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SIMPLIFYING SUSTAINABLE INVESTING: THE DIFFERENCE BETWEEN ESG, SRI, AND IMPACT

There has been an avalanche of articles seeking to explain the most pressing communication problem for sustainable investing: the alphabet soup that confuses asset owners, managers, and investors across the financial services spectrum. The fact that so many are beginning to address the issue is a welcome sign. There is clearly now consensus that the problem exists – and it's about time we solved it.

Unfortunately, the majority of guidance offered in these articles is making matters worse, not better. Viewpoints from each corner of the industry demonstrate that the language being used depends on who is selling what to whom.

The finance industry is rife with jargon to begin with. Acronyms and inside terminology are often cited as one of the most difficult barriers to overcome. This is particularly true for retail investors, who don't have the time between careers and responsibilities at home to research and learn the differences between equity and stocks or bonds and fixed income. Wait…aren't those interchangeable terms?

The fact of the matter is that investments are not confusing or difficult to understand. They are simply communicated poorly.

As communications professionals, we know it is possible to explain what investments are, how they work and why. Just as doctors must be specialists in their area of medicine and develop a bedside manner to work with patients, investment professionals must be able to walk through their approach with clients.

What does this have to do with sustainable investing elements like ESG, SRI and Impact Investing? Industry players have infused their already confusing jargon into these terms, often conflating one or more of them to suit their best interests. Consider that a 2018 survey by UBS showed that 68 percent of investors find sustainable investing terms confusing.[1]

68%

OF INVESTORS CONFUSED BY SUSTAINABLE INVESTING TERMS

It is a frustrating setback: ESG, SRI, and Impact Investing are not the same…and they never have been, even if their definitions are sometimes a moving target. Each has its appeal, depending on the audience. Advisors and managers should know which is which, and how to communicate each to current and prospective clients.

HERE'S A TOPLINE LOOK AT THE MOST PROMINENT TERMS:

ESG

It stands for environmental, social, and governance. These are called "non-financial factors," which is misleading because, today, they have far more to do with value than "tangible" assets or financial factors. In fact, as far back as 2009, reports were showing that:

> "Only 20% of the market value of the S&P 500 firms is embedded in their tangible assets. The 'remaining' 80% is associated with intangible assets. Identifying and valuing intangible assets, such as brand, reputation, culture, customer satisfaction, human capital, risk management, R&D and a company's social license to operate are challenging because they rarely leave a clear imprint in financial statements. They require a fair amount of in-depth qualitative assessment and the application of new fields of academic and financial study, like assessing environmental risks, and evaluating societal externalities, both positive and negative."[2]

Just ask Facebook, which lost close to $120 billion in market capitalization in one day after a series of crises ranging from Russian election interference and Cambridge Analytica to concerns over users' privacy. These risks are clearly more financially relevant than the company's real estate portfolio.

ESG primarily helps identify risks, uncover opportunities, and leads to a better understanding of why a company may perform well. Understanding management's views on operations in the context of climate change, for example, or how it treats its employees, supply chain partners, and customers gives an idea of where the company is going – as opposed to financial reports that show where it has been.

Somewhere along the way, ESG became synonymous with exclusionary screening. Exclusionary screening can and most likely will negatively influence returns. Green, brown, and even "sin" stocks like alcohol and firearms will all perform over the course of a market cycle. Eliminating one or more will likely miss out on the action.

But ESG does not exclude industries from the investment universe. It puts meaningful data to how companies perform in the context of environmental, social, and governance criteria. While the data can be used to construct an exclusionary portfolio, ESG itself is issues-agnostic.

Simply stated, ESG is what good investing is all about. Our question for those who disagree is a pointed one: Why would you not consider all of the data and information at your disposal to understand what you are invested in?

SRI

Depending on who you talk to, it either stands for Socially Responsible Investing or Sustainable, Responsible, Impact investing. This split on its own shows the incredibly confusing language fragmentation plaguing the industry.

For decades, it was defined as Socially Responsible Investing, and the attempt to re-cast the acronym seems to be aimed at broadening the umbrella for firms with a history of SRI.

SRI is all about making a statement through the power of investments. It appeals to a great number of values-driven investors, but it is not primarily about performance – it is about addressing specific issues through the allocation of capital.

The practice initially came to prominence during apartheid, when investors and practitioners sought to divert and divest from companies or industries that could be linked to the atrocities in South Africa. It evolved into an exclusionary screening philosophy, avoiding industries to stifle capital flows to bad actors.

Socially Responsible Investing has its place, and while ESG can be used to support SRI, the two are very different.

Impact Investing

Impact Investing is exactly what it sounds like: investing to positively impact an issue, such as poverty or access to clean water, while generating a financial return. The catch? It is primarily exercised through private markets.

This type of investing is not for everyone. It typically relies on what financial professionals call "patient capital." Impact investors have the ability and the benefit of not needing to prioritize immediate returns through their investments; they instead place equal if not greater value on the social or environmental return/impact.

Often, the principal and profit earned back from the investment is allocated to address another cause; it is a sustainable way for high-net-worth investors and institutions to extend the reach of philanthropic dollars.

58% OF INVESTORS BELIEVE SUSTAINABLE INVESTING WILL BE MAINSTREAM IN

10

YEARS

39%

OF NON-ADOPTERS WOULD LIKE TO INVEST SUSTAINABLY

The previously cited UBS report noted that 58 percent of investors believe that sustainable investing will be mainstream in 10 years, and 39 percent of non-adopters would like to invest sustainably.[3] Bridging the communication gap to help these investors demystify their options is critical to unlocking capital that can influence some of the world's greatest challenges.

We believe that each practice – ESG, SRI, Impact Investing – has its benefits and appeal. The challenges for asset managers and advisors are understanding the audience, identifying the objective, and constructing an effective message to guide their clients as to which is best suited to meet specific needs.

1. UBS, UBS Investor Watch, September 2018
2. UBS, A revolution in Equity Investing, May 2015
3. UBS, UBS Investor Watch, September 2018

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