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The Social Dilemma

An Introduction to Social Factors for Investors

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Social factors and their significance to investors

In this paper, we set out an introduction to social factors, why investors should care, and the momentum we are seeing in policies and investor initiatives responding to social concerns.

Why the increasing focus on social factors now?

There has justifiably been growing attention on environmental issues, such as climate change, as a systemic risk for investors. Social concerns have lagged for a variety of reasons, from definitional issues on what we mean by social factors, to difficulties in quantifying social risks and opportunities for the portfolio. Regardless, we believe it is essential that investors adopt a holistic view of Environmental, Social and Governance (ESG) issues to understand the synergies and trade-offs amongst different ESG objectives.

In the wider landscape, social issues have been brought to the fore, as the cost-of-living crisis continues to build in the UK. But this is not the only social catalyst of late, from the Covid-19 pandemic pushing millions of people into extreme poverty, Russian human rights allegations in their invasion of Ukraine, the Iranian morality police being implicated in the unjust deaths of Iranian women, and the global rise of the Black Lives Matter movement against police brutality; there is clearly social momentum that investors need to engage with. Social issues have never been more important.

How do we define social factors?

Social factors are a diverse set of issues that can be difficult to define and group. Public policy frameworks can provide a useful starting point. In particular, the widely adopted Sustainable Development Goals (SDGs), are aiming to bring about social progress in access to food and water, education, healthcare and decent jobs. The common underlying thread is reducing inequality, which is also an SDG objective (and defined as a state that is not equal). We believe the SDGs can form a useful framework for identifying key social areas of focus for investors. For the integration of social factors at portfolio level, there also needs to be a focus on investee companies' social impacts– from direct impacts (on workers) to indirect impacts (on consumers or suppliers), and beyond on communities – which align with the Department for Workplace and Pensions (DWP)'s definitions.

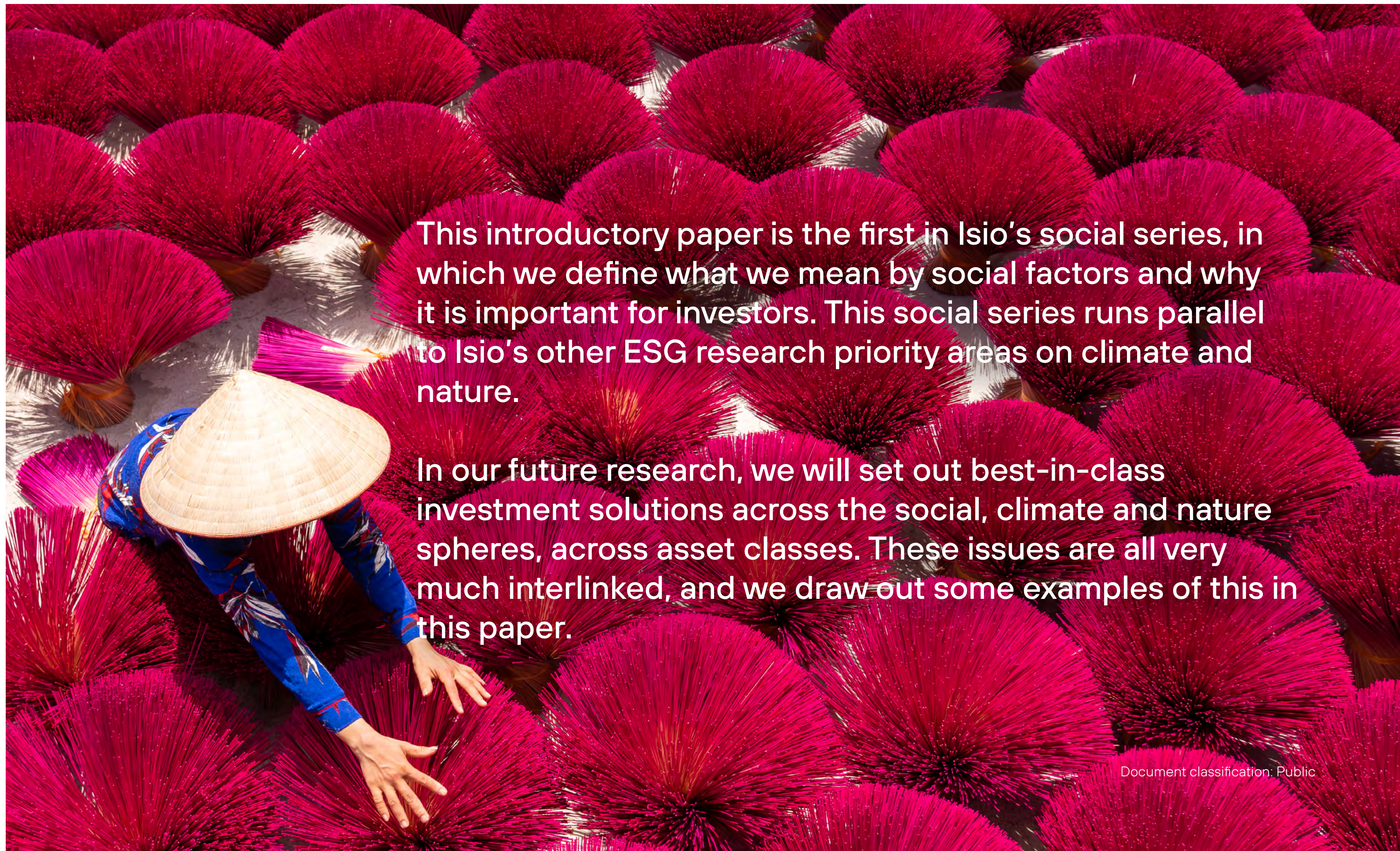
Why should you care as investors?

Rising inflation has led to a cost-of-living crisis, immediately following the Covid-19 pandemic that had already brought economies and financial markets to a halt. We also know that rising inequality can lead to like-for-like declines in GDP, with impacts compounding over time. At the micro level, evidence suggests that social risks can significantly contribute to an investee company's risk outlook.

The world will need to mobilise finance towards social progress. There is evidence that investors have been responding, with rising social investments in response to the cost-of-living crisis. There is also growing collaboration, with the DWP establishing a taskforce to inform future guidance on social risks and opportunities for UK pension schemes. Whilst the Taskforce on Inequality-related Financial Disclosures (TIFD) is also aiming to develop guidance for investors and companies to disclose their social risks and opportunities.

How to integrate social factors in the portfolio?

We set out in this paper how we can help you on your social impact journey. From education and training on social factors, to developing social beliefs and policies, setting the strategy and implementing social impact investments within the portfolio, as well as monitoring social risks and opportunities.



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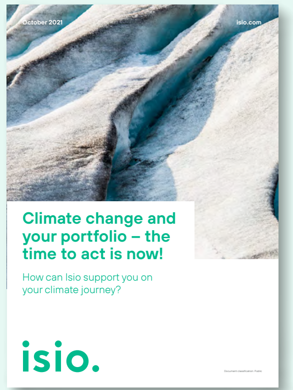
Why social factors, and why now?



For further information on the climate emergency, please refer to our paper, '**Climate change and your portfolio'.**

For further information on why the nature degradation matters for investors, please refer to our paper, '**Focusing on a nature positive future'.**

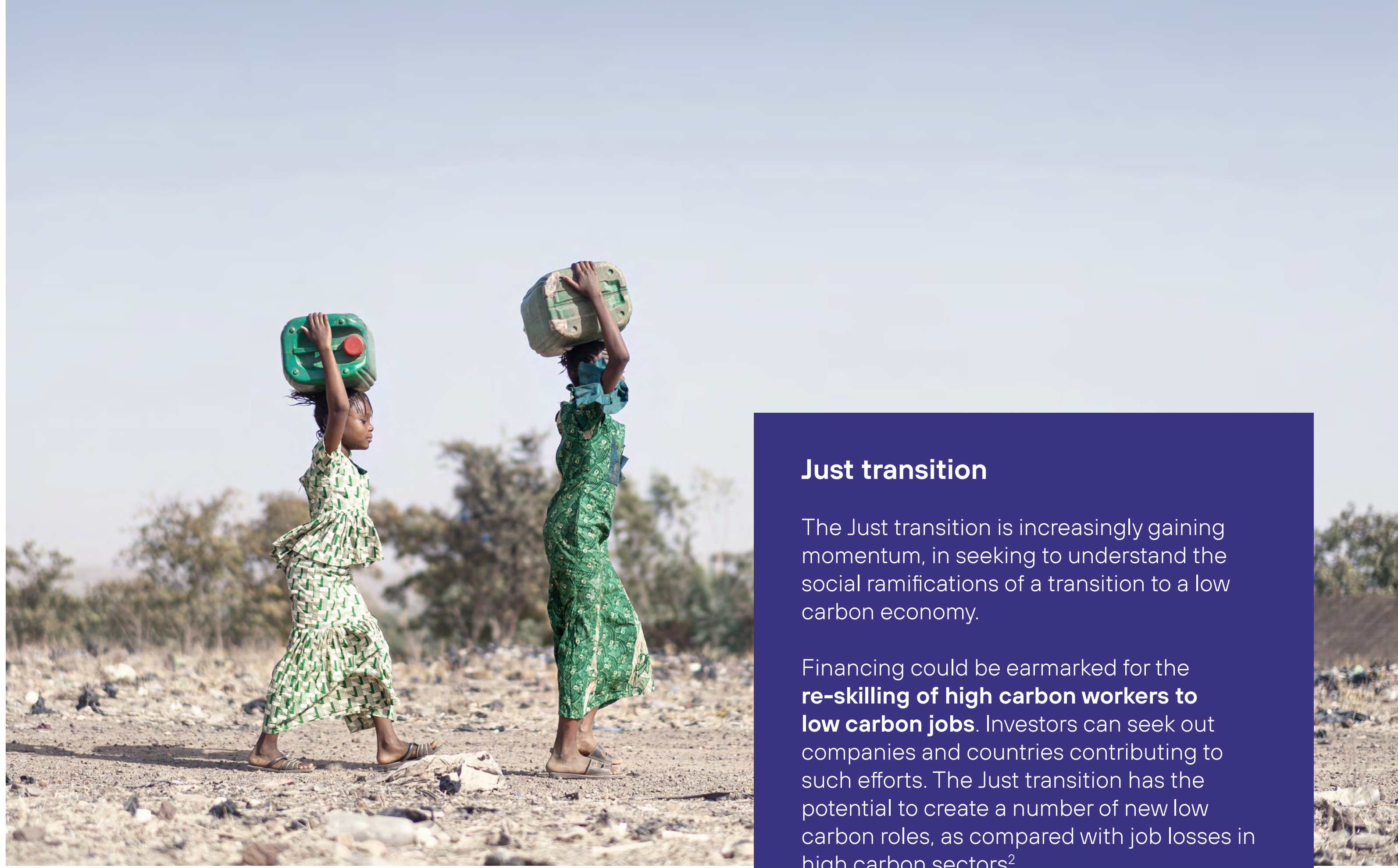
Investors have justifiably been awarding attention to environmental concerns, including the climate emergency and increasingly the nature degradation, given the systemic risks these pose for financial markets. Governance concerns have also received a certain level of attention, in being determinants of the long-term performance of companies and ultimately influencing the performance of investor portfolios. A growing area for investors, however, is social concerns, which have comparatively received little attention to date. There are reasonable explanations for the lag on social factors, from agreeing definitions, to issues in quantifying social risks and opportunities. There is evidence that this is changing and it is not just the integration of social factors that matters, but also the interplay with environmental and governance concerns.

Our world is very much interlinked and ESG concerns should be considered holistically within the portfolio, in recognition of the challenges that may exist in implementing different ESG objectives. For example, an exclusive decarbonisation focus can support climate change objectives, but can also lead to social ramifications, as people and communities exposed to high carbon sectors are adversely impacted by the transition to a low carbon economy. Managing these trade-offs may require explicit consideration. (See the case study to the right on the "Just Transition" for further details).

Of late, there are growing examples of social change. The cost-of-living crisis is causing a social crisis in the UK, with inflationary pressures triggering unaffordable mortgages and energy bills. This is not the only social catalyst of late. From the Covid-19 pandemic causing a deterioration in living standards; to the Black Lives Matter movement drawing global attention to police brutality; the setback to women's reproductive rights following the US Supreme Court ruling on abortion (whilst maintaining the context that five percent of global women experience similar prohibitions)[1]; the multidimensional impacts of Russia's war crimes and violation of Ukrainian human rights; and, Iran's morality police being implicated in the unjust deaths of Iranian women. Social issues have never been more important.

In the following section, we set out how we can seek to define the diverse set of social factors that investors are facing. Throughout the paper, we set out key examples of social issues that are gaining momentum within the investor space.

[1]Centre for Reproductive Rights website, World Abortion Laws Map



Defining the Just transition

The Just transition is a process of greening the economy, in a way that is fair and inclusive, with respect to everyone concerned, creating decent work opportunities, and leaving no one behind.

Source: International Labour Organisation

Just transition

The Just transition is increasingly gaining momentum, in seeking to understand the social ramifications of a transition to a low carbon economy.

Financing could be earmarked for the **re-skilling of high carbon workers to low carbon jobs**. Investors can seek out companies and countries contributing to such efforts. The Just transition has the potential to create a number of new low carbon roles, as compared with job losses in high carbon sectors[2].

The pervasive concern will be on marrying high carbon employees and communities with low carbon re-skilling and employment, in an equitable manner as, using a simple example, where coal mines exist isn't necessarily where the sun shines or the wind blows. In addition, earmarking financing for the Just transition will be essential – with some arguing public finances should be re-directed from the circa 7% of GDP that global governments are awarding as subsidies to fossil fuels[3].

Investor actions include engaging with investee companies and governments on Just transition financing and policy, collectively and individually. Just transition opportunities also pervade all asset classes, including public and private equity, debt markets and beyond, including innovative approaches in community share and bond offers or digital crowdfunding, for example[4].

[2]World Economic Forum, What's the price of a green economy? An extra $3.5 trillion a year
[3]IMF, Fossil Fuel Subsidies
[4]Robins et al, Investing in a Just Transition in the UK

How do we define social factors?

Defining inequality

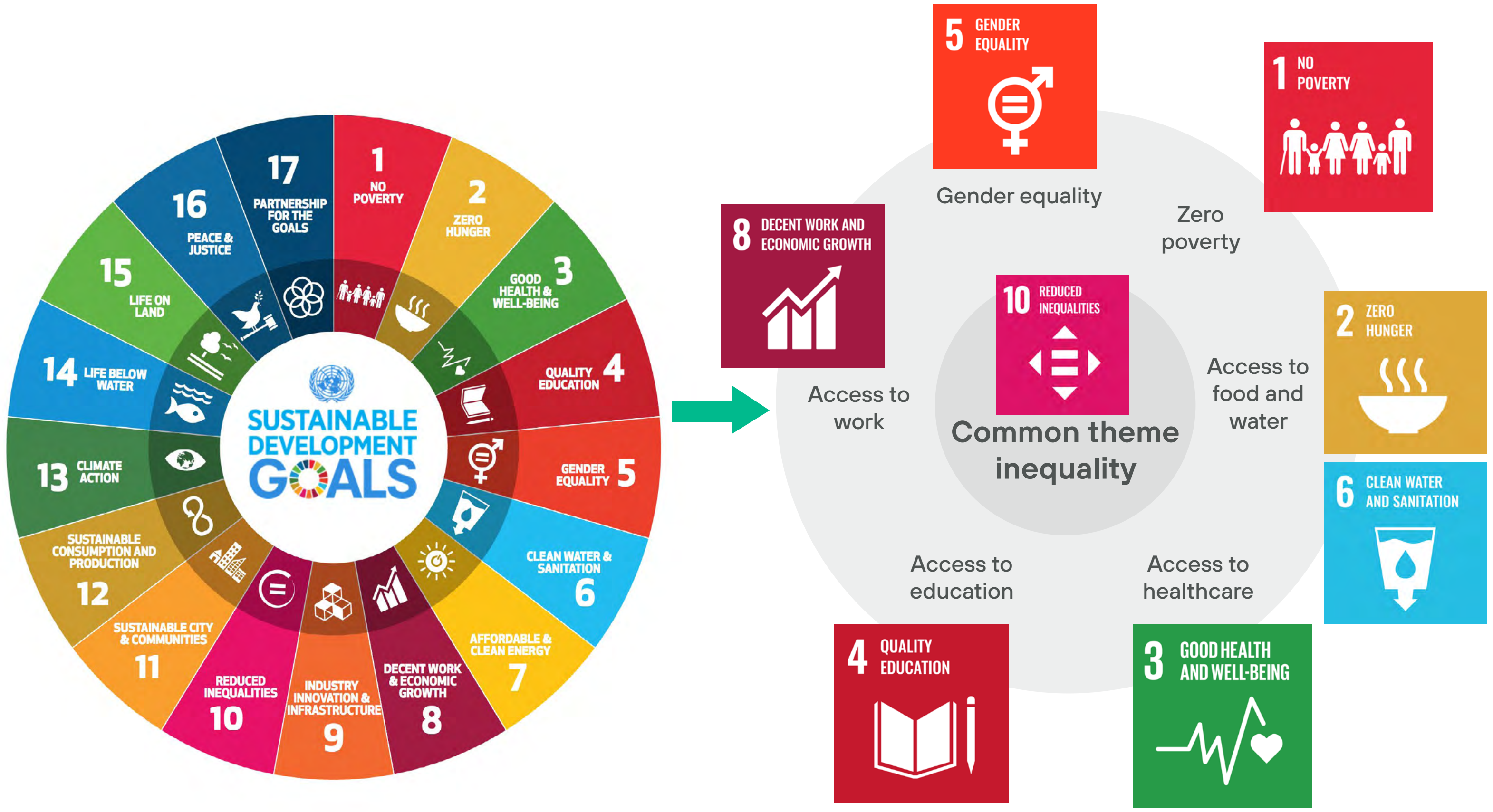
There is no one definition of inequality, covering various facets from income, to age, gender and ethnicity. Inequality is however the state of not being equal, for example, in terms of status, rights, and opportunities. It is often applied in the context of income inequality, as well as the rights of individuals.

Source: United Nations, Organisation for Economic Cooperation and Development

Social factors are a wide-ranging set of issues for investors to consider, which may also be hard to define and group. In fact, definitions of different social issues vary significantly.

Looking at the big picture, a useful starting point would be to consider what public policies are focusing on to bring about global social progress. The SDGs are an internationally recognised policy framework that seeks to drive progress in seventeen social, economic and environmental goals, agreed by global governments in 2015. Many goals are focused (directly and indirectly) on social factors – in particular, social progress in access to food, healthcare, education, sanitation, and decent jobs, for example. It can therefore form a useful organising framework for investors to identify social priority areas to concentrate on within their portfolios.

Inequality is one important unifying concept. Tackling global inequalities would be an important first step towards the social progress being sought out by public policy makers and civil society alike. Below, we highlight select SDGs with direct linkages to social objectives to illustrate the concept.



Inequality has been turned on its axis in the midst of the cost-of-living crisis, with inflationary pressures driving inequality across households and dividing households' abilities to meet rising floating mortgage obligations and energy bills. With the latter also compounded by the Russia-Ukraine war triggering concerns over the future supply of fossil fuels and anticipated supply chain disruptions, realised in the disruption of the Nord Stream pipelines carrying gas to Europe. This also follows a period of under-investment in the energy sector during the Covid-19 health pandemic.

At the micro level, and for the purposes of portfolio integration, measuring social impacts at a company level becomes important. Companies are exposed to a variety of social risks (both direct and indirect), as part of their operations as well as across supply chains. We set out below a list of social factors that may be material for companies and should therefore be considered by investors, drawn from the DWP consultation on social risks and opportunities. In particular, there is some emphasis by the DWP on the interlinkages between climate change and social factors (see introduction on the Just Transition) and modern slavery (see the case study on modern slavery for further details).

DWP list of social factors

Employees
- Health and safety in supply chains
- Workforce conditions
- Remuneration practices
- Modern slavery
- Employee engagements, diversity and inclusion

Consumers
- Product quality and safety, including public health
- Selling practices and product labelling
- Customer privacy and data security (digital rights)
- Consumer protection

Community
- Management of human rights and treatment of indigenous peoples
- Community engagement
- Impact on local businesses
- Use of local workforces

Source: taken from DWP

Why should we care as investors?

There will be an economic cost to inaction on social factors, which can be financially material for investment portfolios. We set out details on this, and the increasing social momentum across regulation and collaborative initiatives, on the right.

Defining the Gini coefficient

The Gini coefficient tracks the distribution of income, within a country or between countries. It is the extent to which the distribution of income among individuals or households deviates from a perfectly equal distribution.

Source: Organisation for Economic Cooperation and Development

Defining the informal economy

The informal economy refers to economic activities and workers that are not regulated or protected by law (e.g. labour regulation).

Source: International Labour Organisation

The economic cost of inaction

There are concerns the cost-of-living crisis will drive a regression in income equality if left unchecked. This comes at a time where the Covid-19 pandemic has already driven rising income inequality across countries[8], with individuals being put through furloughs or layoffs. Investors have been scrutinising company responses to social pressures, seeking to understand any short-termism in company attitudes towards staff retention, or pay rises in light of inflationary pressures. It is becoming increasingly apparent that social risks exist not in isolation, but interplay with economic and financial market disarray.

There is a clear macroeconomic cost to social inaction. Beyond acute systemic social risks, such as health pandemics, there are also slower onset social systemic risks, such as rising inequality. The Organisation for Economic Cooperation and Development (OECD) describe a like-for-like reduction in GDP from rising inequalities – with a one percentage point increase in income inequalities (or the Gini coefficient) reducing GDP per capita by up to 1 percent[9]. The slowdown in economic growth will in turn impact upon financial market returns. Whilst social systemic risks can also impact on markets and portfolio performance.

What we measure matters, with economic earnings themselves subject to inequalities. Up to a third of GDP in developing countries is reliant on the informal economy, with a much lower proportion in developed nations[10]. In the midst of systemic market shocks, informal workers lack rights to hold onto jobs. So, whilst investors scrutinise company responses to social forces, such as modern slavery violations, it is likely the people that will be hit the hardest will be in the less scrutinised informal economy.

There is also a clear microeconomic cost to social inaction. Social risks include labour strikes impacting on the reputation of companies, social dynamics causing permanent shifts in consumer preferences, and health and safety risks impacting on fluctuations in demand for products[11]. The ultimate impact will be on the economic profitability of investee companies, and feed through into portfolio returns. We've seen examples of this, such as the Leicester-based supplier of Boohoo.com found to be paying its staff less than half the minimum wage and resulting in the company's valuation dropping by a £billion in one day, according to news reporting at the time[12]. Future focus will be awarded to ensuring companies are paying the living wage in response to the cost-of-living crisis.

[8]World Bank, Global income inequality and the Covid-19 pandemic in three charts
[9]OECD, Growth and Inequality: A close relationship?
[10]IMF, What is the informal economy?
[11]S&P, What is the "S" in ESG
[12]Guardian, More than £1bn wiped off Boohoo value as it investigates Leicester factory

Defining modern slavery

Forced labour, modern slavery and human trafficking is defined as those situations where people are forced into involuntary work with any associated menace, e.g. using violence or other forms of intimidation, such as manipulated debt, retention of identity papers, or threats of denunciation to immigration authorities.

Source: International Labour Organisation

Modern slavery

Modern slavery has been emphasised within the DWP response on social risks and opportunities. Currently, **nearly 50 million people are estimated to be victims of modern slavery, having grown by 10 million in the 5 years to 2021**[5]. In absolute terms, this would mean there are more slaves today than at any other time in history[6].

Modern slavery is pervasive in our economy and society. Three-quarters of well-known brands surveyed in the UK have admitted a likelihood of modern slavery in their supply chains[7]. An example includes Apple's Chinese suppliers accused of forced labour under the state-run poverty alleviation programmes in China, targeting the Uyghur population.

During the pandemic, global governments' attention understandably shifted to the global health crisis, with experts arguing this has led to a fragmentation in the modern slavery response. This was at a time when the pandemic was increasing social vulnerabilities amongst the poorest. This, in turn, pushed people to risky employment to pay for their healthcare, families or livelihoods, and was accompanied by a surge in demand for cheap labour as company bottom lines were hit. Simultaneously, the suspension of education left children open to exploitation.

Investor actions that can be considered include **adopting a "do no harm" philosophy**, to identify and manage potential or realised modern slavery risks, via monitoring and stewardship, as well as collaborating with others on the issue. There will also be impact investment opportunities, investing in companies in high-risk sectors, targeting fair pay for workers in operations and supply chains.

[5]ILO website, Forced labour, modern slavery, and human trafficking
[6]50 for Freedom, Modern Slavery Myths & Facts
[7]Hult International Business School, Corporate Leadership on Modern Slavery

The main barrier to action on social risks and opportunities remains the data, and in the below box, we provide an example of how a company has overcome this to integrate social factors within its financial forecasting.

Scenario analysis to explore social outcomes[13]

Where bottom-up social data is not readily available to inform decisions, social scenario analysis may become an important tool. As an example, a textiles company undertook scenario analysis to understand the risks of child labour violations within their supply chain. The risk to the company was understood as the extent to which it impacted on the company's shares valuation.

The scenario analysis found supply chain child labour violations had a significant impact on company value via reduced profitability for a time (referred to as downtime), as well as a loss in supply contracts, and higher costs (from hiring new staff and compensating those people and families affected). The overall impact was a halving in the company's valuation.

Understanding the materiality of social risks can help companies (and investors) to not overlook the financial risks social factors can pose. From an investor perspective, clearly climate scenario analysis is now becoming widely used to analyse the potential impacts of climate risks on asset values (and liabilities). We may see developments over the coming years within the social scenario analysis space to quantify these social risks, so they can feed into investment decision making.

[13]Case study from PRI, ESG Integration: How are social issues influencing investment decisions?

Regulatory and industry landscape

At an international level, social policies have been on the rise, with governments seeking to respond to rising inequalities in the wake of the cost-of-living crisis and global health pandemic. In this section, we focus on a couple of areas most relevant to investors, beyond the SDGs which were already discussed above to help inform a view on defining social factors.

The DWP. The UK government released their response to the consultation on social risks and opportunities for pensions schemes, in July of this year. The emphasis was on the need for Trustees to individually consider how financially material social risks and opportunities are for their scheme. Later in this paper, we draw from the DWP's latest consultation response to set out initial steps trustees can take in this area. The DWP has also set up a social taskforce, to develop possible future guidance for pension schemes on social risks and opportunities. The taskforce will also seek to identify data and metrics to help assess and manage financially material social issues, as well as monitor international developments, and understand the implications of the Russian war in Ukraine for modern slavery.

In the accompanying box on human rights to the right, we set out how the Russian war in Ukraine is galvanising attention on the enforcement of international human rights law. We also draw out examples on how some investors may be lagging behind, with respect to the exclusion of controversial weapons from their portfolio.

Foundations of human rights

The foundations of human rights law are based in the 1948 Universal Declaration of Human Rights developed to prevent the atrocities of World War II from re-occurring and enshrined in international law. Human rights recognise that all humans should (equally) enjoy basic freedoms, including respect and dignity. The UN Human Rights Office of the High Commissioner has however set out a catalogue of human rights violations against the Russian government, as a result of the country's war on Ukraine and calling for the immediate end of the invasion of Ukraine.

From an investor perspective, international human rights principles have not found their way into pensions regulation. The industry typically has a reactive approach to human rights, addressing breaches within portfolios. Nearly half of the world's largest asset managers lack policy commitments on controversial weapons. However, in recent years, investors representing $7 trillion in assets wrote a letter to mainstream index managers to exclude controversial weapons[14].

The Russian war in Ukraine is not the only galvanising factor for human rights, with increasing attention on the Iranian morality police, implicated in the deaths of a growing number of women in Iran – as well as the treatment of the Uyghur people in China and associated forced labour camps, with China having recently ratified the International Labour Organisation's forced labour convention.

[14]ShareAction, Point of No Returns Part II: Human Rights

The United Nations Global Compact (UNGC) Principles

The UNGC is an initiative for companies that are committed to align to the ten Principles covering the areas of human rights, labour, environment and anti-corruption. Whilst not directly a policy, investors are engaging with the Principles as part of exclusion policies, where violators of the Principles are excluded from portfolios. It has been widely adopted, including by ESG data providers who seek to report company violations against the principles.

Collaborative initiatives

There are a growing number of social initiatives, and we highlight just a few examples that investors should be aware of. These key initiatives focus on the unifying challenges of social progress, from inequality to human rights:

Taskforce on Inequality-related Financial Disclosures (TIFD): The TIFD is developing a roadmap to inequality-related disclosures for companies and investors. This is likely to follow the approach of its climate and nature-related counterparties, with pillars on Governance, Strategy, Risk Management, and Metrics and Targets. A beta framework is expected to be launched in 2024.

United Nations Principles for Responsible Investment (UN PRI) initiative on social issues and human rights: The objective is to maximise investors' action on human rights. They focus on encouraging the adoption of the UNGC principles, for example, to respect, protect and fulfil human rights and fundamental freedoms, complying with all applicable laws in this area.

Share Action's Workforce Disclosure Initiative: The initiative aims to improve data on how companies manage workers, across both their direct operations and wider supply chains. The annual survey and engagement programme seeks to generate new data on workforce practices.

Lichtenstein Initiative for Finance Against Slavery and Trafficking: The initiative is focused on mobilising action against modern slavery, using fundamental principles around compliance with relevant laws, understanding risks and addressing such risks. It provides tools and training to financial actors to combat modern slavery and human trafficking.

Asset Owner Diversity Charter: The charter helps guide asset owner actions to improve diversity within the investment industry. This includes diversity resources to guide manager selection and monitoring processes, as well as questionnaires to inform engagements with managers on diversity.

Revisiting modern portfolio theory

Economists, Lukomnic and Hawley[15], argue that the foundations on which modern portfolio theory are built are outdated. The focus has been on the ability for investors to diversify away risk, with a focus on non-systemic risk, and failing to account for non-financial risks, such as the treatment of workers, and systemic ESG risks.

In reality, we have seen that social systemic risks can drive economic and financial market downturns. The Covid-19 pandemic drove a period of poor portfolio performance and increasing correlations amongst assets. Diversifying away non-systemic factors mattered less than the impact of the pandemic for financial returns. This brings about renewed focus on the need to safeguard portfolios against social and environmental systemic and non-systemic risks, moving forward, as financial markets don't exist in isolation of real-world outcomes.

[15]Lukomnic and Hawley, Revisiting Modern Portfolio Theory

Defining social impact

Defining impact is difficult, but one definition is an investment which incorporates some non-financial element into the decision-making. We could therefore define social impact investments as those which seek to improve social outcomes as part of investments.

Source: Law Commission

Investor response

There is momentum on social issues in the investor space. This includes some investment managers that are beginning to focus on financial inclusion as a priority area, committing to targets to raise capital in this area. This is paving the way for investors to act as stewards, not only of our environment, but our society.

Investor engagement with the social agenda will be necessary to change the way in which we invest. The consideration of ESG factors as a whole, or social factors in isolation, may help to drive an effective understanding of the impact of real-world outcomes on investment portfolios and vice versa (and not view financial markets as independent of the real economy). A long-term holistic real-world view, integrating social and environmental systemic risks, could help to provide effective hedging over the long-term time horizons of pension schemes (see box on revisiting modern portfolio theory). Several studies have found those funds with ESG criteria may have performed better, or experienced a lower volatility or degradation of returns, during the Covid-19 pandemic.

On the flip side, if social factors are not well-managed, they could pose financially material risks to investment portfolios – beyond systemic financial risks already discussed – to also include regulatory, litigation or reputational risks.

Investment opportunity

There is a need to scale up financing significantly to deliver social progress. The cost of delivering the SDGs is estimated to have increased from $2.5 to $4.2 trillion over the pandemic, including aims, for example, to promote equality in access to jobs and healthcare. [16]Social progress can only become more important in light of the cost-of-living crisis. Given the scale of investment requirement, investors will necessarily need to play a role.

Investors are already mobilising around voluntary social investments, but such investments are lagging other more developed ESG areas, such as climate change. For example, last year, in the passive space, just two of every ten sustainability indices covered the social pillar, whilst just 14% of pension schemes had social-related index investments[17].

This is expected to change. In the next three years, two-thirds of all UK schemes are expected to increase their allocations to social funds. [18]A key driving force is the need to tackle the inequalities exposed by the pandemic and exacerbated by the cost-of-living crisis, as well as responding to regulatory pressures. There has been a ten-fold increase in social impact investments over the past decade, reaching £7.9 billion by the end of 2021[19]. Social impact opportunities can aim to tackle social issues, such as affordable housing or social infrastructure, at a time when the cost of living in the UK has begun to soar.

In the next section, we set out how investors can integrate social risks and opportunities, within a portfolio context.

[16]OECD, Closing the SDG Financing Gap in the Covid-19 era
[17]Create Research, Passive Investing 2021: Rise of the social pillar of ESG
[18]Create Research, Passive Investing 2021: Rise of the social pillar of ESG
[19]Big Society Capital, Investment in social impact increases nearly ten-fold

How can we help?

The case for action on social risks and opportunities is clear. In this section, we have outlined below how we can help investors implement a 'Social Impact Journey'.

Education & training

- Education on social factors including deep dives into specific issues such as modern slavery
- Understand intersectionality of social factors with other priorities, such as climate and nature

Example: dedicated training session on social risks and opportunities at your next Trustee meeting

Agree beliefs, policies & targets

- Expand ESG beliefs and policies to include social themes and priorities
- Consider whether social targets and focus areas may be appropriate, whether qualitative or quantitative

Example: set a social target around the percentage of the portfolio engaged on the topic of modern slavery

Consider strategy changes

- Develop a socially aware investment strategy, aligned to agreed social themes and priorities
- Assess investment managers' social capabilities and consider new social impact opportunities

Example: conduct an assessment on the portfolio managers' approaches to social issues

Implementation

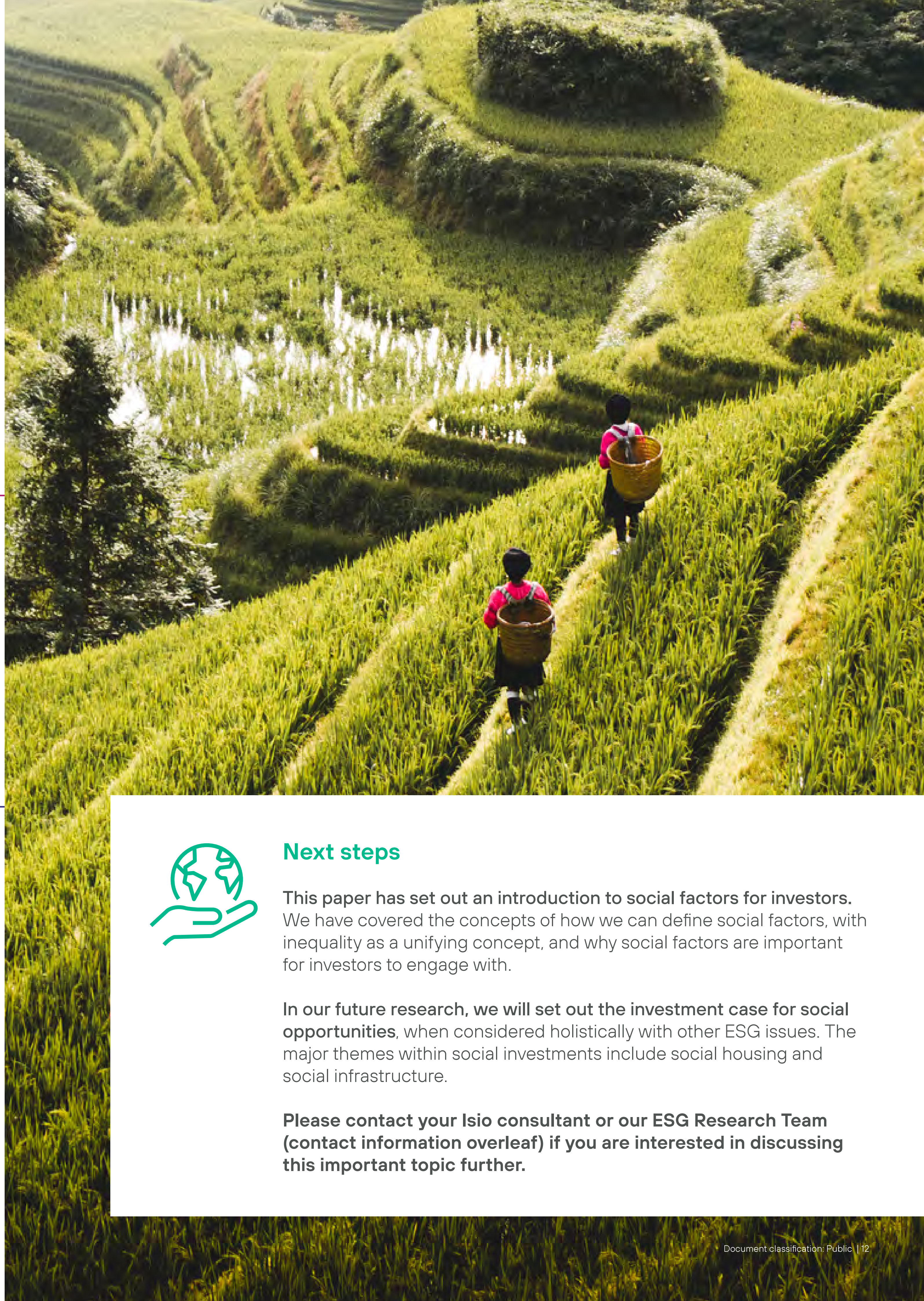
- Consider any potential changes to the manager line-up in light of changes to the investment strategy
- Set and review social objectives with managers, whether qualitative or quantitative

Example: invest in a social impact fund focused on social housing opportunities

Monitoring & reporting

- Respond to potential DWP guidance on social risks and opportunities
- Monitor the progress of managers on social factors and consider social metrics

Example: monitor female representation on the boards of investee companies



Next steps

This paper has set out an introduction to social factors for investors. We have covered the concepts of how we can define social factors, with inequality as a unifying concept, and why social factors are important for investors to engage with.

In our future research, we will set out the investment case for social opportunities, when considered holistically with other ESG issues. The major themes within social investments include social housing and social infrastructure.

Please contact your Isio consultant or our ESG Research Team (contact information overleaf) if you are interested in discussing this important topic further.

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