From Marginal to Mainstream

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It didn't seem too long ago that ethical and responsible investing was viewed as very much at the margins, and one where better ethics came at the expense of investment returns. Today, whether at home in NZ or globally, responsible investing is anything but marginal.

Globally, some US$21.4 trillion of assets are managed in a responsible, sustainable way (around 30% of professionally managed assets as of January 2014, up from US$13.3 trillion since the outset of 2012 according to the Global Sustainable Investment Alliance).

At the end of 2015, in Australia, A$633 billion of assets or 47 per cent of professionally managed assets take a responsible approach to investing, and in New Zealand, the figure is NZ$78.7 billion (the total market capitalisation of the NZX main board is only NZ$125 billion).

This strong take up by the mainstream investment industry has been driven by two key factors. Firstly, that investors of all kinds recognise the economic importance of integrating environmental, social and governance factors into the investment decision-making process, highlighted by the ever more frequent examples of share prices being impacted by these factors (take the VW emissions scandal as a case in point).

Secondly, more and more people and institutions are demanding their investments are aligned to their values (note the massive increase in the divestment movement away from areas such as fossil fuels and tobacco).

In this article, we will briefly examine some of the dynamics underlying this growth, the relevance for the industry in New Zealand and offer some thoughts about the future. But first, a quick re-cap of what responsible investing actually means.

101 of responsible investing

Good investors have long known that there is more that drives investment returns than just what is reported in financial reports; that companies or assets won't thrive whilst ignoring environmental issues (pollution, climate change, water and other resources scarcity), social issues (local communities, employees, health and safety), corporate governance issues (prudent management, business ethics, strong boards, appropriate executive pay) or ethical issues.

In formal terms, responsible investment is a process that takes into account environmental, social, governance (ESG) and ethical issues into the investment process of research, analysis, selection and monitoring of investments.

In simple terms, there are two broad and distinct approaches to responsible investing; those investing ethically, driven by values and beliefs; versus those investing responsibly, driven by ESG risks.

There is also a broad array of methods that responsible investors use to manage these non-financial risks (from excluding companies involved in controversial industries, to supporting the most sustainable companies, to a sharp focus on ESG risks, and using ownership to engage with companies).

What's the fuss all about?

The rapid growth and mainstreaming in responsible investing can be attributed to a number of factors.

Firstly, economic; there is increasing and clear evidence that investing responsibly makes better economic sense, and in two ways.

There is compelling evidence that there is a cost to doing bad stuff. For example, big polluters globally are party to greater regulation (emission trading schemes, resource management acts) and held responsible more and more by local, national and international legislation and communities. Tobacco companies are increasingly likely to be sued by their customers for the harmful effects of their products or suffer from ever more restrictive regulations.

Secondly, there is more money to be made in more sustainable industries. For example, and in response to a rapidly warming planet, currently 173 countries have renewable energy policy targets (all of which requires investment). In 2015, US$286bn was invested in renewable energy.

Thirdly, risk reduction; investing more responsibly, with effective ESG integration into an investment process is more likely to reduce investment risk. BP had an extremely poor safety record in North America in the years preceding the Gulf of Mexico disaster. Volkswagen's share price fell by a third following news of the emissions scandal. These types of risks – environmental, safety, internal ethics and governance - were once considered non-financial. Today, examples such as these highlight just how very material they can be, and so have become core investment risks to manage.

Fourthly, it makes money; numerous studies now indicate that a more responsible approach to investing, one that incorporates ESG factors within the investment process, leads to a reduction in risk, a lower cost of capital and better financial outcomes. The local industry body, the Responsible Investment Association of Australasia's (RIAA) recent annual benchmark report (link here) once again highlights the fact that responsible funds typically outperform their mainstream counterparts, and over the vast majority of time periods. This has been confirmed by a mounting body of evidence from esteemed institutions including Harvard and Oxford universities among many others.[SO1] [MM2]

Next, investor hotspots; there are some areas where responsible investment is at the crux of key global issues and debates. Case in point is the global fossil fuel divestment movement. In response to the threats from climate change, and concerns about long term fossil fuel company valuations, some US $3.4 trillion (as at December 2015) of assets globally have committed to divestment of fossil fuels in some shape or form. The growth and prominence of such issues has propelled responsible investing very much into the limelight.

Finally, the long arm of the law; seemingly out of nowhere, Kiwisaver providers recently became aware of the potential illegality of some of their underlying share holdings, held largely via index funds. In particular, this arises from various pieces of legislation, and treaties that NZ is signatory to (in particular, the Cluster Munitions Prohibition Act 2009). The media and public outcry has highlighted the importance of responsible investing and asks some interesting questions. For Kiwisaver providers, who are responsible for the prudent management of billions of New Zealander's retirement savings (and for most 'mum and dad' investors, this is the main way they will accumulate wealth outside of their home), should their investments better reflect the values of the community that they serve? Ethics is one thing, the law is another.

Responsible investing in NZ

Responsible investors in New Zealand have typically and historically represented large asset owners, in particular Crown Entities such as The New Zealand Superannuation Fund and ACC. As reported in this year's RIAA benchmark report, the landscape is shifting, with the number and types of investors adopting and seeking a more responsible approach is expanding. In particular, we are seeing strong growth in responsible and ethical retail products (both KiwiSaver & Managed Funds), from community based groups, such as Community Trusts and Faith based groups, and an increasing number of mainstream fund managers who recognize the importance of ESG factors on investment risk and return. In summary, responsible investing is increasingly appealing to a broad church of investors.

Looking forward, this trend is set to continue. Notwithstanding the strong case for responsible investing (set out above), there are two areas worth highlighting that are likely to be the focus for New Zealanders.

Firstly, Kiwisaver. Already, providers must disclose their approach to responsible investing (if any) in their offer documentation. In addition, it is a vital piece of New Zealand's long term retirement funding policy (not unlike the New Zealand Superannuation Fund).

As we have also recently seen, it is the focus of much media and political attention. For these reasons, whether at a consumer level, or at a government policy level, Kiwisaver is likely to be at the forefront of policy and uptake in responsible investing. Indeed, the time may be ripe for Kiwisaver default providers to be obliged to adopt more stringent ethical standards that better reflect the laws & reputation of New Zealand, and the community at large.

Secondly, the role of the financial adviser. Very few AFA's currently take in to account responsible investment practices when developing financial plans, and building client investment portfolios. There is however, a strong case to argue that the Code of Professional Conduct, at the very least requires AFA's to ask the question, do you have any ethical or value based issues that should be considered when investing your money?

In concluding, responsible investing, in its various shapes and forms is on the march. Whether it be asset managers recognizing the importance of ESG factors in the investment process, individual investors wanting greater recognition of their values and ethics, or institutional investors adopting international norms and standards, the message appears very clear. Responsible investing makes sense, makes money and is mainstream.

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