The Ideology And Reality Of Sustainable Investing

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Let me start by saying it saddens me to be writing this article. Not that I don't like to write. As an academic and as a tenured professor at Harvard Business School, a lecturer at MIT's Sloan School of Management, and now a professor at the Saïd Business School at Oxford University, I've done a lot of that over the past 40 years. It's like my job. So why am I sad? The reason is that the charge I was given was "to please explain to financial advisors that sustainable investing is more than values-based negative screening, which hurts returns."

I thought we were well past that myth. I think it persists because of right-wing ideology, which sees the world through a lens where facts are what you want them to be, and scientific evidence be damned. It bemuses me every time someone says, "sustainable investing means giving up returns in service of a left-wing political ideology," when the real idealogues are those making this claim. They received moral support from a President who thought that climate change is a Chinese hoax and demanded that the Environmental Protection Agency remove those words from its website. They received more pointed support from speeches by SEC Commissioner Hester Peirce and the Department of Labor ruling against sustainable investing.

Two years ago, I published an article in the Harvard Business Review titled "The Investor Revolution: Shareholders Are Getting Serious About Sustainability." The purpose of this article was to inform company executives that their stock prices and long-term prospects now heavily depend on how well they are managing the environmental, social, and governance (ESG) factors material to their industries and strategies. In it, I cite a number of empirical studies by academics and investors themselves. For a good summary and update see another HBR article, "Social-Impact Efforts that Create Real Value," by George Serafeim. Note that the title of this publication is the Harvard Business Review, not the Harvard Philanthropy Review.

On November 16, 2020, the US SIF Foundation released its biennial Report on US Sustainable Impact and Investing Trends. The report found that U.S.-based assets under management, through some strategy for sustainable investing, now total $17.1 trillion. This is a 42 percent increase from two years ago and now represents 33 percent of total U.S. assets under professional management. In Europe, this number is more like 45 percent or $13 trillion in AUM.

Given the fiduciary duty of investors to earn returns for their beneficiaries, this much money isn't being invested in strategies that earn less than market returns to support some kind of environmental or social cause. The logic is actually the reverse, whether the U.S. Department of Labor likes it or not. Earning market returns requires taking ESG factors into account, as the scientific body of work has so amply demonstrated.

There are seven basic strategies for sustainable investing, which can be used for both passive and active products, and some of them can be used in combination:

Negative/exclusionary screening is the elimination of companies or even entire industries. It is the first sustainable investing strategy and was developed by so-called Socially Responsible Investment (SRI) funds. Companies or industries were screened out for values-based reasons, such as consistent violation of human rights by a mining company or industries selling "sin products," such as alcohol, gambling, and tobacco. In some cases, returns were sacrificed, but not always. Today negative screening is more commonly done for value-based reasons. A company with a poor ESG score is a risker investment or an industry may be regarded as in a permanent downward spiral, such as oil drilling. Obviously, others may view the company's or industry's prospects more positively, but this is an argument about value, not values.

Norms-based screening is a particular type of negative screening that eliminates companies that violate some set of norms, such as the Ten Principles of the UN Global Compact, and again can be done for both values- and value-based reasons.

Positive/best-in-class screening selects companies with especially strong ESG performance because evidence shows their financial performance will be better. As the market has increasingly factored in ESG performance, a more sophisticated version of this strategy has emerged. In it, the investor is looking for stocks that are underpriced due to their ESG performance but show evidence of a positive trend that has not yet been recognized by the market.

Sustainability-themed investing is based on sectors and trends that are regarded as promising for value creation, such as a fund focused on access to clean water or renewable energy.

ESG integration is the inclusion of ESG factors in fundamental analysis. This is really the core of sustainable investing today, in which the material ESG issues for a company and industry are accorded the same importance as traditional factors. A limitation on this strategy is the lack of quality data. But efforts in the U.S. and globally are underway to make the quality of ESG data from sustainability reporting to be as relevant and reliable as the data obtained from a company's financial reporting.

Active ownership is about engaging deeply with portfolio companies with the aim of improving their ESG performance as a way of improving their financial performance.

Impact investing is looking for companies that make a positive impact on an ESG issue, while still earning a market return. This is still a new strategy for the public markets and a difficult one to implement for a variety of data limitation and technical reasons.

The distinction between investing and sustainable investing is blurring and will soon disappear, as ESG integration and active ownership become pervasive. For financial advisors who have been in the business for decades, this is all happening rather suddenly and rapidly. I also realize many of them still conflate sustainable investing with values-based negative screening. But for financial advisors to properly service their clients, they need to get up to speed very quickly on this massive shift taking place in the investing world today. Failure to do so will mean that they aren't meeting the needs of clients who want a proper risk/adjusted return. Sustainability is now at the core of delivering on this. That is reality, not ideology.

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