



ESG Investing guide

Together.
A better future.



Introduction

In the last decade Environmental, Social and Governance (ESG) criteria has played an increasingly important role when investing. The idea of investing purely for financial gain is often considered outdated. Investors are still looking for their assets to deliver a financial reward, but they also want them to have a positive impact on society and / or the environment. Furthermore, by integrating ESG considerations into investment analysis it can help investment managers to evaluate their potential impact on material risk exposures and growth opportunities for these companies.

ESG can incorporate many aspects, and in the absence of global and industry-wide standards, the criteria and methodology can vary between investment managers. In this document we define some of the terminology, look at the pros and cons and explain AFHs approach to ESG investing.

What is ESG?

ESG stands for Environmental, Social and Governance

More companies today are looking to improve their sustainability and impact on stakeholders, not just shareholders. ESG includes a whole host of measures that may not have been considered by companies and investors previously. Each of the three components have a range of contributing factors, but it's important to note that there is no definitive classification and the three often interlink and overlap.

Environmental

Simply put, this is the conservation of the natural world. The production process and our consumption habits contribute to climate change, carbon emissions, air and water pollution, resource depletion, waste, deforestation, water scarcity and more. Investors may want to measure the impact a company is having on the environment.



Social

This is the consideration of people and relationships. Companies can be evaluated on more than working conditions, human rights and diversity. Investors are now including customer satisfaction, data protection, employee engagement and community relations when looking at companies.

Governance

This looks at the process by which a company is managed and the standards for running a company. It includes the composition of the board of directors, the structure of the audit committee, executive compensation, lobbying practices, political contributions, whistle-blower schemes, bribery and corruption. Poor governance can have serious legal and financial repercussions for businesses.

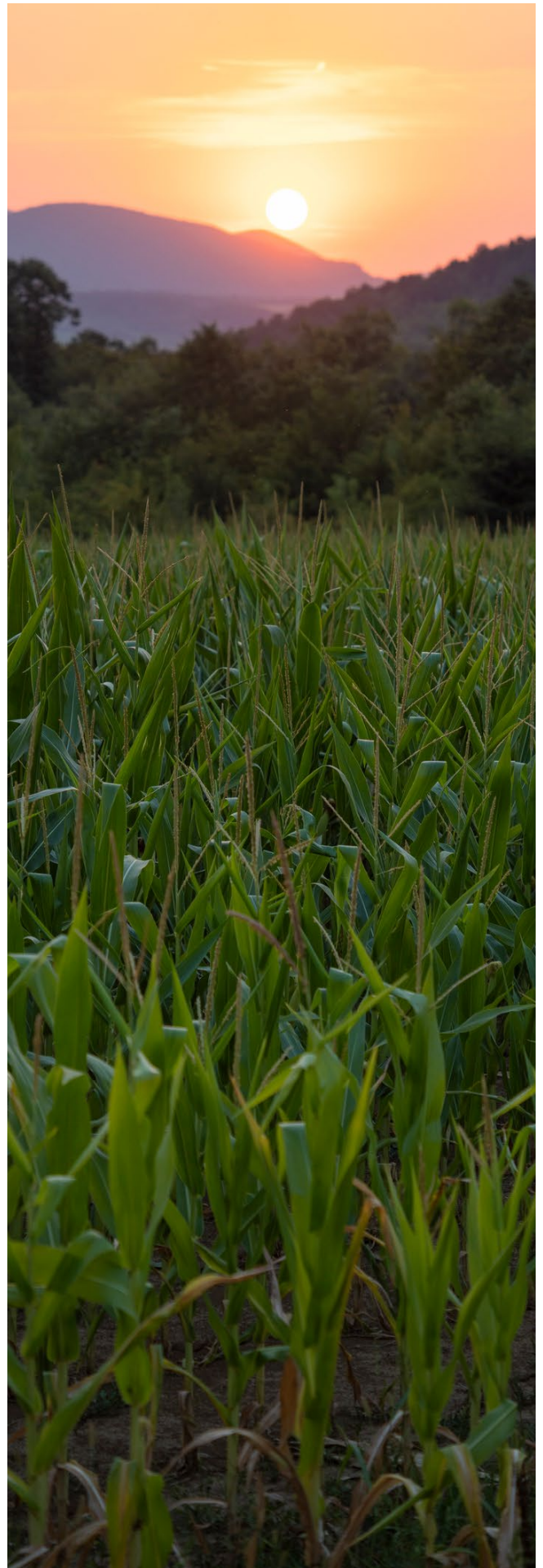


How does AFH implement ESG?

There isn't a globally accepted set of ESG metrics, or standards for how an ESG portfolio should look in practice. ESG remains subjective and approaches to investing can vary across a wide spectrum. Investment managers will often invest in a way that aligns most closely with the views and goals of their clients. Examples of this might include national pension providers focusing on social issues through specific workplace-related metrics, or wildlife charities focusing on environmental issues by targeting carbon emissions and their environmental footprint. Investment management firms with broad investor bases will often take a less targeted approach to create portfolio options that benefit many investors at the same time.

Regardless of the approach taken towards ESG, it is important to be able to have measurable results to ensure that investments are behaving as intended. When investing in collective investment funds ('funds') rather than directly in individual companies, like AFH does, this measurement becomes difficult. This is because every fund is different with distinct themes, criteria and targets. However, there are several data providers that aggregate data in each of the environmental, social and governance categories, with many of them creating a score to allow for comparisons and clear-cut output.

Detailed later in this document, we carefully balance our criteria for fund selection with specific and measurable outcomes.



What can clients expect from AFH sustainable portfolios?

Our clients can expect AFH sustainable portfolios to keep away from what people typically consider 'sin'

companies, whilst positively contributing towards the United Nations' Sustainable Development Goals*.

Funds must meet our strict criteria before being considered for inclusion in our portfolios. We try to reduce certain industries by placing limits on maximum revenue exposure from them. This helps us to reduce exposure to these 'sin' companies.

We're placing a 5% maximum revenue limit on the following industries:

Involvement Categories[†]



Alcohol



Fur & Specialty
Leather



Gambling



GMO



Military
Contracting



Nuclear



Palm Oil



Pesticides



Small Arms



Thermal Coal



Tobacco

Maximum company revenue from industry
is 5% for each category

Funds we invest in must also demonstrate specific and measurable positive outcomes. They must contribute positively to the UN Sustainable Development Goals. We also favour funds that demonstrate they are actively engaging with company management to drive change and achieve positive outcomes.

The UN Sustainable Development Goals are a great way to demonstrate how our clients' investments are contributing to complex ESG issues and themes, as defined by the United Nations. Company engagement also offers a way for our clients to follow the real-life impact of their investments.

† Sustainalytics' (a leading ESG research provider) Product Involvement categories measure a portfolio's exposure to involvement in a range of products, services, and business activities.

* The UN Sustainable Development Goals are 17 goals adopted by all UN members in 2015. They act as a universal call to action to end poverty, protect the planet, and ensure that by 2030 all people enjoy peace and prosperity. Further information can be found at: <https://sdgs.un.org/goals>



A note on exclusions

As we have demonstrated, ESG covers a wider scope than just exclusions. It can sometimes be the case that investors only want to exclude certain sectors such as oil and gas, gambling or tobacco producers, as examples. This may seem like a straightforward request, however with the variety of funds and their differing approaches, our portfolios won't align with specific exclusions. When constructing portfolios, we have taken a balanced view and have combined funds that take a positively tilted position towards certain ESG themes, as well as those that may exclude entire sectors. This allows for a diversified, ESG-aligned portfolio without limiting investment options that would skew the portfolio away from the desired level of risk and potential for financial return.



The drawbacks of ESG investing

Restricted choice

Applying ESG criteria to the investment universe reduces the number of opportunities available for investment. Whilst ESG investing is no longer a new phenomenon, there is still limited choice when it comes to fund selection. Weak performance of ESG funds in recent years (relative to 'non-ESG' strategies) has led to a number of fund closures which has further restricted the choice for firms like AFH. However, it is not just the number of ESG funds available that is restricted; the fund managers themselves are restricted to companies that fit their specific ESG criteria. This means that fund performance versus a broad country benchmark such as the FTSE 100 (for the UK) or S&P 500 (for the US) becomes less relevant. Funds can underperform by tilting their investment selection towards companies that deliver on specific and measurable sustainability outcomes, or by excluding certain companies or entire sectors.

Compromised returns

The act of restricting investment choice has the potential to reduce investment returns. There is a risk that, by excluding non-compliant companies, investors give up potentially attractive returns in exchange for more attractive ESG characteristics. It is unlikely that this risk will materialise on every occasion but it should be considered nonetheless.

Another perspective on this is that there is a larger amount of money flowing into a narrower range of companies, thereby pushing prices up to a level that deviates from the company's actual earnings, and thus reducing the total expected return on the investment. The more investors pay for future expected earnings now, the lower their total expected return.

Aside from the above, there are costs associated with implementing and improving ESG factors within a company. Additional costs can reduce a company's profits and therefore reduce returns to investors. Furthermore, companies that prioritise ESG factors over financial returns will inherently have lower investor returns, such as companies that are primarily working towards creating a positive impact on specific ESG factors.





No one-size-fits-all approach

There is no right way to invest with ESG, as different products suit different investors. Investors span a broad range of views, ethics, morals, values and objectives. They target different ESG themes for different reasons. What one investor considers important, another may be indifferent about.

This is often seen as a drawback to ESG investing. However, we consider this a great opportunity for

AFH clients to benefit from wide-ranging exposure across the ESG spectrum without targeting an individual sub-sector.

Our clients can take comfort in knowing their money is having a positive impact (via the UN Sustainable Development Goals) and limiting exposure to controversial industries, all without having to commit to one specific ESG issue.



Uncertain future and political vulnerability

Despite now having a reasonable track record, it is still too early to tell whether ESG investing works. In recent years ESG investors have experienced significant swings in performance, with returns coming in waves of euphoria and despair. Therefore, it can be difficult to separate out performance specifically in relation to the environmental, social and governance categories versus market sentiment.

There is no doubt that this approach to investing has grown in popularity over the long-term, helped in part by the push for international cooperation from supranational organisations. For example, the United Nations' Paris Agreement was signed in 2016 and covers climate change mitigation, adaption and finance. However, the politicisation of ESG

investing also brings with it the potential for political backlash. In recent years the rhetoric from different governments, and in some cases legal implications, has played an increasing role in performance. This brings into question the viability of ESG investing in some regions in the future.

It is important for investors to consider their objectives when investing. If ESG investing is the primary objective, it should be expected that financial gain may need to be reduced.



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