Ethical Investors

your money makes a difference

If you are reading this, then chances are that you are an investor that wants to do good with your money.

If this is the case, you may also want to know how exactly your money can do this.

This document has been produced to give you an overview of how your money, and specifically the way in which it is invested, can contribute towards better environmental, social, and governance (ESG) outcomes for all.

"As well as helping to secure your future and that of your loved ones, the way in which you invest your money has the potential to secure a better future for everyone."

Mike Head, DipFA – Director, Financial Adviser

"Capital markets underpin modern economies. By choosing how you invest, you can play a role in influencing these markets with a view to increasing sustainability across the globe"

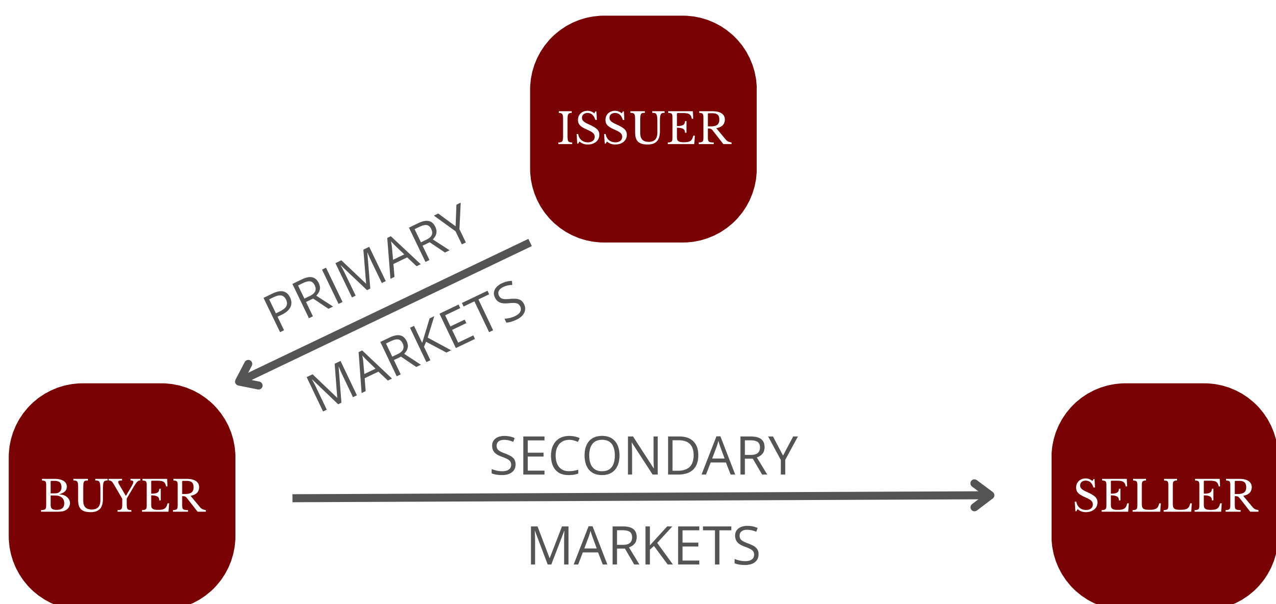
Cameron Barker - Communications and Marketing Lead

The first important aspect of capital markets is to understand the difference between primary and secondary markets.

Primary capital markets are where new securities (e.g. shares, bonds, etc.) are issued for the first time. Here, a company may sell its first shares via an "initial public offering", or issue new corporate bonds, as a means of raising capital for expansion or development.

In these markets, a buyer of a security is directly financing the issuer (i.e. seller) - the money raised from the sale of the security goes directly in the company's pocket.

Secondary markets are where securities are traded after their first sale. Here, the money spent by a buyer of a security goes to the seller of the security – NOT the company that first issued it.



Why, then, can the way in which money is invested make a difference, if the buying securities in the secondary markets does not finance the companies in question? This is explained in the following sections.

Engagement

The first way in which your money can contribute towards improved ESG outcomes is via engagement.

When you buy shares in a company, you are buying a share of the company's equity. In effect, this means you own a part of the business, and thus are entitled to your say in how that business is managed.

If you choose to invest via a manager that is willing to do so, your manager can engage with the companies that you are a shareholder of. A number of managers within the sustainable finance space are willing to do this, and often have engagement, "active ownership", or "stewardship" policies and frameworks in place.

These polices and frameworks outline how the manager goes about engaging with companies in regards to ESG matters, and if enough shareholders and managers conduct such engagement, they can play a role in changing the practices of a company for the better

Engagement is often based on a combination of the following techniques:

Direct engagement with companies:

This involves representatives from an investment manager meeting with management of a company. In these meetings, representatives from an investment manager may outline their concerns, and those of the shareholders they represent, and seek to influence company management to change the way they run the business. For example, they might encourage the company to improve its ESG reporting, or implement an environmental management system.

Annual General Meeting (AGM) Voting:

This method of engagement is less direct, and is based on investment mangers sending signals to companies by voting in certain ways at company annual general meetings (AGMs). They may, for example, vote in favour of shareholder resolutions relating to ESG matters, or even work to bring such shareholder resolutions.

After all, there are reasons why companies and their management wish to keep shareholders happy, and ensure that their share price doesn't fall due to swathes of shareholders wishing to sell their stake. This is discussed in more detail later.

Further Reading

To learn more about engagement and active ownership, see the following:

Un Principles for Responsible Investment - Stewardship

Rathbones – Engagement

LGIM - Investment Stewardship

Castlefield – Stewardship at Castlefield

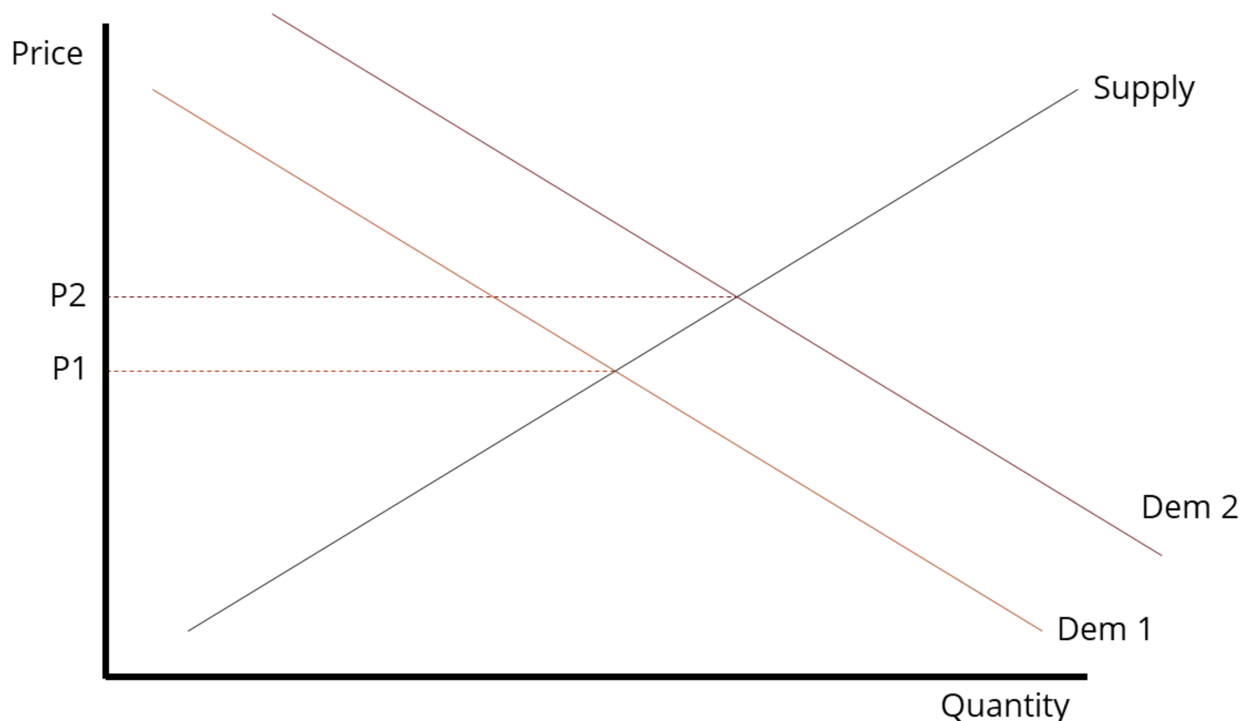
Access to Capital

The way in which you invest your money can also help more sustainable companies in the long-run by increasing their market value.

Market value (a.k.a market capitalisation, market cap), n. – the value of a company obtained by multiplying the number of its issued ordinary shares by their market price.

Oxford Dictionary of Banking and Finance, 4th ed.

According to the basic theory of supply and demand, the more investors demand shares in companies that show strong ESG credentials, the higher the price of those shares is likely to increase, assuming no increase in supply (see the jump from P1 to P2 below):



As a result, the market value of the company is increased; the more investors demand shares in companies that perform well in regards to ESG, the higher the market value of these companies.

Why, though, does this benefit companies? To put it simply, the higher the market value of a company, the easier it is for that company to raise capital for use in future expansion and development. This is due to the following reasons:

Effectiveness of future share issues:

The higher a company's share price, the more capital it can raise in future via the issues of new shares.

Ease and affordability of debt financing:

High market value is seen by lenders as a sign of overall financial health; lenders are more likely to provide companies with loans if they do not see them as a higher risk.

Reduced cost of capital:

As discussed above, a higher market value is seen as a sign of less risk. Lenders (i.e. banks and primary market bond purchasers), are happy to accept lower returns if their investment is lower risk, thus reducing the cost of borrowing for a company.

Ability for expansion via acquisitions:

Shares can be used by company’s as currency in acquisitions; the higher the value of their shares, the stronger the purchasing power of these.

Market Signalling

As discussed in the previous section, a high share price can benefit a company. It can also the benefit its leadership, given their pay is often tied to its share price.

As also discussed, the greater the demand for shares in a company, the higher its share price. As such, companies and their leadership seek to maximise their share price.

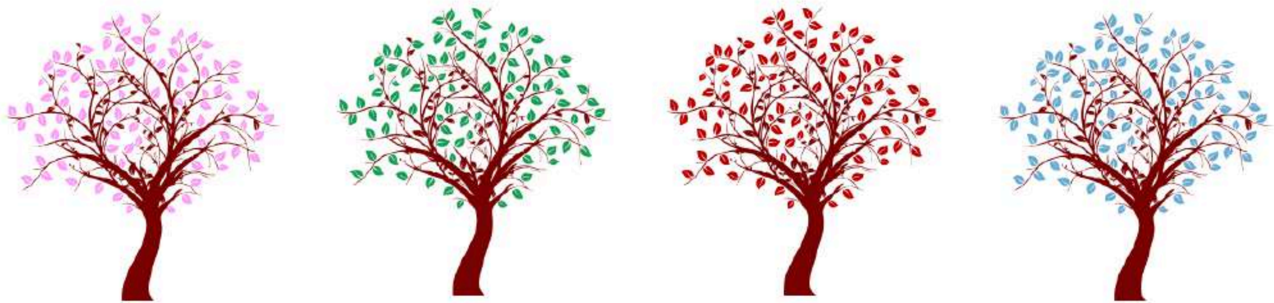
Now, if large quantities of investors demand shares in companies that perform well in relation to ESG, that will drive up the price of their shares. This sends a signal to other companies in the market that improving their own ESG credentials can drive demand for, and thus price of, their shares.

Naturally, then, they may wish to do just that. Companies will begin to acknowledge that there is a demand for shares in companies that perform well in relation to ESG, and they will seek to tap into that demand.

It should also be noted that the above also applies to investment funds. It's likely that, as an individual investor, a proportion of your portfolio will be invested in funds (i.e. you will own a unit, or share, of these funds).

If investors such as yourself wish to invest responsibly, there will be more demand by investment managers for investment funds comprising holdings that have strong ESG credentials. Fund providers, therefore, demand shares in these companies, and the above mechanism applies.

It may be a little more complex, but the system is the same.



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With you, through every season