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Sustainability: What is it and what does it mean for our investments?

In the first of four articles on sustainable investing we look at the asset management industry and how it's developed a framework to address the need for more sustainable investing, which goes beyond environmental issues

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Defining sustainability

Our society is sustainable if it meets the needs of today without limiting the capacity of future generations to meet *their* needs. This general definition espoused by the United Nations (UN) is one that most people can agree on. More contentious is a concrete interpretation. After all, it's difficult to determine objectively when the needs of future generations may be limited.

That said, the UN came to an agreement in 2015 on 17 sustainable development goals. And while not everyone may agree with them, the framework at least gives a broad idea of what sustainability is all about. Significantly, the UN made clear that sustainable development is not just about limiting our negative impact on the environment, though that's certainly an important part. Of the 17 goals, at least nine are related to other factors such as poverty reduction, the reduction of inequality and the pursuit of a healthy labour market.

[How to create a sustainable portfolio]

ESG investing

Sustainability is a broad concept. But how does the financial world deal with this? Well, socially responsible investing is nothing new. Environment, Social and Governance, or ESG investing, which takes into account a company's sustainable practices as well as its ethical impact, has been growing in popularity in recent years. According to MSCI, almost $110 billion has been invested in ETF assets benchmarked to its ESG indexes.

The table below shows a number of issues that are generally regarded as ESG issues. Compared to a traditional strategy based purely on financial indicators, ESG investing takes a lot more variables into account.

Is sustainability good for my wallet?

Environment	Social	Governance
• Climate change and CO2 emissions	• Customer satisfaction	• Composition of the board of directors
• Air and water pollution	• Data management and privacy	• Structure of the audit committee
• Biodiversity	• Diversity in the workplace	• Bribery and corruption
• deforestation	• Relationship with the community	• Lobbying
• Energy efficiency	• Involvement of employees	• Link with political parties
• Waste management	• Human rights	• Arrangements for whistle blowers
	• Labour conditions	

Quantifying ESG

But how exactly are these ESG issues measured? After all, they are difficult to capture in monetary terms. What, for example, is the impact on company profits of a high staff turnover because the employment conditions are bad? Or of a smaller biodiversity?

In order to take the above issues into account in a consistent manner, companies and countries are screened for ESG issues. Banks or asset managers can do this analysis internally or outsource them to specialised companies, such as Vigeo Eiris or Sustainalytics. The outcome of the analysis is an ESG score and this makes it easier to compare different investments. This is done for individual companies and countries, but also for mutual funds. Morningstar, for example, a well-known supplier of research into investments, issues a Sustainability Rating for mutual funds based on research done by Sustainalytics.

Investment strategies that take ESG issues into account have been in place for years. Estimating reputational risk or foreseeing changes in legislation have long been considered a valuable part of the investment process. But today, some investors are going even further and paying systematic attention to relevant and tangible ESG issues. What those relevant and tangible ESG issues are depend on the investor, so there is no standardised way of ESG investing. However, banks and asset managers have delivered financial products where those choices have already been made, making the process easier for consumers.

In part II of our series tomorrow, we'll be looking at some of the key strategies used by asset managers to create sustainable portfolios.

[Click here to read the next in our series: How to create a sustainable portfolio]

[Sustainability: Will the hype fade?]