CAN ESG AND SUSTAINABLE INVESTING REALLY HELP BUILD WEALTH?

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ESG and sustainable investing can enhance long-term risk-adjusted investment returns. Analysing and managing ESG risks helps investors better understand the resilience of business models and their cash flows. This helps build stronger portfolios.

"Sustainability makes good business sense, and we're all on the same team at the end of the day."

– Paul Polman, former CEO of Unilever

The greater focus on environmental, social, and governance (ESG) factors has given rise to misunderstanding about the role it plays in long-term savings. It is often assumed there is a trade-off between incorporating ESG factors into investment decisions and maximising returns. This is not supported by data over the long-term.

Businesses with strong ESG characteristics can deliver superior risk-adjusted returns over the long-term and be more resilient to a range of external shocks.

What is ESG investing?

While 'sustainable investing' is often used interchangeably in the media with 'ESG investing', the terms indicate different concepts. ESG refers to a collection of discreet external factors that give rise to risks (and sometimes opportunities) that impact long-term earnings and market value. Sustainable investing generally incorporates ESG analysis but focuses on how a firm's activities impact the wider world.

ESG investors analyse and manage the ESG risks and opportunities associated with a business or other investable asset. Using ESG data, industry research, fundamental analysis, and ongoing engagement with companies, investors construct portfolios to maximise risk-adjusted returns.

Well-run companies establish robust ESG frameworks which help their brands align with stakeholders. These include customers, investors, employees (current and potential), suppliers, regulators, and the broader community.

ESG reports often feature pictures of wind turbines, but ESG covers a much wider range of issues. These vary between companies and industries – and evolve over time – but typically include:

Environmental

- Carbon emissions
- Pollution
- Waste management
- Water use
- Circular economy

Social

- Diversity and inclusion
- Workplace culture/ labour practices
- Workplace/ product safety
- Supply chain management/ modern slavery
- Community/ indigenous engagement

Governance

- Corporate governance/ remuneration
- Board diversity
- Business ethics/ conflicts of interest
- Tax transparency
- Whistleblower protection

How can businesses become more valuable to ESG investors?

Boards of the more enlightened companies provide the leadership to fully integrate ESG throughout the organisation. They may hire specialist expertise, perhaps from outside their own industry, but the focus is on infusing this thinking into the culture rather than 'ticking the ESG box'.

ESG investing integrates analysis of ESG factors into the entire investment process, including strategy, company research, and portfolio construction. Company engagement and an ESG mindset are key to success. ESG data can be a useful tool, but funds that depend entirely on ESG ratings and quantitative methods often deliver investment products that differ from investors' expectations.

What practical steps can companies take?

The ESG factors that a firm must consider will vary from one business to another, reflecting different customer needs, regulations, environmental risks, supply chains, etc.

While some will impact all business models, investment managers should avoid applying a ‘one size fits all’ framework and instead focus on the ESG risks that impact the particular business and industry.

Tesla is the brand most immediately associated with decarbonisation. The world’s largest manufacturer of electric vehicles (EVs) has grown rapidly, delivering exceptional returns for shareholders. Tesla focuses exclusively on clean energy strategies, also producing electric trucks, battery energy storage, and solar panels. It provides investors with direct exposure to the EV market, although it continues to negotiate other ESG issues.

The clothing industry faces ESG challenges from long supply chains and weak labour rights in developing economies. While this particularly impacts fast fashion brands, **Hermes** the French luxury goods company employs highly skilled artisans, mainly in France. The company boasts a performance-based incentive program, operates a group-wide training structure, and retained its staff through Covid, leading MSCI to upgrade its ESG rating recently.

Food manufacturer **Nestle** reformulated its product recipes to reduce the sugar content and published targets for healthier foods. It is targeting 95% of its packaging to be recycled by 2025. Nestle uses 84% less water in production than its peers and promotes regenerative agriculture in emerging countries where farmers survive on thin margins. It recently invested in a solar project which will help power its US factories.

Technology consultancy **Gartner** improved its business ethics through better oversight, anti-bribery audits, industry-leading data security measures, and board independence. Progress made on business ethics, board tenure, and diversity led MSCI to upgrade its ESG rating. Through taking steps to improve its management of ESG risk factors it becomes investable to a wider range of investors.

John Deere is a long-established brand that manufactures agricultural machinery. Its focus on sustainability aligns well with its customers and shareholders. Its herbicide applicator maximises crop productivity through robots identifying and squirting unwanted plants. This is more environmentally friendly than spraying entire fields with pesticides. Less flashy than Teslas, but the company now also produces zero-emission electric agricultural vehicles.

What should investors do?

These businesses have grown their earnings and valuations by delivering social benefits and attractive long-term shareholder returns.

Investors can enhance their long-term risk-adjusted returns by investing in attractively priced high-quality growing businesses, which are committed to improving their ESG characteristics, and whose products and brand values align well with changing stakeholder expectations.