Is sustainable investment a sop to your conscience or the new growth driver?

Alongside the traditional financial analyses produced for all investments and asset classes, sustainability criteria are becoming a common feature of evaluations by asset managers. The criteria are often referred to by the acronym ESG – environmental, social and governance factors. A decade ago, all of these issues were lumped under the heading of green investments – at the time there was no evidence that the investments offered long-term performance. Nowadays sustainability issues have far more appeal for asset managers. Big banks have incorporated ESG factors into their investment processes, while rating agencies have entered the market by offering sustainability screening. But what is driving this interest? Are banks hoping that ESG products will generate more profitable business amid falling margins? Or is there now so much public pressure on pension funds and non-profit foundations that failing to invest sustainably is tantamount to reputational risk?
We have identified two significant changes.

Firstly, a change in the way people think. In recent years, interest groups particularly younger generations, have been calling for greater transparency about the environmental impact of manufactured products. They have also been raising questions relating to the pay of directors and senior management. As a consequence, awareness of sustainability issues has grown. In addition to looking at the quality of a given company’s products and services, investors now want to know about manufacturing processes, employment conditions and so forth. Essentially, investors have qualms about business strategies that are focused exclusively on maximising short-term profit. In addition, the next ten years will be the decade of inheritance, with wealth passing to a younger generation that tends to be more interested in sustainability issues than their parents. Recent studies found that ESG factors are a significant consideration for 80% of millennials when making investment decisions. Experts predict that inheritance volumes in the coming years will be between EUR 2 and EUR 4 trillion in Germany alone. The boards of non-profit foundations are changing their approach, as are the investment committees of sovereign wealth funds and family offices. There is now evidence that incorporating ESG factors into an investment strategy is not holding back performance. In fact, the factors will be more relevant to future risk/return ratios, as growing numbers of institutional investors expect portfolio reporting to include information about ESG factors and climate change risks.

Secondly, the business environment has changed. Following the signature of the Paris climate agreement in 2015 and the adoption of the United Nations Sustainable Development Goals (SDGs) in the same year, sustainability has been gaining momentum. For companies, that means increased pressure to establish corporate standards for environmental protection, fraud prevention and employment conditions. New regulations are constantly emerging, such as the requirement for pension funds to report on ESG and climate standards, irrespective of whether the issues are an integral part of the investment strategy and analysis. In 2016, the European Union agreed that institutions will have to consider environmental, social and governance factors with effect from January 2019 under the new EU Pensions Directive.

So the trend is a reality and the growth figures for investments that apply the ESG criteria are impressive. In Switzerland alone, sustainable investment advanced 82% from 2016 to 2017, with CHF 390.6 billion invested as at end-2017. The uptrend has continued in 2018, buoyed by the economic situation, not to mention the law of supply and demand. At the moment, it is mainly institutional investors that are implementing sustainable strategies. So how are they going about it, and how can private clients pursue this approach? We should say at the outset that there are a number of different approaches, but with each variation on the theme, investors are essentially asking: “What do I consider an ethical investment? What impact do I want my money to have? And what are my return objectives?” One option is exclusion criteria: choosing not to invest in companies in certain industries, such as nuclear power, tobacco or arms. Here objective criteria are combined with personal values to form the basis...
of the investment strategy. Alternatively, investors can focus on commitment, opting for companies that have undertaken to improve certain ESG elements in the medium to long term. Then there is impact investing, which seeks to influence not only the financial return but also social and environmental issues. Because of the volumes of assets involved, large institutional investors can actively shape corporate policy as shareholders. This type of direct influence is more effective in the case of investments in developing countries.

Private investors will need a good deal of information and advice in order to identify the best sustainable investment strategy for them. Given the wide range of options and similarities between the products and strategies being touted, a clear, personalised investment strategy should reflect return objectives, personal values and the effective sustainability. In light of the massive environmental and social challenges facing our planet and the growing risks, the popularity of sustainable investments is good news. Once demand for sustainable investment has reached the necessary critical mass, concerns about lower returns will become redundant. It is already apparent that sustainable strategies are not linked to poor performance. So on purely financial grounds, the way is clear for establishing widespread acceptance.

*Source: Swiss Sustainable Finance