SPECIAL REPORT
GUIDE TO ESG

SPECIAL REPORT

In association with

FE fundinfo

ADVISING ON ESG

While paraplanners may find that identifying the right ESG and sustainable investment fit for clients brings challenges, as Fiona Bond discovers, there are paths to follow

THE SHAPE OF THINGS TO COME

Changing regulations are putting ESG at the heart of the advice process, says Edward Margot, Head of Client Investment Strategy, FE Investments

CUTTING THROUGH THE GREENWASH

Paraplanners need access to clear, detailed and comparable reporting on ESG, if they are to meet both clients' needs and regulatory requirements, says Edward Margot, Head of Client Investment Strategy, FE Investments

Advising on ESG

While paraplanners may find that identifying the right ESG and sustainable investment fit for clients brings challenges, as Fiona Bond discovers, there are paths to follow

"Engagement has an important role to play. We want to be part of the solution, holding companies to account and influencing decisions made"

Dan Atkinson, Paradigm Norton

Once largely the domain of institutional investors, environmental, social and governance investing has ballooned in popularity among retail investors over the past few years. Data from Morningstar showed that £37 billion was invested in sustainable UK domiciled funds in 2021 alone.

Dan Atkinson, head of technical at Paradigm Norton, says: "In the past year we have seen a huge shift of investment from traditional portfolios to ESG portfolios. There seems to be a general growing awareness that we simply can't afford to be unsustainable for future generations."

Research by OnePlanetCapital showed that 85% of investors now consider climate change as the greatest long-term threat and 12% plan to transfer into ESG funds this year as a result.

Rebecca Kowalski, founder of Overstory Finance, expects demand to increase going forward. "There is growing interest among investors to consider sustainable investing, but many lack the confidence or knowledge and rely on their adviser to steer them. However, as younger investors with greater conviction emerge we are likely to see demand rise. Younger generations are more inclined to find information online and are more comfortable challenging the status quo and the traditional advice route."

Understanding client preferences

While growing interest in the ESG space has seen it move from niche to mainstream, it does not come without its challenges. A lack of consensus on terminology poses one of the biggest hurdles. Research from the Association of Investment Companies found the majority (58%) of advisers were supportive of ESG but found it hard to research investments' ESG policies and credentials.

And as more tools and options emerge, it creates a fresh set of challenges for clients and advisers alike. Atkinson explains: "The terminology around ESG still hasn't been fully defined so companies and funds will interpret terms differently. I would like to see much more consistency in the terms used, not just within funds, but across data tools."

Understanding what clients truly care about is the first step, according to Atkinson. The ESG investment spectrum ranges from funds where ESG is considered part of the traditional financial analysis all the way to funds designed specifically with the aim of achieving positive, measurable ESG impact.

The key is for advisers to know exactly what their client is seeking. "Advisers need to understand if a client is looking for broad exposure to ESG themes in general, or whether they wish to avoid certain industries or would prefer to take a thematic approach such as investing in clean energy," says Atkinson.

He adds that clients need to be aware that ESG investing incorporates different approaches. He points out that clients may be surprised by the inclusion of some companies within so-called ESG funds, but they have been chosen so that shareholders can enter into proactive engagement, using their voting rights to challenge and influence behaviour. "If you choose to divest, those shares don't simply disappear, rather someone else will buy them. As such, engagement has an important role to play. We want to be part of the solution, holding companies to account and influencing decisions made."

With a wealth of nuanced options available, advice firms expect ESG to become a standard part of the client fact find. Paradigm Norton asks clients about their ESG preferences as standard process but is working alongside Oxford Risk to create a more rigorous approach, which would see clients referred to a website and asked a series of questions using behavioural science. Depending on a client's answers, the firm will have a deeper conversation in person to explore possible investment routes.

Kowalski says: "I think it will become increasingly difficult for advisers to ignore. However, it's important that clients are not influenced by their adviser. Clients should be given a guide on ESG investing and the time and space to think about how strongly they feel about it. It can be helpful to let clients reflect on how they feel without feeling pressure to answer a certain way."

Challenges of researching ESG

As the ESG space continues to evolve, there are a variety of fund research tools available. In a recently published article on the *Professional Paraplanner* website, Grant Callaghan, head of paraplanning at

Para-Sols, said free resource fundecomarket can be a useful starting place, covering a wide range of criteria to filter ESG funds. For clients with specific ethical inclusions or exclusions, fund research tool synaptic has extensive options that can be filtered. However, there is not yet a standardised right and wrong when it comes to researching ESG and there can be discrepancies in the way ratings agencies rank companies' ESG scores.

As such, in-depth research is incredibly important to understand if funds are aligned with client's objectives and to avoid the risk of greenwashing.

Louisiana Salge, senior sustainability specialist at EQ Investors, says: "Most advisers are now thinking about ESG and we have seen demand grow substantially over the past year but what some of them can't do is sustainable investing in-house. They simply don't have the resources to carry out the extra layer of analysis that's required.

"There are differences in disclosures from fund managers and ratings agencies often give different weighting to the different elements of ESG which can skew the outcome. We delve deep to check if funds are following the process they have outlined and cut across the greenwash. We don't place much emphasis on the name of the fund, for us it's important to closely study the underlying holdings to see if they align with the objectives of our portfolio."

Paradigm Norton takes a similarly rigorous evidence-led approach. Atkinson says: "Can fund managers show that they are engaging with the companies within the fund? How and what are these companies doing to meet their ESG goals? Our priority is to find evidence and ensure that the information investors are receiving is credible."

Performance versus 'doing good'

There has been a long-held belief that investing in sustainability means foregoing financial returns. While the sector has experienced lower performance this year, hampered by rising interest rates and inflation, experts point out that sustainable funds are not expected to outperform continuously but companies that embed sustainability into their operations will build stronger, more resilient businesses over the longer-term.

Kowalski says: "There are investors who are naturally spooked by underperformance, but it's important to remember that every kind of fund will have a good and bad period and ESG funds can perform very differently to traditional funds. Sustainable investing is a long-term investment and should never be a matter of make money and run. While you need growth to justify the whole process

of investing it should be about making a return rather than seeking to be the best performer."

Salge echoes the notion that clients need to take a long-term view and understand the nuances of sustainable investing. "I believe that ESG investing can be justified on performance alone but it's crucial that clients understand what they are investing in. Some funds may be very restrictive and omit key areas from their holdings which may impact financial returns. It's also important not to consider returns quarter by quarter; investors should take a long-term approach," she says.

Experts agree that ESG will gradually become part and parcel of companies' financial analysis going forward, as company operations, business models and financial returns become increasingly interconnected and companies recognise the need to create value for all stakeholders. As with any investment, a client's financial goals should be at the heart of any decision, but it is looking increasingly likely that ESG will create a new generation of investors who no longer have to make a choice between financial gains and their social and environmental conscience.

The shape of things to come

Changing regulations are putting ESG at the heart of the advice process, says Edward Margot, Head of Client Investment Strategy, FE Investments

The way advisers and paraplanners have to treat ESG investments is about to get an overhaul as several pieces of regulation will force a significant change in the way ESG is treated by asset managers and by financial advice firms. Last October, the government published Greening Finance: A Roadmap to Sustainable Investing . This outlines the government's strategy to drive sustainable investing and ensure the economy meets the target of cutting greenhouse gas emissions by 78% by 2038 and to be net zero by 2050. To do this the strategy focuses on the way information around sustainability is measured and disclosed.

The government's plan is split into three parts:

- Ensuring decision-useful information on sustainability is available to financial market decision-makers.
- Making businesses and investors use this information in business and financial decisions.
- Driving financial flows to companies which align with a net-zero and nature-positive economy.

Sustainability Disclosure Requirements

The first part of the government's plan, to improve the information available for financial decisions, is being based on new Sustainability Disclosure Requirements (SDR) which are already in development . The Financial Conduct Authority launched its consultation on sustainability disclosure last November and has outlined initial plans to improve the visibility of the impact of the underlying holdings in investment vehicles, as well plans for a new set of labels to describe the way investments deal with ESG. The initial consultation closed in January and the FCA should be issuing policy proposals for further consultation soon, but it is likely that the UK's SDR will stay pretty close to the rules set down by the EU Sustainable Finance Disclosure Regulation.

Green Taxonomy

Alongside the disclosure regulations being developed by the FCA, the government is currently developing the UK Green Taxonomy to create a framework to determine which activities can be considered environmentally sustainable. This work is expected to produce an outcome similar to EU regulations which class investment funds under three categories. Article 6 funds do not include any element of ESG in the investment process. Article 8 funds, also known as environmental and socially promoting funds, are funds which include "environmental or social characteristics, or a combination of those characteristics". These could also be described as light green funds. Finally, Article 9 funds that have sustainable investment or reduction in carbon emissions as a clear objective. These funds have to align with at least one of the EU Taxonomy criteria and have no adverse impact on the other criteria.

Consumer Duty

Another factor when considering ESG and the suitability of advice is the new Consumer Duty requirement from the FCA. A policy statement is due at the end of July outlining the new regulations. Although ESG and sustainability are not mentioned specifically in the consultation, the FCA is looking at a general requirement to ensure that customers are able to pursue their financial objectives. The FCA's proposals also include a requirement for firms to clearly communicate all the information that clients need to make effective decisions.

Even if clients have no interest in their investments contributing to improved sustainability, ESG factors have a clear impact on the performance of underlying investments and so clients will need to be aware of how ESG-factors will potentially affect investment performance.

Embedding ESG in an advice process

There are several practical steps that financial advice businesses can take to get ahead of future regulatory requirements. These include:

- Consider all sustainability risk that might cause a negative impact on investment/advice.
- Disclose how sustainability was included in the investment selection process.
- Include responsible investments as part of a centralised investment proposition (CIP).
- Consider using a sustainable benchmark to track.
- Be able to point to ESG and sustainability research/data used in the advice process.
- Disclose the ESG and sustainability approach used by the firm and its policies.

Advice firms should also begin to align clients with the appropriate level of engagement with ESG as part of PROD suitability. This is likely to see clients fall into one of four broad approaches to ESG and sustainability:

1. ESG and responsible investing is not a primary concern. The client has expressed no interest in ESG or responsible investing. ESG is still important as it relates to investment risk and performance – stranded asset risk, for example.
2. Considers ESG important and wants to invest in products that display good ESG processes and outcomes, but it is not a priority over other features. In our opinion this will rapidly become the default category as ESG is becoming more integral to overall investment management. However, it is still possible to identify products that take ESG seriously and ones that don't. It is also possible that regulation enforces this as the default option.
3. ESG and responsible investing is a somewhat important and the client wants it included in investment selection, but not exclusively. This means a client either wants to avoid investing in things they consider unethical or not aligned with their values. This describes your classical ethical investor and would include products with a negative screen. It could also mean a client wants their portfolio to contribute to solving some or all of the issues facing the world. This encapsulates impact investing and includes products that either have a positive screen or are dedicated impact products. Impact in this segment is increasingly coming to mean contributing to the UN Sustainable Development Goals, which include reducing hunger, combatting climate change and preventing pollution, among others.
4. Clients have a highly developed set of personal beliefs and values and want them completely incorporated into their portfolio. This segment will include people who may have specific issues they want addressed – for example, zero animal testing – or have a set of exclusionary criteria that differs from most of the mainstream negative screening products – for example, they want zero exposure to industrial agriculture. This segment is likely to need a specialist solution or even a bespoke portfolio rather than an off-the-shelf portfolio.

The next steps

From individual companies, through asset managers and finally through to end investors, the government's roadmap is going to see much greater disclosure of the sustainable practices and impact of companies and investments.

So far, the government's roadmap to sustainability has focused on the first of the three steps outlined in its roadmap. However, the intention to drive more investment towards sustainable outcomes means that there is a shift to make ESG an integral part of financial decision making and encourage greater flow of funds towards sustainable objectives. The introduction of new regulations is unlikely to stop therefore, with the measures currently in development.

In short, there will be a lot more information available about how investment funds operate and much greater scrutiny over how investment vehicles treat ESG issues in their investment process and impact of their investments.

The FCA has been clear that although some of the new regulations will not initially be apply directly to financial advice it is looking at how these regulations should be rolled out and it should be considered good practice to embed the new level of disclosure into the advice process initially by understanding the new disclosure requirement for investment funds as the appear and aligning client desired outcomes with appropriately labelled investment vehicles as the new labelling system is introduced.

"Even if clients have no interest in their investments contributing to improved sustainability, ESG factors have a clear impact on the performance of underlying investments"

Cut through the greenwash

Paraplanners need access to clear, detailed and comparable reporting on ESG, if they are to meet both clients' needs and regulatory requirements, says Edward Margot, Head of Client Investment Strategy, FE Investments

Paraplanners and advisers are already faced with a huge amount of information when it comes to ESG and investments. The big increase in interest from investors has transferred to strong flows of retail investor money into ESG or sustainable funds. According to the Investment Association, between Q1 2020 and Q1 2021 retail investors placed a total of £11bn in responsible investment funds. This was 38% of all new retail money during this period.

With this amount of investor interest, it is unsurprising that some investment managers have seized the marketing opportunity available and paraplanners, advisers and investors are facing a deluge of material advertising investments as ESG or sustainable.

The different approaches and definitions used by investment managers has created additional confusion and this is compounded by the lack of commonly agreed standards and classification for sustainable investments. This opens up a significant space for greenwashing – using ESG and sustainability as a marketing story rather than an investment approach – and the risk of greenwashing has already prompted the Financial Conduct Authority (FCA) to warn about its rise.

This is being addressed by the FCA's work on Sustainability Disclosure Requirements (SDR) and the government's UK Green Taxonomy. Some of the measures being considered as part of the SDR are the introduction of a common system for labelling sustainable funds and forcing firms to clearly back up claims of sustainability when promoting these funds. But confusion is likely to persist in the short-term while these new regulations are developed.

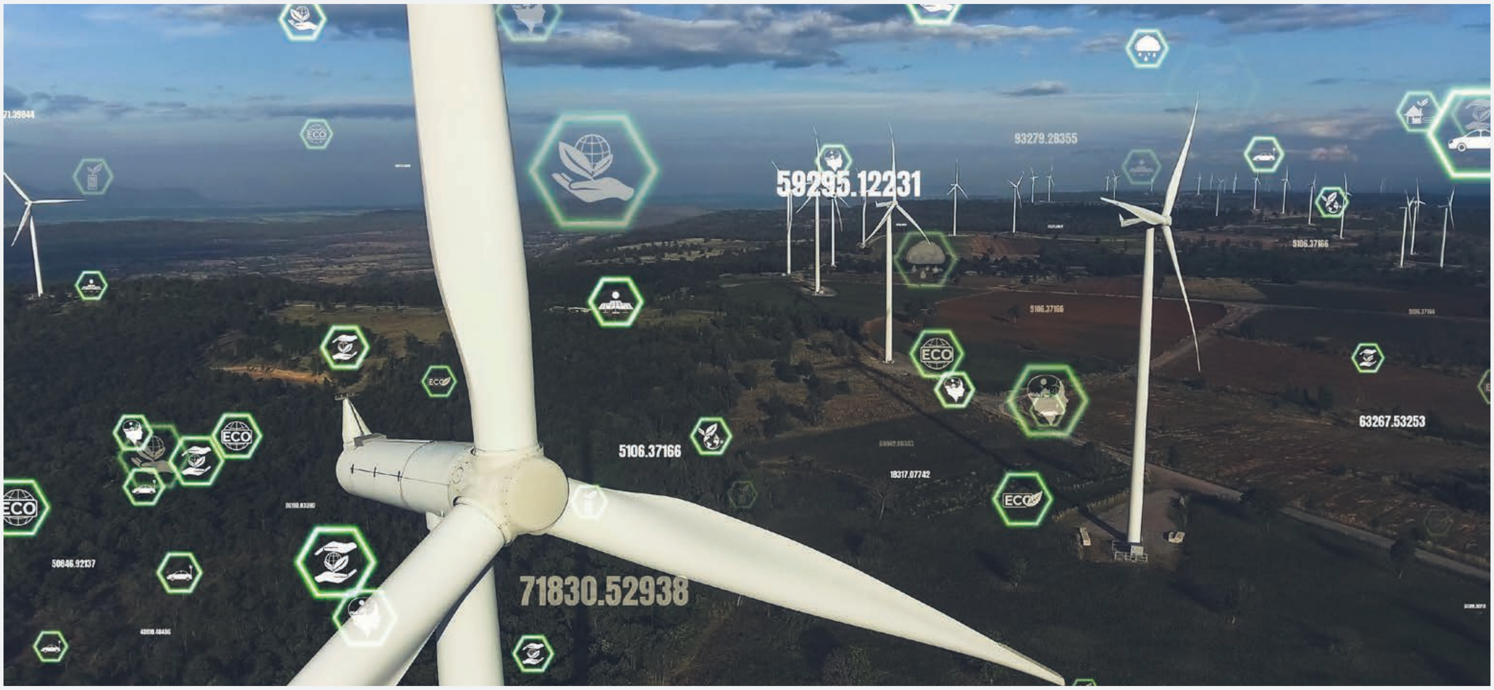
Understanding the investment process

There is a wide range of investment approaches and styles that can be described as responsible, sustainable or ESG. Understanding the investment process used by different funds and model portfolios is key to avoiding solutions which have been greenwashed. However, to truly establish whether investment solutions are living

The Responsible Investment Spectrum of Capital

Approach	No ESG	Ethical	Responsible	Sustainable	Impact		Philanthropic
					Finance First	Impact First	
Financial Goals	Deliver competitive risk-adjusted financial returns					Accept lower risk-adjusted financial returns	No expectation of financial returns
Impact Goals		Exclude unethical/immoral industries or activities					
			Mitigate and/or manage ESG risks				
				Pursue ESG opportunities/outcomes			
					Deliver positive environmental and/or social change		
Client Relevance/ Intentions	*There are inadequate processes to mitigate ESG risks for clients.*	*I want to avoid investments in tobacco/alcohol companies.*	*I want my investments to manage and/or mitigate risks such as water scarcity.*	*I want my investments to pursue positive outcomes and sustain long-term returns.*	*I want my investments to address climate change. I want my investments to provide additional support to excluded or marginalised populations.*		*I want my investments to focus on giving back to the community and environment without any consideration for profits*
FEI Model Portfolios			FEI Hybrid, Mosaic and Income Ranges	FEI Responsibly Managed Range			

STEWARDSHIP



up to their billing it is necessary for investment managers to back up their claims. At the moment there is no regulatory minimum standard to meet so the level of ESG data disclosure can vary widely and even well regarded third-party ESG fund ratings from the likes of Morningstar, ISS or yourSRI only tell part of the story. In order to see the real ESG characteristics of an investment you need to see the underlying data.

Earlier this year, FE Investments launched ESG disclosure reports to cover the ESG characteristics of all our portfolios, not just our responsible investments. We believe this is best-in-class reporting which will provide advice businesses with the detail necessary to carry out their research, and should also provide investors with a better understanding of what they are invested in. The reports show a full breakdown of where their money is invested by themes, such as education, alternative energy or clean water, and show how the portfolios align with the UN's Principles of Responsible Investing. They also provide company level reporting showing the contributions made by individual stocks in the portfolio.

In addition, the reports provide advisers and clients with reassurance about the governance process at work on their behalf by showing the results of our monitoring of controversies involving their investments.

Finally, our reports show where our portfolios have exposure to industries which are usually subject to ethical screens. Although we don't use blanket negative screening in any of our portfolios, it is important that paraplanners, advisers and clients are given full view of what they are invested in. Our position on ESG is slightly different than much of the investment industry. We believe that ESG is a framework for analysis. It is a key part of an investment research, but it is not an investment style in its own right. ESG factors can be used to identify investments that will have a material impact on the world, good or bad, and allow this to be considered as part of an investment process.

Putting ESG analysis to work

We use ESG as a factor in the analysis in all of our portfolios, but only our Responsibly Managed Portfolios are designed to provide a positive outcome in addition to the financial returns our investors are seeking to achieve. Our view is that no retail clients want an 'ESG'-labelled portfolio. They want investments which adequately reflect their beliefs. ESG and the grouping together of disparate and sometimes conflicting investment styles, solutions and themes is an institutional solution which is not meeting client demand. Instead, investors want to know their investments are doing less harm, doing more good and delivering on risk and returns.

Ensuring that clients are invested in the most appropriate solution means advisers and paraplanners need to fully understand the investment process at work and the impact of the underlying holdings. In order to do this properly means having access to clear, detailed and comparable reporting so advisers and paraplanners have reassurance that they are meeting their clients' needs and their regulatory requirements.

"Ensuring that clients are invested in the most appropriate solution means advisers and paraplanners need to fully understand the investment process at work and the impact of the underlying holdings"