ESG
Investment Portfolios

FlyingColours

Introducing a modern approach to ESG investing. Building portfolios which are designed to have strong risk control and still make a positive impact on the wider world.

What is ESG investing?

ESG stands for Environmental, Social and Governance. ESG investing essentially means that the investment solution will seek to invest in businesses which aim to promote or limit the impact of the following activities:

Environmental

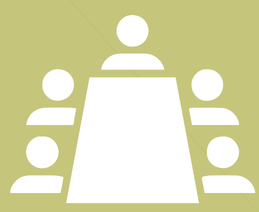
- Climate change
- Pollution
- Natural resource utilisation
- Biodiversity
- Water scarcity
- Waste management

Social

- Health and safety
- Positive labour relations
- Diversity
- Human rights
- Respect for the community

Governance

- Diverse leadership composition and oversight
- Fair executive compensation: structure, performance metrics, and oversight
- Minority shareholder rights protection
- Capital management, dividend payouts and dilution
- Corporate actions, such as Mergers & Acquisition and corporate strategy



As you can see, ESG investing is not just about protecting the environment and being "green". Instead, it has a broader focus on investing in businesses which can demonstrate that they:

- Have a robust approach to corporate governance and diversity; and
  - Are making a positive impact on the world and its people

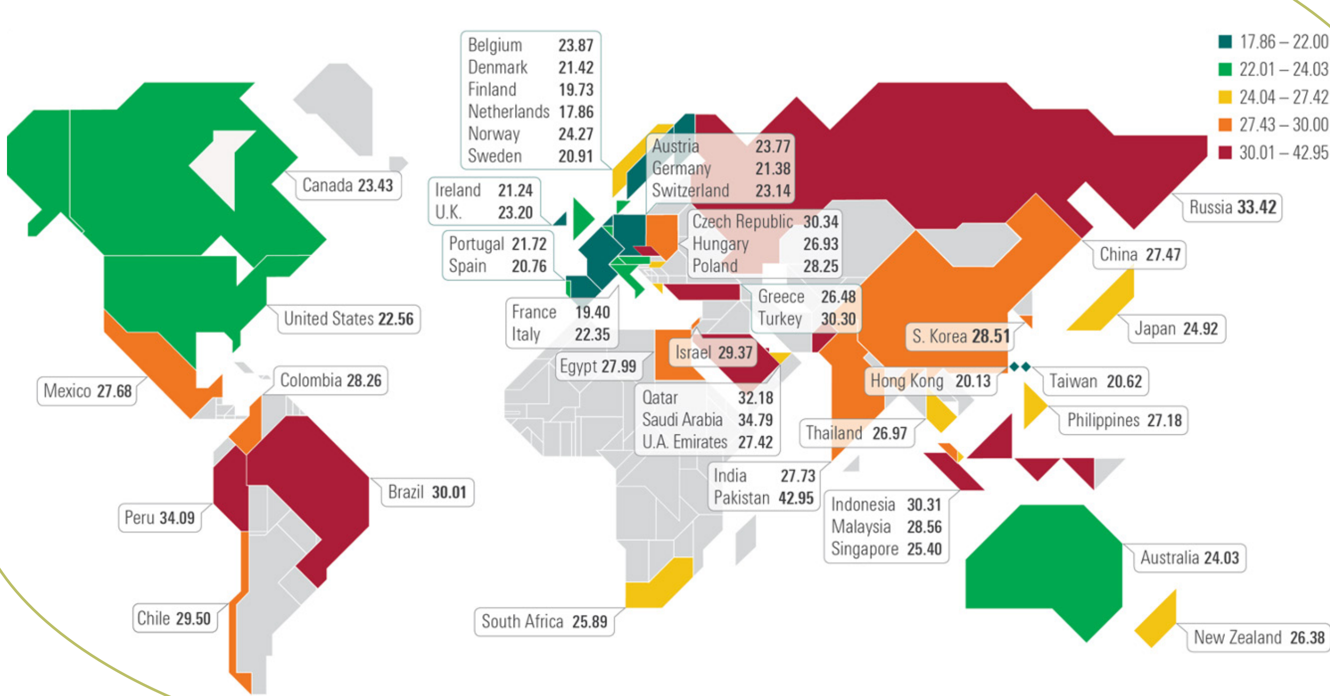
The challenge of ESG investing

As investment management professionals we recognise that there are certain biases within the ESG realm, which affect how a portfolio may perform. We have identified three areas that need to be managed. These are the:

1. allocation between equity (or risk assets) and safe haven assets;
2. different regions of the world where equity investments are made; and
3. style bias that is likely to occur within ESG multi-asset portfolios.

Safe haven, or lower risk, investments are important in portfolios. They complement riskier assets and often rise when the other is falling in value. This makes portfolios significantly less risky. Many ESG managers exclude the only true safe haven asset, these being Government Bonds, from their ESG portfolios based on a concern about defence spending. This doesn't strike the right balance for most investors, and we always include Government Bonds in our portfolios.

Regional equity allocation is another aspect of investing where many ESG multi-asset portfolios often exhibit bias. Multi-asset managers often have increased exposure to Europe and the US due to their advanced ESG considerations, neglecting global markets such as Asia. We believe that such choices are not in the best interests of clients in the long run, as they diminish both regional diversification and exposure to foreign currencies.



Source: Morningstar Direct

The last area of concern is style and sector bias. ESG metrics often lead fund managers to favour certain sectors over others. Generally, these sectors are highly valued companies which are expected to grow quickly in the future. This type of company has what is known as a "growth style".

Within the market there are always companies that are expected to grow quickly and are priced accordingly, alongside those which are mature and much less "expensive" to buy. There are regular cycles where growth outperforms value and vice versa. Holding funds only in "growth" stocks reduces your diversification and removes a lever from your fund manager to try and deliver better returns. We don't favour this approach as we don't believe it will meet our clients' overall investment objectives.

Our ESG Portfolio Principles

Our range of ESG portfolios have been designed to align with our investment philosophy and have three key aims:

1. To advance ESG standards which aim to be superior to those of the broader market.
2. Encourage better practices, wherever feasible.
3. Avoid activities with a particularly adverse impact on ESG.

This means excluding companies which:

- Engage in producing controversial civilian and nuclear or biological weapons, tobacco, and those generating income from thermal coal power and extracting specific fossil fuels.
- Are involved in severe controversies such as bribery and corruption, workplace discrimination, environmental incidents or corporate scandals which have significant financial repercussions.
- Do not comply with the United Nations Global Compact Principles.

This ESG engagement methodology therefore excludes “bad” funds from our portfolios and invests more in those which have ESG credentials.

However, rather than simply excluding or including companies based on ESG criteria, we incorporate ESG factors into our investment process. So, for example, we might invest in companies with a strong environmental record, even if those companies do not demonstrate all of the characteristics of ESG or are not viewed as a “pure” ESG business. For example, some of the companies we invest in may not meet the criteria of being “environmental” but have strong social and governance credentials.

The full make-up of the portfolios, along with the balance between equities and fixed income assets will differ according to your risk profile and will be rebalanced by our investment managers on a regular basis.

Is this ESG solution right for me?

As with any form of investing, there are pros and cons to investing in any ESG investment solution.

On the one hand, ESG investing enables you to support those businesses which are working towards making the world more sustainable.

On the other hand, even with the style of portfolio management we have chosen to adopt, the opportunity for diversification is reduced; in other words, there is a smaller pool of businesses to invest in.

It's also important to note that investment fees will be higher; this is because the fund managers need to monitor more businesses and analyse more data than they would do for non-ESG funds.

Our portfolios are specifically designed to target investment performance whilst controlling risk, therefore, our ESG portfolios are most suited to investors who:

- Want to reduce their negative impact on the world but also control their investment risk and performance.
- Understand that ESG investing can incur higher fees but want to work with investment managers who will work hard to achieve the investment returns which will meet their needs.
- Have a reasonable sum of money to invest – typically above £50,000.
- Are looking for a long-term relationship with a firm whose financial planning and investment management are at the heart of its offering.

Please note that our portfolios are not designed for those who have strong ESG preferences (i.e. not wanting to invest in certain companies,industries or regions). In these circumstances, you may require a bespoke investment portfolio which is structured around your ESG beliefs and preferences by an investment manager.

Your adviser will discuss your priorities, motivations and risk profile before recommending the most appropriate solution to help you achieve your goals, which could include an instruction to a bespoke investment manager if required.

Next steps

If you would like to know more about ESG investing and discuss whether it's the right approach for you, please contact your Flying Colours independent financial adviser.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