pi roundtable

RESPONSIBLE INVESTING






NEWTON
Investment Management

Lloyd McAllister | Robert Campbell | Chandra Gopinathan
Jacqueline Jackson | Claire Jones | Callum Logan

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RESPONSIBLE INVESTING

Responsible investing means different things to different people. This is not a surprise given that it is such a broad church. It can involve investing to protect and reverse the damage we have caused our climate and ecosystem.
Then there is improving social justice and equality. This could be achieved through better access to education, healthcare and adequate housing. Investors could also use their influence to improve the gender, racial and social background mix of those making decisions within corporates and other organisations.
Higher standards of law and order might be on the wish list of some institutional investors who are working to build responsible portfolios.
Responsible investing may mean different things to different people, but the ultimate goal is usually the same: building a better, safer and more secure world for everyone to live in.
There are many routes for investors to help achieve this. From making sure corporates are well behaved to improving their operations or investing in projects that work to make a positive difference.
Responsible investment is just one label for such strategies. Sustainable and ESG are others. But no matter the name, investors put $35trn (£32.7trn) to work last year in strategies that are designed to achieve non-financial outcomes.
One projection believes that the market could exceed $53trn (£49.5trn) in the next three years, up from the $41trn ($38.3trn) that it is expected to be worth at the end of this year.
But what is behind these numbers? To find out, we brought together a group of asset owners with a consultant and asset manager to discuss the responsible strategies that institutional investors are pursuing and how they want to make the world a better place.

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RESPONSIBLE INVESTING IN FIGURES

$41trn

The estimated size of the sustainable finance market by the end of 2022.

Source: Bloomberg

1/3

Sustainable assets could account for a third of the projected assets under management globally by 2025.

Source: Bloomberg

42%

The percentage of ETF flows in Europe that were for ESG funds in the three months to July.

Source: Hargreaves Lansdown

€2trn

The net assets in sustainable funds domiciled in Europe during 2021, three times as high as they were in 2019 and 71% higher than in 2020.

Source: Morningstar/Zeb

38

Out of the 600 ethically-focused funds available in the UK only 38 made a positive return in the first quarter of 2022 in what has been a difficult period for such funds.

Source: FE Analytics

£1.4trn

The estimated cost of the UK achieving net-zero emissions by 2050.

Source: Office for Budget Responsibility

PARTICIPANTS

Lloyd McAllister
Head of ESG research
Newton Investment Management

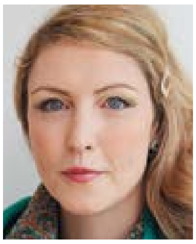
Lloyd McAllister sets Newton's responsible investment philosophy, overseeing the ESG research process and engaging on environmental, social and governance issues.
He qualified as a chartered accountant at KPMG where he worked within the firm's tax, audit and sustainability consulting teams.

Robert Campbell
Responsible investment senior financial analyst
USS Investment Management

Robert Campbell re-joined USS in 2020 having previously been an investment analyst in the scheme's global emerging markets equities team.
He has also been a senior manager in PwC's valuations team as well as a portfolio manager and analyst for Martin Currie Investment Management.
An economics graduate from the University of Glasgow, he started his career as a financial journalist at *EuroWeek*.

Chandra Gopinathan
Senior investment manager, sustainable ownership
Railpen

Chandra Gopinathan is responsible for climate strategy, energy transition investment and integrating risk management across Railpen's portfolios.
He has two decades of investing and portfolio management experience, which means he brings credit structuring, ESG analysis and a multi-asset investment perspective to Railpen's sustainability practices.

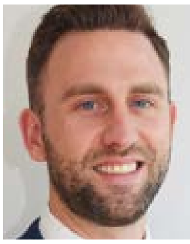


Jacqueline Jackson
Head of responsible investment
London CIV

Jacqueline Jackson is head of responsible investment at London CIV, developing and implementing strategies designed to mitigate financial risks arising from environmental and socio-economic issues.
For almost 20 years she has advised institutional investors, corporations and governments on how to interpret exposure and impact associated with natural resource constraints.
Jackson read sustainable finance at The University of Oxford and is a trustee for several charities as well as an ambassador of The Diversity Project.

Claire Jones
Head of responsible investment
Lane Clark & Peacock

Claire Jones is an actuary with more than 20 years' experience spanning investment, pensions and sustainability.
As head of responsible investment at Lane Clark & Peacock, she helps clients to integrate ESG into their investment processes.
She also advises large pension schemes on implementing the Taskforce on Climate-related Disclosures requirements.
Jones ensures that ESG and stewardship considerations are embedded in the firm's investment manager research across all asset classes. She also leads research into ESG-focused equity funds.



Callum Logan
Senior portfolio manager
Coal Pension Trustees

Economics graduate Callum Logan works across asset allocation and responsible investment for the Mineworkers' Pension Scheme and the British Coal Staff Superannuation Scheme.
Prior to joining Coal Pension Trustees (in-house investment manager of the two schemes) in 2018, Logan was a consultant at Aon advising occupational pension schemes on their investment strategy.

Responsible investing

There are many ways institutional investors can make the world a better place while generating a financial return. Yet with what responsible investing means still featuring in conversations between pension schemes and their asset managers, it is difficult to define what investors want to achieve.

We sat down with several asset owners and those who support them in building portfolios to discuss what pension schemes want from their sustainable investment strategies. How is regulation impacting their efforts and is poor data quality still a barrier to discovering if their portfolios are doing what the managers believe they are?

How is the pension scheme for the coal industry investing responsibly?

Callum Logan: We have a range of priorities. Foremost is engaging with our external managers and holding them to account. It is fundamental to make sure all our managers consider ESG factors when they invest. That means challenging them on any controversial companies they own.

Like many schemes – and perhaps surprising to some given our background – climate change is a key focus for us. It is financially material. We are addressing it from a perspective of opportunities, where we see it driving markets in the decades to come and want to be positioned for that, as well as considering the risks. That includes transition and physical risk, whether it is stranded assets or properties being flooded.

Coal is an old source of energy, so do you invest in new sources of energy?

Logan: We own physical infrastructure assets in wind and solar. We also have a public equity strategy that focuses on the energy transition.

What are Railpen's responsible investment priorities?

Chandra Gopinathan: Responsible or sustainable investing is about active and universal ownership. So active investment and active engagement with companies, policymakers, regulators and peers.

We have a thematic approach to responsible investing. Individual themes range from climate change, where we support the transition in various ways, to workforce disclosure and issues, such as modern slavery. Other themes include responsible technology and sustainable financial markets.

Our approach spans the E, S and the G. A lot of these themes have a clear governance agenda, while two include social factors and climate change is, of course, primarily environmental and social.

USS is a large scheme. Does that make it difficult to invest responsibly across all your portfolios?

Robert Campbell: ESG is important in every asset class, even in private markets where data is sometimes not great.

For us, net zero is front and centre. Human rights are also important. We are increasingly seeing it as an investment risk. Some Chinese companies, for example, have de-listed in the United States due to alleged human rights abuses.

Alongside that, biodiversity might not be a focus at the moment, but it will probably be the next cab off the rank. We are looking at the proposals for the Taskforce on Nature-related Financial Disclosures (TNFD) and are encouraged that they mirror the Task Force on Climate-related Financial Disclosures (TCFD), which is a good framework.

> **Definitions can be quite a dry conversation, but they are important because they define outcomes.**
>
> Lloyd McAllister, Newton Investment Management

Jacqueline, what does responsible investment mean to London CIV?

Jacqueline Jackson: It is not only about responsible investing, but also investing for sustainability. To decide which stewardship themes we want to prioritise, we take a five-step approach.

First of all, we think top-down to identify global drivers including macro risks, policy and regulation as well as stakeholder priorities.

Secondly, we consider bottom-up impacts, assessing company drivers unique to London CIV, including asset specific risk client priorities, our holdings and investments as well as where we can have influence.

Thirdly, recognising social materiality in terms of which issues will have the biggest impact on the world around us. Fourthly, calculating financial materiality in terms of which issues will have the biggest impact on our returns and finally, responding to unforeseen events after a specific and significant incident.

It is about recognising dual materiality, understanding where we can invest to make the world a better place and where risks may impact our bottom line.

Lloyd, what conversations are you having with institutional investors who are pursuing responsible strategies?

Lloyd McAllister: There has been a huge uptick in investors trying to understand what we mean by responsible investment. The industry is being rightly challenged to tighten the definitions of what people are talking about.

Definitions can be quite a dry conversation, but they are important because they define outcomes.

Ensuring clients are clear about whether they are in an exclusion, ESG integration or sustainable strategy is a key starting point. That has been partly driven by Sustainable Finance Disclosure Regulation (SFDR), so definitions are a big piece of the conversation.

Then there is being able to demonstrate that you are doing what you say you are through stock and engagement examples to bring all of the talk to life. So rather than having 15 pages of process and two pages on ESG performance, we are switching that around and saying this is what we do and here are the statements to back it up. That is the big change we have seen this year.

Campbell: Process is important in being able to evidence that you are doing it. Lots of people talk a good game on this.

We have attended meetings with companies to discuss ESG and management have said we are the first professional investors to mention this. If everybody was walking the walk here, we would not be the first people to talk to them about it.

Are pension scheme trustees concerned about the cost-of-living crisis and, if so, is it part of what they are trying to achieve?

Claire Jones: Yes and no. Many pension scheme trustees are focused on the impact on their liabilities. They are thinking about pension increases and, where they are capped, deciding if they should award discretionary increases. They are trying to understand the implications for the inflation-matching characteristics of their assets.

The conversation that is not yet taking place is how they use their influence as an investor on the cost-of-living crisis. That discussion will mature over the coming months and trustees will likely focus on the long-term systemic issues that this is throwing up.

A global investor is not going to be focused too narrowly on short-term inflationary pressures in the UK but will be thinking about global long-term issues. For example, the way income inequality affects the economy and long-term investment returns. There is a synergy there between the social impacts of inequality and the financial impacts, and hence the outcomes for the pension scheme.

That is one of the systemic issues that is thrown up by the cost-of-living crisis. The other one, of course, is the energy transition because a lot of the inflationary pressures are coming from the energy market. So how does that impact the investor's responsible investment strategy? And how can they use their influence to improve long-term outcomes?

Can private capital solve this crisis?

McAllister: I want to say yes, but it is quite difficult. A war and a pandemic caused the cost-of-living crisis in Europe. These factors are hard to control for individual asset managers.

However, there are ways this can be weaved in. When you look at inequality, there are direct trade offs in the short term. When inequality levels have risen, so have shareholder returns over the short term, as the proportion of wealth going to the workforce falls.

That is unsustainable over the long term, so it comes back together. It is the same dynamic on the energy side.

It is possible to run the energy system we have and make good returns from trading individual shares, but the sector has been pretty poor over the long term.

The focus from asset managers in the energy sector over the last five years on value not volume has caused a decline in investment. We have not seen the commensurate re-investment into clean alternatives, which has driven the supply and demand crunch.

So it is weaved within in various ways, but it is tricky. You can support proposals like the living wage at companies, but you are trying to solve a systemic problem with individual actors.

That is difficult. Systemic problems are better suited to being dealt with by government.

Callum, are these systemic problems something you are discussing with your fund managers?

Logan: Our schemes largely do not have caps on pension increases, so we are seeing a big rise in liabilities. That protects our members by increasing their pension in-line with the rising cost of living.

First and foremost, our focus is on delivering financial returns. A war created this and we are in the crisis phase. You need a government response here and they have capped energy bills, which is needed.

As investors, we can be more useful in the longer term, particularly on the energy side. We have investments in wind and solar, but we are also looking at new technologies such as hydrogen. We have a private equity hydrogen strategy because electricity from wind and solar cannot solve all the problems in the transition to net zero.

Then there is a big discussion point about gas, which is the fuel driving the issue in Europe. We are on a transition and cannot get to net zero overnight. Gas has a place in that.

The taxonomy holds the industry up to higher levels of scrutiny, making it harder to get away with greenwashing.

Jacqueline Jackson, London CIV

Is the EU's ESG taxonomy helping investors achieve better outcomes?

Jackson: The EU ESG Taxonomy is a reliable tool which translates climate and environmental objectives into clear criteria. It will drive better outcomes because investors and those reporting can learn from each other, creating a common language around green activities.

The taxonomy holds the industry up to higher levels of scrutiny, making it harder to get away with greenwashing. It will drive innovation within ESG, create a frame of reference for investors and hopefully accelerate projects which are already sustainable.

It begins with reporting for me. That is perhaps because I am from an ESG data background. The added value is that those projects which can clearly articulate alignment with the transition may be able to benefit from scaling up.

It is early days to say whether it will have real world impacts, but it has been widely adopted, is something that will continue to go in one direction and should help to augment investment in green projects necessary to implement the European Green Deal.

Campbell: We are going to see less greenwashing because we have seen the damage it causes. We have seen offices raided in the last few months and likely large material fines for greenwashers.

People are going to have to practice what they preach. Otherwise, action will be taken against them. You may get lucky. Lots of regulators are underfunded and do not have enough people to do the job they would like to do. You are running a risk if you do not follow through on what you claimed you are going to do.

As well as regulators, some asset managers may be caught out by asset owners. Eventually, they will wise up to the fact that you are not doing what you claimed.

Gopinathan: Regulation is a starting point. Disclosure is where it begins. That is an important aspect in becoming more focused on what the issues are and where the materiality lies.

There is an important bridge between disclosure and decisions, where the translation and the contextualisation of that disclosure to the business and/or portfolios needs to happen in a bespoke yet consistent manner.

Campbell: I am going to get nerdy – it depends where things appear in a set of accounts. In the US, under the SEC proposals, something you see as ESG linked may appear in audited elements of the accounts. Whereas an awful lot of ESG metrics appear unaudited.

Gopinathan: The eventual intent of regulation and regulatory disclosure is for positive outcomes. There is an intermediate bridge of contextualising, translating and making the disclosure meaningful. While regulatory disclosure at the start can appear to be a huge burden on resources and budget, it is important to not get lost in the middle and lose the forest for the trees.

It is key to have a holistic approach, contextualize the key elements and their applicability to your business or your portfolio. In principle, disclosure is never a bad thing. Materiality, standardisation and contextualisation are all key to making sense of regulatory disclosure and applying it to your business or portfolio.

Investors have a responsibility to not treat disclosure as a box-ticking exercise and as an end in itself. They need to ask themselves what it means for their portfolios and use it as a lead-in to identifying and managing key risks and opportunities.

Jones: It is worth remembering that regulations like TCFD are relevant in two ways: we have organisations using the data and organisations producing it.

From an investor perspective, better disclosures by companies to inform investment decisions are helpful. But the act of putting together the disclosures is also helpful in terms of driving the decisions and the actions that are taking place. So TCFD has the potential to drive better behaviour by all the organisations that have to report – the asset owner, asset manager and the underlying companies.

Gopinathan: There is the element of disclosure metrics and assessment metrics. The preparer is the one who creates the disclosure, the user is the one who needs to assess the same. While they both are different methodologies serving their respective purposes, but it is important that they are co-ordinated and have a feedback loop in place so they align and converge over time.

For example, currently, if a discloser or preparer publishes unverified targets or metrics data, the user can highlight the need for third party verification. This feedback loop needs to be maintained because those are two independent sets which eventually need to align and become seamless over time.

It is similar to the credit rating space, where a company posts its financial metrics and a rating agency and an investor each do a credit assessment. They do different things but use the same information. That needs to happen independently. That is a step forward, for sure.

McAllister: On regulation, particularly SFDR, what is supposed to be a disclosure regime is turning into a labelling regime.

You can no longer sell an Article 6 fund, which is a normal fund. That distribution route is now difficult within Europe, so there should be a wall of money heading towards the few securities that meet the Article 8 [sustainable funds] and Article 9 [impact funds] labels. But the valuations of those stocks are not rising, so something is happening with a lot of funds labelled Article 8 and Article 9, but the securities that you would imagine seeing huge flows are not going up.

There is this transition phase where some of the labels being added to funds are somewhat aspirational at the moment.

> **Biodiversity might not be a focus at the moment, but it will probably be the next cab off the rank.**
>
> Robert Campbell, USS Investment Management

Are you seeing many institutional investors divesting from non-ESG compliant assets?

Jones: The discussion on divestment versus engagement has matured. Three or four years ago, there was a lot of discussion about divestment and ex-fossil fuel funds. Nowadays, the discussion is much more nuanced, with a higher recognition that you need an escalation strategy.

It is no good having ongoing dialogue with a company if ultimately change is not happening. You need objectives in that engagement with time limits. If the engagement is not working, you step up a gear. In the first instance that may not be divestment. It may be voting against the chair, but ultimately divestment should be part of the escalation process.

Of course, you are holding a company because you think it is a good investment. You should not be holding it because you want to engage for the good of society. Engagement is a tool to make a good investment, a better investment.

Callum, have you ever walked away from an asset due to a failure of engagement?

Logan: From a divestment perspective, we are focused on the UN Global Compact. The companies we own should adhere to

those principles, which cover human rights, labour rights and the environment. Our investment managers should not hold companies that fail to meet these principles.

We have not created a list of companies to divest from. There is a part of governance where we see it as the responsibility of the investment manager, and we will hold them to account on it. We do not want to hold companies failing to meet the UN Global Compact principles and if one of our managers retains such a company they will have to justify why, in their view, it is not failing. They effectively have to sign up to not investing in companies that fail on this, but we give them some discretion.

On engagement, one of the jobs of our active managers is to take large positions in companies based on their view of the financials. They then need to consider material ESG factors. If they are engaging with those companies and there is no progress, then they need an escalation process. The end of that process is divestment.

Jackson: Within our responsible investment and engagement policies, we set clear guidelines as to what our escalation process should look like. We must invest for good returns, not only for the greater good of society. Either way, we do not take a divestment approach and favour engagement.

A blanket divestment approach would mean we lose our voice on key issues, which would not help our clients from a return perspective. Nor would it move the dial on addressing societal concerns, if less scrupulous investors take our place.

It is about achieving outcomes. Generally speaking, we expect to see progress within three years or we have to think about what to do next by way of escalation.

However, there are several steps before divestment becomes an option. We take voting seriously. In an average year, we execute at least 10,000 votes, which is an initial activity on the path to broader engagement with our investee companies.

Gopinathan: Divestment is one tool in the toolbox, but by no means the first or only one. We use a milestone-based approach to assess how a company has progressed and setting the bar higher as the years go by.

At the moment, it is a one-size-fits all approach, so there is a point when a discussion around divestment is needed. The progress is not linear and definitely not the same for every company because some sectors are harder to decarbonise than the others. A utility can decarbonise faster than a cement company, for example.

The discussion around divestment due to a lack of decar-

bonisation progress involves answering a number of questions. Is this a good company using the technology and tools available today to decarbonise? If the technology is not there, how is the company going to transition and how is the business model evolving? Answers to these companies can determine if the divestment needs to happen and when the divestment should be.

Campbell: Data is a starting point, but we need analysts, creativity and imagination. We cannot just apply things blindly. There's lots of road for people to do good, interesting work here.

Is it easy to be a responsible investor in real assets, such as property?

Logan: We have a sizable property portfolio, and some of those assets are not clean. But it is also not clean to demolish them and build shiny new buildings in their place, which involves a lot of emissions.

We are looking at where we can improve the energy efficiency of our buildings. There is regulation pushing us in this direction as well. Most of our assets are commercial properties and there will be certain milestones that we need to meet in terms of energy efficiency. We want to be well ahead of that and not worry about an asset as a legislative deadline approaches.

In infrastructure there is stranded asset risk. Moving from fossil fuel-based power production to one based on electricity is a transition you need to manage.

The final point I would mention on real assets would be some of the physical risks, such as floods.

Is that the way London CIV approach things?

Jackson: We are calculating the footprint of our real asset funds. What is important to understand is that even when there is a net benefit, such as in our renewables fund, they still have an embedded cost of carbon.

Using the data analytic capabilities we have in-house, we calculate the embedded cost and environmental footprint of the funds we hold. Only then can we understand where there could be positive impacts to consider and optimise, or negative impacts to assess and mitigate.

The picture with infrastructure is sometimes more challenging. Historically, ESG standards have not been reported on as uniformly in private markets as in listed equities and fixed

> Regulation will increase but I fear it may not be harmonised.
>
> Callum Logan, Coal Pension Trustees

income. Plus, with some of the asset managers coming from different geographies, reporting standards can vary.

This is why we are committed to calculating the footprint of our infrastructure fund to understand and mitigate impacts and have included a target of 25% renewables within the mandate to capitalise on green growth opportunities.

When investing in emerging markets, how can investors be sure that an asset you own in Africa or Asia is trading as responsibly as the manager claims?

Campbell: Data is important. Even if you cannot get reported data, nowadays you can often get pretty good estimates from third-party providers.

Your investment style can also help. Having a bias towards quality helps because quality management teams generally consider physical and transmission risks.

Having your own fundamental bottom-up research is another benefit. We are lucky to have a team at USS to do the due diligence on companies and engage with them directly.

Gopinathan: I would take a step back and ask what trading responsibly means across asset classes and geographies especially emerging markets. Are we applying the same approach to companies and assets across those jurisdictions?

If you look at South Africa or India, what does a responsible investment mean? Are you scrapping a coal mine which livelihoods depend on? Are you taking jobs anyway without providing a source of alternative income, such as a solar plant where you are improving workers' lives and creating clean energy? Is that a more holistic approach that would work for emerging markets? We need to move away from a one-size-fits-all approach, so the responsible investment policy relates to specific asset classes and jurisdictions.

Emerging markets need growth, you cannot survive without it. The last thing you want to do is take growth away. So the responsible investment story needs to be more a story of inclusive growth rather than climate change or net zero in isolation.

There may be fewer opportunities, but they make sense from a holistic perspective and combine environmental, social and economic goals.

Is the standard of the data provided by specialist companies improving?

McAllister: Their broad coverage is relatively shallow but plays a useful input role into some basic elements of responsible-investment research. It is useful to have different views. I do not want them to all kick out the same answer, I want different points of view to make a judgement based on what we think is important.

Where I have seen things improve is that there seem to be more specialist sector-based scoring teams, such as the World Benchmarking Alliance. They also give more details on how they score companies. It is a deeper dive than the likes of MSCI or Sustainalytics. That sector-specific specialist type of scoring has improved over the last year.

Jones: Our clients use third-party data in a couple of ways. We use it in some of our reporting to give our clients an overall ESG score for their portfolio. This is a tool to have better conversations with investment managers.

We recognise that the scoring systems are just one point of view with scores coming from different providers not being consistent, partly because they are not necessarily trying to score the same things.

We find the scores a useful starting point. We want to find out why a manager's average ESG score is much lower than the benchmark. Which companies are pulling it down? What is the story behind them? Using it as a tool to get beneath the surface and beyond the managers' ESG policies into the nuts and bolts of how the money is being invested.

The scores are also used indirectly by our clients' investment managers as one of many inputs to an active management process or in the construction of an index.

An improvement we are seeing is that the volume of companies covered by the various providers is growing. More companies are reporting data so there should also be better data feeding into the scores.

Ultimately, you have to recognise that different scoring providers are trying to do different things, and we are not going to coalesce around a single view of the right ESG score for a company. In that sense, we are not going to see scores that meet unrealistic expectations.

Campbell: People often try to measure different things. It is great that there are disagreements as you do not want everyone to come out with the same rating.

Roberto Rigobon of the Massachusetts Institute of Technology has some good research on ESG scores. Even on things that are relatively basic, like keeping chairman and CEO roles separate, the correlation between providers is low. I have seen it as 0.6 or lower in some studies. If they cannot agree on basics like that, then on matters of greater judgement I do not have massive confidence.

Sometimes there are also institutional limits on what they can do. Some of them, with the best will in the world, have tried to come up with accounting quality scores, which can be useful for investors. But they do not publish what goes into those accounting quality scores. That then becomes an unhelpful black box.

McAllister: A US politician said he wants an ESG label to be as clear as buying full-fat or semi-skimmed milk. Looking across the different ESG issues, across different time horizons, forward looking, backwards looking – there are so many points of judgement that it is never going to be as simple as a full-fat milk distinction.

Jones: Where I expect to see the market developing is better transparency of the methodologies used. That makes it easier for investors to dig beneath the surface.

Jackson: We forget sometimes why these problems occur. If you think about an index, instead of being like a toothless system spitting out numbers at the press of a button, it is some guys in an office who have been given a deadline by a corporate that has to get a product out to meet their profit target for the quarter.

They have gone through a procurement process to get data to calculate those numbers. But by the time they have sat down to do the analysis, that data has been superseded by something better. But they cannot go through the procurement process again because it has been signed off by the senior managers in the index provider company.

They are using a dataset that analysts do not particularly want to use and there is a deadline next week. There are real people having to make real errors.

The limitations come down to there not being that demand for transparency. If companies that provide some of these indices were held more accountable on transparency, that could drive higher quality within the entire process.

If you use them as a starting point to help you get somewhere, you can then start to engage, dig deeper into the data and overlay potentially more sector specific datasets. If you have the time and capacity.

Gopinathan: Standardised ESG scores as a business has proven to be a case of the tail wagging the dog. You know that you do not have full disclosures from companies, you know you do not have proper audits on these numbers. There is time pressure to make estimation decisions and sell product.

With respect to the underlying analysis, the output scores are based on poor data and assessments, a lot of subjectivity, which has been forced into a model. That is dangerous in some ways.

On the bright side, there is a lot of good progress happening on the disclosure side. We have the TCFD, International Sustainability Standards Board and more emissions and transition planning disclosures. It needs to move forward to a point

Engagement is a tool to make a good investment, a better investment.

Claire Jones, Lane Clark & Peacock

where there is standardisation, quality and usability assurance on data and then progress to create scores and products. That may take a long time.

That is why there is so much talk around regulation. Regulation and licensing allow for standardisation and assurance around data, methodology and skillsets.

Standardised and independently verified disclosure along with transparent and verifiable assessment methodologies is the credible way forward.

Campbell: The E element is the part of ESG data that we have most confidence in. We do see the highest correlation across providers, albeit sometimes the highest correlation could mean that they were all making the same mistake in the same way. But at least the methodologies are clear.

Jackson: At the end of last year, we launched a passive fund that uses an ESG data index called the LCIV Passive Equity Progressive Paris Aligned Fund. Our responsible investment team felt that the particular index selected incorporated the most data on climate-themed objectives such as Paris alignment, carbon emissions and fossil fuel exposure. These types of themes are much easier to quantify in an index than other Sustainable Development Goals, targets which have been used in other indices.

McAllister: We also struggle with the need to supply evidence. Data is the way that people like to see that, but when you are investing you care about the future and what the company is going to deliver. That is hard to boil down into a piece of data.

And it is the forward-looking piece about what the company is going to do and what capital expenditure will be focused on, rather than performance, which is backwards looking, that will be a struggle to codify into a score.

Logan: We all agree that making comparisons is difficult. But useful research is being done and when a company is flagged as poor we can look into why, then speak to the manager to understand their view and challenge them.

The score in itself is not useful, but we do use the underlying research behind it to have those conversations. That for us is useful.

Does investing responsibly have to be an active strategy? Can you invest responsibly passively?

Jones: That follows on naturally from the conversation about ESG scores. We have clients who will invest in indices that use ESG scores in their construction, but that is a minority approach among our clients.

We are not comfortable with the scores being the basis on which to make investment decisions to construct a portfolio. We are more comfortable using some metrics, such as carbon emissions where the data is better, to tilt portfolios.

For the other ESG factors, we feel more comfortable focusing on stewardship. For a passive approach we emphasise the quality of stewardship undertaken by the investment manager.

For me, investing responsibly from an index-tracking perspective, the focus should be more on stewardship. To be able to consider the ESG characteristics of companies, you need more of an actively managed approach.

Logan: Looking at this from a slightly different angle, to be a responsible investor, we need to invest cost effectively for our clients to deliver on our fiduciary duty. Passive has an important role to play here. The engagement part needs to be well resourced, and it is probably why you see passive focused on a few large managers. They can charge low fees, but still have a sizable team to do that engagement.

There is this interesting angle that part of being a responsible investor is recognising that we are delivering net of fee returns as well as making an impact.

Gopinathan: Stewardship and its application to passive ETFs, which are cost-effective vehicles, is a structural challenge. The industry needs to think about this a lot more.

ETFs have been sold as a low single-digit bps fee investment for cheap exposure to the equity market. Stewardship by definition is labor and time intensive. For a 1,000-company passive ETF to go in and steward the portfolio correctly is not a low-cost exercise. So while passive ETFs may play an important role in delivering fiduciary duty, whether that still means responsible investing in its traditional sense is still an open question.

Campbell: In developed markets we are hiring an active team, but we will still have some passive allocation.

We felt that we do not have full confidence in the ESG data, but we have confidence in the E element. A lot of it was backward looking on climate, so we will build a forward-looking element.

> **Standardised ESG scores as a business has proven to be a case of the tail wagging the dog.**
>
> Chandra Gopinathan, Railpen

Where will responsible investing be in 10 years' time?

McAllister: There will be a clear alpha versus impact split on why you are investing responsibly. Distinctions will be clearer on what is going on in portfolios and why.

Another issue will be evidencing that. If you say you are using ESG to better understand risk, you will need a load of examples to back that up. If you claim you are making an impact through your investment choices, you need to demonstrate that beyond trading shares in the secondary market, which is just moving money around the system rather than providing additionality.

The industry will be forced to show it is doing what it claims it is, which will be a good thing.

Gopinathan: Responsible investing is moving on a spectrum. It started being a policy and governance function but is maturing, getting more focused, generating more performance data and moving towards risk management and impact.

Through becoming more focused, bespoke and specific by asset class, hopefully responsible investing policies will enable investors to be a lot more impactful longer term.

Campbell: There will be an increased demand for data. We are working with our quant colleagues a lot more than we did. Historically, ESG was about equities, but more and more asset classes are involved now.

Where we do not have emissions data, in private markets, for instance, we now have the tools to come up with an estimate internally. It focuses minds if we tell a company we are marking them against a certain number.

There are massive risks now for people failing to deliver what they said they would on ESG. Perhaps a good business for consultants could be holding mock exercises where they come in and check that we are doing what we said we are.

Jackson: There will be more regulation, which I hope will be harmonised across the board and pave the way for less greenwashing.

The themes we will look at are going to be more complex. Now that people have finally got their teeth into what climate risk means, the TNFD is to publish a framework on biodiversity. This will be complicated for people to understand from an investment risk-return perspective and yet complexity should never be an excuse for inaction.

What I would like to see is more additionality evidenced as a result of ESG efforts to drive momentum whilst we recognise that things simply need to change.

You cannot always bang the drum for financial returns. There is always a risk of hidden externalities quickly becoming internalised without warning, but we do not need to prove that link to make the world a better place for our beneficiaries.

Jones: The conversations around responsible investment are becoming more sophisticated, more nuanced and that will continue. Part of that nuance is recognising the distinction between risk management, financial outcomes and real-world impacts.

But the conversation needs to evolve to consider what fiduciary duty means. Hopefully, it means moving away from a focus on the immediate financial impact on our members to thinking about the real world more holistically. This means considering the quality of life of members while recognising the interconnectivity of everything.

If we do not look after the long-term health of society and the environment, we are not going to have a long-term healthy economy to provide financial returns. We need a holistic systems-thinking approach to underpin responsible investment.

Logan: Regulation will increase but I fear it may not be harmonised. That is going to be a challenge as you invest in different jurisdictions.

There is also an element of how we communicate with members on this because whilst the increased reporting is valuable to asset owners, there is a lot to digest. So better communication with members would be positive.

Therese Niklasson is global head of sustainable investment at Newton Investment Management

RESPONSIBLE INVESTMENT 2.0: A REVOLUTION IN ECONOMIC THINKING

Why we believe the asset management sector must rethink its approach to sustainability if it is to succeed in helping companies realise a truly sustainable future.

The traditional approach to investment was not designed to tackle the planetary boundaries that are all too apparent in today's world. Neither was the original form of socially responsible investing (SRI).

But while the industry has belatedly woken up to its central role in creating a truly sustainable future, we believe a more fundamental overhaul is needed if we are to collectively succeed in tackling the biggest external threats facing society.

We know that, in addition to the need for capital to go towards truly sustainable investment opportunities, markets must start factoring in the value placed on negative external consequences created by companies. To us, one of the biggest and most consistent market failures is that investors have failed to integrate these considerations for decades.

In their defence, this has to a large extent been because governments have been slow to legislate or have failed to penalise those responsible for the negative effects of those external consequences. In order to achieve a sustainable 'revolution', we believe we also need to undergo a revolution in economic thinking.

The conventional economics that have underpinned investments and fundamental analysis for decades fall short in the face of the biophysical boundaries to our planet, such as climate change, water scarcity, topsoil erosion and loss of biodiversity, to name a few.

Responsible investment 2.0

At Newton, our long-term strategy with respect to responsible and sustainable investing is focused on this transition. We call it 'responsible investment 2.0' but, in reality, it may be 'responsible investment 3.0'.

Over the past decade, our responsible investment team has been supporting our investment teams with dedicated and proprietary ESG analysis on companies as a complement to the analysis of external service providers.

The benefit is that this analysis has been carried out by responsible investment specialists, who have had a direct understanding of the issues and have been able to guide the investment teams. However, while such an approach has helped our industry analysts to capture relevant, material ESG issues, many longer-term sustainability considerations may not be financially material over a typical investment horizon or singularly relevant to an investment case.

As we support the transition towards truly sustainable investment opportunities, we believe that ESG-related risks, issues and opportunities must be integral to the investment decision, in addition to being part of the 'mosaic' of inputs captured during the research process.

In this context, our focus within the responsible investment team has been to hand over the direct responsibility for conducting ESG analysis to our industry analysts, and to help equip them with the skills to integrate that analysis to the highest standard.

Working together

This evolved process is starting to support the vision of the 'new' economic model that we believe we need to work to. Our vision is one of true integration: active stewardship roles for the investment teams, which ensure their accountability and ownership for the risks they buy on behalf of our clients. It's a transformation that we believe needs to happen more widely in our industry.

The evolution of roles is supported by a well-resourced central responsible investment team, whose task is to undertake specialist research, in collaboration with the investment team, and provide support, where needed, on company engagements, as well as to develop tools and insights through ESG data.

By creating a partnership between our investment and sustainability skillsets, we believe we can get the best of both worlds and build genuine thought leadership that should help us outperform for our clients.

A great example of where this is needed more than ever is in the efforts around achieving net-zero carbon emissions.

This is an issue that will never be solved solely by a single responsible investment team or by any industry in isolation. For the necessary transition that needs to happen around energy, or any other system, we must invest with a deep understanding of the issues across our investment teams.

This includes not only the way we build solutions, but also how we evaluate our integration processes. Ultimately, it's about allocating to companies that we believe are best positioned to be truly sustainable, and which do their utmost to be leaders in their respective fields.

NEWTON
Investment Management

A JUST TRANSITION: LEAVE NO ONE BEHIND

If moving the world off oil sounds tough, how about doing it in a way that stops communities falling into poverty? *Mark Dunne* looks at how investors are funding a just transition.

Time is not on the side of governments who have pledged to decarbonise their economy. There are less than 30 years left to achieve the 2050 target of cutting carbon levels to net zero and for countries like the US, the UK and Japan that timescale is becoming more and more challenging.

Switching the global economy from extractive to regenerative energy means finding secure and reliable alternatives to burning oil and gas. So far, making such a breakthrough has proved difficult. Energy bills for homes, businesses and motorists have rocketed since the second half of last year.

Increasing demand has hit the supply of traditional energy sources, such as gas, while modern, cleaner technologies like windfarms were the victim of there not being "enough wind" in the North Sea. Shifting the world onto electrically powered vehicles will only push demand higher, and that is without getting into building the charging infrastructure needed to support the motoring revolution.

Oil and gas have powered the world for more than 100 years. It is deeply embedded within the infrastructure of communities and has made parts of the world extremely prosperous.

Changing this is not easy – and the challenge is not limited to finding alternative sources of energy. Millions of people's livelihoods are directly connected to oil and gas and the industries they support. If governments work to replace fossil fuels with cleaner alternatives, they could be creating poverty. Take the millions of people working in the mining industry in Indonesia. If the mines are closed, what happens to the workers? ESG-led investing is not just about protecting the environment for future generations. There is also a social element in the strategy, so putting lots of people out of work and, therefore, decimating communities to fix environmental concerns is a conflict within the ethos of sustainable investing.

People living in a world of lower temperatures and free from extreme weather patterns is not a trade-off for living in poverty. So, governments and investors are being encouraged to ensure that we have a just transition from fossil fuels to regenerative sources of energy so that no one is left behind as we move towards a sustainable future.

We know that it is important, and that there are deep social and economic impacts to consider but knowing what a good transition looks like is tricky.

Therese Niklasson, Newton Investment Management

Global impact

Yet this does not just affect people working directly in the oil and gas supply chain. Every industry will have to adopt to some form of change brought about by the transition. "There is almost no part of the global economy that is going to be unaffected by the energy transition," says Nick Stansbury, head of climate solutions at Legal & General Investment Management (LGIM). It is not just that the fossil fuel industry will see demand for its products fall. Everywhere, from financial services to consumer goods, to food retailing, to the restaurant industry, to petrochemicals, every place in the global economy will, in some way, be affected and affected significantly. "It is more than thinking about the implications for the oil and gas industry," he adds.

"We use energy in every part of the global economy. Everything we do is affected by energy. Therefore, big changes in the way we deliver energy to the global economy will impact all parts of our portfolios."

Constructing portfolios with the impact of the energy transition not limited to one industry appears to be a common strategy among investors. "The global ecosystem is so interconnected, not just in nature but in how it intertwines with the economy, so doing one thing in isolation would be futile," says Gabrielle Kinder, an environmental analyst at BNP Paribas Asset Management.

"The energy transition theme is one of social justice not just environmental justice," she adds. "By halting climate change there is a lot of climate change inequality around the world which would be abated."

Step one

The desire among asset owners to pursue a just transition is gaining momentum, it is being mentioned more and more in conversations with their asset managers, says Therese Niklasson, global head of sustainable investment at Newton Investment Management. "We are still at the starting point where we are discussing a company's commitment to its transition plan. You have to weave in a just transition at the outset when you

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There is almost no part of the global economy that is going to be unaffected by the energy transition.

Nick Stansbury, Legal & General Investment Management

develop your transition plan,” she adds. The concept of a just transition emerged relatively recently because the nature and direction of what we now call ESG has changed many times since the 1990s. “In the early days, responsible investment focused on governance,” says Mark Jeavons, head of climate change insights and associate partner at Aon. “Then for three to four years it focused on environmental impacts. Now in the past 18 months to two years, there have been more discussions around nature and the social elements, and the frameworks to consider this in portfolios.”

Despite investors working to find their feet on this issue, one point is clear. “From a just perspective, the best thing to do as an investor is not to abandon the sector,” Niklasson says. “It would be socially irresponsible to make it harder for companies to turn themselves around,” she adds. “The cost of capital is affected if the investment community withdraws from it. Countries need capital to transition, to re-train communities and figure out what an employment system would look like in a world where the energy system is relying on more skilled labour. We need to invest in education to ensure that people can support that system.”

(Not) everyone’s a winner

But it is still early days and the just transition is uncharted territory. “There is not yet a good enough understanding among the general investment community about what a just transition means,” Niklasson says. “We know that it is important, and that there are deep social and economic impacts to consider but knowing what a good transition looks like is tricky. “There will be trade-offs,” she adds. “Not everyone is going to be a winner in this transition.” And emerging economies could be big losers due to their high dependence on the sectors net-zero plans are targeting. South Africa is an example of where a just transition could be a challenge. “It has a challenge ahead in terms of the transition itself in weaning the country off fossil-fuel intensive industries, but there is the added challenge of already high levels of poverty.

“If investors stop financing the current set-up you risk cutting the lights off for millions of people. What needs to happen is a plan to finance the transition,” Niklasson says.

A pathway

It is understandable that investors are following strategies that they believe will deliver a positive environmental impact while benefiting society. Jeavons points to the two elements needed to achieve a just transition. “First, you need to understand the risks from the transition and how that will impact social priorities. Second, you need coherent policies and market frameworks that incentivise investors to support the just transition.

“To achieve the rapid change needed to reach net zero, it needs society’s backing,” he adds. “This means making sure that the substantial benefits from the transition to a low carbon, sustainable economy are shared widely, and those that are negatively impacted economically are given the support they need to make a just transition.” Jeavons says that at COP26, in a first of its kind agreement, South Africa will receive around $8.5bn (£6.4bn) from the US and countries in Europe as part of a “Just Energy Transition Partnership”.

“This aims to accelerate South Africa’s green transition but some of the money will be investments in social infrastructure, to manage labour and support workers impacted by the transition. For example, the 90,000 miners involved in coal extraction will be helped to find other industrial roles or education provided to re-skill and work in other areas, such as renewable energy,” he adds. But a just transition cannot happen unless governments, regulators, companies and investors have wider support. “If you want a circular economy instead of a resource-intensive economy, you need to have society on board,” Jeavons says.

“Take the energy transition. Going from wood to coal and from coal to oil took 100 years. We are trying to change our energy systems within a couple of decades or so. That is a real challenge that is bound to throw up destabilising elements in the economy and within society. Managing the bumps in the road means you will ensure the economy remains dynamic and performs well, which will be positive for your investments,” he adds.

But keeping temperature rises low and stopping the flooding and extreme storm patterns we are seeing around the world will not be solved by no longer burning fossil fuels. There are more proactive measure investors can take. “We have to take a holistic approach by reducing our negative impacts on the planet and increasing our positive impacts,” Kinder says. “The handprint has to be larger than the carbon footprint.”

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