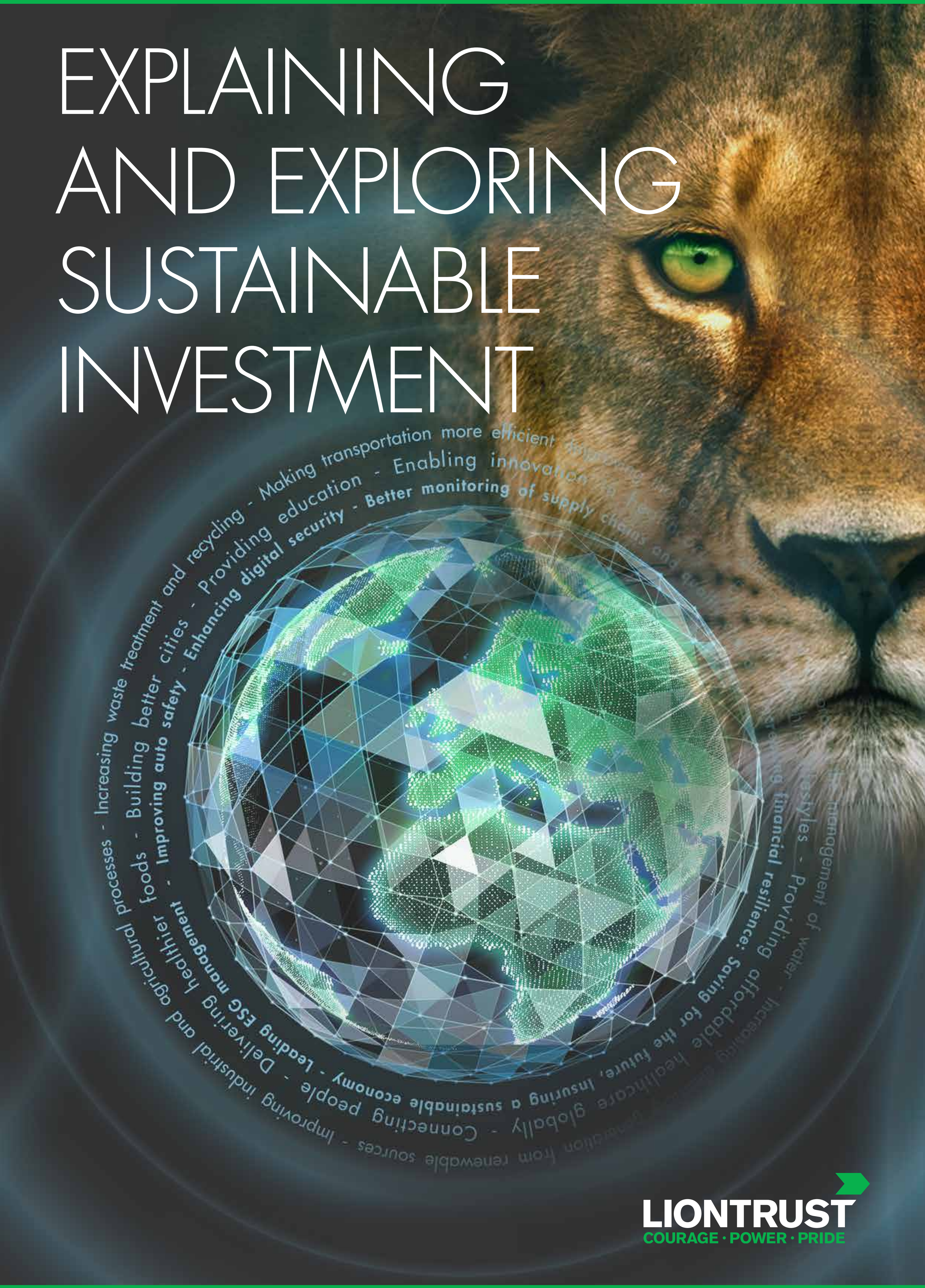
EXPLAINING AND EXPLORING SUSTAINABLE INVESTMENT



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Anyone with a passing interest in investment will have heard the terms sustainable, responsible, ethical, and environmental, social and governance (ESG) more and more in recent years – just as issues like climate change and plastic pollution increasingly dominate the news.

Many might still believe this kind of investing remains primarily about avoiding certain types of companies and sectors and while this approach is still prevalent, sustainable investment has become far more nuanced. One of the main factors driving demand for funds with a sustainable focus – and a key one for us at Liontrust – is the growing realisation people do not need to sacrifice financial returns to meet their values. Sustainable investing is no longer just for those who want their investments to do 'good'.

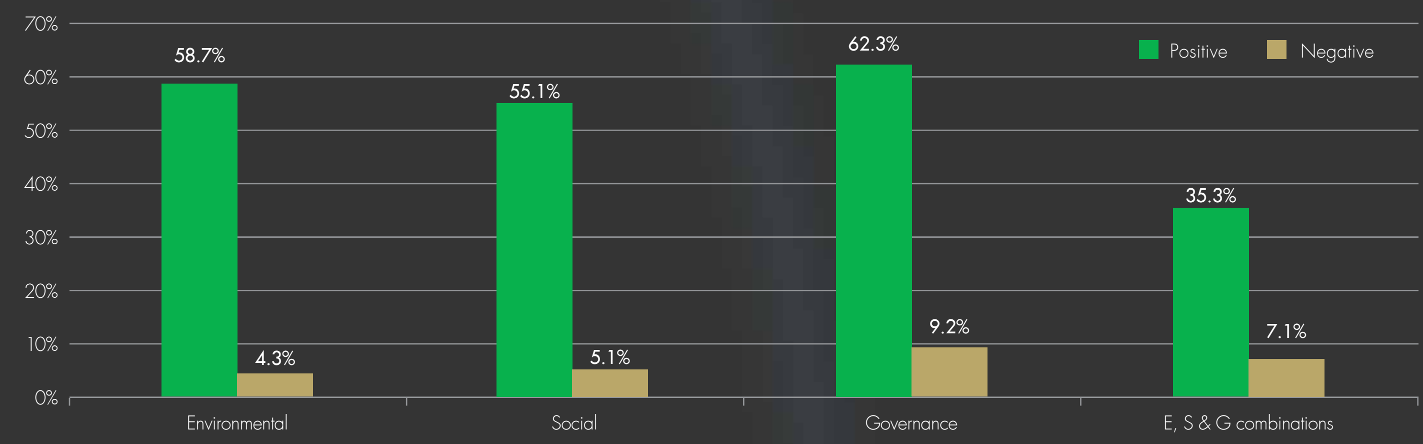
Our starting point is that it is possible to make profits while also having a positive impact and we believe companies producing goods and services that can help make the world cleaner, healthier and safer have a competitive advantage that is often overlooked.

There is growing evidence to show companies that are ranked better in terms of how they manage their interaction with the environment and society, and how they are governed, generate higher investment returns than those rated poorly on these measures. Research published in 2015 – reviewing more than 2,000 pieces of analytical work on the financial effect of ESG factors and highlighted in the chart below – showed overwhelming proof of the positive link between ESG and corporate financial performance.

Beyond this 'performance with principles', there are a number of other factors driving growing demand for sustainable investment, both in the UK and internationally. In the food and clothing industries, for example, sustainability is becoming synonymous with quality (and so it goes in investment). People increasingly expect the companies they use to be socially responsible and this is fundamentally changing businesses, from high street retailers to industrials and even the giant commodity producers.

Basic financial sense is also pushing companies down the sustainable path: as regulation and legislation increasingly penalise polluters, businesses creating less toxic waste and those involved in reduction and efficiency technologies should prosper. Meanwhile, the political climate continues to change: environmental and social responsibility are very much regarded as mainstream issues and policy is increasingly decided with sustainability in mind.

Better ESG management drives better corporate financial performance



Source: Friede, Busche, Bassen. December 2015

A short history of sustainable investing

Roots in religion – back to the 1800s (or beyond)

The earliest ideas behind sustainable or socially responsible investing can be found in the ideas of the Methodists and Quakers in the 1800s around temperance and fair employment conditions – and some might argue even further back in the principles of Sharia.

Whatever the provenance, the founding idea focused on shunning profit at the expense of your neighbours and therefore avoiding investment in areas that made money through alcohol, tobacco, weapons or gambling – the earliest version of what became known as negative or dark green screening.

1960s

Fast forward to the 1960s and broader demand for ethical investment started to take off in the US, with widespread aversion to companies involved in the Vietnam War. This culminated in the launch of the PAX fund in the early 1970s, regarded as the first proper ethical offering.

A changing corporate landscape

Twenty years ago, it was very unusual for investors to ask companies about their environmental impacts, supply chains, corporate governance or treatment of employees. At this stage, the sustainable team would typically have a couple of minutes at the end of meetings with company management to probe these areas and encourage better practice. Reactions tended to vary: some management teams got it, recognising these issues were important to the company's long-term success; others were patronising or even aggressive.

Back then, it was simply not widely accepted that companies had to report on or improve their ESG impacts.

Today, the picture is very different with almost all listed companies reporting on corporate social responsibility and ESG. A landmark came in 2019 when the usually conservative US Business Roundtable issued a new statement on the ultimate purpose of corporations. Since 1978, the Business Roundtable has periodically sent out its Principles of Corporate Governance and each version since 1997 has endorsed shareholder primacy – that businesses exist principally to serve shareholders. In 2019, the Roundtable broke decisively away from this and included a commitment to all stakeholders for the first time, not just shareholders but also customers, employees, suppliers and wider communities.

One of the chief executives supporting this change, Progressive Corporation Head Tricia Griffith, said: 'CEOs work to generate profits and return value to shareholders, but the best-run companies do more. They put the customer first and invest in their employees and communities. In the end, it's the most promising way to build long-term value.'

1970s and 1980s

As social and environmental activism spread through the following decades, so the demand for more ethical and sustainable investment options grew. The first Earth Day was celebrated back in 1970, for example, and disasters such as Three Mile Island in the US and Chernobyl in the Ukraine, plus growing evidence of the catastrophic impact of climate change, focused attention on green investment. The first World Climate Conference was in 1979, opening up the science of climate change and starting on the path towards global recognition of the danger of greenhouse gases.

The fight against the apartheid regime in South Africa also accelerated the promotion of ethical investment in the 1980s, and EIRIS was established in 1983 as the UK's first independent research service focused on these strategies.

Elsewhere in the UK, Friends Provident (founded in 1832 to provide life assurance for members of the Society of Friends, more commonly known – and bringing us back to the start – as Quakers) offered to manage an ethical fund with investment criteria determined by a separate committee, and this led to the launch of the Stewardship range in the mid-1980s.

Meanwhile, in 1983, the United Nations asked former Norwegian prime minister Gro Harlem Brundtland to run a World Commission on Environment and Development, seeking better ways to harmonise ecology with prosperity. After four years, the Brundtland Commission released its *Our Common Future* report, producing the seminal definition of sustainable development.

1990s to 2020s and beyond

Regulatory developments have continued to push the sustainable agenda forward over recent years, starting with the Rio Earth Summit in 1992, which rallied the world to adopt Agenda 21 – a set of goals in sustainable development for the 21st century.

Next came the Kyoto Protocol of 1997, an international treaty that commits countries to reduce greenhouse gas emissions based on the scientific consensus that global warming is occurring. This was eventually superseded by the Paris Agreement, signed in 2016, and various commitments at COP26 in November 2021, with a goal to limit average temperature rises, compared to industrial levels, to less than 2 degrees centigrade and ideally less than 1.5. The seminal Intergovernmental Panel on Climate Change (IPCC) report, published in October 2018, shocked many with its conclusion: to meet the 1.5 degree target and stand any chance of keeping climate change manageable, we need to halve absolute emissions by 2030.

As demand for ethical and sustainable investing has grown, so have the types of strategies available and the terms used to describe them: from ethical, to SRI (socially responsible investing), to sustainable, to ESG. In the midst of this, the term ESG was coined in a landmark 2005 study entitled *Who Cares Wins*. This came out of then UN Secretary General Kofi Annan writing to multiple CEOs of financial institutions seeking ways to integrate ESG into capital markets. The report made the case that embedding ESG factors makes good business sense and leads to more sustainable markets and better outcomes for societies.

This formed the backbone for the launch of the Principles for Responsible Investment (PRI) at the New York Stock Exchange in 2006 and the UN has continued to drive the sustainable agenda with its Millennium Goals, which became the Sustainable Development Goals (SDGs). These are an internationally recognised set of goals to aim for by 2030, which will help the world develop in a more sustainable way.

Defining terms

When examining this kind of investment in more detail, the first hurdle to overcome is the wide range of terms: sustainable, ethical, dark green, SRI (socially responsible investing), ESG, impact and engagement are all used, sometimes interchangeably.

Sustainable investing: This captures the inclusion of sustainability (impacts and interaction with the environment and wider society) into core investment decisions.

Ethical: Avoiding controversial industries such as tobacco, arms, gambling, pornography, fossil fuels and big oil. Also known as dark green or negative screening.

Sustainable themes (or positive screening): Identifying and investing in companies exposed to positive secular trends and expected to experience rising demand as we need more of their products to develop in a more sustainable manner. This includes environmental technologies and renewables but also covers health, education, cyber security and many others. This has sometimes been referred to as light green investing.

Engagement: Challenging companies in which you are invested to take a more proactive approach to how they are run, for the benefit of a broad range of stakeholders rather than just shareholders.

Stewardship: Having formal policies to hold companies to account by actively voting and challenging them to improve how they are run. This is required in the UK but implemented to different degrees.

Responsible investment (or socially responsible investment (SRI)): This typically refers to conventional funds that may avoid certain areas of the market on sustainability grounds and possibly have some engagement.

ESG: Refers to environmental, social and governance issues. It has started to be used more to describe how well a business is managed and less about how sustainable the product or service they provide actually is, and the media and many fund groups also now employ it as a catch-all for anything on these two pages.

Impact investment: This is an extension of sustainability themes when investors want to own companies with meaningful positive impacts. We are beginning to see more disclosure in this area via metrics such as exposure to positive themes and contributions to the UN's Sustainable Development Goals (SDGs), for example, with more evolving all the time.

ETHICAL	SUSTAINABILITY THEMES	ENGAGEMENT
Avoid	Find	Influence

Looking through all this language, however, there are basically three core approaches to understand – the avoid, find and influence outlined in the image above – and most of the descriptions fall into one of these. Most sustainable fund managers offer some combination of the three but however things are described, the most important thing is how much sustainability factors actually affect investment decisions. Is it resulting in significantly different-looking funds than those offered by mainstream peers?

The first strand is traditional 'ethical' investing, which is largely about **avoiding** certain industries because of the negative effects of their products, with standard examples including tobacco companies, fossil fuels and producers of weapons. This dates back to the beginning of this kind of investing and can trace its roots back hundreds of years; as outlined at the outset, for many, it remains the stereotypical image of 'green' investing.

Second, is the fast-growing world of sustainable investing, which includes the light green, SRI, ESG and impact monikers under its umbrella. While the first branch is all about excluding various types of company, or what funds do not own, sustainable focuses on what they do via so-called positive screening. This is about **finding** companies that, in broad terms, are trying to make the world a better place, whether through more effective healthcare and communication networks, more efficient and cleaner energy, or safer transport, for example.

This is where the ESG side comes in and the industry continues to develop ways to assess companies pushing ahead on these environmental, social and governance criteria. As we outlined, there is a wealth of evidence to show companies that perform well in ESG terms are likely to produce attractive investment returns.

Defining ESG

Environmental	Social	Governance
Climate crisis	Supply chains	Bribery and corruption
Energy efficiency	Human rights and modern slavery	Corporate ethics
Biodiversity	Employee safety and opportunity	Remuneration
Plastic pollution	Labour standards	Product safety
Water and waste management	Gender and ethnic diversity	Audit and compliance

Sustainability can be a difficult concept to agree and we find a useful starting point is the definition used by the UN World Commission on Environment and Development: 'sustainable development meets the needs of the present without compromising the ability of future generations to meet their own needs.' Going back to those traditional ideas about 'green' investment, it is important to understand this goes far beyond just environmentalism – although it continues to play a part.

Sustainable practices also support ecological, human, and economic health and vitality – the S and the G are as important as the E within ESG – and concerns about social and economic equality are embedded in any genuine definition of sustainability.

Sustainability presumes resources are finite and should be used conservatively and wisely with a view to long-term priorities; in the simplest terms, it is about our children and grandchildren and the world we want to leave them.

Finally, a third approach is known as engagement, or active ownership, where fund managers look to **influence** the companies they own into changing their strategy or operations for the better. This can be reflected in voting at Annual General Meetings to impact the business, looking to improve labour rights in the company's supply chain or driving change in areas such as employee safety, diversity or remuneration.

Avoiding the greenwash

With the growth in demand for sustainable investment and a proliferation in funds being launched, there are increasing concerns about so-called 'greenwashing'. This is when asset managers talk up their credentials without the required expertise or track record. We have come up with five ways to tell whether funds, and the teams behind them, are capable of meeting investors' sustainable expectations.

1. Transparency

A genuinely sustainable fund manager should be transparent about how they invest, as well as being open to be challenged. This should include clear and simple information explaining how the team runs money: what companies they look for under the sustainable approach and what they avoid. Anyone can write a report on climate change, for example, but how are funds positioned in light of the huge challenges that combatting this will entail?

2. Experience and resource

As in any walk of life, experience and depth of a team is important when it comes to sustainable investing.

3. Knowledge and training

Sustainable investing is a specialist area and subjects like climate change are fast moving so investors need to be confident their managers have the required knowledge to run money in this way. This can be anything from members of the team having specialist qualifications to a general focus on training to ensure people understand the latest sustainability trends.

4. Activism

Engagement is a key part of sustainable investing and we feel managers should be able to highlight a track record of holding companies to account and encouraging them to improve. Managers should be able to talk in detail about their engagement priorities – whether diversity, tax transparency or plastic pollution – rather than making sweeping statements. It is worth looking at managers' annual general meeting (AGM) voting records: do they vote with company management or actually challenge the businesses in which they invest to improve?

5. Evidence

All this knowledge and experience in sustainability should be applied to investment decisions – giving meaningfully different exposure compared to more conventional funds. Are managers able to show how their views are reflected in their decisions: is it simply ESG data and reporting for the sake of it or making a genuine difference to investment?

Sustainable trends and themes

The Liontrust Sustainable Investment team invests in three transformative trends and 20 themes within these trends. The three trends are:

Better resource efficiency: This focuses on companies helping the world make better use of scarce resources, driving improvements in areas as diverse as energy, industrial processes and transport.

Improved health: The team is seeking to invest in companies helping to extend life expectancy and enable people to be fit and healthy enough to reap the benefits of an improving world.

Greater safety and resilience: The underlying themes include transport safety, with a focus on the rapid developments in such areas as Automatic Emergency Braking (AEB).

Better resource efficiency

Improving the efficiency of energy use
We see many ways of making energy cheaper by reducing waste, as well as emissions, through more efficient usage. This cuts across many areas of the economy and includes building insulation, efficient lighting, energy efficient climate control, travel and industrial processes.

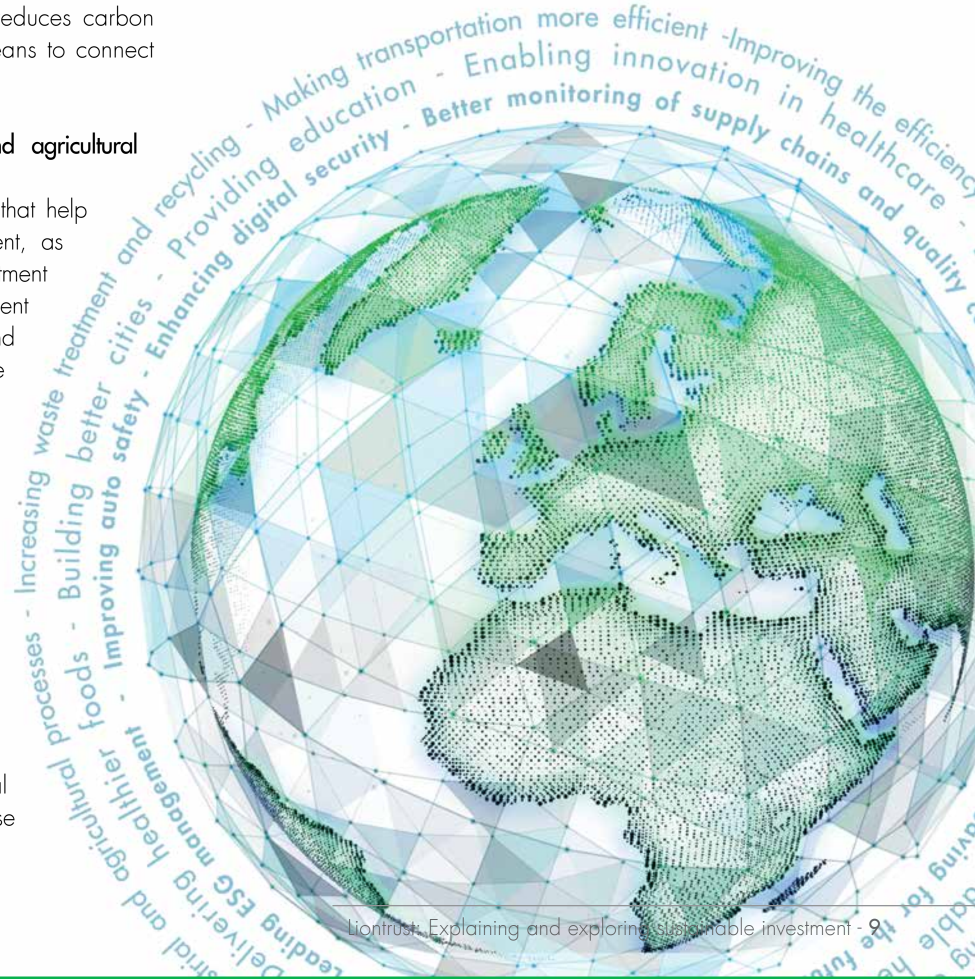
Improving the management of water
Water is essential for life. Companies that can manage waste water treatment, or produce products or services that improve the efficiency of water distribution, are vital and in demand. We like companies that improve sanitation and give affordable access to clean water.

Increasing electricity generation from renewable sources
Substituting carbon-intensive fossil fuel electricity generation (especially coal) with renewable power sources reduces carbon emissions as well as providing a cost-effective means to connect people to cleaner power sources.

Improving the resource efficiency of industrial and agricultural processes
We like companies providing products or services that help to make industrial processes more resource efficient, as well as safer for workers and users. We see investment opportunities in software and systems that help implement life-cycle design (including disposal of products) and manage supply chains, as they modernise and improve industry. We are looking for companies driving real improvements in energy and material use.

Delivering a circular materials economy
With finite resources on earth, recycling remains a huge part of the shift to a more sustainable world. But to make better use of materials, we need to consider the whole life cycle rather than just the 'waste' stage, moving beyond the current take-make-waste model towards a more circular economy. This is based on three core principles – designing out waste and pollution, keeping products and materials in use, and regenerating natural systems – and we believe companies built on these lines should benefit from this trend.

Making transport more efficient and safer
Urban transport systems are improved by reducing congestion as well as emissions (which make local air quality toxic), as the mode shifts from self-driven cars to trains, tubes and buses. We are also interested in active transport such as bicycles as a healthier way to travel short distances. We have identified companies whose products improve safety of travel and reduce accidents. Much of our early work focused on autos but we should not assume cars will remain dominant, particularly with safe, efficient mass transport key to reducing emissions. Whatever the mode of travel, we concentrate on the specialist companies making the kit to improve safety, from active safety systems to more efficient braking.



Improved health

Enabling innovation within healthcare
We focus on companies either coming up with new, more effective ways to treat diseases or providing essential equipment, services or software to help to make treatments more effective.

Delivering healthier foods
Consumers are demanding healthier foods and we have identified companies that provide reformulation services to change recipes to make them healthier (less fat, sugars and salts) while maintaining the taste.

Building better cities
Shelter is a basic human requirement and companies that build quality affordable homes are helping to provide this. We like well designed and built homes that are energy efficient and safe.

Providing education
Education brings important benefits, including longer life expectancy, increased job opportunities and helping to stimulate economic growth, as well as leading to overall higher satisfaction in life. Companies providing education services offer vital knowledge and skills, which help to improve people's lives.

Providing affordable healthcare globally
Currently, the costs of healthcare are very high and we need more effective ways of delivering better patient outcomes. Companies that help to deliver affordable, positive outcomes in managing diseases help to achieve this goal.

Enabling healthier lifestyles
Companies that promote healthier lifestyles, principally through increasing activity, taking exercise and sport, help to improve health. These include positive leisure activities such as gym operators and companies providing sports clothing and equipment.

Connecting people
We believe access to easy communication tools and information, increasing amounts of which are online, is a positive requisite of a more sustainable economy.

Encouraging sustainable leisure
For most people in the twenty-first century, we are lucky enough to be living in an era where there is a natural progression to spend more time on leisure and these activities are increasingly seen as both a fundamental human need and a key part of mental health. Activities as diverse as going to a concert, to the cinema, having dinner at a restaurant or playing a video game all have clear externalities but the social experience is positive and we are looking to invest in companies involved in this growing part of a more sustainable future.

Greater safety and resilience

Increasing financial resilience
We believe a resilient financial services sector is necessary for economic well-being through utility-like provision of banking and lending.

Saving for the future
As people live longer and governments and corporations retreat from providing long-term cover and pensions, individuals will need to take control of their own affairs. Savings rates will have to increase and companies providing suitable products will see strong growth.

Insuring a sustainable economy
This recognises that insurance, when done well, allows risk to be spread across a community. This lessens the impact of any single event, providing greater peace of mind and encouraging greater risk taking and innovation.

Leading ESG management
How a business is managed operationally, particularly in how it deals with the ESG challenges, can provide a competitive advantage over peers.

Enhancing digital security
As more of our lives and critical services are carried out online, we need to trust these systems and protect the data from theft. Digital security helps to make this growing area of the economy secure.

Better monitoring of supply chains and quality control
Companies cannot outsource responsibility for the environmental and social impacts of their supply chains and we see an opportunity in businesses improving their monitoring of these areas.

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Key risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested. The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Some of the Funds managed by the Sustainable Future Equities team involve foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. Investment in Funds managed by the Sustainable Future Fixed Income team involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The value of fixed income securities will fall if the issuer is unable to repay its debt or has its credit rating reduced. Generally, the higher the perceived credit risk of the issuer, the higher the rate of interest. The Monthly Income Bond Fund has a Distribution Yield which is higher than the Underlying Yield because the fund distributes coupon income and the fund's expenses are charged to capital. This has the effect of increasing dividends while constraining the fund's capital appreciation. For the SF Corporate Bond Fund and SF GF European Corporate Bond Fund the Distribution Yield and the Underlying Yield is the same.

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