THE FUTURE IS YOU KLEINWORT HAMBROS

CIO BLOG

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HAVING YOUR CAKE, AND EATING IT

If you could get fitter *with less diet and exercise*, would you?

If you could drive faster, *but with increased safety*, would you?

If you could save more, *while spending more*, would you?

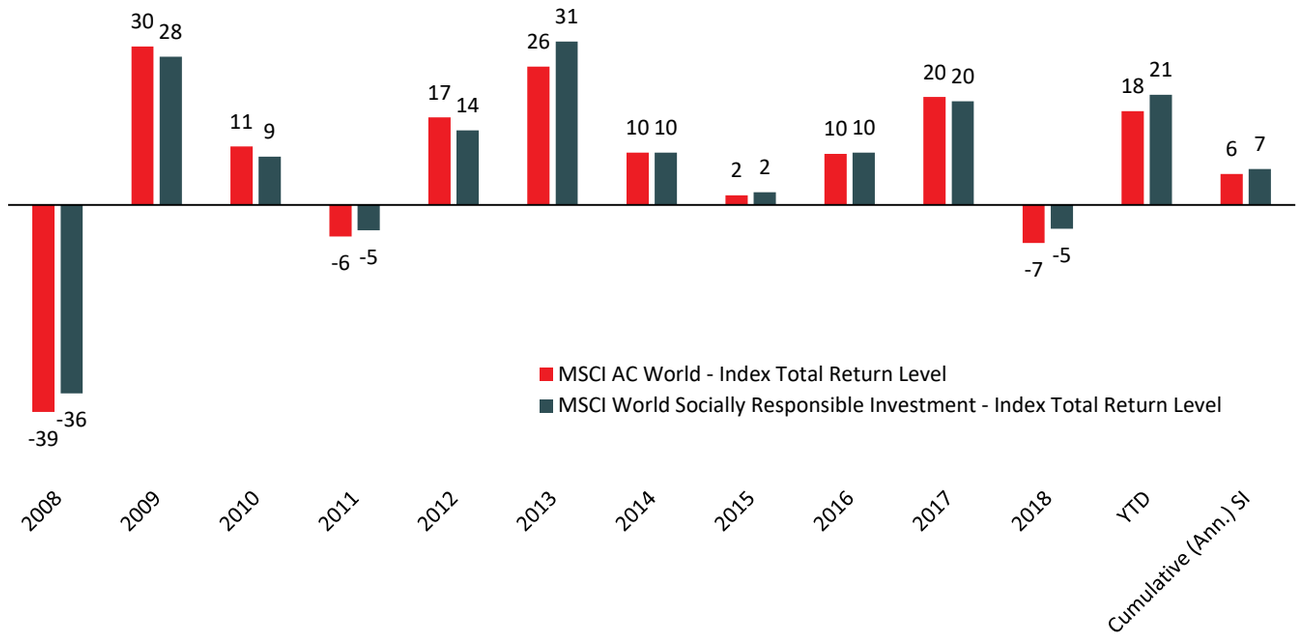
These are fanciful musings, trade-offs are a fact of life. Our brains are wired to consider an array of choices as zero-sum: to spend more here, you must spend less there; to run faster, you must expend more energy; to gain experience, you must lose the naïve exuberance of youth.

Similarly, investing in socially responsible companies – defined as those with superior Environmental, Social and Governance (ESG) ratings, and excluding those whose products have negative social or environmental impacts (e.g. adult entertainment, gambling, tobacco, fire arms[1]) – comes with less return. Like trade-offs everywhere else, there is one between conscience and profit. Right? WRONG.

Since the inception of indices tracking such esoteric concepts as "social responsibility", the evidence suggests there is no trade-off, and perhaps even some outperformance. For example, since the genesis of MSCI's World Socially Responsible Index in 2007 – one of many that attempt to measure "responsible companies" – investors experienced returns of about 114% versus 91% for an unfiltered basket of global equities.

1 The MSCI SRI Indexes use MSCI ESG Business Involvement Screening Research to identify companies which meet stringent best-of-class criteria for managing their environmental, social and governance (ESG) risks and opportunities. Examples of values driven investing include the avoidance of companies that sell products that have high negative social impact (e.g. gambling, tobacco), a commitment to high human rights standards in a company's supply chain, and general adherence to established international normative standards of corporate behavior as represented by organizations such as the UN Global Compact.

General Global equities vs. SRI Global Equities (%, total return, annualised)
2008 - September 2019



Academic research suggests several reasons why such an outperformance has occurred[2]. One, it is likely companies which have higher standards of governance reflect the joint interests of all stakeholders (i.e. not just shareholders, but employees, suppliers, communities, etc). Two, they will tend to have more robust risk management and greater transparency. Three, executive compensation will be specifically linked to environmental and social objectives, which tend to be long term – there will be less incentive to compromise on principles in order to meet "quarterly targets". Four, there will be myriad soft benefits to the brands of companies seen as ESG leaders, which boosts not just market share, but also employee morale and productivity. Going forward, a fifth factor may also play an increasingly important role: "responsible companies" will likely benefit from favourable tax legislation as governments incentivize corporate action linked with public policy goals.

The proof is in the pudding

At a recent client event, we canvassed opinion on the topic of socially responsible and ESG investing, and whether this should be an area of greater focus for us. Some clients said they would want us to take this into account even if there were to be a trade-off. For them, the environmental, social or governance considerations trump all other factors, no matter the return on offer. For others, ESG-factors play a subordinate part in decision making – having enough income and/or growth for expenses and/or retirement takes precedence. For this set of clients, the investment universe should simply be made up of all possible securities that can be invested in legally.

While there appears to be no trade-off between the two for now – socially responsible companies have produced similar (or better) returns since such factors have been tracked – there may well be one in future. At that stage, convictions will be tested. Nonetheless, returns cannot be measured solely in pounds and pence. We have been stewards of capital – and caretakers of multi-generational legacies – for over 200 years. We expect to continue to be doing so for the next 200. When looked at through this lens, it makes sense to evaluate client outcomes much more broadly. It would be myopic in the extreme to consider just the bottom line on a valuation statement but not also the air that our children – and our children's children – breathe. It would be short-sighted to only uphold the law and norms of today, and not strive to channel capital to companies which are setting the standards of tomorrow. At some point in history, brave companies first opened the door to women executives, to the LGBT+ community, to minorities – they set the standards which are now considered normal. In doing so, they also gained access to exceptional and untapped pools of talent by daring to be forward-thinking, yet another basis for competitive advantage.

After careful consideration of clients' views, and the investment case, we believe it is not only prudent to tilt towards companies with higher socially responsible and ESG credentials, but also right. Our equity process – which screens thousands of companies on quality and value factors – has a natural lean to such companies already. For example, within discretionary mandates, our direct equity exposure to businesses that derive more than 10% of their turnover from sales of alcohol, fossil fuels, tobacco products or weapons is below that of the MSCI All Countries World index of global equites. We continue to monitor our approach and are committed to constant improvement.

Here's to the next 200 years!

2 Ioannou, Ioannis. Why it pays to be socially responsible in business (July 2018). London Business School
SI – Since Inception.

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