XPS Investment

Investment Fund ESG review 2021

ESG standards are rising, but so are client expectations

September 2021

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Introduction

Pension scheme trustees are demanding more from their investment managers when it comes to managing risks associated with ESG and climate change, as both regulatory pressure and understanding of the risks increases.

It is critical that investment managers reflect the shift in industry sentiment and recognise the importance of considering ESG and climate change within their strategies.

To monitor this for our clients, XPS undertakes a comprehensive annual review of our clients’ fund holdings, and in this report we publish a summary of our findings of this year’s assessment and compare to last year.

As part of this year’s review we have **analysed detailed information provided by 54 managers covering 199 funds** to understand their current approach towards incorporating ESG and climate change risk management into their funds.

Key findings:

1

Strong progress by fund managers in relation to overall ESG risk management

23% of all funds were awarded an XPS Green rating for ESG, up from **10%** last year. It’s clear that within certain markets integration of ESG is well established (passive equity and fixed income) however there is still work to do.

2

Strong firm philosophies are not consistently backed up by action at fund level

85% of managers assessed to have a well-articulated policy around ESG risk management. However we found evidence that strong firm-wide stances on ESG are not always effectively applied at fund level or between asset classes.

3

Risk of ESG laggards is greatest in active equity, multi-asset and private markets

High dispersion of scores means that thorough fund due diligence is more important in these asset classes.

4

Greenwashing appears to remain an issue

11% of funds were unable to provide any examples of ESG being incorporated into decision making. Within Equities specifically, **26%** of equity managers were unable to provide any examples of E, S and G being incorporated into investment analysis with a resulting action.

5

Progress needed to fully capture climate change risks

Provision of carbon data has increased and is widespread in listed markets with **93%** of equity and **79%** of fixed income funds supplying us with data, but is almost non-existent in private markets. Consideration of forward-looking transition risks is lagging in all markets and is an area for development.

XPS approach to assessing ESG

As part of our comprehensive research process XPS assesses and rates funds Green, Amber or Red across 8 key aspects: Product, Parent, People, Process, Pricing, Positioning, Performance and ESG. We refer to this as the 7Ps and ESG. We combine these ratings to determine an overall Green, Amber or Red rating for a fund. It is a minimum requirement that all funds must at least score Amber for ESG to be recommended to clients. This helps pension scheme trustees ensure the policies and practices of the funds they are invested with are in line with their preferences on an ongoing basis, and XPS also provides feedback to the fund managers themselves on their ESG rating to flag strengths and areas for improvement.

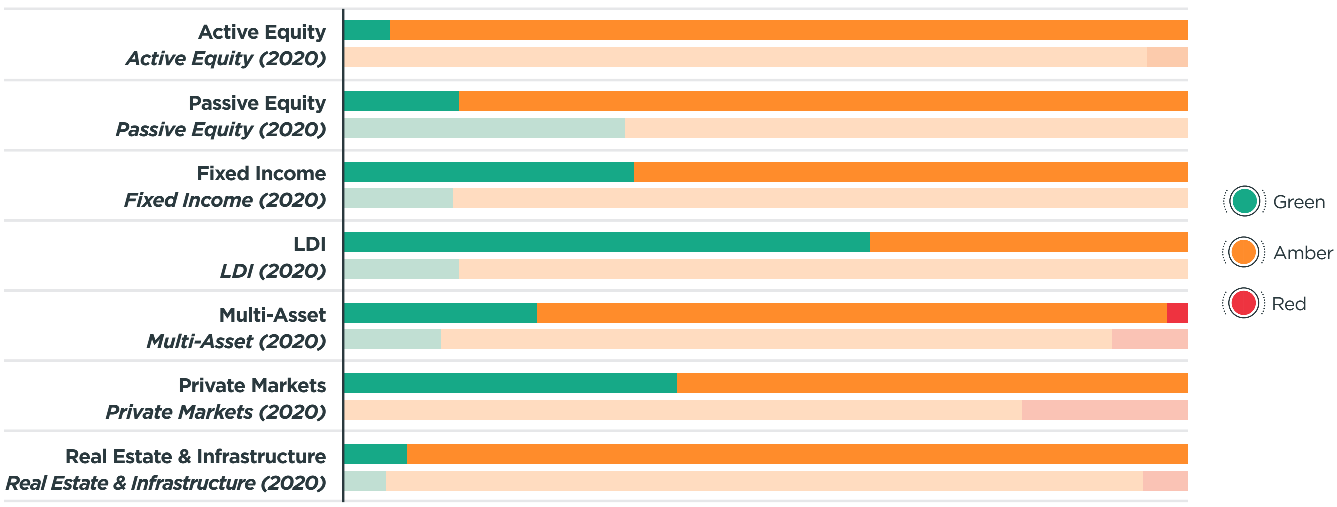
Within the ESG element of our research we assess the quality of ESG risk management, utilising the five key areas that we consider to be fundamental when assessing ESG practices:

Key ESG areas	Explanation
1. Philosophy	Firm-level philosophy relating to ESG, stewardship and broader sustainability issues.
2. Integration	Implementation of the firm's ESG philosophy within research and portfolio construction.
3. Climate change	Explicit climate change considerations within the investment and stewardship processes.
4. Stewardship	Approach to voting and engagement to drive positive change in invested companies and underlying managers.
5. Reporting	Transparent communication of activity to stakeholders.

Note: We note that within passive mandates we do not assess managers on ESG integration or climate change as these managers have less control over stock selection. For these funds our focus is on stewardship.

We request completion of a detailed questionnaire involving over 70 questions as part of our due diligence and score each question +1, 0 or -1 with the score weighted appropriately and combined to inform an overall score within each area. This then informs the overall ESG rating where an average weighted score of below -0.5 is red, between -0.5 and +0.7 amber and a score of +0.7 is green, with qualitative oversight to ensure that overall ESG ratings are appropriate. For instance we do not rate a fund green for ESG overall if it is red on any individual area irrespective how well the fund has scored on other areas.

Overall XPS ESG ratings for 2021 by asset class (compared with 2020)



Source: XPS Investment

Note: The apparent reduction in green rated passive equity managers over the year is due to the number of funds reviewed increasing from 3 to 21, where we had grouped passive funds at the same manager last year where this year we have reported individually. Therefore, we do not believe this represents a deterioration in the practices of managers.

Key findings

1 Strong progress by fund managers in relation to overall ESG risk management

Asset managers are responding well to the demand from investors on ESG and climate change. Consideration of ESG risks is now well established for most managers across the various asset classes.

The majority of managers have demonstrated commitment at firm level to ESG and climate change in response to growing demand from clients. It is commonplace to see dedicated ESG teams, investment policies which refer to ESG and climate change issues, and firms signing up to key initiatives such as the UN Principles of Responsible Investment and the UK Stewardship Code.

In particular we would highlight:

- **Improved stewardship:** We observed a widespread improvement in the approach taken towards stewardship. Specifically in private markets where many funds scored poorly last year, there were clear signs of improvement with 40% of funds scoring green this year for the stewardship element, versus last year when no funds scored green.
- **More widespread carbon reporting:** The other consistent theme was significant progress in respect of carbon reporting, which is perhaps unsurprising, given the increasing pressure from policy makers on emissions reduction. 93% of equity and 79% of fixed income funds are able to report on the carbon emissions and footprint of their portfolio.
- **Fixed income managers are leading the way,** with the most consistent evidence supplied to demonstrate robust ESG risk management.

95%

Of managers stated that they had made an investment decision based on ESG factors.

2%

Only 2% of managers could not provide an example of an ESG factor being used to inform an investment decision.

98%

Of fixed income funds engaged on climate change during the year.

- **Private markets are improving albeit from a low base:** We saw a notable improvement for private markets, where last year only 60% of funds mentioned ESG in their investment policies, this year all the funds did.

However, we have identified a number of key areas which support the continuing need for pension schemes to ensure sufficient due diligence when making investment decisions, and to demand further progress from their managers.

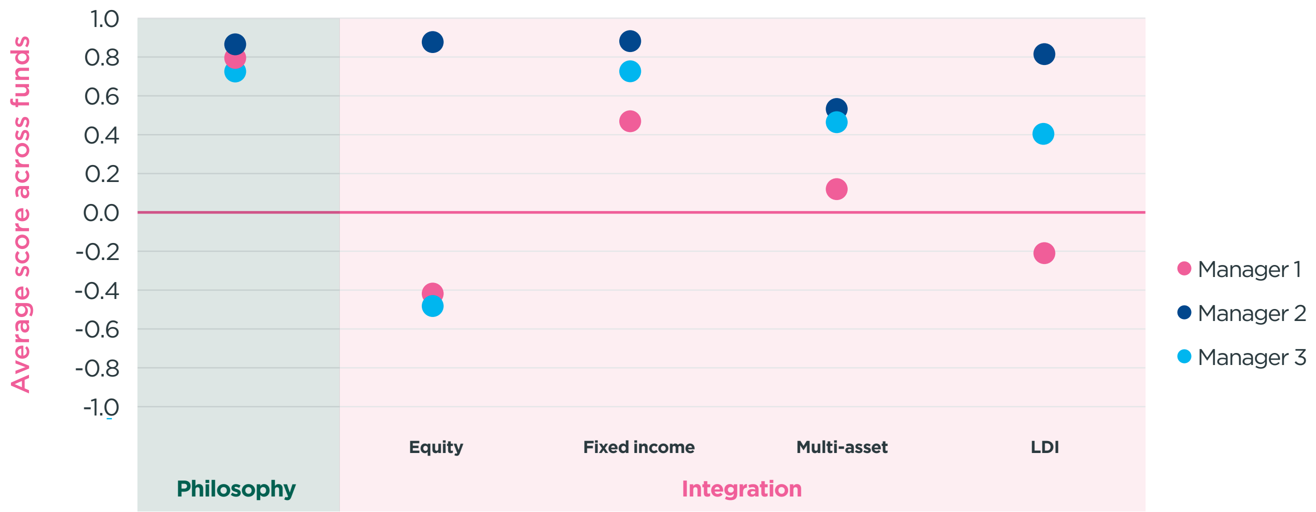
93% of equity and 79% of fixed income funds are able to report on the carbon emissions and footprint of their portfolio.

2 Strong firm philosophies not consistently backed up by action at fund level

We find there may be a risk within the industry of resting on a well-intentioned firm-wide stance that seems good on paper but funds themselves aren't applying those principles in practice. It seems that often there may be a directive at overall firm level, which is not yet applied to all of the strategies.

For example, **whilst 62% of active equity managers scored green (highest) for philosophy**, we found that **only 10% of funds then also scored green on integration.** However, being well intentioned is an important start as we found that no managers who scored amber on philosophy scored green on integration.

Furthermore, we saw dispersion of ratings between asset classes for a given manager, as shown below. For three managers offering funds across asset classes, we saw that whilst the overall firm philosophy score may indicate a commitment to considering ESG risks, the approaches taken by the given funds varied significantly and indicated a weaker integration of ESG into the investment process in practice.

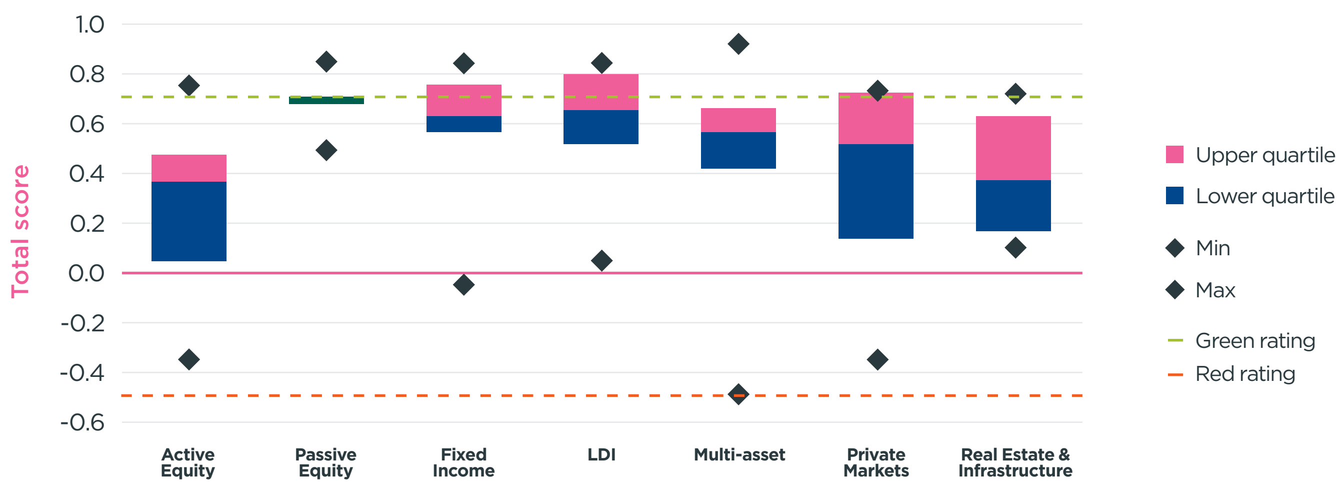


Source: XPS Investment

Note: This is an example sub-set of fund managers offering funds across asset classes, and does not include all multi asset managers.

> Fund managers must ensure the approach taken in practice within their funds reflects the strong messages at firm level.
>
> **Alex Quant**
> Head of ESG research

3 Risk of ESG laggards is greatest in active equity, multi-asset and private markets



Source: XPS Investment

We find that for certain asset classes there is wider dispersion in the overall scores. Notably multi-asset, where some funds had made significant progress, but equally other funds demonstrated an absence of ESG consideration – the only red rated funds from the whole exercise this year were from multi-asset funds. Trustees need to be particularly considerate when entering into multi-asset funds that they carry out sufficient due diligence of managers.

It is interesting to note that active equity on average scores poorly versus the other asset classes. This pattern for active equity is consistent with what we observed in 2020 (**6% green rated in 2021** and **0% green rated in 2020**, the lowest of all asset classes in both years). Therefore it is clear there is work to do here for many equity funds and managers to ensure ESG and climate change risks are properly taken into account, particularly given this is often perceived to be the asset class where incorporating ESG is most straightforward.

It's no surprise that private markets and real assets have a) a wide spread of outcomes and b) lower scoring funds. We consider that the extent to which private market funds will be forgiven for continuing to overlook ESG responsibilities on account of the greater challenges in obtaining consistent information will diminish rapidly, as reporting requirements ramp up for these companies and managers.

For the asset classes we've identified as higher risk, trustees must make sure they conduct the required due diligence to ensure the approach taken is in line with their expectations.

4 Greenwashing appears to remain an issue

Being able to provide evidence is critical to ensuring a manager's stated approach is genuinely applied in the investment process. Below we have reported the extent to which managers were unable to supply any form of example of incorporating ESG into decision making, grouped by asset class compared to last year's assessment.

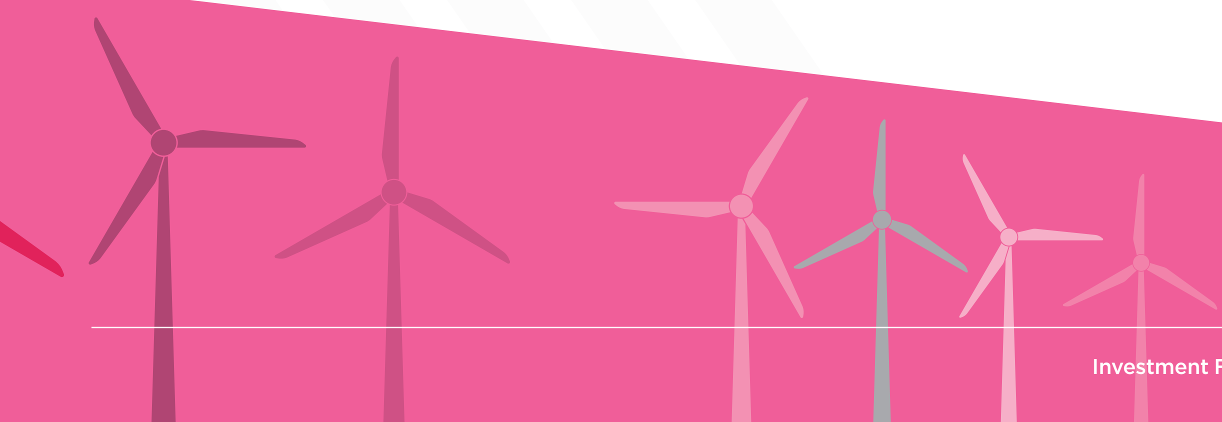
% funds unable to provide any form of example of ESG factor being taken into account

2021	Active Equity	Fixed Income	Multi Asset	Private markets	Real assets
Number of funds	***34***	***61***	***34***	***5***	***25***
Environment	33%	2%	21%	0%	5%
Social	36%	2%	26%	0%	4%
Governance	36%	2%	26%	20%	14%
All 3 areas	26%	2%	21%	0%	0%
2020					
Number of funds	***20***	***37***	***33***	***5***	***18***
Environment	40%	6%	21%	20%	35%
Social	40%	6%	30%	20%	35%
Governance	40%	6%	30%	20%	35%
All 3 areas	40%	5%	18%	20%	33%

Whilst an improvement on previous years, **26% of active equity funds were unable to provide any example for any of E, S or G.** This raises legitimate doubts over whether the ESG processes described are being applied in practice.

By comparison, in fixed income **only 2% could not provide an example of E, S or G integration** – demonstrating much more robust integration of ESG into the investment process.

We saw notable improvement in private markets and real assets where in 2021 all the funds were able to provide a relevant example for E, S or G, whereas in 2020 20% and 33% could not respectively.



5 Progress needed to fully address climate change

Climate change is increasingly a standalone issue when it comes to investing sustainably. Pressure from policy makers is filtering down to pension schemes and it is critical that investment managers recognise the importance of managing climate change risks for pension schemes.

Climate change key indicators

	Active Equity	Passive Equity*	Fixed Income	Multi Asset	Private Markets	Real Assets
Number of funds	***34***	***21***	***61***	***34***	***5***	***25***
Fund manager supports TCFD**	82%	n/a	97%	97%	80%	80%
Consider physical and transition risk	41%	n/a	82%	50%	80%	68%
Decarbonisation plan / target	12%	n/a	7%	21%	0%	60%
Undertake climate stress testing	32%	n/a	44%	50%	40%	48%
Net zero asset managers initiative	32%	n/a	56%	47%	0%	52%
Able to report carbon data	91%	95%	93%	79%	0%	52%
Average % coverage for carbon data***	89%	97%	79%	50%	0%	68%

* Passive management relates to market capitalisation indexing only.
** Task Force on Climate-Related Financial Disclosures.
** Coverage means the proportion of the underlying holdings for which the given fund has carbon data available.

As mentioned above, there has been significant progress here in listed markets with the majority of funds able to report carbon data. However, within private markets none of the funds could provide emissions data, and within real asset funds only 52% could – so there is work to do from the fund managers to push harder for disclosure from their underlying investments, but there is also a role for policy makers and regulators to enhance reporting for private companies.

We note that average carbon data coverage is quite poor (50%) in multi-asset funds, so again there is work required for managers and policy makers to understand how to report on carbon emissions for non-standard asset classes which make up these funds.

This emissions reporting is a bare minimum requirement in order to support pension schemes in starting to understand their exposure to climate risk.

However, this data is inherently backwards looking and, in order to fully understand the nature and extent of the climate change risk exposure, fund managers need to be more forward looking in their approach.

Only 41% of equity funds and 50% of multi-asset funds claimed to consider physical risk (physical impact of climate change e.g. extreme weather) and transition risk (risk of business failure from not adapting to low carbon economy), and climate risk stress testing is still minority practice across all asset classes.

Currently very few funds have an explicit decarbonisation plan or target.

As more and more schemes are asked to set their own targets for TCFD reporting, it will be interesting to see if fund managers respond and align their products to this.

Conclusion

The results of our fund rating review demonstrate that there is clear progress being made, but that there is still room for improvement.

The following should be the priority for fund managers in order to help trustees in their decision making:

- **Commit to robust consideration of ESG and climate change risks within existing strategies –** this is no longer an optional extra, but critical for risk management. We hope to see evidence through our rating system of fund integration echoing the strong messages at firm level. Strong examples of ESG and climate change factors being taken into account in decision making will continue to be the key means of testing this.
- **Utilise power as provider of finance through stewardship to drive positive outcomes in companies.** We will keep looking for examples of engagement, with hopefully more funds being able to demonstrate ongoing monitoring of progress and outcomes as a result of the engagement.

In addition to the results of this review we observe that there is considerable innovation that is currently taking place in relation to fund offerings. In order for this to be most effective it will be important to have clear labelling of funds and reporting to differentiate between approaches taken, in order to avoid greenwashing and enable effective decision making by investors.

Next steps for pension scheme trustees

There are lots of things trustees can do to address the pressing risks posed by E, S and G factors.

The following approach is a good start:

1. **Take XPS's free beliefs survey** to establish your beliefs and establish your approach. (click here to request our survey).
2. **Review** the managers in your current portfolio.
3. **Evaluate** results against your desired approach.
4. **Engage** with underperforming managers.
5. **Monitor managers** for change within a reasonable period.
6. **Make changes** to portfolio to reflect objectives.
7. **Consider** use of sustainable funds which go beyond the minimum expected standards of ESG integration.

If you would like to find out more on sustainable investment and ESG please contact Alex Quant:

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