Global Future Council on Responsible Investing

Responsible Investment: Definitions and Taxonomies

APRIL 2024

Preface

The World Economic Forum network of Global Future Councils is a multistakeholder and interdisciplinary knowledge community dedicated to promoting innovative thinking to shape a more resilient, inclusive and sustainable future.

The Global Future Council on Responsible Investing is tasked with navigating the complexities of today's responsible investment landscape. By fostering collaboration and thought leadership, the council seeks to address the complexities of assessing trade-offs, promoting stewardship and identifying responsible investing practices amid an ever-evolving market environment.

The ideas presented in this paper draw on discussions that took place among the council members – both in person and virtually – over the course of 2023.

The views expressed in this paper are those of the members of the Global Future Council on Responsible Investing and not necessarily those of the World Economic Forum or its members, partners or other stakeholders.

The lead author of this paper is Alex Edmans, Professor of Finance, London Business School.

Responsible investing (RI) is a rapidly growing area of investing but the excitement and enthusiasm have been accompanied by a lack of clarity as to what it involves.

On the one hand, some definitions are too loose. In 2020, the US Sustainable Investment[1] Forum reported that $1 in every $3 professionally managed in the United States ($17.1 trillion) was invested in RI strategies, which was 25 times the level in 1995. However, it revised its methodology in 2022 to exclude investors who state that they practise RI but do not describe any specific RI criteria. After this revision, these figures more than halved to $1 in every $8 ($8.4 trillion).

On the other hand, some definitions of RI are too rigid and fail to recognize that it can be pursued with different objectives and in different ways. Blanket statements about whether RI "works" or "does not work" are meaningless without being clear about the type of RI they are referring to – the criteria against which to assess whether it "works". RI may be more successful at achieving some objectives than others, so it is important to be precise about the form of RI being referred to rather than treating it as a homogenous entity. Goalkeepers are assessed according to different criteria than strikers, and so having a taxonomy of the different positions is useful to understand what criteria we should be using. In addition, some statements refer to footballers in general, and others only to a specific category of footballer.

The primary purpose of this paper is to propose a definition and taxonomy of what RI involves, to provide clarity, concreteness and focus to discussions. A secondary purpose is to highlight the potential trade-offs between its different objectives. Its goal is not to put the different forms into tiers or argue that one form is superior to another.

We define RI as follows:

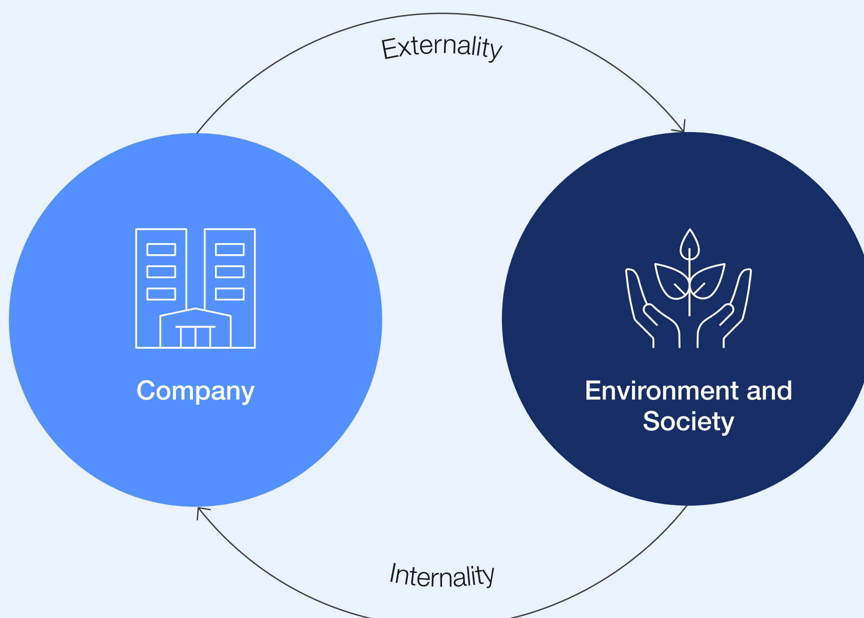
RI is the incorporation of environmental and social factors to achieve one or more of the following objectives:

1. Financial returns
2. Societal impact
3. Values alignment

There are five key elements to this definition.

Incorporation

RI needs to be meaningful. It sometime involves taking decisions that an investor would not have taken if it were not a responsible investor, otherwise there would be no difference between "investing" and "responsible investing". This is why we define RI as the "incorporation" of environmental and social factors, rather than (for example) the "consideration". An investor may consider environmental and social factors but view them as always secondary to financial factors. "Incorporation" implies that they will sometimes change investment decision-making.



Environmental and social

Responsible investing is sometimes referred to as environmental, social and governance (ESG) investing. However, virtually all investors will take governance into account in their investment decisions, as the effects of poor governance are almost always ultimately *internalised* by the company. A company that lacks board expertise, or where CEO pay is insufficiently tied to long-term performance, will likely underperform and destroy shareholder value.

In contrast, some environmental and social (ES) factors are *externalities* that primarily affect wider society. An energy company can emit greenhouse gases, harming agri-businesses that are unable to grow crops in a warmer climate, but may not bear the full environmental cost of their actions in the absence of a global carbon tax. A clothing company can save costs by using forced labour and not be prosecuted because laws are weak. A responsible investor will incorporate ES factors into investment decisions either because they are an investment objective in their own right, or because it believes they will ultimately be internalised and affect financial returns. However, a non-responsible investor will not.

Financial returns

One reason why responsible investors will incorporate ES factors into investment decisions is the belief that they will increase risk-adjusted financial returns. They may increase returns if, for example, customers are more likely to buy from companies with strong environmental records, or employees are more motivated and productive in a firm that invests in their well-being. They may reduce risk if, for example, energy companies that invest in clean energy are less vulnerable to a carbon tax, and companies that mitigate the negative impact of restructuring on their employees are less susceptible to strikes.

Note that even if ES factors increase returns and reduce risk for the company, they will only do so for investors to the extent that they are not already priced in by the market. Thus, responsible investors concerned with financial returns will not automatically invest in companies with positive ES factors but incorporate them into their valuations alongside other drivers of company value and compare them to the current market price.

Societal impact

A second motive for RI is to positively impact society – to create ES value. This may be achieved in two primary ways. The first is *stock selection*.[2] By investing in "green"[3] stocks with a positive societal impact (such as clean energy), investors can – at least in theory – lower their cost of capital, allowing them to expand and increase their positive impact. Conversely, by disinvesting from "brown" stocks with a negative societal impact (such as tobacco), investors raise their cost of capital, hindering them from expanding and increasing their negative impact.

The second is *stewardship*: by voting and actively engaging on ES issues, investors can increase a company's positive impact or reduce its negative impact. Importantly, while stock selection involves investing in green companies and disinvesting from brown companies, stewardship might involve investing in brown companies and engaging with them to reduce their negative impact (such as encouraging a tobacco company to develop less harmful products).

In some cases, financial returns and societal impact will overlap. For example, if a company has strong ES performance that is not priced into the market, buying such a company will create both financial returns and societal impact (by lowering its cost of capital). Engaging with a company to improve its ES performance will have positive societal impact and also enhance financial returns if these ES factors are material to the company's business; i.e. will ultimately be internalised.

However, in other cases, they will not. If ES performance is already priced in (or overly priced in), buying green companies will not enhance financial returns but will have societal impact. Engaging on ES factors that are pure externalities (i.e., will not eventually be internalized) will not enhance financial returns but will have societal impact.

Values alignment

A third motivation for responsible investing is to invest in companies that reflect the investor's (or its clients') values. This is undertaken purely through stock selection, by buying companies that align with the investor's values and avoiding companies that do not. Note that different responsible investors will have different values; one may believe that an alcohol company contradicts its values, but another may not.

Values alignment will overlap with financial returns if companies that align with the investor's values are underpriced, but conflict if they are overpriced. Values alignment will overlap with societal impact if investing in aligned companies reduces their cost of capital and allows them to expand, but sometimes conflict. An investor may achieve societal impact by buying tobacco companies and engaging with them to develop less harmful products, but owning such firms may contradict with some investors' values. An investor may achieve societal impact by buying fossil fuel companies and reducing their cost of capital to help them transition into clean energy, but holding fossil fuel companies may conflict with some investors' values.

Conclusion

The definition of RI is tight, as it involves the incorporation of environmental and social factors, and not just their consideration. In addition, a responsible investor incorporates specifically environmental and social factors, and not just governance factors. However, it is also flexible, as it allows for a range of objectives. Some forms of RI may be more successful at achieving their goals than others; regulations, policies or practices to improve RI may have varying effectiveness on the different objectives.

When academics conduct research on RI, practitioners develop frameworks or policies to implement RI, or policy-makers pass laws or mandate disclosure related to RI, they need to be clear about which of the RI objectives their activities relate to, and consider whether these activities will hinder the achievement of other objectives.

Acknowledgements

Lead author: **Alex Edmans,** Professor of Finance, London Business School

Endnotes

1 In this note, we use the terms “responsible investing” and “sustainable investing” interchangeably.

2 We use the term “stock” for simplicity, but the argument continues to hold for purchasing debt or other securities issued by a company.

3 We use the terms “green” (“brown”) to refer to companies with a net positive (negative) environmental and social impact; these terms are not limited to the environmental dimension.