ESG – Green is in the eye of the beholder

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ESG investing has become mainstream in the last few years, particularly since Covid hit the western world at the beginning of 2020. Many more investors, both individual and institutional, are now looking to apply some form of ethical or environmental screen to their investments, and the demand for suitable products has never been greater.

Total assets in funds described as "sustainable" have risen from below $1tn in March last year to more than $2.2trn in June 2021. Hence it is no surprise that asset management firms have been keen to promote their ESG credentials. But do the sustainable claims made in the promotional materials of these funds really play out in real world?

In identifying the best ESG funds, we believe it is crucial to follow a rigorous methodology, and not simply rely on a third-party provider. When it comes to investing, one of the key features of our analysis is to determine whether, and to what extent, the fund manager actually embraces ESG considerations in their day-to-day management of the fund. To start, we begin at the top, and assess the disclosures made at

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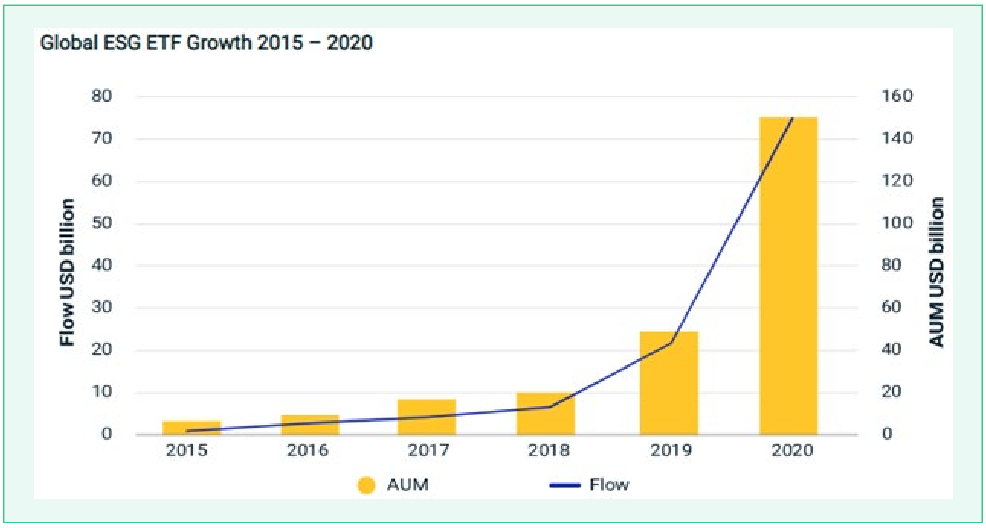
the fund house level, in addition to the policies and methodology applied by the managers. In many cases, while we may find that a house has a strong ESG ethos, they are unable to apply this to a particular fund. This may be attributed to the asset class in which the fund invests – for example, bond investors may be able to engage with companies, but they have no voting rights, while government bond investors, on the other hand, do not have any opportunity for engagement at all. Similarly, a thematic fund may choose the best ESG companies within its sector, but if it is restricted to shares in, say, the oil or mining sectors, they will be limited to choosing from what might be regarded as - "the best of a bad bunch". And unless they specifically track an ESG index, passive funds that are obliged to buy poor ESG companies within their benchmark are also likely to fall outside a house's ESG policy.

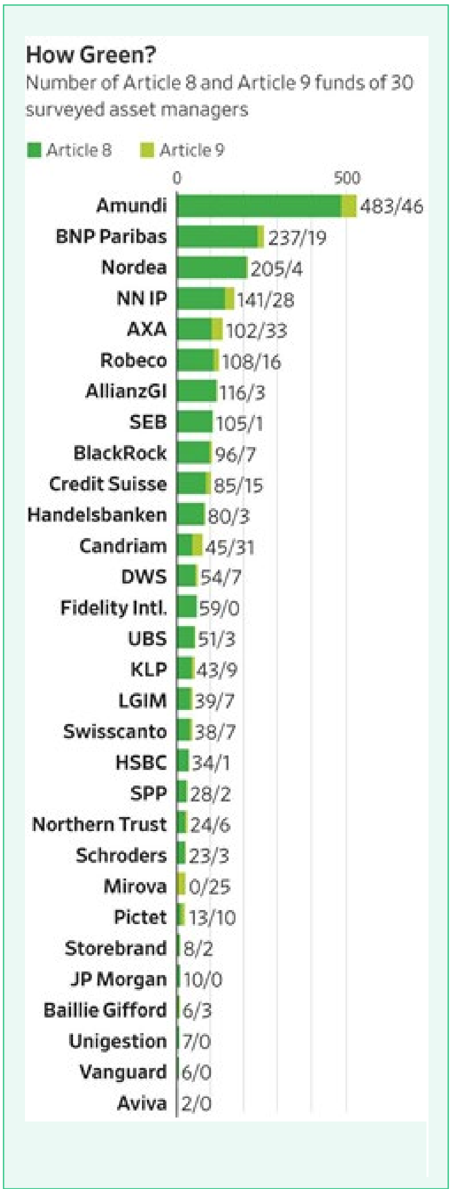


Source: Source: MSCI

Nowadays many fund management houses devote substantial efforts to demonstrate their commitment to ESG, itemising the steps they take to ensure that their investee companies adhere to appropriate standards. It is not unusual to see several large documents detailing the company's approach to ESG, including the bodies and agreements to which they are signatories, etc. Many produce an annual report specifically on their ESG activities. However, keep in mind, this does not mean that those policies are being fully enacted in reality, and one of the responsibilities of our analysts is to determine whether the managers are "doing what it says on the tin".

In some cases, a company may produce an "ESG version" of an existing fund. Whilst there is nothing wrong with this per se, and some companies do an excellent job of running ESG funds alongside their non-ESG counterparts, there are also firms that simply apply a basic negative screen and take no further action. For instance, a UK equity fund might have an ESG version that is the same fund, simply excluding certain sectors. Funds such as this may have a place in the ESG universe, but we do not feel that this equates to a commitment to ESG principles, and we pay particular attention in these situations.

In late August, the asset management business of a major global bank saw its shares fall by 13% on the announcement of an investigation by US and German regulators, after a whistle-blower claimed that the firm had overstated the proportion of its assets that were screened for ESG criteria. If the allegations are proven, the possible repercussions may be severe, including a fine and/or compensation to investors, as well as a requirement to re-label the funds. Even if they are not upheld, the news story is likely to have a detrimental effect on flows into these specific funds, and the 13% fall in the share price shows just how seriously investors take this kind of news.



Source: Morningstarr's Global Sustainable Fund Flows: Q1 2021 in review.

One of the more recent developments in ESG reporting is the introduction of the Sustainable Finance Disclosure Regulation (SFDR) in the EU. Whilst this does not apply to UK-domiciled funds, it does apply to any funds domiciled in Ireland and other EU jurisdictions, and the UK's history of super-equivalence would suggest that something similar may be adopted here in the future. The aim of this legislation is to avoid this "greenwashing" of financial products. Entities are required to make disclosures at both the product and entity level, and each 'scoped' product must comply with one of the following:

» Article 6: products that do not integrate any kind of sustainability into the investment process and could include stocks currently excluded by ESG fundsArticle 6: products that do not integrate any kind of sustainability into the investment process and could include stocks currently excluded by ESG funds

» Article 8: products that promote "Environmental" or "Social" characteristics; there must be additional information on how these are met.

» Article 9: products that have sustainable investment as an objective; there must be an explanation on how the objective is achieved.

Whilst all of this increased reporting will, no doubt, help assess how a fund positions itself vis-à-vis ESG considerations, investors should not rely solely on the documents produced by the fund. Which is why our process uses manager interviews, in addition to fund documentation, to see just how aware the individual manager is of the issues, and to what extent he or she integrates the house's policies into the everyday management of the funds.

ESG regulations, while improving, are still not strong enough to adequately define what is 'best' ESG practice, in addition to helping investors identify their potential shortcomings. It's probably fair to say we will never achieve universal agreement on this. We believe that the best policy goes beyond simply trying to interpret the guidelines, but by applying a very practical and disciplined approach – one in which fund houses clearly define their ESG implementation policy and adhere to it.