tech bites

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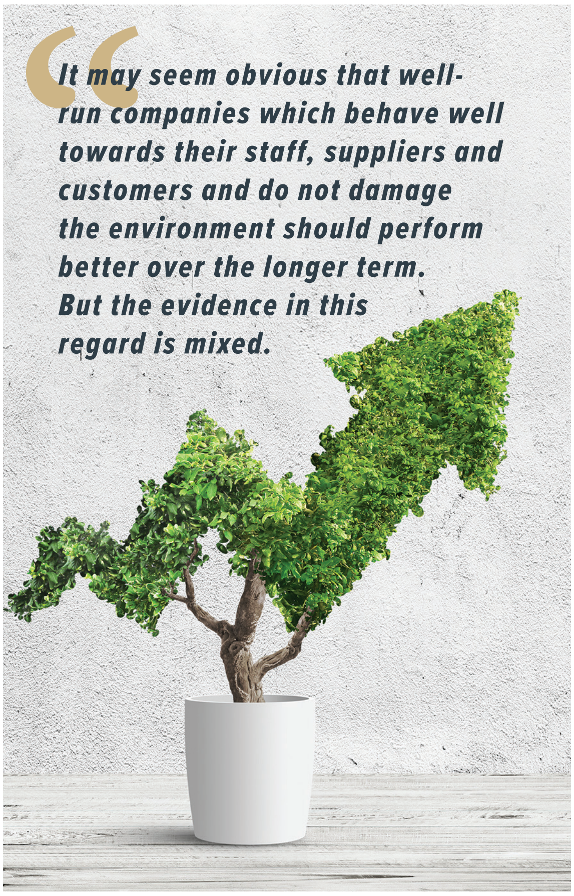
Investment Advice and ESG in Practice

THERE has been a mountain of publicity around ESG, and Sustainable Finance Disclosure (SFDR) visited all of us earlier this year. From August 2022 insurance intermediaries distributing unit-linked funds will be obliged to enquire about a customer's individual sustainability preferences*. That will coincide with the obligation on fund providers to publicise where each fund is classified under SFDR.

But that is next summer and we are all busy; surely I can 'park' it - potentially for a good while?

While re-configuring your fact-find is not a job to be started a week or two before the new regulations come in, that still gives plenty of time. But what if a client raises ESG tomorrow or next week? Your first port of call might be to seek a fund classified as 'Article 8', commonly referred to as 'Light Green', of which there is already a viable selection. Article 8 funds promote environmental and/or social characteristics....so job done?



Depending on the client's particular concerns – and how deeply held – **the answer may very well be no.** The fund might promote characteristics which meet the Article 8 definition, but which do not embrace the main concerns of the client; a fund can meet Article 8's definition by addressing a sub-set of ESG issues. And this is the key problem - the definition of what qualifies under Article 8 leaves a lot of room for interpretation. In seeking to show how this might be a very real issue I came across a particularly good example; a UK Equity fund with Article 8 status (offered by a large manager which has a strong reputation in the area of ESG) has British American Tobacco, Royal Dutch Shell, BP and Rio Tinto among its top 10 holdings. Most people with 'ESG' concerns would probably express surprise, if not horror, at some if not all of these names. The fund in question tracks an index which excludes companies: (a) engaged in pure coal mining; (b) involved in the production of controversial weapons, such as cluster weapons, anti-personnel mines or biological and chemical weapons; or (c) that, for a continuous period of three years, have been classified as being in breach of at least one of the UN Global Compact principles (a set of globally accepted standards on human rights, labour, environment and corruption).

To be clear, I am not alleging any impropriety on the part of the manager in question....but clearly in this instance there is an absolute chasm between the likely expectations of a consumer and the reality of meeting the definition and compliance by the manager. The example I have taken is somewhat extreme – given the make-up of the UK equity market - but it highlights how the theory and reality can diverge.

Even if the 'characteristics' being promoted by the fund and the concerns of the investor are perfectly aligned - something not to be assumed - there is a very practical issue around implementation which could lead to client disappointment. Many managers, possibly the majority, rely on ratings provided by external agencies. It is very common that these ratings assess companies within the sector in which they operate – often taking account of their plans to offend less/do better in the future. A sector-based approach leads, inevitably, to the ownership of the 'least bad' companies in all sectors **including those which might be considered completely out of bounds** – such as Energy, which is occupied almost exclusively by fossil fuel companies. So, a fund which you believe to be 'green' could own Exxon or BP.

The use of overall ratings based on scores derived separately under 'E', 'S' and 'G' (not at all unusual) can also lead to the inclusion of companies which surprise and disappoint investors. For example, a company which has failed badly (and perhaps very publicly) under 'E' could have scored highly under 'S' and 'G' – with the total score being quite good.

Those drafting SFDR were faced with an exceptionally difficult task and what they came up with is a significant step forward. However in defining Article 8 as it is they have massively diminished its usefulness as a badge of meaning to Financial Brokers and consumers. Article 9 ('Dark Green') funds must meet a much tighter definition and would be very much more likely to meet clients' ESG concerns. But as of now there is a very small number – primarily equity funds - from which it might well be a struggle to find one which is suitable in risk terms. In due course their number will grow but it could be a long time before any of the more widely-used funds have Article 9 status.

One other issue to be considered in advising on Article 8 and particularly Article 9 funds is the potential impact on performance. It may seem obvious that well-run companies which behave well towards their staff, suppliers and customers and do not damage the environment should perform better over the longer term. But the evidence in this regard is mixed. The industries on the wrong side of the trend – such as fossil fuel producers – will see higher costs, disappearing markets and progressive curtailment of their activities. However, the more unpopular the 'bad' companies become, the further their valuations will sink; lower valuations might offer quite attractive returns for the few investors still willing to embrace them. A case in point is the tobacco industry, which provided stellar returns over the many years since it first fell from favour. On balance it would seem prudent that ESG investors should not depend on the expectation that virtue will be rewarded.

Despite the imperfections around definitions and the wrinkles around implementation, the integration of ESG into investment processes is moving forward rapidly and should be warmly welcomed. Providers inclined to make invalid or exaggerated claims about their ESG credentials will have noted the predicament of DWS, the asset management arm of Deutsche Bank; it is currently under investigation by the US Securities and Exchange Commission, the US Department of Justice and the German financial regulator over claims that it exaggerated how the firm uses sustainable investing criteria to manage its investments. It is reasonable to expect that the compliance function in all providers will be taking a very keen interest in how ESG is presented - and in compliance with SFDR.

Financial Brokers will need to tread carefully in understanding and documenting what the major ESG concerns of clients actually are and in marrying them – as best they can - to funds or portfolios. Reaching for Article 8 funds is not the simple solution it might first appear. Even where the characteristics being promoted by the fund mirror the client's major concerns the widespread use of rating systems based on sectors can lead to results which surprise and disappoint clients – unless this has been explained to them.

***It is understood that Brokers Ireland plans to issue more detailed guidance on these rules in advance of their coming into force.**