Education

An introduction to sustainable investing

Key takeaways

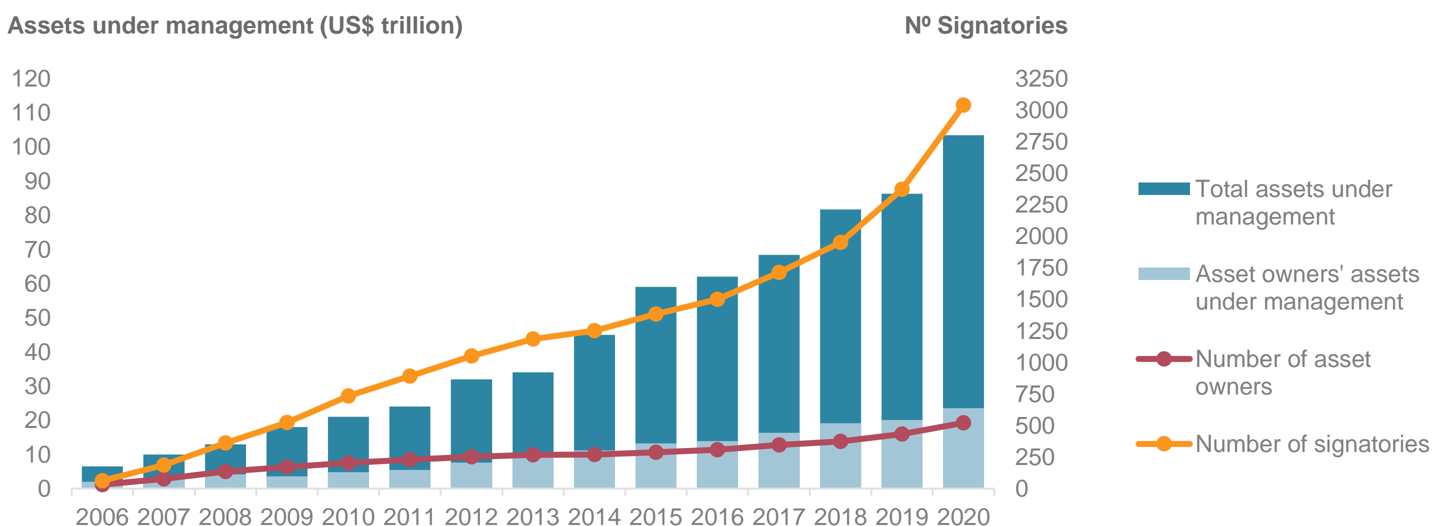
Read this paper for a broad overview of sustainable investing: what it is, who uses it, why interest in this approach is on the rise and how investors can implement a portfolio with a sustainability focus, including:

- Why is interest in sustainable investment on the rise?
- What impact does a sustainability focus have on performance?
- How can investors implement a sustainable investment portfolio?
- How does FTSE Russell measure a companies' ESG performance?

Sustainable investment

Around the world, interest in sustainable investment is increasing rapidly. The assets under management of investment institutions that are members of the United Nations' Principles for Responsible Investment (UN PRI)[1] have risen to over $100T as membership has swelled internationally from around 700 signatories a decade ago to now over 3,000.

Exhibit 1. Growth in UN PRI signatories and assets (2006-2020)



[1] The UN PRI commit signatories to acting in the best long-term interests of their beneficiaries. Signatories also recognize that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios and that applying the principles may better align investors with the broader objectives of society. Finally, signatories also commit to enhanced transparency regarding ESG issues, both at the companies they invest in and with regard to their own investment processes.

But what does sustainable investment mean? In the simplest terms, it means incorporating environmental, social and governance (ESG) considerations into the investment process. The motivations may simply be to generate the best long-term returns based on the view that ESG insights can have a material impact on investment returns. For other investors there may also be a "traditional" motivation to appeal to beneficiaries, or to achieve "societal good."

In this paper, we provide a broad overview of sustainable investing: what it is, who uses it, why interest in this approach is on the rise and how investors can implement a portfolio with a sustainability focus.

What is sustainable investment?

We define sustainable investment as investment approaches that take into account ESG considerations—it's an umbrella term for topics that can be the source both of investment risks and opportunities. Examples of ESG topics are climate change/transition to a low carbon economy, energy and material efficiency, waste and water management, bribery and corruption, board diversity, human capital and labor relations.

As sustainable investment is a concept that's only two decades old, it's important to remember that the surrounding terminology can be fluid. Different institutions may use different terms for the same concepts (for example, "responsible" rather than "sustainable" investment). Also, new, interlinking frameworks do arise, such as the United Nations Sustainable Development Goals (UN SDGs), or the Financial Stability Board's (FSB's) Taskforce on Climate-related Financial Disclosure (TCFD) recommendations.

Investors interested in sustainable investment should focus on understanding which ESG issues they are most exposed to, whether these issues are likely to be material, and what this might mean in terms of investment risks and opportunities.

Why is interest in sustainable investment on the rise?

Three reasons stand out for asset owners' increasing interest in sustainable investment approaches.

Demand for performance

First, there is a growing recognition among investors that ESG issues are not only relevant to investment performance but can have a material impact on that performance.

For example, a company with a record of environmental pollution, poor labor practices and inadequate governance and risk management standards may well end up performing poorly in financial terms, as well, with a resulting negative impact on the company's investors (potentially both shareholders and corporate bondholders).

Conversely, a company that prioritizes sustainability may well be taking a longer-term view of its growth prospects, generating more dependable profits and benefiting investors. In recent years, policymakers have increasingly stressed the idea of a potential virtuous circle involving ESG performance and economic performance.

> "Strong ESG scores could signal that a firm is more naturally disposed to longer-term strategic thinking and planning."
>
> **Mark Carney**
> Governor, Bank of England,
> "A new horizon", March 2019

Demand from fiduciaries

Second, the fiduciaries of large pools of capital—including endowments, insurance companies, pension schemes and sovereign wealth funds—increasingly demand that ESG issues underlie investment goals and play a central role in investment decision-making processes. Climate change and the transition to low carbon economy in particular represents a powerful mega-trend where there is an expectation that it could significantly influence portfolio returns. As a result, fiduciaries are wanting to take early action to mitigate the risks and gain exposure to the opportunities from this transition.

Demand from younger generations

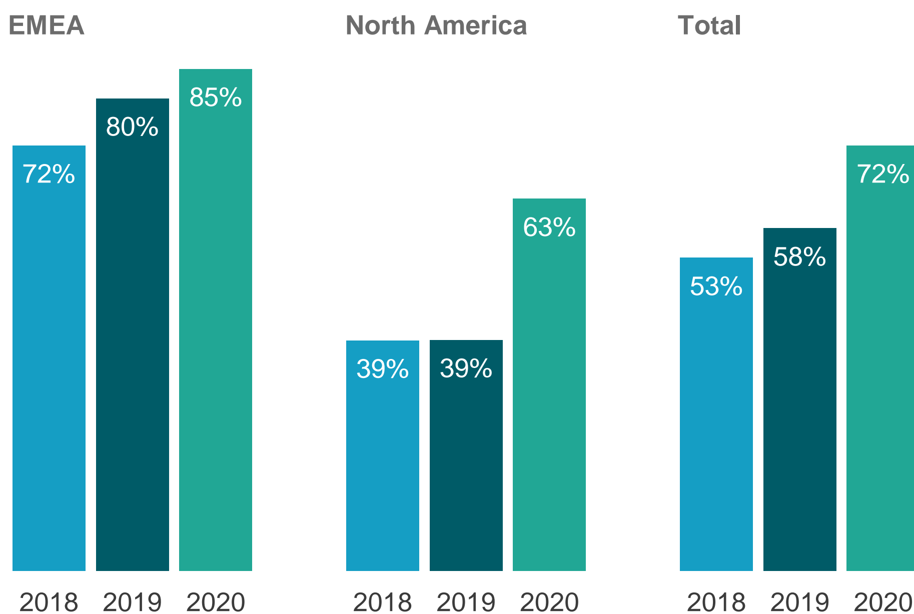
Third, and perhaps most important, interest in sustainable investment is on the rise from the ground up, especially among the younger generation. Many studies have shown above-average interest among younger investors in combining return-seeking strategies with an ESG focus.

Who uses sustainable investment approaches?

Sustainable investment has evolved from a niche activity, focused almost exclusively on listed equities, into an approach to investment that caters to a range of different investor needs and objectives, covering all asset classes.

In two decades, sustainability has also moved to the forefront of institutional investors' decision-making. According to FTSE Russell's 2020 "Smart Sustainability" survey, in which nearly 140 asset owners from around the globe participated, ESG/sustainability considerations are now part of investment strategy discussions for over half.

Exhibit 2. Is your organization currently implementing or evaluating ESG/Sustainability considerations in your investment strategy?



Source: Smart Sustainability: 2020 global survey findings from asset owners

FTSE Russell has seen first-hand evidence of this shift in the form of major portfolio allocations to tracker funds based on our sustainable investment indexes. For example:

- In 2016, the HSBC Bank UK Pension Scheme selected the FTSE All-World ex Controversial Weapons Climate Balanced Factor Index as its default equity saving plan within the company's defined contribution pension scheme;
- In 2017, the FTSE Blossom Japan Index was selected as a core ESG benchmark by the Japanese Government Pension Investment Fund, the world's largest pension fund;
- In 2019, Pensioenfonds Detailhandel, one of the Netherlands' biggest pension funds, decided to invest €5.8B of its developed markets equity portfolio into a fund managed by BlackRock and tracking an index developed by FTSE Russell to align with the UN's Sustainable Development Goals (SDGs).

What impact does a sustainability focus have on performance?

When ESG indexes were first introduced nearly two decades ago, some professional investors dismissed these new benchmarks as a gimmick and declared that such indexes were a distraction from their primary objective to achieve positive long-term returns. However, views on the compatibility of a sustainability focus and investment performance have since changed.

For example, a review of selected academic studies published by consulting firm Willis Towers Watson in 2018 found that: "not only is there a strong risk mitigation argument to incorporate ESG factors into the investment decision process, but that this, together with stewardship, presents the opportunity to enhance portfolio returns."[2]

A 2015 study conducted by the University of Hamburg—covering more than 2,200 academic studies published from the 1970s onwards—found that more than 60% of studies show a positive correlation between ESG factors and (company) financial performance, and only 10% show a negative relationship.[3]

And a 2017 study of the performance of US equity indexes found that the returns of selected sustainable investment products (including the FTSE4Good US Index) showed no statistical difference when compared to two US broad market benchmarks (the Russell 3000 and the S&P 500).[4]

A position taken by many (including Mercer and The Asset Management Working Group of the United Nations Environment Programme Finance Initiative in their joint report, "Demystifying Responsible Investment Performance") is that integrating ESG is unlikely to reduce long-term risk adjusted returns while there is growing evidence that it may improve them.

[2] Willis Towers Watson (2018) *Sustainable Investment – Show me the evidence*

[3] Friede, Busch and Bassen (2015) *ESG and financial performance: aggregated evidence from more than 2,000 empirical studies*

[4] Nuveen TIAA Investments (2017) *Responsible Investing – Delivering competitive performance.*

Looking forward, some observers say it is possible that shifting investor preferences could even drive firms with strong ESG performance to enjoy valuation premia over other companies. According to Mark Carney, former governor of the Bank of England, "Millennials [those born between the early 1980s and the early 2000s], keenly focused on company values and sustainability, are set to inherit $24T of wealth in the US alone over the next 15 years, and will seek the investment opportunities to match."[5]

How can investors implement a sustainable investment portfolio?

Investors who wish to integrate sustainability into their investments can take one or more of the following approaches.

- **Negative screening:** The investor (or the index provider compiling an ESG benchmark) identifies specific companies from the investment universe to exclude based on negative criteria. For example, companies involved in the production of weapons or tobacco products, fossil fuel industries or those involved in serious controversies or misconduct, may be screened out of the portfolio or index.
- **Positive screening:** In the opposite approach, companies are selected for inclusion in the portfolio or index, based on the positive selection of certain characteristics, or the achievement of a minimum ESG score in a ratings system.
- **Integration:** An integrated approach considers ESG information alongside traditional investment data to help identify potential risks or a competitive advantage (such as exposure to the green economy). ESG information can be used in this way to build "Smart Sustainability" indexes, for example by "tilting" constituents' index weightings up or down based on certain sustainability parameters alongside more traditional smart-beta/risk-premia factors.
- **Engagement:** Investor engagement focuses on identifying portfolio companies that are exposed to particular risks but whose management is doing little to manage or mitigate them. By engaging with the company's management and through exercising voting rights, investors target improvements in the company's business strategies, approach to risk and inter-related ESG performance.
- **Thematic Investment:** Investors looking for exposure to ESG opportunities or for "positive impact" may allocate capital to thematic portfolios. Investors may focus on well-established environmental themes (such as energy efficiency, renewable energy and water), or they may use other frameworks, such as the United Nations' Sustainable Development Goals.[6]

[5] Mark Carney, governor, Bank of England, "A new horizon," March 2019, citing Deloitte, "The future of wealth in the United States" (November 2015).
[6] For additional information on the UN SDGs see https://sustainabledevelopment.un.org/.

Sustainability—a quiet revolution

It may have been a quiet revolution, but the incorporation of ESG considerations into investors' decision-making processes has been a steady, unmistakable and increasingly unstoppable trend for the last 20 years and especially over the last decade.

As a result, asset owners are increasingly integrating ESG into the benchmarks and into passive mandates including new "smart sustainability" approaches.

FTSE Russell has two decades of expertise in providing sustainability data, analytics, and indexes, covering thousands of companies worldwide. Our solutions are designed to help a broad range of investors measure their ESG exposure and to incorporate sustainability into their investment strategies, across asset classes and global markets.

How does FTSE Russell measure a company's ESG performance?

FTSE Russell measures companies' ESG performance using a comprehensive ratings scheme, covering more than 7,200 securities. Our ESG Ratings cover all the constituents of the FTSE All World index, our flagship global equity index, and the Russell 1000 index—the leading index of US large-cap stocks.

The ESG Data Model applies more than 300 indicators to calculate a score and exposure for each of the 14 ESG Themes. Depending on the industries and geographies in which a company operates it faces Exposure to different ESG themes. Depending on a companies' Exposure assessment (which determines materiality) relevant themes and indicators are applied. We are then able to calculate scores and exposure for relevant themes and for each of the three ESG pillars (Environment, Social and Governance). Finally, we calculate a single ESG rating: this is a measure of a company's overall ESG performance.

Exhibit 3. How FTSE Russell measures a company's ESG performance

About FTSE Russell

FTSE Russell is a leading global provider of benchmarks, analytics and data solutions with multi-asset capabilities, offering a precise view of the markets relevant to any investment process. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for performance benchmarking, asset allocation, investment strategy analysis and risk management.

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