Foresight

FOR A SMARTER FUTURE

MAKING INROADS:

Challenging preconceptions and overcoming barriers to ESG and sustainable investment

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Challenging preconceptions and overcoming barriers to ESG and sustainable investment

Public concerns about threats to the environment and social justice are growing globally. These phenomena are evident in the coverage of widespread public protests about climate change, inequality and human rights. The demands for asset managers to pursue more socially responsible investment is becoming ever stronger as people look to the investment community to deliver on the movement to a more sustainable future.

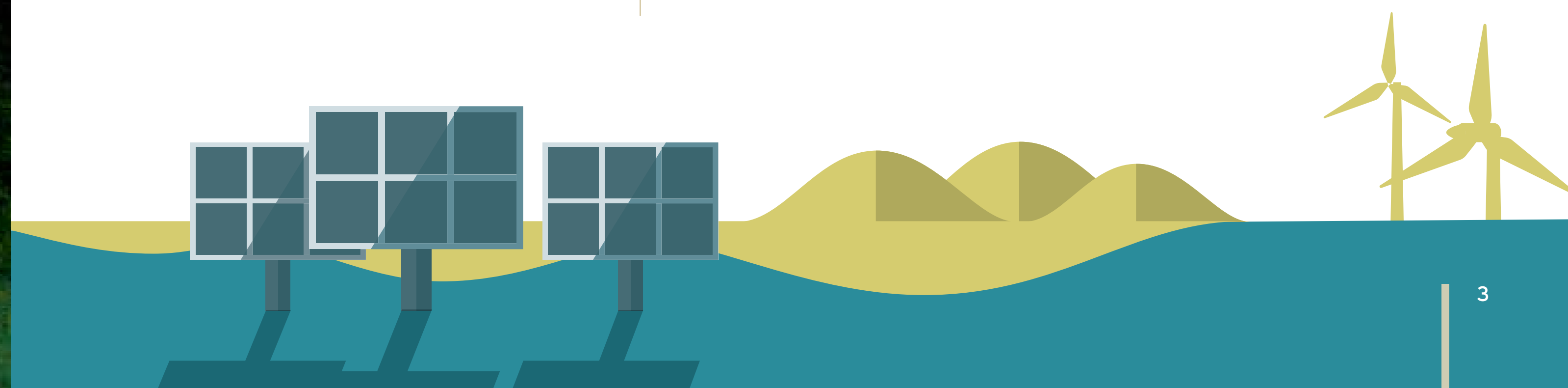
Responsible investment is implemented through the integration of environmental, social and governance (ESG) considerations into investment processes. However, this development is at a nascent stage and the definitions and understanding of what it means to invest sustainably remain unclear.

Financial advisers can play a pivotal role in guiding their clients towards investments in line with this new world of ESG.

- **What are advisers' perceptions of ESG and sustainable investing?**
- **How do advisers' views compare with their clients'?**
- **Do advisers believe ESG integration will impact investment returns?**
- **What are the barriers preventing more rapid or wider adoption of ESG principles by investors?**

To cast some light on these issues and to offer some practical solutions to overcoming barriers, Foresight commissioned research among financial advisers.

The findings and themes are outlined in this report.



MAKING INROADS:

ESG progress - from niche to mainstream

There is plenty of evidence to show that ESG and sustainability considerations are gaining importance amongst the general public and policymakers. Waves of new legislation include the ambitious zero-carbon target introduced by the UK Government and the Paris Agreement established by the United Nations which was adopted globally as a commitment to reduce dramatically the emission of harmful gases that affect the climate.

The purpose of Foresight's research was to understand the extent to which these global trends are influencing investment decisions within the adviser community.

The research shows that most advisers (64%) already see ESG considerations as important when building portfolios for their clients, including 15% who see them as very important.

More generally, positive sentiment towards ESG principles is strong amongst advisers. For example, 80% consider investment as a critical factor if the UK is to meet its net-zero carbon targets. More than a third regarded this as very important, indicating that investment products now have a broader mandate than simply providing financial returns. Furthermore, the majority of advisers (77%) say they would consider investing into a global equity fund focusing on companies that combat climate change.

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MAKING INROADS:

Barriers

The research revealed the barriers that advisers consider to be hampering the wider adoption of ESG amongst their clients.

Commitment to sustainability from clients is perceived to be low at present, with the majority of advisers saying that only a small proportion of their clients express a preference for ESG investing.

Despite the momentum within the asset management industry towards the greater adoption of ESG principles, confidence in what these principles mean is lacking and many investors - and even advisers - remain unsure of the distinctions.

WHAT IS NEGATIVE SCREENING?

"Investing in companies judged not to have a detrimental effect on environmental or social concerns"

"Ethical investing where companies are filtered out that show unethical behaviour"

"Avoiding investment into companies that might be considered to be unethical"

Participants' qualitative answers when asked to define ESG investing in their own words.

A lack of consensus around ESG and sustainable investment

The biggest barrier to advising clients on which ESG strategies to select is the lack of an industry definition of what constitutes an ESG investment. This lack appears to be the most debilitating issue the industry faces and has a knock-on impact to other perceived barriers. A clear understanding of what can be considered ESG or sustainable investment is a fundamental step in building an industry-wide 'gold standard' for ESG criteria and a robust reporting framework. Consequently, if the industry is unclear on what constitutes ESG investment, it is unable to measure accurately returns in comparison to the non-ESG equivalent. This lack of clarity means that advisers struggle to manage clients' concerns around performance.

Our qualitative research reveals no discernible consensus amongst advisers around the distinction between ESG and sustainable investing. This shows a lack of understanding of both terms and their application. One comment highlights the frustration some advisers feel when navigating purportedly ethical investments:

"There should be no difference between SRI, ESG, ethical or any other term, then we all know where we stand."

Notably, it was clear that while there was no consensus, advisers feel there is a difference between the terms ESG and sustainable investing with none arguing that they can be used interchangeably. Another common theme is that advisers considered one to be more comprehensive than the other, although there was again no consensus on which this may be.

A proportion of advisers believe ESG investing is about negative screening. Broadly this means avoiding companies that might be considered unethical. Industries cited included: tobacco, animal testing and weapons. Depending on whether ESG investing is defined by positive impact or negative screening, it represents a very different investment mandate for asset managers.

Other advisers believed that for an investment to be considered as ESG investing, it needed to display more characteristics than simply avoiding harmful or unethical behaviour. Whilst they deemed this to be important, they also believe it is more important for companies to have a demonstrable positive impact, particularly in relation to the environment.

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MAKING INROADS:

Barriers

The greatest challenges advisers see when advising clients on selecting suitable ESG strategies:

Answers	Responses
Lack of an industry-wide definition of ESG investing	37%
Lack of an industry wide 'gold standard' for ESG criteria	26%
Lack of transparency when reporting ESG activity	25%
Other	12%

Adopting a sustainable approach at the expense of returns

Although incorporating ethical considerations into their portfolios is preferable for many investors today, there is still an ingrained preconception that ESG investing can be detrimental to returns.

Encouragingly, the research found that amongst the adviser community, more than two thirds believe that incorporating ESG considerations into investment strategies does not impact financial returns negatively, suggesting that perceptions are changing.

These results support evidence showing that incorporating ESG considerations into investments can actually improve returns. The potential reasons for this are many. Companies that are well-governed seem to be more likely to outperform companies that aren't. Equally, conforming with ESG principles reduces the risk of falling foul of ever-changing ESG-linked regulations. It is becoming more common for suppliers and customers to expect companies to adhere to strict sustainability principles in order to engage with them.

A 2017 MSCI study[1] showed that companies with stronger ESG profiles typically exhibited higher profitability, lower frequency of severe drawdowns and lower systematic risk. Morningstar Financial Research provided further evidence, reporting that 73% of the 56 Morningstar ESG indices outperformed their non-ESG equivalents from inception[2]. Companies that effectively manage ESG risks and can capitalise on sustainability opportunities may in fact be better long-term investments.

In contrast to advisers' own views, the biggest barrier preventing advisers from recommending ESG options is their clients' concerns about underperformance; 3 in 10 advisers cited this as their largest limitation. This sentiment among investors runs counter to the empirical evidence outlined above. Other difficulties mentioned by advisers include clients' low understanding of, and lack of familiarity with, ESG investment.

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Advisers indicated that few of their clients are aware that there is a proven positive relationship between corporate ESG scores and financial performance, or that funds with a commitment to ESG are outperforming non-ESG funds on a risk-adjusted basis. Only 4% of advisers claim that the majority of their clients recognised this performance.

Given the gap highlighted by our research between advisers and their clients on ESG familiarity and favourability, it is unsurprising that advisers estimate that it will take an average of five years before most clients are invested in portfolios in which ESG is a core component.

Solutions

If the world is to see more assets invested responsibly then financial advisers will clearly play a pivotal role by directing more clients towards ESG strategies. The next section will explore what factors play a part in driving this change forward and what solutions may exist to overcome the barriers expressed by advisers.

SOLUTIONS:

Fostering a deeper understanding of ESG and sustainability in investment

First and foremost, there is a knowledge gap that needs to be addressed by the investment community. Advisers require a more nuanced understanding of ESG investing in order to feel empowered to challenge misinformation and have those conversations with their clients.

This becomes even more pertinent as we look forward to the investors of the future, when it is anticipated that the next generation will be more environmentally conscious than any generation before them; advisers need to be equipped with the tools and understanding to cater for these clients.

There are many ways the industry can boost the knowledge base and education sessions were cited as the key to increasing the adoption of ESG portfolios. The development of tools such as seminars, webinars and case studies will all play a part in meeting this objective.

Craig Hart is a Client Relationship Manager at King & Shaxson Ethical Investing

“Education is key. It is our job as Discretionary Fund Managers to support advisers when necessary. This could be seminars or one to one training sessions. Advisers need to be confident that they have a product they understand and can champion before entering into a conversation with e thically minded clients.

We feel with inter-generational planning the likelihood of ethics and values being raised will increase. The drive for solutions will come from the client, and the adviser needs to be ready and willing to embrace their clients’ values.

SOLUTIONS:

An industry collective approach to defining ESG and sustainability

More transparency around funds with an ESG mandate is essential in order to establish ESG and sustainable investment as a credible and reliable investment strategy.

There have been some accusations of ‘greenwashing’ in the current market, whereby some investments are not as environmentally friendly as they might claim, and there is also existing ambiguity due to a wide range of definitions of ESG.

It is paramount that the industry provides clarity on what can be defined as ESG and sustainable investing. This will involve establishing an agreed framework to determine the status of each investment product and whether or not it meets the criteria.

WHAT IS POSITIVE IMPACT?

“Investing in companies or funds which are helping the environment or avoiding companies which undertake harmful activities such as animal testing/weapons/ tobacco etc.”

“Inclusion of companies that are actively seeking to reduce the environmental impact of their business, provide decent conditions and pay for their workforce, and are governed in a fully transparent way with integrity.”

“Investing in something positive to the world as opposed to companies being negatively screened out.”

“Trying to invest to achieve a positive outcome - focused on protecting the natural, built and social environments.”

Participants' qualitative answers when asked to define ESG investing in their own words.

SOLUTIONS:

Establishing reporting standards for ESG funds

More rigorous reporting standards for ESG funds will undoubtedly play a key part in any solution, and new legislation should be put in place to govern reporting of key metrics such as the gender pay gap or environmental impact. There are benchmarks that are already in place which continue to be refined, such as the United Nations Principles of Responsible Investing (UNPRI) and ESG scorecards covering funds and companies. These organisations have reporting expectations outlined, yet will need to continue the development of their auditing process.

Reporting and measurement must be in line with the expectations of advisers, with two thirds saying they would expect annual reports to be filed outlining the ESG credentials of funds. Independent endorsements, such as recognised compliance with the UNPRI, would be helpful according to 47% of advisers. Nearly half would like to see industry certification on funds such as the Climate Bonds Initiative and would like auditing to be outsourced.

Types of reporting advisers expect for ESG funds

Options	Responses
Yearly reporting	61%
Third party endorsement i.e. UNPRI	47%
Industry certification i.e. Climate Bonds Initiative	45%
Outsourced auditing	43%

SOLUTIONS:

Challenging ingrained misconceptions around performance

One of the key areas for improvement is building a strong case for ESG investments as a means to provide returns. This will help to overcome existing concerns around comparable performance.

Evidence already exists to challenge this notion, but it is clear that more needs to be done to foster credibility and to build a good track record for these funds. The proposed reporting requirements referenced above will go a long way in demonstrating this.

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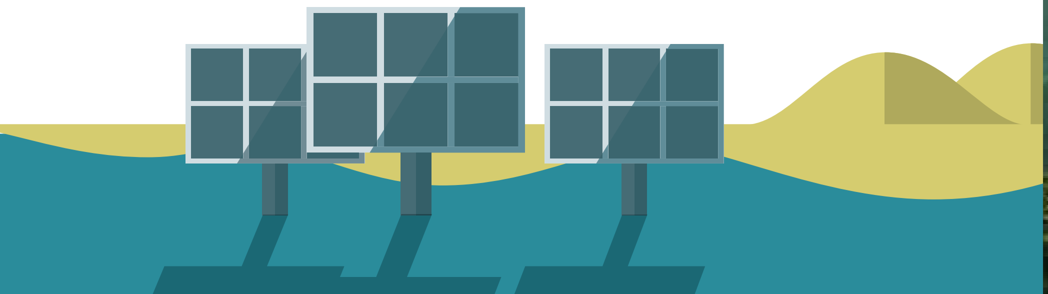
Conclusion

The need for greater ESG adoption in asset management is unavoidable: the world is becoming ever more conscious of the importance of preserving the environment and guaranteeing social justice, and the industry must meet the changing expectations of its stakeholders.

There is still a long way to go in moving ESG and sustainable investing from a niche concept to the mainstream, making it an attractive and credible option for investors with a financial as well as an ethical agenda. For example, the need for a universal definition was highlighted in absolute terms in the research and for as long as this ambiguity exists it will hinder more widespread adoption of ESG.

Financial advisers, fund managers and investment professionals alike all have a responsibility to develop their knowledge of ESG to keep up with the growing demand for sustainable investment.

At Foresight we pride ourselves on being a sustainability-led investment manager with excellent ESG credentials. We continue to wrap our investment strategies around the trends shaping society which are increasingly concerned with issues relating to environmental, social and governance factors. We are leaders in this field with an unapologetic commitment to sustainability, and we are prepared to take on responsibility to educate the investment community and shape ESG and sustainable investing in the years to come.



RESEARCH METHODOLOGY

The survey was conducted by PollRight among 124 financial advisers between 21 October and 8 November 2019.

The advisers had an average of 158 clients and managed an average of £50m.

More than half (54%) followed a prescribed asset allocation policy

(1) Source: MSCI ESG Research, LLC, **"Foundations of ESG Investing Part 1: How ESG Affects Equity Valuation, Risk and Performance."** Contributors: Guido Giese, Linda-Eling Lee, Dimitris Melas, Zoltan Nagy, Laura Nishikawa. November 2017

(2) Source: ESG Funds Beat Non-Sustainable Sister Funds, Morningstar, 24 September 2019

Appendices

Do advisers believe incorporating ESG considerations into investment strategies impact investment returns negatively?

Answers	Responses
Yes	16%
No	68%
Don't know	17%

How important are ESG issues when advisers are building client portfolios?

Degrees of importance	Responses
Very important	15%
Fairly important	49%
Not important	35%

How important is investment to advisers in ensuring the UK delivers its 'net zero' carbon targets?

Degrees of Importance	Responses
Very important	38%
Fairly important	42%
Not important	10%
Don't know	10%
All important	**80%**

Would advisers consider investing in a global equity fund with a mandate to focus on companies that combat climate change?

Answers	Responses
Yes	77%
No	11%
Don't know	12%

What proportion of clients express a preference for ESG investing?

Proportion of advisers' client base	Responses
Up to 25%	66%
Between 26% and 50%	8%
Between 51% and 75%	1%
Between 76% and 100%	8%
None	13%
Don't know	4%
Average:	**20.2%**

How long do advisers expect it to be before more than 50% of their clients are invested in portfolios with a core ESG component?

Time Frame	Responses
Within two years	14%
In between three and five years	31%
In between six and 10 years	23%
In between 11 and 15 years	8%
Never	12%
Don't know	14%
Average years:	**5.0**