Navigating Managed Funds

Beneath the Surface of Responsible Investing

April 2023 (Updated from November 2021)

Contents

The RIPPL View

Responsible investing seems to be front of mind at the moment. Many countries are a long way ahead, New Zealand included, in the way the topic is integrated and discussed at a political level. Europe arguably led the way in certain areas, but many of the challenges lie in Emerging Markets, and since Covid-19 and Biden's election we have seen greater focus from US managers. But what is responsible investing? The topic is so broad and the interpretation so far reaching.

In this paper we aim to shed some light on the topic, explore some of the jargon and pose some questions to investors and fiduciaries to help frame your thinking in this area. Responsible investing has become a focus area in the investment industry, but greenwashing is rife and the sales pitch is strong, so what really matters?

At Research IP we believe that ESG principles should be integrated into the process and in ten years' time we won't be discussing them like we do today. Integration will be assumed in managed fund investment processes, and investment exchanges will set the standard. However, this raises further questions, if all Fund Managers invest in this way what happens to the "other" assets, do more get pushed into private hands?

We also explore the investment landscape and the implementation through passive structures. Is the ESG thematic driving performance in market sectors? Is this performance persistent? Is there alpha in the opportunity set or is ESG simply a subset of a broader quality measure?

Responsible investing also opens a raft of other ethical considerations. Do you want your impact fund to outperform the market index? Is payday lending legal? If your country goes to war, do you want to know you are protected? What will we do with all the old batteries? Do you want a wind farm in your backyard? If coal production is banned in Australia (some of the cheapest and highest quality in the world) where does that production shift to – China, where it is "dirtier" and overall worse for the world? Do you turn the lights on at night?

A great example of the transition is the Danish company Ørsted. It was once one of the most coal-intensive energy companies in Europe. Today, they claim to be the world's most sustainable energy company, and a global leader in the transition to green energy. This is a great example of where capital arguably should be directed, but appeared on many exclusion lists.

Most of these questions we cannot answer, they are personal preference, but hopefully *Beneath the Surface of Responsible Investing* highlights the many different ways to think about the topic.

Research IP helps many of our consulting clients navigate the maze, but no one client is the same. Please reach out if you believe we could be of assistance.

The latest version of *Beneath the Surface of Responsible Investing* can be found here.

Get on Board

Responsible investment, socially responsible investing, sustainable investing, ethical investing, green investing, and ESG. What are the differences between these investment terms? How long has responsible investing even been around?

Environmental, social and governance (ESG) factors have been considered in various portfolios for many years now, but Covid-19 and the Russia-Ukraine war has shone a light on the topic. Since Biden was elected as US President, the Securities and Exchange Commission (SEC) launched the Climate and ESG Task Force to develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment. Several issues specific to New Zealand have also surfaced in recent years concerning investments into companies manufacturing cluster bombs and anti-personnel mines, supplying weapons to the Saudi Arabian military, producing nuclear weapons, or with links to the Myanmar military. But where can you find more information to help you understand how a Fund Manager is managing your or your clients' money responsibly?

At the surface level you can search through several fund documents, including the Product Disclosure Statement, Statement of Investment Policy and Objectives, Responsible Investment Policy (if available), Proxy Voting Reports (if available) or Other Material Information documents. You can also search the Responsible Investment Association Australasia directory or signatories to the United Nations Principles for Responsible Investment. However, there is no standard framework and there is a fine line between communicating well and marketing spin. Case in point regarding Vanguard in Australia and the infringement notice issued by the Australian Securities & Investments Commission.

The fundamental approaches a Fund Manager can apply range from integration of ESG factors and corporate engagement, to screening, to sustainability themed investments and impact investing. The latest benchmark reports by Responsible Investment Association Australasia (RIAA) revealed ESG integration as the most common primary or secondary responsible investment approach in Australia, whilst it was a close second in New Zealand after negative screening. Research IP has always integrated ESG considerations into our research and we believe global and Australian Fund Managers have been more progressed in this respect compared to New Zealand Fund Managers.

Each year Research IP recognises and awards the best Fund Managers in the New Zealand market, including the first award for responsible investing in New Zealand in 2020. The Responsible Investment Manager of the Year award recognises the Fund Manager that demonstrates the most commitment to responsible investing and its benefits to stakeholders. But how do you prudently evaluate a Fund Manager's approach to responsible investing? Is the Fund Manager ultimately providing value for money?

Regulators are pushing for more transparency on ESG investing and corporate disclosures. The European Union introduced legislation in 2019 which "…seeks to achieve more transparency regarding how financial market participants and financial advisers integrate sustainability risks into their investment decisions and investment or insurance advice."

New Zealand moved to make climate-related financial disclosures mandatory for certain publicly listed companies, large insurers, banks, and investment managers. Furthermore, the regulator in New Zealand issued the following guidance recently regarding asset stewardship and value for money: "If a scheme claims its asset stewardship, including taking account of non-financial factors within an integrated financial product, adds value, can they substantiate it by demonstrating how it fits member values? Or how it benefits investment outcomes? For example, does it reduce risk without reducing return, enhance return, have quantifiable non-financial impacts, or shape company behaviour?"

Beneath the Surface of Responsible Investing takes a deeper look at the investment merits of different managed fund approaches applied in New Zealand, Australia, the United States and Europe. We assess the application of the United Nations Sustainable Development Goals in an investment context, the Principles for Responsible Investment, and broader ESG considerations. We believe independent, objective, and holistic analysis is required to understand the efficacy and nuance of different responsible investment strategies and how these relate to investors' altruistic objectives. Independent research will give investors something to hang their hat on when evaluating which managed funds suit their objectives. If you have any questions regarding responsible investing, please get in touch here, we would love to know what aspects of responsible investing matter to you, or if we can help explore a specific area further.

The Jargon

Responsible investment

An investor will recognise the link between the success of a company and its interaction with society and the environment. Key factors taken into account are collectively known as ESG factors (environmental, social, governance).

Socially responsible investing (SRI)

Commonly known in its abbreviated form, the definition is the same as “responsible investment” and “sustainable investing”. Any perceived differences in the definitions are likely due to the time in which they were first coined and the underlying investment approaches they first referred to. For example, “SRI” was initially understood to mean negative screening.

Sustainable investing

Commonly accepted definition is the same as “responsible investment” and “SRI”.

Ethical investing

An investor’s moral, religious and/or social values and beliefs guide what they invest in.

Green (light/dark/deep) investing

Commonly referred to in the context of ethical investing where the shade of green gives the investor an idea of how rigorous the ESG criteria for investment has been applied.

ESG

Environmental, social and governance issues are underlying factors an investor may consider when determining the future value of an investment.

PRI

Principles for Responsible Investment. UN-supported organisation that examines how investors can incorporate consideration of environmental, social and governance factors when investing.

SDGs

Sustainable Development Goals. A total of 17 goals designed as “a blueprint to achieve a better and more sustainable future for all by 2030”.

Glossary of Terms – please explain the jargon in this report

Any other jargon that isn’t easy to understand? Please contact us:

The Voyage So Far

Charting the Course

The roots of responsible investing arose from **negatively screened** investments at religious organisations.

- Around the mid-1700s the Quakers prohibited members from associating with the slave trade.
- In the early 1900s the Methodist Church wished to exclude companies involved in alcohol and gambling from their investment portfolio.
- Shariah-compliant investing developed from the 1960s onwards where funds aimed to exclude companies deriving an income from alcohol, pork, and gambling.

Winds of Change

Social issues through the 60s and 70s started to influence how investment decisions were being made.

- The origins of **corporate engagement and proxy voting** can be traced back to 1970 in the United States. Ralph Nader proposed corporate responsibility amendments at the General Motors annual shareholder meeting. These sought to address issues like air pollution and vehicle safety. This was supported by a student body at the University of Pennsylvania. The University was a significant shareholder in General Motors.
- **Negative screening** became more prevalent during the Vietnam War where protesters called for a boycott of companies manufacturing weapons for the war. For example, Dow Chemical was boycotted for manufacturing napalm. In 1971 the Pax World Fund was created by two Methodist ministers for the churches' funds which excluded weapon manufacturers. Anti-war protesters also put pressure on US university endowment funds to avoid investments associated with the war.
- Anti-apartheid pressure through the 70s and 80s forced widespread withdrawal of capital from South Africa. The Sullivan principles were created in 1971 which promoted **social responsibility** as part of a corporation's code of conduct. One example of these principles in use were by Catholic nuns who were able to confront corporations by filing shareholder proposals via holdings in their pooled retirement assets. The Calvert Social Investment Fund was launched in 1982 which **integrated ESG** factors and opposed any investments associated with apartheid.
- The Exxon Valdez oil spill in Alaska in 1989 sparked the need for more **environmental** awareness in business conduct. Non-profit organisation, Ceres, was formed as a direct result of the oil spill with a specific focus on **sustainable** business practises.
- The Domini Social Index (now called the MSCI KLD 400 Social Index) was created in 1990 to benchmark several US mutual funds that **integrated ESG** factors into their investment decision making.
- In 2006 the United Nations Principles for Responsible Investment (PRI) was launched which created guidelines for the **integration of ESG** factors.
- The United Nations Global Compact was launched in 2000 which encourages businesses to adopt more **socially responsible** and **sustainable** policies.
- Responsible Investment Association Australasia (RIAA) was created in 2000, originally known as Ethical Investing Australia.
- The Paris Agreement, often referred to as the Paris Accords or the Paris Climate Accords, is an international treaty on **climate change**, adopted in 2015. It covers climate change mitigation, adaptation, and finance. The Agreement was negotiated by 196 parties at the 2015 United Nations Climate Change Conference near Paris, France.
- The United Nations **Sustainable Development Goals** were adopted by all member states in 2015. The SDGs have progressively made their way into investment management strategies.
- From 2015 onwards there has been a proliferation of organisations with a focus on **sustainability**, including the Australian Sustainable Finance Initiative, Investor Group on Climate Change (IGCC), and the Centre for Sustainable Finance.
- The United Nations Climate Change Conferences are global forums for multilateral discussion of climate change matters held on an annual basis.

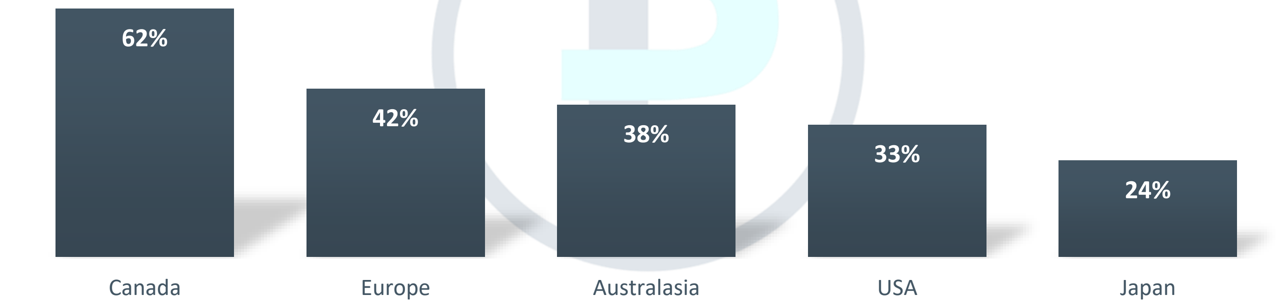
The Mainstay of Today

RIAA issue a benchmark report each year which provides a comprehensive look into the responsible investment industry in New Zealand and Australia. Some of the key findings in the 2022 benchmark reports were:

- Of the total professionally managed assets under management in New Zealand, approximately 49% (NZ$179bn) could be defined as responsible investment, compared to 43% (AU$1.54tn) in Australia.
- Of the survey respondents, the most common primary or secondary responsible investment approach in New Zealand was **negative screening**, followed by **ESG integration**, and **corporate engagement and shareholder action**. In Australia, **ESG integration** was the most common followed by **corporate engagement and shareholder action,** and **negative screening.**
- Of the investment managers within the responsible investment universe in New Zealand, 92% have a responsible investment policy but only 90% make the policy publicly available. This compares to 87% in Australia (a decrease from 92% in 2021), with 84% disclosed publicly (an increase from 76% in 2021).

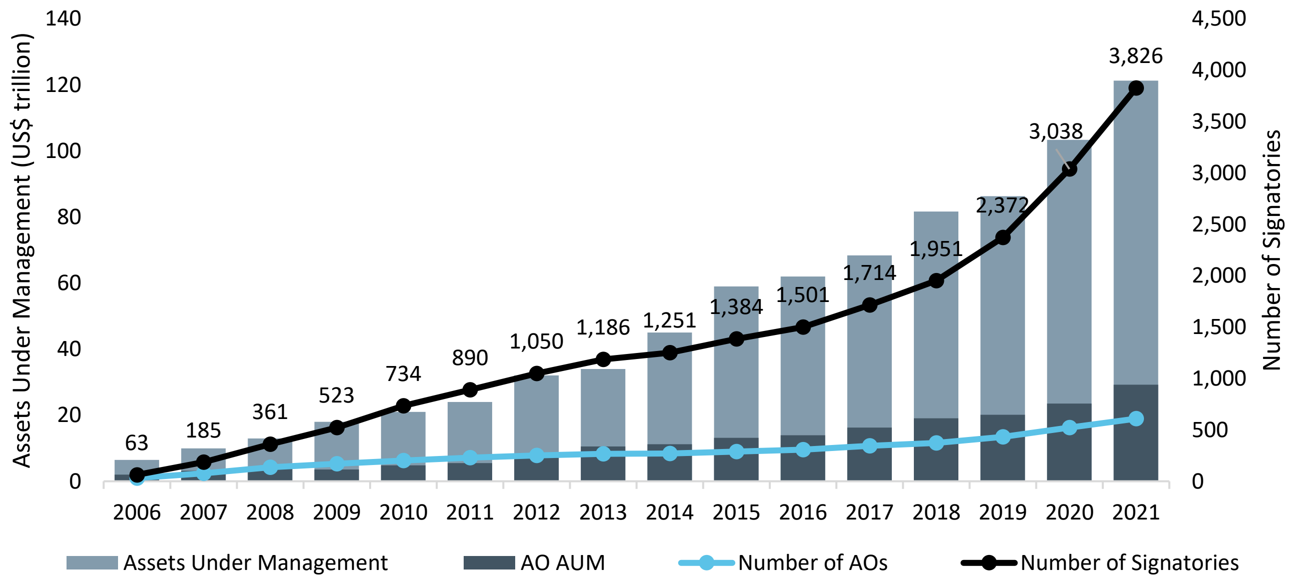
Looking at a comparison on a global scale, the proportion of sustainable investing assets relative to total managed assets differs significantly according to the biennial Global Sustainable Investment Review 2020. Canada had the highest proportion of sustainable investing assets (62%), followed by Europe (42%), Australasia (38%), the US (33%) and Japan (24%).

Figure 1 Proportion of sustainable investing assets (Source: GSI Review 2020)



An indication of the growth in **ESG integration** as an investment approach is shown by the growth in UN PRI signatories in Figure 2 below. The number of signatories more than doubled over the five years to 2021 (latest data available).

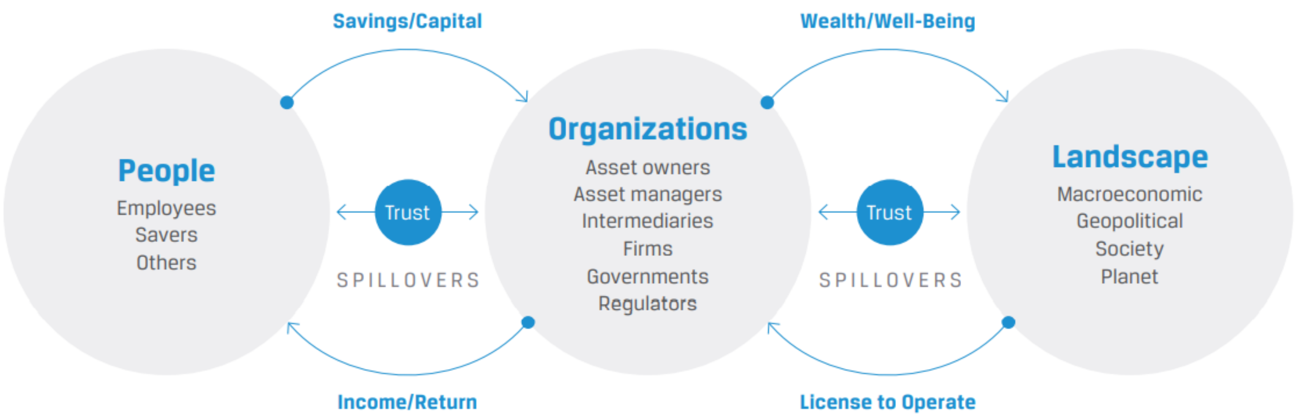
Figure 2 Growth of PRI signatories including breakdown of Asset Owners (Source: unpri.org)



Keeping Investments on an Even Keel

Financial markets, the real economy and broader society are all interdependent. An efficient financial market should reflect the real economy and broader society over the long run, thus ESG issues should impact the ongoing concern of companies. Considering ESG issues will be critical to risk management. ESG considerations may disrupt the myopic nature of earnings announcements that have been a critique of financial markets for years.

Figure 3 The Financial Ecosystem (Source: cfainstitute.org)



The following developments are likely to see the further growth in responsible investment:

- Market expectations – Consumers, investors, and fiduciaries will continue to demand more transparency on their investments and how ESG issues are considered. The idea of financial citizenship will grow; the person on the street will become more aware of the role they can play as an investor, for example, by ensuring stronger stewardship of companies as long-term owners via investments in their KiwiSaver fund. Greater transparency on responsible investing will enable a wider group of investors to direct capital where they wish, rather than relying solely on public institutions and NGOs to achieve similar non-financial objectives. Greater market expectations with responsible investing will continue to blur the lines between values and value, so any perceived cost of investing responsibly will be null.

- Regulation, disclosures, and standards – Due diligence requirements for investors, financial advisers, and investment managers will increase with the volume of ESG information disclosed. Regulators are progressively implementing requirements for ESG/sustainability disclosures. Standard-setting bodies are developing and improving existing frameworks.

- More concrete data – Consistent, objective, and timely data will help regulators and standard setters provide more clarity on their requirements; it will enable investors to make more informed decisions; and ultimately direct capital to align more closely with investors' intentions. Big data has the potential to advance the link between financial objectives and non-financial objectives.

- Technology – Greater freedom of choice will be available with growth in the number of investment platforms available. Platforms will continue to evolve and adapt to the needs of financial advisers and consumers. The range of managed fund products will grow. Competition amongst Fund Managers will help create more effective responsible investment strategies. Greater transparency and awareness will enable investors to decide which strategies are best for them – financial advisers will be at the heart of this.

Navigating the Fundamental Approaches

There are many different approaches to responsible investing, some approaches are more proactive and pragmatic than others. Multiple approaches could be used within the same managed fund. The underlying considerations across all approaches are environmental, social and governance factors.

Figure 4 gives a simple overview of the fundamental approaches a Fund Manager may pursue.

Figure 4 Fundamental approaches to responsible investing via managed funds

Integration		Screening		Thematic/Impact	
Incorporate ESG factors into analysis and decisions	Corporate engagement and proxy voting	Negative	Positive, best-in-class or norms-based	Sustainability themed	Impact
Investment Example: an analysis of a company's labour standards and how this affects employee satisfaction, brand, reputation, and company revenue	Investment Example: vote for shareholder proposals asking for reports on board diversity; any poor outcomes can be integrated back into investment decisions with engagement	Investment Example: exclude companies involved in the manufacture of tobacco	Investment Example: select companies that use more renewable energy sources; or select companies that have a better ESG rating	Investment Example: a fund that is positively focused on selecting securities under the theme of sustainable agriculture and forestry	Investment Example: a bond fund targeting and measuring tangible non-financial outcomes in sustainable infrastructure projects as well as having a financial return objective. 'Intentional, measurable and additional' are key characteristics of impact investing

Check the Pulse

Overall Entity

Research IP has witnessed a significant shift in the amount of information provided by Fund Managers on ESG issues in recent years. To help understand the motives and overall credibility of the Fund Manager regarding responsible investment, Research IP seek to answer the following questions about the overall entity:

- How often does the Fund Manager review their responsible investment policy? Who undertakes this review?
- Why has the Fund Manager chosen their responsible investment approach?
- Does the Fund Manager issue any regular reports to demonstrate recent activity with respect to ESG factors in their portfolios?
- Does the Fund Manager have any third-party external assurance from responsible investing organisations? e.g., PRI or RIAA
- Does the Fund Manager's responsible investment approach apply to all investment products, or specific products? For example:
    - Some Fund Managers use a whole of business approach, with ESG teams filtering the list of securities from a corporate perspective which flow through all products.
    - Other managers address ESG through a sleeve or product suite, rather than overlay the whole list of available securities meeting ESG requirements.
- Do the qualifications or experience of the investment team help the Fund Manager gain a deeper understanding of ESG issues?
- Does the Fund Manager vote some / all of the proxy votes? Do they ever vote contentiously, i.e. against management and not simply follow one of the proxy advisers like ISS?

Integration

Integration means that factors related to ESG issues are incorporated into the quantitative and qualitative analysis of a company and the industry in which it operates. Corporate engagement and proxy voting is a valuable aspect when used in this approach. ESG integration simply means investment analysis is viewed through a broader lens. Research IP believes integration is the most holistic approach.

Having an "ESG team" in London that the local fund managers "disagree" with is a form of greenwashing.

Research IP seeks to answer the following questions when evaluating a Fund Manager's approach to ESG integration:

- What is the Fund Manager's reason for considering ESG issues in their investment process?
- Where in the investment process are ESG factors integrated? E.g., in the initial screening of the investment universe, through research analysts, by the portfolio manager, all of the above?
- What ESG research does the Fund Manager undertake internally versus use of external providers? How does this research affect the construction of the portfolio?
- What examples does the Fund Manager have where ESG considerations played a key part in the final investment decision? Did corporate engagement or proxy voting play a significant part in the final decision?
- What factors does the Fund Manager focus on more – environmental, social or governance factors?
- If the Fund Manager is a PRI signatory, how has the Fund Manager's investment process changed since signing up?
- Does the Fund Manager use any third-party research with respect to the integration of ESG factors in their investment process? How do they use the information? (Portfolio analysis, equity research, screening, or quantitative analysis).
- Thanks for the pretty sales pitch, with clearly articulated examples, now tell us about the rest.

Screening

Screening is the most mechanical approach. A 'screen' can be applied by a Fund Manager to exclude or include securities in a managed fund. To understand the screen used by a Fund Manager there are two key considerations:

Nature of the business activity
For example, companies involved in tobacco, fossil fuels, gambling, controversial weapons, or alcohol maybe excluded. On the other hand, companies with lower carbon emissions might be part of a positive screen and therefore more likely to be included.

Criteria used to define the screen
The Fund Manager could define this several ways. Some definitions are more objective than others. Financial metrics such as revenue are easy to pinpoint e.g., “companies generating more than 10% of revenue from alcohol”. Conversely, a Fund Manager may positively screen for companies with higher ratings from an ESG data provider. These ratings incorporate multiple underlying metrics.

Research IP seeks to answer the following questions when evaluating the Fund Manager’s approach to screening:

- Where is the line drawn on exclusions? How are securities defined and excluded? Be cognisant of the terms used in managed fund disclosures, for example “material”, “significant involvement”, “directly involved”, or “x% of revenue”. Ultimately it is about materiality and proximity to the business activity. Note: this is directly relevant to default KiwiSaver providers.
- How does screening affect portfolio construction? How does the portfolio compare to the benchmark? Is there more concentration in certain sectors?
- How does the Fund Manager think about overall portfolio risk after applying screens?
- Does the Fund Manager have any recent examples of an ESG issue that caused them to exclude, decrease, or increase an investment?
- If best-in-class screening is used, what are the ranking thresholds and why did the Fund Manager choose these?
- Does the screening process simply reflect a ‘box ticking’ approach?

Thematic/Impact

Thematic/Impact investing aims to achieve non-financial objectives (as well as a financial return). The intentions of a Fund Manager versus actual contribution to non-financial objectives should be examined. The important consideration regarding contribution is how material an investment is. In this context materiality refers to the influence on outcomes, which in practice relates to the size of an equity investment or the agreed bond covenants. Materiality is a key element that differentiates a Fund Manager in public markets versus one in private markets.

Research IP seeks to answer the following questions when evaluating the Fund Manager’s Thematic/Impact approach:

- Is the Fund Manager investing in unlisted debt/equity? Note this asset class is not typically available to retail investors.
- What is the size of an individual investment in reference to the issuer? How much influence does the Fund Manager have on decision-making? How much can you attribute impact to non-financial objectives to a Fund Manager?
- Does the Fund Manager seek to address the UN SDGs? Which specific SDGs? What examples does the Fund Manager have of specific SDGs already being addressed in the portfolio?
- What metrics is the Fund Manager using to assess the impact on non-financial objectives? Internal metrics or external data providers?
- How often and where is the Fund Manager reporting the impact metrics?
- What level of continued engagement and analysis is the Fund Manager applying to ensure investments achieve the non-financial objectives?

Shown the Ropes

Which documents will explain what responsible investing approach a Fund Manager applies?

Figure 5 Fund Manager disclosures on responsible investing

Responsible Investment Policy / ESG Policy / Exclusions Policy

The Fund Manager may have separate documents (called any of the above or similar) which present the most detail on how they invest responsibly.

Proxy Voting Reports / Advocacy Reports / Corporate Engagement

The Fund Manager should have a record of any voting or corporate engagement if they take this active approach to responsible investing.

Statement of Investment Policy and Objectives (SIPO)

In the absence of a separate section on responsible investing, broadly speaking the Fund Manager will refer to their responsible investing approach within the sections on Investment Philosophy and Investment Process.

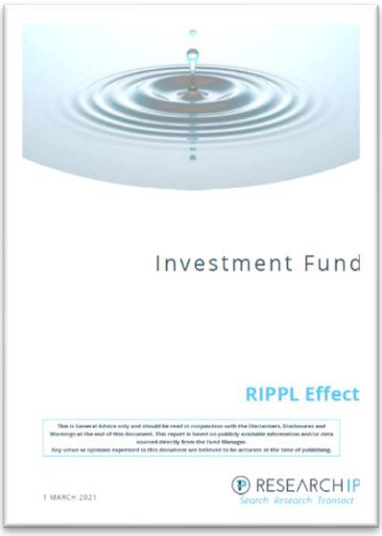
Product Disclosure Statement (PDS)

Commonly explained in "Section 2 – How Does This Investment Work?" This section will have a brief overview of the Fund Manager's approach.

Other Material Information (OMI)

The amount of information on responsible investing in this document will vary depending on the Fund Manager.

Further information on the investment approach a Fund Manager applies can be found in our [RIPPL Effect] reports. The RIPPL (Research IP Pty Ltd) Effect is a free offering for financial advisers and consumers.



The RIPPL Effect is designed to bridge the gap between our Quantitative Tear Sheets and full Qualitative Research Reports.

The reports provide a simple summary of every fund in the market. Simple data points are collected and presented in the same place on every report, in particular key information typically found in the PDS, SIPO, or on the manager's website, but often hard to find.

Information on the Fund Manager's responsible investment approach includes UN PRI ratings, consideration for SDGs, ESG screening and proxy voting. Research IP's opinion on the approach is explained in a full Qualitative Research Report.

Managed Funds Sailing Close to the Wind

The following table gives some examples of different managed fund products and what fundamental approaches to responsible investing the Fund Manager applies. The information has been collected from the Fund Manager Disclosures on Responsible Investing and summarised by Research IP to align with the Fundamental Approaches to Responsible Investing.

Figure 6 Managed fund examples of different responsible investing approaches

Managed Fund & Asset Class	Integration	Screening	Thematic/Impact
Discrete approach used by Manager 'A' **Global Equity**	ESG Integration – The Manager's objective is to assess material ESG risks via their investment process, and act as responsible owners by engaging with companies and exercising voting rights where risks exist. The Manager considers ESG issues when analysing a company's agency and business risk. In other words, will company management act in the best interests of shareholders? And will any ESG issues increase the risk to future cash flow and earnings. Ratings are given to a company by an analyst on the 'ES' and the 'G'. These are again considered by the Manager's Investment Committee. Company research and the relevant ESG risks are reviewed annually. Proxy voting and engagement – The Manager's objective is to promote the economic interests of clients. The Manager engages with senior management on a range of issues. Proxy voting proposals are analysed by the internal Governance and Advisory group in consultation with research analysts, with Portfolio Manager's reviewing all voting recommendations.	Negative – Exclude companies involved in tobacco, alcohol, gambling, adult entertainment, and weapons. The threshold for exclusion is greater than 10% of a company's revenues. Best-in-class – Selects companies based on their carbon emission intensity whilst further applying a cap on the total portfolio emissions.	Not directly applicable for this product.
Discrete approach used by Manager 'B' **Fixed Interest**	ESG Integration – Investments are analysed via a three-step ESG and Impact assessment framework consisting of (1) ESG assessment, (2) Impact assessment and (3) SDG mapping and alignment. A dedicated impact and ESG team	Negative – The Manager complies with the International Finance Corporation exclusion list. Best-in-class – The Manager screens the investment universe down to those	Impact – The Manager invests in bonds and loans of emerging market development banks, financials and microfinance institutions that focus on advancement of UN SDGs, with a particular focus on SDGs 1, 7, 8, 9 and 10. The Manager

	perform the assessments which are subject to multiple layers of review both before and after the investment is made. ESG Integration – Signatory to the United Nations Principles of Responsible Investment. Engagement – this is undertaken in the ESG assessment stage of the investment process where issuers are challenged on ESG and impact related questions.	investments that have low or medium ESG risk ratings, and medium to very high impact. Norms-based – The Manager is mandated to address specific UN Sustainable Development Goals.	prepares regular updates to stakeholders on material impact & ESG parameters.
Discrete approach used by Manager 'C' **Diversified**	ESG Integration – The Manager analyses ESG factors related to a company to assess corporate risk and how much value can potentially be created. The Manager rates the company using a wide set of criteria in this assessment. The rating helps the Manager gain a better understanding of financially material ESG-related risks and how these affect an investment's long-term performance. The Manager assesses risks as they relate specifically to the company but also the industry in which the company operates. The basis of the Manager's approach to ESG integration is a detailed philosophy underlined by the belief that companies with the best ESG practices will make better long-term investments. The Manager's policy on responsible investing is reviewed and updated annually by the Chief Executive. Proxy voting and engagement – The Manager actively votes and engages with companies to influence corporate behaviour and promote change. The Manager promotes ethical investment within the broader industry through public advocacy and collaboration with proactive organisations regarding ESG issues.	Negative – Exclude companies in tobacco, gambling, civilian and military weapons, alcohol, cannabis, pornography, animal testing, factory farming, livestock export, whaling, animals for entertainment, fossil fuel extraction, palm oil, genetically modified organisms, and controversial weapons. Best-in-class – companies managing climate change risks, human rights awareness, animal welfare, board diversity and assessing companies for controversial behaviour. Norms-based – UN Sustainable Development Goals are used as a reference.	Not directly applicable for this product.
Discrete approach used by	ESG Integration – The Manager uses a range of external data to inform their view on material risks to individual companies.	Negative – Excludes companies with >5% operating revenues from fossil fuels, uranium, gold mining, specific animal welfare	Sustainability Themed – The Manager takes a broad approach to sustainability themed investing with

Manager 'D' **Global Equity**	Analysts, a Sustainability Manager and Sustainability Committee all provide inputs into a risk review. Quantifiable ESG issues are integrated into financial modelling before engaging directly with companies. Frequent reviews are undertaken at the company and portfolio level. ESG Integration – Signatory to the United Nations Principles of Responsible Investment. Corporate engagement – The Manager believes the right to vote as proxy is a valuable asset to their investors and intend to vote on every resolution put to shareholders. The primary objective is to maximise the value to unit holders' investments. The Manager publicly discloses their proxy voting record and guiding principles.	concerns, predatory lending and hostile debt collection, alcohol, gambling, old growth forest logging and non-RSPO palm oil, and pornography. Zero revenue tolerance for controversial weapons and tobacco. Best-in-class – Companies with superior ESG characteristics, assessed through proprietary research and external research providers. Norms-based – The Manager assesses a company's products and operations and how they align with the UN SDGs. Qualitative and quantitative methods are used to measure contribution to SDGs.	reference to SDGs 1-15. The Manager demonstrates the application of these themes through integration and screening.
Discrete approach used by Manager 'E' **Global Equity**	ESG Integration – The Manager considers ESG issues at all stages of their investment process, ultimately targeting investment in companies that provide services/products helping to solve social and environmental issues. ESG Integration – Signatory to the United Nations Principles of Responsible Investment. Corporate engagement – The Manager maintains proxy voting records and engages directly with companies to improve management and performance.	Best-in-class – The Manager screens companies in line with nine sustainability themes: water management, cleaner energy, resource efficiency, sustainable transport, environmental services, safety, health, well-being, and education. Norms-based – The Manager uses the UN Sustainable Development Goals as a reference.	Sustainability Themed – The Manager takes a broad approach to sustainability themed investing by specifying nine sustainability themes. The Manager applies an impact methodology to calculate the impact from the products and services provided by the companies in the portfolio. *Note: a key difference with this product versus more direct impact investment products is that this one invests in listed companies, whilst other products invest in private companies – materiality of the investments differ and is important in the definition of 'impact investing'.*
Discrete approach used by Manager 'F' **Fixed Interest**	ESG Integration – The Manager integrates responsible investment criteria into their investment process with the view that it ultimately translates into incremental investment returns over the long term. ESG Integration – Signatory to the United Nations Principles of Responsible Investment.	Positive – The Manager selects green/social/sustainable bonds for the portfolio.	Sustainability Themed – The selected green / social / sustainable bonds finance companies that aim to generate positive externalities for society.

	Corporate engagement – The Manager follows the UN PRI guidelines for responsible investment engagement.		
Discrete approach used by Manager 'G' **Global Equity**	ESG Integration – The Manager combines fundamental, bottom-up research with in-depth analysis of ESG issues to help identify those companies in the best position to achieve risk-adjusted, long-term outperformance. The Manager uses external and independent sources as well as proprietary research. ESG Integration – Signatory to the United Nations Principles of Responsible Investment. Corporate engagement – The Manager considers engagement and advocacy a fundamental responsibility of theirs to help generate positive change on ESG issues. The Manager publicly discloses their shareholder resolutions, proxy voting record and guiding principles. The Manager has a dedicated shareholder advocacy team.	Negative – No fossil fuel exposure. Excludes companies with material involvement in agricultural biotechnology, coal mining, hard rock mining, nuclear and coal power, private prisons, tar sands, tobacco, gaming, pornography, weapons and firearms. Restrictions on investments involved in controversies within animal welfare, environment, governance, human rights and product safety. Best-in-class – research is undertaken by analysts to assess companies that meet positive thresholds of performance on ESG issues e.g., limiting harmful pollutants and chemicals, operates an ethical supply chain, strives to have a diverse board. Norms-based – Alignment with the UN SDGs, specifically goals 3, 5, 6, 7, 9, 10, 11, 12, and 15.	Sustainability Themed – The Manager invests in companies addressing sustainability challenges in three areas which are aligned with multiple SDGs: Climate Change, Economic Empowerment and Healthy Living. An Impact Assessment report is disclosed quarterly.
Discrete approach used by Manager 'H' **Global Equity**	ESG Integration – The Manager employs an index investment strategy. Integration of ESG considerations into the investment process occurs through the Responsible Investment Committee whose purpose is to provide input and advice on responsible investment policies and investments, assess negative/positive screens, and provide recommendations for ESG-related shareholder resolutions. ESG Integration – Signatory to the United Nations Principles of Responsible Investment. Corporate engagement – This is undertaken by the Responsible Investment Committee which will engage with companies and seek more detail on issues and advocate for improved corporate behaviour.	Negative – A number of screens are in place to remove companies directly involved in the fossil fuel industry, companies with >20% revenue customers engaged in fossil fuel industry, generation of nuclear power, >5% revenue from armaments or >0% from controversial weapons, no alcohol, no adult entertainment, no gambling or tobacco. Positive – companies must have minimum market cap of US$200m and ≥50% of revenue associated with activities that enable reduction or avoidance of CO_2 emissions. These are separated into five sectors (green energy, green transportation, water and waste improvements, decarbonisation enabling solutions, sustainable products).	Sustainability Themed – The strategy targets climate change and environmental problems through the reduction or avoidance of CO_2 emissions. Alignment to SDGs, carbon emissions, and renewable sourced power across the portfolio is reported periodically.

Principles for Responsible Investment

What are the Principles for Responsible Investment?

A UN-supported organisation that examines how investors can incorporate consideration of environmental, social and governance factors when investing. It is underpinned by six voluntary and aspirational principles that investors must commit to if they wish to sign up to it. Investors that sign up to the PRI include asset owners, investment managers and service providers.

The six principles that signatories commit to are:

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

The Principles are reasonably broad and most managers are now signatories, we have believed for a number of years that they will be tightened with time and we will see a few Fund Managers drop off the list, but have yet to see significant changes.

Figure 7 PRI signatories' minimum requirements, reporting and assessment

PRI Minimum Requirements (PRI link)

- A formalised policy that sets out an approach to responsible investment or ESG factors with coverage of more than 50% of assets under management.
- Staff (internal or external) explicitly responsible for implementing the responsible investment or ESG policy.
- Senior level oversight of the stated policy and accountability mechanisms for implementing responsible investment.

  Note: There are proposals to make these requirements stricter. However, the existing minimum requirements will remain in place for the 2023 reporting cycle, and their review will continue in 2023.

PRI Reporting (PRI Link)

- Fund Managers must report information on assets where the assets make up at least 10% of their assets under management (or more than $10bn). If this criterion is not met then the reporting becomes voluntary for those asset classes.
- Reporting for Fund Managers is live between May and August in 2023.
- The new Reporting Framework was released in early 2023, more information here.

PRI Assessment (PRI Link)

- The organisation does not receive an overall rating. The ratings will be given to certain "modules" instead. The modules assessed are as below:
  - **Policy Governance and Strategy (previously called Investment and Stewardship Policy), including climate change, human rights, and stewardship approach of the overall organisation.**
  - Manager selection, appointment, and monitoring (applicable if the Fund Manager uses externally managed assets).
  - Asset specific modules (six possible, where applicable) e.g., listed equity, real estate, private equity, fixed income, infrastructure, and hedge funds.
- Fund Managers answer questions within each applicable module. These questions are divided into "core" or "plus" questions:
  - The "core" questions are mandatory, closed-ended and only these will be used in the assessment.
  - The "plus" questions are voluntary, mostly open-ended and may allow the Fund Manager to elaborate on their practises.

- A star rating (1-5 stars) will be awarded on each module. Before 2021 the ratings were labelled as letters i.e. A+ to E. Therefore, previous years' ratings cannot be compared to the new star rating system.
- Ratings are released annually in the second half of the year in an Assessment Report specific to the Fund Manager, although these are not released publicly unless the Fund Manager chooses to. However, Transparency Reports and Climate Change Reports are available publicly here.

What are the investment merits of PRI?

The PRI are focused on enhancing returns and better managing risks through responsible investment, rather than a broader, more impactful and/or ethical approach to responsible investing.

Of the six Principles, the first three relate to how a Fund Manager should invest and where ESG issues should be considered. The last three essentially relate back to the first three. If a Fund Manager is a signatory to the PRI, then an investor can assume 'Integration' is one of the fundamental responsible investing approaches applied by the Fund Manager. This is demonstrated through the Fund Manager's commitment which starts with the belief that "...environmental, social, and corporate governance issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time)." However, Research IP notes the degree of integration varies considerably.

For an investor the value of a Fund Manager being a PRI signatory is the increased transparency it provides. It makes it easier to assess the Fund Manager's responsible investing practises within the reports provided via the PRI public signatory report page. A standard framework and consistent data points for the investment industry for ESG integration will make Fund Manager comparisons easier. It can provide a suitable reference point for investors and financial advisers to engage with Fund Managers.

Research IP consider signing up to the PRI as a bare minimum for any Fund Manager choosing to take ESG issues into consideration. Simply being a PRI signatory must be assessed further to distinguish a committed investment approach from a 'greenwashed' approach. A Fund Manager's PRI rating could be used as a starting point to evaluate their commitment to responsible investing. The PRI rating should not be the only factor in this evaluation as there are many ways to implement the six principles. The scale and depth of ESG integration will vary across Fund Managers.

The following comparison shows the differences between the investment management approaches from two different Fund Managers that are signatories to the PRI.

Figure 8 Comparison of managed funds approaches from Fund Managers that are signatories to the PRI

Fundamental Approach	Discrete approach used by Manager 'A'	Discrete approach used by Manager 'C'
Integration	ESG Integration – The Manager's objective is to assess material ESG risks via their investment process, and act as responsible owners by engaging with companies and exercising voting rights where risks exist. The Manager considers ESG issues when analysing a company's agency and business risk. In other words, will company management act in the best interests of shareholders? And will any ESG issues increase the risk to future cash flow and earnings. Ratings are given to a company by an analyst on the 'ES' and the 'G'. These are again considered by the Manager's Investment Committee. Company research and the relevant ESG risks are reviewed annually.	ESG Integration – The Manager analyses ESG factors related to a company to assess corporate risk and how much value can potentially be created. The Manager rates the company using a wide set of criteria in this assessment. The rating helps the Manager gain a better understanding of financially material ESG-related risks and how these affect an investment's long-term performance. The Manager assesses risks as they relate specifically to the company but also the industry in which the company operates. The basis of the Manager's approach to ESG integration is a detailed philosophy underlined by the belief that companies with the best ESG practices will make better long-term investments. The Manager's policy on responsible investing is

	Proxy voting and engagement – The Manager's objective is to promote the economic interests of clients. The Manager engages with senior management on a range of issues. Proxy voting proposals are analysed by the internal Governance and Advisory group in consultation with research analysts, with Portfolio Manager's reviewing all voting recommendations.	reviewed and updated annually by the Chief Executive. Proxy voting and engagement – The Manager actively votes and engages with companies to influence corporate behaviour and promote change. The Manager promotes ethical investment within the broader industry through public advocacy and collaboration with proactive organisations regarding ESG issues.
Screening	Negative – Exclude companies involved in tobacco, alcohol, gambling, adult entertainment, and weapons. The threshold for exclusion is greater than 10% of a company's revenues. Best-in-class – Selects companies based on their carbon emission intensity whilst further applying a cap on the total portfolio emissions.	Negative – Exclude companies in tobacco, gambling, civilian and military weapons, alcohol, cannabis, pornography, animal testing, factory farming, livestock export, whaling, animals for entertainment, fossil fuel extraction, palm oil, genetically modified organisms, and controversial weapons. Best-in-class – companies managing climate change risks, human rights awareness, animal welfare, board diversity and assessing companies for controversial behaviour. Norms-based – UN Sustainable Development Goals are used as a reference.
Thematic/Impact	N/A	N/A

The information in Figure 8 above was taken from publicly available Fund Manager Disclosures on Responsible Investing. To assess the implementation of their investment approach and evaluate the Fund Manager's commitment to responsible investing, a deeper dive on the Fund Manager is required, as outlined earlier in Check the Pulse.

The answers to parts of our questions can be found in the PRI Transparency Reports, though parts require further engagement with the Fund Manager. For example, within the PRI assessment, Fund Managers can indicate which processes they use to ensure ESG integration is based on robust analysis; several answer boxes can be ticked including, "comprehensive ESG research is undertaken or sourced to determine companies' activities and products" or "third-party ESG ratings are updated regularly". Further research should follow to ascertain how comprehensive the research is and which third-party rating providers the Fund Manager uses.

Sustainable Development Goals

What are the Sustainable Development Goals?

A total of 17 goals designed as "a blueprint to achieve a better and more sustainable future for all by 2030". Within these 17 goals there are 169 underlying targets, each with specified indicators which help to measure progress towards the goals. The goals were adopted by all members of the United Nations in 2015 as a core part of the 2030 Agenda for Sustainable Development.

Figure 9 Sustainable Development Goals

What are the investment merits of the SDGs?

The SDGs were developed for global policy makers, so applying them within the investment industry is not straight forward. The most useful aspect is that the SDGs are a globally accepted framework. Fund Managers can map investments against the 17 SDGs and articulate to investors how an investment portfolio is aligned with the goal of a more sustainable future. Alignment with the goals is the easy part; linking the tangible impact of an investment to the SDGs is the hard part.

Fund Managers need a tangible way of measuring the impact to the SDGs. Ideally a Fund Manager should target and measure investments alongside the ‘indicators’ relevant to each SDG. The indicators provide a quantifiable point to measure an investment’s impact. However, some SDGs are more investable than others. Take for example SDG #17 and one of its underlying indicators. This would be more applicable for central government.

Goal	**Target**	**Indicator**
17. Partnerships for the Goals	17.1. Strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection.	17.1.1. Total government revenue as a proportion of GDP, by source.

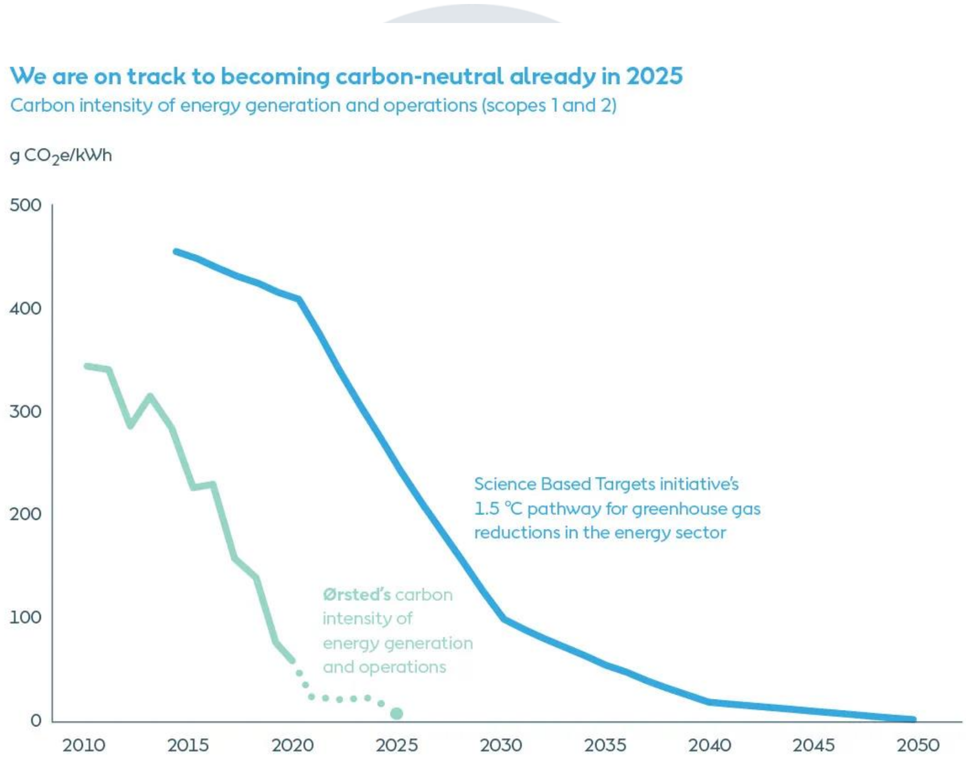
On the other hand, the underlying indicator for SDG #7 related to an increase in renewable energy would have far more investment merit.

Goal	Target	Indicator
7. Affordable and Clean Energy	7.2. By 2030, increase substantially the share of renewable energy in the global energy mix.	7.2.1. Renewable energy share in the total final energy consumption.

An investment into a company such as SSE would be aligned with SDG #7 given it is a leading developer and operator of renewable energy across the UK and Ireland. Similarly, in NZ, Genesis Energy would be aligned given the development of wind farms, despite its current exposures. So, you could tick the box on 'alignment'. However, what is the actual impact on the indicator from investing in the company's shares? What measure of "total final energy consumption" is appropriate? If a Fund Manager promotes alignment with the SDGs, do some Fund Managers make more of an impact on the SDGs than others?

A great example of the transition is the Danish company Ørsted. It was once one of the most coal-intensive energy companies in Europe. Today, they claim to be the world's most sustainable energy company, and a global leader in the transition to green energy. The transition is almost complete, but has taken over a decade.

Figure 10 Ørsted carbon intensity of energy generation and operations



A lack of data, inconsistent metrics, timeliness, and an absence of benchmarking leads to difficulties when comparing the application of SDGs across managed funds. However, this area of data and standard setting is constantly evolving and will help ensure more impact can be demonstrated through investment. The Impact Management Project and Global Impact Investing Network are two organisations at the forefront of these developments. Furthermore, the development of big data methodologies could see significant advancement in the application of SDGs by Fund Managers. Any efficiencies developed could lead to an increase in the number of accessible investment strategies for a wider range of investors.

Prudent comparisons of investment strategies require a deeper understanding of the Fund Manager's investment philosophy and how it is applied through the investment decision-making process and eventual portfolio construction. The following comparison shows differences between the investment management approaches from two different Fund Managers that apply the SDGs:

Figure 11 Comparison of managed funds that consider SDGs

Fundamental Approach	Discrete approach used by Manager 'B'	Discrete approach used by Manager 'G'
Integration	ESG Integration – Investments are analysed via a three-step ESG and Impact assessment framework consisting of (1) ESG assessment, (2) Impact assessment and (3) SDG mapping and alignment. A dedicated impact and ESG team perform the assessments which are subject to multiple layers of review both before and after the investment is made. ESG Integration – Signatory to the United Nations Principles of Responsible Investment. Engagement – this is undertaken in the ESG assessment stage of the investment process where issuers are challenged on ESG and impact related questions.	ESG Integration – The Manager combines fundamental, bottom-up research with in-depth analysis of ESG issues to help identify those companies in the best position to achieve risk-adjusted, long-term outperformance. The Manager uses external and independent sources as well as proprietary research. ESG Integration – Signatory to the United Nations Principles of Responsible Investment. Corporate engagement – The Manager considers engagement and advocacy a fundamental responsibility of theirs to help generate positive change on ESG issues. The Manager publicly discloses their shareholder resolutions, proxy voting record and guiding principles. The Manager has a dedicated shareholder advocacy team.
Screening	Negative – The Manager complies with the International Finance Corporation exclusion list. Best-in-class – The Manager screens the investment universe down to those investments that have low or medium ESG risk ratings, and medium to very high impact. Norms-based – The Manager is mandated to address specific UN Sustainable Development Goals.	Negative – No fossil fuel exposure. Excludes companies with material involvement in agricultural biotechnology, coal mining, hard rock mining, nuclear and coal power, private prisons, tar sands, tobacco, gaming, pornography, weapons and firearms. Restrictions on investments involved in controversies within animal welfare, environment, governance, human rights and product safety. Best-in-class – Analysts undertake research to assess companies that meet positive thresholds of performance on ESG issues e.g., limiting harmful pollutants and chemicals, operates an ethical supply chain, strives to have a diverse board. Norms-based – Alignment with the UN SDGs, specifically goals 3, 5, 6, 7, 9, 10, 11, 12, and 15.
Thematic/Impact	Impact – The Manager invests in bonds and loans of emerging market development banks, financials and microfinance institutions that focus on advancement of UN SDGs, with a particular focus on SDGs 1, 7, 8, 9 and 10. The Manager prepares regular updates to stakeholders on material impact & ESG parameters.	Sustainability Themed – The Manager invests in companies addressing sustainability challenges in three areas which are aligned with multiple SDGs: Climate Change, Economic Empowerment and Healthy Living. An Impact Assessment report is disclosed quarterly.

The information in Figure 11 was taken from publicly available Fund Manager Disclosures on Responsible Investing. Evaluating a Fund Manager's overall strategy is critical when trying to understand the investment merits of SDGs.

The breadth of investments aligned with or targeting the SDGs will differ between Fund Managers. Whether or not a Fund Manager pursues multiple SDGs or single SDGs should be considered. A more focussed approach may allow the Fund Manager to make more of an impact, though this will depend on the type of managed fund and stated investment objectives. For example, a diversified global equity fund may align itself with multiple SDGs, whilst a green bond fund may focus solely on financing projects that aim to mitigate the effects of climate change. The corollary of this is determining investment materiality, and ultimately impact.

Investment materiality will play a determinant role in achieving tangible outcomes in the progress towards a better and more sustainable future. The intentions of a Fund Manager versus actual contribution to the SDGs should be examined. A Fund Manager can articulate intent towards the SDGs within their investment philosophy, however, demonstrating the contribution to the SDGs is where the rubber hits the road.

The important consideration regarding contribution is how material an investment is. In this context materiality refers to the influence on outcomes, which in practice relates to the size of an equity investment or the agreed bond covenants. Materiality is a key element that differentiates a Fund Manager in public markets versus one in private markets.

Research IP seeks to answer the following questions when assessing a Fund Manager's commitment to the SDGs:

- What is the size of an individual investment in reference to the issuer? How much influence does the Fund Manager have on decision-making? How much can you attribute to a Fund Manager the impact to non-financial objectives?
- Where in the investment process are the SDGs considered by the Fund Manager?
- Which SDGs does the Fund Manager seek to address? And how?
- What examples does the Fund Manager have of specific SDGs already being addressed in the portfolio?
- What metrics is the Fund Manager using to assess the impact on the SDGs? Internal metrics or external data providers?
- How often and where is the Fund Manager reporting the impact on the SDGs?
- How does company reporting and transparency fit into the equation? Which reported metrics relate to the SDGs? What level of continued engagement and analysis is the Fund Manager applying to ensure the focus on the SDGs is relevant?

All Hands on Deck

ESG Data

What part does data play in the consideration of ESG issues when investing in managed funds?

ESG data providers in the investment industry evaluate ESG factors primarily at the company level. Fund Managers can use the data to help understand the risk/return prospects of investing into a company. Index providers can use the data to construct products, which in turn can also be used as benchmarks for other managed funds. Figure 12 below illustrates very simply the procession of data from a company to a managed fund via ESG ratings.

Figure 12 ESG data flow

Note: The ESG data discussed here relates to managed funds across traditional asset classes. What is not mentioned is the data used to measure 'impact', or non-financial objectives. This element of ESG data is much less developed. However, the Impact Management Project and Global Impact Investing Network are two organisations at the forefront of these developments.

What are some key aspects to be aware of regarding ESG data?

There is no single, agreed way to measure ESG factors. There are dozens of data providers to choose from. Each of the providers apply different frameworks. A few of the larger and more commonly used providers include:

- Bloomberg
- FTSE
- ISS
- MSCI
- Refinitiv
- RepRisk
- RobecoSAM
- Sustainalytics
- TruValue Labs
- TruCost
- Vigeo Eiris
- Upright Project

The ratings for a specific company could differ significantly across data providers. For example, a Fund Manager may want to include Tesla in their portfolio; one ESG data provider may rate Tesla highly, whilst another may rate it lower. All other things being equal, what percentage weighting of a managed fund should Tesla hold? Which ESG data provider is correct or most relevant? Simply put, the ESG information from data providers that feed managed funds is noisy, which leads to our discussion of the merits of active vs passive management in this space.

The following points summarise several aspects that may differ between the underlying frameworks employed by ESG data providers.

Data sources
e.g., annual company reports, corporate sustainability reports, stock exchange filings, news sources, company websites, individual directors, shareholder meeting results, non-governmental organisation research and reports. The other major issue is the availability and the gaps in the data across the global universe to enable broad comparison.

Algorithms and/or human processes
e.g., analyst opinion and additional insights, data audits, manual checks by analysts, language translations, picking up missing data, formal committee reviews vs systematic monitoring.

The building blocks that make up the final ESG rating
Broadly speaking this entails three ESG pillars > sub-categories > indicators > data points. e.g., starting with the 'E' from the three ESG pillars > a sub-category might be climate change > carbon emissions would be an indicator > metric tons of CO^2 emissions per million dollars invested would be a data point. The following table shows examples of different sub-categories specified by commonly used ESG data providers. Note the similarities, or lack of. Underneath these sub-categories are several indicators which have hundreds of specific data points assigned to them.

Figure 13 Examples of the sub-categories specified by ESG rating providers

ESG Data Provider	Environmental sub-categories	Social sub-categories	Governance sub-categories
A	Biodiversity Climate Change Pollution and Resources Supply Chain Water Security	Customer Responsibility Health and Safety Human Rights and Community Labour Standards Supply Chain	Anti-corruption Corporate Governance Risk Management Tax Transparency
B	Resource use Emissions Innovation	Workforce Human rights Community Product responsibility	Management Shareholders CSR strategy
C	Climate Change Natural Capital Pollution & Waste Environmental Opportunities	Human Capital Product Liability Stakeholder Opposition Social Opportunities	Corporate Governance Corporate Behaviour

Validity of specific data points
Are the data points hard or soft, quantitative or qualitative, objective or subjective? The definition of subjective is 'based on or influenced by personal feelings, tastes, or opinions.' The definition of objective is 'not influenced by personal feelings or opinions in considering and representing facts.' For example, one of the data points for climate change is CO^2 emissions which is quantitative and can be measured objectively. However, the measurement of corporate behaviour is more subjective and would require more qualitative analysis.

ESG category weights and materiality
What weights are applied to the ESG categories to calculate the overall ESG rating? What issues does the data provider place more emphasis on? Over what time horizon will the risks materialise? Are adjustments made to consider the industry a company operates in? The materiality of ESG factors differ across industries. Does the ESG rating separate systematic risk exposure from idiosyncratic risks? For example, the 'E' is more relevant in the energy sector than the technology sector given the direct exposure to fossil fuels and CO^2 emissions. If a company is transitioning away from fossil fuels but is still emitting a significant amount of CO^2 currently, does the company get a higher score for managing the risk better on a forward-looking basis, or will the current measure of CO^2 emissions influence the rating more heavily? Is the rating taking into account the *net* materiality of different ESG factors?

Frequency of updates
How often are the ESG ratings updated? Is the underlying data sourced in a timely manner? Can the data then be collated and analysed efficiently? Parts of the rating process may be monitored daily or weekly, but a complete review of a company is more likely to be on an annual basis. An ESG data provider may also have triggers that necessitate a more in-depth look at a company e.g., controversies in the news.

Final rating description and interpretation
Is the rating a score out of 100? Is the rating assigned to one of 5 risk categories? A letter-based system with 7 categories? The interpretation of the final rating can lead to different conclusions, for example, does the rating allow an investor to compare it to companies in other industries, or is it only comparable against industry peers? Is it possible to compare the ratings for the underlying 'ESG' pillars, or only use the overall company rating for comparisons?

Comparison of a company's rating against itself through time may not be directly comparable if elements of the research process has changed.

Aside from differences in underlying frameworks of ESG data providers, the following points should also be considered when evaluating the use of ESG data within managed funds:

The quality of the ESG data at its source

An ESG rating can only be as good as the underlying data. Company disclosures are a crucial part of this. The disclosure organisations listed in Figure 17 Key organisations regarding regulation, disclosure, and standards are tasked with ensuring ESG disclosures are consistent and relevant. One aspect to be aware of is a company's self-reporting bias where there is a risk of greenwashing.

The depth of integration in the investment decision-making process

Investors should consider the extent to which the Fund Manager uses the ESG data. Fund Managers may use the data as a reference to supplement their proprietary research when 'scoring' a company. Other Fund Managers may use a combination of data from different ESG data providers on top of their proprietary research to calculate a company's cost of capital. Some Fund Managers may use the data to rank companies and define screens that reduce the investment universe.

Construction of an index

This is relevant for index products but also managed funds that use an ESG index as its benchmark. The following table compares two S&P 500 ESG indices based off the main S&P 500 Index. Variation in portfolio construction can mean significant differences in risk and return outcomes.

Figure 14 S&P 500 Index vs two S&P 500 ESG Indices (Source: S&P Dow Jones Indices and S&P Dow Jones Indices - ESG)

Data as at 30 December 2022	S&P 500 Index	S&P 500 ESG Index	S&P 500 ESG Tilted Index
Number of constituents	503	304	451
Mean total market cap (USD million)	67,160	79,712	68,975
Median total market cap (USD million)	29,391	34,172	29,552
Weight largest constituent (%)	6.1	8.4	8.4
Weight top 10 constituents (%)	24.4	32.6	31.7
Sector Weightings (%)			
Information Technology	25.7	28.3	28.6
Health Care	15.8	17.1	15.2
Financials	11.7	11.6	11.9
Consumer Discretionary	9.8	8.4	10.8
Industrials	8.7	6.8	6.4
Communication Services	7.3	7.5	8.5
Consumer Staples	7.2	7.4	6.5
Energy	5.2	5.6	5.2
Utilities	3.2	1.8	1.6
Real Estate	2.7	2.7	2.6
Materials	2.7	2.8	2.6

Key observations:

- Less constituents in the ESG indices results in higher weightings to certain stocks, and higher concentration shown by weighting to the top 10 stocks.
- Bias towards stocks with higher market cap in the ESG indices.
- Higher allocation to information technology in both ESG indices.
- Lower allocation to industrials and utilities in both ESG indices.

Active, Passive or ETF

This is not the place to have the debate about active or passive, but just like fixed income (bond) investing we certainly lean towards active implementation in this space.

We are currently witnessing a phase of increased interest in responsible investing. Similar to technology, this is a thematic, and with it comes new funds and new strategies to capitalise on the interest. This is where we, as investors, need to be careful. Is it simply greenwashing? Or a sales pitch to raise funds under management?

We highlighted earlier the challenges with the data, so constructing a quantitative investment process around these data points can be challenging. When constructing indices or passive structures, the size of the universe is also critical. Concentration and liquidity of an index must be evaluated. A good example of a concentrated index which received significant inflows of money was the S&P Global Clean Energy Index. The trading volumes of Meridian Energy and Contact Energy shares were substantial in early 2021, which led to opportunities for active managers to exploit. To reduce the likelihood of volatile periods like this, S&P DJI ended up expanding the S&P Global Clean Energy Index's target constituent count to 100 and amending the liquidity screen for constituent selection.

It is also important to understand the objective of the strategy - is it to be sustainable, is it to screen out bad companies, target good companies, invest for impact, or to outperform a specific index? The reality is, we operate in a world where the dollars flow toward the funds that perform, so sustainability of the fund structure is also critical.

We have seen strong performance from a number of available strategies but is it the ESG thematic driving the performance in market sectors? There are vast amounts of money moving into this thematic which helps support performance, but also, these strategies tend to invest in more asset-light technology type businesses, and avoid the old world economy. This broader thematic has been performing very well itself for the last 10+ years. After 30+ years of bond compression, as the cost of capital rises again, do some of these business models begin to be challenged?

So, is this performance persistent? Is there alpha in the opportunity set, or is ESG simply a subset of a broader quality measure?

From a broader investment portfolio perspective, is this a sleeve, a bit of play money, or is it core to your investment philosophy? Can you access credible strategies for all elements of your portfolio? Often your wealth and investment strategy are linked to your retirement outcomes, we can save the world in many different ways, but you may not enjoy it so much if you are still working at 90. Do you turn the lights on at night? In most of the world they are still coal fired.

Again, the jury is out on this one, but there is plenty to consider when building out an investment strategy.

Regulatory Compass

The PRI website maintains an excellent regulation database documenting sustainable finance policies around the world. Further due diligence on policies can be sought through the hyperlinks provided in the database. The following provide an overview of responsible investing regulation around the globe and key organisations to follow to keep up with developments.

Figure 15 Cumulative number of policy interventions as at April 2022 (Source: unpri.org)

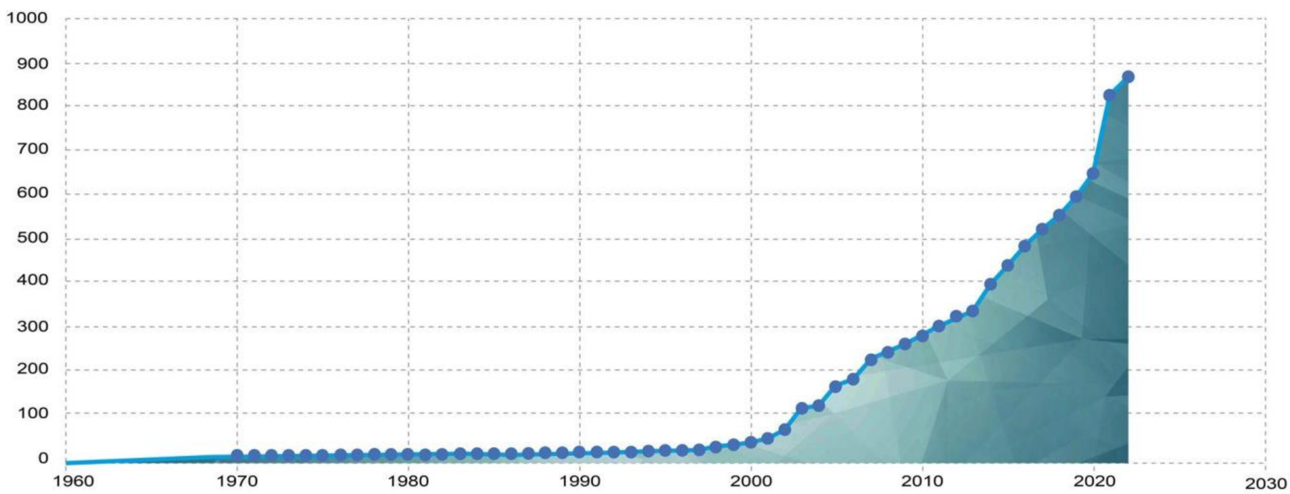
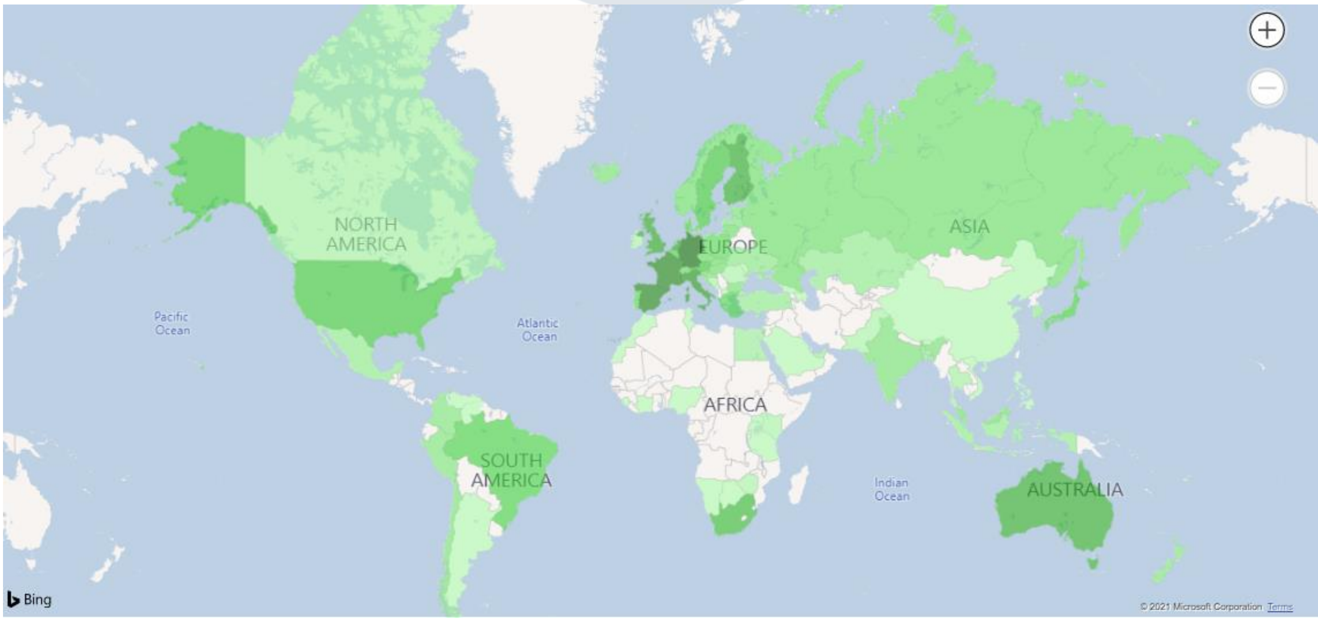


Figure 16 Global responsible investment regulation map as at August 2021 (Source: unpri.org)



The darker shades of green denote more responsible investing policies in that country. The country with the most is Germany (27), followed by Spain (24) and France (24). This is ahead of the US (15), UK (20), New Zealand (7) and Australia (19). The European Union (23) is not included on the map.

Figure 17 Key organisations regarding regulation, disclosure, and standards

Type of Organisation	Links to Organisation
Regulation	NZ - FMA - Corporate governance in New Zealand: Principles and guidelines NZ - Code Committee - Code of Professional Conduct for Financial Advice Services - Suitable Advice NZ - NZX - Corporate Governance Code Australia - ASIC - Corporate governance Australia - ASX - Corporate Governance Council Global - PRI - Regulation database Europe - European Commission - Sustainable finance Europe - European Union - Sustainable Finance Disclosure Regulation US - SEC - Response to Climate and ESG Risks and Opportunities
Disclosure	NZ - External Reporting Board (XRB) - Sustainability Reporting NZ - NZ Parliament - Climate-related Disclosures and Other Matters) Amendment Bill NZ - FMA - Disclosure framework for integrated products Global - Task Force on Climate-Related Financial Disclosures (TCFD) Global - Taskforce on Nature-related Financial Disclosures (TNFD) Global - International Integrated Reporting Council (IIRC) Global - Sustainability Accounting Standards Board (SASB) Global - Climate Disclosure Standards Board Global - Global Reporting Initiative (GRI) Global - CFA Institute - ESG Disclosure Standards for Investment Products
Standard Setting	Global - World Federation of Exchanges - WFE Annual Sustainability Survey Global - IOSCO - Consultation on ESG Ratings and Data Providers Global - OECD - Due Diligence Guidance for Responsible Business Conduct Global - Principles for Responsible Investment Europe - Eurosif - promotion and advancement of sustainable and responsible investment Global - UNEFI - UN-convened Net-Zero Asset Owner Alliance Global - Impact Management Platform Global - Global Impact Investing Network (GIIN) UK - Financial Reporting Council - UK Stewardship Code Australia/NZ - Responsible Investment Association Australasia (RIAA) New Zealand - Stewardship Code

Staying Above Board

The growth in managed funds focused on ESG considerations across the globe has warranted reviews by regulators to assess whether the actual practices of Fund Managers match how the products are promoted. Basically, tackle "greenwashing". The breadth and depth of disclosure requirements are continually developing and differ across investment jurisdictions. The following sections give an insight into recent developments and links for further information.

Australia and the US – Reviews into responsible investing disclosures

In Australia ASIC published the RG 65 Section 1013DA disclosure guidelines in 2011, but more recently in 2022 issued an information sheet on how to avoid greenwashing when offering or promoting sustainability-related products.

At the start of 2021 in the US, the Biden administration sought to address climate and ESG risks through the SEC. Recent actions by the SEC can be viewed here. In May 2022, the SEC proposed amendments to rules and reporting forms to promote consistent, comparable, and reliable information for investors concerning funds' and advisers' incorporation of ESG factors. Regulatory tailwinds for ESG investing in the US are substantial.

New Zealand – FMA guidance, disclosure framework, and review of managed fund documentation

In December 2020 the FMA published the disclosure framework for integrated products which takes a principles-based approach with the overarching requirement of meeting 'fair dealing' provisions. The guidance provides disclosure expectations within the following framework:

- The standard 'vanilla' elements of the integrated financial product
- What does the integrated financial product purport to offer beyond a standard financial product?
- Measurement and evidence of non-financial performance
- Internal audit or external assurance provided
- Governance framework
- Risks or costs associated with the integrated financial product
- Consequences of failure

Guidance provided by the FMA in April 2021 for Fund Managers regarding fees and value for money notes the following regarding responsible investment:

- 'If a scheme claims its asset stewardship, including taking account of non-financial factors within an integrated financial product, adds value, can they substantiate it by demonstrating how it fits member values? Or how it benefits investment outcomes? For example, does it reduce risk without reducing return, enhance return, have quantifiable non-financial impacts, or shape company behaviour?'

In July 2022, the FMA released the report Integrated financial products: Review of managed fund documentation. The aim of the review was to better understand how Fund Managers provide information to help people make investment decisions, including information about the risks and benefits of funds that take a responsible investing approach.

European Union – Sustainable Finance Disclosure Regulation

The Sustainable Finance Disclosure Regulation (SFDR) was drawn up as part of the European Union's response to the 2030 Agenda for Sustainable Development. The SFDR "…lays down harmonised rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products." A key part of the regulation is the concept of "*principal adverse impacts*" (PAIs), which are the negative effects on ESG/sustainability factors that stem from investment decisions.

The SFDR essentially aims to help minimise "greenwashing" through greater transparency. More transparency enables a more informed investment choice. The regulation addresses requirements for both financial advisers and financial market participants (e.g., fund managers, pension products, venture capital funds etc).

The introduction to the regulation indicates that "financial advisers should disclose how they take sustainability risks into account in the selection process of the financial product that is presented to the end investors before providing the advice, regardless of the sustainability preferences of the end investors." Increased transparency requirements for financial advisers (unless where there are less than three employees) include the following:

Figure 18 SFDR transparency requirements for financial advisers

Key Articles	Summary of transparency requirements for financial advisers
Article 3	Policies published on their *websites* regarding integration of sustainability risks in their investment decision-making process.
Article 4	Information published on their *websites* as to whether or not they consider PAIs on sustainability factors; if not, why not and when they might begin to consider PAIs.

Article 5	Publish remuneration policies on their *websites* explaining how the policy is consistent with the integration of sustainability risks.
Article 6	*Pre-contractual* disclosure on integration of sustainability risks: ○ How sustainability risks are integrated into investment decision-making. ○ Likely impacts of sustainability risks on returns.

Increased transparency for financial market participants (e.g., fund managers, pension products, venture capital funds etc) includes the following:

Figure 19 SFDR transparency requirements for financial market participants

Key Articles	Summary of transparency requirements for financial market participants
Article 3	**Transparency of sustainability risk policies** Policies to be published on their *websites* regarding integration of sustainability risks in their investment decision-making process.
Article 4	**Transparency of adverse sustainability impacts at entity level** Policies to be published on their *websites* regarding the consideration of PAIs (or not) within investment decisions regarding sustainability factors at the entity level – how they identify the PAIs, actions taken, engagement policies, adherence with recognised standards/codes/reporting, and alignment with objectives of the Paris Agreement.
Article 5	**Transparency of remuneration policies in relation to the integration of sustainability risks** Publish remuneration policies on their *websites* explaining how the policy is consistent with the integration of sustainability risks.
Article 6	**Transparency of the integration of sustainability risks** *Pre-contractual* disclosure on integration of sustainability risks: ○ How sustainability risks are integrated into investment decision-making. ○ Likely impacts of sustainability risks on returns.
Article 7	**Transparency of adverse sustainability impacts at financial product level** Where PAIs are considered, disclosures from Article 6 should include how the financial product considers principal adverse impacts on sustainability factors, and quantification of these in reference to regulatory technical standards.
Article 8	**Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures** *Pre-contractual* disclosure on promotion of environmental or social characteristics: ○ How the product meets the characteristics. ○ How the reference benchmark index meets the characteristics and the methodology.
Article 9	**Transparency of sustainable investments in pre-contractual disclosures** *Pre-contractual* disclosure where a product has a sustainable investment objective: ○ How the objective is aligned with a specified index and why the index differs from a broad index; if no index, then how the objective is to be achieved. ○ A carbon emission reduction objective will require reference to the long-term global warming objectives of the Paris Agreement and how the continued efforts are helping to work towards this goal. ○ Calculation methodology for indices.
Article 10 & 11	Article 10 and 11 address disclosure requirements via *websites* and *periodic disclosures* for products referred to in Articles 8 and 9.

A critical part in the implementation of the SFDR is the 'regulatory technical standards' (RTS). These were published in July 2022. The requirements apply from 1 January 2023. In summary, the RTS address the following:

- Specify the details for presentation and content regarding:
  - products that *promote* environmental or social characteristics in pre-contractual disclosures.
  - products that *specify* a sustainable investment *objective* in pre-contractual disclosures.
- Develop standards for the content, methodologies, and presentation of information:
  - regarding sustainability indicators in relation to *adverse impacts* on the climate and other environment-related adverse impacts.
  - regarding sustainability indicators in relation to *adverse impacts* in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

The result of the SFDR is that investment products are categorised according to the applicable Articles and must disclose the information as per the RTS. Basically, a managed fund is now categorised as one of the following:

1. No integration of sustainability risks promoted or any sustainable investment objective (Article 6).
2. Integrates sustainability risks and promotes environmental or social characteristics (Article 8).
3. Integrates sustainability risks and has a sustainable investment objective (Article 9).

Responsible Investing Champions

Financial Markets Authority – Disclosure framework for integrated financial products

https://www.fma.govt.nz/assets/Guidance/Disclosure-framework-for-integrated-financial-products.pdf

To help investors gain a better understanding of responsible investment products the Financial Markets Authority issued a disclosure framework in December 2020 and a review of managed fund documentation in July 2022. Further resources on ethical investing can be found on the FMA website.

Responsible Investment Association Australasia (RIAA)

https://responsibleinvestment.org/

An active network with over 350 members managing more than $9 trillion in assets globally. Membership includes super funds, fund managers, banks, consultants, researchers, brokers, impact investors, property managers, trusts, foundations, faith-based groups, financial advisers, and individuals.

NZ Super Fund – Responsible Investment

https://nzsuperfund.nz/how-we-invest/responsible-investment/

An insight into how the NZ Super Fund integrates responsible investment into their investment approach.

Principles for Responsible Investment

https://www.unpri.org/

UN-supported international network of investors working together to implement six aspirational principles.

United Nations Sustainable Development Goals

https://sdgs.un.org/

A total of 17 goals designed as "a blueprint to achieve a better and more sustainable future for all by 2030".

United Nations Global Compact

https://www.unglobalcompact.org/

Ten principles designed for businesses to help meet their responsibilities in the areas of human rights, labour, the environment, and anti-corruption.

The Global Impact Investing Network (GIIN)

https://thegiin.org/

The GIIN is the “global champion of impact investing, dedicated to increasing its scale and effectiveness around the world”.

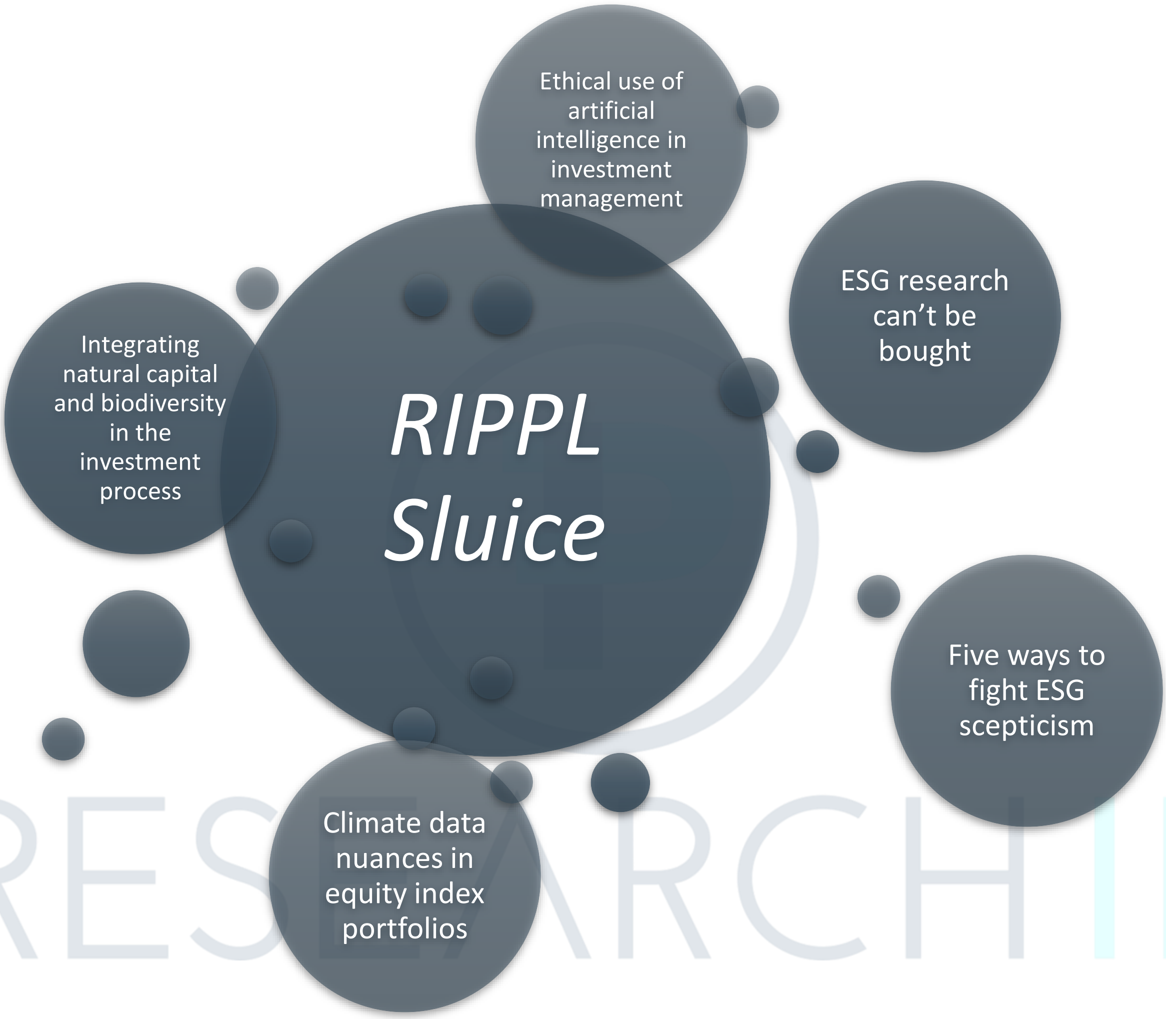
Mindful Money

https://mindfulmoney.nz/

A consumer-oriented approach with comparisons of ethical investment options in New Zealand. Very helpful for comparing portfolio holdings and the outcomes of Fund Manager screening processes.

Responsible Investing News, Articles, and Research

Research IP helps many of our consulting clients navigate the maze, but no one client is the same. The *RIPPL Sluice* provides examples of responsible investment in action every month.



Next Port of Call

This paper was not designed to be an opinion piece, rather more to bring some attention to the breadth and nuance of responsible investing.

However, what we do know is that becoming a signatory to the PRI is no longer a differentiator, it is the standard, but the discussion has also moved on. The PRI are really about enhancing returns and better managing risks. They are not connected to the UN SDGs, so are not focusing on a broader, more impactful and/or ethical approach. For example, in relation to climate change, PRI is saying "take account of climate change to reduce the long-term risk of your portfolio", it is not saying "take account of climate change because we should care deeply about how we care for our planet and the world we are passing to future generations."

When we extrapolate this into the world of financial advice, where does this lead us? Financial advice is generally principles based, so advisers need to assess if 'suitability' includes taking account of non-financial factors, and how these may fit a client's values. Advice must be suitable and an adviser must have reasonable grounds for the advice. If the advice includes a comparison of managed fund products, an assessment of each managed fund should be undertaken.

Every year Research IP runs our Fund Manager of the Year Awards, and in 2020 we introduced the Responsible Investment Manager of the Year. At the time, the universe of Fund Managers was fairly limited, but we knew that the space would expand with time and it was important to recognise excellence in the industry.

Looking forward there are many unanswered questions as responsible investing advances. When will we hit net (carbon) zero? How can investors and fiduciaries respond to biodiversity and natural capital under the Taskforce on Nature-related Financial Disclosures? Will the responsible investment focus widen from just a manager's funds to also include the manager's underlying business? How do standard strategic asset allocation (SAA) models account for sustainability, can they? How will we define, measure and report on 'impact' to ensure tangible benefits result from each dollar invested? Will we see better non-financial reporting more broadly to enable more quantifiable 'impact'?

We hope that *Beneath the Surface of Responsible Investing* has helped shed some light on this far-reaching topic. Research IP helps many of our consulting clients navigate the maze, but no one client is the same. We will continue to share examples of responsible investing in action, while also continuing to dive deeper into specific areas of this paper. In the meantime, please reach out if you believe we could be of assistance.

About Research IP

Research IP has been providing clients with investment governance, financial product research and investment technology solutions since 2015. By leveraging the skills of our team of specialists, Research IP is able to provide innovative and tailored financial services solutions to clients. We are a specialist investment research provider which is used and trusted by charities, not-for-profit organisations, family offices, & financial advisers for investment, Superannuation and other Pension schemes throughout the Asia Pacific region.

Our experience has been gained in well over 20 years of roles across different facets of the industry, so we understand the key drivers and challenges for people trusted with the management of investments.

Client focused outcomes are underpinned by the belief that the role of business model innovation and accelerating technological change opens up new possibilities, to put client interests at the centre of the financial services industry focus. We have strong philosophical alignment with John Hagel's work on the possibilities for "Disruption by Trusted Advisors" and John Kay's views in "Other People's Money: Masters of the Universe or Servants of the People".

Some of the consulting services we provide to financial advisers, charities, not-for-profit organisations and other investors include:

- Financial service licence reviews
- Platform and Financial Adviser Software reviews
- Fee negotiations for better client outcomes
- Investment committee terms of reference / charter
- Investment committee skills assessment
- Investment policy development
- Investment committee implementation review
- Chair or independent investment committee member
- Investment manager review
- Investment manager / adviser selection
- Quarterly reporting and commentary
- Sustainability and ESG policy development
- Sustainability and ESG investment selection / implementation of strategies.

If you would like to discuss one or a number of these consulting services, please contact info@research-ip.com.
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