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What NFPs should consider about ESG investing

By Perpetual Private Insights

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The responsible investment market is growing - fast. Funds managed under responsible investment approaches in Australia increased 17% over 2019 to $1.15 trillion, representing 37% of total professionally managed Assets Under Management, according to the most recent Responsible Investment Association Australasia's (RIAA) 2020 *Benchmark* report[1]

As responsible investing gains momentum, donors and stakeholders increasingly expect Boards to align their investment strategies with the values of their not-for-profit organisations.

With this increased scrutiny – and the risk of losing donors – it's becoming clear that integrating Environmental, Social and Governance (ESG) factors into the investment process is simply good business, rather than being a costly but ethical 'nice-to-have'.

At Perpetual Private, we're part of this evolution. We have been running a Socially Responsible direct Australian equities portfolio for over five years, and ESG/SRI investments are broadening and deepening as part of all our portfolios. Last year Perpetual also acquired pioneering US ESG firm, Trillium Asset Management. Established in 1982, Trillium has one of the longest track records globally within responsible investing, including fossil fuel free strategies that have been operating for over 20 years.

In this article, we look at what Boards need to consider when implementing socially aware and profitable ESG investing strategies – and how Perpetual is helping this happen.

Building an ethical investment portfolio

Historically, ethical investing was a relatively simple proposition – steer clear of 'sin' industries such as tobacco or firearms. These days, however, Boards need to factor into their investment decisions how companies manage a wide range of issues such as equal opportunity for gender and race, climate change, human rights and even executive remuneration or political donations.

So what are common, and some lesser known, strategies that Boards can use to build an ESG portfolio?

Perhaps the most common strategy – and least difficult for Boards to implement – is '**negative screening**'. That is, excluding investments which don't align with the goals and purpose of your organisation. Cancer-related charities can screen tobacco-related stocks or obesity-related securities, for instance. Community organisations may exclude a broader range of 'social' securities, such as gaming and alcohol production.

On the other hand, '**positive screening**' actively seeks to include investments which reinforce your organisation's goals or actively contribute to your values.

An issue in this regard is access to enough investments of appropriate quality in the domestic market. A broader range of positive investments may be available internationally, but the Board may not consider this to be relevant to the Australian market.

'Impact investing' takes positive screening to the next level. Investments are required to have a measurable positive impact – usually, these investments are off-market, tailored and likely illiquid. Impact investing is an emerging field in Australia, and covers the development of solar farms, water rights, low carbon investing, clean energy, social housing and other similar initiatives.

How Trillium and impact investing changed a football team

Established in 1932, the Washington Football Team in the NFL was, until 2020, known as the 'Redskins' with team uniforms and logos brandishing a picture of a Native American originally found on a Buffalo nickel (a five cent piece in circulation until 1938). For over 25 years, the Oneida Nation people from the Wisconsin area in the US have, via a Trust assisted by Trillium Asset Management, invested in companies such as Nike and FedEx – companies they hoped, through sponsorship pressure, could force the Redskins to change their name.

Following the US race riots in 2020, and after years of shareholder pressure led by Trillium, the team finally agreed to change their name and ditch their mascot. The team is now simply known as the Washington Football Team.

Use of shareholder advocacy is increasingly seen as an important tool to promote environmental, social and governance change within listed companies.

Mythbusting – ESG investments have lower returns

One question we sometimes hear from NFP Boards is "it's a great idea – but do we have to give up financial returns for ESG investing?"

It's an important question – after all, Boards and investment managers alike have a fiduciary responsibility to optimise investment returns for a set level of risk.

Perhaps surprisingly, the answer is not necessarily. Whether it's less diversification, or the exclusion of heavyweight market incumbents, it's understandable, but untrue, to believe that ESG funds inherently underperform non-ESG funds.

While past performance is no indicator of future performance, according to RIAA's 2020 *Benchmark* report Australian and multi-sector responsible investment funds outperformed mainstream funds over most time horizons.

Australian share funds	1 year	3 years	5 years	10 years
Average responsible investment fund (between 17and48 funds sampled depending on time period)	2.000	0.113	0.101	0.09
Morningstar: Australia Fund Equity Large Blend*	0.223	0.09	0.078	0.068
S&P/ASX 300 Total Return	0.238	0.103	0.091	0.078
International share funds	**1 year**	**3 years**	**5 years**	**10 years**

Average responsible investment fund (between 13 and 50 funds sampled depending on time period)	0.225	0.137	0.11	0.119
Morningstar: Equity World Large Blend*	0.252	0.126	0.108	0.109
Multi-sector growth funds	**1 year**	**3 years**	**5 years**	**10 years**
Responsible investment fund average (between 13 and 39 funds sampled depending on time period)	0.1948	0.1126	0.0873	0.0824
Morningstar category: Australia Fund Multisector Growth*	0.1622	0.0756	0.0652	0.0688

*Source: Morningstar Direct™

Underperformed by the average RI fund // Outperformed by the average RI fund

It's a trend which continued in 2020. According to a Morningstar review of US fund performance to 31 December 2020 – "funds with higher ESG ratings – that is, those that courted less ESG risk – beat their style-specific index more often than funds with lower ESG ratings." [2]

So why have some ESG funds outperformed, particularly during COVID-19?

Many large international ESG-screened funds have benefited by investing in large tech stocks that performed well during 2020. ESG screened funds are also less exposed to the fossil fuel investments, particularly oil and gas, which suffered from the plunge in prices in April last year and have been volatile since.

More generally, ESG screened funds are more focused on identifying and managing non-financial risks, such as reputational risk, which over time is reflected in a superior market valuation.

Importantly, some risks inherently increase when we limit our universe of available investments. When an investment is screened out following an ESG review, the lower number of investment choices in that portfolio mean the volatility of that portfolio measured against its benchmark is likely to rise. This is known as Tracking Error.

While naturally not all tracking error is attributable to ESG screening, Boards should have a clear view of what is acceptable against their investment benchmarks.

How to make ESG right for your NFP – and how Perpetual can help.

Cyclical stocks such as mining can often outperform in bursts which can lead to second guessing by Boards on ESG investment decisions and portfolio construction when the market turns.

Moving into and out of cyclical investments in response to prevailing market conditions is time consuming, expensive and will almost certainly leave your NFP's investment portfolio worse off. A more effective way to invest is to take a long-term approach based on your NFP's risk and return objectives.

Boards need to also bear in mind that the ESG investing decision was taken for a reason, and the long-term benefit to the environment or society is in line with their, and their donors', values.

Deciding what your NFP's values and ethics are may seem simple but can often lead to difficult discussions with other Board members. After all, ethics are personal, and not all ethical investing is the same.

A critical tool for Boards can be running an investment policy workshop to build consensus, agree on values and develop your investment mandate. With a clear investment mandate based on agreed values and ethics that are aligned to your NFP, Boards can defend possible future market underperformance as the 'social margin' of an investment decision. That is, in the case of below benchmark returns, the investments have still been for the greater good.

As the options – and pitfalls – for ESG investing have grown, finding the optimal balance between return and reputation (within your universe of ethical options) has become increasingly complex and time consuming.

Perpetual Private's experience as an investment adviser can help NFPs design and implement ESG sensitive investment portfolios. As Scott Hawker, Perpetual Private's National Manager of Not For Profit Endowments explains "ESG continues to broaden and deepen in the portfolios Perpetual Private manages. As we reach out, we find more opportunities, we assess those opportunities against the background of the quality and background parameters we apply to all our portfolios."

"We're not going to give away quality and value in the search for ESG – it has to be integrated as a part of a whole," Scott said.

Global ESG strategies and approaches such as Trillium's shareholder advocacy, will form an important part of any Board's considerations going forward.

Measuring the impact of your ESG efforts

The investment returns from your portfolio are easy to measure and report. But how do you measure your contribution to ESG goals for your business?

Perpetual Private is a signatory to the United Nation Principles of Responsible Investing (UN PRI). An initiative from the United Nations that attempts to hold investors accountable for the companies they choose to invest in. It is a network of institutional-scale investors working to uphold a set of six principles that aim to develop a sustainable international financial system.

The six principles focus on embedding ESG factors in investment decision making, and being transparent about how choices are made.

Perpetual Private can also help you measure the benefit of your investing against the 17 UN Sustainable Development Goals.

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1. RIAA RI Benchmark Report Australia 2020>
2. www.morningstar.com/articles/1016714/did-esg-pay-off-for-fund-investors-last-year-yes-and-no