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## Adviser Guide to

# SUSTAINABLE INVESTING

In association with

Aberdeen Standard Investments

BM Brooks Macdonald

Hermes Investment Management

Pictet Asset Management

Rathbones Look forward

WHEB

Guide edited by **John Lappin**, leading industry commentator

# Preface

*It seems so obviously right to want to invest sustainably. Who could make a case for investing unsustainably? Investing purely for short term gain, without concern for the impact on the environment, or social standards or basic principles of governance? None of that seems to make any sense, even if the goal is expressed in narrow financial terms. Yet the practice of sustainable investing is still developing and that's exactly why we have published this, the second edition of the Adviser Home Guide to Sustainable Investing.*

*In terms of running a business, sustainability has to be a primary goal – you want the business to run for the long term. To achieve that your customer proposition must be compelling, you must get the basics right with due attention to E – the environment, defined in its broadest sense, S – Social standards adapting always to changes in societal attitudes, and G- Governance without which your legal, and control functions can't survive.*

*Anyone considering investing in any business needs to consider these factors. If there are failings in E or S or G then not only will the business be prone to reputational damage but financial or investment return will be almost certainly compromised in the long run – in other words, it won't sustain.*

*So from an investor's point of view the minimum requirement is for a company to tick the E, S and G boxes. Even a client with the purest financial objectives would need to accept this. But there's another layer to consider – where the client wishes to use their money to achieve not only a decent return but to help with other, much wider objectives. Impact investing is discussed in this guide and there are now many specialist investment vehicles which can help clients use their money for "good".*

*The adviser's role in all this is changing fast. It seems likely that suitability reports will need to take account of client attitudes to sustainable investing and to ensure these issues are an integral part of the fact find process.*

*We see this as a good thing in terms of client / adviser relationships. A focus on sustainability tilts the conversation towards the long term. It may also create an opportunity to bring the client's family into the conversation which may naturally lead to developing intergenerational planning.*

*We hope you find this Guide of value and you will see contact details for our Guide partners in Section 10.*

**Brendan Llewellyn**,
*Director Adviser Home*

# Contents



Section 1
# Introduction

An environmental, social and governance approach to investing is rapidly moving into the mainstream.

Fund managers are embracing ESG, but what may be more significant is the increase in information, help and support available to financial advisers. They are, in turn, better equipped to advise and communicate with their clients as result. There is still, however, a need for more education too.

The ESG phenomenon is being driven by increasing demand from investors. Historically the first moves were made by investment funds and foundations, especially those with an ethical stance reflecting their charitable or religious nature.

Now ESG is being embraced in word and deed by the big institutional investors and pension funds, but also the broader population of pension scheme members including those in auto-enrolment schemes. Advisers will have different experiences depending on their client bases, but a significant number are reporting increased client interest too.

There is an important regulatory element to these developments covering the full waterfront of regulators including the Bank of England, the Financial Reporting Council, the Pensions Regulator and the Financial Conduct Authority although the market awaits crucial details as to whether ESG will be incorporated into the suitability process as the European Union is currently suggesting.

Beyond regulatory concerns and actions, there is a deepening awareness that ESG can drive returns and provide a means of identifying investments that will perform well. It can also help with managing risks not just to the environment and society but to the firms themselves and thus to performance.

ESG will still involve a filtering process to screen out certain stocks but there is no longer an expectation that avoiding certain stocks and securities necessarily means forgoing performance. Most asset managers say it is also about identifying stocks that are likely to underperform or outperform.

Asset managers continue to make their case for their particular approach and advisers to test and scrutinise their process, but the terms and even vocabulary of their conversations are shifting substantially.

Most advisers would suggest that we are not there yet in terms of agreed terms and understanding. Yet there is a desire for improvement reflected in the fact that the Investment Association is consulting with asset managers on suggesting clearer terminology and better information about ESG.

Finally, events seem to lend themselves to the ESG concept providing a rationale for investing in and indeed for avoiding certain classes of securities or specific stocks and bonds.

There is a lively debate about stranded assets i.e. oil, coal and gas that may be left in the ground but also a parallel debate about how to manage the transition because there are risks involved with a sudden stop in resource extraction.

In terms of governance concerns, corporate governance failings and even company failures have increased the political emphasis on good governance in the UK.

Meanwhile as even ESG specialist managers agree, the S of ESG is the area where the least information is available with both E and G more easily evaluated. However, demands are being made of firms and efforts made to identify what "social" really means for different business sectors.

Of course, most advisers will have little desire to be on the frontline of campaigning, but these developments have the potential to provide a great deal more information which can only help the sector, including intermediaries and interested investors as they increasingly pursue their investment goals using ESG factors.

Finally within the overall ESG sector, impact investing warrants specific mention with some managers arguing that it is a more embracing approach that can drive both returns and sustainable investing.

**Laurent Ramsey**

*Managing Partner and CEO, Pictet Asset Management*

## On the value of ESG firms

The environmental products and services industry is already firmly in the ascendancy. It is currently worth some USD2 trillion and is growing at an annualised 6 to 7 per cent – double the rate at which the world economy is expanding. The number of patents filed for environmental technologies have more than tripled over the past decade to some 20,000 per year, according to the World Intellectual Property Organisation.

## Section 2
# ESG in the UK

Although elements of ethical investing have a very long history in the UK and US stretching back to the 19th Century with religious foundations and philanthropy in the vanguard, the concept has undergone a radical transformation in the last five years.

It has moved from the realm of activist investors to become much more mainstream. The most recent and sustained wave of interest looks a lot less faddish than in the past.

It is becoming much more firmly embedded and encompasses a much broader approach to investing across the asset classes. In other words, ESG itself looks increasingly sustainable.

Nevertheless, we still have the modern equivalent of green-hued environmental or stewardship funds and advisers say there is a growing demand for this kind of specialist approach too.

**Ben Palmer**

*Investment Director and Head of Responsible Investment Research, Brooks Macdonald*

### On changing generations

We are heading into an unprecedented period of intergenerational wealth transfer and as baby boomers increasingly pass their wealth the rate of transfer will only increase, beginning a trend that will continue to develop for many years. It is also clear from investor studies that the percentage of clients who want to reflect their values around sustainability and responsibility in portfolios is growing, and pleasingly there is also a growing body of evidence disproving the old belief that reflecting these principles will inherently be detrimental to investment returns.

At the same time, ESG is now firmly embedded either as a speciality within many asset management firms or sometimes applied across the range of investments, funds and solutions. Clearly firms have their own methods of organisation, but ESG teams are frequently providing a form of internal consultancy to the rest of the fund management teams through analysis and advice.

They sometimes exist as a separate business unit although these approaches are not mutually exclusive. There is also growing demand for this sort of expertise. Last year, the Financial Times reported that there was a scramble to hire ESG expertise among fund firms.

ESG can now help asset managers in their approach to equities, bonds and credit markets and infrastructure and property. It also straddles both passive and active investment with a strong emphasis on engagement with company boards.

We have also seen a concomitant rise in asset managers styling their approach as impact investing.

Certainly, the instruments for effecting change have evolved dramatically, from very blunt business boycotts to much more sophisticated techniques involving not just screens, but more engagement and positive tilts to asset allocations and specialist funds.

These firms are, to some extent, building on the pioneering work of a few. In early 1984, the UK saw the launch of the arguably the first explicitly ethical fund the F&C Stewardship Growth Fund while the 1990s and 2000s saw the launch of many more green-tinged funds.

These fund managers and some specialist advisers have supported the sector throughout but apart from some debate about including a fact find question, the sector remained very much of interest to a minority.

Things are starting to look very different first with the embrace of the acronym ESG which really came of age with the publication of six principles for responsible investing by the UN in 2006 (included later in this Guide) and which have been built on since then.

At the same time, it remains important to distinguish between philanthropy, impact investing and broader ESG-style investing demanded by pension funds and increasingly investors in the retail market. It does not necessarily involve a trade-off between doing good and achieving returns. It also provides tools to manage downside risks.

Clearly, ESG does not operate in a vacuum from real world and real market events.

Some of these disciplines have allowed fund managers to avoid certain high-profile corporate reverses and even business failures. A few have even gone public to say the ESG approach has seen them steer clear of problem stocks even those that had a previously unblemished reputation.

Most managers acknowledge that very tight screening can have an impact on returns by limiting the universe of stocks, but a broad ESG approach implemented through quants or active fund management appears, on recent evidence, to be very much holding its own. It is likely that the next stage will be the significant and more widespread adoption of some of the tools and processes of ESG.

**David Harrison**

*Global Equity Analyst and Manager Global Sustainability Fund, Rathbones*

## On the challenges

We have to solve a number of issues. We need to look at resource efficiencies including how we use the resources which are currently in the ground. We need to manage our food, both on land and on water.

On the governance side, there is a recognition among asset owners that we need to take more of a role and to hold management teams to account if they do not have the right governance structure. These are the key challenges.

Some companies have realised if they don't think about this stuff there is a risk to their businesses. Other companies are benefitting from solving some of the environmental problems.

## Section 3
# How the regulatory landscape is shifting

The regulatory landscape has shifted significantly in the last few years with the key drivers including the Paris Climate Change agreement signed in 2015 and the UN's Global Development Goals agreed the next year.

A great deal of attention has been focused on cutting carbon emissions and that is driving much regulatory behaviour in the United Kingdom. However, regulators are also embracing the wider ESG agenda. We look at some of the main developments below.


Mark Carney

BANK OF ENGLAND

The Governor of the Bank of England **Mark Carney** has been one of the leading figures in the debate regarding climate change. One of Mr Carney's big issues is transition risk.

For example, last year, Mr Carney, while warning about climate change risk in general also talked of a potential *Minsky moment*, where certain assets could see a collapse in value if there was too fast a transition. Views such as this show that the issue is not entirely straight forward.

However, advisers are arguably more interested in concrete regulations rather than views even if from such a senior source.

## The Prudential Regulatory Authority

The PRA, which sits within the Bank of England and ensures banks and insurers have enough capital, has just completed a consultation – launched in late 2018 - about climate change risk for these firms. We still await final rules, but its plans are clear from the initial consultation documents.

**Governance**
You should take into account factors which are financially material to the performance of an investment.

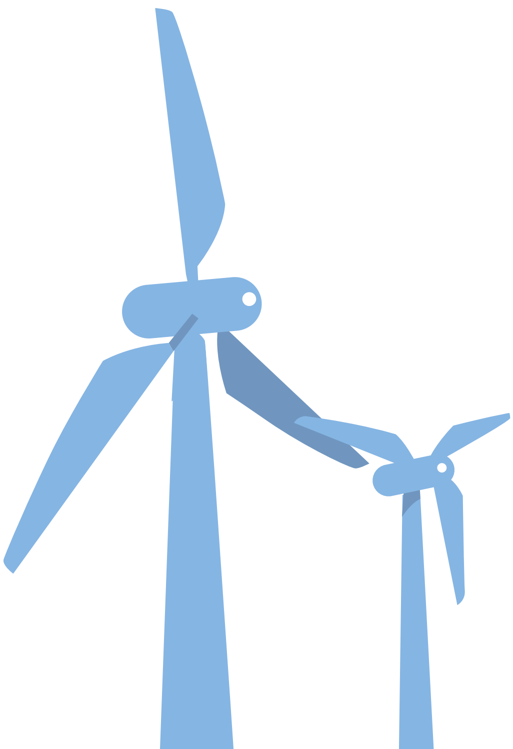
**Risk Management**
Risks should be addressed through firms' existing risk management frameworks, in line with their board-approved risk appetite, while recognising that managing financial risks from climate change requires a strategic approach.

**Scenario analysis**
This should be conducted to inform a firm's strategic planning and determine the impact of the financial risks from climate change on its overall business strategy.

**Disclosure**
Firms should consider the relevance of disclosing information on how financial risks from climate change are integrated into governance and risk management processes.

This process is likely to increase the amount information available to asset managements, advisers and investors.

The PRA consultation



## The Pension Regulator

In November 2018, the Pensions Regulator published guidance for trustees informed by a Law Commission report outlining new ESG responsibilities for pension trustees and schemes. The Government department overseeing the change was the Department for Work and Pensions.

The relevant section from the 'investment governance' section is excerpted below:

> You should take into account factors which are financially material to the performance of an investment.

> Where you think environmental, social and governance (ESG) factors are financially significant, you should take these into account. Likewise, if you think certain ethical issues are financially significant.

> While the pursuit of a financial return should be your main concern, the law is sufficiently flexible to allow you to take other, non-financial factors into account if you have good reason to think that scheme members share your view and there is no risk of significant financial detriment to the fund.

Investment governance

## The Financial Reporting Council

Under the heading **Recognising the importance of ESG factors**, the proposed Code refers to environmental, social and governance (ESG) factors. Signatories are expected to take material ESG issues into account when fulfilling their stewardship responsibilities.

FRC press release

## The Financial Conduct Authority

The FCA is moving forward on many fronts but a crucial development may depend upon relations with the EU which we consider at the end of this section.

First however in terms of concrete action, the FCA published a paper on climate change and green finance last year.

There is overlap with many of the other regulatory initiatives. The regulator is due to consult on requiring Independent Governance Committees to comply with the Law Commission report on pension funds and social investments which has informed other regulators.

These suggest that firms running workplace schemes should take account of financially material risks relating to ESG factors.

They should also take account of non-financial factors, including non-financial ESG factors, if this does not risk significant financial detriment to scheme members, and the firm has good reason to think that scheme members collectively share the concern. The FCA will consider whether to include explicit additional guidance to similar effect in its Handbook.

Other areas of work:

> The FCA says it is taking steps to boost innovation in specialist green products and ensure these markets work well and deliver good outcomes for all consumers.

> It is considering requiring more disclosures by issuers of securities.

> It is seeking views on introducing a new requirement for financial services firms to report publicly on how they manage climate risks to their customers and operations.

FCA Climate change and green finance discussion paper

Law Commission report: Pension funds and social investment

**Ben Palmer**

*Investment Director and Head of Responsible Investment Research, Brooks Macdonald*

### On government and regulatory influence

Clearly governments want to support sustainability. That will help some business, and it will create headwinds for others and more broadly we would say that positive ESG factors can act as instructive indicators of a company's longer-term outlook.

As for the regulator, as part of the Europeans Commission's Action Plans on Sustainable Finance, draft rules have been published on how investment firms should take sustainability issues into account when advising clients. The European Commission believes advice can play a central role in reorienting the financial system towards sustainability.

## The European Union

The Commission has set up a technical expert group on sustainable finance (TEG) to assist it in the development of a unified classification system for sustainable economic activities, an EU green bond standard, methodologies for low-carbon indices, and metrics for climate-related disclosure.

It has 35 members from civil society, academia, business and the finance sector, as well as additional members and observers from EU and international public bodies.

### Implementing the action plan

In May 2018, the Commission adopted a package of measures as part of its action plan for sustainable finance including:

> A proposal for a regulation to a framework to facilitate sustainable investment particularly regarding taxonomy i.e. various terms used.

> A proposal for the regulation to introduce disclosure obligations on how institutional investors and asset managers integrate environmental, social and governance (ESG) factors in their risk processes.

It is working on creating a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks, which will provide investors with better information on the carbon footprint of their investments.

The EU action plan on sustainable finance

## And finally, the EU and the FCA

The European Commission published draft rules early this year on how to incorporate environmental, social and governance preferences into investment advice which would require advisers to address a client's ESG concerns as part of suitability. The EU plans to do this through amending the MiFID II rules and the Insurance Distribution Directive.

Of course, this is EU legislation and the UK's relationship with the EU is rather up in the air. We would note that there are plans for a transition until at least the end of 2020 during which the UK is expected to follow MiFID rules and indeed changes to MiFID. So FCA action remains likely. Indeed, it is quite possible that even where the UK decided to develop its own path, it might develop similar rules.

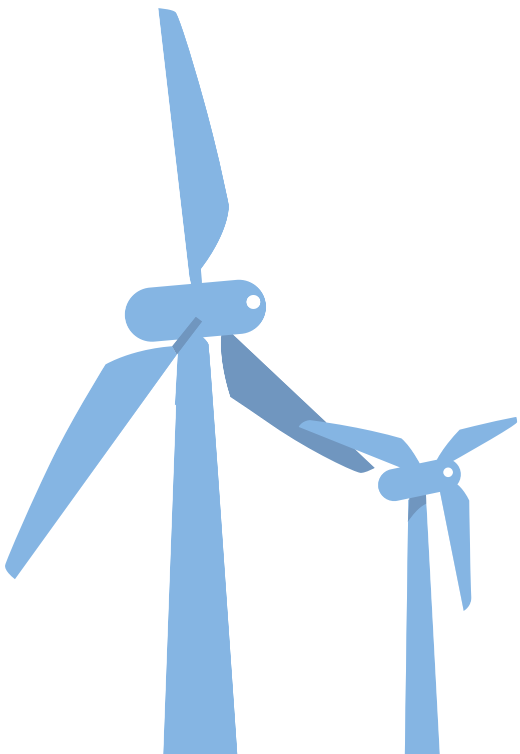
The European Commission press release

**Ben Palmer**

*Investment Director and Head of Responsible Investment Research, Brooks Macdonald*

### On suitability

Advisers need to start thinking about how they are going to engage with new ESG requirements now. Changes to MIFID II will make it mandatory for firms providing investment advice and portfolio management to introduce questions into their suitability assessment to identify ESG preferences, offer products and services that correspond to those ESG preferences and report to the client on how their ESG preference has been taken into consideration.



Section 4

# Eight real world developments that may change the ESG debate

## 1 Norway divests from most oil exploration

The decision by the Norwegian Sovereign Wealth fund - now approved by Norway's politicians - is not directly due to ESG considerations, but instead about spreading risk as per the recommendation of Norway's central bank. The US$1trillion/£770bn fund was, of course, built up from oil and gas deposits so Norway and its fund could, conceivably, face charges of hypocrisy. It is divesting from specialist oil firms, but will continue to hold shares in some oil majors which it believes could lead the way in terms of sustainable energy. What may really interest advisers is the fund's concerns about overexposure to oil prices.

The report

## 2 BP and Glencore agree to look at stranded assets

Many oil majors have come under pressure to begin examining the issue of stranded assets – i.e. whether some of their oil, gas and coal reserves will be left untapped. BP have now agreed to back a motion that will require it to analyse the following.

> Whether its business strategy is consistent with the goals of the Paris Agreement on climate change

> How the company evaluates the consistency of each new material capital investment with the goals of the Paris Agreement

> Related metrics and targets, consistent with the goals of the Paris Agreement, together with the anticipated levels of investment in oil and gas and other energy technologies; targets to promote operational greenhouse gas reductions; the estimated carbon intensity of energy products; and the linkage of its targets with executive remuneration.

The move is significant and links to a similar action being taken by mining giant Glencore which is limiting coal production for environmental reasons and examining capital expenditure and climate risks under pressure from the Church of England Commissioners which hold £10m in the group.

These moves could start to provide huge amounts of information on the issue.

Share Action's website concerning BP

Church Commissioners' press release regarding Glencore

## 3 The IA consults on ESG terminology

The Investment Association has launched an industry-wide consultation looking at ESG and sustainability criteria which should be of significant help for financial advisers not just in terms of ESG labels but also how fund firms have built up their ESG expertise. Among other things, it is working on the following standards.

### Agreed standard definitions

Proposed definitions for the different sustainable investment approaches, including commonly used terms such as: environmental, social and governance (ESG), integration, impact investing, and negative screening, with the aim of agreeing an industry-endorsed set of standard definitions.

### Development of a UK product label

A proposed voluntary UK product label designed to assist retail investors and their advisers to easily identify funds which have adopted a sustainable investment approach. The label would also draw attention to the sustainability and responsible investment expertise within the UK.

### 'Stock-take' of reporting frameworks

A review on reporting frameworks used by asset managers to disclose how they embed ESG considerations into their investment process, and the impact that their investments have had on wider sustainability indicators.

IA launches first industry-wide consultation on sustainability & responsible investment

**David Harrison**

*Global Equity Analyst and Manager Global Sustainability Fund, Rathbones*

### On investor sentiment

"There is a generational change - younger people just get this stuff. Investor demand is strongest among Millennials, but it covers all ages. You get demand that is strongly green, others feel the need to seek more comfort around returns.

## 4 The Legal and General Master Trust default fund has embraced ESG in response to member demand.

The provider assessed its members' opinions with 60 per cent supporting a move towards using ESG factors though members also said they did not want to sacrifice performance. The firm has now applied an ESG tilt within its default auto-enrolment fund.

L&G master trust default goes green due to member demand

## 5 Many of the world's corporate reporting bodies are cooperating to create global reporting standards for firms to demonstrate progress towards meeting the UN's Global Development Goals.

A new report from the International Integrated Reporting Council is aiming to identify how corporate reporting can illustrate which specific Sustainable Development Goals (SDGs) are relevant to a company's business model. It says this will enable both businesses and investors to focus on those SDGs most likely to affect financial performance.

The Sustainable Development Goals and the future of corporate reporting

## 6 Demand growing for more 'social' information

The International Organisation for Standardisation has completed work on a human capital reporting standard ISO 30414. 'Human resource management – Guidelines for internal and external human capital reporting' is the first International Standard that allows an organisation to get a clear view of the actual contribution of its human capital. In the US, the Securities and Exchange Commission is facing calls from the Human Capital Management Coalition, which has US$ 2.8 trillion under management to add nine new categories to company disclosures regarding their staff.

New ISO International Standard for human capital reporting

## 7 EU aims for action on plastics

Last year the EU began to set out plans to restrict single use plastics focusing on the top ten items found polluting Europe's beaches. It has now beefed up a 2011 directive to increase regulation. Single use plastic has also entered public consciousness with Collins dictionary making it word of the year in 2018!

EU directive

'Single-use' has been named word of the year 2018

## 8 Economists win Nobel Prize for work on climate change in 2018

William D. Nordhaus who has advocated for a carbon tax and Professor Paul M. Romer who believes that governments can make a key contribution to climate change jointly won the Nobel prize for economics in 2018.

2018 Nobel in Economics Is Awarded to William Nordhaus and Paul Romer

**Laurent Ramsey**

*Managing Partner and CEO, Pictet Asset Management*

### On the Nobel award

The Laureates Paul Romer and William Nordhaus have, respectively, devoted their careers to understanding why the world economy grows and whether it can continue to do so without causing irreparable harm to the planet, issues that cut to the heart of sustainability.

The Nobel jury and the UN's climate change panel delivered a clear message to investors. Without the investment community's commitment to the cause, the battle to protect the world's natural resources will be lost.

Investors matter because they have the power to withhold or withdraw capital from businesses that fail to take their environmental responsibilities seriously.

Section 5

# What do the E, S and G stand for?

The environmental, social and governance criteria are often deployed together and shade into each other. Unsurprisingly different advisers and fund managers take different approaches and place different emphases on each factor. However, the three letters do provide reasonable underpinning to the ESG approach. So below, we look at the definitions for each and then consider some of the other terminology in the next section.

## Environmental

The environmental criteria evaluate a company's energy use emphasising $CO_2$ emissions i.e. a firm's carbon footprint. It will consider a firm's approach to managing waste and pollution, and what might be described as more positive factors such as its approach to natural resource conservation or energy conservation. In the past year, other environmental concerns have risen up the agenda such as the approach to plastics - given the pollution in the oceans - and concerns about soil quality. A big fall in insect populations is also a worry.

It could, depending on the sector, include the treatment of animals. These approaches vary significantly firm by firm and sector by sector. Some firms will offer a clear environmental benefit; others may be taking a positive approach to minimising their use of energy or reliance on plastics. All these factors could influence whether an equity or bond manager tilts their portfolio towards certain firms in an index, away from others or simply screen out firms altogether.

## Social

Social criteria look at what might broadly be described as a company's business and societal relationships so, for example, whether a company's working conditions show a high regard for its employees' health and safety. It may involve asking whether stakeholders including employers, customers, suppliers and the arguably local communities' interests are taken into consideration. It could extend to ensuring suppliers broadly hold the same values as the company including across international borders. There are obligations under various global initiatives surrounding the employment of younger workers and children and protections ensuring that the company does not risk enabling modern slavery somewhere in its supply chain though there is a strong cross-over with governance too for many of these matters.

# Governance

The Governance criteria are likely to appeal to the broadest group of investors. Those focusing on governance will want to know that a company uses the appropriate accounting standards, fully meets the required standards for selecting board members, fully manages conflicts of interest and is transparent about all these and other management practices. Governance may also extent to meeting regulatory standards, something advisers will certainly be familiar with. It will be interesting to watch how governance may be updated to take account of recent high profile crises and failures of UK FTSE companies.

**Lewis Grant**

*Senior Portfolio Manager, Hermes*

## On governance

It is my belief that companies which improve their governance then go on to improve their environmental and social performance. If a company wants to improve overall the first thing they can improve is how they are run. Governance is the key to this.

## On the asset classes covered

At ASI, we integrate the consideration of key, material ESG related risks and opportunities of assets into our investment processes for equities, fixed income, real estate, private equity and infrastructure. We undertake this type of assessment because it helps us make better informed investment decisions for our clients around the globe. We look at our investments and do not separate ESG related issues from financially related issues, but look at these holistically, since all material issues impact our investments. As part of our stewardship platform, we undertake rigorous engagement with our holdings as well as vote our proxies, whereby upholding our active investor perspective.

**Cindy Rose**

*Head of ESG Clients and Products, Aberdeen Standard Life*

Section 6
# Getting the rest of the terminology right

Terminology varies somewhat between fund managers and so it is important to examine what is meant in detail but the following cover most ESG approaches.

## Screening

When creating ESG based portfolios, fund managers and advisers will often apply screening. In general, the process is regarded as having moved on in terms of sophistication with a lot more emphasis on managing for, and avoiding, risk.

A screen is generally used to define the universe of stocks initially. Most ESG managers screen out for various kinds of armaments and weapons and often tobacco.

They can also avoid types of securities for investors with certain religious convictions. Screening for environmental reasons can range from a very strict approach to a looser version. It could, for example, exclude pure oil explorers but not conglomerates developing renewables. Some managers suggest they have more sophisticated approaches than just screens to deal with issues like this.

Others describe the techniques they use to select a potential universe of stocks as positive screening.

## Overlays

An ethical or ESG overlay may be applied across a wide range of portfolios or indeed across the complete fund group to remove or reduce exposure to certain types of investments. Much of the debate about overlays concerns the effectiveness of screening out stocks which may, for example, have governance concerns. It is generally regarded as a relatively light application of ESG.

## Tilts

An ESG tilt will position a portfolio to be overweight in certain types of stocks and underweight in others. Once again, there are many approaches such as incorporating an ESG based benchmark into stock decisions or decisions about the original universe. For example, you might have a relatively light screen but then also weight an index according to certain criteria.

## Thematic ESG investing

This refers to more specialist investment strategies in much the same way as it does for broader investing. Themes within this might include water and waste management, energy efficiency and climate change mitigation solutions. Social themes could include supply chain management, while governance themes could include board diversity and corporate transparency.

## Socially Responsible Investing

This is an investment strategy which seeks to consider both financial returns and social good but is increasingly replaced by ESG. It can involve a best in breed approach to various sectors

## Stewardship and Engagement

This approach means utilising proxy voting and discussions with companies. These moves are to encourage better behaviours by companies, but it can be done in a risk managed and performance focused way. Passive and active managers will have different emphases. Some active managers can, for example, take a very detailed approach to encouraging improvements in behaviour either from firms that have faced ESG challenges or to demand improvements from firms that would be seen as well run in ESG terms. Some fund managers, especially passive managers, can have very public disagreement with boards. ESG's influence on corporate behaviour across the corporate spectrum in the UK is still up for debate given recent failures, but ESG can mean that at least investors may be more likely to avoid such pitfalls.

## Powerful engagement

**Lewis Grant**

*Senior Portfolio Manager, Hermes*

> Engagement is very powerful. The way you really do good is by working with a company to improve how it does things. Engagement is a huge part of what ESG is about.

**George Latham**

*Managing Partner at WHEB Asset Management*

> We are long term with an average holding period of around seven years. That means stewardship and engagement is something that comes naturally to us. We have an active dialogue with companies. It is also embedded within the investment process. So, the analyst on the investment team is holistic. He looks at ESG as part of the appraisal of a firm and is active in engaging with the business as well.

## Impact investing

The World Bank definition of impact investing runs as follows – it involves investments made into companies, organisations, vehicles and funds with the intent to contribute to measurable positive social, economic and environmental impact alongside financial returns. We would suggest that - as with all descriptors - advisers need to ask questions about the exact meaning. We have seen views that impact investing is not primarily return focused. For others, it is very much so. It is essential for advisers to test out this definition and indeed it underlines why the IA initiative is of such importance.

## Impact and returns symbiosis

**George Latham**

*Managing Partner at WHEB Asset Management*

From our view, the definition of impact involves having the intention of creating a social and environmental return alongside a financial return with a commitment to measure and report on that impact. You can approach that as philanthropy plus. In our approach, we believe that by focusing on businesses that create a social and environmental return we are focused on businesses exposed to higher growth and that are better managed and therefore have a long-term ability to generate cash. There is a symbiotic relationship between sustainability and growth in the long term.

## An ESG approach to bonds

While ESG is often seen as an issue for equities, the approach is being adapted to the bond market as well. There are two main characteristics to this approach. The first is investment in credit labelled as ESG or green some of which will have been created specifically to raise money for green or social projects by the government or corporate entity concerned. The second aspect will involve an ESG approach towards general bond investing which uses many techniques such as screening and tilting. ESG minded bond managers believe that ESG strengthens the financial evaluation of their investments in credit. The approach is also now being applied to emerging market debt as well.

**Mary-Therese Barton**

*Head of Emerging Market Debt, Pictet Asset Management*

### On research

Advisory services and rating agencies have responded to the growing demand for sovereign-based ESG analysis. And that's likely to grow as investors see direct evidence of a relationship between how sovereigns rank on various ESG criteria and how their bonds perform.

# Integration

While ESG is often seen as an issue for equities, the approach is being adapted to the bond market as well. There are two main characteristics to this approach. The first is investment in credit labelled as ESG or green some of which will have been created specifically to raise money for green or social projects by the government or corporate entity concerned. The second aspect will involve an ESG approach towards general bond investing which uses many techniques such as screening and tilting. ESG minded bond managers believe that ESG strengthens the financial evaluation of their investments in credit. The approach is also now being applied to emerging market debt as well.

**Cindy Rose**

*Head of ESG Clients and Products, Aberdeen Standard Life*

## On integration

Advisers can talk to 100 companies but no two will see it the same way. We don't yet use the same language. There is an opportunity to make these businesses accountable. You need to ask about two things. Do you integrate ESG into your fundamental investment processes. If not, you don't have to ask anything else. If the answer is yes, you need to know how, the process, the time horizon, the implications.

## On performance

As long as you have a sensible approach - the evidence shows an ESG approach gives you two things - the ability to strengthen your business and to open up revenue opportunities. For a portfolio point of view, it needs to be well constructed but even without tobacco or oil and gas, I can still buy 85 per cent of the index, the FTSE World or FTSE Europe. You are not sacrificing returns for enhanced comfort from ESG.

**David Harrison**

*global equity analyst and manager Global Sustainability Fund, Rathbones*

**Lewis Grant**

*Senior Portfolio Manager, Hermes*

## On governance

From a returns' perspective, we have found a relationship between returns and governance. From an investment perspective, why would you look for something that was poorly run – well unless you had plans to turn it around?

It is easier for people to accept that rationale for governance. With the E and S, some think it is about doing good rather than generating returns. The data suggests otherwise.

Section 7

# The global context

We do not have space to cover all the details of the UN initiatives designed to drive global development and wellbeing, but they do underpin much of the work towards ESG with a huge emphasis placed on the role of the global investment industry.

The ESG definitions also rely heavily on the Six Principles for Responsible Investment created in 2006 with signatories from some of the world's biggest institutional investors. There is a strong emphasis on cooperation between firms and even in spreading the practice of ESG. Some 2206 asset owners and investment managers are listed on the PRI website as having signed up to date.

**The UN encouraged investment groups and asset managers to put together the six principles for responsible investment in 2006. These are as follows:**

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

**IN 2015/2016, the UN put together its 17 Global Development Goals, which are influencing a lot of ESG thinking.**

**These are - No Poverty. Zero Hunger. Good health and wellbeing. Quality education. Gender equality. Clean water and sanitation. Affordable and clean energy. Decent work and economic growth. Industry, innovation and infrastructure. Reduced inequality. Sustainable cities and communities. Responsible consumption and production. Climate action. Life below water. Life on land. Peace and Justice with strong institutions. Partnerships to achieve the goal.**

What may be of most interest to advisers is that the fact that the PRI makes an investment case too.

We have provided an edited version below:

## 1 The SDGs are the globally agreed sustainability framework

The SDGs can support investors in understanding the sustainability trends relevant to investment activity and their fiduciary duties.

## 2 Macro risks: The SDGs are an unavoidable consideration for "universal owners"

Large institutional investors' long-term portfolios are sufficiently representative of global capital markets that they effectively hold a slice of the overall market, making their investment returns dependent on the continuing good health of the overall economy. They can therefore improve their long-term financial performance by acting in such a way as to encourage sustainable economies and markets.

Failure to achieve the SDGs will impact all countries and sectors to some degree, and as such create macro financial risks.

## 3 Macro opportunities: The SDGs will drive global economic growth

Achieving the SDGs will be a key driver of global economic growth, which any long-term investor will acknowledge as the main ultimate structural source of financial return.

The SDGs aim to create a viable model for the future in which all economic growth is achieved without compromising our environment or placing unfair burdens on societies.

## 4 Micro risks: The SDGs as a risk framework

In the last 10 years, responsible investment has evolved from being a primarily exclusionary approach to one focused on identifying companies that can effectively manage ESG risks and opportunities. The challenges put forward by the SDGs reflect that there are very specific regulatory, ethical and operational risks which can be financially material across industries, companies, regions and countries.

At some point in the future, a significant proportion of currently external costs such as environmental damage or social upheaval might be forced into companies' accounts. The uncertainty surrounding the timing and extent of this internalisation is a critical component of the overall risk landscape facing investors.

## 5 Micro opportunities: The SDGs as a capital allocation guide

Companies globally moving towards more sustainable business practices, products and services provide new investment opportunities.

In many cases investors are implicitly taking these factors into account already, but not articulating it: the SDGs give a common language with which to shape and articulate such an investment strategy.

**David Harrison**

*Global Equity Analyst and Manager Global Sustainability Fund, Rathbones*

"The UN SDGs are being adopted more and more by asset managers and companies. They are linking it to their core business strategy. That is the single most powerful thing to happen in the last three years. We use it as framework when we speak to management teams asking how the SDGs impact their sustainability focus. It can be manipulated as a marketing ploy, so we want to understand how this is linked to their business. Asia and the US are behind. There is less investor pressure, but the UN SDGs have really helped with this in terms of the risks.

Section 8

# The views of advisers and fund experts

**Nick McBreen**

*IFA, Worldwide Financial Planning*

## ESG is a game-changer but we still need clarity

“Following on from the Adviser Home ESG event, not a day goes by without comment in the media about sustainability. It strikes me that the momentum for fund management groups to embrace what I consider to be the game-changer for the future of investments for both investors and markets is increasing, but it still lacks clarity in terms of what good really looks like. What one person considers to be a sustainable approach may indeed be miles apart from others; hence the plethora of different terminology being used ranging from ethical right through to socially responsible.

“One part of the discussion at the ESG event definitely merits a lot of attention; namely how a “passive strategy” will fit when, for example, more and more questions are being asked about the composition of an index. It may well be a timely reminder for people to look again at FTSE4Good!

“It is going to take time and effort for people to make sound judgement calls about who to entrust with their financial futures, but the shift is happening for sure as concern for our planet’s sustainability and the impact of investment on global populations attracts more and more attention.  Along with that, we have to hope greenwashing will hopefully be quickly exposed for what it is too!”

**Robert Reid**

*Director, CanScot Solutions*

## Shades of green

"I have a few clients who are very into ESG investing. Looking at it from a risk profiling point of view, on the one hand, you have someone who is cautious and as part of their cautious nature, they like things which are environmentally friendly.

"But there is a difficulty – on the investment side what they want could be totally different in terms of the profile of the assets. We may need a paler shade of green rather than people being the investment equivalent of a vegan.

"We have generic terms and non-generic treatment of ESG. That is why the shades are so important. They may have concerns primarily about ethics, or want ethics, the environmental and the social side and we need things that meet these different demands."

**Kerry Nelson**

*Managing Director, Nexus IFA*

## ESG is cutting through

"It is very interesting. We are seeing moves in the market and the launch of ESG portfolios from fund managers and DFMs. We like the whole emphasis on governance, but we think the sustainability label is fading as ESG is becoming mainstream. Indeed, we are seeing ESG becoming mainstream across portfolios. The millennials really like it. The older generation also say we want to invest like this because of our children and grandchildren, because it is also a lifestyle thing, so it is cutting through more, than the old-fashioned sustainable investing.

"You can include some of the FTSE 100 companies because they are adopting this whole culture of change. It is very interesting for advisers now."

**Darius McDermott**

*Managing Director, FundCalibre*

## Governance needs more clarity

"I have heard this story for 20 years with ethical funds back in the 1990s, but it does look like this time is different. The next generation of investors do care more about the E, S and the G.  You can tell it is different this time because you can see more and more fund groups positioning themselves. Ethical funds used to screen things out – light green and dark green – it used to be armaments, tobacco – stocks like that for light green – and looking even at banks that lent to those sectors for dark green. It was all about screening out.

"It is now about positive inclusion for companies that meet those criteria. The part that is woolly is the governance part. Environmental is clearer. But it is the governance part where we need a stronger set of criteria. I have spoken to managers who have said to me 'we always included governance and have always been concerned about the management and the board', but that doesn't tick the governance box for me. I want to know who is on the remuneration committee? What is the gender balance? Are we looking to keep executive pay at a reasonable level? How are they treating their workers? Do workers have a management board, pensions?"

**Adrian Lowcock**

*Head of Personal Investing, Willis Owen*

## Companies which take ESG seriously tend to produce better long-term returns

"With regards to ESG in terms of investor demand it is still a niche area as many investors view ethical as sacrificing opportunities.  However we are seeing a big shift amongst younger investors who do place greater importance on ESG factors and want to invest ethically first.

"We provide Morningstar sustainability ratings for investors to search for funds based on their ESG factors.  Because this is a look through, the ratings don't cover every sector but is very good for equity funds.

"From a fund selection perspective we place a growing importance on ESG analysis and company selection criteria. We do believe that companies which take ESG seriously tend to produce better long term returns and are less likely to experience governance issues which could impact company performance. To recognise the importance of ESG we have appointed one individual within Willis Owen to lead on this to help understand what is a rapidly evolving space."

**Damien Lardoux**

*Head of Impact Investing, EQ Investors*

## Education still needed

"ESG looks at the operational side of the business. With impact investing you want to look at the whole business. That is the type of businesses – those businesses that will make a positive impact on society and the environment. It is a more holistic approach. You should also be able to measure it. We do a lot of work telling stories but also measuring impact. The idea is to help investors understand even with a 20K Isa, they can make an impact. I think it is the best side of capitalism that we are promoting here.

"If you talk to fund managers, there isn't a single one not mentioning ESG being embedded. It is a must have now. I know some didn't have ESG, but in pitching institutional mandates they were required to have ESG. It was demand led.

"Now there is evidence you can reduce your downside risk and improve your upside potential. So that is a given. If it doesn't it becomes an orange flag."

"We work with advisers and private clients across the country. We find a growing interest but there is still confusion about the terms - sustainable, impact and ESG. There is a lot of education work to be done. Even with private clients, they are not clear what it means in investment terms when they have ethical preferences. We are at the point where education is still needed."

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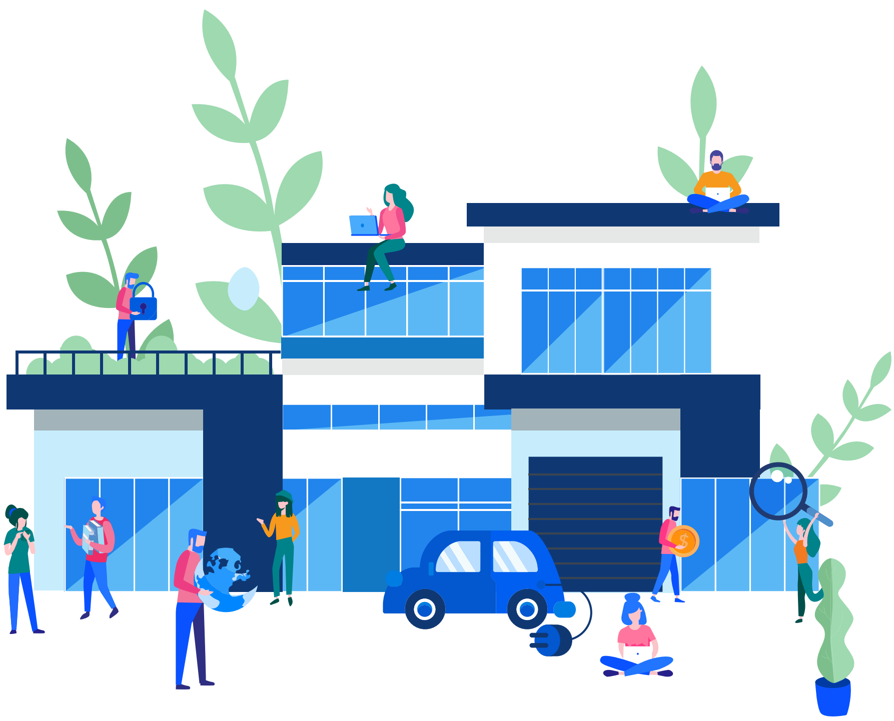
Section 9

# Useful adviser resources

- The EIRIS Foundation: campaigning for better environmental information
- EIRIS' consumer facing Yourethicalmoney website
- The Ethical Investment Association - a group of IFAs who offer ethical and green advice
- Investopedia definitions
- The Morningstar section on ESG investing
- The UN's Development Programme's sustainable development goals
- The UN Principles for Responsible Investing
- UN PRI investor tools (generally aimed at fund firms)



Section 10
# Adviser Guide Partners

## Aberdeen Standard Investments

At ASI, we integrate the consideration of key, material ESG related risks and opportunities of assets into our investment processes for equities, fixed income, real estate, private equity and infrastructure. We undertake this type of assessment because it helps us make better informed investment decisions for our clients around the globe. We look at our investments and do not separate ESG related issues from financially related issues, but look at these holistically, since all material issues impact our investments. As part of our stewardship platform, we undertake rigorous engagement with our holdings as well as vote our proxies, whereby upholding our active investor perspective.

### Contacts

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## Brooks Macdonald

Our Responsible Investment Service (RIS) is designed for clients with the dual objective of responsible investment and return generation in line with defined risk profiles. We offer two distinct Responsible Investment strategies: **Avoid** and **Advance** and the service is available via professional advisers both through our Bespoke Portfolio Service and on select platforms.

RIS is integrated into our centralised investment process. This ensures that same level of due diligence, monitoring and accountability is applied across all investments. This is extremely important as the Responsible Investment Service is designed to offer the core expertise of Brooks Macdonald, while additionally meeting your responsible investing requirements.

### Contacts

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## Hermes Investment Management

Hermes Investment Management provides active investment strategies and stewardship. We offer public and private market solutions across equity, fixed income, real estate and alternatives for a global clientele of institutional and wholesale investors. For Hermes, ESG investing is not a recent phenomenon. Responsible investing is core to our business, and we have been at the vanguard of ESG investing for more than three decades. We integrate ESG across all our strategies. We believe that our duty extends beyond achieving clients' financial outcomes: we must act as stewards of the investments we manage and advise. In 2004 we established Hermes Equity Ownership Services (Hermes EOS), which is now one of the largest stewardship teams in the industry.

### Contacts

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## Pictet Asset Management

We are convinced that Environmental, Social and Governance (ESG) considerations can help us make better long-term investment decisions for our clients.

For decades, sustainability has been central to our way of thinking. Since the Pictet Group was founded in 1805, we have aimed to ensure the prosperity of our clients over the long term. In doing so, we have instinctively considered the interests of future generations.

Pictet Asset Management believes in responsible capitalism and takes an enlarged view of the economy and its interactions with civil society and the natural environment.

Consistent with our fiduciary duty to act in the best interests of our clients and our adherence to the UN Principles for Responsible Investment (UN PRI), we are committed to integrating material ESG criteria in our investment processes and ownership practices with a view to enhance returns and/or mitigate risks. We also aim to embed ESG in our risk management and reporting tools in order to maintain high standards of transparency and accountability.

### Contacts

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## Rathbones

Rathbones
Look forward

To us sustainable investing is about long-term value creation for investors, society and the environment. We believe Investors shouldn't have to compromise their own personal values when it comes to putting their savings to work.

Mindful of our responsibilities to our clients, we seek to be good, long-term stewards of the investments which we manage on their behalf.

Suitability for inclusion in our sustainable and ethical funds isn't a one-off event, but something monitored continuously over time throughout the entire investment life-cycle. Utilising a robust and well-established investment process, the investment team work collaboratively with our ethical research team, which has over 20 years' experience in assessing the social, environmental and ethical performance of companies.

We believe companies displaying strong policies and practices with regard to ESG issues are likely to be well-positioned to deliver long-term value creation for investors.

### Contacts

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## WHEB

WHEB

Generating investment returns through positive impact is WHEB's sole focus. It's the only way we have ever invested and it's the only way we ever will as we believe sustainability is a driver of alpha. Our investment strategy has a thirteen year track record so we are an experienced team of specialists. We define impact by whether a company's product or service has a positive impact on the environment and/or society. As the world transitions to a more sustainable economy, companies that enable this shift are likely to experience significant structural growth. Growth derived from the positive impact of our investments is at the root of our ability to generate attractive financial returns.

### Contacts

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