ESG: Is the investing landscape changing for good?

An analysis of trends and challenges in environmental, social and governance investing - and the factors that will help to shape the future of retail investing in the UK.

Introduction

In general, people don't invest in the stock market for the fun of it; investors would like a return. So while environmental, social and governance (ESG) investors may want their money to be improving the world, there are two key questions they also need answers to: the first is whether they're likely to generate a higher return with ESG, and the second is whether they might avoid significant losses. The first would be ideal. The second is crucial.

ESG investing has been on the rise for a few years, but 2020 saw a boom. Investing platforms have had to keep up with rising customer demand for ethical portfolios. And Finder analysis suggests the industry is delivering: most providers we've reviewed have some kind of ethical portfolio on offer. But the industry is dogged by confusion about terminology, and lack of standards.

The rise in ethical investing is casting a spotlight on companies' practices. Customers and regulators alike are paying closer attention to company behaviour and its impact on the environment and employees. Fines are hitting record figures.

President Joe Biden's win in 2020 will see dollars pouring into green initiatives, and more into green investments. The iShares Global Clean Energy ETF saw considerable growth in 2020 as Biden launched his climate plan and went on to win the election.

Our report includes new Finder research and analysis, and explores the trends, the challenges and some potential solutions for the ESG investing industry, as well as expert predictions for what comes next.

Contents

There was an explosion of interest in ESG and impact investing in 2020, with vast inflows into sustainable funds. According to the Investment Association (IA), sales of sustainable mandates hit £1 billion for the first time on record in October that year. The IA reported in December that the total for the year to date was almost £9 billion - around four times that of the previous year.

So far in 2021, interest is continuing at high levels - as the Google Trends graph below shows.

What are customers saying?

In August 2018, Wealthify launched 5 ethical portfolios. Nutmeg followed in November 2018, launching 10 of its own. Wealthsimple first launched three ethical portfolios in 2016, but updated them in June 2020 to make them "even more socially responsible".

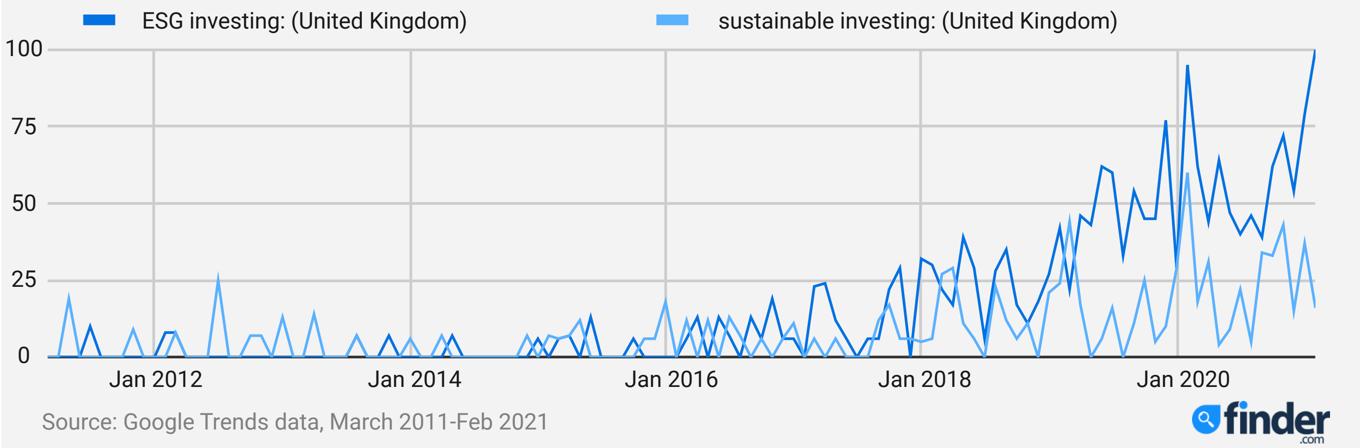
Pension platform PensionBee has two specifically ethical or environmentally friendly portfolios, Fossil Fuel Free and Future World, plus a Shariah-compliant portfolio. In January 2020 it surveyed 2,000 of its Tailored Plan customers; it found that 81% want transparency about which companies their pensions are invested in and 61% want providers to remove any banned weapons manufacturers from their pensions.

Plum, which has an ethical portfolio, "Clean and Green", told us: "Sustainable investment opportunities have been one of the most requested product features by Plum customers. In a survey conducted with our investor base in October 2020, almost 30% of our investors voted ESG funds as their top preference on new fund additions in the platform."

The platform saw new investor allocation rise from 5.5% to 8.9% for its Clean and Green portfolio in November/December vs March/April.

It's becoming the norm to see platforms offering a choice of ethical investments for users. Of the 15 "robo-advisors" Finder has reviewed, 11 offer ethical portfolios. And we're seeing new providers like Clim8 and tickr that are specifically aimed at ethical investing. Another newcomer is the analysis platform Sugi, which customers can link to their existing provider to see the carbon footprint of their investments.

Google searches for "ESG investing" and "sustainable investing" over the past decade



Source: Google Trends data, March 2011-Feb 2021

The world of sustainable investing is a word salad: "ESG", "ethical", "exclusion", "engagement", "impact", "sustainability", "green", plus a host of thematic options – from the "circular economy" to the "energy transition". With no established definitions, investment groups interpret these as they choose. Investors have to pick through it to find the right option, and are vulnerable to "greenwashing", whereby companies overplay their green credentials.

There are signs of change. March 2021 saw the introduction of the EU's Sustainable Finance Disclosure Regulation - likely to be adopted in the UK. And a new taxonomy is due to be published in June. Early drafts were criticised as too prescriptive and the final rules are under discussion.

In the meantime, some investment managers apply an ESG screen across all funds – Schroders, Federated Hermes, Aberdeen Standard. Others have a dedicated ESG range, or funds in specific areas, such as climate change or recycling. Some just use ESG as part of their risk management and don't compel fund managers to follow it. But the EU approach may bring more uniformity, enabling easier comparisons.

Passive funds

Recently, the passive industry has got involved: launches include the L&G Clean Energy Ucits and the JPMorgan Carbon Transition Global Equity Ucits, while iShares, HSBC, Xtrackers and Vanguard all now have climate-aware funds. These launches have been made easier with the recent arrival of benchmarks on which to base passive strategies. These, in turn, have been made easier by better disclosure and wider availability of data. S&P Dow Jones Indices and MSCI have both launched a range of Paris-aligned indices.

New asset classes

Most sustainable funds are equity funds (196 out of 293, according to the consultancy Square Mile). However, recently other asset classes have started to catch up. There are more fixed income funds (39), plus infrastructure funds (20). Mixed asset funds are also coming to the market, enabling investors to build diverse portfolios, which had been a problem when only equity funds were available.

Ultimately, this is a fast-moving sector. After a strong year in 2020, more fund groups are likely to wake up to the importance of ESG for investors and take action. We expect the market to keep changing throughout 2021.

Practising what they preach

Diversity is an important part of the "g" in ESG. Strong female representation on boards is part of good governance, helping to challenge "group think". Increasingly, it seems, fund managers of ethical, socially responsible and ESG funds are reflecting this idea. Finder research of 212 funds listed on Hargreaves Lansdown in February 2021 found that 23% of ESG funds have one or more women in their management teams, vs 12% of other funds. Analysis of the first eight months of 2020 by Goldman Sachs found that all-women and mixed-gender teams at 496 large-cap US equity funds outperformed all-male portfolio management teams.

Comparing the performance of ESG vs non-ESG funds is complex. ESG funds tend to hold fewer stocks such as oil and have more in technology, which has fewer greenhouse gas emissions. Sometimes in the market cycle, this approach will do well - at other times, it will do badly. Equally, ESG funds favour higher quality companies with strong governance. Investors will like this at times - and at other times, they will go for something racier. However, the signs have been positive recently.

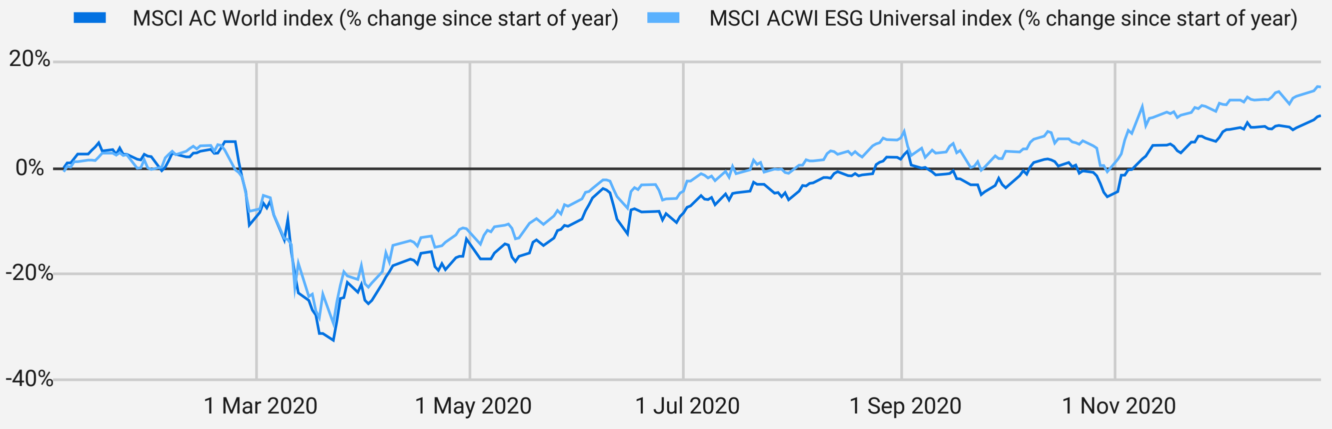
A swathe of investors embraced ESG during 2020. In the IA Global sector, home to the most ESG strategies, the average ESG fund made a 10.1% total return over the first 8 months of 2020, compared to just 4.09% for conventional peers, according to investment research firm FE fundinfo. Longer-term numbers stack up, too. In Morningstar analysis of 745 funds, most strategies outdid non-ESG peers over 1, 3, 5 and 10 years; with outperformance highest in funds investing in the US market. The study showed that most sustainable funds would have beaten normal funds even excluding pandemic factors. The graph below compares the MSCI ACWI ESG Universal index and its parent index, the MSCI AC World index. The ESG index ended 2020 with a growth of 15.22%, vs the parent's 9.84% growth.

This doesn't mean sustainable funds will always outperform - "sin" stocks, such as tobacco, may become so cheap that private equity buyers swoop in. Or high quality ESG stocks may become too expensive to be good investments. But it's clear that investors don't need to give something up to invest sustainably.

Is ESG safer for investors?

Companies managing risks such as climate change or labour rights might well be regarded as lower-risk investments. Banks and bond investors seem to think so - high ESG scorers can borrow at lower rates, according to investment research firm MSCI. And neglecting such risks is set to become more perilous in the face of growing social and environmental pressures and penalties. In January 2021, Toyota was fined $180 million (about £131 million) for violating the Clean Air Act - the largest ever civil penalty for a breach of US federal emissions-reporting requirements. Clothing group H&M was fined €35 million (about £30 million) in October 2020 after a German data watchdog said it had violated employees' privacy.

Performance of stocks with a "robust" ESG profile vs conventional peers in 2020



MSCI ACWI ESG Universal index text vs its parent index the MSCI AC World index 1 January 2020 - 31 December 2020
Source: Financial Times (graph data)

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How popular is investing ethically?

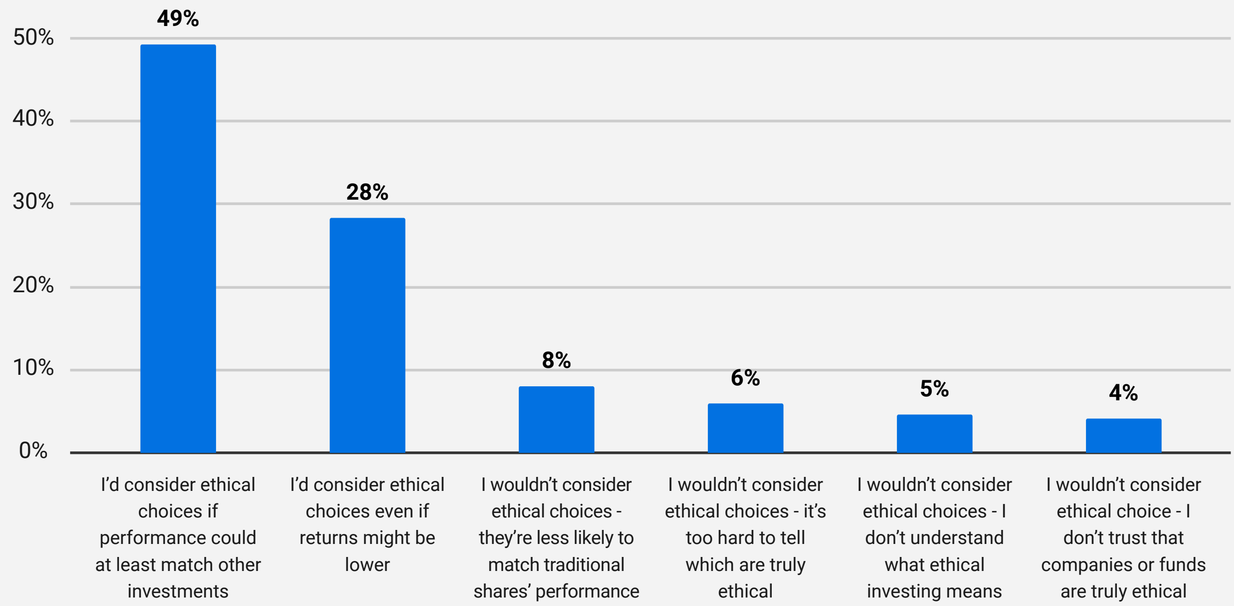
Finder explored attitudes to ethical investing in a survey of 2,000 UK consumers in February 2021. We found that 28% of Brits have ESG investments. The figure was highest for generation Z (born 1996-2010) - among this group, 45% had ethical investments. Second was millennials (born 1977 -1995) with 40%.

Of those who invest at all, 57% said they have ESG investments, but a little under half of these say they didn't choose them deliberately.

The issue of trust surfaced in our findings. Of those who plan to invest in stocks, funds, ETFs or private pensions, 77% said they would consider ethical choices. Among those who wouldn't consider them, 64% of investors who choose not to invest ethically say it's because it's too hard to understand which companies or funds are truly ethical, they don't understand what ethical investing means or they don't trust that these companies or funds are truly ethical, all of which underlines the need for robust new standards (see p4).

Returns from investments were naturally a key consideration; 49% of those who invest said that they would consider ethical choices only if they thought these could perform as well as, or better than, other investments. However, 28% were prepared to tolerate lower returns from ethical choices.

Consumers who plan to invest: Performance of ethical choices is key



Source: Finder research, February 2021

The future's green

Companies are recognising the importance of embracing ESG values - both the risk from being seen to neglect carbon emissions or labour rights, and the mileage in getting it right. Increasingly, this is not just about reputation, but also about money.

As governments and policymakers set ambitious net-zero emissions targets, they're imposing large fines on companies that break carbon emissions rules. Car manufacturers in the EU could face fines of €20 billion (about £17 billion) in 2021 and 2022, according to the car industry data specialist Autovista. Companies that break labour laws or create pollution can expect similar penalties, and as fines hit profitability, investors will take note.

Globalisation has created a smaller world where supply chains are increasingly transparent. If an outsourcing partner for a major company is using child labour, it's easier to discover, and companies will be held accountable for the whole chain - their investors, customers and regulators demand it.

More consumers care about the credentials of their goods. In a Finder survey of 2,000 UK consumers in July 2020, three in four planned to reduce their impact on the environment. The top three intentions were: reducing waste, using greener transport and buying ethical or second-hand goods. Companies on the wrong side of this trend may lose customers.

Increasingly, governments are directing money towards green initiatives, such as building green energy infrastructure. In the US, President Joe Biden has ear-marked $2 trillion (£1.46 trillion) for his "Green New Deal" (this was increased from his original pledge of $1.7 trillion, or around £1.2 trillion, see p9), while the EU has committed €1 trillion (£0.86 trillion). Companies helping curb climate emissions are likely to receive more government support. And those adopting ESG practices will enjoy a competitive advantage. So investors are likely to see more companies shouting about their green credentials in the year ahead.

75% of Brits said they'd make at least **one lifestyle change** to reduce their **impact on the environment** over the following year

Source: Finder research, July 2020

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The ESG stocks of choice

To see which companies the investment industry is spotlighting for their ESG credentials, Finder analysed major UK investment platforms. Our study shows that the tech multinational Microsoft appears in ethical funds more frequently than any other company, with 9 occurrences across 299 holdings we analysed.

Microsoft has been carbon neutral since 2012 and plans to be carbon negative by 2030. It says it aims to “promote sustainable development and low-carbon business practices globally”. ESG research specialist Sustainalytics gives it an ESG score of 14.7, which makes it low risk.

Our research looked at the top 10 holdings for the funds that Nutmeg, Wealthify, Wealthsimple, Moneybox and Plum invest in for their sustainable, environmental or ethical portfolios. Nutmeg, Wealthify and Wealthsimple’s portfolios feature a diversified range of funds, while Plum and Moneybox’s are ethical funds from another provider (for example, Moneybox’s “SRI” portfolio is the Old Mutual World ESG Index fund).

The rest of the top five are semiconductor industry supplier ASML Holding, consumer goods multinational Unilever, entertainment conglomerate The Walt Disney Co and electric vehicle and clean energy company Tesla, respectively.

In March, Unilever became one of the first multinationals to publish a corporate net-zero action plan for shareholders to vote on (in an advisory vote).

Position	Company	Company type	Holdings	ESG score
1	Microsoft Corporation	Technology	9	14.7 - Low risk
2	ASML Holding	Semiconductors	8	12.8 - Low risk
3	Unilever	Consumer goods	7	23.8 - Medium risk
4	The Walt Disney Co	Entertainment	6	16.2 - Low risk
5	Tesla	Electric vehicles and clean energy	6	31.3 - High risk

Source: Sustainalytics

The US environmental plan

On President Joe Biden's first day in office, he signed an executive order to re-admit the US into the Paris Agreement, the international treaty on climate change, and this came into force on 19 February, 2021.

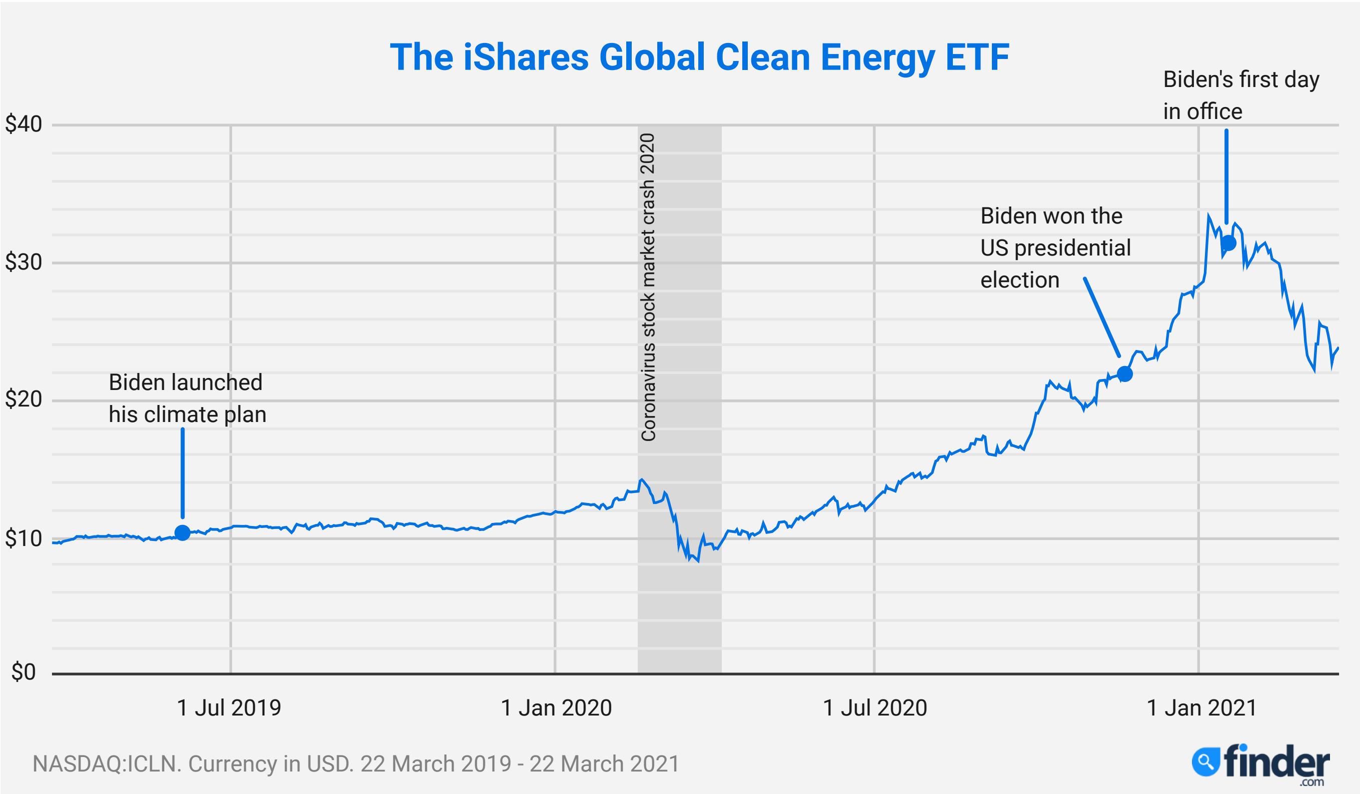
The Trump administration had reversed or revoked nearly 100 rules - including the Paris Agreement - designed to protect the environment in the US, according to a "regulatory rollback tracker" from the Harvard Law School.

But Biden had long signalled that he planned to do the opposite. In June 2019, he had unveiled a $1.7 trillion (about £1.2 trillion) plan for ensuring the US achieves a 100% clean energy economy and reaches net-zero emissions by 2050.

Investors were listening throughout the lead-up to the presidential election. The period from the launch of Biden's climate plan to his election victory saw a 106% increase in the iShares Global Clean Energy ETF (ICLN). And between his win and first day in office there was a further 45% lift.

While 2020 was an exceptionally strong year for all types of ESG, this was particularly true for the IA North America sector, where the gap between returns for ESG and non-ESG was close to 20% for the first 8 months of the year, according to figures from FE fundinfo.

Biden's work to further reverse the Trump "rollbacks" is likely to continue driving interest in ethical investing.



The UK’s environmental plan: Timeline

The UK launched its own environmental plan in January 2018. The 25 Year Environment Plan set out ways the country will improve the environment through wildlife habitats, better air and water quality and reducing plastic in the oceans. The agenda will have a huge impact on many industries. We’ve highlighted key dates in our timeline.

2025
Reduce water lost to leakage by at least an average of 15%
Eliminate use of polychlorinated biphenyls

2030
Halve the effects of air pollution
Minimise harmful bacteria in designated bathing waters
Reduce land-based emissions of mercury to air and water by 50%
Manage all of England’s soils sustainably

2040
End the sale of new conventional petrol and diesel cars and vans

2042
Eliminate avoidable plastic waste

2050
Reduce net emissions of greenhouse gases by 100% vs 1990 levels
Double resource productivity (the value and benefits of food, fish and timber)
Zero avoidable waste

2060
Increase woodland in England to 12% cover

In June 2019, parliament passed legislation requiring the government to **reduce the UK’s net emissions of greenhouse gases** by **100%** compared with 1990 levels by 2050

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ESG, ethical and socially responsible investing are still seedlings, in the early stages of their growth. There are still challenges around trust and standards that can perplex would-be investors.

Greenwashing

This term, which appeared in the 1980s, relates to misleading product and service names and claims about green credentials. In the investing industry, without standards for what counts as ethical, greenwashing is likely to persist and to undermine investors' trust.

Josh Gregory, CEO and founder of Sugi, says: "These problems could largely be overcome with greater regulation and transparency. Laws are being introduced around the world to determine whether an investment can be called 'ESG' and require companies to publish details on their environmental performance. This is a good start, but it will take a while to filter through. The information also needs to be packaged in a user-friendly format for retail investors."

In 2020, Wealthsimple rebuilt its ethical portfolios because it believed the way the ETFs it previously invested in were created was flawed. In a blog post to explain the change it said: "Some of these ETFs still invested in fossil fuels companies and tobacco companies and arms manufacturers and problematic mining companies. They simply invested in the least bad of those companies. The problem is that a company might be the "most responsible" weapons manufacturer — but it's still a weapons manufacturer."

Confusion

Since ESG scores aren't consistent between scoring companies, this generates confusion and makes it hard for investors to make comparisons.

The wording alone is confusing: environmental, social and governance investing (ESG), socially responsible investing (SRI), ethical investing, green investing, environmental investing and impact investing. The terms are sometimes used interchangeably but they have different meanings. Standardising names would be a small but significant step.

> The problem is that a company might be the "most responsible" weapons manufacturer — but it's still a weapons manufacturer.
>
> *Wealthsimple, 2020*

Julia Dreblow, founding director of SRI Services and the Fund EcoMarket tool

“This strategy [ESG] is rapidly becoming ‘business as usual’. My…expectation is that as more asset managers get a taste of being seen as ‘the good guys’…they will increasingly recognise the benefits of going further – proactively working with investee companies to address issues like climate change…and inequality.”

Clare Reilly, chief engagement officer, PensionBee

"At PensionBee, we believe sustainable investing is the future of engagement with pensions…Late last year, we launched our Fossil Fuel Free Plan, which completely excludes companies with oil, gas and coal reserves from their investments. We hope this is the start of all savers using their investment power to transform the world they live in - for the better of the planet, society and their retirement.”

Josh Gregory, CEO and founder of Sugi

"Thousands of ESG investment products are now available, and it’s very difficult to choose between them. In many cases, investment products with no sustainable credentials have been rebranded... With no guidance, retail investors often give up. Specialist asset managers and robo-advisers [are] targeting first-time investors with simplified ESG portfolios. Meanwhile, the big names are expanding their sustainable offering with ready-made portfolios and online resources for investor research. Once retail investors have access to better information…we should see many more people participating in this important movement."

Thanos Bismpigiannis, head of product - wealth, Plum

“We’re already starting to see better options out there for those who want to consider ESG when investing. But there is still a lot of evolution to do. We don’t even have a universal framework on how an ethical company is selected. ESG is more than just a trend; it’s a reflection of changing priorities globally. As we see ethical and sustainable concerns being normalised in our day-to-day life, we should expect it to become normal in the investment world too. People are looking to build a world that will last.”

Conclusion

There’s been a surge in interest in ESG investing, particularly among millennials, who tend to hold more ethical investments than other generations. But there’s clearly potential for more participation. Our research and several of our expert contributors highlight confusion and mistrust of ESG labels. Investment providers are offering more ethical portfolios - but without universally agreed, robust standards, some consumers will hold back from taking up these options.

Regulators and policymakers are on the march to curb poor environmental, social and governance practice, through more rules and tougher fines. Consumers demand better practice and transparency from their retailers and manufacturers. More transparency could pay dividends for ESG investing, too.

About Finder

Finder is a personal finance website which helps consumers compare products online so they can make better-informed decisions. Consumers can visit the website to compare utilities, mortgages, credit cards, insurance products, shopping voucher codes, and so much more before choosing the option that best suits their needs.

finder.com/uk launched in the UK in February 2017 and is privately owned and self-funded by two Australian entrepreneurs – Fred Schebesta and Frank Restuccia – who successfully grew finder.com.au to be Australia's most visited personal finance website (source: Experian Hitwise).

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