ESG INVESTING: EVERYTHING YOU NEED TO KNOW TO GET STARTED

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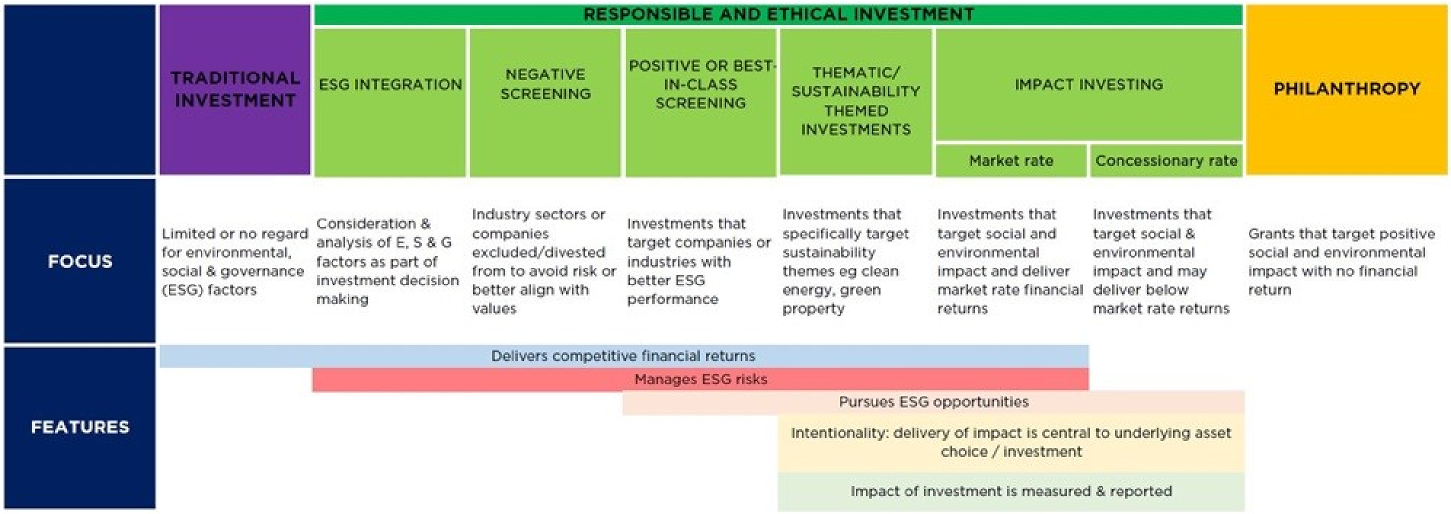
ESG is certainly a new concept to a lot of Australians, in fact, in Perpetual's recent *What Do You Care About?* Survey, only 4%[1] of all respondents were familiar with ESG investing. There are also certain intensities in which you can pursue ESG strategies, so we'll take you through what is known as the 'ESG spectrum' so you can understand which one you may want to pursue. Also, another thing to be privy to when contemplating ESG investments are discrepancies in how these ESG products are rated or labelled. The most similar parallels we can make are health ratings on foods which are designed to determine the nutritional quality of packaged foods and aimed to help consumers make healthier choices. However, there were examples of food items that scored well on this scale as they had low trans-fat levels, but they were also high in sugar, so how you perceive its overall 'healthiness' depends on your personal views towards sugar. We'll delve into this a little further into the article.

So very quickly, what is ESG investing?

ESG investing is an investing style that makes investment related decisions that accounts for some sort of measurable social, environmental or governance consideration, along with a financial return. There are a wide range of approaches an investor can consider.

The ESG spectrum

There are varying intensities of ESG investing, table 1, below sets out to differentiate them. Investors should choose the appropriate ESG investing style based on what they want to achieve for their investments. For example, a person who prioritises the social impact of their investment over a financial return may choose an 'impact investing' style, which actively seeks to deliver positive social and environmental impact but *may* sacrifice some financial returns in order to achieve this goal. On the other hand, a person who wants to achieve a good financial return on their investment and wants to protect their investment return from potential ESG risks may choose ‘ESG integration’ or ‘Negative screening’ styles. These investment styles’ overarching objective is to deliver a certain financial return and avoid investments that may have material ESG risks.



Once you’ve got your head around what type of ESG investing you’d like to partake in, it’s also important to understand how these funds are labelled or scored.

ESG Labelling

In the ESG world, more and more companies are labelling funds as ESG or ‘green’ when in fact they may not be. Why?

1. Younger generations are viewing their investment dollars as an extension of their personal values. A TF Ameritrade survey revealed that 19% of ESG investors consider human rights as the most important factor in their decision making.[2]
2. Non-financial performance is often a leading indicator for a company’s long-term success.[3]
3. A TD Ameritrade survey indicated that 67% of ESG investors care more about advancing social and environmental causes than a financial return.[4]
4. 38% of survey respondents in the Responsible InvestmentBenchmark Report (2020) said the top driver of growth in their responsible investment funds was ‘institutional investor **demand**’ increasing from 24% in 2018.
5. Finally, research has shown that ESG funds are performing at par, or out-performing non-ESG funds.[5]

Which means it’s more and more appealing for companies to label their funds as ESG ones. Unfortunately, investors relying on pure ESG product scores or more importantly, labels are at risk of being misled about the true sustainability of the product’s underlying investments.

So what should you look out for?

Basically, funds that may score well on a pure ESG basis do not necessarily score well based on sustainability measures that consider the specific *industries and activities* that companies within that fund may be exposed to. Daniel Nelson, Perpetual’s Senior Research Analyst goes on to say that “the more traditional ESG approaches tend to be more about *processes* and less about consequences or outcomes”.

How companies score on ESG can vary wildly depending on which body is awarding the rating. Such that regulators are starting to seriously investigate how they might set more rigorous standards to stamp out the potential for ‘greenwashing’. Greenwashing is the process of conveying a false impression or providing misleading information about how a company’s products are more environmentally sound. Pretty much, funds are deceiving consumers into believing that a company’s products are environmentally friendly, or more so than reality and they’re capitalising on the growing demand for ESG investment options.

Steven Maijoor, chair of the European Securities and Market Authority has said “personally, I believe that, where ESG ratings are used for investment purposes, [accredited] rating agencies should be regulated and supervised appropriately by public sector authorities”. He added that consumers are not able to “effectively compare investments which are marketed as sustainable, thus contributing to the risk of greenwashing”.

Scores given by different bodies can be all over the shop. For example, researchers at the Massachusetts Institute of Technology found that when different rating bodies rank the same company across a range of ESG factors, their scores only line up approximately 60% of the time. And that discrepancy is exactly what is confusing investors.

Take Tesla as an example; one rating agency (JUST Capital) placed them in the bottom 10% but another (MSCI) graded them with an “A”. It’s very easy to see why investors are left scratching their heads. Although there is a party who think these different scales and ratings are in fact a good thing, as they argue it may help investors make better informed decisions. (Personally, that just sounds like a lot of homework).

Another issue with these scores and ratings is the underlying data, which can wildly differ (for example very different metrics used between companies) and/or be of varying quality. In a dream-world you'd see consistent sustainability data in Company's Annual Reports that could be verified and audited, in an attempt to level the playing field.

And without tighter regulations, Company's will continue to report on issues they deem important and/or perform well for, and they'll likely omit issues they might not be keen to share. At the end of the day, there needs to be more transparency and consistency so investors can make better informed decisions.

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1. Lembit, G., (2020) 'What do you care about: The personal edition', Perpetual Client Insights and Analytics, released 13 August 2020
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