled negative screening. This morphed into SRI (socially responsible investment) which is aimed at a wider group of investors and has a greater emphasis on wider social issues. ESG (Environment, Social and Governance) strategies would expand this even further and explicitly take into account procedures, policies and practice within the investee companies. With the progression also came a greater degree of pro-activity where investment managers would look to positively screen for those companies displaying good social attributes and indeed looking to influence company behaviour where appropriate. The distinctions may appear academic but they matter when it comes to portfolio construction

and critically for the investor who needs to be sure that the final portfolio is one that reflects their views and one that they can stand over in terms of meeting any of the ethical, social or governance pillars of the investment philosophy. For the balance of this paper we will be using SRI as a “catch-all” for the varying strands.

How does it impact investment performance?

In reviewing the evidence on investment returns for SRI funds compared to conventional funds, it appears to us that one thing is clear – it is inconclusive!

Academic research and studies by practitioners have over the past twenty years been able to show both sides of the argument that SRI type strategies can both help or hinder investment performance. Perhaps the most comprehensive review of the research was a 2007 Mercer report on behalf of the United Nations Environment programme. Of the 20 research papers into SRI performance, only three produced a negative result. 85% of the research material concluded that taking account of SRI criteria produced a positive or neutral impact on investment performance. Yet there have also been studies which show that such strategies have hindered performance. The truth is that many of the results are spurious as size and sector effects can totally swamp SRI type factors in any given time period and the actual choice of that time period is a determining factor in determining the outcome. The 2012 work by Managi, Okimoto and Matsuda probably sums it up best, suggesting no clear differences between such strategies and conventional investing over meaningful time periods.¹ SRI neither helps nor hinders returns.

We also know that poor governance can lead to value destruction – sometimes on a grand scale.

But in our view, this is only half the investment story.

It is possible that SRI type strategies can have an impact on risk! Very solid research in 2013/4 (Investec, MSCI) points to such strategies being able to deliver comparable *returns* but with lower levels of *risk*. This is important as it means such strategies have the potential to deliver superior risk adjusted returns. This is what the real target for investors should be – more return for a given unit of risk. The research shows that stocks with higher SRI scores typically have lower volatility and lower beta. Our own view is that SRI is acting as a proxy for corporate quality and is seeing the same superior risk-adjusted return profile that other quality criteria such as return on equity display. At the individual company level it is plausible to think that a company which is aware of and looks to manage energy costs or emissions can actually improve efficiency and operating margins. This means quality and sustainability of returns are enhanced. This view is supported by a recent study by

McKinsey which shows how corporations which have sought to improve their environmental and social “credentials” have enjoyed a direct benefit in both profits and business opportunities.ⁱⁱ

We also know that poor governance can lead to value destruction - sometimes on a grand scale. Volkswagen lost almost half its market value in 5 days when corrupt practices on emissions data were unearthed!

Rather than focus solely of return comparisons, which are subject to so many factors as to make them almost spurious, to establish how well an SRI policy is working, our view is that an equal focus on the risk profile of the portfolio and the risk adjusted outcome is a more meaningful and worthwhile exercise. And the positive news is that research suggests SRI can reduce overall risk and deliver superior (less volatile) returns to the client.

This is a growing area. As well as charities, religious orders, or endowments looking to support their own ethos through investment choice, there is a rising global awareness around such issues as sustainability both from the public and from corporations. When the United Nations created the Principles for Responsible Investment in 2006, for institutions who committed to introducing SRI factors into their investment process, it garnered about 25 signatories. Today there are just under 1400. In September this year the world’s largest pension fund, the Japanese Government Pension Investment Fund joined.

The most recent report in the US (SIF Report on SRI Trends 2014) pointed out that assets in SRI strategies had expanded 76% in two years from \$3.74 trillion in 2012 to \$6.6 trillion in 2014. This meant that SRI strategies accounted for more than one out of every six dollars being managed in the US. Moves by the US government this summer are likely to see greater choice in federal retirement options with greater flows into SRI funds. The US has been the fastest growing region over the past two years followed by Canada and Europe but the global numbers also highlight the pace of growth in SRI-type asset - 60% plus in the past two years.

Globally, negative screening strategies still have the largest share, followed by more ESG-based approaches and then more recently by investment strategies which encompass corporate engagement and shareholder action. At Appian we have also seen an increased interest in what is termed Social Impact Investment where specific social needs such as housing or education can be addressed in tandem with providing a return on investment.

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Demand for, and interest in socially responsible and ethical investment strategies is set to rise further. Growth in such funds is today significantly outpacing overall growth in the overall asset management industry. In what can be a crowded market, for charities, endowments or individuals looking to allocate to these strategies, we believe there are two issues worth focussing on:

- (i) Be demanding of the investment managers in terms of specific criteria they are considering and the rigour around their application. The US Sustainable Investment Forum noted that half of the leading ESG managers did not fully disclose what criteria they used.
- (ii) The risk profile of the returns matters as much as the return themselves. Research suggests that returns to SRI funds are generally comparable to conventional investment strategies but that risk (or volatility) if managed correctly can be lower. This is a vital component in compounding and delivering sustainable long term returns.

ⁱ Managi et al; Tohoku University 2012

ⁱⁱ McKinsey; Profit with Purpose 2014



To discuss any of this further please contact:

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