ESG Market Review

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More than **2,500 funds** reviewed

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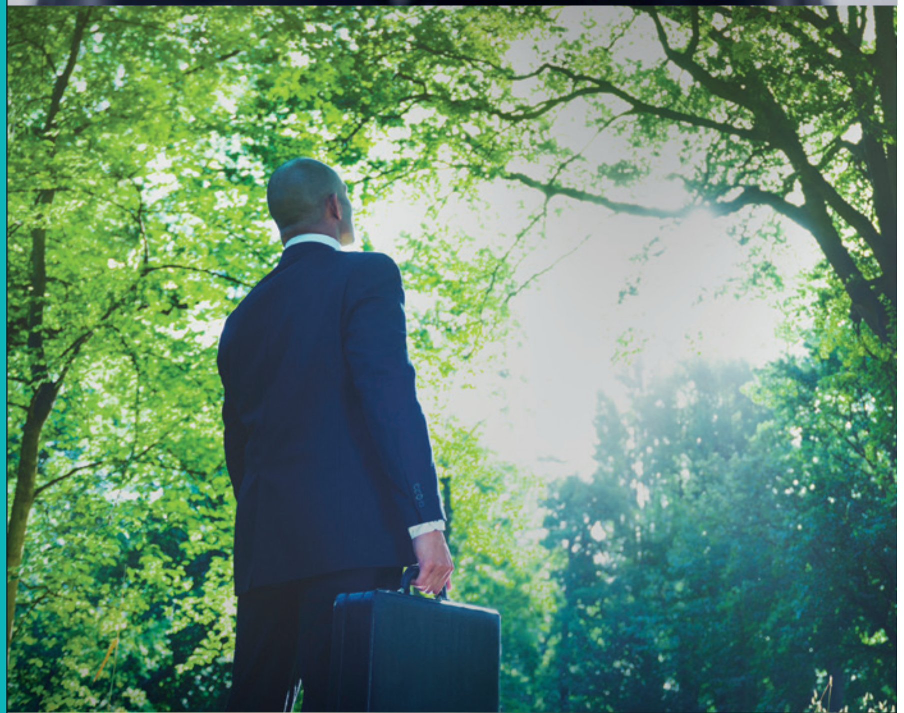

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Executive summary

The next step

Despite the surge in popularity of ESG investing, there is no such thing as the typical ESG investor. Catering to your clients' values and principles will require the integration of new sources of data into the fund-selection process, writes FE fundinfo's **Hamish Purdey**

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ESG AND SUSTAINABLE INVESTING has grown exponentially as the Covid-19 pandemic has accelerated the long-term shift towards responsible investment. Recent years have demonstrated that investing by ESG principles does not mean compromising on financial returns, while responsible investment strategies have steadily captured inflows – bucking the trend of investors pulling money from active funds. From being on the sidelines of the industry, ESG has moved firmly into the mainstream.

While this is one of the most important developments in today's investment landscape, this strong growth has brought greater demands for ESG data and transparency. That's why FE fundinfo has significantly enhanced its ESG offering over the past 18 months, including through the acquisition of consulting and research house CSSP and its state-of-the-art ESG reporting capabilities, such as the yourSRI.com platform; an agreement to include MSCI's ESG fund ratings across FE Analytics, Trustnet and fundinfo.com; and the launch of our Eco-Label service to help fund managers certify their ESG credentials.

The 2021 FE fundinfo ESG Market Review pulls together our in-house expertise to create a unique snapshot of how the UK funds industry is rising to the demands of higher ESG standards. This analysis shows how the average fund sector stacks up for its ESG, impact and controversy exposure, offering a valuable yardstick for individual funds to be compared against and allowing investors to make better-informed decisions.

What can be seen, for example, is how some regions – such as the UK and Europe – are more plentiful hunting grounds for funds considered to be ESG 'leaders', while others, such as emerging markets, seem to be lacking in obvious opportunities. It is also clear how funds vary in their performance on the individual environmental, social and governance factors and how a strong ESG process doesn't always mean managers avoid companies in morally controversial sectors. All of this underpins the need to carry out detailed fund research.

Recent years have demonstrated that investing by ESG principles does not mean compromising on financial returns

There's no such thing as the typical ESG investor. Each client will differ – in their focus on the E, the S or the G; their ethical preferences; their willingness to engage with 'bad' companies; and many other factors. Likewise, our analysis shows ESG funds are anything but uniform and can take varying approaches – leading to different portfolio holdings and ESG, impact and controversy scores.

Understanding an individual investor's values and principles, where they want their money to have the most impact and what they want to avoid – essentially determining what matters the most to them – is a vital part of supporting the ESG journey. But building a portfolio that can live up to this will rely on integrating new ESG data sources into fund-selection processes. We at FE fundinfo look forward to providing the industry with clear, accurate and transparent data on this critically important area. ■

Hamish Purdey is Chief Executive Officer at FE fundinfo

Analysis

Seeing the light

The move towards ESG is a powerful trend and the 2021 FE fundinfo ESG Market Review offers a unique snapshot of how the UK funds landscape is addressing the challenge of responsible investing

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THE UNPRECEDENTED EVENTS OF 2020 focused investors' attention on issues such as climate change and social inequality, accelerating the shift into responsible investment. But how well are funds meeting expectations of higher ESG standards?

Alongside a plethora of ESG and impact investing fund launches in recent years, flows of capital have increasingly headed into strategies with an emphasis on these areas. According to the Investment Association, there was £27bn invested in UK-based responsible investment funds at the start of 2020, representing some 2% of the industry's total assets. By August 2021, this had climbed to £85bn – or 5.4%.

And the above statistic only refers to funds that label themselves as 'responsible'. Under the surface, the move towards responsible investing has seen more and more asset management houses place greater emphasis on ESG considerations in their processes without necessarily rebranding them to reflect this move.

The 2021 FE fundinfo ESG Market Review aims to provide investors with a snapshot of how the UK funds industry stacks up in terms of ESG, ethical and impact factors. The analysis section later in the report details funds' MSCI ESG quality scores, exposure to morally controversial companies and positive impacts by peer group.

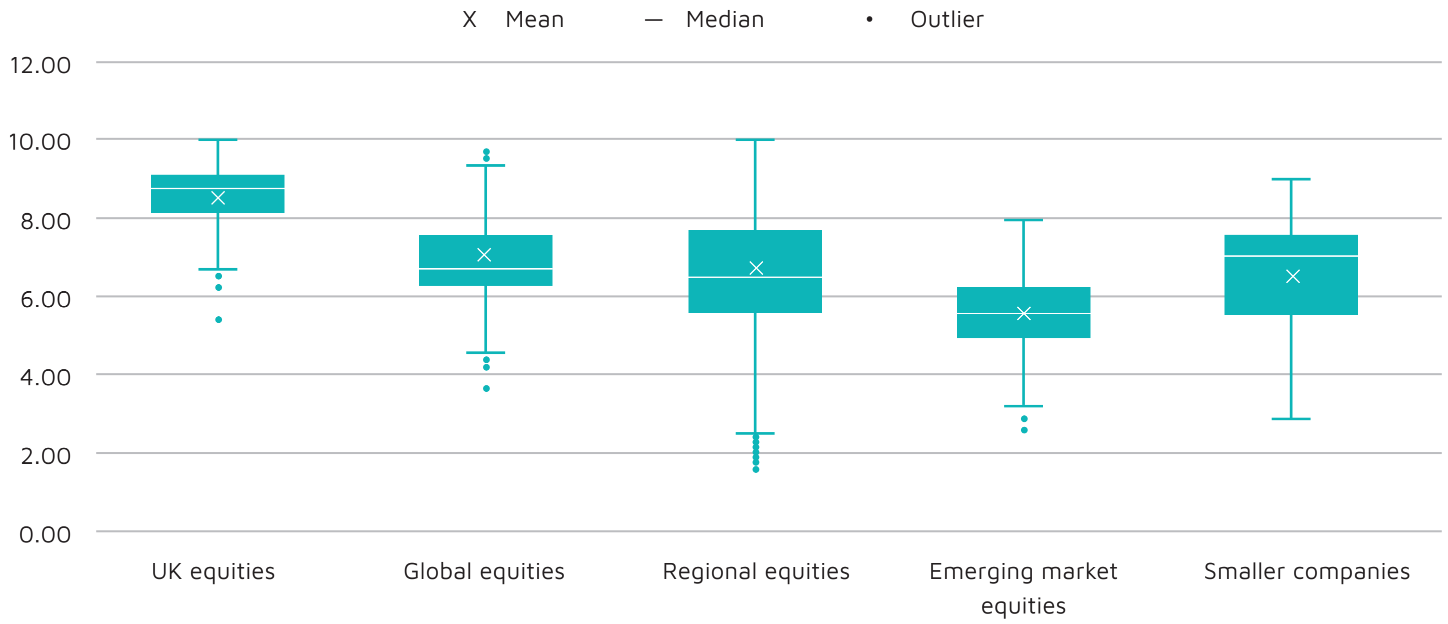
This offers a unique insight into the UK funds landscape from a responsible investing point of view. However, more than anything else, the findings highlight the need for investors to undertake further research using specialist ESG analysis tools such as yourSRI's ESG Fund & Portfolio Screening tool.

THE UK AND EUROPE LEAD THE WAY

One of the most eye-catching findings of the 2021 FE fundinfo ESG Market Review was the strong performance of UK equity funds when it came to their ESG scores – as shown in Figure 1.

Under MSCI's ESG ratings process, the average UK equity strategy had a score of 8.60 – around

Figure 1: Distribution of ESG scores by equity fund groups



two points higher than those with a global (6.88) or regional focus (6.46). For emerging market equities, the average fund had an ESG score of just 5.55.

The overwhelming majority of UK equity funds – 97.7% of those assessed in this report – were classed as ESG 'leaders' under MSCI's methodology. Less than 40% of global and regional funds were given this rating, and only 4% of emerging market portfolios.

This suggests that some regions are better hunting grounds than others for funds with strong ESG credentials – it's interesting to note that the weakest UK fund had an ESG score around that of the average emerging markets strategy.

Delving deeper into the underlying scores, there were signs of a clear geographic trend at play with ESG – the highest-scoring funds tended to be found in northern Europe, with these figures falling as you move further away from this region.

The handful of equity funds that concentrate on German or Nordic stocks (there aren't enough to warrant their own sector) joined the UK at the top of the table for ESG scores. Figure 2 shows the average ESG scores on an individual sector level – UK and European funds are top, with global, US and Asia ex-Japan strategies in the middle and emerging markets (especially China) at the bottom.

There are some obvious reasons behind this

Some regions are better hunting grounds than others for funds with strong ESG credentials

geographic trend, given that Europe and the UK tend to be ahead of the US and emerging markets for environmental and governance standards. However, this wasn't the case for all of the individual elements of ESG.

As shown in Figure 1, there was a wide variance in ESG scores among equity funds – even in those investing in the same regions – highlighting the importance of further research. While you may be more likely to find a fund with strong ESG credentials in UK equities, this is not guaranteed; likewise, even in a low-scoring area such as emerging markets, select funds performed relatively well in this regard.

BREAKING DOWN THE E, S & G

The need for thorough fund research is further stressed when environmental, social and governance factors are considered separately.

European equity sectors were the areas with the highest environmental and social scores, on an average basis at least

Starting with the example of UK funds again, it's clear that their strong ESG performance was largely down to the high governance standards of domestic companies. The average governance score for UK funds stood at 6.42 (compared with 5.11 for global funds and 4.83 for regional funds).

This should not be too surprising given London's status as a leading financial centre – the UK corporate governance model is widely regarded as one of the strongest in the world and has influenced those in several European and Asian nations.

Of the 16 equity fund sectors covered by this research, the three UK peer groups – IA UK Smaller Companies, IA UK Equity Income and IA UK All Companies – held the highest average governance scores, followed by IA European Smaller Companies, IA Europe Including UK and IA Europe Excluding UK.

However, UK equity funds fell behind when it came to the environmental and social elements of ESG – underperforming global and regional portfolios on both measures. UK funds were also

The high ESG score of the average UK fund does not mean it topped the tables for its environmental and social credentials

narrowly beaten by emerging market strategies in the social factor.

FE fundinfo's data suggests the European equity sectors were the areas with the highest environmental and social scores, on an average basis at least, while funds with a global remit also stacked up pretty well on both these measures, too.

But once more, emerging markets – Chinese equities in particular – and Japanese smaller companies funds fell to the bottom of the list.

Again, this stresses the importance of further fund research with regards to ESG. As we have seen, the high ESG score of the average UK fund does not mean it topped the tables for its environmental and social credentials.

ESG LEADERS AND CONTROVERSIAL BUSINESSES

A closer look at the findings in this analysis also shows why you can't rely on ESG scores alone as

Figure 2: Average ESG scores by IA sector

IA sector	Average ESG score
IA UK All Companies	8.64
IA UK Equity Income	8.47
IA Europe Including UK	8.22
IA Europe Excluding UK	7.77
IA UK Smaller Companies	7.60
IA Global Equity Income	7.52
IA European Smaller Companies	7.09
IA Global	6.80
IA Asia Pacific Excluding Japan	6.42
IA North America	6.00
IA Asia Pacific Including Japan	5.87
IA Japan	5.82
IA Global Emerging Markets	5.55
IA North American Smaller Companies	5.27
IA China/Greater China	3.37
IA Japanese Smaller Companies	3.33

Figure 3: Average scores of individual ESG factors by IA sector

IA sector	Environmental factor	Social factor	Governance factor
IA UK All Companies	5.49	4.97	6.41
IA UK Equity Income	5.58	4.88	6.48
IA Europe Including UK	6.24	5.45	5.79
IA Europe Excluding UK	6.34	5.48	5.52
IA UK Smaller Companies	4.48	4.76	6.51
IA Global Equity Income	6.25	5.08	5.29
IA European Smaller Companies	4.98	4.90	5.84
IA Global	5.99	5.03	5.09
IA Asia Pacific Excluding Japan	5.28	4.97	4.43
IA North America	5.93	4.80	4.83
IA Asia Pacific Including Japan	5.39	5.10	4.44
IA Japan	5.70	5.28	4.20
IA Global Emerging Markets	5.23	4.96	3.94
IA North American Smaller Companies	4.38	4.45	5.27
IA China/Greater China	4.45	4.55	3.48
IA Japanese Smaller Companies	4.47	4.87	3.81

Figure 4: Average portfolio weighting to morally controversial business areas

IA sector	Laggards	Average	Leaders
IA Asia Pacific Excluding Japan	2.05%	2.90%	5.09%
IA Asia Pacific Including Japan		2.12%	5.34%
IA China/Greater China	10.76%	3.97%	
IA Europe Excluding UK		5.18%	10.71%
IA Europe Including UK		5.39%	8.87%
IA European Smaller Companies		1.71%	2.72%
IA Global		5.14%	5.24%
IA Global Emerging Markets	4.61%	2.39%	2.59%
IA Global Equity Income		7.07%	8.81%
IA Japan		1.83%	0.98%
IA Japanese Smaller Companies	0.0%	1.24%	
IA North America		4.78%	7.34%
IA North American Smaller Companies		2.19%	
IA UK All Companies		5.71%	7.41%
IA UK Equity Income		1.54%	7.84%
IA UK Smaller Companies		2.63%	4.34%

Blank cells denote that no funds are found in this ESG quality category

Care needs to be taken to avoid seeing ESG as synonymous with ethical investing

a guarantee that a fund has avoided businesses in morally controversial sectors.

Again, the UK represented an interesting case study. While funds in the UK equity category achieved the highest average ESG scores, our data also showed they tended to be more exposed to morally controversial stocks than other sub-groupings.

What's more, better-rated funds in most sectors appeared to hold larger positions in companies involved in controversial business areas than lowly rated ones. Figure 4 on the previous page shows just how common this was.

Just 98 of the 762 funds classed as ESG leaders in this study – or 13% – had a zero weighting to stocks in morally controversial sectors. These sectors include companies involved with adult entertainment, alcohol, gambling, genetic engineering, tobacco, weapons and nuclear power.

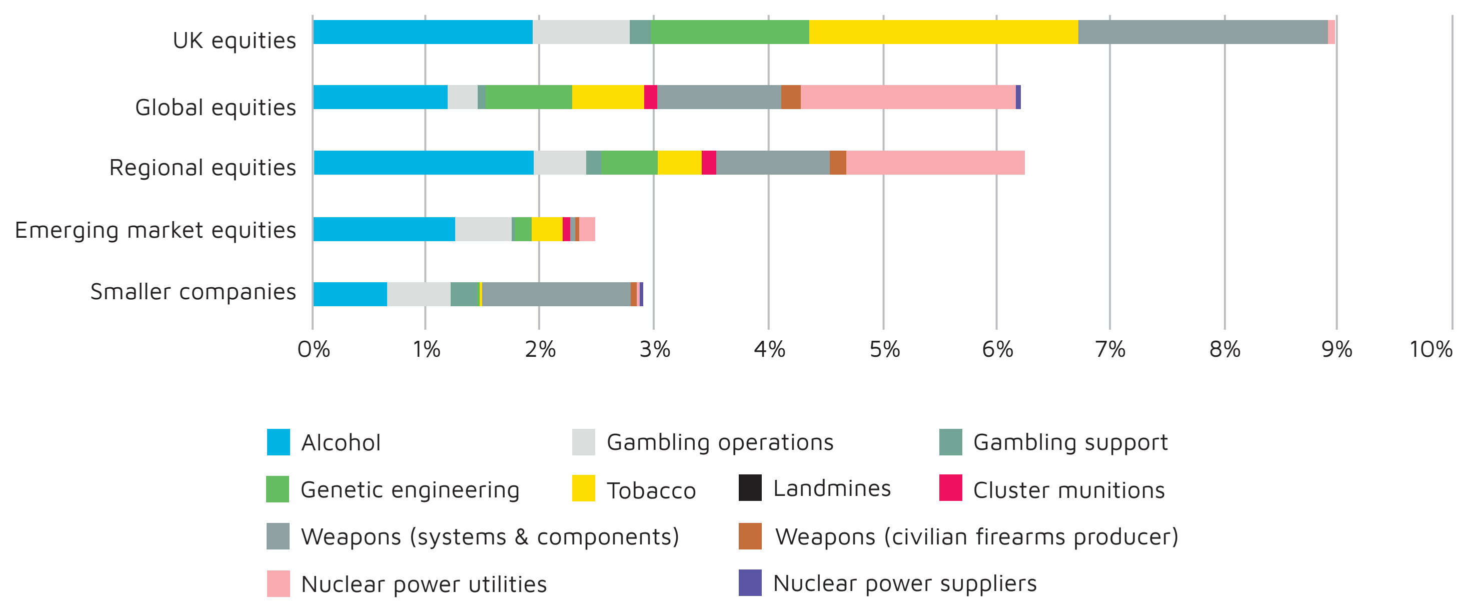
Of course, this may not be as contradictory as it appears. Care needs to be taken to avoid seeing ESG as synonymous with ethical investing – after all, companies can operate in sectors that many people consider to be morally wrong, yet score highly when their environmental, social and governance performance is assessed.

For example, as one of the world's largest producers of spirits and beers, Diageo is firmly in the alcohol bucket of morally controversial sectors. However, it holds an 'AAA' score under MSCI's ESG Ratings.

Other companies that are deemed ESG leaders in sectors that are morally controversial include BAE Systems (aerospace & defence, AA-rated) and Flutter Entertainment (gambling, AA-rated).

The above examples underscore the need to get under the bonnet of ESG funds in order to assess their suitability: some investors want to actively avoid any companies they consider to be morally controversial, while others may be happy to own the best businesses in 'bad' sectors, and a further group would prefer to positively engage with ESG laggards to help turn them around. ■

Figure 5: Average portfolio exposure to stocks in morally controversial sectors



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Cleaning up

Amanda O'Toole, Portfolio Manager of AXA IM's Clean Economy Strategy, says there are huge growth opportunities in the transition to carbon neutrality

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AS GOVERNMENTS AROUND THE WORLD RAMP UP INVESTMENT IN GREEN ENERGY, the demand for clean technologies is set to increase.

In September last year, as dozens of countries were still struggling to contain the coronavirus pandemic, China's president, Xi Jinping, made an announcement that took the world by surprise: by 2060, China would aim to achieve carbon neutrality.

"The human race cannot ignore the warnings of nature over and over again," the leader of the Chinese Communist Party told a virtual meeting of the United Nations (UN).

The announcement has huge global implications for demand for clean technology, injecting unprecedented dynamism into the evolving 'clean economy' and potentially helping companies with exposure to clean tech grow faster than the broader market.

There is a clear growth opportunity here. The energy transition has now become a global phenomenon, and we are talking about markets where there is clear visibility in terms of long-term structural growth.

On top of China's announcement, it is thought that at least two other forces are driving demand for clean tech, rapidly expanding the potential market and creating big growth opportunities for companies in the sector.

THE ENGINES OF GROWTH

The first is a shift in public attitudes as growing consumer awareness over issues such as climate change and sustainability pushes companies to look long and hard at their carbon emissions.

Businesses are recognising that in order to retain and grow their market share, they need to invest in cleaner solutions. The knock-on impact of that is enormous because it means that corporates need to become sustainable in their own right.

A second, related driver of clean tech, is that an increasing number of investors are focusing on environmental, social and governance (ESG) factors as a principal building block of their portfolios.

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Advertorial feature

By the end of last year, for example, total global assets in sustainable funds hit a record $1.7tn, a jump of 50 per cent on the previous year[1].

A lot has happened in the past 12 months. More and more clients care about sustainability, and that is pushing money towards the kind of strategies that are most supportive of these changes.

> “More and more clients care about sustainability, and that is pushing money towards the kind of strategies that are most supportive of these changes”

SECTORS LEADING THE ENERGY TRANSITION

So which areas are most likely to benefit from future demand for clean tech?

Electric car manufacturers are expected to see a big acceleration in demand, helped by strong support from governments. The UK recently announced a ban on new petrol and diesel cars from 2030 onwards. More than a dozen other countries have proposed similar measures[2].

“Electric vehicles are a key technology to reduce air pollution in densely populated areas,” the IEA said last year. “Environmental and sustainability objectives drive electric-vehicle-policy support at all governance levels.”

One of the most promising growth areas in the clean tech sector is energy management and smart grids. In the US, Ameresco, a clean tech integrator and renewable energy asset developer, owner and operator, has been expanding rapidly thanks to its wide portfolio of energy-saving solutions*.

> “We have just seen the very first year of real mainstream adoption of some of these technologies, but I think we are right at the beginning”

Through a range of contracts with the Department of Education and other federal agencies, Ameresco has guaranteed more than $2.8bn in energy savings for the US government in recent years.

In Denmark, the energy company Ørsted has already built more offshore wind farms than any other developer in the world, with farms in the US, Taiwan and across Europe[3]*.

Over the past decade it has transformed itself from a fossil fuel-based company into a green energy company — with renewables as a share of its energy generation rising from 17 per cent in 2006 to 90 per cent in 2020[4].

Many other companies are also making huge investments in the green transition. Iberdrola, the Spanish utility company, has announced it will ramp up annual investments to about €10bn (around double the level of previous years) as it ploughs money into renewables and building the networks to handle them.

Among its bigger current investments are a €1.5bn Portuguese hydro energy-storage project, a $2.8bn offshore wind farm in the US and a €300m solar energy development in Spain[5].

GROWTH POTENTIAL IN CLEAN TECHNOLOGIES

Those are sizeable investments, but I believe that there is more to come. We have just seen the very first year of real mainstream adoption of some of these technologies, but I think we are right at the beginning.

For investors focused on the evolving economy, this growth in the renewable-energy sector is likely to provide a continuing stream of opportunities. The transition from fossil fuels towards carbon neutrality has become an environmental imperative – a shift will only be possible with increasing investments in clean technology. ■

*All companies or stocks mentioned are for illustrative purposes only and should not be considered as advice or a recommendation for an investment strategy.

[1] ESG funds defy havoc to ratchet huge inflows, Financial Times, February 2021

[2] Burch I and Gilchrist J, Survey of Global Activity to Phase Out Internal Combustion Engine Vehicles, March 2020

[3] Our offshore wind farms, Ørsted, as of 20 April 2021

[4] By the numbers: How we build a world that runs on renewable energy, Ørsted, as of 20 April 2021

[5] Iberdrola plans €10bn-a-year clean energy push, Financial Times, 6 July 2020

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At cross-purposes

FE fundinfo's **Mikkel Bates** says financial authorities are struggling to keep up with the booming popularity of ESG investing, leading to a divergence in standards across different countries

WITH ESG INVESTING THE TOPIC CURRENTLY ON EVERYONE'S LIPS, you might have expected some consistency on what companies and funds need to disclose and how.

But ESG is also a political issue and some countries have been moving faster than others and focusing on different aspects. Even within the EU's single legislative block, there are national differences when you get down into the weeds.

According to the Sustainable Finance Disclosure Regulation (SFDR), the EU's flagship set of ESG disclosure rules, the minimum requirement for a 'green' fund is that it promotes social and/or environmental characteristics, with the added hygiene factor that "the companies in which the investments are made follow good governance practices".

"ESG is also a political issue and some countries have been moving faster than others and focusing on different aspects"

Mikkel Bates is Regulatory Manager at FE fundinfo

SHADES OF GREEN

But the SFDR is not about the classification of funds as light green, dark green or any other colour. It's about the strict disclosure standards required of funds that claim to have sustainable characteristics. This could include having the word 'sustainable', 'green' or 'ESG' in their name. Those funds that go further and have sustainable investment as an objective are subject to even stricter disclosure rules.

However, almost inevitably, the fund industry has adopted the SFDR definitions to create its own classification system as a form of shorthand for advisers and distributors to filter those funds that meet the standards required by their clients. As a result, we now have funds being classified as Article 8 (light green), Article 9 (dark green) or Article 6 (the rest).

There is no minimum threshold of sustainable investments required for a fund to classify itself as an Article 8 product, but countries such as Germany are setting their own standards around what a fund can invest in – or how much of its assets need to be in suitable investments – to qualify, to further clamp down on the possibility of greenwashing. This means that investors in some countries could invest in funds that are a much paler shade of green than those in other countries, without being aware of the difference.

"What a fund sets out in its objectives and policy must match the resources the group can put behind it, and this must all be disclosed to investors in a clear and understandable way"

All funds marketed in EU countries now have to disclose on their website how they integrate sustainability risks in their investment process or, if they don't, why not. ESG funds also need to explain how their ESG characteristics are met and, if applicable, how their benchmark index fits with them.

SETTING THE STANDARDS

In the UK, the FCA has set out the standards it expects from fund groups when claiming ESG credentials for a fund. It wrote to all fund groups this year, telling them that it expects consistency between a fund's design, delivery and disclosure. In other words, what a fund sets out in its objectives and policy must match the resources the group can put behind it, and this must all be disclosed to investors in a clear and understandable way.

In terms of ongoing disclosure requirements, the FCA has for the time being opted to focus on climate-related matters, taking the Task Force on Climate-related Financial Disclosures (TCFD) recommendations as its guide. In its consultation on such disclosures, the FCA said that its new ESG Sourcebook will "expand over time to include new rules and guidance on other climate-related and

wider ESG topics" and it acknowledged that there needs to be at least a degree of consistency with the ESG reporting requirements elsewhere. But for now, it is walking a very different path from the one the EU is taking.

But the UK is not alone. The Hong Kong regulator, the SFC, is also focusing initially on climate change on the basis that "many areas relating to ESG are still developing" and, like the FCA, "will remain abreast of international and market developments and explore expanding regulatory coverage to other aspects of ESG over the longer term".

TEETHING TROUBLES

While ESG reporting is in its infancy, there are bound to be national differences, but the closer it comes to being regarded as business as usual, the more aligned the world is likely to become. What funds and fund groups can disclose will always depend on what the companies they invest in disclose and that in turn will depend to a large extent on financial reporting standards.

It may be a few years before all the ducks are lined up properly, but the speed with which ESG investing has gone from being on the fringes to being the headline act suggests that it won't be too long before it is taken for granted and everyone agrees on what it really means. ■

"The speed with which ESG investing has gone from being on the fringes to being the headline act suggests that it won't be too long before it is taken for granted and everyone agrees on what it really means"

FE Investments

Getting under the skin

Ensuring ESG factors are fully integrated into the decision-making process helps FE Investments avoid the funds that merely pay lip service to this topic, writes **Nimisha Sodha**

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RESPONSIBLE INVESTING HAS SEEN SIGNIFICANT TRACTION IN RECENT YEARS, particularly since the start of the pandemic. It has become a focal point for the investment industry, but has seen a lot of scrutiny from various stakeholders as greenwashing continues to be an issue. Environmental, social and corporate governance (ESG) factors have become part of the norm for the industry but the term has led to some confusion for investors.

In our view, ESG factors provide a framework for analysis and should be used to better manage risk and create positive outcomes. Incorporating ESG factors represents a core competence and is representative of good investment management.

WHAT WE LOOK FOR

ESG analysis is not just an issue for specialist funds. It is important for asset managers to understand financial and non-financial factors such as ESG risks and climate change.

As part of our assessment process, we look for a range of factors, including the following:

- Policies and governance structures to better manage ESG-related decisions in the organisation

- Processes and mechanisms to appropriately implement, manage and monitor ESG risks at the product level

- Reporting and transparency to evidence how ESG risks have been implemented in practice

Greenwashing is an ever-present risk in the world of responsible investing. Managers can add a veneer of ESG process and policy to their pre-existing methods of analysis. To counteract this, we look for evidence that ESG factors are properly integrated into investment decisions, rather than running in parallel to their traditional process. In particular, we want to see any ESG concerns raised by research analysts are taken into account and factored into decision making.

WHAT WE ARE SEEING IN THE MARKET

The sharp increase in interest in responsible investing has been matched by an explosion in ESG funds. Across Europe last year, fund inflows almost doubled from €126bn to €233bn to take the total over €1trn. This increase in demand was met by the launch of 505 new ESG funds. This growth has continued in 2021 as 111 new ESG funds were launched in the first quarter.

The Investment Association describes five different styles of ESG funds: ESG integration, exclusions, impact investing, stewardship and sustainability focused. We consider the spectrum of capital that covers all these descriptions, which is based on the level of outcome investors are interested in. At one end is ensuring ESG factors are incorporated for better risk management. At the other end are funds designed to achieve specific environmental or social objectives. Identifying where funds sit on this spectrum and matching them with investors' intentions is essential in ensuring clients remain satisfied.

CONCLUSION

The potential for a mismatch between a fund's label and how it is run has already caught the attention of regulators. The Financial Conduct Authority (FCA) recently raised this issue with asset managers and provided more defined guidance on how to ensure investors understand whether a fund is suitable for them. The potential for greater regulation may help deter some of the more blatant examples of greenwashing and bring clarity to investors. In the meantime, detailed investment research can cut through green-tinged presentations to establish what is going on at the heart of a fund.

Responsible investing is a complicated area. The growth in interest from investors is helping to fuel change, but this has also increased complexity and the potential for confusion. Some of this will be addressed by an evolution in the way responsible investing is regulated, and other aspects through standardisation. However, ESG factors by themselves do not lead to positive outcomes. Instead, they remain an important component in investment decision making and analysis. ■

Nimisha Sodha is Head of ESG at FE Investments

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Analysis

Methodology

The FE fundinfo ESG Market Review aims to create more transparency, measurability and comparability within the asset management industry to promote more sustainable investing

THE FOLLOWING ANALYSIS OFFERS A SNAPSHOT OF THE FUNDS INDUSTRY when it comes to ESG factors, impact investing and exposure to controversial business areas, providing investors with a yardstick for how their own holdings compare with the average peer.

Outside of this report, a comprehensive, independent and up-to-date assessment of ESG risks and opportunities can be accessed at any time on yourSRI's online platforms.

HOW WE DID IT

The 2021 edition of the FE fundinfo ESG Market Review measures and compares the portfolio quality of investment funds with regard to environmental, social and governance criteria using yourSRI.com's ESG Fund & Portfolio Screening tool. This combines traditional financial data with high-quality ESG data (using MSCI ESG Research) in a unique way.

The innovative scoring procedure enables the early identification and assessment of hidden opportunities and risks that are inadequately captured by conventional financial analysis. Thus, yourSRI.com offers an objective framework for the assessment and comparison of ESG opportunities and risks, the changes in which can be viewed at any time at yourSRI.com.

True to the principle 'do you know how your money is invested?', yourSRI.com creates transparency that goes far beyond that of conventional financial analysis.

HIDDEN RISKS

The ESG ratings used in the 2021 FE fundinfo ESG Market Review are based on the methodology of MSCI ESG Research. The sustainability ratings are based on analysis of material opportunities and risks stemming from environmental, social and governance (ESG) factors. The detailed analysis enables the comparison of management practices in a sector, highlighting hidden ESG risks and opportunities that are not captured by conventional financial analysis.

Investors are confronted with risks when ESG factors are not taken seriously. These include, for example, natural resource scarcity, workforce strikes and constantly changing legislation and regulation, which strongly influence the risk-reward profile of investment portfolios.

ESG ratings help investors to analyse these sustainability risks and opportunities, and integrate these factors into portfolio construction and management. The global team of more than 200 analysts at MSCI assesses the ESG data of more than 8,500 companies. The focus is on the relationship between the core business and its most important industry-specific issues, which represent ESG risks and opportunities for the company.

MSCI's final ESG rating is based on a seven-point scale (AAA to CCC) and is subject to a quantitative multi-level analysis that aims to determine the extent to which a company is exposed to ESG risks and opportunities. By subsequently comparing all companies in a given sector, the rating signal enables a distinction to be made as to how well companies are positioned to identify and manage risks in the future and to spot opportunities and create added value from them.

The valuation intends to be style-neutral and can be used for both equity and fixed income holdings.

ASSESSMENT CRITERIA

This study focused on the ESG portfolio quality of around 2,600 investment funds on yourSRI.com, covering equities, bonds and mixed assets.

For a fund to be included in the rating, holding data of less than 12 months old must have been available and at least 60% of the portfolio must have been assessable in terms of ESG factors. This coverage threshold ensured that the informative value and comparability were not diluted.

The ESG evaluation criteria are based on a numerical evaluation from 0 to 10 (ESG rating score), which ultimately results in a grading system similar to a credit rating: a standardised seven-level evaluation grid ranging from AAA (highest value) to CCC (lowest value). ■

Equity funds: Key facts

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IN THIS REPORT, WE HAVE ANALYSED EQUITY FUNDS FROM A VARIETY OF VIEWPOINTS** to offer a unique snapshot of how the asset management industry is performing when it comes to ESG and impact investing.

Our analysis centred on three main areas: **ESG quality and risks**, or how strong funds were on the three pillars of environmental, social and governance issues; **controversies**, or funds' investments with companies that violated the UN Global Compact or were active in morally controversial areas; and **impact**, or the positive outcomes of funds' investments.

In total, 1,626 funds were analysed from 16 of the Investment Association's equity sectors. To give a more detailed view, the equity universe has been broken down into five sub-groupings:

- UK equity funds (comprising those in the IA UK All Companies and IA UK Equity Income sectors)
- Global equity funds (IA Global* and IA Global Equity Income)
- Regional equity funds (IA Asia Pacific Excluding Japan, IA Asia Pacific Including Japan, IA China/Greater China, IA Europe Excluding UK, IA Europe Including UK, IA Japan and IA North America)
- Emerging market equity funds (IA Global Emerging Markets)
- Smaller companies funds (IA European Smaller Companies, IA Japanese Smaller Companies, IA North American Smaller Companies and IA UK Smaller Companies)

* The analysis used in this report was performed before the IA launched six new sectors that a number of IA Global funds subsequently moved over to

Equity funds overview

What has been checked?

TO MEET THE INCREASING DEMAND FOR TRANSPARENCY AROUND ESG, the funds' portfolios were comprehensively examined for risks and opportunities using the ESG Fund & Portfolio Screening tool from yourSRI.com.

In particular, the three dimensions of ESG risk, controversy and impact were examined in detail in this analysis.

ESG quality & risks

Exposure to controversies

Social & environment impact

Results at a glance

ESG scores

THE AVERAGE EQUITY FUND achieved an ESG score of 6.90, putting the asset class ahead of bonds (5.78) and mixed asset (6.7). Across the five equity sub-groupings examined, funds from the UK sectors posted the highest ESG scores, averaging 8.6, with the vast majority of UK funds classed as ESG 'leaders'. Global equities came next with an average ESG score of 6.88, followed by regional equities at 6.46.

Emerging market equities were at the bottom of the rankings, with an average ESG score of 5.55, and only 4% were regarded as leaders.

E-S-G quality

WHEN THE THREE ELEMENTS of environmental, social and governance were considered independently, equity funds scored their highest marks in the former, with an average of 5.69. This was followed by governance (5.18) and social (5.02).

UK equity funds, however, scored lower than global and regional funds for both the environmental and social pillars, but were significantly ahead for governance: 6.42 versus 5.11 for global funds and 4.83 for regional strategies.

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Controversies

A REVIEW OF EQUITY FUNDS for possible violations of national and international laws and regulations, as well as generally accepted global standards, showed that on average more than 80% of equity portfolios' stocks were green – meaning they had not been caught up in any recent critical controversies. In contrast, the average exposure to massive controversies inside equity portfolios was less than 0.5% – a better result than for bond and mixed-asset strategies.

UN Global Compact

SOME 47% OF EQUITY FUNDS were flagged for UN Global Compact violations, meaning that at least a small part of the managed assets were invested in companies that violated the compact. UK portfolios were the worst offenders, with 68.65% failing this test, while smaller companies funds led, with only 5.62% failing. Most of the flagged equity funds exhibited violations of 2.4% of their portfolio's market value, but with a significant range between the groups – just 0.1% of the average smaller companies fund violated the UN Global Compact, compared with 4.78% for the average UK equity strategy.

Morally controversial businesses areas

STOCKS INVOLVED IN THE PRODUCTION OF ALCOHOLIC BEVERAGES were the most common morally controversial businesses found in the equity portfolios we examined, with close to 60% of funds exposed to some extent. Companies with links to weapons systems or components, nuclear power, gambling and genetically modified organisms were the next most common.

Impact

MORE THAN TWO-FIFTHS OF EQUITY FUNDS were found to have created a 'significant' or 'high' impact through their investments. Global equity strategies were the most impactful, with just under 54% making it into these top-two impact categories. This put them well ahead of emerging market strategies, only 7.14% of which had a 'significant' impact rating.

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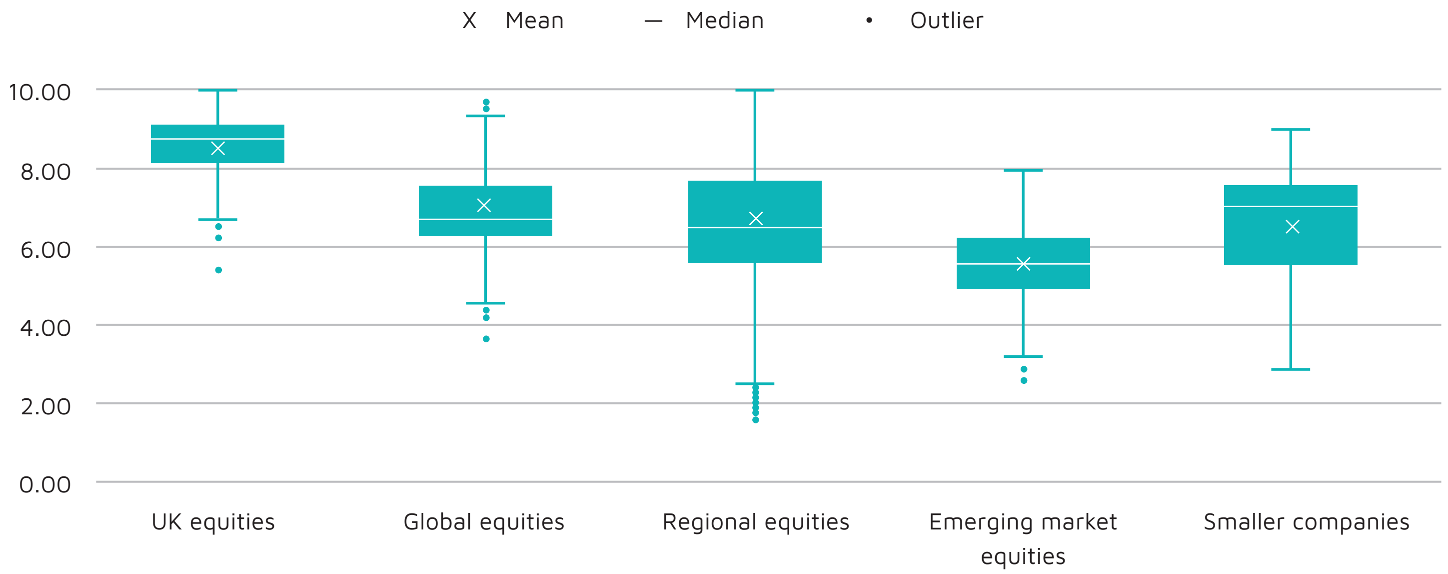
Sector breakdown

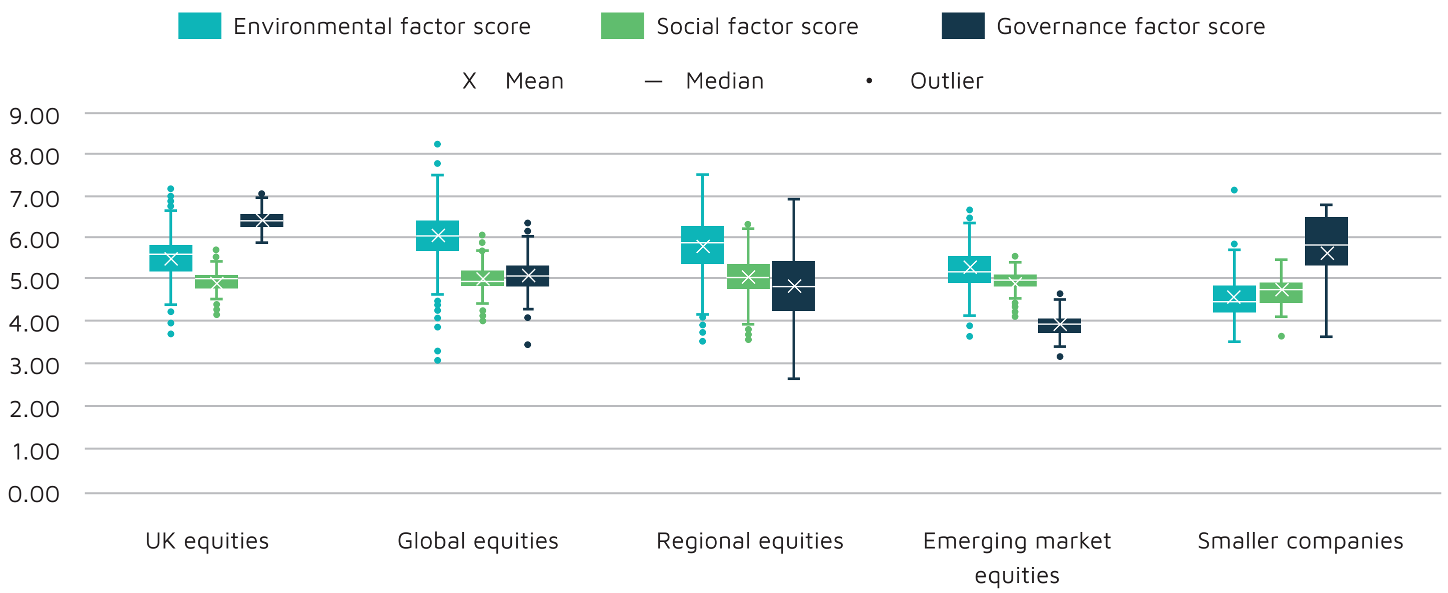
FUNDS FROM THE UK SECTORS had the highest ESG quality, with an average score of 8.6. This was driven by a high score for the IA UK All Companies sector (8.64). The lowest-scoring UK equity funds were on a similar level to the average emerging markets portfolio. Regional funds lagged behind global strategies, but a more granular analysis showed European equities were a clear leader – the average score for IA Europe Excluding UK funds was 7.77.

Average ESG scores



ON THE THREE INDIVIDUAL ELEMENTS OF ESG, equity funds scored their highest marks in the environmental pillar, with an average of 5.69, followed by governance (5.18) and social (5.02). Global equities had the best environmental score (6.02), regional equities topped social issues (5.09) and UK equities won on governance (6.42). Small caps were bottom for environmental and social issues while emerging markets lagged behind for governance.

ESG pillar scores



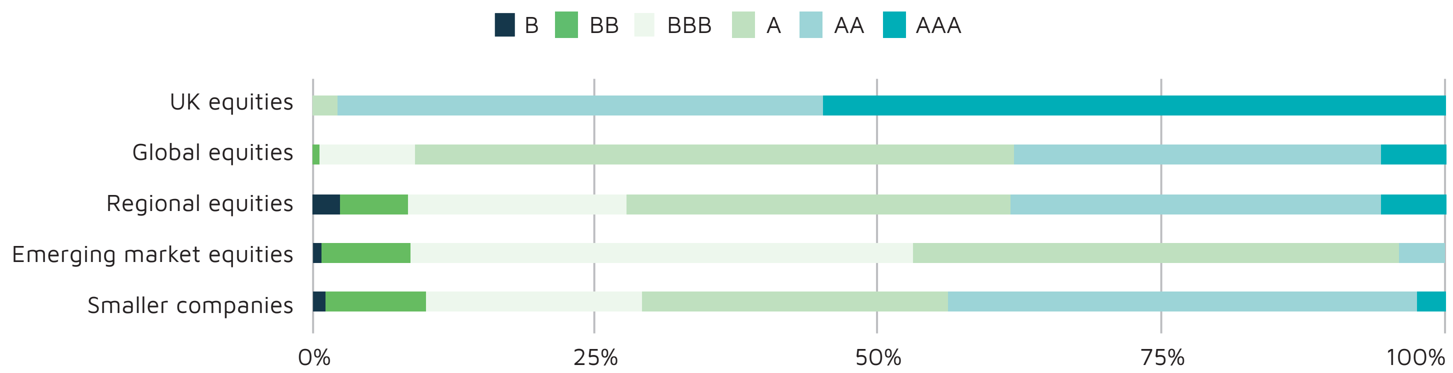
Equity funds’ letter-rating distribution

THE FUNDS’ ESG SCORES ultimately led to a seven-level grading system similar to credit ratings, which range from CCC (lowest value) to AAA (highest value); the distribution of these letter ratings can be seen in the following chart. More than 45% of equity funds were rated AAA or AA – known as ESG leaders. UK portfolios had a significant lead over their peers, with 97.69% sitting in the top-two categories. Of the other fund groups, around 40% had a quality rating of AA or higher, aside from emerging markets, where only 4% of funds were rated this highly.

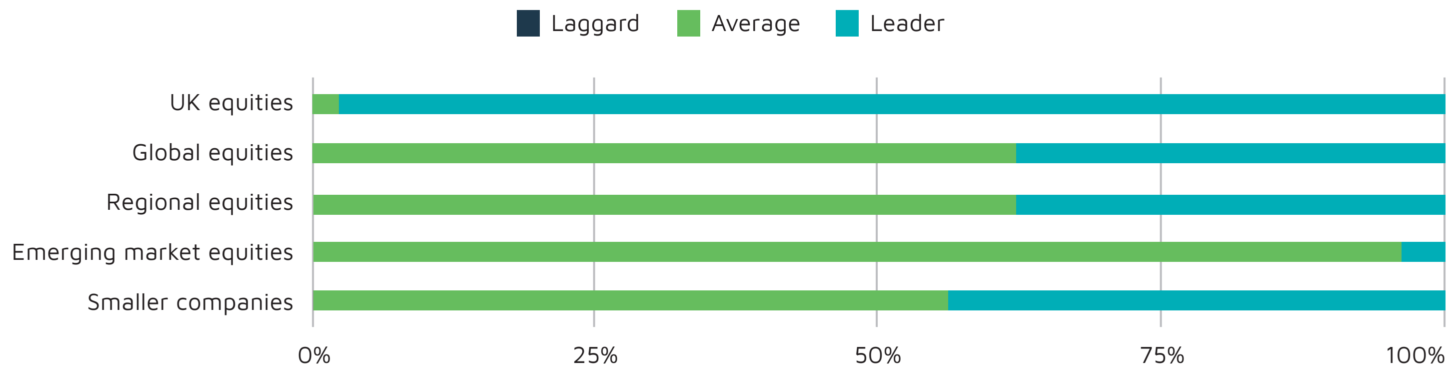
ESG quality scores

Fund ESG ratings				What it means
AAA	8.57 - 10.0	AAA AA	LEADER	The companies that the fund invests in tend to show strong and/or improving management of financially relevant environmental, social and governance issues. These companies may be more resilient to disruptions arising from ESG events.
AA	7.14 - 8.56			
A	5.71 - 7.13	A BBB BB	AVERAGE	The fund invests in companies that tend to show average management of ESG issues, or in a mix of companies with both above-average and below-average ESG risk.
BBB	4.29 - 5.70			
BB	2.86 - 4.28			
B	1.43 - 2.85	B CCC	LAGGARD	The fund is exposed to companies that do not demonstrate adequate management of the ESG risks that they face, or show worsening management of these issues. These companies may be more vulnerable to disruptions arising from ESG events.
CCC	0.0 - 1.42			

Distribution of ESG letter ratings



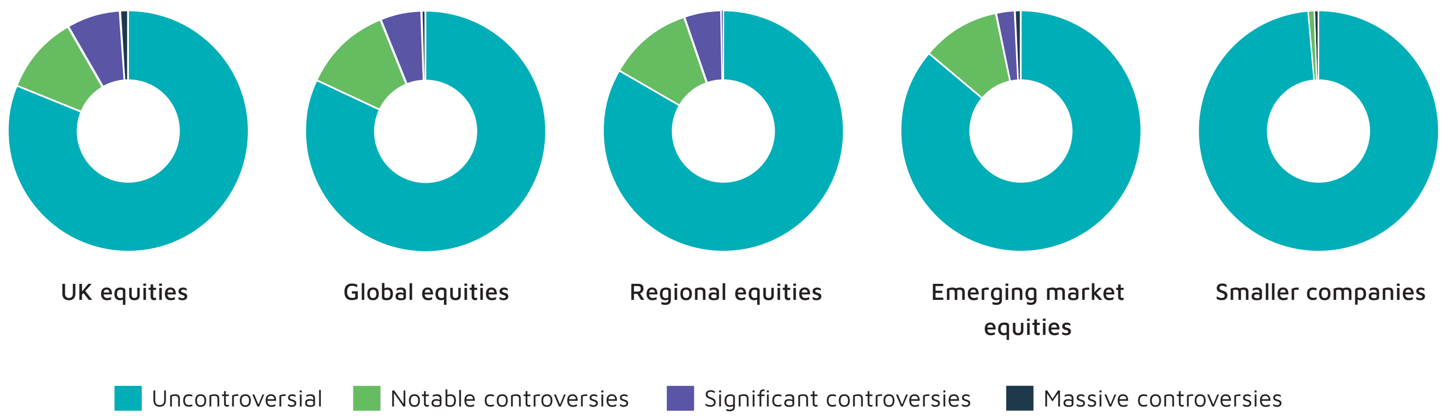
Distribution of ESG leaders & laggards



Portfolio controversies

WITHIN THE EQUITY FUNDS EXAMINED, almost 84% of the average portfolio was built from unobjectionable companies without major violations of national or international laws or regulations. Smaller companies funds stood out – on average just under 99% of those portfolios had no involvement in any recent major controversies. Exposure to 'massive' controversies averaged just 0.41%, ranging from zero for small-cap funds through to 0.96% for UK equities.

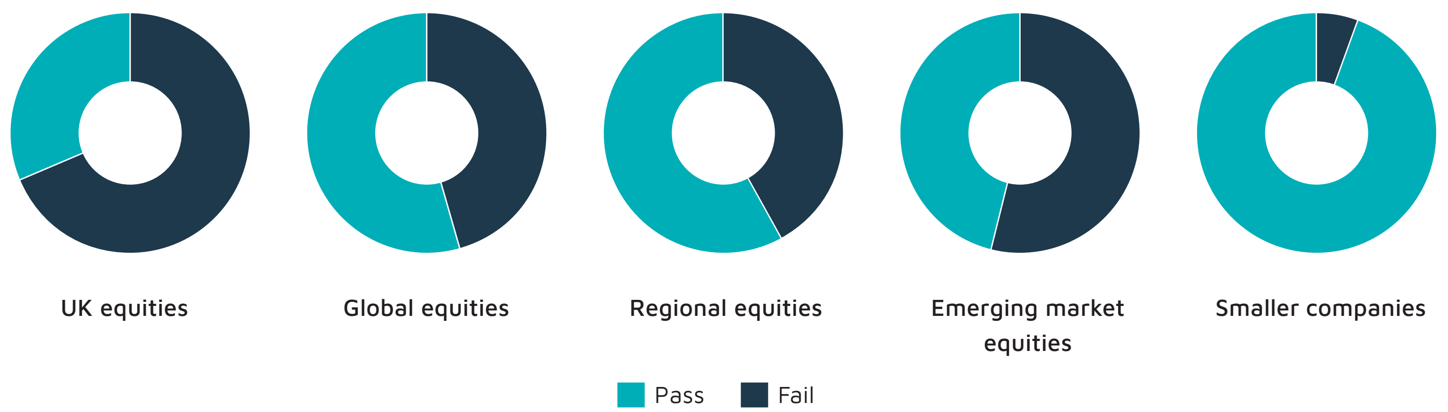
% in each severity of controversies



UN Global Compact-compliant funds

THE 10 PRINCIPLES OF THE UN GLOBAL COMPACT (UNGC) cover the areas of human rights, labour conditions, environmental protection and anti-corruption, and require companies to comply with certain minimum social and environmental standards. Of the three main asset classes, equity funds showed the highest UNGC adherence, with only 47% having exposure to stocks that violated the compact. Again, small caps came off best with just 5.62% exposed to UNGC-violating holdings, while UK equities were bottom with a 68.65% fail rate.

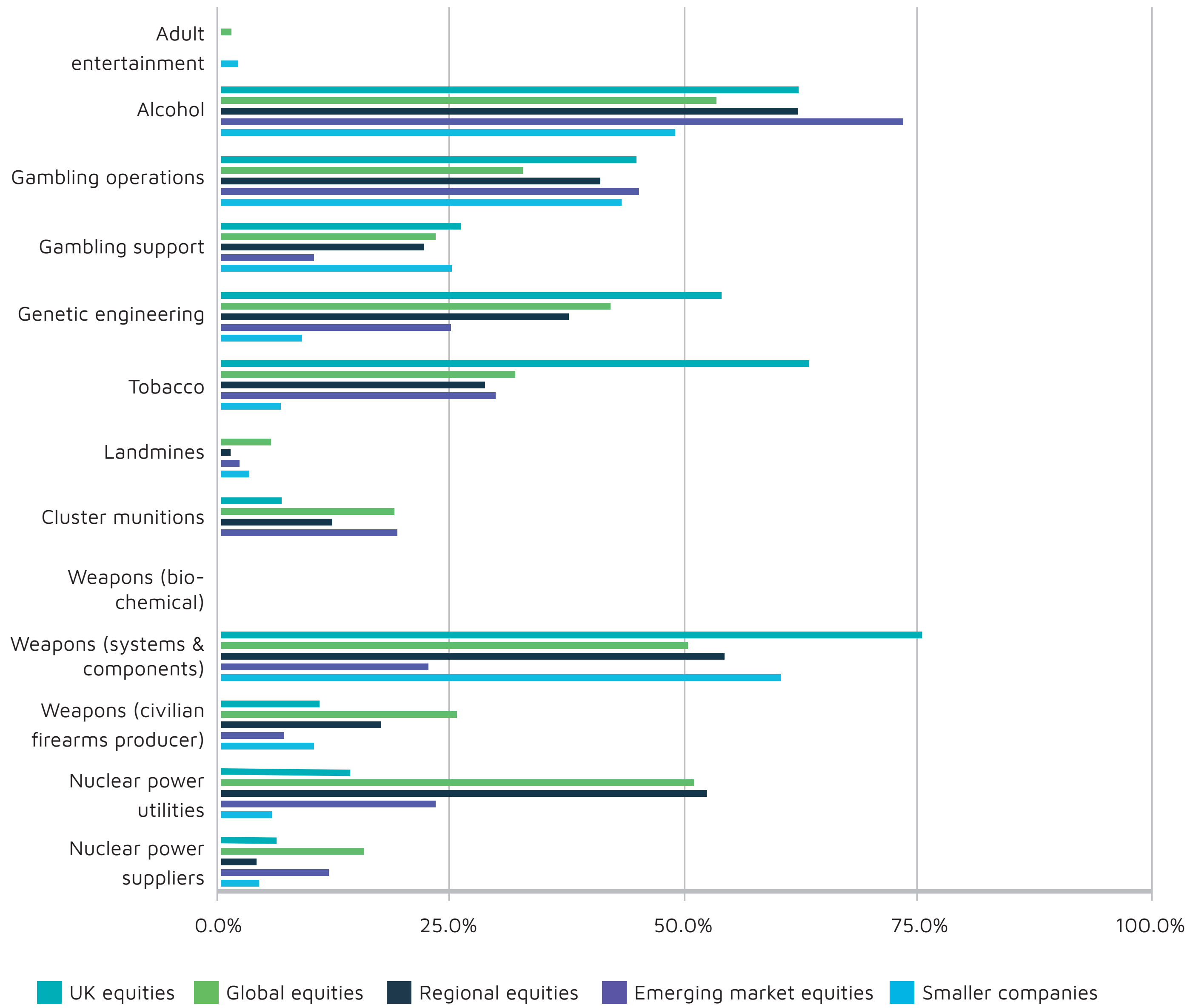
% of funds passing or failing UNGC test



Funds with investments in morally controversial business areas

AROUND 60% OF EQUITY FUNDS OWNED BUSINESSES that derive at least 5% of revenues from alcohol, while more than half owned companies that make weapons systems or components. Meanwhile, around two-fifths had links to nuclear power, gambling or genetically modified organisms. Some groupings had more exposure than others: three-quarters of UK funds held companies that make weapons systems or components, 72.2% of emerging market strategies held firms making or selling alcoholic beverages, and half of global funds were exposed to nuclear power, for example. Bio-chemical weapons, adult industries and landmines were the areas managers had the least exposure to.

% of funds with exposure to morally controversial business areas



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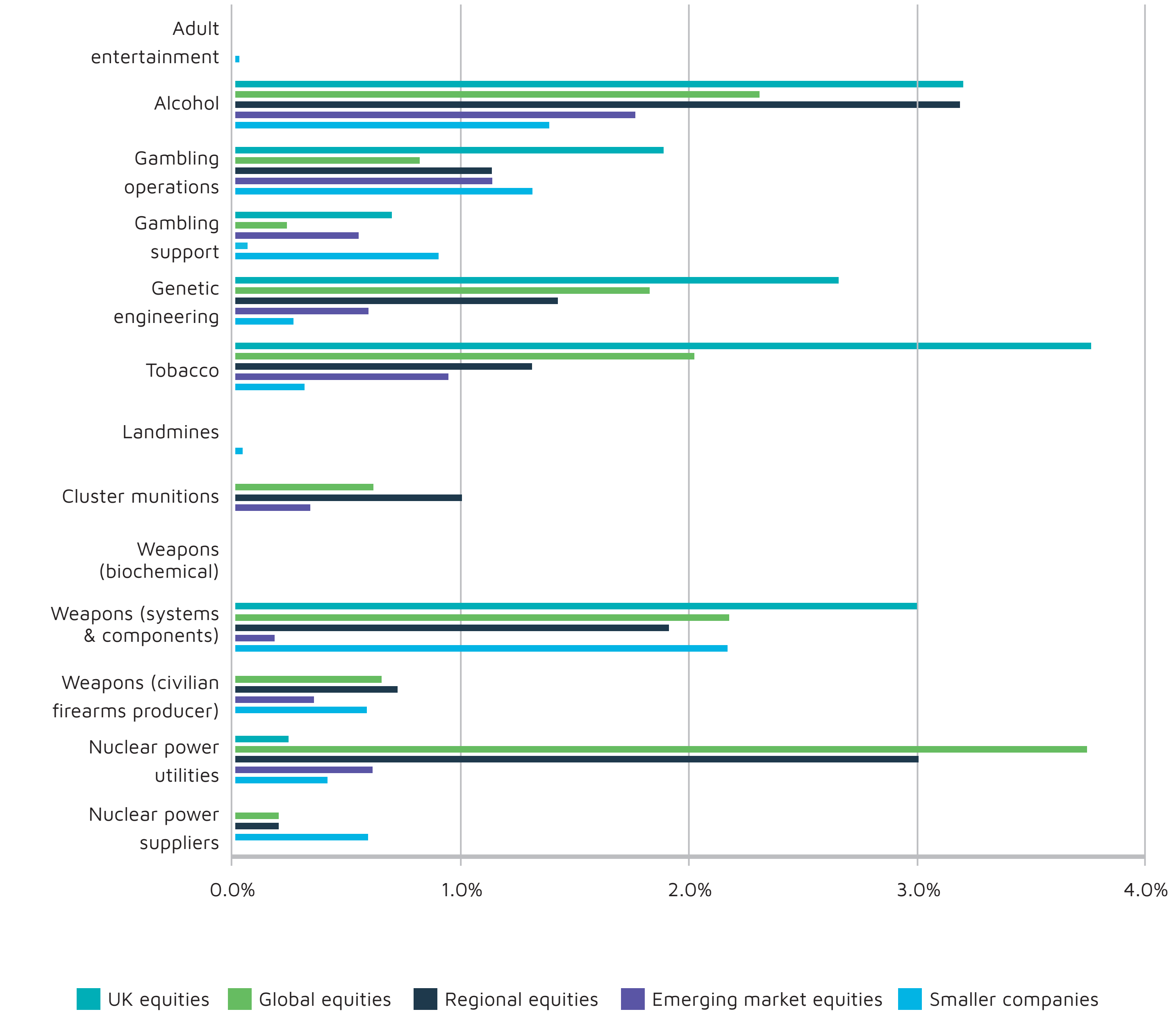
Average portfolio weight of morally controversial business areas

WHILE THE PREVIOUS CHART shows many funds had some exposure to stocks that derive at least some of their revenues from morally controversial business areas, these were far from major positions for the average portfolio. The weighting of equity strategies with exposure to companies flagged for one or more controversial business activities ranged from 2.93% for emerging markets to 8.25% for UK strategies. Across equity funds as a whole, exposure to morally controversial business areas averaged out at just 6.64% of assets.

Average exposure to morally controversial business areas



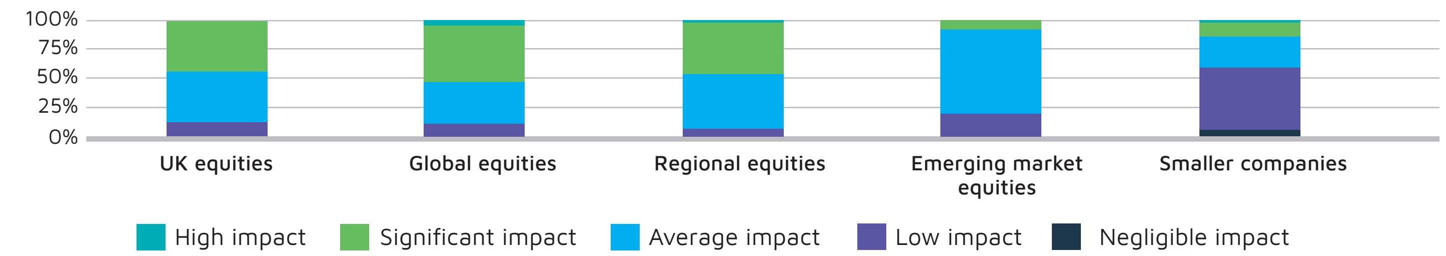
Average portfolio's share of sustainable impact

OF THE EQUITY FUNDS ANALYSED IN THIS STUDY, 43.67% had significant exposure to sustainable impact themes. Global equity strategies were the most impactful, with just under 54% found to have a 'significant' or 'high' impact. Regional equities followed (47.22% in the top-two impact buckets) then UK equities (44.88%). Emerging market funds brought up the rear as only 7.14% had a 'significant' impact, with none classed as 'high' impact.

Sustainable impact categories

Portfolio share with sustainable impact (%)	
% of portfolio exposed to companies where the majority of revenue is derived from: climate change (alternative energy, energy efficiency, green building); natural capital (sustainable water, pollution prevention); basic needs (healthcare, nutrition, sanitation); and/or empowerment (education, social finance, affordable housing). Excluded from consideration are companies that have faced significant or massive controversies in the provision of the above themes.	
25-100%	High exposure to sustainable impact themes
10-25%	Significant exposure to sustainable impact themes
5-10%	Average exposure to sustainable impact themes
1-5%	Low exposure to sustainable impact themes
0-1%	Negligible exposure to sustainable impact themes

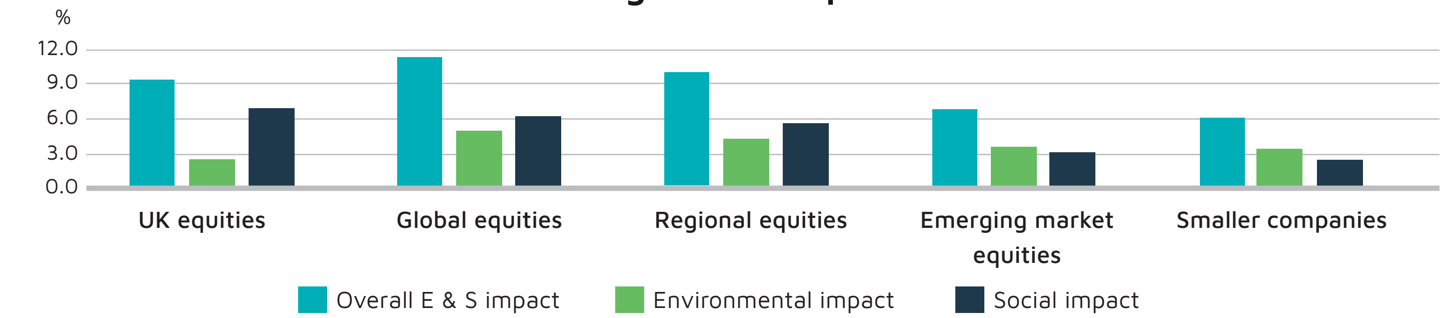
% breakdown of each kind of impact



Average environmental & social impact share

EQUITY FUNDS' AVERAGE SOCIAL IMPACT WEIGHTING of 5.7% was higher than their environmental weight of 4.1%. Global equities had the highest total impact with a weight of 11.3%, thanks to the highest environmental impact. UK funds had the strongest social impact weight, but the lowest environmental impact (2.6%).

Average E & S impacts



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Advertorial feature

Balancing act

The Janus Henderson Sustainable Future Technologies and Janus Henderson Global Sustainable Equity Funds aim to help meet the needs of the present without compromising future generations, according to Senior Product Specialist **Tim Brown**

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A **STRAIGHTFORWARD CONCEPT** underpins the sustainability approach of the Janus Henderson Sustainable Future Technologies Fund and Janus Henderson Global Sustainable Equity Fund: "Sustainable development is all about meeting the needs of the present without compromising the ability of future generations to meet their goals."

"This gets everyone round the table," says Tim Brown, Senior Product Specialist for both funds.

This definition of sustainable development is built on the UN-commissioned Brundtland Report from 1987. The report ultimately spawned the basis for the Millennium Goals in 2000 and the more well-known 2015 UN Sustainable Development Goals.

Brown says: "It is important for us to be as transparent as we can be – to set out why we're doing what we're doing, the reasons behind our voting decisions and our hopes for change. We try to be partners with all our portfolio holdings – working with them on issues such as board diversity, racial equality and sustainable initiatives. We aim to have an engagement plan as a framework to operate with companies."

Both the Sustainable Future Technologies and the Global Sustainable Equity teams have dedicated sustainability analysts that sit within the investment team. They are supported by firm-wide resources that focus on governance and sustainability.

STRONG FOUNDATIONS

For the two funds, the sustainable objectives are on a par and their foundations closely aligned. Nevertheless, there are some nuances in terms of how each fund invests. The recently launched Sustainable Future Technologies fund is managed by Janus Henderson's well-respected UK-based technology team. Their view is that technology is all about the science of solving problems. Many of the world's greatest challenges are centred around sustainability – from inequality and poverty, to a growing and ageing population, resource constraints and climate change.

Advertorial feature

The fund focuses on technology companies that can help address some of these environmental and social challenges, notably in sustainable transport, clean energy technology and low carbon infrastructure. On the social side, issues can be addressed through education technology, tech health and fintech. Brown believes there are clear synergies between technology and sustainability.

The team's five-stage analysis looks to capture product and operational impact analysis, rather than just a company's output. The investment universe is focused on eight main themes – clean energy, sustainable transport, resource and productivity optimisation, smart cities, low carbon infrastructure, data security, tech health and digital democratisation. Every stock in the portfolio must be at least 50% aligned to one of these themes, and the remainder must not be a negative influence by causing environmental or social harm.

DON'T BELIEVE THE HYPE

The technology team is skilled at managing the 'hype' around technology companies, says Brown. It doesn't hold any FAANG stocks, for example, which score poorly on valuation and on the group's social metrics. Instead, its top ten includes companies such as education technology group Chegg, and sustainable transport group TE Connectivity.

The Global Sustainable Equity fund also starts with the challenges the world is facing, Brown says: "We believe there is a real link between sustainable development, innovation and long-term compounding growth. The team is looking to find those opportunities with a positive impact on society, while looking to stay on the right side of disruption as we transition to a more sustainable global economy."

A low-carbon approach is embedded in the team's investment process. This means excluding not just fossil fuel extraction, but industries relying on fossil fuels such as shipping or the airline industry. The fund will also hold companies that help with the transition to a lower-carbon economy, such as renewables, batteries, semiconductors or buildings and design efficiency. The fund is 85% less exposed to carbon than the benchmark[1].

"We believe there is a real link between sustainable development, innovation and long-term compounding growth"

BREAKING IT DOWN

There are 10 themes in the portfolio for idea generation – five environmental, five social – including clean energy, efficiency, environmental services, sustainable transport and water management, and on the social side, safety, health, quality of life, knowledge and technology and sustainable property and finance. As with the technology fund, nothing makes it in unless it is at least 50% exposed to the theme.

Brown adds: "ESG analysis is integrated into the investment process across both portfolios. We have a positive criteria and a 'do no harm' standard – which automatically excludes areas such as gambling, weaponry, or alcohol. Nothing enters the fund if it trips the avoidance criteria. In some instances, it is because they are going to be disrupted, for example by government regulation (carbon tax), and other times it is because we want to take a moral position."

Design, engineering and construction software group Autodesk is a good example of the process in action. The company is aiming to be net-zero carbon this year, while also helping customers to decarbonise by making sustainable design easier and more effective. The group is delivering products and services that make sustainable design easy, insightful, and cost-effective; it has a positive impact in manufacturing as its tools can help revolutionise the environmental impact of these processes. Of fundamental importance, Autodesk is well-run, with low debt levels, high and improving operating margins, plus a significant expanding total addressable market. Brown says: "It is a great story for the environment and a great potential growth opportunity."

"The important thing is the triple bottom line. Is the world a better place for this company? Is there a large growth opportunity? How do companies think about profits, planet and people? We are trying to identify companies that answer these questions positively and deliver for the environment, for society and economically." ■

(1) Source: Janus Henderson Investors, ISS Climate Impact data, as at 31 January 2021

Bond analysis

Bond funds: Key facts

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AFTER EQUITIES, WE LOOKED AT FIXED INCOME FUNDS from a variety of ESG viewpoints to provide a view of the sustainable and impact investing on offer in this part of the market.

Again, the analysis looked at three main areas: **ESG quality and risks**, or how strong funds were when it came to the three pillars of environmental, social and governance issues; **controversies**, or funds' investments with companies that either violated the UN Global Compact or were active in morally controversial areas; and **impact**, or the positive outcomes of funds' investments.

In total, 439 funds were analysed from 17 of the Investment Association's fixed income sectors. To give a more detailed view, the bond universe has been broken down into five sub-groupings:

- Government bond funds (comprising the IA EUR Government Bond, IA Global Government Bond, IA UK Gilts and IA USD Government Bond sectors)
- Index-linked bond funds (IA Global Inflation Linked Bond and IA UK Index Linked Gilts)
- Investment grade bond funds (IA EUR Corporate Bond, IA Global Corporate Bond, IA Sterling Corporate Bond and IA USD Corporate Bond)
- High-yield bond funds (IA EUR High Yield Bond, IA Global High Yield Bond, IA Sterling High Yield and IA USD High Yield Bond)
- Emerging market debt funds (IA Global EM Bonds – Blended, IA Global EM Bonds – Hard Currency and IA Global EM Bonds – Local Currency)

Bond funds overview

What has been checked?

TO MEET THE INCREASING DEMAND FOR TRANSPARENCY AROUND ESG, the funds' portfolios were comprehensively examined for risks and opportunities using the ESG Fund & Portfolio Screening tool from yourSRI.com.

In particular, the three dimensions of ESG risk, controversy and impact were examined in detail in this analysis.

ESG quality & risks

Exposure to controversies

Social & environment impact

Results at a glance

ESG scores

THE AVERAGE FIXED INCOME FUND had an ESG score of 5.78, making the asset class the lowest scoring of the three examined in this study. But within the five bond sub-groupings, there was a wide variance in scores. The average investment grade bond fund, for example, had an ESG score of 7.32 – which ranked it higher than every equity grouping aside from those with a UK focus. In keeping with the findings from equity funds, emerging market bonds were the worst-performing group with an average score of 3.54, which put them in the lower-quality ESG bracket.

E-S-G quality

OF THE THREE PILLARS OF ESG, BOND FUNDS scored their highest marks in the social category, at 5.76. This was driven by strong performance from government bond funds. Corporate bond funds scored better for environmental factors over social ones. The environmental pillar came next (5.49), just ahead of governance (5.47).

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Controversies

LOOKING AT CONTROVERSIAL BUSINESSES within fixed income funds only makes sense for corporate bond strategies. Across the corporate bond groups we examined, the average fund had just under 80% of its portfolio in bonds issued by companies that have not been involved in any recent critical controversies. Around 1.3% of the average bond portfolio was exposed to companies that have been caught up in a massive controversy.

UN Global Compact

When looking across the investment grade, high yield and emerging market debt sub-groups for funds that have been flagged for UN Global Compact violations, more than three-quarters failed the test. High-yield bond funds came off worst: 78.8% of them had at least a small part of their portfolio invested with companies that violated the UN Global Compact Principles. The share of the portfolios invested in these offending businesses, however, tended to be smaller than that seen among equity funds.

Morally controversial business areas

The most common morally controversial businesses found in fixed income portfolios were those connected to nuclear power – almost 80% of bond funds had exposure to companies involved in this area. Other common holdings included companies involved with weapons systems or components and genetically modified organisms.

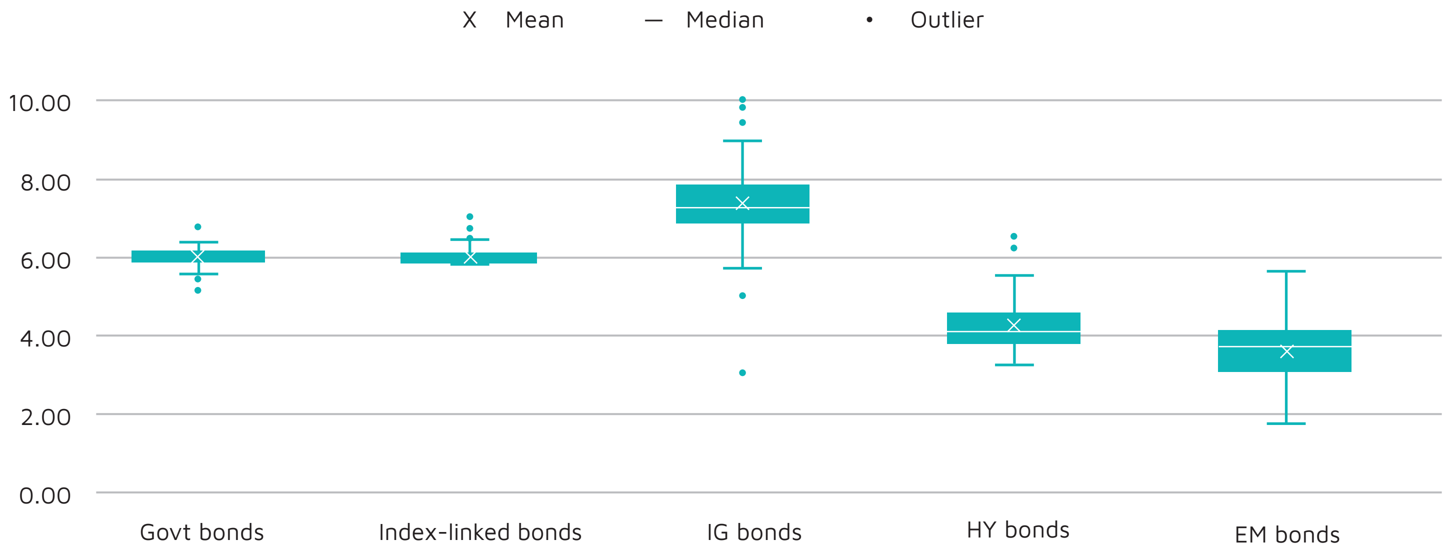
Impact

In equity funds, 43.7% of portfolios had a 'significant' or 'high' impact. For fixed income funds, however, only 3.56% had a significant impact, while none were placed in the high impact category. Investment grade strategies demonstrated the best impact performance by a clear margin.

Sector breakdown

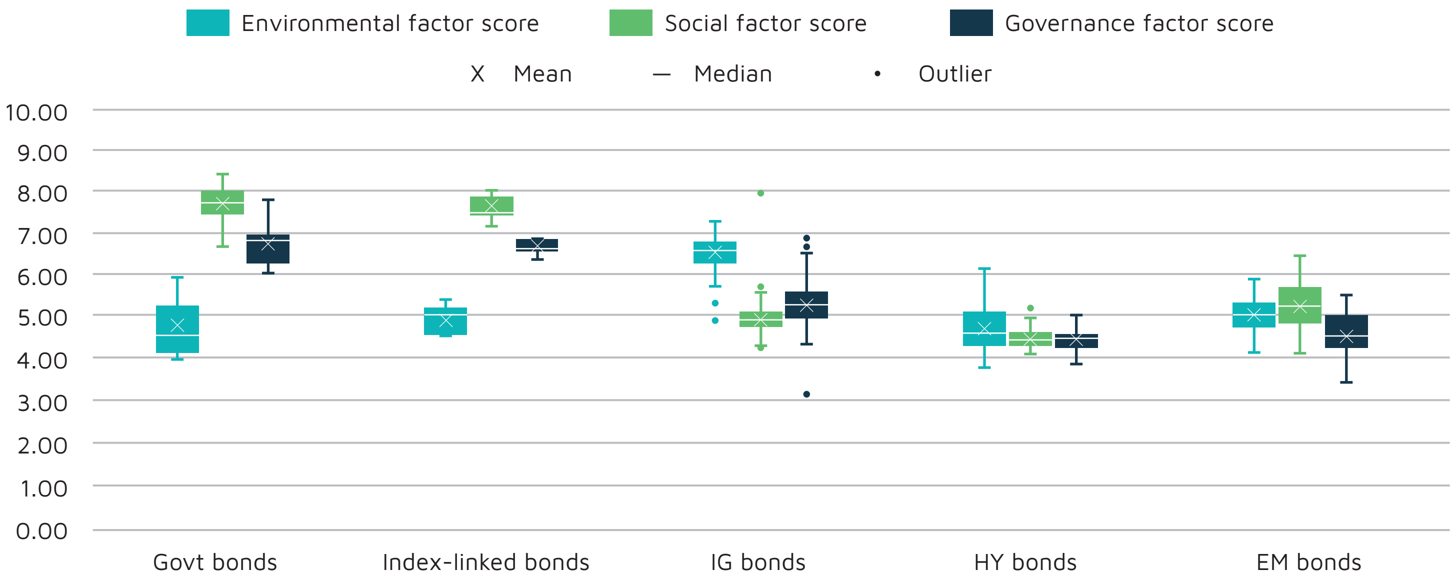
WITH AN AVERAGE ESG score of 5.78, bond funds fell behind equities and mixed-asset strategies – although those focused on investment grade assets beat all sub-groups aside from UK equities. In the regionally based investment grade sectors, the best results came from IA EUR Corporate Bond (7.57), followed by IA Sterling Corporate Bond (7.47). Again, emerging market funds had the lowest ESG score, with an average of 3.54.

Average ESG scores



ON THE THREE INDIVIDUAL ELEMENTS OF ESG, the social pillar was the highest scoring among bond funds, with an average of 5.76. This was driven by sovereign bond funds – the sub-grouping scored 7.68 in this area. Investment grade bond funds beat all other sub-groupings on the environmental pillar, with a score of 6.53. Conventional government and index-linked bond funds were top for governance, scoring 6.74 and 6.69 respectively.

ESG pillar scores



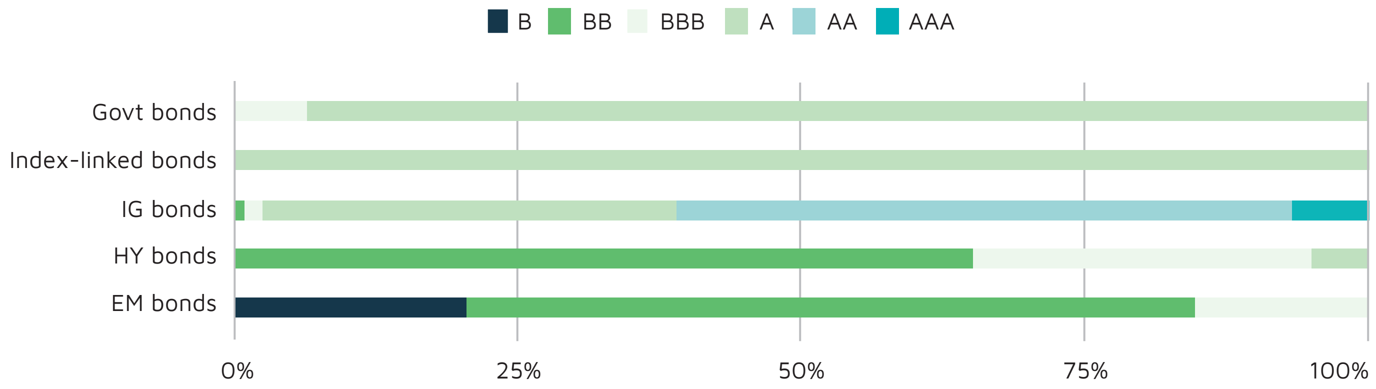
Bond funds' ESG letter-rating distribution

THE FUNDS' ESG SCORES were turned into a seven-level grading system, ranging from CCC (lowest value) to AAA (highest). Just over 20% were in the two ESG 'leaders' categories. Investment grade funds were well ahead here: 54.27% were rated 'AA' with another 6.71% 'AAA'. No funds from the other fixed income sub-groupings made these categories. Around one-fifth of emerging market debt funds were classed as ESG 'laggards', the only fixed income funds that were. Two-thirds of emerging market and high yield funds were rated 'BB'.

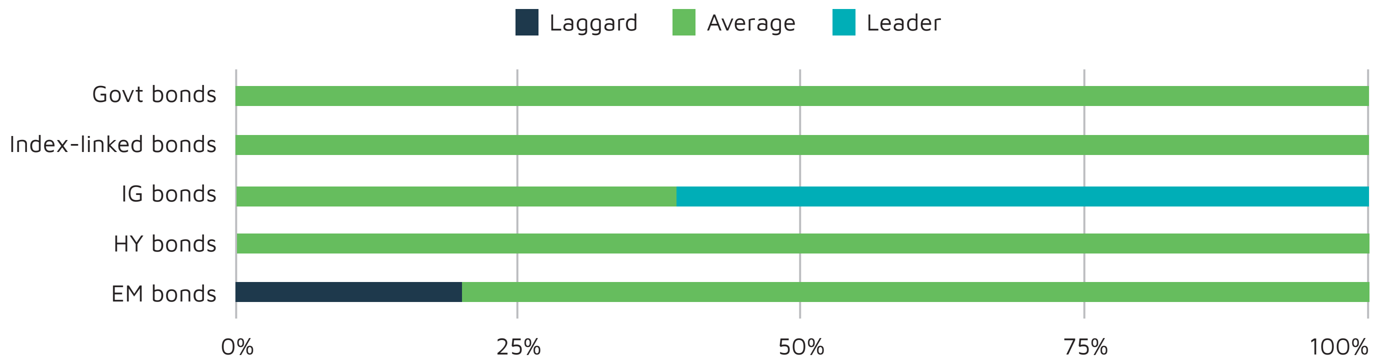
ESG quality scores

Fund ESG ratings			What it means	
AAA	8.57 - 10.0	AAA AA	LEADER	The companies that the fund invests in tend to show strong and/or improving management of financially relevant environmental, social and governance issues. These companies may be more resilient to disruptions arising from ESG events.
AA	7.14 - 8.56			
A	5.71 - 7.13	A BBB BB	AVERAGE	The fund invests in companies that tend to show average management of ESG issues, or in a mix of companies with both above-average and below-average ESG risk.
BBB	4.29 - 5.70			
BB	2.86 - 4.28			
B	1.43 - 2.85	B CCC	LAGGARD	The fund is exposed to companies that do not demonstrate adequate management of the ESG risks that they face or show worsening management of these issues. These companies may be more vulnerable to disruptions arising from ESG events.
CCC	0.00 - 1.42			

Distribution of ESG letter ratings



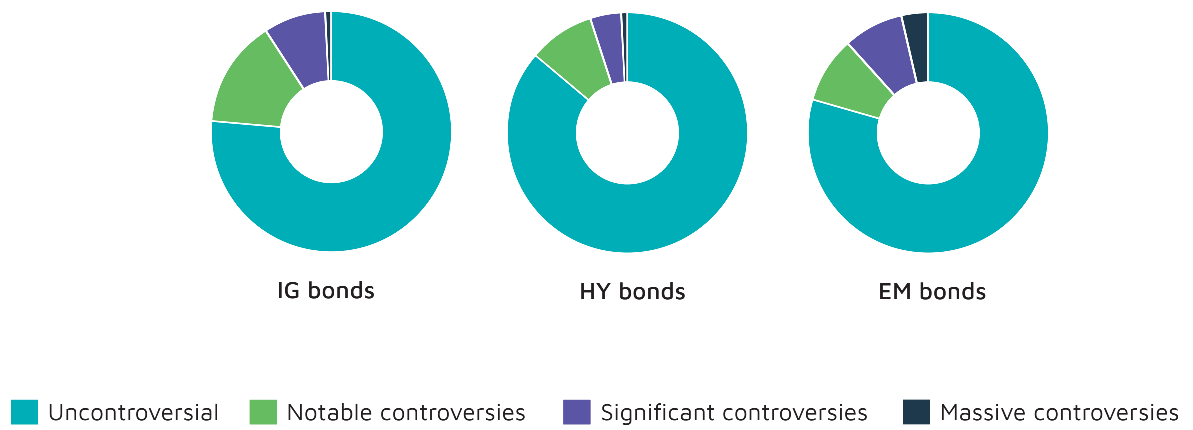
Distribution of ESG leaders & laggards



Portfolio controversies

ON AVERAGE, 79.37% of corporate bond funds' holdings were rated green, meaning they are unobjectionable companies without major violations of laws or regulations. Notably, 86.28% of the average high yield bond fund was green, compared with 76.42% for investment grade. Bond funds had a lower exposure to green companies than their equity peers, but they also had a higher weighting to red ones – or those involved in 'massive' controversies.

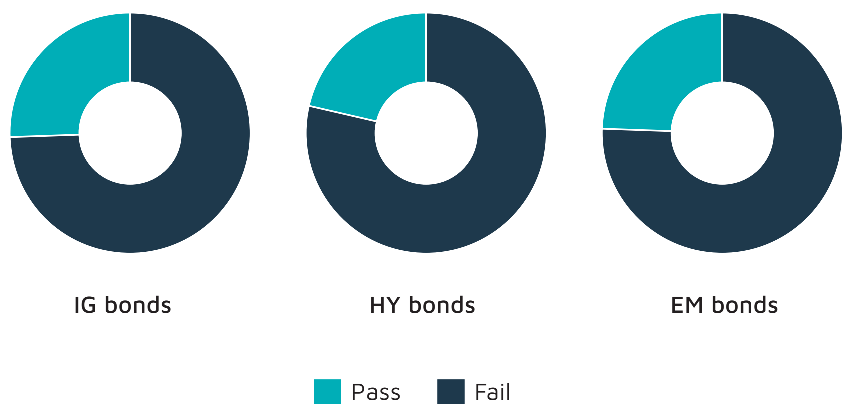
% in each severity of controversies



UN Global Compact-compliant funds

OUR ANALYSIS FOUND 76.05% of corporate bond funds held bonds issued by companies that violate the UN Global Compact (UNGC). There was no significant difference in the share of funds exposed to UNGC-violating companies across the three sectors – it was about three-quarters in each, with the high yield sub-group reaching 78.8%. But the weighting in portfolios did show some differences, with emerging market funds' 2.5% position in UNGC-violating companies much higher than the 1.8% average for fixed income portfolios.

% of funds passing or failing UNGC test



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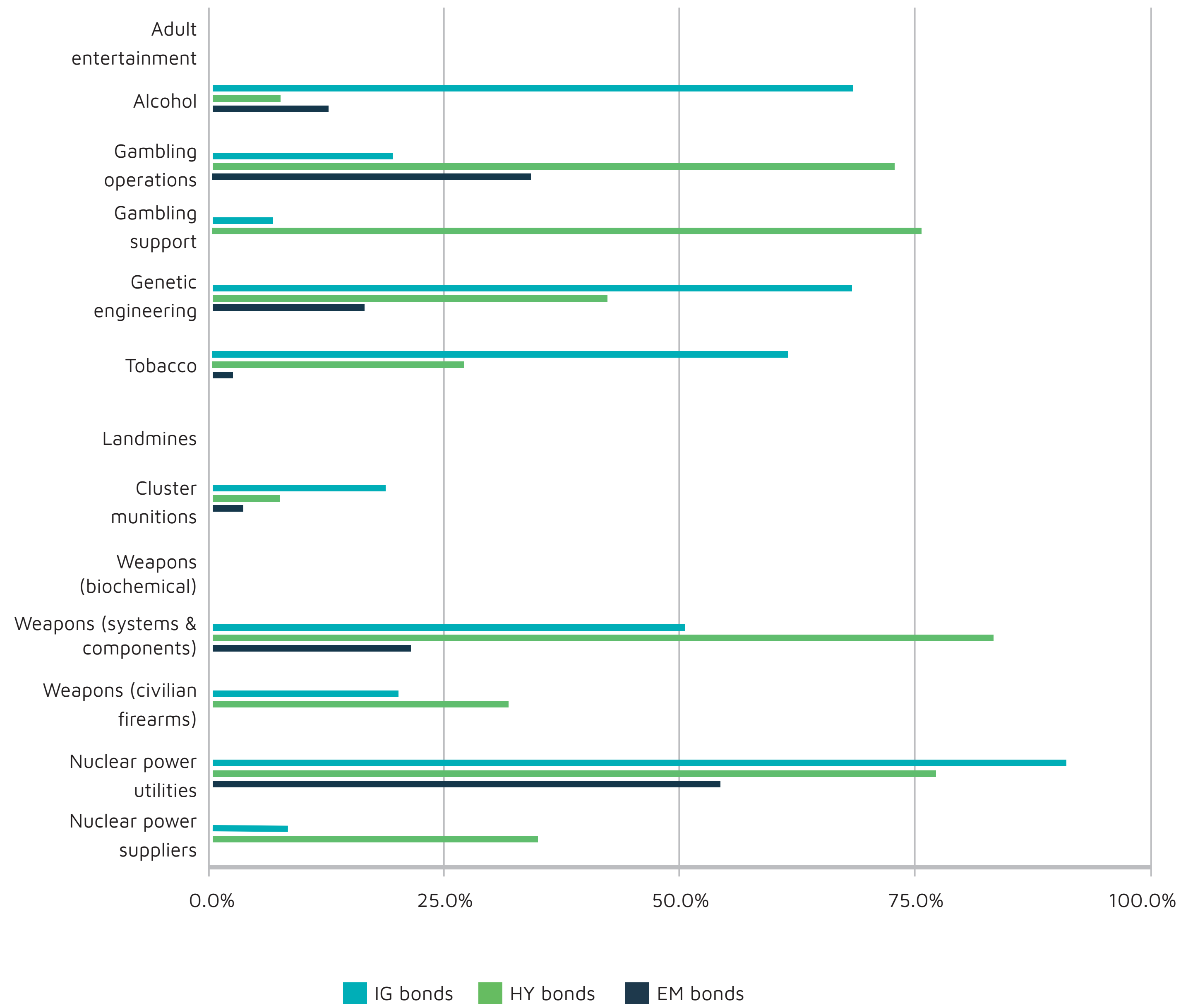
Funds with investments in morally controversial business areas

THE MAJORITY OF FIXED INCOME FUNDS had exposure to at least one morally controversial business area, with 78.64% holding the debt of companies linked to nuclear power. This climbed to more than 90% for investment grade bond funds, although less than 55% of emerging market debt funds had exposure to this area. Meanwhile, around half of funds were exposed to weapons systems or components, or genetically modified organisms. Across bonds, there was no exposure to landmines or bio-chemical weapons.

% of funds with exposure to morally controversial business areas



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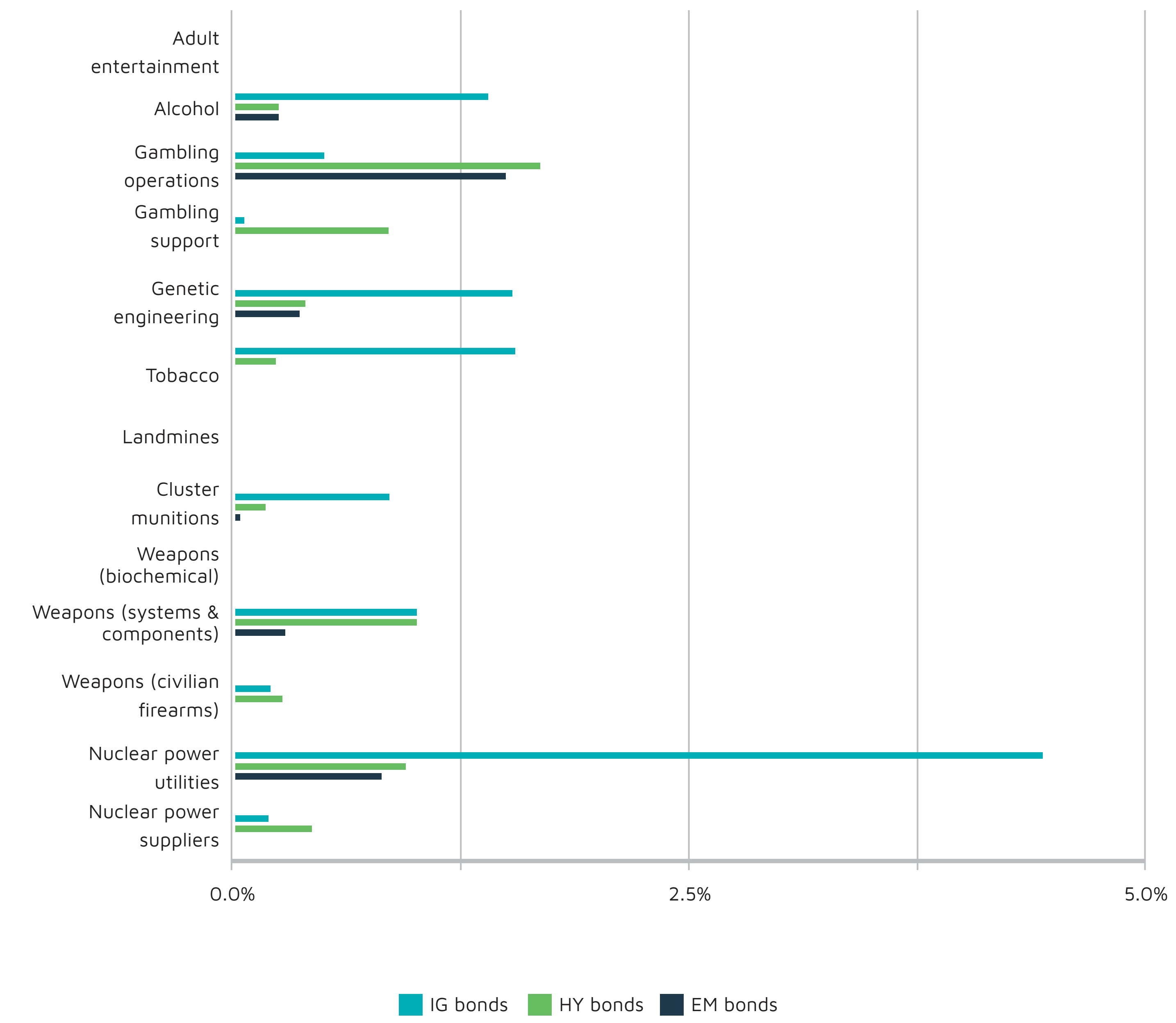
Average portfolio weight of morally controversial business areas

MANY BOND FUNDS WERE exposed to morally controversial areas, but these tended to be minor positions. The average weighting to companies with controversial business activities stood at 5.52% of assets (compared with 6.64% for equity funds). The highest average exposure came from investment grade bond funds, at 7.41%, followed by high yield at 4.03%. Emerging market debt funds had much less exposure – just 1.69%. The highest single individual exposure was investment grade bond funds' weighting to nuclear power, at 4.46%.

Average exposure to morally controversial business areas



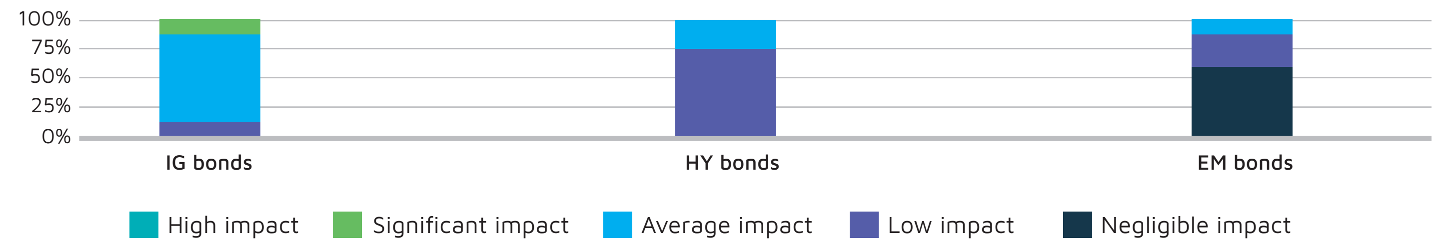
Average portfolio's share of sustainable impact

ONLY 3.56% OF BOND FUNDS were deemed to have a 'significant' impact and none had a 'high' impact. This was far below the 43.7% of equity funds deemed to have a significant exposure to sustainable impact themes. Investment grade funds showed the best results, with 6.71% rated as having a 'significant' impact. Emerging market funds were at the bottom of the pile – around three-fifths fell into the 'negligible' impact category.

Sustainable impact categories

Portfolio share with sustainable impact (%)	
% of portfolio exposed to companies where majority of revenue is derived from: climate change (alternative energy, energy efficiency, green building); natural capital (sustainable water, pollution prevention); basic needs (healthcare, nutrition, sanitation); and/or empowerment (education, social finance, affordable housing). Excluded from consideration are companies that have faced significant or massive controversies in the provision of the above themes.	
25-100%	High exposure to sustainable impact themes
10-25%	Significant exposure to sustainable impact themes
5-10%	Average exposure to sustainable impact themes
1-5%	Low exposure to sustainable impact themes
0-1%	Negligible exposure to sustainable impact themes

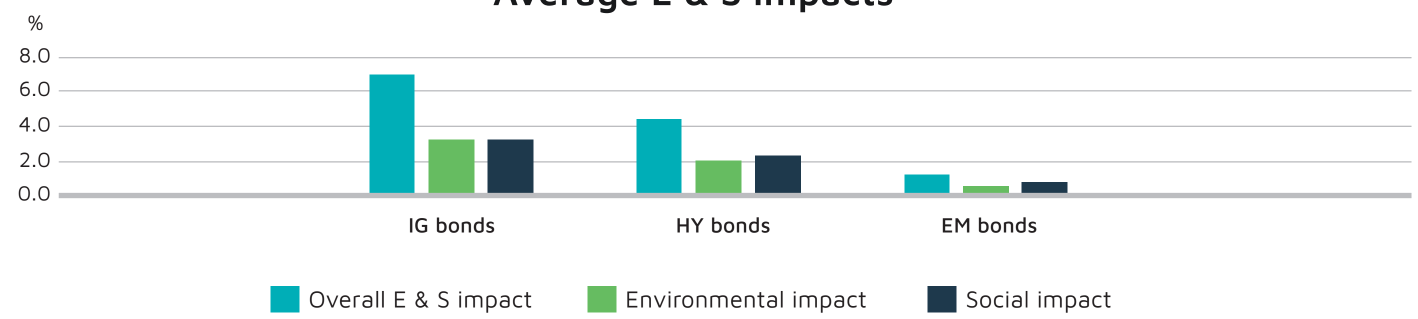
% breakdown of each kind of impact



Average environmental & social impact share

THE AVERAGE INVESTMENT GRADE, high yield and emerging market debt funds had a social impact weighting of 2.54% versus 2.48% for environmental impact. Investment grade funds came top, with a combined environmental and social impact weighting of 7.01%, followed by high yield (4.30%). Emerging market debt strategies scored just 1.51%.

Average E & S impacts



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Advertorial feature

Making an impact

Disruptive impact companies are developing solutions to combat climate change and help ensure a sustainable future. This translates into a growing range of environmentally focused opportunities for fixed income investors, write **Campe Goodman** and **Paul Skinner** of the Wellington Global Impact Bond Fund

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AMID RECENT NATURAL DISASTERS AND GROWING AWARENESS, climate change has become a focus of social and political discourse, and we believe the ranks of market participants seeking solutions are growing rapidly. Many impact issuers contribute to environmental sustainability and help society better prepare for climate change. Here we share some of the environmental and climate-related innovations we are seeing across the impact investing universe and the associated investment opportunities for fixed income investors.

ALTERNATIVE ENERGY

In our view, the global energy infrastructure must evolve to support the transition to a low-carbon economy. Alternative energy sources like solar, wind and hydropower help reduce greenhouse gas (GHG) emissions and slow the global temperature rise, improve health outcomes and drive both social benefits and cost savings. We believe we will see more technological advances and more investable alternatives driven by a combination of intensifying climate awareness and consumer activism, increased governmental support for climate-mitigation regulation and policy, and a continued decline in the cost of renewable energy.

Fixed income issuers in our opportunity set include banks and supranationals that have issued green bonds for renewable energy generation projects as well as corporate issuers using the green bond market to finance grid modernisation or the shift from fossil fuels to renewable energy sources.

RESOURCE EFFICIENCY

Rising consumption and a dwindling supply of non-renewable, finite resources like fossil fuels, metals, minerals, arable land, timber, water and clean air are putting enormous pressure on the planet. Shifting to more responsible, efficient production and use of resources is vital for the environment and the global economy. Modernising resource extraction, production and distribution methods can help reduce waste, mitigate pollution, save money and safeguard health and lives.

Fixed income issuers we have identified encompass those underwriting transportation infrastructure projects as well as building and energy efficiency projects, including select commercial mortgage-backed securities. We also see increased opportunity in new-issue sovereign green bonds that finance sustainable infrastructure projects and help countries advance toward carbon-emission reduction targets.

RESOURCE STEWARDSHIP

Amid population growth and rapid urbanisation, the need for better resource stewardship is becoming acute. Moving toward self-sustaining, regenerative production and consumption and upgrading infrastructure and technologies for safe, effective resource management may become an economic necessity. Decomposing landfills release harmful GHGs and runoff pollution contaminates surface and groundwater and forms breeding grounds for diseases such as cholera and malaria.

Fixed income opportunities include municipal bonds issued by non-profit organisations to acquire and protect conservation land, including forests. We have also identified debt issued by recycling companies

Moving toward self-sustaining, regenerative production and consumption and upgrading infrastructure and technologies for safe, effective resource management may become an economic necessity

Impact strategies can target this climate innovation potential through a robust framework

Did you know?

- Up to **3.5 billion people** could face water scarcity as soon as 2025.[1]
- The world consumed **92.1 billion tons of material** in 2017.[2]
- Efficient production and use of materials could help cut CO2 emissions by **25 gigatons.**[3]
- Renewables are expected to meet nearly **30%** of power demand in 2023.[4]

to fund advanced, broad-spectrum waste-recycling solutions, particularly construction waste. Water sanitation is another area of focus.

The above examples are illustrative only, but they speak to the rich opportunity set we access in practice in our Impact Bond approach. Across the impact universe, disruptive companies and forward-thinking non-profit or public entities are developing environmentally oriented solutions to help society adapt to or mitigate the effects of climate. Impact strategies can target this climate innovation potential through a robust framework comprising both financial and environmental goals, and in doing so, contribute to a more sustainable future. ■

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1. World Resources Institute, March 2021. | **2.** Materials used to build cars and homes key to tackling global warming," UN Environment Programme, December 2019. | **3.** Special edition: progress towards the Sustainable Development Goals," Report of the Secretary-General, United Nations Economic and Social Council, May 2019. | **4.** Renewables 2018: Analysis and reports to 2023," International Energy Agency, 2018.

Mixed-asset analysis

Mixed-asset funds: Key facts

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AS WITH EQUITY AND BOND FUNDS, this analysis of mixed-asset funds focused on three areas: **ESG quality and risks**, or how strong funds were when it came to the three pillars of environmental, social and governance issues; **controversies**, or funds' investments with companies that either violateed the UN Global Compact or were active in morally controversial areas; and **impact**, or the positive outcomes of funds' investments.

In total, we examined 529 funds from six of the Investment Association's sectors, labelled with the following sub-groupings:

- Adventurous mixed asset (funds in the IA Flexible Investment sector)
- Balanced mixed asset (IA Mixed Investment 40-85% Shares)
- Cautious mixed asset (IA Mixed Investment 20-60% Shares)
- Very cautious mixed asset (IA Mixed Investment 0-35% Shares)
- Volatility managed mixed asset (IA Volatility Managed)
- Absolute return (IA Targeted Absolute Return)

Mixed-asset funds overview

What has been checked?

TO MEET THE INCREASING DEMAND FOR TRANSPARENCY AROUND ESG, the funds' portfolios were comprehensively examined for risks and opportunities using the ESG Fund & Portfolio Screening tool from yourSRI.com.

In particular, the three dimensions of ESG risk, controversy and impact were examined in detail in this analysis.

ESG quality & risks

Exposure to controversies

Social & environment impact

Results at a glance

ESG scores

THE CLEAREST FINDING IN THIS SECTION was that mixed-asset funds looked more like each other in ESG terms than equities or bonds, with most sectors achieving similar scores. With an average ESG score of 6.7, mixed-asset funds did better than fixed income strategies but were just behind equity portfolios.

E-S-G quality

MIXED-ASSET FUNDS PERFORMED STRONGLY when environmental, social and governance factors were considered separately, especially in terms of the environmental pillar.

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Controversies and UN Global Compact

The mixed-asset universe had the highest share of funds across all classes triggering any involvement with morally controversial businesses. Despite this they showed average weightings to these companies. The majority of mixed-asset funds were also invested in holdings that violated the UN Global Compact.

Impact

Our analysis found that mixed-asset funds tended to be less impactful than equity strategies – with none being deemed 'high' impact. Adventurous mixed-asset, balanced mixed-asset and volatility managed strategies posted the best results when it came to their positive environmental and social impact.

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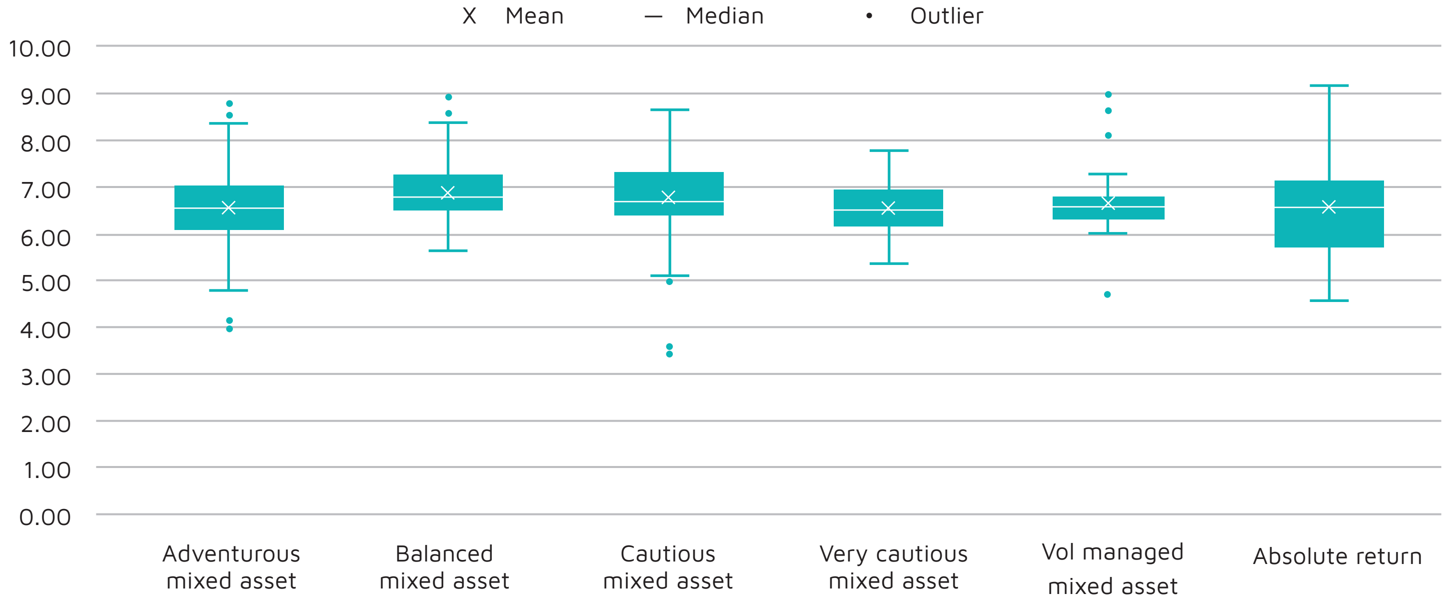
Sector breakdown

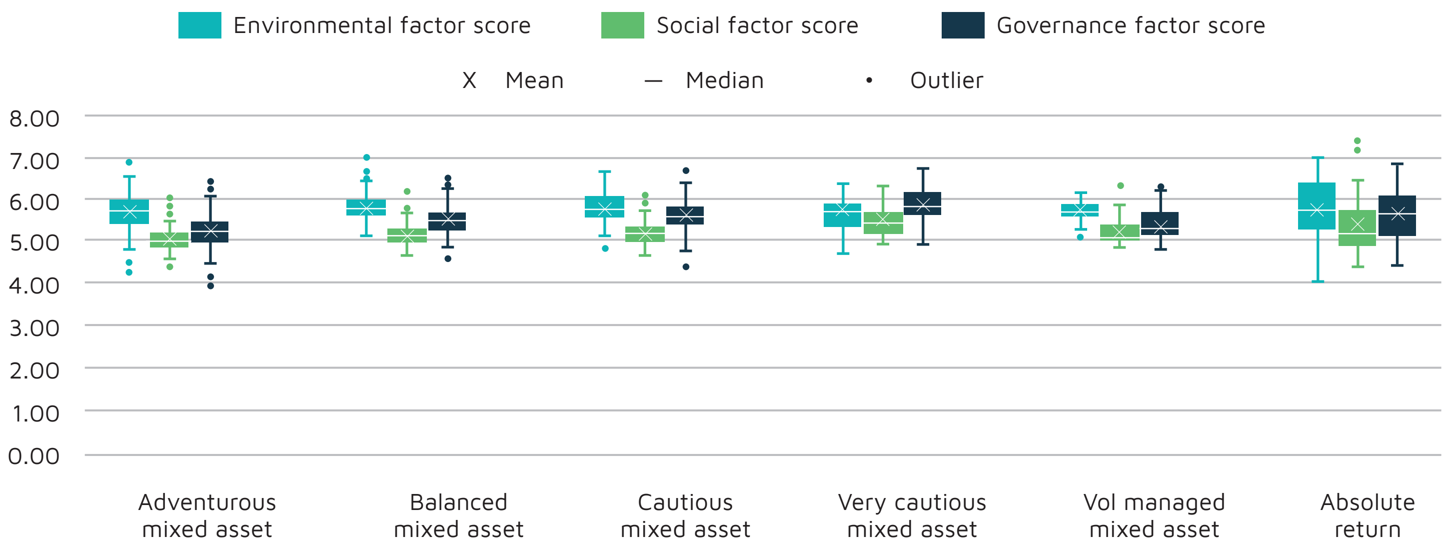
MIXED-ASSET FUNDS APPEARED HOMOGENEOUS across all sub-groups, with a narrow range of scores around the mean of 6.7. This meant the typical mixed-asset fund's ESG quality range was at the higher end of 'average' quality or lower end of 'high' quality. The most heterogeneous area was absolute return strategies – ESG scores here ranged from 4.56 to 9.19 – reflecting the diverse nature of funds and approaches found within this peer group.

Average ESG scores



OF THE THREE ELEMENTS OF ESG, the highest-scoring pillar for mixed-asset funds was environmental – the average was 5.75. This was higher than equities (5.69) and bonds (5.49). Mixed-asset funds also beat the average equity fund on the social and governance pillars, and bonds for governance, but fell behind the latter on social issues. The average scores across the mixed-asset sub-groupings were in a tight range for all three ESG pillars.

ESG pillar scores



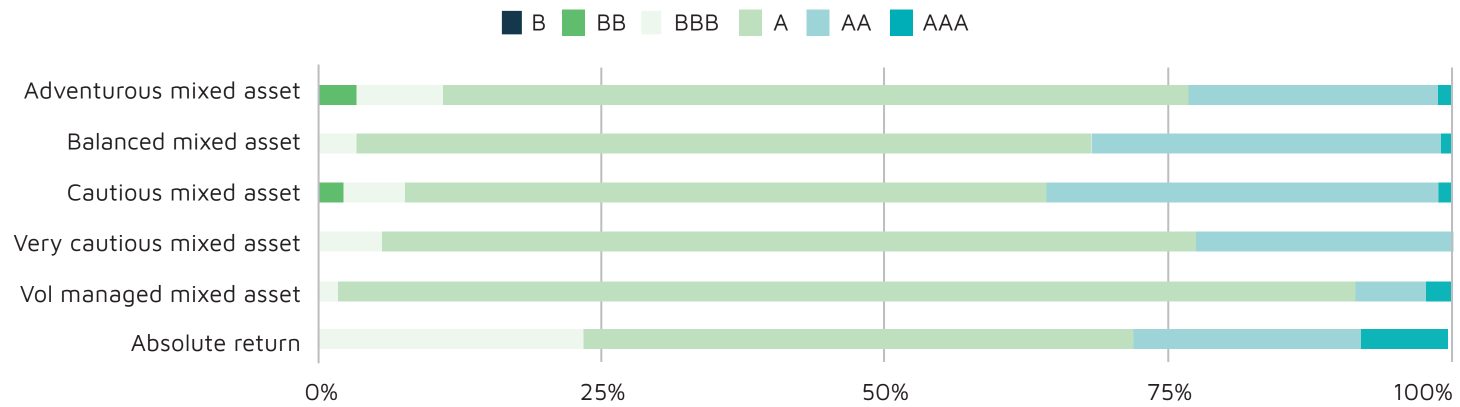
Mixed-asset funds' ESG letter-rating distribution

MIXED ASSETS HAD THE HIGHEST PROPORTION (75%) of 'average' quality funds (A, BBB and BB) – 75% – with most of these funds (68%) in the first group. At 36%, cautious mixed assets offered the highest share of ESG 'leaders'. Volatility managed mixed assets had the highest percentage of average funds. Of note is that no 'laggard' funds (CCC or B) were found among the mixed-asset funds assessed in this study.

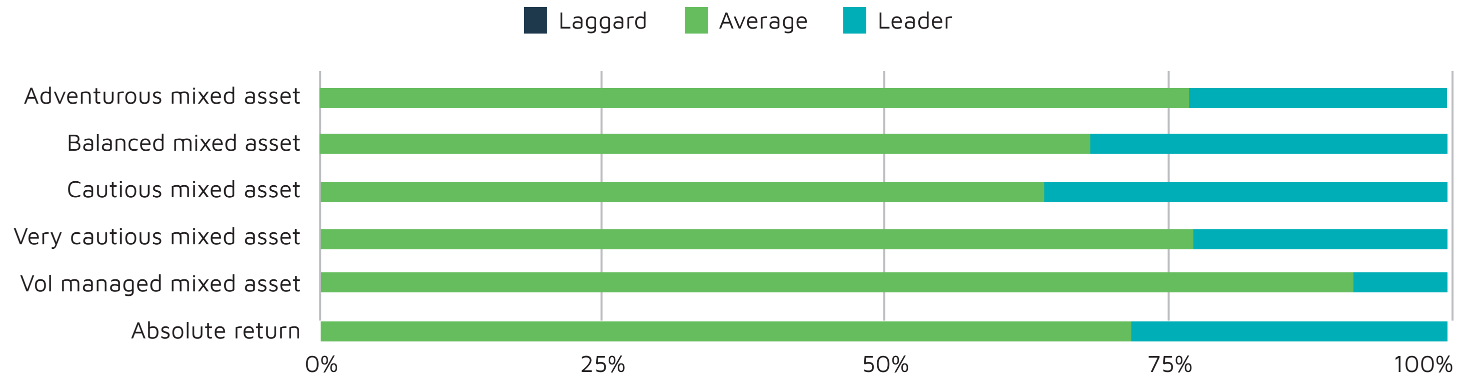
ESG quality scores

Fund ESG ratings				What it means
AAA	8.57 - 10.0	AAA AA	LEADER	The companies that the fund invests in tend to show strong and/or improving management of financially relevant environmental, social and governance issues. These companies may be more resilient to disruptions arising from ESG events.
AA	7.14 - 8.56			
A	5.71 - 7.13	A BBB BB	AVERAGE	The fund invests in companies that tend to show average management of ESG issues, or in a mix of companies with both above-average and below-average ESG risk.
BBB	4.29 - 5.70			
BB	2.86 - 4.28			
B	1.43 - 2.85	B CCC	LAGGARD	The fund is exposed to companies that do not demonstrate adequate management of the ESG risks that they face or show worsening management of these issues. These companies may be more vulnerable to disruptions arising from ESG events.
CCC	0.00 - 1.42			

Distribution of ESG letter ratings



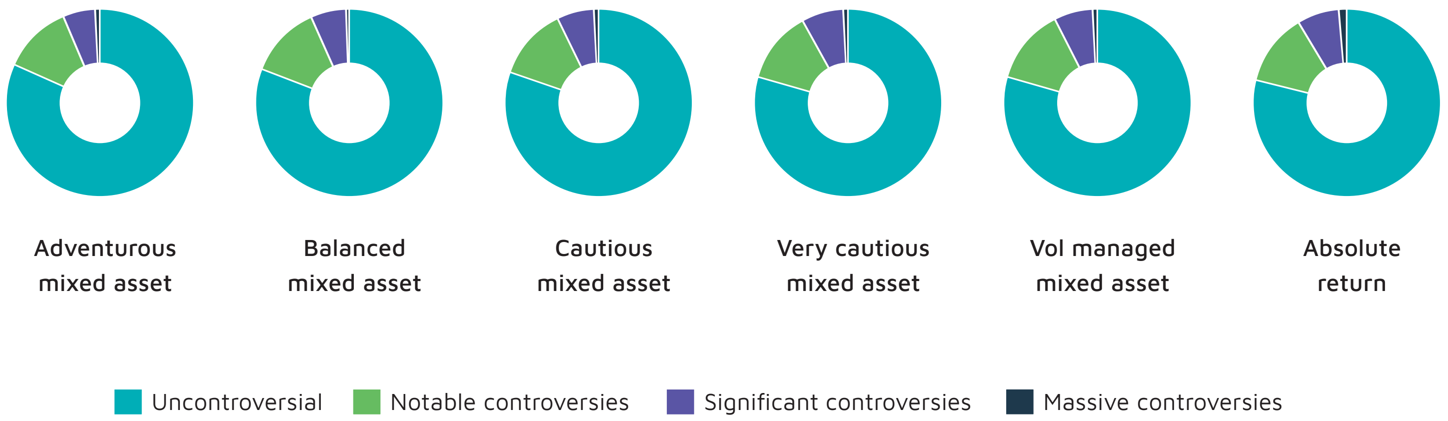
Distribution of ESG leaders & laggards



Portfolio controversies

MIXED-ASSET FUNDS DISPLAYED A SIMILAR CONTROVERSY PROFILE to the other asset classes, with 80% of the average portfolio labelled 'green' (not involved in major issues) and less than 1% in 'red' (massive controversies). Absolute return strategies had the highest amount of red-flagged portfolio content (1.14%).

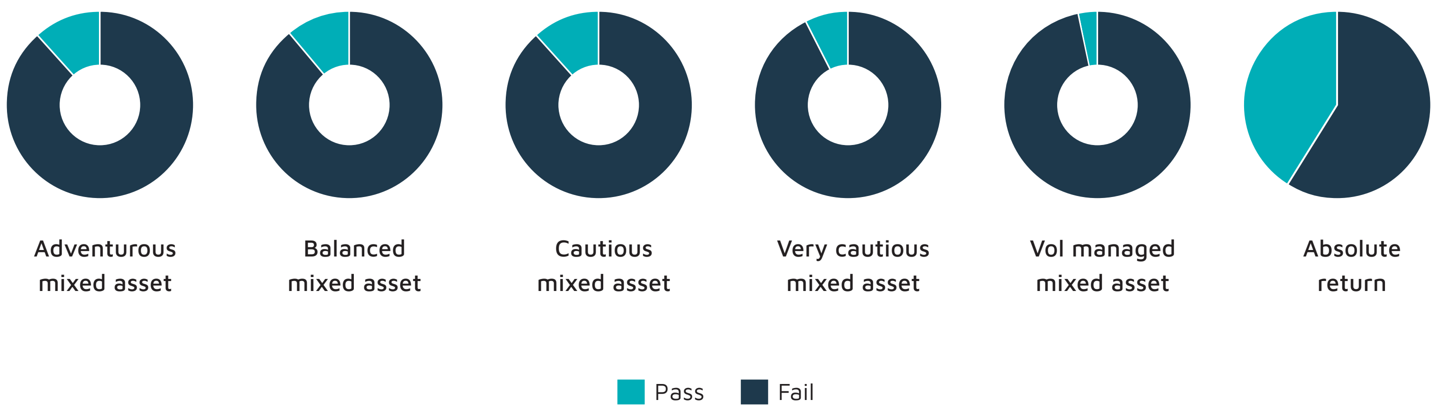
% in each severity of controversies



UN Global Compact-compliant funds

A SIGNIFICANTLY HIGHER NUMBER OF MIXED-ASSET FUNDS were flagged for holding stocks that violated the 10 principles of the UN Global Compact (UNGC) – 88.28% failed this test, compared with just 47% of equity funds and 76% of bond portfolios. But there was a higher variance across the mixed-asset sub-groupings: 96.88% of volatility managed funds had UNGC-violating holdings compared with just 58.97% of absolute return strategies.

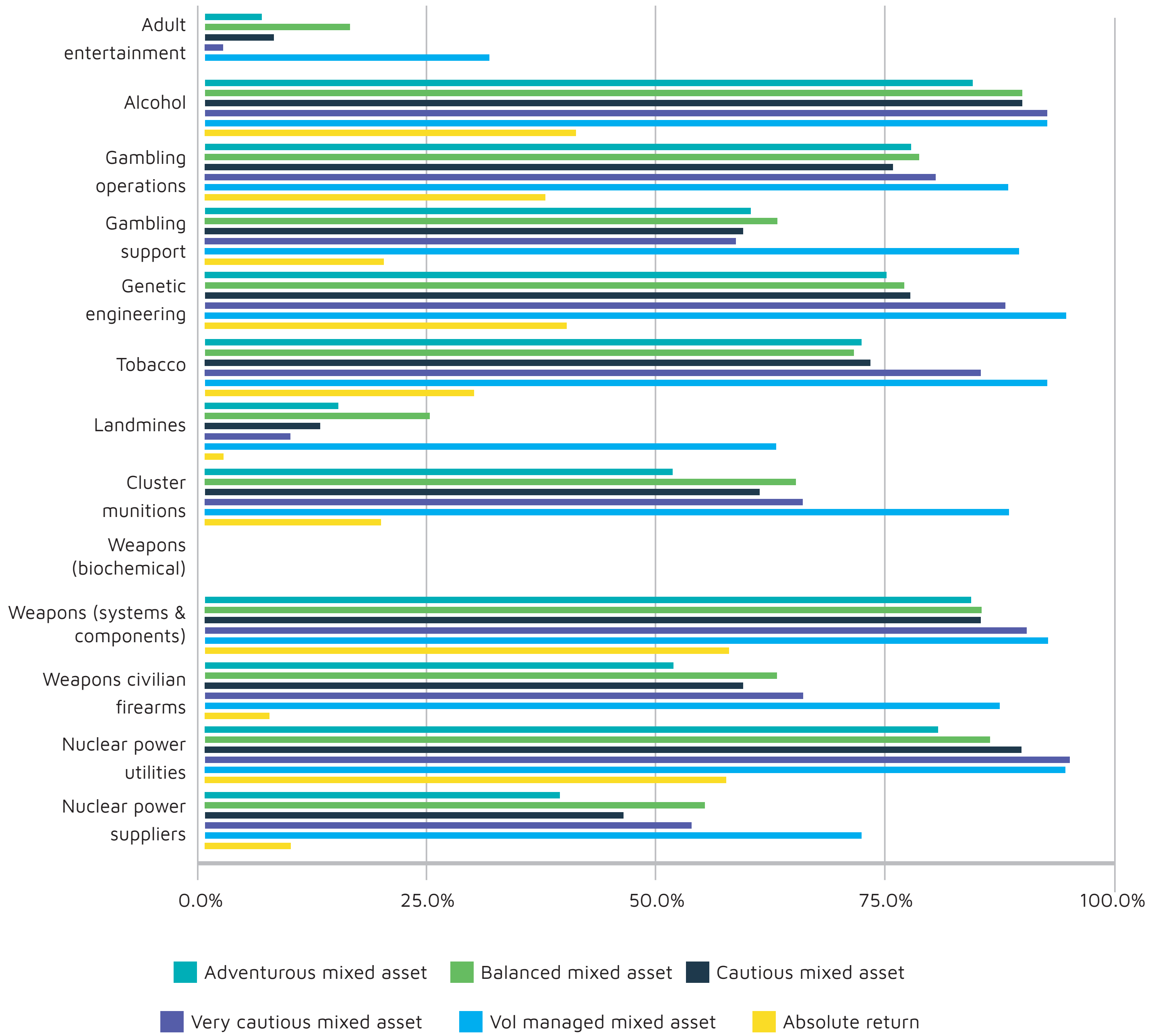
% of funds passing or failing UNGC test



Funds with investments in morally controversial business areas

MIXED-ASSET FUNDS HAD THE HIGHEST PERCENTAGE OF PORTFOLIOS THAT TRIGGERED FLAGS for investments in morally controversial business areas (61.14%). Investments with links to nuclear power, alcoholic beverages and weapons systems or components were the most common; the only area with a zero weighting was biochemical weapons. Volatility managed strategies tended to have the highest allocations to morally controversial business areas, while absolute return had the lowest.

% of funds with exposure to morally controversial business areas



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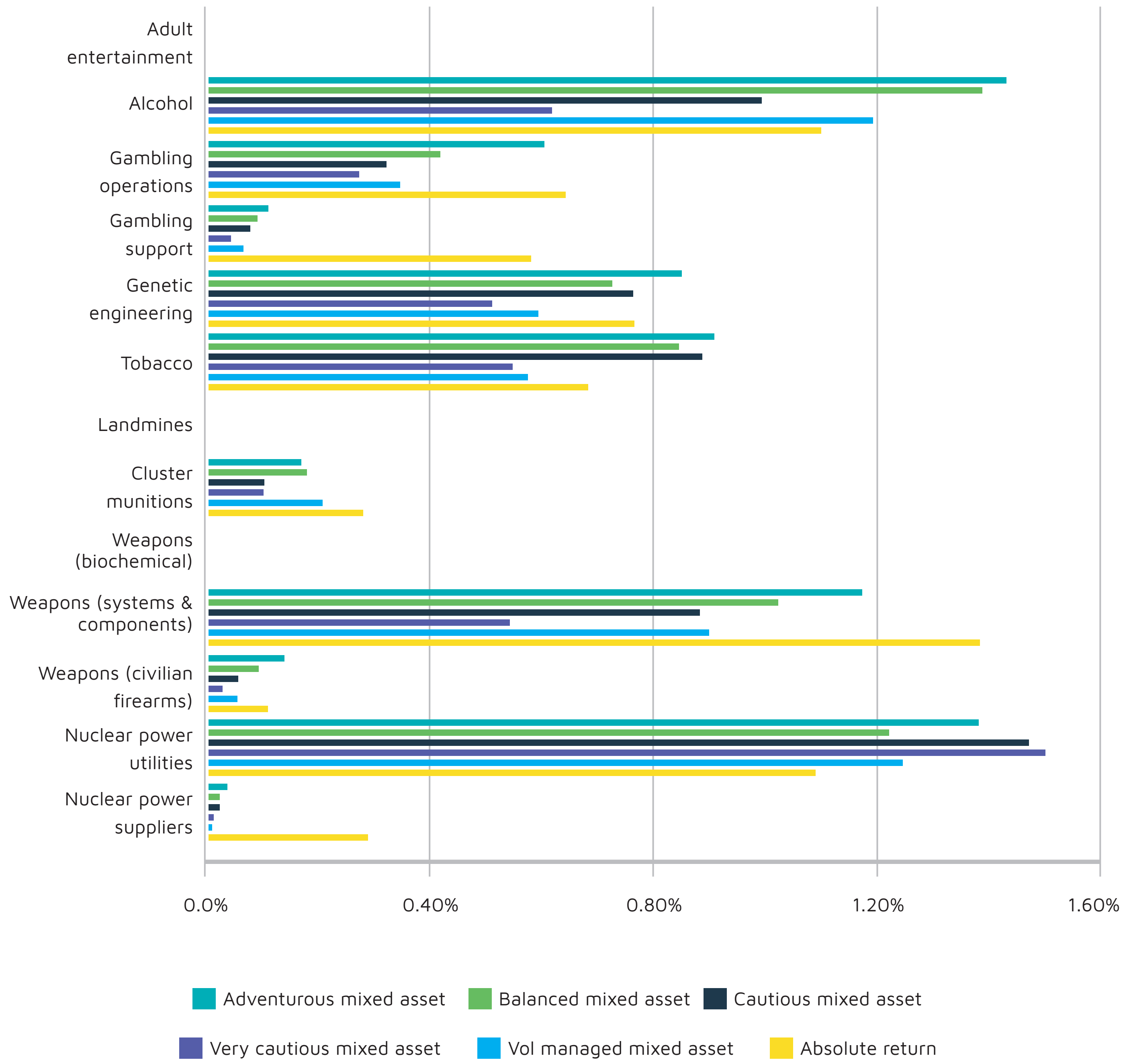
Average portfolio weight of morally controversial business areas

EVEN THOUGH MIXED-ASSET PORTFOLIOS were more likely to be flagged for involvement with morally controversial businesses, on average they showed the lowest portfolio weight involvement. The average mixed-asset fund had an allocation of 4.42% to these investments, compared with 6.64% for equity portfolios and 5.52% for corporate bond strategies.

Average exposure to morally controversial business areas



Average portfolio's share of sustainable impact

DATA SHOWED 11.53% OF MIXED-ASSET funds had a 'significant' impact, while none had a 'high' one. Adventurous mixed-asset, balanced mixed-asset and volatility managed strategies were most impactful. Around two-thirds of mixed-asset funds fell into the 'average' bracket; another 20% were 'low' impact and just 1.51% were 'negligible'.

Sustainable impact categories

Portfolio share with sustainable impact (%)	
% of portfolio exposed to companies where majority of revenue is derived from: climate change (alternative energy, energy efficiency, green building); natural capital (sustainable water, pollution prevention); basic needs (healthcare, nutrition, sanitation); and/or empowerment (education, social finance, affordable housing). Excluded from consideration are companies that have faced significant or massive controversies in the provision of the above themes.	
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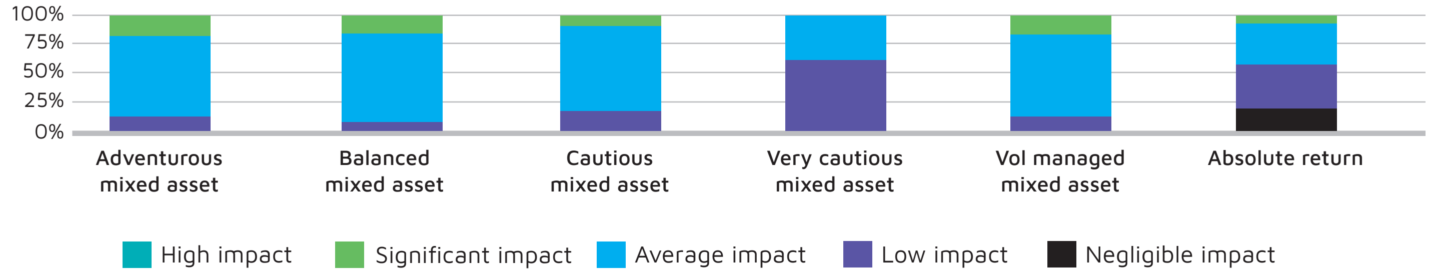
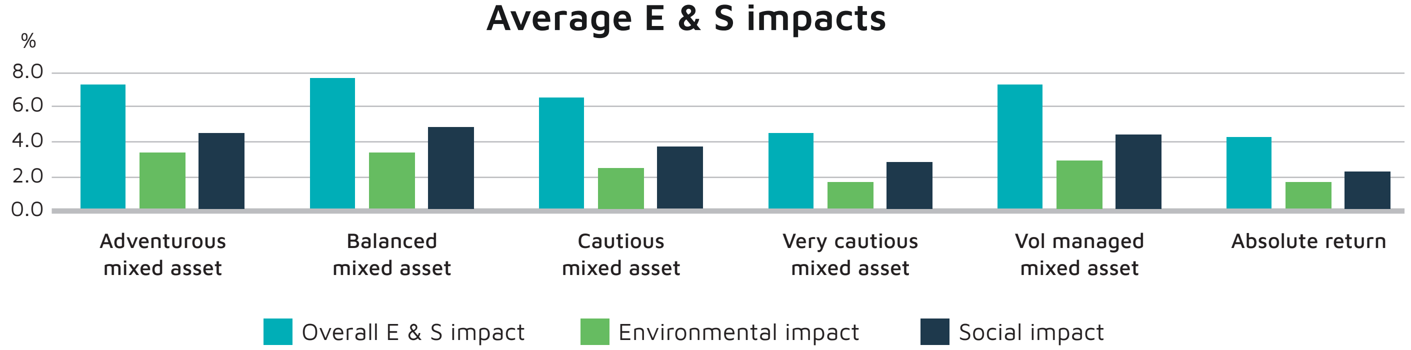
% breakdown of each kind of impact



Average environmental & social impact share

MIXED-ASSET FUNDS WERE MORE impactful than bonds but less so than equities, with an average impact weighting of 6.89%. This was down to a strong showing in the social area (with a weighting of 4.01%) rather than the environmental one (2.88%). Adventurous mixed-asset, balanced mixed-asset and volatility managed strategies were most impactful.

Average E & S impacts



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Making a difference

When Amanda O’Toole invests in a business, she needs to know it will use the money to do something that wouldn’t happen without it

OVER TWO-THIRDS OF GLOBAL GDP IS NOW UNDER A NET-ZERO COMMITMENT. This shows the intent among governments, policymakers and the corporate sector, says Amanda O’Toole, Portfolio Manager of the AXA ACT Framlington Clean Economy Fund, and highlights the vast investment opportunity in moving to a clean, sustainable economy.

“This is visible growth,” she says, believing this argues for a purity of approach: “I won’t invest in a consumer company putting better packaging in place, or a delivery company just because it’s using electric vehicles for its fleet. I invest in the goods and services that they have to buy to make the transition to being a sustainable business. The fund is aiming to access all of the relevant growth and impact opportunities associated with the shift towards a sustainable system.”

DUAL OBJECTIVE

The Clean Economy Fund has a dual objective – long-term growth alongside a positive environmental impact. O’Toole says that the fund has been deliberately designed to incorporate the areas where the impact of the transition is most significant and material, incorporating four areas: low-carbon transport, smart energy, agriculture and food, and natural-resource preservation. She adds: “If we can achieve sustainability in those areas, we will have made significant progress.” Investing across these areas brings natural diversification to the portfolio. She adds: “These are areas where companies are willing to spend on research and development, and to keep innovating, because the demand is visible.”

Amanda O’Toole
Portfolio Manager, AXA ACT Framlington Clean Economy Fund

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BEHIND THE SCENES

The demand runs down into the supply chain: as the recent fuel crisis has shown, the growth in renewables is no good if it isn’t backed with energy storage and smart-grid solutions. Electric vehicles also have a long and complex supply chain. Equally, O’Toole needs to ensure that innovation in, say, renewable energy doesn’t come at the expense of other natural resources, such as water.

Stock selection on the fund has three layers. The first is a stock screen whereby we screen out worse ESG players to address ESG-tail risk. The CIA team helps to identify those companies with high and medium exposure to the four themes, giving the team a well-defined stock list on which they can do more intensive work.

From there, the team filter for companies with investable characteristics – reasonable liquidity and strong balance sheets, for example.

They do the majority of their work on 300 companies with the aim of building a portfolio of 40-60 holdings. O’Toole says: “In these markets, investors have to pick carefully because they are so fast-moving. Technology can become obsolete and errors on the part of management come to fruition very quickly, equally the pace with which that opportunity is realised can be rapid for those getting it right.”

The final portfolio is built on three screens: a conventional financial analysis looking at factors such as balance sheet health, the strength of the management team and the competitive landscape. The second is a detailed environmental, social and governance analysis. “These are often highly skilled areas. Having a strong reputation as an employer can be extremely important in securing the right talent and the difference between achieving and not achieving growth.” The fund has the highest ESG score within the AXA Framlington range.

There is also an impact analysis, which is done by listed equity impact analysts. This aims to get to the core of the company’s purpose: O’Toole needs to ensure that the company has the right intentions embedded in its culture. “The sustainability goal has to drive the performance of the business…Also, when we give capital to this business, we need to know they’re going to do something that wouldn’t happen without it.”

The Clean Economy Fund has a dual objective – long-term growth alongside a positive environmental impact

DIVERSIFIED HOLDINGS

The result is a well-diversified portfolio. Its largest weighting is in industrials, but it also has meaningful weightings in materials, IT, utilities and healthcare. Although the US is the largest region, we are underweight the US and overweight Europe versus the MSCI ACWI, which can bring diversification. The fund’s largest holdings include energy efficiency and smart-grid specialists, renewable energy providers, producers of recycled organic ingredients and EV suppliers.

O’Toole says that amid the turmoil of 2020, the resilience of corporate spending on the transition to a clean economy was notable. While companies were cancelling other types of capex, they sustained their commitment to decarbonisation and other projects. It shows how seriously companies are taking the issue. For O’Toole, it supports the view that this is an enduring theme for the next decade and beyond. ■

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Sponsor profile

Janus Henderson ESG: Active because active matters

We believe it is important to be active about an issue as pressing as ESG investing

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INVESTING, in our view, demands active and ongoing engagement and we are committed to maintaining a focus on long-term sustainability and returns. We also recognise that the ESG investment world is evolving and we seek to partner with clients and act as a guide on that journey. Our corporate commitment extends to our people, the environment, climate risk, the communities we are part of and our governance structure. We are proud to have been CarbonNeutral® since 2007, maintaining a net zero carbon emissions footprint across our global offices*. We are also proud that our Global Sustainable Equities team was one of the pioneers of sustainable investing having applied a positive impact approach since 1991.

SUSTAINABLE INVESTING

While ESG considerations help inform the thinking of our investment teams more broadly, we also offer focused strategies. Our Global Sustainable Equities Team marked its 30th anniversary in 2021, having been one of the pioneers of positive impact investing. The team's approach focuses on companies that have a positive impact on the environment and society, employing a low-carbon approach.

In addition, we recently launched a Sustainable Future Technologies strategy. This draws on the strong ESG heritage of our Global Technology team to focus on technology solutions that have a positive impact on the environment and society.

TRANSPARENCY OF THINKING

We believe asset managers should play an active role in, and have an active voice on, ESG issues. It is critical that clients fully understand the approach and objectives of the managers they partner with to ensure interests are aligned. We also believe clients should be able to access insight and analysis from asset managers on the ESG themes impacting the world and their clients' portfolios. This aligns with our ethos of Knowledge Shared and making the views of our investment professionals on ESG readily available. ■

https://www.janushenderson.com/en-gb/adviser/about-us/esg-environmental-social-governance/

*CarbonNeutral® certification applies to Janus Henderson Investors since 2017 and Henderson Global Investors prior to this date.

Sponsor profile

Wellington's approach to sustainable and impact investing

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Partnerships with leading sustainability organisations help Wellington deliver measurable social and environmental benefits

WELLINGTON MANAGEMENT IS ONE OF THE LARGEST INDEPENDENT INVESTMENT MANAGEMENT FIRMS IN THE WORLD, serving as a trusted adviser for institutions in over 60 countries. Our innovative investment solutions are built on the strength of rigorous, proprietary research and span nearly all sectors of the global securities markets.

As a private firm with investment management as its sole business, our long-term view and interests are aligned with those of our clients. And to better assess risks and opportunities in client portfolios, we have integrated the analysis of environmental, social, and corporate governance (ESG) factors into our investment and risk-management processes firmwide. Our dedicated ESG team provides our investors with proprietary research and insight to support ESG considerations, incorporating analytics, company engagement, and in-depth portfolio reviews.

In 2018, Wellington began an initiative with Woodwell Climate Research Center — the world's leading independent climate research institute — to integrate climate science into asset management. This collaboration is focused on creating quantitative models to help analyse and better understand how and where climate change may impact global capital markets. Projects range from the development of investor tools to innovative analytical methods seeking to improve climate risk assessment and investment outcomes.

Along with our extensive research on sustainable investing, we seek to enhance our knowledge and provide leadership by partnering with leading organisations such as the United Nations Principles for Responsible Investment (UN PRI) and the Global Impact Investment Network (GIIN). Most recently, Wellington became a founding member of the Net Zero Asset Managers initiative.

We have a long track record in impact investing and measurement, launching our first impact strategy as far back as 2015. Each of our impact strategies seeks to achieve positive, measurable social and environmental outcomes alongside competitive financial returns. ■

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Learn more about sustainable and impact investing at our firm: https://www.wellington.com/en/sustainable-investing/

Wellington Management supports the UN SDGs.

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