Responsible Investing

Evolution and Impact

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The evolution of responsible investing: from SRI to ESG and 'Impact'

Responsible investing, like the parable about the blind men and the elephant, can feel like different things to different people.

For some, it may amount to a desire to "do no harm" by avoiding investments that violate personal beliefs. For others, it may have more to do with risk management, by understanding the long-term implications of a company's controversial business practices. And for others still, it's about leveraging their investment dollars to bring about the future they want to see.

Terms like SRI, ESG and "impact" investing are often used interchangeably, but these labels refer to three very different approaches — each one falling at a different point along a spectrum of engagement that goes from passive, to active, to proactive.

Passive: Socially Responsible Investing

Socially responsible investing (SRI) involves screening out assets that an investor may deem unethical, and it is by far the oldest form of responsible investing.

As far back as the colonial era, according to the Commonfund Institute[1], abolitionists protested the slave trade by refusing to invest in companies that were involved. In the 1920s, teetotalers during Prohibition opted for mutual funds that excluded "sin stocks" like tobacco, alcohol and gambling. In the 1960s, it was about civil rights and the anti-war movement. And in the 1970s, environmental concerns came to the fore.

Because SRI investors are choosing not to engage with these industries, SRI can be viewed as the most passive form of responsible investing. Investors may be comforted in knowing they've extricated themselves from questionable industries, but in doing so they've also given up any influence that, as shareholders, they might have wielded.

By the turn of the century, the use of negative screening on its own had largely fallen out of favour, as returns proved unacceptably low for many investors. Though the term "SRI" is still widely used, it now usually refers to methodologies that incorporate screens alongside other, more active strategies.

Active: Environmental, Social and Governance

Money managers today, including those at TD, have moved beyond negative screens to incorporate more sophisticated techniques that evaluate assets on their environmental, social and governance (ESG) characteristics. TD generally does not screen out individual stocks, but we do make use of proprietary tools that take ESG risks into account for investment analyses.

At the core of ESG philosophy is the theory — supported by mounting evidence[2] — that, over the long term, companies with strong ESG policies will, all else being equal, outperform those with weak policies. Studies have shown that these companies may be more energy-efficient. They may foster greater loyalty with employees and customers. And they may develop stronger relationships with local communities and regulators.

The purpose here is not necessarily to exclude assets. Rather, ESG analysis aims to assign an objective, value-neutral rating that informs decisions around buying, selling and voting shares. Armed with this information, investors can decide for themselves what level of ESG compliance they're comfortable with.

This analytical framework leads to various strategies. For example, an "ESG Exclusion" strategy can be used to screen out undesirable assets. An "ESG Tilt" strategy involves weighting a portfolio to suit the ethical and risk profile of an investor. An "ESG Momentum" strategy, meanwhile, may find hidden value in companies that have made great strides to improve their ESG rating.

Beyond influencing investment decisions, ESG analysis is also influencing how shareholders vote. Banks and

[1]From SRI to ESG: The Changing World of Responsible Investing. Commonfund Institute, September 2013.
[2]See The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance (Harvard Business School, November 2011) and Sustainable Investing: Establishing Long-Term Value and Performance. (Deutsche Bank Climate Change Advisors, June 2012.)

pension funds now rely on this data to encourage the companies they hold to improve on areas of weakness, either by working through the board of directors or by filing formal shareholder resolutions. They're also collaborating with regulators, and with like-minded shareholder groups.

Where SRI can be viewed as passive, ESG analysis supports an active and collaborative approach that enables informed decision-making and encourages responsible corporate policies.

Proactive: Impact Investing

On the other end of the spectrum, impact investing — also known as "mission-related" or "values-aligned" investing — makes no claims to objectivity or neutrality. Here, the investor is typically driven by a particular vision for the future, and is actively pursuing investment opportunities that support his or her vision.

These investors may prioritize their mission above investment returns, but that doesn't mean they're willing to settle for low returns. Impact investors typically take an optimistic view. They want the best of both worlds, by investing in promising ventures that are riding the wave of consumer ESG adoption. That may translate into an investment in clean technology; or in a company that has built its brand on the promise of fair labour practices; or even directly in a local organization that's working to improve the lives of those in the community.

Impact investors, in other words, are looking for champions to support their cause. That being said, when these champions fail to live up to expectations, impact investors may also be willing to leverage their clout as shareholders to press for improvements. Though impact investors make up a smaller proportion of the responsible investing world as a whole, this type of investor can be seen as the most proactive along the spectrum of engagement. □