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Rollercoasters and regulators

Julia Dreblow considers the future direction for the sustainable investment sector

Sustainable investment and ESG have undoubtedly been on something of a rollercoaster ride recently. The novelty was starting to wane in some quarters a couple of years ago, but the war in Ukraine, the cost-of-living crisis and the 'US anti woke push back' took this to an entirely new level.

Having devoted my entire career to sustainable, responsible and ethical investment you may expect me to find this upsetting, and in many ways I do, but I am also somewhat relieved.

It is not unusual for investment trends to become 'frothy'. But seeing newcomers ignoring the complexities that others had carefully navigated for years was particularly galling - so while growing scale has been hugely welcome, storing up problems for the future was not. If you have seen me present you may well have seen one of my favourite slides, showing the evolution of this area – moving from ethical to environmental, sustainable, responsible, ESG, social and impact investment.

Like the proposed Sustainability Disclosure Requirements (SDR) fund labels, I refer to these areas as 'complementing not competing'. These are different strategies, with different objectives, intended clients and responses to real world business dynamics, risks and opportunities.

Complicated questions to answer

We all have personal preferences, but to imply that any single type of strategy or methodology is 'the answer' and without imperfections is naïve in the extreme and can only serve to reduce the cohort of potentially interested clients and undermine trust. The problems we face are so large and complex, and our responses so personal, that it is time to recognise, communicate and maximise the opportunities presented by real world complexities.

Perhaps the first concept we need to be more open about is that we need to differentiate between improved practices that are the result of changing business realities - namely the need to manage ESG risk and be better 'stewards' of the assets we manage - and explicitly focusing on solving environmental and social problems – sometimes called 'intentionality'.

The SFDR and SDR rightly focus on the latter, putting climate change front and centre because of its magnitude. (I am writing this as fires rage in Scotland and Canada - and New York is engulfed in haze).

Enabling better-informed decisions

The SDR allows space for environmental and social issues to be dealt with separately or together and for different levels of emphasis on engagement and stock selection with the proposed 'Improver', 'Focus', and 'Impact' sustainable fund labels. This makes sense not only because it keeps the door open for sustainable investors to pull all available levers, while helping clients to make better-informed decisions.

However, fund pickers would do well to recognise that funds that major on sustainability are not the only ones addressing such issues. Ethical funds will remain as relevant as ever. Their strategies may be different, but plenty of people still care about ethical issues (consider the rise of veganism and the concerns about gambling and football).

There is also no reason to assume exclusionary strategies are problematic, as some imply. While I am a big supporter of engagement, and want it to succeed, there is no good reason to push investors into assets that make them uncomfortable. Indeed, asset manager wide exclusions are gaining support. We recently added a 'Company Wide Exclusions' area to the fund

management company area of our database for that reason.

Considering all the risks

This line of thought reflects the EU's current DNSH ('Do No Significant Harm') disclosure deliberations - which are used to inform which assets may and may not form part of sustainable funds. And with Consumer Duty taking centre stage in the UK, it seems legitimate to consider how exclusions and the imminent 'foreseeable harm' obligations might interact. It is hard to see how assets that clearly cause harm might not come into question at some point, particularly if or when fires, floods and food prices increase further and asset values fall. There may be no simple answer, but any intermediary's decision to overlook such risks could easily prove problematic - as might flimsy questionnaires.

Likewise, the process through which ethical issues are subsumed into the sustainability agenda is also undervalued. While some ethical issues may always split opinions (eg nuclear, animal testing, pro-life) many have become firmly part of the sustainability agenda over time – although their 'labels' may have shifted. Some of the earliest ethical exclusions were the apartheid regime in South Africa (human rights, equality, inclusion), deforestation (nature/biodiversity/habitat loss), POPs (persistent organic pollutants – dangerous chemical pollutants) and PCBs (plastic pollution - microplastics). Lines shift. Ethical funds lead the 'best steer clear' school of thought today – although some sustainable funds are not dissimilar.

So, where are we now on rule making in the UK? SDR works are ongoing in the FCA. We are expecting to see output in Q3. There remain issues to resolve, as I understand it, around issues like labels (eg some love and others loathe the proposed 'Improver' label), the allowable 'not sustainable' percentages and portfolios.

Alongside this work and their international work on listings and more there has also been a recent paper on culture.

The need to better understand sustainability

The FCA's consultation paper CP23/1 'Finance for positive sustainable change: governance, incentives and competence in regulated firms' goes to the heart of one of the key stumbling blocks of SDR. If people understood sustainability better and accepted key concepts like the need for diverse investment objectives, real world business complexities and the fact 'perfect' simply does not exist, investors would be better placed to help avert environmental catastrophes and related social nightmares.

Progress undoubtedly requires shifting skill sets as well as incentives. The CP responses deadline has passed, but I would recommend reading it as it is unlikely to go away. Revisiting why speed matters, the widely reported warning that global temperatures are rising faster than expected and may breach the dreaded +1.5 degrees C this year - thanks in part to the El Nino effect – has concentrated minds.

More precisely - the World Meteorological Office said in May 2023: "There is a 66% likelihood that the annual average near-surface global temperature between 2023 and 2027 will be more than 1.5°C above pre-industrial levels for at least one year. There is a 98% likelihood that at least one of the next five years, and the five-year period as a whole, will be the warmest on record."

> “Regulators have a job to do, as do CEOs and specialist sustainability teams, but change needs to be far deeper than this. Everyone must be involved.”

This is the scary scenario we have been trying to avoid – relating to the Paris Agreement of 2015, which admittedly left some wriggle room (indicating +1.5 – 2 degrees centigrade). Many countries, like the UK, have been focused on getting to Net Zero by 2050 in order to keep temperature rises below +1.5, the point at which social implications become very serious - according to IPCC scenarios.

Sadly, 2050 targets may soon start to look a bit odd (if we are already at or around +1.5 C) and there is a risk that the investment community (and beyond) could suffer shocks that start to make DP23/1 look dated - as markets adjust to events. But let's hope not.

The other paper to look out for is the Treasury's 'Future regulatory regime for Environmental, Social and Governance (ESG) ratings providers. This area has, in my view, largely fuelled the ESG rollercoaster. Too often, data providers have assessed management of investee assets in house ESG risks (often focusing on governance – as discussed previously). Few have been open about data imperfections – investee companies have struggled to meet their demands for new 'data' – and placed insufficient emphasis (if any) on what companies (or funds) actually do – effectively rewarding mediocrity.

Asking 'better' questions

But again, this comes down to training and culture. Better-informed users would ask better questions and make better-informed decisions.

Drawing on our response to DP 23/1 (which is on our website) some suggestions include:

1. Financial services employees should be trained on and directed to focus on 'real world' issues, including the interconnectedness of environmental and social issues and investors.
   - We need to move away from sanitising sustainability with talk of methodologies - and start talking about WMO and IPCC reports.
2. The investment community must prioritise the biggest risks – and accelerate the necessary 'just transition'.
   - Nothing in this area is 'black and white'. Priorities will always vary (eg both homelessness and carbon matter) - but if we don't deal with issues like climate change and nature loss swiftly the level of suffering will be off the scale and markets will eventually fail.
   - We need to recognise why change has been so slow. Politics should not ideally come into this - but business dynamics certainly do. 'Incumbents' have fought change for decades for obvious reasons, and some investors thrive on extreme volatility – but most do not. Tails should not wag dogs. (Intermediaries beware).
3. Finance and investment organisations must manage ('govern') and remunerate people for better real world outcomes.
   - There must be effective sticks and carrots in place that encourage and incentivise positive, impactful and constructive activities and disincentivise (prevent) investors from causing harm.
   - We all have a part to play. Regulators have a job to do, as do CEOs and specialist sustainability teams, but change needs to be far deeper than this. Everyone must be involved.

And a final thought - we have not ridden this exact rollercoaster before, but it is familiar (history tends to rhyme). Sustainable investment was riding high ahead of the financial crisis – as it was in 2021 - but this time it is different. In spite of all the fine words, and in many cases actions, emissions have continued to increase as have temperatures - and people are more scared now. The science is also now better – as are the 'solutions' – and regulation is getting there. We may not be able to exit the rollercoaster onto terra firma just yet but I suspect many people would welcome the investment community helping us to move swiftly onto something a little less extreme.

The teacup ride might be nice.

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