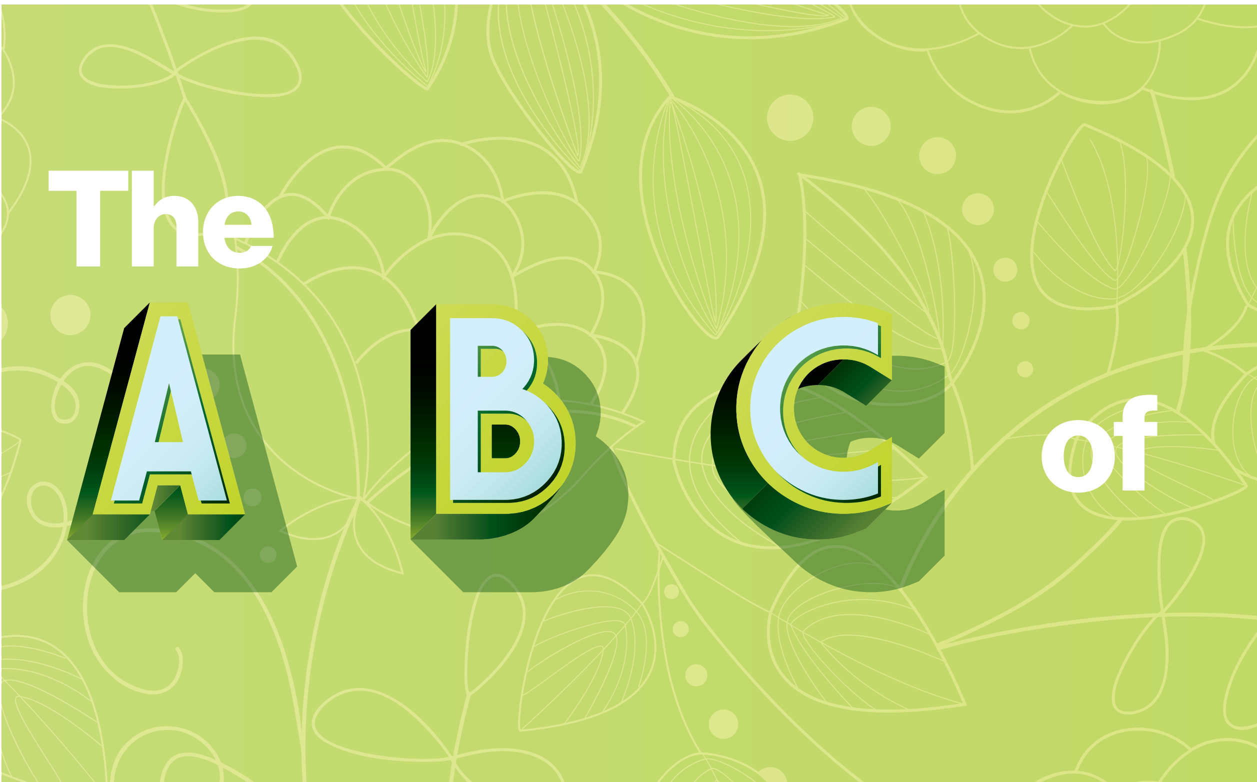
KEY POINTS

What is the issue?
Trustees are being asked to consider the integration of ethical and impact investing into the management of their financial assets, but where do they begin?

What does it mean for me?
Trustees that hold investment powers will learn with whom and how they should engage on ethical considerations for the trust fund.

What can I take away?
An understanding of the development of ethical investing and some of the challenges or considerations trustees may deliberate with beneficiaries before making strategic changes.



AS INTEREST GROWS IN ESG AND INVESTMENT SOLUTIONS, MIKE FARLEY DISCUSSES CONSIDERATIONS FOR TRUSTEES

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As a trustee, it is rare to meet an investment manager who does not mention their environmental, social and governance (ESG) strategy or new ethical product range. ESG investment solutions are as fashionable within the investment services industry as family office solutions are within the fiduciary services industry.

ESG refers to three core factors when measuring the sustainability and ethical impact of an investment: is this a fad or the future, and how should private client trustees consider such factors?

First, this is the future; as we develop, we need to look responsibly at how we behave and what lies ahead. This is also being backed up by pending regulatory change. The younger generation are often embarrassed about wealth, and while investment returns are of interest, the purpose and impact of such wealth are becoming more important.

A GROWING CULTURE

Impact investing is not new, but it has gathered momentum in recent years as investors have come to recognise the risk-management benefits of investing in a business with a responsible and considered culture. Historically, shareholders applied a discount on such companies' valuations, perceiving an unnecessary burden to doing business. However, it would appear that the opposite is true today, with pressure to do the 'right thing' now being applied to companies. Their fear is that if they do not, they will end up losing out with a low sustainability rating, resulting in a higher cost of capital relative to their investors, and therefore be unable to compete effectively.

This is being backed up by performance data; for example, Morningstar has reported that, in 2019, US-based ESG funds outperformed conventional funds.[1] Another report by the data provider showed that ESG had outperformed other funds consistently over the past ten years.[2] It is therefore no surprise that the investment industry has seized this enticing opportunity.

Investment approaches vary, from negative screening (ensuring certain sectors or companies are excluded from the building blocks of your strategy) to accentuating those sectors or companies driving change.

One immediate hurdle is classifying each company and what screening processes one uses. Index providers, considered experts in their field for ratings, can have opposing views when assessing companies on their ESG credentials. Tesla Motors, as an example, was recently considered one of the best-rated car manufacturers by American finance company MSCI from an ESG perspective, whereas the FTSE rates it one of the least ethical, as it did not disclose the environmental impact of its manufacturing process and has been challenged on its corporate governance practices.

Further, is this about companies' willingness to adopt cultural attitudes? If we look at the oil sector, would you exclude

all such companies, or support those fast-tracking a path for the better? This is a headline from a company's annual report the author recently read: 'We want to help the world reach net zero and improve people's lives'. Would you believe that company was multinational oil and gas giant BP?

And then there is 'greenwashing', where companies imply they have strong ESG or advocacy values. As mentioned at the outset, ESG is very fashionable, so everyone wants a slice of the opportunity. The ethical investor's investment qualitative analysis must be thorough and extend right through to supply chains. In addition, when selecting a professional service provider, some private clients are starting to enquire about their legal advisors' and trustees' ethical values.

SO, HOW DOES THE PRIVATE INVESTOR ARTICULATE THEIR ETHICAL VALUES?

Just as an investor's risk appetite will vary and is a purely personal view, an investor's ethical and sustainability views are very much personal principles. Such principles are not one-dimensional, with one person's view on an ethical issue being very different to another's. This causes profiling difficulties in both expressing one's exact personal view and the investment manager's interpretation of that view. It may be that there has to be some acceptance that managing money aligned to such personal values is more art than science. However, amendments to the Markets in Financial Instruments Directive (MiFID) II regulations (due March 2021) will mandate EU advisors to ask all clients of their ESG preferences and align any advice accordingly.

This is the conundrum private investors face, but where does a private client trustee with investment powers begin?

Every trust should have an investment policy statement, so this would be the starting point. Unlike personal investing, the investment considerations of a trustee need to take into account a multitude of interests and they are never exclusively about a single person. The considered trustee needs to balance often competing demands and opposing views in the best interests of the trust fund.

Like determining the attitude to risk, an understanding of beneficiaries' views on ESG is developed over time through a trustee's active relationship management skills. Some may like to take a proactive approach to raising the subject as they continue to strengthen that client relationship. Where there is recognition that the ethical impact is important, the trustee might choose to work with their appointed investment manager/s in assessing these personal values.

Most investment service providers have evolved their risk-profiling methodology to capture such values held by their clients. These vary, but some processes can be in-depth and will assess the client's views against the UN's 17 Sustainable Development Goals, which are at the heart of a shared blueprint for peace and prosperity. UN Member States recognise that ending poverty and other deprivations must go hand-in-hand with strategies that improve health and education, reduce inequality and spur economic growth, all while tackling climate change and working to preserve our oceans and forests.[3]

Some of the feedback from a beneficiary may present the trustee with very strong personal values, but as with other factors that inform a trustee's investment objectives, the extremes may need to be tempered by wider considerations, including those of the prudent trustee.

Once agreed, these value principles may be captured in one's investment policy statement. Trustees need to consider carefully how they document such principles. Are they restrictions or a softer 'tilt' consideration? Can you benchmark and target score your objectives? While the latter can help quantify individual views and aspirations, the tools, the data quality and interpretation from providers, as mentioned before, does vary. However, objectivity continues to improve, supported increasingly by non-profit organisations.

When it then comes to implementing an ethical approach, the trustee may decide to work with their existing manager. Although most may offer a solution, one should consider how robust their process is, and whether they can clearly articulate their methodology and track record.

An alternative approach might be to consider allocating a proportion of the trust fund to an investment manager who culturally lives and breathes similar ethical values to the investor's principles. Identifying these can be challenging, but good qualitative analyses by leading investment consultants can help.

One growing trend is those businesses that have obtained recognition as certified 'B Corporations'. By harnessing the power of business, B Corporations use profits and growth as a means to a greater end: positive impact for their employees, communities and the environment. For a business, B Corporation certification is considered the most powerful way to build credibility, trust and value. However, achieving such recognition is no mean feat, committing businesses to consider stakeholder impact for the long term, including building it into their legal structure. That presents challenges for listed companies where significant shareholder support is required, but who can say where the current momentum will take us?

In conclusion, how should a fiduciary investor react and address ethical values? The answer is: 'as a prudent person would'.

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1 bit.ly/2Jrpw1O **2** bit.ly/39GwGKB **3** More information can be found on their website: sdgs.un.org/goals