SUSTAINABLE INVESTING

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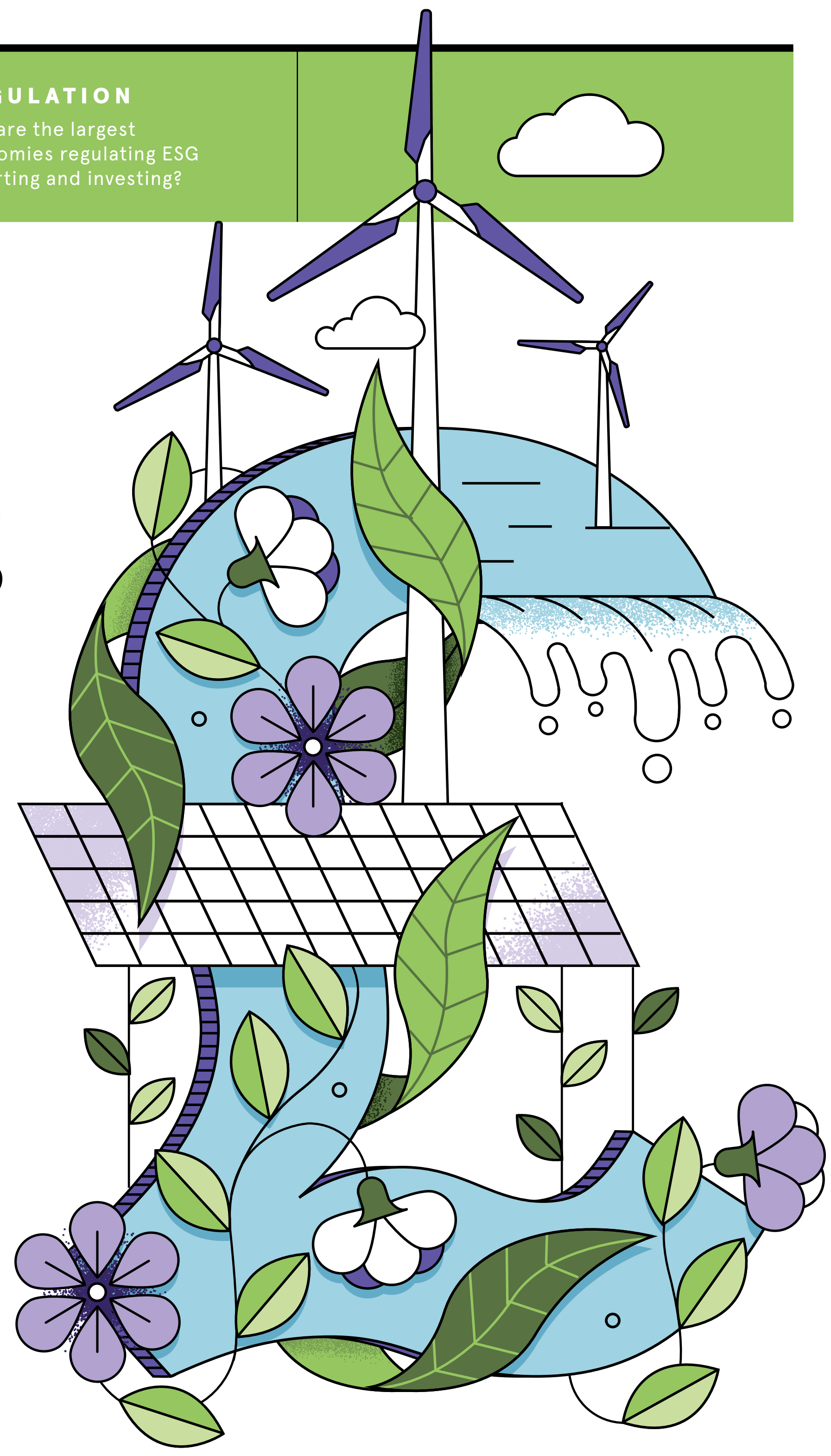
IMPACT

Moral money: ESG v impact investing

There are growing doubts about the transparency and financial performance of ESG-rated investments. Could impact investing be a better bet?



Daniel Thomas

The rapid rise of environmental, social and governance (ESG) investments should be viewed as a remarkable success. But amid the excitement, critics have cast doubts on the transparency and measurability of ESG, warning that some listed businesses may be abusing the label.

Investors and consumers alike want businesses to do more about issues such as climate change, diversity and human rights abuses. The corporate world is responding. According to Bloomberg, money held in sustainable mutual funds and ESG-focused exchange-traded funds rose globally to $2.7tn (£2.35tn) last year – up by 53%.

But concerns remain. For example, the ratings agencies that grade ESG performance tend to focus on a firm's efforts to offset harms and risks linked to sustainability, rather than its actual products and services. This explains why electric carmaker Tesla was excluded in May from a list of the most socially responsible companies in America – the S&P 500 ESG index – while the likes of Amazon and oil and gas giant ExxonMobil remained in place.

Ratings agencies also rely on ESG data provided by companies themselves to make their assessments, making it harder to avoid so-called greenwashing. Researchers at Columbia University and the London School of Economics recently compared the ESG records of US companies in 147 ESG fund portfolios with those in 2,428 non-ESG portfolios and found the former group had worse compliance records when it came to labour and environmental rules.

Even the financial performance of ESG investments is now being called into question – this at a time when rising inflation and interest rates are rattling markets. Some investors are seeking alternative ways to invest ethically.

One increasingly popular choice is impact investing. Unlike an ESG investment, where financial returns and risks take priority, impact investments first and foremost aim to produce a tangible and measurable social good. That could mean backing companies that are helping to roll out clean energy, sustainable agriculture or microfinance, or public services such as healthcare and education.

"Impact investing means focusing your investments on companies and activities deemed to be actively solving the world's problems," says Becky O'Connor, head of pensions and savings at the investment platform Interactive Investor and author of *The ESG Investing Handbook*. "Focusing on impact is a neat way of avoiding some of the contradictions and disappointments that can ensue from ESG labels, which are far less prescribed."

> **Focusing on impact is a neat way of avoiding some of the contradictions and disappointments that can ensue from ESG labels, which are far less prescribed**

According to the Global Impact Investing Network (GIIN), a US non-profit advocacy group, impact investing offers an effective alternative to philanthropy and can be deployed in both emerging and developed markets. Investments are expected to make a return, but these will vary depending on an investor's goals. According to a 2020 survey, GIIN found 67% of respondents were targeting risk-adjusted market-rate returns, 18% were content with below market-rate returns, and 15% expected something closer to capital preservation.

Yet the market, while growing, remains small. At the end of 2019, GIIN estimated that around 1,720 organisations globally had about $715bn of impact-type investments under management.

This may change as big players dip their toes into the impact market. In 2020, the global asset manager Schroders partnered with Big Society Capital, one of the UK's leading impact investors, to launch the Schroder BSC Social Impact Trust. This London-listed fund invests in firms tackling "pressing social problems" and aims to achieve a sustainable return.

"We are targeting the deepest level of impact and find organisations who use all their resources to contribute to solutions to social challenges such as homelessness, mental health, unemployment and fuel poverty," says Andrew Beal, managing director of investor engagement at Big Society Capital. About two-thirds of the trust's investments are linked to inflation, he says, and it is targeting returns equivalent to CPI plus 2% once it is fully invested over three to five years. "The trust's investments are largely uncorrelated to mainstream markets, so we would expect the portfolio to show resilience in times of market volatility," Beale adds.

Another well-known impact investor is Nesta Group, which was set up by the government but now operates as an independent charity. It targets private equity-style investments, in areas such as ed tech, food tech and climate tech, investing both from its endowment and on behalf of private investors.

Lisa Barclay, its executive director of investments, says a wave of impact funds have launched over the past few years, thanks in part to the "mainstreaming of ESG". But while impact isn't higher risk than other asset classes, she says, it does come with "a different sort of risk" and won't be for everyone.

"We do expect impact investment to grow, but it will likely remain a relatively niche investment strategy."

In truth, the market's challenges are many. Impact investors are under greater pressure to report and measure the social and environmental performance of their investments, which can be complex. Some complain of a lack of suitable exit options for impact investments, a shared definition of what constitutes an impact investment, relevant professionals with the right skills to manage these assets, and research on market trends, practices and performance.

"The pool of investments that match true impact criteria is of course narrower [than ESG] – so this can mean it is harder to diversify, which is one of the golden rules of investing," O'Connor says. "However, if you are committed to planetary betterment and you want all of your money to be too, this may be a risk you are willing to take."

Glen Yelton is head of ESG client strategy for North America and EMEA at the fund manager Invesco. He agrees that impact strategies are "only truly actionable in a limited number of asset classes and markets", even if impact investing often has a "clarity to it" that other categories of ESG investing may lack.

Eoin Murray, head of investment at the fund Federated Hermes, says that no one form of sustainable investing is better than the other; it very much depends on what clients want to achieve.

"Impact can be made through engagement and investing in companies that are capable of additional transformation, whereas integrating ESG will be sufficient for others and is equally capable of playing a role in the necessary transition."

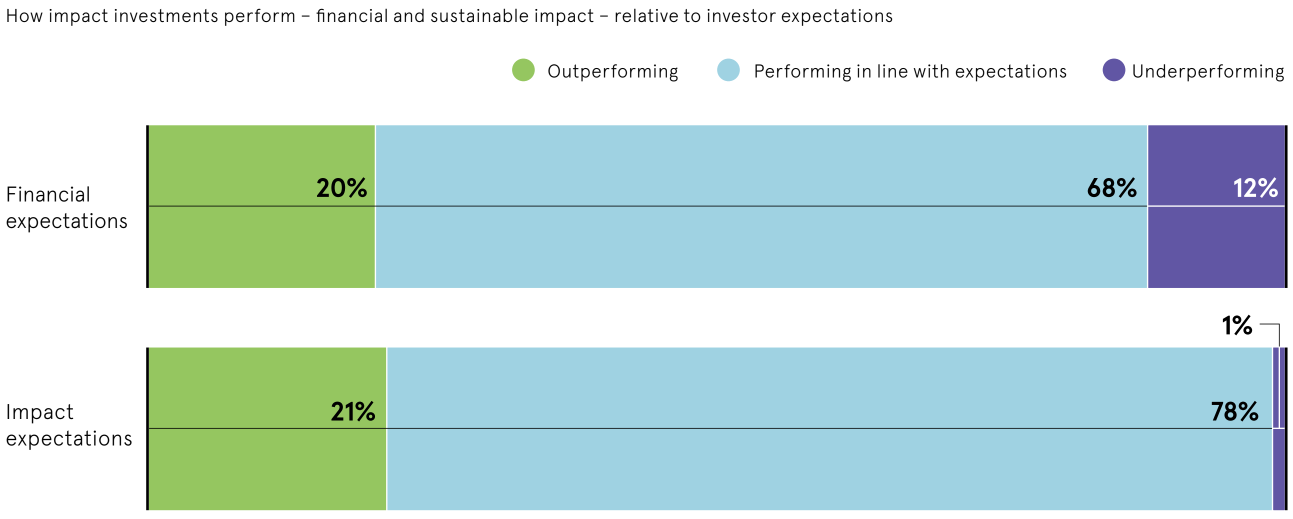
He accepts that ESG as a concept is facing a backlash as firms jump on the bandwagon, but thinks there will be a shakeout that leaves the industry "in a far better place".

Every type of ethical investment strategy comes with trade-offs and professionals must be honest about this. But experts warn that a lack of clarity over terms and labels in the industry can lead to disappointment.

City regulator the Financial Conduct Authority is looking into sustainable fund labelling and will publish a consultation paper in September. It hopes to categorise funds and make more explicit options available to investors, including impact. Until then, those who wish to put their money to work responsibly would be wise to do their own research thoroughly. ●

EXPECTATIONS VERSUS REALITY

How impact investments perform – financial and sustainable impact – relative to investor expectations



GIIN, 2020

67%

of investors are targeting risk-adjusted market-rate returns on their impact investments

66%

of investors cite impact washing as the main challenge for the industry – this is by far the biggest concern among investors

GIIN, 2020

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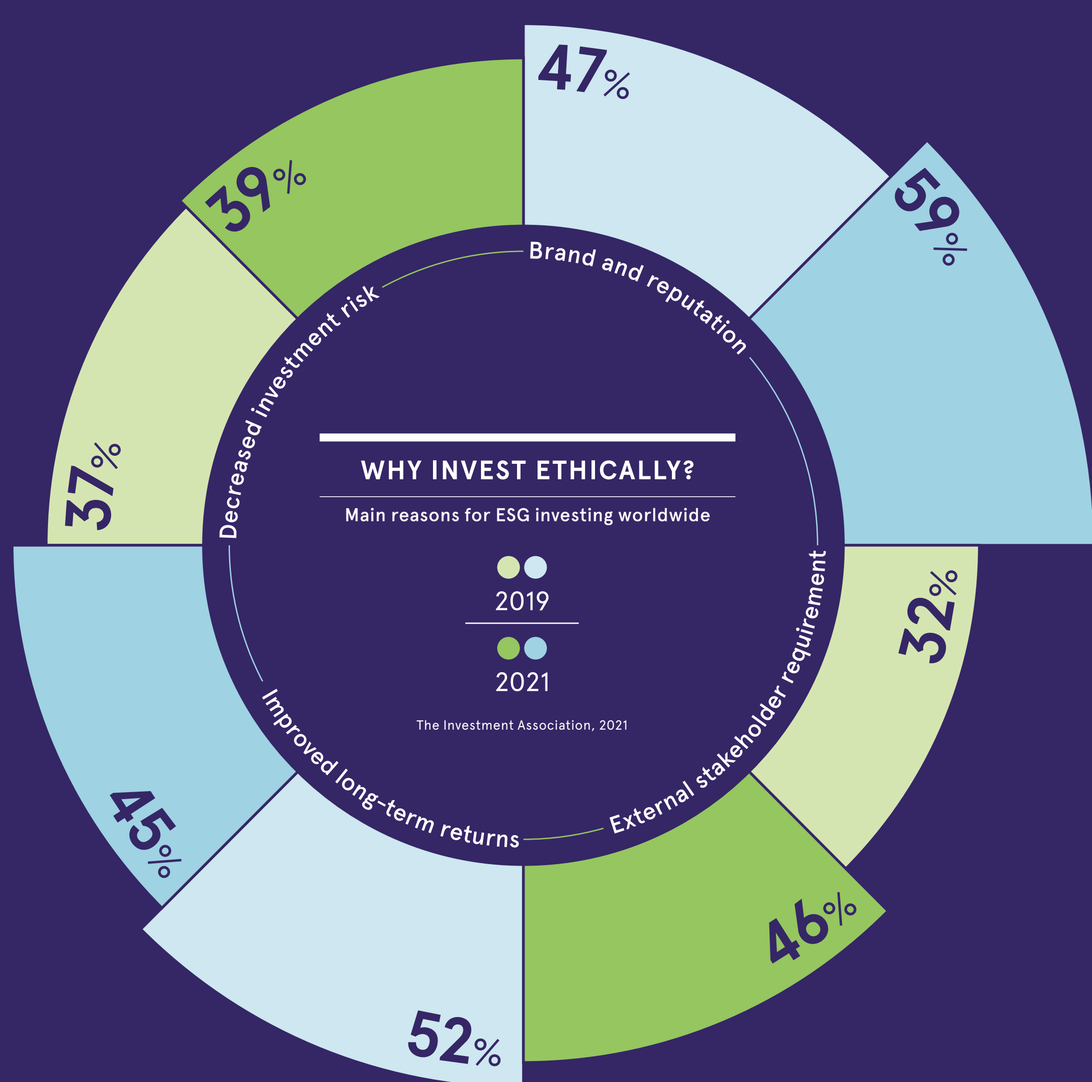
MOTIVATIONS, OBSTACLES AND STRATEGY

Different investors have different reasons for investing ethically. For some it's about actively helping to make a better world, while others are beholden to their stakeholders. Whatever their motivations, ESG investors are facing regulatory complexities, staff shortages, fears of greenwashing and general economic uncertainty. So how are investors minding the risks while maintaining the rewards?

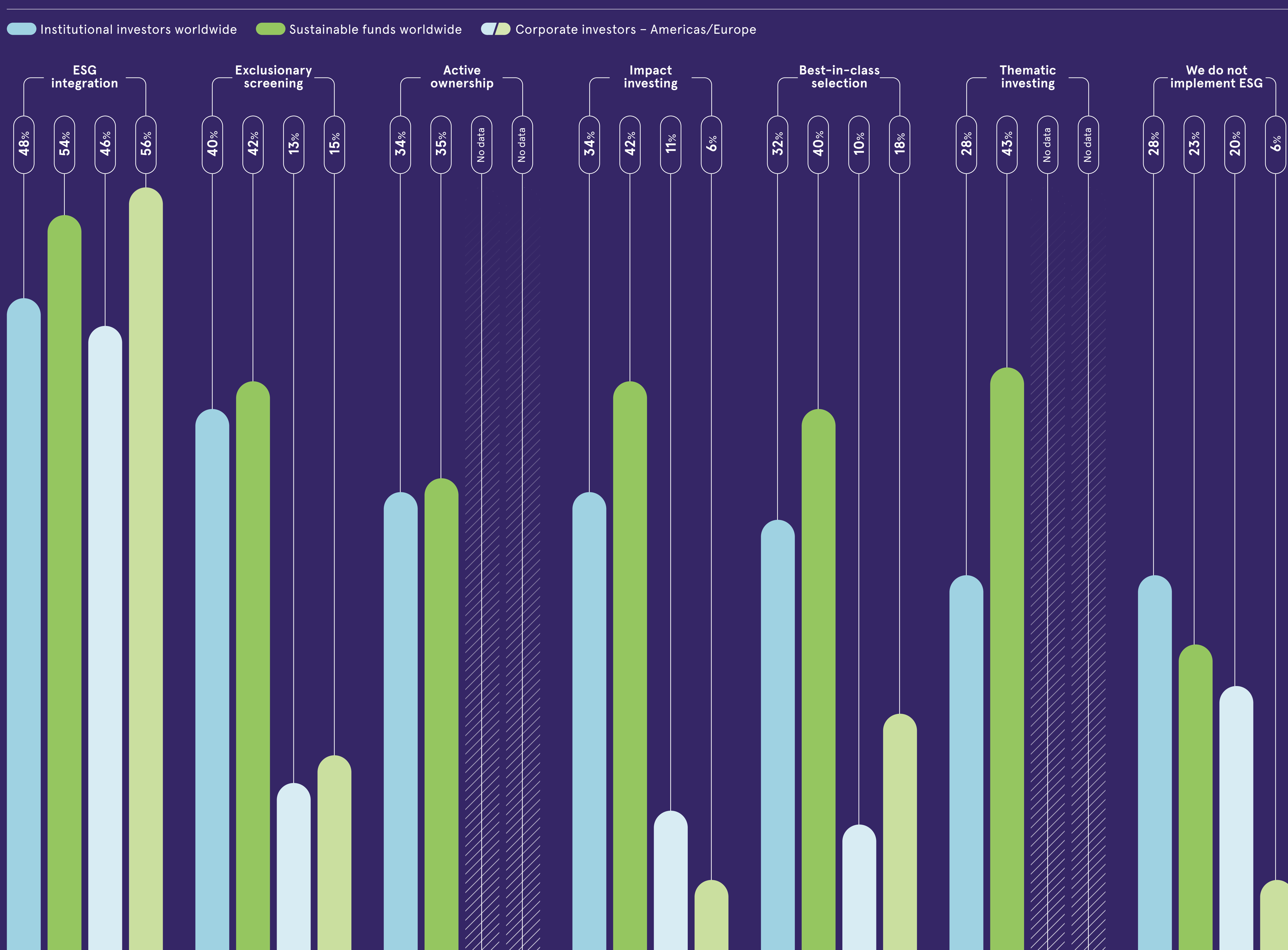


WHAT'S STANDING IN THE WAY?

Main obstacles to broader ESG adoption worldwide

HSBC, 2021

MOST COMMON ESG STRATEGY OR METHOD OF INVESTING



Natixis Investment Managers, 2021; Deutsche Bank, 2021

Reframing ESG: empowering investment decision-making

With climate change affecting every industry and business, investment decisions must now consider ESG commitments, actions and activities. How can data and insights ensure investors make successful decisions?

ESG INVESTMENTS ARE INCREASING, BUT NEED TO RISE FURTHER

27% Year-on-year increase in energy transition sector investments
BloombergNEF, 2022

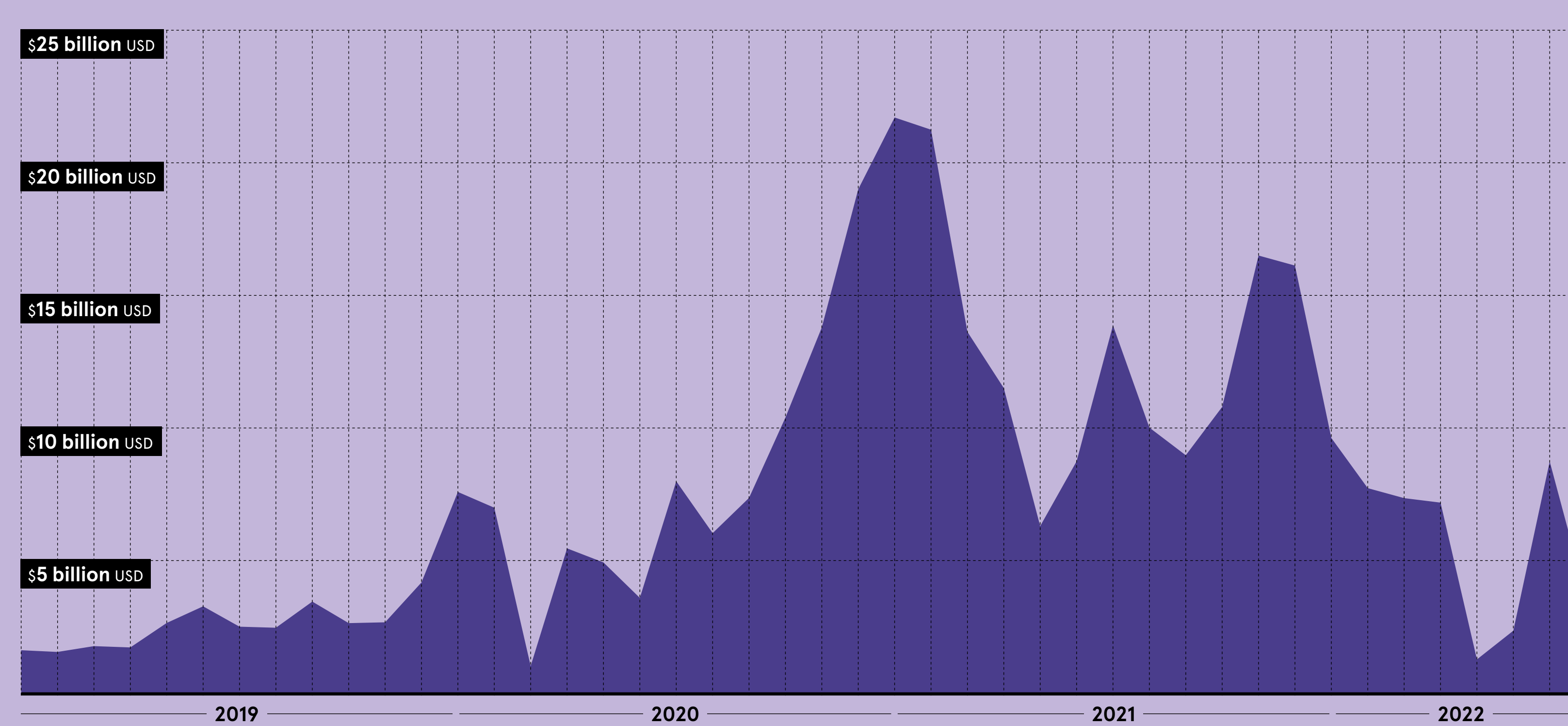
39% Share of companies that mentioned climate change in their 2021 CSR reports, up from 27% in 2020
Bloomberg Intelligence, 2021

$755bn Total value of the investments in the energy transition sector in 2021
BloombergNEF, 2022

$4tn Average investment required between 2026 and 2030 to ensure global business is on track to reach net zero by 2050
BloombergNEF, 2022

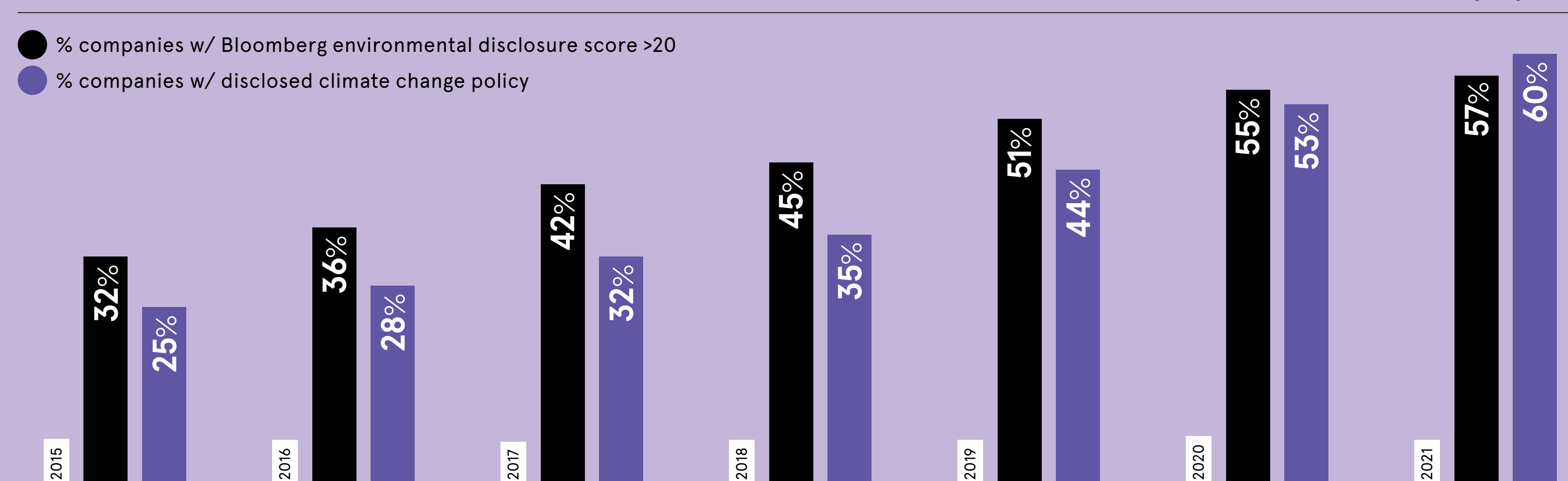
ETF NET-FUND FLOWS SHOW APPEAL OF SUSTAINABLE BUSINESSES

Bloomberg Intelligence, 2022



RUSSELL 1,000 COMPANIES COMMITTED TO ESG SWAY INVESTORS

Bloomberg Intelligence, 2022



According to a recent report by the New Climate Economy, transitioning to net zero is set to deliver up to $26tn in investment and job creation opportunities by 2030. But unless investors are using a reliable platform to help them sift through rhetoric and company promises, they are left without a holistic picture to correctly assess opportunities.

For instance, take a cement company that naturally has high carbon emissions. To reduce emissions, this company then launches a project to offset carbon emissions and issues a sustainability-linked bond to finance this project. As a result, this company looks on track to meet both its targets and government legislation and investing in this company's stock or in this bond suddenly looks pretty favourable to an investment firm.

Good investment, right? Not necessarily, says Patricia Torres, global head of sustainable finance solutions at Bloomberg LP.

"When Bloomberg calculates a carbon intensity score for this company to help investors compare it with peers, we don't take into account this carbon offset," she says. "We base our scores on how much companies actually emit, so cement companies that emit less compare better to others. Also, investment firms in the EU, or who market their funds in the EU, need to report to clients how much of their portfolio aligns with the EU's taxonomy of sustainable activities, which provides clear definitions for which activities are sustainable."

Bloomberg's ESG investing capabilities and data platform can place a company's sustainability plans in a wider, global context showing investors how much of the company's activities will meet wider policy, in the case of the cement company, the EU taxonomy. Torres says: "In this example, for this company to pass the test the carbon intensity per tonne of cement it produces needs to be lower than 0.469 tCO2e. The taxonomy also allows offsets to be counted under some conditions. This shows why investors need solutions that provide them with a holistic picture."

Bloomberg can help investors uncover unexpected findings and investment opportunities as well as shine a light on poor investments. The provider recently launched a government climate scores screen that helps investors understand not only the emissions outlook for a country, but also how well it is doing compared to other countries in terms of carbon transition, power sector transition and climate policies.

"Interestingly, China, which represents 35% of global CO2 emissions, has a relatively low score compared to other heavy emitters like the United States," says Torres. "Investors can easily find out how different countries are transitioning, and that China is a leader in the development of solar and wind power capacity."

She adds that data rom the company's BloombergNEF (BNEF) analysts shows that China accounted for 53% of global investments in renewable energy in the first half of 2022. "This impact can be seen now in the Shanghai Shenzhen CSI 300 Index, which has 15 companies in the renewable energy sector today, versus seven last year."

While evidence indicates that climate change is real, ESG investors everywhere suffer from a lack of quality data to do anything about it, missing anything from how much greenhouse gas corporates emit to how they will be affected by physical risks caused by extreme weather conditions, or transition risks such as government schemes to support green energy production, or innovation in the clean tech space.

"As we say at Bloomberg, 'You can't manage what you can't measure,'" says Torres.

ESG assets under management are anticipated to reach $50tn by 2025, says Bloomberg Intelligence, as corporates seek to adapt to severe climate-related weather impacts such as rising sea levels, heatwaves and droughts, or mitigate those risks by shifting their production to satisfy government regulation, especially with the Paris agreement attempting to halve global emissions by 2030 and limit global warming to 1.5 degrees Celsius by end of the century.

However, according to Harvard Business Review, 70% of corporations are not even confident in the ESG data they disclose. With that in mind, Bloomberg is taking action by driving industry collaboration through the Task Force on Climate-related Financial Disclosures and the Glasgow Financial Alliance for Net Zero. This will provide comparable data from companies to assess how they will be affected by physical and transition risks.

Torres says: "Our data solutions help investors understand a company's carbon footprint and compare it to peers based on a range of different ESG criteria and also assess if it is on track to reach its climate targets and its exposure to climate risks. Bloomberg also provides tools to help investors assess their investments and reporting obligations in line with sustainable finance regulations, which are no longer box ticking exercises, but require investors to shift their investment strategies and decision-making."

> We help investors understand a company's carbon footprint and compare it to peers based on a range of different ESG criteria

This ESG data is also reviewed to Bloomberg's editorial standards making sure it is fully transparent – investors simply need to click to get to the source document of the data – and has real breadth, ensuring each profile covers 80% of operations or employees. Beyond climate change data, Bloomberg is also working to help investors understand wider environmental and social impacts of companies, e.g. on water and biodiversity, or on their diversity, equity and inclusion practices and interactions with the communities in which they operate.

"We also provide ESG indices that fund managers use to benchmark their portfolios or launch ETFs," says Torres. "Many fund managers, mainly in Europe and the UK, shifted their investments to Paris-aligned benchmarks, which are based on methodologies aligned with EU benchmark regulation. It's important to be rigorous when selecting a benchmark, to make sure it is based on credible data, uses rigorous methodologies, and a clear, well-defined process for how companies are included or excluded."

Understanding the rapidly changing climate and its impact on companies and their long-term outlooks, investors will need to turn to reliable sources of data and analysis in order to make educated decisions around investments.

Take big steps forward in sustainable finance, not big risks. Learn more at bloomberg.com/explore/esg

Bloomberg

Q&A

How can investors assess climate risk?

In a recent Bloomberg survey, 85% of executives said they have started assessing climate risk but taking positions can seem as much fortune telling as data modelling. **Edo Schets**, product manager for climate finance solutions at Bloomberg LP discusses how investors can assess risk when it comes to ESG

Q Why is climate risk so difficult to assess?

A Climate-related risks are more difficult to measure than 'traditional' financial risks because, rather than looking at historical patterns as is customary in risk management, climate change looks forward. Furthermore, as climate change is a process, not a single event, its impacts evolve and may be very different in the next five to 10 years compared to the next 20 to 30 years.

In 2020, the Australia bushfires are estimated to have cost $5bn and wildfires on the US' west coast led to damages of $20bn. Floods in Pakistan led to $1.5bn that year, and we are seeing a similar situation in Pakistan today. Climate scientists have shown that, in the best-case scenario, global warming causes rises of 1.5 degrees Celsius by 2100, and physical risks will be bigger than today. So, investors are rightly concerned, but how to manage this risk is very much the issue they are trying to solve for now.

Q How can investors assess climate change as a financial risk?

A Broadly, climate risk can be divided into two interrelated risks: physical risk to assets from flooding and storms, and risk associated with transitioning to a low carbon economy, for example if fossil fuel reserves need to be written off.

Firms with large loan or mortgage portfolios should ask themselves how they will be affected when rising sea levels, droughts, and other adverse conditions become the new normal. Firms with exposures to heavy emitters should evaluate their positions if more stringent regulation comes into force.

From there, there are at least three challenges. The first is to find the right data as climate change is not well reflected in historical data. We therefore rely on scenarios and climate models to understand the risks we are exposed to going forward. The second challenge is, while many areas will be exposed to more severe weather such as extreme heat or rainfall, it is difficult to estimate how these unprecedented events will impact financial valuations. The third challenge is, even if you have the data and models to estimate what could happen, it is hard to know what to do with this information given the huge uncertainties around which future is most likely.

Q What does the future hold for those assessing climate risk?

A Will the future be one where we successfully transition to a low carbon economy – with high transition risk but low physical risk as a result – or will we fail to take sufficient action and face much more severe physical risks? We are working on a solution that looks at all possible futures and provides risk estimates based on the probabilities of all the various outcomes.

However, companies often do not disclose complete data on how they are exposed to climate risk, and when they do, the provision of this data is voluntary and unaudited, and not always reliable. But as new disclosure rules take effect notably with the help of the framework developed by the Task Force on Climate-related Financial Disclosures, the quality, consistency and availability of data will improve.

> Climate-related risks are more difficult to measure than 'traditional' financial risks because, rather than looking at historical patterns as is customary in risk management, climate change looks forward

Q How will government strategies on climate change impact investors over the next two to five years?

A Firms have a variety of reasons for considering climate risk, and regulations are an important piece of the puzzle. Momentum to reduce greenhouse gas emissions is building, with numerous UN initiatives and the creation of the 450-firm Glasgow Financial Alliance for Net Zero. Governments and regulators are increasingly asking financial firms climate questions. The survey we conducted recently showed that regulation and disclosure requirements came in first for 25% of respondents. The Bank of England also asked banks and insurers to evaluate how holdings could evolve if countries limited emissions in line with the Paris agreement, or if intervention is limited and economies instead face physical risk from extreme weather.

INTERVIEW

Ahead of COP27, a growing role for private investors

With climate talks looming, private investors are in the spotlight. They could make a huge contribution, says **Clare Shine**, director and CEO of the Cambridge Institute for Sustainable Leadership

Oliver Balch

Heads of state will soon gather in Sharm el-Sheikh in Egypt for the UN's latest round of global talks. Such summits are nothing new, but the 27th Conference of the Parties (COP27) is unique in one regard – the number of private investors set to attend.

Global finance has moved from the sidelines to the centre of climate discussions, a trend that will be on display at the meeting in November. But just how important is the private sector in beating the climate emergency? For Clare Shine, director and CEO of the Cambridge Institute for Sustainable Leadership, its role is huge.

Take Africa. For the continent's 54 nations to meet their climate transition plans, an extra $1.29tn (about £1.12tn) will need to be found between now and 2030. But public funders simply do not have pockets deep enough for this, says Shine, who describes the recent emergence of investor-led alliances around climate action as "nothing but positive".

As an example of "important progress", Shine points to the Glasgow Financial Alliance for Net Zero (GFANZ). Launched ahead of last year's climate summit in Scotland, the GFANZ coalition represents more than 450 financial firms with more than $130tn in assets – enough to make government budgets look like petty cash.

But the climate clock is ticking. As Shine observes: "A lot of people are saying, 'Show us the progress on delivering that funding [and] how it is actually feeding through into concrete investments."

The danger, of course, is that the investor presence is branded as greenwashing. Levels of trust at global climate talks, especially between the industrialised North and the developing South, are fragile at the best of times. Add to this the "growing trend for litigation" among climate activists and investor participation could easily backfire, Shine says.

> We're not just talking about global public goods here. We're talking about human survival

Shine's advice is twofold. First, get delivering. That's easier said than done, she admits. Climate mitigation and adaptation projects are frequently small in scale and high in risk, two attributes that complicate matters for institutional investors. Added to this, many such projects will necessarily be found in climate-hit regions in developing countries, and the list of hurdles grows.

"You have high up-front costs, many technical challenges, unproven business models, poor data, currency fluctuation, unpredictable business environments and potential for political upheaval, to name just a few," Shine notes.

That said, none are beyond the wit of policymakers to fix, she insists. Investment guarantees, credit-risk enhancements, and commitments by public funders to cover 'first losses' are just some of the mechanisms available to assuage investors' fears.

Early precedents are already emerging. Shine points to the Green Guarantee Company. Another product of last year's COP, this government-backed finance firm acts as a guarantor for climate bonds issued in global capital markets.

An even simpler step is to encourage knowledge sharing. Multilateral lenders like the World Bank have been in the carbon finance game long enough to know how best to structure carbon deals, as well as the loss ratios to expect. These are "typically lower than expected", Shine notes.

In the spirit of "radical transparency", Shine calls on public funders to open their books and help private investors navigate a new and often daunting marketplace.

What sounds easy in principle, though, may prove harder in practice. Trust is in short supply. Public finance institutions exist primarily to promote development, not financial returns. Little wonder, then, that the prospect of for-profit investors 'muscling in' on climate finance makes some feel queasy.

Shine gets this. A qualified barrister, she has worked in and around the development field for three decades. For this reason, when she says that the public financiers are growing more open to working with their private-sector peers, it carries weight.

"Some multilateral development banks are beginning to ask themselves some tough questions about their responsibility and their role for accelerating transformation."

In this role they will not be funders of climate action, as in the past, but mobilisers of private capital, argues Shine. She is keen not to be misunderstood: this isn't about public investors stepping back. Rather, it's about creating a new kind of investment ecosystem grounded in public-private cooperation.

Again, she has been in the development game long enough to know that talk of a public-private partnership often covers "a multitude of sins". Nonetheless, without welcoming private investors into the climate tent, any hope of achieving a climate-stable future is effectively dead.

Such a prospect is unconscionable, Shine insists. "We're not just talking about global public goods here. We're talking about human survival. And that means thinking about scale, reach and longevity of future climate efforts. No one institution, no one government, no one region can do this alone."

So what's the ideal message for private investors in Sharm el-Sheikh? Demonstrate some deliverables. That starts with hard figures on capital deployment, but it doesn't end there. External observers will also be on the lookout for credible long-term investment strategies and governance measures.

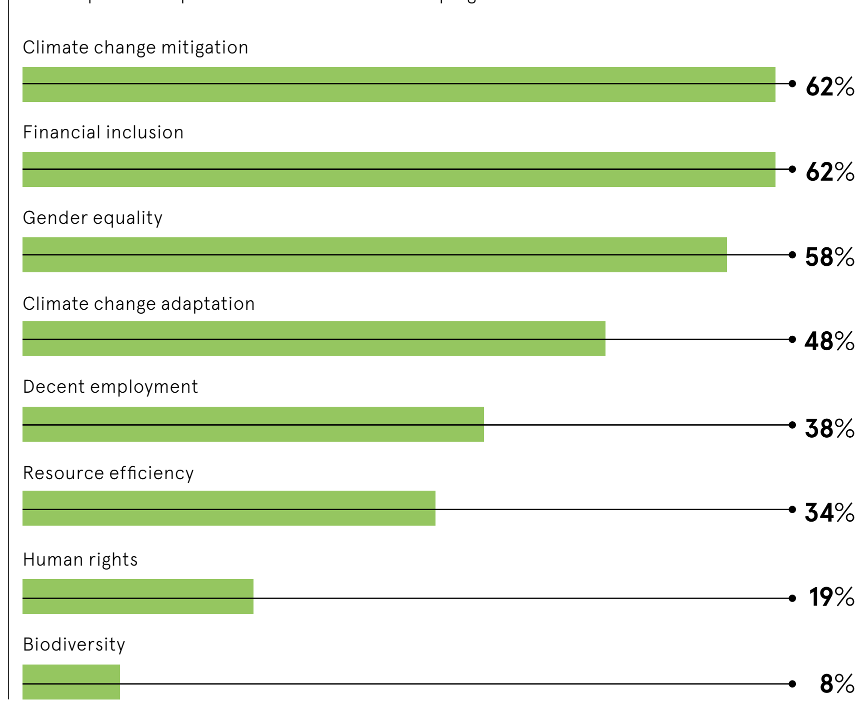
Second, investors should listen and learn. Obvious as it sounds, Freetown is not Frankfurt, says Shine. Seize the opportunity of a climate summit in Africa to discern which investment approaches translate across borders, and which do not.

"One thing that excites me about COP27 being in Egypt is the chance it gives us to learn from each other, especially in terms of seeing how people are thinking through a net-zero transition in a region where climate change is really biting."

Finally, make clear that a climate-secure future is "doable". Investors, like every other segment of society, have a "duty of hope", says Shine. Where they differ is having the money to turn hope into action.

PRIORITIES FOR SUSTAINABILITY

Most important impact areas for banks in developing countries



UNEP, 2021

Commercial feature

How ESG is shaping the economy of tomorrow

Environmental sustainability is changing how people invest and transforming the business landscape, says **Jean Rogers**, global head of ESG at Blackstone

Q How has the rise of ESG altered the investment landscape?

A Environmental sustainability is an increasingly important part of how organisations deliver value to their customers and shareholders. We believe companies that consider it will ultimately be more resilient and therefore have a competitive edge. The investment landscape looks totally different than it did in previous decades. More capital has been flowing into the ESG space, particularly into energy transition. To reach net zero by 2050, experts estimate that it will take $3.5 trillion in investments – every year. Investors can and want to play their part.

Q How are you helping to drive environmental sustainability at Blackstone?

A Since it first began operating in Europe 25 years ago, Blackstone has invested over $100 billion to back the companies and industries powering the future.

Across our businesses, we see an opportunity to invest an estimated $100 billion in energy transition and climate change solutions over the next decade, building on the approximately $16 billion we've committed to investments we believe are consistent with the broader energy transition since 2019. Several of our platforms enable this investment, including funds within Blackstone Energy Partners, which focus on climate solutions and energy transition in private equity. We do this in two ways: by investing in environmental services companies and by helping companies implement environmental improvements. DESOTEC is an environmental services company that helps industrial companies clean the air, water and soil around their sites through its fleet of 2,700 mobile filters. Last year, this fleet contributed to the reduction of 110,000 tonnes of CO_2-equivalent emissions

We have also invested in the NEC Group, a leading live events business, whose Birmingham campus will deliver one of the largest electric vehicle (EV) charging hubs in Europe, capable of charging 32 EVs at a time in just 15 to 30 minutes.

Q How can investors work with companies within their portfolio to make them more sustainable?

A Some investors leverage existing greenhouse gas footprints to inform their investment decisions, choosing to divest from the highest-emitting companies and assets. Others have set their sights on 2050 and committed to a net-zero portfolio over the course of the next several decades. Both approaches, however, disregard the need for urgent, deep decarbonization during the time of ownership. We believe this can help put companies on a trajectory to make their portfolio more sustainable for the long-term and achieve their goals.

We focus on what we call the carbon delta, or the carbon emissions that we can abate during our holding period.

At Blackstone, we have quantified our work on Greenhouse Gas (GHG) Delta by setting a numeric target focused on actionable improvement over the short term. We have committed to a goal of reducing carbon emissions by 15% in aggregate for all new investments where we control the energy use over the first three years of ownership – a commitment that is informed by climate science and focuses on near-term, urgent reductions.

To measure progress reducing GHG emissions, it is important for investors to have a robust, measured GHG footprint of their holdings. We are investing significant resources in getting this right at Blackstone. Our portfolio includes approximately 12,000 real estate assets and over 250 portfolio companies. A rigorous carbon accounting program is central to understanding our portfolio's GHG footprint. Our program will allow us to measure progress while also providing our investors with the data they need to measure progress against their climate commitments.

Q What is the future of sustainability in business and investing?

A Meaningful, measurable interventions that are material to a company's core business model – not just an add-on or nice-to-have – are needed to position a portfolio for the changes of the coming decades and deliver lasting value to investors. We believe that to make a company more sustainable is to make it more resilient and thus competitive. We're excited about the trajectory Blackstone is on and confident that we have the programs and people today that will help the companies in our portfolio build for tomorrow.

For more information, visit blackstone.com/investuk

Blackstone

The Kenyan gold mining industry still lacks regulation

James Wakibia/SOPA Images/LightRocket via Getty Images

DATA

Can technology measure the 'S' in ESG?

A growing number of companies use technology to measure social value. But how accurate and comprehensive is this reporting?

Simon Brooke

ESG investors, fund managers and companies are increasingly aware of the danger of greenwashing and the need for hard metrics. This is a particular challenge for the 'S' in the acronym.

It is becoming easier to verify a company's environmental impact and to a lesser extent, its governance. But assessing and benchmarking its social impact is much harder.

According to ratings agency Moody's, social considerations were the most frequently cited ESG issue during last year, driven by the Covid pandemic. But how can investors get a proper sense of whether a company's supply chains are free of sweatshops and modern slavery contraventions, for example?

Over the past few years, a growing number of companies and platforms have sprung up that aim to address the issue by providing clear, comprehensive and accurate metrics on social value. RepRisk and FactSet are among those that use algorithms, artificial intelligence (AI), social media sentiment, natural language processing (NLP) and data to measure social value and impact for the benefit of ESG investors, while helping companies manage their risk in this area. Technologies such as blockchain can provide more detailed, accurate and timely information about supply chains.

RepRisk, for instance, leverages a combination of AI and machine learning with human intelligence to systematically analyse the publicly available information of more than 200,000 public and private companies and more than 55,000 infrastructure projects in 23 languages.

"Essentially, RepRisk serves as a reality check for how companies conduct their business around the world – do they walk their talk when it comes to human rights, labour standards, corruption and environmental issues?" explains Alexandra Mihailescu Cichon, the company's executive vice-president for sales and marketing. "This perspective, in combination with a transparent, rules-based methodology and daily updates, ensures that our clients have consistent, timely and actionable data at their fingertips."

Social Value Portal helps businesses to quantify and communicate social, economic and environmental value creation. According to the company's CEO, Guy Battle: "Clarity about the social value initiatives that a firm is looking to deliver allows people on the ground – whether they are fund or asset managers, property managers, suppliers, occupiers or corporate employees – to pull in the same direction, target important initiatives and to help communities thrive. And the way you'll get that clarity is from a consistent and accountable framework to report and measure against."

But some investors are sceptical about the accuracy and helpfulness of the information that these technological evaluations produce. Sophie Lawrence is stewardship and engagement lead at Rathbone Greenbank Investments. She says that until there is a more comprehensive regulatory framework in place, requiring the disclosure of comparable, independently verified social data by companies, "We would caution against an overreliance on third-party ESG data tools, which use technology to scrape company-reported social data and aggregate it for investors.

"This approach risks creating an overly simplistic view of company performance."

Johan Vanderlugt is sustainable finance specialist at Van Lanschot Kempen, an independent wealth manager. The metrics employed depend on the AI techniques a data provider chooses to use, he says.

"Transparency regarding data and methodology is a challenge with traditional data providers like MSCI, Sustainalytics, and ISS ESG. And it remains even more so with AI ESG data providers.

"Ultimately, the quality of the data is dependent on the independence of the data source, and this is no different for social data than for environmental data."

There are numerous factors and variables to manage. The opportunities for different interpretations of facts and figures, though, are also extensive. Tiia Sammallahti is CEO and founder of whatimpact.com, a provider of technology that helps companies on social value through partnerships with charities. She takes the example of a food retailer donating to local homeless people.

"They may also automatically increase that value by including the wider benefits of homeless people being better nourished and therefore more empowered to move into employment or housing," she says. "But this doesn't necessarily take into account whether the food provided is healthy."

Sammallahti suggests that qualitative surveys and interview data could be more accurate and useful than figures published by the company concerned or metrics derived from algorithms. "The key is to combine tools that are robust in their proxy numbers with qualitative, evidence-based reporting that verifies the impact," she argues. "This enables a more accurate calculation to be matched with the results."

> **Ultimately, the quality of the data is dependent on the independence of the data source, and this is no different for social data than for environmental data**

Investors can and should demand more data from companies and data providers that is focused on the effects of the companies' policies and impacts, while paying closer attention to supply chains. So says Nicola Stopps, founder of ESG consultancy Simply Sustainable.

"This is key, because emerging evidence shows that the integration of 'S' criteria in investment analysis leads to improved returns, less volatility and lower downside risk," she says. "Better integration of social indicators in particular can help to identify more resilient and profitable investment opportunities that are already aligned with established and anticipated regulation. It is key for investors to develop a strategy for their total portfolio covering engagement, advocacy and integration. Voluntary policies and tick-box exercises are not a solution for avoiding investment risks."

Despite the complexities and contradictions, Ioannis Ioannou, associate professor of strategy and entrepreneurship at the London Business School, is generally optimistic. He thinks that competition across technology companies with different approaches plus new entrants into the industry will be beneficial in the longer term.

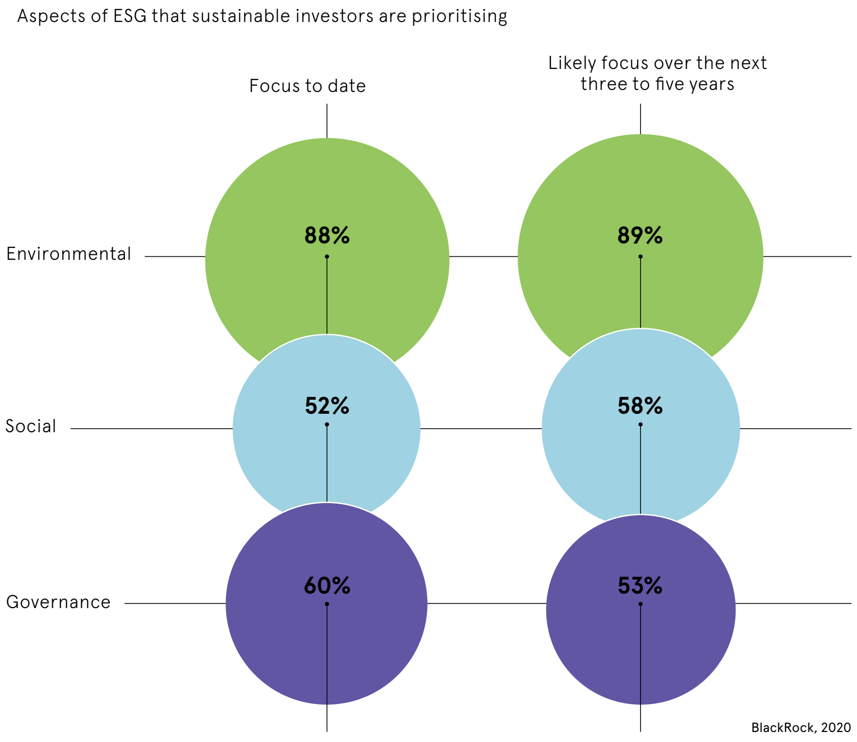
That's because ESG issues in general – and S issues more specifically – are complex and continuously evolving.

"We're far from being able to have a single optimal approach or one ideal metric that would adequately capture what's happening on the ground," he says.

"The more ideas we have, the more approaches and the more we criticise and scrutinise them as they compete, the higher the chances that once the industry starts consolidating, we will have metrics and approaches that are more robust."

HISTORICALLY NEGLECTED, BUT THE FOCUS ON SOCIAL-BASED INVESTMENTS IS ON THE RISE

Aspects of ESG that sustainable investors are prioritising



BlackRock, 2020

Commercial feature

Q&A

ESG takes centre stage on the tricky path to 'good business'

Lynne Baber and **Jon Williams**, partners in PwC UK's newly expanded sustainability practice, outline the evolution of ESG and the need for an integrated approach optimising profit and sustainability

Q How has the way businesses perceive and approach sustainability evolved?

LB Regulation has undoubtedly impacted stakeholder expectations, but so too has the wider climate change agenda, social movements like Black Lives Matter and #MeToo, and the pandemic. It is their collective impact that has moved sustainability and ESG from the margins to the mainstream of business. Sustainability is no longer something you can have as an adjunct – it's now firmly embedded within strategy, or it should be at least. If companies don't take this seriously it could threaten their reputation, share price, access to capital and talent attraction and retention. We talk about it as 'good business'. Previously, a good business was simply one that made financial sense. But to be a good business today you also need a sense of responsibility and, crucially, the ability to optimise both responsibility and profit.

The big challenge, of course, is how to do that. It's all about developing a strategy-led mindset rather than a compliance-led mindset. This allows for a broader set of considerations to be in scope, viewed through a 'no regrets' lens. For example, those who have to comply with regulations need to think beyond them and those who don't should nonetheless take a steer from them. The understanding of investors requirements, and the ability to attract and retain talent, is also key. Our PwC 2021 Global Investor survey found that 82% of investors believe that companies should embed ESG directly into their corporate strategy, and 49% said they would sell their investment if a company is not showing enough action to address ESG issues.

Our focus on helping organisations become good businesses is supported by a framework of 10 attributes. This framework is designed to help organisations think broadly but holistically, recognising the value of integrated thinking, which brings together purpose, commercial strategy and ESG strategy.

I worry that the rise of ESG as an asset class is the wrong way of thinking about it. What's important is the rise of ESG issues and how companies manage, integrate and communicate them to their stakeholders. Materiality is key. Sometimes companies need to be able to confidently say, I'm not addressing these issues because they're simply not material and I can't influence them or they don't impact me. That honesty and focus on what is material will resonate with investors. Once you've decided something is material, you need to articulate the impact on, in the simplest form, your earnings and assets, your plan to mitigate that impact and what it means for the value of the company. And as an investor or asset manager, how do I ensure the value that is either at risk or could be created, can be captured?

> **We want to live in a society that is balanced with nature, decarbonised and fair**

Q How is the rise of ESG impacting the financial ecosystem?

JW I've been doing this for over 20 years and for the first 10 years of that it was difficult getting anyone to take ESG seriously. Now everybody is talking about ESG and developing ESG products and services. Banks have to make sure they take ESG into account when lending. Insurers have to think about the climate impact on and of the infrastructure they underwrite. Asset managers need to understand what ESG issues mean for asset values and the development of new products to meet clients' rising demand for responsible investments.

Q COP26 was the year of the target, it seemed. Are the ESG targets we've seen publicised by companies achievable?

LB Companies face a huge challenge in achieving these targets. The importance of global, consistent standards is key. It's also vital to create the strategy and infrastructure that will successfully support a company's transition – whether that's around data, processes, governance or KPIs – away from the current disjointed state of ESG data. These kinds of frameworks are very mature within financial reporting, having had hundreds of years of development. But as non-financial reporting is still at a nascent stage, companies are struggling to understand the baseline they're working from and what to do to reach their goals. We fundamentally believe it isn't just about compliance – companies need a more integrated approach where they think holistically about purpose, ESG and commercial strategy. Sustainability shouldn't be the side track to your business reporting or strategy, it should be part of it, flowing all the way through to your annual report. For this to feel real, be real and to show it is lived and breathed in an organisation, business and sustainability reporting should be integrated and that should be very clearly reflected throughout the business.

Q What will be the impact on people?

JW Our Green Jobs Barometer estimates that 400,000 jobs need to be created in the energy sector alone in the UK to meet the requirements of the energy transition. Now, while there is a pool of 270,000 skilled workers in the oil and gas sector, 20% of them are expected to retire soon, leaving a gap of more than 200,000 jobs to meet the demands of net-zero targets.

I remember the miners' strikes of the 1980s and the impacts it had on whole towns because there wasn't a proper reskilling strategy to take people out of the coal mining industry and move them into new industries. The ability to reskill and retrain is going to be critical because if we don't then there will be stranded companies, jobs and economies in parts of the UK and globally. We've got 10 years – two business cycles – to limit climate change, and what we don't mitigate in those 10 years will then have to managed in the future. We need to ensure the people entering the workforce from schools and universities today will have skills relevant for tomorrow, not for yesterday.

Q How is PwC helping companies overcome these barriers?

LB Everyone talks about sustainability being a journey. We are very clear that any journey worth embarking on needs to have an exciting destination. Bringing all our expertise together in our newly expanded sustainability practice enables us to support clients across every stage of their sustainability journey, from strategy and implementation through to reporting. Our brand is based on trust around reporting. We can help companies build the credibility of their non-financial reporting, including climate reporting. We're helping them to develop and implement investment strategies for the future, and supporting them through a fair transition, including reskilling and upskilling, while engendering trust and pivoting risk into opportunity. That's also what we're focusing on in terms of our own business. We're developing a strategy-led mindset rather than a compliance-led mindset. PwC has had a market-leading sustainability practice for over 20 years, so it's almost like the market has caught up in terms of demand. Most recently, we've brought our technical expertise together with our pedigree for broader business acumen to create PwC Sustainability and ensure ESG strategy resonates with the C-suite leaders who are now being met with demands to do something in this important space.

> **Sustainability shouldn't be the side track to your business reporting or strategy**

Q What is the future of sustainable business?

JW I don't see any other outcome than sustainable business because, frankly, without a sustainable planet and sustainable societies, you don't have a viable business. We want to live in a society that is balanced with nature, decarbonised and fair. But I don't for one minute assume that we'll get there on a nice, clear linear path. We are going to have deviations because the rollout of technologies doesn't work as quickly, or because governments and priorities change, or because there might be further major economic or geopolitical shocks. Businesses need to be clear with governments about the urgency to do this. PwC can act as the connector between what we hear our corporate clients saying, what we hear our finance-sector clients saying and what we hear governments saying, ensuring we do our piece to drive towards a sustainable outcome. There is no alternative – sustainable business has to become business as usual. It's good business.

For more information, visit pwc.co.uk/services/risk/insights/good-business-framework.html

pwc

REGULATION

Tough climate: global ESG regulations and the UK investor

Sustainable investing around the world is governed by an alphabet soup of regulations. Here's what UK investors need to know

Nicola Tavendale

Governments and their financial watchdogs have accelerated their efforts in ESG finance in recent years, rolling out a dizzying array of rules and regulations. This has created a kaleidoscope of policies, differing vastly by geography and jurisdiction.

ESG issues were first mentioned in the *2006 UN Principles for Responsible Investment* (PRI) report, requiring the criteria to be incorporated in the financial evaluations of companies. But the regulatory output has truly ramped up over the past two years, as policymakers and officials work to ensure providers meet the necessary criteria.

> We must learn from the lessons of the EU SFDR implementation and build on those to create a framework that enables the UK financial market to transition

ESG is, though, a relatively new sector in terms of regulatory development and there are numerous criticisms and pitfalls created by the new rules. What's more, the lack of common definitions around environmental sustainability heightens the risk of firms engaging in 'greenwashing' – misleading investors and consumers about how green a product really is.

According to the UK Treasury, about 70% of the British public want their money to help make a positive difference to people or the planet. What, then, do investors definitively need to know about global ESG policies so that they can ensure they are making informed decisions?

The EU's Sustainable Finance Disclosure Regulation (SFDR), which came into effect in March 2021, remains the most significant piece of ESG regulation for UK investors. It is a key part of the EU's overarching ambitions to direct more capital towards truly sustainable investment firms and financial products. This includes an attempt to reduce the occurrence of greenwashing, increase transparency and standardise the labelling of investment products. SFDR sits alongside the EU Taxonomy for Sustainable Activities and the EU Climate Benchmark rules, all of which are part of the wider EU Sustainable Finance Action Plan.

SFDR applies to a wide range of financial market participants (FMPs), such as investment firms or institutions, and is intended to apply to all financial products marketed within the EU, including those managed by non-EU firms.

One important aspect of SFDR is that financial products can be classified into three Articles. There is Article 6, which covers products that do not integrate ESG considerations into the investment decision-making process. The Article 9 classification indicates a product that has sustainable investment as its main objective, while Article 8 focuses on products that promote ESG principles, but where ESG investing is not the key objective. Disclosures are required at both the firm and product level for financial products with an ESG focus – and for those without.

Agathe Kuhn is associate director of policy and legislation at global sustainability consultancy Longevity Partners. She explains that lenders targeting Article 8 or 9 classification for their funds under SFDR will need to disclose and consistently report against clear sustainability indicators to show investors that they are delivering on their green claims.

"The SFDR regulation has implications for UK financial market participants who market their funds in the EU. EU investors are increasingly keen on Article 8 and Article 9 funds and apply pressure on UK FMPs to reclassify their funds as such," she adds.

Alexandros Michailidis/Alamy

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The three European Supervisory Authorities have also recently published clarifications concerning draft regulatory technical standards. These included the financial product disclosures under the Taxonomy Regulation.

Emma Russell is head of the finance practice group at the international corporate law firm Haynes and Boone. She comments that, while UK investors are already feeling the effects of global ESG regulations coming into force this year, this is just the beginning. They should also be well prepared for ESG regulation to impact activity even more significantly, going forward.

"The SFDR – in particular – will require close attention from UK investors, as it sets out prescriptive standards to report against," she says.

"The new regulations will mean that ESG investing should touch increasing pockets of the market."

INSIGHT

'Future regulations must accommodate a range of investment strategies to support the transition to net zero'

Jack Inglis, chief executive, Alternative Investment Management Association (AIMA), explains why hedge funds are poised for sustainability and what investment managers expect from future regulation

Q How are hedge fund managers incentivised to pursue net-zero investing strategies and what are the challenges they face to implement them?

A Net-zero commitments and reporting have traditionally focused on a specific model of long-term, buy-and-hold, engagement-heavy equity investing.

But things are slowly shifting. Investor interest in whether hedge funds have established net-zero investment strategies and targets is on the rise, with questions about firm or product-level net-zero targets increasingly featuring in the due diligence process. This is incentivising hedge funds to consider how the net-zero philosophy might work in the context of their strategies.

This means confronting some of the challenges that arise in articulating a net-zero target for an alternative investment strategy.

A net-zero commitment entails defining what share of AUM will be managed in line with net zero by 2030, with a view to 100% coverage by 2050. But setting a credible interim target is not straightforward for a high-turnover portfolio that might change its composition radically by that date. This is not an issue that long-only, index-tracking portfolios have to grapple with, given they enjoy much less freedom than hedge funds in terms of what they invest in.

Equally, a hedge fund might invest in asset types for which methodologies for assessing emissions and emissions-reduction plans are much less developed, including sovereign investments.

These challenges will take time to resolve, but the desire to confront them is building.

Q How could investment strategies typically associated with hedge funds be incorporated into net-zero commitments?

A Something that differentiates hedge funds from long-only products is their ability to use more sophisticated investment tools and techniques, including short positions and derivatives. We believe this sophistication could ultimately give alternative investment managers the edge in sustainable investing.

Short selling, for example, can be an excellent tool for achieving two common goals of contemporary responsible investment. The first is to provide a better approach to addressing undesired ESG risks than simply exclusions or disinvestment, noting that ESG risks cannot be avoided entirely. Secondly, when taken in aggregate, short selling is a way to create economic impact by influencing the nature of capital flows through active investing. We've seen a growing industry consensus that disclosure to investors of long and short exposures to ESG risks is vital to allow them to fully assess how their investment managers are doing when it comes to sustainability considerations.

How specifically shorting should be handled in net-zero commitments is the subject of a lively and welcome debate. The key for us is to ensure that the way hedge funds report to end investors has sufficient detail about the approach and its strengths and limitations.

Q What principles should underpin the future regulation of investment managers' ESG approaches?

A Future regulations, such as the FCA's Sustainability Disclosure Requirements (SDR) will need to accommodate various strategies to support the transition to a net-zero economy. We've argued that regulation should not ignore the impact of short positions and derivatives exposures and further thought be given to how firms report on these under climate or sustainability reporting requirements.

We also believe it's important that future regulation of investment managers' ESG approaches is based on the principle of materiality, acknowledging the reality that investment managers can only report on their ESG exposures if the corporates they invest in are reporting comprehensive data on ESG factors. This has important implications for the sequencing of rules. Finally, regulators should be mindful that poorly crafted disclosure rules could even heighten greenwashing risks, particularly if regulation is based on unclear product boundaries or classification systems. ●

Jack Inglis
Chief executive, Alternative Investment Management Association (AIMA)

Commercial feature

How pension funds can help decarbonise the planet quickly

Smart Pension's CIO **Paul Bucksey** explains why sustainable investing should focus on carbon reduction rather than offsetting, and how technology can make ESG investing cheaper

As companies demand that their workplace pension providers offer more sustainable investments, the pension industry has an opportunity to drive faster decarbonisation by investing in businesses that are serious about cutting their carbon emissions.

Pension holders are also increasingly willing to accept slightly lower returns if their investments are more ESG friendly. A Smart Pension survey in 2021 found that 39% of respondents said they would be willing to earn a lower return on their pension savings in order to create a better future world. This year, that number has risen to 42%.

"We believe that investing in companies that are doing good things for people and the planet will actually generate a better investment return," says Paul Bucksey, chief investment officer at Smart Pension. "We think it's a slightly moot point anyway because we don't think you have to sacrifice returns for doing the right thing."

While some pension schemes are attempting to meet their net-zero targets by buying carbon offsets, Bucksey says this doesn't actually help reduce emissions.

> Smart Pension reduces costs associated with sustainable investing through the technology platform Keystone

"In and of itself, offsetting doesn't actually decarbonise the economy," he says. "If you're claiming to be achieving net zero by using offsets, that's a little bit disingenuous – it's just kicking the can down the road. And, if you take into account the cost of buying offsets, compared to the potential for better returns by investing in decarbonising companies, we believe the latter is a better approach financially, too."

For Bucksey, a more authentic approach to sustainable investing is to focus on companies or projects that are actively decarbonising the economy. That means investing in assets that are already contributing to a low-carbon economy, such as renewable energy providers. It also means engaging with companies that are striving to improve their green credentials by having a clear carbon-reduction plan, and then funding their transition. Smart Pension is making impact allocations, such as investing in biodiversity projects and green bonds, as well as new carbon transition strategies.

"There are a number of strategies we've identified that we're confident will lead to decarbonisation," says Bucksey.

While pension providers have traditionally allowed scheme members to select the level of risk they are willing to take, he says that for ESG funds it makes more sense to adopt a belief-based system that allows members to choose their investments based on how green they want to be.

"There's no one size fits all with ESG," Bucksey continues. "One person might be more interested in excluding tobacco from their investments, while someone else might have a stronger preference for leaving fossil fuels out of their portfolio. With our digital platform, we're able to move away from a very bland risk-rated approach to one that is beliefs-orientated and gives members more options."

He says that this approach means scheme members can choose between different shades of green-flavoured funds. For instance, some might want to invest in a darker shade of green that has a more immediate ESG impact but is therefore slightly more expensive. Others might prefer to invest in a lighter shade of green that has a slower impact trajectory but is therefore slightly cheaper.

Part of the reason why sustainable investments tend to cost more from a fee perspective compared to traditional passive or index-fund investments is that more active management is often involved, with some projects having more venture capital-like characteristics.

Smart Pension reduces costs associated with sustainable investing through the technology platform Keystone, which was developed by its parent company Smart. By automating administrative processes, Smart Pension can lower its own fees and ensure more pension holders' contributions go into investments.

"It's all about embracing technology and really understanding what our customers want," he says. "We're investing in a way that is going to generate good returns but will also ultimately benefit society more broadly, as well as the planet," says Bucksey.

Find out more about Smart Pension at www.smartpension.co.uk, or Smart's Keystone retirement technology platform at www.smart.co

Patrick Hertzog/AFP via Getty Images

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The European Commission adopted the Sustainable Finance package in 2021

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Executive vice-president of the European Commission Valdis Dombrovskis, speaking at a press conference on the new Sustainable Finance measures

Following Brexit, the UK was free to chart its own regulatory course for ESG rules and policymaking. As a result, it became the first G20 country to make it mandatory for the country's largest businesses to disclose their climate-related risks and opportunities, in line with the Task Force on the Climate-related Financial Disclosures (TCFD) recommendations.

The UK's 'answer to SFDR' covers a range of disclosures, including the Financial Conduct Authority's (FCA) plans to introduce Sustainability Disclosure Requirements (SDR) in September, after extended delays.

Jodie Tapscott is a vice-president and the director of responsible investing strategy at AllianceBernstein (AB). She says that, while the EU's SFDR no doubt has the largest impact on the global investment community, for UK investors it is the SDR that will likely improve their understanding of the key ESG characteristics of their funds.

"The introduction of the new ESG-related product disclosure regulations will result in better transparency of philosophy, process and metrics of investment products that integrate ESG, as well as those that pursue ESG-related objectives," she says. "The regulations are targeted at ensuring 'truth in advertising' and should help UK investors have more clarity and confidence in the investments they're making, while also keeping product issuers accountable when implementing their investment processes."

Tapscott says the various new ESG and climate-related corporate disclosure requirements will also improve the quality of corporate ESG data available to investors. "This will enable investors to better assess the material ESG risks and opportunities of portfolio companies and issuers, to better assess the credibility of issuers' sustainability and climate strategies, and to deepen our stewardship activities when we engage for insight and for action," she adds.

According to the Treasury, the new integrated regime is intended to bring together and streamline existing climate reporting requirements, such as the UK's commitment to implement mandatory reporting aligned with the TCFD – and go further.

"This will ensure consumers and investors have all the information they need to make investment decisions that drive a positive environmental impact," it adds. Importantly, the new requirements will also apply to pension schemes, investment products and asset managers and owners.

SDR will introduce a set of disclosure obligations for corporations, asset managers and owners, as well as investment products. Those subject to the new reporting rules will have to disclose information on the environmental impact of financed activities, clearly justify any sustainability claims and lay out transition plans in their annual reports. These requirements seek to ensure that investors and consumers driven by sustainability have access to the information they need to make their decisions, says Kuhn.

"Detailed reporting requirements under the SDR will be developed following a government consultation and enter into force in the next two years," she adds. "This period gives experts the opportunity to inform the decision-making process and should be capitalised on by industry leaders and future reporting entities. We must learn from the lessons of the EU SFDR implementation and build on those to create a framework that enables the UK financial market to transition."

TCFD reporting has been mandatory in the UK since April 2022, impacting UK-traded companies, banks and insurers, as well as private companies with more than 500 employees and £500m in turnover. As a policy, TCFD stands in contrast to regulations such as the SFDR and EU Taxonomy, in that it focuses firms' attention on the impact that climate change could have on their operations, as opposed to the other way around, Kuhn explains.

"In terms of its effect, mandatory TCFD disclosure will increase the amount of climate-related information on the market, which will act as a force for good," she adds. "The new requirement will increase the proportion of companies that analyse their material exposure to climate risk, which will in turn help to inform investors on the level of climate risk across their portfolio. Firms with robust scenario analysis and appropriate mitigation measures may be seen as less risky, which will aid their ability to attract long-term investment."

The first reporting period for TCFD commenced this year for large asset managers, with plans to extend this to smaller managers next year. "This is just the beginning of the regulatory treatment of ESG. To date, particular emphasis has been on the environmental aspects of ESG, which has in part been due to the prescriptive requirements of the SDFR and the UK Green taxonomies. But, attention is likely to move toward the social and governance aspects of ESG, which will increase requirements on the UK investment community," says Russell. She thinks that many ESG-challenged sectors have also become too divested because of ESG regulation; there needs to be greater recognition that divestment does not always bring the desired effect. "Investors have high expectations of implementation this year. Going forward, transparent disclosure and forward-looking data will be key," she comments.

The UK Green Taxonomy is still in draft but is expected to closely follow the EU Taxonomy in providing a common classification system for sustainable economic activities which will underpin the SDR. The full technical screening criteria for the UK Taxonomy are due to be finalised by the end of 2023, according to the FCA, but this deadline is under revision. "This system will directly impact large corporates and the financial sector in its effect on reporting, disclosure and green labelling," Kuhn says.

The US Securities and Exchange Commission (SEC) has proposed its own version of mandatory climate risk disclosures as part of firms' annual reporting. Under the proposed rules, companies would be required to report on the oversight of climate-related risks, how such risks are managed and the inclusion of physical and transitional risk on financial statements. The rules are under review and may be finalised as early as the end of this year, with disclosures beginning – for the largest companies – in 2024.

"This demonstrates that ESG transparency laws are fast becoming the global standard and beyond Europe as well," Kuhn says. "This is likely to have an impact on UK investors with operations in the US, with disclosures being required for both domestic and foreign registrants."

The SEC has said that the proposed rules would also require firms to disclose information about their direct greenhouse gas (GHG) emissions, using a similar system to the global corporate standard protocol established in 2001. Under this system, scope 1 covers the GHG emissions that a company makes directly, while scope 2 emissions are those it makes indirectly from purchased electricity or other forms of energy, for example to heat or cool its buildings. Scope 3 covers all emissions for which a firm is indirectly responsible "from upstream and downstream activities in its value chain".

Smaller reporting companies may be exempt from disclosing scope 3 GHG emissions, adds Kuhn. "However, all public companies will be required to disclose scope 1 and scope 2 emissions at minimum."

Tapscott warns that one of the key challenges for global investment managers is responding to differences in the reporting, labelling and disclosure regulations required by the various regions. She notes that the industry appreciates the regulatory willingness to run open consultations, which is aided by the active participation of various industry bodies in coordinating consultation feedback for the regulators. "Continuing to offer opportunities for investment practitioners to provide input into future ESG regulations will ensure they are consistent, achieve their intent and are practical to implement," she adds.

> **Mandatory TCFD disclosure will increase the amount of climate-related information on the market, which will act as a force for good**

70%
of the British public want their money to help make a positive difference to people or planet

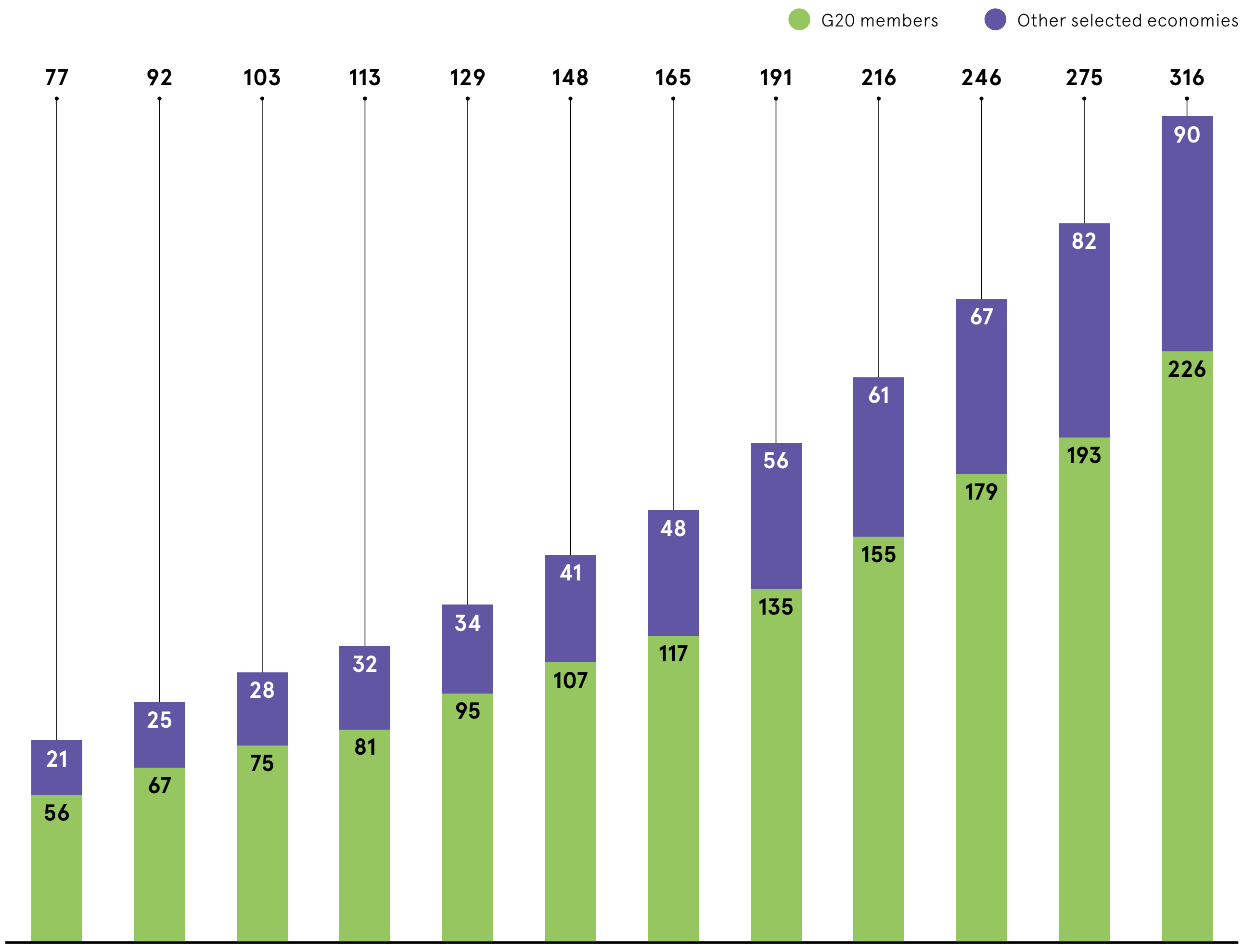
UK Treasury

31%
of executives worldwide believe that volatility of regulatory requirements is one of the largest barriers to ESG progress

PwC US, 2021

SUSTAINABLE FINANCE POLICIES

Cumulative number of sustainable finance policy regulations among the 35 economies accounting for 93% of global GDP



UNCTAD, 2022

How the multiplier effect can help drive greater sustainability

CBRE Investment Management's head of sustainability **Helen Gurfel** explains how real estate and infrastructure businesses can influence their networks to create meaningful change

As environmental, social and governance (ESG) issues become a growing priority for governments and companies around the world, real estate and infrastructure investment management businesses are in a unique position to drive change by influencing stakeholders across the built environment.

To put that scale of potential influence in context, with almost $150bn in assets under management, CBRE Investment Management (CBRE IM) has a portfolio that equates to the size of an average city. By engaging and influencing its network of investors, operators and tenants to adopt more sustainable practices, CBRE IM aims for a multiplier effect that will significantly move the needle on ESG and create a more sustainable future. The firm believes that a focus on sustainability can enhance returns and mitigate risk for its investors.

To underpin this goal, CBRE IM has adopted a three-pronged approach that incorporates climate, people and influence.

"As a global leader in real assets investing, CBRE IM has an opportunity and responsibility to help the environment and the communities we serve," says Helen Gurfel, head of sustainability and innovation at CBRE IM. "Our opportunity lies in using our market position, scale and expertise to influence how buildings are built, managed, occupied and sold. We regularly exert our influence as a global investment manager through robust engagement with our stakeholders, including tenants, employees, clients and communities."

Depending on the investment strategy, CBRE Investment Management will have different approaches for engagement and driving change.

Tenants

"Since millions of people use our assets every day, we strive to help improve their social and physical wellbeing," Gurfel says. "One of our many tenant-engagement programmes aims to anticipate and address tenants' needs through next-generation property management and place-making practices that enhance tenant satisfaction and retention."

The firm is also able to partner with tenants to help them develop their own ESG mandates.

Gurfel says that with operations in 20 countries worldwide, the firm thinks creatively as to how it can accelerate decarbonisation across its portfolio where possible. For example, CBRE IM has over 600 logistics assets spanning 200 million square feet, and Gurfel says the firm is establishing a solar programme across its logistics assets in Europe and the US.

"Recently we started working on four community solar-rooftop projects, which will provide renewable energy at a lower cost to our tenants and also the larger community, as well as accelerate our decarbonisation efforts," she says. "These projects require engaging with tenants to get their buy in for implementation and in some cases have led to further sustainability engagement."

Investors

The firm has deep relationships with institutional investors around the world and considers these to be a significant catalyst for change. "As an investor-operator, we strive to help our investors understand that driving sustainable operational efficiencies can improve returns and mitigate risk. We also work with our clients to measure these results through industry-recognised frameworks, which has further deepened their desire to expand their own initiatives.

> **Our assets are the building blocks of communities, and we want to have a positive impact in making these communities stronger**

Companies

When CBRE IM invests in listed securities, they actively engage with those companies to understand their ESG strategy and risk factors; convey the responsible practices which are most important; and influence them to apply best practices and a disciplined proxy voting process.

Similarly, when CBRE IM invests with other managers, they require the other managers to either have in place or agree to implement certain ESG commitments. CBRE IM also engages with partners on an ongoing basis to continuously improve their portfolios. As an example, they ran a physical risk assessment for all 8,000 assets in their indirectly managed portfolio and asked managers to create plans to mitigate any identified physical climate risk.

In their infrastructure portfolio, CBRE IM's sustainability commitments include investments in renewable energy and sustainable transportation. Their infrastructure team now owns a company called Norled, a leader in innovative and environmentally friendly transportation solutions, which has invested significantly in new types of vessels and eco-friendly technology, including hybrid and battery-driven vessels. Since the initial acquisition, Norled has launched the world's first hydrogen-electric ferry. While this is a clear win for the environment, the sector's resilience also makes it an attractive investor proposition.

Communities

"Our assets are the building blocks of communities, and we want to have a positive impact in making these communities stronger," says Gurfel.

The firm recently worked across several stakeholder groups on a new life science development in Atlanta, partnering with a developer, a client and a new tenant to create an educational fund that helped establish a life science initiative to train teachers and students in the surrounding neighbourhood in careers in biotech. "We want to make sure that we're creating communities that are genuinely giving people the opportunity to thrive," Gurfel notes.

Employee upskilling

Gurfel believes that change must begin with the firm's own people. "They are a critical component of our ecosystem," she says.

"A vital aspect of integrating sustainability across our global business is knowledge and education, which is why one of our key objectives is to create greater sustainability fluency across our organisation," she says. "Education drives empowerment, so we're upskilling our entire organisation to positively influence others across our network."

CBRE IM's employee engagement programme started with an internal sustainability knowledge hub, which provides educational tools and resources, including a gamified learning platform, that has helped employees further embrace sustainability efforts.

To further integrate sustainability across the organisation, the firm launched an ESG ambassador programme comprising 80 internal champions who will embark on a formal learning programme centred on sustainability.

Gurfel concludes: "If you're not embracing sustainability then you are missing an opportunity. Standing still is no longer an option. The more people have a sustainability mindset, the better off we are as a society."

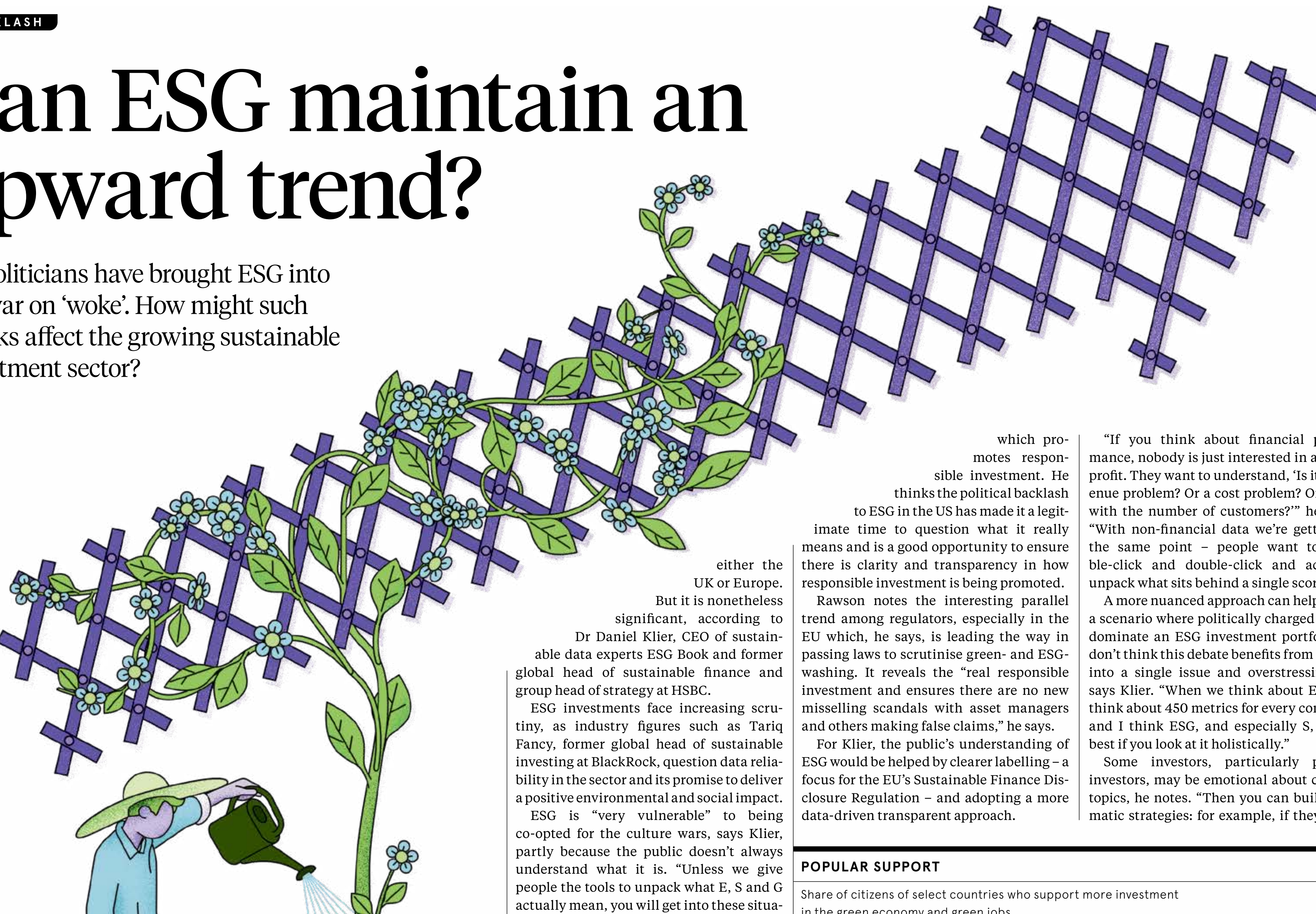
For more information please visit cbreim.com

CBRE Investment Management

BACKLASH

Can ESG maintain an upward trend?

US politicians have brought ESG into the war on 'woke'. How might such attacks affect the growing sustainable investment sector?



Sam Haddad

In August 2022, Florida governor Ron DeSantis passed a resolution that bans fund managers from applying environmental, social and governance (ESG) factors when investing for the state's pension funds.

The move underscored a new reality for ESG investing: it is now firmly part of the culture wars.

DeSantis bemoaned ESG investments as using corporate power to "impose an ideological agenda on the American people" and accused Wall Street financial firms of employing ESG to implement policies that Florida voters had rejected at the ballot box.

The DeSantis play might seem to be a parochial US political concern, far removed from the sustainable finance landscape in either the UK or Europe.

But it is nonetheless significant, according to Dr Daniel Klier, CEO of sustainable data experts ESG Book and former global head of sustainable finance and group head of strategy at HSBC.

ESG investments face increasing scrutiny, as industry figures such as Tariq Fancy, former global head of sustainable investing at BlackRock, question data reliability in the sector and its promise to deliver a positive environmental and social impact.

ESG is "very vulnerable" to being co-opted for the culture wars, says Klier, partly because the public doesn't always understand what it is. "Unless we give people the tools to unpack what E, S and G actually mean, you will get into these situations, with people interpreting things in a way that may not be intended," he says.

Klier believes this situation was inevitable, as the industry has been overhyped for some time. "There is no CEO or investment officer speech that doesn't address ESG," he says. Now is the right time for the industry to grow up, he suggests.

"We've been through ESG 1.0, which was very much driven by exclusionary approaches, such as not investing in coal or fossil fuels, and a single often quite opaque ESG score," he says. "It's time for the next stage, where there is real transparency and integration into investment choices."

For Klier, ESG 2.0 should deliver a nuanced discussion around what investors are trying to achieve, whether that's a return-enhancement strategy, a risk-management strategy, or an impact strategy.

Simon Rawson is director of corporate engagement at Share Action, a charity which promotes responsible investment. He thinks the political backlash to ESG in the US has made it a legitimate time to question what it really means and is a good opportunity to ensure there is clarity and transparency in how responsible investment is being promoted.

Rawson notes the interesting parallel trend among regulators, especially in the EU which, he says, is leading the way in passing laws to scrutinise green- and ESG-washing. It reveals the "real responsible investment and ensures there are no new misselling scandals with asset managers and others making false claims," he says.

For Klier, the public's understanding of ESG would be helped by clearer labelling – a focus for the EU's Sustainable Finance Disclosure Regulation – and adopting a more data-driven transparent approach.

"If you think about financial performance, nobody is just interested in a firm's profit. They want to understand, 'Is it a revenue problem? Or a cost problem? Or to do with the number of customers?'" he says. "With non-financial data we're getting to the same point – people want to double-click and double-click and actually unpack what sits behind a single score."

> If you think about financial performance, nobody is just interested in a firm's profit. With non-financial data we're getting to the same point, people want to unpack what sits behind a single score

A more nuanced approach can help avoid a scenario where politically charged issues dominate an ESG investment portfolio. "I don't think this debate benefits from diving into a single issue and overstressing it," says Klier. "When we think about ESG we think about 450 metrics for every company and I think ESG, and especially S, works best if you look at it holistically."

Some investors, particularly private investors, may be emotional about certain topics, he notes. "Then you can build thematic strategies: for example, if they want to back companies that are led by female founders or to back companies that have a better-than-average diversity on the board. But it's driven by data," he says.

Rawson agrees: "If a business was taking a particularly extreme approach on a social issue which was arguably harmful to society, that would be a legitimate argument for stepping back. But some of those issues are better settled in democratic debate and our political system."

Despite the vocal minority in the US, Rawson says data from real investors show that 95% of millennials continue to be interested in sustainable investing, while 85% of all investors continue to be interested in responsible investing, according to a Morgan Stanley study.

He believes the culture wars are a response to the increasing polarisation in society, fuelling instability and systemic risk within the investment sector, but that pandering and rejecting ESG factors as a result is not the answer.

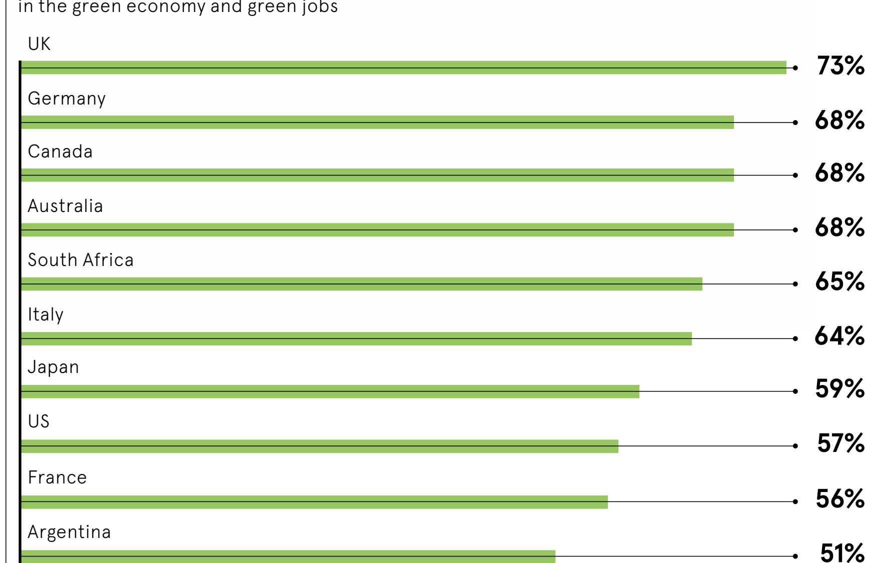
"A chunk of the wealth that is invested is ultimately owned by pension savers and beneficiaries, who may even have these low-paid jobs. What's the point of having a pension that is 10% more valuable if we're living in a world that is inhospitable because of runaway climate change? Or in having a pension pot that is 10% bigger if you've worked all your life on such low pay that your health and wellbeing has suffered?"

Rawson isn't convinced the culture war discourse around ESG will spread to the UK. "We've seen that asset owners and people interested in responsible investment can see through this culture-war rhetoric. They know that slipping back into a system that prioritises financial returns at all costs is the opposite of what we need now," he says.

The same debate isn't occurring in other parts of the world, says Klier, despite the new pressures coming through inflation and high energy prices. At the same time, the US remains the fastest-moving ESG market globally. "We see the biggest demand in the US market because people have realised they've missed out on a very important dimension of their investment decisions over the last few years and are trying to catch up," he says. ●

POPULAR SUPPORT

Share of citizens of select countries who support more investment in the green economy and green jobs



UNDP, University of Oxford, 2020

INSIGHT

'This movement is not about moral philosophy, it's a free-market response to real risks'

Nathan Fabian, chief responsible investment officer, Principles for Responsible Investment (PRI), provides a brief history of the sustainable investment industry and highlights future challenges and opportunities

Q How has the sustainable investing industry developed over the last two decades?

A Since the Kyoto Protocol, companies and investors have been thinking about how to respond to a world where government agreements are being made on climate change mitigation. PRI was formed in 2006 with just a handful of members who agreed simply that investors should start to consider environmental, social and governance factors. This was not a high bar, but it was a starting point for recognising that the world was changing around environmental trends.

The story of how the industry has developed since then can be told through three numbers: $100tn, $20tn and $2tn.

Today, PRI has 5,000 institutional investors signed on, which account for more than $100tn of investment. The managers of those assets have all agreed to consider ESG. But climate objectives have become more precise with agreements like the Paris Accords and the Sustainable Development Goals, and investors have acknowledged the need to get more precise as well. So within that $100tn, $20tn is allocated through a strategy that attempts to be explicit about environmental or social performance. But then there's an even smaller share, approaching $2tn, invested with the primary purpose of being active, specific and intentional about positive environmental and social impacts.

So those three numbers – $100tn, $20tn and $2tn – illustrate the industry's growth and the growing importance of specificity and measurability. But they also demonstrate how far we have to go before we know whether financial market activity will contribute to environmental and social goals in a meaningful way.

Q Has the emphasis on sustainability forced investors to reconsider value and risk?

A The focus on sustainability has revealed a new category of long-term investment risk. Investors are responding to the world around them and they recognise the need to value companies differently. Sometimes a client will demand a financial product that aligns with environmental or social outcomes, but more often the key drivers of change are regulation and policy, technology and pricing.

Investors are considering their portfolios and taking stock of this new, long-term risk category. Institutional investors in particular realise that unless they position their capital differently or influence the environmental or social outcomes that affect higher-risk holdings, there will be significant impacts on those investments, which are meant to perform well, in perpetuity over decades. These revised assessments of long-term risk are now an essential part of the fiduciary role.

Ultimately, this movement is not about moral philosophy, it's a prudent assessment of what's going on in the investment environment – a free-market response to real risks.

Q What will enable further growth in the sustainable investing industry in the future?

A Some regulation and policy will be standardised across jurisdictions and some will vary by region. As a baseline, corporate accounting standards describing how ESG factors affect enterprise value are desirable and we will likely get those through the International Sustainability Standards Board (ISSB). Financial product disclosures on the other hand will be regulated differently in different countries. What's important is that countries have clear environmental goals and clear descriptions of how economic activities are aligning with those goals. The ISSB's standardisation project is called a 'baseline' because it provides a common global basis that different countries can build on with their own financial laws.

The behaviour that presents the greatest threat to the industry is misstating commitments to ESG or measurable actions towards sustainability. If real assessments of sustainability performance are not being made, there can be no compelling defence against those who criticise on the basis of greenwashing. If investors cannot be precise about their sustainability actions and the results, they will appear to be responding to a broader social agenda, rather than fulfilling essential duties to their clients and beneficiaries. ●

Nathan Fabian
Chief responsible investment officer, Principles for Responsible Investment (PRI)