

Investing money sustainably

Outline

Interest in environmental, social and governance (ESG) investing has seen rapid growth in recent years and shows no sign of slowing. Investors are increasingly seeking to ally financial returns with ESG considerations by investing in companies that operate sustainably. In this factsheet we explain what ESG-aligned investing is, and explore

the various considerations involved in a sustainable investment strategy, including sustainability assessment, risk and returns, and the approaches and methods that can be adopted to improve the sustainability characteristics of an investment portfolio.

When is an investment sustainable?

The concept of sustainability was decisively shaped by the *Our Common Future* report, which was published by the United Nations Brundtland Commission in 1987. In it it declared: “Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs”. This basic premise can also be applied to financial investments. Accordingly, sustainable investments aim to create long-term and lasting value in an efficient way, striking a balance between minimising risk and maximising returns, alongside delivering a positive impact. Furthermore, the integration of sustainability criteria should enable a more robust investment approach.

Sustainability is a broad concept that can be defined in different ways. Despite ongoing regulatory efforts, there is currently no common global standard/method for assessing the sustainability of companies. However, the term ‘ESG’ has become firmly established in the sustainability lexicon in recent years. ESG stands for environmental, social, and governance, with these three non-financial performance indicators used to assess the sustainability and ethical impact of companies. Investor appetite for ESG-aligned investing has increased substantially over the past few years.

Environment

The environmental criterion focuses on the ecological footprint of a company. It examines factors such as the extent to which a company implements or promotes ecological product responsibility – for example, in relation to its waste management programme, or air and water pollution. The handling of scarce natural resources, or the promotion of sustainable technologies (e.g. in the renewable energy field) is also evaluated.

Society

The social dimension analyses, among other things, human resources management and employee engagement, product safety, and whether a company makes a positive contribution to society (e.g. through responsible investments). It also examines whether labour standards are respected in the production chain.

Governance

In the corporate governance field, the management of a company is assessed. Business ethics, board composition, performance measurement, and financial/accounting transparency are some of the factors that may be considered when assessing the governance credentials of a company.

Assessing sustainability with ESG ratings

Companies are considered particularly sustainable if they can deliver on all three ESG aspects. ESG ratings can be used to identify those companies that perform particularly well (or, conversely, those that perform poorly). These ratings are provided by specialised ratings agencies, such as MSCI ESG Research and Morningstar/Sustainalytics. These third-party providers analyse a wide

range of publicly accessible information and proprietary research across the three ESG pillars, in order to measure a company’s ESG exposure and performance. Each area consists of several categories that are assessed and weighted individually. The final rating is composed of the individual scores that a company receives in each of the three areas.

Sustainability rating

Illustrative example

Assessment criteria

Environment

- Impact on biodiversity and resources
- Toxic emissions and waste
- Energy efficiency

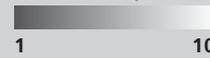
Society

- Health and safety of employees
- Labour standards in the supply chain
- Product safety and quality

Governance

- Shareholder ownership
- Gender pay equality
- Vulnerability to corruption and instability

Company A



Company B



Sustainability rating

8.7 / 10 ✓

2.9 / 10 ✗

However, many ratings agencies employ differing metrics and weighting systems when evaluating ESG performance, which can lead to results that are often inconsistent, or even conflicting. It is therefore advisable to assess ratings from more than one agency, to provide a broader objective analysis of risks and opportunities. Those who pursue such an approach can, for example, calculate the average of two ESG ratings.

It's not just companies that can be assessed; countries and state-backed organisations can be evaluated too. This is particularly important when it comes to the sustainability assessment of government bonds. As is to be expected, the individual criteria evaluated differ from the criteria used to analyse company performance. Aspects that can be examined include the handling of natural resources, management of healthcare systems, old-age provision, and the political environment.

Approaches for sustainable investment

There are various approaches for those seeking to improve the sustainability characteristics of an investment portfolio. One option is investing in securities with good or very good ESG ratings. This is also referred to as the 'best-in-class' approach. For example, preference is given to companies that have an above-average ESG profile within their particular industry.

Exclusions have long been applied to improve sustainability characteristics. This involves avoiding certain business activities or sectors as far as possible. This often means excluding companies that achieve a significant share of their turnover via the production of 'sin stocks', such as controversial weapons or tobacco. Negative screening is another form of exclusion that involves scanning for violations of international conventions and initiatives, such as the United Nations Global Compact principles, and/or companies with poor ESG scores. This means that no investments are made in companies which violate these standards or minimum ESG thresholds.

A positive influence approach, also known as thematic investing, means investing in those companies that make a particularly positive contribution to sustainability through their business activities. This is the case if their core activities are in areas that have a lasting positive impact on the environment or society. This includes, for example, the production of water-saving sanitary facilities or educational programmes.

'Impact investing' is a heightened form of thematic investing that focuses on financing sustainable projects. The focus is explicitly on how strongly these projects have a measurable impact on targeted aspects, such as poverty reduction. One example is green bonds issued by companies or governments.

In addition to these various forms of investment, the practice of 'ESG engagement' is also widespread. This sees investors, such as fund management companies, engage in active dialogue with the companies they invest in, in order to create and deliver greater ESG-related shareholder value.

Sustainable investing also pays off financially

The return and risk characteristics of investment portfolios can be improved by taking sustainability aspects into account, meaning that investors don't have to compromise on returns if they wish to pursue an ESG-focused strategy. Numerous studies have disproved the theory that sustainable investments yield a poorer return than their conventional counterparts. In fact, there is often a correlation between positive sustainability characteristics and higher stock returns.

Additionally, companies with good sustainability characteristics tend to be exposed to less risk. For example, the risk of fluctuations in value due to natural disasters. It has also been shown that companies with above-average sustainability performance are better at managing company-specific risks, and are therefore less likely to be surprised by incidents that negatively affect the share price. For example, they are less involved in scandals concerning environmental pollution or human rights abuses.

Low-cost access to sustainability

Exchange-traded funds or index funds are passive investment vehicles that track the performance of an index, such as the FTSE 100, as closely as possible. Typically, fees are very low, as opposed to the higher fees associated with active funds managed by professional fund managers. There are now a large number of passive funds that focus explicitly on sustainability indices. This is in contrast to older indices, which have tradi-

tionally limited their stock selection and weighting to market capitalisation, without also taking sustainability aspects into account. Various approaches can be used for such sustainability indices, as previously described (e.g. a best-in-class approach, or exclusions). Investors now have the opportunity to positively tilt sustainability characteristics in a portfolio in a diversified and cost-effective manner.

	MSCI World	MSCI World SRI
Number of constituents (stocks)	1,582	357
Index weight of largest stock	4.4%	12.7%
Index weight of 10 largest stocks	17.2%	33.3%
Exclusion criteria	No	Yes
Best-in-class	No	Yes
Positive influence approach	No	No
Impact investing	No	No
Proportion of undesirable business activities	3.7%	0.2%
Proportion of UN Global Compact violations	1.4%	0.0%
Proportion of high controversies	2.7%	0.0%
VZ sustainability profile	16	19
Weighted CO ₂ intensity (tons of CO ₂ per \$1m turnover)	140	78

Source: MSCI

VZ is committed to the UN principles

The United Nations Principles for Responsible Investment (UN PRI) is an investor initiative in partnership with the UN Envi-



ronment Programme Finance Initiative and the UN Global Compact. More than 3,500 asset owners and investment managers worldwide have signed up, including VZ Depotbank AG, a subsidiary of VZ Group.

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