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TAKING THE LEAD ON ESG INVESTING THROUGH CLIENT COMMUNICATIONS

Exploring ESG integration strategies, stakeholder engagement, and the critical role of client communications

JULY 2020

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SimCorp

EXECUTIVE COMMENTARY

A powerful client communications platform is the key to effective ESG reporting

Sarah Prior,
Global Client Communications Strategist, SimCorp Coric

There is a clear global trend towards ESG investing.

Embedding environmental, social and governance (ESG) factors into financing decisions is now a core concern in the investment management industry. According to the Global Sustainable Investment Alliance, the estimated global value of sustainable investments that are professionally managed stood at USD 30 trillion in 2019, representing a 34% increase in just two years.

At the same time, investment managers are recognizing ESG as a smart way to hedge risk, find alpha and achieve competitive advantage. Increasingly, we're seeing a widening of the returns gap between ESG and non-ESG funds, with ESG funds typically performing better.

Covid-19 has further accelerated the focus on responsible investment strategies.

The pandemic has started to change views on ESG dramatically as investors and other stakeholders re-think the value and impact of their investments. What we're seeing is a shift in focus, with people who previously concentrated on environmental factors now prioritising the social and governance aspects of investing.

As people reflect on their social responsibility, there has been a steady increase of assets into ESG funds. Consequently, the integration of ESG data into the investment management process is expected to become more mainstream.

Investor pressure to include ESG factors in client communications continues to grow. Meeting this demand requires the right set-up and tools.

Institutional and retail investors are making it known that monetary return is no longer their only concern. Clients want to be informed of the impact of their investments and see ESG factors included in the reports that they receive. At the same time, they expect communications that are timely, transparent, accurate, consistent and compliant – something which many organisations are not set up to provide.

The consequences of getting reporting wrong can be severe, with 76 percent of investors saying that client experience is a factor in choosing to change providers, so not prioritising client communications can easily impact the bottom line. Conversely, firms that provide high levels of client servicing have greater opportunities for cross-selling, onboarding new clients and ultimately increasing AUM.

To meet client demand for timely and accurate reporting on ESG factors requires a strategic approach to ESG integration and the client communications process. Achieving this requires an automated, workflow-driven client reporting and communications platform with seamless integration to the required data sources. When chosen well, the platform must also provide the flexibility to view the same data in different layouts and formats to meet a client's individual needs. Forward-thinking firms are going one step further and investing in digital technologies to empower their investors to view and extract ESG factors for their own analyses.

By delivering the ESG data clients demand in their reports as standard, and in the formats they require, investment managers can improve their customer experience and develop more meaningful relationships, helping them to retain and win more business.

SECTION 1

ROUNDTABLE DEBATE

Taking the lead on ESG investing through client communications

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Moderator

Elie Constantine,
Senior BA and ESG Specialist, SimCorp

Panellists

Sarah Prior,
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Ruby Paramanathan,
Director, Client & Distribution – Wealth & Asset Management, KPMG

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Director, Client Communications, Baillie Gifford

David Benson,
Investment Director, Ruffer

POINTS OF DISCUSSION

- *Incorporating ESG, transparency in reporting, and developing benchmarks*
- *Data quality and data technology*
- *Stakeholder engagement*
- *Using indexes to contextualise strategy for investors*
- *Key steps to carrying out due diligence on ESG data*
- *Communicating with clients*

Elie Constantine: ESG has never been more pressing for our clients or more talked about in the news and media. Now with Covid-19, we are all waiting to see whether this crisis will further accelerate the implementation of ESG within the investment management industry, or whether it will have the opposite effect.

A good starting point when talking about ESG is understanding the client objectives. In this introduction, I would like to provide an overview of the main ESG drivers, before we discuss how to best implement ESG within the organisation.

In terms of ESG drivers, I like to call this the revised social contract, which is focused on sustainability. We have new realities happening in the market where, as consumers, we are becoming more conscious about sustainability and are asking more questions about the everyday products we buy. We want to know where our products come from, how good they are for our health, and how good they are for the environment.

Examples of these new realities include climate change and global warming, the impact of which is becoming increasingly tangible across all parts of the globe. In addition, the Covid-19 pandemic has introduced unprecedented levels of uncertainty, proving the ultimate resilience test for both people and organizations. At the same time, investors are asking more questions than ever before, and demanding greater levels of transparency.

One of the main drivers behind this new social contract has been the Sustainable Development Goals (SDGs) of 2015, which provides a globally accepted blueprint for achieving peace, prosperity and sustainability for people and the environment. Other important standards include the United Nations Global Compact, - a voluntary initiative to encourage businesses worldwide to adopt sustainable and socially responsible policies, and to report on their implementation -, and the COP21 Paris Agreement, a global agreement on the reduction of climate change, signed in 2016.

> WE HAVE NEW REALITIES HAPPENING IN THE MARKET WHERE, CONSUMERS ARE BECOMING INCREASINGLY CONSCIOUS ABOUT SUSTAINABILITY AND ARE ASKING QUESTIONS ABOUT THE PRODUCTS WE BUY

As the investor mindset has started to shift, the fiduciary duty of investment managers has started to evolve, where the focus is not only on performance-based financial returns, but also takes into account the sustainability goals of the investor.

When we look at ESG from a satellite perspective, a few key themes emerge. The first is data generation, which encompasses everything from how we source data on ESG factors, the reports that are generated by listed companies, and the news relating to companies' activities. This data has never been controlled and audited in detail, and we are still missing a regulatory framework for these companies on how to provide disclosure.

At the same time, we're seeing a steady increase in the number of ESG data providers, with approximately 21 companies available in the market today. Each of these providers has different methodologies, sources and coverage. How to select between them is an important and not necessarily straightforward question.

Once the data is available and ready to use, we can talk about its use from an investment management standpoint. For example, how do we incorporate ESG into our everyday compliance rules? How should ESG be incorporated into portfolio and asset management? How can we ensure we have the right benchmarks and can perform effective risk management? And, most importantly, how can we effectively communicate this information with our clients through reporting and disclosures?

When thinking about reporting – whether it's fund reporting, regulatory reporting or disclosure – the ESG component is typically missing or not sufficiently covered. What's lacking is a comprehensive evaluation of the performance attributions and standards for reporting the impact of ESG on the financial performance of an investment.

Ruby Paramanathan: The way that we describe ESG and embedding into an enterprise is with seven thematic areas, which resonates with a number of asset managers that we have spoken to. It is largely driven by the regulations, whether it be the FRC stewardship code through to the EU sustainability disclosures and tax on any new regulations. It provides a good framework around the various strands of ESG when you think about implementing it across your organisation.

When we talk about sustainability risk integration, the key word that jumps out is systematic integration across the organisation. This is around considering sustainability risk as a new pillar of your risk management framework, as well as embedding it within your investment process and investment decision making. It is about considering it in the same stance that you would credit or liquidity risk.

The other areas that are quite prominent, which will create a lot of thought and work within organisations are around product. For example, product governance, suitability for your investors and the disclosures that you put around your ESG products, all of which are as important as the products that perhaps don't satisfy ESG criteria.

The regulations have stipulated the types of disclosures to include. An important point to draw out here is that at a product level, disclosures in underlying investments are very important. This is an area where I see the creation of quite an uplift in terms of effort, thought in terms of what organisations need to be thinking about.

Linked to this is the data point and having a close collaboration with the data providers, which will help you in determining the right disclosures and having confidence around the messaging that you are displaying.

Another important point is around stewardship and engagement. I have seen a rise in asset owners, clients and end investors having a vested interest in how asset managers are engaging the underlying companies and being very transparent and informative about the types of discussions that they are having. The outputs they are getting through due diligence and really showing an active engagement role, both through voting statistics and conversations and dialogues that they are having with the board level.

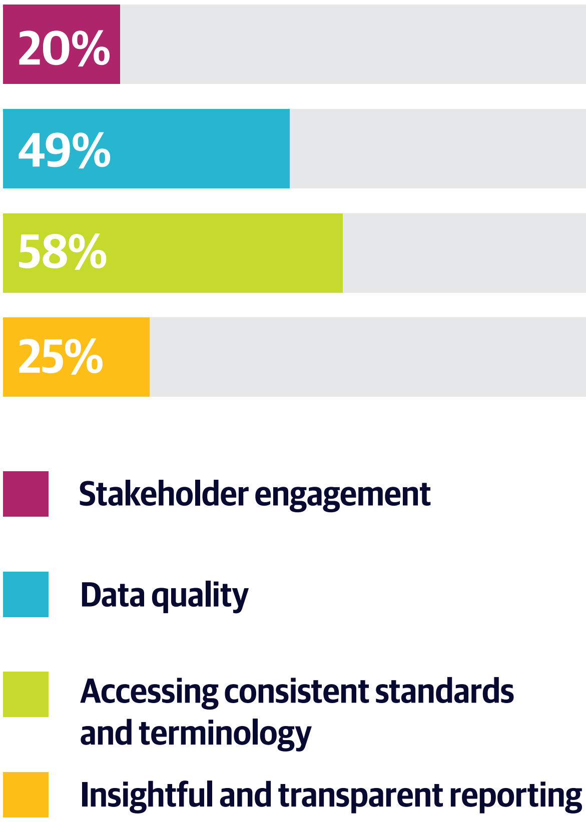
The best way to think about embedding it is almost to think about a business transformation and operating model transformation, with technology and data being enablers. This cuts through your governance and organisation and is about making sure that every corner and function of the organisation and hand off is very clearly embedded.

Several asset managers had ESG products within their product ranges for some time. The thought process that they are going through now is around ensuring that there is a level setting, i.e. that the strategy at a corporate level, the mission and vision that you set, is very clear and well understood. This is distilled through your client communications but also it comes through your organisation's DNA, which means that it is understood by your employees and shareholders.

Training and awareness are key when we think about consistent application and investor messaging. This means making sure that the message is consistent, protected and preserved as it reaches the end investor. This is where working with your distribution partners, your advisor network, and so forth onwards, to make sure that your ethos, products are well understood, becomes key.

As with most transformations, data technology is essential, and several managers have understood the differences and variations that you see in terms of external data providers, ratings and methodologies. Off the back of this they have taken steps to develop their own proprietary analysis and ratings. Making sure that this is transparent to investors, and that it is well tested and back tested to ensure that on an ongoing basis the data points are consistent, understood and articulated is also very important.

What are the key challenges to embedding ESG in the organisation?



Participants chose all responses that applied to their organisation

Elie: Yes, I believe there will be a continuous learning curve for everyone on this topic but having a clear and engaged vision with a systematic process that is driven by a standard enterprise technology platform or tool will be key to achieving the ESG targets and objectives.

I will now ask David, what are your thought on this?

David Benson: In our firm we offer a single investment, absolute return strategy to all our clients. Educating people across the firm, getting buy in to the investment process has been very important and is clearly an emotive topic with a lot of opinions.

In terms of the reporting element, we have a single strategy. We have a broad range of clients from the most sophisticated institutions and investment consultants to individual private clients. It's interesting that over the past few years, this would have been seen as more of an institutional issue, but it is much clearer now that many of our private clients are just as concerned, which has helped in terms of getting that broad buy in across the firm.

We have a wide variety of people that we need to report to, and it is a very technical area. We need to be very cognizant of avoiding the jargon in reporting and explaining very clearly what we are doing. We hired a responsible investment specialist about 6 years ago and then appointed champions across the firm. This is how we have spread it in a very bottom up way, but in the next phase of our development we need a top down push. As such, our executive committee has set ESG integration and development of our ESG offer as a firm priority.

Catherine Flockhart: Data quality, accessing consistent standards and insights, and transparent reporting are all tied up in some of the stakeholder issues that we are unpacking at Baillie Gifford. This relates to how we give evidence or show more generally good ESG credentials in what we are doing.

Stakeholder engagement is slightly different to the other three areas, but it is critical because many elements of ESG reporting, or what one is trying to demonstrate, can be fairly subjective. What matters to one client might not matter to another. For instance, a colleague of mine was presenting to someone in the US who asked why they would screen out weapon manufacturers from a portfolio, as they really believed in their right to bear arms. Therefore, something that would seem like a basic negative screen from an ethical perspective went against an investor's beliefs. Stakeholder engagement is crucial to better understand what matters to them. Also, what is vital for asset managers is to clearly lay out the ESG credentials or values of that product, so that it is very clear to the end stakeholder what products are reporting to do.

Three of those options on reporting are big and thorny issues but stakeholder engagement is slightly separate, but it is important and will become increasingly important.

Elie: How can ESG data be properly integrated in the investment management process?

David: Our strategy is a multi-asset strategy and is unconstrained and un-benchmarked in terms of asset allocations and stock selections. We tried to integrate data looking at macro ESG issues, but really, we focussed more on climate change issues, where we use a variety of third-party data, and water scarcity where we used CDP data. Understanding how the harder to abate sectors are responding to the required transitions is a key area of focus.

If we look at the issue from a bottom up perspective, we concentrate on the use of third-party data. We have an ESG research provider, a proxy research provider, who we use for governance and voting support, as we make our own governance and voting decisions.

Asset allocation is a key part of our strategy. When we look into ESG data in our asset allocation models it's about how to integrate the data at an asset allocation level. What providers and data, we use which will be similar for reporting to clients on portfolio level metrics?

> “WE NEED TO BE VERY COGNIZANT OF AVOIDING THE JARGON IN REPORTING AND EXPLAINING VERY CLEARLY WHAT WE ARE DOING”

A key challenge for us as a company with an un-benchmarked strategy is, when we think about carbon metric or carbon intensity data at the portfolio level, it is rather meaningless without any context. The question then is, what do we compare it to, which is a real communication challenge and an investment process challenge. Most people would look at our strategy versus an index, if only 30-40% of your portfolio is equities and it is not benchmarked against an index, then it is quite hard to know how to contextualise this. This is particularly true when reporting to clients because it is quite nuanced. We need to be able to provide some context to our investors with respect to this.

It is bottom up in an investment process sense rather than an organisational sense at the issuer and equity selection levels, but then it is also about how you integrate the data when you are looking at bigger asset allocation decisions which are really critical to the overall strategy.

Elie: **Yes, and I believe that the index provider has been catching up on the indexing to add ESG flavouring into it but nevertheless the gap hasn't been fully covered in the market.**

Catherine, you mentioned the focused approach and everyone who has followed Baillie Gifford will see that ESG is part of your vision, but for now you have continued with a very selective approach where you have launched very specifically focused funds. How did you phrase your strategy into a process that you can use every day?

Catherine: We are an asset management partnership who is primarily focused on active, long-term equity investing. We have the luxury of holding a relatively small number of companies and being able to get to know them incredibly well across all our portfolios.

We have also launched our positive change impact strategy, which sets ESG targets as equally important to financial. This goes to a whole other level in terms of integration of ESG or impact alongside investments. Firstly, there is no shortcut to what makes a good ESG portfolio or investment.

The credentials of a company cannot be boiled down to just one number. For instance, one of the ESG passive funds out there, which is scrapping data from some of the larger providers, one of them has a higher weighting in British American tobacco and the other to a micro lender in Indonesia who we hold in our impact portfolio. This is because whilst British American tobacco has all the good ESG policies and its staff really like working for them, there isn't a way for these vast data systems to factor in the subjective value judgment. The fact that one of those companies provides a product that is very damaging to people's health, whilst the other is keeping afloat small farmers in areas of the world who desperately need access to more finance.

We have taken the approach of having a dedicated governance and sustainability team comprised of 24 individuals. We also rotate all our investment managers to a graduate program through our governance and sustainability team, so that we can attack this from both angles.

We are using a huge range of data, as it is important not to use just one but to get many different approaches. Of course, speaking to the companies themselves is also critical indicator. As are the views of specialists throughout the finance industry who really know the ESG elements inside out. Whilst there are lots of challenges that we face, to do this properly and thoroughly there are no short cuts. It is about having an asset manager who knows what they are invested in, inside out.

Sarah Prior: When we talk to the market, we hear of incomplete data sets, inconsistent knowledge across the organisation and little-to-no strategy for wider integration of the ESG data, which is such a challenge to be faced with. Once you've decided upon going down the route of ESG integration, there are few things you can do to sustainably oil the gears for change.

First off, education – having the data is fine, but the organisation needs to understand what it represents, and how that may affect client's views. There is also an element of client education to undertake, too. Next, look to technology: make sure you have flexible systems to incorporate new data streams – you may have multiple ESG data sources, and you need to be able to change or add sources easily.

> there is no shortcut to what makes a good ESG portfolio or investment

Currently firms may limit their ESG data into specific products rather than enterprise wide. If this is the case at your firm, ask yourselves how scalable this is for the organisation's future vision and strategy. Are you going to be able to meet your own ESG goals, if it's not folded into the entire investment management process? I'd recommend making ESG data a central criteria for future tech decisions, so that all systems are designed with ESG in mind, it cannot be an afterthought.

Elie: **I agree that it is important for the asset manager to know the ins and outs, but data is also an important driver.**

Ruby, if you are an asset manager today and you want to do due diligence to on board ESG data into your investment management process, what would be your key steps?

Ruby: The main shift that I have seen is beyond the simple negative screening that is applied, to integrating ESG into the end to end investment process. This is from the very early stages around looking at the pool of investment opportunities and distilling that through the due diligence process.

Most asset managers will have a very robust, tried and tested due diligence process that is inherent in their investment strategy as it stands today. Embedding a comprehensive ESG checklist within this strategy, that aligns back to the sustainability objectives that you have outlined in your products and investment strategies, will be critical. Also, ensuring that you have more robust and detailed site visits and that the outputs from these site visits are accessible, transparent, fully comprehensive and fully documented, covering

> BY SEEING THE VALUE ON INVESTMENT OF THE ESG INTEGRATION INTO CLIENT REPORTING, FIRMS CAN GET MORE POWER FOR THEIR CAUSE

all of the material risks ranging from environmental pollution right through to workplace safety.

The evolution of due diligence is a step beyond what exists today, in terms of integrating the detailed checklists and the ESG criteria that you have attested to through your strategies.

Sarah: This area is only seeing growth at present, even the latest GSIA report shows that over $30Trn of assets fit the ESG moniker, with significant increase expected when the next report is released. Investment firms need to do something now to make sure they meet their investor's expectations. Clients are demanding the ESG data, and not just the millennial investors – firms may be equipped to deliver on one-off requests, but few are set up for full scale ESG integration into their client reporting framework.

It's best to look at incorporating ESG data into client reporting from the outset. Consider your client demands up front – you can find this out by simply talking to them and monitoring what they engage with. Then you need to make sure you have the data, the ability to amend existing reports to include it in a digestible format, and ensure you have the workflow processes in place to support this throughout the organisation.

Think about what the purpose of the reporting is, and who will benefit from it – map it out to prove the value to your clients and organisation. By seeing the value on investment of the ESG integration into client reporting, firms can get more power for their cause. Make sure the framework looks at multiple areas of the organisation, not just product and marketing, to avoid being accused of greenwashing.

Elie: Our focus here is on seeing what type of ESG integration has been done so far. Sarah, what are your thoughts?

Sarah: It is quite evident from our discussions and within the marketplace that most firms are at varying stages within their ESG integration journey, especially within the client reporting and communication. I am not surprised that the ability to deliver data to a subset of clients is seen as one of the most important elements to an investment businesses success. We work to understand the needs of firms and what their client expectations are, as well. I am not sure that the abilities here are necessarily aligned with the expectations of the end clients.

There are some firms who can deliver a certain amount of ESG data as part of their client reporting. However, something that is quite good, is that firms can tailor the prioritisation of different ESG factors as well within their reports. This means that the information presented is relevant and specific to the client and it shows that they are seeing what matters to them. This is a positive in terms of delivering it as a subset. Although, firms should look at how they can integrate this across their entire reporting process and have a blanket approach when delivering this, with a small flavour of tailoring the information as well.

Elie: Yes, and this is what I have been seeing from my side as well. The follow up question to this is, how can we build a forward-looking reporting framework to bridge the gap between ESG reporting and investor expectations?

Clients have already been voicing their concerns so how can asset managers leverage the feedback?

Ruby: It is crucial to leverage any client councils or feedback groups that you have in place or are looking to set something up where you start to test some of the messaging and reporting needs. This can avoid prioritising the wrong parts and ensure that what you deliver starts with what the investor needs.

Within this you need to break down who the investor type is. I would avoid the temptation of overloading with information, as there is so much that you are naturally collating through the data and investment processes. It is important to test what is relevant to the client so that the message is clear and articulate.

In the more institutional domain, I expect that these investors are increasingly data hungry and they are going to want the ability to drill down into data and bring together engagement and voting statistics with portfolio, risks and the Social Development Goals that you are aligned to. Starting to think about prototyping and creating something that visualised what you could produce to generate a feedback loop early on, may ensure that anything you are building out is likely to hit the mark.

One of the benefits of having a singular strategy is that we can provide a very detailed annual ESG report, which is applicable to all our clients because they are all invested in the same strategy. The major part of this in terms of content is engagement and case studies because this is a key pillar of our ESG approach. We have a team of equity analysts who meet companies all the time, and we engage with them on many topics. It is a core part of our report as well as voting statistics and other areas which are included in our annual ESG reporting. There are also quarterly engagement updates that we provide to clients and investors across a diverse base.

We also do provide bespoke reports for the investors when particular formats are requested, or if they have specific needs. We would like to make this more scalable, as we have many segregated portfolios, as well as funds that also represent our strategy. We want to embed this into all of our clients, so that it is not just provided on an ad-hoc or request basis. Clearly the regulations are also pushing in this direction.

In terms of quantitative reporting, this is a real challenge for someone like us who is running an un-benchmarked or multi-asset strategy. For instance, if we are providing carbon intensity data, that some clients request then what are we comparing it with? It is meaningless without context.

> “As the data starts to improve and it becomes more of the industry norm, this type of reporting will become more easily providable across the industry”

Elie: David, how did you manage to incorporate a qualitative assessment of your strategy? Was it similar to how you would incorporate a risk disclosure into your fund reporting?

David: It is important for us to understand what our investors require and to try and meet these needs across a very broad client base. A few years ago, we would have communicated to clients and investors about our ESG activities, where we felt they were interested. We have pivoted on this approach because we discovered that if we don't tell people about it, they just assume you don't do it. We are much more proactive now and aim to communicate with people as much about what we do with respect to ESG. It is core to our investment processes and should be spoken about as such.

Our reporting to clients shouldn't be aspirational. We shouldn't be talking to investors or clients about things that we aspire to do, but only when we are actually doing it. The worst thing for one's credibility is to be talking about doing something within the ESG space but then perhaps through thorough due diligence you find out that it is not really being done as described. A consequence of this is that in the past we perhaps under communicated to our clients.

Elie: Catherine, as much as you want to ensure the long term returns for your investors, we know that not all investors are seeing this as only sustainable investments. What steps are you taking to ensure that you have better quantitative assessment of the impact of ESG?

Catherine: What we are doing for our impact portfolio is a good example of what is at the cutting edge of initiatives being tried in the industry. We do have the luxury of being able to do this on our portfolios with a 5-10 year holding period that has an explicit impact focus. I am not suggesting that the rest of the industry will necessarily be here yet because it is very complex.

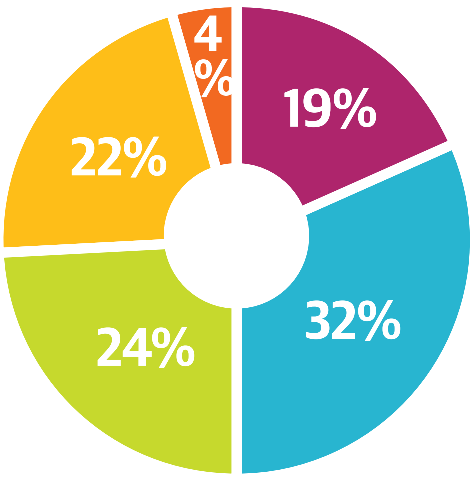
For each company in the portfolio, we lay out what we call the positive chain, which is the industry best practice for how you report on systemic changes that the company can drive. We will report bespoke metrics, which is done annually. For example, if it is a healthcare company, we will show how many patients they have treated or for a clean energy company, how many tons of carbon the company has saved. This is done for every stock portfolio. We also outline where there are materially negative contributions because this is important.

We then map all the business activities of the holdings to the UN sustainable development goals. We do this ourselves at target level using a robust framework, as this is an increasingly common language that people like to see.

We also produce overall portfolio snapshots for the clients who do not want all the detail. For example, in 2019 the products and services of companies in our portfolio helped customers to save 152 million tons of carbon. This is the equivalent to taking 32 million passenger cars off the road. We have also produced a calculator, which allows clients to plug in what their investment would have been and to see the share of that impact.

Data and the comparability of it is not perfect, in terms of what we are getting out of the companies. We air on the side of conservatism and only report where we can clearly get data that can be verified by companies, but even then it isn't always a perfect like-for-like, so we try to be as transparent as we can about this and don't guestimate or inflate the numbers. We also have KPMG audit the reporting that we give to clients. It is quite labour intensive, but as the data starts to improve and it becomes more of the industry norm, this type of reporting will become more easily providable across the industry.

How does your firm deliver ESG data as part of the client reporting process?



- **We deliver ESG data upon special request, outside our normal reporting process**
- **We deliver some ESG data to a subset client reports**
- **We do not include ESG data currently but have plans to incorporate it**
- **We incorporate ESG data into all of our client reporting**
- **We do not include ESG data and we do not intend to**

Elie: Sarah, how can you prepare your system to be generic and flexible enough? How can you help your clients with the right tools to drive insights and competitive advantage?

Sarah: What we see is that both institutional and retail investors are looking to incorporate ESG factors into their investment choices. There is evidence which demonstrates a correlation between a company's ESG performance and its financial performance, so it is a no brainer that we all need to start focusing on this area if we haven't already.

Flexibility is key to winning over the client communications championship. When it comes to ESG, making sure that you know that you've got the ability to flex and pivot those data sources, as and when they become available or the regulators have decided that they are more or less applicable as the case may be. You also need to adjust your stance in having the systems and processes in place to be able to change your reporting avenues and layouts, so that you can adapt to what your clients needs.

The value of investments and the definition of this is changing significantly, so firms need to be able to deliver these metrics within their client communications. This includes fund factsheets that they put out on their websites to the quarterly investment reports and the valuation reports that they provide to their end clients. It needs to be at every single point within the client communications process.

I would add a little warning that ESG data needs to be treated the same way as all other financial data. It shouldn't be a second-class data citizen, because firms who do this end up running the risk of being the second choice for their end client's assets and losing market share. If you embed it properly within your client reporting communications processes you will be able to generate greater market share and share of client wallet - which is what we are ultimately after.

Also, embedding ESG into the reporting in a way that is comparable is important because there is still the issue out there around the different terminologies etc. and until we have this nailed down it is going to be difficult. If an education process happens throughout every organization and throughout the client base, we will be in a better position to be able to deliver those insights through our client communications.

Firms need to also ensure that the data within their client communications and reports is relevant to the investor and it shows consideration to the areas of ESG that take precedent for them. It is not just about providing the data in a format that resonates with their end clients but showing that you understand your clients. There are nuances that can be found, even by geography where the significance of the environmental, social or governance factors changes. If you can pivot your client reporting mechanism to make these changes in representation within the end

> THERE IS EVIDENCE WHICH DEMONSTRATES A CORRELATION BETWEEN A COMPANY'S ESG PERFORMANCE AND ITS FINANCIAL PERFORMANCE, SO IT IS A NO BRAINER THAT WE ALL NEED TO START FOCUSING ON THIS AREA IF WE HAVEN'T ALREADY

reports, you will be seen as an aid in your client's investment processes and outshine your competitors. It becomes a market differentiator. The key to all of this is flexibility of data representation for your clients to make informed investment decisions.

Elie: Is the stakeholder engagement poll number potentially so low because of the lack of consistent terminology or that it is difficult to get stakeholders on board if you are having to clarify what sustainability is in the first place versus pure climate change impact, let alone the technical standard?

Catherine: Whilst customisation and stakeholder engagement is critical to a degree, when we talk to our stakeholders and clients, investors are actually looking for asset managers to provide leadership and are bamboozled by the technology. They aren't clear on all of the differences and terms. It is then incumbent on us to provide this leadership and it is crucial that we don't try to be all things to all people. When we are running funds that proport to be high on ESG, that we are clear about the values on which we are running those funds in a relatively consistent way. I do believe that this helps with client and stakeholder engagement.

Elie: Ruby, how can asset managers ensure that they are not deviating of the track and going in the wrong direction?

Ruby: Clarity in terms of the ESG product set that you have, who they are targeting in terms of the type of investors they have and the outcomes that they are expecting. If we think of some of the segregated types of portfolios and mandates where you have more scope to incorporate specific investment preferences, being able to be flexible in modelling portfolios and ensuring that co-creation and solution meets the end demand and outcome are key differentiators. It is also essential to stay on track in terms of what investors are expecting in terms of outcomes.

Elie: Thank you all for sharing your thoughts on this topic.

SECTION 2

INTERVIEW

Designing a feedback loop of emerging ESG trends and application to future client reporting procedures

INTERVIEW

Designing a feedback loop of emerging ESG trends and application to future client reporting procedures

Interviewer

Sara Benwell,
Editor, FundOperator.com and Insurance-Investor.com

Interviewee

David Czupryna,
Head of ESG Development, Candriam

SUMMARY

- *Setting ESG goals and having a comprehensive list of targets to achieve this*
- *The importance of transparency in reporting*
- *Lack of ESG standardisation as an on-going issue*
- *Investment decisions and their impact on the climate*
- *Emphasising the social and governance aspects of ESG*
- *Integrating ESG and quantitative ESG indicators*

Sara Benwell: There has been talk of whether some managers are greenwashing. Therefore, what counts as ESG or SRI factors and practices, particularly considering France's regulator, Autorité des Marchés Financiers (AMF), mandating disclosure of ESG factors as part of fund prospectuses?

David Czupryna: There is quite a lot of greenwashing going on, and the more that investors ask for ESG the more greenwashing there is. It is not entirely surprising, considering how popular ESG has become.

The AMF has been at the forefront of introducing and forcing mandatory disclosures. They have introduced a new doctrine about two months ago, which established several ways that you can confirm the credentials of your ESG strategy. One way is to eliminate 20% of your starting investment universe, where you show your starting universe and show what you can invest in. The 20% reduction must be achieved based on ESG criteria.

The second way is to improve the average ESG quality of your portfolio versus your starting universe. You don't necessarily have to eliminate, but you need to show that your starting universe has a carbon footprint of say X numbers of tons of CO2. Then you show that you are going to decrease this by a certain amount.

Of course, as you can imagine some thematic strategies don't necessarily reduce the universe in a way that is very mathematical. They don't improve ESG quality from a general standpoint but focus on a very specific theme or impact. The third strategy for these types of investors is showing that they have a very impactful philosophy and strategy that seeks to benefit a sustainability goal.

Sara: How has adherence to the Social Development Goals (SDGs) impacted your approach to client reporting?

David: We have been integrating the SDGs into our analysis since they were launched in 2016. This has allowed us to assess to what extent companies are providing positive contributions to these development goals.

To offer some clarity around the SDGs, there are 16 goals which represent the agenda for the planet and humanity. 2030 is the deadline of to solve all of our collective problems: hunger, climate change, lack of access to water, destruction of biodiversity, etc. There are the targets to support these goals.

The goals themselves are very simple to understand, for instance, SDG 1 is end poverty and behind this there are 169 individual targets that are quantitative. For example, no one dies from hunger by 2030 or that malnutrition becomes a story from the past. From these 169 goals, not every one of them can be easily addressed by a company. If you are trying to end poverty, companies providing jobs and salaries are, in a way, attacking poverty. This isn't what the UN has in mind, so companies can address only a portion of these goals. For those that can be addressed, we are measuring how they are achieving this. We

> “THERE IS QUITE A LOT OF GREENWASHING GOING ON, AND THE MORE THAT INVESTORS ASK FOR ESG THE MORE GREENWASHING THERE IS”

have been doing this for the last five years, so now we are introducing a set of reporting where we share in a very transparent way how our strategies and funds are contributing to each of these 16 SDGs. For some, there is very little contribution, and for others you can see a positive contribution, whilst for others we even go as far as showing a negative contribution.

Some find it strange that we show a negative contribution within a marketing document, but it is a matter of transparency. Realising that for some SDGs - such as number 7, which is about developing renewable energies - if you have any kind of investment in fossil energy in funds, these companies will be counted as negatively contributing to STG 7.

We want investors to be able to make up their minds by showing them how we do this and comparing it to our benchmarks where we tend to do very well, which is what really matters.

We would be delighted if everyone adopted the same kind of transparency, as the investors would be better able to assess this area. Unfortunately, there is a lack of standardization, which is an issue that has been raised by panelists in the previous roundtable. It is a crucial factor that is impeding the broad adoption of SDGs within investments.

Sara: How do you look at key indicators, such as climate emissions, and explain all the ESG related factors and link them back to your investment plans in a way that your clients can understand?

David: Some of them are becoming standards and because they are becoming more widely used, the industry can get used to them. A paramount example of an indicator becoming a standard is carbon emissions. This is because there is a regulatory requirement in many countries for investment managers to disclose this. This has been the case for the past three years with the article 173 in France, but it is now coming to the EU level with the taxonomy and regulation directive on ESG disclosures. Investors are now able to get a better sense of this area.

For example, when we tell retail investors that there is 122 tons of CO2 per million euro invested, they aren't always sure exactly what this means. We measured the amount of CO2 released by the companies that we invest in. For what they release into the atmosphere, we measure and compare that amount of CO2 gas to the equivalent for something that everyone used to do – before the Covid-19 outbreak – which is flying or driving. We compare the difference in CO2 emissions between our strategies and benchmark to how much you could fly or drive with that difference, so that people can understand it better. If you have £100,000 to invest and put this in a FTSE tracker, it means that you are investing in companies who, for that amount of money, will send X amount of tons of CO2 into the atmosphere. Alternatively, you can take that money and invest it in a Candriam sustainable fund where this fund will invest in companies who are releasing Y amount of CO2. The difference is then calculated so that people can see just how much their investment decisions have impacted on our climate.

Sara: You mentioned that some of your funds are still invested in fossil fuels, how do you reconcile an investment in fossil fuels with an ESG strategy? Do you find that there is more focus on moving away from fossil fuels? Why is it that you haven't completely eliminated them from your investment strategy?

David: We have removed thermal coal which is used to generate power from all our investments Candriam wide. We don't invest in thermal coal at all, with a threshold of 10% revenues.

We also stopped investing in unconventional oil and gas across all our sustainable investments, which is over €40 billion. This means that we do not invest in the US fracking industry or the oil sands in Canada because the environmental impact of such areas is gigantic.

However, we do still need oil and gas. There are many chemicals that we use in our daily lives that can only be made with oil. We can't produce electricity in the U.K without natural gas and can't power your car without oil either.

We need to reduce our reliance on oil and gas and want to encourage oil and gas companies to transition away from oil towards gas, and then from gas towards renewables. Consequently, we want power utilities using fossil energy we invest in to generate at least 40% of their revenues from natural gas as it is less CO2 intensive than burning oil or coal.

There is an energy transition that is happening now at a very fast pace. The pace has been speeding up over the past few years and we hope that it will keep on this trajectory despite the breakout of the Covid-19 crisis.

We are completely aligned with this transition. This is also the position of the authorities in the UK and Europe. We do still rely on oil and gas and still need them, but we want to encourage companies to move away from them into the renewables space.

Sara: End investors are quite clear on what they think the environmental factors are in ESG investing. What are some of the more important factors that you look at when it comes to the social and governance parts of ESG?

David: If there is one good thing in terms of investing that can come out of the Covid-19 crisis, it is that people have realised that ESG isn't just about the environment.

When I talk about ESG and the carbon footprints and water measurements we never really put as much importance on the 'S' and 'G', which are as important. They are more short term as well, as some argue that climate change is a more medium-term issue.

Under 'social' we mean working conditions and looking at how companies are managing their workforce. Do they have a very aggressive management with a high turnover with low benefits and not allowing people to unionize or provide sufficient maternity leave, etc. Social is a very broad area, which includes how companies approach their relationships with their clients, client policies, the quality of their products, and so forth. A pharmaceutical company for instance can have a big impact on the social contribution, as they can provide necessary medication.

the board. This is supposed to work well, but often you see companies with non-independent board members and executives who are on the board and picking other members of the board, which can then lead to issues in terms of accounting fraud and so on. These are all issues which can ultimately help to avoid crisis and add value to investors.

Sara: If it isn't easy to get consistent data reporting, how can clients distinguish between good and bad data providers? With regards to the 'S' and 'G', how can investors distinguish between a firm that is good socially or good from a governance perspective and one that isn't?

David: You can look at how the manager is integrating ESG data at the portfolio management level by asking simple questions. For example, whether they exclude any sectors or activities for ESG reasons that they deem unsuitable, does their ESG analysis lead them to overweight specific companies versus others? Can they prove this and demonstrate the results? You would be surprised if an investment manager who has seriously considered the way that they integrate ESG would struggle to provide tangible examples. They may provide a few examples of companies they invest in and say that they are ESG leaders, but that isn't the question. The question is whether they can provide you with concrete examples of overweight and exclusions based on ESG, and which ESG factors it is based on.

Obviously, unless you have access to the fund management, this is a question that you will struggle to get an answer to. The other way is to look at the impact or result. Here we discussed reporting, but there are many ways to measure ESG impact. Many managers are still measured and compared to traditional none ESG benchmarks. Taking specific and quantitative ESG indicators, such as carbon emissions, water consumption, the number of women sitting at the board level of the companies that you invest in, or the number of independent board members, etc. – all of these are tangible indicators and there is a lot of choice that you can compare overtime to a benchmark to see what the result is.

> “We would be delighted if everyone adopted the same kind of transparency, as the investors would be better able to assess this area.”

This isn't just about analysis, but also about engaging with companies and asking them to provide us with this information. Investors tend to be less interested in the 'S' and 'G', which means that companies have been providing less information on these areas. Thus, we are supporting engagement initiatives to ask companies to provide more information.

The governance aspect is all about how the company is structured, the way it provides for checks and balances. You have an executive board that is responsible for the management of the company. You then have the board of the company, who is there to supervise and control what the executives do. Shareholders are there to nominate members of

Sara: It is fair to say that over the past couple of years the level of intensity and focus on ESG has increased from a regulatory perspective. Do you feel that this is the direction of travel now and that we will see more of this kind of action on behalf of regulators? If so, would you expect to see more firms being transparent and providing better data around ESG?

David: The trend is clear. The Covid-19 crisis has to a large extent provided water to our mills in terms of asserting the added value of integrating ESG into your decision making.

> IF THERE IS ONE GOOD THING IN TERMS OF INVESTING THAT CAN COME OUT OF THE COVID-19 CRISIS, IT IS THAT PEOPLE HAVE REALISED THAT ESG ISN'T JUST ABOUT THE ENVIRONMENT

We can expect managers who were not integrating ESG now start to follow suit. Even if it's only because their clients will ask how they ensure that the companies they invest in have good quality human capital management that allows them to work better in times of crisis.

I also hear from my US colleagues that the Securities and Exchange Commission (SEC) is now reflecting on whether to introduce some minimum standards for strategies that are described as ESG. They have done a survey of the market to prepare their opinion.

This is really moving worldwide, and it will be a chicken and egg situation where it is unclear whether you will see more ESG strategies being launched with unclear ESG credentials or the regulators cracking down first in order to avoid greenwashing. Both will be linked. The quality of the strategies that describe themselves as ESG being launched will determine a response from the regulators as well.

Sara: **There are a couple of ESG indices out there. How useful are they for people who may want to invest in a tracker ESG fund or as a reporting, benchmarking tool?**

David: Any initiative that is credible and is ensuring that companies improving their ESG practice are laudable. If the ESG indices are built in a credible way and are not just taking out certain sectors but keeping everything else, then it is positive.

At Candriam, we don't use these ESG indices and have instead built our own indices that are backed by our proprietary research. We are in a way providing indices to our clients, but it is an open field and free market, so we are happy to see other people stepping in and providing credible ESG solutions.

Sara: **There has been research that suggests that particularly for the 'S' and 'G' factors, what matters most from a return's perspective is not necessarily that a company is good but is improving. How easy is it as a fund manager to evaluate not where a company is at but the direction of travel and is getting better at these areas?**

David: A lot of ESG data that you get is backwards looking, so it is looking at the number of accidents at a company's facilities from past years that you can then draw a trend from. What we are interested in is looking at the forward-looking trend, as this is the only way that we can spot what will become material. The materiality of the ESG factors is crucial.

The trend is essential, and we don't add a trend indicator to our ESG assessment. We integrate the trend into the final scores that we give to companies for internal consumption. Trend is not always easy to measure. An improving trend in governance is not obvious, as it is harder to quantify good governance. In the social sphere you can provide the number of training hours to your staff, the number of accidents or the extent to which your management has its remuneration linked to improving working conditions, and the environmental performance of the company. It is through all these factors that we can try to capture the trend.

Sara: **Thank you for sharing your thoughts on this topic.**

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