Adviser Home
DEVELOPMENT PLATFORM

Sustainable Investments

Guide 2022

In association with

AEGON

M&G Investments

PICTET Asset Management

Aegon and responsible investment

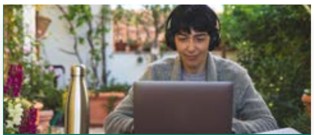
As an investment provider and responsible business, we think holistically and long term. ESG is ultimately about protecting and growing our customers' savings, as well as contributing to a more sustainable world.

Challenges such as climate change are global and systemic in nature, requiring bold action from governments and the private sector. At Aegon, we have committed to net-zero carbon emissions for our pension default funds by 2050, and a 50% reduction by 2030.

We're continuously enhancing our ESG approach. Our responsible investment framework articulates our approach to ESG and sets a minimum standard for fund managers on our platform to adhere to. We currently have around 200 ESG funds to choose from on our platform. What's more, we've added dedicated ESG components to our pension default funds, improving their sustainability profiles. And to help you and your clients navigate the impact of climate change in savings, our website has useful responsible investment guides and insight.

In short, responsible investment is a top priority for us, with exciting proposition developments to come in 2023.

Find out more



Responsible investment **adviser hub**

Responsible investment **customer hub**

Our investment **proposition**

Contact details

Simon Clark
Investment Specialist

Simon.clark@aegon.co.uk

Continue

M&G Investments

At M&G Investments, we've been investing money for individual and institutional clients for more than 85 years and our principles of investing for the long-term, responsible stewardship of our assets and active fund management have been the foundation of our approach throughout.

We consider it our responsibility to support our customers' investment and savings goals by aiming to generate sustainable returns over the long term. We also recognise that, increasingly, customers are looking to align their investments with their environmental and social values and have a range of funds that can help meet this need.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Contact details

David Halfacre
Sales Director (Head of Partnerships)

david.halfacre@mandg.co.uk
0208 162 3558

PICTET Asset Management

Sustainable credit:
ESG is key

Properly assessing a company's environmental social and governance credentials gives credit investors an edge.

It's become the norm for equity investors to appraise a company on environmental, social and governance (ESG) criteria. Bondholders increasingly realise that the non-financial aspects of a business's performance can have a lasting effect on its creditworthiness and investibility. ESG factors come into play from various directions. For instance, government regulation is taking on ever more environmental and social dimensions. Public awareness of the impact companies have on the environment or social justice is causing them to vote with their wallets – increasingly, they stop buying goods and services from companies that are unethical or polluting. And investors are becoming more sensitive to the potential for reputational risk of being associated with badly run companies. At the same time, new techniques and metrics are emerging to help analyse the non-financial factors that had hitherto been overlooked because they couldn't be measured, but which carry material risks. We believe that a clear understanding of company ESG profiles gives investors a clear edge in surfacing the gems from a broad and deep pool of corporate credits.

Contact details

Clemmie Collett
Sales Manager Intermediaries

ccollett@pictet.com

Continue

CPD

This Guide offers 1.5 hours accredited CPD

Learning outcome

For readers to be current and up to date in their understanding of terms of the most recent events (i.e., the US Inflation Reduction Act), developments, consultations and discussions that have taken place or about to take place as regards to sustainable investing. Specifically, to have a better understanding of:

1. **COP 26 -** Key takeaways; new deals and announcements and targets for 2030 (i.e., reversal of land and forest degradation); by 2050 a 30% reduction in emissions. Other promises and pledges made in anticipation of a reality check at COP 27 in Egypt later this year.

2. **Financial Advisers** – the gatekeepers to sustainable investing; discussions around sustainability and suitability and the retail investment market; delays to implementing systems and processes as they await more definitive guidance so they don't have to later change. How the big asset owning institutions are increasingly using aspects of ESG to help frame their asset allocation strategies, stock selection and risk management.

3. **Fund Labelling** – EU, UK and US; EU- what's covered in Articles 6, 7 & 9 and the partially in force Sustainable Finance Disclosures Regulation (SFDR); US – SEC seeking to bring in a new regime of fund labelling and a clamp-down on financial firms that are mis-labelling themselves as ESG. The FCA argues there is a clear appetite for sustainability labelling.

4. To better understand the **differences and implications** of ESG; its impact both as a category and a discipline; ESG as a risk management tool; what ESG involves; the importance of G and work being done on S. The political backlash in the US over the phrase ESG and how it's been blamed for the energy crisis in some Republican party circles.

5. To be able to explain the FCA's ESG **strategy** – 5 core themes for advisers and asset managers in relation to ESG strategy – e.g., Transparency, Trust, Tools, Transition and Team.

6. To understand the **terms and terminology** such as greenwashing, impact investing etc.

Contents

INTRODUCTION

This is the **2022 Adviser Home Guide to Sustainable Investing**. It has been a remarkable few years' with sustainable investing matters rising to the top of the regulatory agenda along with huge changes in requirements across the regulatory landscape governing banks, insurers, pension funds and, increasingly across the whole economy for listed shares, large private companies and large partnerships.

Financial advisers will, of course, have noticed that the retail investment market still awaits some key pieces of regulation. One important paper regarding climate disclosures from asset managers and, arguably more importantly for advisers – fund labelling – is currently at consultation stage having been postponed.

Yet another important regulatory initiative, pre-announced several times by the FCA and Treasury in the past 12 months will involve another crucial piece of the puzzle - regulation regarding sustainability and suitability.

UK financial advisers are likely to be required to discuss sustainability with clients to see if they would favour a sustainable approach and then find ways to reflect these preferences in their investment recommendations.

Frankly, this has left things a little up in the air and, it is clear, some advisers are taking things a little more slowly as a result.

In the words of one, they are 'keeping their powder dry' on the basis that they do not wish to go too far down the road in terms of developing systems and processes that might have to change subsequently.

There is, of course, also a deeply sceptical camp among some advisers who are perfectly content with the delays.

All that said, many firms had established a sustainable, ethical or environmental, social and governance approach long before these key regulations had even been proposed.

Some had seen the market opportunity or decided it was simply part of a process of getting to know their clients.

Treasury Building, Great George Street, Whitehall

Continue

Of course, it is not just about advisers. The big asset owning institutions are increasingly using at least some aspects of ESG to help frame their asset allocation strategies, stock selection and risk management.

In addition, many business practices are changing across many key sectors, among listed shares, bonds and in infrastructure.

Although the drivers and shape of reforms vary across jurisdictions with the US, China, the rest of Asia, the EU and UK sometimes emphasising different approaches, it is safe to say that many of the calculations made by businesses are shifting along with rules and regulations.

New business models are being developed around existing and new technologies. The most recent headline grabbing reform is the US Inflation Reduction Act, an historically large investment in sustainable energy and transport.

Finally, if much of this feels as if it is mostly about the E in ESG, there is long established practice for governance while detailed work is now being done on the S as well. We look at this a little later in the guide.

A BACKLASH IN SOME CIRCLES

Of course, it hasn't all been plain sailing for advocates of the ESG and the sustainability approach.

There has been something of a political backlash in the US – the phrase ESG has been blamed for the energy crisis in some Republican party circles. In the UK, net zero or at least the speed at which it can be achieved became controversial in some of the debates and from certain candidates in the Conservative Party's selection of a Prime Minister. The net zero target and timetable, however, look set to remain in place even if there are questions about whether some of the underlying reforms can deliver.

THE PANDEMIC AND ENERGY TURMOIL

The profile of sustainability and sustainable investing did not suffer particularly during the pandemic helped by the strong performance of many lower carbon intensive sectors. Alongside this, those calling for the international community not to lose focus on climate change and the UN sustainable development goals were heeded. They were helped by the number stocks fitting into many ESG and sustainable frameworks and indeed specialist funds did well with big inflows as well.

Recently the huge spikes in inflation, turbulent markets, and the share big price rises and dividend pay-outs from the oil and gas giants and even something of a coal revival have underlined that

Continue

progress towards the transition is not always inevitable or at least not always smooth.

The current soaring energy costs have seen energy markets and technologies and indeed energy companies come under extraordinary levels of scrutiny. The debate has raged between some who want to slow the energy transition and those who want to accelerate it. There are also discussions around gas and nuclear in terms of definitions and taxonomies.

Public sentiment remains favourable to change at least partially underpinned by extreme weather events as well. The targets remain in place and, as with the US, big pots of money are being made available to attract more private investment and to drive change.

Advisers may query how much of this is relevant to their advice and their recommendations in the long term. We aim to reflect some of those views here.

Yet many of these issues will have an impact whether driven by financial regulations, new duties placed on companies, increased government and private investment, new technologies, new market opportunities and indeed consumer sentiment.

We would argue that it is useful for advisers to have a good grasp of these matters even if some of the details governing advice are 'yet to be confirmed'.

If that is the broader picture however, the Guide will also seek to inform advisers about where exactly we are now, what the likely regulatory picture will be in future and some views on market developments. There is a huge amount of regulation and we have only examined some of the most significant elements.

Without some of the finalised regulations, we do, unfortunately, also lack some of the answers. Yet with this Guide we will endeavour to inform you of forthcoming regulation and the terminology being used. We will also consider the key challenges specific to advisers and to share what other firms are doing.

Section 1

WHAT IS THE SHAPE OF THE MARKET AND THE KEY TRENDS WITHIN IT?

To understand the ‘market’ for sustainability, there are several ways to frame things. The first is global with competing perspectives and requirements emerging in Europe and the US, and in very broad terms, a set of different priorities or at least a different emphasis in China and to a degree the rest of Asia.

There are likely to be many push and pull factors affecting stock and bond markets globally, but they are not all universal with many different national approaches influencing firms within countries or for multi-nationals across many jurisdictions.

The second frame is regional, in this case with the European Union, its regulations and taxonomy having an impact on the UK even as ministers mull whether there is an advantage in diverging significantly.

Many UK asset managers are applying new European rules and want to see reasonably close alignment with those for the UK although whether that happens remains to be seen.

The third way to frame the market is within the UK itself. Here much is being defined by regulation. It covers the whole waterfront of financial and real economy business though with the focus mostly on disclosure and comply and explain rather than tougher requirements to comply alone. For example, in workplace pensions, schemes are being encouraged to set targets using established standards and to measure progress towards them, but no government targets are being enforced quite yet.

The fourth way is to look at asset management and advisers in the UK, something likely to be most of interest to advisers. We intend to look at each in turn below with some useful statistics to follow.

Continue

Section 1a

GLOBAL DEVELOPMENTS

The last big climate change meeting COP 26 in Glasgow got a mixed review from many commentators though a lot of emphasis was placed on the agreements from financial institutions as well as governments. Some may argue that with record profits for fossil fuel majors and even a coal market revival, the exit from the pandemic has cast a further cloud over the global climate change agreements. Nevertheless, these net zero and decarbonising targets remain and, as we will see a little later, progress is being made in some quarters notably the US.

COP 26 IN BRIEF

Here's the UN summary, but expanded a little further here.

→ **Recognising the emergency**

Countries reaffirmed the Paris Agreement goal of limiting the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit it to 1.5°C.

→ **Accelerating action**

Countries stressed the urgency of action "in this critical decade," when carbon dioxide emissions must be reduced by 45 per cent to reach net zero around mid-century with a call the publication of national plans to be accelerated.

→ **Moving away from fossil fuels**

Countries agreed to a provision calling for a phase-down of coal power and a phase-out of "inefficient" fossil fuel subsidies.

→ **Delivering on climate finance**

Developed countries promised to deliver US$100 billion a year for developing countries in climate financing by 2023.

→ **Stepping up support for adaptation**

The Glasgow Pact called for a doubling of finance to support developing countries in adapting to the impacts of climate change and building resilience.

Continue

Completing the Paris rulebook

Countries reached agreement on the remaining issues of the so-called Paris rulebook, the operational details for the practical implementation of the Paris Agreement.

Focusing on loss & damage

Acknowledging that climate change is having increasing impacts on people especially in the developing world, countries agreed to strengthen a network— known as the Santiago Network – that connects vulnerable countries with providers of technical assistance, knowledge and resources to address climate risks.

New deals and announcements

- 137 countries committed to halt and reverse forest loss and land degradation by 2030 backed by $12bn in public and $7.2bn in private funding.
- 103 countries, including 15 major emitters, signed up to the Global Methane Pledge, which aims to limit methane emissions by 30 per cent by 2030, compared to 2020 levels.
- Over 30 countries, six major vehicle manufacturers and other entities, like cities, set out their determination for all new car and van sales to be zero-emission vehicles by 2040 globally and by 2035 in leading markets.
- Developing countries announced $8.5 billion over the next 3-5 years to help South Africa transition away from coal to a low-carbon economy.
- Private financial institutions and central banks announced moves to realign trillions of dollars towards achieving global net zero emissions with over 450 firms across 45 countries controlling $130 trillion in assets, requiring its member to set robust, science-based near-term targets.

This is, of course, an impressive array of pledges and we certainly don't want to be too cynical but COP 27 in Egypt later this year may bring something of a reality check when progress is assessed.

WHAT ABOUT THE US?

The most recent good news regarding sustainability has to be from the US where a lot of taxpayers' dollars are being devoted to the Inflation Reduction Act. It earmarks $369 billion for energy and climate change priorities - potentially game-changing sums. There is some debate but Moody's Analytics says the following in terms of CO2 reduction.

> " By 2050, we estimate emissions will be reduced by nearly 30% compared with a scenario in which there is no additional policy changes to address climate change.

US fund labels

We would also note that as a hugely significant global financial centre, the US through the Securities and Exchange Commission, is seeking to bring in a new regime of fund labelling.

It is proposing establishing a category of ESG Integration funds and ESG-Focused funds including funds that "*apply inclusionary or exclusionary screens, funds that focus on ESG-related engagement and funds that seek to achieve a particular ESG impact*".

Separately, the SEC is already pursuing regulatory action against financial firms that are mislabelling themselves as ESG using existing rules.

This Guide is clearly not able to provide an exhaustive look at the world situation. However, we also decided to take a brief look at China which has begun to sign up to various global pledges though once again with questions about the detail.

This Mercator Institute for China studies article "Greening" China: An analysis of Beijing's sustainable development strategies provides a neat summation.

> China's leadership acknowledges climate change and environmental degradation as real and pressing threats to long-term regime survival and economic prosperity. However, while a trend towards a concerted push for sustainability shows in national-level policies, the lack of forceful sectoral and local-level incentives leaves China with a mixed track record on sustainability.

Continue

> “ China’s Covid-19 stimulus measures are more targeted at investing in carbon-heavy infrastructure for economic stability. However, the pandemic has not stopped Beijing’s policy machinery for more sustainability and a greener economy.
>
> China’s authorities pursue a non-disruptive and incremental green policymaking approach, always concerned about political stability and economic costs.
>
> Beijing’s strategic bet for its sustainable future is on achieving state-guided and funded technological breakthroughs in, enabling a green transformation at home and global tech leadership in all areas, from renewables to environmental protection equipment.

As you can see the consultancy is sceptical about many of the details but acknowledges big drivers of change.

Section 1b
THE EUROPEAN REGION

The European Green Deal signed in 2020 has some rather spectacular numbers attached representing a €1 trillion with over half of the budget, €528 billion coming directly from the EU budget and the rest from the EU Emissions Trading System. It represents an incredibly ambitious programme of investment over many years but with the main aim of the EU being carbon neutral by 2050. As with many of these promises, it will be interesting to see what the current energy crisis does to these ambitions though it is, again, probably a little early for detailed analysis.

However, several EU initiatives are likely to have an influence on the UK as well.

These include the taxonomy – an extraordinarily ambitious set of definitions for all manner of sustainable activity which is intended, among other things, to be of significant use to investors in bonds and equities with S&P offering a ‘short’ guide to the 550 page (and growing!) document here.

The most recent and controversial addition to the taxonomy came in February where the European Commission agreed to include nuclear and natural gas in the list of economic activities covered under the EU Taxonomy Regulation, but arguments and debates are ongoing.

Continue

SETTING A STANDARD FOR GREEN BONDS

One component of the overall EU strategy, arguably of great interest to investors is the creation of standard for green bonds.

This update for Oxford University's Faculty of Law policy blog, by the European Banking Institute associate researcher **Nikos Maragopoulos**, discusses its innovative features. He notes that:

> " Proceeds [from the bond] should be used to finance assets and expenditures that are either Taxonomy-aligned or contribute to the transformation of activities to become environmentally sustainable within a defined period.
>
> It introduces enhanced disclosure requirements for issuers based on standardized templates, pre- and post-issuance and it requires issuers' disclosures to be assessed by external reviewers to ensure compliance with reviewers registered with and supervised by the European Securities and Markets Authority.

The potential for setting standards is, of course, only one aspect of a host of European initiatives but it could be a very significant one.

EU FUND LABELS

Also of interest is the fund labelling regime under the partially in force Sustainable Finance Disclosures Regulation. Broadly speaking, funds are grouped in the following ways and summarised here by Robeco.

Article 6 covers funds which do not integrate any kind of sustainability into the investment process and could include stocks currently excluded by ESG funds such as tobacco companies or thermal coal producers.

Article 8, also known as environmental and socially promoting, applies "*… where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.*"

Article 9, also known as 'products targeting sustainable investments', covers products targeting bespoke sustainable investments and applies "*… where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark.*"

Continue

We would note that a debate is ongoing particularly about the wide spread of funds likely to fit into article 8, so these definitions could be finessed further. There are also moves by some EU countries such as Germany seek to devise their own fund labels with some funds required to contain 75% sustainable content as KPMG notes here.

Section 1c
NATIONAL DEVELOPMENTS - The full waterfront of UK regulation

The UK approach looks to cover the waterfront of financial services and all public and significant private companies at least in terms of disclosure.

Many of these regulatory initiatives refer back to the Task Force on Climate-Related Financial Disclosures (TCFD) which set out a framework for climate disclosures based on the Paris targets around 1.5 and 2 degrees and first published in 2017. It is likely to be at the heart of most climate change disclosures including for asset managers (when published).

Other initiatives include work by the Bank of England through the Prudential Regulatory Authority, which is now requiring banks and insurers to incorporate climate change risks into their strategies and to tell the PRA about it. It is complicated but perhaps summed up best with the quote below.

As the PRA wrote this year in a Dear CEO letter:

> “We expect firms to take a forward-looking, strategic and ambitious approach to managing climate-related financial risks. The PRA will pay particular attention to how firms quantify climate related risks and incorporate those risks into business strategies, decision-making, and risk-taking.

Continue

In pensions, most big schemes and master trusts are being asked to consider climate risks in detail in their portfolios. A consultation that completed earlier this year said:

> "Policy proposals, draft regulations and draft statutory guidance to require trustees of larger occupational pension schemes, authorised master trusts and authorised schemes providing collective money purchase benefits to calculate and report a metric setting out the extent to which their investments are aligned with the Paris Agreement goal of pursuing efforts to limit the global average temperature increase to 1.5˚C above pre-industrial levels.

It comes into force in October with the government suggesting that 80 per cent of schemes will be covered.

The disclosure regime for publicly-listed and big private firms and LLPs has been in force since April 2022 and subsequent company reports must now include climate change risks including any targets and progress towards them. Much of the responsibility for policing these firms will fall to the Auditing, Reporting and Governance Authority soon to be the successor to the Financial Reporting Council.

Much remains controversial of course and these do not yet include imposing targets though with the strongest of hints about the Paris targets. There will be a host of information potentially of huge use to sustainability and climate change minded investors but without firm targets, could they could still be said to lack teeth.

Section 1d

NATIONAL DEVELOPMENTS -
Advisers and asset managers still waiting details

The FCA does have a published ESG Strategy with five key core themes as follows:

- **Transparency**
  promoting transparency on climate change and wider sustainability along the value chain
- **Trust**
  building trust and integrity in ESG-labelled instruments, products and the supporting ecosystem
- **Tools**
  working with others to enhance industry capabilities and support firms' management of climate-related and wider sustainability risks, opportunities and impacts
- **Transition**
  supporting the role of finance in delivering a market-led transition to a more sustainable economy
- **Team**
  developing strategies, organisational structures, resources and tools to support the integration of ESG into FCA activities

The retail financial services market has however become a bit of a laggard when it comes to the details. Two key pieces of regulation are promised. We know what the regulator was mooting at least last November in a discussion paper entitled Sustainability Disclosure Requirements (SDR) and investment labels.

The FCA now says that a consultation paper will be published in the third quarter.

In a July update, it said:

> We had aimed to consult in Q2 of 2022. We are now planning on consulting in the autumn, to allow us to take account of other international policy initiatives and ensure stakeholders have time to consider these issues.

Continue

Those international developments may include the SEC's fund labelling regime mentioned above.

For now, the UK labels are as follows:

- **Responsible**
  may have some sustainable investments and arguably aligned with asset managers who apply ESG integration

- **Sustainable**

- **Transitioning**
  sustainable characteristics, themes or objectives; low allocation to Taxonomy-aligned sustainable activities

- **Aligned**
  sustainable characteristics, themes or objectives; high allocation to Taxonomy-aligned sustainable activities

- **Impact**
  objective of delivering positive environmental or social impact

These are, we must stress, subject to change as we move beyond the discussion stage to the consultation stage.

RATINGS AND DATA OVERSIGHT

As part of broader reforms of capital markets in terms of ESG integration, a recent FCA feedback statement said it "*sees a clear rationale for regulatory oversight of certain ESG data and rating providers. So, we will continue to work with the Treasury, who are considering bringing ESG data and rating providers within our regulatory perimeter.*"

Another development to watch closely.

Continue

COMING SOON?

In October 2021, in the Green finance, a roadmap to sustainable investing, the Treasury said:

> HM Treasury and the FCA are exploring how best to introduce sustainability-related requirements for financial advisers. A key aim will be to ensure that they take sustainability matters into account in their investment advice and understand investors' sustainability preferences to ensure suitability of advice. Details of the proposals are subject to further consideration and will be set out on a different timescale to proposals for financial market participants. The proposals will be subject to consultation and cost benefit analysis.

Advisers could be forgiven for being a little impatient about progress to date for their sector.

One long-standing sustainability investment figure who is involved in the process has a more upbeat view.

Julia Dreblow, founding director *SRI Services*, says:

> We are currently waiting for the FCA's SDR consultation paper, to which I contributed to as a member of their Disclosure and Labelling Advisory Group.
>
> The sustainable investment market has now grown so large that what was once seen as welcome diversity of fund options – to suit different clients' opinions - is now seen as confusing and sometimes off-putting.
>
> Their paper will mark an important step in the right direction as it will help ensure that intermediaries – and their clients – have access to better quality fund information. The CP will also include a set of labels that will make it easier to recognise different types of sustainable funds. This approach is important as there are advantages and disadvantages to different fund strategies.
>
> Some funds are more focused on companies with high sustainability standards whereas others are more focused on driving change, for example. Once it has worked its way through the system it will help lift the fog, many feel has descended on this area. Addressing greenwash concerns and directing capital towards companies that are helping to deliver a sustainable future is crucial both for financial prosperity and our continued success as a species.

Section 2

FACTS AND FIGURES ABOUT GLOBAL AND UK SUSTAINABLE TRENDS/DEMAND

We have compiled a brief list of statistics which demonstrate the extent of change, estimates about the move to sustainability investors and a couple of indications about attitudes from advisers and investors.

1. The Climate Bonds Initiative suggests that Green, Social, Sustainability, Sustainability-Linked and Transition-themed debt rose to almost $1.1tn in 2021, marking a 57% increase upon 2020 volumes.

2. An analysis by Bloomberg suggests ESG assets soared to an unprecedented $37.8 trillion by the end of 2021 and are predicted to grow to $53 trillion by 2025, which would be a third of all global assets under management.

3. The Investment Association's ESG Global survey 2021 surveyed a broad range of institutional investors and asset managers. It found that 22% of investors surveyed integrate ESG into at least 75% of their portfolios. In addition, almost half of institutional investors (45%) say their ESG capabilities are embedded throughout the organisation nearly double the number (23%) in 2019.

4. The Investment Association noted earlier this year that in 2020 and 2021 retail investors consistently put more than £1bn a month into funds with a social or environmental purpose. Flows have slowed in the wakes of the various crises but responsible investment flows in March 2022 were still £935m.

5. Consultancy Investment Metrics' analysis of 52 funds from 45 asset managers in the Global ESG equity peer group found that global ESG equity products nearly doubled (+98%) from 2019 to 2021 with 80% of Global ESG equity products outperforming over a three-year time horizon with a three-year median return of 8.54% while outperforming the benchmark by 2.3% and the broader IM Global Large Cap Equity Peer Group by 1.2%.. Yet these products have struggled so far in 2022, with 78% of ESG equity products underperforming the benchmark.

6. The FCA argues there is a clear appetite for sustainability labelling. The FCA's Financial Lives survey (published in February 2021) found that 80% of respondents wanted their money to do some good, while also providing a financial return and 71% wanted to invest in a way that is protecting the environment while 71% would not put their money into investments which are unethical.

Continue

7 Aegon research with more than 10,000 customers found that found that 72% are concerned about environmental issues, 61% worry about equality, and 65% have concerns about poor corporate governance. The research showed that the intent to invest sustainably is broadly consistent across the age groups, with pre-retirees (55-64 years) equal or slightly ahead of the younger age groups. It also showed a clear correlation between receiving advice and investing responsibly. 59% of those surveyed who had a financial adviser invested 40% or more of their savings sustainably, where only 12% of those who had a financial adviser had no exposure to sustainable investing.

8 The Schroders Financial Adviser pulse survey 2022 which surveyed more than 200 advisers in May 2022 found that 90% of advisers agree that events over the past two years have reinforced the importance of stewardship and using an asset manager who actively engages with company management. Some 83% of advisers agree that events over the past two years have "*increased the attention I pay to the environmental, social and governance risks associated with investments*". Around 72% of advisers have been making preparations for the coming requirement to consider and note their clients' sustainability preferences and 54% have been preparing for changes in sustainability related requirements on product labelling.

9 A survey of investors published in May by M&G Wealth titled Family Wealth Unlocked showed that 35% of consumers expect their adviser to be an expert when it comes to ESG investing. A further 23% anticipate their adviser will bring this investment opportunity into financial planning discussions and just 9% would not want their adviser to bring the subject of ESG investing to the table.

Section 3
WHERE ARE WE WITH THE LETTERS E, S AND G?

Advisers will have noticed that ESG remains something of a moveable feast as regulators, not just in the UK, but in Europe and the US try and nail down the terminology.

For UK advisers, the matter is not helped by the UK consultation paper on fund labelling being delayed.

The FCA is clearly using ESG as part of its own 'ESG strategy' – obviously. In addition, while its proposals regarding fund labels did not use ESG as one of the main labels or sub-labels it does discuss ESG integration as part of the broad Responsible category.

The paper also notes that one aim is to

> build trust in the market for ESG and sustainable investment products by combatting potential 'greenwashing' (where sustainability claims made by firms do not bear scrutiny) and enabling consumers to make informed choices

Interestingly one of the reasons cited for the delay to the paper in summer 2022 was to consider international developments. That likely meant the US as the EU approach was already well known.

The US regulator, the SEC is suggesting that labels ESG integration and ESG focused are applied to funds.

The EU is using an Article 6, 8 and 9 designation – useful for intra-industry debates but unlikely to be of much use for communicating with investors.

There are concerns that the broadest categories so Article 8 in the EU and ESG Integration in the US are too loose. Although at an earlier stage, that might equate to what the FCA has suggested for a responsible category in the UK.

There is still a lot of work to be done in this area particularly with another group of terms still in use in terms of ethical, sustainable, responsible and more recently impact.

The latter term impact, for example, is sometimes regarded as a discipline within ESG, but is also used as a category in its own right.

For now, it appears that UK advisers would likely be best deciding what emphasis to place on these terms, discussing them with clients and maintaining a watching brief for the next consultation.

Continue

For now, many in the market are taking the initiative with their own explanations.

Fund Calibre, managing director *Darius McDermott*, says:

> "We've tried to educate our investors about E, S and G via our Viewpoint magazine and our e-newsletters for the past five years or so. It's been in the past couple of years that there has been more interest and I would say they definitely understand more today. It's not helped by the fact that all funds are very different and that the level of ESG can differ so dramatically from one fund to another. So we've also introduced ESG badges for FundCalibre recently, which show if ESG is explicit in the process of a fund, integrated, or limited - with an explanation. This is to help investors understand better if the fund is looking at all three aspects or just one or two and how much emphasis is on each.

Ben Constable Maxwell, head of impact investing at *M&G*, recognises that we are grappling with definitions but aims to give a neat summation.

Ben Constable Maxwell

Head of impact investing at M&G

M&G Investments

> "Broadly speaking, sustainable investing is investing in a way that balances the interests of numerous stakeholders, from the employees of companies we own, to the communities they interact with and the environment in which they operate. It is inherently long-horizon and involves thinking about the challenges and opportunities that companies and society will face in the years to come.
>
> Within that broad definition there are different approaches to take in the responsible and sustainable investing landscape.
>
> One approach is to remove companies causing harm from your portfolio, which may also help to align your portfolio with your clients' values. Then there is ESG integration, which is essentially about making better-informed decisions by considering non-financial ESG risks as well as traditional financial ones – which should result in improved risk-adjusted investment outcomes. The third part is about actually investing intentionally for good. It could be through engagement to improve company behaviour or performance on ESG issues; or it could be through impact investing in a way that intentionally generates positive impacts on social and environmental outcomes for the good of the world, but doing it in a way that generates a decent return for your investors. So we can characterise this as avoiding the bad stuff, improving your likely risk-adjusted returns through better portfolio management and then intentionally doing good, balanced by doing well in an investment context.

INDIVIDUAL LETTERS

In terms of developments, it remains clear that E – environmental attracts the greatest attention and specialist funds, that G for governance has been incorporated by the greatest number of managers for the longest time with a strong emphasis on risk management and to a slightly lesser degree engagement, but that regulators and investing organisations are moving rapidly to increase the understanding and disclosure around the S for social.

G can to a degree clash with E – as can be seen by the decision by a major index provider to leave Tesla out of its ESG index partly over governance issues, despite its many strong environmental credentials and a decision that has been questioned by Tesla CEO Elon Musk.

Increasingly the S, for a while less well defined is now coming into its own. The UK pension minister Guy Opperman has created a taskforce to help the UK pension industry engage with the S in social. The EU is now also working on a social taxonomy and you can now invest in social bonds with increasing work on standards such as this from the International Capital Markets Association.

How much this is widely adopted in terms of specific funds' strategies remains to be seen.

Constable Maxwell does makes a case for a reappraisal of what might have been once regarded as dark green and super ethical.

Ben Constable Maxwell

Head of impact investing at M&G

M&G Investments

> "If you're facing a societal problem, and you've got a company providing the solution, as long as they tackle that challenge in a resilient, well-managed way, they should be well positioned to do it profitably. The solutions-oriented approach to this seems the logical one. I think capital regulation will align with those solutions providers, because society needs to support and promote them. If we've got to solve climate change, we've got to tackle health challenges like COVID, or we've got to address the challenge of excessive waste, regulation will support those sorts of companies, customers will want to use their products and capital will flow towards them. So, you should see these long-term tailwinds towards those areas. It may once have been dark green and seen as super-ethical but I think now with impact investing there's a really strong investment logic to it.

Continue

NextWealth manager director **Heather Hopkins** says:

> “
>
> We’re just updating our report on Sustainable Investing. I think the big issue for me - and it was brought out in our last Sustainable Investing Tracker Study is that the language is a mess. When providers talk about ESG they are talking about integration - an input to investment decision making. Clients are talking about outputs - it’s really about sustainable investing.
>
> The data is a mess and it relates to the above. Asset managers are reporting the ESG rating of their funds based on metrics that often don’t make much sense to investors and don’t relate to their individual priorities. There is a huge reporting challenge for financial advisers who want to report metrics against client individual goals and priorities, but consistent data is often not available.
>
> The sooner we stop conflating ESG and sustainable investing the better - it will make it easier to make sense of various data sets that will then feed through to suitability and reporting.
>
> We don’t compare performance for sustainable funds versus conventional funds, but we do ask about perception of performance. In the past few years, most advisers think performance is about the same. Increasingly though, we’re hearing advisers say that sustainable investing represents a different journey - clients that want to invest according to their values don’t expect to have the same returns.

Section 4
ESG AS A RISK MANAGEMENT TOOL

The management of ESG risk is increasingly something adopted by asset managers and indeed to a lesser degree by companies themselves.

It is also a focus of the FCA's work as *Aegon's* head of responsible investment **Hilkka Komulainen** acknowledges:

Hilkka Komulainen

Head of responsible investment at Aegon

> "There's a risk element. Much of the way the financial services industry has looked at climate risk is as an investment risk. That's very much the view of the regulators who are also enforcing it. It is part of the reason that firms like Aegon and other large insurance companies, banks and pension funds, are now being required to consider climate risk as part of their business strategy. There's a sense that this isn't just a feel-good approach about connecting with people's values- it's also a big part of risk management, although that does also depend on the product.

In this frame, there is a broad regulatory move towards managing risk, a meeting of investor's concerns and values and avoiding doing harm and then another approach in terms of doing additional good. All carry an element of assessing risk at a company level, a pension and investment portfolio level and stock level.

One classic example of how an ESG risk management approach can inform investors' decisions at stock level is the case of BP and the DeepWater Horizon oil spill. The company was subject to hundreds of warnings from the US Environmental Protection Agency beforehand and arguably, an ESG risk management approach would have placed lots of red flags on the company especially post-merger. Some academics have argued exactly this point.

Elsewhere, research from Sustainalytics has found companies that experienced high to severe ESG incidents can lose 6% of their market capitalisation on average with consumer staples and utilities at greatest risk of declining market value from ESG-related controversies.

Increasingly the ratings agencies will provide risk assessments on companies which may be used by asset managers though of course many managers also use their own risk scores. The G is ESG has often been regarded as of particular relevance in risk terms. Ratings can also be used to tilt portfolios.

Continue

A report published this year from the Bayes Business School (formerly Cass) from **Professor Andrew Clare**, Professor of Asset Management, **Professor Nick Motson**, Professor of Finance, and **Professor Aneel Keswani**, Professor in Investment Management found that enhancing (ESG) profile of a European fixed income portfolio would not have undermined performance over the last 10 years, with tilts improving performance at the margin and controversial sectors making little impact historically.

That arguably feeds into arguments about investment performance as well.

Section 5

PERFORMANCE vs. ESG – CONFLICT OR HARMONY?

The matter of ESG and performance is one that has been long debated and something that is likely to continue. The assumption, certainly for early ethical portfolios, was that relatively heavy screening would reduce the available universe of securities to buy and that would likely impact performance. This has been subject to much greater challenge in recent years.

A recent report from State Street The future of ESG – Supplying the Demand contains the following perceptive paragraph:

> We still lack a coherent, complete and widely accepted definition that clarifies ESG's scope. That makes it challenging for investment professionals as well as everyday investors to identify whether ESG initiatives are being carried out effectively.

It then quotes **Professor Olivia S. Mitchell** of the *Wharton Business School* saying:

> " Without agreement on what ESG involves, it is almost impossible to show that ESG helps or hinders investment performance.

Continue ▶

This paper from late 2021 looked at Impact of ESG Performance on the Financial Performance of European Area Companies: An Empirical Examination by Greek academics **Phoebe Koundouri** from Athens University of Economics and Business, **Nikitas Pittis** from the University of Piraeus and **Angelos Plataniotis** from the National and Kapodistrian University of Athens. To quote:

> "As far as the results on the correlation between ESG performance and financial results are concerned, our study showed that the beta coefficient, a very widely used measure for shareholders' risk, tends to be lower in companies with strong ESG performance, thus implying a comparatively lower equity risk; firms in the automotive sector are an exception, however.
>
> Our analysis revealed a clear dominance in the profitability of companies that have good ESG performance compared to the rest, in all sectors. This was observed to be the case for both ROA and ROE and agrees also with results from the literature.

Yet other studies may cause pause. A recent paper by **Ryan Flugum** of the University of Northern Iowa and **Matthew Souther** of the University of South Carolina reported that when managers underperformed the earnings expectations (set by analysts following their company), they often publicly talked about their focus on ESG. But when they exceeded earnings expectations, they made few, if any, public statements related to ESG.

The Harvard Business Review also sounds a sceptical note here and a more positive note here!

WAS TOO MUCH MADE OF PANDEMIC PERFORMANCE?

More recently there have been some concerns that sections of the sustainable investment sector made too much of pandemic performance.

CWC director **Clive Waller** has some harsh words, and it is fair to say that he also predicted this would happen just as the pandemic struck. He says:

> "Some ESG and ethical providers were bragging about the outperformance during lockdown when industry and travel were locked down! It was not only utterly predictable, but it was also clear that the tables would turn when lockdown ended or with the arrival of a successful vaccine. Arguments made by asset managers, commentators and journos demonstrated the short termism and focus on a quick buck that kills trust in the industry.

Continue

Reflecting on views such as Waller's, **Jake Moeller**, senior investment consultant at *Square Mile Investment Consulting Research* says:

> "The bout of underperformance in 1H 2022 has caused the penny to drop for many advisers that ESG considerations potentially create a "style bias" (e.g., structural underweights to oil and gas). These can have material effects on risk and return outcomes. These need to be understood and articulated to clients. Many clients will have dipped their toes into the ESG waters recently for the first time and will have been spooked by the drawdowns. To become long-term converts to the cause, advisers are key in educating how performance can be influenced by ESG decisions.

McDermott says:

> "The perception around performance (that you had to give up some performance to invest responsibility) was all but gone as these funds had enjoyed quite stellar performance for some time. It's taken a knock in recent months as many of these areas are 'growth' areas that have been hit by rising inflation and interest rates, but the long-term theme is undeniable and I think we are past the point where people say you have to sacrifice performance for your principles. You really don't.

Julia Dreblow takes the long view. She says:

> "The science is very clear. It tells us that we must achieve net zero (and stop destroying nature) very swiftly if we are to continue to thrive as a species. This year, the markets have been telling a different story – thanks to world events. Whilst understandable this will not serve clients well as it cannot continue. Intermediaries need to be mindful of clients' investment terms, their opinions and the kinds of businesses that are most likely to thrive longer term.

CanScot Solutions principal **Robert Reid** says that many clients do raise the issue of performance in conversations about this approach to investing and when asked about the impact his answer is "*We don't know.*" He notes one client who said: "*My daughter would want something greener, but I am light green.*"

Section 6

ESG IN DIFFERENT ASSET CLASSES AND INVESTMENT APPROACHES

ESG has moved beyond an equity-based approach to one that covers many asset classes.

There is certainly a strong sense that along with greater emphasis on the G and S components, fixed interest and to a degree other asset classes are increasingly encompassed.

Some of this is driven by initiatives to require greater disclosure around green and indeed social impact bonds.

This is from the FCA paper on ESG integration in capital markets which says:

> We encourage issuers of ESG labelled Use of Proceeds debt instruments to consider voluntarily applying or adopting relevant industry standards, such as the Principles and Guidelines that the International Capital Market Association (ICMA) has developed for green, social, and sustainability bonds.

Moeller adds:

> “The future augurs well. Issuance of Green and Social Bonds is growing strongly and this includes well subscribed sovereign issues (such as the UK and Spain a year ago). This is only going to increase as fund groups become more embedded “responsible lenders”. ICMA is responding with the maintenance of credible standards and frameworks for issuance, and we are seeing a large increase in the number of sustainable and impact bond funds becoming available for advisers to recommend.

Continue

AN EXTRA LAYER OF RISK MANAGEMENT

Audrey Laurencet, Senior Client Portfolio Manager at *Pictet Asset Management* discusses the ESG approach to credit here. She says:

Audrey Laurencet

Senior Client Portfolio Manager at Pictet Asset Management

"One of the difference between credit and equity investors is that we are focusing more on risk management, because the main risk that we are incurring as credit investors is a risk of default.

With our approach we aim to have a positive environmental and/or social impact, while selecting good quality issuers able to navigate and survive throughout the market cycle.

First we have a financial approach as we remain credit investors above all. We will not invest in a name just because it has a good ESG rating.

Then, we have a second approach, which is centred on ESG and adding some extra layers of risk management.

We have developed our own proprietary financial and ESG scorecards that help us to narrow down the field of the global investment grade universe and to highlight the sector leaders. When I say leaders, I mean the issuers that are the best placed to survive throughout the market cycle. Our ESG scorecard is particularly powerful as it helps to highlight hidden corporate risks, not readily visible in financial statements.

Each sector has its own scorecards taking into account its own specificities. It doesn't make sense to treat the utility and the healthcare sectors in the same way. E will be prominent for utilities; G will be prominent for healthcare. Within social, we will look at various risk-oriented KPIs, with the likes of employee incidents, operational incidents or supply chain incidents, i.e. all the kinds of accidents and incidents that took place in the past and that are likely to take place in the future if unaddressed by management. Thus, we can say that we are really focused on risk management.

Continue

She cites the example of avoiding Wirecard in terms of governance issues.

The sustainable side also informs the financial side where they have developed scorecards for each sector.

Audrey Laurencet

Senior Client Portfolio Manager at Pictet Asset Management

> “ In our portfolio, we won’t own companies that are distributing outrageous dividends or are involved in huge share buyback programmes. We will focus on capex, R&D and inventories. We believe that if you invest in your business, you will have a strong and sustainable balance sheet, and therefore be better positioned to adapt to the changing trends that we are seeing in the world today.

Despite the different steps of the investment process, Laurencet says that they are not losing sight of their key investment objective, i.e. having a positive environmental and social impact, subject to good governance practices. They will therefore invest mainly in good quality companies where a significant proportion of their activities are deemed to generate green revenues, or in companies with low/reducing environmental footprint, or in ESG labelled bonds with the use of proceeds contributing to a social and/or environmental goal.

CHALLENGES FOR MULTI-ASSET

There does appear to be good news but some challenges in terms of portfolio composition.

Richard Whitehall, head of portfolio management at *Aegon* says:

Richard Whitehall

Head of portfolio management at Aegon

> “ There are increasing options on the bond side with particular interest in green bond funds. The challenging question from an investment perspective is what do you want bonds to do in your portfolio; are they there as a safety net or as a volatility dampener, while your returns are driven by equites? The challenge from the multi-asset investors point of view is whether the bond funds that have the RI focus will do that to the same extent, particularly when your equity is a little bit higher beta and riskier? Because of that risk element we’ve combined bond funds that have that particular focus with some more standard bond funds, while still ensuring it is achieving the sustainability outcomes we want.

Continue

Komulainen says:

Hilkka Komulainen

Head of responsible investment

AEGON

> The challenge that we currently have is that there aren't enough companies that meet these kinds of criteria, which was why a lot of sustainable funds and the sustainable finance industry is quite focused on engaging with companies and bringing the voice of the shareholder to support sustainability objectives, as well.

There does appear to be good news but some challenges in terms of portfolio composition.

Corporate credit, says Laurencet does remain narrower than equities. With equities you can target one theme, such as clean energy, but more diversification is required in a bond portfolio, especially if you focus on quality. The corporate credit universe (excluding private debt) would be too small to run a pure one thematic fund. She says that is why they focus on a global approach without sector bias. There are positive developments with standards being developed and improved, not least in the US, which should see the sustainable credit universe grow.

Audrey Laurencet

Senior Client Portfolio Manager

PICTET Asset Management

> We can have more transparency and access to better quality data, especially in the US. The US was behind the curve in terms of data reporting, but thanks to the SEC, we can now expect to have access to more accurate data. This is a clear positive of regulation that it will standardise company reporting to the benefit of investors.

BEYOND BONDS

ESG is increasingly applied to property and again, regulators are broadly turning their attention to these matters with the UN Principles for Responsible Investing organisation issuing guidance just this spring.

There is also increased ESG integration in alternatives with 85% of investors in alternative investments saying they are integrating ESG criteria into their investment decisions, an increase of 10% points over the last three years, according to new research from LGT Capital Partners.

Continue

Moeller adds:

> "We are certainly seeing increasing disclosures, reporting and efficacy in alternatives such as property and infrastructure investments – especially with respect to carbon and environmental touchpoints.
>
> Ironically, many fund managers have been involved in managing the environmental efficiency and footprints of these asset classes long before it has become fashionable.

WHAT ROLE CAN PASSIVE ESG PLAY?

The conventional view and indeed occasional adviser gripe that passives are not well represented in ESG or indeed that ESG represents a kind of marketing comeback for active fund management, does not appear to be borne out, at least by the number of passive options available and its embrace by those constructing portfolios.

Dreblow says:

> "The passive ESG / sustainable fund market has expanded incredibly fast, though it is not clear that clients understand what such funds do. This area will benefit from greater regulatory clarity.

But it is becoming easier to stock a portfolio.

Quilter investment director **Rick Eling** says:

> "We have WealthSelect Responsible, that comes as fully active, blended and passive. What you have got is the intersection of the biggest investment themes of the past 10 years, passive investing and responsibility.
>
> There are now enough underlying instruments on the market that are passive in their selection but have a hard screen in place for ESG - a fundamental tracker. There is enough to build a risk rated model portfolio and I think you will see a lot more of those come to market in the next two or three years.

Continue

Moeller sees some issues for adviser to be aware of. He says:

> “ ESG does fit more comfortably into the active fund narrative, certainly around engagement and stewardship. Nonetheless there are increasing passive ESG solutions available now which cover a range of environmental and social preferences. They do pose some problems as they can result in unforeseen exposures and tracking errors and investors need to understand the rules underpinning either their exclusions or revenue/product screens.

Section 7
THE ROUTES INTO ESG AND COMMUNICATING WITH CLIENTS

The question of how advisers accessing ESG arguably fits together with how advisers are communicating about ESG with clients.

Research from NextWealth in 2022 showed that 18% of client assets are in sustainable funds or solutions, down from 21% in 2021 but still higher than in 2020 when it was just 12%.

It also found that a core-satellite approach, with sustainable investment solutions sitting alongside advisers’ core investment propositions continues to grow in popularity, rising to 66% in 2022 from 56% in 2020.

Full integration of sustainable criteria into a portfolio was at 25% in 2022 and just 7% rejected the sustainability concept altogether.

Advisers may be addressing the issue in their centralised investment propositions.

Moeller says:

> We are increasingly seeing advisers create ESG-based centralised investment propositions with the assistance of investment consultants or DFMs. For time-constrained advisers, this is undoubtedly going to help as SDR kicks in. Today there are now sufficient building single strategy funds for advisers to create their own model portfolios and there are also fund groups with credible multi-asset propositions as well – however the fund research requirements may be too onerous for all but the best resourced advisory groups. Risk profiling tools are probably still some ways behind in accurate modelling of ESG specific risks as ESG data sets and time series are relatively young.

Mark Rendle, head of marketing at *AJ Bell Investcentre* discussing the platform's offer to advisers, says:

> We launched two new investment offerings to help advisers cater for the growing demand from clients for ESG focused investment solutions. The Responsible MPS aims to deliver long-term growth for clients who want their investments to avoid controversial industries as well as companies with low ESG rankings. It follows the same structure as AJ Bell's Passive, Active and Pactive (combined passive and active) MPS options, with six risk-managed portfolios. The Responsible MPS invests in ETFs that track a MSCI SRI index where possible, giving a robust range of values-based exclusions and ensuring that AJ Bell targets companies with high ESG rankings to invest in.
>
> "The Responsible Growth Fund was launched to cater for clients that want diversified exposure to companies with strong ESG credentials. It invests in responsibly screened ETFs which remove stocks from controversial businesses such as tobacco or alcohol. Any company that breaches the UN Global Compact is also excluded. Once these companies are removed, companies that have strong ESG factors are included to give a diversified exposure to different regions and sectors, with better than average impact on both people and the planet.
>
> "There are also third-party MPS options available via the AJ Bell Investcentre platform, with more than 10 providers featured and different ESG and SRI options included. Our Morningstar research tool also provides information on funds with sustainable and ESG preferences to assist advisers in selecting investments for their clients.

Continue

HELPING CLIENT UNDERSTANDING WITHOUT LEADING THEM ON

Yet communicating about ESG also has an influence on the solutions advisers are seeking and there are arguably more distinctions in the investment approach and some frustrations about what is available.

Plan Money director **Peter Chadborn** says:

> “ We first provide an introduction document which is designed to educate clients about what ESG is, and just as importantly what it is not. This also serves as an initial filter, to see who says: *“That’s interesting but it’s not for me”*, and who says “*tell me more*”. Either way it answers many questions.

Among other things, the document sets out a clear difference between ethical and ESG investing noting the firm can accommodate the latter but not the former.

> But in terms of implementation, it can throw up more questions than answers, if only for the advisers. That was certainly our experience in putting this together and being happy with an in-house recommendation. For every point of view there is a counter point of view, with each investment house avidly promoting what suits their proposition. So no, there are not enough central, reliable, impartial, accountable points of reference.

Anna Pollins, managing director at *Fairstone Group* is mindful of not leading the witness when it comes to advising clients? She says:

> “ We talk to our advisers a lot about starting this conversation and where will it lead. Like any area of financial advice, it’s really important that we’re not pushing our own views on to our clients. When we talk about advocating for sustainability, we need to be careful that we can introduce this as a concept and educate our clients on this. Even the word sustainability can be confusing.
>
> With our questions, the starting point is do you have any preferences in the way your money is managed? That’s a question that we’ve always asked and that also calls in to active and passive and so on. But then we ask do you prefer to have a positive impact? Or would you prefer to avoid a negative impact? We try not to get too closed on the questions. But to open that discussion – “*tell me more, why is that important to you?*” to get to the underlying reason why a client might have a strong view or not.

Continue

Komulainen links it to people are already making changes in their lives. She says:

Hilkka Komulainen

Head of responsible investment

AEGON

> We know that people are concerned about climate change and concerned about sustainability. How can we link the daily actions that they're taking to their investment decisions? How can we bring investing into their toolkit for taking action around sustainability?

Constable Maxwell *says:*

Ben Constable Maxwell

Head of impact investing at M&G

M&G Investments

> If there is an opportunity to invest in a way that generates decent risk-adjusted returns over time and in a way that is driving positive change, I see that as an attractive option for clients. Advisors certainly need an understanding of their clients' needs in this regard and impact investing may only be appropriate for a relatively small portion of their portfolio. But if the case can be made that your investment approach is methodical and robust and you can invest in a way that intentionally addresses the real-world impacts of your investments, then if you ask the client, of course some might say no… but a lot would say yes.

Advisers remain sceptical of some approaches at least for most clients. *CanScot Solutions* principal **Robert Reid** says:

> When you get into sustainability and impact, I see a much higher risk profile with impact because of its nature. Sustainability is different with companies finding a way not to damage the environment and the same time making the company more efficient.

He says a lot of client conversations tend to get to the matter of returns very quickly and when asked does it make a performance difference, he suggests 'we simply don't know'. Clients tend towards light green solutions while one recently acknowledging his daughter would go for much greener options, he would not.

Continue

He suggests that the sustainability conversation is still mostly initiated by financial industry professionals and not by clients themselves.

> “ We are all having this heavy journey into sustainability and impact, but the general public aren’t.

However, that may raise an interesting point regarding a light approach.

SERVING THE QUITE CONCERNED MIDDLE

Quilter’s **Eling** says:

> “ There is a phrase “*Storming, forming and norming. It is usually applied to group dynamics, but I think it really explains where the industry is in terms of responsible/ sustainable investing. We are still storming right now. There is no standard taxonomy that everyone has agreed on. There are competing taxonomies and they are jockeying for position to become the industry standard. There are third party ratings groups jockeying for position on how funds are rated for ESG integration and even within single plcs, you will the use of several rating firms. That is to be expected. There is no agreed way.*”
>
> Yet the investment solutions side is very interesting. We have a middle category, that I think the industry has started to fill. What I mean is you will always have investors who are not interested. And you have investors who care deeply, and they want sustainable investing that is deeply embedded in the DNA of the mandate. There are plenty of solutions for these. The middle category is growing and it is interesting and underserved by purpose-built investments and solutions. Quilter has launched a new profiling tool called the Four Dimensional customer profiling tool. One of the four dimensions is ESG preference. More than half our customers do have an interest and do care about it, but they are not ready for it deeply in the DNA of the mandate.

WITH REGARDS TO FCA POLICY

To a degree therefore, advisers and clients are waiting for the regulator.

Pollins says:

> “ A lot of … financial advice firms that I speak to in the same space, are … waiting. People don’t want to go too far down a particular path if the regulator turns around and put some different rules in place. The danger we have, at the moment, is just inconsistency. From a suitability perspective, we think many clients will be happy to invest in companies that are sustainable over the long term, and that just makes good investment sense. Yet inconsistencies remain in ratings for advisors who are trying to select funds for clients that meet particular objectives with different ratings agencies screening and using ESG metrics in different ways. So everyone … is keeping their powder dry’?

Section 8
GLOSSARY OF SUGGESTED TERMS

Any adviser reading this guide will be aware that we await regulatory decisions especially in the UK with little sign yet of a global consensus. We are presented with the possibly of several labelling regimes and perhaps more importantly for those constructing portfolios, companies, borrowers and indeed asset managers all meaning slightly different things in the use of different terms.

The taxonomies are they emerge are also very word heavy, so this is slightly lighter in approach and a combination of industry terms so far.

A

→ **Active ownership**
Engaging with companies and potentially using AGM voting rights to press for change on a range of issues to improve environmental, social, governance and broad sustainability outcomes.

→ **Article 6, 8 & 9 funds**
Classification under the EU's Sustainable Finance Disclosure Regulation (SFDR) framework with 6 not applying sustainability factors, 8 including a very broad range which pay heed to ESG factors and 9 delivering where sustainable investment is part of the fundamental objective and which includes impact funds.

B

→ **Best in class**
An investment approach identifying companies or government bonds with strong ESG characteristics relative to their peers.

C

→ **Carbon footprint**
In the context of a portfolio, the footprint is the value of shares held over company market cap, multiplied by total carbon emissions for the company. It can be applied to individuals, other organisations and indeed countries with slightly different underlying calculations.

→ **Carbon neutral**
This is the aim of achieving parity between carbon emissions and the removal of carbon from the atmosphere in business activities.

→ **Carbon pricing**
Putting a price on emissions of greenhouse gases applied to businesses but not as widespread as may have been predicted several years ago nor has it led to a deep market for carbon credits though the EU has ambitions to have such a market.

C

Circular economy
Reducing waste and pollution by keeping products and materials in use rather than sending them to landfill and in many ways the next evolutionary step up from recycling.

Clean tech
Any technology that reduces or eliminates a pollutant including CO_2.

CO_2 equivalent
CO_2 equivalent – to measure the global warming potential of other greenhouse gases such as Methane but converted to CO_2 terms.

D

Divestment
Selling shares and bonds – in an ESG context after engagement has failed to encourage change though with most managers viewing it as a last resort.

E

Engagement
Where an asset manager engages with a company on matters relating to ESG factors with the aim of improving practices.

ESG
Umbrella term for environmental, social and governance issues often referred to as ESG factors. We do get a sense that in a fund context there is still debate across many global jurisdictions about a distinction between a reasonable light application of ESG and a more focused approach. For example, with the US suggesting ESG and ESG focused funds as a distinction.

Environmental criteria consider how a company or related security safeguards the environment including but not exclusively climate change,

Social criteria examine how a firm manages relationships with employees, suppliers, customers, and the communities where it operates sometimes extending to suppliers.

Governance deals with a company's leadership, executive pay and sometimes behaviour, internal controls and shareholder rights. It can include diversity, equity and inclusion and certainly data hygiene and regulatory compliance.

ESG can be used to help manage risk and inform investment decisions or can be used as part of the underlying strategy seeking to achieve returns and impact.

E

→ **ESG Integration**
In terms of ESG, it means integrating ESG factors into a fund or portfolio though often with an emphasis on risk management and financial analysis. ESG will have an influence on investment decisions though with a lighter touch than with some focused funds. Some asset managers now apply integration across all their portfolios.

→ **Ethical investments**
Using certain moral principles as a filter and in many ways, one of the first labels applied to this kind of investment along with stewardship, though still applied by some as a label today.

→ **Exclusions**
Screening out shares or bonds in a certain category or because a security fails to meet certain thresholds. The former might include weapons or types of weapon. The latter may be where too much of a firm's revenues come from fossil fuels.

G

→ **Green bonds**
Bonds where the borrowed money is used to finance or refinance green projects increasingly offered by both companies and countries. Increasingly the criteria and disclosures are being tightened.

→ **Greenwashing**
Exaggerating sustainable characteristics or environmental benefits from a company, fund or even arguably governments though sometimes an out and out misdescription with recent clampdowns in the US and Germany in particular suggesting regulators increasingly regard this as misselling.

I

→ **Impact investing**
An impact investment or impact fund must demonstrate an intentionality to have a positive impact, additionality and, increasingly, supplying data to demonstrate the impact or impacts.

→ **The International Financial Reporting Standards Foundation**
The IFRS Foundation is a not-for-profit, public interest organisation established to develop high-quality, understandable, enforceable and globally accepted accounting and sustainability disclosure standards.

→ **The International Sustainability Standards Board (ISSB)**
This is an independent, private-sector body that develops and approves IFRS Sustainability Disclosure Standards (IFRS SDS). The ISSB operates under the oversight of the IFRS Foundation.

N

→ **Net Zero Asset Managers Initiative**
A UN-convened group of asset managers who have committed to transitioning their investment portfolios to net zero emissions by 2050.

N

Net Zero target
Net zero is achieved by reducing the level of emissions a company or country creates to as close to zero as possible. The target year for the UK is 2050 though it has been the subject of a great deal of controversy recently.

P

Principle adverse impacts
Principal Adverse Impacts (PAIs) are negative, material, or potentially material effects on sustainability directly related to investment choices.

R

Responsible Investing
Investment that arguably encompasses ESG investing and sustainable investing. However, for now, the FCA is currently considering using Responsible as a lighter label than more focused approaches which it is calling sustainable. It will be interesting to see if a consensus emerges globally or different definitions apply across different fund markets.

S

Science-Based Targets Initiative (SBTi)
International organisation which accredits corporate targets on climate with being science-aligned to the Paris target of 1.5 degrees.

Scope 1, 2 and 3 emissions
Categorisation of emissions by a company - Scope 1 - direct emissions

Scope 2 - indirect emissions from the generation of purchased electricity.

Scope 3 - emissions in the supply chain or by customers' use of the product and by far and away the toughest.

Screening
Using filters to decide which shares and bonds are eligible or ineligible for a fund or portfolio.

Social bonds
Bonds used to finance social projects with work on terms and disclosure standards ongoing.

Social taxonomy
A scheme of classification that establishes a list of socially sustainable economic activities, such as are currently being developed by the EU.

Stewardship
The responsible allocation, management and oversight of capital to benefit investors and society and a very long-established concept.

S

Stranded assets
A stranded asset is a term frequently applied to assets on a firm's balance sheet which may not be exploitable or of value generally as global or government regulations shift and write downs become more likely.

Sustainability
All activity that meets the needs of the present generation without compromising the ability of future generations to meet their needs.

Sustainability bonds
Bonds with proceeds exclusively used to finance / re-finance sustainability projects.

Sustainability tilted funds
These funds consider environmental and social sustainability related issues when deciding where to invest and they typically 'overweight' more sustainable companies and 'underweight' less sustainable companies.

Sustainable Development Goals (SDGs)
17 global goals produced by the United Nations, intended "to achieve a better and more sustainable future for all", increasingly used by some specialist fund managers to inform their investment strategies.

Sustainable Finance Disclosure Regulation (SFDR)
A set of European Union rules established in early 2021 to allow better comparisons of funds.

Sustainable Taxonomy
A scheme of classification to allow much more transparency around a huge range of economic activities to inform investment but with controversy around the recent inclusion of gas and nuclear as transition fuels in both the EU and, likely, the UK version.

T

TCFD
The Task Force on Climate-related Financial Disclosures – created to increase and improve corporate reporting of climate-related financial decision-making information and usually referred to by its acronym.

U

UN Guiding Principles on Business and Human Rights (UNGP)
The UN Guiding Principles on Business and Human Rights are a set of guidelines for states and companies to prevent, address and remedy human rights abuses committed in business operations and are important in informing the 'S' in ESG.

Guide author

John Lappin

John Lappin is a financial journalist who reports and commentates on financial services, financial advice and sustainability. Among other things, he is the former editor of Money Marketing, consumer investment title Mindful Money and specialist investment website Global Investment Megatrends.

Adviser Home
DEVELOPMENT PLATFORM

October 2022