Friends Provident Foundation

Fair economy. Better world.

ESG investing olympics
State of the sector report 2020

Foreword

“Three charities – Friends Provident Foundation, Joffe Trust and Blagrave Trust – came together to launch the 2020 ‘ESG investing olympics’.

We did this because we believe that charities should use all their endowment to achieve their mission, not just their income. The three charities have very different objectives: Friends Provident Foundation seeks a fair and sustainable economy that serves people and planet; Joffe Trust’s mission is to realise human rights and reduce poverty in developing countries; and Blagrave Trust provides funding to bring lasting change to the lives of young people facing challenge. But we all believe that the purpose of investment should be to direct capital to socially and environmentally useful activity, to create social as well as economic value, and to help address societal challenges.

By running the ‘ESG investing olympics’, we hoped to:

- bring greater transparency to the world of investment management
- draw on the expertise of like-minded investors and other organisations
- share learning on emerging best practice in the market across different investment approaches, and
- send a message that asset owners are looking for investments with purpose and higher standards of ESG integration and impact.

The three charities also have differing financial needs in terms of income and liquidity. We hoped to find an investment manager that could maximise social and environmental return on investment, whilst maintaining a reasonable financial return and accessibility for a wide variety of asset owners. In doing this, we sought an investment model that had the potential for scalability and systemic impact on how investment markets operate.

Growing demand from asset owners to have a purpose beyond financial return is leading to exponential growth in funds that are labelled as impact, sustainable, responsible, green or ESG. However, the quality of these funds varies greatly, with marketing claims not always aligned with investment practice.

With Moody’s claiming that “ESG investing is the next growth frontier for asset managers” and new entrants including some of the world’s largest managers, there is enormous potential to effect real change. But there are also risks to the credibility of ESG as a concept if the approach taken is too piecemeal or tokenistic.

This report aims to share our experience, and we hope it will assist both asset owners and asset managers establish what best practice looks like and to make better decisions.”

Stephen Muers

Chair of Trustees,
Friends Provident Foundation

Background

In what we think to be a first, we took the unusual approach of making our tender for an investment mandate of £33.5m public, with the key instruction simply to 'impress us' on environmental, social and governance (ESG) integration and impact. The scale of response blew us away.

We received proposals from 59 investment managers with combined assets under management of £15 trillion. Following assessment, a shortlist of five were invited to present at the Royal Institution to an audience of asset owners who share our desire to create impact through their investments, including charities, churches and pensions, and some grant recipient NGOs that focus on sustainable finance.

A range of different managers were invited to present, from boutique impact investment managers seeking to drive capital to solutions to multi-trillion-pound publicly listed investment banks seeking to integrate ESG and move markets via their stewardship.

The 'ESG investing olympics', as it was dubbed, attracted a great deal of attention, with extensive coverage in the Financial Times and specialist press.

To shortlist the five managers, we assessed the proposals on the following indicators of ESG integration:

- in-house expertise
- intentional social and environmental impact
- stock selection
- voting record
- engagement and escalation
- exclusions
- impact reporting

We have produced this 'state of the sector' report based on that assessment, looking at sector standards, recent improvements, and remaining gaps where standards are still falling short of expectations.

State of the ESG Sector

In-house expertise

The weakest proposals we received were totally reliant on third-party ESG indices and from asset managers with no in-house ESG expertise. This invites questions like how do these managers know whether their ESG product is credible and how do they propose to manage it? When we looked at these funds' holdings, we were not reassured about their ESG integration.

Most of the proposals we received claimed to have some in-house ESG expertise, but upon reading team bios few of them did, especially on environmental and social (E&S) issues. Many had experience of charity client relationship management, but very few had specialist E&S qualifications or experience with NGOs, academia, business, finance or government. Some cited occasional training days as evidence of an ESG knowledge base.

This lack of E&S knowledge and expertise extended to some funds that could evidence internal processes to integrate ESG into investment decision-making. However, without in-house expertise, it raises questions about how meaningful that decision making can be.

Again, we looked at the holdings in these funds to sense-check their ESG claims, and found mixed results.

Stock selection and intentional impact

Looking at equity fund holdings, a key finding is that the 'S' of ESG is the poor relation of E&G.

Most ESG funds tend to invest in sectors like tech, media, consumer, utilities, manufacturing, and retail. Many of the companies are high risk from the social perspective, but integration and engagement are obviously far less well developed. Some proposals did not cover social issues at all.

The same companies are well represented in the top holdings of global equity funds like Amazon and Alphabet, two notoriously aggressive tax avoiders that have also been singled out by PRI for failing to substantively respond to engagement on the subject. Amazon is also a regular news item for poor working conditions.

Recent events, such as the global pandemic and BLM movement, should put the 'S of ESG' firmly on the agenda. Key social issues, from decent work and conditions to workforce and management diversity to aggressive tax avoidance, are going to require far greater attention and integration.

Boutique impact, multi-asset and thematic ESG proposals had the most intentional stock selection processes for impact.

The weakest proposals came from global equity funds that solely relied upon third-party indices for stock selection or solely excluded fossil fuels. The poorest proposals from an impact perspective were solely concerned with 'mitigating investment risk'.

Emerging best practice for ESG funds includes disclosing all holdings on a quarterly basis. Asset owners should consider this a minimum standard, as it is the easiest way to sense-check whether funds' ESG claims match their practice.

The five shortlisted proposals were for multi asset class funds, meeting our liquidity needs with equity but also providing access to intentional high-impact, more illiquid asset classes, such as renewable energy, microfinance and social housing – offering the twin benefits of directing capital to solutions, and using shareholder influence to effect behaviour change and move markets.

Voting

The next indicator of ESG integration we looked at was shareholder voting, especially votes against management and for independent ESG resolutions. We found a very wide range of behaviour.

The worst practice was non-disclosure of voting record and outsourcing of voting with no accompanying ESG policy or instructions.

Best practice included quarterly disclosure of voting decisions, including statements on votes against management, votes for and against independent ESG resolutions and abstentions. The best proposals could also evidence high levels of support for ESG resolutions and votes against management as part of engagement escalation. Rationale for votes was also communicated to investee companies.

Broadly speaking, our assessment found an inverse correlation between voting against management and size of assets under management, particularly on independent ESG resolutions. There were notable exceptions, with several medium to large asset managers demonstrating best practice disclosure and support for a significant majority of ESG resolutions.

Asset owners should consider this a minimum standard. It is disingenuous for asset managers to make claims about ESG integration and engagement, and then vote against their stated ESG objectives. Asset managers need to overcome this reluctance to either oppose management when necessary or support independent resolutions.

Our investment statement on climate change, shared as part of the request for proposals, states that we expect investment managers to vote for all climate change related shareholder resolutions, taking a 'comply or explain' approach. Very few had a presumption in favour of ESG resolutions, but most stated they were willing to adhere.

Given the very wide range in voting track record, this is a very positive development and hopefully will become an ESG sector norm. It is something asset owners should be including in management tenders and reviews; and it has the potential to effect real change in corporate and market behaviour.

Engagement and escalation

Another area where market standards are not where they should be is engagement and its escalation.

Most examples of engagement provided by ESG equity proposals were limited to letters or meetings. Some could provide evidence of results, many could not. Too many relied on being signatories to collective engagement initiatives, primarily on climate change, as proof of active engagement and many lacked policy and processes covering issues like escalation.

In 2019, an UKSIF survey of members found that 86% claimed to be engaging companies to align their business with the Paris Climate Agreement, but only 18% set deadlines for engagement objectives to be met, and more than half had no plan for how to act if companies did not respond or meet their demands. Our assessment of proposals found a large majority did not have an engagement escalation policy.

Asset managers should be producing clear policy around escalation of engagement and how this might happen, for example voting against board re-elections, tabling shareholder resolutions and ultimately divestment, plus transparent disclosure on the implementation of that policy.

The best proposals demonstrated programmes of active and meaningful engagement, from raising points of difference and requesting action via letters and meetings through to more forceful stewardship, such as co-filing shareholder resolutions. Their engagement also went further than just requesting better disclosure or targets in the distant future to actual behavioural change, such as requesting new strategies and policies with short and medium term targets.

Promisingly, some managers recognised that their engagement frameworks, particularly around escalation, were lacking, and offered to work with us on the development of those frameworks if they were to win the tender. This included one of the world's largest asset managers. Hopefully that recognition will be acted upon regardless of winning our mandate. It is a positive sign for the future. This is also something asset owners should be insisting on in manager tenders and reviews.

Again, the 'S of ESG' was the poor relation, with few proposals showing active engagement, despite holdings in high-risk sectors. Only a few included evidence of engaging in one of the priority social issues identified in our investment policy, including the promotion of fair pay, decent work, diversity in management and the responsible payment of tax.

Most high-impact or thematic proposals concentrated the bulk of their efforts on stock/fund selection, and any engagement undertaken was at that stage. A minority, primarily funds of funds, undertook ongoing engagement with underlying funds on impact reporting and, occasionally, investment decisions. Any ongoing engagement by funds with direct company investments tended to be limited to impact reporting.

The best of these proposals could provide evidence of impact from engagement, for example underlying fund divestment of holdings with weak impact rationale.

There was little ESG engagement with investee companies either directly or indirectly via underlying funds, despite there being material ESG risks. For example, we saw no evidence of engagement in renewable energy funds regarding supply chains and the sourcing of components and raw materials, or in emerging market funds paying attention to human and worker rights, such as the ILO Core Conventions.

Exclusion

Virtually all the proposals received excluded fossil fuels, as per our investment policy. This is perhaps the most marked improvement identified in the ESG market. For many years, fossil fuel exclusion or divestment was one of the biggest bones of contention between mission-led asset owners and fund managers. It was not long ago that the number of mainstream asset managers with exclusion policies could be counted on one hand, and raising the spectre of divestment could empty a room of asset managers. Now there are dozens of investment products and strategies that offer just that. This demonstrates that where mission-led asset owners prioritise today, the market often follows tomorrow.

Some asset managers recognised they had gaps in their wider exclusion policies compared to ours, such as the unsustainable harvesting of natural resources or intensive agriculture that degrades the environment, and offered to work with us to fill those gaps.

Many proposals ignored the social exclusions in our investment policies, and most of those that claimed adherence did so with a commitment to the UN Global Compact. Besides fossil fuels, most only specifically excluded traditional ethical issues such as tobacco, armaments and gambling.

To ensure better integration of the 'S of ESG', we would like to see more specific exclusion policies on issues like failure to implement basic labour rights (as set out in the ILO Core Conventions) and failure to uphold basic human rights within sphere of influence, and on pertinent issues such as the promotion of discrimination and incitement to hatred.

Impact reporting

The best reporting generally came from purposeful impact funds. This was an area in which boutique high-impact managers shone. A variety of reporting approaches were used. Many used the Sustainable Development Goals as a framework, along with stats for positive environmental impact or social value added.

The reporting of impact was absent or generally of poorer quality regarding ESG equity proposals. For example, among those that emphasised engagement, few published their goals, assessments of progress or outcomes against defined objectives. There was very little integrated financial and impact reporting from any proposals.

Most asset managers acknowledged that there was still much work to do on impact reporting, and current practice is often inadequate. A lack of data was often cited as a barrier to comprehensive impact and ESG reporting. The most developed reporting was generally climate change related, for example portfolio carbon footprint reporting. A noticeable sector trend was the increasing number of asset managers that reported having undertaken climate scenario analysis.

Pooled voting

Whilst not specified in our request for proposals or in our investment policies, several proposals included the ability to direct votes in pooled funds. This has been another bone of contention between mission-led asset owners and the assets' managers in recent years. This may indicate market responsiveness to asset owner demand, but could also be bespoke offers for a high-profile tender.

Our priority was a properly integrated ESG policy that would direct shareholder voting across the portfolio or fund, or better, all assets under management. We sought a presumption in support of ESG resolutions, taking a 'comply or explain' approach, and an engagement escalation policy that covered voting on ordinary resolutions.

Recommendations

Our analysis of the 59 proposals, as a proxy for the ESG sector, brings us to conclude that there are several areas that still require attention. The priority should be to address the most basic and serious gaps which, if unaddressed, risk damaging the credibility of the ESG market.

As such, we recommend asset owners consider the following as minimum ESG standards in asset manager tenders and reviews; and that managers use it to review ESG products, strategies, policies, and practice.

A presumption to vote in favour of ESG resolutions, taking a 'comply or explain' approach with disclosure of rationale. This should be the starting point for ESG policy. Asset managers cannot make claims to ESG integration and engagement and then by default vote against their stated ESG objectives. They need to overcome any reluctance to oppose management when necessary or reluctance to support independent resolutions.

Active ESG engagement that goes further than disclosure or distant targets to effect real change in the near term. For example, on climate change, it should include net zero transition plans with science-aligned short and medium term targets. Memberships of third-party initiatives and signing occasional group letters are insufficient evidence of active engagement.

Engagement escalation policy. Asset managers should produce clear policy around escalation of engagement and how this might happen, for example voting against board re-elections, tabling shareholder resolutions and ultimately divestment, plus transparent disclosure on the implementation of that policy. Claims to ESG engagement are unconvincing without such a policy and willingness to oppose management when necessary.

Integration of the 'S of ESG' into stock selection and shareholder engagement. In general, social issues are more difficult to integrate than environmental issues due to lack of consistent, comparable, comprehensive data across a very wide range of issues. For many asset managers this is exacerbated by a reliance on third party data-driven indices. Asset managers need to develop greater in-house ESG expertise to be able to take a materiality approach and make judgements on the best available evidence; and overcome an aversion to working with social and environmental NGOs.

Regular disclosure of all holdings, voting record and engagement activity, including statements on votes against management, votes for and against (and abstentions from) independent ESG resolutions, and disclosure of ESG engagement goals, methods of engagement and escalation, assessments of progress, and outcomes against defined objectives.

Mainstream ESG managers also have much to learn from boutique high-impact managers on purposeful investment, stock selection processes for impact and impact reporting. But there are areas where high-impact funds and managers can improve. For example, the lack of ongoing investee company or underlying fund engagement after investment should be addressed. This should be related not just to improving disclosure but also to improving impact, for example on ubiquitous ESG issues such as low carbon transition or human and labour rights.

‘ESG investing olympics’ winner Cazenove Sustainable Growth Fund

The Cazenove Sustainable Growth Fund is an innovative multi-asset fund that will launch in early 2021. Investors will be able to maximise the positive impact of their wealth on people and the planet whilst targeting attractive financial returns. The fund will invest across a broad range of assets such as sustainable businesses, social development, renewable energy and social housing, combining intention with action to generate real and measurable positive impact.

The core of the Fund will be invested in the Schroder Global Sustainable Growth strategy, a first quartile equity approach that combines the expertise of an award-winning sustainability team and global equity specialists to select the world’s leading sustainable businesses. This will be complimented with satellite positions in specialist thematic and impact managers, where there is a clear intention to allocate capital to areas of social and environmental need. Available to charities and individual investors, the fund will have a carbon footprint of less than half of the global equity index, and will generate four times the social impact.

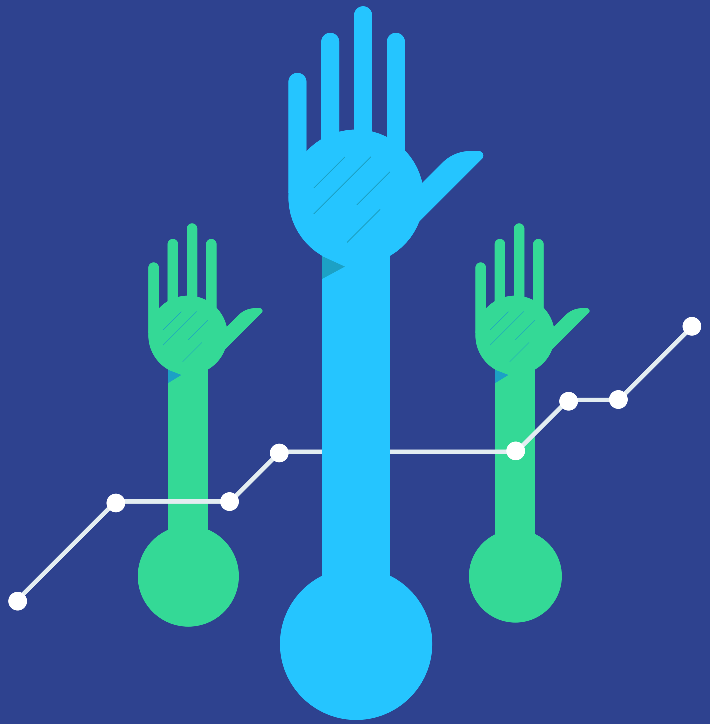
Cazenove, as part of the global asset manager Schroders, are committed to using their influence as a large asset owner to encourage positive change across companies, asset managers and policy makers, and to accelerate progress towards achieving the UN Sustainable Development Goals. The Fund has:

- Four times the social impact
- 63% reduction in carbon emissions
- Offsetting carbon emissions: using an innovative partnership to offset equity emissions and planting 20,000 trees a year
- Investments with a positive impact on people and planet
- Attractive financial returns – seeking inflation plus 4% returns over the long term

Katherine Davidson – Global Equity Fund Manager, Sustainable Growth

Emilie Shaw – Sustainability Lead and Portfolio Director

Kate Rogers – Head of Sustainability and Co-Head of Charities



Selecting the winner

The five shortlisted managers invited to present were EQ Investors, Tribe, Eden Tree, Cazenove and UBS. A wide range was deliberately chosen, from boutique impact investment managers to multi trillion pound publicly listed investment banks. All were considered by our shortlisting to be the best in their respective classes from the proposals received.

These five each gave a presentation to an invited audience of like-minded asset owners. After each presentation, the audience gave them a score using electronic keypads. Following all five proposals, audience members voted on the highest environment, social and systemic impact, and their preferred proposal.

Cazenove was voted the most preferred proposal, followed by EQ Investors and then Tribe. Cazenove was also voted top for social and systemic impact, with EQ second for both. Tribe was voted top for environmental impact, with Cazenove second.

The proposals also received a final assessment covering organisational values alignment, direct impact via our capital, engagement impact of direct portfolio (companies and/or funds), engagement impact on investment manager's wider AUM, and potential for systemic impact.

The final decision rested with the trustees of the three charities making the investment, who favoured two proposals based on the above: a new publicly available multi-asset ESG fund from Cazenove and a new multi-asset OEIC investment vehicle from EQ Investors. We would be cornerstone investors to launch both of these new 'best in class' funds. Much deliberation revolved around which proposal would have the biggest impact on the wider investment system – an 'evolving incumbent' or a 'new disruptor'?

Friends Provident Foundation's overall investment strategy includes both supporting disruptors/innovators and working with incumbents to bring about the change that is needed to fulfil our mission. For example, we are a founding partner in Snowball, a new high impact multi asset class fund with the objective of changing behaviours in capital markets so that all capital is invested for social and environmental as well as financial returns.

In September 2020, trustees were delighted to announce Cazenove as the winner of the 'ESG investing olympics', with EQ Investors the runner-up.

Ongoing engagement and radical transparency

Friends Provident Foundation believes in the potential of 'investing to engage' and 'radical transparency' to effect change in mainstream financial markets, and we are delighted to share a vision with Cazenove for the new Sustainable Growth Fund that includes pushing the boundaries of sustainable investing, radical transparency, and a new collaborative approach with active client participation.

In a positive first step on this journey, an Investor Sustainability Forum will be formed for any investor in the new fund o engage with. It will be a forum to discuss sustainability issues important to investors, represent unit holders' views on sustainable investment trends, and help to inform the fund's sustainability policy and priorities.

In the spirit of the 'ESG investing olympics', Friends Provident Foundation will be publicly open and honest about our experience and will report annually against a set of KPIs, including to the new Investor Sustainability Forum.

The KPIs are yet to be developed but will include ESG standards covered in this report and some independent benchmarks such as ShareAction's 'Point of No Returns' ranking of the world's 75 largest asset managers on responsible investment. Published in March 2020, it ranked Schroders 7th with a 'BBB' rating (reassuringly the highest rated asset manager amongst those that submitted proposals). Perhaps the Cazenove Sustainable Growth Fund could engage its largest underlying asset manager, Schroders, to achieve a 'AA' rating in the next report, expected in 2023.

Runner up
EQ Investors

EQ Investors is a discretionary fund manager focused on sustainable and impact investing. As a founding Certified B-Corporation, investing for good is in their DNA. They manage portfolios for charities, high net worth individuals, IFAs, family offices and other institutions who care about their social and environmental impact.

EQ's experienced investment team has been pioneering impact investing – seeking out investments that make a measurable positive impact and a financial return – for over a decade.

In 2012, EQ made social and impact investing available to retail investors. Their focus is on investing in companies whose products and services help and solve social and environmental problems. They provide detailed impact reporting using environmental and social impact metrics and their approach naturally avoids controversial sectors.

EQ manage portfolios to align investments with your values, providing diversified exposure to the UN Sustainable Development Goals, combining strategic and tactical asset allocation with best-in-class manager selection.

John Spiers, Chief Executive, EQ Investors

Friends Provident Foundation

Friends Provident Foundation is an independent charity that makes grants and uses its endowment towards a fair, resilient and sustainable economic system that serves people and planet. We connect, fund, support and invest in new thinking to shape a future economy that works for all.

www.friendsprovidentfoundation.org

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