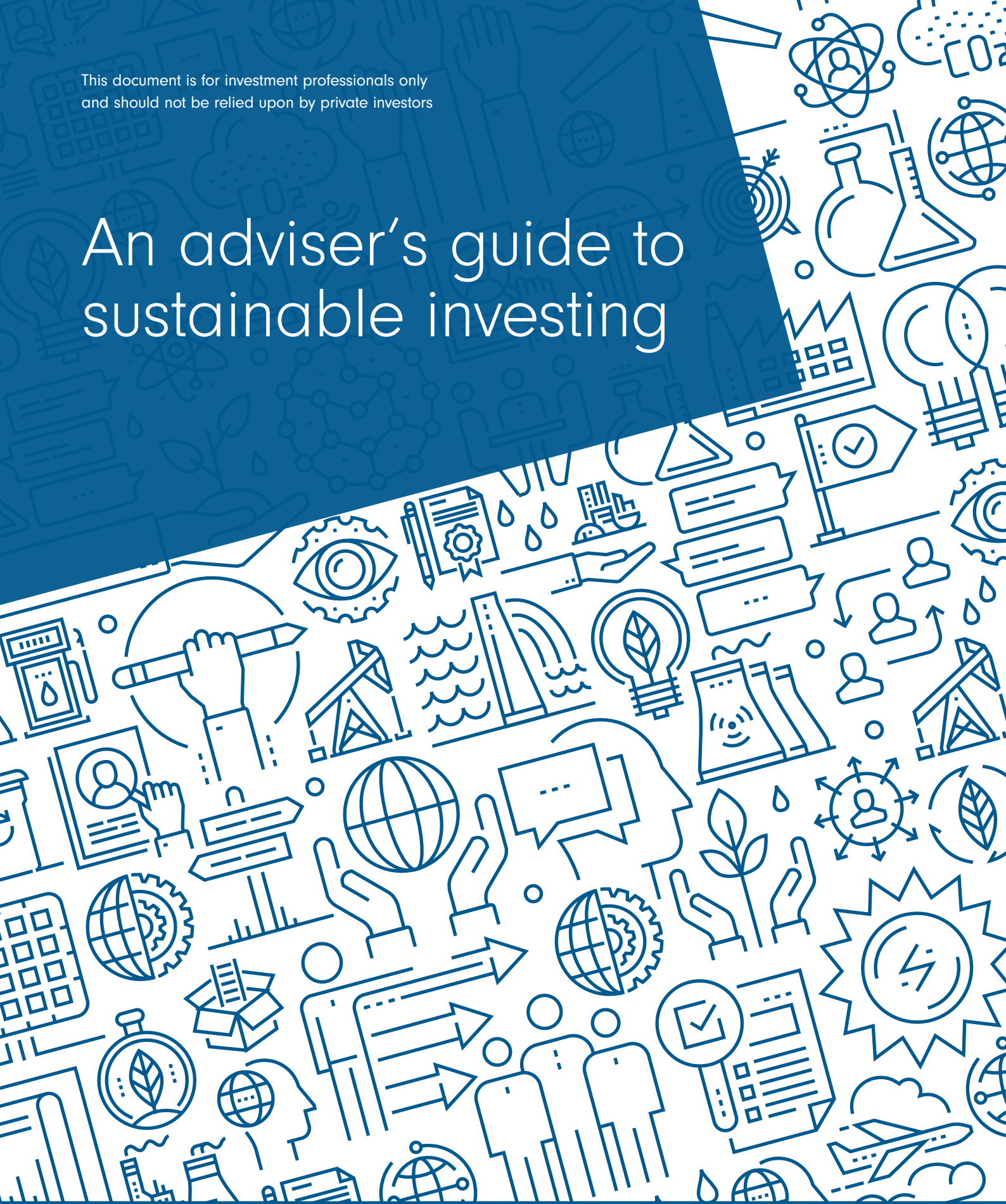


This document is for investment professionals only
and should not be relied upon by private investors

An adviser's guide to sustainable investing



FundsNetwork



Fidelity[™]
INTERNATIONAL

Matching money to morals

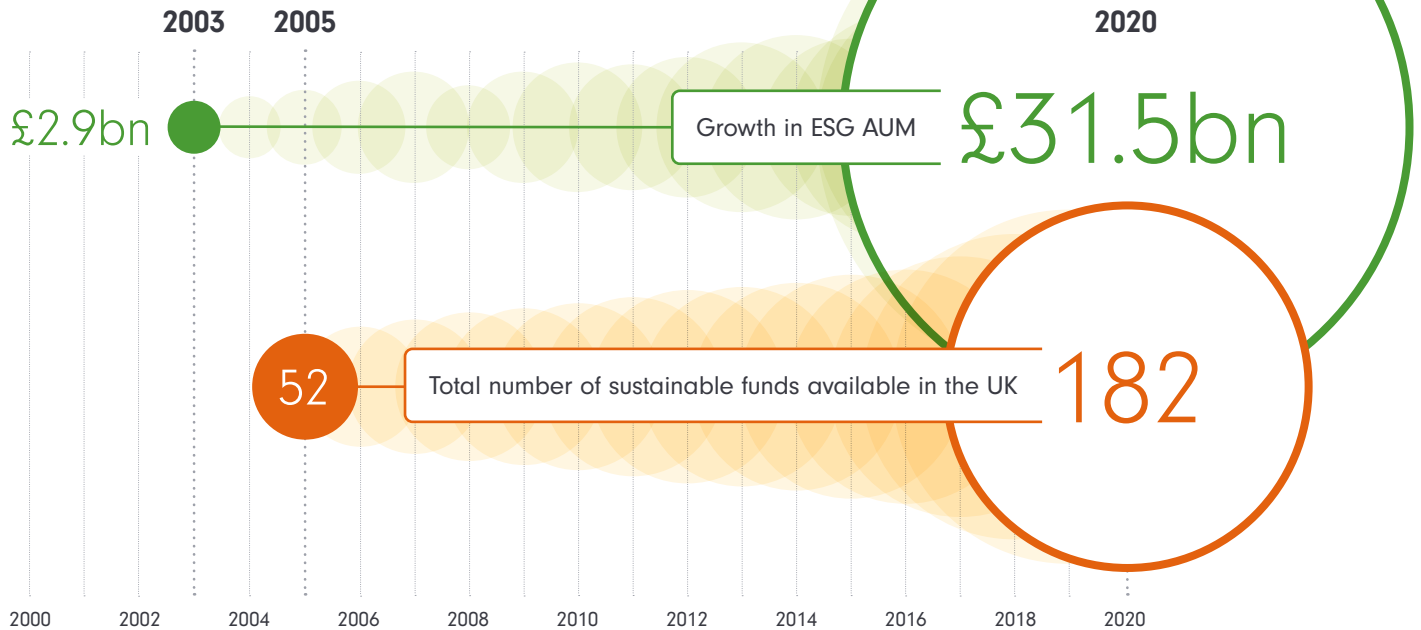
Sustainable investing has been around for many years. It first emerged in the UK around the 1980s with the launch of a number of what were previously known as ethical funds. While there have always been investors keen to match their money with their morals, it is fair to say that up until a few years ago, sustainable investing remained a somewhat niche interest. However, this is no longer the case – sustainable investing has now moved into the mainstream and many more clients are now taking an active interest in just how their money is invested.

‘Clients are more aware of the impact reduced human activity has had on the planet and are keen to support businesses that are ESG focused’

Respondent to ‘How the advice sector is responding to the coronavirus crisis’³

The trend towards a more sustainable approach has been led by institutional investors such as pension funds and investment foundations. The legislative and regulatory backdrop has facilitated this move with, for example, the introduction of legislation to tackle climate change. As wider society has become much more conscious of environmental and social issues, retail investors have come on board too.

Increase in sustainable investing in the UK

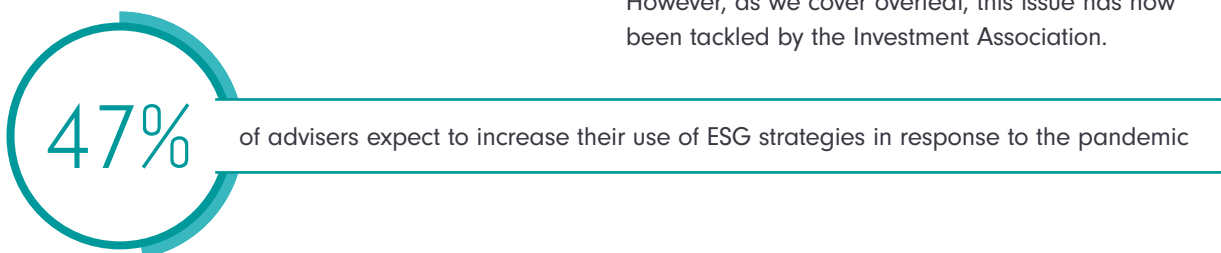


The money flowing into sustainable investments¹ and the choice of funds²

The coronavirus pandemic may accelerate this trend further. FundsNetwork's own research into [how advisers are adapting to the crisis](#) shows that 47% of advisers expect to increase their use of ESG and sustainable strategies in response to the pandemic (and lower their use of passive strategies)³. This is also having an effect at a corporate level too – our colleagues at Fidelity International say they have seen an acceleration in the adoption of sustainable capitalism since the start of the crisis. Companies are becoming increasingly willing to protect and support employees, customers, suppliers and communities. In addition, Fidelity also report that companies at the top of their Environmental, Social & Governance (ESG) ratings scale outperformed those with lower ratings on average over the height of the crisis, albeit over a very short timescale (February-March 2020).

One other interesting point to note about the increasing popularity of sustainable investing is that women appear to be at the vanguard. More than half of advisers in our [Financial Power of Women survey](#)⁴ said that women tend to be more interested in investing responsibly than men.

One issue that could potentially put the brakes on this growth in the retail market is confusion over what exactly constitutes an Environmental, Social and Governance (ESG), impact or socially responsible investment. In another recent FundsNetwork survey on the [changing picture of financial advice](#), only 3% of advisers felt that a strong and clear consensus currently exists⁵. The absence of a clear definition has made it difficult for advisers to compare ESG products and providers and to feel confident they will adhere to their clients' definition of a sustainable investment. However, as we cover overleaf, this issue has now been tackled by the Investment Association.



1. Source: UK Investment Association as at 31 May 2020. Funds flagged as Ethical according to the IA.

2. Source: Morningstar as at 30 September 2020, includes onshore and offshore funds identified as sustainable within all IA sectors.

3. Fidelity FundsNetwork: How the advice sector is adapting to the coronavirus crisis, June 2020.

4. Fidelity FundsNetwork: Unlocking the power of advice, February 2020.

5. Fidelity FundsNetwork: The changing picture of financial advice, June 2020.

What is meant by sustainable investment?

There are many terms used to describe sustainable investing, such as green, responsible, socially responsible and impact investing. These are often used interchangeably even though they can signify different investment approaches. Traditional ethical investing, for example, typically involves excluding companies from specific 'sin' (exclusion) sectors such as alcohol and tobacco. Impact investing, on the other hand, goes further and involves investing to make a positive social and environmental impact.

Today, the common theme amongst sustainable investments is that they tend to focus to some degree on Environmental, Social and Governance (ESG) considerations, although some funds may concentrate on specific factors such as climate change. The following can be regarded as typical examples of issues within the three pillars of ESG investing:



Environmental issues

Climate change, resource depletion, waste, pollution and deforestation.



Social issues

Human rights, modern slavery, child labour, working conditions and employee relations.



Governance issues

Bribery and corruption, executive pay, board diversity and structure, political lobbying/donations and tax strategy.

Sustainable investing isn't restricted to just equity investing. It extends across asset classes – there are, for instance, responsibly-managed bond and multi-asset portfolios available to retail investors. Passive and smart beta strategies are also offered by some providers.

'To help investors better understand what is on offer to them, clear product categorisation is needed to navigate the different approaches taken by investment managers to responsible investment. This relies upon commonly used terminology and its use in the context of an agreed framework.'

The Investment Association, November 2019

Sustainable investment approaches and industry-agreed definitions

The lack of a common language and framework with which to describe different approaches to sustainable investment was identified as a key barrier to the promotion and development of sustainable investment in the UK in 2018.

In order to address this issue – and to create a common language for advisers, fund managers and investors – the Investment Association (IA) has introduced a range of definitions on sustainable investing. This followed widescale consultation with the investment industry. Published in November 2019, all investment managers are now encouraged to adopt these definitions.

Stewardship

Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

Please note:

In some circles, stewardship may be referred to as 'corporate engagement', 'shareholder action' or 'active ownership'. Shareholder power is used to influence corporate behaviour through direct corporate engagement, filing or co-filing shareholder proposals, and proxy voting guided by comprehensive ESG guidelines.

ESG integration

The systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions.

ESG integration alone does not prohibit any investments. Such strategies could invest in any business, sector or geography as long as the ESG risks of such investments are identified and taken into account.

The precise ways in which ESG considerations will be taken into account in investment analysis and in the investment decision-making process will differ in practice between different investment funds, mandates and strategies.

Exclusions

Exclusions prohibit certain investments from a firm, fund or portfolio. Exclusions may be applied on a variety of issues, including to align with client expectations. They may be applied at the following levels: sector; business activity, products or revenue stream; company; jurisdictions/countries.

Examples:

- An investment approach that excludes investments on the basis of ethical, values-based or religious criteria, for example, gambling, alcohol, or pork.
- An investment approach that applies norms-based exclusions – excluding investments on the basis of not complying with international standards of conduct, for example, the UN Human Rights Declaration.
- An investment approach that applies exclusions on the basis of sustainability considerations, for example, fossil fuel companies.
- An investment approach that applies exclusions on the basis of ESG assessment – excluding the worst performing companies relative to peers on the basis of ESG assessment, for example, on the basis of ESG ratings.

Other terms used to refer to exclusions may include 'exclusionary approaches', 'negative screens' and 'screens'.

Sustainability focus

Investment approaches that select and include investments on the basis of their fulfilling certain sustainability criteria and/or delivering on specific and measurable sustainability outcomes. Investments are chosen on the basis of their economic activities (what they produce/what services they deliver) and on their business conduct (how they deliver their products and services).

Examples:

- **Sustainability themed investing** – an investment approach that specifies investments on the basis of a sustainability theme/themes. These include, for example, climate change mitigation, pollution prevention, sustainability solutions and approaches that relate to one or more of the UN Sustainable Development Goals (SDGs).

- **Best in class** – an investment approach that includes investments based on certain sustainability criteria to focus exposure on sector-leading companies.

Best in class approaches can vary from selecting from amongst the best performing companies (e.g. the lowest carbon/most energy efficient energy producers) to excluding the worst performing companies relative to peers. Adopting a Best in Class approach can mean having exposure to companies from sectors that may not typically be considered 'sustainable'.

- **Positive tilt** – a portfolio that overweights investments that fulfil certain sustainability criteria and/or deliver on a specific and measurable sustainability outcome(s), relative to a benchmark (e.g. FTSE 100, S&P 500) – for example, half the carbon intensity of the benchmark.

Impact investing

Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.

Examples:

- **Social bond funds** – a fund that invests in bonds, whose funding is ring-fenced for projects or initiatives that have the intention to generate positive, measurable social and environmental impact alongside a financial return, for example, one or more of the Sustainable Development Goals (an 'SDG fund').

- **Private impact investing** – investing directly in unlisted projects, companies or initiatives that have the intention to generate positive, measurable social and environmental impact alongside a financial return, for example, one or more of the Sustainable Development Goals (an 'SDG fund').

- **SDG impact funds** – funds where impact is measured against the UN Sustainable Development Goals (SDGs). This can be achieved, for example, through listed equities, a social bond fund or private impact investing.

Impact investments intentionally contribute to social and environmental solutions, which differentiates them from other strategies. They seek a financial return on capital that can range from below market rate to risk-adjusted market rate. Impact investments can be made across asset classes. A hallmark of impact investing is the commitment of the investor to measure and report the social and environmental performance of underlying investments.

Investment Association responsible investment framework

The Investment Association's framework is intended to help explain to investors the different components of sustainable investment that make up sustainable investment approaches available today. The components below are not mutually exclusive. They will typically be used in combination with one another. Fund-level components is a short-hand and can also refer to segregated mandates and individual investment strategies.

Firm-level components



Stewardship

Examples include: setting expectations, oversight of assets and service providers, engaging with issuers and holding them to account, exercising rights and responsibilities (for example, voting) and escalating concerns.



ESG integration

Examples include: PRI signatory, statement of commitment and firm-wide policies.



Exclusions

Examples include: ethical, values-based, religious, norms and sustainability.

Fund-level components



Sustainability focus

Examples include: sustainability themed, positive tilt and best in class.



Impact investing

Examples include: social bond funds, private impact investing and SDG funds.



Exclusions

Examples include: ethical, values-based, religious, norms, poor sustainability and ESG assessment.



Stewardship

Approach and activities specific to investment strategy.



ESG integration

Approach and activities specific to investment strategy.

ESG standards and practices

A number of principles and standards act as a common reference point for investment managers adopting a responsible approach. A selection of these are detailed below. Ensuring that an asset manager has signed up to some of these codes or standards could form part of the due diligence process when selecting a responsible fund manager on behalf of a client.

The UN-supported [Principles for Responsible Investment](#) (PRI) is regarded as the world's leading proponent of sustainable investment. It encourages investors to use sustainable investment to enhance returns and better manage risks. It has issued a set of voluntary and aspirational investment principles that all signatories must commit to (shown opposite). In the UK and Ireland, 392 assets managers have currently signed up to the PRI⁶. Signatories are regularly assessed on their progress against targets and peers with ratings allocated to certain indicators.

The UN's Sustainable Development Goals (SDGs)

Launched in September 2015, these 17 high-level goals form a blueprint to achieve a better and more sustainable future for all. The aim is to achieve them all by 2030. A short description of each SDG appears in FundsNetwork's glossary of sustainable investment terms. These goals are influencing asset managers in many ways. Firms may take these into account when analysing companies as part of the stock selection process, for instance, and when engaging with the companies as shareholders. Some asset managers have also launched SDG impact funds.



6. Source: Principles for Responsible Investment, as at 2 August 2020.

What are the Principles for Responsible Investment?

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice.

Signatories commit to the following:

- 1 We will incorporate ESG issues into investment analysis and decision-making processes
- 2 We will be active owners and incorporate ESG issues into our ownership policies and practices
- 3 We will seek appropriate disclosure on ESG issues by the entities in which we invest
- 4 We will promote acceptance and implementation of the Principles within the investment industry
- 5 We will work together to enhance our effectiveness in implementing the Principles
- 6 We will each report on our activities and progress towards implementing the Principles.

Source: PRI.

The UK Stewardship Code

[The UK Stewardship Code](#) sets high expectations of those investing money on behalf of UK savers. It consists of 12 principles for asset managers and asset owners. It establishes a clear benchmark for stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

Climate Action 100+

[Climate Action 100+](#) is an initiative taken by the investment industry to ensure the world's largest corporate greenhouse gas emitters take the necessary action on climate change. To date, more than 450 investors with more than USD \$40 trillion in assets under management have signed on to the initiative⁷. Signatories engage with companies to curb emissions, improve governance and strengthen climate-related financial disclosures.

Task Force on Climate-related Financial Disclosures

The [Task Force on Climate-related Financial Disclosures](#) (TCFD) develops voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders.

7. Source: climateaction100.org, August 2020

Four things to consider when selecting a sustainably-managed fund

1

Is the fund's management consistent with the client's aims?

Many clients may be satisfied that a fund is managed on a broadly responsible basis, whereby ESG factors are considered as part of the investment process. Stocks from certain 'sin' sectors may be included, for example, if the company has demonstrated that their ESG credentials are moving in the right direction. However, some clients may state that investment in certain stocks or industry sectors should be completely avoided due to ethical, moral or religious considerations. It is therefore important to check whether the investment manager or fund has an appropriate exclusion policy in place that covers a client's concerns.

2

How committed is a fund manager to sustainable investment?

One way to establish whether an asset manager is committed to sustainable investment is to check whether they are a signatory to certain standards or make specific pledges on areas such as climate change or the UN's Sustainable Development Goals. A manager may be a signatory to the Principles for Responsible Investment (PRI), for example. As part of this commitment, signatories are assessed on their progress towards certain targets and against peers. Asset managers frequently make PRI Assessment Reports available to investors in order to demonstrate how they are performing in this area.

In addition to the above, asset managers may publish their engagement and voting policies as well as disclosing their voting records and other relevant stewardship and sustainability reports or commitments. These can be analysed to help establish a firm's ESG credentials.

3

The fund manager's investment process and resources

Sustainable funds, like all other funds, will be managed in a certain way. As such, researching an asset manager's investment process may be an important factor in your due diligence process. Some may claim that their ESG research process goes further and deeper than others, for example. Some asset managers may have dedicated ESG teams or have groups focused on specific activities, such as stewardship. If the fund takes a passive approach, consideration could be given to how the index is constructed and how the constituents are weighted within that index.

4

Sustainable fund ratings

In the same way as a fund can be assigned a rating based on its performance or the perceived robustness of its investment process, it can also be rated in terms of its ESG credentials. 3D investing, for example, analyse over 200 UK funds regarded as 'ethical or sustainable' and allocate a star rating based on their findings. SRI Services have also announced that they will be shortly launching a badge which will be awarded to funds based on certain ESG criteria. It is important to note that ratings services may analyse different factors or score certain criteria in different ways when arriving at their ratings.

FundsNetwork: your home for sustainable investing

As interest and assets in responsibly-managed investments continue to grow, FundsNetwork is committed to providing advisers with all the information they need on this area of investing. This ranges from helping advisers identify appropriate solutions for their clients through the provision of research and tools as well as educational guides, client-facing materials and fund partner insights.



For tools, news and insights on sustainable investing visit

fundsnetwork.co.uk/sustainable-investing

FundsNetwork

