IOR | The New Option
Investment Office Resources

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PART II: Values-Based Investing Today

In Part II, we provide a brief history of 'values-based investing' and we illustrate how this history has informed the spectrum of values-based investment techniques utilized by investors today. By looking back, we can better understand the context for our current landscape and can better map our future. The term 'ESG' has morphed over the years into a confusing term which has fueled some of today's misunderstanding and divisiveness.

Most investment offices would describe today's 'ESG' environment as complex, polarizing and at times even controversial. Terms are misunderstood, agreed upon definitions are difficult to find and standardization has not yet formed. A flood of information (and misinformation), the productizing and, more recently, the politicization of ESG integration has added to the noise and confusion. For some, investing has even become divisive as stakeholders 'pick a side' for or against ESG.

Although it is a hot topic today, the idea that organizations invest in alignment with their values ("Values-Based Investing") is nothing new.

In fact, the origins of 'Values-Based Investing' can be traced back to the 18th century when Quakers refused to invest in the slave trade as doing so would have been in direct conflict with their espoused values. This approach marked the beginning of socially responsible investing (SRI), a type of investing that considers returns but also the ethical beliefs of the organization. SRI investing was (and still is) typically implemented through the designation of prohibitive investments which are often determined through the use of negative screening.

In the 1960s, the anti-war movement saw investors divest from chemical companies that were producing toxic chemicals used in warfare, pressuring companies to be more responsible. Again, negative screening/prohibitive investing was used by investors to reflect their beliefs and to take a stance.

Prohibitive investments continue to be a part of the institutional investor landscape, but other techniques and priorities such as mission-aligned proxy voting, advocacy and positive screening, have since emerged.

From the 2000s, there has also been growing momentum around formalizing **sustainability** efforts.

> *Sustainability refers to the ability to meet the needs of the present generation without compromising the ability of future generations to meet their own needs.*

These efforts have led to a series of international initiatives such as the United Nations Global Compact, Sustainability Accounting Standard Board (SASB) and blueprints like the Sustainable Development Goals (SDG).

In a June 24, 2004 report issued by the UN Global Compact entitled '*Who Cares Wins*,' the grouped externalities of environment, social, and governance were first coined giving us the now-(in)famous abbreviation ESG.

Today, **sustainable investing** is commonly recognized as a type of investment approach that integrates ESG considerations. But as values-based techniques have expanded, so has confusion!

Defining the Term 'ESG'

Adding to (or maybe even fueling) the confusion and complexity today is that the term 'ESG' itself is misunderstood and often misused. As noted above, the term 'ESG' was initially coined with a narrow focus on sustainability factors. However, over the years the term has morphed into a 'catch-all' term for all things 'values-based'. We strongly believe this broader use of the term 'ESG' has created confusion as there is a distinct difference between ESG integration and other approaches to 'values-based investing'.

> ***ESG Defined***
>
> *ESG is a framework to assess a company using information beyond what is captured in financial statements and focused on three categories: environment, social and governance.*
>
> *ESG is not a product, but:*
> - *A tool that can be utilized to align investments with organizational values*
> - *A means to obtain a more holistic picture of a company that allows for investing in companies that align with organizational 'Critical Concerns'*
> - *Best integrated with flexibility rather than rigidity in recognition of the complexities, inconsistent interpretations and the lack of consensus around data integration*
> - *A tool to assess risks and allow for a more holistic view of investments*
> - *Unique to each institution – no two institutions have the exact same approach to ESG Integration*
>
> *Although ESG data is still often left open to interpretation, the growth of ESG integration has led to attempts to develop standardized ESG metrics which aim to facilitate consistency and comparability between ESG data. The demand for increased transparency and standardization in data have also led to the need for more regulation, which is evolving almost daily.*

While we believe it is useful to define and clarify the term ESG, we recognize that there has been a growing push to eliminate the term ESG altogether, mainly because it has become such a polarizing concept. ***Even if the term ESG goes away, it does not mean that organizations must cease integrating their values into the investment process***.

Here are the different ways an organization can integrate its values into the investment process, including our attempt to explain the differences between terms that are often blurred or used interchangeably.

Spectrum of Values-Based Investing

'ESG Integration' discussed above is one implementation technique for values-based investors. Two other techniques include "Socially Responsible Investing" (stock screening based on the organization's ethical views) and "Impact Investing" (desire to earn a return while also driving change).

The table below describes key differences in these techniques:

- **Socially Responsible Investing** is done to help an organization avoid investing in a way that directly conflicts with its stated ethical beliefs, through stock screening.
- **ESG Integration** informs an organization how it will reflect Environmental, Social and Governance factors into its investment decision process.
- **Impact Investing** involves making direct investments that both makes a return (even if it's a concessionary return), and a positive and measurable difference toward the organization's 'Critical Concerns.'

Values-Based Investing Spectrum

Implementation Techniques

	Socially Responsible Investing	ESG Integration Investing	Impact Investing
Definition	Balance financial returns with an organization's core beliefs. These beliefs could be independent of the organization's position on ESG criteria.	Maximize returns while considering Environmental, Social & Governance (ESG) criteria alongside traditional financial metrics.	Make direct investments that address a specific priority ('Critical Concern') while also generating a financial return.
Implementation	Typically negative screening.	The investing organization determines what ESG criteria to consider to best align the institution's values with investment decisions.	Typically conducted through direct or GP-led private (not public) investments intended to make a measurable impact pertaining to the institution's 'Critical Concerns.'
Considerations	A critical tool for aligning investments with an organization's own beliefs or ethics. - Helps prevent reputational risk (investing in conflict of its public position and/or its espoused values). - This may or may not have connections to sustainability themes often captured with ESG Integration.	There are no standardized frameworks for ESG Integration. - To allow for alignment of initiatives and actions, each organization should apply ESG data through the lens of their internally decided upon 'Critical Concerns'.	Positive outcome should be measurable and reported. - Some impact investors may decide to accept a concessionary return on their investment in order to achieve the desired impact.

Source IOR

As discussed, investing in accordance with values is nothing new. This concept is old and simple! You may still be asking why this should be a focus; in Part III we will further discuss why we believe this should be incorporated into an investment process.

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