

Sustainable Investing Tracker Study

ESG and sustainable investing: as different as American and British football

May 2022



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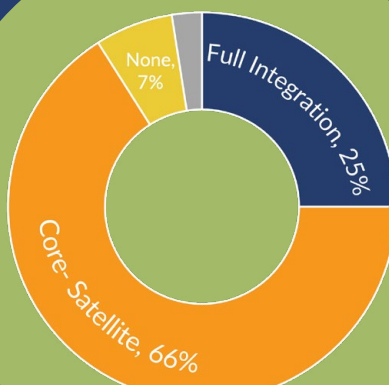
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Executive Summary

The core-satellite investment approach grows in favour

Suitability concerns and consistency of data is preventing wider adoption of sustainable investing.



Terminology in the KYC continues to evolve

Advisers are more likely to ask clients about sustainable/responsible preferences than ESG preferences. They also approach the topic from multiple perspectives.

Advisers are feeling less confident with most aspects of sustainable investing

On-going reporting, performance reporting and research of sustainable investing options are particular gaps for advisers.

Perception of sustainable products improves slightly on risk and performance

Sustainable products are seen as a 'different journey' than mainstream investment solutions.

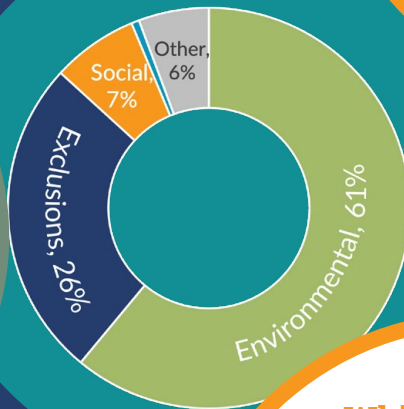
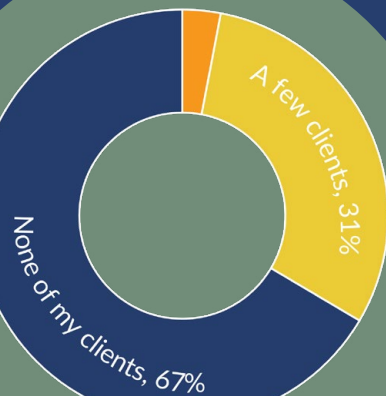
Stock slows and flows grow

18% of advised client assets were invested in sustainable funds and portfolios in April 2022. This is down slightly from 21%. Advisers report that 23% of new client money goes into sustainable funds and solutions.

Interest in sustainable investing remains but cost of living and the energy crisis are front of mind. About one fifth of clients raise the topic of sustainable investing.

E, S or G?

Environmental inclusions are the most stated sustainable preference from clients social and governance factors are less well understood.



Russian invasion of Ukraine

Two thirds of advisers have had no contact from their clients about changing their investments because of the Russian invasion of Ukraine.

Which football do you mean?

Both advisers and providers are using the term ESG but are referring to different things. Much like how Americans and Europeans both enjoy 'football' but are talking about two different sports.

Providers see ESG as a risk factor or an investment input. Advisers see it more as being about 'doing no harm' or 'doing good', an investment output to meet the subjective preferences of their clients.

Contents

Introduction	4
Sponsors	4
Research methodology	4
1. The end client	5
1.1 Adoption	5
1.2 Russian invasion of Ukraine	6
1.3 The E, the S and the G	7
2. Advice process	8
2.1 KYC requirements	8
2.2 Adviser terminology	8
2.3 Adviser confidence	9
2.4 Client reporting	10
3. Investment selection	11
3.1 Ratings and information	11
3.2 Investment proposition	11
3.3 Investment strategies	12
3.4 Adviser perception of sustainable products	13
Price vs performance	14
Conclusion	16



Introduction

This report details the findings of the fourth wave of the NextWealth Sustainable Investing (ESG) Tracker Study. We continue to ask a number of tracking questions to measure changing perceptions and processes over time as well new questions as the topic evolves. The research focuses on two main areas; understanding the client interest in sustainable investing and the processes of advisers.

One of the main themes of this research is the clear difference between ESG (an objective measure of investment risk) and sustainable investing (investing according to the subjective sustainability preferences of a client). Both topics get referred to as ESG but are in fact very different. Much like how the term football is used on the two sides of the Atlantic to refer to very different sports. The difference between how advisers and asset managers use the term ESG is as fundamental as the difference between football in the UK and US.

In recognition of this difference, we have changed the name of this report from ESG to sustainable investing. Since launching this report two years ago, awareness and understanding of sustainable investing has improved dramatically. A distinction is being drawn between ESG as an investment input and sustainability as an investment output. At NextWealth we want to make that distinction clearer.

Asset managers often tell us their funds are fully ESG integrated, that ESG considerations are built into their decision-making process. When an adviser talks to a client

about sustainable investing, the conversation isn't usually about the ESG risk factors that might influence the future price of a stock or fund. Instead, it is about making choices about how capital is deployed to align more closely to values.

We think this distinction between ESG as an investment input and sustainability as an investment objective or output is hugely important. Otherwise investors and financial advisers might be as perplexed as Tom Brady if he was asked to 'boot it' or if Cristiano Ronaldo were told 'hut, hut, hike'.

In the fourth update to our research and we are encouraged to see that financial advisers are more likely than ever to ask clients about their sustainability preferences, again, proving that they are ahead of regulatory requirements and focussed on client needs and preferences. Financial advisers tell us that interest in sustainable investing remains but other issues, such as inflation and the cost of living crisis are more pressing. We also found significant gaps in adviser confidence when it comes to researching sustainable funds and solutions and reporting performance and against client preferences.

We hope employees of financial advice firms find this report useful to benchmark their own approach and process. Thank you to our sponsors for continuing to support this research. We couldn't publish this work without them. If you are considering your sustainable investing solutions, we hope you'll give them a look.



Research Methodology

This report is written based on both quantitative and qualitative research:

- Online survey of 200 financial advisers in March and April 2022.
- In-depth phone interviews with 14 financial advisers in April 2022

1. The end client

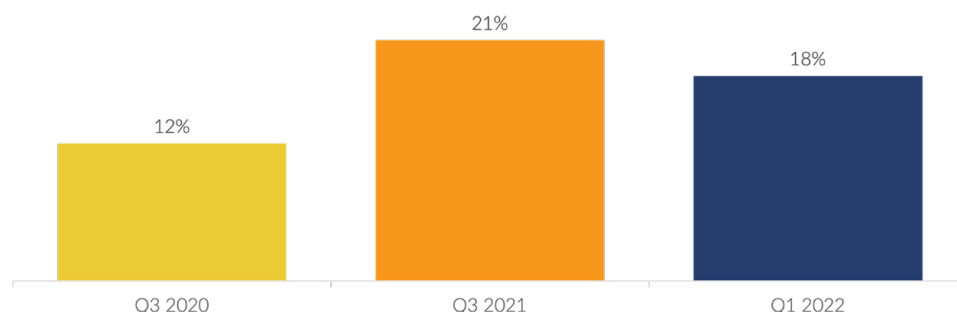
Understanding what clients want from advisers

1.1 Adoption

18% of advised client assets were invested in sustainable funds and portfolios in April 2022. This is down slightly from 21% in September 2021. The decrease may be a result of a change in methodology. As mentioned in the introduction, we are no longer asking about ESG, ethical, impact and sustainable funds and solutions but instead now ask only about sustainable funds and solutions.

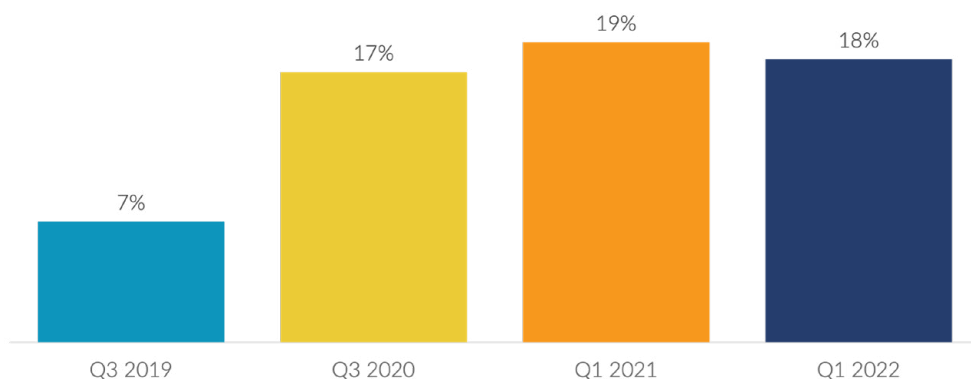
In this wave of our research, we also asked about new client assets. We wanted to get a comparison of stock versus flow, assets versus sales. Advisers reported that 23% of new client money goes into sustainable funds and solutions, suggesting more new money is being invested in this way.

Figure 1: Percentage of client assets in sustainable funds or solutions



The share of client conversations in which sustainable investing comes up remained just shy of 20%, consistent with the past two years.

Figure 2: Percentage of client conversations where clients raise sustainable investing



"We have designed a really good questionnaire that we think is great. It's a great way of engaging clients. Our compliance don't want us to use it yet, because they're waiting to see what the FCA says."

While client interest in sustainable investing remains steady, financial advisers we interviewed for this research said more pressing issues are top of mind for clients, including interest rates, inflation and the cost of living.

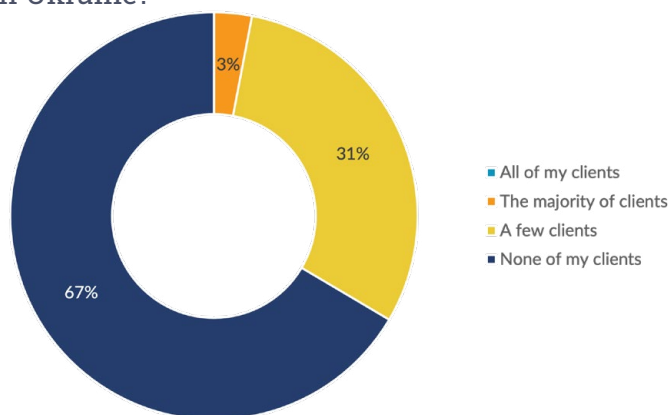


"I think what you see on your BBC News app, and things like that, is what drives discussion from people. So inflation, energy, cost of living, that kind of stuff is coming up a lot more."

1.2 Russian invasion of Ukraine

We wanted to understand whether advisers were being contacted by clients in response to the Russian invasion of Ukraine. There was some thought that the conflict would increase demand for sustainable investing, with a greater focus on energy sources and geographic exposure. As the chart illustrates, two thirds of advisers have had no requests from clients to change investments. Nearly one third heard from a few clients.

Figure 3: How many clients have expressed their desire to change their investments given the conflict in Ukraine?



We explored this topic in our in-depth interviews with financial advisers:

- Few advisers report having clients with direct exposure to Russia
- Potential market volatility as a result of war resonated more with some clients than the volatility triggered by rising inflation and interest rates
- Some advisers have found that news coverage has strengthened clients' views on avoiding certain areas and sectors. "It's very hard to make ethical guns."



"We haven't seen a specific kind of kickback of lots of people calling in saying 'do I have any Russian exposure?' or anything like that. On all client portfolios I think we have two with some form of Russian exposure, which was self-selected."

“

“Clients can relate to the impact of a war causing market volatility, more so than discount rates and interest rates causing market volatility, which is perhaps the bigger cause for concern over the last three months than the actual war.”

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“The invasion has accelerated Europe and the West’s desire for energy independence.”

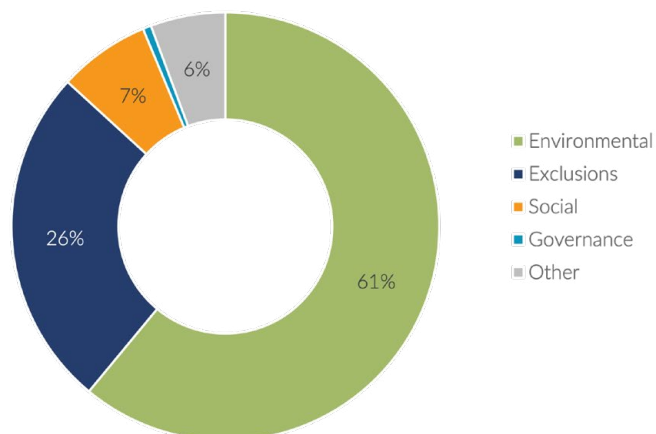
“It’s proved to so many people that we can’t rely on unstable states for our energy needs, and that reinforces their commitment to investing in sectors outside of standard oil and gas.”

“

“I think it’s really brought up the question around energy significantly, and also natural resources and what that might mean to the cost of living and where we get things from. I think there’s going to be bigger implications of that in general. ”

1.3 The E, the S and the G

Figure 4: Which of the following sustainable preferences are asked for most by clients?



We asked financial advisers what clients are most interested in when it comes to environmental, social and governance investing. The lion-share, 61%, said ‘environmental’. We listed exclusions as a separate option and 26% selected this option. This focus was reiterated in our in-depth interviews:

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“Certainly I’m finding that the top thing is environmental inclusions.”

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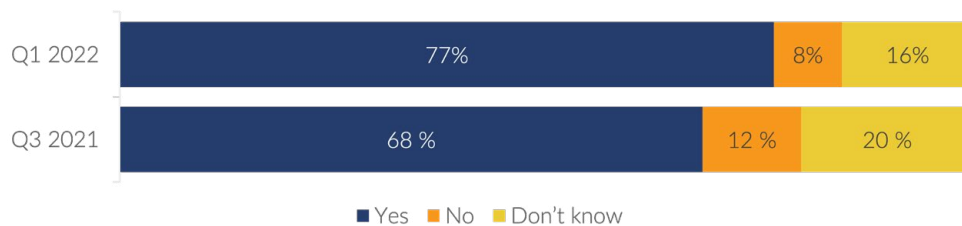
“The one that gets mentioned specifically the most is climate. People mostly talk about investing in green things. That’s what they’ll say. But I think people don’t fully understand the options.”

2. Adviser process

2.1 KYC requirements

Increasingly advisers consider it their obligation to understand clients' sustainable preferences. 77% agree KYC rules under COBS require them to take into consideration client views on climate change, sustainability and ethical investments when making product recommendations

Figure 5: Do advisers agree that KYC rules under COBS require them to take into consideration client views on climate change, sustainability and ethical investments when making product recommendations?

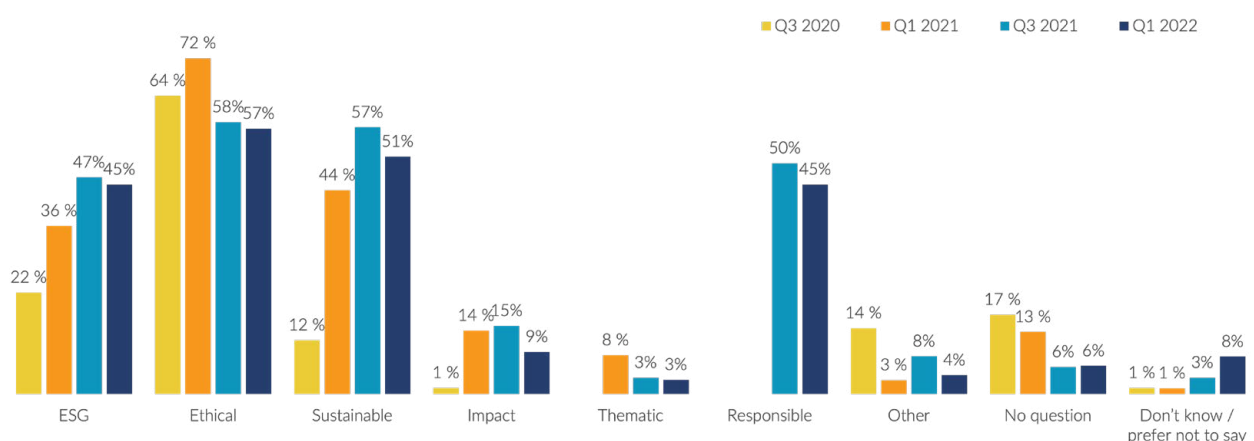


2.2 Adviser terminology

The terminology used in the KYC to understand client sustainable investing preferences continues to evolve. In our first two waves of this study in Q3 2020 and Q1 2021, 'ethical' dominated. That changed in Q3 2021, when 'sustainable' started being used just as frequently with 'responsible' not far behind. Since then, we have seen advisers adopt multiple headings under which to discuss a client's interest in sustainable investing, approaching the conversation from multiple angles.

- Advisers are more likely to ask clients about their sustainable preferences than ESG
- The percentage of advisers not asking at all has fallen by two thirds, 94% are asking about client sustainable investing preferences in some form

Figure 6: Terminology used in the KYC



2.3 Adviser confidence

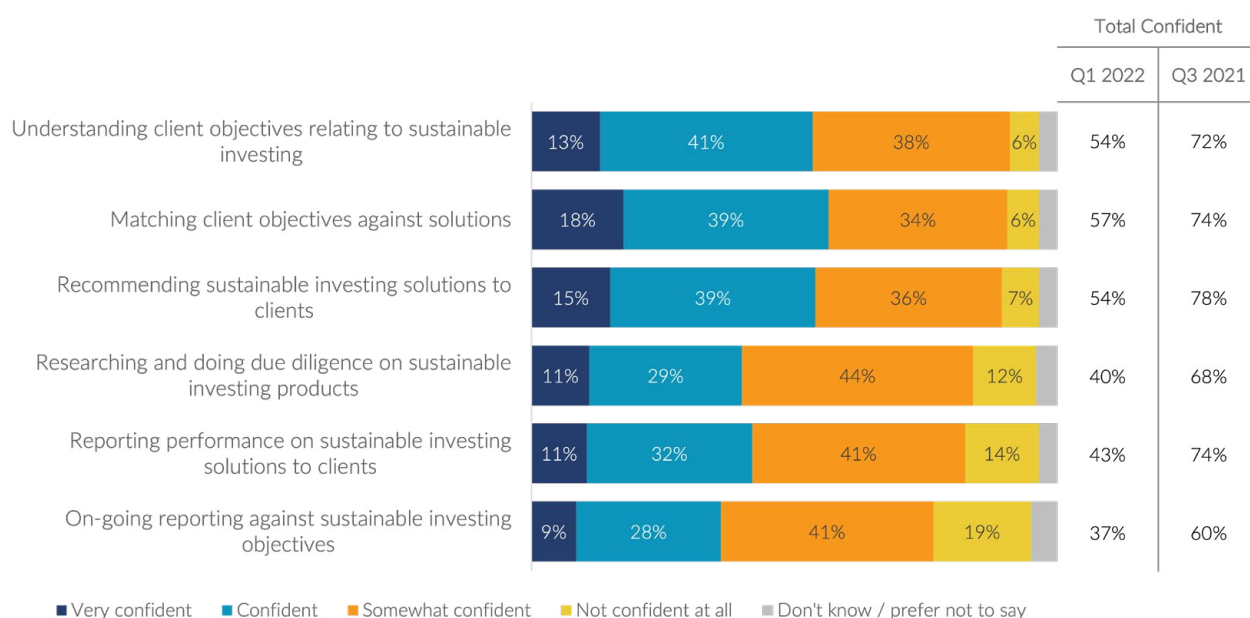
Only about half of financial advisers report being 'very confident' or 'confident' in the steps of the advice process relating to sustainable investing, including understanding client preferences, researching products, recommending products and reporting to clients a significant decline from six months ago. As familiarity with the complexities of sustainable investing have grown, adviser confidence has declined.

This highlights a significant gap and suggests more support is needed from product providers. The biggest challenges remain on-going reporting against sustainable investing objectives where only 36% of advisers report being 'very confident' or 'confident'. One fifth say they are 'not confident at all'.

Reporting performance on sustainable investing solutions is the next biggest challenge with 14% saying they are 'not at all confident', followed by research and due diligence.

Adviser confidence is strongest on understanding client objectives and weaker on due diligence and ongoing reporting. Supporting advisers with client reporting is a potential competitive advantage for platforms and asset managers. In our interviews several advisers said they only use funds where they have transparency to the entire underlying holdings of the fund.

Figure 7: How confident are advisers on their process to support sustainable issues?



These challenges came through clearly in our interviews as well. While a solution suggested by many to the challenge of suitability is to fastidiously document client preferences, as one adviser pointed out, there is a fine line to tread between capturing detailed preference and balancing that against cost and complexity.



"It's very difficult to research what's right without putting our integrity on the line, because not everyone publishes their holdings. So the recommendations we make is for solutions where they do publish everything, because otherwise how are we going to tell our clients if they want to know exactly what they're investing in? That's much more important for some people in this space, then I think fund managers appreciate."

“

“The hardest bit around sustainable is proving that the suitability is right. I think a lot of firms are getting themselves in a lot of trouble by capturing very detailed forced preferences. So you know, here's a questionnaire, I want you to tick loads of detailed boxes. You're then giving yourself an utterly impossible task as to how you find something suitable. So we're trying to make sure that advisors capture things in broad thematic, rather than very, very specific detail.”

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“It's very hard for us to do the report on, I don't know, how much your investments have saved in terms of CO2 emissions. Not because we don't have the capacity necessarily, but because the data is not consistent across fund houses.”

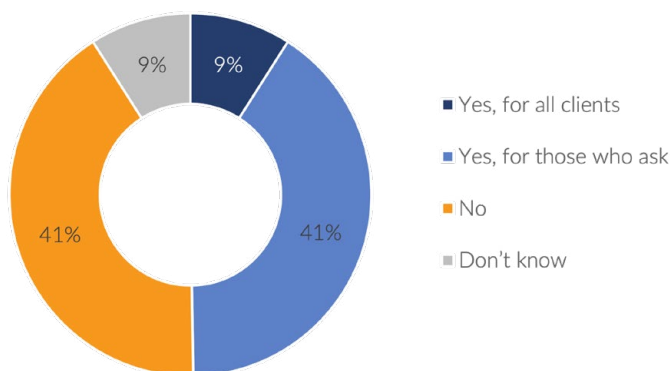
Given the complexity of suitability, researching and reporting, it is perhaps unsurprising that advisers are more likely to look for external expertise, such as labelled multi-asset or discretionary managed portfolios (See Figure 11 in section 3.3).

2.4 Client reporting

Given this on-going challenge of client reporting, we wanted to understand whether financial advisers are reporting sustainability ratings of portfolios to clients. About half are reporting an ongoing assessment or rating of the sustainability of client investments but most are only doing this for clients that request it. New tools are coming to market that should make high level reporting easier, including Aviva's ESG Profiler.

Half of advisers provide an ongoing assessment/rating of the sustainability of clients' investments.

Figure 8: Do advisers report an assessment/rating of the sustainability of investments to clients?



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“It's not easy to plug into how the client reports are generated. When it's not aligned with what you do, it just confuses the client and you waste half your meeting explaining why it's useful but it's not quite useful.”

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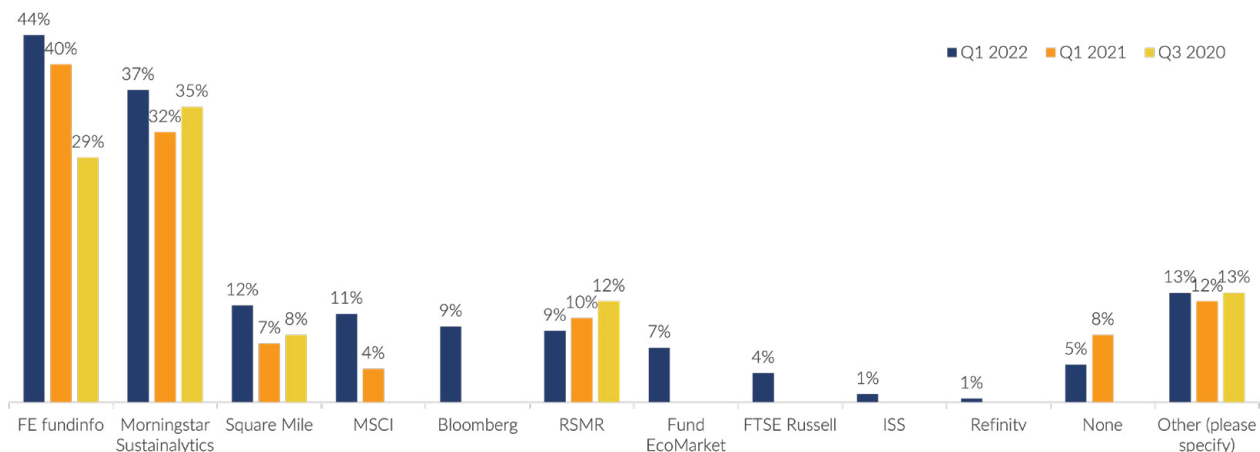
“It would be an added value for a lot of clients. Across the board to be able to set criteria on a traffic light basis; knowing it's going to be wrong at a granular level, but broadly right at a higher level. That will trigger some clients to say, tell us more, and for those clients we should be able to do more.”

3. Investment selection

3.1 Ratings and information

We asked financial advisers which research tools they are using. FE fundinfo and Morningstar dominate. When we first conducted this research in Q3 2020, Morningstar had recently acquired Sustainalytics and FE fundinfo had not yet defined their proposition for sustainable investing research. Fast forward to our most recent survey and FE fundinfo has overtaken Morningstar.

Figure 9: Sustainability information providers used by advisers

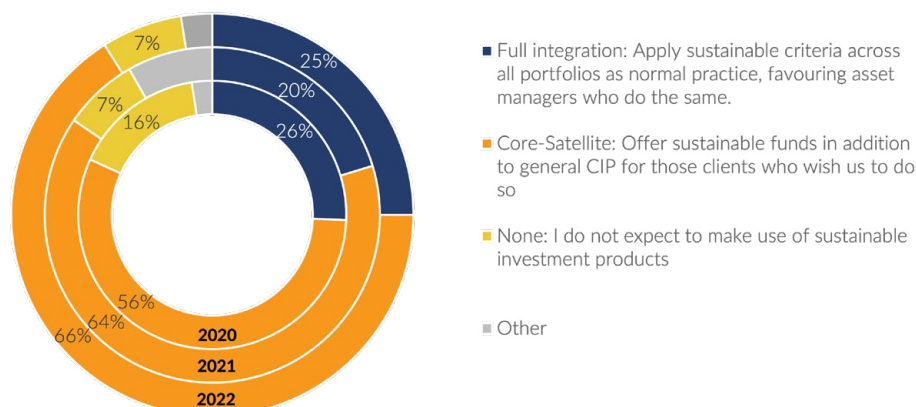


3.2 Investment proposition

A growing percentage (66%) favour a core-satellite approach, with sustainable investment solutions sitting alongside their core investment proposition.

In our interviews most advisers said they see sustainability as an additional offering distinct from their CIP, whilst a few specialists embed ESG criteria across all funds and portfolios.

Figure 10: Preferred strategy to integrate ESG, ethical, impact and sustainable into the firm's investment products



This shows that for advisers this topic is not about measuring ESG risks across their portfolios but about offering a sustainable investing option alongside their core proposition. Many advisers said that data transparency was the biggest barrier to implementing ESG risk measurements across all portfolios.

“

“So we are looking for funds that go the extra mile when it comes to responsible investing. All of the funds, regardless of the proposition, we would expect to integrate ESG. But in the responsible investing proposition, we look for more than just that.”

“

“We still see most of our investment flow into traditional non-ESG solutions, albeit with probably an increase in marketing about the broader impact of those solutions. But we certainly don't build it in across and we think that anyone is doing that is walking a very, very dangerous path on client suitability.”

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“It sits slightly differentiated. Because I think there's a danger of covering everything with it. And clients would say well, I didn't actually ask for this.”

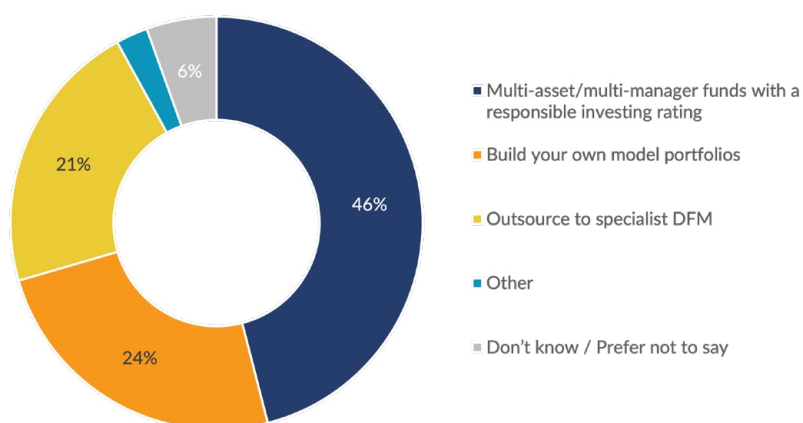
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“ESG is just another constraint for those clients that want to apply it. So we weren't going to ever apply it to everyone, we were going to have it available for those that demanded it.”

3.3 Investment strategies

We wanted to understand the investment options financial advisers use most when clients have a sustainable investing preference. Most advisers rely on a multi-asset or multi-manager fund with a responsible investing rating. Compared with other NextWealth research, the preference for a multi-asset or multi manager solution is higher for those looking for sustainable investing options.

Figure 11: Sustainable investing strategies



3.4 Adviser perception of sustainable products

We wanted to understand whether financial advisers perceive sustainable funds as better, similar or worse on price, performance and risk.

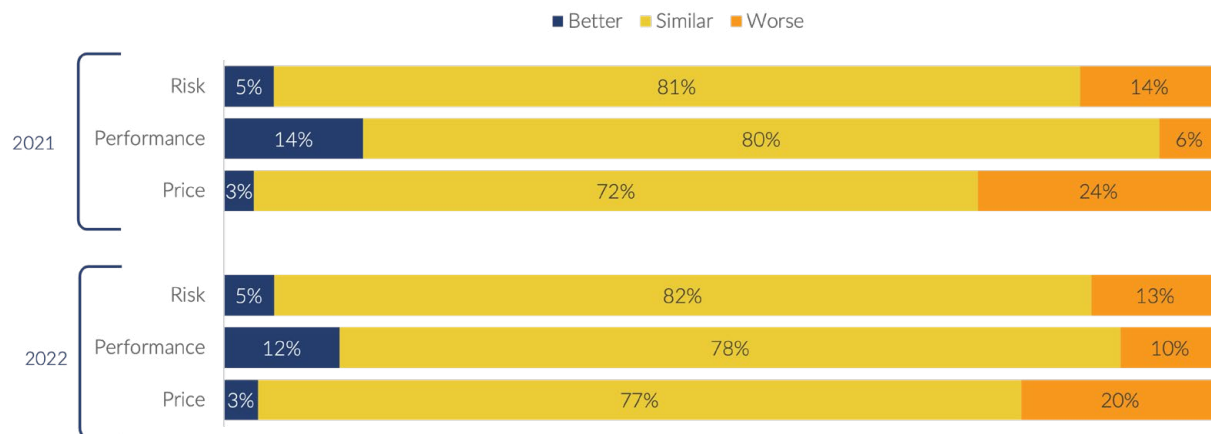
Sustainable funds are seen as broadly similar to mainstream funds on price, performance and risk. However, one fifth of advisers consider sustainable funds to be worse on price.

This tallies with NextWealth analysis of FE fundinfo data showing that EU article 8,9 funds are more expensive than article 6 and non-classified funds.

Average of AMC + OCF	
Article 9	1.36%
Article 8	1.43%
Article 6	1.21%
Non classified	1.13%
Total	1.25%

Perception of all three metrics (price, performance and risk) against mainstream products has improved slightly.

Figure 12: Position of ESG, ethical, impact or sustainable investing products to a client in comparison to other similar options



Price vs performance

NextWealth analysed data from FE fundinfo on 5188 funds domiciled across the UK and Europe, at the performance, costs and EU classification.

Our analysis shows:

- Very little correlation between costs and performance over 1,3 and 5 year periods.
- Article 9 funds (most sustainable) have lower average costs than article 8 and show strongest average performance.
- A common thread amongst advisers we interviewed was that sustainable funds have a different performance and risk journey to non classified funds. Returns and volatility of sustainable investments are not perceived as more or less risky but are likely not to behave in lockstep with the general market.

Performance v Costs by Classification

Figure 13: One year performance against total cost (AMC + OCF)

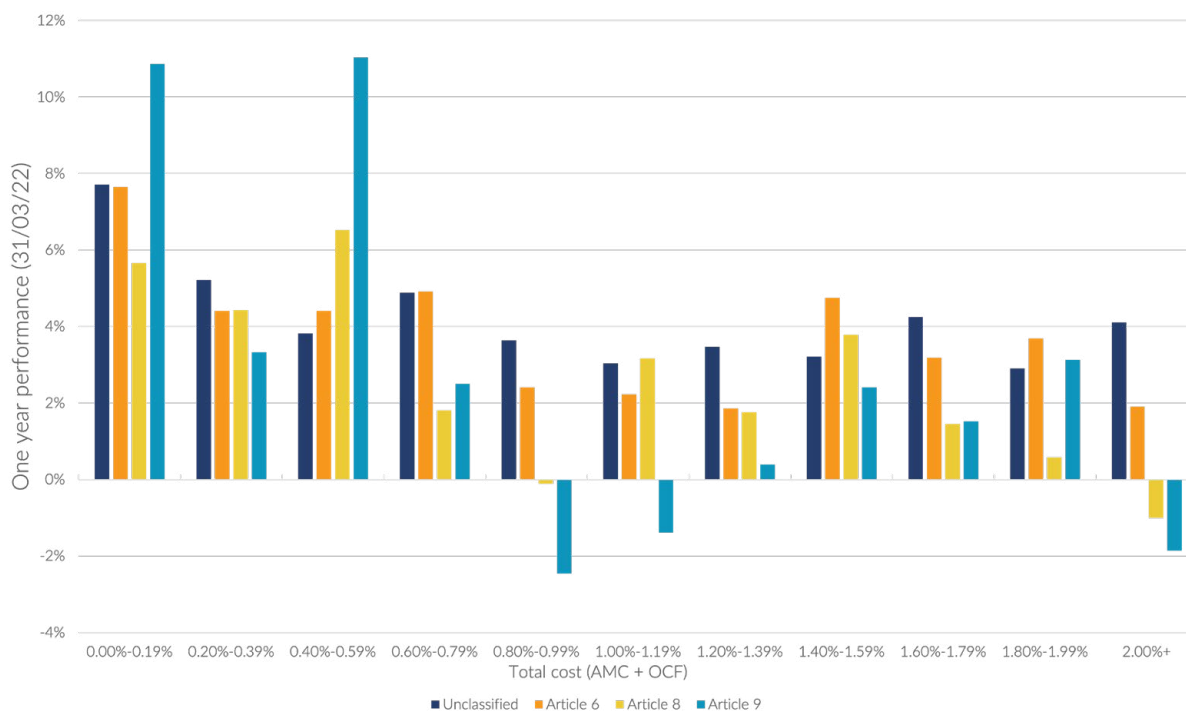
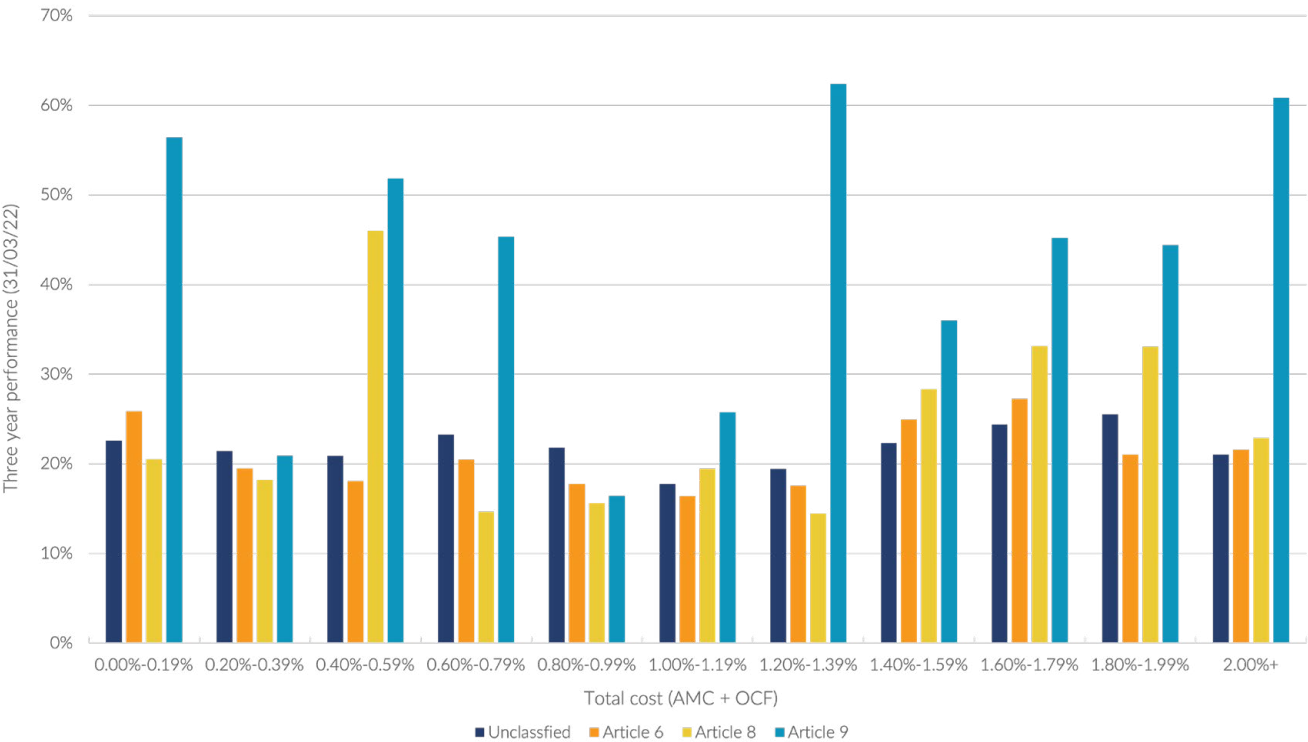


Figure 14: Three year performance against total cost (AMC + OCF)



Conclusion

Our main takeaway from this report is that asset managers and financial advisers are using the term ESG to refer to different things. Much like how Americans and Europeans both enjoy 'football' but are talking about two different sports.

Providers see ESG as a risk factor, an investment input. Advisers see it more as being about 'doing no harm' or 'doing good', an investment output to meet the subjective preferences of their clients.

Adoption of sustainable investing has stalled in the financial adviser market. Advisers tell us that it is still important but is being overshadowed by concerns about market returns, inflation and the cost of living crisis.

In six months, when we publish the fifth wave of this report, we hope to see progress on the following:

1. **Reporting capability:** Platforms, back office systems and DFMs need to get better at client reporting. Less than half of financial advisers are confident with on-going reporting against client sustainable investing preferences, a major step back over the past six months. As advisers have become more familiar with the complexities of sustainable investing, their confidence has dropped. Platforms and back office systems should integrate sustainable investing data where possible to allow financial advisers to report against client objectives. For clients interested in sustainable investing, this can be as important as performance reporting. More needs to be done to support financial advisers.
2. **Transparency and data:** Fund managers need to offer better transparency into fund holdings and ESG scores for those holdings. New rules are coming into effect that will require better reporting from listed companies. We hope to see a trickle-down effect with better data available to fund selectors, research and ratings providers, financial advisers and their clients.
3. **Clarity of terminology:** As we have set out in this report, we want to draw a clear distinction between ESG and sustainable investing. They are as different as American and European football. ESG cannot be used interchangeable with sustainable investing. The confusion in terminology leads to scepticism and is holding back further adoption.

We welcome your comments and feedback. Our next update will be published in the autumn. Email us with suggestions for what we should cover in the next update: enquiries@nextwealth.co.uk.





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