Socially responsible investing: The next paradigm for businesses

Traditionally, investing has focussed around delivering financial returns. While the use of proceeds has always been important, the consequences on the environment and humanity has not been a consideration in decision-making. While some businesses have corporate social responsibility (CSR) programmes and some investors follow policies around ethical investing—avoiding sectors such as tobacco, alcohol, gambling etc.—there have only been a few such instances, and the implementation of these policies has been ad hoc and inconsistent.

However, times are changing. Globally, an ethical and long-term sustainable investing strategy is gaining importance. Stakeholders now reco-gnize the importance of res-ponsible investing and the role of financial markets in fostering sustainable development.

Firms and investors ack-nowledge that social and environmental issues can be material to the financial outlook of investments, and ultimately, their own performance. There is a noticeable trend, that, to the extent it is consistent with their investment objectives, investors are now looking to incorporate environmental, social and governance (ESG) issues as part of their decision-making processes.

ESG comprises the following dimensions: environmental—resource-depletion, renewable energy, clean-technology, pollution, climate-change; social—human rights, workplace-conditions, discrimination, community-relations; and governance—compliance, transparent reporting, managing conflicts.

Europe and North America have been the early adopters of ESG. Six EU countries have started a four-year project to implement circular models, where the focus is to use materials for longer and preserve their value through smart solutions. Corporates too are getting involved—a supermarket in UK only sells food that would have been discarded.

Ikea is expanding circular offerings by reselling used furniture and creating new products from leftover textiles. Between 1940 and 1980, Costa Rica suffered from large-scale deforestation—it was stripped almost bare from a 70% forest cover.

The government enacted strict deforestation guidelines and rainforests are now back to 52%. The consequence of this environment-focussed decision, benefitted the agriculture industry, and the improving climate is attracting tourism, making it the top industry.

Why are ESG policies, that were once viewed as additional costs, now being embraced? The primary reason is a change in the awareness of the social and institutional environment. The interpretation of what constitutes fiduciary duties has also changed. Hitherto, the application of ESG criteria on returns on investment was believed to be in conflict with fiduciary duties. However, recent legal analysis has concluded that considering the intangible benefits of ESG is not a breach of fiduciary responsibilities.

Reports indicate that over $2 trillion has poured into sustainable investments during the last two years, aggregating to almost $9 trillion, or 20% of managed investments.

Analysis indicates that socially responsible funds have performed on par with peers. In fact, some analysts believe that as ESG algorithms improve, and as such funds gravitate towards finding better companies, rather than excluding bad ones, they may outperform conventional funds.

With stakeholders looking at indices and performance reviews in choosing products, business leaders are looking to improve their reporting standards. ESG can create a distinguished outlook for businesses. Firms look for new ways to differentiate themselves. There are studies that screen corporates and products based on sustainability—these studies evaluate ESG compliance, reporting, ESG-related controversies, etc., and rate firms alongside their peers. Businesses that have a high ESG rank will generate positive interest.

Of the three ESG dimensions, governance is considered to be most relevant in creating shareholder value, and is more visible. However, the materiality of an ESG dimension, and the type of ESG criteria varies across sectors and geographies.

While measuring ESG, environmental and social factors will have a lower weightage for a services business, compared to an industrials business.

Similarly, nations with access to cheap labour will consider more social factors, while environmental factors will be more relevant for developed nations with higher levels of mechanization. ESG indices should be filtered and weighed, to reflect such differences. Currently, there aren't globally accepted standards to determine ESG scoring, but principles are being laid out and these standards should evolve.

While still at a nascent stage in countries like India, ESG is still an important issue. There is mounting global pressure on countries to enact legislation around climate-change, resource-depletion, pollution, human rights etc. and non-compliant nations face risks of a backlash.

The 2015 Paris Agreement on climate-change, signed by 194 nations, is one such initiative. While developed nations may differ from their developing counterparts on the applicability and extent of the standards and milestones, as well as the implementation time frames, there is a general consensus towards being more ESG-compliant.

India has enacted regulations around improving corporate governance, with requirements to have independent directors, more accountability, transparent boards, etc., addressing potential conflicts of interests of stakeholders. However, environmental and social norms remain low. Foreign capital plays a significant role in the Indian capital markets. As investors become more compliant, they may be forced to avoid businesses that do not meet their requirements, and this will affect the valuations of such firms.

Norway's Government Pension Fund Global (GPFG), the world's largest sovereign wealth fund, managing around $1 trillion—put many Indian companies in the metals, coal and thermal power sectors on its exclusion/watch lists, citing human rights, environmental and climate-change concerns.

In April 2016, GPFG div-ested from 13 leading Indian coal firms and made strong observations on ongoing transgressions in operations and increasing, unaddressed human rights risks in a large Indian natural resource company. Several other top-league funds such as T-Rowe Price and Blackrock are also moving their portfolio to only include ESG-compliant businesses.

The need of the hour is to start the process of moving towards sustainable investing practices and being socially responsible, instead of a knee-jerk reaction when regulatory compliance becomes mandatory. Corporates need to be at the helm of implementing policies in the true spirit and being transparent in disclosing their actions.

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