Ethical investing: portfolio tilting and corporate engagement

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Biography

Quintin has worked for actuarial and investment consultancy firms and a multi-national European bank, including wide experience in quantitative fund and risk analysis. He is a Fellow of the Institute of Physics, a Chartered Fellow of the CISI and a Chartered Wealth Manager. Quintin has applied skills gained from his Oxford University Physics Doctorate and while working in engineering to finance. He is the second UK graduate from the Sustainable Investment Professional Certification (SIPC) programme and joined P1 Investment Management in January 2017, founding their ethical and sustainable investing proposition.

Introduction

Previous articles asked why ethical investment matters [1]; introduced sustainable investing (with its emphasis on environmental, social and governance issues, or ESG) [2]; and looked at the 'screening' and 'best-in-class' approaches [3]. This article continues looking at different techniques for achieving ethical investment goals, exploring portfolio 'tilting' and corporate engagement. Future articles intend to explore topics such as performance.

Ethical investors choose to allocate resources to deserving areas while avoiding businesses carrying out unacceptable activities. Sectors of concern often include alcohol, tobacco, gambling, pornography, armaments and nuclear power, or other areas [4]. Investors may avoid these altogether or reduce exposure to them in their portfolios.

Investors may consider whether to

- Avoid unethical companies, but accept companies doing neither good nor harm
- Invest only in ethical companies, avoiding both the unethical and those that do neither good nor harm
- Actively seek to influence corporate behaviours to improve.

These questions help to identify different approaches.

Investment approaches

Using sustainability can help determine whether business activities have positive or negative impacts, based on ESG factors [2]. A common approach is screening, but others include 'best-in-class', 'tilting', or 'engagement'. Screening and best-in-class have been discussed previously; [3] the focus here is on 'tilting' and using corporate engagement to influence firms' behaviours.

For companies in ethically challenging sectors, screening may not be effective at discouraging harmful behaviours. Consider assessing a fictitious mining company under different ethical investing strategies [5]. Suppose it has a poor record regarding environmental damage, pollution, treatment of labour and indigenous peoples. Screening would exclude the company based on its sector, which would likely be unacceptable. Management can do nothing to make the company acceptable, apart, presumably, from winding its operations up.

However, the company could be influenced by approaches such as 'tilting', corporate engagement or shareholder activism. Looking at 'tilting', for example, the company could reduce carbon emissions, and only has to be better than its peers to attract investors in terms of climate change issues.

Tilting investment portfolios

Commercial data providers can supply scores on individual firms' ESG ratings or carbon emissions. This means that fund managers can determine (say) whether their portfolio generates more, or less, carbon than the firms in its benchmark.

This graduated approach tilts a portfolio away from carbon-intensive sectors or companies towards lower carbon areas. For investors fearing that ethical investing might undermine performance, this offers a 'light green' approach. Exposure to carbon-intensive activities is permitted, provided that elsewhere enough weight is given to low-carbon industries, so that overall the portfolio has a lower carbon-intensity than its benchmark index. The manager can still allocate across many companies or sectors to ensure broad diversification.

Returning to broader ESG ratings, individual firm scores can be used to assess risks associated with different companies. Thus, a firm with poor scores on social or governance issues, say, might be deemed riskier than its peers. As a result, it would be underweighted (but not necessarily excluded) from a portfolio. This is one approach included in a technique called 'ESG integration' [6].

Another practical implementation of tilting is to clients' overall portfolio profiles. A client may be concerned that ethical funds may underperform. So, the bulk of their portfolio can be invested conventionally (allaying underperformance fears) and the remainder ethically. Perhaps they could invest 80% conventionally and 20% ethically. As the client becomes comfortable with ethical investment, the conventional proportion can be reduced.

Corporate engagement

Engagement involves influencing company directors to make improvements in matters of ethical concern [4]. Directors are encouraged and supported to improve the balance between risk and return in the best interests of long-term owners or to address specific issues.

The process may involve management meetings, questionnaires, and collaboration with other fund managers. The intention is to influence companies to consider their responsibilities to the environment and their stakeholders (including staff, customers, shareholders, those living near their centres of operation and society as a whole).

Problems with engagement include the quality of implementation and the willingness of company boards to be receptive to shareholders' views. The quality and commitment of engagement activities by investors can vary hugely. One fund manager may write a letter expressing their concerns on an issue to the CEO of a firm with no follow-up. Another may set up an extended programme, researching the issues in-depth, having two-way discussions with board members and be an active presence at shareholder meetings.

How this helps Investors

By appreciating approaches ethical fund managers use when selecting companies, individuals who wish to invest ethically should be better placed to understand the strengths and weaknesses of techniques offered. In areas such as tilting, ESG integration and engagement, it can be hard for clients to realise what is involved. A better appreciation should help them choose an approach that meets their needs.

References

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