Better insight into the impact of investments

A framework for transparency

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As the number of socially responsible investment funds grows, there are growing suspicions about just how sustainable these investments truly are. Consumers, regulators and other external stakeholders are asking more and more questions about the real sustainability of investments.

Some fund managers and institutional investors answer several of these questions by using their own methodologies to label certain investments as more sustainable and/or to demonstrate aspects of the impact of their investments (e.g. carbon footprint).

These methods have enabled them to make certain statements regarding the environmental and social impact of investments such as global warming, biodiversity decline and child labor. But they fall short of providing insight into the impact of the portfolio on a wide range of issues. In other words, they fail to provide the level of transparency that would enable stakeholders to assess the sustainability of their portfolios.

Providing insight into the overall impact of investment portfolios is challenging because there is often no data on the impact of the investments held in the portfolio (companies). The need for a framework that deals with these challenges is growing, and recently the Cambridge Institute for Sustainability Leadership (CISL) developed a framework that provides a solution.

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01 Why transparency matters

We recently saw some commotion on LinkedIn following a post by a responsible investment analyst about a socially responsible investment (SRI) fund that had been offered to one of his relatives, which had McDonalds as one of its top ten holdings. The fund's position in McDonalds was over four times as large as in the benchmark. This prompted a fair number of comments from responsible investment experts, investment professionals and consumers who hold positions in other SRI products. Some of these investors claim that McDonalds can be seen as a sustainable company because it provides food, which is a basic need. Others argue the same because of the company's efforts to reduce its environmental footprint. On the other side, a number of professionals and consumers state that fast food is not a basic need, that the ingredients that McDonalds uses (especially beef) have a substantial environmental impact, and that McDonalds did not provide good working conditions and wages for all of its employees. So they considered this position to be an outrage for an SRI fund. Whether certain investments could be considered 'green' is similarly open for debate with regards to virtually all investments and on numerous issues (e.g. 'are investments in nuclear energy green?').

In recent years, as consumers have become increasingly aware of the environmental and social impact that can be associated with investments, we have seen a steady rise in these types of discussions. They tend to focus on two places where consumers generally hold investments: directly at their fund manager, where they hold investments as a retail investor, and indirectly at their pension fund, insurance company and the like (hereafter referred to as: institutional investors). At KPMG, we recognize this at virtually all our clients in these sectors. Unfortunately, there is a severe lack of good data points on the number of questions received by fund managers and institutional investors.

It is disconcerting that up until now fund managers and institutional investors have been unable to adequately answer the question that underlies all these discussions: "Are my investments doing harm or good?" In an interview with the Financial Times, Paul Smith (the president of chief executive of the CFA Institute) was quite vocal on this point: "The next generation of investors – and a growing number in this generation – will not accept the absence of precise quantitative frameworks as an excuse for inaction."[1]

The significance of this question to end-clients can be illustrated by the fact that nowadays most large fund managers offer investment products that have been tailored to address these concerns, and the fact that many large institutional investors actively seek to report on how they try to reduce these impacts. These fund managers and institutional investors adopt one or more from a range of approaches and have named their policies and products accordingly. Examples of these approaches are: ESG integration, responsible investment, SRI and impact investment. All of them claim that their investments are 'a shade of dark green'.

This development is creating a landscape that is becoming more and more complex and difficult for consumers to oversee and understand. The complexity of this landscape can be illustrated by the outcome of an analysis conducted by Novethic 2 of the names of 396 investment funds with a label validating that such an approach has been adopted, indicating how complex this landscape has become (see figure 1 on the next page).

[1] Smith, P. (2018). The next generation of investors will demand action on sustainability. Financial Times

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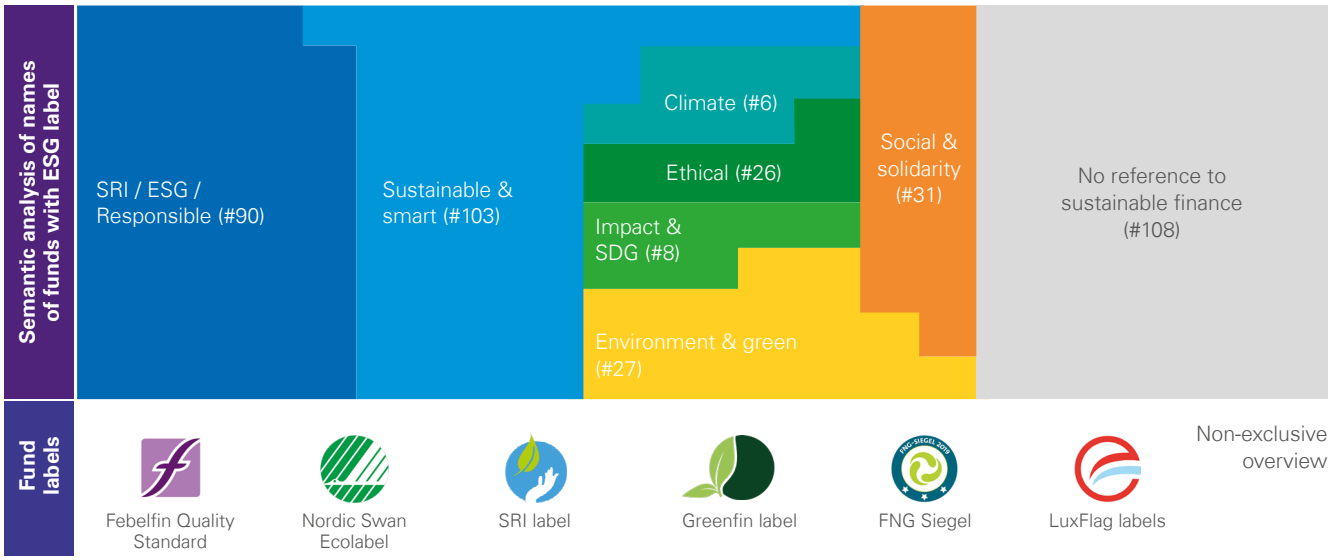
Figure 1 Summary of outcomes of semantic analysis of the names of 396 investment funds with a type of ESG label (adopted from: Novethic, 2019)[2]



The fact that so many fund managers and institutional investors claim to be 'dark green' is raising suspicions among consumers, advocacy groups and other stakeholders. To reassure these stakeholders that their processes and/or holdings meet certain (own) standards for responsible investment, an increasing number of fund managers and institutional investors are asking external auditors / verifiers to validate the correct application of these standards.

Investment funds are increasingly using ESG labels to confirm a certain level of transparency and to reassure investors about the nature of the funds in which they are investing. These labels are mostly private sector led but governments have also started promoting national labels, such as the national SRI label in France (see figure 1 for a selection of labels). However, as the number of labels increases, it is not always easy for retail investors to fully understand what is on offer, especially because labels are not adopting a uniform approach.

Labels or other common standards are not widespread among institutional investors. They generally ask external auditors to verify certain claims they make about the shade of green of their investments and the adoption of their own criteria for responsible investment. This makes it difficult for consumers to compare their sustainability performance.

[2] Novethic (2019), Overview of European Sustainable Finance labels

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02 The Regulators perspective

Confronted with discussions as about McDonalds stock, both consumers and regulators are becoming increasingly suspicious about just how sustainable many of the investments held in investment funds and by institutional investors truly are.

On a global level, regulators are therefore demanding that fund managers and institutional investors disclose additional information on how they integrate ESG factors, which investments they hold and the impact that can be associated with these investments. This has resulted in a sharp rise in the number of responsible investment-related policy interventions by regulators in recent years (see figure 2).

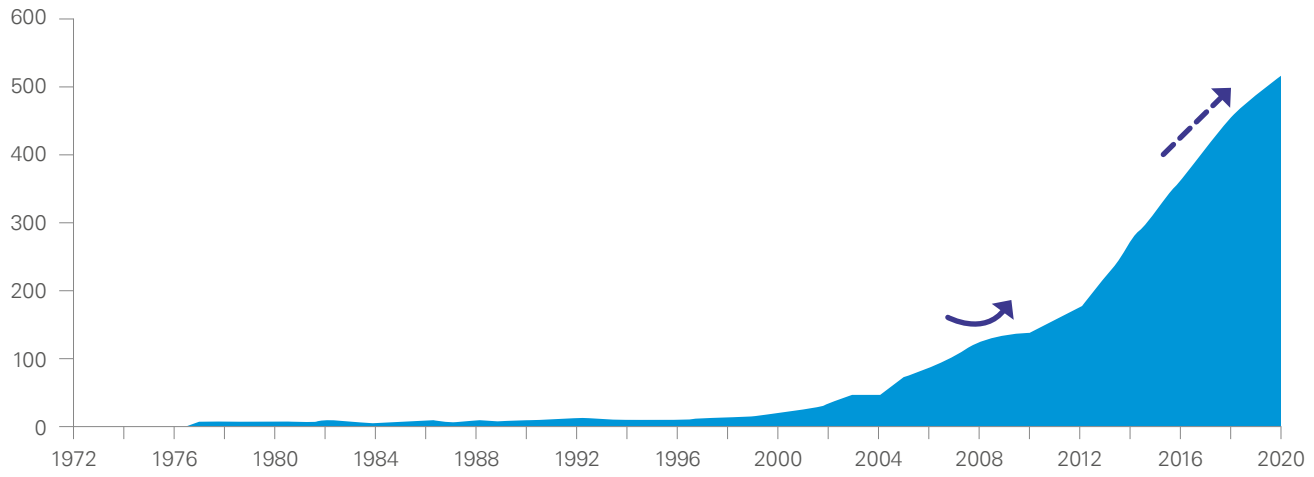
For instance, last year the European Commission launched an action plan for sustainable finance, which included a taxonomy that requires financial institutions to report and provide criteria on which investments can be categorized as green. Currently, this taxonomy only provides criteria on which investments can be considered green in relation to their contribution to global warming and the adaptation to global warming. However, in the coming years this taxonomy will be expanded to include criteria related to: (a) the use and protection of water and marine resources, (b) the transition to a circular economy, (c) pollution prevention and control, and (d) the protection of ecosystems.[4]

This action plan also includes other disclosure regulations that will require financial institutions to disclose information on certain other specific adverse impacts that can be associated with investments (e.g. human rights violations). The European Securities and Markets Authority (ESMA) has already stated that it will be embedding the review of the application of ESG considerations at the core of its activities.[5]

In the United States, the Securities and Exchange Commission (SEC) has recently sent examination letters to various firms offering ESG investment funds.[6]

In one letter the SEC sent to an investment manager offering ESG investments, the SEC asked for a list of the stocks the investment manager had recommended to clients, its models for judging which companies are environmentally or socially responsible, and its best and worst performing ESG investments, according to a copy of the letter viewed by The Wall Street Journal.[7] This indicates that the SEC is asking investment managers questions about how they assess whether the companies in their portfolio are scoring better on ESG factors and how they ensure that they meet the expectations of consumers.

Figure 2 Overview of the cumulative number of policy interventions (adopted from: UNPRI, 2019)[3]



[3] UNPRI (2019), Responsible Investment Regulation Map
[4] EU Technical Expert Group on Sustainable Finance (2020), Financing a sustainable European economy: technical report, Taxonomy - Final report of the Technical Expert Group on Sustainable Finance
[5] ESMA (2019), Strategy on Sustainable Finance
[6] Bloomberg (2019), The SEC Is Asking About ESG
[7] Wall Street Journal (2019), ESG Funds Draw SEC Scrutiny

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03 The issue for fund managers and Institutional investors

Many fund managers and institutional investors try to provide insight into how sustainable their holdings are, by using their own methodologies to label certain investments as more sustainable and/or demonstrate aspects of the impact of their investments (e.g. carbon footprint). These methods have allowed them to make certain statements about the environmental and social impact of investments. But they fall short of providing insight into the impact of the portfolio on a wide range of issues.

Fund managers and institutional investors have found it difficult to answer these questions in full, due to a lack of adequate, reliable, comparable, transparent and simple data. Since the societal impacts of investments differ, investors require a wide set of indicators to understand the overall impact of their portfolio. For instance, the societal impact of an equity investment in an oil & gas company would focus primarily on environmental impacts, whereas the impact of a pharmaceutical company is primarily related to access to medication.

Since many companies are still not reporting such information, this data is simply is not available or not for all the companies held in a portfolio. Another issue is that the data that is available is often less reliable than the financial indicators investors are used to working with.

There are several reasons for this lower reliability:

- companies do not always disclose the relevant non-financial data, which means research providers have to make estimates;
- inconsistencies in company disclosures due to the use of different measurement protocols, frameworks and/or scopes;
- less strong governance and internal controls for non-financial data compared with data containing financial information;
- and companies not always having assurance provided on non-financial data or a lower level of assurance (limited assurance).

In addition, there is often a delay in the availability of non-financial data. Most corporate non-financial data is disclosed as part of the year-end reporting. This means that data providers are only able to collect, clean and analyze this data later in the year.

The previously described challenges are creating the need for a pragmatic approach, since we cannot wait another decade for aggregated level investment portfolio reporting. We have to make a start now, so we can eventually progress to a reporting methodology that meets the needs of all stakeholders in the market. This vision is shared by the CISL[8], and the members of the Investment Leaders Group (ILG)[9] associated with the CISL.

[8] University of Cambridge Institute for Sustainability Leadership (2016), In search of impact: Measuring the full value of capital, Cambridge, UK.

[9] At the moment of publication the ILG consists of: AEGON Asset Management, AON, HSBC Asset Management, HSBC, La Banque Postale, Nordea, Nuveen, PIMCO, State Street, UBP and Zurich

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04 A clear framework from CISL

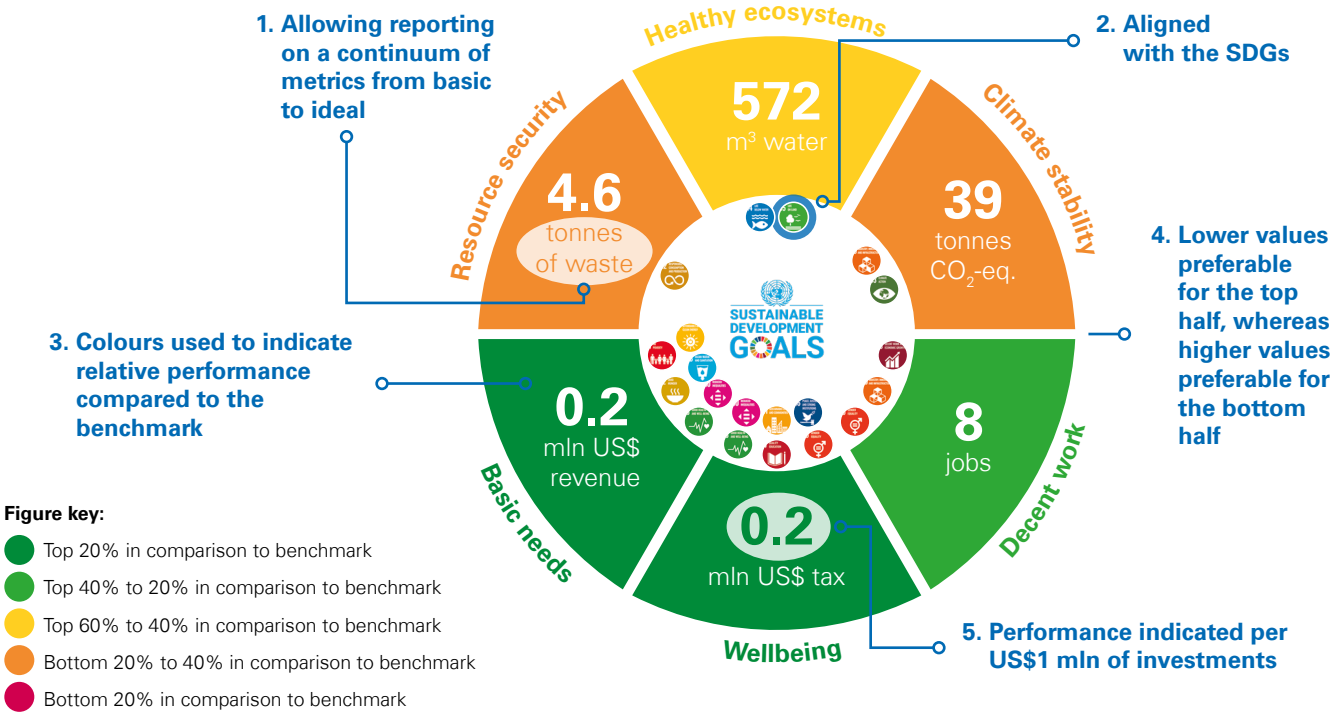
The CISL, in conjunction with a group of large institutional investors, the ILG, has developed a framework that provides a solution to the issue of data availability (see figure 3). Fund managers and institutional investors can use this framework to answer the questions from end-clients and regulators.[10]

The solution it provides is that it has reduced the wide range of impacts to six themes, three of which are environmental and three of which are social. For each of these six themes, the CISL has identified basic metrics for which the underlying data is already available via ESG data providers. The six identified themes have been derived from the universally acknowledged UN Sustainable Development Goals (SDGs).

It is important to note that the basic metrics identified are at best proxies of the impacts that external stakeholders are looking for insight into. For instance, to assess the sustainability of a portfolio on the theme 'climate stability' one would want to know which future warming scenario the portfolio is aligned with (in °C) based on the consumption of the global carbon budget by the parties in the portfolio, rather than the scope 1 and 2 greenhouse gas emissions (in CO_2e) of these parties. The CISL acknowledges this. However, reporting this information according to this framework would provide a start towards a complete answer to the aforementioned questions. The CISL states that the sub-optimal state of impact data should be a call to action for the whole investment chain.

Another important feature of this framework is that it requires an assessment of the portfolio's impact performance compared with the societal impact associated with investing in the benchmark of the portfolio. This is clearly communicated to the user of the information using color coding in a range from dark green to red. This helps stakeholders to evaluate the portfolio manager's performance on impact. It would also help if many fund managers and institutional investors were to adopt this framework, as that would allow stakeholders to compare their performance.

Figure 3: Illustrative example of outcomes Cambridge Impact Framework (adapted from: CISL, 2019) – highlighting key characteristics[10]



[10] University of Cambridge Institute for Sustainability Leadership (2019), In search of impact: Measuring the full value of capital. Update: Investment Impact Framework, Cambridge, UK

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05 How to adopt this framework

As one of the leading global audit firms, KPMG also plays a role in the investment chain and thereby in answering the questions asked by consumers, regulators and advocacy groups. Traditionally, our role has focused on providing assurance on the reliability of financial information, but nowadays we are increasingly reviewing the quality of reported non-financial information, such as the data required for the adoption of the Cambridge Impact Framework. We believe that the framework could become the industry standard for impact reporting on investment portfolios, since it: (a) fulfills the demand for insight into the sustainability performance of portfolios, (b) provides solutions to the aforementioned issues and (c) has been developed in collaboration with a set of recognized institutional investors.[6] Because of this conviction and our role in the investment chain, we would like to stimulate the adoption of this framework. To this end, we have developed a tool that can generate the overview depicted in figure 3 for any portfolio consisting of listed equities. Part of the fee for the use of this tool will be shared with the CISL, which will reinvest this in additional research into better proxies for the societal impact of investments. This will enable fund managers and institutional investors to provide greater insight into the social and environmental performance of their portfolios, in turn enabling retail investors and end-clients to understand and make informed choices regarding the impact of their investments. This would also shift the discussion from the inclusion of individual stocks to the overall impact of holdings within portfolios.

Be the first to receive our news regarding the new impact measurement tool by clicking this link.

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