



## GATEWAY INSIGHTS

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### # 19 ESG investing - is the hype translating into action and what does it mean for fund managers?

Environmental, social and governance (ESG) issues are increasingly attracting wide attention from all types of stakeholders, from governments and large institutions to 'mum and dad' investors. But is this interest translating into demand for ESG funds? Do ESG funds have a future, and how does a fund manager capitalise on this trend? This Gateway Insight aims to address some of these issues and demonstrate why fund managers need to be thinking strategically about ESG investing going forward.

#### The overseas experience

In the US the ESG industry is thriving. It has grown from \$12bn in 1995 to \$202bn in 2007, growing at a faster pace than the broader universe of all investment assets under management. Roughly 11% of all assets under professional management are now involved in ESG Funds.<sup>1</sup> The following factors are the key to the staggering growth of these funds:

- **Demand** in the US from institutional and individual investors, socially concerned 'high net worth individuals' and 'mission driven' institutions such as foundations, endowments, labour unions, and faith based investors is high.
- There is growing **concern about effects of climate change** and its' risks for portfolios is intensifying this interest. Investor demand is also growing for opportunities in clean, green technology, alternative and renewable energy, and other environmentally driven businesses.

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<sup>1</sup> (SRI US Report, 2007).

- The continuation of industry **developments** in the ESG space are making it easier for a broad range of investors to participate in this expanding universe.

Certainly many fund managers in Australia have already recognised the importance of ESG investing or Responsible Investment with over 50 Australian investment managers and another 40 or so Superannuation Funds having signed up to abide by the Principles of Responsible Investment developed by the United Nations (UNPRI)<sup>2</sup> thereby committing to the following:

1. To incorporate ESG issues into investment analysis and decision making processes
2. To be active owners and incorporate ESG issues into ownership policies and practices
3. To seek appropriate disclosure on ESG issues by the entities in which they invest
4. To promote acceptance and implementation of the Principles within the investment industry
5. To work together to enhance the effectiveness in implementing the Principles
6. To report on activities and progress towards implementing principles

### **Investment management implications**

What are the implications of ESG investing for fund managers who have an interest in this sector? What does this mean for investment guidelines and what does it translate into in terms of funds under management?

There are a wide variety of approaches to investment of ESG Funds. There are for example:

- negatively screened funds – funds that will exclude stocks on the basis of a screen, for example a fund may not allow mining stocks
- funds that use positive screenings, for example a fund may have a mandate that 80% of the portfolio must be invested in sustainable or renewable resources
- ‘best of sector’ type of approaches where investments are only allowed in the highest rated ESG stocks in a sector - this approach is based on the premise that companies with strong sustainability credentials are better managed and therefore better investments
- thematic funds – for example green funds, water funds, environmental or technology funds etc.
- sustainability analysis –which involves the quantitative and qualitative study of all stocks to determine their ESG performance

Some investors might want to invest in an ethical product that doesn’t involve gambling, tobacco or alcohol. Others might want a fund that only invests in companies which have been rated by an Ethical Standards rating agency. This variety of approaches creates confusion for investors and advisers. Hence it is important to understand what the implications are of the different types of

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<sup>2</sup> [www.unpri.org/principles](http://www.unpri.org/principles)

methodologies, where this may bias the portfolio, and how it may be addressed. For example a portfolio that excludes mining companies, may allow investments in mining services related companies or other surrogates and so can still participate in the benefits of a resources boom. It is important that there is transparency around the portfolios objectives – and then that communication with clients is clear from the beginning – what the Fund invests in and what it doesn't invest in and what the investment implications are. One of the most obvious and common criticisms of ESG funds is that their securities holdings are very similar to a regular mandate so therefore what is the point in investing in both.

### **What's happening in Australia?**

The trend in Australia has become to invest in funds that support sustainable activities – to focus on positive developments in the ESG space, and to become less overtly focused on avoiding bad companies according to a recent report on ESG investing in Money Management.<sup>3</sup> Further to that, the independent research house, Lonsec, offer the following definitions on the different types of ways advisers and investors can segment this universe. They report the following types of categories:<sup>4</sup>

1. **Ethical:** negative screening of companies in certain industries deemed to have harmful societal impact. Avoiding bad companies is the overarching motivation.
2. **Socially Responsible Investing (SRI):** Generally negative screening of certain sectors in line with the Ethical category, but may also include a positive screening element seeking to include socially responsible companies.
3. **Sustainable investing:** A belief that those companies with advanced approaches to ESG risk management will exhibit superior performance than companies with sub optimal approaches.

### **Implications for fund managers**

ESG investing raises some issues for fund managers promoting these kinds of products:

1. Despite the progress and positive momentum of the sector generally, Lonsec has found that the area provides challenges for those providing financial advice. Investors in this sector are broadly grouped together under a 'Responsible Investment' categorization, though bringing different investment motivations, which can make it tricky for advisers to confidently select investment managers for clients. There is an opportunity here for fund managers to provide not only product but also education in this sector.

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<sup>3</sup> Money Management, 8/7/2010, Responsible Investment Supplement, page 17

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2. Further clarity is required by the market on where funds are positioned in terms of ethicalness and sustainability.
3. There tends to be a bias towards large cap stocks when looking at ethical investments simply because they have the resources to report their sustainable practices. Smaller companies just can't do that. If a fund manager doesn't want to bias the pool of stocks available to invest in to extraneous factors like market cap, measures need to be put into place to allow smaller companies to participate in screening in a format appropriate to them.

Regarding potential for growth in funds under management, providing an environmentally and socially responsible fund clearly has translated into a growing funds management sector in the US. Over \$US20 trillion is now being managed using methodologies promoted by signatories to the UNPRI. In Australia there are now more than 80 managed funds purporting to support the concept of sustainable investing, managing more than \$4.1 billion between them<sup>5</sup>. This means that there is now quite a large amount of choice for investors.

### **Opportunities for fund managers**

Whilst there are a decent number of fund managers in Australia offering ESG or Ethical investments there appears to be a lack of knowledge amongst retail investors. This is an opportunity for fund managers. Anne O'Donnell, chief executive officer with Australian Ethical, says it is difficult for the average retail investor to choose individual stocks "unless they have a lot of knowledge". This view is echoed by Louise O'Halloran, executive director of the Ethical Investment Association, who says it is hard for individuals to have that depth of knowledge. According to O'Halloran, ethical funds would conduct "deep analysis of anywhere between 100 and 200 issues which relate to a company's governance performance and its impacts on environment and its impacts on the environment and society". Australia is now recognised as a world leader in the delivery of quality ethical and sustainable investments, not least because it has a consumer certification process in place — a world first.<sup>6</sup>

The ESG sector also helps some clients to satisfy their investment objectives. The numbers range from 60-80%<sup>7</sup> of Australians who say they would like to have some or all their money invested in a responsible way, although at the moment many don't invest at the same levels that they say they will.

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<sup>5</sup> [www.greengeneration.com.au](http://www.greengeneration.com.au), Sustainable Investing, Gillian Bullock, September 2008

<sup>6</sup> [www.greengeneration.com.au](http://www.greengeneration.com.au), Sustainable Investing, Gillian Bullock, September 2008

<sup>7</sup> Money Management, 8/7/2010, Responsible Investment Supplement, page 17

According to Paul Harding-Davis from Australian Ethical Investment, an Australian fund manager with a focus on ESG investing, research shows that socially responsible investors are less sensitive to one month's poor performance, and are less likely to take money out after short term poor performance – making them very attractive clients.

The Responsible Investment Association of Australia (RIAA) has established a financial adviser training course which provides financial advisers with a number of tools they can use to communicate with investors about ESG investment. Once they have gone through the training program the financial adviser can apply for certification as a certified Responsible Investment Adviser. (See [www.responsibleinvestment.org](http://www.responsibleinvestment.org) for further information.)

### **In summary....**

Taking ESG issues into consideration is likely to be increasingly incorporated into the investment process. Whether investors will go for specialist products or for investment managers who have signed up to the UNPRI and use this process in their products is not clear. What is clear is that it is an issue and an opportunity for fund managers in the future.

### **About Gateway**

Gateway Financial Marketing (Gateway) was established in February 2004 by Amanda Rethus and Edwina Best for the purpose of offering fund managers, other product providers and international new entrants, expert advice, services and assistance in negotiating entry into the Australian Retail Financial Services market. Use of Gateway's services provides the opportunity for clients to overcome the hurdles that can often confront fund managers when transitioning from institutional to retail and hence improve participation in retail funds flow. Prior to Gateway, Amanda and Edwina spent over 30 years combined with major institutions in the Retail Financial Services market.

### **Our qualifications**

Amanda has over 20 years experience in the Financial Services industry and was formerly a Divisional Director in the Financial Services Group of Macquarie. Amanda managed investment portfolios for over 10 years, and has spent in excess of 10 years introducing investment products to the Australian Retail market.

Edwina has a Bachelor of Business from UTS majoring in Marketing and International Business. She has over 12 years experience in the financial services market, concentrating in relationship management, product management and marketing. They both have extensive contacts in the retail financial services market especially with key decision makers.

If you would like to confidentially discuss your current approach to the retail market or have any questions on the above please do not hesitate to contact us on – Edwina 0404 046 179 or Amanda or 0414 658 323.