THE INVESTMENT ASSOCIATION

SUSTAINABILITY
AND RESPONSIBLE INVESTMENT EXPLAINED

BACKGROUND

Responsible investment has existed in various forms for many years but it is in the last decade that sustainability, more specifically, has gained increased focus both within the UK and around the world.

In part, this has been driven by growing global awareness of the threat posed by climate change to the environment.

It also reflects increased demand from investors for new solutions, as investors and pension funds in particular, have become increasingly aware of the material impact of sustainability issues on financial returns, as well as on the economy and wider financial stability.

This increased focus also comes from a growing awareness that we all – as individuals, private institutions, policymakers and businesses – have a part to play in promoting a more sustainable economy and planet.

Societal pressure as well as the realisation that Environmental, Social and Governance (ESG) matters can lead to positive long term performance, means that investors increasingly see any company that rejects these principles as a questionable source of long-term returns.

All these trends have helped fuel the growth in the sustainability and responsible investment landscape, which asset managers continue to play an active role in shaping.

THE ROLE OF ASSET MANAGERS

As significant long term investors on behalf of our clients in the UK and globally, asset managers play a key role in channelling finance from savers to companies and infrastructure projects. This means asset managers can play a vital part in promoting sustainable growth.

It is our role to help investors – whether individuals or institutions – achieve their investment goals. These goals can be financial, for instance to retire with enough

The Investment Association (IA) supports UK investment management, supporting British savers, investors and businesses. Our 250 members manage £7.7 trillion, £1.8 trillion of which is on behalf of European clients providing the UK with an important economic contribution in the form of export earnings, tax paid, and jobs created.

October 2018

money to live on, and also non-financial, such as to invest in companies or projects that improve diversity or facilitate access to healthcare.

One way in which asset managers are doing this is by integrating an assessment of ESG factors in their investment processes. This involves asset managers continually monitoring and mitigating ESG-related risks, and benefiting from ESG-related opportunities.

Active engagement by asset managers with investee companies further helps to identify, analyse and influence the management of ESG risks and to seek out and benefit from ESG-related opportunities. Asset managers do this with the aim of ensuring that these companies remain successful for years to come and provide their clients with long-term risk-adjusted returns on their investments. Engagement will typically cover a company's governance arrangements, as well as the management of social and environmental risks and opportunities that are relevant and material to the business.

In summary, a new paradigm has been triggered in the investment industry which has led to an increase in the creation of new products, designed to meet savers' and institutional investors' diverse sustainability and responsible investment goals.

If I take a sustainable and responsible approach to investing, does this necessarily mean I have to sacrifice returns relative to other approaches?

Absolutely not. Sustainability and responsible investment encompasses a plethora of approaches – some target returns alongside non-financial outcomes and others are carried out precisely with the aim of increasing long term returns for investors.

WHAT DO WE MEAN BY SUSTAINABILITY AND RESPONSIBLE INVESTMENT?

Sustainability and responsible investment is to do with factoring ESG considerations into investment processes and decisions.

It is carried out to fulfil a number of different investor intentions, including:

- *To maximise long term returns by helping companies address issues which could have an impact on long term value and, in so doing , helping these companies play their part in a sustainable society;*
- *To achieve particular sustainability outcomes, for example, meeting greenhouse gas emissions targets; or*
- *To reflect a particular world view or set of values.*

It may also be driven by a mixture of the intentions set out above. Below we outline some of the most widely adopted approaches:

ESG INTEGRATION

ESG integration is the incorporation of environmental, social and governance risks and opportunities into investment analysis and decision-making processes, alongside traditional financial analysis. This is one of the most common approaches, with the Global Sustainable Investment Alliance (GSIA) reporting that ESG integration represents $10.37 trillion of assets, globally.[1]

Environmental: Factors relating directly to the planet, such as a company's level of greenhouse gas emissions and its impact on climate change, as well as on water and air pollution.

Social: Factors relating directly to people. This can include not only employees, but also wider stakeholders in the community, with areas of focus including human rights, health and safety and child labour.

Governance: Factors relating to how a company is run and being held accountable. Examples include: Board composition, Board effectiveness, executive pay, shareholder rights, and diversity and equal opportunities.

[1] Global Sustainable Investment Alliance, Global Sustainable Investment Review, 2016.

SHAREHOLDER ENGAGEMENT AND STEWARDSHIP

By engaging with investee companies, asset managers seek to promote the long-term success of companies so savers' investments prosper over the longer term. Our industry believes that well run companies, which take a long-term approach and proactively identify and manage ESG risks as well as benefiting from ESG-related opportunities, are more likely to deliver long term returns for their clients and be prosperous in the long term. If an issue is not resolved by engaging with companies through dialogue, asset managers can use their right to vote at the Annual General Meeting of an investee company.

It is in this capacity – as stewards of the companies in which we invest on behalf of clients – that asset managers are able to effect real change and help transition businesses to more sustainable practices by engaging on governance, and increasingly on social and environmental risks and opportunities. Stewardship can therefore contribute to better run, more sustainable companies, which are the building blocks of a more sustainable and resilient economy.

NEGATIVE SCREENING/EXCLUSION INVESTING

Negative or exclusionary screening is one of the largest sustainability and responsible investment strategies used, with more than £10 trillion invested across the globe in funds that adopt this approach.[2] Exclusionary or negative screening is where a particular sector or company is excluded from an investment portfolio, usually because of environmental or social criteria. Examples include thermal coal, tobacco and weapons companies. This method can also be used to exclude investments for ethical or values-based reasons, and can be used to help meet frameworks like the UN Global Compact.

THEMATIC INVESTING

Thematic investment is a form of positive screening in which asset managers invest into companies solving specific ESG challenges. Selections – typically made by asset owners – can be made on the basis of considerations such as sustainable energy technology or water management.

IMPACT INVESTING

Impact investments are investments that help to solve pressing social or environmental challenges (the degree of impact being measured against the underlying goals), as well as generating a financial return. This can include social investment (investment in regulated social sector organisations such as charities and social enterprises), as well as investment in mainstream profit-seeking businesses that are also helping to create and support societal change.

Isn't there limited choice when it comes to choosing appropriate funds?

There is a very wide choice of investments which take into account ESG considerations, with the increasing recognition that such an approach supports long term performance. There are also thousands of funds that are marketed as targeting particular sustainability and/or responsible investment objectives.

Data and information exchange is improving in the sustainability and responsible investment landscape – from the way the investment industry is communicating the impact of investments across a range of sustainability issues, to the abundance of information available to clients today. We live in a globalised and digitised world in which information is generated and exchanged at unprecedented levels.

[2] Global Sustainable Investment Alliance, Global Sustainable Investment Review, 2016.

Millennials becoming savers is expected to have a significant impact on demand. According to a study by Morgan Stanley, 86% of millennials say they are interested in sustainable investing. They are also twice as likely to invest in companies targeting social or environmental goals, compared to the overall population.* Moreover, a 2017 UBS Study estimates that global Millennial wealth could be in the region of $24tr by 2020.**

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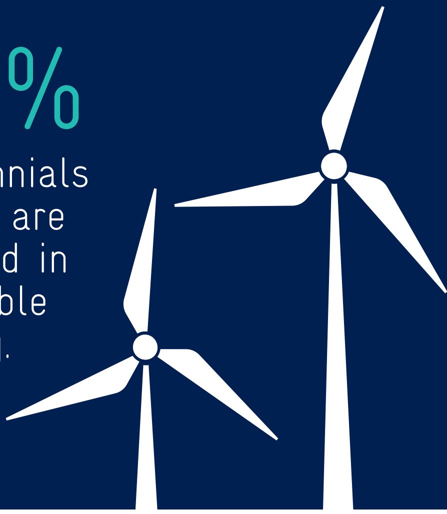

* (Morgan Stanley, "Millennials Drive Growth in Sustainable Investing", 2017)

** (UBS, "Millennials – the global guardians of capital" June 2017).

KEY PRIORITIES FOR THE ASSET MANAGEMENT INDUSTRY

In its role as representative of the asset management industry, the IA is developing a coordinated approach to progress the sustainability and responsible investment agenda to the benefit of savers, investors and wider society.

This work aims to:

1. Support the Development of Standards and Definitions

Asset managers are developing a set of industry-wide standard definitions to articulate the various forms of sustainability and responsible investment. Industry is also carrying out an evaluation of fund labelling systems with the aim of identifying an appropriate application to the UK context. Labels should make it easier for savers to compare funds and to make better informed choices in line with their investment objectives.

2. Improve Transparency related to Sustainability

Asset managers are looking to develop consistent, comparable and timely ways of reporting the non-financial outcomes of our investments on the planet and society, so that investors can more clearly understand both the impact of sustainability on their investments and the impact that their investments are having on society and the environment.

3. Progressing Social Impact Investing

Asset managers are working to take forward the recommendations from the November 2017 report: "Growing a Culture of Social Impact Investing in the UK". The report was published by a Government-appointed independent advisory group led by Elizabeth Corley CBE. It investigates how providers of savings, pensions and investments can engage with individuals to enable them to support more easily the things they care about through their savings and investment choices.

Is there actually any real impact on society?

There are some significant examples of where sustainable and responsible investment has had a positive impact on society, for example, investment in sustainable logging practices which aim to protect the world's endangered forest areas has played a crucial role in mitigating global climate change.

The Investment Association
Camomile Court, 23 Camomile Street, London, EC3A 7LL

www.theinvestmentassociation.org
@InvAssoc

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