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FINANCIAL BROKER

ESG INVESTMENT - A GUIDE FOR FINANCIAL BROKERS

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INTRODUCTION

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The term 'ESG' has become familiar to Financial Brokers: it refers to investment in accordance with Environmental, Social and Governance principles. It is also often described as 'Sustainable Investment', 'Responsible Investment' or 'Socially Responsible Investment' (SRI). In a nutshell, it means making investment choices that take account of their wider impact on the world.

Environmental

'Environmental' is the strand of ESG that attracts most attention. It addresses an investment's impact on the physical environment. At a time when climate change seems to be running out of control, the most pressing dimension of 'E' is of course greenhouse gas emissions and the quest for a zero-carbon world. But it should also embrace a much broader range of environmental issues – pollution of water, air and land, unsustainable use of scarce resources, habitat destruction, loss of biodiversity and so on.

Social

'Social' refers to impacts on people – employees, customers, suppliers, and those living near to a company's operations. There is a growing awareness that many of the goods we import from the developing world are made by workers whose pay and conditions are shockingly poor by our standards. In regions with weak rule of law, companies may also abuse local communities, through forced takeover of land and property for example. Closer to home, many businesses lack diversity among staff, and may be guilty of discrimination on grounds of race, gender or age. The past decade has seen the development of the 'gig' economy, where service workers must tolerate low earnings and uncertain conditions under the guise of being self-employed contractors.

A lot of companies – and entire industries – fall short in their treatment of people, and socially-driven investment looks to favour the companies that do better on this score.

Is the company run in a way that is fair and just, conducive to good decision-making, and has proper regard to the interests of external investors?

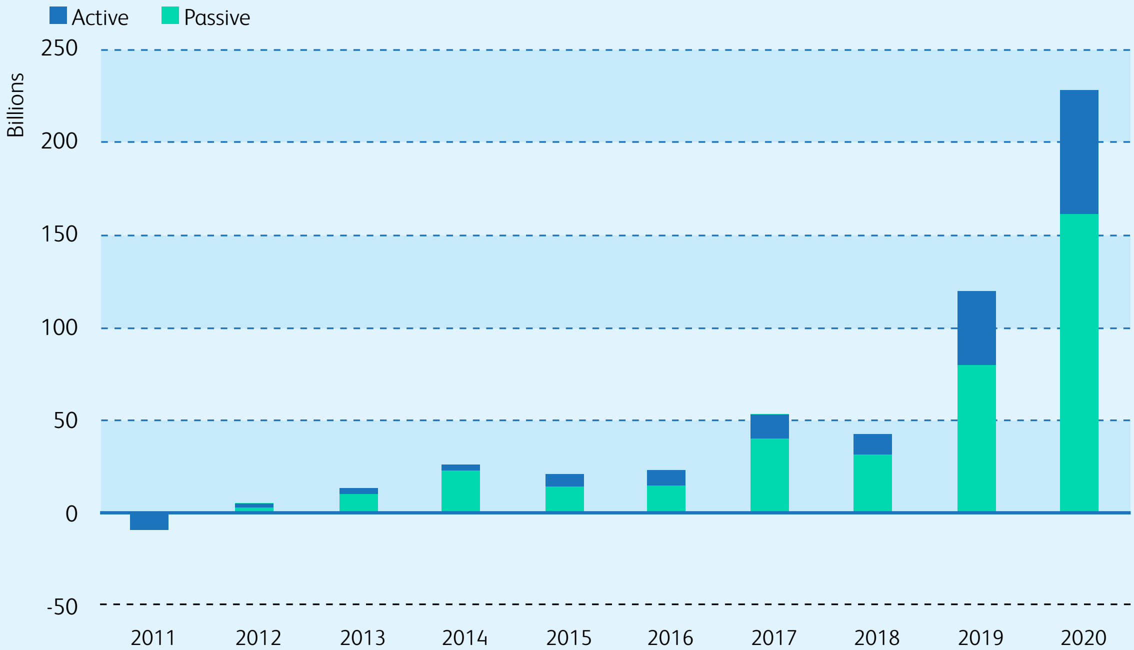
Governance

'Governance' asks the question 'Is the company run in a way that is fair and just, conducive to good decision-making, and has proper regard to the interests of external investors?' Examples of governance failures are all too easy to find. For public companies, potential red flags can include egregious executive reward packages, dominance by an insider shareholder, classes of shares with unequal voting rights, inadequate reporting, unbalanced board composition, and excessively long tenures by directors and chief executives. The perceived norms of good governance can of course vary from one country to another and tend to evolve over time. For example, in the US it is commonplace for one person to occupy the roles of Chairman and Chief Executive, whereas in Britain and Ireland it is considered unacceptable.

An Accelerating Trend

The adoption of ESG principles is rapidly gathering momentum, even though Ireland has been something of a laggard up to now. Bloomberg reported in June 2021 that €1.2 trillion, more than half of European total fund inflows, went to 'Sustainable' products in 2020. Total sustainable assets between 2018 and 2021, and now account for more than 11 % of total European assets under management.

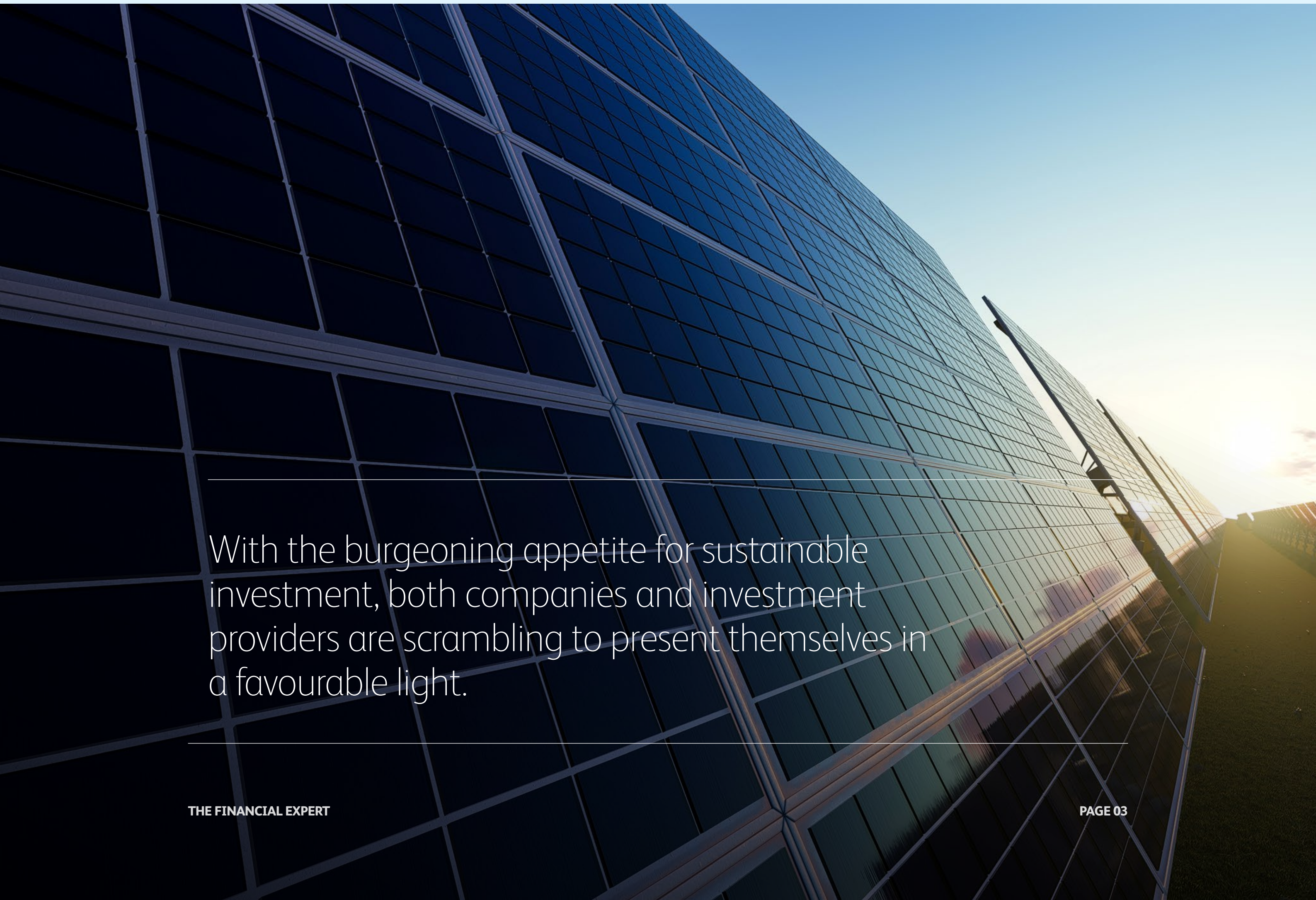
Annual European Sustainable Funds Flows (EUR Billion)



Source: Morningstar Direct, Manager Research. Data as of December 2020.

Disclosures and Greenwashing

With the burgeoning appetite for sustainable investment, both companies and investment providers are scrambling to present themselves in a favourable light. There is little doubt that there has been much ‘greenwashing’ at play – entities claiming credentials beyond what are merited and not supported by hard data. At the same time, many of their peers are making genuine and worthy progress down the road of sustainability. There is no easy way to separate truth from fiction in this regard. Over time, the development of regulation and agreed standards should improve the quality of disclosures, and also encourage greater alignment on what constitutes ‘good’ and ‘bad’ in this arena.



With the burgeoning appetite for sustainable investment, both companies and investment providers are scrambling to present themselves in a favourable light.

THE CASE FOR ESG INVESTMENT

Why should you, as a Financial Broker, engage with ESG investment? There are a number of possible reasons to consider.

It may seem obvious that well-run companies that behave well towards their people and their environment should perform better over the longer term.

1. Higher Returns?

The advocates of ESG like to claim that it will enhance investment returns, and some point to evidence of past outperformance by ESG funds. The truth is that we cannot be sure what the future will bring. It may seem obvious that well-run companies that behave well towards their people and their environment should perform better over the longer term. The industries on the wrong side of the trend – such as fossil fuel producers – will see higher costs, disappearing markets and progressive curtai ons will sink, and so might offer excess returns for the few investors still willing to embrace them. A case in point is the tobacco industry, which provided stellar shareholder returns over the many years since it first fell from favour.

In short, it would not be prudent to hold out to clients that ESG should lead to outperformance. It might do, but their choice must be based on other considerations.

2. Lower Risk?

There is a greater basis for expecting ESG-compliant companies to be less risky. Some of the highest profile share price collapses of recent times have been associated with corporate wrongdoing. In 2015, Volkswagen AG shares halved in the wake of the 'Dieselgate' scandal, which brought a total cost to the company in excess of €30bn. In 2010, the Deepwater Horizon oil-rig disaster cost the lives of 11 people and saw the BP stock price fall 54%. Looking to the future, investing though an ESG filter should help avoid those businesses who could lose most in the transition to a zero-carbon world.

That is not to say that risk reduction through ESG is guaranteed. Some of the more radical investment approaches can lead to high concentration in a small number of sectors, which might be overvalued because they have become 'crowded trades'

.3. Regulation?

There is a steadily accumulating body of regulatory measures aimed at both improving behaviour by companies and encouraging ESG adoption by investors. The trend is particularly marked in Europe, and with the advent of the SFDR Regulations in March 2021, it has come to the door of the Irish wealth management sector. Regulations do not yet oblige Financial Brokers to recommend sustainable investment products, but they do now require them to engage with the issue and consider how to take account of it. Please refer to the following chapter for more information on the regulations most relevant for Financial Brokers.

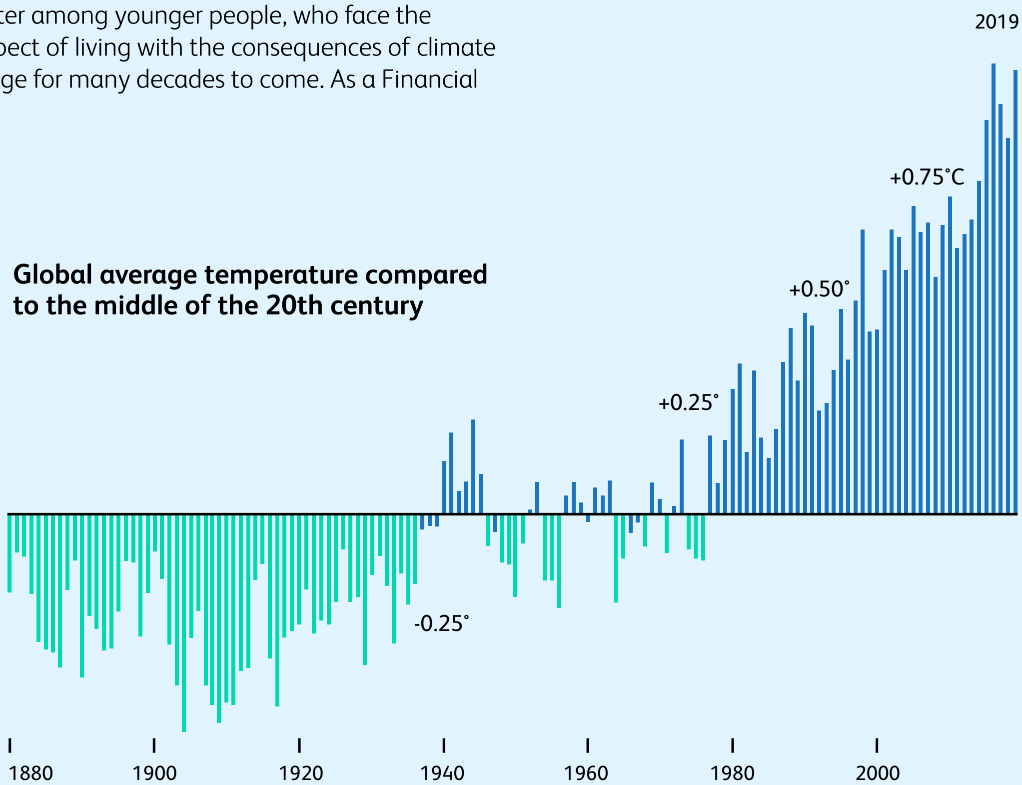
4. Client Choice?

Many investors feel an obligation to 'do right' in their investment choices. The impulse is perhaps greater among younger people, who face the prospect of living with the consequences of climate change for many decades to come. As a Financial Broker, you need to be equipped to satisfy the demands of clients who want to invest responsibly and in accordance with their own moral principles when allocating their money, even if they do not expect it to enhance their return or reduce their risk.

5. Climate Change - An Existential Challenge?

On some projections, the current path of greenhouse gas emissions will render large parts of the Earth uninhabitable within a few decades. The economic and social consequences would be almost unimaginably severe. If that is the threat facing humankind, then there is an onus on everyone to do what they can to address it, in their personal choices and also in their investment decisions.

No long-term financial investment will produce a good return in the face of catastrophic global warming. As a Financial Broker advising clients who are making provision for a distant future, you need to guide them towards choices that are consistent with preserving that future for themselves and their children.



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THE ADVANCE OF REGULATION

Regulation in the area of environmental standards, carbon emissions and ESG investment is expanding at pace, with the EU in the vanguard. A full review of all regulation is beyond the scope of this Guide; we discuss the initiatives that impact most directly on the Financial Broker. Much of what has been introduced up to now applies primarily to the 'upstream' part of the investment value chain – to companies and to the fund managers investing in them. But some more recent regulations require action and compliance by investment advisors.

Thus far there have been no regulatory steps to oblige the application of ESG investment approaches. Legislation has focused on measures to facilitate and encourage its adoption, such as

i. better disclosure on the part of both the issuers of investment instruments and the fund managers investing in the instruments, and

ii. requiring certain categories of investor (such as pension schemes) to consider ESG factors in framing their investment policy.

Of the measures outlined below, the last two (IORP II and SFDR) are those that bear directly on Financial Brokers.

Non-Financial Reporting Directive

The EU's Non-Financial Reporting Directive (NFRD), which came into force in 2017, applies to large listed and public interest companies. It lays down requirements for their reporting of information in relation to:

- environmental matters
- social matters and treatment of employees
- respect for human rights
- anti-corruption and bribery
- diversity on company boards.

It ensures that the 'raw material' is available for research providers and investors to make informed assessments of a company's ESG credentials.

In 2021 a new Corporate Sustainability Reporting Directive (CSRD) has been proposed, which will, *inter alia*, extend the NFRD to smaller companies and bring the reporting material within the scope of the company audit.

Shareholder Rights Directive II

The Shareholder Rights Directive II (SRD II) extends and amends the earlier SRD I and came fully into force in 2020. It sets standards and obligations for the relationship between public companies and their shareholders, in areas such as voting on director remuneration, identification of shareholders, and disclosures on remuneration and related party transactions. Asset managers must establish a policy on shareholder engagement with their portfolio companies, and report annually on it to their investors.

EU Taxonomy Regulation

The EU Taxonomy is described later in this Guide. It establishes a standard framework for determining which economic activities can be considered environmentally sustainable.

IORP II Directive

After a long delay, the IORP II Directive was transposed into Irish law in April 2021. It sets out a comprehensive set of standards for the operation and governance of occupational pension schemes. Within that, there are specific requirements in relation to ESG investment. It is directly relevant to any Financial Broker who advises the trustees of an occupational pension scheme.

In summary, the relevant provisions of the Regulations are that:

1) All pension schemes must conduct a risk assessment of their activities
2) Trustees should consider whether to take ESG factors into account in the risk assessment
3) The trustees must communicate to members if and how account is taken of ESG factors.

Sustainable Finance Disclosure Regulations

Phase 1 of the Sustainable Finance Disclosure Regulations (SFDR) came into force on March 10th 2021. It is by far the most significant piece of ESG-related regulation affecting the day-to-day activities of Financial Brokers. It sets out mandatory disclosures on sustainability issues to be made by asset managers and investment advisors, in a 'comply or explain' framework.

The Directive defines a 'sustainable' investment as one that contributes to an environmental objective or a social objective, without doing any significant harm to other environmental and social objectives, and where the investee company follows good governance practices.

After a long delay, the IORP II Directive was transposed into Irish law in April 2021.

SFDR - Requirements for Financial Brokers

For the investment advisor, the overarching requirement is to disclose whether and how they consider principal adverse impacts of their investment advice on sustainability factors. Within that, specific attention must be paid to the interaction between the firm's remuneration policy and the management of sustainability risks. If they do not consider sustainability factors, they must state clear reasons for not doing so, and state whether and when they will commence such consideration.

In more detail, Financial Brokers must disclose and maintain on their websites:

- Information about their policies on the integration of sustainability risks in their insurance or investment advice;
- Information as to whether they consider, in their insurance or investment advice, the principal adverse impacts on sustainability factors;
- If relevant, the reasons why they do not consider adverse impacts of investment decisions on sustainability factors in their insurance or investment advice, and, where relevant, including information as to whether and when they intend to consider such adverse impacts; and
- Information on how their remuneration policies are consistent with the integration of sustainability risks.

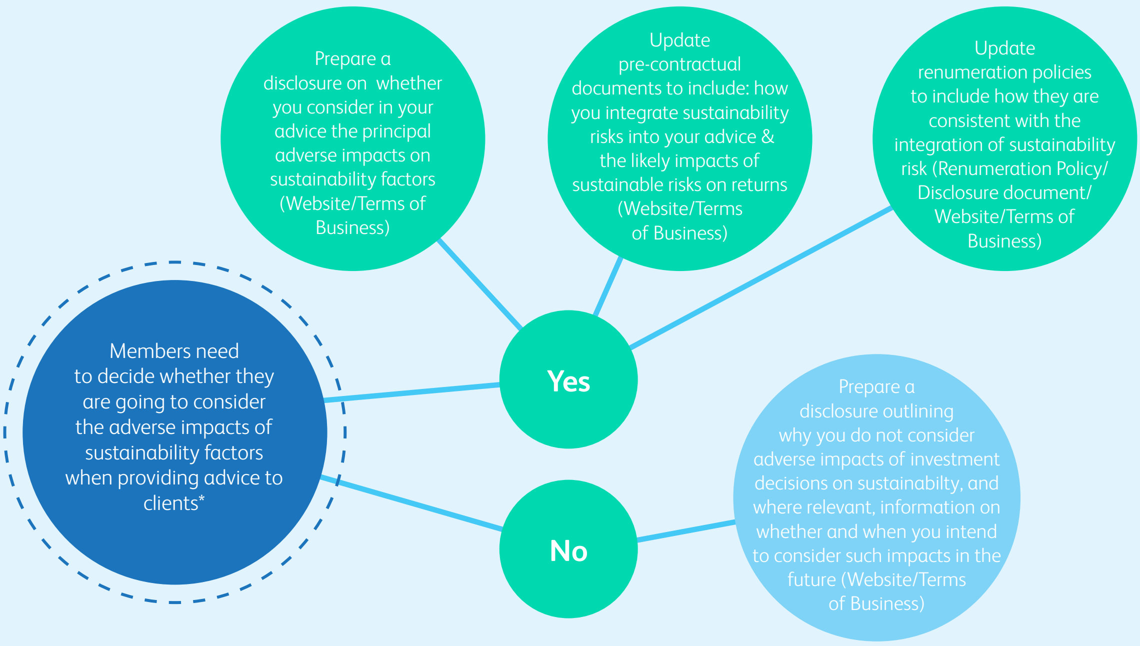
They must include in pre-contractual disclosures:

- How sustainability risks are integrated into investment or insurance advice; and
- The result of the assessment of the likely impacts of sustainability risks on the returns of the financial products they advise on.

If sustainability risks are assessed as not relevant, insurance intermediaries, insurers (acting as financial advisors) and investment firms must give a clear and concise explanation of the reasons why.

Graphically, the requirements are summarised in the chart below, circulated in Brokers' Ireland guidance to members ahead of SFDR's introduction.

What members need to do?



The Directive gave discretion to national authorities to exempt small firms (fewer than three employees) from its requirements, but in Ireland the Department of Finance chose not to avail of it. They did however grant a twelve-month extension, until March 10th 2022, for them to become compliant. See Brokers Ireland guidance on Sustainable Finance Disclosure Regulations for further information.

In conducting the fact-find, the intermediary should first assess the customer's other investment objectives, time horizon, tolerance and capacity for risk, and individual circumstances.

SFDR - Sustainability Classification of Investment Products

A second element of SFDR of great relevance to Financial Brokers is the framework it sets out for investment providers to classify their funds with respect to sustainability. This will make it easier to assess the ESG credentials of funds they are choosing from, although they should avoid the obvious temptation to reduce the process to a box-ticking exercise. Under SFDR, the provider's website information on each fund must identify if:

1) The fund promotes sustainability characteristics, among other characteristics; in this case it is classified under Article 8 of the Regulations, or

2) The fund has sustainable investment as its primary objective, in which case it is classified under Article 9.

Article 8 and 9 investments are commonly termed 'light' and 'dark' green respectively. In both cases above, the product provider must make additional disclosures in support of the particular status claimed for the fund. Investment products that do not qualify under Articles 8 or 9 are, by default, classified under Article 6, which means that they do not claim any particular sustainability or ESG characteristics.

The deadline for full implementation of these disclosure requirements is currently set for July 1st 2022.

Incorporation of Sustainability Issues to Client Fact-Find

In August 2022 a series of amendments to EU regulations governing the provision of investment advice will come into effect. The regulations in question are MiFID, UCITS, IDD, AIFMD and Solvency II. The thrust of the new rules is to oblige insurance intermediaries distributing unit-linked funds, or investment firms giving investment advice, to ask questions to identify a customer's individual sustainability preferences. In conducting the fact-find, the intermediary should first assess the customer's other investment objectives, time horizon, tolerance and capacity for risk, and individual circumstances. Where there is no investment product available that meets the customer's sustainability preferences and is suitable with respect to their other circumstances, they should be offered the opportunity to adapt their sustainability preferences. In such circumstances the intermediary must keep records of the customer's decision and their explanation supporting the adaptation.

Brokers Ireland will issue more detailed guidance on these rules in advance of them coming into force.

FRAMEWORKS FOR ESG IMPLEMENTATION

The past twenty years have seen much effort by governments, regulators, international bodies and so on to develop common frameworks, groups and language through which ESG principles can be defined and investments assessed. It has led to a confusing array of jargon and acronyms, but the effort was necessary in order to advance the sustainable investment agenda.

UNPRI

Perhaps the best-known initiative is the UN Principles for Responsible Investment (UNPRI). In 2005 UN Secretary-General Kofi Annan convened a group of leading institutional investors to define the principles, which are set out below.

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

UNPRI is promoted by a not-for-profit global entity, and to date more than 3,000 fund managers, pension schemes and other financial market participants have signed up to the Principles.

UN Sustainable Development Goals

In 2015 the UN published an agreed list of 17 Sustainable Development Goals, commonly labelled UNSDG. While they may seem rather aspirational, they provide an important tool for defining what is and is not consistent with ESG principles. Represented graphically, the goals are

UN Global Compact

The UN Global Compact is, analogous to the UNPRI, a network of businesses, NGOs and other organisations who have made a commitment to advancing the values of sustainability and social responsibility as encapsulated in the UNSDG. It defines ten Principles that all members should apply:

	Category	Principle
1	Human Rights	Businesses should support and respect the protection of internationally proclaimed human rights; and
2	Human Rights	Make sure that they are not complicit in human rights abuses
3	Labour	Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining
4	Labour	The elimination of all forms of forced and compulsory labour
5	Labour	The effective abolition of child labour
6	Labour	The elimination of discrimination in respect of employment and occupation
7	Environment	Businesses should support a precautionary approach to environmental challenges
8	Environment	Undertake initiatives to promote greater environmental responsibility
9	Environment	Encourage the development and diffusion of environmentally friendly technologies
10	Anti-Corruption	Businesses should work against corruption in all its forms, including extortion and bribery

Task Force on Climate-Related Financial Disclosures (TCFD)

Fund managers cannot implement ESG principles without having the right information on the companies they might invest in. In particular, they need data on a company's greenhouse gas emissions and carbon intensity. Likewise, investors cannot make informed decisions in the absence of similar data from funds and fund managers.

The TCFD was established by the Financial Stability Board[1] in order to devise guidelines for capital markets participants to enhance and deepen their climate-related disclosures. Many of their recommendations remain voluntary; some are being incorporated over time into mandatory requirements set by governments and regulators.

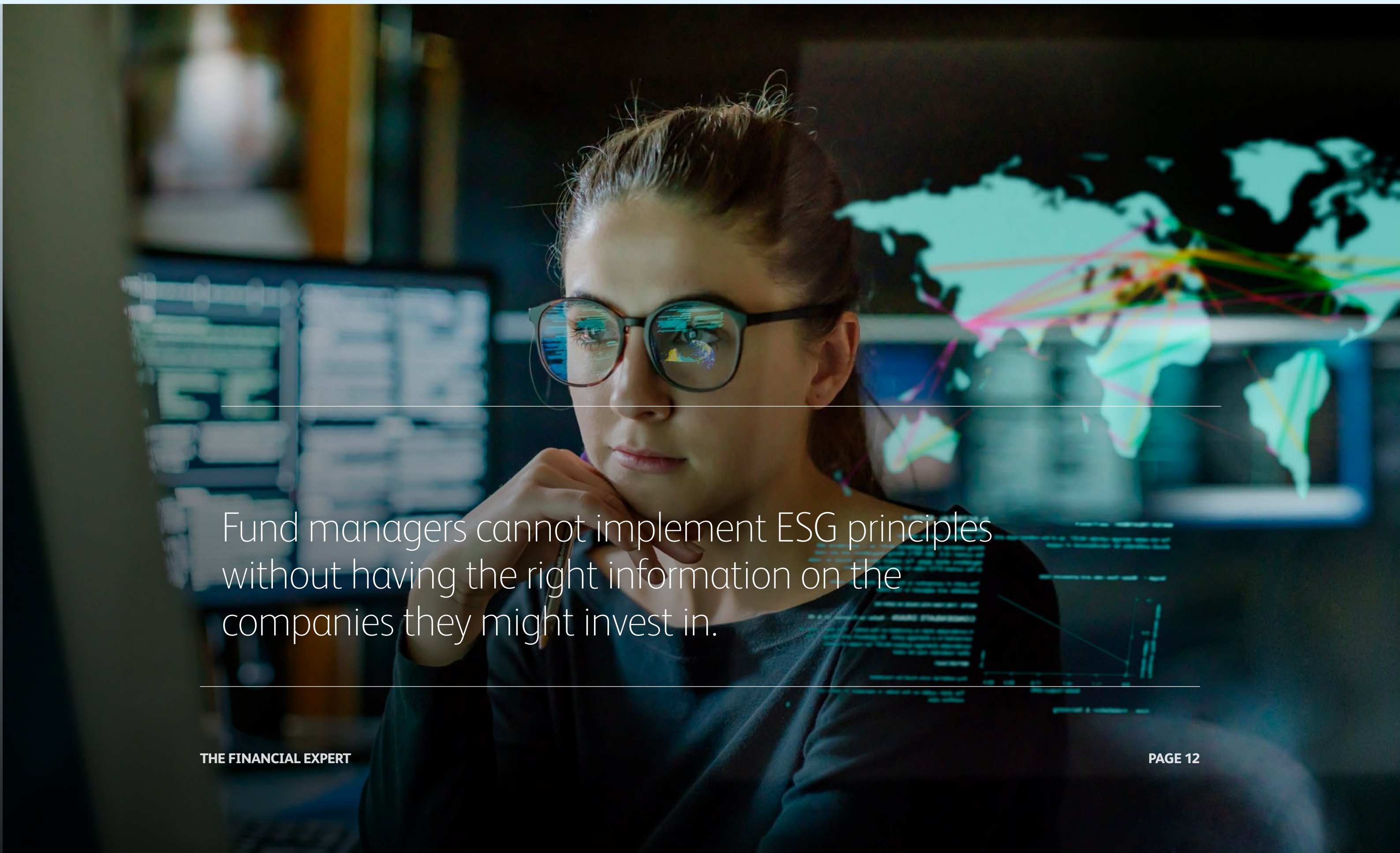
The EU Taxonomy

The EU has been to the fore in promoting sustainability and responsible investment. The EU Taxonomy was legally established in 2020. It is a classification system that defines six overarching environmental objectives and sets out a detailed list of economic activities that can contribute to at least one of the objectives, without doing significant harm to any of the others. For each activity, it sets performance hurdles for defining what constitutes a positive contribution.

The six objectives are:

1. Climate change mitigation
2. Climate change adaptation
3. The sustainable use and protection of water and marine resources
4. The transition to a circular economy
5. Pollution prevention and control
6. The protection and restoration of biodiversity and ecosystems.

[1] An international body tasked with promoting global financial stability



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THE DEVELOPMENT OF ESG INVESTMENT

Ethical Investment

The earliest form of ESG investment was the 'ethical investment' mandates that developed in the 1970s and 1980s. Typically, an institutional investor (often a charity or other not-for-profit body) would require its investment managers to avoid certain sectors that were deemed ethically unacceptable – such as alcohol, tobacco, pornography, weapons manufacturing and so on. Growing demand for such mandates prompted some managers to launch 'ethical' funds for offer to the general public.

Broader Considerations

With greater general awareness of environmental issues, and especially climate change, the appetite for ethical investment grew into a broader aspiration for sustainability criteria to be applied. In tandem with that, greater attention was paid to social and governance issues. Governance became particularly topical in the wake of high-profile corporate scandals throughout the 1990s and 2000s, when catastrophic wrongdoing at some companies (Enron, WorldCom, Polly Peck, Tyco and more) was attributed to their lack of proper checks and balances at senior management level.

The earliest approaches to responsible investment were based on the blanket exclusion of certain companies and sectors. That became problematic as the definition of ESG criteria grew ever wider; blanket exclusion might leave too small a universe to select from. It led to the use of ratings, which assessed companies in their own right or within their sector: the portfolio would own more in the relatively good companies and less in the relatively bad companies than the underlying market index, with only a few sectors deemed so unacceptable as to be excluded altogether.

Shareholder Engagement

Hand in hand with portfolio tilting approaches, the importance of shareholder engagement came to the fore. It operates at two levels. Firstly, it is considered that institutional shareholders should exercise their votes in all the companies they own, and make sure they make properly considered choices on any controversial issues that come up. In the past, fund managers often did not bother casting their votes, but there is now regulatory and public pressure on them to ensure that they do so. Secondly, some promoters of ESG argue that it is better to remain invested in a ‘bad’ company and promote change from within by engaging with the management than to sell and walk away. If all the undesirable sectors are shunned by responsible investors, their ownership will drift towards actors (perhaps private equity, hedge funds, sovereign wealth funds) who are unconcerned about ESG, and there will be less pressure on them to change their businesses for the better.

Impact Funds

Impact funds are a more recent entrant to the ESG landscape. They are funds that restrict themselves to investing only in companies or projects that have a specific positive ESG impact – renewable energy, sustainable transport, other green technologies, social housing and so on. Clearly such a fund will have a radically different sector mix to the broader market, and its performance could deviate from the market by a wide margin. But the concept has appeal to clients who would like their investment to be a force for good.

The Evolution of ESG Investment Approaches

ESG-Specific Funds vs Full ESG Integration

While most of the development of ESG has been focused on specific funds and products, fund managers are increasingly claiming to adopt ESG principles throughout their investment process. Undoubtedly that is a positive in many respects. Investment decision-making can only be enhanced by, for example, paying more attention to company governance issues, and thinking carefully about the long-term risks to a company posed by climate change factors.

However, the Financial Broker needs to be careful in placing too much reliance on these claims, as the degree of ESG adoption cannot be readily verified. It would not be prudent to assume that all a manager’s funds meet ESG criteria just because it claims to embed ESG principles across the board. Rather, each fund must be evaluated on its own merits, and the SFDR disclosures are the primary point of reference in that regard.

ESG RATINGS AND INDICES

Research and Ratings

Only the very largest global fund managers have the resources to do their own ESG assessments of the many thousand companies they may potentially invest in. The rest must rely on the services of third-party research and ratings agencies.

Most of the big name index providers (**MSCI, S&P, FTSE etc.**) and credit rating agencies (**S&P, Moody's, Fitch etc.**) have moved quickly to develop an in-house ESG research capability, or have acquired entities with the requisite expertise. In addition, there is a large number of independent specialist agencies covering the same ground, such as **Refinitiv** and **Sustainalytics**.

The research agencies typically provide a composite ESG score for each company assessed. It may be a single-point score, which allows companies to be easily ranked against each other, or it may be multi-point, where several criteria are independently rated. Single-point scores are attractively simple, but problematic, because a company's score will depend greatly on the weightings assigned to a multitude of criteria. This means that different agencies may produce radically different ratings of companies (and frequently do) and the fund manager using the research needs to ensure that the agency's criteria weightings are reasonably consistent with their own. Moreover, a company's rating may be penalised for failing to 'talk the talk' rather than failure to 'walk the walk': smaller enterprises can simply lack the resources to pad out their annual reports with the extensive statistics and policy statements that find favour with the research agencies.

These issues are the concern of fund managers in the first instance, but the Financial Broker should be aware of them when it comes to assessing the ESG credentials of investment products.

Development of ESG Indices

The early manifestations of ESG investment followed an active approach. Typically, the fund manager applied a bespoke set of rules and exclusions, perhaps dictated by a particular client's needs. As broader interest picked up, the index providers entered the market, and there is now a rich selection of ESG equity indices that can cater for almost any set of criteria. The proportion of passive ESG products has grown in tandem with the development of indices, and the passive share of the market can be expected to grow further.

Most of the ESG equity indices are based on an underlying general index (such as FTSE World or MSCI World), which is then altered to meet a specified set of criteria. Some are designed to not stray too far from the structure of the parent index, while others incorporate very high selectivity of companies and sectors.

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Index Construction

To illustrate the complexity of index choice now facing investors, the graphic below shows the menu of ESG indices presented on the MSCI website

	MSCI ESG Equity
Integration	• ESG Leaders • ESG Focus • ESG Universal • Low Carbon • Climate Change
Values & Screens	• SRI • KLD 400 Social • ESG Screened • Ex Controversial Weapons • Ex Tobacco Involvement • Ex Fossil Fuel • Faith Based
Impact	• Sustainable Impact • Global Environment • Women's Leadership

When evaluating and comparing indices, there are a number of dimensions to consider.

1) What activities are subject to outright exclusion from the index? The most common exclusions include industries such as Thermal Coal, Controversial Weapons and Tobacco.
2) What is the threshold for determining the exclusion of a company in a proscribed industry – e.g. more than 10 % of its turnover from the banned activity, or more than 5 % ?
3) With the remaining companies in the index pool, how steeply are their weightings tilted away from the parent index, in accordance with their ESG scores? Do they all remain, or are the lower-ranked companies in each sector eliminated?
4) How much overlay is applied to limit the extent to which country and sector weights might vary from the base index? Most indices incorporate a degree of overlay in order to avoid a very large deviation of risk or return from the base index. The downside of an index overlay process is, of course, that the strength of its ESG credentials might be diluted.

In effect, there is a wide spectrum of ESG indices available, ranging from mild to very pronounced tilts away from the overall market.

Degree of ESG Tilt

More

- Minimal outright exclusions of stocks and sectors
- Many constituents
- Similar country & sector weights to overall market
- Similar risk level to overall market

Less

- Many exclusions
- Fewer constituents
- Greater concentration
- Skewed country & sector weights
- Could be higher risk than overall market

These considerations are important when selecting products (especially passive products) for recommendation to a client who has more demanding ESG requirements. It is vital that the client's expectations are aligned from the outset with the product recommended to them. If the ESG mandate to be chosen brings an extra degree of investment risk, there must be a clear understanding on the part of the advisor, and the client, of the nature and scale of that risk.

For example, the MSCI Global Environment Index replicates a 'dark green' ESG strategy and is described as being "...comprised of securities of companies that derive at least 50 % of their revenue from environmentally beneficial products and services". But, as of September 2021, Tesla Inc. has a weighting of 35 % in the index – a share that is valued on a price-earnings ratio of 400, and that has risen by 1,800 % in five years.

Conversely, if the client with more demanding requirements invests in a 'softer' mandate, tracking one of the indices that does not deviate far from the parent index, then they may have to accept that their portfolio will still have some exposure to 'bad' companies and sectors.

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LOOKING BEYOND EQUITIES

At first glance, the principles of sustainable investment seem most readily applicable to equities, and that is how they developed. But much work is being done to extend the approach to other instruments.

Corporate Bonds

Equity-based approaches can be easily transposed to Corporate Bonds. The same research, scoring and exclusion processes can be applied to corporate debt issuers. Furthermore, this category offers the potential for investment in 'green bonds'. A green bond is a debt issue whose proceeds are ring-fenced for investment in projects that are consistent with sustainable criteria. They are subdivided into 'Light Green' – where the monies are not allocated to anything inconsistent with ESG principles – and 'Dark Green' – where the monies go to specified projects that will have a positive ESG impact.

Sovereign Bonds

Countries can be rated on ESG criteria along with individual companies, allowing ESG investment approaches to be applied in the arena of Sovereign Bonds. Issues taken into account typically include environmental performance, carbon emissions, governance, rule of law and social justice metrics. The assessment is complex, and it can be even harder than with companies to find a consensus on sovereign ESG ratings. In practice, country ratings tend to be highly correlated with their overall wealth, which could lead to the perverse result of global inequality being reinforced through poorer nations seeing their borrowing costs go up.

Sovereign entities may also issue green bonds, and more than ten European countries, including Ireland, have already done so.

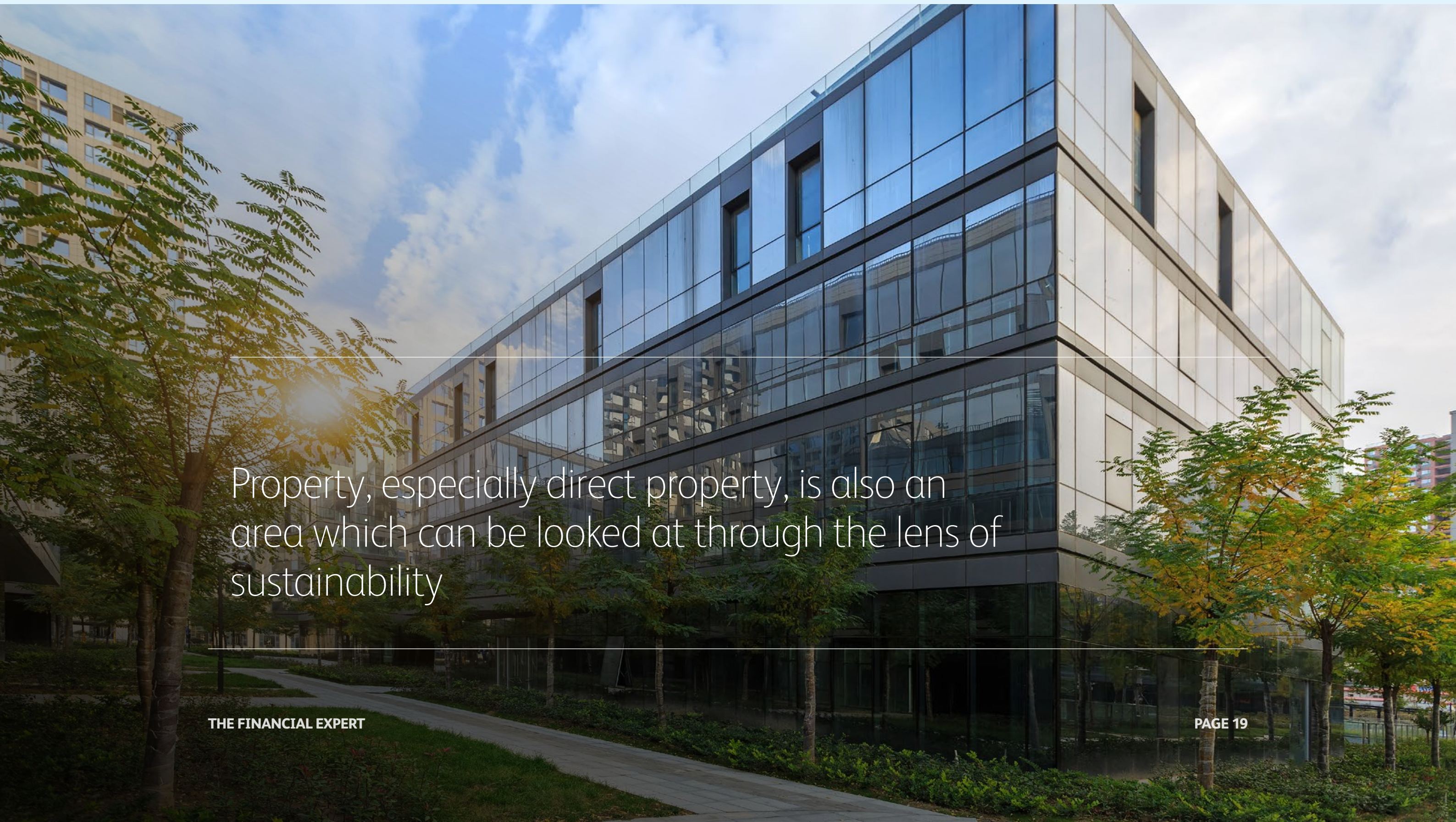
Property estates can be evaluated on criteria such as energy efficiency, sustainable construction materials, waste treatment and so on.

Property

Property, especially direct property, is also an area that can be looked at through the lens of sustainability. Property estates can be evaluated on criteria such as energy efficiency, sustainable construction materials, waste treatment and so on. The Global Real Estate Sustainability Benchmark (GRESB) is a well-known framework within which funds can be rated against each other.

Multi-Asset Funds

The application of sustainability criteria to Multi-Asset and Absolute Return funds is more problematic, because of the range of asset classes they contain. Nonetheless, there are some funds in these categories that are promoted under ESG labels. In practice, this is likely to mean that ESG principles are applied to some of the portfolio holdings but probably not all of them.



FRAMING CLIENT ADVICE

How should you take account of ESG issues in framing client advice? There are four key elements to be considered:

1. Know the Client's Requirements

Some clients may have no interest in ESG, and only want the best return for their chosen risk level. In that case it could be unwise to press an ESG option on them, at least not without due comparison against non-ESG alternatives.

If they wish to choose a sustainable investment, it is important to understand their requirements. Are they satisfied with a fund which follows a generic ESG mandate? Or do they have specific requirements which they want strictly applied (typically, the exclusion of certain industries from the portfolio)? In that case the chosen fund should be aligned with those requirements, and if it is not possible to find one, the client should be guided to the best compromise available.

2. Know the Product Landscape

There is a myriad of equity UCITS funds and ETFs with ESG mandates, and a broad choice in corporate bonds also. Financial Brokers using fund platforms should have little difficulty in satisfying client needs in this area.

The range of choice among Irish unit-linked funds is narrower but is advancing quickly. It may not be possible to find a fund which meets the particular needs of a more demanding client. The choice among multi-asset and absolute return funds is quite limited, but there are some options available.

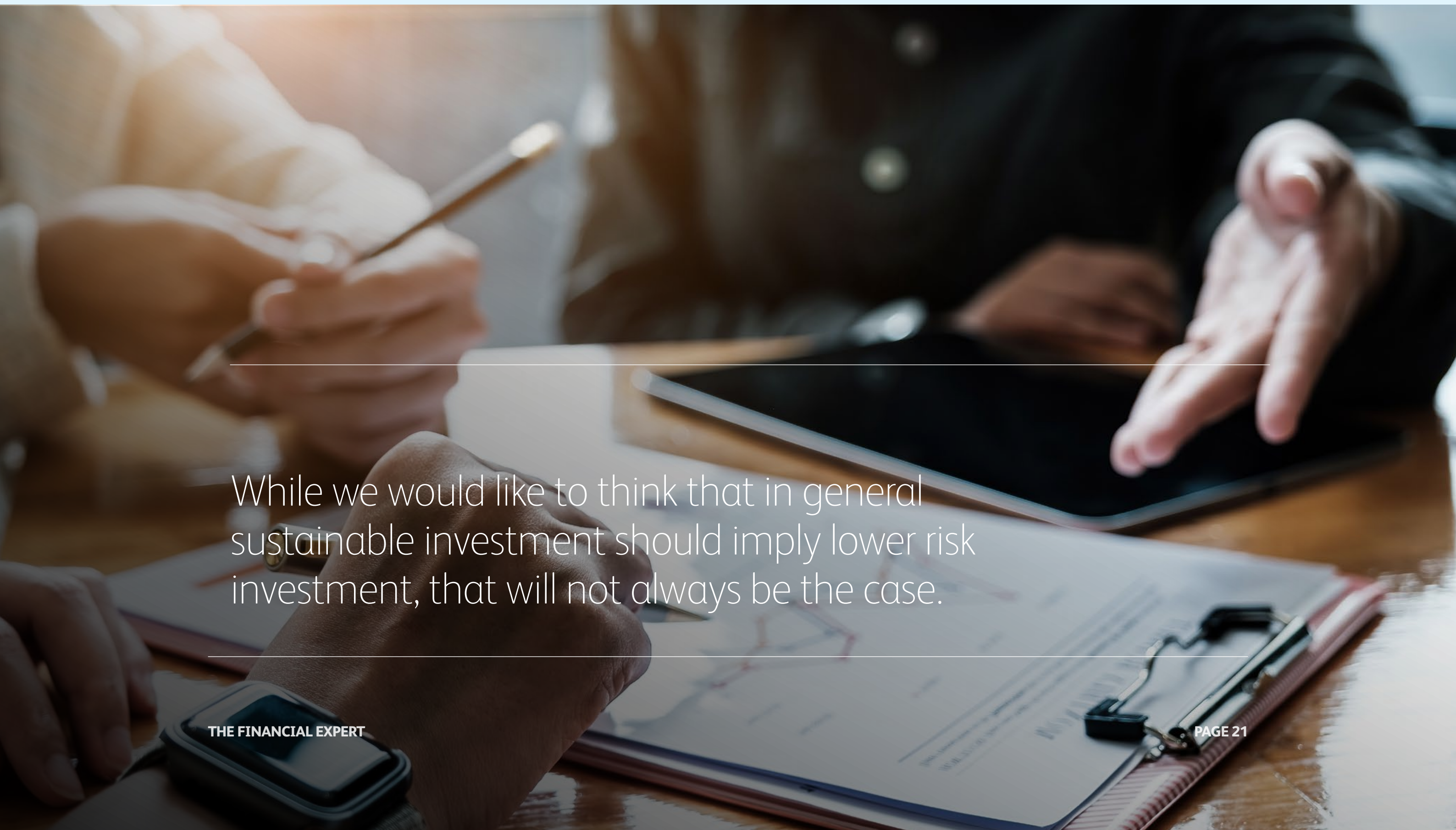
A number of the Irish life companies have announced the adoption of ESG principles across the board in their management of equity and corporate bond portfolios, but it should be noted that the funds in question do not all qualify for classification under SFDR Article 8. A fund in this category may be sufficient to satisfy a client who has an 'ESG-lite' requirement, but not one who has more specific demands. Where a client has particularly strong views it may be unwise to recommend anything other than an Article 8 or possibly an Article 9 fund to them.

3. Know the Risk

While we would like to think that in general sustainable investment should imply lower risk investment, that will not always be the case. In framing a recommendation for a client, you need to establish whether the fund brings higher risk (perhaps through higher concentration in stocks and sectors, or a pronounced geographic skew). If so, the client needs to understand and accept it before proceeding.

4. Know the Charges

Sustainable investment products typically (but not always) have some premium built into management charges. How much higher are the charges, and is the client willing to accept them?



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GLOSSARY

Term	Explanation
Active ownership	An investor exercising their rights as a shareholder, through voting and engagement.
Article 6 funds	Article 6 funds under SFDR are all those which are not classified under Articles 8 or 9.
Article 8 funds	Article 8 funds under SFDR are those which promote, 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 funds	Article 9 funds under SFDR are those whose primary objective is a sustainable investment.
Carbon capture and storage	Technology that removes carbon dioxide from the atmosphere, or traps it from an industrial process before entering the atmosphere. It is then stored in a manner that permanently prevents it later leaking into the atmosphere.
Carbon pricing	A variety of industries are subject to a form of carbon taxation where they must pay for credits related to the volume of their carbon emissions. The credits are freely tradeable on wholesale markets.
Controversial weapons	Weapons that have a disproportionate and indiscriminate impact on civilians, such as nuclear weapons, anti-personnel mines, cluster bombs and chemical weapons.
COP26	The 26th UN Climate Change Conference, held in Glasgow between 31st October and 12th November 2021.
Engagement	Investors entering dialogue with companies, usually to encourage adoption of more sustainable practices.
ESG	Environment, social and governance factors, as applied to investment.
Ethical investment	A variant of ESG investment, which focuses primarily on the exclusion of certain companies and sectors on ethical grounds.
EU Green Bonds Standard	A planned certification scheme to ensure that financial products marketed as 'green bonds' can be verified as such.
EU Sustainable Finance Action Plan	An EU policy initiative to promote sustainable investment, which is giving rise to a range of regulations and directives, including SFDR.

EU Taxonomy	An EU-mandated framework for determining which economic activities are environmentally sustainable.
European Green Deal	A commitment by the EU to meet the goals of the Paris Agreement, principally by making the territory carbon-neutral by 2050.
Exclusion	Excluding a company or sector from an investment portfolio because it is deemed unacceptable on ESG grounds.
Green bond	A debt security whose proceeds are allocated exclusively to investments that promote climate and environmental sustainability.
Greenwashing	The practice of companies and investment product providers claiming sustainability credentials beyond what is merited by the facts.
Impact investment	An investment made with the intention to generate a positive, measurable social and environmental impact alongside a financial return.
Integration	Adapting the firm-wide investment process to incorporate consideration of ESG/ sustainability criteria.
Negative Screening	According lower or zero investment weighting to companies who score poorly on ESG criteria.
Paris Agreement	A 2015 international accord, which aims to limit the average global temperature rise to 2.0 degrees Celsius, and pursue efforts to restrict it to 1.5 degrees.
Positive screening	According higher investment weights to companies who score well on ESG criteria.
PRI	The UN Principles for Responsible Investment (also designated UNPRI).
SFDR	The Sustainable Finance Disclosure Regulation, which sets standards of disclosure on sustainability issues for financial services providers.
Stranded Assets	Assets whose value may be impaired because environmental regulations curtail their use, such as hydrocarbon reserves.

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