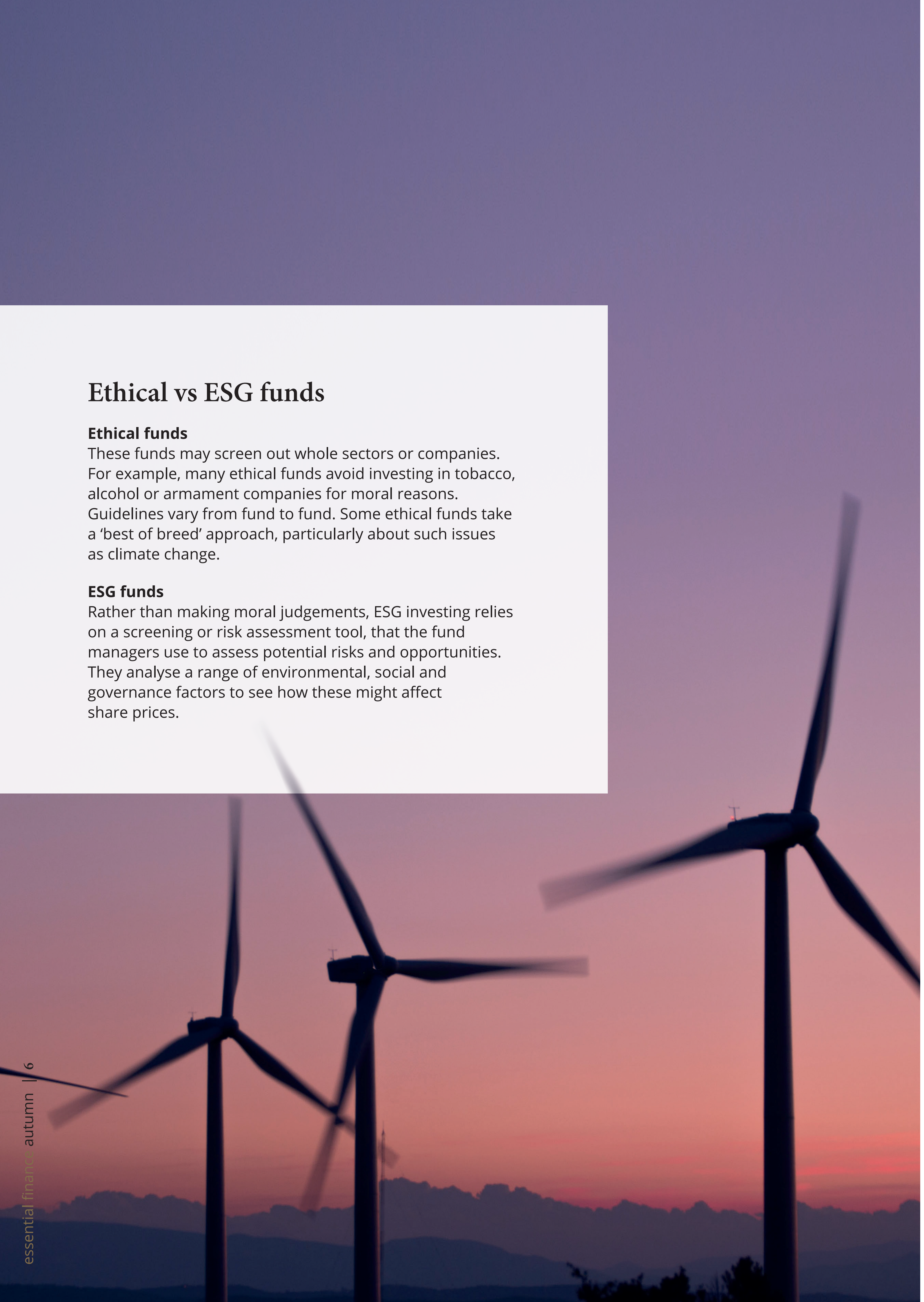

Ethical vs ESG funds

Ethical funds
These funds may screen out whole sectors or companies. For example, many ethical funds avoid investing in tobacco, alcohol or armament companies for moral reasons. Guidelines vary from fund to fund. Some ethical funds take a 'best of breed' approach, particularly about such issues as climate change.

ESG funds
Rather than making moral judgements, ESG investing relies on a screening or risk assessment tool, that the fund managers use to assess potential risks and opportunities. They analyse a range of environmental, social and governance factors to see how these might affect share prices.

ESG investment comes into its own

Taking a more principled approach to investing doesn't mean you necessarily have to sacrifice returns.

This year has been a rollercoaster ride for investors, with markets falling sharply in March as the economic effects of the Covid-19 pandemic became clear. There has been some recovery, although prices remain volatile.

Yet certain funds seem to have fared better than others during this period of turbulence. In many cases, these are funds that engage with a range of environmental, social and governance (ESG) factors alongside standard financial metrics for selecting shares. This is also often labelled 'responsible investing'.

Whereas some ethical funds (see text box) automatically avoid whole sectors, ESG funds do not. Instead they assess how, for example, a company's environmental policies — or lack of them — might impact its future share price. These are investment judgements, of course, so may not always turn out to be correct in retrospect.

ESG funds have generally weathered the recent market storms well. Research from Morningstar shows that in the first quarter of 2020 70% of ESG funds were ranked in the top halves of their investment categories which consist of funds invested in the same assets or geographic region. By contrast, just 11% of ESG funds were in their category's bottom quartile, indicating that they performed better than funds that did not look at these wider ESG factors when selecting stocks.

Bear in mind that this information covers a very short timeframe and there is no guarantee that ESG funds will continue to outperform. However, there are several reasons why these funds may have performed better during recent volatile markets and may continue this trend in the coming years.

One factor is that many have less exposure to oil companies, which have been hit by collapsing oil prices. The Covid-19 crisis has boosted other sectors too, such as those delivering technology solutions to help businesses and people work remotely. This may play into ESG themes about reducing travel and carbon emissions.

While much of the focus around ESG is on environmental issues, it's important to remember that the selection process most of these funds undertake also considers how well a company is run and its corporate polices on such issues as executive pay, gender equality and transparent supply chains.

Over the longer term it remains to be seen whether ESG fund managers will identify the companies that will prosper in future, but with many more people thinking carefully about where to invest their savings, ESG investment is no longer a fringe area. As with all investment decisions, you should take expert advice.

The value of your investments and the income from them can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit with your overall attitude to risk and financial circumstances.