A lightbulb moment

Richard Eagling reports on how proposed pension law changes recognising the importance of climate risk could prove a pivotal moment for socially responsible investing

More and more investors are asking questions about where their money is being invested and the causes that it could support. Indeed, this rising interest in ensuring investments reflect an individual's own values has enabled Good Money Week – an annual event to help grow and raise awareness of sustainable, responsible and ethical finance – to become a firmly established part of the financial services calendar.

Such events are likely to take on even greater importance as the millennial age group starts to exert their spending power. Research suggests millennials are more likely to care about their social responsibility when it comes to how their money is invested. According to research carried out by Good Money Week, millennials are twice as likely to think they have a social responsibility to ensure their pension is invested ethically compared with those over the age of 45. Furthermore, more than half of investors aged 18-34 years (54%) said they would like to be offered fossil-free investments as standard compared with the national average of 40% and only 34% of those aged over 55.

Record ethical fund sales

This demand is translating into greater sales of ethical funds and socially responsible investments (SRI). Last year, net retail sales of ethical funds hit a record £1.04 billion, far higher than sales of £625 million in 2016. Total ethical funds under management also saw a healthy rise, increasing from £12.43 billion in 2016 to £15.42 billion in 2017.

"The market is currently very vibrant with regular new product launches and strong news-flow around sustainability and the desire by investors to make more of their investments by choosing a responsible option," says *Neville White, Head of SRI Policy and Research at EdenTree Investment Management.*

And yet these growing ethical fund sales cannot mask some disappointments, namely the small share of the investment fund industry that ethical funds account for. Despite the fact ethical fund assets under management has more than trebled over the last decade, its share of the overall fund market has only increased from 1.2% to 1.3%. Contrast this with the growth of other investment types such as tracker funds, which has seen its market share increase from 6% to 13.7% over this period, and it is difficult not to feel slightly underwhelmed by the size of the ethical fund market.

"The main issue to keep in mind is that consumer interest is still far higher than actual assets under management in this area, so there is room for growth all-round," suggests *Julia Dreblow, Director at SRI Services and founder of Fund EcoMarket.*

Turning interest into action

If the ethical/SRI sector is to fulfil its undoubted potential then it needs a catalyst capable of turning consumer interest in socially responsible investing into action. Arguably this could come in the shape of the Government's recently published final response to the 2017 Law Commission Report on pension funds and social investment. This suggests that UK pensions law could soon require pension scheme trustees to ensure climate risk is part of their core investment decision-making.

Through the *Department for Work and Pensions' (DWP's) Consultation on clarifying* *and strengthening trustees' investment duties*, the Government has set out how it proposes to update the law to require pension scheme trustees to consider the impacts on their investments from a changing environment, corporate governance and social trends.

The DWP consultation points out that despite The Pension Regulator's guidance, confusion and misapprehension over trustees' responsibilities persists, with evidence suggesting some trustees incorrectly think that environmental, social and governance (ESG) risks are irrelevant to, or run counter to, financially material concerns. As a result, under the Government's proposals, by 1 October 2019 trustees will be required to produce a Statement of Investment Principles (SIP) setting out how they take account of financially material considerations including (but not limited to) those arising from ESG considerations, including climate change. They will also be required to set out their policies in relation to the stewardship of the investments, including engagement with investee firms and the exercise of the voting rights associated with the investment.

Crucially, the Financial Conduct Authority (FCA) has said it intends to take forward – and build upon – the Law Commission's recommended policy changes, by consulting on a range of rule changes in relation to Independent Governance Committees (IGCs). The FCA will consult on rule changes in the first quarter of 2019, which will require IGCs to report on their firms' policies on evaluating ESG considerations, including climate change, and how they take account of members' ethical concerns and carry out stewardship. At the same time, the regulator said that it will also consult on industry-related guidance for providers of workplace personal pension schemes on considering financial factors (such as ESG risks and climate change) and non-financial factors (such as responding to members' ethical concerns) when making investment decisions.

"This is very welcome and marks the culmination of a lot of work by groups, such as the UK Sustainable Investment and Finance Association, over many years," says Julia Dreblow. "It sends a signal that pension schemes (with more than 100 members) should now consider climate change, ESG risk, stewardship and where appropriate scheme members' ethical values."

Hitting the mainstream

Some commentators have hailed the Government and the FCA's response to The Law Commission's recommendations as a breakthrough moment for the UK pensions industry. "Climate risk has hit the mainstream," says *Danielle Lawson, ClientEarth pensions lawyer*. "The UK's top financial regulator has acknowledged that climate change presents material risks for investors, equating it with core economic risks like liquidity, interest and inflation. This busts a persistent myth in the industry. At the same time, the proposed changes to UK pensions law will end any debate among trustees: climate change risks and opportunities must be considered in schemes' investment strategies. This is a lightbulb moment for UK pensions – the FCA's acknowledgement that financially material climate risks should be incorporated into investment decision-making, as part of pension providers' legal duties, opens the door to a much more in-depth consideration of exposure to climate risk for UK markets and financial institutions generally. This is a promising indication that the regulators will recognise the need to align their investment guidance on climate risk and other financially material long-term factors."

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The realisation that climate change should be considered a financial risk has been building for some time. In May 2017, the Institute and Faculty of Actuaries sent out a risk alert to its members about the financial risks posed by climate change, while more recently the Pensions and Lifetime Savings Association (PLSA) also cited it as a severe risk to pension funds.

Other recent significant developments in the SRI arena include the publication of the Growing a Culture of Social Impact Investing in the UK report, which considers how the UK can increase investment in ways that have positive social impacts, and the unveiling of the EU's draft recommendations in its Sustainable Finance Initiative, which proposes integrating ESG considerations into the investment and advisory process. "The European Commission is looking at regulation that would not only formalise sustainable investing across the EU, but also build climate risk into portfolio analysis," adds Neville White. "We support moves to encourage wider acknowledgement of the risks climate change poses, and for investment managers to build this into their long-term thinking; we currently avoid most fossil fuel companies as a response to climate risk."

Work in progress

It is clear that this rising interest in climate change risk among the Government and regulators is dominating the thoughts of many within the SRI arena, especially as it is also likely to present plenty of challenges. "Broadly, the direction of travel is towards a recognition that investors can help deliver environmental and social benefits and that it makes sense for investors to consider such issues," says Julia Dreblow. "Much of the regulatory and policy work we see today is however still 'work in progress' and there is some concern that well-intentioned rule changes could backfire if things go wrong. One worry is that new rules may be too prescriptive and that this could hamper innovation. For many of us who have worked in this area for some time its diversity and ability to innovate is seen as highly beneficial. We are therefore faced with the challenge of helping to draft policies that are sufficiently robust as to facilitate growth (and therefore help drive us towards more sustainable – and also profitable – business practices) without any new rules being so vague that they are meaningless or encourage greenwash."

Greenwashing fears

Indeed, within the ethical/SRI sector, fears remain that greenwashing – whereby funds employ a very loose definition of ethical or socially responsible investing, seemingly for marketing purposes – could undermine the good work being done by those who fully integrate ESG risk into their investment processes. "The strong interest in sustainability bears both risks and opportunities," warns Neville White. "Definitions remain problematic and there is a danger that the market may overheat with products that do not stand up to scrutiny or are not genuinely sustainability focused."

One area under the spotlight where greenwashing is concerned is the practice whereby some ethical/SRI providers reference the Sustainable Development Goals (SDGs) in their offerings to clients and map portfolios to them. The SDGs are a collection of 17 global goals set by the United Nations that cover social and economic development issues including poverty, hunger, health, education, climate change, gender equality, water, sanitation, energy, urbanisation, environment and social justice.

"We have previously warned that the industry is facing an increasing risk of greenwashing," says Neville White. "This has become particularly acute in the last couple of years with the launch of a wave of new strategies marketed as 'sustainable' or 'impact' by houses not normally associated with this form of investment, and often framing their objectives within the SDGs. With a three-decade track record of powerfully integrating responsible investment into our process, we are acutely aware of the complex requirements of investing through an often simplistic ESG lens. Our early analysis suggests that framing impact solely through the SDGs could fail to adequately promote any real change in the way investment portfolios are constructed and managed… Investors must be alive to 'greenwash' and simplistic solutions drawn from limited data and grounded solely in the SDGs, that may not offer the nuance required to understand a portfolio's full qualitative value and 'impact'."

While many experts agree SDGs can provide a useful framework for SRI funds, it is important to understand their real purpose and limitations. "They are intentionally aspirational. They were not written for investors and are therefore only suitable to use as points of reference – not benchmarks," explains Julia Dreblow. "They are being used differently by different investors and in this area it is common to see fund managers 'mapping' their strategies to the SDGs. Two further factors to consider are that most SRI funds predate the SDGs by many years so it would be inappropriate to expect them to change their policies to fall into line with the SDGs (as this may not suit existing clients); and, importantly, the SDGs are a 15-year framework (which we are nearly a third of the way through) so I would not generally recommend setting up new funds where mapping to their goals is their sole purpose as this may cause problems in years to come."

Plastic pollution

If the greater recognition of the financial risks of climate change and the need for pension trustees to consider this does not boost interest in responsible investing, then perhaps the renewed focus on tackling plastic waste could spark investors into action. The Government has said it is committed to eliminating all avoidable plastic waste by 2042, and has been consulting on how changes to the tax system or charges could be used to cut the amount of single-use plastics that are wasted by reducing unnecessary production, increasing reuse, and improving recycling.

"Plastics are a big issue for SRI investors, largely thanks to Blue Planet 2," says Julia Dreblow. "Images of plastic bags, bottles and straws are far more visual than for example, carbon emissions, and so make it easy to understand how changing what we do can help protect wildlife. Fund managers are reporting increased interest in this area from customers which shows that people increasingly recognise that investors can help solve this problem. As a result most of the fund managers I speak with are working on how they can help reduce plastic pollution."

Plastic is certainly an issue on EdenTree Investment Management's agenda. "Plastic has become a strong talking point, and clients are also showing keen interest," agrees Neville White. "This is managed through our Environment pillar and we have recently joined an investor coalition that will drive focused engagement with companies around reduction and recycling, and may also target innovation from a manufacturing perspective. An Amity Insight on waste will be published in the autumn which will look at waste across several streams including the problem of plastic."

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

	1 year	3 years	5 years	10 years
All ethical funds	4.80%	25.76%	54.82%	106.48%
All non-ethical funds	4.02%	26.21%	50.33%	109.32%
IMA sector performances				
Ethical £ Corporate Bond funds	-0.04%	13.97%	27.10%	76.59%
Non-ethical £ Corporate Bond funds	-0.64%	13.41%	25.66%	74.38%
Ethical Mixed Investment 40-85% Shares funds	6.95%	30.28%	71.10%	115.71%
Non-ethical Mixed Investment 40-85% Shares funds	3.60%	22.26%	44.22%	89.40%
Ethical Global Funds	6.49%	38.84%	70.83%	117.03%
Non-ethical Global funds	7.68%	42.68%	78.96%	136.81%
Ethical UK All Companies funds	7.49%	22.00%	59.18%	123.30%
Non-ethical UK All Companies funds	7.81%	23.74%	56.94%	124.10%

Source: Lipper Investment Management. % growth as at 23 July 2018, total return, UK net, no initial charges

However, tackling the problems posed by plastic pollution will not be straightforward for SRI fund managers. "It is not easy for investment funds to simply avoid plastics in the way they might exclude tobacco or oil companies," explains Julia Dreblow. "For a start, plastics have many positive applications such as helping to reduce food waste and reducing carbon emissions by being lighter weight than other materials in cars. Yet, calls for a reduction in single-use plastics, supporting and encouraging biodegradable alternatives and improved filtration systems that stop waste from reaching our seas are well within the remit of investors."

Strong performance credentials

With so many new developments for the SRI market to contend with, there has perhaps been less focus recently on the performance merits of ethical/SRI funds.

Investment returns across most funds have been modest over the last 12 months but, as **Figure 1** shows, ethical funds (4.8%) have still managed to outperform non-ethical funds (4%). It is a similar story over five years, with ethical funds (54.8%) producing superior returns compared with conventional funds (50.3%). Non-ethical funds take the performance honours over a 10-year period, but even here there are 20 ethical/SRI funds that have outperformed their average return of 109.3%.

Overall, ethical funds outperformed their non-ethical rivals in 11 of the 20 scenarios analysed showing that there is no performance case for ethical/SRI funds to answer. "We strongly believe that integrating ESG risk into fundamental stock analysis makes for better stock selection over time; companies managing risk holistically are better placed to perform well for the long-term," adds Neville White.

Adviser attitudes

Despite the strong performance of ethical funds, some advisers are reluctant to incorporate SRI/ethical considerations into their advice processes. Not surprisingly, the Growing a Culture of Social Impact Investing in the UK report has recommended providing more tools and training on social impact investing for pension scheme trustees and independent financial advisers. This includes encouraging professional bodies, such as the CFA Institute, the Chartered Institute for Securities & Investment (CISI) and the Chartered Insurance Institute (CII) to accelerate professional development around ESG and social impact investment, through CPD and professional qualifications.

"There continue to be challenges around empowering advisers to ask the ethical question," says Neville White. "Undoubtedly, confidence in understanding the market, products and the variety of offers may be confusing and daunting, however we strongly support the adviser community in ensuring clients are equipped to choose from a range of investor solutions that include ethical and responsible options."

More to come

The SRI market has come a long way since the first ethical fund was launched back in 1984 and is in many respects maturing nicely. However, there is still a prevailing feeling that there is much more for the sector to do.

"Short-termism remains rife in our industry, and it's hugely damaging to the environment and many people," says Julia Dreblow. "The sustainability message is nowhere near as mainstream as it deserves to be – and the SRI market view that investment decision-making needs to be better aligned to investment terms hasn't yet reached a tipping point. On the ethical side, the fact some people have views that differ from their adviser's or scheme trustees remains challenging. Many continue to be viewed as almost deviant if they want their 'financial self' to align with their 'real life self'!

"There is also the minor issue of the areas highlighted in recent reports: taxonomies, labels, standards, changes to the advice process and to SIPs – plus related regulation in areas such as climate change and calls for investors to meet growing social needs. Any of these could drive substantial change in this area – and far beyond. My hope is that the SRI market will retain its character, dynamism and optimism once these settle down."