Personal Finance Society
Standards. Professionalism. Trust.

Good Practice Guide

MAY 2021

A practical guide to Sustainable Investing

In partnership with

Schroders

This paper is in response to members' requests to provide a summary of good practice within one source document and is based upon the Personal Finance Society's understanding of the regulators rules and current stance. Whilst a summary, it is not intended to be exhaustive and should not be relied upon at the exclusion of other sources of information.

Foreword

Keith Richards

Chief Executive Officer,
Personal Finance Society

We are hearing a lot about sustainable investment and ESG (Environmental, Social and Governance) considerations recently. It has left some asking about whether this is a significant change in financial advice, or just another passing fashion.

I think that there can be little doubt that we are looking at a permanent shift in the investment market, for three reasons:

- First, environmental issues are no longer seen as a drag on business, but as a disruptive technology that will open up new markets and stimulate economic activity. A survey by the CBI and PwC in 2020 found that 80% of financial services businesses have set ESG as a fundamental part of their strategic plans.
- Second, we live in a much more transparent world – the impact of regulation and social media combined means that it is far harder to keep secrets, and corporates' governance and risk management must be far sharper to manage regulatory risks. The UK Government has put the target of reaching Net Zero by 2050 which has an impact on all its regulatory activity.
- Finally, and most importantly, investors' attitudes are changing – research by the UK Government shows that 68% of consumers say that they would tick a box to indicate they would like their investment to be sustainable if given the choice to do so.

Much has been made about the changes to MiFID that will require a specific focus on ESG factors within the advice process, but we should remember that the current requirements for advisers already require ESG factors to be considered as part of the advice process:

- The FCA's rules on competence require advisers to be aware of ESG issues, and how to build client preferences into their investment portfolio.
- The FCA has also said that "clients' objectives… should be explored and considered by advisers, regardless of whether they are financial or non-financial goals" – giving the FCA the right to intervene if, at some point in the future, ESG issues are considered to have been neglected.

So everything points to ESG issues being an integral part in the advice process, now and into the future. This guide gives strong good practice guidance, not just about the technicalities of an ESG approach, but also about how to manage conversations about ESG with clients.

Investing for a more sustainable world

Social and environmental change is happening faster than ever. Global warming, shifting demographics and the technology revolution are reshaping our planet. In this fast-changing world, there are a growing number of investors who want to understand how social and environmental change is affecting their investments, and how the way they invest affects the environment and society.

Research indicates that the majority of investors believe they can contribute to a more sustainable world through their investment choices and that additional information from financial advisers would encourage them to allocate more of their investment portfolio to sustainable investments[1].

To help you meet your clients' needs, this guide covers the key things you should know about sustainable investing, including how to identify your clients' preferences.

Sustainability factors are a key consideration for people in the UK when selecting investments[1]:

52%

of people consider sustainability factors when selecting an investment product

61%

of people who believe that individual investors can significantly contribute to a more sustainable world by choosing sustainable investment products

Factors that people think would be highly likely to encourage them to allocate:

56%

If my financial adviser provided me with more, easy-to-understand information on sustainable investments

53%

If my financial adviser prompted me to put more money into sustainable investment

What is sustainable investing?

Sustainable investing is about generating returns that are sustainable into the future.

It involves considering more than just traditional financial analysis though. It is about also paying attention to how non-financial factors such as Environmental, Social and Governance (ESG) considerations may impact an investment's ability to generate long-term returns. The idea is that those actively preparing themselves for future risks and opportunities by recognising their social and environmental impact will have better long-term prospects than those that do not. Their ability to generate sustainable financial returns should therefore be superior to those that take a shorter-term view.

1 Schroders Global Investor Study 2019

Why has it become so important?

Social and environmental trends post increasingly significant risks to investments, to a point now where they can no longer be ignored. Moreover, it is increasingly being considered a normal part of fiduciary duty to clients to consider ESG factors.

People all over the world are becoming increasingly conscious of acting in the best interests of the environment and society at large. As a result, investors are increasingly looking to invest in a way that reflects these personal values. It is no longer about profits above all else. How a company makes its money is just as important as how much it makes. As a result, investors are demanding more from their investments; more transparent reporting, greater commitment to tackling social and environmental issues, and more concrete evidence of them having done so.

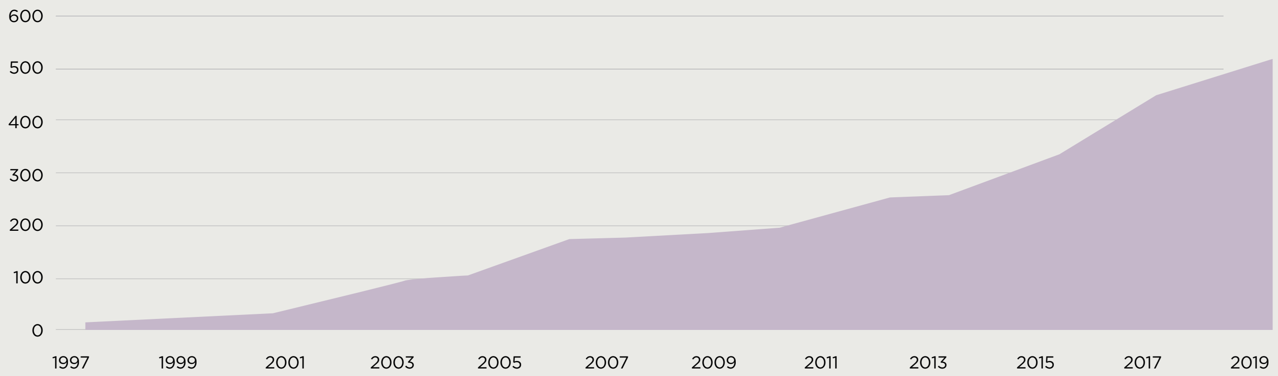
How does this affect me as an adviser?

With this rise in popularity has come an exponential rise in regulatory scrutiny. Regulations relating to sustainable investing have increased significantly as the chart below shows.

Arguably one of the most important regulations for you as an adviser is the proposed amendment to MiFID II. These planned changes will obligate you to incorporate a client's sustainability preferences into their suitability assessment. It will not be enough to simply tick a box confirming you have asked a client about their sustainability needs; taking sustainability considerations into the advice process will become a formal requirement that you will need to evidence to the regulator.

You need to first determine and record your client's sustainability preferences and take this into account, along with the other factors in your suitability assessment, when you make your recommendation. This will involve helping your client identify whether and how they would like to incorporate environmentally sustainable investments, social investments or good governance investments into their investment strategy. To be clear, sustainability considerations do not take priority over other suitability criteria, they are simply meant to be an additional way to provide insights into your client's needs. Based on this information, you can then start to recommend suitable products. You will also need to disclose all the ESG-related features of the products you propose and be able to show regulators that you have done so.

ESG regulations and amendments in the top 50 largest economies



Source: PRJ and Schroders as of June 2020

Asking the right questions

While ascertaining your client's sustainability preference is an increasingly important part of the advice process, it is also crucial that you form a holistic view of their underlying needs and desires.

For example, investors do not just invest to make money; they also invest for expressive and emotional reasons. The questions you ask your clients should therefore delve deeper into understanding these reasons and try to address their need for financial security, for nurturing their families, for staying true to their values and for gaining social status. Understanding these aspects will help you establish a more realistic and meaningful view of what your clients want to achieve with their investments.

The below chart will help you start to have those conversations and understand where on the sustainable investing spectrum your client lies based on their priorities and sustainability preferences.

Financial benefits → **Social impact**

Does your client want to maximise their investment opportunity set but ensure financial material risks relating to E, S or G issues are taken into account in the investment decision-making process?

Does your client have a preference for engagement and encouraging better ESG performance over divestment?

If yes

Integrated

Does your client only want to invest in those companies at the forefront of sustainability practices and stakeholder management?

Are there specific sustainability themes they would like to gain exposure to/ their investments to prioritise?

Are there specific investments or areas of the market they wish to avoid?

If yes

Sustainable

Does your client have religious, ethical or personal values that they wish to be reflected in their investments?

Are there specific investments or areas of the market they wish to avoid?

Do they wish to exclude companies directly involved in those areas or also those that they are indirectly involved?

If yes

Screened

Does the client want their investment to deliver a specific, positive, measurable social and/or environmental benefit alongside a financial return?

Is there appetite to potentially invest in private markets to achieve this?

If yes

Impact

Is your client most focused on maximising their social impact?

Are they willing to donate their money to good causes?

If yes

Philanthropy

Fund search considerations

Once you have determined your client's goals and which strategy is likely to best suit them, you can start to look for funds that meet their needs.

With a growing number of funds being launched under the broader "sustainable investing" umbrella, asking the right questions during this process to understand what different funds are trying to achieve is key. Here are some suggestions to start you off:

Integrated

Does the fund systematically consider ESG factors throughout the investment process, and if so, how does it do so?

Can the manager evidence this with examples rather than just using their status as a signatory to the UN PRI as proof?

Does the manager outsource the ESG analysis to a third party ratings provider or have they developed their own, more sophisticated approach?

How do they engage and what outcomes do they seek?

Do they have a voting policy? Is their voting record consistent with the voting policy?

Sustainable

Does the fund target a specific sustainability theme (e.g. environmental solutions, education, diversity) or outcomes (e.g. a lower carbon intensity)?

How does the fund positively select the best performing companies from a sustainability perspective?

How do the managers invest responsibly and hold companies to account?

Does the fund apply any exclusions? How are these determined?

Screened

Does the fund exclude investments in specific companies or activities?

How are these exclusions defined? For example, is a revenue threshold applied?

Are exclusions base on company exposure to a controversial activity throughout its entire value chain, or just during production?

Roughly how much of the benchmark is excluded from investment? What impact might this have on the fund's performance and risk?

Impact

Does the fund target a specific social or environmental impact/ outcome as well as financial returns?

Can the managers demonstrate a clear link between the capital provided and the positive social or environmental impact?

Do the managers clearly demonstrate and regularly report on the fund's impact?

Helping your clients make the right choices

Just because you have walked your client through these options, does not guarantee that they will make the right choices according to their overall outcomes.

You could consider the four-step EAST model to encourage positive and sustainable financial behaviour from your clients.

1. **Make it Easy.** Presenting your clients with default options helps; this has been proven effective in plans for pension contributions.
2. **Make it Attractive.** For example, encouraging a sense of civic duty in a client's plan can be very powerful, whilst being careful to attach financial incentive.
3. **Make it Social.** Within the constraints of client confidentiality, clients are more likely to support a plan if they have socialised it with the people most important to them. This is especially powerful in next generation family wealth transition planning, but it is rarely used.
4. **Make it Timely.** Immediate benefits encourage action. Just the feeling of having contributed to sustainability can help clients feel better very quickly.

Answering your client's questions

There are a number of myths surrounding sustainable investing. We expect your clients will want to know whether these are true or not, so here are some common questions and possible answers to support you with any 'difficult conversations'.

Is there a trade-off between performance and sustainable investing?

Sustainable investing is not about sacrificing financial returns. The goal is still to make money but in a more responsible, long-term way. While there are other influences (some of which may be outside a company's control) that will affect how well a company does over time, several academic studies have shown a connection between sustainability factors and improved performance. One study (Friede & Busch 2015) found that companies focused on ESG enjoyed, on average, enhanced financial performance, while analysis by Arabesque Asset Managers and Oxford University show that good sustainability practices positively impact share prices. Morgan Stanley has also done research that shows sustainable funds can help protect investors against downside risk.

Are sustainable funds expensive?

Historically, sustainable funds have been more expensive than their traditional counterparts because it used to be something of a niche area that required specialist skills. But now sustainable options have become more widespread and the skillset more prevalent. Sustainable funds have become more competitively priced compared to traditional funds, and in many cases cost the same as a traditional fund.

Must I avoid 'sin' stocks?

This is entirely up to you. With such a wide range of sustainable funds on offer, there is no reason why you should have to invest in a fund that does not completely align with your values and beliefs. If you want to exclude such stocks, you should focus on funds that screen for these types of companies and actively avoid investing in them so that you have nothing to do with them.

Should I avoid fossil fuels given the scale of the global climate challenge?

Again, this is entirely up to you. If investing in such companies is not in line with your beliefs then you can invest in funds which exclude investment in fossil fuels. If you do not want to exclude them entirely, but are still worried about the potential investment risks, you can always look at funds with an integrated approach to investing. Here, individual companies or activities are not excluded, but they are held at a weight that reflects their risk. Managers are usually committed to actively engaging with them to improve the sustainability of their business practices and corporate behaviour to mitigate potential risks arising from the negative impact they are having on the environment or society.

The important role of advisers

Sustainable investing is becoming increasingly popular as investors look for ways in which to align their investments with their personal beliefs.

As an adviser, you have an important role to fulfil; you can help your clients meet both their financial and sustainability objectives, and feel more engaged and emotionally connected with their investments. This guide should help you navigate this growing field, understand your client preferences and recommend investment options that best suit their needs and circumstances.

Adviser checklist – Top 5 tips

1. Start
a conversation with your clients on sustainable investing

2. Ask
your clients the right questions – understand their sustainability preferences

3. Record
your client's sustainability preferences

4. Search
for a sustainable investment solution

5. Present
your client with a sustainable investment strategy

Demystifying sustainable jargon

The field of sustainable investing has become a sea of acronyms and technical terms, which can leave investors confused. We've put together a glossary of some of the key terms to know:

2°C limit or "2 degrees"
It is widely agreed that limiting the average rise in global temperatures to less than 2°C above pre-industrial levels by the end of this century may help stave off the worst of the natural disasters associated with global warming.

Active ownership
Actively exercising your shareholder rights and engaging with investee companies to encourage responsible corporate behaviour and improve long-term shareholder value.

Carbon footprint
A measure of a group, individual or a company's total greenhouse gas emissions.

Carbon pricing
The cost of emitting CO2 into the atmosphere, either in the form of a fee per tonne of CO2 emitted, or an incentive that's offered for emitting less. Putting an economic cost on emissions is widely considered the most efficient way to encourage polluters to reduce what they release into the atmosphere.

Divestment
The sale of any investment related to controversial activities for social or political goals. For example, investors divested from South African assets during the apartheid era in protest against the regime.

ESG
Environmental, Social and Governance.

ESG criteria
A set of standards that investors use to screen potential investments. Environmental criteria consider how a company performs as a steward of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay and shareholder rights.

ESG integration
An investment approach that takes into consideration a range of environmental, social and governance-related risks and opportunities, in addition to traditional financial analysis.

Greenwashing
Falsely communicating the environmental benefits of a product, service or organisation in order to make a company seem more environmentally friendly than it really is.

Impact investing
Investments that are made with the intention of achieving specific, positive. measurable social and/or environmental benefits alongside a financial return.

Impact measurement
This is not the same as impact investing. It is the measurement of how companies' activities affect the world both positively and negatively. Schroders developed SustainEx for this purpose. It measures the effect on companies' profitability if their negative social or environmental impacts or benefits were recognised financially.

Screening
An investment approach used to filter companies based on pre-defined criteria before investment. As an investor, you can use a negative screen (in which you deliberately exclude certain companies because of their involvement in undesirable activities or sectors) or a positive screen (in which you select companies based on their sustainability practices). In the jargon, this can also be a "best-in-class investment" – where you only invest in companies that lead their peer groups in terms of sustainability practices and performance.

Sin stocks
Stocks of companies associated with activities considered to be unethical or immoral, such as tobacco, alcohol, gambling and adult entertainment.

Stewardship
An ongoing dialogue between shareholders and boards that aims to ensure a company's long-term strategy and day-to-day management is effective and aligned with shareholders' interests.

Transition risk
The financial risks that could result from significant policy, legal, technology and market changes as we transition to a lower-carbon global economy and climate resilient future.

UN Sustainable Development Goals (SDG)
A collection of 17 goals reflecting the biggest challenges facing global societies, environments and economies today.