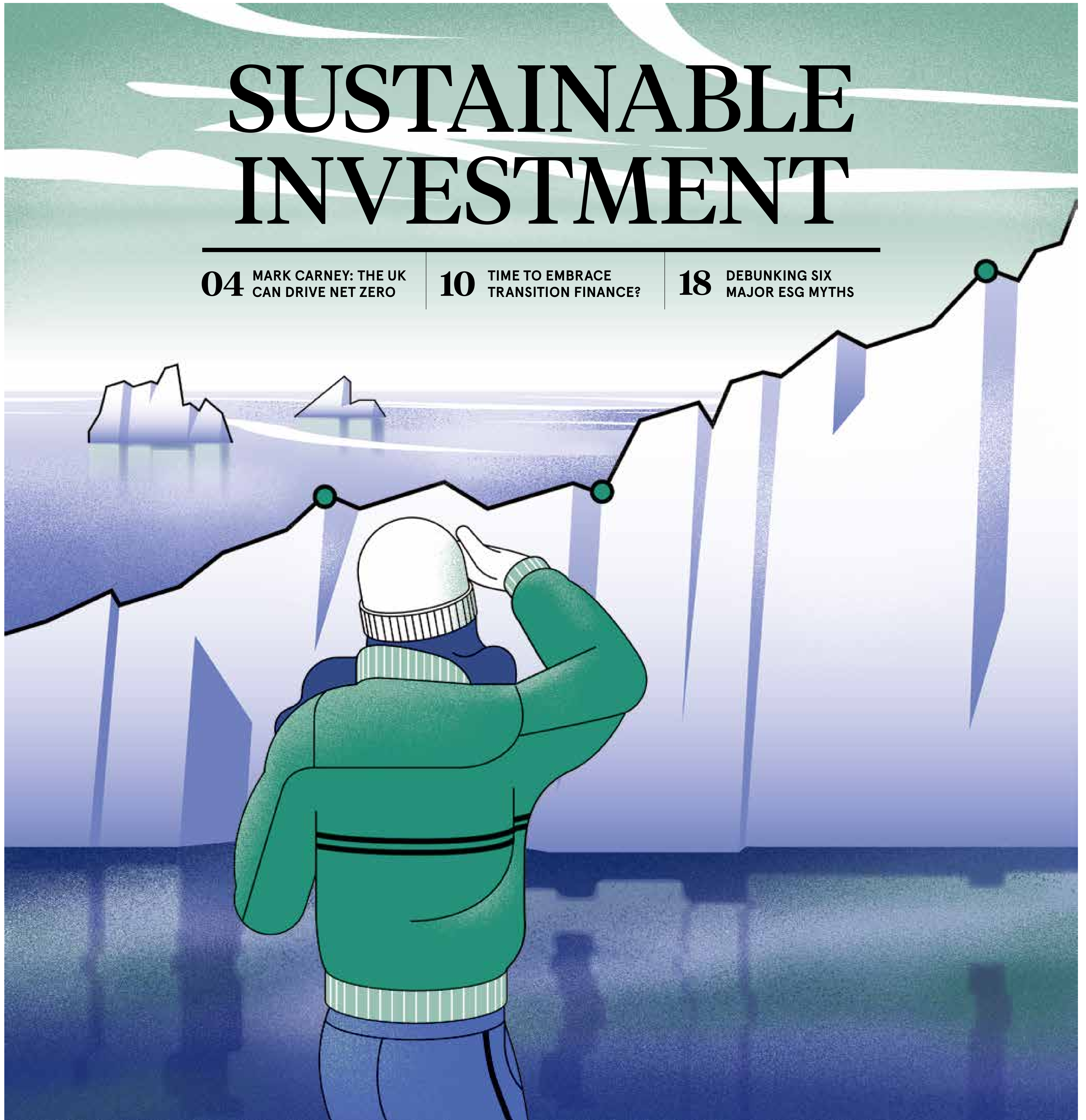


SUSTAINABLE INVESTMENT

04 MARK CARNEY: THE UK CAN DRIVE NET ZERO

10 TIME TO EMBRACE TRANSITION FINANCE?

18 DEBUNKING SIX MAJOR ESG MYTHS

Create change

INVESTING WITH COUTTS

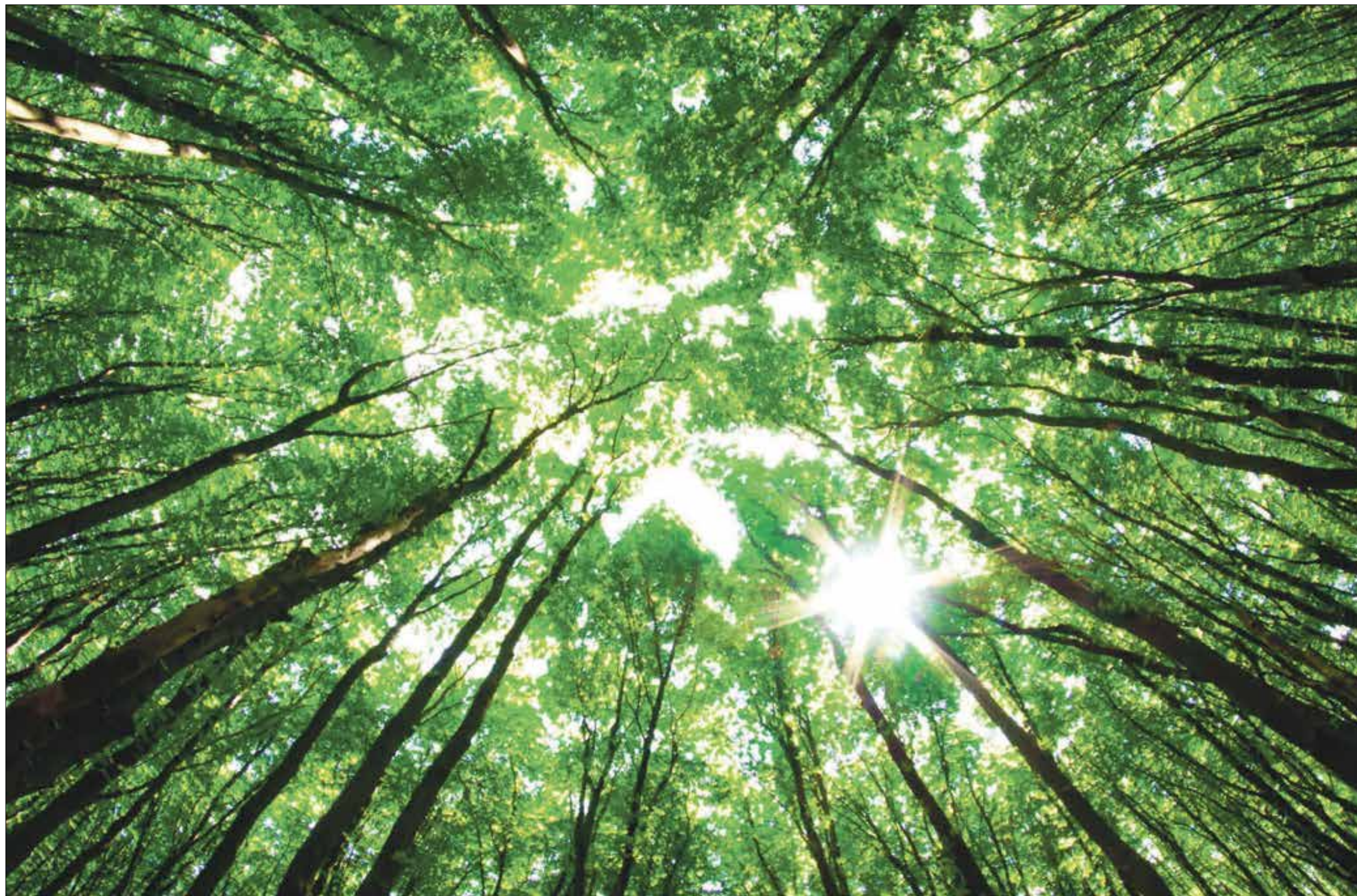
We look for actionable outcomes from every company and fund we invest in. With so much at stake, we need to be change makers, not change followers, even if that involves making hard choices.

MOHAMMAD KAMAL SYED, HEAD OF ASSET MANAGEMENT

PRI Principles for Responsible Investment

HERMES EOS

Coutts



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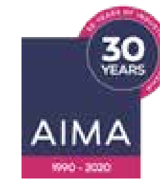

UKSIF UK Sustainable Investment and Finance Association

PRI Principles for Responsible Investment

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GREEN RECOVERY

Defining moment for sustainable investment

Coronavirus has been cited as a once-in-a-lifetime opportunity for us to clean up our act. But green investment is more than a good thing to do, it could be the secret to post-pandemic recovery

Jim McClelland

As 2020 staggers uncertainly towards a close, fortified by hopes of green recovery, it is easy to forget the year actually began pretty green in investment terms.

January saw green action by both of the world's biggest fund managers. BlackRock took its money out of coal and the Church of England backed its climate beliefs with a new transition index on the London Stock Exchange. Then along came coronavirus.

COVID-19 has affected different markets in different ways: it has stalled or stopped some trends forever; others it has accelerated and intensified. Sustainable investment is one of the lucky ones, says Tom McGillycuddy, co-founder of tickr.

"The returns from sustainable and impact investments have consistently outperformed the stock market since the beginning of the pandemic. The industry no longer has to sell a principle, or morals-based argument, it can now point to returns as well," he says.

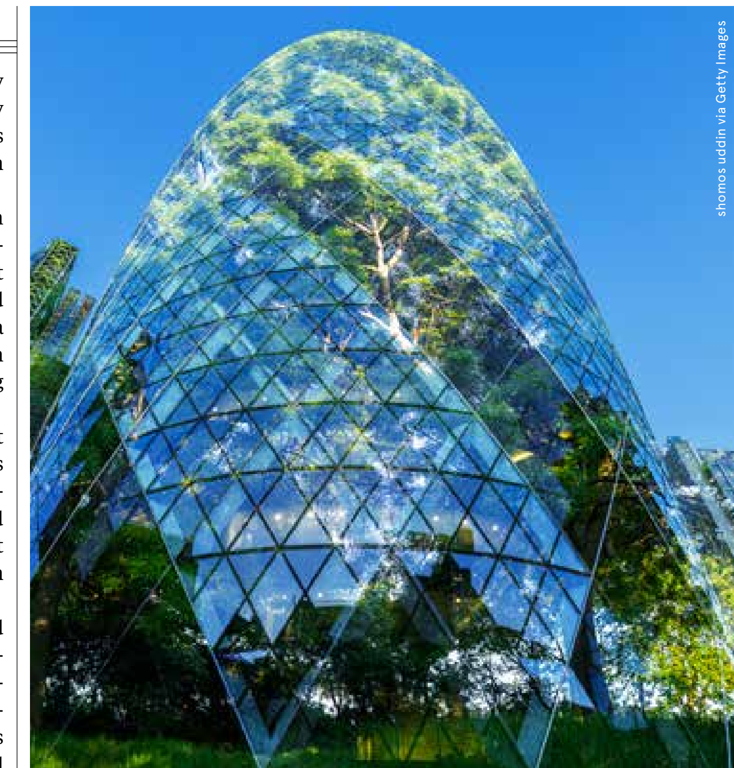
As an impact investment app, tickr taps into a smartphone generation for whom environmental, social and governance (ESG) criteria are becoming not just relatable, but attractive.

Professionally, too, there is a growing acceptance that investing sustainably can make money, that it does not cost you dearly to do good, says Edward Lees, co-head of the Environmental Strategies Group at BNP Paribas Asset Management.

"ESG-themed inflows to exchange-traded funds have been massive and quite consistent this year, helping to lift various related sectors. This is in part a reflection of a greater public awareness around climate and social issues," he says.

If anything, the green recovery idea has simply provided a big boost to an established trend, adds Tim Cockerill, investment director at Rowan Dartington, part of the St. James's Place Group. "Financial returns and environmental principles go hand in hand. Consumer demand and necessity drive change; this creates the investment opportunity and profit motive," he says. "The more businesses become sustainable, the more that'll drive change and consumer behaviour; one thing feeds the other."

In fact, research by Triodos Bank has found that the pandemic is driving growth in sustainable investments, motivating more than one in five UK adults (22 per cent) to explore ethical funds, with over a third (39 per cent) considering them key to addressing climate issues and avoiding future pandemics.



shomos uddin via Getty Images

Much as sustainability and ESG-screened indices have skyrocketed in popularity, however, this red-hot promise of green growth comes with a few caveats, argues Jacco Minnaar, chair of the management board at the sustainable bank's investment arm, Triodos Investment Management.

"Too many products are aligned to marketing hype rather than an authentic impact investment strategy," he says. "The problem is that the term 'sustainable' is not protected and there are no globally or nationally recognised definitions."

So where should the smart money go in a green recovery? Published in July, the World Economic Forum's Future of Nature and Business report identified 15 transitions that form a blueprint for a green economy, which could generate $10.1 trillion in annual revenue and create 365 million jobs by 2030.

In the case of the energy sector, evidence of the economic viability of renewable power generation is everywhere, with the International Energy Agency confirming solar power to be the cheapest source of electricity in history.

Furthermore, the sustainability wins are multiple from electric vehicles cutting carbon and city-centre pollution, to solar farms cooling datacentres that power the digital revolution.

As well as the environmental benefits accruing, there is a significant wealth-creation opportunity with the energy transition, says Duncan Grierson, founder and chief executive of Clim8 Invest.

"Trillions of pounds and dollars need to be invested into clean energy to meet the goals of the Paris Agreement and returns can be very good, especially in a zero interest-rate environment where investors are desperate for returns," he says.

The banking sector is also in a strong position to help drive a longer-term strategic play, says Scott Barton, head of corporate and institutional coverage at Lloyds Bank. "Banks have an important role in reducing the carbon footprint by incentivising businesses to move towards more sustainable funding strategies," he says. "This investment will help create high-value jobs and build a more resilient economy. The pandemic hasn't dampened our focus on sustainability, it has strengthened it."

Steering investors to "build back better", in a literal sense, the launch by Lloyds in June of a Green Buildings Tool was designed to help commercial customers identify potential energy savings and recommend performance improvements. Clients have already used it to assess an area of real estate, equivalent to about 520 football pitches.

On the domestic front, investing in a green recovery might also include such initiatives as the UK government's new Green Homes Grant scheme, announced as part of a £3-billion green buildings package, delivering up to 140,000 jobs.

The grants fund vouchers to help landlords and low-income homeowners retrofit insulation to fix leaky properties that both burn energy unaffordably and generate emissions unsustainably.

Ultimately, though, when it comes to investment, the classic argument applies: if you think the business case for sustainability is hard, try making the alternative.

Especially now with the Green New Deal back on President-elect Joe Biden's White House agenda, who would back dirty money against clean power?

Dr James MacGregor, environmental economist at Ramboll, says the green recovery is a defining moment for sustainable investment. "It has long been said that meeting the sustainability imperative would require restructuring entire economies and injecting trillions of dollars in public funding. Now we are injecting trillions, we have a once-in-a-lifetime opportunity to fund the transition to a sustainable future while relaunching the economy," he concludes.

Triodos Bank 2020

Peter Summers - WPA Pool/Getty Images

> Funds will have to look for new solutions that are consistent with what people want

INTERVIEW

UK green investors can drive net zero

Former governor of the Bank of England **Mark Carney** believes the UK is uniquely positioned to transform pensions and work towards a net-zero future

Simon Brooke

He might be Canadian, but Mark Carney believes his adopted country has a unique opportunity to lead the global financial sector to challenge climate change.

"The UK is very good at financial innovation," says the former Bank of England governor, who is now the prime minister's finance adviser for the United Nations Climate Change Conference (COP26) and UN special envoy for climate action.

"When it gets behind what society wants and when it's aligned, it can do extraordinary things. The UK is the leader in many respects among the 125 countries that are looking to transition to net zero. Finance will play a decisive role in that."

Carney is setting out a challenge to pension funds. "With people increasingly demanding climate action, those who invest our savings should disclose how closely their portfolios are aligned with the transition to net zero," he says.

"Some of the world's largest insurers, pension funds and asset owners, with over $5 trillion in assets under management, have committed to manage down the carbon footprints of their investments by up to 29 per cent, preferably on a scope-three basis [including all indirect greenhouse gas emissions] by 2025 and to be at net zero by 2050. This metrics-based approach will likely become increasingly common."

Carney is a supporter of Make My Money Matter. The campaign is aimed at capitalising on the UK's talent for developing new finance initiatives to help those who are contributing to a pension ensure their money is more likely to be invested in companies and activities that prevent climate change rather than cause it.

"Investors must provide transparent and readily understandable answers when their clients ask whether their savings are being invested in line with the transition to net zero. The challenge to the financial industry is to 'make a meaningful metric' so people can 'make their money matter'," he says.

By aligning the finance sector with society's values, Make My Money Matter aims to support the transition of the whole economy towards net zero. "This could turn the existential risks from climate change into the greatest commercial opportunity of our time," says Carney. "Private finance, including pension funds, will provide the $3.5 trillion needed annually for investments in sustainable infrastructure and fund the innovation and re-engineering of business in every sector of the economy.

"Make My Money Matter and our work for COP26 will help investors disclose how their clients' money is supporting these investment needs, so people can decide whether their priorities are being met. This will help deliver the world our citizens demand and future generations deserve."

According to polling by Make My Money Matter, whose founders are film director and co-founder of Comic Relief, Richard Curtis, and Jo Corlett, former adviser to the prime minister and the Department for International Development, more than half (57 per cent) of respondents want to see their pensions go towards building a better future for people and the planet post-coronavirus.

Alongside this, 52 per cent want their pensions to be part of the solution to combating climate change. However, nearly three quarters (72 per cent) of those who have a pension either do not believe or do not know whether their pension investments are in line with their values.

The UK has been one of the worst affected countries by COVID-19 and this presents a challenge and an opportunity for its extensive, diverse and innovative financial services sector, Carney argues.

"Consumers have been shaken, not just with health concerns, but also concerns about employment," he says. "All this means companies are going to need to adjust their strategies during a time when the overarching goal is to achieve net zero and people have been standing back and saying, 'What do we want?' However, bring these things together and there's a huge commercial opportunity."

Next year's COP26 in Glasgow will further this agenda with the UK financial sector and the country's investors and savers firmly in the spotlight. "One of the things we're doing in preparation for COP26 is to work with the industry to figure out ways they can communicate," Carney explains.

"It's not just answering questions about specific companies, but looking at whether the totality of the investment, my whole pension fund, is being invested in a way that's going to solve the problem and move the economy towards net zero."

Simple box-ticking won't wash any more, according to Carney, who has also argued that banks should link executive pay to climate risk management. "We don't just need brown/green; we need 50 shades of green and we need a way to communicate more precisely."

He describes Make My Money Matter as exactly the catalyst the financial sector needs to help open the door all the way.

"Demands from pension funds and retail investors for more detailed and robust information about the impact of their savings on climate change will force companies in all sectors to demonstrate how they're transitioning to net zero," Carney concludes. "As people move their money or express their preferences, funds will have to look for new solutions that are consistent with what people want. That's what creates the innovation and that's what creates the jobs and growth of the future."

Commercial feature

Why we need sustainability across all investments

Time in Japan set **Mohammad Kamal Syed** on a personal journey towards understanding purpose, for himself and the investment business he leads. But what does this mean in practice and is it possible to create meaningful change?

Head of asset management at Coutts, Mohammad Kamal Syed became interested in the Japanese concept of *ikigai*, which seeks to define purpose as the combination of passion, mission, vocation and profession. In investing, this has led to him evolving a definition of purpose as "considering the intended consequence and impact of our wealth".
He says: "It could be your legacy for relatives, children or society and it quickly brings in the concept of sustainable investing."

But can such ambition become reality? Syed has been driving this purpose across the group's investment process zealously and Coutts has become one of the few UK wealth managers to apply a rigorous sustainable investing policy across all assets under management.
"We haven't launched a sustainability fund, like some others. We're applying it across all our £30-billion assets," he says. "That gives us a much greater overall impact. It's the only way to effect large-scale change without affecting investment returns."

Overcoming barriers

The biggest barrier in this journey towards sustainability was some clients' perception that sustainable investing would compromise returns. But recent data has shown returns from sustainable companies are no worse and, in many cases, better over the short and long term. "It's gratifying to see clients now embrace this and have come on the journey with us," says Syed.

Rather than using negative screening to improve sustainability, Coutts prefers engagement through actively trying to influence companies' attitudes. It takes a robust approach to this with the help of engagement service provider EOS at Federated Hermes. "We prefer engagement because we know it drives change," says Syed. "But not all engagement works." As part of its sustainability framework, Coutts has created a list of activities it will not support and things it wants to change. Climate change is a major thrust, and it has a climate change governance structure and a working group with ambitious one to three-year targets.

Measuring impact

Coutts has been at the forefront of measuring the sustainability impact of investments."We have been in existence for 326 years," says Syed. "This history, and the way our clients are increasingly looking at the consequences of their wealth, led Coutts to start our sustainability journey in 2016, earlier than many others.

"The group signed up to the United Nations-supported principles for responsible investment (PRI) three years ago and now has a PRI A+ rating for governance and strategy. "To get a score like that, you must build a proper framework from the start," says Syed. "But this is not just about the principles or narrow investing lenses. It is also about making responsibility an intrinsic part of the investment process from end to end."

> We want to go much further and we see our ability to influence ESG issues increasing significantly in 2021

Ambitious targets

Coutts has set itself stretching sustainability targets. For example, by next year, it has committed to reducing the carbon footprint of all equity investments by 25 per cent. This has been a powerful, unifying incentive for its team and they are well ahead of targets. But is it possible to go further? Syed says: "We want to go much further and we see our ability to influence ESG [environmental, social and governance] issues increasing significantly in 2021."

For example, in the coal, oil and gas sectors, the group will move progressively towards only supporting activities that result in no net impact on the climate, helping end harmful emissions. Similar targets extend to all parts of Coutts' business, including banking, lending and operations. For example, it aims to make its operational carbon footprint net zero by 2021 and climate positive by 2025. Coutts has also signed up to the Green Finance Institute's Green Home Retrofit Finance Principles, launching a green mortgage pilot this November to support clients in improving the energy efficiency of their properties.

This is part of Coutts' plan to help 50 per cent of its clients' homes achieve at or above energy performance certificate rating C, or equivalent, by 2030. Coutts' parent NatWest Group is playing a major role too. For example, it is providing an additional £20 billion in funding for climate and sustainable finance by 2022, and aims to reserve at least 25 per cent of its entrepreneur accelerator hub places for firms supporting environmental activities.

Future challenges

There is still much to do. Syed says the next stage of Coutts' strategy is to make sustainable investing core for more investors by making it more accessible.

A focus will be engaging more on human rights, including encouraging companies to improve transparency and report more data on the subject. Another is to help address low levels of access to equity capital among women and people of colour. Syed highlights the work of NatWest Group chief executive Alison Rose, who was commissioned by the UK Treasury last year to conduct a review of female entrepreneurship. That has resulted in a series of actions aiming to bridge the gender gap in this area, including signing up big banks and private equity companies to an ethical code. NatWest Group has also instituted a council for female entrepreneurship in conjunction with the Treasury, looking at funding gaps and how it can fill them. One result has been to launch a fund to provide equity capital for female-led businesses.

Recently, Syed's focus on purpose has also seen him joining the advisory board for the British Academy's Future of the Corporation programme, which aims to review the role of business in society.

Wider actions

Coutts aspires to champion potential, helping people, families and businesses to thrive. The group has put this concept at the heart of its training programme, operations, and all products and services.

"Working for an organisation that has clear statements on sustainability and purpose resonates with employees," says Syed. "We have seen a step-change in positive employee feedback over the last two years."For its clients, all this activity means they can rest assured everything Coutts does aims to benefit all stakeholders, not just shareholders, consistently across the value chain. This includes how it treats employees, its supply chain and the environment.

For more information please visit coutts.com

STAKEHOLDERS

ESG's ecosystem of influence

A lack of in-depth understanding of environmental, social and governance issues among the diverse stakeholders involved in sustainable investment can trip up the sector's progress

Marianne Curphey

The Green Horizon Summit earlier this month is evidence that environmental, social and governance (ESG) Investing is high on the agenda of business and government. More than 100 global business and climate leaders, including the Prince of Wales and United Nations secretary-general António Guterres, took part.

Business leaders, asset managers and institutional investors are already clued up on the benefits of ESG investing. Yet for sustainable investing to become mainstream, it needs the support of financial advisers, corporates and retail investors.

Figures from the Investment Association suggest the amount invested in stocks and funds with ESG characteristics could be 50 per cent greater than in 2019, thanks in part to high-profile campaigns by Greta Thunberg and Sir David Attenborough.

"There has been a massive increase in interest in sustainable investing in recent years," says Martin Shaw, chief executive of the Association of Financial Mutuals. "Consumer research indicates people are looking to support more ethical and environmentally-friendly companies."

However, judging the appropriateness and performance of different funds is difficult unless you have an intimate knowledge of how the money is invested, he says. Even then, there is currently no universal method for classifying the green content of investments.

One of the issues, says Angela Hayes, partner at law firm TLT, is the lack of a common approach among firms in describing sustainability objectives. There are no common standards for measuring whether sustainability objectives are being met.

"Without this clear regulatory framework, retail advisers will be naturally more cautious about advising their clients to buy green investment products," she says. More standard language and metrics would also help retail investors to learn, understand and make decisions about the products available.

Indeed, one of the sticking points for the wide-scale adoption of sustainable investing is having a meaningful definition, says Jeff Waller, senior director and head of financing solutions at sustainability consultancy ENGIE Impact.

"Investments that are labelled 'sustainable' fall along a wide spectrum. An investment can be deemed sustainable if it simply screens out companies that don't meet a minimum threshold of ESG factors, like those in the tobacco and weapons sectors," he says.

One solution might be to create market-accepted guidelines, such as those for green, social and sustainability bonds.

"If the rest of the industry adopted similar frameworks across the sustainable investing landscape, it could bring a level of transparency that could help the market grow," says Waller.

A poll of 200 UK independent financial advisers (IFAs) by the international business of Federated Hermes found that 82 per cent reported an uptick in inquiries from investors about how their capital can be committed to combat the effects of climate change, raise governance standards and improve human rights.

Pete Drewienkiewicz, chief investment officer of global assets at Redington, argues the pressure towards sustainable investing is now coming from investors.

"It is important for investment advisers to hold the asset managers to account to help get everyone on the same page, because I don't think the asset owners are going to tolerate inaction much longer," he says.

New European Union regulations on sustainability will apply from March 2021 and will require financial advisers to provide information to enable investors to make informed investment decisions based on ESG factors.

"To really drive change, we need to see fund managers changing the way they allocate portfolios to meet the growing impact demands of their clients and to prevent tokenistic investing with an ESG or impact label," says Daniela Barone Soares, chief executive of Snowball, an impact investor.

Asset managers and IFAs have the potential to be change-makers because they are able to drive change with the weight and influence of the capital they manage on behalf of their clients, says Richard Ker, partner in the financial services practice at Odgers Berndtson.

"Companies with poor ESG credentials should expect to see greater scrutiny from asset managers and asset owners more broadly," he says. "Capital will naturally flow to companies with strong ESG credentials, which in turn drives better performance."

Jeffrey Mushens, technical policy director of The Investing and Savings Alliance says IFAs will need to cater for these changing investor preferences and field more queries about the ESG rating of existing investments.

This is particularly true when dealing with millennial investors, who take a much more ethical stance on investment.

"IFAs need to be one step ahead of the curve to ensure they can advise on these wishes of the younger demographic who care about sustainability," he says.

Patrick Sheehan, a founder and partner at ETF Partners, says the investment industry is responding to the more extensive changes happening in society and needs to be aware of the new investing credentials of younger generations.

"The real issue is that we face societal change and younger generations are moving the needle forward," he says. "The younger generations are driven by purpose and we see a generational shift towards purpose, perhaps because of the bigger crises the world is facing, and in parallel we are seeing and experiencing investment demand."

William Burrows, managing director at AHR Private Wealth, says the shift towards sustainable investing has largely been driven from the bottom up. Grassroots climate change movements, the #MeToo campaign and investors have all led the charge and applied pressure to businesses to change their image and place sustainability at the heart of what they do.

These movements have also influenced governments to encourage sustainable investing. The economic uncertainty caused by the coronavirus pandemic has made advisers and clients reassess their perceptions of value and adjust portfolio allocations accordingly.

"Many investors have used the crisis as an opportunity to adapt their portfolio to new or changing views about the importance of sustainability as climate change becomes ever-present on the news agenda," he says. This and the relative strong performance of many ESG funds during the pandemic has led a growing number of consumers to embrace sustainable investment practices.

Investment advisers will need to rethink their role in the future and change the way they work with clients, says Dr Emilio Marti, assistant professor at the Rotterdam School of Management, Erasmus University.

"Discussing sustainable investing with clients often pushes traditional investment advisers outside their comfort zone," he says. "When it comes to sustainable investing, investment advisers need to solve problems together with clients."

Ilaria Calabresi, sustainable investment lead at J.P. Morgan Private Bank, says it is the need to stay competitive that will drive companies towards sustainability in the future.

COVID-19 has accelerated change, and Celene Lee, principal and senior investment consultant at Buck, argues that any education gap which previously existed between institutional investors and large corporates, has already shrunk dramatically.

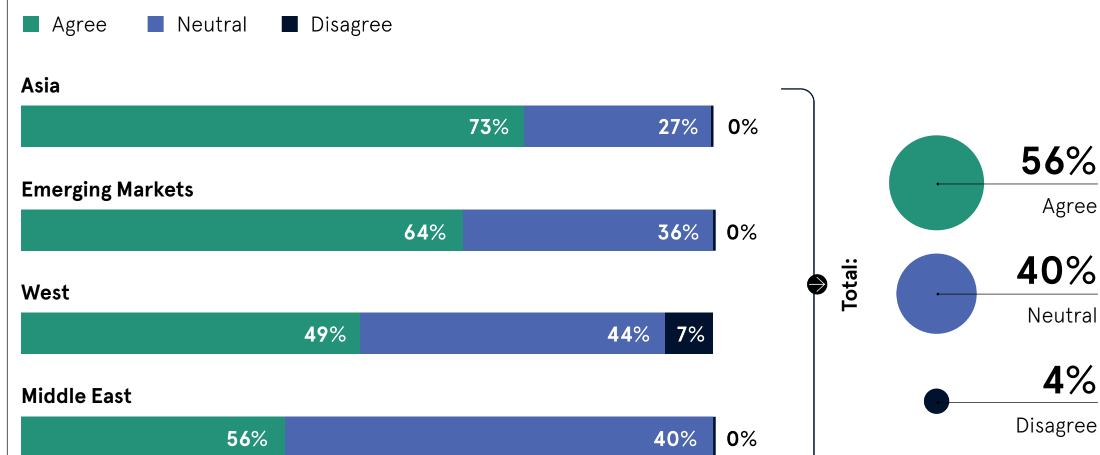
"With ever-increasing access to sustainable investing information, such as carbon emissions data, consumers and investors have been able to begin building a picture of who is doing well and who is not, on the sustainability scale. It's this knowledge that is beginning to shift the balance in terms of capital flows towards more sustainable businesses," she says.

Josh Gregory, founder and chief executive of Sugi, concludes: "What's needed is a different way of presenting sustainable information to retail investors as well as financial advisers and corporates in a way that's directly relevant to them and their needs."

> "When it comes to sustainable investing, advisers need to solve problems together with clients

DO INSTITUTIONAL INVESTORS CARE ABOUT CLIMATE CHANGE?

The share of institutional investors around the world who believe climate change should be considered in their portfolios



NMG Consulting 2020

Commercial feature

Covid-19 crisis adds urgency to sustainable investing agenda

The speed and scale of the global economic downturn in the wake of the coronavirus pandemic has reinforced the importance of sustainable equity investing, says leading investment manager **AllianceBernstein**

With the private sector playing a key role in efforts to halt the virus and accommodate evolving consumer trends, investors will increasingly turn their focus to companies helping solve the world's most pressing problems with strong environmental, social and governance (ESG) credentials, according to leading global investment manager AllianceBernstein.

Daniel Roarty, chief investment officer, sustainable thematic equities at AllianceBernstein, says: "Companies with the strongest ESG practices are, by definition, higher-quality companies. They are more profitable, have less volatile earnings and are better at mitigating serious business risk that can lead to large financial losses and bankruptcies. As a result, they tend to provide enhanced reduction of downside risk in times of market stress."

These attributes were in high demand in the sell-off earlier this year. During the first quarter, companies with the highest ESG ratings in the MSCI ACWI Index fell by 15.6 per cent, around 650 basis points less than those with the lowest ESG ratings. The spread was even greater for US equities, where ESG leaders dipped by 10.8 per cent in a market that tumbled by 19.6 per cent.

As a result, funds that focus on ESG performed well during the period. According to data from Morningstar, 70 per cent of sustainable equity funds ranked in the top half of their respective categories.

Stakeholder capitalism

The pandemic has also shone a light on ESG leadership. As the social and economic impact of the pandemic escalates, investors will witness the first major test of stakeholder capitalism.

In 2019, 181 American chief executives, including at Amazon and Xerox, co-signed a declaration stating that their businesses would include consideration for all stakeholders, not just shareholders. However, actions that may have been dismissed as public-relations spin at the time are now being viewed through a very different lens, says Roarty.

Home Depot, for example, extended extra paid leave to employees over 65, who are most at risk of getting sick from a coronavirus infection. PayPal established an emergency relief fund for employees with short-term cash needs.

While these actions may not directly feed through to short-term earnings, investors are increasingly recognising the benefits a stakeholder approach can have, not only on lower regulatory risk, but customer loyalty and employee engagement.

Long-term growth themes

The pandemic has served as a wake-up call for global sustainability, with the world's biggest environmental and social challenges unable to be solved by public policy alone.

Roarty explains: "To drive meaningful change, governments require the innovative and financial capacity of the private sector, and companies with the best solutions will be the ones to tap into substantial long-term growth opportunities."

He points to the United Nations Sustainable Development Goals as a good starting point. Accomplishing the UN's ambitious agenda will require more than $90 trillion in capital over a 15-year period, with the bulk of that being supplied by the private sector.

According to Roarty, digital communication technologies are gathering huge momentum, while financial technology and payments companies that enable growth for small and medium sized businesses (SMBs) will likely fare well, with the current crisis highlighting the vital importance of SMBs. Recent events have also pushed health-related investment themes to the fore.

"While the ultimate solution to this crisis will be a vaccine, other solutions will have an important role to play too," he says. "Telemedicine, drug discovery and diagnostic testing stimulate innovation, lower the cost of healthcare service delivery and extend its reach."

Looking ahead, the outlook for sustainable companies is bright. Roarty concludes: "The longer-term prospects for sustainable stocks are very promising. The crisis is adding new catalysts for companies that can provide innovative solutions to our largest environmental and social challenges as the world emerges from the COVID shock."

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INVESTMENT STRATEGY

Investing to generate genuine impact

With a lack of standardisation around criteria and a passive approach to screening, sustainable investing is yet to reach its potential. A change of mindset is needed

Oliver Balch

Shutterstock, Todamo

Sustainable investing is enjoying its moment in the sun. After years of platitudinal rhetoric, investment markets at last appear to be putting their money where their mouth is. The wolf of Wall Street has discovered its soft side.

ESG, the acronym *du jour*, is everywhere. Investor webinars, investment indices, management reports, analyst notes, all are now singing the virtues of environment, social and governance themes.

It's not just public-relations spin, either. Cold, hard cash is finding its way into sustainable investing. New research from the US Forum for Sustainable and Responsible Investment indicates that around one in every three dollars of the $51 trillion in assets under management is now subject to at least one ESG criterion.

This shift in capital allocation should be seeing investment dollars moving away from irresponsible companies and into those championing a more ethical form of capitalism. But is it? And, if not, what changes might help it to do so?

Amid the ESG excitement, sceptics abound. One is Lynn Forester de Rothschild, chairman of the UK wealth management fund E.L. Rothschild and a fervent convert to "conscious capitalism". For Forester, the lack of exactitude as to what qualifies as ESG has left the door open to a number of anomalies.

She gives the example of Air Products and Chemicals, a US firm dedicated to the sale of carbon-intensive gases and chemicals. But because the firm is commercialising hydrogen, it's a darling of ESG markets. In contrast, Denmark-based Ørsted, the world's leading offshore wind power producer, is marked down because of some legacy fossil fuel assets.

The examples point to how counterproductive relying on ESG indices can be. "Unfortunately, when you look into what is owned by the majority of ESG-branded ETFs [exchange-traded funds], they are virtually the same stocks as conventional ETFs, so they make precious little difference," she says.

It is a verdict endorsed by a recent research briefing on sustainable investment funds by market analyst firm Massif Capital. The report argues the hotchpotch approach to stock selection means investors remain exposed to the non-financial risks that ESG supposedly prevents.

Worse, it keeps money from going to the problem-solvers. Take cement, which given its huge footprint, most ESG investors agree is a major no-no.

> Unfortunately, what is owned by the majority of ESG-branded funds is virtually the same as conventional ones

As a result, however, capital for progressive firms in this in-demand $312-billion industry to look into clean alternatives is effectively being choked off.

According to Massif Capital's managing partner Will Thomson, investors need to adopt a more transitional mindset. Instead of identifying benign companies, he argues, impact-minded investors should be picking firms in problematic sectors that boast a clear strategy for change.

"We cannot recreate the economy without carbon-intensive businesses as if we had a blank sheet of paper; it is crucial to work with the businesses we have," he says.

Part of this more selective approach is an upgrade in data. Recent years have witnessed a boom in the market for ESG ranking and analytics, but determining which stocks are genuinely committed to sustainability issues is still a stab in the dark for many investors.

The problem is two-fold. On the one hand, lack of standardisation means investors are frequently left comparing apples with oranges. And because disclosure of non-financial information is still largely voluntary, they often find themselves with too few apples or oranges even to count, let alone compare.

Change is afoot, however. A collection of recognised standards is beginning to emerge – the Sustainability Accounting Standards Board is a good case in point – while legislators are also getting tougher on disclosure requirements. In the UK, for instance, fiduciary regulations enable pension funds to specifically accommodate ESG factors.

Time horizons are equally important. At present, financial information looks almost exclusively backwards. But to exert impact, sustainable investing needs forward-looking data as well. So says Amer Khan, European managing director at Entelligent, a data platform that integrates climate-risk information. It is important to have hard data on how a company will reduce emissions in the future, not just on how it has reduced them in the past.

Khan is also an advocate of innovation in trading mechanisms themselves. He points to the example of smart beta ETFs, which use a rules-based system for selecting investments to be included in the fund portfolio. To date, those rules typically apply to predetermined financial metrics. So how about a "climate beta" equivalent for listed equity stocks?

His suggestion gets to the crux of sustainable investing's current lack of impact: namely, passivity. The great appeal of tracking funds is its hands-off approach. Investors opt for an index that meets their mandate, issue instructions to the index manager and then essentially sit back and twiddle their thumbs.

Impact doesn't work that way. It requires investors to be more proactive, asking questions of management, exercising their voting rights, pulling out of certain sectors, investing in others. The upside of equity indices is the trillions of dollars at play; minuscule shifts can create enormous waves.

Tribe Impact Capital is one of a growing number of investment houses determined to take a more explicitly active position. The UK wealth management firm invests exclusively in high-impact firms. With the satisfaction of making a tangible difference, however, comes high management oversight and a small pool of capital.

It may not be Tribe's chosen strategy, but Fred Kooij, the firm's chief investment officer, still believes sustainable investing can make a mark in mainstream investment markets. He takes heart from advances in transparency and reporting, as he does the emergence of "well thought-through, informed and managed indices".

Oxymoronic as it may sound, these developments hold out hope for those who want to do more in the passive space.

Understanding sustainable investment definitions

ESG
Now a fixed part of the investor lexicon, the acronym ESG stands for environmental, social and governance issues.

According to the Financial Times Lexicon, ESG is "used by investors to evaluate corporate behaviour and to determine the future financial performance of companies". The base assumption is that how companies behave with respect to non-financial issues impacts on their future profitability.

What constitutes a material ESG issue is yet to be defined. The European Federation of Financial Analysts Societies suggests nine broad areas, including energy efficiency and greenhouse gas emissions (environment), employee training and absenteeism (social), and litigation risks and corruption (governance).

ESG investing covers almost all asset classes, from equities and fixed income through to highly tailored private investment vehicles. It contains within it a panoply of different sub-categories, including socially responsible investing, impact investing and values-based investing. One of the stand-out characteristics of ESG funds is their long-term focus, with ESG investors working to multi-year cycles rather than quarter to quarter. Far from sacrificing profits, however, research indicates that ESG funds frequently outperform the market over the medium and long term.

SRI
SRI stands for socially responsible investing. One of the more established forms of ESG investing, it grew out of the concerns of ethically-minded investors, starting with the Quakers and later championed by the likes of church pension funds and university superannuation funds.

Given its origins, SRI is historically associated with a tactic known as negative screening. This practice sees industries deemed unethical or irresponsible removed entirely from portfolios. Typical examples include companies dealing in tobacco, gambling, alcohol, pornography and arms. These became labelled as "sin stocks".

Over the last few decades, SRI investors have adopted more nuanced approaches. One popular tactic is to select the most ethical or responsible performers in specific industries, so-called best-of-class companies. Another approach is to constructively engage with firms, offering them an opportunity to change key policies or practices rather than immediately excluding them.

These developments reduce the moral associations of the term "responsible", which have historically made mainstream investors uncomfortable, but which shareholder activists have embraced. The vogue over recent years has been towards less deterministic descriptors such as sustainable and resilient.

Central to SRI is a belief that capital can generate positive social and environmental outcomes as well as, not instead of, financial returns. Debate continues regarding the profitability of SRI. A recent survey of existing research by RBC Global Asset Management concludes that SRI does not necessarily result in lower returns, but evidence for its generating above-average returns remains inconclusive.

Impact investing
As the term suggests, impact investing represents a highly active form of ESG, with a particular focus on generating positive social and environmental outcomes. Depending on their mandate, impact investors may often settle for a lower-than-average or slower rate of financial return in exchange for high impacts.

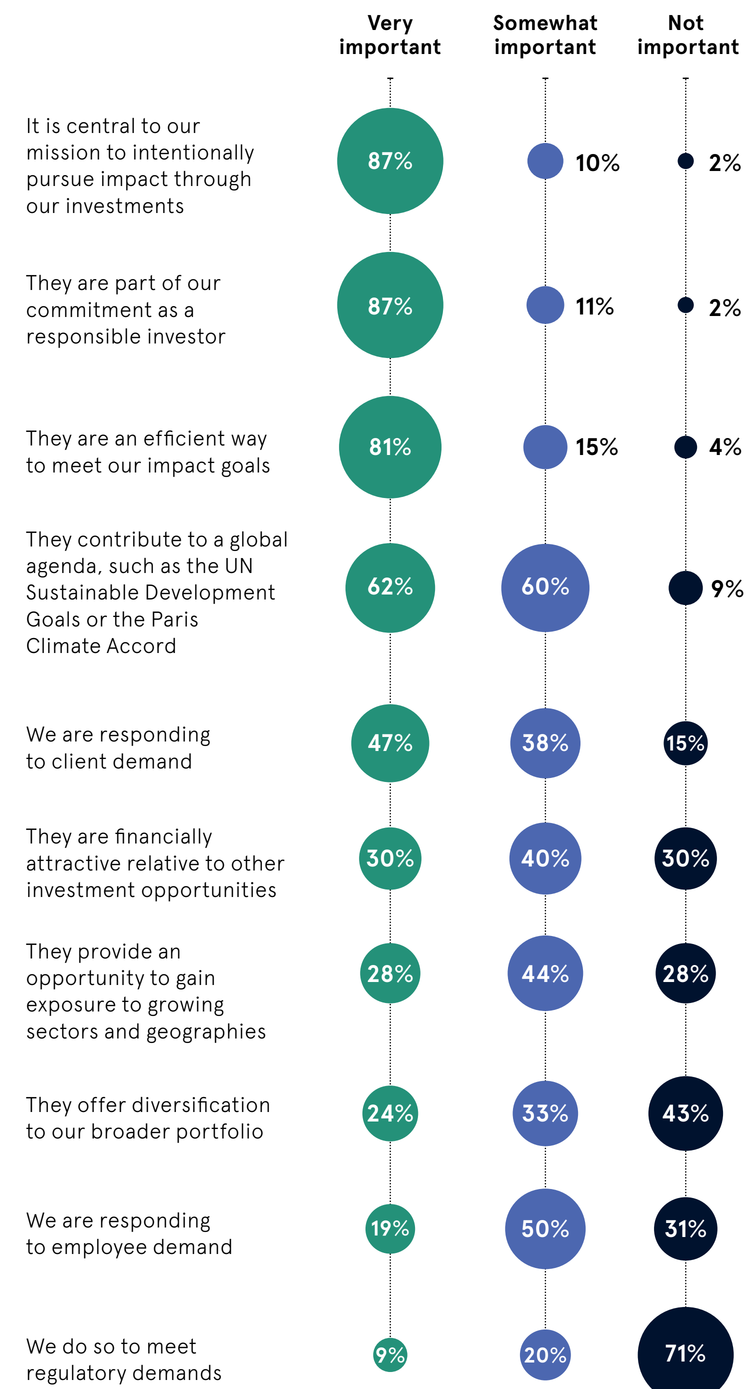
"You can deliberately choose to go into lower-return funds to gain a high social return," says Stephen Muers, chief executive at UK impact investor Big Society Capital. "Although some asset classes such as affordable housing funds offer a financial return similar to mainstream asset classes."

Given their focus, impact investors typically choose much more specific social or environmental metrics than conventional ESG investors. The very first social impact bonds, for example, were issued a decade ago with the goal of reducing reoffending by former prisoners in the UK. Around 138 similar social impact bonds have been issued since then.

Moves are underway by the Impact Management Project to design an agreed framework for measuring and assessing the outcomes of impact investments. Veteran UK investor Sir Ronald Cohen is also championing an approach to valuing companies, known as impact-weighted accounting, that incorporates social and environmental costs or externalities.

MOTIVATIONS FOR MAKING IMPACT INVESTMENTS

The world's leading impact investors explain the factors driving their investments.



Global Impact Investing Network 2020

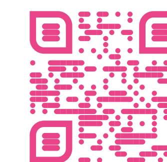
Investments that return more than a little change

As the **UK's first dedicated impact wealth manager**, we believe you can have the best of both worlds. Investing in businesses that are solving global issues are, by their very nature, improved, in every sense.

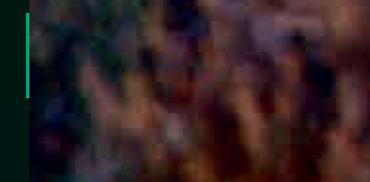
At Tribe we go beyond negative screening and ESG assessment to look at the true impact of each investment. The result is an investment portfolio that drives both **long-term sustainable growth and impactful returns**.

Now that's a win-win.

Tribe A NEW WEALTH ORDER



With any investment, including impact investing, your capital is at risk. Past performance is not a reliable indicator of future performance.



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TRANSITION FINANCE

Signposting a priority pathway to Paris

A new type of green finance has emerged and, rather than simply blacklisting "bad" companies, it is offering even the heaviest polluters a pathway to a greener future

Nick Easen

If overnight the world's money men divested out of everything that wasn't truly green, the global economy would be on its knees. From oil and gas to steel, cement or aviation, carbon-intensive industries keep the wheels of commerce moving. These hard to abate sectors need investment right now if they're to shift to a net-zero world. This is where transition finance comes in.

To date sustainable finance has focused on activities that are already green, yet there are many pathways to the Paris climate agreement. Some investors are now taking a carbon-footpath approach instead, using their capital to persuade heavy polluters to change their ways rather than eliminate them from investment portfolios, through a decarbonisation or carbon-footprint strategy.

"We've built a successful green finance market so far in the 2020s, with momentum towards that vital first trillion dollars in annual green investment. But the urgency remains. We need to replicate that market in transition finance, at speed, sector by sector, industry by industry," says Sean Kidney, chief executive of the Climate Bonds Initiative (CB).

> **"You need a big carrot, not a big stick... you need to reward companies for doing the right thing**

This is a crucial time for transition finance. There is an unprecedented need to tackle climate change and, in the process, high-emitting sectors, which are unable to access green funds. Many businesses have ambitions to change, but they need money and encouragement to do so. Since there's a lack of regulatory incentives to decarbonise, such as a meaningful price on carbon, the drive will come from markets.

"You need a big carrot, not a big stick. That's the view of those holding trillions in funds who are looking to park them in businesses tackling green issues. There is an increasing realisation that you need to reward companies for doing the right thing," says Marisa Drew, chief sustainability officer, advisory and finance, at Credit Suisse.

Robust standards, definitions and benchmarks are also required for transition finance to work. This is why the CB and Credit Suisse with others are trying to develop a framework defining credible strategies for companies.

At the same time, the Transition Pathway Initiative, led by asset owners that assess companies' preparedness for the transition to a low-carbon future, is empowering investors with tools and data to help investment decisions in this area. Players in this field are increasingly figuring out what "good" looks like.

"Transition aims need to be backed up by a plan and concrete metrics and not just pledges with no substance," says Drew.

It is early days, but it's an exciting class of investment, providing clear financial benefits for change. It also opens up the market to a much wider group of investors around the globe who aren't just focused on green bonds and financial products.

"This is the fuel that will power many industries' transition costs. The size of the required capital investments is in the many trillions of dollars without which we cannot move to net zero and have thriving economies," says Jan Laubjerg, global head of power, utilities and renewables at HSBC. "We recently announced steps to support our customers with between $750 billion and $1 trillion of finance and investment by 2030 to help with their transition."

Transition finance is not without its challenges. Greenwashing - making false green claims - primarily comes to mind. Just like other forms of sustainable investing, science-based targets are vital, underlined by third-party oversight and disclosure. Standardisation is also crucial.

"To avoid the risk of greenwashing, a steel company, for instance should not be issued with a transition bond without allocating at least some of the proceeds to the decarbonisation of its most carbon-intensive activities. Some bonds issued to date under the transition label have not been strong and have faced criticism," says Kevin Ranney, director of sustainable finance solutions at Sustainalytics.

"The issue is that the goal of decarbonising is far more ambitious than improving ESG [environmental, social and governance] performance, and it requires greater levels of investment, stronger strategies and a longer-term view. This is more than most companies have contemplated to date."

Shipping, livestock and energy are just some industries where carbon intensity is high, other sectors include chemicals, mining, plastics and aluminium production. It's better to get seasoned businesses to evolve, use their know-how and market connections to transition, than slash funding with a scorched-earth investment policy.

"The problem is many high-carbon-producing industries are highly leveraged; just look at airlines and energy companies," says Barnaby Barker, investment analyst at SCM Direct. "Although we're currently in a low interest rate environment, some companies are already highly indebted, without the added, yet unknown, negative effects of COVID-19. So they may not have the debt capacity to finance the costs involved in transitioning major parts of their business."

It doesn't help that some companies aren't engaged with this transition process yet. There is not always a clear financial benefit to transitioning, at least not in the time horizon that companies or boardrooms plan for, and the short-term quarterly pressures of earnings announcements don't help.

"No major fossil fuel energy company has yet aligned its emissions reduction plans with limiting climate change to 2C, although some companies such as Eni, Shell and Total are starting to get close," says Adam Matthews, co-chair of the Transition Pathway Initiative.

"The gap between US and European oil and gas companies is stark, with no US company even disclosing intentions to align. In contrast you are seeing alignment to greater ambition among electric utilities in both America and Europe."

Like green investing, transition finance needs to gain its own momentum and create its own virtuous circles. Each player in the market, including governments, issuers, underwriters, investors and auditors, will need to come forward with their piece of the puzzle so a robust ecosystem is created over time.

"Once companies use it to transition, this type of finance will be a signal to others that they can attract funding, if they are willing to change," says Masja Zandbergen, head of sustainability integration at Robeco. "We strongly believe companies that drive transition finance are likely to thrive in the long run and therefore be good investments." This will be a good thing.

4 PRINCIPLES TO PROTECT TRANSITION FINANCE FROM GREENWASHING

01

All transition pathways must align with zero carbon by 2050 and nearly halving emissions by 2030

02

All pathways must be led by scientific experts

03

Offset don't count

04

Credible transitions are backed by actions, not simply pledges

Climate Bonds 2020

Because sustainability is too long-term for short-term thinking

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Celebrating Africa's conservation leaders in the fight for a sustainable future.

Join us, Thursday 3rd December, 6-7pm (GMT)

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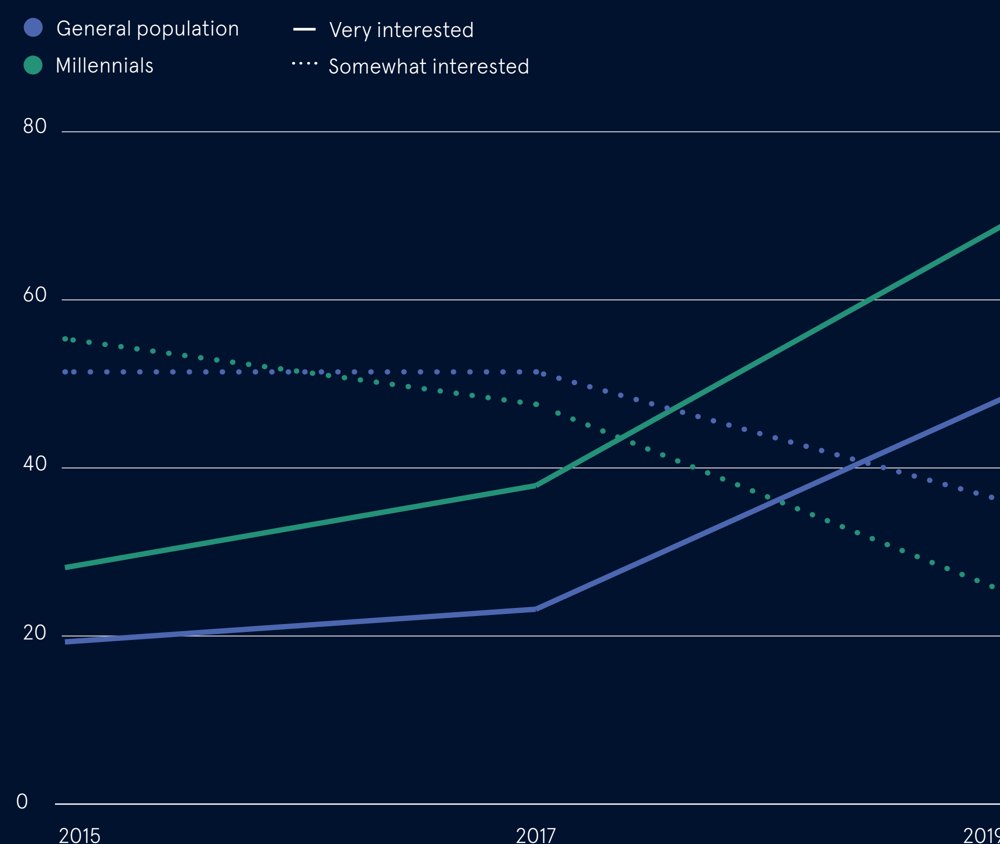
SUSTAINABLE DRIVERS

Investors' interest, enthusiasm and passion for sustainable investing have been growing steadily over recent years, but what are the key drivers of more conscious investments?

INTEREST JUMPS, ESPECIALLY AMONG MILLENNIALS

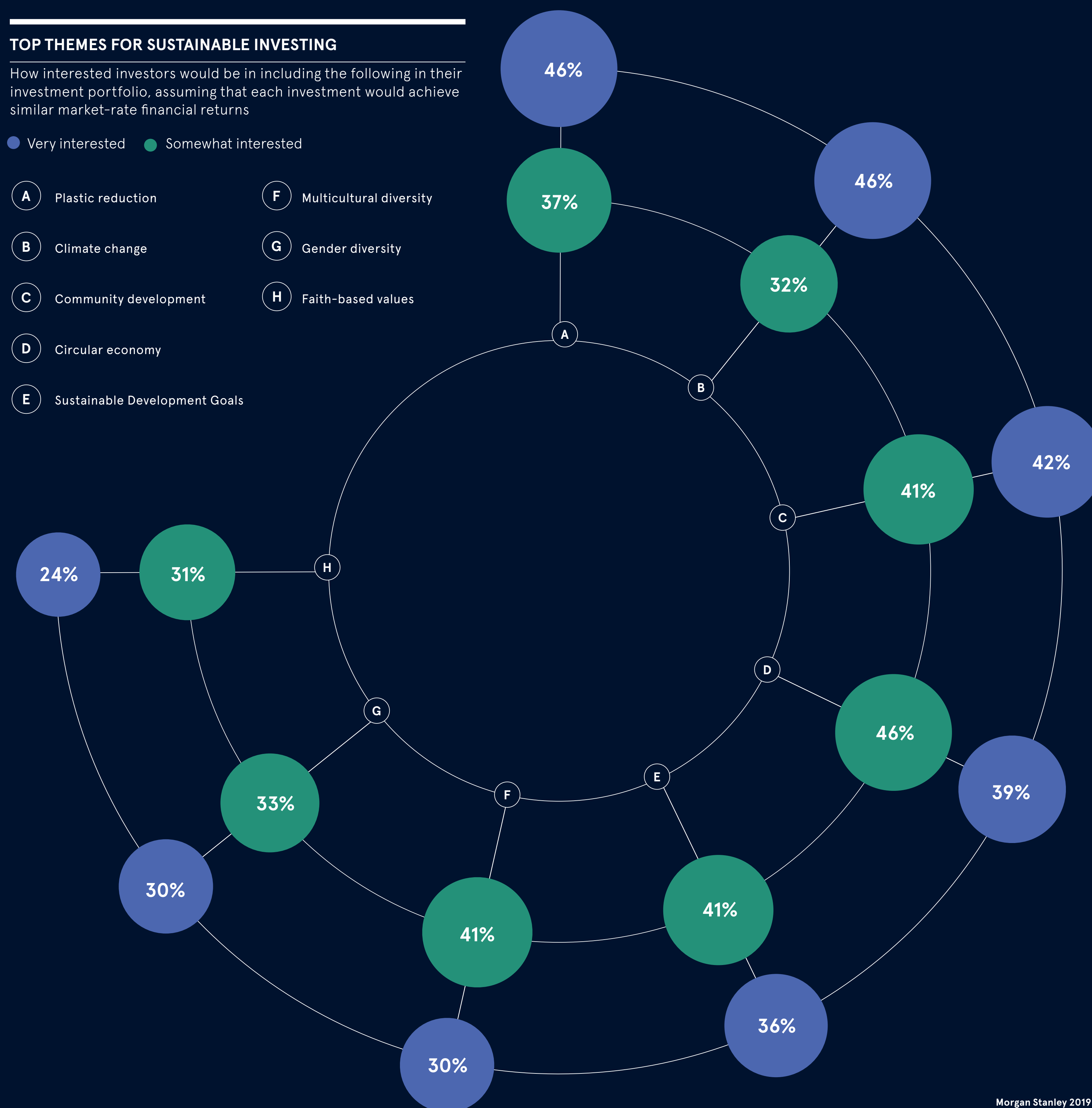
How interested the general population and millennials are in sustainability investing



Morgan Stanley 2019

TOP THEMES FOR SUSTAINABLE INVESTING

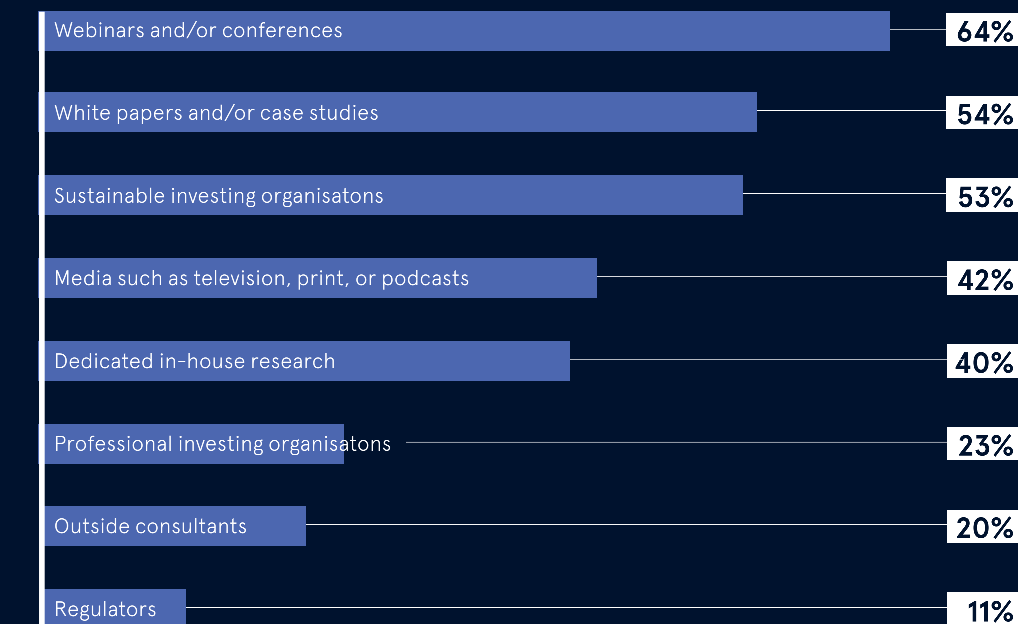
How interested investors would be in including the following in their investment portfolio, assuming that each investment would achieve similar market-rate financial returns



Morgan Stanley 2019

STAYING UP TO DATE

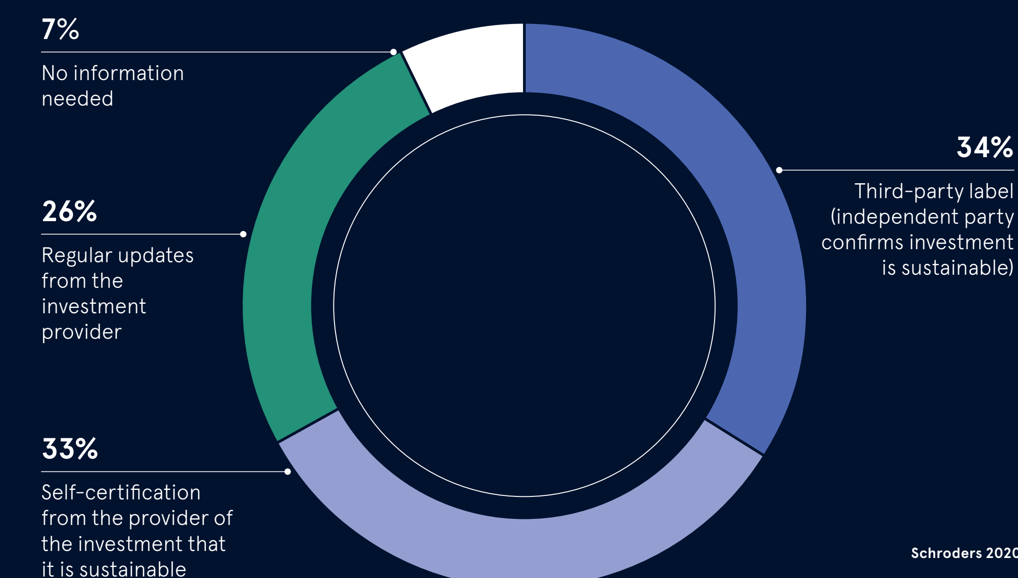
How institutional investors stay abreast of ESG and sustainable investment developments



Pitchbook 2020

MAKING INFORMED DECISIONS

Global investors were asked which types of information are required for them to be confident in the sustainability of an investment



Schroders 2020

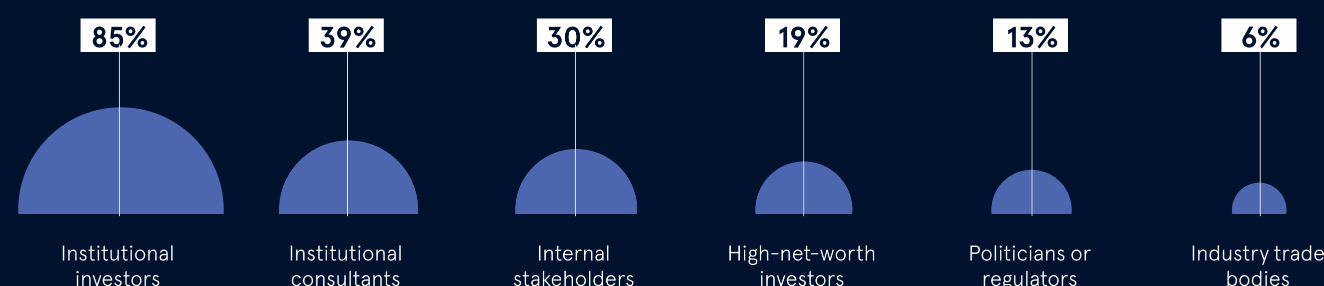
INVESTING WITH CONSCIENCE

Choice to invest against personal beliefs, by level of investment knowledge

Schroders 2020

DRIVING ESG INTEREST

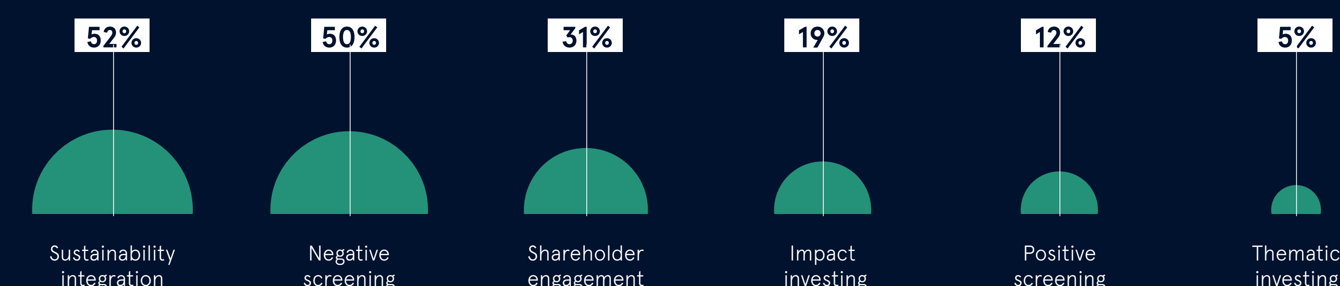
Institutional investors, hedge fund managers, long-only managers and pension consultants were asked which groups were driving interest in ESG investing



KPMG/AIMA/CAIA 2020

INDUSTRY SUSTAINABLE STRATEGIES

Institutional investors, hedge fund managers, long-only managers and pension consultants were asked what describes their strategies when it comes to ESG



KPMG/AIMA/CAIA 2020

UK

How the City of London can keep its green crown

Vladimir Zakharov/Getty Images

As Brexit threatens the UK's pre-eminence as a financial hub, spearheading sustainable finance offers a welcome lifeline

Nick Easen

Staying on top as a pre-eminent global financial centre requires constant reinvention and the City of London has been doing it for hundreds of years. Brexit is the latest catalyst, factor in climate change and you have a new cause célèbre. Chancellor Rishi Sunak and the Treasury think they have the answer and want the UK to reinvent itself as a world leader in green finance.

But is the City up to the job? The Global Green Finance Index is a good indicator. It measures depth and quality. Zurich and Amsterdam top the charts, followed by the UK. "If these types of reports are anything to go by, then London may face an uphill struggle in years to come," says Emily Kreps, global director of capital markets at CDP.

Don't write London off in the global grand prix for leadership in sustainable finance. Look beneath the bonnet and the engine is increasingly green. "The growth in sustainable investing that we've seen this year highlights the resilience of the City of London as a sustainable investment hub. This is at a time when COVID-19 has disrupted the global economy and financial markets," says David Schwimmer, chief executive of the London Stock Exchange Group.

"The City is uniquely placed to drive commercial innovation in green finance products. It also offers exceptional international market access to liquid, diverse and deep capital markets."

City of London Corporation research shows more than 220 UK organisations have expressed support for the Task Force on Climate-Related Financial Disclosures, the highest number in the world only after Japan, while 577 UK investors are signatories to the United Nations Principles for Responsible Investment, which is the largest number after America.

> Historically, the City has always been at the forefront of change

The UK was the first country to make a legally binding commitment to net-zero greenhouse gases, it is also hosting COP26, the international climate summit, next year. "The UK remains the leading venue for international green bond issuance, now a green gilt would catalyse our domestic sterling green bond market and cement the UK's position as a leader in green finance. There is strong demand for a green sovereign bond," says Dr Rhian-Mari Thomas, chief executive of the Green Finance Institute.

As luck would have it, chancellor Sunak has now announced that he'll issue a sovereign bond. It's not a new financial instrument though. This form of borrowing is already used in 16 countries including Germany and Sweden. Green gilts are being rolled out by governments to fund low-carbon infrastructure projects. But it shows progress.

"The City of London has come from a long way behind on the European Union and fast. It's caught up with the Nordics and Benelux when it comes to green finance. Historically, the City has always been at the forefront of change. Over centuries it has developed an extremely sophisticated framework from which to drive new initiatives and green finance is no exception," says Narina Mnatsakanian, director for sustainable investment at Kempen Capital Management.

LONDON'S SUSTAINABLE FINANCE HUB IN NUMBERS

£67bn
combined market capitalisation of 86 Green Economy Mark issuers

$26tn
could be delivered through to 2030 from 'bold climate action'

230+
bonds, raising £33bn

120+
Green Funds and ETFs

180+
FTSE Russell Sustainable Indexes

London Stock Exchange Group 2020

The big question now is how the City stays ahead of rival financial hubs. It helps that there is an ecosystem approach in London. The UK's policy and regulatory environment underpins the green economy. There are also numerous initiatives supporting sustainable finance on its markets. Mark Carney, former governor of the Bank of England, has been instrumental in pushing this agenda into mainstream financial thinking.

"Inaction is more of a threat than action; the City now needs to maintain its sense of urgency. However, there are many reasons to believe it will play a pivotal role in green finance, perhaps the pivotal role," says Faith Ward, chief responsible investment officer at Brunel Pension Partnership.

Issuers wishing to raise substantial capital linked to sustainable investing goals still look to the City. London also has a strong debt market supporting green funding. But it's not immune to the uncertainties from a divorce with Europe. "With Brexit, London is at risk of losing some of the green funding to Europe," says Gordon Kerr, head of European structured finance research at DBRS Morningstar.

"However, one of the main strengths supporting the UK in terms of funding markets is the legal framework. Most issuers prefer to have contracts written under English law due to the market view of its strength as a neutral dispute resolution location. However, bonds using English law have declined in recent years, though it still remains a high proportion of issuance."

London is also home to the groundbreaking biennial exploratory scenario, an exercise requiring the largest UK banks to disclose the financial impact of climate change on their corporate lending portfolios.

"This is a world first and a critical missing piece of the data and risk management pie, so it's a huge first step in rightsizing the cost of risk for green, brown and transitioning companies. Once completed by the end of 2021, banks will have a globally leading depth of knowledge into the financial impact of climate change on their corporate lending books," explains CDP's Kreps.

The thing about the City of London, European rivals and who takes centre stage in green finance post-Brexit is it's not a 100-metre sprint where the winner takes all. According to Murray Birt, senior environmental, social and governance strategist at DWS, it's a marathon.

"The objective in tackling climate change is to have as many people, institutions and countries cross the finish line as soon as possible, achieve lower emissions and greater prosperity through job creation," he says.

There are few cities on the planet that have a critical mass and a financial ecosystem that can achieve all these green ambitions at once. "The innovation of thought in the City is awe-inspiring," says Caroline Saul, partner at Osborne Clarke. Maybe London is where it's at?

Commercial feature

Investing in decarbonisation is a once-in-a-generation opportunity

Transition to a low-carbon economy presents a significant opportunity to invest in a multi-year structural-growth trend while also helping to tackle an existential crisis

Climate change is one of the most urgent challenges facing the world. The understanding that it is an existential issue is now widespread, as is the realisation everybody is responsible for supporting the transition to a low-carbon economy.

Of course, this includes investors, as such a monumental shift in the ways people produce and consume requires vast capital. But the savviest investors know funding a green industrial revolution offers them far more than the chance to make a positive environmental impact.

Efforts to cut carbon emissions are transforming not only energy and transport systems, but also the design and manufacture of products and buildings. This creates enormous growth potential for companies offering low-carbon products and services, and consequently opportunities for investors.

So much spending is required because green technologies need to play a far bigger role in the economy. To achieve the Paris climate goals, by 2025 100 million electric vehicles must be sold every year, for example, up from around two million in 2019[1], implying considerable growth not only for electric vehicle manufacturers, but companies in their supply chains.

Propelled by the decarbonisation tailwind, such companies have the potential to outperform the rest of the market. "Decarbonisation-fuelled growth is a structural trend that will persist through economic and political cycles, which is a crucial point during a time of such uncertainty in the world," says Deirdre Cooper, co-portfolio manager at global asset manager Ninety One.

"Given the vast investment required to limit temperature rises, the growth potential of companies that support or benefit from decarbonisation is huge. It's a misunderstanding that there need be a trade-off between investing sustainably and generating returns."

However, she believes only the market leaders are likely to reap the full potential of decarbonisation. The key to leveraging this opportunity is therefore selectively investing in the leading businesses enabling and benefiting from decarbonisation, through a dedicated and focused approach.

Though first seen as a possible inhibitor of decarbonisation progress, coronavirus is now viewed as an accelerant as governments centre their post-pandemic recovery plans around the low-carbon transition. This is particularly the case in Europe where the European Union's Green Deal and related fiscal policy is being positioned to help reshape economies.

Elsewhere, China pledged in September to become carbon neutral by 2060, which would require a faster decarbonisation than expected and a radical reconfiguration of its economy towards more sustainable ways of producing and consuming. Incoming US president Joe Biden's announcement of a green agenda has further strengthened the tailwind behind stocks perceived as positively exposed to decarbonisation. Together, the United States and China account for 43 per cent of global carbon emissions[2].

Investors seeking businesses most likely to benefit from environmental tailwinds follow these developments closely, given that government policy has a major influence on where, how and how fast decarbonisation drives economic growth. However, the necessary funding cannot come from governments alone.

"The world is investing just $500 billion of the $2 trillion to $3 trillion required annually to decarbonise the global economy," says Cooper. "To make up the shortfall, we need companies to spend much more on tackling climate change. Investors can play a valuable role in this by engaging with listed businesses, as shareholders, to encourage them to accelerate spending on transitioning the global economy to a lower-carbon model."

To find companies likely to contribute to decarbonisation, Cooper and her colleagues use proprietary models and detailed carbon analysis. "Within our portfolio, we analyse carbon impact for each company. This includes analysing emissions profiles, initiatives to align strategies with the Paris climate goals, and 'carbon avoided', which measures the extent a company's products or services have a lower-carbon footprint than the alternative."

Ninety One's Global Environment strategy has identified around 700 businesses which earn at least half their revenues from areas impacted by decarbonisation and offer products and services that are quantifiably more carbon efficient than the alternative. These businesses have a combined market capitalisation of $6.5 trillion, but investors in broad benchmarks have limited exposure to them as together they account for only 7 per cent of the MSCI All Country World Index by weight[3].

Cooper believes investors have a higher probability of outperforming the market if they take a selective approach, focusing on the businesses within this group that have the best growth potential, sustainable returns and competitive advantages.

The businesses in Ninety One's Global Environment portfolio are predominantly in the industrial, utilities, energy, technology, materials, chemicals and automotive sectors.

However, rather than dividing the decarbonisation universe into traditional industries, Ninety One believes it is more useful to identify the pathways to a lower-carbon economy, such as renewable energy, electrification and resource efficiency. Within each pathway, the investment team looks at opportunities throughout the value chain, from makers of components to service providers and distributors.

> The rising tide of decarbonisation will not lift all boats, so very careful analysis of the exposure of each company is crucial

The renewable energy pathway, for example, includes regulated utilities that provide clean electricity, as well as manufacturers of the equipment needed to generate wind and solar power. Electrification includes companies that provide semiconductors and battery technologies for electric vehicles, for example, while resource efficiency incorporates energy-efficient heating and lighting appliances.

But investors should remember decarbonisation is a nascent area because the world's transition to a lower-carbon economy has only just begun. While this suggests tremendous growth potential, it also requires a targeted investment approach.

"The rising tide of decarbonisation will not lift all boats, so very careful analysis of the exposure of each company is crucial," says Graeme Baker, co-portfolio manager of the Global Environment strategy with Cooper at Ninety One. "Seeking high-quality businesses with competitive advantages and defensible market positions gives us the best chance of handling whatever is around the corner.

"As an investment theme, decarbonisation comprises a hugely diverse group of businesses, but diversification doesn't happen by chance. Given the economic uncertainty, it is strongly advisable for any decarbonisation portfolio to actively seek and manage it."

Sources

[1] Ninety One and Dr Daniel Quiggin, 31 March 2019.
[2] Union of Concerned Scientists, updated 12 August 2020
[3] Ninety One, March 2020

For more information please visit ninetyone.com/climate

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ESG FUNDS

Picking a green winner

There is compelling evidence that environmental, social and governance funds can outperform their less sustainable counterparts, but what's driving superior returns

Tim Cooper

Huge flows into environmental, social and governance (ESG) funds have pushed their prices up this year, making future returns harder to sniff out. But many believe the ESG market is not yet a bubble and there will be more good returns available if you look carefully.

ESG funds' popularity has rocketed, with some statistics showing funds under management exploding by 1,000 per cent in the last 12 months. This follows increasingly compelling evidence that ESG funds outperform non-ESG funds over the short and long term. A recent study from Morningstar showed most sustainable strategies outperforming non-ESG funds over one, three, five and ten years.

But research explaining that outperformance, which is essential for picking future winners, is harder to find. ESG funds' good returns may be due to direct ESG factors, other indirect causes or even chance. And even if we can identify causes of performance, it is hard to know whether they will repeat in future.

ESG fund managers have jumped on evidence of outperformance, touting their approach as a "vaccine" against stock price falls in a crisis.

But simply investing in ESG is no guarantee of success. Morningstar data shows the best performing ESG fund this year (Baillie Gifford Positive Change) has returned 55.5 per cent so far, but the worst (Schroder Responsible Value UK Equity) lost 32.9 per cent.

A study by New York University suggests, contrary to fund managers' claims, that sustainable stocks do not perform better in times of crisis. Instead, innovation and good liquidity are more likely to make a stock financially resilient.

But others believe ESG factors can drive outperformance. For example, research from Amundi Asset Management shows that, for European portfolios, governance is particularly important in determining outperformance. For North American portfolios, environmental factors are most significant.

Other studies suggest these drivers could also strengthen in future because ESG funds are becoming more targeted on "material" sustainability issues that impact a firm's valuation. For example, carbon emissions are material for an energy company, but not for a financial services group.

Most specialist ESG financial advisers say it will continue to offer good returns. Richard Skerritt, managing director at Skerritts Wealth Management, says: "It is not a bubble. It is at the start of a long run, with more companies embracing ESG principles and more good stocks becoming available. The types of company ESG funds invest in, for example those promoting remote telecommunications to reduce travel, are here to stay."

Sophie Kennedy, head of investment at EQ Investors, says: "We see ESG's outperformance as long term and expect these companies to further benefit from recovery packages around the world, such as the European Union Recovery Fund. A third of that funding is earmarked for digitalisation and cutting carbon, so ESG businesses should be in pole position."

Philip Wise, retirement income planning director at Informed Choice, says: "Drivers such as UK changes to pension scheme rules that favour strong ESG companies have only just started to have an effect. Europe is focusing on a green recovery and incoming US president Joe Biden has a green outlook. So there will be more money available for ESG projects."

Sector allocations could play a key role in picking future winners. ESG funds have generally performed well this year because the sectors they tend to avoid, such as oil, have suffered during the pandemic. But those they prefer, such as healthcare and technology, have fared well.

These trends look set to continue. So picking a fund that does not constrain itself to sector allocations, but can adjust them according to the manager's conviction could be advantageous.

A stronger ESG process should also help. "In the past, people thought the greener your fund, the more you compromise performance," says Skerritt. "Now, we believe the opposite: the better the fund's ESG credentials, the better its prospects."

Wise says that in good ESG funds, additional scrutiny and focus on profit sustainability will make a difference to performance. "Future outperformers will have ESG embedded into their processes, not outsourced," he says.

> Future outperformers will have ESG embedded into their processes, not outsourced

Lee Coates, director at Ethical Investors, recommends using actively managed funds rather than index trackers to find future ESG returns. "Data can help drive performance, because good managers can look for valuable information about climate change and corporate activity," he says. "Passive funds cannot assess that and predict change, they can only follow."

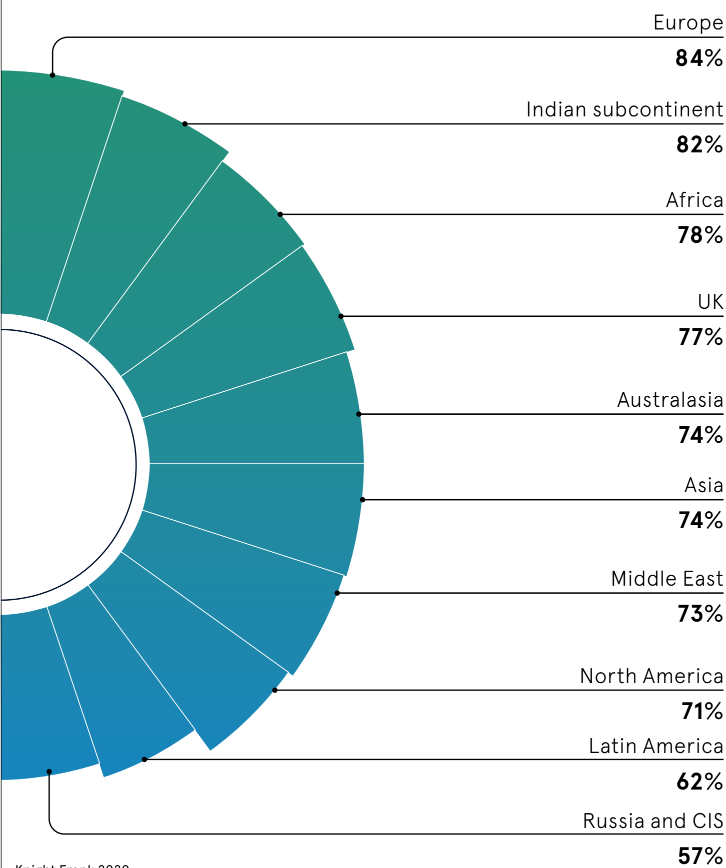
Kennedy says picking winners will require lots of research, especially if you want to make sure the funds also match your ethical values.

"Plenty of funds and portfolios are labelled sustainable or ESG, but on closer inspection are nothing of the sort," she says. "Check the holdings match your values and that the fund has a dual mandate: to deliver long-term returns and positive change."

There is evidence showing that cheaper, passive index trackers can succeed in this sector as well, for example 73 per cent of Morningstar's ESG indices have outperformed their non-ESG equivalents since inception. Given the huge range of good and bad-performing active managers, passive could be the safest option. But it would also mean giving up some of the positive returns an active manager might continue to get from this sector.

WHICH NATION HAS THE GREENEST INVESTORS?

Share of private bankers and wealth advisors who say their clients are becoming more worried about climate change



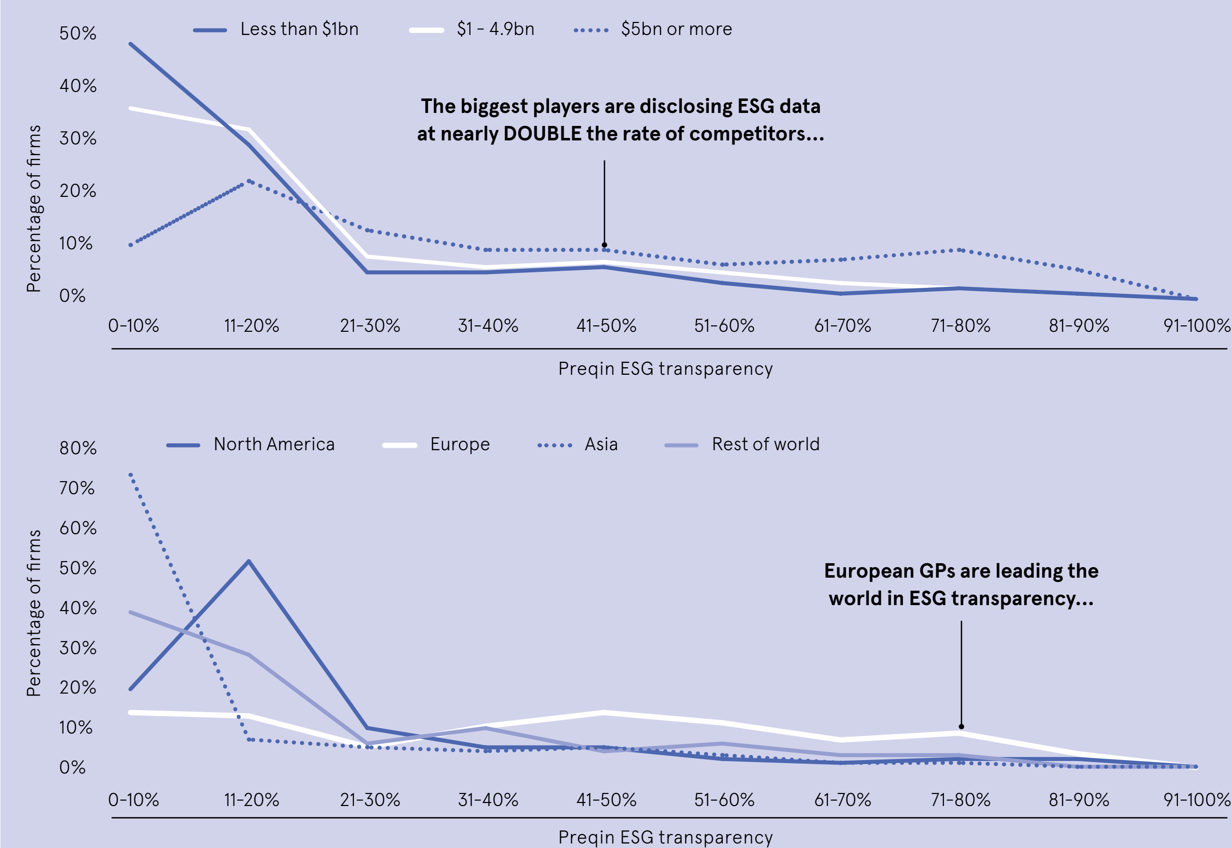
Knight Frank 2020

Commercial feature

Private markets urgently need robust ESG data

Reliable data on environmental, social and governance factors has been hard to find in private investment markets, but investors need it urgently

DISTRIBUTION OF PREQIN ESG TRANSPARENCY SCORES BY FUND MANAGER LOCATION & AUM



Preqin Pro

Environmental, social and governance (ESG) data, while increasingly adopted across public markets, has largely been elusive in private markets. Our data collection efforts for ESG transparency cover a sample of the 1,500 largest alternative asset fund managers and their public disclosure of 37 key metrics sourced from leading frameworks we've deemed to be relevant to the private market. As expected, the mean ESG transparency for private markets sits at 21% globally, although this is higher for European and North American markets where ESG is more mainstream. As private markets evolve and managers grow larger, we expect ESG transparency to increase – as shown, ESG transparency increases with greater AUM.

There has been a buzz around environmental, social and governance (ESG) in private markets for the last few years. This grew to fever pitch after KKR announced in February that it had raised a spectacular $1.3 billion with its KKR Global Impact Fund. As demand for more sustainably invested assets grows rapidly, so does the need for better ESG-related data in the sector.

ESG propositions will help managers attract inflows and improve their brand value and customer engagement, providing they stand out. Public market players who focused on sustainability and differentiated themselves early had better ESG data processes, a stronger story to tell and captured greater market share. As private markets are ten years behind public markets in developing ESG, early movers can expect the same advantage in private markets.

ESG-related risks can have even greater impacts in private markets because most assets are illiquid. Investors generally hold them to maturity, so cannot sell out of them to avoid risks, as they can with equities. For example, if you made a ten-year private investment into a factory in an area exposed to flooding, this locks you in to climate-related risk for a decade.

Meanwhile, private market investments in carbon-emitting coal and oil companies have seen steep price discounts in the last three years as people realise they are likely to deliver lower returns over a ten- or twenty-year period. Such factors are leading investors and regulators to demand more disclosure of ESG data from private market firms and managers. The increased general use of disclosure frameworks, such as from the Task Force on Climate-Related Financial Disclosures (TCFD), will only intensify this pressure. Private market players will have no choice but to disclose more.

But they are responding and coming together to ask what the data should look like, especially given the lack of a dedicated framework for ESG disclosure in private markets.

Barriers to ESG adoption

Investors are thinking about what ESG data they need to drive portfolio choices, such as sector allocations or selecting new managers, and how quickly it will allow them to act.

Institutional investors, in particular, are deepening their understanding of ESG and asking more savvy, detailed and robust questions. To differentiate, you must answer these questions effectively. For example, you must be able to talk about your ESG goals and processes, and what data you are using and can disclose.

Low levels of data disclosure are a symptom of the market's private and idiosyncratic nature, but are the biggest barrier to ESG adoption. Investors, for their part, should not let the lack of perfect, fully comparable data lead to inertia. You need less data than you might think to make good decisions, providing you ask the right qualitative questions alongside it.

Another roadblock to further ESG adoption in private markets is continuing questions about the veracity and usefulness of data, and about greenwashing, which means presenting your investment as more ethical than it is. Bob Vickers, head of sustainability solutions at Preqin, says: "We're just now at the tip of the iceberg with data provisioning in private markets, and we expect continued evolution over the coming years. Preqin is committed to getting the maximum amount of useful data possible from managers and we are unique in our ability to leverage our relationships in private markets and access data.

"As an investor, you want data to be as objective, high quality, consistent and useful as possible. You also want it updated as frequently as possible. Preqin is committed to achieving all those things."

Vickers also warns the problems associated with ESG adoption are small in comparison to the damage that could come from not adopting ESG criteria, for example, around climate risk.

ESG framework fatigue

One challenge to better data provision is the plethora of ESG frameworks available, such as those from the Sustainability Accounting Standards Board (SASB) and the TCFD. Parts of these frameworks are often not relevant or suited to private markets. This leads to framework fatigue, when investors become so tired of choosing and comparing frameworks, they end up using none.

"We tackle this fatigue by using the most codified frameworks only, not creating new ones," says Vickers. "By marrying what managers disclose with what we know about who invests where, we can address these problems and create insight and insider views."

Preqin's ESG Solutions provides visibility of environmental, social and governance factors at scale across limited partners, general partners and ESG funds. The range includes transparency and risk attribution modules that map data against the SASB materiality risk matrix and give insights into potential ESG risks. In building ESG Solutions, Preqin looked at 300 data points from a range of frameworks. It filtered them in relation to private markets and found only 15 per cent were applicable and useful. Preqin then transmuted these targeted data points into a private market setting to maximise usefulness. "This solution gives users one view of risk," says Vickers. "We have found it gives them a palpable sense of relief that they don't have to create something; we've done it for them. Now they can build their processes around those metrics.

"Developing these solutions involved an incredible amount of attention to investors' needs. We are seeing the fruits of this rigour in client feedback that it's an excellent, usable starting point. It is a crucial opening baseline as we begin the ESG movement in private markets.

"But it will evolve. We view the challenge of procuring data as an engagement opportunity and a chance to ask why the data doesn't yet exist. Everyone we've spoken to recognises that providing more robust ESG data is inescapable. Some investors and fund managers are advancing in this area, but the vast majority don't know where to start. They tell us they want to use more ESG data, but have been waiting for someone to help them do it."

> Public market players who focused on sustainability and differentiated themselves early had better ESG data processes, a stronger story to tell and captured greater market share. Early movers will now get the same advantage in private markets

For more information please visit preqin.com/esg-solutions

MYTHS

Debunking six ESG myths

From low returns to a lack of interest among the elderly, there are many misconceptions around environmental, social and governance investing. Here are our top six myths

Marina Gerner

Unsplash, Annie Spratt

Myth 1: It's more expensive

The most common refrain voiced by naysayers when it comes to sustainable investing is the fees are much higher and it doesn't significantly outperform the rest. That's a misconception. Morningstar has analysed 4,900 investment funds domiciled in Europe, including 745 sustainable open-ended and exchange-traded funds. Hortense Bioy, director of sustainability research, Europe, Middle East, Africa and Asia-Pacific, at Morningstar, says: "We found in Europe, active environmental, social and governance, or ESG, funds charge lower fees than active non-ESG funds across the vast majority of categories. I would attribute this to the increased competition among ESG funds as their popularity grows." This was particularly apparent in the categories US large-cap blend equity and Europe large-cap blend equity. In both categories, ESG funds are 30 per cent cheaper on average than their non-ESG counterparts. However, passive ESG funds tend to charge a small premium relative to their plain-vanilla passive peers. "That's because the latter have cut fees very aggressively in recent years, with funds charging fees as low as 0.05 per cent," says Bioy. This year ESG funds have seen record inflows spurred by the pandemic. Should global inflows continue to rise, fees are likely to decrease further, as providers vie to attract customers.

Myth 2: It doesn't perform as well financially

The majority of ESG funds have outperformed their traditional peers over three, five and ten years, according to Morningstar. Over the ten years to 2019, some 59 per cent of sustainable funds (defined as ESG funds in this research) have beaten their traditional counterparts. Across the industry, ESG investments have shown to be more resilient during the market crash brought about by coronavirus. This is partly due to their focus on technology stocks and avoidance of carbon-intensive industries like aviation, which have suffered as a result of the pandemic. But it also reflects a wider mind-shift among investors. "The COVID-19 pandemic has reinforced the value of sustainable investments," says William de Vries, director of impact equities and bonds at Triodos. "When it hit, we were faced with massive market volatility and uncertainty; however, our fund managers took steps early to respond quickly." He says their defensive positioning has meant the Triodos Pioneer Impact Fund outperformed its benchmark by 7 per cent in the first half of 2020. Sustainable investment has been on the rise over the last few years and the pandemic may be a turning point for the sector to continue its march into the mainstream. The UK's Investment Association reports a record inflow of £7.1 billion invested in responsible or sustainable funds so far this year, which is nearly four times the £1.9 billion that flowed into the sector over the first three quarters in 2019.

Unsplash, Jan Antonin Kolar

Unsplash, Mick Haupt

Myth 3: There are only a very limited number of sustainable investments

Sustainable investors tend to use a negative filter to exclude so-called sin stocks, such as oil, weapons and tobacco, while focusing on companies that have good environmental, social and governance credentials. This means a vast range of profitable stocks get excluded from the investable universe. But that doesn't mean there's not enough to choose from. "We've curated over 400 companies in the Clim8 portfolio that have a product or service that's making a positive difference to climate change," says Duncan Grierson, founder and chief executive of Clim8 Invest. The startup has raised £1.8 million on Crowdcube this year for its digital platform that focuses on sustainable investments in clean energy and technology, sustainable food, smart mobility and recycling. "The problem appears to be one of perception," says Grierson. "The impact investment industry needs to do better at educating people that there are alternatives which will deliver a great return financially and a more secure future for them and the planet."

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Myth4: It's all just greenwashing

While there are isolated cases of greenwashing, in particular when funds fail to exclude industries like weapons, the sustainable investment sector continues to develop reliable metrics to ensure it delivers on its promises. A key issue is a lack of shared definitions. Rating agencies have differing scores and investment managers apply their own filters and definitions. Therefore, the quality of "responsibility" or "sustainability" in funds varies. "With such diversity in the ratings themselves and the scoring criteria used, and then the interpretation and use of these data points, it's not unsurprising some are sceptical when looking at ESG funds," says Amy Clarke, chief impact officer at Tribe Impact Capital, a wealth manager. "It highlights why the work of regulators globally, including the European Union on its Sustainable Finance Action Plan is so important; taxonomy and labelling are two of the ten-point action plan that aims to address this issue." Sophie Lawrence, senior ethical, sustainable and impact researcher at Rathbone Greenbank Investments, echoes this point. "There is a need to build consensus on how to measure, assess and report impacts on environmental and social issues in a consistent way, to bring further credibility to ESG investing," she says. "The Impact Management Project, a practitioner community of over 2,000 organisations including Rathbone Greenbank Investments, has gone some way in doing this."

Myth 5: You need a financial adviser to invest responsibly

Just like dating, which no longer requires a matchmaker, investing no longer relies on a middle person. For decades, investing was the preserve of a small group of the well informed and sustainable investing even more so. But over the last two decades, the rise of the internet has brought investing to a larger group of people. Self-directed investing is accessible from as little as £25 or £50 a month, which enables those who have historically kept their cash in a savings account to access the stock market directly, without needing a financial adviser. Most investment platforms have ESG funds on offer and some platforms, such as EQ Investors, exclusively focus on investing in companies with a positive impact. "In 2020 you don't need a financial adviser to invest ethically," says Clim8 Invest's Grierson. On digital platforms, people can choose their own funds as well as opting for curated portfolios. When assessing how green an investment is, Grierson says, "our primary filter is the impact a company is making on reversing climate change, and then the expertise of the management team and how sustainably run the business is".

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Myth 6: It's just for millennials; retired people don't want to invest sustainably

It's often said that sustainable investing, just like takeaway lattes and balayage hair dye, is the preserve of millennials. It's true sustainable investing appeals to most millennials. In 2019, a Morgan Stanley Institute for Sustainable Investing survey of investors found 95 per cent of millennials express an interest in sustainable investing. But so did 85 per cent of the general population. *The Great British Retirement Survey* by interactive investor revealed that only 50 per cent of retirees in the UK aren't interested in ethical, or sustainable, investing. Meanwhile, 31 per cent of those who are already retired are interested and 19 per cent already invest ethically. What's more, 56 per cent of all UK investors have increased their allocations to ethical funds over the last five years, according to KPMG. John David, head of Rathbone Greenbank Investments, says their clients span the full age spectrum from youngsters with Junior ISAs to nonagenarians. "Many of our clients are retirees, choosing to invest their portfolios in line with their values," says David. He concedes that millennials are an important driver of sustainable investment, but social and environmental interests are apparent in all age groups, from Greta Thunberg to Sir David Attenborough.

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Commercial feature

Doing the right thing for your investments

Responsible investment by socially conscious investors can not only do good, it can do well

Environmental, social and governance (ESG) have come sharply into focus, driven further and faster by the climate crisis and the coronavirus pandemic. We are at an inflection point in society and the global economy where the social and profit motives are intersecting and no longer oppose each other.

Off balance sheet costs that were thus far borne exclusively by society are now going on balance sheets due to changes in investor tolerances. Capital intensity, margins and valuation are now directly impacted by ESG and this will only accelerate as investment flows intensify into these responsible strategies.

Investors are actively seeking out new investment opportunities, optimising opportunities to do well and at the same time do right. As one of the first alternative investment firms to develop and launch an ESG integration strategy, Waratah Capital Advisors is at the leading edge.

Three years into our research and development on ESG, it became clear that by applying a new lens to investing, one which emphasises ESG factors, we could better identify and manage inadvertent ESG risk factors.

It also allows us to identify incremental opportunities to deploy capital in new high-growth areas of economic activity, such as water technology, battery materials, waste mitigation, renewable energy and energy-efficient real estate, to name a few.

Early on, in the product development phase, we realised we were not going to be able to rely on third-party ESG data sets, which are based on voluntary corporate ESG reporting. In response, we set out to build a team and a proprietary scoring methodology that is dynamic and based on primary research with company management teams and asset site visits.

"By closely scrutinising a company's activities through first-person fundamental research, combined with industry and third-party data, we can subjectively allocate an ESG score in real time that accurately reflects how it is performing," says Blair Levinsky, co-founder and chief executive of Waratah.

"A prime example is the water industry, where we are long on companies that build valves and fittings for municipal infrastructure and desalination plants, and short on companies that use large diesel trucks to deliver water jugs to office buildings."

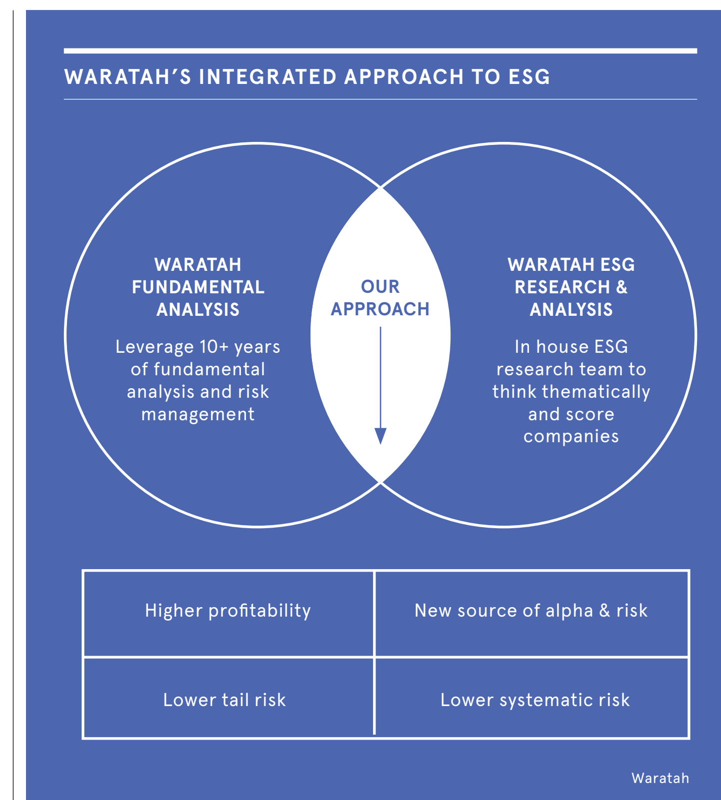
Jason Landau, portfolio manager at Waratah, adds: "We have a non-exclusionary approach to ESG and do everything on a relative basis. We believe the greatest way to make a change is by encouraging an industry to do better. We feel that incorporating ESG into our fundamental investment analysis not only makes us better investors, but is the right thing to do."

A bad ESG-scoring company making improvements can have a greater positive change on society than a good-scoring company getting incrementally better. To address this dynamic we established a framework, which can go both long and short on a negative-scoring company.

That's where Waratah fits in with its resilient approach to investing, reflecting our name, derived from a tough Australian plant that grows in the harshest environments. By taking a long-term view and integrating ESG both long and short, Waratah strives to achieve sustained compound growth and protect our investors' capital while leading the way towards more sustainable investment.

Waratah is a Canadian investment manager with a track record of more than ten years and over C$2 billion of assets under management. Our alternative ESG philosophy is to compound wealth and protect against loss through integrating ESG factors into our fundamental investment and risk-management analysis.

> We feel that incorporating ESG into our fundamental investment analysis not only makes us better investors, but is the right thing to do



For more information about ESG investing with Waratah Capital Advisors please call +1 416 687 6791 or email info@waratahcap.com

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WARATAH

LOCAL AUTHORITIES

Powering a low-carbon future

UK local authorities have pledged to work towards cleaner air and greener energy, but with limited government investment, they are having to resort to other funding sources

Jonathan Weinberg

Bristol, which was the first UK city to declare a climate emergency, is just one of many local authorities battling to attract investment in green projects

From Bristol to Leeds, Swansea to Manchester and Nottingham to Edinburgh, local authorities are facing one of their biggest challenges in decades; how to finance projects to solve climate change at a local level as they transition to a low-carbon future for their communities.

Many have pledged to shift to 100 per cent clean energy by 2050 to reduce air pollution and cut related deaths, while ushering in new energy-efficient measures across homes, businesses, transport and infrastructure.

However, central government funding for such innovative initiatives can't ever finance the number of projects on the table, leading to cash-strapped councils seeking development capital from the private sector.

Such green finance initiatives are now increasingly recognised as a lucrative choice by private investors, but there is still a lack of confidence, often due to issues over market clarity, alongside inconsistent government policy and ever-changing regulation.

As director of UK100, Polly Billington heads a network of more than 100 local authorities committed to the 2050 pledge. Her organisation's members collectively campaign for greater central government assistance for local clean energy while sharing best practice.

She says: "Local authorities' budgets are tight, but their commitment to acting on climate is strong. They want to see that investment in rebuilding the economy is aligned with meeting our net-zero target as a country and are keen to develop partnerships with the private sector to make it happen. But they struggle with capacity and know-how."

To combat this, UK100 is backing the idea of a net-zero development bank to work with local projects to gain private finance. Billington adds: "Without this kind of savvy deployment of taxpayers' money to give the private sector confidence, we could miss our climate targets and the huge opportunity to rebuild our country in a way that leads the world in climate action and benefits the people who live in our communities."

From county council to city council and among combined authorities, the collective will, if not the funding, is there to make clean energy a reality.

In its latest report, *Accelerating the Rate of Investment in Local Energy Projects*, UK100 says there is potential to unlock more than £100 billion of investment in local energy systems by 2030 through partnership approaches, but this requires £5 billion of initial development funding.

Projects include battery storage, an increase in renewable fuels, electric vehicles (EVs), and heat-led projects in homes and workplaces.

In Bristol, the first UK city to declare a climate emergency, a number of pilots are underway through its City Leap plan, which aims to combine significant private investment with innovative projects and community-led initiatives.

Mayor of Bristol Marvin Rees says: "In Bristol's One City Climate Strategy we have mapped out the investment opportunities that will help create carbon-neutral energy and transport systems. Cities like Bristol are a catalyst to help facilitate investment by the private sector.

"We have developed our pioneering City Leap initiative to create an energy partnership which will attract over £1 billion in investment to help create a carbon-neutral Bristol by 2030.

"In recent years we have invested around £60 million in sustainable projects, including the development of our own wind turbines, the introduction of a low-carbon heat network, establishing an EV charging infrastructure and energy efficiency upgrades to more than 10,000 social homes."

At Cheshire Energy Hub, £700,000 of government funding has delivered E-Port, a low-carbon smart energy system in the Ellesmere Port area, with private partners adding an additional £230,000 to meet total costs. Those behind the project say the blueprint could generate investment of £100 million in the region by 2025.

Ged Barlow, Cheshire Energy Hub chair, explains: "UK industry has reached a critical phase in its journey to net zero. In the North West we are beginning to see early signs of initiatives such as public-private co-investment in low-carbon infrastructure, public sector underwriting of industry's low-carbon investment, simpler and more supportive planning regimes to support low-carbon technology, and a more holistic approach from industry and local government.

"They are working in partnership to attract low-carbon investment from national government and heavyweight institutional energy infrastructure investors."

In Leeds, city council leader councillor Judith Blake says private investment will be essential, especially when it comes to decarbonising the city's housing and transport.

"Local authorities like Leeds can be very effective at making the case for, and helping to facilitate, change-making private investment, but only if markets are receptive and there is a case to be made," she says.

Interest does appear to be growing. Earlier this month, chancellor Rishi Sunak announced plans to issue the government's first Sovereign Green Bond in 2021, subject to market conditions, and Labour has called for greater green investment to create hundreds of thousands of new jobs.

Banks are on board too, with Barclays setting a target of providing £100 billion of green financing by 2030.

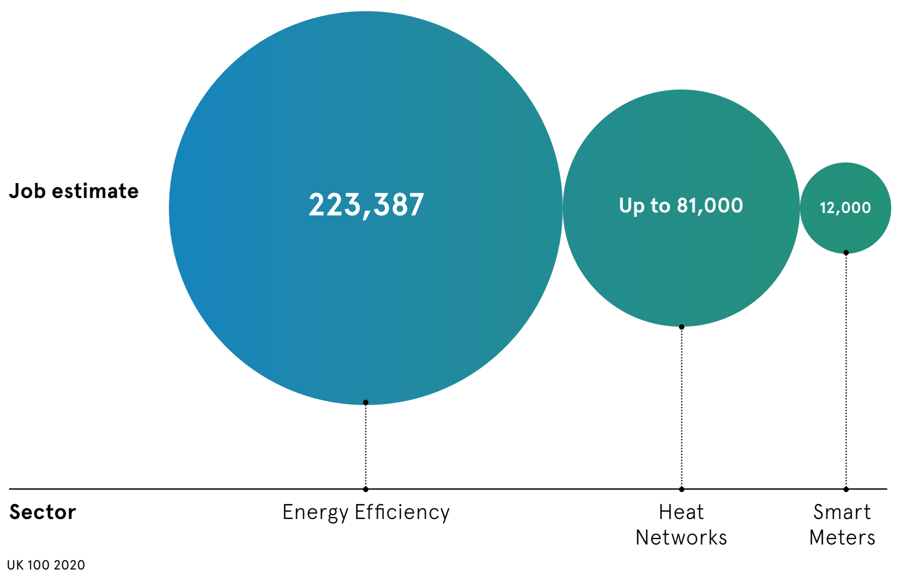
Siemens Great Britain and Ireland is a private company invested in the project. Writing in the UK100 report, its chief executive Carl Ennis says: "There is an urgent need to scale up local energy investment across the UK if we are to have any chance of meeting net zero by 2050. This requires a national effort with government, business and the public all playing their part."

Councillor Sally Longford, deputy leader of Nottingham City Council, which has the ambition to be the first carbon-neutral city in the UK by 2028, concurs. "Green investment is critical to facilitating this shift, enabling risk to be shared across the private and public sectors, but crucially enabling innovative technologies and solutions to be deployed, stimulating new green jobs and the low-carbon economy," she concludes.

> Local authorities' budgets are tight, but their commitment to acting on climate is strong

LOCAL GREEN PROJECTS REVITALISING THE WORKFORCE

The number of jobs which are projected to be created in each sector by 2030.



UK 100 2020

OPINION

The time has come for investors to raise the bar on respect for human rights

In 2020 we find ourselves facing a culmination of global crises: the climate emergency, growing economic inequality and the coronavirus pandemic. As we work to build back better, a growing chorus of voices is now calling not simply for a regeneration of the status quo, but for a new more people-centric economic and societal model, fit for the 21st century.

Key to this is respect for human rights, the promotion and protection of which is already enshrined in international law.

Just as for all businesses, institutional investors have a responsibility to respect human rights. Yet, despite this expectation being formalised by the United Nations (UN) and the Organisation for Economic Co-operation and Development (OECD) nearly ten years ago, there is still a significant implementation gap.

At the Principles for Responsible Investment, a UN-supported initiative with more than 3,000 global investors representing over $100 trillion in assets, we believe the time has come for institutional investors to raise the bar on respect for human rights.

In the past, social issues have often been treated by investors, corporates and governments alike as the black sheep of the environmental, social and governance (ESG) family, consistently passed over in favour of environmental and governance themes, which can often be more tangible and easier to measure.

However, the pandemic has brought social issues to the fore, highlighting and in many cases exacerbating them. Issues such as workers' rights, health and safety, forced labour and employee relations, to name a few, are now firmly on the radar of global investors. These are all, at their heart, human rights issues.

Interest in social issues, or human rights issues, was already beginning to grow in the past few years and the pandemic has only served to accelerate and increase the urgency of this trend.

In fact, this growth in recognition of social issues parallels a wider acceleration in ESG investing and both a mainstreaming and maturing of responsible investment philosophies and practices. While there is much more to be done on this agenda, for the first time investors are beginning to widen their focus and thinking on sustainability.

We're now seeing a shift from investors thinking purely from a risk-and-return standpoint to also considering their role in driving real-world outcomes and ultimately the impact of their portfolios on the wider world; the world in which we all live and the world in which the members of their pension funds will retire. This, critically, includes consideration for human rights in line with the UN Guiding Principles (UNGPs) on Business and Human Rights and to help achieve the UN Sustainable Development Goals.

Even for those investors not yet making the leap to shaping outcomes, the materiality of many human rights concerns, even by the narrowest definition, is undeniable. The price is high for the many companies which have miscalculated human rights risks on lack of materiality grounds.

In addition, there is increasing momentum in governments championing human rights and embedding their expectations of investors in hard law and regulation. With further regulation on human rights due diligence in the pipeline, and policy-making converging around the UNGPs and OECD standards, investors must future-proof their approach to ESG issues now by implementing these frameworks.

The climate emergency, decades of widening economic inequality and the COVID-19 crisis are all drawing focus on investors' behaviour. As a result, expectations from employees, beneficiaries, clients, governments and wider society are continuing to grow. It's becoming increasingly clear that respect for human rights is not only a "nice to have" or the "right thing to do", but is a material consideration, critical to investors to more effectively and proactively manage a range of complex ESG issues. ●

Fiona Reynolds
Chief executive
Principles for Responsible Investment

Commercial feature

While COVID-19 occupies minds, climate risk threatens portfolios

The impact of the novel coronavirus continues to be front of mind for many investors, but ignoring the looming threat from climate change could spell disaster for the planet and their portfolios, according to ISS ESG data

Climate change is being overlooked as the world continues to battle the coronavirus pandemic, despite warnings that it is a much bigger threat than the virus.

As the pandemic took hold and countries found themselves locked down, the International Energy Agency warned the COVID-19 outbreak could significantly slow the world's transition to clean energy, suggesting it was up to governments to utilise green investments during the slowdown as a way of bolstering economic growth. It comes as the United States, under President Donald Trump, officially withdrew from the Paris Climate Agreement, which was set up to limit global warming to two degrees above pre-industrial levels and was signed by 197 countries.

Dr Maximilian Horster, head of climate solutions at ISS ESG, says many countries have only just started to address climate change. "Globally, we are at the tip of the melting iceberg. China's September 2020 announcement to be net neutral by 2060 is just the beginning," he says.

"However, COVID-19 won't slow down investor focus on climate change. If anything, it accelerates the need for understanding potential corporate winners and losers of the crisis. With stimulus money tied to climate targets under new European Union agreements, better environmental performers have a better chance to be bailed out." Air France is a case in point. The government agreed it would be willing to rescue the failing airline, but on condition it becomes "the most environmentally respectful airline", said Bruno Le Maire, French minister of the economy and finance. Generally, investors' interest in climate change stems from two mindsets: those who want their money to have a positive impact on the world, and those who acknowledge there is climate-change regulation and so need to measure risk.

"The situation for investors looking for data has become easier, but we've come from a world where there was too little data, to a point where there is almost too much," says Horster. "We help investors to cut through the noise with our automated tools which measure climate risk in seconds."

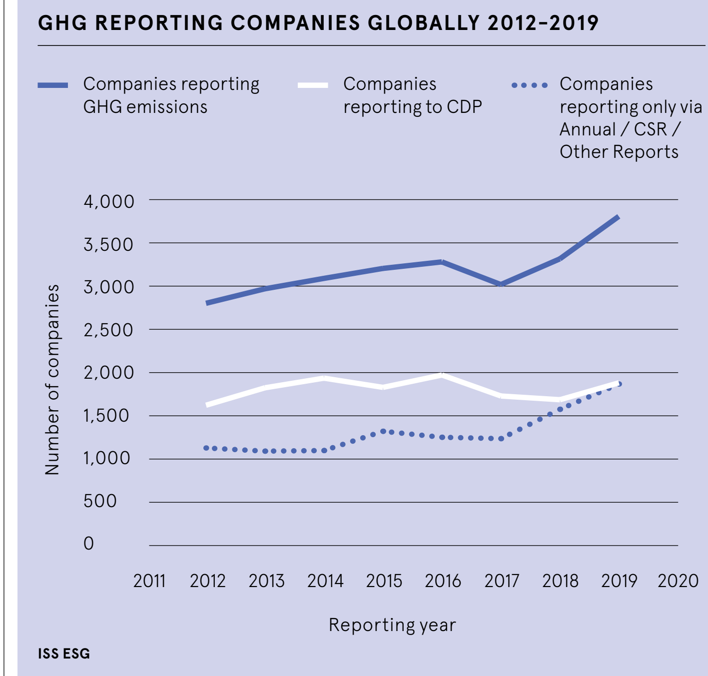
ISS ESG Climate Solutions provides investors with data and analytics on more than 25,000 companies worldwide and currently has over 600 data points per company, just on the topic of climate change. "For example, investors cannot simply focus on excluding the energy sector to claim fossil-free investments," Horster explains. ISS ESG Climate Solutions' data highlights companies such as Coca-Cola Amatil, Toyota and Berkshire Hathaway with a substantial exposure to fossil reserves, although they are not categorised as oil and gas companies. A further challenge for investors is there are more than 60 investor-focused climate reporting regimes across the globe, some of which are voluntary and some mandatory. Horster also acknowledges that regulation is one of the main drivers of new products coming to market, particularly the European Union's green financial system initiative, a series of guidelines and reports that form part of a broader action plan on sustainable finance.

"The past year-and-a-half has seen quite a lot of investment products launched which are Paris Agreement aligned or climate-transition focused, the two benchmark concepts that were given out by the regulator," he says.

"These benchmarks have a good chance of establishing themselves as the regulator leaves it to the market to develop matching products. This is creating a new level playing field for badly needed innovation."

> We help investors to cut through the noise with our automated tools which measure climate risk in seconds

GHG REPORTING COMPANIES GLOBALLY 2012-2019



ISS ESG

For more information please visit www.issgovernance.com/esg/climate-solutions/

OPINION

'Hedge funds are building products that meet investors' needs; regulation must not stymie this'

For many of us, sustainability and climate change have become key areas of focus; and the financial sector is no different. Institutional investors, such as pension funds and insurance companies, as well as private citizens and policy-makers are all keen to direct investments towards greener activities. Our concern, though, is that well-meaning rules could at times hinder rather than support this trend.

The EU is the most advanced region globally when it comes to rules on this topic. Last year it adopted several pieces of prescriptive regulation on "sustainable finance", which apply to all financial market participants, including those not headquartered in the EU but who serve EU clients. This action plan primarily aims to protect investors from "greenwashing" and empower them to better understand the myriad environmental, social and governance factors (ESG) related to their investments.

Central to this is the EU's so-called "Taxonomy", the first ever attempt to classify economic activities according to their sustainability. As such, when the Taxonomy enters into application (January 2022), it will be possible to measure an investment fund's "sustainability" based on its alignment to this 70-sector classification. As an example, a company building cars emitting less than 95g of CO_2/km with tires complying with noise labelling requirements will be considered as sustainable by the Taxonomy.

As a necessary complement to this, investment managers will also be required to be transparent about the level of sustainability of their funds. The EU has therefore adopted a series of disclosure rules, to ensure that an investor, when being presented with a "green financial product", knows what he/she is going to get.

Asset managers will also have to either consider the potential negative effects of their investments on environmental or social aspects – the so-called "principal adverse impact" - or explain why they chose not to consider these. These "principal adverse impacts" will be publicly disclosed, on an aggregated basis, on the websites of asset managers who have made the choice to consider them.

In short, the EU's rules are set to transform industry practice when it comes to the investment process and disclosures in the area of sustainability.

The hedge fund community is already working hard to deliver sustainable strategies to investors that seek them. But it is important that disclosure rules recognise that many hedge fund strategies have no material impact on E or S issues – think of investment strategies linked to currency investments, sovereign bonds or interest rates. The EU's rules are therefore limited as they focus primarily on funds investing in companies, but do not consider investment in other assets or strategies.

For example, a hedge fund can take a short position (sell borrowed shares to benefit from their price drop) on an oil company with high CO_2 emissions to diminish its exposure toward a possible environmental risk. There is nothing in the adopted EU regulations today which knows how to deal with short selling - one of the most basic risk management techniques used by hedge funds to deal with sustainability risks.

The final – and perhaps most important – challenge in sustainable investing currently is the lack of reliable data. Investment managers have been requested to consider, manage and disclose their ESG exposures, but very few investee companies publish a reliable and easily accessible set of non-financial data. Policy-makers seem to have put the cart before the horse by requiring fund managers to disclose data which does not yet exist. This is why we are actively making the case for upcoming regulatory changes to improve corporate disclosure.

Sustainable finance is here to stay. Hedge funds are already working hard to build products that meet investors' needs. But regulation must ultimately be designed to support this trend, rather than stymie it. ●

Jack Inglis
Chief executive
Alternative Investment Management Association

LEGISLATION

ABCs of the ESG alphabet

In an effort to clear the often murky waters of environmental, social and governance investment, a wave of regulation is gathering momentum

Rachael Revesz

Unsplash, Sara Kurfeß

The EU Taxonomy for sustainable finance is a first-of-its-kind move towards protecting ESG investors and standardising who can label themselves as a "green" fund.

It is clear that the number of responsible and sustainable investment funds is only going in one direction: up. According to the Investment Association, UK retail investors poured more than £7 billion into these funds during the first ten months of 2020.

But legislation regarding environmental, social and governance (ESG) investing is less straightforward. In the void, multiple definitions, acronyms and industry body initiatives have sprung up, all working to define and monitor the booming number of ESG funds.

Without doubt, legislation is necessary, as Amy Clarke, chief impact officer at Tribe Impact Capital, warns: "In the absence of regulation, there is a growing sense that we may be approaching another product mis-selling scandal."

Here are the most important moves from industry bodies and regulators to standardise the ESG industry.

EU Taxonomy

The European Union Taxonomy for sustainable finance is the most substantive regulation that has challenged the financial industry on green issues.

From March 2021, asset managers will be required to start upping their reporting game, stating to what extent their green funds, or any fund that claims to have environmental objectives, are aligned with the EU Taxonomy framework.

Helena Viñes Fiestas, global head of stewardship and policy at BNP Paribas Asset Management, explains there are 32 indicators asset managers have to report on, covering everything from due diligence and remuneration to adverse impacts on society and the environment.

"This concept of 'double materiality' is where you not only have to take investment risk into account, but also the risk to society and the environment, and it will cover everyone from asset managers and banks to data providers and credit rating agencies," she says.

There is no minimum requirement of alignment that a fund has to hit to be marketed as green, unless the asset manager wants to adopt the new "Ecolabel" for retail investors, but even then the threshold has not yet been set. Instead, the European Commission points to "minimum safeguards" being the Organisation of Economic Co-operation and Development Guidelines on Multinational Enterprises and United Nations Guiding Principles on Business and Human Rights.

Due to Brexit, the Taxonomy will only apply to UK asset managers selling their products to European investors.

MiFID II

The Markets in Financial Instruments Directive is being updated by the EU to require product providers to ensure investors' wishes around ESG are considered when recommending a product to invest in.

"It will be compulsory to ask clients' ESG preference and to match that," says Clarke at Tribe Impact Capital. "The only obligation attached to the Taxonomy is the reporting side of things. The MiFID amendment is a smart way to get around the fact that the Taxonomy has not set a minimum requirement of alignment."

In other words, the update to MiFID will ensure end-investors do not become victims of greenwashing and unfounded green claims.

TCFD

The Task Force on Climate-Related Financial Disclosures was set up by the Financial Stability Board to provide a way of reporting common climate-related financial risk disclosures that could be used by companies to enlighten their investors.

"A lot of the big institutional managers have to get their heads around what sustainability really means," says Clarke. "The work of the TCFD has pushed them to look at the level of climate risk embedded in their portfolios and has put pressure on the industry in general."

But the UK is not a member of the TCFD. However, this year the Financial Conduct Authority (FCA) proposed a new rule which would require UK-listed companies to comply with the TCFD recommendations and, if not, explain why.

Groups including the Investment Association claim the rule doesn't go far enough and have called on the government to make TCFD disclosure mandatory for all listed firms, not just those with a premium listing. The FCA completed consultation in October and will finalise its position this winter.

However, the TCFD is not the only body working to harmonise how the financial industry goes about disclosing climate-related information. The International Organization of Securities Commissions, the global regulatory body, is working to translate all reporting frameworks, including that of the TCFD, into one model which can be used consistently across the board.

Pension Schemes Bill

At the moment, UK pensions have a lot of free reign, evidenced by movements like the Make My Money Matter campaign which, in the absence of other requirements, encourages pension providers to commit to all their default pension funds being carbon net zero by 2050.

But the Pension Schemes Bill, making its way through the UK parliament, could change things fast. It would require large pension funds to disclose climate-related risks to assets in their portfolios by 2022, in line with TCFD recommendations.

"The bill will be very welcome; whether it sets the bar high enough remains to be seen," says Clarke. "ESG is a good starting point, but it's really an entry-level activity. The Dutch and Scandinavians are well ahead of us on this."

A recent report from the Pensions and Lifetime Savings Association said pension providers should adopt TCFD guidelines around reporting and provide more training for pension trustees on ESG issues.

Responsible Investment Bill

Following the lead of Scandinavian countries, charity ShareAction and the All-Party Parliamentary Group on Sustainable Finance have proposed a Responsible Investment Bill, which would increase directors' accountability for their investment decisions, allowing beneficiaries of investment schemes to seek judicial redress.

Going much further than the Pension Schemes Bill, it would require default and green pension funds to align with the Paris Agreement, and for this to be enforced by the FCA and the Pensions Regulator. It would also force pension providers to ask beneficiaries about their ESG views.

"This proposal is absolutely grounded in pension funds delivering the strategies which are in the best interests of their beneficiaries, trying to break out beyond the straitjacket of profit maximisation," says Catherine Howarth, chief executive of ShareAction.

"It's not trying to prescribe how pension schemes invest, rather it takes them through a process to check they've thought in a more holistic way about strategies that will deliver the best long-term outcomes to the people they owe duties."

UK Stewardship Code

A decade after the Financial Reporting Council introduced the UK Stewardship Code, for the first time it is now necessary for signatories to integrate ESG considerations into their decision-making. The new code has also moved away from "comply and explain" to "apply and explain", minimising the opportunity for greenwashing.

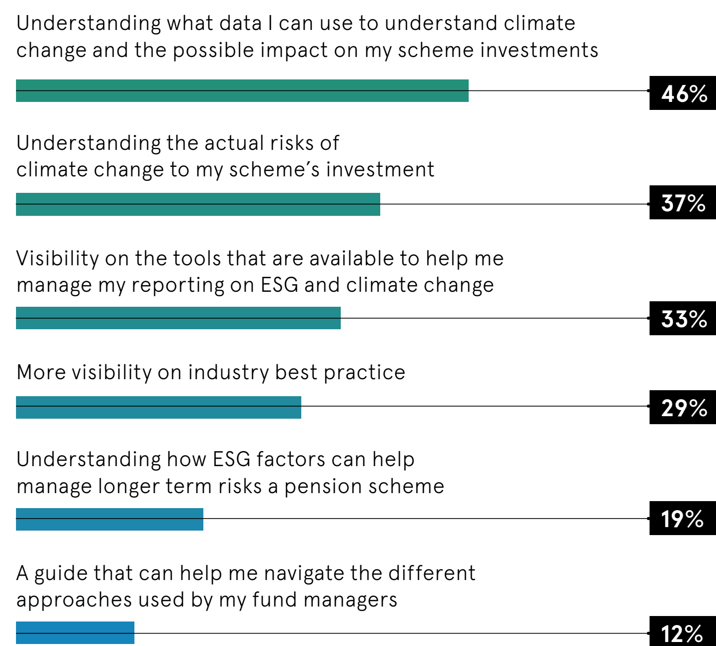
As the code states, as of 2020 signatories must "systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities".

B Corporations

Not all the positive reform and effort is on the investors' side. There are growing numbers of so-called B Corporation companies, totalling more than 3,500 around the world and 250 in the UK.

These companies are like for-profit versions of social enterprise, placing equal emphasis on people, planet and profit. A recent example is Bookshop.org, which raises sales for independent bookshops. Some are listed and certified B Corps include subsidiaries of very large companies such as Unilever and P&G.

"B Corps emphasise a growing movement from shareholder to stakeholder capitalism and in the process strengthen the link between business and society," says Tribe Impact Capital's Clarke. ●



OPINION

'Investors are ready to follow the call, but achieving net zero cannot be the responsibility of the market alone'

As Joe Biden begins to shape his presidential transition in the United States, it is clear action on climate change is a campaign priority that will drive forward his new administration. A net-zero commitment from America would bring 63 per cent of the world's emissions under such a pledge, following bold announcements from the European Union, Japan, South Korea and, importantly, China, that have all joined the UK's pledge this year.

Such commitments signal increasing momentum towards a sustainable future. The UK, as host of United Nations COP26 climate change conference and president of the G7 next year, must demonstrate bold leadership, particularly in one of the UK's most important industries: financial services.

In a policy victory for the UK Sustainable Investment and Finance Association (UKSIF), chancellor Rishi Sunak has announced world-leading UK regulations requiring climate risk reporting across the economy. Investors will soon have access to a large volume of data on the impacts different climate change scenarios could have on their investments. However, more work is needed and the UK must remain closely aligned with other major regulatory developments, particularly from the EU.

Understanding risks alone will not be sufficient to prevent catastrophic climate change. For this we need focused and extensive sector-by-sector decarbonisation plans and to understand the government's climate priorities and direction of travel. To this end, the government's plan for a Green Industrial Revolution is a great step forward.

To help ensure finance flows into areas of the economy that will contribute most to the UK's net-zero plans, the government needs to continue sending strong market signals and back these up with new funding, legislation and, if necessary, regulation developed in partnership with the finance industry. Investors are ready to follow the call of business secretary Alok Sharma to align with the Paris Agreement and finance the transition, but achieving net zero cannot be the responsibility of the market alone.

With growing hopes for a viable coronavirus vaccine, 2021 should mark the year we focus on building back better. Our aim must be to restore our economy and our communities in such a way that actively drives us towards the low-carbon future we need to see and to which the government and sustainable finance community have committed. Following our departure from the EU, the UK should create a national green development bank with a net-zero mandate to support the COVID-19 recovery and drive the UK's green infrastructure revolution.

The COVID recovery, much like the transition to a net-zero economy, must place people at its heart. These efforts must prioritise the development of the future we want, simultaneously maximising the benefits of this transition for jobs, livelihoods and the economy.

With the eyes of the world on the UK in 2021, the government has a unique opportunity to shape the future of sustainable finance across the globe, achieving our shared ambition for the UK to become the global leader in green finance. Setting a bold direction of travel, developing a flexible, innovation-friendly and internationally aligned regulatory environment, engaging closely with the industry and ensuring action follows plans, will drive this ambition and ensure capital flows to the industries most essential for a low-carbon future.

UKSIF was founded to bring together institutions across the finance industry to build a fair, inclusive and sustainable finance system that works for the benefit of society and the environment. Next year, as we celebrate our 30th anniversary with a growing membership, we are publishing a bold future vision placing sustainable finance and investment at the heart of the UK's efforts to lead the world in a just transition to a clean economy. The transition task is substantial, but we have the imperative to succeed and our members are ready for the challenge. ●

James Alexander
Chief executive
UKSIF

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