STONEHAGE FLEMING

KNOW HOW BULLETIN

SOCIALLY RESPONSIBLE INVESTING

AN INTRODUCTION TO THE WORLD OF SUSTAINABLE INVESTMENT PRACTICES

NOVEMBER 2016

Socially Responsible Investing (SRI) is an increasingly important factor when creating an investment portfolio. It is, however, a complex and diverse subject. In this document we present a guide to investors who have an interest in this topic, and provide some insight on how we address SRI within our clients' portfolios.

INTRODUCTION

Our recent survey of wealthy families entitled 'Four Pillars of Capital for the 21st Century' showed that families increasingly seek to strike a balance between growing their assets, and doing so in a socially responsible manner.

We have seen a shift in the way families approach the long-term management of their wealth, with an ever increasing emphasis on the commitment to wider society. When we survey views on an intergenerational basis, these perspectives tend to be even more strongly held by Millennials (those born between 1980 and 2000) than their predecessors.

Whilst many families express an interest in Socially Responsible Investing, the 'SRI' landscape can be a confusing and complex one. In this document, we provide a guide to investors looking to investigate this topic, and seek to demonstrate how SRI factors influence our investment decision making.

Stonehage Fleming Investment Management
November 2016

EXECUTIVE SUMMARY

Socially Responsible Investing encompasses all investment methods which incorporate Environmental, Social and Governance (ESG) criteria into investment decision making.

However, there are no standard definitions for these criteria – each investor and investing entity will set their own parameters for what they believe constitutes a socially responsible approach.

Stonehage Fleming Investment Management (SFIM) generally divides socially responsible investing into three categories – 'do no harm', 'seek out good', and 'actively do good'.

The first subset usually involves a basic screen to eliminate investments that do not meet the ESG factors defined by the investor. The second goes one step further in saying that it's not sufficient to merely eliminate the 'bad', but that we should actively seek to invest in the 'good'. The final approach is more hands on and refers to 'impact investing' - rather than looking at a company which conducts itself in an ethical manner, impact investing considers specialist projects that actively meet a social or environmental need, whilst simultaneously producing an investment return. Here, at times, the line between investment and philanthropy can blur.

The initial challenge for investors looking to allocate capital within an SRI framework is the variety of ways in which parameters can be defined. Establishing a bespoke portfolio which fits specific criteria can be expensive, and often requires a significant commitment of capital. This particularly applies to impact investing, where investors may also need to be able to tolerate a high degree of illiquidity.

Potential investors should beware that, as socially responsible investing becomes more popular, there is heightened risk of 'greenwashing' (i.e. tick-box approaches to improve marketability of investment funds, rather than a real commitment to SRI). This occurs where firms promote their SRI credentials, but in practice only apply them selectively, notably when they support other investment objectives.

At SFIM we view SRI as a natural extension to fundamental investing. Much of what can be defined within environmental, social and governance criteria would naturally be considered when looking at a company's business sustainability.

As part of ensuring that our portfolios reflect these views, we have conducted a survey of our external third party managers.

The results were interesting, with the majority demonstrably incorporating some degree of ESG screening into their investment process. In particular corporate governance is routinely taken into account, with almost all managers considering criteria in this area. Indeed 77% of managers thought that socially responsible investing led to higher returns, and 61% of the fund managers are members of the United Nations Principles for Responsible Investing (UNPRI) initiative.

Whilst the above relates principally to the more traditional components of our portfolios, our Private Capital (i.e. Private Equity and Private Debt) team have developed strong relationships with a number of 'impact investors', and many of these projects may be of interest to clients looking for a more targeted approach to SRI.

DIFFERENT APPROACHES TO SOCIALLY RESPONSIBLE INVESTMENT

There are several overlapping and complementary terms such as 'sustainable investing', 'ethical investing' and 'values-based investing' which are used interchangeably to describe SRI practices.
We outline below some common approaches to implementing an SRI overlay.

i) Do no harm

Negative screening, also called exclusion, is the 'entry-level' approach to SRI that excludes individual companies or entire sectors from a portfolio if they conflict with an investor's values. Imagine for example an investor who does not want any of his or her money to support companies involved in animal testing. Negative screening will exclude all companies involved in such practices from the investment universe. The most frequently used negative screens include removing 'sin' stocks - tobacco, alcohol, gambling, adult entertainment and weapons.

ii) Seek out good

Positive screening, on the other hand, is a more proactive approach that can be split up into 'thematic investing' and 'best in class screening'.

Thematic investing focuses on companies offering innovative solutions to specific sustainability challenges, like water scarcity or renewable energy, and attempts to benefit from the attractive return potential of growth companies in sustainable industries. Thematic investing is often focused on investments in small or mid-sized companies.

Best-in-class screening involves selecting the most sustainable or socially responsible companies based on ESG-criteria, in the conviction that financial markets will reward sustainable practices over the long-term. An investor who has decided to invest in the consumer goods market, for example, might utilise best-in-class screening to identify the most socially responsible companies in terms of environmental awareness, employee relations and governance practices. Best in class thus requires a more knowledge-intensive process than negative screening, and a deep understanding of the factors relevant for each industry. Companies chosen according to this approach tend to be larger organisations.

iii) Actively do good - Impact Investing

Investors looking for a more direct mechanism to engage in SRI should potentially consider impact investing.

Also called 'community investing', this usually refers to Private Debt or Equity investments with the explicit intention of generating a measurable environmental or social impact, together with a financial return.

Impact investments thus provide capital to address pressing challenges in sectors underserved by traditional financial services such as sustainable agriculture, clean technology, and microfinance, as well as basic services like housing, healthcare and education. This approach requires active measurement of how environmental and social factors have been improved by the investment.

Impact investing is a much more direct approach than using screening and filtering tools, and in some instances blurs the line between an investment opportunity and a charitable initiative.

The impact investing market is currently estimated to include several hundred specialised fund managers with in excess of $30 billion under management. That is still relatively small in comparison to the overall Private Equity market, which is estimated to be worth c. $4.2trillion.

At Stonehage Fleming we characterise impact investing by three principles:

- The investor has the intention to have a positive social or environmental impact;
- A financial return on capital, or at least a return of capital, is expected (i.e. to distinguish it from a charitable donation);
- The environmental and social performance and progress of underlying investments is measured and reported, ensuring transparency and accountability.

However, impact investing is typically considered to be higher risk than traditional Private Equity, and investors should be aware that market rate returns may not be achieved. Management of investor expectations is therefore key.

INTEGRATING ESG FACTORS WITH INVESTMENT MANAGEMENT

To determine to what extent our external fund managers integrate ESG-criteria into their investment decisions, we surveyed our core 17 equity and bond managers, of whom 2 declined to participate.

Of the 15 managers that responded, we found that the majority incorporate ESG principles in their investment decision making process; however, as three quarters believe that socially responsible investment leads to higher returns, some of them may be motivated as much by improving financial performance as by the wish to be 'socially responsible'!

One of our external third party managers is focussed on investing in corporate bonds. The firm has put in place a dedicated ESG Policy Framework which guides their investment decision making, and has hired an investment analyst to focus solely on ESG related issues.

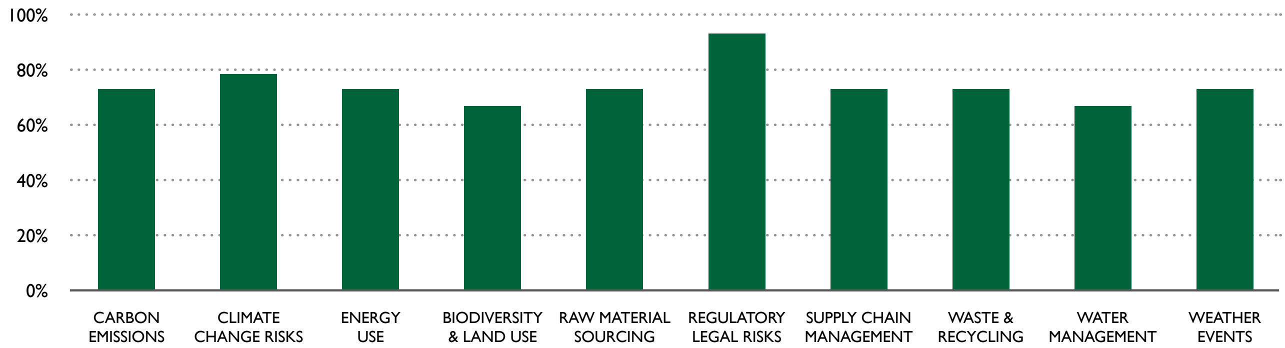
Prior to 2013, the fund manager had always incorporated some form of ESG review as part of a standard risk assessment of a business. However, after becoming a UNPRI signatory, they sought to formalise this approach and incorporate ESG factors into the risk management process.

The ESG focus among these managers centres on potential threats to a firm's business model, led by Governance issues, with high importance also attached to Social and Environmental factors. At least 85% (13 of 15) of surveyed managers consider each of the Governance factors listed, and every manager considers bribery or corruption, ownership structure and transparency when making investment decisions.

Of the Social factors explored, employee relations was deemed most important. The example of Sports Direct in the UK illustrates why; in this case workers employed on zero hours contracts experienced conditions compared by a committee of MPs to Victorian workhouses[1]. A hugely damaging report had serious consequences for both the firm's public profile, and its share price.

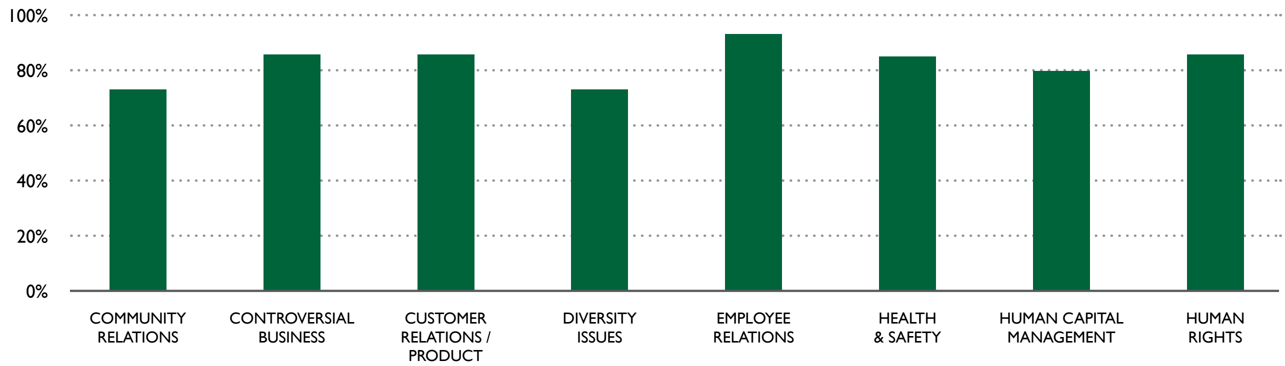
The following charts demonstrate to what extent different ESG criteria are being incorporated into the managers' investment decision making.

CHART 1: ENVIRONMENTAL FACTORS



Source: Stonehage Fleming manager survey, July 2016

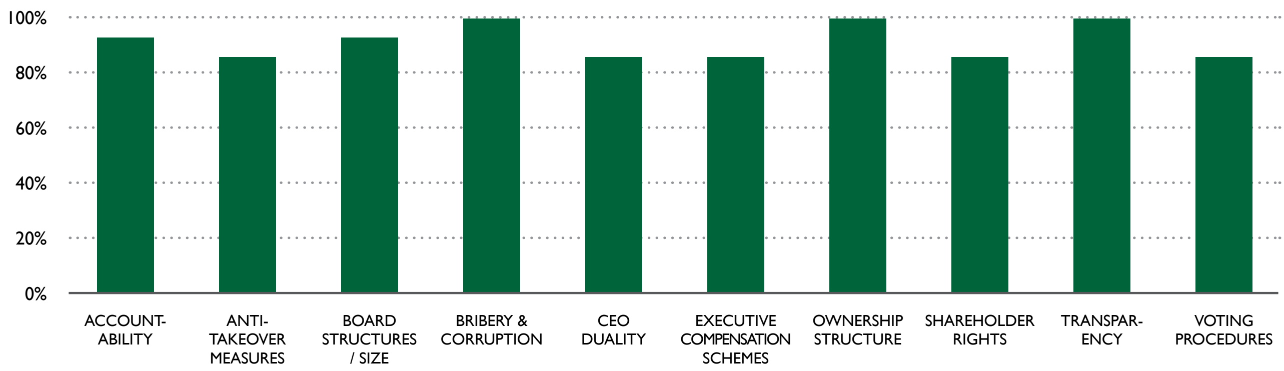
CHART 2: SOCIAL FACTORS



Source: Stonehage Fleming manager survey, July 2016

1. https://www.ft.com/content/d4b89c2a-4f65-11e6-8172-e39ecd3b86fc

CHART 3: GOVERNANCE FACTORS



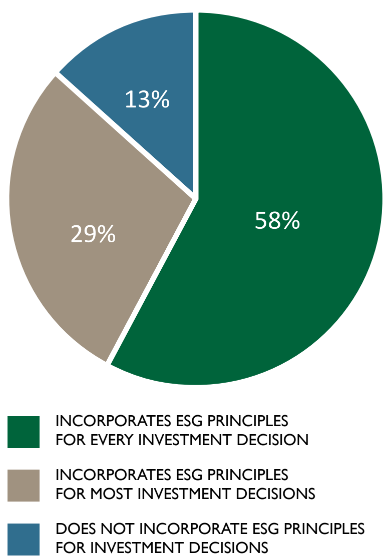
Source: Stonehage Fleming manager survey, July 2016

The clear conclusion is that many investors incorporate SRI principles into their analysis without necessarily labelling themselves as such. The most common form of this is through 'ESG integration'.

This approach is based on the assumption that companies that score well on ESG metrics will generally be characterised by a lower risk profile, and may therefore attract a higher valuation.

It is therefore apparent that the trend towards ESG has influenced best practice across the whole investment industry, and will probably continue to do so for some time to come.

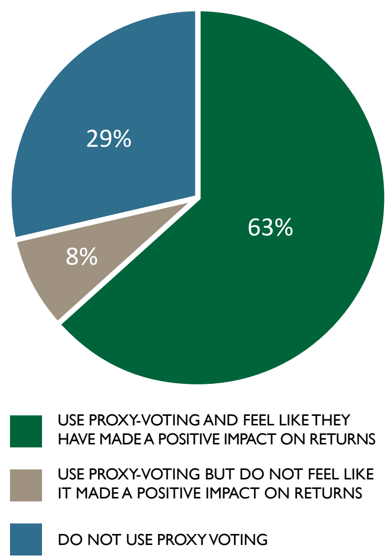
CHART 4: SURVEY OF MANAGERS



Source: Stonehage Fleming manager survey, July 2016

The survey also found that 67% (10 of 15) of the surveyed managers actively engage with companies to improve sustainability, mainly through proxy voting.

CHART 5: SURVEY OF MANAGERS



Source: Stonehage Fleming manager survey, July 2016

Furthermore, nine of the fifteen fund managers interviewed are members of the UNPRI initiative, which works with its international network of signatories to put principles for responsible investment into practice.

We are therefore encouraged that whilst not fully SRI compliant or marketed as SRI solutions, a high proportion of our third party managers actively consider ESG/SRI criteria within their fundamental investment process.

IMPACT INVESTING THROUGH PRIVATE CAPITAL

The above review considers our allocations to the more liquid components of the market (Fixed Income and Equity). However, within our Private Capital team, we have been closely engaged with impact investing and have established relationships with some of the pioneers in the industry. A recent UBS report showed that 61% of family offices are now active or expect to be active in this area.

One such example invests in commercially viable and scalable businesses in Africa and Asia which promote financial inclusion, as well as access to healthcare services. It was one of the early backers of the company ***in the case study below***.

One South African company, which focusses on providing life insurance to HIV sufferers in Africa, provides an illustration of the type of business covered by impact investing.

This company has developed innovative processes and partnerships that have enabled it to profitably insure over 20,000 HIV sufferers. The company also allows customers access to traditional bank lending, including housing finance.

More recently they have expanded their services to cover diabetes, providing a platform for international company growth.

Another well respected business in this area is one of the pioneers of impact investing in the UK. The firm targets areas such as job creation in areas of high unemployment, building environmentally-friendly elderly care homes, and providing financing for youth employment programmes.

We believe that this is an area which will have growing relevance to wealthy families as the barriers between wealth management and philanthropy begin to blur. Specifically, it will enable families to achieve some of their explicit social and philanthropic objectives through this component of their investment portfolio. Unfortunately, impact investing does require a degree of scale and a tolerance for illiquidity and may not be appropriate for all investors.

CONCLUSION

The investment industry has seen a rapid but inconsistent increase in SRI related approaches coming to market. This has resulted in a complex and varied opportunity set which can be difficult to navigate. Without a universal definition of what constitutes SRI, there is room for 'greenwashing'.

An additional challenge for investors is that they themselves will have differing interpretations of what constitutes a valid approach.

We believe that SRI is becoming increasingly important not just from an ethical perspective, but also because it forms the basis of sound fundamental investment.

Whilst the resources required to create a customised solution are substantial and are more the domain of pension and endowment funds or single family offices, we are encouraged by the extent to which our third party managers are incorporating basic ESG factors into their research process. This leads to our investment solutions exhibiting a high degree of overall ESG awareness. Our Private Capital team are also actively engaged with a number of 'impact investing' initiatives, although this remains a niche component of the market.

We view this document as fulfilling several functions – as a guide to investors learning about SRI, an analysis of the types of issues that investors might wish to consider, and an exploration of the extent to which SRI/ESG factors are incorporated into our existing investment portfolios.

It is however only a summary, and we continue to engage actively with the market and our clients to meet our twin goals of delivering exceptional portfolio performance, while doing so in a manner consistent with the values of our clients.

"Philanthropy and social responsibility are at the heart of our philosophy and our culture - we believe that playing a useful role in the community is a moral imperative"
Giuseppe Ciucci - Group CEO, Stonehage Fleming

APPENDIX:

POSITIVES AND NEGATIVES OF SRI APPROACHES

We highlight below our perception of some of the positives and negatives of the different SRI approaches, and the challenges of SRI in general.

	POSITIVES	NEGATIVES
NEGATIVE SCREENING	• Peace of mind • Encourages companies to meet criteria • Reduces risk of exposure to companies with poor ESG scores • Reduction in universe can enhance investor's focus on fewer stocks	• Excluding companies or sectors might imply giving up on good investments and thus higher returns • Challenge in matching screen criteria to investors' own preferences
POSITIVE SCREENING	• Thematic investing allows investors to make a more direct impact • Sustainable companies are expected to outperform peers in the long term, and may generate higher returns • Might encourage companies to become sustainability leaders • Best-in-class reduces long-term risk	• Positive screening does not filter out specific sectors • Requires a more intensive process, likely therefore to cost more and require specialist skills
IMPACT INVESTING	• Impact is not a by-product • Active measurement of impact • Specific focus on sustainability themes chosen by investor	• Risky and usually illiquid • Limited amount of investments available • May be some reputational risk if seen to be profiting from poor communities

FOR MORE INFORMATION

Kirsten Boldarin
Partner - Investment Management

Kirsten is a Partner of Stonehage Fleming Investment Management, coordinating investment research and developing individual portfolio strategy. She also shares responsibility for a number of client relationships.

Prior to joining the Group in 2006, Kirsten worked for Old Mutual Asset Management in Cape Town. She holds an honours degree in Actuarial Science (Quantitative Finance) from the University of Cape Town. Kirsten is a CFA Charterholder.

Caspar Helmore
Senior Associate - Client Management

Caspar is a Senior Associate within Stonehage Fleming Investment Management.

Prior to joining the Group Caspar worked at Thurleigh, a boutique asset management firm, where he spent four years as a Portfolio Manager focussed on investment research and managing client accounts. He has an Honours degree in Modern Languages and is a CFA Charterholder. Caspar is on the Board of Governors at a school in London, where he chairs the Finance Committee.

enquiries@stonehagefleming.com
For other Stonehage Fleming Know How Bulletins please visit www.stonehagefleming.com

stonehagefleming.com