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# Responsible investing: a case of mistaken identity

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In his 2001 letter to investors, Warren Buffett wrote, "Bad terminology is the enemy of good thinking.[1]" We believe the asset management industry suffers from this affliction more than most and that responsible investing is its crowning achievement of confusing terminology. Modern responsible investing was first started in the 1970s, and the number of buzz words and acronyms used to describe the space has expanded and changed over the years. This report will define some of those terms and provide some clarity within this rapidly expanding investment style.

## What is responsible investing?

Responsible investing means many things to many people. There is no type of investing that is more personalized to the individual investor's beliefs, world view, and values. The following is a small sample of the terms that fall within the responsible investing umbrella:

- Socially responsible investing (SRI)
- Environmental, social, and governance (ESG)
- Impact investing
- Fossil fuel free investing
- Values-based investing
- Sustainable investing
- Mission-related investing
- Green bonds

Discussing what prospective investors mean when they say they want to take a responsible approach is a very important first step.

## What is the difference between SRI, ESG, and impact investing?

Below is a general description of each but is by no means the only way these terms are used.

### Socially responsible investing

Simplistically, SRI, is what many investors incorrectly think of when they hear the term responsible investing. SRI started as the umbrella term for all types of responsible investing, but in the modern nomenclature it is generally used as the term for negatively screened portfolios, which is one type of responsible investment.

Values-based investing and fossil fuel free investing are examples of SRI portfolios. An individual or organization may not want to invest in companies that engage in certain activities, such as weapons manufacturing, alcohol production, or the extraction of fossil fuels, so they are removed from consideration.

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## Environmental, social, and governance

ESG investing recognizes that these factors play a material role in the potential risk and return of an investment. Issues like climate change, resource depletion, labour conflicts, health and safety of employees, and executive compensation are examples of issues considered. Global Manager Research published the paper *Sustainable Competitive Advantage Through ESG Integration*, which showed that considering ESG data when making an investment decision could in fact lower a portfolio's risk and increase its opportunity to outperform.

Some responsible managers will engage or interact with portfolio holdings to try to elicit a change of the company's behavior on those ESG issues. The PRI Association defines engagement as, "The process through which investors use their influence to encourage companies they invest in to improve their management of ESG issues. This may, in turn, improve the companies' financial performance and the long-term performance of investment portfolios.[2]"

## Impact investing

Impact investments are made with the intention of generating social and environmental impact with financial return being second in importance. This may include considering elements of SRI, ESG, or both. These investments combine some of the attractive elements of philanthropy and market investments and allow investors to integrate their values into their investment strategy while still receiving a market return. Foundations and endowments are able to use impact investing to align their holdings with their mandate through mission-related investing in this manner.

Green bonds are public debt securities issued to raise capital specifically to support climate-related or environmental projects. They are a form of Impact Investing in that they are supposed to generate environmental impact with the proceeds. The first green bonds were issued by the World Bank in 2008. New offerings have come from many sectors, countries, and currencies. Issuance ballooned to approximately $42B in 2015 from $2.6B in 2012. Through July 2016, green bond issuance had surpassed $44B[3].

**Responsible investing categories:**

| | Socially responsible investing (SRI) | Environmental, social, and governance (ESG) | Impact investing |
|---|---|---|---|
| **What?** | Negatively screened portfolios that remove certain securities from consideration based on the investor's beliefs or values | The systematic and explicit inclusion by investment managers of ESG risk and opportunities into traditional financial analysis | Investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return |
| **Who?** | Religious institutions, fossil fuel free investors | Environmentally conscious investors who do not want to negatively impact returns | Foundations, endowments, and high net worth individuals |
| **Return expectation?** | Negligible impacts versus traditional portfolios | Shown to reduce risk and may add alpha when integrated | Focus on impact of investment with return being secondary |

Source - Global Impact Investing Network (https://thegiin.org/impact-investing), US SIF Foundation

## What organizations have taken the lead in the world of responsible investing?

The Principles for Responsible Investing (the PRI) is the global leader. The organization was formed in 2006 as a partnership between the United Nations Environmental Programme Finance Initiative and the United Nations Global Compact. Asset owners and managers become signatories and agree to follow the six principles at their firm. As of April 2016, 1,500 firms with $62T in assets under management had signed to follow the principles.

**The six principles**

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

Source — PRI (2016) The Six Principles (https://www.unpri.org/about/the-six-principles).

## Who is providing ESG research and how is it used?

A flurry of mergers and acquisitions over the past 10 years has created two large third-party ESG research firms, Sustainalytics and MSCI ESG Research. Both firms have large analyst teams that provide ESG research reports on thousands of stocks and bonds. Investment managers, consultants, and asset owners use their services as an unbiased source of ESG data.

Here is an example of how firms' information is used. Sustainalytics recently partnered with Morningstar to provide ESG ratings on mutual funds. Sustainalytics data is used to evaluate the underlying holdings in each fund and then Morningstar aggregates that data into a rating.[4] Morningstar calls this their Sustainability Rating (another name for an ESG rating).

MSCI and Sustainalytics are vast sources of ESG knowledge and information. The biggest consideration when evaluating ESG research is that, like all forms of analysis, these evaluations are an opinion and a point-in-time assessment. Having a strong ESG profile does not mean a company will perform financially better than a lesser-rated company. Investment managers must assess the materiality of the information as well as the fundamental attractiveness of a security before making an investment decision.

## Conclusion

The responsible investing space hasn't done itself any favors by creating such a confusing soup of acronyms and competing terms. In this report, we have explained what many of those terms mean and hope any confusion that may have prevented investors from considering a responsible mandate in their investment portfolio has been removed.

[1]"*2001 Berkshire Hathaway Annual Report*" http://www.berkshirehathaway.com/2001ar/2001ar.pdf. Berkshire Hathaway, 2002.

[2]*PRI (2016) Introductory Guide to Collaborative Engagement* report (Copyright 2013) https://www.unpri.org/about/pri-teams/esg-engagements

[3]"*Green Bond Market, 2016 Issuance*". https://www.climatebonds.net/. Climate Bond Initiative, 2016. Web.

[4]"*The Morningstar Sustainable Investing Handbook*". http://www.morningstar.com/. Morningstar, 2016. Web.

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