XPS Investment

Investment Fund ESG Rating Review

How well are investment managers rising to the challenge of ESG and climate change?

September 2022

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Introduction

2022 Fund ESG Ratings

To help our clients identify whether ESG is appropriately embedded within their investments, **we conduct an annual rating of all our clients' funds**, 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 **63 managers covering 255 funds** to understand their current approach towards incorporating ESG and climate change risk management into their funds.

This document sets out a summary of our analysis and findings and illustrates how managers across the full range of asset classes are progressing in terms of ESG.

2021 saw continued focus by the investment community on ESG issues, with continued strong inflows into funds which have specific environmental or social purpose.[1] Climate change in particular was a standout topic, with COP26 taking place and the climate change reporting disclosures coming into force for the largest schemes during the year.

Meanwhile, anti-ESG sentiment has risen in prominence, with some commentators arguing against the merits of ESG investing. For instance it has been argued that real world impacts can only be delivered at a government level with political intervention, or that ESG is a distraction or even at direct odds with the fiduciary duty of institutions to generate returns for end investors.

However, we're resolute that consideration of ESG factors (including climate change) into the investment process is a critical part of good investment management – from both a risk and opportunities perspective. The UK Government and several other nations have been clear with their intentions, as evidenced by the regulations and targets enacted, and whilst much more needs to be done, this presents a real threat to those companies and investors who do not position themselves to adapt. Furthermore, we think investors have a responsibility to factor sustainable ideas into their decision making, to deliver their financial objectives without detrimentally impacting the prospects of future generations. However, these factors form one of several relevant considerations when making investment decisions, and a robust ESG approach is only part of a successful investment process.

> Consideration of ESG factors into the investment process is a critical part of good investment management – from both a risk and opportunities perspective.

Alex Quant
Head of ESG research

[1] **Source:** Investment Association Responsible Investment Conference 2022

Executive Summary

1

In general, we have seen some improvement in manager capability, but there has been deterioration where some funds are scoring worse than last year in certain areas.

Overall Green ratings remain stable at 24% (2021: 23%), whilst total Red ratings rose slightly to 2% (2021: 1%).

The vast majority of managers are able to demonstrate some level of ESG integration, however we continue to see examples of managers (31% of funds) not able to provide any examples of ESG analysis factoring into investment decisions, which raises doubts about the credibility of their policies.

2

Climate change is high on the agenda – but there is work to be done to fully embed the risks and opportunities into investment decisions.

The Net Zero Asset Managers Initiative is widely supported (81% vs 41% in 2021), which is encouraging and perhaps a reflection of increased purpose resulting from COP26. However, a limited number of managers (22%) could demonstrate a credible plan to support their firm-level commitment.

The availability of climate-related data is broadly consistent with 2021 – with low levels of coverage outside of listed equities and fixed income.

3

Reporting stands out as area for improvement.

This year we introduced a specific sub rating on reporting, with 36% funds rated Red on this element, causing several funds to be downgraded overall. Reporting is becoming increasingly important to meet disclosure regulations and to evidence robust and consistent consideration of ESG across the portfolio.

4

Alternative asset classes continue to lag behind.

Whilst we've seen examples of very strong managers in this space, **secure income, diversified private markets, and real assets were the worst scoring asset classes this year** and overall scored lower than last year. This was primarily driven by poor scoring on stewardship and reporting. Carbon data also remains a concern with very low levels of coverage.

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 on ESG in order to be green rated overall and 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 tailored feedback to all fund managers on their ESG rating to flag strengths and areas for improvement.

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: 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.

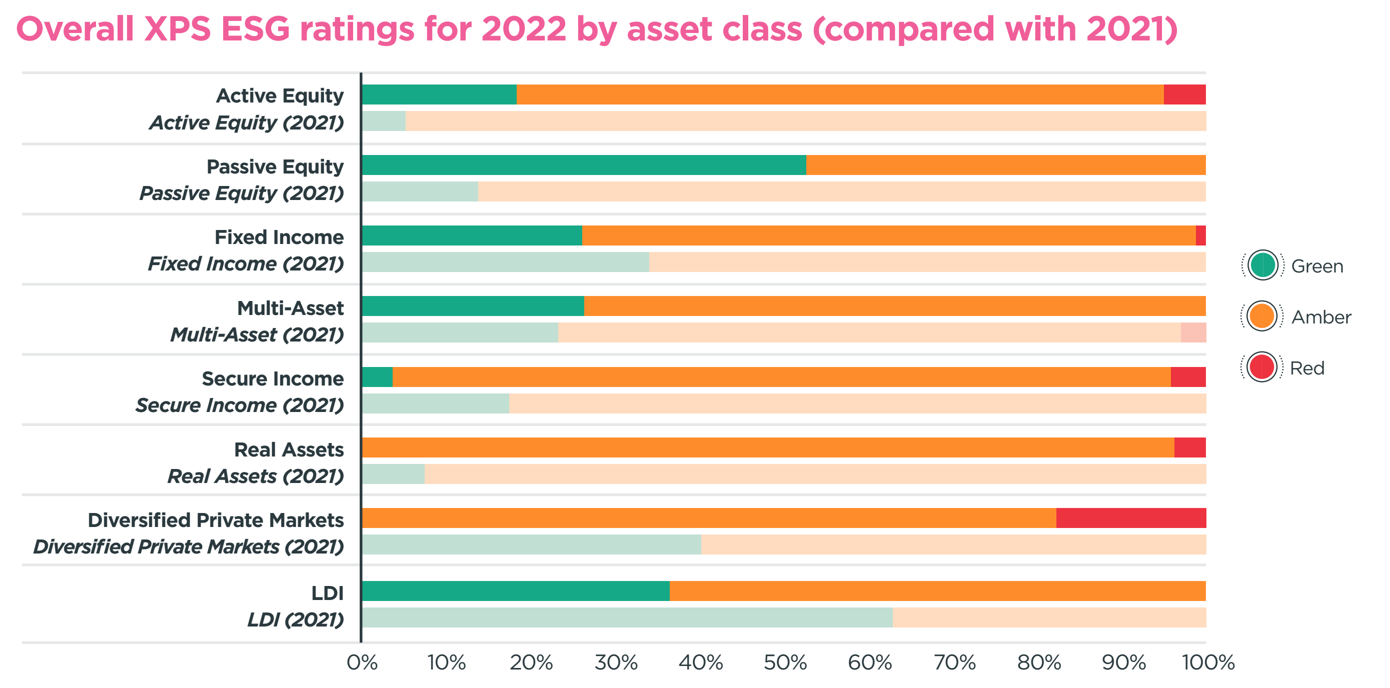
We request completion of a detailed questionnaire involving **over 70 questions** as part of our due diligence and score each question +1, 0 or -1 with the score weighted appropriately and combined to inform an overall score within each area. This then informs the overall ESG rating where an average weighted score of below -0.2 is red, between -0.2 and +0.7 amber and a score of +0.7 is green, with qualitative oversight to ensure that overall ESG ratings are appropriate. We do not rate a fund green for ESG overall if it is red on any individual area, irrespective of how well the fund has scored on other areas.

Key changes to assessment to note vs 2021

- Most critically, the score required to achieve an **Amber rating** has **increased from -0.5 to -0.2.** This is part of our ongoing efforts to raise the standard for asset managers.
- We have asked for more granular detail on the level of engagement which has taken place for each fund.
- We have refined our assessment of ESG reporting provided and this now constitutes a more significant part of the overall rating.

Key findings

1 Year on year progress is limited, with areas of concern still remaining



Source: XPS Investment

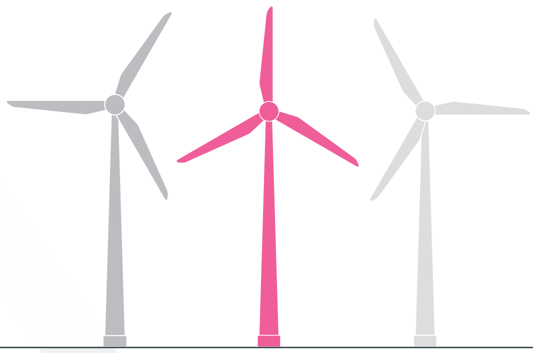
Our analysis indicates a similar picture to previous years – the vast majority of managers were able to demonstrate some consideration of ESG factors in relation to their investments (24% overall greens vs 23% in 2021).

There have been **improvements across active equity funds and multi-asset funds in particular**, the latter showing more Green rated funds (27% vs 24% in 2021) and no Red rated funds this year compared to 3% in 2021.

Our observation is that the better managers within multi-asset are increasingly able to consider ESG factors more robustly across a wider range of asset classes than in previous years.

It is disappointing not to see clearer improvement from last year. By comparison, last year we reported a noticeable overall improvement versus 2020, where there were 10% Green ESG rated funds and 5% Red rated. This highlights that we may not always see year on year improvement, and therefore we hope that our engagement with managers on areas to improve will come through in years to come.

Overall, there are **significantly more Red ratings overall compared to last year**. This is in some way a function of our change in scoring methodology – we intentionally increased the score required to achieve amber this year, so all other things equal we would expect more red ratings. However, expectations are rising and therefore we would hope to see improvement in ratings despite this.



Year on year progress is limited, with areas of concern still remaining (cont.)

We saw a clear pattern of funds scoring worse than last year due to providing weaker examples to evidence their integration and engagement activities, and disappointing reporting across the board (*see section 3*). **An average of 31% of all funds were unable to provide integration examples for any of E, S or G**. This raises legitimate doubts over whether the ESG processes described are being applied in practice. **This is a deterioration on last year (11%) and is concerning.**

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

	Active Equity	Fixed Income	Multi -Asset	Secure income	Real Assets	Private Markets
Number of funds	***21*** (-13)	***91*** (+30)	***41*** (+8)	***22*** (+11)	***27*** (+2)	11 (+6)
Environment	38 % (+5%)	29% (+8%)	41% (+20%)	32% (-)	59% (+54%)	45% (+45%)
Social	33% (-3%)	29% (+3%)	49% (+23%)	55% (-)	63% (+59%)	36% (+36%)
Governance	29% (-7%)	40% (+14%)	49% (+23%)	36% (-)	70% (+56%)	55% (+35%)
Any of ESG	24% (-2%)	21% (-)	41% (+20%)	27% (-)	56% (+56%)	27% (+27%)

Note: Year on year change indicated where data was collected in 2021.

31% of all funds were unable to provide integration examples for any of E, S or G.

This is a deterioration on last year and raises legitimate doubts over whether the ESG processes described are being applied in practice.

2 Climate change high on the agenda, but at risk of not being fully considered

In 2021 climate change took centre stage in the investment market agenda. With COP26 dominating headlines and TCFD requirements coming into force for the largest pension schemes, investors now require their investment managers to take into account and address climate change within their portfolios. However, our analysis shows that there is still room for improvement in a number of areas to ensure risks and opportunities are adequately considered.

Key climate change indicators	Active Equity	Passive Equity	Fixed Income	Multi-Asset	Secure income	Real Assets	Private Markets
Number of funds	*21* (-13)	*34* (+13)	*91* (+30)	*41* (+8)	*22* (+11)	*27* (+2)	*11* (+6)
Supports TCFD*	95% (+13%)	100% (-)	100% (+3%)	85% (-12%)	100% (+31%)	100% (+20%)	91% (+11%)
NZAM signatory**	62% (+30%)	94% (-)	86% (+32%)	78% (+31%)	77% (+19%)	74% (+22%)	27% (+27%)
Credible plan to support NZAM commitment	43% (-)	24% (-)	18% (-)	17% (-)	27% (-)	37% (-)	0% (-)
Consider physical and transition risk	71% (+30%)	n/a	65% (-17%)	63% (+13%)	82% (-)	67% (-1%)	64% (-16%)
Undertake stress testing	52% (+20%)	n/a	47% (+3%)	49% (-1%)	23% (-)	59% (+11%)	36% (-4%)
Able to report carbon data	86% (-5%)	91% (-4%)	85% (-9%)	63% (-16%)	23% (-)	41% (-11%)	9% (+9%)
Average coverage for carbon data***	95% (+6%)	97% (-)	73% (-6%)	61% (+11%)	50% (-)	51% (-17%)	70% (+70%)

Note: Year on year change indicated where data was collected in 2021.

* Task Force on Climate-Related Financial Disclosures.
** Net Zero Asset Managers Initiative.
*** Coverage means the proportion of the underlying holdings for which the given fund has carbon data available.

Availability of carbon data

We reported last year on the work needed to improve availability of carbon data. The results indicate that there has been progress in diversified private markets in particular, where last year no managers could provide this data. This is still an issue given the role this sector has to play in supporting a successful transition.

Most disappointingly the ability to provide data for equity and fixed income is slightly down on last year. As reporting regulations affect a larger number of schemes over time, we expect the ability to provide carbon data will start to become a critical factor in manager selection.

Firm level commitment to climate transition not supported by action at fund level

There has been an overall increase in the number of managers that are in support of TCFD and which have signed up to the Net Zero Asset Managers Initiative, which is really positive news as the importance of managing climate change risk is increasingly important for pension schemes.

However, when asked to provide further details on the steps taken within the mandate to support the firm level commitment to carbon emissions reduction, the proportion of managers able to provide strong evidence was significantly lower. We looked for managers to provide credible and robust steps or plan within the mandate, including for example interim targets, plans for engagement / portfolio construction process changes.

Growing focus on climate risk analysis

As part of the new TCFD requirements from The Pensions Regulator (TPR), the trustees of pension schemes that are within scope will need to carry out scenario analysis, in addition to reporting annually on chosen climate change metrics. In general we noted a higher number of funds that are now able to provide climate related stress testing and scenario analysis.

3 Reporting stands out as an area for improvement

We observed a fairly consistent lack of sufficient reporting capability on ESG issues. As investors place greater focus on ESG and sustainability factors, it will become increasingly important that funds are able to provide reporting on a broad range of ESG areas to support effective decision making.

Across the sub-rating areas, we found that the reporting had a significantly larger proportion of Red ratings than the others. In particular, secure income, diversified private markets and LDI scored poorly.

Key climate change indicators		Active Equity	Passive Equity	Fixed Income	Multi-Asset	Secure income	Real Assets	Private Markets	LDI
Number of funds		***21***	***34***	***91***	***41***	***22***	***27***	***11***	***12***
Reporting	Green	14%	62%	38%	17%	9%	7%	0%	0%
	Amber	71%	29%	23%	44%	18%	63%	36%	45%
	Red	14%	9%	38%	39%	73%	30%	64%	55%

Enhanced reporting on ESG issues is important both as a means of managers evidencing that they are fully considering ESG issues as expected, but also so that investors can make better informed decisions.

We appreciate this is an area of development and have had many promising conversations with managers recognising the need to improve here.

4 Alternative asset classes make progress, but risk of laggards remains high

Across secure income, real asset and diversified private markets, there were notably fewer funds which scored Green, and these asset classes had the highest level of Red ratings.

Source: XPS Investment

We've seen evidence of more managers developing proprietary ESG assessment scorecards and drawing on a growing number of external tools to inform their views. Hence the scores for Integration were relatively good versus the other sub areas.

The lower ratings for most funds in these asset classes were driven by stewardship and reporting, where these asset classes responded poorly compared to others.

However, our review indicated shortcomings in respect of other aspects, such as consideration of climate change. This is a critical aspect of long-term risk management, particularly in real estate, infrastructure, and secure income (where flooding or extreme weather damage directly impact financial viability) and so we want to see more managers proactively considering physical and transition risk.

Conclusion

Improvements in some areas have been offset by stagnation in others, but that said, we appreciate that a lot of effort is being spent in this area across the investment management industry. Our observation of areas that are in need of greatest attention are as follows:

- **Rising to the challenge of climate change reporting –** disclosure is critical for investors to make informed decisions which will ultimately have a bearing on real world issues. Related to this, with a transition alignment metric now added to the TCFD requirements it's vital that there is focus on utilising and reporting forward-looking metrics – to avoid reliance on reducing current portfolio emissions which may look good on paper but isn't necessarily in the best interests of the investor or society.
- **Greater engagement in private markets –** continued work by asset managers in secure income, real assets and private markets to consider ESG through the life of their investments. Notably we'd like to see more proactivity of engagement with all relevant stakeholders, including for example underlying managers/investment partners, and tenants.
- **Maintain awareness of the broader range of ESG issues –** whilst it is a critical issue to address, it is easy to get blinkered with climate change. As focus on issues such as biodiversity and social factors grows, investors will expect investment managers to deliver on a growing range of objectives. Providing more relevant examples is a key way that managers can evidence that they are doing what they say they are doing.

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 within their investments.

The following approach is a good start:

1. **Take XPS's free beliefs survey** to establish your board's views and use our Responsible Investment Framework to assess and enhance your approach. (click here to request our survey).
2. **Review** the managers in your current portfolio, taking advantage of our annual ESG ratings and more comprehensive sustainability report.
3. **Evaluate** the results against your desired approach.
4. **Engage** with underperforming managers.
5. **Monitor** managers for change within a reasonable period.
6. **Make changes** to your portfolio to reflect your objectives, including considering the 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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Alternatively, please speak to your usual XPS Investment contact.

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XPS Pensions Group is a leading pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 968,000 members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 51 with assets over £1bn.

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