XPS Investment

Investment Fund ESG Rating Review 2023

ESG integration becoming the norm, but work to do on engagement

October 2023

Contents

Introduction

2023 Fund ESG Ratings

To help our clients identify whether ESG considerations are appropriately embedded within their investments, we conduct an annual review of all our clients' funds. This is our 3rd annual report setting out a summary of our findings of this year's assessment in comparison to previous years.

As part of this year's review we have analysed detailed information provided by 53 investment managers covering 227 funds to understand their current approach towards incorporating ESG factors and climate change risk management into their funds.

This report provides a summary of our analysis and conclusions and illustrates how managers across asset classes are progressing in terms of their ESG approach.

ESG issues continue to dominate global affairs with environmental issues such as wildfires and flooding across the planet becoming increasingly prevalent. It is widely accepted that these events pose considerable risks for financial markets and therefore must be considered during the investment decision-making process.

During the last year there has been significant development within the asset management industry in relation to megatrend issues such as climate change, biodiversity, and social impact, with a host of new investment strategies emerging to target these issues. These strategies are encouraging and create a framework for investors to better tailor their strategy to reflect these topics and invest in solutions to these challenges.

However, it is important to take a step back and reflect on the basics of ESG integration – i.e. fundamentally considering ESG risks during the investment decision making process. We expect this as the minimum standard across all investment managers and consider those that do not effectively do this as having a material shortcoming in their approach.

This review focusses on the extent to which investment managers have made progress in relation to their ESG approach. Over time we expect managers who consistently fail to sufficiently evidence consideration of ESG issues to be replaced.

Our research highlights an overall improvement in approach to ESG this year – in comparison to relative stagnation last year. Whilst good progress is being made, it's important that managers continue to invest in the tools and resources to fully embed ESG considerations and effective stewardship into their process.

Alex Quant
Head of ESG Research

Executive Summary

1

Managers make progress as ESG integration becomes the norm

ESG integration becoming the norm 'Overall ESG' Green ratings increased to 36% (2022: 24%), whilst 'Overall ESG' Red ratings decreased to 1% (2022: 2%), indicating that managers are responding to the ongoing requirements of investors.

Green scores on Integration increased from 44% to 54%, showing the majority of managers now robustly embed ESG factors into their decision-making.

2

More focus needed on engagement to ensure quality outcomes

Despite the improvement on ESG integration above, 51% of fund engagement examples were rated Amber, indicating a general lack of positive outcomes resulting from engagement activities.

Across all funds, governance issues were the most common examples of engagement (average 24% of holdings), with limited focus on other 'E' and 'S' issues. Only 53% provided good evidence that diversity and inclusion was part of their engagement approach.

Across alternative asset classes there was limited evidence of engagement taking place.

3

The gap narrows on climate change reporting and analysis

33% of private market managers are now able to provide data on carbon emissions, whilst active equity managers providing carbon data fell 11%. This improvement in private markets is pleasing as this asset class has been less capable versus others in previous years. However, this improvement is from a low base and there remains lots of work to be done to fully evaluate climate risks.

Several high-profile managers withdrew from key collaborative initiatives in the year. However, across the investment managers within our review participation in the Net Zero Asset Managers Initiative remains high at 89%.

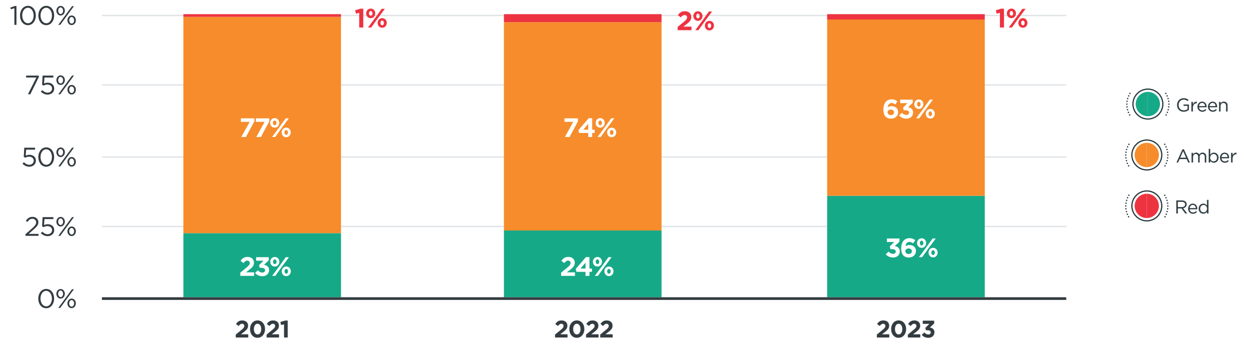
4

Private markets improve but from low base

There has been improvement in the approach to ESG within private markets as proportion of Reds fell from 18% to 7%. We also saw an improvement in ability to report carbon data as above, which has been supported by collective initiatives to address the challenges faced.

However, as evidenced by the fact no private markets managers rated Green, there is still work to be done to fully embed ESG.

All fund ratings



Source: XPS Investment

XPS approach to assessing ESG

As part of our comprehensive research process XPS assess and rate funds either Green, Amber or Red across eight key aspects: Parent, People, Product, Process, Positioning, Performance, Pricing 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 across all funds that the ESG rating be Amber or Green 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 in are consistent with their preferences on an ongoing basis. In addition, XPS provides tailored feedback to every fund manager on their ESG rating to highlight 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.

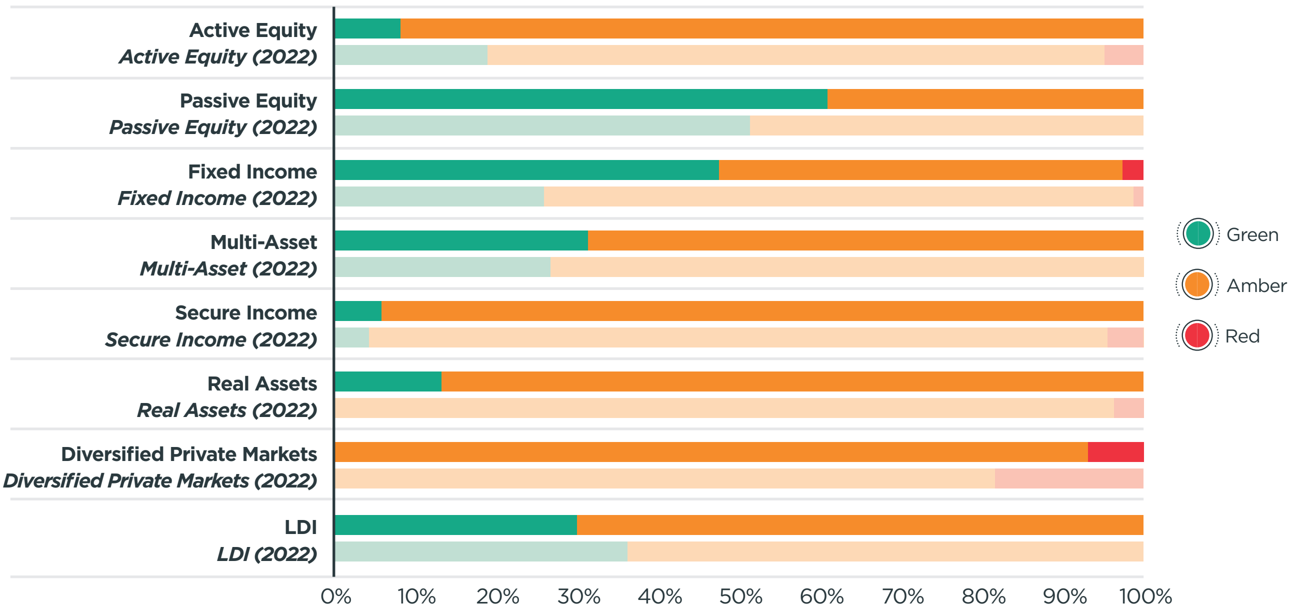
We request completion of a detailed questionnaire involving **over 70 questions** as part of our due diligence and score each question +1, 0 or -1 with the score weighted appropriately and combined to inform an overall score within each area. This then informs the overall ESG rating where an average weighted score of below -0.2 results in a Red rating, between -0.2 and +0.7 an Amber rating and a score in excess of +0.7 a Green rating, with qualitative oversight to ensure that overall ESG ratings are appropriate. We have not made any significant changes to our assessment framework this year.

We do not award overall Green ESG ratings to funds which score Red on any individual area, irrespective of how well the fund has scored on other areas.

Key findings

1. Managers make progress as ESG integration becomes the norm

Overall XPS ESG ratings for 2023 by asset class (compared with 2022)



Source: XPS Investment

We have seen an overall improvement in ESG approach compared to previous years. Overall, Green ratings increased to 36% (2022: 24%), whilst total Red ratings decreased to 1% (2022: 2%).

We believe this is a function of the ongoing dialogue we, and other investors / asset owners, are having with investment managers to reinforce the importance of embedding ESG.

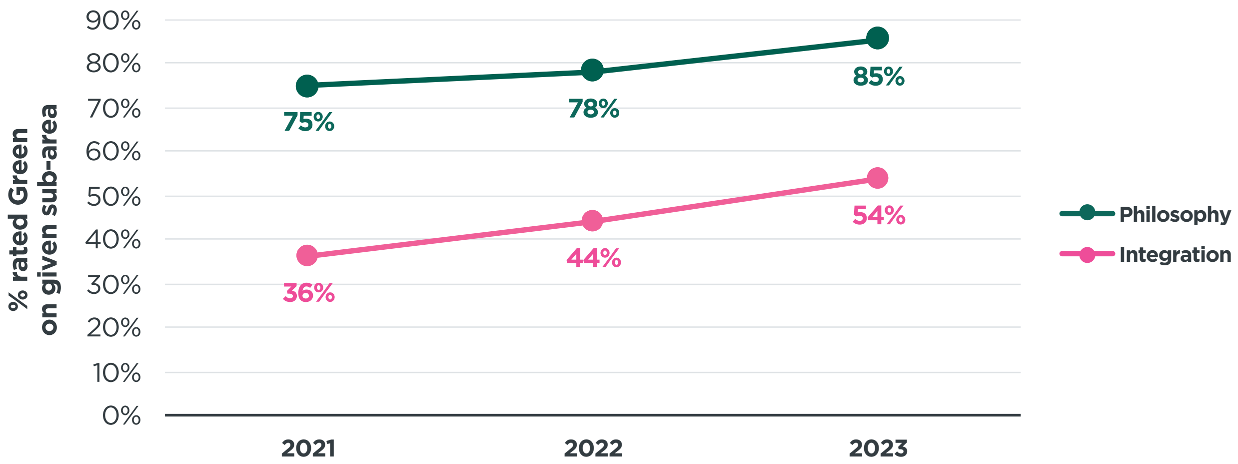
Last year we reported that there had been a fair amount of stagnation across the funds rated. However, as illustrated in the chart asset classes such as passive equity, fixed income, multi-asset and real assets in particular showed improvement compared to last year.

Integration scores show improvement to better reflect firm level commitments

We were encouraged by the responses to the 'Integration' section, which looks to understand how managers assess the ESG risks and opportunities facing investments and how this informs decision-making. Overall, the number of funds that scored Green for Integration increased to 54% (2022: 44%). This improvement was seen in all asset classes apart from Diversified Private Markets and LDI, which saw modest declines.

We have commented before on the risk of a disconnect between a manager's firm-level Philosophy (commitment and messaging around ESG, which has historically scored highly), and the practices within funds, and therefore it's good to see Integration improve, suggesting that firm-level policies are filtering down into fund-level action.

Integration score catching up with firm-level Philosophy



Source: XPS Investment

Managers must do more to evidence their actions in practice

Despite the improvement overall, in a repeat of concerns raised last year 23% of funds were unable to provide examples illustrating an E, S or G issue being taken into account. This is an improvement on last year where 31% of managers could not provide any example but is still too high.

It's critical that managers are able to demonstrate the decisions they are making to take into account key risk factors including ESG.

% 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	*12* (-9)	*82* (-9)	*35* (-6)	*17* (-5)	*15* (-12)	*15* (+4)
Environment	17% (-21)	22% (-7%)	31% (-10%)	12% (-20%)	47% (-12%)	33% (-12%)
Social	25% (-8%)	23% (-6%)	37% (-12%)	47% (-8%)	47% (-16%)	47 (+11%)
Governance	25% (-4%)	24% (-16%)	29% (-20%)	24% (-12%)	47% (-23%)	47% (-8%)
Any of ESG	0% (-24%)	22% (+1%)	26% (-15%)	12% (-15%)	40% (-16%)	33% (+6%)

Note: Negative year on year change in brackets represents an improvement, as fewer funds were unable to provide examples.

2. More focus needed on engagement to ensure quality outcomes

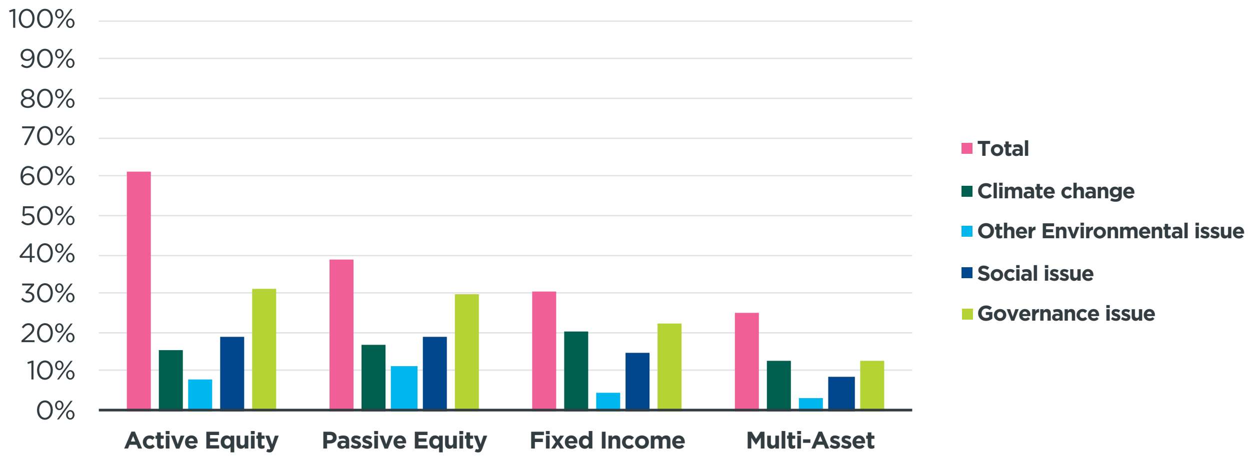
Engagement is a critical part of good investment management, helping investors better understand and manage risks with their investments, and good engagement is also seen as a key means of improving behaviours to drive value.

Our Stewardship sub-rating captures the quality of a fund's engagement and voting activity, and overall Stewardship Green ratings increased to 27% (2022: 22%).

Governance discussed more than E or S issues

We found that active equity managers had the most prevalent engagement activity (61% of holdings had been engaged with on an ESG issue), whereas multi-asset funds reported the lowest level of engagement on ESG issues at 25% of holdings.

Average proportion of holdings engaged with on ESG issues



Source: XPS Investment. Please note, managers in real assets, secure income and diversified private markets provided weak responses, hence have not been included.

Engagement on governance issues were the most common examples provided across all the asset classes. We've seen certain criticism of ESG factors being used to justify executive pay despite poor financial performance. In our view aligning renumeration to ESG outcomes is the right thing to do, but it requires choosing the right measures and genuinely challenging targets which encourage the right behaviours. Hence, we believe engagement and investor pressure on this topic needs to continue.

Conversely, other environmental issues in particular (including biodiversity loss and waste-water management) saw low levels of engagement. These are risk areas which are becoming increasingly well understood and therefore we hope to see engagement and action on these topics increase in future years.

Alternative asset classes struggle to evidence engagement

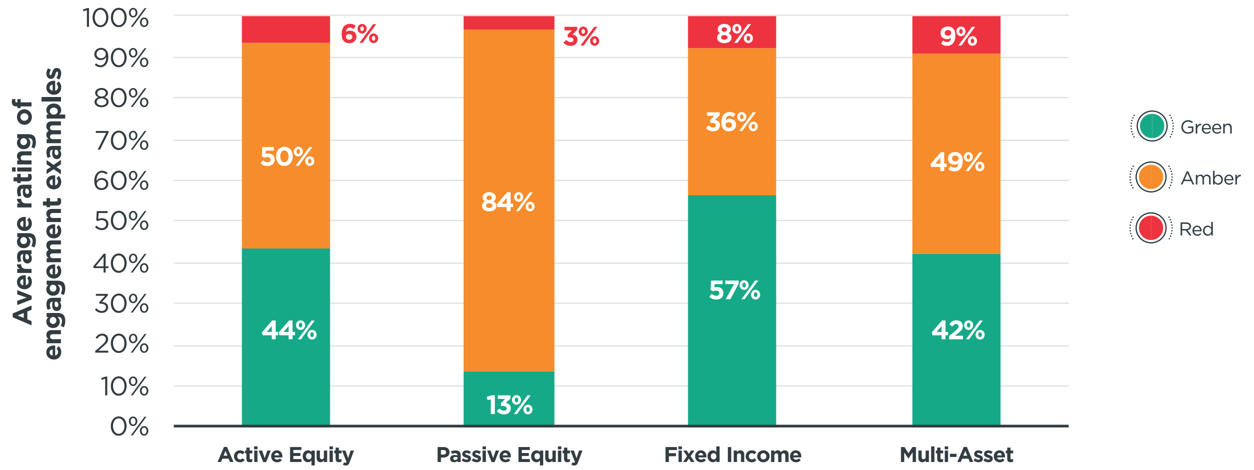
We note that managers in real assets, secure income and diversified private markets had the weakest responses on engagement, hence these have not been included in the above chart. Managers within this space face challenges around sparse ESG data and therefore engagement is even more crucial in order for them to fully understand the risks involved and to deliver value. We see the best managers within this space making a real effort to engage with key stakeholders and collect information at the point of initial investment but also throughout the life of the investment.

Quality vs quantity of engagement

Whilst it is important to engage across a material proportion of underlying holdings, investment managers must also ensure the engagements are meaningful and outcome-oriented i.e. identifying a material issue, setting targets for improvement and ongoing monitoring with escalation. Based on the examples of engagement provided **we observe that most engagements are not as comprehensive as they should be, with 56% of engagements being assessed as Amber or Red.**

Fixed income saw the highest proportion of Green-rated examples, however we continue to see examples of fixed income managers claiming that they are unable to engage as a bond holder, which is unacceptable.

Assessment of engagement examples



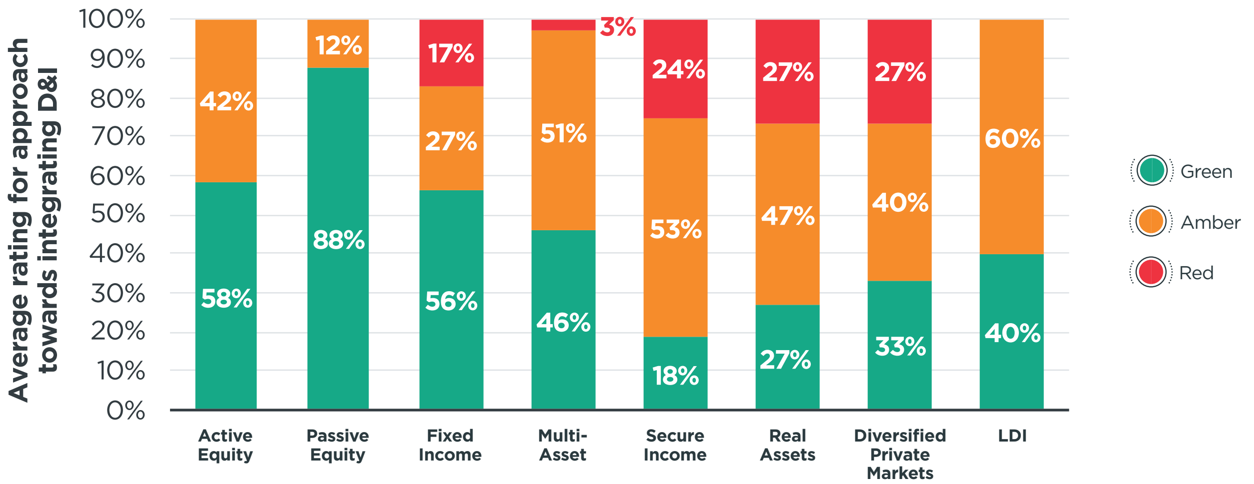
Source: XPS Investment. Please note, managers in real assets, secure income and diversified private markets provided weak responses, hence have not been included.

Diversity and inclusion needs attention

The Asset Owners Diversity Charter encourages investors and consultants to pay greater attention to how diversity and inclusion is considered by their managers. We found 53% of managers were able to provide evidence of good firm-level policies and targets in relation to diversity and inclusion.

Within their engagement approach, results were mixed, with passive equity managers scoring well, indicating this topic is well embedded into their conversations. Across all, only 53% of funds were rated Green here, with 12% providing no evidence it is on the agenda, suggesting there is much more focus needed.

Assessment of approach to integration of diversity and inclusion within engagement



Source: XPS Investment

3. The gap narrows on climate change reporting and analysis

Climate change continues to dominate the agenda across investment markets. COP27 brought a landmark deal to prevent 'loss and damage' and to provide funding to developing nations. Furthermore, Climate Change reporting requirements were extended to include pensions schemes with assets in excess of £1bn, meaning the expectations on investment managers increased, in terms of their ability to fully embed climate change analysis into their investment approach and to report risks and opportunities back to investors.

Associated topics such as biodiversity loss rose up the agenda as global targets were set at COP15 in Canada, and the Taskforce for Nature-Related Financial Disclosures (TNFD) framework for identifying biodiversity risks and opportunities was recently finalised in September 2023.

Key climate change indicators 2023

Key climate change indicators	Active Equity	Passive Equity	Fixed Income	Multi-Asset	Secure income	Real Assets	Diversified Private Markets
Number of funds	*12* (-9)	*41* (+7)	*82* (-9)	*35* (-6)	*17* (-5)	*15* (-12)	*15* (+4)
Supports TCFD*	100% (+5%)	98% (-2%)	96% (-8%)	100% (+15%)	76% (-24%)	100% (+3%)	93% (+2%)
NZAMI**	92% (+25%)	95% (-5%)	90% (-3%)	100% (+22%)	71% (-8%)	87% (+4%)	53% (+26%)
Credible plan to support firm level NZAM	33% (-10%)	n/a	21% (+1%)	26% (+9%)	24% (-7%)	40% (+6%)	27% (+27%)
Consider physical and transition risk	92% (+20%)	n/a	74% (+5%)	71% (+8%)	94% (+12%)	93% (+28%)	67% (+3%)
Undertake stress testing	50% (-2%)	n/a	72% (+21%)	60% (+11%)	18% (-4%)	73% (+15%)	20% (-16%)
Able to report carbon emissions data	75% (-11%)	93% (+1%)	90% (+1%)	86% (+22%)	18% (-8%)	60% (+15%)	33% (+24%)
Average coverage for carbon emissions data***	85% (-10%)	92% (-5%)	72% (-22%)	66% (+5%)	73% (+23%)	97% (+46%)	84% (+14%)

Note: Year on year change indicated where data was collected in 2022.

* 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.

Alternatives show improvement from low base on carbon emissions reporting

We have seen an overall improvement in the availability of carbon emissions data, with all asset classes improving over the year apart from active equity and secure income. It is surprising to see active equity decrease again, given we saw a reduction in 2022 as well; listed equity may anecdotally be seen as an asset class where reporting of carbon emissions data is widely available, but this emphasises that there are still managers who have not invested in their reporting and data capabilities.

Similarly, it's notable that **coverage of carbon emissions data has fallen in active and passive equity and fixed income.** This is concerning and requires engagement to understand the reasons for this as well as what managers are doing to improve.

We are **encouraged by an increase in the number of funds able to report data and the improvement in data coverage within multi-asset, real assets, and diversified private markets,** as these have historically lagged other asset classes. However, this increase is from a very low base, and there is still much work to do for these managers to get a full view of climate risk within their portfolios.

Climate analysis and stress testing more prevalent

Another positive improvement is the **increase in the number of funds that consider physical and transition risks** compared to last year across all asset classes, as well as **the number of funds undertaking stress testing.** This is vital as it facilitates managers gaining a greater understanding of the risks which exist, how they may impact the portfolio and what actions can be taken to mitigate.

We note recent wide-spread discussions concerning the credibility of stress testing being undertaken by investors under various climate scenarios. Well-recognised shortcomings have been highlighted particularly in relation to the financial impacts of physical risks in a high global warming scenario.

We would also question the inclusion of modelling of an 'orderly' climate transition scenario, as there are doubts as to whether this plausible anymore given latest lack of progress against the international commitments required to deliver such an outcome.

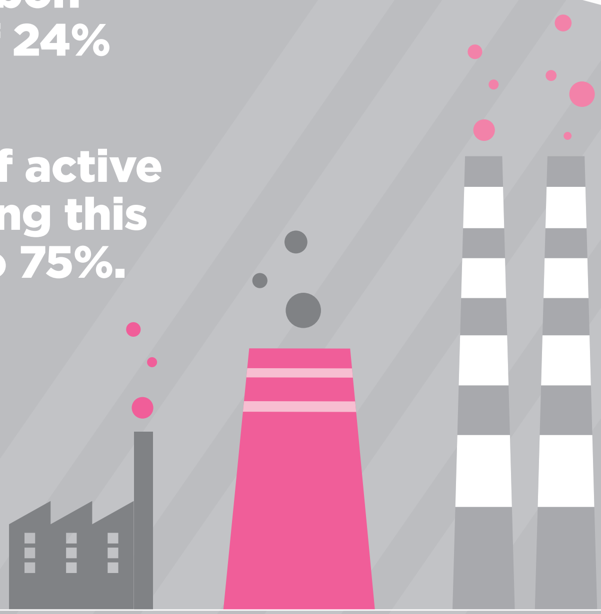
Nevertheless, it is **encouraging that more managers and schemes are carrying out stress testing,** and we have already seen that this is encouraging innovation into more reliable and useful modelling to inform decision making (notably the recent work undertaken by USS and the University of Exeter in developing a set of scenarios which look to focus on the short term to overcome some of the challenges experienced by others).

Industry initiatives see growing support overall

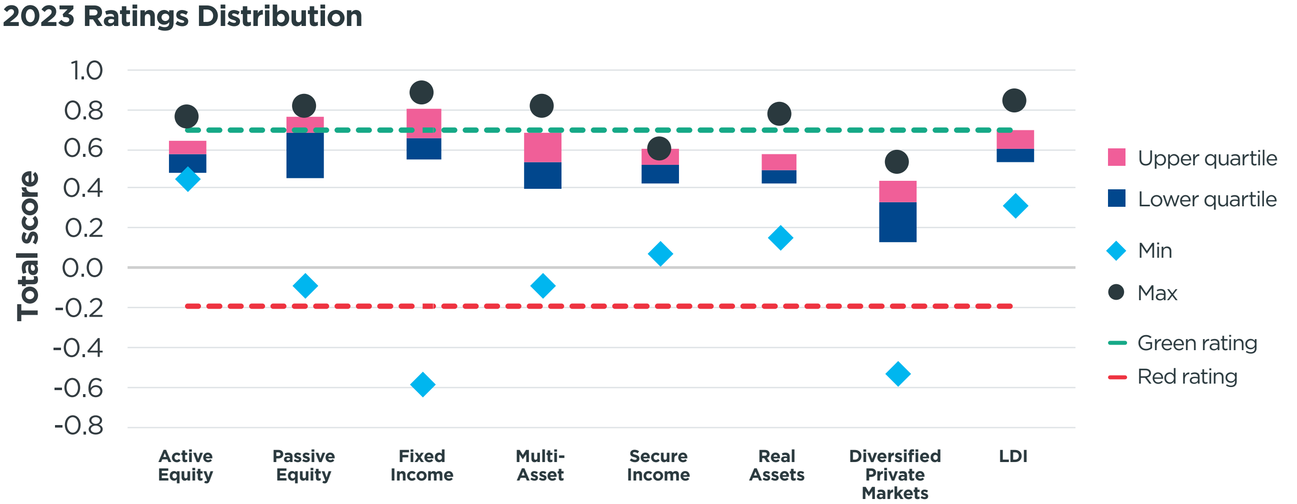
There have been a few notable cases of high-profile managers withdrawing from key initiatives such as the Net Zero Asset Managers Initiative, however **our results show support has increased across our manager base.** Industry collaboration is critical to ensuring global progress, including applying consistent pressure to particular companies which are essential for delivering the Paris Agreement but aren't yet taking the necessary steps.

33% of private managers can provide reporting on carbon emissions, an increase of 24% on last year.

Meanwhile the number of active equity managers providing this information fell by 11% to 75%.



4. Private markets improve but from low base



Source: XPS Investment

In comparison with last year's results, multi-asset, secure income, real assets, and active equity have considerably improved in their overall ratings and the distribution of scoring narrowed too. It's interesting to see fixed income emerge this year as having managers which are at risk of becoming laggards, due to a minority of poor performing outliers - this emphasises that thorough manager selection is important as appointing the wrong manager could have meaningful impacts.

We see an increasing number of private market managers that do take the issue of ESG seriously, as evidenced by the positive trend in scoring on Integration (Section 1) and Climate Change reporting (Section 3). These managers make concerted efforts to engage closely with underlying companies and form an assessment from qualitative factors in a more holistic way.

Nevertheless, it's clear that there is still work to do, in that there are no Green rated managers overall, and we observe relatively high proportion scoring Red on climate change, stewardship and reporting.

Summary of private markets funds' ratings across sub-areas

	Overall	Philosophy	Integration	Climate Change	Stewardship	Reporting
Green	0%	53%	33%	0%	13%	0%
Amber	93%	40%	60%	60%	47%	33%
Red	7%	7%	7%	40%	40%	67%

Overall, our hope is that the trend of improvement in this asset class will continue, supported by industry wide initiatives such as the ESG Integrated Disclosure Project (IDP), which promotes greater transparency in ESG disclosures for private credit.

Developments like this should lead to improvement in the quality and availability of data, by standardising requests. This will help to overcome key challenges relating to a lack of experience within the underlying companies on the ESG data points and the high costs currently required to provide the data.

We note that given the dialogue in relation to DC pension schemes and their expected increased investment into private markets, it's important that managers can demonstrate robust management of ESG risks to meet the needs of this investor group.

Conclusion

The results of our latest fund rating review demonstrate that there is progress being made with the overall number of funds Green-rated increasing. It's clear that the majority of investment managers are investing into their people and tools to continue enhancing their approach, and we are grateful for the ongoing dialogue on this issue. Going forward, we believe the following areas need specific attention:

Adding value through engagement

- Whilst most asset classes did show some signs of engagement, we saw the most engagement taking place on governance issues, and in the majority of cases the examples provided suggested the engagement taking place was not robust and outcome-driven.
- More engagement is needed on issues such as biodiversity loss, and diversity and inclusion.

Ongoing work to improve availability of data and analysis

- All managers need to invest in the tools and research capabilities to improve the collection of data on key issues like climate change and to facilitate providing investors with what they need to do meet their reporting requirements. This is particularly true for real assets and private markets where coverage remains low and many managers are unable to provide any data to their investors.
- We encourage investment managers to embrace the incoming Taskforce on Nature-Related Financial Disclosures (TNFD) and the Asset Owners Diversity Charter in order to provide more information on biodiversity and diversity and inclusion across their operations and portfolios.
- As more schemes look to climate scenario analysis to inform decision-making, the industry needs to recognise the shortcomings of existing models and develop solutions to address these. However, investors should not dismiss the importance of considering existing analysis which is available alongside other data points to form a holistic view from which decisions can be made to enhance portfolios.

Next steps for pension scheme trustees

1. Ask for XPS's free beliefs survey to clarify your preferences (here)	**2. Review** your managers in terms of their ESG approach	**3. Evaluate** the results in context of your beliefs
4. Engage with managers on key sources of risk and how they can be mitigated	**5. Monitor** managers periodically for progress	**6. Make changes** to your portfolio in line with your objectives

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

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