Do good to do well

Guy Jubb welcomes the growth in responsible investment but says safeguards need to be in place to ensure that the term does not become just a gimmick to attract funds

Environmental, social and governance (ESG) issues are starting to move capital in a meaningful way. There are now trillions of dollars of assets managed under responsible investment strategies. ESG investment has come a long way in a short time and the increasing influence of millennials suggests it still has much further to go. That is why, for asset owners and asset managers, integrating ESG into their investment processes is no longer an optional extra.

Importantly, there is also a growing appetite for impact investing, making capital investment work for social good. ESG investing should be a win-win strategy. Improved sustainable long-term returns for investors, coupled with demonstrable non-financial dividends for stakeholders and society, serve the public interest.

That means fund managers have now woken up and are smelling the ESG coffee – but there are worries that it may be ersatz. There is a suspicion that the fund management industry might use ESG investment less as a force for good than as a marketing gimmick to help generate funds flow and try to restore trust in its tarnished reputation. Terms such as "responsible investment" and "ESG focus" have a nice, warm, fuzzy ring to them and can look attractive in bold type on a marketeer's brochure.

Do investors know what they are really getting when it comes to ESG and responsible investment? It is naïve to suggest that fund managers can go from zero to hero overnight: regulatory rigour is needed to sort out the ESG wheat from the chaff. Retail and institutional investors alike need to know in what they are investing. For example, they should ask how ESG factors are integrated into stock selection processes. They also need to know the fund manager's ESG engagement strategy and, importantly, how ESG investment factors are embedded in the remuneration policies.

Fund managers themselves often rely on third-party information. That is why the response of index providers to the increased transparency that comes with the new UK Corporate Governance Code and other global transparency initiatives will matter. These present a commercial opportunity to develop and promote increasingly sophisticated ESG indices, tailored to the demands of the ESG investment community. Academic research led by Professor Charles Wang, of Harvard Business School, demonstrates that the corporate desire to acquire membership of prestigious indices serves as an incentive to improve corporate behaviour. The research focused on Japanese companies but has wider geographic application. By acquiring membership of ESG indices, companies can access the increasingly deep pools of ESG capital and thereby lower their cost of capital. The indices have the latent power to raise progressively the bar of corporate behaviour around the world.

To deliver the full potential of ESG investment, institutional investors must develop and implement strategies that will stand up to scrutiny by investors and the public. No one investment manager can beat the boundaries of the whole ESG parish but, as good stewards of their clients' interests, they must not turn a blind eye when lines are blurred. If they do, their reputation will be at stake. Rather, they must implement well-thought-through and proportionate engagement strategies. These should be disclosed in sufficient detail to enable their clients and customers – and, arguably, their regulators and other stakeholders with a legitimate interest – to hold them to account for what has and, importantly, has not been done.

> *"ESG indices have the power to raise the bar of corporate behaviour around the world*

The Financial Reporting Council (FRC) is embarking on a review of the UK Stewardship Code, which has changed little since it was introduced in 2010. Now that ESG investing has belatedly come of age and is here to stay, the FRC must raise its game. It must ensure that compliance with the revised code is not a fig-leaf for fund managers but will drive the delivery of ESG investing's full potential. Savers and society expect no less. ■

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