

# Responsible investment and sustainability

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I recently completed an MBA research project which involved an examination of the linkage between responsible investment (RI) and managing risk. My research confirmed that RI is a concept in its own right and that there is a link between RI and managing risk and sustainability.

The research revealed sound evidence that RI is not simply an airy-fairy concept. Rather, it is a best-practice investment management process involving an enhanced approach to managing risk, as well as identification and management of sustainability issues. Furthermore, having better risk management procedures should result in a greater probability of avoiding adverse outcomes and enhancing positive outcomes.

The concept of RI is becoming better known, particularly in the financial and business communities and also in the broader public domain. However, RI as a concept or business practice is not yet well understood and it has various meanings to different individuals and organisations. For example, it is often taken to mean that an investor will only focus on ethical, moral and social considerations when making investment decisions – in other words, that RI is the same as “ethical investing” (EI). Additionally, there are views that the implementation of RI may restrict investment opportunities and investment performance.

To seek common views, practices and trends, existing knowledge bases and literature were examined, including direct surveying of professionals from the investment industry who actively pursue RI initiatives, as well as professionals from other business sectors. The research created the scope for a practical definition

of RI to be made for the benefit of all investors and interested stakeholders, to help achieve the development of a common understanding of RI.

## Defining RI

After conducting an exploration of published literature from academic and business sources, as well as interviewing business professionals, it was clear that there were different meanings and interpretations held by various individuals and organisations about the meaning of RI.

While there are some views that RI has evolved from other concepts such as EI and socially responsible investing (SRI), the majority of views highlighted that there are three separate concepts – RI, EI and SRI. However, some views expressed that RI also involves ethical and social issues.

My research concluded that RI is a concept in its own right and it does not hold the same meaning as longer-standing concepts such as EI or SRI. In other words, RI is not the same as EI. It may include analysis of some factors involving ethical issues and it does include analysis of social factors and issues, but RI is a concept with a much broader focus on a variety of issues than EI and SRI.

Accordingly, RI can be defined as follows:

*Responsible Investment (RI) is an approach to investing in a manner that focuses on a far broader range of issues than solely financial criteria and traditional investment risk. It involves the integration of environmental, social and governance factors into investment analysis and decision-making processes. This assists with enhanced management and mitigation*

*of all associated risks and issues that may result in a positive, or negative, impact on financial and non-financial outcomes of investments undertaken. Consideration is given to impacts on the investor as well as on the broader society.*

## Managing risk, sustainability

The main objective of the research project was to determine if there was a link between implementing RI and managing risk. My view was that RI was about enhanced risk management, which in turn would lead to enhanced or stabilised investment returns and outcomes. Essentially, I hypothesised that there was a link between RI and managing risk.

Of most significance to the research project was that approximately one-third of the business professionals interviewed described RI as involving an approach to managing risk. Some academic literature highlighted a similar view: that investing in a responsible manner would contribute to better risk management. This is also where the matter of sustainability comes to the surface. The following discussion provides a brief context to the type of risk being referred to.

Within the investment industry, risk is commonly defined as being “the chance that the actual return on an investment will be different from the expected return”.<sup>1</sup> However, it is important to note that investors are not necessarily seeking to minimise their risks in an absolute sense. Investors are typically focused on maximising returns on investments within certain risk parameters – for example, for a given level of risk exposure, they expect a certain return. This is also referred to as

the “risk and return” characteristics of an investment.

A high-yielding investment, or an investment paying a high return, will typically have a high level of associated risk. In contrast to a low-risk, low-return investment<sup>2</sup>, there will be a greater probability that the high-risk, high-return investment will be unsuccessful and not deliver the expected return or worse, that the capital invested is lost or devalued. If the particular high-yielding investment is successful, the high return paid is to reward the investor for the level of risk taken.

When an investor analyses the risk and return characteristics of an investment as part of its investment decision-making processes, all known and possible risks are considered and evaluated. If RI is implemented, environmental, social and corporate governance (ESG) factors are incorporated into this investment analysis and decision-making process.

Table 1 includes a summary of some of the currently identified ESG issues.

If any of the above ESG issues are discovered as being present, or could potentially exist in the future, and have an impact on an investment or business, these should be quantified, where possible, and included in the risk and return evaluations. However, it is important to note that RI is not just about identifying quantifiable issues that could lead to non-execution of an investment on account of unsatisfactory risk and return characteristics. Neither does it necessarily mean that an investment should be excluded<sup>4</sup> from an investment portfolio if it does not receive the highest quality rating due to exposure to negative ESG issues.

When ESG issues are identified and are not easily able to be quantified in terms of impact on value, then at the very least issues can be assessed and a programme of positive action can be implemented. Active engagement, whether it is with other shareholders, the management of a company, or interested community stakeholders, can be extremely powerful and create the influence necessary to educate and change behaviour. For

Table 1: Examples of ESG issues<sup>3</sup>

Environmental (E)	Social (S)	Corporate Governance (G)
<ul style="list-style-type: none"> <li>• Climate change</li> <li>• Environmental policies</li> <li>• Environmental management</li> <li>• Toxic chemicals</li> <li>• Genetic engineering</li> <li>• Pollution</li> <li>• Water</li> <li>• Sustainability of resources</li> </ul>	<ul style="list-style-type: none"> <li>• Stakeholder relations</li> <li>• Working conditions</li> <li>• Supply chain management</li> <li>• Health and safety</li> <li>• HIV/AIDS</li> <li>• Product safety</li> <li>• Treatment of customers</li> <li>• Labour relations</li> <li>• Global pandemics</li> </ul>	<ul style="list-style-type: none"> <li>• Board structure</li> <li>• Independent directors</li> <li>• Independent leadership</li> <li>• Separation of Chairman and CEO</li> <li>• Remuneration</li> <li>• Shareholder rights</li> <li>• Accounting quality</li> <li>• Audit quality</li> <li>• Board skills</li> </ul>

example, encouraging and influencing companies to implement environmental policies and enhance their environmental management procedures and use of natural resources, or raising awareness if matters such as the use of child labour are discovered. These examples concern both managing risk and matters of sustainability, which are not mutually exclusive.


The relevance of RI to sustainability is considered pertinent. Other points to note where RI and sustainability overlap include management and mitigation of all the ESG issues noted in Table 1 above. From an investor’s perspective, it extends to being concerned with the actual sustainability or survival of a company, due to holding an equity investment in the company (shares in the company) and not wanting to lose funds invested. An investor wants the company it has invested in to be sustainable, i.e. that the company will have good business practices, including ESG practices, so that the company is positioned for survival into the future and the investor can receive a return on its investment.

### Implications of implementing RI

There have been claims by various investors that implementing RI is costly and can result in reduced returns on investment. However, many of the professionals interviewed stated that while there are costs involved for labour resources to undertake additional analysis, the benefits of doing so should outweigh these costs.

Furthermore, there have been many academic and business studies conducted

to measure whether RI has a positive or negative impact on investment outcomes. Published literature does provide mounting evidence that RI will have at least a neutral impact, and often a positive impact, on investment performance. When there is a neutral impact on investment performance, there may still be a positive impact on broader non-financial outcomes – for example, social benefits to the community.

John F Kennedy summarised the situation well when he said: “*There are risks and costs to a programme of action. But they are far less than the long-range risks and costs of comfortable inaction.*” 

### Footnotes

- 1 Jones C P, Gilroy N, Shamsuddin A and Simpson K, (2003) *Investments – Analysis and Management*. Queensland, John Wiley & Sons Australia Limited. (pp 16 and pp 131-134)
- 2 For example, typically funds invested in a term deposit with a registered bank are considered low risk and therefore pay lower returns than other investments such as shares, which are typically more risky due to uncertainty of growth and earnings targets being achieved as expected.
- 3 Certain examples contained in this table have been adapted from reference materials issued by Mercer Investment Consulting in December 2006.
- 4 E.g. omitting prior to investing in, or divesting if already invested in a particular investment given new or updated analysis.

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