Green power

Richard Eagling reports on some new initiatives that should spark greater interest in responsible investment and how ethical funds are generating superior returns

Driven by greater awareness of the environmental and financial risks posed by issues such as climate change, responsible investing has increasingly come to the fore in recent years. Many individuals are not only looking to align their financial decisions with their own values, but also ensure that their investments drive positive change in society and the world we live in. The momentum behind responsible investing has been steadily building for some time, but there is a sense that a raft of new initiatives, changing regulation and some truly impressive sustainable fund performances could prove a catalyst for further growth.

Rethinking the global economy

Having exposed major weaknesses in the economy and social inequalities, the Coronavirus pandemic has ushered in a period of reflection for many individuals and businesses. There is a growing sense that it will also encourage investors to take long-term risks more seriously and steer the world onto a more sustainable path. "The world is seeing significant challenges right now," says *Esmé Van Herwijnen, Senior Responsible Investment Analyst at EdenTree Investment Management*. "We can only hope that it will allow a rethink about priorities, including putting people and the planet at the heart of our economies. Aligning capital with these values and priorities will be a necessary next step."

The extent to which the Coronavirus pandemic is influencing a shift into a more sustainably conscious outlook is reflected in a recent survey by the Make My Money Matter campaign, which found that nearly a third (32%) of people with a pension said that they now care more about the impact that their pension has on people and the planet compared with at the start of the crisis. Furthermore, over half (57%) said that they now want their pensions to be part of the solution in tackling climate change.

"While the pendulum was already beginning to swing, we feel the outbreak of the Coronavirus will cement this transition towards sustainably invested products," says *Harry Thompson, Fund Manager at King & Shaxson Ethical Investing*. "The outbreak has accelerated a lot of the global megatrends that had been emerging, with many feeling that now is a golden opportunity to reset and focus the global recovery on prevalent issues. While we have already seen steps taken to align with many of the United Nation's Sustainable Development Goals, this could begin to pave the way for further concrete commitments from the private sector. We feel underlying consumer demand is strong and the virus has only confirmed this."

Stronger sales

Indeed, according to the latest Investment Association fund statistics, responsible investment funds saw another strong month of net retail sales in May, attracting £911 million, meaning it has been close to pulling in a record £1 billion for a second consecutive month. Although responsible investment funds only account for 2.5% of funds under management across the entire investment fund universe, this is up from 1.5% a year ago.

"When COVID-19 came along, there were questions being asked about whether or not environmental, social, and governance (ESG) and sustainable investment might become sidelined, just as the magnitude of the climate risk was starting to be understood," says *Julia Dreblow, Director at SRI Services.* "I was less sure, as both highlight our vulnerability, interconnectedness and utter dependence on the planet. Indeed, almost from day one, COVID-19 turned the spotlight on social issues (the 'S' in ESG), raising important issues about often overlooked and underpaid workers. COVID-19-related topics range from calls to improve animal welfare standards through to recognition of the importance of social issues and in particular employment standards. These social issues overlap significantly with the Black Lives Matter movement, as the need to treat people fairly becomes increasingly high profile."

For Julia Dreblow, the recent rise in support for the Black Lives Matter campaign following the shocking death of George Floyd in May is reminiscent of the very beginning of the ethical fund movement in the UK, where opposition to the Apartheid regime in South Africa was one of the main reasons for the launch of the first ethical fund. She adds: "The public outcry that followed George Floyd's death has rightly made diversity a key social issue that no investor should overlook – and one that I would expect will lead to fund managers and fund management companies revisiting their social and diversity policies."

Company behaviour

The behaviour of certain companies and industry sectors has also come under the spotlight during the Coronavirus pandemic, particularly with regard to how ethically they have treated their staff and wider stakeholders. Ultimately, these are decisions that some investors will find difficult to forget.

"Companies can do well to highlight their good credentials when everything is going swimmingly, but it is often in times of hardship that you see true colours emerge," says Harry Thompson. "There has obviously been huge decisions made by a number of companies in order to survive, but other companies have been able to thrive. There is scrutiny on companies that have taken Government aid who potentially did not require it. In recent weeks, we have seen a number of companies return bailout funds, but I can imagine as the situation settles and we have a chance to reflect, there will be a number of question marks raised. We feel this will open up the debate on responsible investing even further."

Build Back Better

One interesting movement to arise from the Coronavirus pandemic, which could boost interest in responsible investing, is the Build Back Better campaign. A key element of this movement, initiated and co-ordinated by Green New Deal UK, is that the policies and investments implemented for recovery should not prop up the profits of the big banks and the executives of corporations fuelling climate change and inequality. "There is a feeling that we have been presented with an opportunity to reset and focus the global recovery with the environment and society in mind," says Harry Thompson. "This is in stark contrast to previous recoveries, and we have seen a number of governments and companies have support packages aligned to sustainability criteria."

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The Build Back Better movement argues that rather than returning to the pre-COVID-19 society, it is time for a new deal that protects public services, tackles inequality, provides secure, well-paid jobs and creates a shockproof economy able to fight the climate crisis. It also stresses the importance of rebalancing the economy and ensuring that the country's infrastructure is climate-ready. "The Build Back Better movement is all about making sure the post-pandemic world is cleaner, greener and fairer," says Julia Dreblow. "To a large extent, this is about saying we need to direct investment towards decent companies with bright long-term futures, rather than into sectors that will either have to be re-engineered or ended if we are to achieve 'net zero'."

Make My Money Matter

Build Back Better is not the only recently launched campaign that could spark greater engagement with responsible investing. Last month saw the launch of the Make My Money Matter campaign, which aims to shift the £3 trillion in UK pensions into sustainable investments by giving pension savers more voice and choice in how their pensions are invested. Launched by Richard Curts, the Co-Founder of Comic Relief, the initiative has called on the pensions industry to commit to net-zero carbon emissions by 2050, and for the Government to require, in the forthcoming Pensions Bill, that pension funds report on their emissions projections to 2050 and their alignment to the Paris Climate Agreement.

"The Government having committed to 'net-zero' carbon emissions last year is a further factor that has massively strengthened the case for investing in companies with high ESG standards, and this looks set to continue," says Julia Dreblow. "The international support for the Build Back Better message has been phenomenal and given the team they have in place, the recently launched Make My Money Matter campaign, will almost certainly send this to new heights."

While campaigns such as Build Back Better and Make My Money Matter are likely to resonate with a growing number of consumers, it is still the case that the regulatory response will largely shape the future trajectory of responsible investing.

"There is a raft of new regulations that are heading towards investors that are mostly aimed at getting us to play our part in addressing climate change," says Julia Dreblow. "In the intermediary market, this mostly relates to the expected (but not guaranteed) MiFID II changes. Elsewhere it is Sustainable Finance Disclosure Regulation (SFDR), Task Force on Climate-Related Financial Disclosures (TCFD) and the EU Taxonomy and labelling initiatives."

The EU Taxonomy is rightfully regarded as one of the most significant developments in sustainable finance and is likely to have wide-ranging implications for investors and issuers working in the EU and beyond. It provides a tool for investors to understand whether an economic activity is environmentally sustainable, and to help them navigate the transition to a low-carbon economy.

By setting a common language between investors, issuers, project promoters and policymakers, the Taxonomy should help investors to assess whether investments are meeting robust environmental standards and are consistent with high-level policy commitments such as the Paris Agreement on Climate Change. The hope is that the Taxonomy will enable investors to refocus their investments on more sustainable technologies and businesses. The Taxonomy requirements relating to the climate-related objectives are due to apply from the end of 2021, with other requirements due to apply at the end of 2022.

"The regulatory environment is heaping huge amounts of pressure on the industry to transition towards a more transparent market, and it is the EU who are leading the way," says Harry Thompson. "While we have seen a number of pressure points come to the fore already, the wheels are in motion to go way beyond what is currently in place and improve the transparency of all financial products. They are seeking to promote a harmonised approach to documenting the integration of sustainability risks across investment products, with the targets of the Paris Climate Agreement the main aim in sight. These are sweeping changes that have implications on the industry as a whole, which will no doubt drive more products to be more sustainable in their approach. While being an EU directive, we expect the UK to follow suit."

Pensions and climate change risk

Where the UK does arguably lead in the field of responsible investing is in terms of legislation around pension schemes' governance of climate change as a major financially material risk to their investments. In 2019, the Government introduced regulation requiring pension schemes to document their policy on climate change and other financially material risks related to ESG, and to update their Statement of Investment Principles.

However, an amendment has been tabled to form part of the upcoming Pension Schemes Bill that will require climate change risk governance and TCFD reporting. Trustees will be required to review the exposure of the scheme to climate change risks and assess the assets of the scheme in light of this risk. In addition, they will have to determine whether a review of its strategy and a revision of its targets relating to exposure to climate change risk are needed. Trustees will also need to measure performance against such targets and prepare documents with this information.

"When enacted, the Bill gives the Government powers to lay regulations so that certain pension schemes are required to take certain actions with regard to climate risk," says *Mike Clark, Founder Director at Ario Advisory*. "It is deliberately high-level wording to support later developments. The latest Amendment (41A) is actually an amendment to Amendment 41 (tabled in February) reflecting an increasing pace around climate financial regulation. The Bank of England (often through the Prudential Regulation Authority), the Financial Conduct Authority (FCA) and Financial Reporting Council (FRC) are all acting on climate risk in their areas of responsibility, and it is a joined-up effort. The yet to be published pension regulations arising from the Act will be enforced by The Pensions Regulator and are likely to focus on larger schemes and TCFD reporting initially, in line with the Government's Green Finance Strategy. They also show the path to scenario modelling, at least by larger pension funds. This is significant for pension funds as it shows the Government working through its commitment as a signatory to the Paris Agreement. And of course the net-zero goal came into law last year."

"Over time, the move to manage the financial risk of climate change will affect all actors: advisers (investment, legal, actuarial, covenant, and more), as well as asset owners and investment managers," adds Mike Clark. "There is already a discussion about fiduciary best practice for defined contribution (DC) defaults – which has started with trust-based schemes. Independent Governance Committees (IGCs) have paid but modest attention to overseeing climate risk to date, and there will be a growing expectation there. And although superfunds have only recently been advised of their regulatory framework, I would not be surprised if the Government were now considering this aspect of their regulation."

Figure 1: Ethical funds versus non-ethical funds (percentage growth)

	1 year	3 years	5 years	10 years	15 years
All ethical funds	4.29%	18.35%	41.40%	134.43%	202.44%
All non-ethical funds	-1.46%	8.47%	31.88%	103.43%	155.71%
IMA sector performances					
Ethical £ Corporate Bond funds	3.89%	9.98%	25.13%	72.56%	90.35%
Non-ethical £ Corporate Bond funds	6.17%	13.90%	34.38%	89.26%	110.22%
Ethical Mixed Investment 40-85% Shares funds	8.39%	32.92%	61.30%	186.98%	248.11%
Non-ethical Mixed Investment 40-85% Shares funds	-1.18%	7.96%	29.60%	89.37%	132.26%
Ethical Global Funds	14.85%	50.77%	79.97%	193.57%	239.56%
Non-ethical Global funds	2.96%	21.14%	60.89%	175.30%	243.42%
Ethical UK All Companies funds	-8.22%	3.93%	21.64%	121.78%	205.60%
Non-ethical UK All Companies funds	-12.64%	-4.70%	13.06%	98.40%	117.98%

Source: Lipper Investment Management. % growth as at 1 July 2020, total return, UK net, no initial charges

MiFID II amendments

Financial advisers are also facing important regulatory changes around responsible investment that could have a significant impact on the advice process. Amendments to MiFID II (planned Q1 2021) around the requirement to consider sustainability risk (the risk of fluctuations in the value of an investment due to ESG Factors) will mean that advisers will need to take account of their client's ESG preferences when assessing their investment objectives and embed them in their fact finds and annual reviews. "This is a long-awaited and welcome change and we believe it provides a significant opportunity to inform and educate the market about their choices and the different ways to invest responsibly," says Esmé Van Herwijnen.

However, due to Brexit, there is still some uncertainty as to whether the MiFID II amendments will impact UK advisers, although the prevailing feeling is that if this does not go ahead then something similar probably will.

"These amendments, assuming they go through, will have major implications for both front and back-office intermediary operations," says Julia Dreblow. "Advisers will be obliged to identify interested clients and their personal needs as well as considering sustainability related risk. Irrespective of whether or not this gets caught up with Brexit, the key point to keep in mind is that changes are being driven by the EU's sustainable finance work, which is all about addressing sustainability challenges – most notably climate change. Given that the UK Government has been keen to lead on 'net zero' and other climate initiatives, the expectation is that intermediaries will need to play their part. This is made all the more likely by the fact that the UK will be co-hosting the next round of international climate talks, COP26, in November 2021 – a major focus of which will be finance."

"For most intermediaries, this will mean having processes in place that will enable them to bring sustainability issues and opportunities into their investment advice processes," adds Julia Dreblow. "On fund selection, this will boil down to choosing between business as usual funds that may have been given an ESG rating – and funds that have explicit policies, themes or strategies, which explain where the fund will and will not invest."

More robust sustainability solutions

The greater consumer appetite for building a more sustainable world, coupled with regulatory changes, is not surprisingly encouraging advisers to take more interest in responsible investing. "The upcoming requirements for advisers to consider sustainability risks and include this in their due diligence has seen a rise in firms seeking a robust sustainability solution for their clients," says Harry Thompson. "Our adviser audience has expanded drastically. Initially, our models were set up for a number of ethically minded independent financial advisers, but they are now being accessed by a broad range of adviser firms. We have seen an increase in the number of requests from advisers to speak to or present directly to their clients, not just on our offering, but to explain the basic concepts around ethical, ESG and sustainability."

The latest statistics from the sustainable investment fund database Fund EcoMarket, which shows an almost 50% increase in unique users over the first six months of 2020 compared with the same period in 2019, reflects the fact that more advisers are seeking information about sustainable, responsible and ethical funds. It also revealed that the dominant area of interest is sustainability and environmental themes – with the desire to 'avoid coal, oil and gas companies' the most searched for individual policy option.

Scintillating performance

The argument that investing responsibly must mean a trade-off between value and values or profits and principles has been increasingly debunked in recent years and the latest results of our ethical fund performance survey provide further clear evidence to refute it. "For us, responsible investment and long-term investment horizons go together, and we've always believed that responsible business is good business too," says *Esmé Van Herwijnen*. "Strong ESG practices can also contribute to reducing risks and negative impacts: strong sustainability credentials and generating returns are not mutually exclusive."

As **Table 1** shows, ethical funds have proved particularly resilient during the Coronavirus pandemic, with the average ethical fund producing growth of 4.2% over the last year, compared with an average loss of 1.4% from non-ethical funds. The performance of some ethical funds, particularly those in the IA Global Sector, has been even more impressive with the average ethical Global fund up by 14.8% over the last year, easily eclipsing the average return of just 2.9% from non-ethical Global funds. Leading the way across all ethical funds is Baillie Gifford Positive Change which has returned an impressive 48.3% over the last year.

"I believe that there are two main reasons why the sustainable, responsible and ethical investment sector has fared relatively well recently," says Julia Dreblow. "The first is because these funds normally avoid oil companies and other hard-hit sectors. The second is because, by their nature, these funds tend to invest in companies with strong ESG practices and businesses models that look forward not back – including healthcare and technology."

Indeed, while sectors such as oil and gas have suffered badly this year, areas such as healthcare, renewable energy and technology, which ethical funds typically have a high exposure to, have performed well, boosting returns. "Some funds do have a higher allocation to more defensive sectors with more stable cash flows, such as utilities or healthcare, providing ballast in times of uncertainty," says Harry Thompson.

However, while the one-year performance figures are impressive, it is over the longer-term that the comparison between ethical and non-ethical funds becomes more meaningful. "The double impact on markets of the oil price crash and the outbreak of COVID-19 in Q1 of this year has seen the scrutiny of performance of ethical/SRI funds been catapulted into the limelight due to widespread outperformance versus conventional investment approaches," says Harry Thompson. "Although fantastic for the industry, some of the headlines have been rather simplistic in their approach, as this is an argument ourselves and many of our peers have been promoting for some time. It is true that ethical/SRI funds have outperformed during the recent market turmoil, but this is also true when you venture further afield, and is not just a phenomenon seen in 2020 alone. We are beginning to see more studies highlight this, which inevitably provides greater understanding of why funds that adopt an overlay do outperform over time, and not just because 'oil went down'."

Our own survey shows just how strongly ethical funds are performing over these longer timescales. Over three years, the average ethical fund has produced growth of 18.3%, more than double the growth produced by the average non-ethical fund (8.4%), while they also hold the advantage over five years with an average return of 41.4% compared with 31.8% from their conventional fund rivals. If this isn't enough to convince sceptics of the performance potential of ethical funds then consider the 10-year and 15-year results, where ethical funds have returned 134.4% and 202.4% respectively, a significant improvement on the average non-ethical fund returns of 103.4% and 155.7% respectively.

Overall, ethical funds outperformed their non-ethical rivals in 19 out of the 25 scenarios analysed. Even in sectors such as Global equities where traditionally non-ethical funds have had the edge, ethical funds have surged ahead over most timescales. Such results should appeal to all investors, not just those that are sustainably minded. "We are seeing the shift from old economy to new," says Harry Thompson. "Focussing on resilient companies that are disrupting or providing a value add to the environment or society are inevitably companies that will be sought-after as demand for their products or services grow."

New funds

For the investment fund industry, the race is on to translate investor demands around responsible investor into funds. "The appetite for a fairer economy that protects people and the planet will not go away," says Esmé Van Herwijnen. "Clients are keen to ensure their investments support this – we expect demand to grow further. It is now up to the investment management sector to deliver this."

Investment houses certainly seem to keen to respond, with the number of sustainable and ESG funds increasing rapidly in 2020 following a spate of new launches. Earlier this year, Royal London launched a Global Sustainable Equity Fund while last month Vanguard unveiled two new ESG equity index funds (Vanguard ESG Developed World All Cap Equity Index Fund and Vanguard ESG Emerging Markets All Cap Equity Index Fund), widening the previously limited range of passive ethical funds open to investors. Aberdeen Standard Investments has also recently launched two new sustainable funds (Aberdeen Standard SICAV I - Global Corporate Bond Sustainable and Responsible Investment Fund and Aberdeen Standard SICAV I - Emerging Markets Sustainable and Responsible Investment Equity Fund), while Aviva Investors has launched its Climate Transition Global Equity Fund, following on from its Climate Transition European Equity Fund that was introduced last year.

Beware greenwashing

While greater sustainable fund options are to be welcomed, advisers and clients need to guard against greenwashing, marketing that portrays an organisation's products, funds, activities or policies as producing positive environmental outcomes when this is not the case. "DC investment advisers will need to ensure they know enough about investment products to screen out any greenwashing that may creep into a manager's pitch," says Mike Clark. "If an investment manager says "sustainability is in our DNA", double your research efforts. They may just mean in their marketing DNA!"

Greenwashing is on the FCA's radar, although many experts feel that the regulator needs to do far more to protect consumers from misleading statements. In its Climate Change and Green Finance report the FCA noted that the absence of common standards and metrics, are often barriers to effective product design and delivery, and make it difficult for consumers to validate the information they receive about products. It stressed that this could increase the risk that products are misleadingly marketed as producing positive environmental outcomes.

"Greenwashing is an area for concern as the sector continues to grow," says Esmé Van Herwijnen. "We see a significant increase in new product launches and relabelling of existing products, with a variety of terminologies ranging from ethical, ESG, to responsible, sustainable and impact. Clients need to know what they are buying and the industry is not good at providing clarity and transparency – this can be misleading."

The FCA itself has carried out some initial diagnostic work on firms' sustainable product offerings, to gauge whether there is evidence of potential greenwashing and has stressed that it will challenge firms where necessary. It has also stated that it intends to carry out further policy analysis on this going forward.

"Greenwashing is obviously a huge issue for the sector's credibility," says Harry Thompson. "Having been investing with a responsible mandate since 2002, it's something we feel you can easily uncover, although it does require an extra layer of scrutiny. We personally feel, that no matter who the fund manager is, or who the fund house is, the underlying holdings should be screened to ensure they meet the demands of the investor. Sadly, you cannot rely on the label, although there are a number of fantastic funds in the market place that have a genuine commitment, so clients and advisers should not feel distressed. Inevitably, as the market matures, I think it will become less of an issue, especially with regulation in place such as the EU Taxonomy rules that should ensure funds display sufficient factual evidence to warrant a sustainable title."

With investors struggling to understand whether a product or a fund is genuinely green or sustainable, up-to-speed advisers should be well-placed to ensure their clients do not purchase unsuitable products. "The problem with greenwash is that it is hard to recognise, in part because the broad church that is 'sustainable, responsible and ethical investment' has many 'necessarily diverse' strategies," says Julia Dreblow. "Recognising greenwash therefore comes down to understanding how investment decision-making, stewardship (notably voting) and fund communication interact. Initiatives such as the TCFD and the EU Taxonomy may help – alongside strengthening the FRC and changing pension rules and more. For now, I'd continue to recommend intermediaries 'look under the bonnet."