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INSIGHT: Beware of Box-Checking in Sustainable Investing

On March 28, the European Parliament will hold another vote on regulating sustainable investing. Members of the European Parliament are grappling with a question on the minds of policymakers around the world: namely, how can they best encourage capital markets to become more sustainable?

These are heady decisions. Their constituents—i.e., all of us—need companies to more efficiently use the planet's resources while supporting economic productivity by investing in people and capital.

Plus, basic challenges remain: Recent headlines have reminded us that there is still much work to be done to maintain fundamental governance standards, reduce the risk of accounting fraud, protect the health and safety of workers, and ensure fair pay.

Finally, there is the question of scope: Broad improvements in sustainability need to take place across the whole economy, we can't just ''greenwash'' our con-sciences by buying a few clean technology stocks.

The proposed EU regulation endeavors to solve for these challenges by requiring institutional investors to declare whether or not they consider sustainability objectives in their investment process.

This alone is an important step, and one that regulators in other markets should consider following. But unless the regulation is amended, this runs the risk of initially only addressing two niches—a subset of ''sustainable'' labeled investment products, and a subset of companies whose industry sector or business activities an expert European Union body determines are ''environmentally sustainable.''

Mindful of this, we wonder if there isn't room for policymakers and regulators to be even bolder.

Right Way, Wrong Way To be sure, institutional investors can and should offer investment products which pursue sustainability outcomes like mitigating climate change or contributing to the sustainable use of water resources. By doing so they may drive down the cost of capital for businesses supporting these outcomes.

But there is a right way and a wrong way to go about this. The wrong (but alarmingly prevalent) approach is to make this a ''check box'' exercise that passively maps a subset of companies to a handful of sustainability outcomes. This approach divides the world into ''predators and producers'' based on simplistic analysis that may be outsourced to a third party using patchy data.

Nothing would undermine broad investor support for regulated sustainable investment products faster than if naive portfolio construction leads to poor long-term investment performance, a phenomenon that would also drive capital away from the underlying companies and hurt the overall drive toward greater sustainability.

A few examples: A company involved in solar power and electric vehicle manufacturing, but with poor oversight or a high worker injury rate, could make the cut despite significant social and governance risk. Yet a sustainable investor doing their homework would have real concerns about owning the company for both financial and sustainability reasons.

Conversely, a specialty chemical company innovating its plastics manufacturing process to incorporate a greater proportion of recycled content may not meet the criteria for ''substantial'' contribution to the circular economy for several years while it scales production. Yet owning the company as it allocates capital to grow the business unit could be profitable and sustainable.

Boldness of Spirit And somewhere in the middle, investors may disagree on whether an alcoholic beverage manufacturer that is making significant steps to improve water efficiency meets the criteria for ''substantial'' contribution to sustainable use of water resources. Yet with global beverage demand expected to grow such a company undoubtedly has an important part to play in the transition to a more sustainable economy.

This level of discernment requires investment managers to be active and vigilant in considering material environmental, social, and governance (ESG) risks and opportunities for all companies in all sectors. It also requires hands-on engagement processes led by ESG-savvy professional investors in dialogue with company management, and extensive disclosure around the process to achieve these outcomes.

The good news is that academic and real-world evidence shows that taking these steps can empower stronger long-term investment performance that is in the best interests of investors and society as a whole.

There is a live opportunity for regulators around the world to take the boldness of spirit from Europe and unite in ensuring all investment managers across all investment products rise to meet these goals. We, and our clients, will applaud them if they do.

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