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Evolution of Responsible Investing

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Evolution of Responsible Investing

Investors have a long history of directing their capital towards organizations whose activities lead to desirable social outcomes. The earliest examples of this practice were often associated with specific religious or spiritual frameworks. For example, Shari'a investing principles dating to the first millennium are informed by specific Islamic values that forbid the consumption of pork or alcohol, gambling, or charging interest. The United Methodist Church requires all investments made on behalf of that organization to align with their Social Principles, avoiding investments in companies that produce or distribute anti-personnel weapons and armaments; alcohol or tobacco; operate correctional or gambling facilities; or produce adult entertainment. The earliest attempts at implementing these types of investment strategies is usually referred to as the era of "ethical investing." Allocations to ethically responsible strategies have been common in Europe for centuries, where there are many pension funds and sovereign wealth funds that have wanted their invested funds to have a positive societal impact. But it is only in the last few years that similar strategies have become popular in the US.

The earliest roots of ethical investing essentially involved a negative screening or divestment strategy. This implied that certain types of organizations were "screened out" as permissible new investments, and current holdings of securities issued by these types of organization were required to be sold. These types of trading activities began in earnest in the US in the 1960s with the rise of social activism and the civil rights movement. As an example, the securities of certain defense contractors such as Dow Chemical were screened out of, or divested from, a number of endowment and pension funds because they were the primary manufacturer of napalm--a weapon that was increasingly viewed as immoral as the Viet Nam war progressed.

This era also saw significant increases in the allocation of investor capital into organizations or projects that were perceived as being correlated with desirable outcomes such as affordable housing and small business job creation. For example, certain institutions were able to attract investment capital by becoming a Community Development Financial Institutions (CDFIs), a designation granted by the CDFI Fund at the US Department of the Treasury, which provides support to CDFIs through a variety of programs. The substantial growth in the number and size of these organizations was an attempt to address societal issues such as racial and economic inequality. Capital invested in these institutions were dispersed as loans to small businesses and housing programs in low-income communities. The repayment of these loans provided investors with returns that were in addition to purely economic ones, while borrowers who might not have otherwise been able to gain access to loans were able to establish credit in order to secure additional loans in the future. Many other types of investment opportunities attempting to achieve certain types of socially desirable outcomes also emerged during this period.

By the 1980s there was enough domestic demand in the US for ethical investment opportunities that a number of asset managers (most notable Calvert Investment Management), were able to start mutual funds that made these types of investments available to the general public. It was also at this point that this type of investment strategy became more commonly known as "socially responsible investing," or SRI. By 1990, the substantial growth in SRI-aligned mutual funds led to

the development of widely followed market indices covering a multitude of asset classes and investment strategies that were considered socially responsible. Today, leading providers of indices such as MSCI, ICE, Russell, Morningstar, and Bloomberg calculate benchmarks against which SRI investment strategies can be evaluated. The companies whose securities make up these indices are selected based on a wide range of social and environmental criteria that can differ substantially from index to index.

Socially Responsible Investing in the Late 20th Century and Beyond

Many investors continued to be attracted to investment opportunities that either screened out or divested of securities issued by firms with negative or socially undesirable characteristics as determined by their own moral or ethical perspectives. However, many other investors began to express a preference for investment strategies that would allow them to make a positive impact on some aspect of society or the environment. The demand for this type of investment opportunity emerged more or less in parallel with the corporate sustainability movement, which was a reflection of society's increasing desire to encourage commercial enterprises to engage in socially beneficial and environmentally sustainable practices while also attempting to maximize shareholder value. It became widely recognized that there were many stakeholders in the actions of corporate enterprises (primarily customers) beyond shareholders who were being impacted by corporate activities, and many of these impacts (such as the generation of pollution or the destruction of scarce resources) were negative.

The decades of the 1980s and 1990s saw increasingly stringent environmental and socially responsible movements having a greater impact on the actions of corporations and other large organizations in an attempt to create incentives to align corporate interests with those of society as a whole. However, these attempts were not sufficient to prevent a number of highly visible failures of corporate governance in the early 2000s, as the senior management teams of companies like Enron and WorldCom were found to have engaged in substantial fraudulent activities which ended up destroying billions of dollars in economic value and also decimating the jobs and retirement savings of many individual employees of those firms -- as well as their suppliers and vendors.

The breakdown of corporate governance that was experienced in the early 2000s led to increased legislation and additional regulations and accounting standards intended to prevent financial fraud on such a scale from ever happening again, including the Sarbanes-Oxley Act (SOX). Investors also began realizing that they could have a positive impact on the actions of the firms that they were financing through the capital markets. This was accomplished by directing their investments only to firms that were engaged in activities that were considered socially desirable or environmentally sustainable, in the hopes that the SOX legislation and other initiatives were sufficient.

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Recent Developments in the Aftermath of the UN PRI

Investor interest in SRI strategies began to crystallize, particularly in the US, after the publication of the United Nation's Principles for Responsible Investing (UN PRI) in 2003. It was also at this time that the concept of environmentally sustainable, socially responsible, governance-oriented (ESG) investing emerged. ESG fundamentally differs from SRI in the sense that it is not exclusively based on negative screening of certain investments, but rather based on those having a positive impact on society and the environment. Firms that become signatories to the UN PRI (almost 2,000 member firms as of 2018) agree to adhere to the Principles when implementing strategies on behalf of their investors:

UN Principles for Responsible Investing

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.

In addition to the Principles, signatories are also expected to support the UN's Sustainable Development Goals (SDGs). Examples of issues that investors seek to address by engaging in ESG-oriented investment strategies include the following:

- Environmental
    a. Climate change
    b. Water
    c. Sustainable land use
    d. Fracking
    e. Methane
    f. Plastics
- Social Issues
    a. Human Rights and Labor Standards
    b. Employee relations
    c. Conflict zones
- Governance Issues
    a. Tax avoidance
    b. Executive Pay
    c. Corruption
    d. Director nominations
    e. Cybersecurity

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- Ethical investing (values-driven) – 1500s onwards: Motivated by religious inclinations, this era was defined by negative screening, or deliberately choosing not to invest in companies or industries that did not align with investor values;
- Early socially responsible investing (values-driven) – 1960s to mid-1990s: Socially responsible investing (SRI) became a newly coined 'catch-all' term for ethically oriented investing and referred to a value-based exclusionary investment approach (therefore somewhat indistinguishable from the previously used 'ethical investing');
- Current socially responsible investing (values-driven; risk and return) – late-1990s to present: This period represented a shift away from ethics-based investing towards incorporating ESG factors into investment decision-making – therefore linking it to investment returns. Early and modern practices are differentiated by the growth in shareholder activism and the introduction of positive-screening investing;
- ESG / responsible investing (risk & return, best-in class) – 2003 to present: This emerged from a renewed interest to include corporate governance into SRI (in addition to financial, social and environmental factors). Investors' desire for improved risk/return outcomes drove focus to this type of investing. Bolstered by the UN-backed Principles for Responsible Investing (PRI), responsible investors became a universally defined concept representing those investors who incorporate ESG factors into their investment process.

Source: Deutsche Bank Sustainable Investing – Establishing Long-Term Value and Performance (June 2012)

ESG-oriented investment strategies often exhibit two important components that differentiate them from traditional SRI strategies. The first is that investors are actively engaging with the management of the firms in which they are investing. This can include attendance at annual shareholder meetings and investor calls as well as voting proxy statements. The second component is the desire to create impact through engagement with management. Impact in this sense is defined as measurable changes in management's behavior based on investor engagement that results in the company aligning more strongly with ESG factors – in essence, causing these companies to have a friendlier environmental footprint, exhibit more socially responsible actions, and demonstrating strong corporate governance.

Based on the 2018 Global Sustainable Investment Review, the largest sustainable investment strategy globally is negative/exclusionary screening ($19.8trn) followed by ESG integration ($17.5trn) and corporate engagement/shareholder action/ESG impact investing ($9.8trn). The GSIR also reported that the fastest growing strategy, albeit currently the smallest, was ESG impact investing.

In Europe, total assets committed to sustainable and responsible investment strategies grew by 11% from 2016 to 2018 to reach €12.3 trillion ($14.1 trillion), but their share of managed assets

declined from 53% to 49%. (Source: 2018 Global Sustainable Investment Review, published by the Global Sustainable Investment Alliance)

Sustainable investing in the United States continues to expand. Total US-domiciled assets under management using sustainable strategies grew from $8.7 trillion at the start of 2016 to $12.0 trillion at the start of 2018, a 38% increase. Of this, $11.6 trillion is held by asset management firms and community investment institutions applying ESG criteria in their investment analysis and portfolio selection, predominantly through ESG integration and negative screening. ESG integration, the dominant strategy, is used across an estimated $9.5 trillion in assets. (Source: 2018 Global Sustainable Investment Review, published by the Global Sustainable Investment Alliance)

The US sustainable investing total also includes $1.8 trillion in US-domiciled assets at the beginning of 2018 held by institutional investors or asset managers that filed or co-filed shareholder resolutions on ESG issues at publicly traded companies from 2016 through 2018. Assets managed with sustainable investing strategies now represent 26% of all investment assets under professional management in the US. (Source: 2018 Global Sustainable Investment Review, published by the Global Sustainable Investment Alliance)

Challenges Going Forward

Most of the investment strategies that have emerged around ESG principles have been in the equity space, as investors become shareholders that have the right and ability (through proxy voting) to impact the decisions that management is making to align their firms more strongly with environmentally sustainable and socially responsible activities, while exhibiting strong corporate governance. However, fixed income strategies are increasingly becoming aligned with ESG factors as well. Investors that purchase bonds issued by firms do not have the same proxy voting rights and control over the management of those firms that equity investors have. However, they are providing an important source of financing through the capital markets that enables these firms to fund their operations. This gives debt investors substantial leverage in influencing these firms to incorporate ESG factors into their business operations.

Structured finance (asset-backed securities) is the most challenging asset class for alignment with ESG factors – in some senses it's the last frontier of securities-based ESG investing. Asset-backed securities are inherently not an investment in single companies but rather a pooling of assets that generate cash flows. Some of these asset pools comprise corporate equity or (more commonly) debt securities, with collateralized debt obligations (CDOs). But these pools most often comprise hundreds or thousands of individual loans or credits to individuals, and investors are challenged to demonstrate how these investments can individually or collectively align with ESG principles. Much progress is being made in structured finance and it is widely anticipated that there will be actively managed investment strategies in the structured finance space in the near future.

Given the substantially increased attention that investors are paying to ESG factors in their allocation decisions, three factors are emerging that will need to be quantified to satisfy their requirements: risk, return and impact. While risk and return metrics have always been a key

component of every investor's performance evaluation, impact is expected to receive increasing levels of attention. Investments that can demonstrate positive impact will only gain in popularity in the coming years.

About the Author: Rob McDonough

Rob McDonough is currently the Director of ESG and Regulatory Initiatives at Angel Oak Capital Advisors, LLC, a registered investment advisory firm serving the investment, risk management, and capital markets needs of financial institutions.

Rob also coordinates a variety of research and publication activities with a focus on developments in the regulatory environment for financial institutions of all types. He previously led Angel Oak's financial institution advisory practice, managing client engagements which included risk model validations, strategic and regulatory stress testing implementations, and investment portfolio risk and performance assessments. Earlier, from 2012-2014, Rob was Angel Oak's Chief Risk Officer, where his responsibilities included developing risk monitoring systems to assess market, credit, and operational risks associated with multiple public and private investment funds. He also initiated the organization's enterprise-wide risk management framework and SEC compliance program.

Rob is also the President and CEO of a financial services consultancy specializing in risk management consulting and training for institutions managing market, credit, operational, and other risks. He is a consultant and instructor for the Investment Training and Consulting Institute, Inc. and a Certified Investments and Derivatives Auditor (CIDA). He is also an instructor for many other organizations and industry groups including GFMI.

Rob started his career with the Federal Reserve System, where for twelve years he was an economic analyst and a capital markets safety and soundness examiner. His primary focus was regulatory policy development as well as assessing the condition of large complex domestic and international financial institutions. He developed significant field work experience in conducting safety and soundness examinations for banks and holding companies domestically and internationally. Rob also chaired a Federal Reserve System-wide committee to design, develop and deliver training for selected capital markets examiners across the country. This training was also implemented in a number of foreign central banks.

After leaving the Federal Reserve System in 1998, Rob joined Accenture as a Senior Manager in the Financial Services Industry Group, where he headed a joint task force responsible for defining and implementing the post-merger organizational structure for First Union's Brokerage Division's IT department.

Rob is a charter holder of the Bank Administration Institute's Certified Risk Professional (CRP) designation and the ITCI Certified Investments and Derivatives Auditor (CIDA). He is a CFA Level II candidate for 2016. Rob has delivered capital markets and risk management seminars to financial institutions across the US as well as in 28 countries throughout LATAM, Asia Pacific, and Europe.

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