ESG investing: what does it mean and what ESG strategies do investment funds apply?

Sustainable Finance can be defined as the provision of financial services, which consider Environmental, Social and Governance (ESG) factors in the investment decision making process and are aimed at securing lasting benefits for the client, the planet and society at large. Though definitions and approaches may vary, ultimately it should result in the responsible provision of financial services. While increasing concerns over climate change and social inequality have led retail investors to consciously consider their investment choices, the demand from institutional investors for sustainable investment products is primarily driven by regulatory and policy driven initiatives, as well as the enormous growth potential that sustainable investments represent.

Sustainable funds apply the following ESG strategies:

Best-in-class: An approach where leading or best-performing investments within a universe, category or class are selected or weighted based on ESG criteria. This approach involves the selection or weighting of the best performing or most improved companies or assets, as identified by ESG analysis within a defined investment universe. This approach includes best-in-class, best-in-universe and best-effort.

Engagement & Voting: Engagement activities and active ownership refer to exercising voting rights and engagement with companies on ESG matters. This is a long-term process seeking to influence behavior or increase disclosure.

ESG Integration:The explicit inclusion of ESG risks and opportunities by asset managers in traditional financial analysis and investment decisions, based on a systematic process and appropriate research sources. This encompasses explicit consideration of ESG factors alongside financial factors in the mainstream analysis of investments. The integration process focuses on the potential impact ESG-related issues could have on company financials (positive and negative), which may in turn affect the investment decision.

Environmental issues include all aspects of a company’s activity that affect the environment in a positive or negative manner. Examples include greenhouse gas emissions, renewable energy, energy efficiency, resource depletion, chemical pollution, waste management, water management, impact on biodiversity, etc.

Social issues vary from community-related aspects, such as the improvement of health and education, to workplace-related issues, including the adherence to human rights, non-discrimination and stakeholder engagement. Examples include labor standards (along the supply chain, child labor, forced labor), relations with local communities, talent management, controversial business practices (weapons, conflict zones), health standards, freedom of association, etc.

Governance issues relate to the quality of a company’s management, culture, risk profile and other characteristics. It includes board accountability and their dedication towards and strategic management of social and environmental performance. Furthermore, it emphasizes principles such as transparent reporting and the realization of management tasks in a manner that is essentially free of abuse and corruption. Examples include corporate governance issues (executive remuneration, shareholder rights, board structure), bribery, corruption, stakeholder dialogue, lobbying activities, etc.
Exclusions: An approach that excludes specific investments or classes of investment from the investible universe such as companies, sectors or countries. This approach systematically excludes companies, sectors, or countries from the permissible investment universe if they are involved in certain activities and based on specific criteria. Common criteria include weapons, pornography, tobacco and animal testing. Exclusions can be applied at individual fund or mandate level, but increasingly also at asset manager or asset owner level, across the entire product range of assets. This approach is also referred to as ethical- or values based exclusions, as exclusion criteria are typically based on the choices made by asset managers or asset owners.

Impact Investing: Impact Investments are investments made into companies, organizations and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to at a market rate, depending upon the circumstances. Investments are often project-specific and are distinct from philanthropy, as the investor retains ownership of the asset and expects a positive financial return. Impact investment includes microfinance, community investing, social business/entrepreneurship funds and French “fonds solidaires”.

Norms-based Screening: This approach involves the screening of investments based on international norms or combinations of norms covering ESG factors. International norms on ESG are those defined by international bodies such as the United Nations (UN).

Sustainability-themed: Investment in themes or assets linked to the development of sustainability. Thematic funds focus on specific or multiple issues related to ESG. Sustainability themed investments inherently contribute to addressing social and/or environmental challenges such as climate change, eco-efficiency and health.

Among the 123 LuxFLAG ESG Labelled products, which represent over 60 billion euros of assets under management, the ESG strategies employed are 26% Exclusions, 22% Engagement/Active Ownership/Voting, 22% ESG Integration, 17% Norm-based Screening, 14% Best in class and 1% Impact Investing.

Though exclusions seem to be the most commonly used ESG strategy across various asset classes, ESG integration and engagement are also gaining momentum. Moreover, as opposed to the early days of ESG investing, when a mere exclusion of a number of controversial sectors and activities from the investment process was already considered good enough, today asset managers tend to apply multiple ESG strategies as an integral part of the decision making process. The vast majority of LuxFLAG ESG Labelled products apply between 4 and 5 strategies in their investment process.

*LuxFLAG ESG Label criteria currently require applicants to apply a minimum of 2 ESG strategies.