ESG Investing and How to Get Started

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In the past 2 years, we have seen the stellar ascent of ESG or environmental, social and governance factors in the investment realm. Formerly a niche term popular amongst sophisticated and institutional investors, ESG investing has now found itself pushed into the mainstream and embedded firmly into public consciousness.

Global investors have become more aware about the broad sustainability challenges that we face in the world today as the pandemic exposes the wider rifts in society. However, a lack of standardisation coupled with overuse of the term has created a lot of confusion about what ESG actually entails.

Here is a closer look at ESG investing (sometimes interchangeably referred to as sustainable investing) and how investors can get started.

Definition of ESG

As alluded earlier, ESG are a set of non-financial factors that investors or fund managers use to assess the sustainability of a company through 3 distinct lenses namely environment, social and governance.

Environmental factors consider the company's stewardship of natural resources including conservation of the environment as well as reducing its carbon footprint.

Social factors examines the company's relationship and treatment of all its stakeholders including suppliers, customers, staff and the wider community it operates in.

Governance deals with the company's set of policies and procedures related to its corporate governance to ensure clear lines of accountability between shareholder and management. These include safeguards to avoid conflict of interests such as the presence of independent boards as well an audit or remuneration committee.

By evaluating all 3 factors, investors can then screen out potential investments especially if they pose a material impact to the company's operations and its financials. Such information can be typically gleaned through the company's annual report where enhanced disclosure guidelines require companies to provide information about its key sustainability indicators such as environmental and social footprint.

Environment

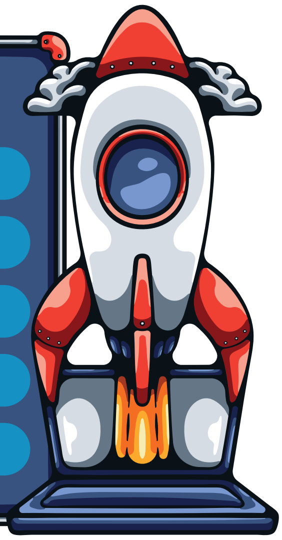
- Conservation
- Carbon Emission
- Biodiversity
- Waste Management
- Renewable Energy

Social

- Labour Protection
- Gender Equality
- Human Rights
- Community Impact
- Health & Safety

Governance

- Board Independence & Diversity
- Business Ethics
- Audit & Remuneration Committee
- Robust Internal Controls
- Anti-corruption Policies



Steps to Building an ESG Portfolio

The first challenge for investors looking to dip their toes in the ESG arena is finding out where to even begin. Given how large the investment universe has grown, it's important to take a methodical approach and establish several things first at the outset.

Step 1: Identify Investment Objective and Intent

The first question you need to ask is your investment intent and objective in wanting to incorporate an ESG strategy in your portfolio. There may be some introspection required to unpack your motivations to understand the specific causes or issues that you are prepared to invest/not invest in. It's an important step because this would determine how deep you would go in this specific route:-

- Is this a strategy to add diversification and reduce asset correlation?
- Are you looking to gain exposure to specific themes like green energy?
- Are there certain causes that you deeply believe in and want to include in your portfolio through purpose-driven solutions?
- Alternatively, do you want to embrace ESG wholeheartedly as an investment philosophy and want a pure ESG portfolio?

All investors have different goals and objectives which would in turn influence their degree of involvement in ESG.

On one end of the spectrum, investors may not be ESG-aware and does not consider ESG factors at all in their investment decisions. On the other end, investors are fully on-board with ESG and want it fully ingrained in their portfolio. More often than not, they are situated somewhere in between.

Wherever you find yourself, it's okay to pick a point to start and then move along the spectrum as and when you feel comfortable.

Step 2: Which Approach Suits You?

Once you've uncovered your motivation to get started in ESG, it's now time to explore which approach suits you best.

Very broadly, ESG funds are grouped according to the following categories depending on the strategy it employs:-

Negative screening is an exclusion strategy where companies with poor ESG scores are sieved through and ruled out from the portfolio's investable universe. Common exclusions include those companies with a poor track record in environmental management or with a history of labour malpractices.

Values-based funds such as Shariah-compliant funds also employ a negative screen to filter out companies that to not adhere to the principles of the faith such as gambling or alcohol.

Positive screening seeks out companies with a strong ESG score to be included in the portfolio's holdings. Companies are often benchmarked against their peers or the industry's best practices in choosing the cream of the crop. Companies that are actively committed to improving their ESG scores may also be considered by the fund manager.

Thematic funds often use a positive screen to choose best-in-class companies involved in specific investment themes like decarbonisation or climate change.

However, both positive and negative screening are typically regarded as two sides of the same coin and are used concurrently by fund managers.

ESG Integration is the inclusion of material ESG factors on top of traditional financial metrics in the investment decision making process. For example, a company's emission data are evaluated alongside other financial measures to assess potential risks or opportunities. A more encompassing approach, ESG integration gathers data from multiple sources with an aim to deliver better risk-adjusted returns.

This approach is often used for funds which may not even have an explicit sustainability mandate or objective such as traditional equity or bond funds. This is because more investors realise that ESG integration offers enhanced risk management by identifying the mid-to-long term risks that could hurt the stock's fundamentals. For instance, companies that have poor labour practices face increased risk of lawsuits, customer order cancellations as well as reputational damage.

Impact Investing refers to funds or investment solutions designed to produce specific outcomes that are beneficial to society or the environment, alongside financial returns. It has a more explicit intent to generate social or environmental returns such as development of clean energy or microfinancing. Types of investments include green bonds or sustainability-linked bonds which are earmarked to finance specific projects or initiatives.

Depending on your investment objective, either one or a combination of the above approaches might suit your portfolio needs. There is no one-size-fits-all approach when it comes to ESG investing as the requirement of each portfolio hinges on very personal choices and values. It's all a matter of aligning the outcomes you want and your investment objectives.

Step 3: Make a Plan to Invest

Mutual fund investors can then integrate ESG into their portfolios either by:-

- introducing ESG specific themed funds; or
- integrating ESG factors into their investment analysis for all funds.

With a growing array of ESG funds spanning different strategies and asset classes, there is plenty to choose from. Malaysian investors can find a list of sustainable and responsible Investment (SRI) funds on the Securities Commission Malaysia website.

Like picking any fund to invest, it's crucial that investors understand the fund's objective and strategy by reading up its prospectus and product highlight sheet. Be on the lookout for greenwashing red flags in funds that make unwarranted or ambiguous claims. Ensure that you actually understand what the fund aims to do and its strategy in achieving those outcomes. Is it to avoid certain industries or companies? Does it aim to make an impact in a sector?

Investors should also ensure the ESG characteristics of the holdings are also consistent with the fund's claims. Traditional tools and resources in fund selection can help in ensuring that you're picking the right fund for you by looking at its ESG rating and profile of its holdings.

Why ESG?

ESG or sustainable investing provides a platform for investors to demonstrate their personal values and play a role in financing assets that are contributing positively to environmental and social causes.

Besides that, ESG investing also offers several distinct advantages to investors in terms of enhanced risk management as well as a differentiated driver of returns. Companies with higher ESG scores could mean more ethical business practices that leads to improved stakeholder engagement as well as staying on the right side of governments/regulators. In recent times, we have seen the share price of companies with poor ESG practices being punished as global fund managers shun these companies. Many see ESG investing as a structural trend that will persist as long as social & environmental imbalances exist and there is a desire to address these gaps.

Invest with Purpose

In the past 2 years, we have seen a global shift with more people embracing sustainability as the new imperative for good business, corporate stewardship and mitigating climate change impact.

As stewards of our investors' wealth, Affin Hwang AM is also playing our part as asset managers towards advancing sustainability through active ownership of our investee companies as well as corporate engagement. As a primary ESG investment strategy, we adopt ESG integration towards all our internally managed funds so that investors can reap the benefits of enhanced risk management to generate better risk-adjusted returns.

Scan here:

Start your ESG investing journey today and invest with purpose. Book an appointment with us or scan the QR code **https://affinhwangam.com/get-in-touch/book-an-appointment**