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The many dimensions of sustainability

by Lorenzo La Posta, Portfolio Manager

I am writing this piece from a wet and cold Italian countryside in early June, quite unusual for what should instead be "the good season" already. Last year on this very day, I was on holidays with a friend in Puglia, it was really hot and we were cooling down in the Adriatic sea. There's climate change for you! But that is only one of the many things that worries me. There's climate change, social inequalities, human rights, justice, environmental preservation, poverty and (unfortunately) a lot more.

From an investor's perspective, I'm twice as worried though. What's the impact that all these dynamics are having on my investments? What's the impact my investments are having on these dynamics? How do I devise a win-win plan for my portfolios?

When it comes to incorporating sustainability considerations into investment decisions, there is a growing consensus on the importance of doing so, both from a responsibility perspective (position your investments to have an impact) and from a financial return perspective (position your investments to benefit from sustainable characteristics). However, there is still ongoing debate and little agreement on the best approaches to do so and several different methodologies are being used, each with its own pros and cons
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The first method is sector exclusions, that involves excluding specific industries or sectors from investment portfolios based on their negative environmental or social impacts. For example, investors may choose to avoid companies involved in tobacco, weapons, or fossil fuels. The advantage of sector exclusions is that it provides a straightforward way to align investments with sustainability values, but it can limit diversification and potentially restrict opportunities for engagement and positive change within those industries.

Controversy exclusions represent another approach. This methodology involves excluding companies that are involved in controversies related to environmental or social issues, such as child labour or human rights violations. By avoiding those, investors aim to promote responsible practices. However, determining the extent and severity of controversies can be subjective, and there may be challenges in obtaining accurate and timely information.

Environmental, Social, and Governance (ESG) risk mitigation revolves around considering and quantifying how ESG factors can materially impact a company's financial performance. This approach provides a comprehensive assessment of a company's sustainability performance and its potential impact on investment returns.

However, there may be challenges in accurately measuring and quantifying these factors, as well as variations in methodologies used by different investors and data providers.

Another methodology is centred around reducing the environmental footprint of the investment companies, seeking to minimize carbon emissions, waste generation, and water usage, for example. By investing in companies that actively work towards environmental sustainability, investors can contribute to positive change but setting reduction targets and accurately measuring environmental impacts can be complex and require ongoing monitoring and verification.

Measuring and increasing impact towards the United Nations' Sustainable Development Goals (SDGs) is gaining traction as a methodology for sustainable investing. This approach aligns investments with specific SDGs, such as poverty alleviation, gender equality, and climate action. By directing capital towards companies that contribute to these goals, investors aim to generate positive social and environmental outcomes. However, defining measurable impacts and assessing the alignment of investments with the SDGs can be challenging, even more than with ESG risks.

Lastly, voting and engagement play a crucial role in sustainable investing. This methodology involves actively using shareholder rights to influence companies' practices and policies through voting on resolutions and engaging in dialogues with management. It allows investors to drive change from within and hold companies accountable for their environmental and social performance. However, it requires dedicated resources and expertise to effectively engage with companies and promote sustainable practices.

Incorporating sustainability considerations into equity investment decisions can be approached through various methodologies, each with its own advantages and challenges. I firmly believe that by integrating them all, in a measured, holistic and risk-managed way, one can achieve substantial results and benefit through better long-term risk-adjusted returns. After all, sustainability is just another dimension of quality. Sustainable companies should face lower costs of running their business (less carbon taxes, fines, renovation costs etc…), improved market sentiment, lower cost of capital and ultimately better returns.

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