TERMES. RISK. FOCUS.

A Service of the Termes Partnership LLP

ESG As An Integral Part Of Your Wealth

When the world's governments made a binding agreement at the United Nations Climate Change Conference in December 2015 to reduce CO2 emissions they were principally thinking about ice-caps and sea levels, but they did something incredibly significant for businesses too: they once and for all aligned doing well financially with doing good environmentally.

Since the Paris Agreement was signed, over 400 businesses and major institutional investors have signed the Paris Pledge for Action which makes a commitment to "reduce greenhouse gas emissions to a safe level" without waiting for the Agreement to come into force in 2020. The Paris Agreement was a defining moment in the history of ESG, and may turn out to be the single most important catalyst for making firms and investors think not just about financial results, but also environmental ("E"), social ("S") and governance ("G") issues.

ESG has been gaining traction for a long time. Until now the starkest example, perhaps, was when the Rockefeller Foundation announced that it was divesting from fossil fuel stocks last year. That a family whose fortune came from oil was going green was a powerful indicator that ESG had become an essential component of decision-making for major investors.

All of this comes as no surprise to us. One of our core principles at Termes has always been that clients should only ever invest in something when they have a high conviction that it is right for them. ESG considerations are a part of that, and always have been. To us, that has always seemed entirely natural.

We just think you probably want to know whether the firms you invest in use child labour or pollute the environment, and to be sure that the company doesn't systematically exclude women or ethnic minorities from their management, or don't pay their taxes and so on.

Established in 2002, The Termes Partnership is an independent firm exclusively serving family offices and family-owned businesses both large and medium-sized. We are not an asset manager or an intermediary for any financial services providers, all of whom we keep at arm's length. Our partners' expertise covers a wide range of crucial business functions required for the successful and effective deployment of family business & investment assets, including business strategy & governance, capital structure & project finance consulting, strategic asset allocation advice and technology consulting.

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We believe that these factors are as important in guiding your investment decisions as more traditional financial measures such as dividend yield and price to earnings ratio. None of this seems radical or even controversial to us. You don't have to be flying a flag for ethical investing to care about ESG.

THREE CHANGES

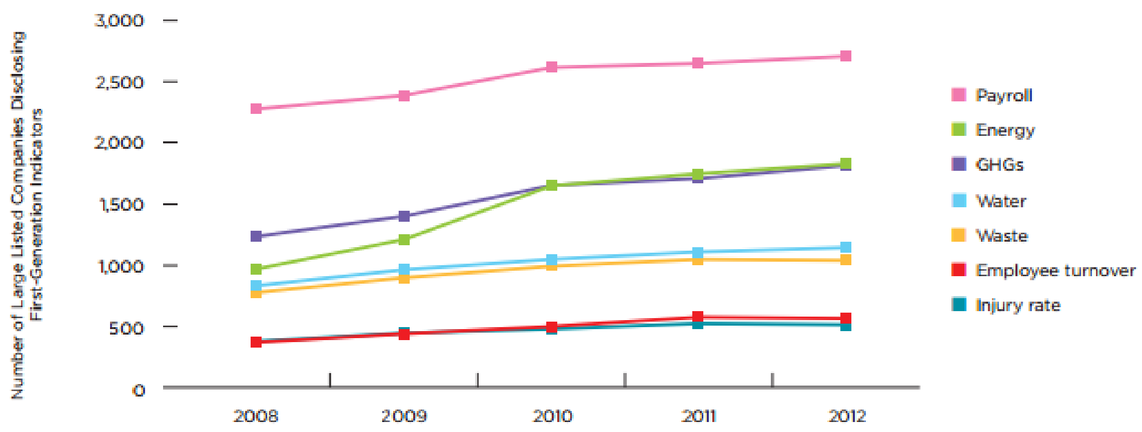
Investors have always thought about these questions; in a sense, only the label "ESG" is new, having come to prominence over the past ten years or so. That said, three large-scale changes have made ESG considerations more central to investors in recent years.

One is that investors have far more information about ESG now than they ever used to. In the past companies only ever reported financial information, but over the past 10-20 years firms have increasingly started releasing ESG information too.

According to recent research of 4,609 companies, each with a market cap of over $2bn, 60% disclose their payroll expenses and 40% their energy emissions, although fewer publicise their water usage and the amount of waste they produce. These numbers should be higher, but this is a huge improvement on knowing nothing, and disclosure is improving year by year. And as well as self-reporting, there are numerous bodies which monitor businesses' ESG behaviour, such as EIRIS (the Ethical Investment Research and Information Service.)

These days investors have the power to make informed choices about aspects of companies that they previously didn't, and they obviously want to use information to make the choices that are right for them.

Sustainability indicator reporting by the 4,609 largest companies, 2008-12



Source: Bloomberg, Corporate Knights Capital, "Measuring Sustainability Disclosure: Ranking the World's Stock Exchanges"

[http://www.corporateknights.com/wp-content/reports/2014_World_Stock_Exchange.pdf]

The second reason ESG is higher up the agenda is that globalisation has made these issues more pressing. As recently as 20 years ago the emerging markets were dominated by closed economies and business-unfriendly dictatorships, but many are now opening up to foreign investment and trade.

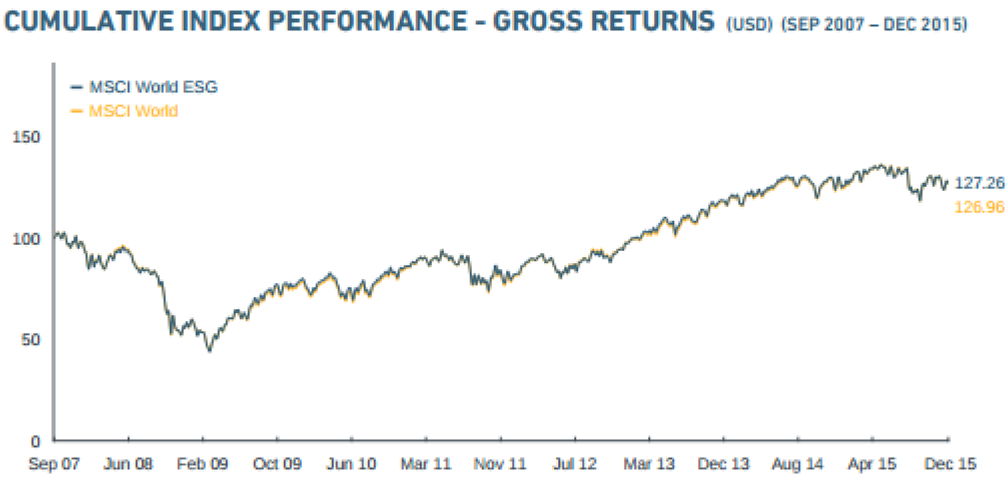
As a result big companies are exposed to business practices that might not be acceptable to investors. Offshoring means that supply chains are longer and often more opaque, opening them up to risks. So, even firms that used to be seen as solid-gold companies with impeccable reputations such as IBM, GE or Boeing are now prone to all sorts of ESG risks.

A third reason stems from the changing nature of the media, which means that citizens can blow the whistle and publish information about poor business practices. In the past you had to wait until the Guardian or the New York Times found out about that you were dumping waste in rivers.

These days anybody can upload the proof to YouTube and if it goes viral it can destroy your reputation - and share price - overnight. This is perhaps the starkest way in which behaving well can affect the bottom line, and shows that behaving well is not just right, but prudent too.

RISKY RETURNS?

This all sounds very nice, the cynic might say - but doesn't investing in companies with high ESG scores hit your returns? After all, you are reducing the number of companies you can choose from, aren't you? We just don't buy that argument. (The chart below shows that, at least for big companies, having good ESG scores makes almost no difference to share price performance.)



Source: MSCI

[https://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-esg-index.pdf]

Okay, if you decided to exclude huge swathes of investable companies - ones with less than 50% female board members, for example - then your portfolio's performance would probably suffer. But most people wouldn't do anything so radical.

And yes, there might be a hit to returns if you reallocated all your assets to companies with high ESG scores overnight. But why would you do that? The move can be gradual. Why wouldn't you want to travel in that direction?

If your aim is to construct a portfolio that tracks a market's performance with similar volatility, then there is no reason you couldn't do that and incorporate ESG principles into your investment choices.

There is just no reason that thinking about ESG means you have to abandon classic portfolio construction principles such as diversification, getting the right liquidity and maturity profile, ensuring the title to the asset and so on. ESG is just part and parcel of the decision about whether to make an investment.

The way we see it is that, whilst your investments can certainly cause you sleepless nights, this should not be because you didn't expend every effort to ensure you understood the attendant risks, both financial and ESG-related. Everybody agrees that your portfolio should fit your financial risk profile. We say that you'll sleep better if it fits your ESG risk profile too

And if the rest of the world is starting to agree, we can only say: what took you so long?

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