ARTICLE SERIES 5 OF 5 - SPOTLIGHT ON SDR: SEEING ESG CLEARLY

Five things for advisers to look for when selecting sustainable funds

LGIM

The forthcoming Sustainability Disclosure Requirements should serve to make sustainable funds more comparable and therefore ease the process of fund selection for financial advisers. But there is still work to be done to ensure a fund reflects the objectives and values of investors.

Fund selection can be tricky at the best of times. But with sustainable funds, the task becomes even harder.

Mainstream funds tend to have easily understood investment remits and philosophies, and their performances can be readily assessed by looking at standard metrics such as performance versus benchmark, alpha and volatility.

But it takes a bit more legwork to understand the makeup of sustainable funds, says Amelia Tan, head of responsible investment strategy at LGIM.

'There isn't really a homogeneity in terms of the naming conventions and terminology and understanding of that.

'Funds that are effectively called the same thing – "ESG" or "sustainable" – can have very different underlying objectives. They can use very different assessment methodologies in terms of how they allocate assets and identify or select securities.'

Advisers trying to navigate the myriad of sustainable funds available to clients can look forward to a helping hand from 30 June 2023 when the FCA's Sustainability Disclosure Requirements (SDR) prompt asset managers to use more clearly defined fund labels and make better disclosures on a fund's objective and strategy, and stewardship activities that support these. It will be no silver bullet, however.

'Even within, for example, the "sustainable focus" label, how you determine what assets are sustainable is up to the asset manager,' says Tan. 'It still isn't going to answer all questions because different asset managers will determine "sustainability" differently. It will help, but advisers still have to do their due diligence.'

1. SUSTAINABILITY OBJECTIVE

When selecting sustainable funds it is important not to judge a book by its cover.

'Let's not judge funds by their names alone, because that is not enough information,' says Tan.

The critical first step is to focus on the sustainability objective – firstly, developing an understanding of what the investor wants to achieve from a sustainability perspective and secondly, ensuring the fund's formal sustainability objective reflects this.

'A lot of greenwashing or mixed messaging can occur in a fund's marketing material, so it's best to see what the manager is formally tied to,' says Anna Mercer, head of 3D research at Square Mile Investment Consulting and Research.

Allied to this, how does a fund's financial objective balance against its sustainability objective?

'There are two aspects to this,' says Tan. 'What is the primacy of the sustainability objective vis-à-vis the financial objective? That will help advisers better understand what a fund is trying to do.'

2. INVESTMENT STRATEGY

Secondly, how does the investment strategy help the fund achieve its sustainability objective?

'The clearer the link between the two, the more comfort an adviser or investor can take that the strategy is credible,' says Tan.

Some thorough analysis has to be done to understand the investment rationale for portfolio construction and security selection.

'Examine the definitions used in creating the ESG profile of the fund,' says Dan Kemp, global CIO of Morningstar Investment Management.

'It is important to look beyond the "headlines" of the ESG criteria and really dig into the definitions for each exclusion or area of focus to ensure that the manager is being thoughtful and diligent about setting and applying those criteria.'

A full assessment of the strategy should ascertain the underlying methodology being used. Is it a third-party independent data provider or proprietary and what is being considered in those methodologies?

3. FUND REPORTING

The proof, as they say, is in the pudding. So does the strategy have clear key performance indicators? How does the fund manager intend to measure and evidence performance relative to the objective and over what timeframe? To what extent in the fund's reporting does it meet or exceed its targets?

Impact, engagement and wider stewardship activities can be key metrics for sustainable funds.

'When seeking to make an impact, understand how investing in the fund will make a meaningful difference,' says Kemp.

'Too often investors claim they are making an impact simply because they own companies making a positive contribution to sustainability. Unless this investment represents new capital to the company – for example, a rights issue – being the owner of shares that would otherwise be owned by someone else is unlikely to have a meaningful impact.'

Recognise too that twin objectives of sustainable impact and financial returns may be at odds, especially over the short term.

'When investigating the engagement of a fund manager with the companies they hold, be aware of how the fund manager prioritises maximising impact and maximising returns,' adds Kemp.

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Amelia Tan, head of responsible investment strategy, LGIM

4. ASSET MANAGER

When selecting sustainable funds, set the same high standards for those funds as for any other.

When assessing either mainstream or sustainable funds, Morningstar focuses on the same key areas: the people managing the fund, the quality of the organisation for which they work, the process they use to manage the portfolio, and the cost of investing.

Particularly on the point of engagement, making an assessment across an organisation is indicative of the resources an asset manager puts into this. To aid this, a key tenet of SDR is disclosure of active investor stewardship conducted by asset managers.

'Does the activity go beyond a specific product level to an entity level?' asks Alexander Burr, ESG policy lead at LGIM, which publishes annual and quarterly reports on its active ownership activities.

'Sometimes you must work collectively to raise market standards. It's important to have an appreciation for that.'

5. ONGOING SUITABILITY

Understanding what a fund excludes as well as what it focuses on is imperative to ensure suitability.

'There is little point in selecting a fund that excludes a large portion of the investable universe or emphasises a small part of that universe unless those areas of exclusion and emphasis match the client's own concerns,' says Morningstar's Kemp.

It is a point equally stressed by Mercer at Square Mile. 'Is there anything your client wouldn't want to have exposure to, and what are their hard lines when it comes to fund holdings – is oil a hot no?

'If they have any hard nos, is it likely that the fund could have some exposure to them? And would they be able to tolerate that?'

Concentration or unintended biases can be particularly problematic when building sustainable portfolios, so it is something advisers should be acutely aware of.

'Funds with sustainable objectives tend to avoid more controversial sectors, such as energy or defence, and an unintended consequence may be lower exposure to certain style factors like value,' says Tan.

'If your portfolio is only in impact funds your investment universe is going to be much smaller.'

An analysis of the dispersion of returns among multi-asset funds by LGIM shows that it is the narrowest for risk-targeted funds and the widest for sustainable funds, so advisers could look to the small group of risk-targeted sustainable multi-asset funds to manage volatility and ensure ongoing suitability.

LGIM believes multi-asset ESG investing is about balancing material ESG benefits while not losing sight of other key portfolio considerations such as diversification, costs and risk stability. This is a key principle driving the L&G Future World ESG Multi-Index fund range, which consists of five ESG-focused, risk-targeted multi-asset funds.

Each fund targets a specific risk profile, as defined by Distribution Technology's Dynamic Planner, to ensure long-term suitability, while aiming to provide a material ESG improvement.

Reflecting sustainability preferences shouldn't come at the expense of ongoing suitability, so it is important advisers thoroughly examine this balance for the benefit of their clients.