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The second Sustainability Summit, chaired by UN Environment Programme's Butch Bacani, offered pension funds, insurance companies, charities and corporates the opportunity to learn from their peers about emerging trends in the sustainable investment industry. Sancroft Analysts Eilidh Morrison and Mariana Granziera share their highlights of this conference.

ESG ratings

There are enormous pressures on investors to incorporate Environmental, Social and Governance (ESG) considerations into the investment process. Nonetheless, this is not necessarily an easy task. It is even more challenging for smaller organisations that might not have the capacity, required skills or budget to develop a proprietary ESG framework. Primarily because of this, ESG rating frameworks such as Sustainalytics and MSCI have become increasingly popular as a solution to assess corporate performance across non-financial factors.

ESG ratings, however, are not a panacea. In fact, speakers shared their views – and scepticism – with using these tools as a sole resource to determine non-financial performance. One of the main issues discussed was the fact that different ESG ratings are often incomparable, as they aggregate information using different methodologies and can be subjective. This lack of consistency among ESG ratings was the subject of a recent article by Kate Allen, published in the Financial Times last December, where she sheds light on the lack of correlation between rating systems. A second key issue was the fact that ESG ratings don't provide information about how a company manages its risks. Therefore, the use of ratings can be misleading.

Despite this, ratings can be a valuable resource for investors. In fact, Justine Vroman (Pictet Asset Management) highlighted the power of using them as part of a broader framework with a more holistic approach comprising both financial and ESG factors. In this way, ESG can add value to the analysis of non-financial information.

Engagement

The key message of the day was: engagement is fundamental. Raj Shant (Newton Investment Management) was precise when saying that successful engagement with companies leads to higher returns.

Exclusion lists used as a method of ESG investing typically consist of countries, sectors or companies that should be excluded from the pool of potential investments. It was interesting to hear speakers' opinions on exclusion lists as it presents a simpler approach for the investor, as specific risks can be eliminated from the portfolio. However, for society more broadly, it might not be the ideal solution. The potential investment can find an alternative investor that does not operate the exclusionary principle and has a laxer approach, and the company or product will continue to operate or exist. Therefore, instead of immediately excluding certain sectors, investors should engage to see if they can achieve better social and environmental outcomes.

The main caveat on the day was the tobacco industry. Dr Rachel Melson (Tobacco Free Portfolios) gave a very interesting talk appealing for the exclusion of tobacco from investors' portfolios. In her view, tobacco is one of the few sectors where engagement as an investment strategy cannot win, as the ideal outcome would be to stop tobacco production. If a moral argument wasn't convincing enough, Dr Melson exposed three main business risks associated with the tobacco industry: emerging regulation risk, litigation risk, and supply chain risk.

Although exclusion lists can eliminate specific risks, the dominant message for investors was to engage with companies, with the aim that this will lead to higher profitability and better outcomes for society.

Impact Investing[1]

Impact investing is a concept that was formally introduced to the financial world just over a decade ago. However, it has quickly become increasingly relevant. John William Olsen (M&G Investments) and Dominic Byrne (Aberdeen Standard Investments) shared exciting challenges that their impact investing initiatives face. For more about challenges and opportunities in the impact investment sector, please have a read of Mariana's last insight Impact Investing: a decade on, what is missing to scale it up?

1 According to the Global Impact Investing Network's (GIIN) definition, as 'investments made with the intention to generate positive, measurable, social and environmental impact'

Pipeline was identified as a major challenge for this sector. Impact investors aim to allocate their capital into organisations that 1) offer financial return for investors and 2) deliver a benefit for society and/or the planet. Unfortunately, the number of companies that meet these criteria and investor requirements is significantly limited, further proven by the fact that a large number of companies in M&G's portfolio were also in Aberdeen's portfolio. As the transition to profit with purpose continues, the situation leads to two questions: first, are impact investors' investment models adjusted to the reality of social business? And secondly, what can be done to better prepare impact companies to receive an investment?

Reporting was another common problem stated by professionals in the impact investing industry. The lack of a common language and confusion over definitions, and the use of multiple frameworks and methodologies make it harder for impact investors to communicate impact in a consistent and comparable way. Although reporting is challenging, it is absolutely necessary to increase the profile and credibility of the industry.

Millennials, Gen Z and the next generations

There is no novelty in saying that Millennials and Gen Z have different aspirations from previous generations. Nonetheless, it is clear that the financial industry is not prepared to deal with the emerging objectives of these age groups. March 2019 was the month that children in more than 120 countries demanded cuts in greenhouse gas emissions. It is very unlikely that this generation will accept pension funds that are not taking climate change seriously enough. This begs the question: are pension funds in a good position to secure long-term benefits for their clients of the future?

Another issue that has been explored previously is the fact that young professionals are seeking purpose in their jobs. Are investors of companies with poor ESG credentials considering that their future workforce has different career aspirations? This was one of the questions addressed by John William Olsen from M&G Investments. The warning was that, in fact, the business-as-usual attitude will struggle to attract and retain young bright minds – this will be a major risk for investors.

Finally, but no less obvious, consumer preferences are changing. People today want products that do not cause harm to people or planet. In fact, there is a growing trend to buy goods that help address the most pressing issues of our time, for example reusable cups and water bottles to prevent plastic pollution. Investors that do not capture these emerging trends stand to lose-out and fail in the long-term.

Regulation

There is no doubt that tackling overwhelming issues such as climate change or human rights needs engagement and collaboration with multiple stakeholders, including business, government and non-profits. At this event, however, speakers had different expectations towards regulators. While some speakers called for more regulation, others suggested that there is already enough. Good regulation can be a very effective tool in encouraging the financial sector to move the sustainability agenda forward, however it often lacks enforcement. Undoubtedly complex, we need further analysis to develop the most effective regulation in the future.

The event concluded with David Rule's (Bank of England) keynote speech. In what was perhaps the most realistic reflection of the day, Rule was categoric in saying that the regulator should be careful while designing climate policies to avoid distortions in the market. Furthermore, he stressed the point that the role of the regulator was to raise awareness and guarantee stability, as we shift to a low-carbon economy.

The sustainability agenda continues to evolve in the finance industry, with emerging regulation, an increasing number of voluntary initiatives and high customer pressures. Sancroft continues to support financial services to design and operationalise ESG management systems, conduct screenings and deliver improvement plans, and help demonstrate responsibility. If you would like to find out more about any of our services, please get in touch.