The STAR Guide to Equity Investment

Section 9 – ESG Investment Screening

November 2021

9 ESG Investment Screening

9.1 What is ESG Investing?

The acronym ESG stands for Environment, Social and Governance in relation to the ways in which businesses are run and the factors that responsible investors should take into account when evaluating investments and in particular equity investments.

Needless to say, given the inevitable subjectivity regarding the definition of these three terms there is a considerable lack of clarity on the definition of the terms ESG and the associated SRI acronym that is used to describe Socially Responsible Investment. This section of the Guide outlines ways in which investors may wish to incorporate the elements of environmentalism, social factors and governance (ESG) into their screening processes.

9.2 Is ESG Important for investors?

Given that the Investosphere has always been prone to succumb to the latest widely publicised trends, whether they are bullish and positive or bearish and negative, it is fair to question whether investors should really treat ESG and SRI investment as yet another fad or take it seriously as a really vital component of a rapidly changing landscape.

To the extent that modern investment may be taken to have evolved in tandem with the evolution of stock exchanges, a broad view of the key major positive and negative influences on investment needs to encompass what has evolved over the past four centuries. The ups and downs of investment since the early 17th century have tended to veer between excitement surrounding new ventures such as the Dutch East India company in early 1600, the Tulip Mania bubble and subsequent collapse in the 1630s and also the massive investment in canals in the late 1700s and early 1800s. This latter investment boom was quickly followed in Europe and north America by a slump in canal traffic as funds quickly shifted to the even bigger railway construction bonanza. During this period the key investment drivers were, of course, the massive investment in manufacturing and commerce as industrialisation spread through the western economies.

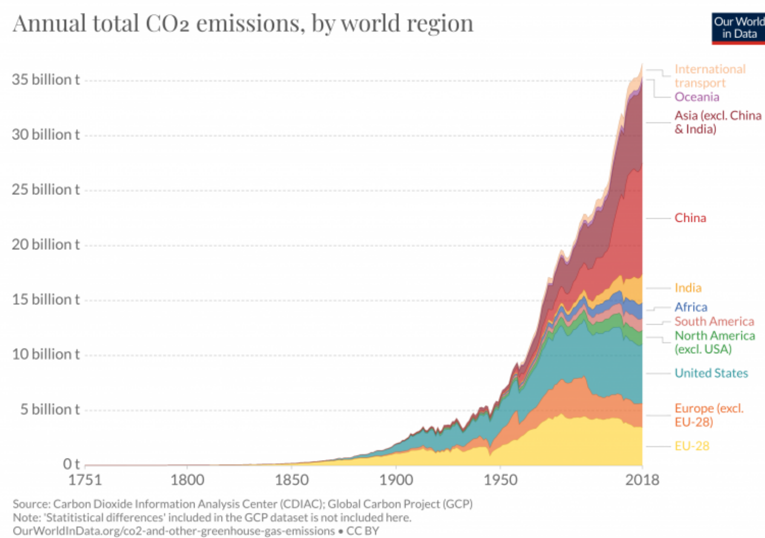
Moving forward, temporally, we witness the investment fortunes made and lost during periods of major conflict, such as the Napoleonic wars and more recently the first and second world wars.

In the period following the end of World War 2 it was technology combined with the rapid growth in global population and increasing levels of per capita productivity that dramatically boosted economic growth and, in turn, equity markets. In developed economies this led to an even faster rise in the service sector which has been amplified in the expansion of the whole financial services sub-sector. Investment in science and technology has been the key to the exponential growth of the IT and digital sector.

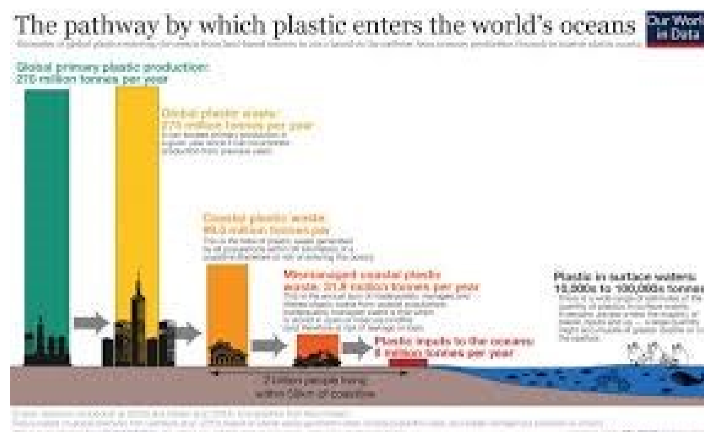
It is fair to say that, until recently, the financial and economic measures that have been used by investors to judge the merits of potential business opportunities in both the private and listed fields have taken little account of the wider costs of economic growth at either the micro level of the business or the macro level of the wider community. Before the rise of the ESG movement and the growing awareness of social responsibility in the business community and the belief that entrepreneurs are responsible to more than one group of stakeholders, investors had assumed that these matters were outside their sphere of decision making and were the province of the government and public sector.

Thus, it is only in recent years that the true costs of global economic growth, the externalities, have begun to enter the decision matrix employed by leading professional investors who wield meaningful amounts of money in the wider Investosphere. In a sense this is a new development in the wider investment process in which investors are accepting that the traditional financial and economic metrics are inadequate to measure the true worth of businesses as they do not take full account of all the various negative impacts that are part of the modern economy. In reality, the full gamut of negative factors created by all types of business from manufacturing to the ever-expanding service sector are virtually infinite so it is necessary to focus on the major ones that concern diligent professional investors.

In terms of the environment the main subjects, as highlighted by the United Nations, cover climate change, pollution and biodiversity loss. Graphs showing the rapid rise in carbon dioxide and methane emissions, accompanied by dire predictions of a planet out of environmental control, are well known to most of us and are one, but far from the only one, of the main drivers behind the ESG movement in the Investosphere.



Associated with the massively rising costs of climate change are the huge problems of mankind's addiction to pollution. It has been estimated by researchers at Imperial College that global plastic production, much of which is highly toxic and extremely polluting, has expanded from a mere 1.5 m tonnes in 1950 to 350m tonnes in 2017 and may well reach 2,000m tonnes by 2050.



9.3 Professional Approaches to ESG Investing

Websites such as **Interactive Investor** (www.ii.co.uk) contain a lot of information and suggestions of ways to select ESG focused investment funds. The ii website divides the ESG methods employed by professional fund managers into those that **Avoid** businesses that fall foul of basic ESG criteria, those that **Consider** ethical issues when making investment decisions and those that focus and target ethics and thus **Embrace** ESG criteria. They term these the three measures their ACE criteria for evaluating fund managers' rankings in terms of this subject.

AJ Bell (www.ajbell.co.uk), another leading investment platform, prefers to use the nomenclature of **Socially Responsible Investing (SRI).** In choosing investments for their Responsible Growth Fund they adopt both positive and negative metrics that lead to them selecting companies that specifically focus on SRI criteria and omitting those whose businesses demonstrate negative ones.

Financial advisory website Nutmeg evaluates investments according to five specific headings for each of the Environmental, Social and Governance metrics. For the first (**environmental**) they award points covering; carbon emissions, water stress, climate change, pollution and waste and renewable energy. Under the **social** banner they itemise; privacy and data, labour and management, health and safety, supply chain management and controversial sourcing. As far as **governance** is concerned they rate companies on: business ethics, board diversity, executive pay, tax transparency and anti-competitive practices.

The lists adopted by the very large number of fund managers and advisers that are adopting socially responsible investment criteria are long and, to be honest, fairly exhausting. However, searching through the internet under the subject headings of both ESG and SRI investing it is clear that there is no single definitive guidance on this emotive subject. Problem is not one of definition so much as one of degree. How far does one go in assessing the harm that a particular business may do the environment? How fair are corporate rules and pay as between the top managers and the lowest ranked staff? To what extent is it possible for companies to track the means by which the components making up their products are produced?

It is probably not an exaggeration to say that virtually all economic activities impose some degree of external cost that is not capable of being incorporated into the final monetary cost charged to the final purchaser.

9.4 The STAR Screening Approach to ESG Investing

As far as the primary STAR screens are concerned the priorities remain those of selecting companies that exhibit the strongest financial metrics and then to use this ranking list to drill down into the secondary screens. At this secondary stage it becomes practical to introduce sectoral and business metrics that include both positive and negative ratings that allow for the incorporation of selected SRI/ESG criteria.

As the prime focus of the STAR process is that of seeking out strongly growing businesses the secondary screens have been modified over the past few years with the objective of assessing the possible incremental benefit to each reviewed company from changes to the Investosphere resulting from ESG forces deriving from both regulatory and market led movements.

Over the past five decades I have tracked, and benefited from, the positive effects of UK regulatory changes such as the introduction of seat belts in cars in the 1960s and more recently the, poorly conceived but profitable, smart metering regulations. The global moves to embrace and enforce changes to the way we live is now providing similar investment opportunities.

These positive aspects of applying ESG criteria through screening are captured mainly by means of the secondary filtering process at which stage both positive and negative ESG ratings covering climate change and environmental issues as well as governance ones are included under the growth and value metrics sections.

A section of the secondary growth ratings deals mainly with positive ESG aspects where, for instance, clean energy businesses will benefit from enhanced demand as carbon intensive ones are more heavily taxed or forced out of the market. Similarly, in the value ratings section the assessment is more related to negative aspects such as higher taxation or the imposition of specific controls on the business.