ESG Investors: Beware of Greenwashing!

Description

ESG investing is one of the most popular investment philosophies to come about in recent years. Purporting to help investors maximize their social impact while getting satisfactory returns, it has risen in both scale and influence. Major investors, such as Norway's $1.4 trillion sovereign wealth fund, buy stocks with ESG principles in mind. As a result, a cottage industry of ESG funds has sprung up, catering to their needs.

There's no doubt that ESG has a noble intention behind it. Investing in ethical companies should have a positive impact on the world, if enough people do it. The problem is defining what is ethical. Sometimes, a particular category of stock will be considered unethical until current events change, making it in favour. For example, defence stocks were generally considered ESG-unfriendly until the war in Ukraine made many fund managers reconsider their positions.

There is another, more long-term issue with ESG investing. The drive to be seen as ethical can lead companies to exaggerate how ethical they actually are. Known as "greenwashing," this practice can be amplified by advertising and marketing. Potentially, it could lead you to invest in companies you'd never invest in if you knew what they were really up to.

What is greenwashing?

Greenwashing is when companies use marketing to play up their ESG characteristics to an unreasonable degree. Companies know that being seen as ESG friendly can attract investment, so, in some cases, they market themselves to appeal to ESG investors. Common examples include

- Food companies claiming that products are "organic," even when they are manufactured the same way as their competitors' food;
- Oil companies touting emission reduction efforts in their own country, while making no such efforts in foreign countries; and
- Companies putting out statements about ESG issues in industries other than their own.

All of the practices above are quite common. The last one on the list is particularly troubling, as it allows companies to “score points” in areas where they cannot be held accountable.

Another issue to keep in mind

In addition to greenwashing, there is another issue to consider with ESG investing: questionable results.

Although we’d all like to live in a world where the most ethical companies are the most profitable, we know that isn’t the case. ESG funds have a long track record of underperforming the broad market indexes. Perhaps these funds are doing a service to society by allocating capital to its most ethical use case. But they aren’t particularly good at helping investors achieve their financial goals.

An alternative investment to consider

If you are investor who wants to invest ethically but are concerned about being duped by ESG funds, you could consider one very good alternative: broad market index funds.

Index funds like **iShares S&P/TSX Capped Composite Index Fund** (TSX:XIC) invest in the entire stock market. Inevitably, the biggest companies become their biggest holdings. The companies with the heaviest weighting in index funds are simply too big to avoid regulatory scrutiny. If the government is ethical, then the biggest companies in the index will probably trend ethical over time, as the law will force them to.

Additionally, index funds tend to produce satisfactory returns. These funds are very diversified, reducing the risk inherent in them. With a fund like XIC, you might experience some down years, but you’re unlikely to lose it all.

XIC is a particularly good fund to highlight because it offers low fees. Coming in at 0.06%, XIC’s MER is tiny. Yet you still get exposure to the same large-cap stocks you would with an actively managed ESG fund. So, it is definitely a pick worth considering.

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andrewbutton