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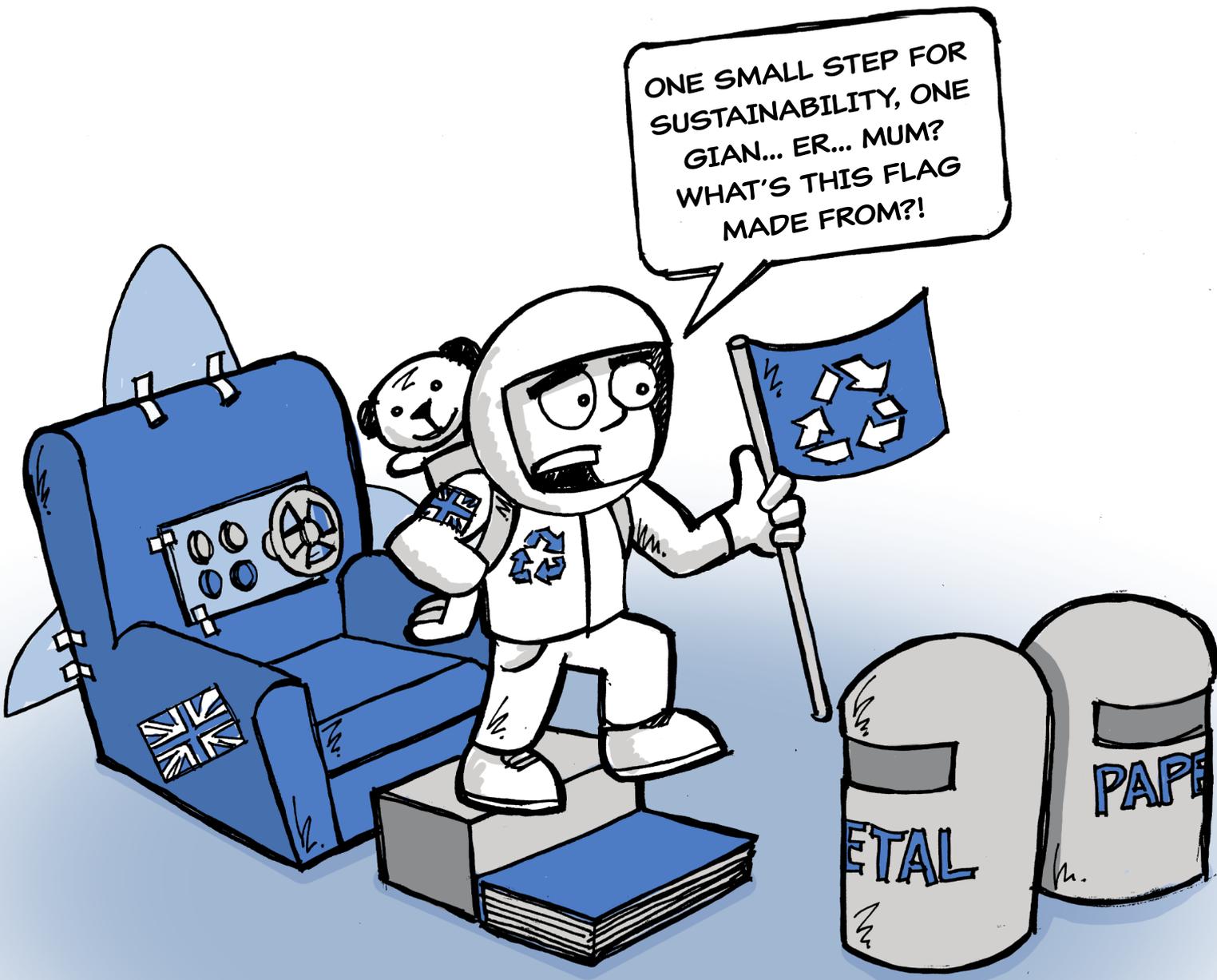
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BARNETT
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WEALTH MANAGEMENT

Taking small steps towards a more sustainable world



“ You must unite behind the science. You must take action. You must do the impossible. Because giving up can never ever be an option.”

Greta Thunberg
Addressing the US Congress, Washington DC, 17 September 2019

The discussion of climate change, and more broadly building a sustainable model for the future, has become mainstream. Whilst the enormity of the challenge can seem daunting, we can all make a difference. The problem is that we face a range of trade-offs and contradictions; for example, we may dislike fossil fuels and CO2 emissions, but we still drive diesel cars and fly to nice places for our holidays. However, we can all take sensible ‘steps in the right direction’ in our daily lives that can make a difference, including how we invest. A simple continuum from traditional portfolios to impactful direct investments provides a range of choices. We feel that maintaining the structural integrity of portfolios and adhering as closely as possible to our tried and tested philosophy, whilst identifying funds that favour companies trying to make a difference, is a prudent and worthy first step, for those who want to take it.

Feeling the heat

It does feel as if the world is at an inflection point: step up to the challenges of global warming and other non-sustainable pressures on the Earth’s resources today or let our children and grandchildren reap the havoc of the melting ice caps; sea water level rises; deforestation and a decline in biodiversity; desertification and the potential social and migratory upheaval that will accompany it. To some this may seem alarmist, but to the vast majority of people it is – or is becoming - a personal call to arms. Most of us are aware of the problem – highlighted by the recent bush-fires in Australia - and have taken steps in our lives to try to at least do something: boiling half a kettle; buying a more fuel efficient or hybrid car; avoiding products with palm oil; offsetting long haul flights; or simply taking our own reusable water bottle with us rather than buying a single use plastic bottle. Coca Cola uses a staggering 3 million tonnes of plastic every year for single use bottles and packaging. To put that into perspective, that is equivalent to the weight of 15,000 blue whales¹, just from one company. Surely that is not the way forward.

Our consciences have been piqued by the likes of David Attenborough in his Planet Earth II series and his appearance at Glastonbury in 2019, and also by Greta Thunberg who has challenged both the political leaders around the world and the older generations to take responsibility for the mess we are in, for the sake of future generations.

The internal challenge that many people feel is whether or not, on their own, they can really make any sort of meaningful difference, or if anything they do is simply a drop in the ocean. After all, looking at the data on CO2 emissions², we see that China, USA and India account for nearly half of all emissions, whilst the UK represents 1% of emissions out of the EU's 10% contribution. The answer is 'yes', we can make a difference! The great cheers at Glastonbury for Attenborough - combined with the efforts of the organisers to reduce waste - made a meaningful impact on the filth and plastic rubbish usually discarded: one million fewer plastic bottles were used by the 200,000 revellers and there was an 80% reduction in other debris, such as tents left behind³.

The UK, as a whole, has made some positive steps in greenhouse gas emissions which have fallen by around 45% since 1990, according to government statistics⁴. Renewable energy represented almost 40% of all energy production in the UK in 2019, up from around 10% a decade ago⁵. Last year was the first year in the UK that renewable energy sources and nuclear power delivered more electricity than gas and coal-fired power stations. We have become a world leader in wind-farm technology. We still have a long way to go.

We are all conflicted

The concept of sustainability – in its broadest and simplest sense – is to organise the world in a way that ensures that the health of the Earth, the use of its resources and the well-being of future generations are safe-guarded against the claims of the present. Today's generations are at risk of taking too much now and letting future generations pay. Few would argue that this is not a reasonable and worthy goal.

In our heart-of-hearts, many of us know that we are conflicted in our attempts to manage our carbon footprint. We will diligently recycle paper, glass and plastics on a regular basis, wheeling out the green bin every Sunday night, yet will jump into our large comfortable petrol or diesel cars and head off to Heathrow for a holiday in the Far East.

From a broader sustainability perspective, every decision we make has an impact. We probably don't think too hard about simple decisions such as buying a pair of cheap jeans and a T-shirt. Yet it requires around 20,000 litres of water⁶ to produce these two items. The rights and conditions of garment workers are still poor in many parts of the world. The ecological footprint of pesticides, water use and chemicals used in the dyeing process, and the CO2 emissions of transporting the finished garments to our shops half-way around the world, is high. Corruption and poor governance remain rife in many countries. Sometimes we need to pause and think about our choices.

Another example is switching from cow's milk to almond milk, which is a big improvement from a sustainability perspective as it materially reduces greenhouse gas emissions and land use, yet it still takes 74 litres of water to produce just one glass of almond milk⁷, far higher than oat or soy. California produces around 80% of the world's almonds, which is having a very severe impact on its water reserves, increasing pesticide use and damaging bio-diversity. We could just pour a glass of water.

Even Greta Thunberg found herself embroiled in controversy when it was revealed that although she had taken a moral stand to sail, rather than fly, from Europe to the US to attend the UN climate change conference in a zero-carbon yacht, the yacht's owners had to fly two crew to the US to bring the boat back!

Taking 'steps in the right direction'

At a governmental level, it seems to be two steps forward and one step back. The US has pulled out of the 2015 Paris Accord and the recent 2019 United Nations Climate Change Conference - also known as COP25 - held in Madrid was underwhelming in its conclusions, to say the least. The positive is that the sense of urgency is growing along with pressure on governments from the people they represent. A tension naturally exists between rapidly developing economies who want to promote growth and the welfare of their citizens that healthy capitalism brings, and tackling climate change. China, for example, has made great strides in the use of renewable energy to meet its energy needs but has increased its coal power generation capacity by almost 5% in the 18 months to June 2019 compared to a decline of 8% in the rest of the world⁸. Western economies cannot crow. The US remains one of the highest user of energy per capita and lobby groups continue to push the case for unsustainable practices, companies and industries. An element of game theory also exists: why would one country trying to do what's right economically disadvantage itself while others are failing to either meet their obligations or to sign up to them in the first place?

We would certainly like to think that we live in a country that wants to play its part fully and lead the way for others to follow. Perhaps we can benefit economically by becoming a world leader in sustainable energy technology and production and become a role model for sustainability in industry, urban and countryside environments. Glasgow and Edinburgh are in a race to become the UK's first net-zero carbon cities, well before the Scottish Government's target of 2045. Perhaps the next climate change summit to be held and chaired by the UK in Glasgow will be an opportunity to force some real action, given the growing sense of urgency that exists. We can only hope.

On a personal level, there are all sorts of things that we can do to improve the sustainability of our lifestyles, perhaps starting with understanding our own carbon footprint in more depth. The UN, for example⁹, has a simple-to-use calculator that provides useful insight that compares your lifestyle emissions relative to the UK and world averages and ideas about how this can be offset. Be prepared to be surprised, not necessarily in a good way! We can be mindful of the electricity we use, change our car less frequently, consider the impact of the holidays we take, the food we eat and direct our consumer purchases toward more sustainable businesses. We can also consider how we invest our money. Today US\$1 out of every US\$4 under professional management in the US (around \$12 trillion) incorporates some form of sustainable/socially responsible investing strategy¹⁰.

Taking 'steps in the right direction' in your investments

We have certainly seen a trend towards a growing focus on sustainability by companies themselves, investors looking to make a difference and fund management firms defining how they will construct more sustainable portfolios for these investors. Although 'ethical' funds have been around in the UK for some years, they were traditionally quite binary in nature, excluding the companies and industries such as alcohol, tobacco and arms.

In the last few years the investment industry has begun to focus on integrating the reported environmental, social and governance credentials – or 'ESG' as they have become known - of companies around the world into their investment processes and portfolio construction. These are metrics such as CO2 emissions, governance policies and the way in which they treat stakeholders in the business. The data is improving, particularly in larger and more developed markets and there is increasing pressure on reporting this data in a standard, timely and transparent manner. It is still a brave new world out there; the data tend to provide more of an indication of the direction of travel and broad quantum than any sense of accuracy and is sometimes at danger of 'green-washing', where the reporting is more a PR exercise than forming part of the core values of the firm in question.

- Environmental issues: biodiversity loss, greenhouse gas emissions, energy efficiency, renewable energy, resource depletion (including fresh water), ocean acidification, ozone depletion, etc.
- Social issues: mass migration, wealth distribution, access to healthcare, workplace health and safety, diversity, employment rights, child labour, slavery and indenture, controversial weapons such as cluster bombs, etc.
- Governance issues: executive compensation, bribery and corruption, independent directors, ethics in business, transparent disclosure of ESG criteria, whistle-blowing policies, stakeholder relations and the implications of business strategy on social and sustainability issues.

Perhaps the easiest way to break up the options is to think about a continuum from traditionally structured portfolios, say on the left-hand side, where investors are concerned primarily with the financial risk and return characteristics of their portfolio. At the other end of the spectrum are portfolios where the primary goal of the investment is to make a material impact through the funding of specific, targeted investments. Return of capital is not certain and certainly a return on capital is a secondary requirement. At the extreme right-hand end sits philanthropy where money is passed to good causes with the only financial return being a tax deduction. The diagram below provides a generic view of this world and not all funds will fit exactly in these categories. The general concept is helpful.

Category	Investing	Impact	Philanthropy
Driver	Financial return (mainly public markets)	Direct involvement (often private markets)	Values
Financial outcome	Market returns and characteristics	Return of capital plus	Tax relief, satisfaction, social status
Strategy choice			
Return and risk characteristics	<p>Can make a meaningful difference.</p> <p>Returns are more broadly in line with traditional portfolios.</p> <p>Risks are controllable.</p> <p>Low cost systematic options available.</p>	<p>Investments can reflect very specific preferences.</p> <p>Potentially material structural difference to traditional portfolios.</p> <p>Risks such as stock and sector concentration, liquidity and corporate failure are harder to manage.</p> <p>Higher costs and active management.</p>	<p>Enjoyment of being able to support good causes close to your heart.</p>

Figure 1: How to think about your choices
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The traditional portfolios that we structure for clients are built on the evidence available to us that results in an investment philosophy that focuses on a number of key choices: to diversify broadly; capture the market returns on offer using systematic, disciplined, rules-based funds; and to keep costs low. These simple guidelines provide clients with a favourable chance of experiencing a comfortable investment journey and the financial returns that they need to fulfil their financial and lifestyle goals. As one moves from left to right, this is traded away in return for the potential to make a more directly measurable and significant impact.

An approach that overweights firms with 'better' ESG credentials and underweights those with 'worse' credentials, and which broadly sticks to the country and sector allocations that one would choose in the absence of ESG screening, can still make a surprisingly material difference whilst preserving the underlying risk and return characteristics sought. As this is new field, only a few high-quality products exist, which are generally in the more mainstream asset classes such as developed market equities. Each product also tends to have its own focus and process for incorporating ESG. As such, portfolio construction inevitably focuses on moving the portfolio into generally better space, rather than matching a specific list of wants and needs. Every week new products are being launched. Investors face the choice of either excluding assets where no sensible product exists or using a 'traditional' product that does not include any direct ESG methodology. Generally, the latter course of action helps to maintain the structural integrity of an investor's portfolio, having taken a 'step in the right direction'. Over time, as more quality product becomes available further steps can be taken to improve the portfolio's sustainability credentials, but only when these funds pass muster.

In conclusion: oak trees out of acorns grow

It is easy to feel somewhat helpless when it comes to sustaining the world for future generations, as well as one's own. Yet, we can make a difference and sometimes more than we might think by changing the way we live our lives and, as part of that, how we invest. For many being able to make a difference, whilst not jeopardising the returns and risk control of a sensibly structured portfolio, may be something worth considering. This is a relatively new world, where data and metrics are evolving, new products are being brought to market and in which there is no perfect solution. All choices require trade-offs. We believe that investors can take a first, yet meaningful step towards a more sustainable world. It's a journey that we think is best navigated by sticking as closely to our guiding principles as possible and moving at a prudent pace. That requires a well-thought out long-term strategy, implemented using ESG-screened funds only when they are robust enough to earn a place in a portfolio. One step at a time...

End notes

1. Coca-Cola reveals how much plastic it uses. 14th March 2019 www.bbc.co.uk
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4. UK Government: 2018 UK Greenhouse Gas Emissions, Provisional Figures – Statistical Release
5. <https://www.gov.uk/government/statistics/energy-trends-section-6-renewables>
6. The Times (4 October 2015) Q: How much water does it take to produce a T shirt and a pair of jeans? A: 20,000 litres (paywall)
7. BBC (2019) Which vegan milk is best? <https://www.bbc.co.uk/news/science-environment-46654042>
8. Reuters (2019) China coal-fired power capacity still rising, bucking global trend: study, Nov 19 2019 <https://www.reuters.com/>
9. UN Carbon Offset Calculator: <https://offset.climateneutralnow.org/footprintresult>
10. GA Institute (2018) Breaking News: \$12 Trillion in Professionally Managed Sustainable Investment Assets – \$1-in-\$4 of Total U.S. Assets. <http://ga-institute.com/>

Other notes and risk warnings

Use of Morningstar Direct data

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