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A guide to responsible investing

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A guide to responsible investing

A lot of the time, investing can feel pretty abstract. You buy funds or shares through a computer or smartphone, and log in to your account to see how they're doing. All being well, their value goes up – and your wealth with it.

Responsible investing acknowledges that investing – abstract as it can seem – has a real-world impact. It's about choosing investments with the heart as well as the head, so performance and returns don't come at the expense of people and the planet.

While performance is important, it isn't the only reason people might want to invest responsibly. You might like your money to make a positive contribution to climate or social issues, or you might simply not want your money to go to companies which may have poor practices.

In this guide, we'll explain what might make an investment responsible, look at the main approaches, and discuss how to research responsible funds and shares. Responsible investing is also variously called 'ethical', 'ESG' and 'socially responsible' investing, and we've used these terms interchangeably throughout the guide. To help you get your head around all the lingo, you'll find a useful jargon buster at the end.

What makes an investment responsible?

Companies have an impact on the world. Responsible investing, simply, sets out to avoid those companies that have an adverse impact, and favour those that have a positive one.

When weighing up whether a company is suitable for a responsible portfolio, there are several different factors to consider. These are usually grouped under three main headings: environmental, social and governance (or ESG for short). To give you an idea of what each heading covers, here are some examples:

Environmental

Climate change
Deforestation
Plastic waste
Pollution
Resource depletion

Social

Child labour
Employee relations
Human rights
Modern slavery
Working conditions

Governance

Bribery and corruption
Executive pay
Board diversity
Political lobbying & donations
Tax affairs
Cyber security

Strategies for investing responsibly

Responsible investing is becoming increasingly popular, with today's investor able to choose from a wide array of responsible funds. But not every fund manager invests the same way. In this section we'll look at three approaches to responsible investing.

These three approaches aren't exclusive – many funds use them in combination. So always look 'under the bonnet' and check if the approach (or combination of approaches) matches your responsible investing aims by doing additional research.

ESG integration

ESG integration is a fairly straightforward way to introduce responsible investing to a portfolio. It simply means that when researching an investment, you consider ESG factors alongside the usual financial ones. An ESG rating may form a very small part of a decision-making process, or at the opposite end of the spectrum, it might lead to a fund manager excluding a particular investment from a fund or portfolio.

ESG integration can be a complex process, and lead to seemingly counterintuitive results. For example, it's possible that an oil and gas company is selected if a fund manager's ESG analysis concludes that their work in other areas, such as renewable energy, makes them a responsible player overall.

Socially responsible investing

To avoid the counterintuitive results that ESG integration can produce, socially responsible investing generally uses a form of 'screening'. That includes negative screening, which is a blanket exclusion of all companies within non-socially responsible sectors, such as oil and gas. This might suit investors who don't mind too much where they invest, as long as their money isn't held in companies which they believe are doing harm. This is a traditional way of investing ethically, and it's also straightforward to understand and implement.

Positive (or best in class) screening, on the other hand, permits investment across a range of industries, even carbon intensive ones, but picks a portfolio of companies which are leading their sector in terms of their ESG credentials such as a strong gender diversity policy or track record in carbon emission reduction.

Impact investing

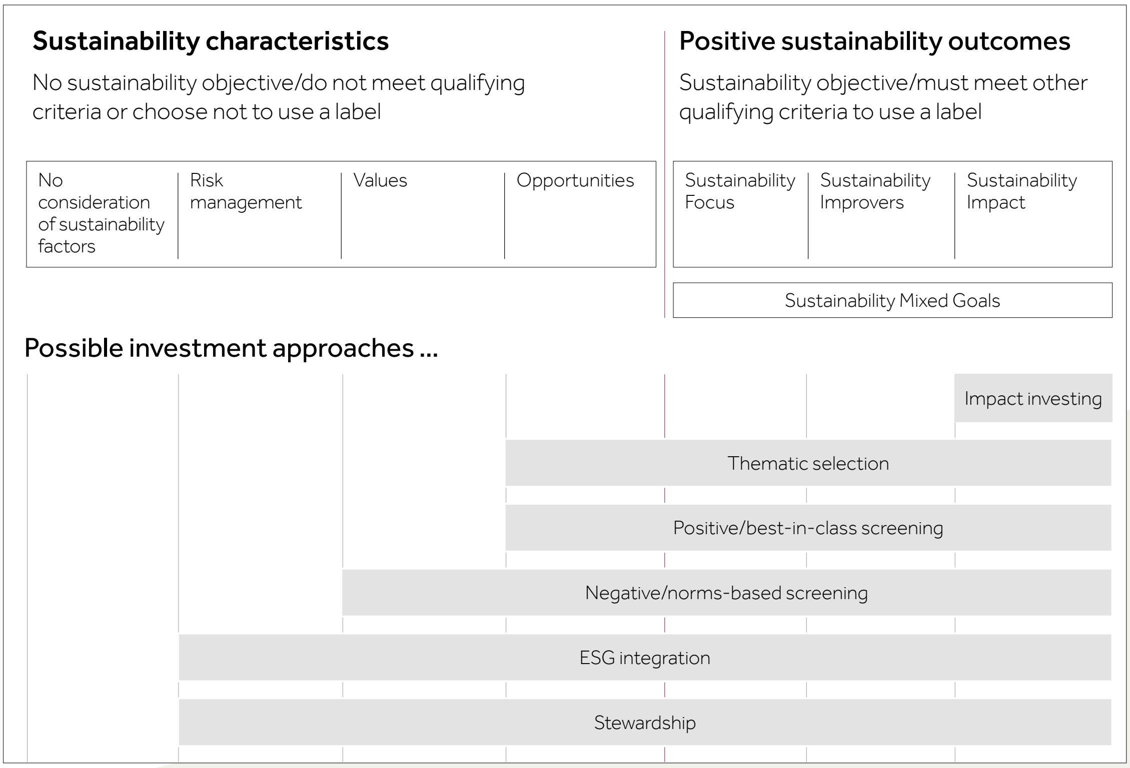
In contrast to the other two approaches, impact investing prioritises social outcomes over and above financial returns. It selects companies specifically for the positive, measurable effect they have on society or the environment, often following a specific theme – such as renewable energy, gender equality or water management. Generalist funds pursue a number of ESG themes, and thematic funds will focus upon one part of the ESG space, for example clean water or clean energy. This special focus on one industry or area will come with a higher degree of risk.

Values or value? Deciding how responsible your portfolio should be

Responsible investing has a spectrum. For some, financial returns will be the priority; for others, choosing ethical investments is the crucial consideration, and returns are secondary.

That's why there are different approaches to responsible investing. These range from the 'lightest touch', which seeks to avoid the biggest ESG offenders (but would be unlikely to qualify to use sustainable investment labels), all the way to impact investing, where the focus is largely on addressing societal and environmental issues.

In the following chart, you can see how different investment styles might approach sustainable investing goals and what approaches could qualify to use sustainable investing labels.



Source: Policy Statement PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels
www.fca.org.uk/publication/policy/ps23-16.pdf

Performance versus principles – a trade off?

Prioritising ethical considerations over financial ones doesn't have to leave you with an underperforming portfolio. But your investments will perform differently to benchmarks and indices that don't take ESG factors into account. Sometimes this will be for the better, sometimes for the worse

ESG funds might appear to be underperforming traditional investment indices, for instance if oil and gas or tobacco companies are in the ascendancy, and by taking an ESG approach you end up with certain biases in your portfolio, such as a high weighting to technology. If that sector is doing well then you'll reap the rewards, but the opposite will happen if technology is doing badly.

To help illustrate this, we've looked at total return of the FTSE All Share and MSCI World indices and compared them with their ESG counterparts in the past decade.

Index	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
FTSE 4Good UK	2.11	1.13	15.62	12.3	-7.14	19.56	-11.3	17.38	0.87	8.34
FTSE All Share	1.18	0.98	16.75	13.1	-9.47	19.17	-9.82	18.32	0.34	7.92
MSCI World SRI		4.12	28.45	12.93	-0.92	24.75	16.16	28.22	-12.74	20.62
MSCI World	11.46	4.87	28.24	11.8	-3.04	22.74	12.32	22.94	-7.83	16.81

Source, FE Analytics, total return in GBP

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But be aware of bias

It's important to note that a responsible portfolio is likely to show a bias towards certain types of companies. For example, European companies tend to score better on ESG metrics compared to US or emerging market companies. In a similar vein, technology companies tend to score better than energy companies. This means that in the short term, performance could vary from a mainstream index, such as the MSCI World – either for better or worse, depending on other factors such as the health of the underlying economy.

What to do before you begin choosing investments

Responsible investing is, by definition, subjective. Although there are new 'sustainability' labels from the financial regulator that funds can only use where they can clearly evidence their claims, there's no universal standard on whether an investment is ethical or not. It will come down to your personal values. A company considered problematic by some investors might be thought perfectly fine by others – and vice versa.

Perhaps the most important first step, then, is to ask yourself:

- What are your personal values?
- Which sectors and companies are you happy to invest in, and which do you want to avoid?

Doing this will help you choose investments in line with your principles.

How to choose responsible funds

Not sure you've the time, or confidence, to pick individual shares? You could opt for funds instead. Funds have the benefit of providing quick diversification, as well as the expertise of a professional fund manager with dedicated resources.

When picking a fund with a responsible mandate, you'll need to carry out a bit more research than usual. You'll need to look at how the fund is managed responsibly – and decide whether these standards meet your own. Knowing that a fund has a 'responsible', 'ESG' or similar label is a useful starting point, but this doesn't always tell the full story.

For instance, what is the fund manager's investment strategy? As we've discussed, there are different responsible investing styles, and you may prefer one to another. A manager may use a negative or positive screening approach similar to that described earlier, or may invest according to specific themes – for example, a dedicated gender diversity fund.

Be wary of 'greenwashing'

Another reason you should carefully consider a fund's management strategy is to avoid those guilty of 'greenwashing'. Greenwashing is when a fund markets itself as responsible, but includes non-responsible investments. You can spot a greenwashed fund by scrutinising its screening criteria, as well as the underlying investments it holds.

The increasing attention paid to responsible investing in recent years has prompted new rules that mean funds and investments labelling themselves as 'sustainable' must provide clear and complete evidence of their responsible credentials. This means it's getting easier to tell the genuinely responsible investments from the fakes.

Should I choose a passive or active fund?

When choosing a responsible fund, one question you'll need to answer is: active or passive?

An active fund has a fund manager who aims to outperform the market, choosing investments based on their views and strategy. Typically higher charges.

A passive fund looks to mirror the performance of an index, such as the FTSE 100, and isn't actively managed. Typically lower charges.

Both approaches have their pros and cons. But when you're looking for a responsible fund, there are several additional factors to consider.

How consistently does it exclude non-ethical investments?

If you're sure you want to avoid certain companies or sectors, a passive fund may be more appropriate. That's because passive funds follow a defined set of rules, while an active investment enjoys greater freedom.

However, it isn't always that black and white. For example, if you want to avoid investing in tobacco, you could choose a passive fund that expressly avoids tobacco. However, the fund may also include holdings in a supermarket that sells tobacco products, or a paper company that produces cigarette cartons. Similarly, an active manager may also exclude tobacco products, but come to a different conclusion about what can and can't be included.

How does it assess an investment's ESG credentials?

To assess a company's ESG credentials, most passive funds enlist third-party data providers – such as MSCI and Sustainalytics – who award companies an ESG rating.

Though they seem objective, such ratings depend on subjective judgements and you might still want to look beyond the rating numbers. For example, one data provider may score Tesla highly because they produce electric cars; another may mark them down for perceived governance problems. A passive fund can give your portfolio a better ESG score in the round, but dig deeper and certain companies could be outliers.

Active managers will usually consult ESG rating agencies too. But they can also analyse the different issues a company faces, and draw their own conclusions from their data.

How much does it engage with the companies it invests in?

To truly tell how responsible a company is, it's important to engage with it directly. Passive and active fund managers do this in different ways.

A passive fund will often contain hundreds, if not thousands of companies – making it difficult for managers to engage with them all. They are also less flexible than active funds, and must invest in a company if dictated by the index it tracks. However, some of the world's biggest fund managers are passively managed, including Blackrock, Vanguard and State Street. This gives them the resources to engage with the companies they invest in. They can also vote down the re-election of board members that have failed to enact important changes – such as disinvesting in unethical companies.

Active funds, on the other hand, generally have a smaller number of holdings – making it easier to engage directly with companies. They are also more flexible than passive funds, enabling them to disinvest from unethical companies.

Cost

Responsible funds typically cost more than non-responsible ones. The premium for passive funds is fairly small (around 0–0.3%). However, it's larger for active funds, in which investing responsibly involves additional work.

There are three main reasons why responsible funds cost more:

Data

Assessing a company's ESG credentials requires extra research. Outsourcing this research to third-party data providers is an additional expense.

Engagement

It's important to liaise with companies to make a proper ESG assessment. This takes time and comes at a cost.

Reporting

A responsible fund needs to explain to investors the societal and environmental benefit it is delivering, which can also be expensive.

How to choose responsible shares

Building a portfolio of shares you've chosen yourself requires more research than buying a fund. But it also allows you 100% control over what goes into your portfolio – meaning you can be sure it aligns with your principles.

Once you've decided which sectors to avoid and include, one way to get started is by using a screening approach, as described on page 5.

Negative screening excludes companies that conflict with your personal values – for example, firms with poor records on animal testing.

Positive screening looks to actively include companies whose activities benefit society – for example, renewable energy companies.

How to assess a company's ESG credentials

So you've ruled out – and ruled in – certain sectors. The next step is scrutinising individual companies. Thankfully, you can divide this process up into the environmental, social and governance (ESG) factors we've described earlier.

It's worth noting that it's hard to find companies which do all three impeccably. There is no 'perfect' company, and all firms would do well to continually look to improve their standards. The good news is that ESG reporting is becoming more and more transparent – making your research easier – but keep in mind the reliability of this data is sometimes still questionable. Here is what you need to look at in each category.

Environment

What is it?

A company's impact on the natural world – including waste and pollution, resource depletion, greenhouse gas emissions, deforestation and climate change.

How do I research it?

These days, company reports have a greater focus on non-financial reporting. Annual reports should usually include information on environmental policies and specific climate-related financial disclosures. This includes the company's greenhouse gas emissions and energy use – making it relatively straightforward to tell if a company has reducing their carbon footprint over time. This can be a good indication of how seriously they take wider environmental issues.

Social

What is it?

The well-being and rights of a company's people and communities – covering working conditions, conflicts, health and safety, employee relations and diversity.

How do I research it?

Social issues tend to be more intangible and harder to analyse than environmental and governance ones. But you can get an idea by reviewing a company's website and looking for reports or policies on social issues such as a Modern Slavery statement. You can also look at public information. This could include information such as reports on gender pay gap or health and safety records. Other sources could include HR awards won by the company, such as The Times Best Places to Work For.

Governance

What is it?

How a company is directed and controlled and how risk is managed. Polices might cover executive pay, board make-up, diversity and tax strategies as well as mitigation to prevent scandals or cases of bribery and corruption.

How do I research it?

For public companies, you can check the board structure, and the diversity of board members, by visiting its website. You should also find terms of reference for various board committees. Additionally, company polices and mission statements which mention ESG, or any dedicated ESG mission statements you can lay your hands on, can give you a helpful steer.

Finally: old-fashioned research

Once you're satisfied that a company's ESG credentials are sound, you can then get on with the more traditional work – researching whether it might be a good investment.

You can learn more about the nitty gritty of researching shares in our First-time investor guide, as well as on our website.

Owning a share also brings voting rights. You can use yours to influence company management for the better. If you grow disappointed with a company's ESG policies, and don't see them changing for the better, you may decide it's better to sell up.

What are the risks?

No matter how well-run a company, or impressive its ESG record, it still faces the usual risks. It can go out of business during challenging economic conditions if it isn't flexible enough to cope.

Investing responsibly, however, can help you avoid putting money into companies with looming environmental problems. As discussed on page 4, ESG rating agencies flagged the risks faced by BP and Volkswagen before their respective disasters in 2010 and 2015.

But it isn't absolutely foolproof. In 2020, the company Wirecard in Germany was embroiled in a case of corporate fraud that led to its eventual insolvency. But this governance risk wasn't uncovered by all ESG rating agencies.

So, while a responsible approach could lowers your chances of investing in a bad bet like Wirecard, it doesn't remove the possibility completely.

The easy way to invest responsibly

Want to invest with the heart as well as the head? At AJ Bell, we offer all the resources a responsible investor could need. You've thousands of funds and shares, investment trusts and ETFs to choose from, along with extensive accompanying data and research. Want to narrow down your search? Our AJ Bell Favourite funds list includes our specialists' pick of ethical funds.

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The value of investments can change, and you could lose money as well as make it.

The information contained in this guide is based on our current understanding of ESG investing which may be subject to change.

We don't offer advice, so it's important you understand the risks. If you're not sure, please speak to a financial adviser.

Jargon buster

Corporate governance	The processes, procedures and frameworks that direct and control a company. Usually the responsibility of the company's board of directors.
ESG	Environmental, social and governance. The three central factors when assessing a company's responsible credentials.
ESG integration	An investment process that takes environmental, social and governance factors into account, as well as financial outcomes.
Ethical investing	A type of investment process which is guided by overarching values or beliefs rather than a strict focus on financial outcomes.
Green bond	A bond whose proceeds are used exclusively to fund environmentally friendly initiatives.
Green investing	Investing in companies specifically focused on making a positive impact on the environment.
Greenwashing	Giving the false impression that a company, fund or portfolio is much more ethical or responsible than it really is.
Impact investing	An investment strategy that prioritises ESG concerns over financial returns.
Negative screening	The process of filtering out companies from non-responsible industries (such as tobacco, alcohol or arms).
Positive screening	The process of actively investing in industries or companies with good ESG practices, such as a strong gender diversity policy or track record in carbon emission reduction.
Principles for Responsible Investment	Six principles defined by the United Nations as a framework for fund managers to incorporate responsible investing into their process. You can learn more here: https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment
Responsible investing	An investment strategy in which environmental, social and governance (ESG) factors are a fundamental consideration, rather than focusing solely on performance and return. Encompasses different approaches such as ESG integration, socially responsible investing and impact investing.
Socially responsible investing (SRI)	An investment process that uses positive or negative screening to choose companies with good ESG credentials.
Stewardship	Actively engaging with companies to promote strong corporate governance. Aimed at fostering long-term value for shareholders as well as the wider economy.
Sustainable Development Goals (SDGs)	A set of 17 targets designed by the United Nations as a blueprint for addressing a range of social and economic problems. The SDGs are often integrated into responsible investment practices. You can learn more here: https://www.un.org/sustainabledevelopment/sustainable-development-goals/