



SFDR – where are we?

THE answer attributed to the man on the country road when asked for directions comes to mind – “Well, I wouldn’t start from here...”

Three years after the introduction of the Sustainable Finance Disclosure Regulation (SFDR) there is quite a broad consensus that it has not been a success. In the face of widespread criticism – including by some regulatory bodies – the European Commission embarked on a consultation process in relation to SFDR last September. They received close to 400 submissions and, in a triumph of transparency, it is possible to see how each of them responded to every question and statement in the consultation document. A dive into the detail reveals just what a failure SFDR is considered to have been. Time after time the vast bulk of responses said ‘mostly disagree’ or ‘totally disagree’, to questions/statements which reflected positively on the regulation. To questions or statements that suggested SFDR was ineffective or difficult to implement, the majority of answers are ‘mostly agree’ or ‘totally agree’. An example of the former which struck me was this statement in question 1.6 of the consultation document: “The SFDR is not used as a disclosure framework as intended, but as a labelling and marketing tool (in particular Article 8 and 9)” – to which a large majority responded ‘mostly agree’ or ‘totally agree’.

It is very hard to see the responses as other than a comprehensive verdict that SFDR is not fit for purpose. To get back on track will require a radical redrafting, with some commentators suggesting it is possible that the whole Article 6/8/9 structure will be dismantled.

It may have been deeply flawed, but SFDR has clearly had a major impact on the product landscape. A large number of funds have made whatever changes were needed to qualify for Article 8 status. In some product categories on certain providers’ fund shelves, there is only an ‘ESG’ choice available. This would seem to suggest that the providers believe the majority of people actually want the ESG version - not what we hear from the Financial Brokers we work with – or that they believe the ESG version will be better for them. The latter chimes with how often we see and hear the impression being conveyed that ESG is likely to deliver better performance - often by people and organisations who should know better.

Hand in hand with preference for ‘ESG’ funds is the extent to which consumers are willing to sacrifice investment return – or, conversely, believe that they should expect better returns. We can think of active equity investment, for example, as a process where the manager attempts to construct an optimised selection of holdings from the

available universe. If you impose a new constraint on that opportunity set, such as an ESG overlay, then it is illogical to expect that a superior optimisation can be constructed from the reduced opportunity set. Put another way, if following ESG principles was a ‘sure thing’ for enhancing performance, then a good active manager will have been doing it long before the regulators and the marketing department started to push them in that direction. The same logic can be applied to passive approaches to ESG investment. We think it more likely than not that applying an ESG overlay will lead to some sacrifice of risk-adjusted return in the long term.

Similarly, we hear claims being made that ‘ESG’ funds have outperformed in the past. Actively managed ‘ESG’ funds are a very diverse group for which readily comparable and reliable data over a long enough period is very scarce. That is not to say that the area has not been the subject of many studies, the conclusions of which are highly inconsistent. In terms of the ‘ESG’ fund choices available to Financial Brokers, many track ESG indices. So how have they done? The ‘ESG’ index for which we have the longest dataset is the MSCI ESG Focus index. Like most of the widely used ‘ESG’ indices, it is designed to maximise exposure to positive environmental, social and governance (ESG) factors while exhibiting risk and return characteristics similar to those of its parent index – in this case MSCI World. From its inception in November 2006 it returned 8.4% p.a. with a volatility of 13.8%; the parent index also returned 8.4% p.a., with volatility of 13.7%, so there has been no material difference in risk and return outcomes. If a fund or index is engineered to have very low tracking error against unconstrained benchmarks, we are sceptical as to how far it can satisfy any given sustainability preference. From a Financial Broker’s point of view such funds may also disappoint sustainability-aware consumers; because they typically operate by over/underweighting within sectors on a relative basis, they will still have positions in the ‘bad’ industries such as mining and fossil fuels.

To finish, SFDR v.1 has been a failure, but the battle to bring (meaningful) responsible investing to consumers will continue. On a positive note, we observe that there is a growing emphasis by asset managers on stewardship, namely engagement and voting – the part of the ESG edifice most likely to bring about change in the real world.