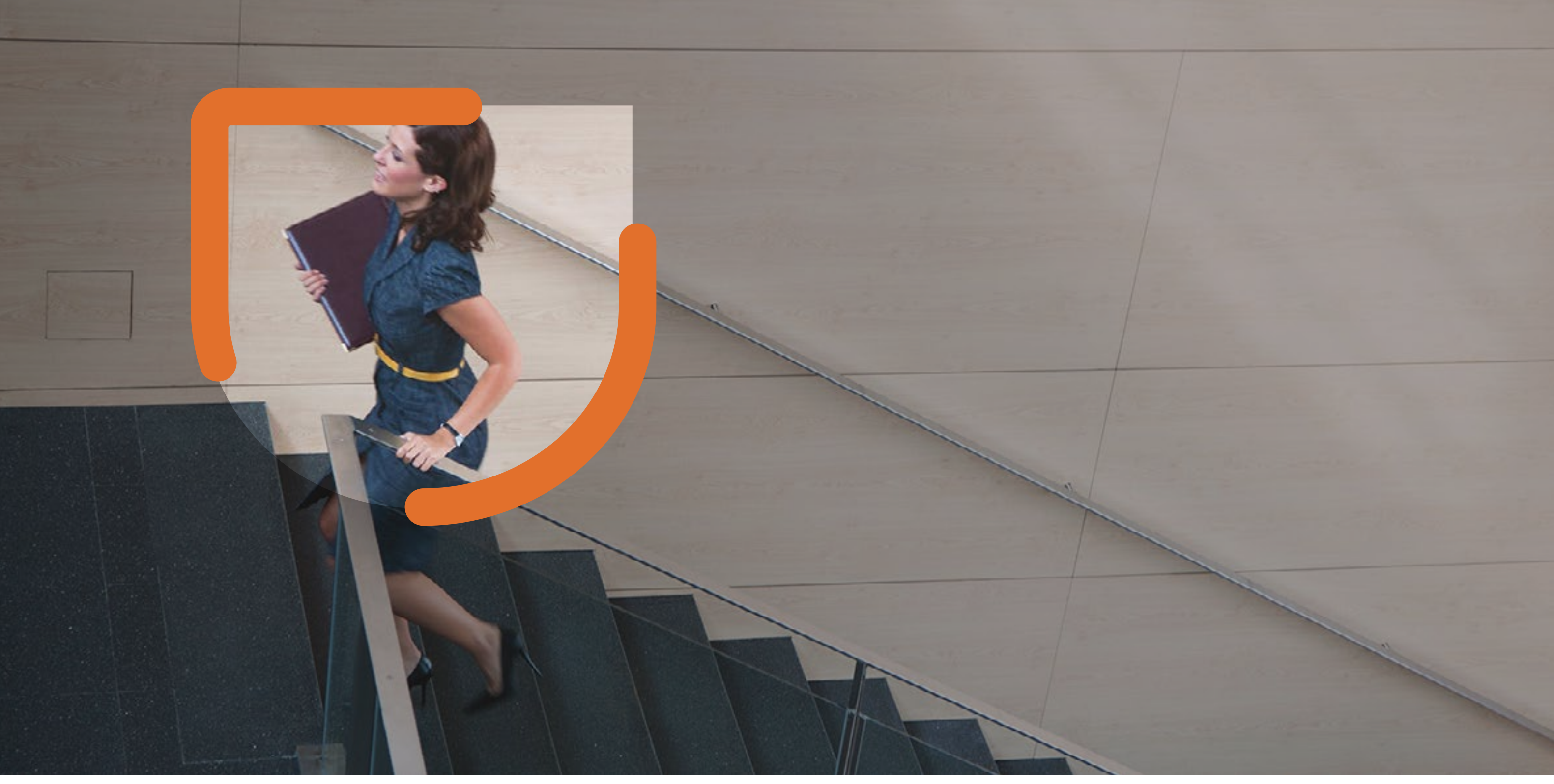
Do well while doing good

Ethical investing for market returns

White Paper, 2020

“Ethical investment goes beyond managing risk. It’s about investing for the right reasons: not investing in industries that have a detrimental impact on communities, and instead investing in positive industries that benefit society… It’s very much a marriage of pragmatic financial stewardship and good progressive values.”

– Mathew Browning,
Chief Executive Officer, U Ethical



Overview

Today's investment markets are characterised by an ever-increasing number of participants who not only require their investments to be profitable, but also expect them to meet certain non-financial criteria. The primary evidence for this trend is the rapid rise of responsible investing, which now accounts for an estimated one-quarter of assets under management (AUM) globally, and more than forty percent in Australia.

This white paper explores three elements of responsible and ethical investment:

In the first section, we examine the current state of the market for responsible and ethical investment, and explore its driving forces. The lines dividing different types of responsible investment approaches have become blurred, and the moral rigour underpinning them diluted. We clearly distinguish "ethical" investing from other "responsible" counterparts, and highlight it as an effective approach that seeks to deliver positive outcomes for both the world and investors financially.

Section two weighs up the popular debate on whether responsible and, by extension, ethical investment strategies produce lower returns than traditional ones. The best empirical evidence drawn from thousands of studies suggests that responsible investment strategies don't compromise on investment performance over medium to long-term horizons.

The final section moves beyond financial returns to focus on the social and environmental impacts of ethical investing. Measuring and proving the beneficial real-world impacts of ethical investing is an important challenge for the industry, one that must be met in order to continue its growth momentum. Efforts are now mobilising on this front, with progress being made and tangible solutions starting to emerge.

Section 1: **What is responsible and ethical investing?**

Ethical investing: the effective approach for achieving both financial and non-financial outcomes

The origins of responsible and ethical investing lie with religious groups, that sought to invest according to their moral principles. Their strategy was to avoid products or activities that harmed fellow human beings; one early exclusion was the slave trade, followed by industries such as alcohol, tobacco and gambling.

The scope, definition and adoption of responsible investing have expanded over time. Responsible investment concerns have spread to many aspects of society, the natural world and corporate behaviour. From the 1960s onward, US colleges and other institutions decided not to invest in apartheid South Africa, while a similar shift is now underway with fossil fuels.

However, the rise of responsibly and ethically charged investment is not due to any single issue or event: an ever-shifting landscape of corporate scandals, environmental concerns, changing societal demands and rapid transformations in technology and business models make for constantly evolving dynamics.

Definitions

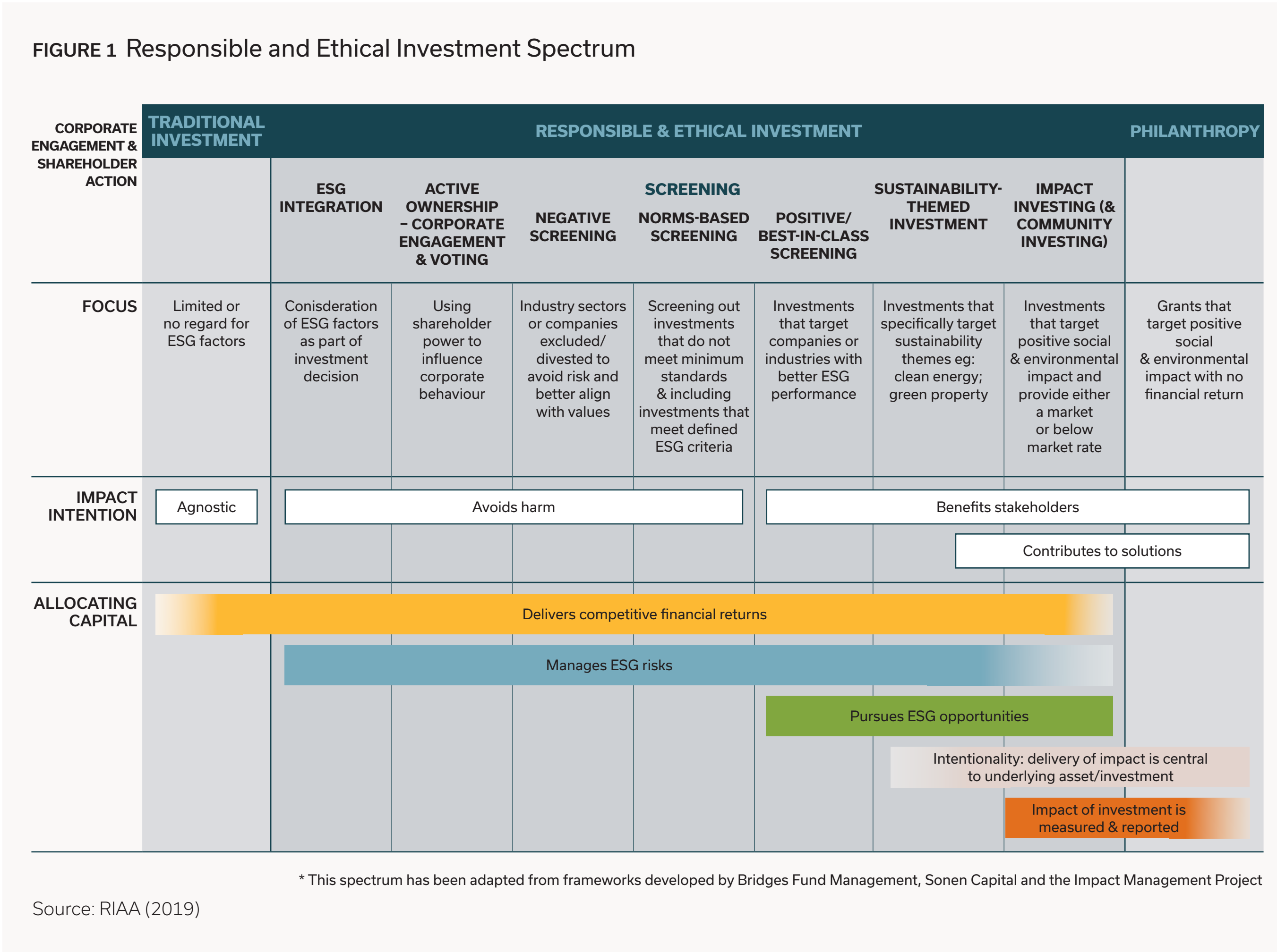
Gone are the days when investments were assessed solely on the basis of risk and return. "Non-financial" factors are now of growing importance, but the terminology and methods can be confusing. When "responsible investing" is discussed, a jumble of terms are used, often interchangeably, when in fact they may only partly overlap, or have slightly different meanings.

This white paper doesn't seek to refine or add to the existing terminology, but rather to draw out the distinctions between different types of responsible investing, and to outline an effective investment approach for achieving both financial and non-financial outcomes: ethical investing.

So what is "responsible investing"? A useful starting point is the Responsible Investment Association of Australasia's (RIAA) definition: responsible investing is an umbrella term used to describe *"an investment process which takes environmental, social, governance (ESG)* ***or*** *ethical considerations into account".*

This raises an important point: while ethical investing comes under the umbrella term "responsible investing", not all responsible investing strategies will take ethical considerations into account.

FIGURE 1 Responsible and Ethical Investment Spectrum



Source: RIAA (2019)

ESG recognises that non-traditional environmental, social and governance factors have financial relevance

RIAA's "Responsible and Ethical Investment Spectrum" sets out the range of investment strategies and approaches on offer, ranging from those that seek to avoid harm, to those that aim to benefit various stakeholders and/or contribute solutions to real-world problems.

Let's consider "Environmental, Social and Governance (ESG) integration", the most common modern-day tool used by fund managers seeking to adopt a responsible approach. ESG recognises that non-traditional environmental, social and governance factors have financial relevance. But from an ethical standpoint, ESG is not enough: it is only concerned about the *financial implications* of factors such as pollution, carbon footprint, or labour relations for companies — not whether they are right or wrong.

Take a fund manager who's weighing up a possible investment in energy giant BP: ESG analysis would involve considering the company's carbon footprint and the possible effects of future carbon taxes on company profitability, but not a decision on whether BP's business activity is fundamentally good or bad for the world. It is quite possible for companies that operate in detrimental industries to have top ESG ratings. For example, Aristocrat Leisure Limited — Australia's largest gambling machine (pokies) manufacturer — has an ESG rating of AA,[1] the second-highest rating possible. Imperial Brands, which sells its cigarette and tobacco brands in more than 150 markets worldwide, has an A rating.[2]

1 MSCI ESG (2019).
2 MSCI ESG (2020).

more than one-quarter of assets under management (AUM) globally are now being invested in responsible investment strategies

Ethical investment goes both further and deeper than ESG analysis. An ethical investment strategy uses a range of tools, including ESG analysis, but also applies its own ethical filter based on the fund manager or investor's own principles. This can get complicated, because what is considered "ethical" can vary between investors and organisations, but there are typically some overlaps.

Ethical investment involves research and judgement as well as standards. It involves asking questions, gathering facts, and weighing up the potential ethical implications of investment decisions. How do you conduct a deeper assessment of an international supply chain that might, on the surface, meet ESG standards? Take Woolworths Group, a large Australian retailer that is often screened out by responsible investors due to its alcohol production and poker machine operations. Has the company's decision to spin off these businesses made it eligible for investment? What about a retailer that sells some tobacco products?

A thriving market

In its early days, the shift to responsible and ethical investing was slow to gain momentum, because it was seen as an additional cost or a restriction on investment choices.

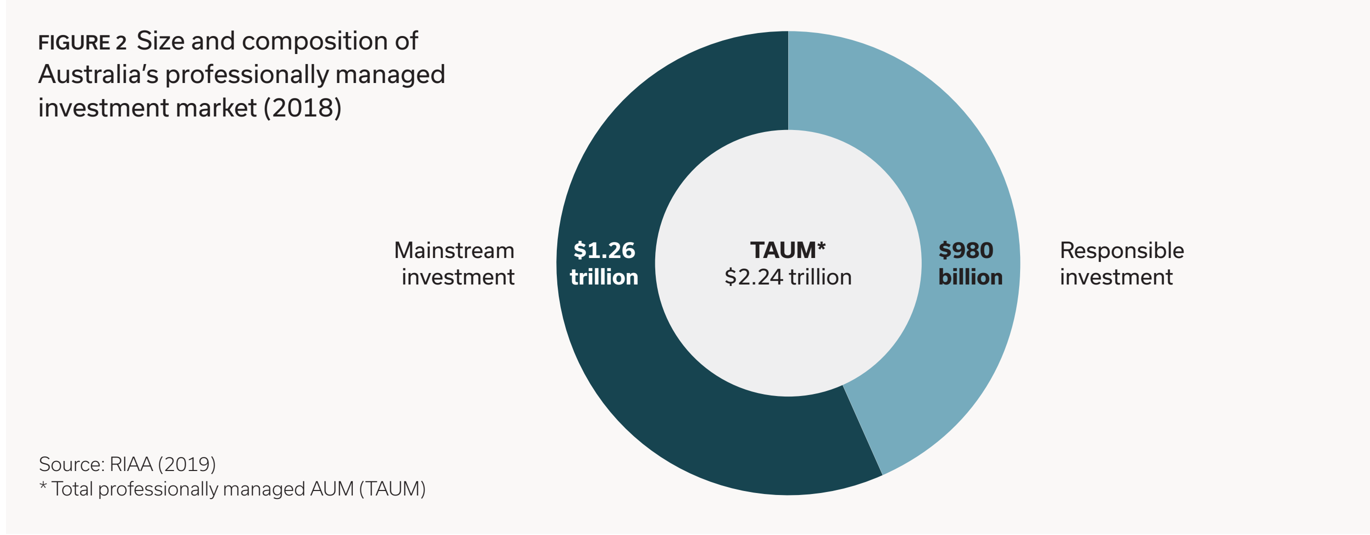
But importantly, the shift continued to be driven by bottom-up demand from investors who wanted to take non-financial considerations into account, while still wanting a return. Today, almost all large asset managers trumpet their commitment to responsible investment in order to cater for this demand.

A 2017 study[3] estimated that more than one-quarter of assets under management (AUM) globally are now being invested in responsible investment strategies — the Global Sustainable Investment Alliance's 2018 trends report[4] put the figure at $US30.7 trillion.[5]

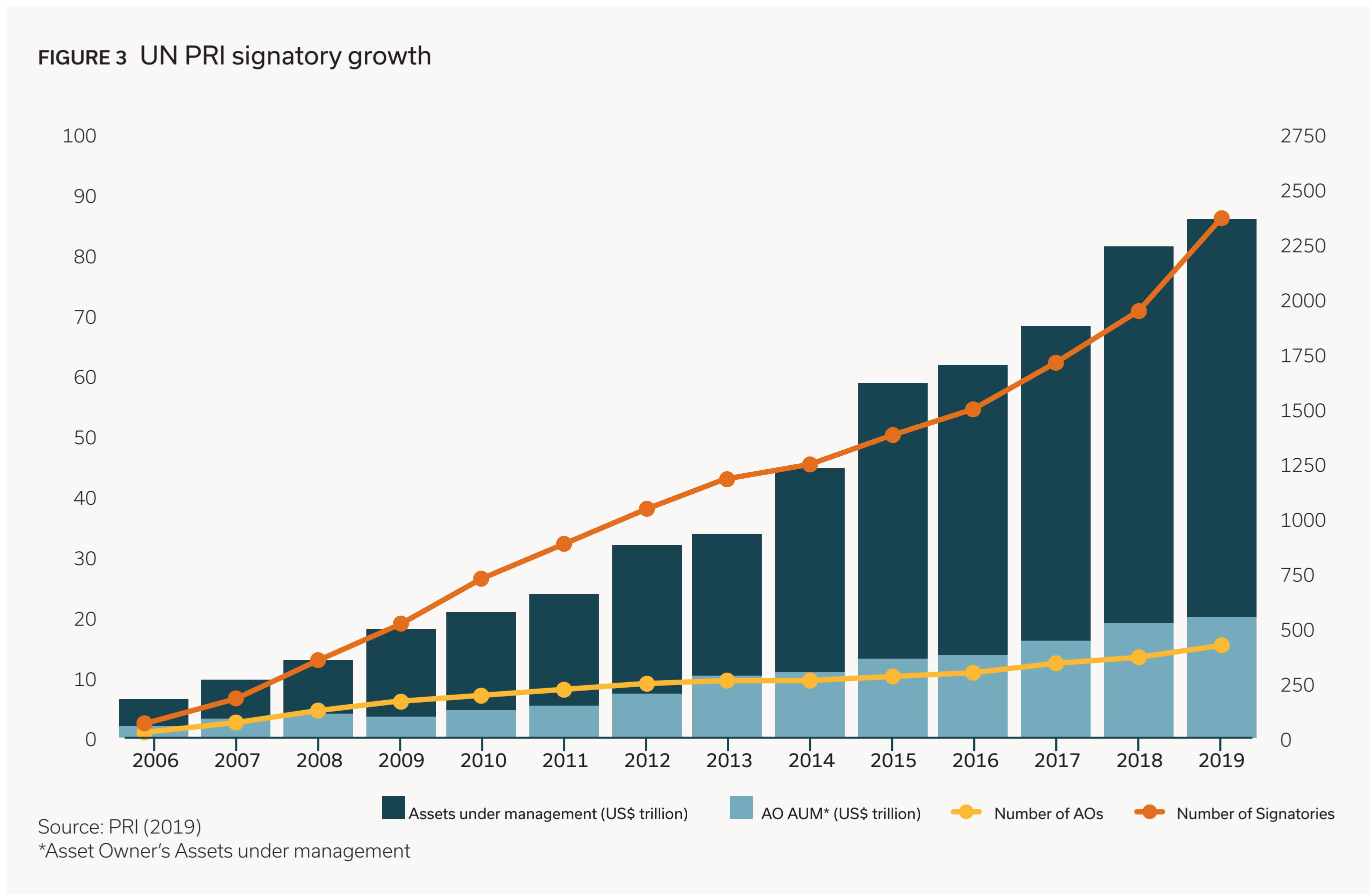
While Australia is small in terms of responsible assets under management compared to Europe and the US, our participation rates are high (see Figure 2, below). In 2018, Australia's responsible investment market grew 13 percent to

3 Bernow et al (2017).
4 Global Sustainable Investment Alliance (2018).
5 Global Sustainable Investment Alliance (2018).

FIGURE 2 Size and composition of Australia's professionally managed investment market (2018)



Source: RIAA (2019)
* Total professionally managed AUM (TAUM)



Source: PRI (2019)
*Asset Owner's Assets under management

four out of five Australian superannuation funds are committed to some form of responsible investment

$980 billion, or 44 percent of total professionally managed assets ($2.24 trillion in total). Retirement assets play an important role, with four out of five Australian superannuation funds are committed to some form of responsible investment.[6]

The number of signatories to the United Nations-backed Principles for Responsible Investment (UNPRI) — whereby ESG principles are incorporated into an investment manager's company analysis, ownership policies and practices — has more than quadrupled over the past decade (see Figure 3).

It is important to note that headline numbers, such as those cited above, can potentially be misleading, because some fund managers adopt a very "light touch" in their commitment to ethical investing. However, these fund managers can be exposed and their activities scrutinised, raising the prospect of reputational risk and fundamental questions over their ability to manage investments responsibly.

As U Ethical chief investment officer James Cook explains:

> **"A lot of companies that signed up for the UNPRI signed up quickly, but are doing nothing to meet their commitment to responsible investing. The UNPRI sent a strong message in 2018 when it issued a formal warning to 185 companies from its list of 1967 signatories. If those companies don't clean up their act, they'll be expelled and publicly named."**

6 RIAA (2018).

As responsible investing becomes increasingly mainstream, the rigour of the responsible strategies being used by various fund managers is up for debate. However, the overall upward trend is not in question. Some of the primary factors driving this high demand are:

millennials are **twice as likely** as the overall population to invest in companies targeting social or environmental goals

1. Demographic Changes

The profile of wealth holders is changing, influenced by broader demographic trends. Globally, we're seeing the start of a major shift whereby capital is transferring to women and millennials. Worldwide, women are likely to hold $US72 trillion of private wealth by 2020,[7] more than twice the amount they held in 2010. Millennials are set to be worth as much as $US31 trillion collectively by 2020.[8]

These trends are significant because both these groups — particularly younger investors — tend to invest in order to make a clear and measurable positive impact on society, as well as for financial gain. A 2017 report found that millennials are twice as likely as the overall population to invest in companies targeting social or environmental goals.[9] By choosing to invest ethically, these groups are sending a strong signal to the market about what they value and what type of activities they want to profit from.

2. Fiduciary Duty

Globally, regulation and policy are increasingly designed not only to safeguard client assets, but also to assist industry with change and innovation to foster a more responsible global financial system.

European regulators are leading the way here. In 2018, the European Commission released its "Action Plan for Financing Sustainable Growth" — its most ambitious-ever package of measures aimed at reorienting capital flows towards sustainable investment, and mainstreaming sustainability considerations into risk management. Measures include tighter disclosure standards for asset managers, the introduction of responsible benchmarks for investors, and the inclusion of ESG considerations into the advice that investment and insurance firms offer their clients.[10]

The growing recognition of non-financial factors within Australia's financial system is reflected in a 2019 speech by Guy Debelle, Deputy Governor of the Reserve Bank of Australia (RBA):

> **"Challenges for financial stability may arise from both physical and transition risks of climate change which could cause previously valuable assets to become uneconomic. All of these consequences could precipitate sharp adjustments in asset prices, which would have consequences for financial stability."**[11]

7 Boston Consulting Group (2016).
8 UBS (2017).
9 Morgan Stanley Institute for Sustainable Investing (2017).
10 European Commission (2018).
11 RBA (2019).

3. Greater Transparency

One of the world's first supply chain scandals came at the start of the 20th century, over the treatment of workers who harvested cocoa on the islands of São Tomé and Príncipe, off the west coast of Africa. Slavery had officially been abolished, but the owners of major British chocolate makers Cadbury, Rowntree and Frys, who were all Quakers, had heard disturbing rumours. An investigative journalist took a slow boat to Portuguese West Africa, and his reports exposing the industry's use of forced labour were published in *Harper's* magazine in 1905–06 and later released as a book, *A Modern Slavery*.[12]

evidence shows that companies that adopt effective responsible business practices can enhance their competitive advantage

Compare this historical example to the present day, with the explosion of the internet and social media, 24-hour news channels, "citizen journalists" and online activists. Today's media landscape exposes all parts of the supply chain to instantaneous and ongoing coverage, as we've seen with Nike, the Foxcon component factories making Apple equipment, and Western clothing suppliers using garment sweatshops in Bangladesh, including brands affected by the Rana Plaza factory collapse in 2013.

In 2018, the Australian government followed the lead of Britain and passed the *Modern Slavery Act*. The legislation requires entities with revenue of $100 million or more to lodge annual public reports on their actions to address modern slavery risks in their operations and supply chains.

Big data, algorithms and other sophisticated tools have also enabled greater analysis of companies' environmental, social and governance performance, on a scale previously unimaginable.

4. Improvements in Corporate Financial Performance (CFP)

A growing body of evidence shows that companies that adopt effective responsible business practices can enhance their competitive advantage, increase their operational cost-effectiveness, and ultimately improve their long-term financial performance.

While many of these factors are not captured by traditional accounting practices, they can have a real impact on financial metrics and long-term value creation. We explore this idea further in the next section of this paper.

12 Fwelling (2016).

Section 2: **What does responsible investing mean for returns?**

research reveals a marked shift in attitudes towards the financial merits of responsible investing

The tremendous growth of responsible and ethical investing has been accompanied by debate on its merits from a financial return perspective.

Initially, many in the investment sector assumed that ethically focused funds were compromised, and the prospect of poor returns was enough to curb the growth of the industry for some time.

But more recently, a significant body of research has emerged that dispels this idea, and reveals a marked shift in attitudes towards the financial merits of responsible investing.

The critics

Sceptics argue that applying non-financial considerations to the investment process — for example, ethical screens — must result in lower returns, as it reduces the number of investment opportunities. Based on Modern Portfolio Theory (1952),[13] this position assumes that portfolios constructed from an investment universe of 1000 companies will be more efficient (that is, will have higher expected risk-adjusted returns) than portfolios built from a smaller investment universe of 500 companies.

This distortion effect can be exaggerated because entire stock market sectors (such as mining) are often screened out on ethical grounds, rather than just a few select "bad eggs". Hypothetically, at some point in the market cycle, those excluded sectors may provide attractive opportunities for an astute investor.

This presents a challenge for ethical funds, which often have a large "tracking error" (the gap between a portfolio's actual returns and its benchmarks). With blanket screening, building an ethical portfolio of Australian stocks that yields market returns is theoretically more difficult than with European or US stocks. For example, Australia's resource and energy sectors account for almost one-quarter of the market capitalisation of the S&P/ASX 300, compared to 7 percent of the S&P 500[14] or 9 percent of the MSCI World Index.[15]

13 Markowitz (1952).
14 S&P Dow Jones Indices, as at 31 Jan, 2020.
15 MSCI, as at 31 Jan, 2020.

responsibly inclined companies should be **less exposed** to "tail risks"

recent empirical research shows that the **underperformance of responsible** and **ethical investment is a myth**

The supporters

The backers of responsible and ethical investing argue that integrating measures such as ethical screens into the investment process delivers benefits that more than offset any losses in portfolio efficiency.

The rationale here is that companies that embrace responsible, sustainable and ethical practices demonstrate better operational performance, which ultimately translates into better financial performance and better outcomes for shareholders. Supporters also point out that adherence to strong ESG standards can function as a guide to a company's overall quality of management and long-term sustainability.

The logic is that more ethically and responsibly inclined companies should be less exposed to "tail risks" — losses resulting from unforeseen negative events, such as environmental accidents or corporate scandals. In addition, advocates argue that ethically responsible companies are more likely to use their inputs sustainably, and to generate customer and employee loyalty over the longer term.

Supporters also point to a large body of recent empirical research that challenges sceptics' claims, and shows that the underperformance of responsible and ethical investment is a myth (see below). In regard to sceptics' claims about the potential costs of screening out mining companies, the evidence is not conclusive one way or another. However, in some circumstances, screening out mining companies on ethical grounds has in fact resulted in outperformance for some investment funds.[16]

The neutrals

At first glance, the third school of thought lies somewhere in the middle of these two positions. It contends that the application of ethical screening techniques has a modest effect on returns, if any at all, especially when considered alongside more dominant factors such as asset allocation or market dynamics.

On closer examination, this stance — that ethical investors can "do equally well or equally badly, while also doing good" — in fact *supports* the argument for ethical investing. Ethical fund managers operate on the premise that their methodologies have social and environmental benefits that don't detract from performance, but they will rarely claim that applying an ethical lens will result in strong outperformance.

16 Foo (2017: 15). See also Frost (2016).

FIGURE 4 Responsible and ethical investing: three schools of thought

The critics	The neutrals	The supporters
Reduced choice = lower expected returns Australian market is considered particularly challenging	Ethical screens have neither positive nor negative effect on returns	Companies with ethical practices exhibit better corporate financial performance (CFP) Translates to improved investment performance

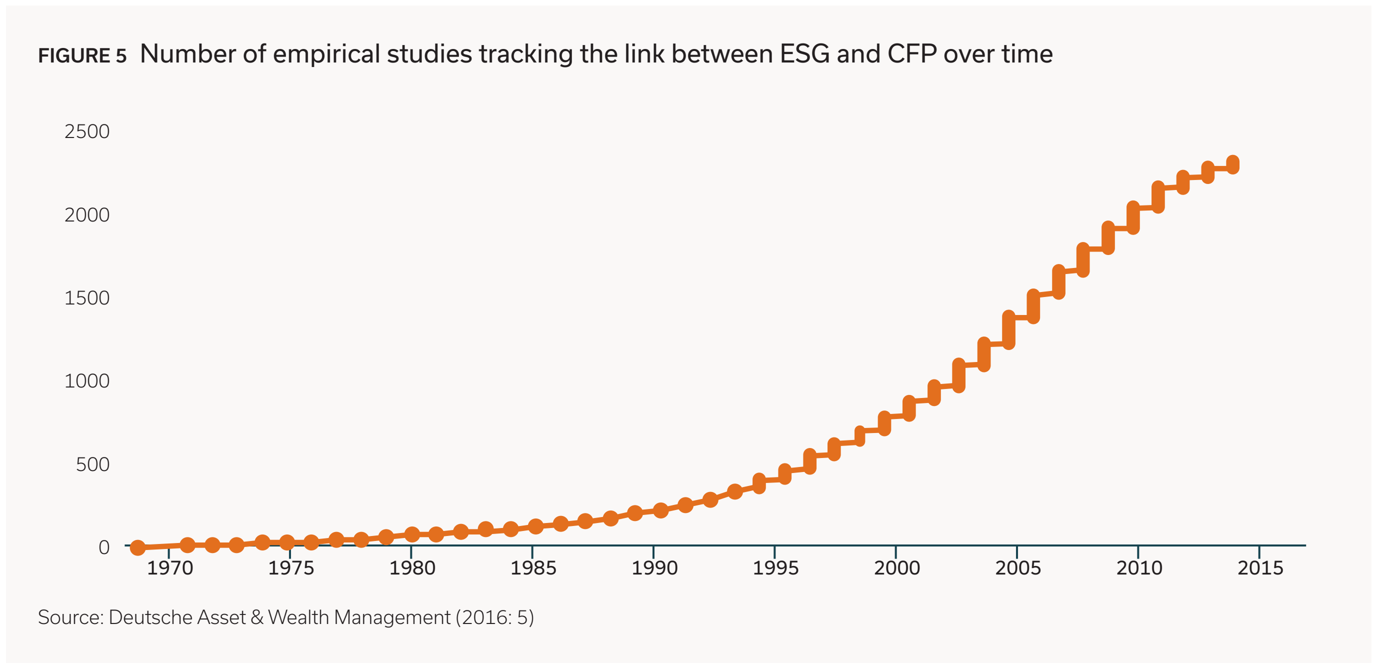


FIGURE 5 Number of empirical studies tracking the link between ESG and CFP over time

Source: Deutsche Asset & Wealth Management (2016: 5)

What does the empirical evidence say?

Given these diverse perspectives, the question of how responsibly tilted portfolios perform relative to traditional portfolios is, at the end of the day, an empirical one. So what does the research say?

Existing research mostly focuses on ESG, rather than pure ethical investing. This is understandable: ethical investment is governed by principles that may derive from personal values, religious beliefs or societal norms. These principles can vary between individuals/entities, change over time, or involve detailed and nuanced deliberations. This type of subjectivity does not lend itself well to scientific research, which requires greater uniformity of data.

investors in ESG mutual funds could expect to lose nothing compared to conventional fund investments

ESG data is also very plentiful, and ESG criteria are well defined and applied in similar ways across organisations. Thus, most existing research comparing the performance of responsible and traditional investing tends to focus on ESG. The research can be divided into:

- **Portfolio studies**, which compare the performance of responsible investment portfolios and indices; and
- **Non-portfolio studies**, which examine the relationship between ESG and corporate financial performance (CFP).

Thousands of non-portfolio studies have been published on this topic in recent decades, meaning that meta-studies, which combine the results of multiple analyses deliver the strongest insights.

One of the most comprehensive and widely referenced academic studies examining ESG, corporate financial performance (CFP) and portfolio performance is a 2015 study by researchers at the University of Hamburg and Deutsche Asset & Wealth Management. It examined the findings of over 2200 academic studies published since 1970, and found that the business case for responsible investing is well founded.[17]

17 Friede et al (2015).

The researchers' analysis showed that only **10 percent of the studies found a negative ESG–CFP relationship** while an overwhelming **63 percent yielded positive results**.

Findings from the portfolio studies — consisting of research looking at mutual funds, indices and long-short portfolios — were neutral, with any positive ESG effect wiped out by fees. Nonetheless, investors in ESG mutual funds could expect to lose nothing compared to conventional fund investments,[18] a finding that is in itself an endorsement for responsible investing.

over most timeframes and asset classes, Australian responsible share funds outperformed mainstream Australian share fund benchmarks

These findings are reinforced by a similarly rigorous meta-study by Fulton et al (2012),[19] which found that:

- 85 to 89 percent of the sub-studies analysed showed firms with high ratings for ESG had market-based or accounting-based outperformance;
- there were "mixed results at the fund level".

The researchers' findings are supported by practical evidence from RIAA, which publishes the investment performance of responsible funds versus traditional benchmarks, both domestic and global.

RIAA's 2019 report shows that over most timeframes and asset classes, Australian responsible share funds outperformed mainstream Australian share fund benchmarks, while international statistics were more mixed (see Figure 6, below).

The upshot is that overwhelmingly positive results at the company level, and non-negative findings at the portfolio level, provide strong support to the investment case of both responsible and ethical funds alike.

The clear conclusion, based on evidence drawn from thousands of studies, is that applying ethical filters to the investment process delivers benefits that could offset the loss, if not exceed it, of portfolio efficiency caused by the more limited investment universe.

18 Friede et al (2015).
19 Fulton et al (2012).

FIGURE 6 Performance of responsible investment and mainstream funds

Australian share funds	1 Year	3 Years	5 Years	10 Years
Average responsible investment fund (between 17 and 34 funds sampled depending on time period)	-1.24%	5.70%	6.43%	12.39%
Morningstar: Australia Fund Equity Large Blend	-5.49%	4.87%	4.42%	7.95%
S&P/ASX 300 Total Return	-3.06%	6.65%	5.60%	8.91%

International share funds	1 Year	3 Years	5 Years	10 Years
Average responsible investment fund (between 7 and 38 funds sampled depending on time period)	-0.03%	11.18%	9.48%	9.50%
Morningstar: Equity World Large Blend	-0.68%	6.37%	8.42%	8.97%
MSCI World Ex Australia NR AUD	1.52%	7.49%	9.81%	9.57%

Multi-sector growth funds	1 Year	3 Years	5 Years	10 Years
Average responsible investment fund (7 funds)	-1.13%	4.75%	5.65%	7.66%
Australia Fund Multisector Growth	-2.26%	4.39%	4.92%	7.02%

Source: RIAA (2019)

Section 3: **Investing for impact**

As the research summarised in the previous section shows, the business case for ethical investing is well established. Knowing that ethical investing can provide risk-adjusted returns that are similar to or better than the broader market, it is also crucial that an ethical investment strategy can demonstrate its positive impact on the environment and society. However, comparatively few studies have examined the social and environmental case.

This is problematic. Ethical investing is designed as a tool to benefit humanity and the natural world, but how can we be certain whether it is making a discernible difference to lowering greenhouse gases, tackling poverty, or increasing gender equality?

it is also crucial that an ethical investment strategy can demonstrate its positive impact on the environment and society

Indeed, for all the growth ethical investing has enjoyed over recent decades, the main barrier to it becoming truly mainstream is the difficulty of demonstrating the non-financial impacts.

This is where the idea of "investing for impact" comes into play.

The concept of investing for impact

Impact investing aims to generate a *measurable* positive social or environmental impact, alongside a financial return. To explain investment for impact, we follow a conceptual framework laid down in two major studies on the impact of sustainable investing (Kölbel et al, 2018,[20] and Brest & Born 2013[21]).

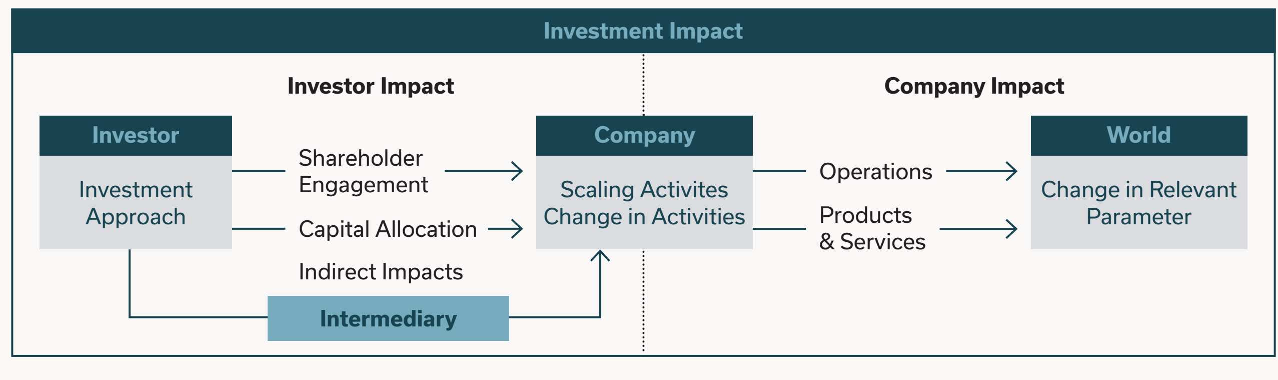
These studies highlight that investment impact consists of two complementary components:

- **Investor impact:** the extent to which investors influence companies; and
- **Company impact:** the extent to which those holdings align to the non-financial outcomes the investor is seeking.

So how is impact measured? Consider, for example, a company that manufactures wind turbines. When connected to an electricity grid like Victoria's, which traditionally relies on highly polluting brown coal, each kilowatt hour (KWh) of power the turbines generate avoids the greenhouse gas emissions that would otherwise have been released into the atmosphere. This is the "company impact". Investors can amplify this impact by helping the company to scale up its operations. If an investor provides capital that enables the company to double its output, this is the "investor impact".

20 Kolbel et al (2018).
21 Brest & Born (2013).

FIGURE 7 Two complementary components of investment impact



Source: Beyond Returns (2018).

The question of "additionality"

In our wind turbine example, impact has clearly been achieved. The key condition of "additionality" is satisfied – that is, the quantity or quality of social outcomes has increased beyond what would have occurred without the investment. Additionality sits at the heart of impact investing.

But perfect conditions for demonstrating impact are rare. Most commonly, they occur in:

- companies that are much smaller than typical listed companies, such as social enterprises;
- single-purpose transactions that are relatively illiquid, such as "green" or social impact bonds; or
- investments that offer a "concessionary" (below-market) return for a similar level of risk.

As shareholders, ethical investors engage with companies about their ESG performance in order to influence the company's impact on society

These conditions don't apply to the vast majority of responsible and ethical investments, which take place on public listed markets, like the Australian Securities Exchange, and seek a market or better-than-market return. Trading on these markets is "secondary" — that is, no new capital is provided to the company. Therefore, an investor cannot reward a responsible company by committing additional capital, nor can they punish a company they deem to be irresponsible by withholding capital.

However, Kölbel et al (2018) outline three ways in which public market investors may achieve impact: shareholder engagement, capital allocation and indirect impacts.

- The researchers found robust evidence that investors can affect companies through **shareholder engagement**, especially when the reforms they are requesting are low-cost, and the company has prior experience with engagement. As shareholders, ethical investors engage with companies about their ESG performance in order to influence the company's impact on society. This signals the investor's ethical values to company management, and to the market. Moreover, when like-minded investors band together, "collaborative impact" can be a powerful force in driving change for the better.

banks are showing reluctance to finance new coal ventures, a stance shared with major re-insurance companies

- The study found indirect evidence for investment impact on **capital allocation**, whereby a company's access to capital is either improved or impeded. However, this is a growing trend in areas such as climate change, with banks showing reluctance to finance new coal ventures, a stance shared with major re-insurance companies. Impact on capital allocation was found to be more likely when responsible investors hold a larger market share, and where investee companies depend on external financing for growth.
- **Indirect impacts** include "stigmatisation" — where dissatisfied investors "stigmatise" a company by divesting its shares, or categorically excluding it from their portfolio; and "endorsement" — where investors endorse a company for its social or environmental performance by including it in their portfolio or sustainability index. Endorsements may help increase a company's visibility and reputation, thus indirectly helping it to gain customers or motivate employees. However, to date evidence of any clear impact from these mechanisms is purely anecdotal, as research in this area is thin.

The future

The three mechanisms outlined above all clearly show *intention* to achieve impact through positive social or environmental outcomes. But they also underscore the need to develop a way of demonstrating additionality more clearly.

The field of impact measurement is still relatively young, and there's a healthy ongoing debate about the protocols, best practice and reasons for evaluating impact.

The most commonly cited barrier to progress is not a lack of measurement, but rather the failure to adopt a single, universal standard.

Currently a number of different standards are used to measure impact, including GRI, TCFD and IRIS (see Glossary). There is growing demand for a universal approach to measuring impact, and findings from RIAA's 2018 "Benchmarking Impact" report show that the UN Sustainable Development Goals (SDGs) have emerged as the clear favourite for a measurement framework.

FIGURE 7: Two complementary components of investment impact

Source: United Nations (2015).

UN Sustainable Development Goals, SDGs, provide a common language in conversations around sustainability

Arising from the 2012 United Nations Conference on Sustainable Development, held in Rio de Janeiro, the SDGs were officially launched in 2015 with the aim of creating a new global agenda for sustainable development. The 17 goals were developed by governments, but government action alone won't be enough to achieve them. The United Nations has estimated that meeting the 17 SDGs will require global investment of between $US5 trillion and $US7 trillion every year until 2030.

The private sector has a significant role to play here. The goals are applicable to all nations, and aim to cover the whole sustainability agenda: poverty, human development, the environment and social justice. With 17 ambitious goals, 169 underlying targets and a deadline of 2030, the SDGs provide a common language between the public and private sectors in conversations around sustainability, and have sharpened international focus on the non-financial impact of investments.

In Australia, RIAA has identified a noticeable shift by responsible and ethical investors — super funds and fund managers in particular — to start assessing their portfolios against the SDGs, and this trend is expected to continue. These investors are integrating SDGs through asset allocation, product development, engagement with investee companies on issues outlined in the SDG Conceptual Framework, and support for regulatory reforms that align with the SDGs, such as the *Modern Slavery Act.*

Summary

Concerns continue to emerge over the sustainability of our present-day industrial ethic, and the need for business to respect the limits of environmental and social capital. Against this backdrop, the field of responsible and ethical investing has flourished.

This white paper has examined responsible and ethical investing through the lens of what investors are increasingly seeking: 1) competitive returns and 2) tangible positive impacts. In other words, investors want to **"do well while doing good"**.

Based on the robust research findings outlined in this paper, there should be no lingering doubts about the ability of responsible portfolios to "do well". Empirical evidence from thousands of studies comparing the returns of responsible and traditional portfolios shows there is no sacrifice of returns for those who adopt responsible investment strategies. In fact, Australian responsible equity funds have outperformed traditional benchmark indexes over the past ten years.[22]

While the financial merits of responsible investing are now well established, there is less confidence amongst investors about exactly how their investments are "doing good".

While popular approaches such as ESG integration are adept at identifying and quantifying "non-traditional" risks and their effects on company *profitability*, they are ineffective at deciphering whether a company's activities are fundamentally good or bad for the world.

As such, we distinguish ethical investing as an approach which aims to cater to both financial and non-financial considerations. A true ethical investing strategy won't deploy ESG considerations in isolation, but will instead couple ESG analysis with ethical filters that explicitly direct capital away from negative industries and companies and into positive ones.

In this way, investors have the greatest chance of achieving positive "non-financial" outcomes through their investments, while also achieving competitive returns.

The aims of responsible and ethical investing are dynamic rather than fixed. Social attitudes shift over time, and activities once considered acceptable become unacceptable, as do the companies and sectors associated with them. In future we will see new businesses, industries and technologies arise, posing new challenges for both investors and humankind.

Whatever the future holds, it is clear that responsible and ethical investing will play an increasingly prominent role in tackling the challenges we face.

22 RIAA (2019: 5)

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Glossary

Assets Under Management (AUM): The total market value of the investments an entity manages on behalf of clients.

Corporate Financial Performance (CFP): A measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period.

Environmental, Social, Governance (ESG): A set of standards for a company's operations that are used to evaluate potential investments. Environmental criteria consider how a company performs as a steward of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights. ESG is only concerned about the financial implications of these factors — not whether they are right or wrong.

Ethical investment: Also known as sustainable investment and socially responsible investment (SRI). This term describes an investment process that incorporates consideration of environmental, social and ethical factors when selecting investments, in addition to the objective of achieving a competitive financial return.

Global Reporting Initiative (GRI): An international independent standards organisation that helps businesses, governments and other organisations understand and communicate their impact-critical sustainability issues such as climate change, human rights and corruption.

Impact Reporting and Investment Standards (IRIS): A set of standardised metrics that can be used to measure and describe the social, environmental, and financial performance of organisations and businesses receiving impact investment capital.

Meta-studies (or meta-analysis): Analysis of data and findings from a number of independent studies on the same subject, in order to determine overall trends and draw more robust conclusions.

Task Force on Climate-related Financial Disclosures (TCFD): Organisation that develops voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders.

Tracking error: The difference between an investment portfolio's returns and those of the benchmark or index it is compared against.

Responsible Investment Association Australasia (RIAA): Member organisation championing responsible investing and a sustainable financial system in Australia and New Zealand.

United Nations Sustainable Development Goals (SDGs): The blueprint to achieve a better and more sustainable future for all. The 17 SDGs address the global challenges we face, including those related to poverty, inequality, climate, environmental degradation, prosperity, and peace and justice.

There should be no lingering doubts about the ability of responsible portfolios to "do well". Empirical evidence from thousands of studies comparing the returns of responsible and traditional portfolios shows there is no sacrifice of returns for those who adopt responsible investment strategies.

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