

# Poor ESG investment standards are risking credibility

*Last year, the ESG Investing Olympics took place.*

*Colin Baines reflects on they revealed about the offerings available to charities*

**“WE FOUND A WIDE VARIANCE IN THE QUALITY OF THESE FUNDS AND THAT MARKETING CLAIMS WERE NOT ALWAYS ALIGNED WITH PRACTICE”**



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THREE CHARITIES, Friends Provident Foundation, Joffe Trust and Blagrave Trust, came together in 2020 to launch the “ESG Investing Olympics”, a first-of-its-kind, open, competitive tender for an investment mandate of £33.5m. The key instruction was simply to “impress us” on environmental, social and governance (ESG) integration and impact.

The scale of response blew us away, with proposals from 59 investment managers with combined assets under management of £15tn, and a great deal of interest from asset owners and press.

To shortlist five managers from the 59, we assessed the proposals against various indicators of ESG integration, including in-house expertise, stock selection, shareholder voting record, shareholder engagement and its escalation, exclusion policy and impact reporting.

The shortlist of five were invited to present at the Royal Institution to an audience of asset owners who share our desire to create impact through their investments, including charities, churches and pension schemes.

Cazenove Capital was declared the winner and the Cazenove Sustainable Growth Fund was launched in early 2021.

To help fulfil our objectives, we have taken our analysis of the 59 proposals and produced the ESG Investing Olympics – State of the Sector 2020 report. Our analysis of the proposals brings us to conclude that there are areas in need of urgent attention.

Growing demand is leading to exponential growth in funds that are labelled as impact, sustainable, responsible, green or ESG. However, we found a wide variance in the quality of these funds and that marketing claims were not always aligned with practice.

**“ Some proposals did not cover social issues at all ”**

We believe the priority for asset managers should be to address the most basic and serious gaps we found which, if unaddressed, risk the credibility of the ESG market. As such, we ask that asset owners, like endowed charities, utilise the report’s recommendations as minimum ESG standards in their asset manager tenders and reviews.

## THE STATE OF THE SECTOR

Some key findings from our report:

### In-house expertise

Most proposals claimed to have in-house ESG expertise but on examination few did really, especially relevant environmental and social experience, whether in finance, business, NGOs, academia or government.

The weakest proposals were totally reliant on third-party ESG indices and from asset managers with no in-house ESG expertise. This raised some fundamental questions around credibility and capability, and when

we looked at these funds’ holdings, we were not reassured about their ESG integration.

### Stock selection

The weakest proposals came from global equity funds that solely relied upon a third-party screen or solely excluded fossil fuels. We suspect most of these were rebadged standard funds.

A key finding from looking at stock selection is that the “S of ESG” is the poor relation of E and G issues. We found a lot of funds investing in sectors like technology, media, consumer, utilities, manufacturing and retail, many of which are high risk from a social perspective. Yet, manager’s integration of social criteria and engagement on social issues are observably far less well developed. Some proposals did not cover social issues at all.

High risk companies kept appearing in the top holdings of global equity funds, such as Amazon, an aggressive tax avoider singled out by the principles of responsible investment (PRI) for failing to substantively respond to engagement on the subject, and a regular subject of news coverage regarding poor working conditions.

The lack of consistent, comparable, data across a very wide range of issues was often cited for this poor integration. Social issues are often more difficult to integrate than environmental issues due to a lack of data, but we still found a wide range of standards.

### Voting

We found a very wide range of voting behaviour. The worst practice

we found was non-disclosure of voting record and outsourcing of voting with no accompanying ESG policy or instructions. Best practice included quarterly disclosure of voting decisions, including statements on votes against management, votes for and against independent ESG resolutions, and abstentions.

The best proposals we received could evidence high levels of support for ESG resolutions and votes against management as part of engagement escalation. The rationale for votes was also communicated to investee companies.

Very few asset managers had a presumption to vote in favour of ESG resolutions, but most stated they were willing to adhere to our investment policy that necessitates this.

### Engagement

Another area where we believe ESG market standards are not where they should be is shareholder engagement and its escalation.

Most examples of engagement provided were limited to letters or meetings, and too many relied on being signatories to collective engagement initiatives, primarily on climate change, as proof of active engagement.

The best proposals could evidence active and meaningful engagement programmes, from letters and meetings through to more forceful stewardship, such as voting against board re-elections and co-filing shareholder resolutions. Their engagement also went further than requesting better disclosure or distant targets to actual short and medium-term behaviour change.

Many managers lacked formal engagement policies and processes, and a large majority did not have an engagement escalation policy. Promisingly, some managers recognised that their engagement frameworks, particularly around escalation, were lacking, and offered to work with us on the development of those frameworks if they were to win the tender. Hopefully that recognition will be acted upon regardless of winning the tender.

Once again, proposals were poor on the “S of ESG”. Few included

evidence of any engagement on the priority themes identified in our investment policy, for example, fair pay, decent work, management diversity, and tax avoidance.

### Exclusions

Virtually all the proposals excluded fossil fuels, as per our investment policy. This is perhaps the most marked improvement we identified in the ESG market.

It was not long ago that the number of mainstream asset managers with exclusion policies could be counted on one hand, and raising the spectre of divestment at a conference could empty a room of asset managers. Now there are dozens of investment products and strategies that offer just that. This demonstrates that where mission-led asset owners prioritise, the market often follows.

“It would be quite incredulous to not divest coal and tar sands”

Whilst our policy is clear on fossil-fuel exclusion, the whole divest versus engagement debate is often disingenuous. The number of managers either divested or engaging on climate change meaningfully (science-led and escalating as necessary) are in a minority and it is that that needs to change. It would be quite incredulous to not divest from coal and tar sands immediately though.

But again, exclusion was another area lacking on the “S of ESG”. Those that did address it did so with a general commitment to the UN Global Compact.

### RECOMMENDATIONS

Based on these findings we produced the following recommended minimum standards.

- **A presumption to vote in favour of ESG resolutions**, taking a “comply or explain” approach with disclosure of rationale. Asset managers cannot make claims to ESG integration and engagement and then by default vote against their stated ESG objectives. They need to overcome any reluctance

to oppose management when necessary or any reluctance to support independent resolutions.

- **Active ESG engagement that goes further than disclosure or distant targets to effect real change in the near term.** For example,

on climate change, it should include net zero transition plans with science-aligned short- and medium-term targets. Memberships of third-party initiatives and signing occasional group letters are insufficient evidence of active engagement.

- **Engagement-escalation policy.**

Asset managers should produce clear policy around the escalation of engagement and how this might happen, for example voting against board re-elections, tabling shareholder resolutions and ultimately divestment, plus transparent disclosure on the implementation of that policy. Claims to ESG engagement are unconvincing without such a policy and a willingness to oppose management when necessary.

- **Integration of the “S of ESG”**

into stock selection and shareholder engagement. In general, social issues are more difficult to integrate than environmental issues due to a lack of consistent, comparable, comprehensive data across a very wide range of issues. For many asset managers this is exacerbated by a reliance on third-party data-driven indices. Asset managers need to develop greater in-house ESG expertise to be able to take a materiality approach and make judgments on the best available evidence, and must overcome an aversion to working with social and environmental NGOs.

- **Regular disclosure of all holdings, voting record and engagement activity**, including

statements on votes against management and votes for and against (and abstentions from) independent ESG resolutions, and disclosure of ESG engagement goals, methods of engagement and escalation, assessments of progress and outcomes against defined objectives. Examination of holdings and voting record is perhaps the easiest way for asset owners to sense-check whether ESG claims match their practice. This level of disclosure should be considered a minimum standard. ●