pi ESG CLUB

The climate is still changing, nature is being depleted and inequality is growing – are these the issues institutional investors will be focusing on in 2023? portfolio institutional spoke to its ESG Club members to find out.

DECEMBER 2022

Members

FCA'S GREENWASHING RULES: LESSONS FROM THE SFDR BOOMERANG

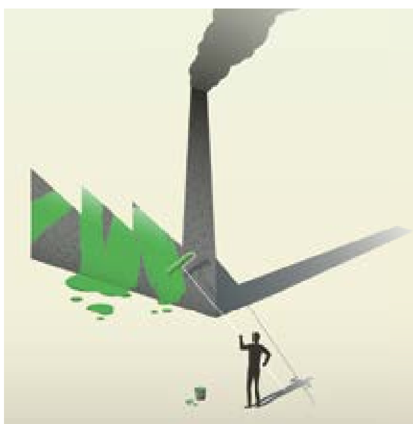
Critics claim that the regulator's proposed rules to tackle greenwashing lack teeth, but if SFDR is anything to go by, asset managers could be facing greater scrutiny.

Asset managers making unvalidated ESG claims could face harsher consequences, if proposed rules aimed at tackling greenwashing are implemented.

Under the rules proposed by the Financial Conduct Authority (FCA), sustainable funds will be ranked in three categories. In the first category are assets that are environmentally and/or socially sustainable, so called "sustainable focus" investments. The second category includes investments aimed at improving the social sustainability of assets over time, through stewardship, for example, to be listed as sustainable improvers.

The third category covers investment strategies aimed at offering dedicated solutions to environmental and social problems, so called sustainable impact funds.

The FCA's rules also foresee more stringent naming and marketing rules around sustainability claims and more detailed disclosure standards for institutional investors and retail investors looking for more information.



In the footsteps of SFDR

The new Sustainability Disclosure Requirements (SDR) step in the footsteps of the EU's Sustainable Finance Disclosure Regulations, which came into force in 2022 and distinguish between Articles 6, 8 and 9 funds. While Article 6 funds have no ESG credentials, those labelled Article 8 are promoted on an ESG basis and require companies to follow at least good governance standards. Meanwhile, Article 9 covers funds that have sustainable investment as an objective and offer a designated benchmark index.

While the UK is no longer required to implement EU regulations, British regulators were nevertheless responding to the challenge that most fund providers would de facto be marketing their products in the UK and EU. So a close overlap between UK and EU rules was seen as desirable by both sides.

While EU funds have an implicit ranking, with Article 9 funds being seen as greener, the FCA is keen to stress that there is no hierarchy between its sustainability categories. Evidence from the SFDR rollout shows that the categorisation of funds is likely to have a far reaching impact as asset managers scrambled to brand their funds as Article 9.

Voting with their feet

In the third quarter of 2022 alone, Article 8 funds reported outflows of €28.7bn (£23.7bn) while Article 9 funds recorded more than €12bn (£9.9bn) in inflows. Meanwhile, Article 6 assets dropped by nearly 10%, according to Morningstar.

More than 380 funds changed their SFDR status in the third quarter, according to Morningstar, with most upgrading to Article 9 status. But the data provider warns that many of these supposedly upgraded funds fall short of the EU's new reporting rules. Less than half have disclosed a minimum percentage of sustainable investments.

Enforcement

While enforcement of SFDR rules is lagging behind, the European Commission has significantly raised the bar for Article 9 funds in a guidance published in July. It now says that all issuers in Article 9 funds must be considered sustainable.

This does not bode well for the flurry of branded Article 9 funds. According to Morningstar, less than 5% are targeting a sustainable investment exposure between 90% and 100%.

As a result, asset managers are facing pressure to review their green credentials. By the end of November, some of the largest asset managers, including Blackrock, Amundi, Axa, Invesco and NN Investment Partners, confirmed that they had to downgrade some of their Article 9 funds.

FCA rules state that any firm labelling a product remain responsible to ensure the classification is appropriate. This approach has come under criticism. Mick McAtthew, co-director of the Financial Inclusion Centre, warns that the FCA's proposals will not work. "Firms marking own homework won't prevent greenwashing. So, we'll be campaigning to get the FCA to significantly toughen up their proposals," he says.

A warning

The FCA proposals are at the consultation stage, with comments being received until the end of January. The regulator intends to publish the final version of the rules at the end of June.

It remains to be seen whether the FCA will intervene to challenge asset managers on their greenwashing claims. If the evidence of the SFDR rollout is anything to go by, asset managers could indeed be tempted to mark their own homework more favourably. But it also heeds a warning that the eventual climbdown could be embarrassing.

INTERVIEW – DIANDRA SOOBIAH

"It is important to achieve real-world impact through engagement, rather than just decarbonising our portfolios."

In the first of *portfolio institutional's* asset owner interviews looking at ESG integration, Diandra Soobiah, Nest's head of responsible investment, explains how the master trust is playing its part in decarbonising the economy and promoting human rights.

How are you influencing Nest's ESG strategy?

I have been with Nest for just over 13 years, so quite a long time. ESG has been at the core of our investment approach since our inception, and I've helped develop our responsible investment approach, integrating ESG across our strategies. That includes addressing a range of ESG priorities that we have been thinking about.

A lot of our work has been driven by a belief that ESG issues are likely to be financially material over the long-term and will impact member returns at retirement if we do not address them.

The ESG priorities we focus on are primarily climate change, human capital, technology and, more recently, natural capital and sustainable food.

These are issues we have selected because we feel there is a clear link to financial materiality and that they align with our members' views and expectations.

One example of that is the climate-aware tilt across your global equity portfolio. How does this affect your investments?

Essentially, it just means managing our members' money in-line with our investment beliefs and their expectations. It is also in-line with our fiduciary duty, considering that climate risk is likely to have an impact on member returns at retirement. That is why we put a lot of emphasis on risks like climate change, which we believe are likely to play out over the long term.

We have built a climate-tilting approach for our developed and emerging market portfolios to reduce exposure to the riskiest companies from a climate perspective. This includes companies that are not on an upward trajectory of carbon emissions, companies that are not committed to decarbonisation or are not reporting to their shareholders on what they are doing.

These are the companies that we look to be underweight while investing more in companies with better disclosures and transparency.

That means you are not necessarily divesting from energy companies as such, but instead focusing on companies that are doing better?

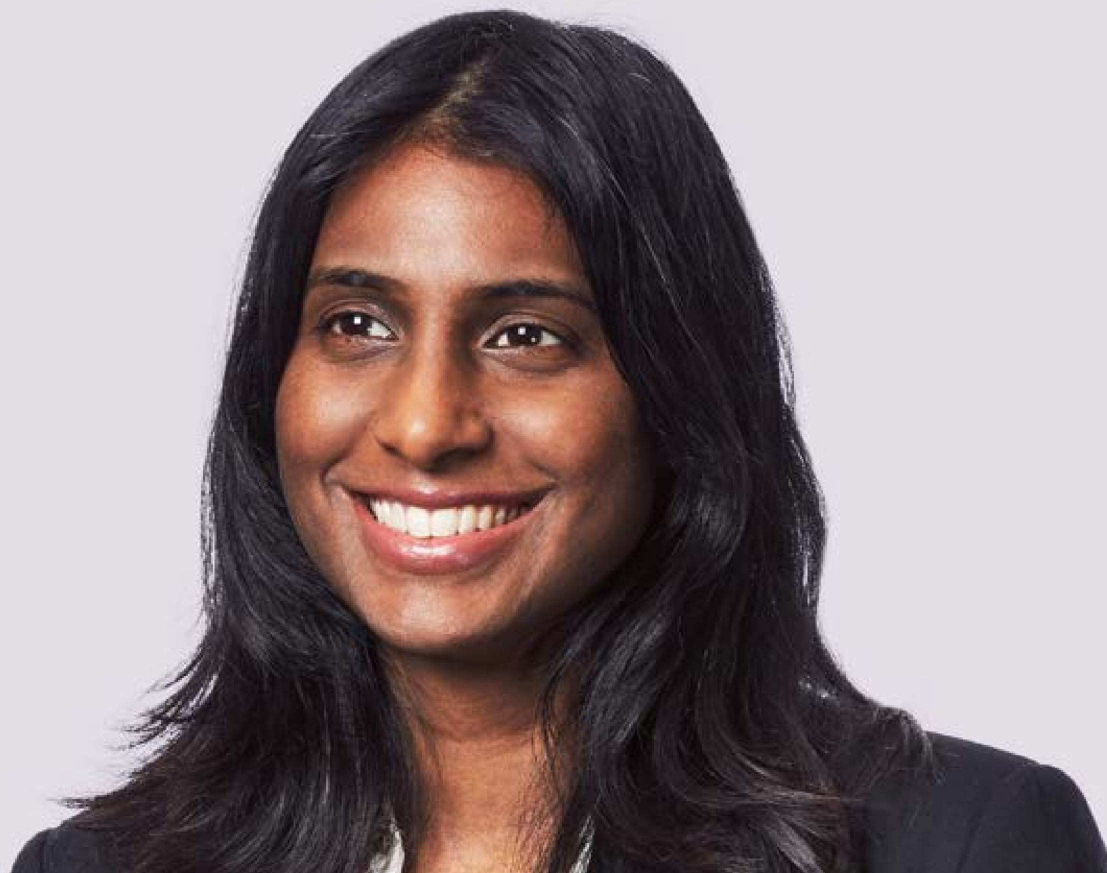
We focus on the transition, rather than divestment. We are trying to encourage companies to make those changes and to be more transparent in how they are managing those risks. We want them to put out a robust plan of how they will implement those changes over the short, medium and long term.

We are focussed on engagement, with companies directly and via fund managers. We have engagement programmes with some of the biggest laggards and where these companies have not met our objectives, we divest.

Last year, we divested from several companies [Exxon Mobil among others] on the back of poor progress and a lack of willingness to engage.

Many energy companies have benefited from the surge in wholesale prices. How has the energy crisis affected your portfolios with a climate tilt?

From a climate standpoint, our strategy has performed as expected. Obviously, we are generally underweight the fossil fuel sector, but we are trying to be neutral or



overweight on the companies which are showing progress towards the 2050 milestones. It is not like we have a blanket policy on being underweight on energy.

We were underweight Exxon but slightly overweight Total, which has set targets, improved their reporting and started talking about a just transition.

We try to identify leading companies within the energy sector, which we can continually engage with. We do not have a blanket approach to energy and we are not any worse off than the market.

It has been a tough environment for climate strategies. But we are focussed on long-term sustainable returns for our members and the short-term geopolitical risks should not distract from that.

Does a climate tilt pose a risk of higher exposure to other assets, such as US tech, which might lead to unwanted portfolio concentration?

We are sector neutral, but the FTSE Developed index is skewed towards US tech. That is the nature of the market. So we have a high exposure to US tech, but we are balancing that out with exposures across other asset classes.

In private markets, we do not have much tech. Where we see specific issues unfolding in the sector we try to manage them through engagement.

For example, we are members of the Ranking Digital Rights Initiative and engaging with companies on things like data privacy, human rights and governance. We are active in engaging with US tech companies where we see those risks.

Are you planning any changes to your strategy as a result of the energy crisis?

No, our underweight is quite marginal and we tend to not make short-term decisions on the back of short-term geopolitical factors.

We have talked a lot about equities, but in 2021 Nest announced significant private equity mandates. What does ESG integration look like in that asset class?

Private markets, specifically private equity, are slightly more challenging. This is an asset class where ESG risks are quite prevalent, but there is an issue around data and transparency. It is something we are focusing on with our fund managers.

We are trying to build a picture of where ESG risks are across the portfolio. We engage with general partners (GPs) to get information on the ESG risks of the underlying portfolio companies. And our fund managers are committed to getting as much relevant and material information from GPs as possible.

We are building up our levels of disclosure, which has been quite difficult in private markets. These are not publicly listed companies, so they do not have the same level of scrutiny as publicly owned companies. We are on a journey to build better transparency and, once we get a fuller picture of where the risks are, engaging with those GPs.

Our fund manager has started to incorporate ESG requirements within the side letters to GPs. At the point of selection, the GP has to demonstrate that they are engaging with the underlying holdings and are asking for more information in relation to ESG policies and practices.

It is work in progress, and most investors within this space are on a journey towards fully embedding this, but it is important that our fund managers work with us on this.

We have also seen new FCA [Financial Conduct Authority] rules come through which are capturing more companies. So far the focus has mainly been on larger public companies, which is why it is important to appoint managers that are engaging with the underlying portfolio companies to get good quality, consistent data and start generating good reporting frameworks.

It is quite important that we are targeted and prioritised with this. We have to focus on the most material issues.

Climate change is your key ESG priority, but how are you planning to reduce greenhouse gas emissions in your portfolios by 2025?

We have committed to reducing emissions by a third with a baseline of 2019. We have several pillars within our policies that help us with that target. We already discussed the climate aware strategy, which has a 35% decarbonisation target within that mandate.

We have made progress within equities and are in the process of setting up net-zero alignment strategies across other asset classes. That involves decarbonisation targets for the short, medium and long terms.

We are also stepping up our climate engagement with companies, looking at how they are positioned. We are engaging with them where disclosures are lacking, or if they do not have robust strategies that meet the targets they have published.

For us it is important to achieve real-world impact through engagement, rather than just decarbonising our portfolios because that does not make the blindest bit of difference to real world emissions. It is important that we move with the market and take the market with us on this journey.

Another strand of our work is through advocacy. We spend a lot of time engaging with policymakers to help set out a range of regulations and new reporting requirements that form better policy disclosures for our investee companies on what "good" looks like.

We are part of the Transition Plan Taskforce, for example, to set up transition plans for different sectors across the economy and investments in climate solutions and allocating capital into renewables. It's important that we do not just think about risk, but also tap into the opportunities.

The flipside of focussing on real world impact is that it might become harder to meet your target. Will you meet it?

We are on track to do so in terms of where we are positioned with the Climate Aware fund, which is where a lot of our decarbonisation is coming from. It just so happens that the mandates we have elsewhere do not lend themselves to being heavily invested in fossil fuels.

A lot of our carbon emissions are generated from our equities. Other strategies are naturally quite low in carbon, but that does not mean we are not working with them. At the moment, it does not look like we need to make radical decisions to meet the target.

You didn't attend COP27?

Not this year. On the emerging market side, obviously the event was in Egypt this year. We are part of a group looking into how investors can support an emerging market transition.

It is important that investors do not overlook the importance of emerging markets in their transition plans. The market has a different pathway to net zero, it is more carbon intensive but in order to reduce real world emissions, it is important that emerging markets are part of that transition.

What are the main topics you engage on and how could this change in 2023?

It is a tough economic backdrop for our members at the moment. We will continue to focus on the long-term.

Climate change will still be a key focus but there are other areas of interest, for example, human rights on the back of the Russia-Ukraine war. We are thinking more about the companies and countries that we invest in. We are considering human rights more.

We have done a lot of work on low pay, which will continue to be a focus going forward. We have campaigned for a living wage. That is set to continue, particularly with the tough financial situation in the UK. It's important that where companies can, they should pay workers fairly.

There are always new things on the horizon. We are also stepping up on stewardship, but climate change and workforce conditions are going to be key.

It is important that investors do not overlook the importance of emerging markets in their transition plans.

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ESG: THE YEAR AHEAD

Considering environmental, social and governance (ESG) factors when investing long-term capital feels needed now more than ever. Indeed, with the world recovering from the impact of a pandemic, war in Ukraine has increased the pressure on resources. The result is that the cost of food and energy has leapt to levels not seen since the early 1980s in some parts of the world.

Energy security has become a priority for governments, leaving some to wonder if their decarbonisation plans might take a backseat until prices fall to affordable levels. Access to healthcare is another issue as systems are under strain following Covid, while the spectre of recession could fuel rising inequality.

All of this is just another step in the evolution of ESG, which has come a long way since simply not investing in weapons or South Africa. The question is, how will what is happening in the world today influence the discussions between asset owners and those they entrust to manage their capital? We spoke to the members of our ESG Club to find out.

The cost of living

The affordability crisis will continue to feature in conversations during 2023, with more attention paid to the social elements of sustainable investing, says Caroline Ramscar, head of sustainable solutions at Legal & General Investment Management (LGIM).

One area LGIM will continue to focus on is promoting the living wage in light of the leap in energy and food prices. Early in 2022, LGIM co-filed a resolution at a supermarket chain to ensure it was paid across its business. “How companies balance that with inflation will be interesting, and how we are taking that into account in company engagements is something clients will be interested in for 2023,” Ramscar says.

Solving traditional problems

Jon Wallace, who manages the Jupiter Ecology Fund, says that in 2022 environmental solutions progressed where there were multiple, converging drivers for their uptake. He believes this will continue into 2023, although with a different emphasis.

We had a similar situation during the financial crisis and in the early stages of Covid as we do today with energy prices in that the world changes dramatically and there are new priorities to contend with.

"That happened to some extent in 2022," Wallace says, pointing out that COP27 took place with little global co-operation or urgency. "But this is where we are optimistic that although the drivers for the energy shock link back to Russia and Ukraine, the energy landscape has changed permanently.

"Many of the solutions to having affordable and secure energy, will fortuitously be the solutions that also ramp up green and sustainable energy," he adds.

Wallace points to research from E3G, a think tank, which claims that due to clean power, Europe avoided about €11bn (£9.4bn) worth of gas expenditure during 2021. "Had there been a higher rate of renewable penetration over the past seven years, and better uptake of energy efficiency solutions, we would have had less of a problem now," he says.

Investing in efficiency particularly helps improve energy security and could avoid a repeat of the exorbitantly high energy prices we are paying today.

"The big trend for 2023 will be a growing recognition of the role environment solutions can play in tackling issues that are not necessarily green – energy security, for example," Wallace says. "That is set to continue, because the problems we have around energy and the cost of food are not going to change. We will be discussing the same macro backdrop this time next year, it is just that the conversation around those issues will change."

In the detail

The phrase we could hear regularly when discussing ESG in 2023 is "in the detail", believes Hannah Skeates, co-head of sustainable investing at Allspring Global Investments.

"There is a lot we are aware of from a sustainability perspective, but we are getting more sophisticated, more into the detail about what it means, what the implications are and for whom," she says.

New regulations, an energy crisis, growing inequality and the continuing journey towards net zero: what does the year ahead hold in store for sustainable-led investors? *Mark Dunne* reports.

Sustainability is about transformations and in 2023 it is the detail of how those transformations are implemented that investors will be discussing. Skeates points to COP27 in November being set up as the implementation COP as a sign of things to come.

"We have the transformation of our everyday systems towards sustainable versions," she says. "That is happening at the industry level, as well as when companies discuss their transition plans.

"It is about how transportation is evolving, and what the sustainable versions of personal transport, freight shipping and aviation could be," Skeates says. "It is how we think about food and agricultural production, and the shift from polluting and destructive processes to regenerative versions."

This would mean investment approaches need to be potentially "re-thought".

"If you were to look at this from a historical perspective, we are living through a pan-economy transformative event. We can see it moving from one state into another. That is what I mean by "in the detail" of these transformations occurring," Skeates says.

Many of the solutions to having affordable and secure energy, will fortuitously be the solutions that also ramp up green and sustainable energy.

Jon Wallace, Jupiter Asset Management

Long-term impacts

Amelia Tan, LGIM's head of responsible investing strategy, says: "In 2023, people will want to ascertain whether the world is on track to meet our collective goal to limit global temperature rises to 1.5-degrees Celsius. This includes whether governments and companies have set targets that are ambitious enough and plans that would be credible in implementation.

"The energy crisis has clearly put a spanner in the works, let's put it that way," she adds. "We have found that people are concerned that the short-term measures taken will have a long-term impact on our net-zero ambitions. That is an emerging area of concern about the global economy, not just in specific portfolios."

Show me the data

Concerns over the success of net zero come at a time when asset owners want more than words from their asset managers. They want evidence that the strategy is working.

Ramscar says that many asset managers have committed to net zero, but in the year ahead they will be under pressure to evidence what they are doing more widely on their clients' behalf.

"We have spoken a lot about measurability and outcomes, and how there has been that evolution in stewardship of outcome-driven engagement to make real world impacts, but in 2023 there will be more of a focus across the E, the S and the G.

"This will be a big focus in 2023, as will bringing the granularity and quality of data to investors. While this has undeniably got better, it is still a work in progress. Clients want to see a lot more of this information relating to their own investments being evidenced back to them," she adds.

The natural world

There is more to the environment than climate change. Biodiversity has been in the background for some time but it is being discussed more and more during the roundtables we regularly host and was featured in *portfolio institutional's* ESG Club Conference in July. "For the past few years, greenhouse gas emissions have been the focus, but biodiversity and deforestation are increasingly coming to the fore," Tan says.

It appears that biodiversity's time has come. "At some point, we have to stop saying this issue is on the horizon and get into the nitty gritty," says Therese Niklasson, head of sustainable investment at Newton Investment Management.

"I have picked up on more practical work coming into the market around frameworks and applications for how to think about biodiversity. That should take us forward.

"If we feel that climate change is tricky, this is another beast, but it is important," Niklasson says.

Tackling this particular beast means that the level of detail Skeates discussed earlier will be evident in this area, too.

Thinking about the issues affecting nature and biodiversity, such as water, deforestation and agriculture, in detail means considering the impact by location, an economy's dependency on nature and how to supply more information to investors.

"We have seen the climate-related impacts from water shortages and the link to a society's ability to produce food. Nature provides solutions to climate in tandem with the shift to a net-zero economy as well as supporting our everyday lives.

"2023 is likely to bring a much wider investment industry

understanding of the scale of the dependencies and impacts on nature, and its importance to us," Skeates says. "We will have more detailed discussions around how sustainable investment relates to natural assets across the realms of freshwater, marine, land and atmosphere."

This means mapping pollution and the degradation effects as well as looking at the physical climate risks locally. "Practically that means understanding deforestation in a different level of detail, or what actions are occurring in biodiverse-sensitive areas, and what transforming those interactions looks like as a part of these wider industry transformations," Skeates says.

"We are going to get to a different level of understanding around how finance can link to conservation and appropriate restoration efforts," she adds. "So, taking more holistic approaches to how to think about the potential investment connections to restoration."

The opportunities and risks linked to biodiversity come in many forms. Indeed, Ramscar is seeing interest from investors in tackling water pollution. "It is an extension of biodiversity: an emerging theme in the past couple of years that has become much more pointed in 2023," she says.

"Biodiversity, deforestation and water pollution are areas that clients are now focusing on and asking us what we are doing to improve things.

"What is interesting is that the market has been talking about anti-microbial resistance for quite a long time, often under the S considerations," Ramscar says. "Linking the S and the E in the food chain and in water pollution has been an interesting development.

"It is a nuanced discussion, but people want to know what we are doing with water companies on pollution and how those companies monitor and treat these issues," Ramscar says. "This is about the results of engagement being more tangible."

Ramscar's colleague Amelia Tan says that they are working on such issues because the sustainable industry is maturing and investors want to see results. "We have always talked about our stewardship activities but what people want to know more about are the outcomes of those engagements. In many ways, our clients expect us to better articulate that on an aggregated basis, within their portfolio holdings.

"It is a measure of success, but it is also the measure of the companies who have not responded, so what is the consequence of that non-response? This will be the overarching theme," Tan says.

For Niklasson agriculture and food are areas Newton will continue to focus on. "The inflation situation, and the Russia-Ukraine situation, are putting pressure on the food system. That will definitely continue into next year," she says.

One asset manager who has been "beating the drum" to get more attention on biodiversity is BNP Paribas Asset Management. For Pieter Oyens, who is the asset manager's co-head of global product strategy, the hard work is paying off. "This year will be progressively more about the critical role biodiversity and natural capital plays," he says.

"Agriculture and forestry are going to be a far hotter debate, because people will understand that continuing high intensity agriculture is simply not a solution. You have to change," he says.

Peter Mennie, chief sustainable investment officer for public markets at Manulife Investment Management, describes biodiversity as an existential challenge, just like climate change. "It is important that people realise that nature is a crucial part of our economy. The goods and services nature provides are critical.

"We have to act to address biodiversity loss in the same way that people are getting together to act on climate change," he adds.

For Sandra Carlisle, head of sustainability at Jupiter Asset Management, it is not about wanting to focus on biodiversity, it is a must. "We will see more focus on nature and nature positive solutions next year," she says.

"50% of global GDP is linked to nature. Due to our demand on nature, we are depleting it faster than it can regenerate itself. That is not sustainable in the long term, so we have to find innovative ways of protecting it."

Carlisle expects to see more innovative companies next year which will work to make the world more sustainable. "Our Ecology Fund is looking at lab-based meat, for example, because the population will continue to grow.

"Land is being stressed by water challenges, but also climate change. If you get more floods and encroaching on land, we are going to have to feed more people on less land and find different ways to do it.

"There will be opportunities in innovative new companies that emerge to solve these issues," she adds.

It is important that people realise that nature is a crucial part of our economy.

Peter Mennie, Manulife Investment Management

The enablers

COP26 made 2021 a big year for ESG. In the lead up to the event in Glasgow, some of the world's largest companies made net-zero commitments. "The theme in 2022 for us was understanding how they plan to achieve those commitments and what activity enables those transitions," says Rhys Petheram, an investment manager in the environmental solutions team at Jupiter Asset Management.

So, instead of investing in Tesco, for example, Jupiter's environmental solutions team could invest in the suppliers that help enable it to be sustainable, such as packaging companies' alternative solutions to plastics.

"Companies are thinking about their carbon footprints in an increasingly sophisticated way through looking at their supply chain, which supports the companies we invest in," Petheram says. "Alongside that dynamic, taxonomies highlight the enabling investment activity, which asset managers will start reporting on in 2023.

"The taxonomies and data requirements are going to make it more obvious who is doing what in driving sustainability, and where the solutions are. In 2023, we will see a greater focus on the development of these enabler universes," Petheram says.

Making an impact

Environmental investing discourse looks set to broaden out beyond climate change in the year ahead, a result of the introduction of taxonomy objectives and corporate sustainability goals starting to incorporate biodi-versity and natural capital risks. Petheram says. "There will be more focus on companies with products that impact on multiple policy domains.

"Another regulatory shift is fund labelling, which is increasingly recognising impact and helping define it.

"We will have a clearer idea of the regulators interpretation of what impact is in 2023, which could sharpen the minds of asset managers in terms of how they in turn think about impact," he adds.

This "clearer idea" includes defining how to differentiate impact investing funds from broader environmental portfolios or ESG-compliant portfolios. "It could be an interesting year for impact funds," Petheram says.

Bond…green bond

In 2022, the economy deteriorated, and so did green bond issuance. In the third quarter of 2022, volume reached $152.3bn (£127bn), 45% lower than in the same period 12 months earlier. It was a slow year for green bond issuance because of the broader market backdrop and going into 2023, this does not look set to change.

With taxonomies being implemented globally, Petheram hopes to see more transparency in green bonds, which could make the market more attractive. "Taxonomies are going to play an increasingly important role in trying to improve the quality of the green bond market. That will help underpin growth in market share because it gives investors more confidence in the instruments," he adds.

But could issuance be driven by the US? The world's largest economy has been under-represented in raising funding from the green bond market, with it being home to less than half the funds raised. But with the Inflation Reduction Act passing in 2022, could this prove to be the catalyst for the green debt market to grow once again?

"With the momentum we are seeing in terms of policy support for green investment, support for green investment in the US, I would expect to see more green bonds issued out of that market," Petheram says. "If the market wants to keep growing, it cannot be Europe that underpins its growth. The US needs to come to the fore," he adds.

Time to Act

Under the Inflation Reduction Act, the US will spend $369bn (£302bn) making the country more sustainable. Could this encourage more capital in sustainability beyond green bonds?

"That bill was important in terms of its symbolic nature," Mennie says. "When there is a clear signal from governments that they are investing in the transition, you are making the case for companies to invest in line with that.

"The Act makes our work easier, because you can point to that clear alignment, which has existed here in Europe and clearly exists in the legislative framework the US has now set up," he adds.

Rules and regs

There is one topic which always dominates ESG strategies: regulation. And in 2023, there are two pieces of regulation that will likely feature in such conversations: Sustainable Finance Disclosure Regulation (SFDR) in the EU; and Sustainability Disclosure Requirements (SDR), which is in consultation and is designed to tackle greenwashing in the UK through improved disclosures and fund labelling. "What the FCA is trying to tease out is what an ESG fund is," Mennie says.

"The FCA's new framework is quite interesting in that it brings in this idea of sustainability impact and sustainable improvement categories," he adds.

These labels are designed to identify certain funds, but there will still be questions over which key performance indicators (KPIs) are used and how focused is a fund on stewardship.

"That is going to be a big focus on regulatory activity next year, which is all for the good," Mennie says.

BNP Paribas AM's Pieter Oyens agrees that regulation will be the hottest topic in ESG during 2023. "Institutional investors

It could be an interesting year for impact funds.

Rhys Petheram, Jupiter Asset Management

in Europe will be deciding how they want to align with SFDR," he says. "Is Article 8 or Article 9 the best way to manage their portfolios and how do they connect with the new disclosures?

"In the UK, the draft regulation of SDR is going to be a topic of discussion," Oyens says. "The key difference between SFDR and the draft regulation SDR under consultation is that SFDR is disclosure focused. You get all the information which you need to digest, but then you need to make sense of, for example, the sustainable investment definitions from one asset manager to the next and bring it all together. On the other hand, SDR may add minimum standards for different categories of funds."

Newton's Niklasson believes that the SFDR regime will be challenging. "I describe this as a Rubik's Cube. At the centre of it you have your own taxonomy, your philosophy, and now you need to solve this Rubik's Cube of needing to look perfect on all fronts. That is not an easy task," she adds.

At the heart of this is the greenwashing debate. "It is a complicated landscape to navigate," Niklasson says. "That brings it to compliance. I have never in my career spent as much time as I do today with legal and compliance teams."It is needed. There is a clean-up exercise to do internally around language and around marketing, which is overdue. It is creating a degree of fear and paranoia, but that is not necessarily a bad thing. I suspect that is going to dominate in 2023.

"For me, being the head of sustainable investment is very different from a couple of years ago," Niklasson says. "The skillset needed is changing. Demand for people from legal and compliance backgrounds will be huge."

At Newton, this is a core part of how those teams are led. "You cannot just create language and develop frameworks and definitions in isolation anymore, you need to understand the language that is being formed from a regulatory perspective," Niklasson says. "It might not be the most exciting aspect of our work in 2023, but it is materially important."

Asset managers will continue to be under pressure. "Our clients want to see more information, but they want it simplified. This is a challenge which we are trying to solve. To an extent, it is also what the labelling regime in the UK is trying to solve," Niklasson says. "The trend that we expect to see is that TCFD-compliant reports will hopefully go from being quite long to being crisper and to the point, because people will be looking for specific information," Niklasson says. "The days when it was simply about describing the issues and why they are important are behind us."

Keeping score

Mennie believes regulators could have ESG ratings in their sights during 2023. "Sounds like a good idea," he says. "Ratings are comparatively uncorrelated, but it will be a difficult task because no one has decided what ESG ratings are for."

"When they were created, there was a sense that they were filling a gap because corporate disclosure was low. But for climate change, in particular, there is now a lot more data. So, what are they trying to do now? Predict some kind of outcome?" he adds.

The difficulty with ESG ratings is that providers are trying to condense a broad set of characteristics into a single number. "Getting to the point where you can say this is good or bad is difficult," Mennie says. "Focusing on the specifics of what you are trying to do with a particular product will increasingly come to the fore, rather than trying to match some average target across a whole range of sustainability issues," he adds.

The voice

Jupiter's Sandra Carlisle is interested to see how the emerging debate around voting rights and giving individual investors the ability to express their views will evolve in the next 12 months.

"The world of corporate governance proxy voting is obscure to most investors," she says. "But people care about what their money is doing, what it is contributing to, positively or negatively, and the way in which they can influence companies through the exercise of a vote.

"And the technologies that are developing to enable perhaps more direct expression of end investor wishes is maybe not something we will see in 2023, but it is definitely emerging as a live topic," Carlisle says.

Looking to the future

ESG is a broad church and it appears that while some issues will always be with us, new areas in need of attention will come to the fore in the 12 months ahead. The story of investing to make the world a safer, cleaner and more equitable place is one of evolution and 2023 will be no exception. It will be interesting to see what the world looks like a year from now and what our ESG Club panel will say when I ask: "What ESG trends do you expect to see in 2024?"

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