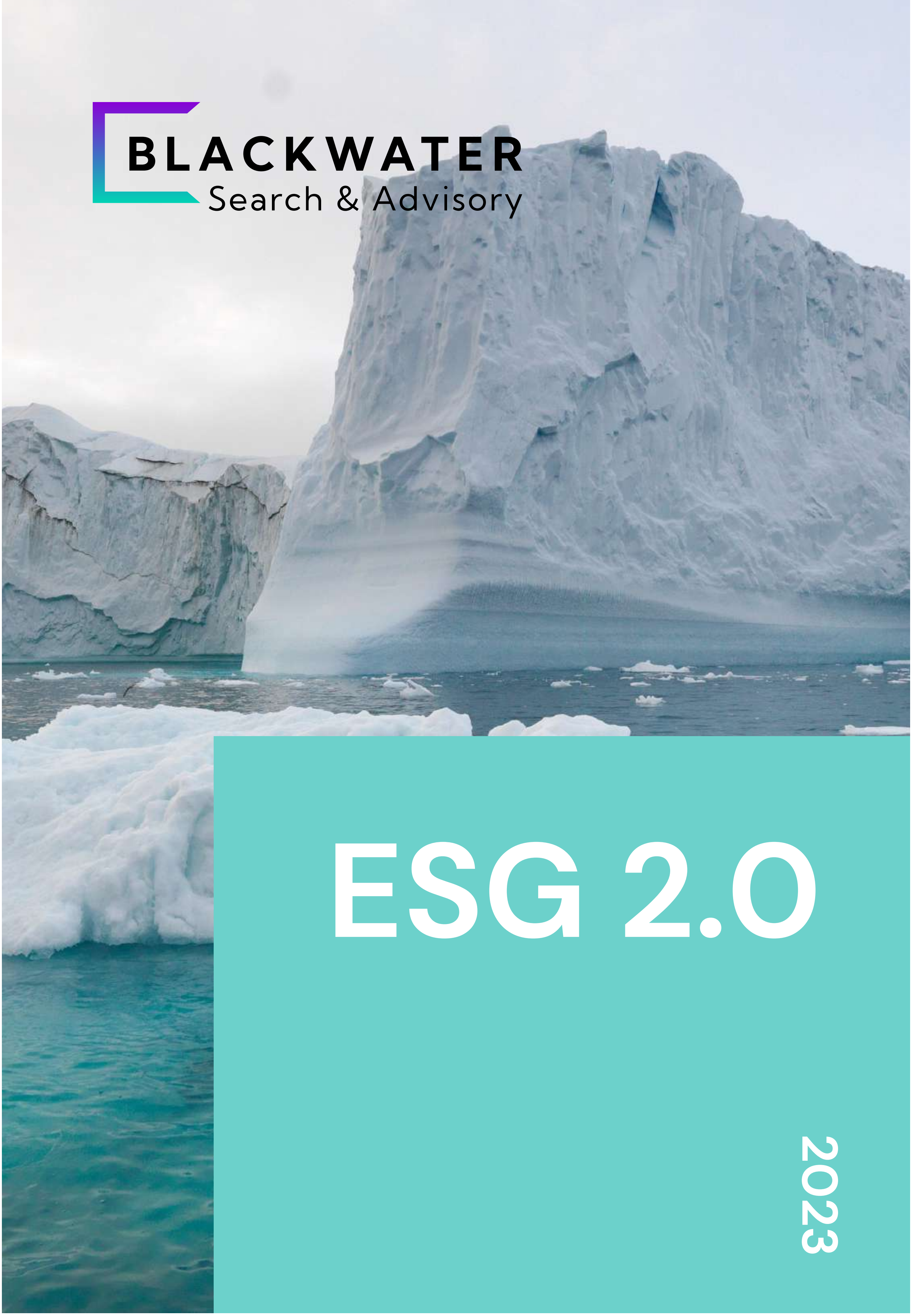


BLACKWATER
Search & Advisory

ESG 2.0

2023

INDEX

This comprehensive report is structured into three distinct sections, with each section dedicated to a thorough exploration of the primary issues pertaining to ESG (Environmental, Social, and Governance) investing, providing a comprehensive analysis of this evolving field in the financial landscape.

BLACKWATER Search & Advisory

ESG IS HERE TO STAY

PART I

ESG investing continues to advance and develop despite the challenging macro environment in recent years and outflows suffered year to date in 2023.

Increased regulatory focus, common framework development, and growing levels of investment into ESG teams and capabilities by asset owners and managers are all signs that this is a structural, secular movement that, although bound to experience dips and troughs, has a clear direction forward and upward.

2022 ushered in COP27, with positive outcomes on loss and damage and climate finance reforms.

The UN Biodiversity Conference (COP15) highlighted this key area for focus and development for investors and asset owners.

In the US, the gargantuan Inflation Reduction Act will have a huge impact on the development of the green economy, both in the US through incentives, and via pressure on other countries to increase support for local sustainable development.

Sustainable finance's structural growth therefore seems inevitable given societal awareness of climate change and the sector's role in funnelling capital towards mitigating its effects.

However quite a number of issues arose last year which exposed fissures in the ESG edifice, and perhaps poked a few holes in the prevalent narrative that investing sustainably and producing an acceptable risk adjusted return could be, at all times, co-incidental outcomes.

Sustainable finance's structural growth seems inevitable.

Wholesale SFDR downgrades, increasing political pressure on asset managers, issues with Net Zero commitments, criticism of stewardship & voting efficacy, litigation fears, and the war in Ukraine are just some of the concerns this note will examine in further detail.

Forward looking asset managers would do well to adapt to these concerns, and **investors will need to enhance their due diligence to allow them to identify those managers that are well equipped to deal with the ever-evolving landscape of sustainable investment.**

Sustainable investment professionals consulted for this paper were in agreement that despite recent growth pains, the industry is here to stay and no slowdown in adoption is on the cards.

The standardisation of disclosure, a focus on impact measurement from clients and regulators, and biodiversity were highlighted as important areas of interest going forward.

The issues most commonly raised as top of mind where related to the **lack of pace in corporate decarbonisation versus existing financed emissions commitments, the regulatory overload currently swamping sustainability departments** making thoughtful development challenging.

And finally, the **need for systematic engagement frameworks** to deal with the lack of efficacy and difficulty in attributing impact in this crucial undertaking.

A focus on outcomes in sustainability objectives, impact and engagement is clearly the direction of travel, away from the current prevalent process-oriented, 'box ticking' approaches which are also driving ESG fatigue at sustainability departments within asset managers and corporates alike.

A focus on outcomes in sustainability objectives, impact and engagement is clearly the direction of travel.

The crucial role of due diligence

The second half of this paper will focus on how due diligence needs to evolve to account for these concerns, on a company and product level.

There is increasing pressure on the delivery of effective ESG diligence due to complexity and variety of implementations in the industry, and the investment, reputational, regulatory, and legal risks associated with getting it wrong.

A high degree of ESG specific knowledge is needed within due diligence teams, and the lack of standards and clear definitions make knowledge gathering tricky.

ESG STRATEGY

This report recommends the following areas of focus for ESG due diligence on a company and product level.

This will help to identify the asset managers and products that are meaningfully engaging with the myriad issues identified earlier in the report, and are able to deliver truly sustainable outcomes.

COMPANY LEVEL AREAS TO FOCUS ON DURING THE DUE DILIGENCE PROCESS

- Firm approach to ESG integration into investment process & internal ESG ratings
- Greenwashing risk assessment
- Net Zero commitments and strategies
- Engagement processes, including voting records

PRODUCT LEVEL FOCUS AREAS SHOULD INCLUDE

- Strategy and sustainable objective definitions
- ESG integration and its influence on the investment strategy
- Methodologies, Data coverage, Impact measurement
- Portfolio holdings analysis to highlight outliers and incongruencies

GROWTH WILL NOT BE A STRAIGHT LINE

PART II

The last 18 months has been hectic year on many fronts, the war in Ukraine, increasing inflation across the world, and the poor performance of most asset classes excluding commodities which have performed well.

Despite the disruption, the ESG landscape has been evolving at a high pace in both international agreements and regulatory aspects.

Stockholm+50 took place five decades after the 1972 UN Conference on the Human Environment.

The event provided an opportunity to draw on 50 years of multilateral environmental action to achieve the bold and urgent action needed to secure a better future on a healthy planet.

Based on the recommendation of the Taskforce for Climate-related Financial Disclosures (TCFD), the SEC, in June 2022, unveiled ambitious plans for companies' climate disclosure rules.

In November 2022, COP27, the UN climate conference had mixed reviews.

It did deliver though in areas such as the need for funding for loss and damage, the increased awareness of the danger of greenwashing and finally the emergence of food and agriculture in the agenda.

An estimated $369 billion will be spent in order to address energy security and climate change over the next 10 years.

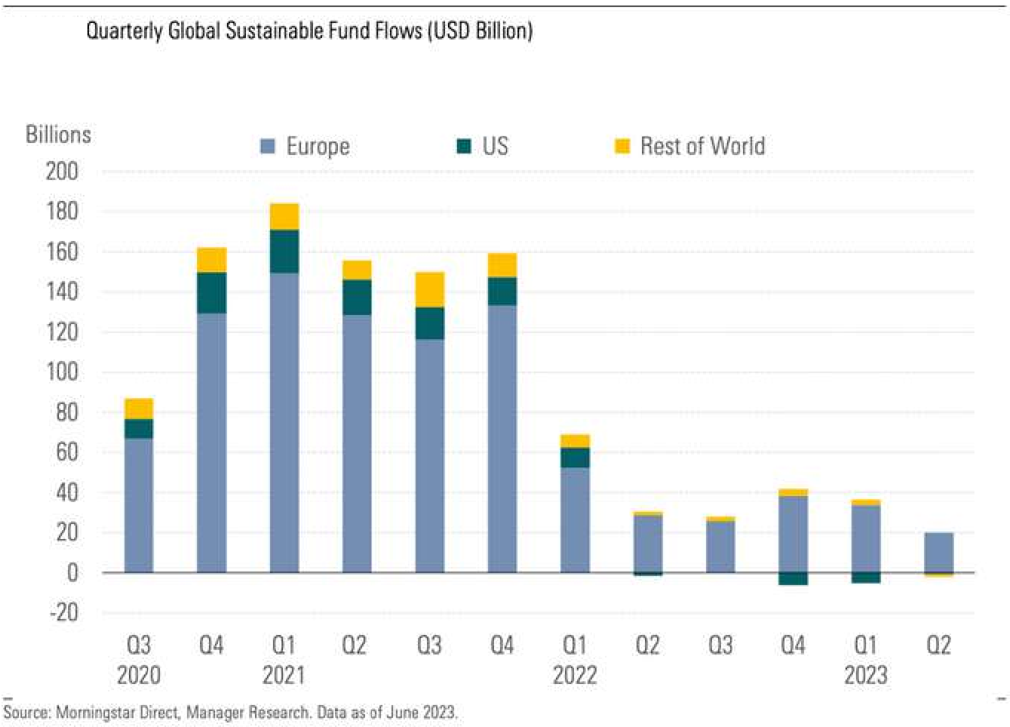
Biodiversity has been discussed at length during COP15, its outcome includes a target to protect 30% of nature on Earth by 2030, up from the current level of 17% (2020).

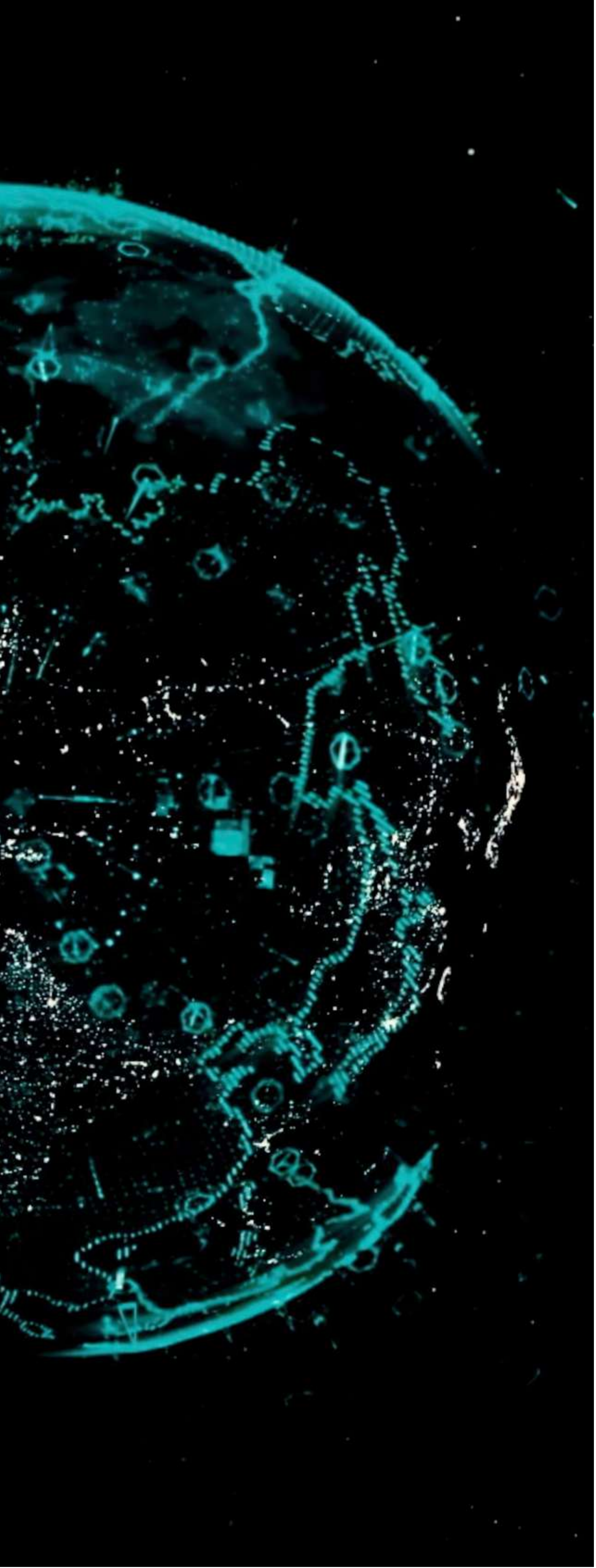
On the financial side, during summer 2022, the U.S. Congress passed the Inflation Reduction Act (IRA), combining a wide array of clean energy tax incentives.

Under this new law, an estimated $369 billion will be spent in order to address energy security and climate change over the next 10 years.

ESG demand from investors continued to be strong despite the macro environment, and also regardless of the performance struggles of many ESG funds given the super normal returns to the energy sector during the year.

Quartely Global Sustainable Fund Assets





The ever-increasing available amount of data, along with the tools to interpret them is giving greater transparency to asset managers to verify how companies are addressing ESG areas including the energy transition.

In terms of ESG growth into novel asset classes, liquid alternative strategies that incorporate ESG have also been developed.

An especially important tool that liquid alternatives offer is the ability to short poor ESG stocks.

Iliquid investments have been popular within institutional investors and we have seen an increased number of illiquid funds with an ESG flavour.

Impact private equity, green infrastructure and green real estate are now available to investors looking to diversify their return and build strong long-term portfolios.

2022: The beginning of cracks in the façade?

After many years of solid asset growth, enthusiastic uptake by asset managers, and a narrative that assured investors that it was possible to invest sustainably without jeopardising returns, 2022 witnessed quite a few cracks in this happy façade.

Signs, possibly, that some of the contradictions and tensions that previously had been swept under the rug by the industry had come to light, exposing some of the deep-rooted issues that need to be addressed to advance sustainable investment to the next stage.

To recap some of what we've seen:

1 SFDR downgrades

Ahead of tightening SFDR regulations many asset managers have been forced to downgrade billions of assets in SFDR 9 products to the more lenient SFDR 8 designation, largely because of the obligation for 'dark green' products to be invested in 100% sustainable investments[1][2].

For example, SFDR 9 Funds utilising Paris aligned benchmarks were in a tough spot as the underlying holdings, despite being Paris aligned, were not necessarily completely sustainable in their activities.

These downgrades point to two issues – one is that asset managers were hasty in their green labelling activity and may have cast their net too wide (as also attested by the number of greenwashing claims seen this year, more below), and this retrenchment will not add confidence for clients when picking funds.

In addition, this raises the question of whether the SFDR labelling regime has serious design flaws.

Attracting funds to companies that are Paris aligned is surely a desired outcome of regulators, however, the SFDR labelling framework does not deem them as such.

Is the SFDR regime aiding or hindering capital allocation into sustainable companies?

The FCA's SDR labelling regime (currently in consultation), with its 'Sustainable Improvers' label, is more flexible in that respect, and should allow labelling 'brown to green' economic activity as sustainable investment, which is, in reality, the most pressing social requirement.

2 Political pressure over Asset managers

Asset managers have seen enormous political pressure (especially in the US) regarding their ESG activity, with criticism both from the right and the left on their investment approaches.

Asset managers are performing a delicate balancing act trying to appease calls from them to concentrate solely on return generation whilst not imposing top down so called 'woke' views on their clients potentially eroding returns, vs. claims that they are in fact, not doing enough on the climate side and are in effect involved in greenwashing activities.

In reaction, some asset managers have been leaving initiatives like NZAMI and GFANZ[1], and those that stay have enacted changes to the commitments embedded in these associations to make them more palatable (and less restrictive).

In **response to pressure from JPMorgan, and Morgan Stanley GFANZ has broken ties with the UNs Race to Zero[4], viewing its net zero protocol to be too restrictive.**

Lenders are wary of signing up to strict limits on funding activity for fossil fuels especially in an environment of rising energy prices and incentives to invest, as well as exposing themselves to litigation from clients and breaches of antitrust litigation[5].

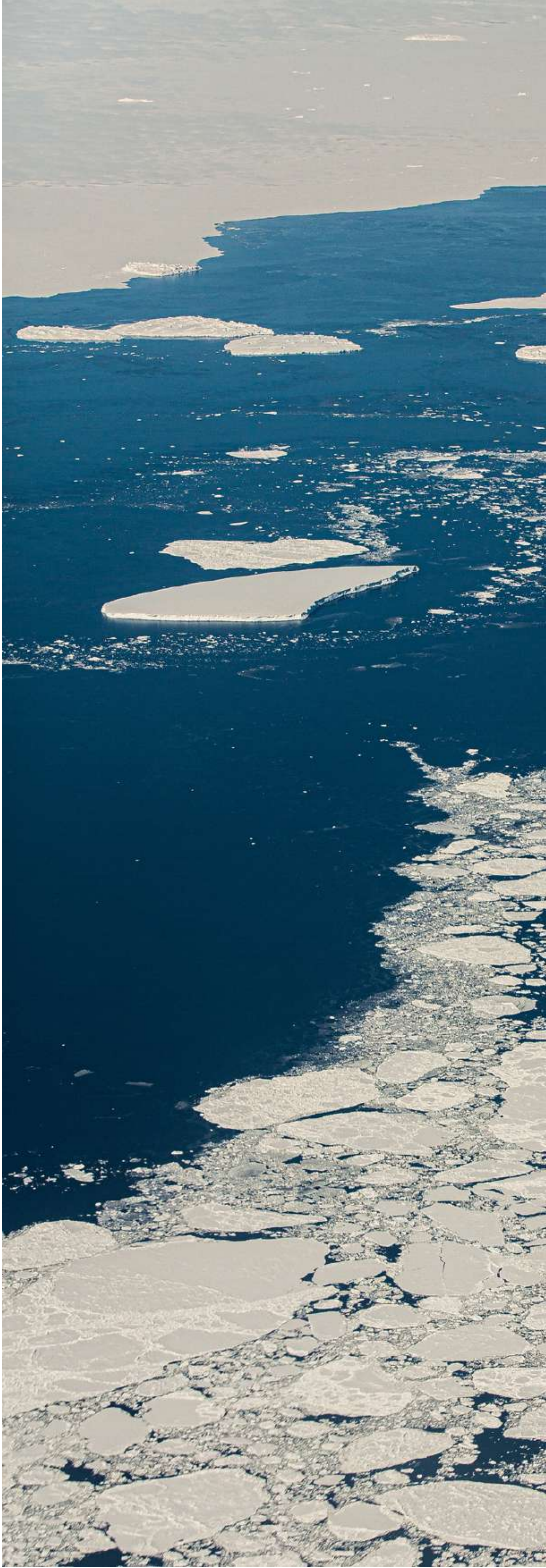
3 Blackrock

Blackrock is the weathervane for the direction of travel in ESG investing, being the largest asset manager and one of the more vocally committed to ESG, **especially via its CEO, Larry Fink.**

Its travails are a clear illustration of the delicate balancing act large asset managers must perform.

Given the aforementioned political pressures on the industry there has been some softening of Blackrock's language around ESG objectives and commitment.

In addition, their voting record has been criticised as not being consistent with their stated intent.



Statements coming from Blackrock concerning the Texas ESG meetings certainly de-emphasised Blackrock's commitment to decarbonisation[6], as has their recent voting record[7].

A UK manager even called for Mr. Fink to resign due to the "contradictions and apparent hypocrisy of BlackRock's actions"[8].

In the meantime, Florida stated it will pull out $2b in state pension funds from Blackrock for being too green, in their view.

4 Greenwashing investigations

Whilst greenwashing claims have been a constant backdrop to the ESG investment industry, 2022 saw a ratcheting up of the focus by regulators on perceived greenwashing activity in multiple jurisdictions.

On top of tightening regulations from the SEC, the FCA and the EU, we've also seen DWS investigated in the US and Germany (and its CEO departing due to the allegations), HSBC tapped by the UK's advertising watchdog on greenwashing in its advertisements, and Goldman Sachs investigated by the SEC.

There is clear regulatory intent to expose and weed out these practices, and responsibility for missteps will lie at the highest level, as we've seen with DWS.

Furthermore, investors, climate NGOs and other groups are starting to utilise the legal system to take corporates to task on their ESG claims and activities[9].

Whilst most of the action so far has been outside the investment sector, it stands to reason that complaints against managers from both sides of the fence will increase.

One recent example is a suit against one of the UK's largest pension plan regarding its failure to divest from fossil fuels[10].

Pension funds in the US could be litigated against if they suffer losses derived from divestment.

Civil suits on corporate greenwashing (as we've seen with Oil[11] and Agribusiness, amongst others) may well extend to asset managers.

5 Ukraine

The war in Ukraine has also exposed fault lines within the industry.

Not least regarding methodologies for country ESG rankings and the high AUM of Russian securities in ESG funds prior to the start of the war[12], but also on the effect of high energy prices on sustainable approaches to investment in the energy complex.

Fully divested portfolios from oil stocks would have suffered enormously from the negative exposure.

Would clients abandon those managers that excluded oil from their strategies?

Would clients appreciate that in the short term being 'good' has driven underperformance?

Would new concerns like energy independence (as well as defence spending) drive a readjustment in attitude to these sectors?

"One year's underperformance doesn't take away from the validity of a long term short on the fossil fuel energy sector" Brunno Maradei, Global Head of RI at AEGON.

One year's underperformance doesn't take away from the validity of a long term short on the fossil fuel energy sector.

Brunno Maradei,
Global Head of RI at AEGON.

6 Engagement & Voting record controversies

Investors, NGOs and academics are turning a spotlight on managers' voting records and their level of alignment with stated sustainability objectives.

See for example, ShareAction's criticism of CA100+ engagement record[13], and voting practices both by ShareAction and Majority Action, especially of the large US asset managers showing a fall in the number of ESG resolutions voted for in 2022 versus 2021[14].

A study by Gita Rao as highlighted how some large ESG funds voted against almost all environmental and social resolutions over the time examined[15].

7 ESG vs. Sustainable investment

'ESG is a tangled concept' says Brunno Maradei, Global Head of RI at AEGON.

There is a large degree of misunderstanding, and many definitions of what ESG investing is and should be.

Voices such as Tariq Fancy, and engagement focussed managers like Engine No. 1 in the US are highlighting the fact that framing the buying and selling of securities in the secondary market as an action that has some real-world impact with attendant sustainability credentials is greenwashing.

Claims that these transactions can influence firms' cost of capital haven't been robustly proven either[16][17] .

Put simply, divestment simply 'passes the buck' over to somebody else, who most probably does not have as stringent sustainability agenda as the seller.

Does tilting a portfolio towards higher ESG scores have any real world impact?.

In addition, narrowly defining ESG scoring as considering only what is financially material to one's investment, without assessing double materiality and inside-out impact could hardly be classed as sustainable investment.

This definitional fuzziness leads to worse investor outcomes and potential greenwashing claims.

The industry needs to 'untangle' the definition of ESG.

IS ESG INVESTING ...

1. Incorporating only material outside-in risks and opportunities into financial analysis?
2. Avoiding certain activities deemed not green?
3. Investing in areas related to the green transition such as renewables and clean-tech?
4. Investing to achieve real world impact such such as reducing emissions, improving social outcomes, etc?

Are these events simply indications of a maturing industry that is going through some necessary growing pains, or are these issues exposing material conflicts that will need to be addressed if ESG investing is truly to deliver on its social purpose – diverting capital towards sustainable investments and away from unsustainable activity?

ESG2.0 will not solve all these issues.

But the forward-looking asset manager will be engaging with them, transparent about their own capabilities and methodologies and importantly, aware of their limitations and blind spots.

Selecting a forward-looking manager should involve appraisal of the approach in these areas, as we'll examine in the last section.

Despite these problems, Industry experts consulted for this report highlighted that ESG momentum is currently strong and they do not foresee any slowdown in its adoption despite the known issues, and that they could see no let-up of investor appetite despite the performance challenges.

Going forward, standardisation of disclosure, a focus on impact measurement (SFDR PAIs being a first stab at a common regulatory definition of impact were highlighted), and biodiversity were all mentioned as areas of focus.

The huge uncertainty around the pace of corporate decarbonisation vs. manager commitments, regulatory overload, and lack of efficacy and standards in engagement campaigns were all common concerns.

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ESG DUE DILIGENCE

PART III

INCREASING THE PRESSURE FOR ESG DUE DILIGENCE

Clients and regulators are looking for clear and measurable climate criteria and targets, which have to be efficiently controlled by the risk teams and reported regularly

Nuno Teixeira, Head of Cross Asset Solutions at Natixis Investment Managers

How can asset managers react and adapt to the issues highlighted previously? How can investors identify the asset managers that are successfully engaging with them?

For an institutional investor, performing due diligence on funds is a crucial component of successful investment.

When ESG became an investment pillar for many funds, investors added an ESG component to their due diligence.

The rapid proliferation of sustainable funds, methodologies and approaches means that it can be hard for due diligence departments to keep up with the pace of change.

ESG due diligence (DD) is one of the most complex parts of a due diligence process as ESG touches many areas of the company and the investment strategy.

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In addition, the recent backdrops and scandals in the ESG space have alerted investors about the importance of a disciplined and rigorous ESG DD.

Investors have now seen enough evidence to show that ESG have direct financial and reputational impacts on their investment performance.

> ***The investment industry will benefit from speaking the same language. It will help investors with their due diligence process. Common terms and definitions are key for investors and asset managers.***
>
> Hortense Bioy, Global Director of Sustainability Research, Manager Research, Morningstar

> ***ESG Investors want more for their buck, for the same fees, without huge tracking error. They are becoming more demanding, driven by their end clients, making for an interesting time in an industry becoming more sceptical.***

Reduced focus on ESG matters including the due diligence would then increase the risk of bad investment and returns.

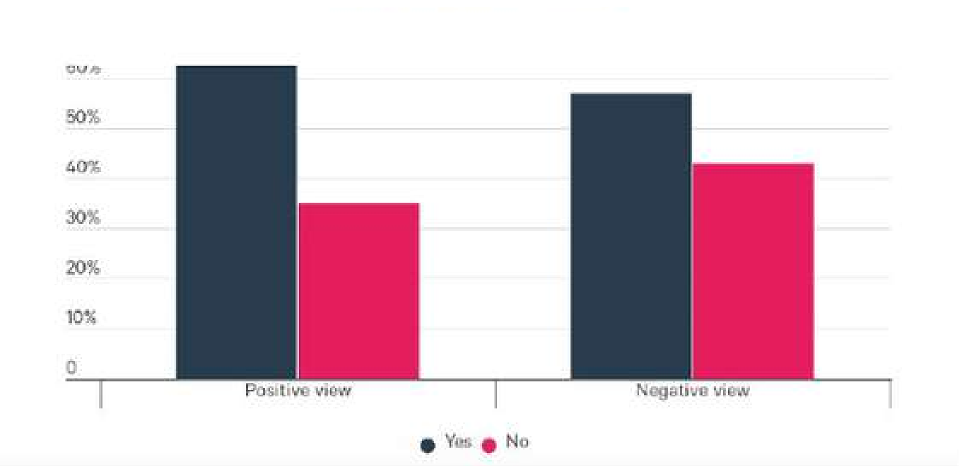
Cases such as Volkswagen and most recently Orpea have shown how important is the ESG risk for an investment.

Also, for some investors such as Fund of Funds managers, an **ESG mis-selling could be comparable to financial mis-selling and would have a negative effect on the company reputation, hence, financials and returns.**

Analyzing the different ESG factors and risks, due diligence could be split into the following sections. Company level due diligence:

ESG Integration & rating approach

Most asset managers today would claim to be fully ESG integrated, however a fund selector would do well to point them to a Redington [1] survey from last year, and **ask for tangible demonstration of how ESG considerations have impacted valuation & trading decisions in the previous year.**



This is a surprisingly hard hurdle for many managers to clear.

True ESG integration entails material sustainability information to be available to fund managers and analysts at the point of investment decision (whether trading or building models), and having the underlying technology to document these linkages.

In addition, the forward-looking investor would also be able to incorporate impact measures of his investments into the investment process and have an informed double materiality view of his portfolio.

A manager which is only concerned with single materiality cannot be said to be running sustainable strategies.

The due diligence process should also incorporate an evaluation of how the manager creates an ESG ratings for his investments, including usage of data providers and materiality considerations, and the data & technology strategy underpinning the creation of the ratings.

When evaluating active houses with in house research capabilities, the following aspects should also be probed:

- Are forward looking views incorporated into ESG ratings or only static point in time or backward-looking data?
- Are internal fundamental analyst views being utilised in the formation of sustainability and materiality views?
- Is there cooperation and information flow between the ESG and fundamental research teams or are the departments siloed?

- Are investment professionals able to access a holistic view of fundamental and ESG data (including estimates, ESG data points, engagement narratives etc.) or is ESG data not truly integrated into the investment process?

It is worthwhile to compare the ESG rating evolution to credit ratings, which are more quantitative, and took a long time before they got to their current form.

In ESG, there is more subjectivity. For example analyzing human rights is difficult to fully modelise.

We are happy to have many sources and different views as at the end, we have to form our own opinion!

Brunno Maradei, Global Head of RI at AEGON

- Are ESG models backed by robust quantitative research or is the manager utilising data without full accounting of the effect of its integration into the business process?

All interviewees we've spoken to for this report were sanguine about the heterogeneity of approaches to ratings and the lack of correlation between providers and practitioners, pointing out the advantages in having multiple viewpoints on a single issue, similarly to buy and sell ratings.

In addition, the fact that contrary to credit ratings, corporates are not paying for their ESG ratings means that there is less conflict of interest around them.

There are issues associated with this state of affairs however[2].

A lack of agreement on definitions means that any research on the efficacy of ESG investment can hardly be said to be conclusive, as it captures only one of many views on sustainability that are in use.

From a corporate point of view, it is challenging for companies to adjust their behaviour towards more sustainable activity if their shareholders and ratings providers are pointing them towards multiple, sometimes contradictory, directions.

Net Zero

One of the biggest challenges facing our industry is reducing carbon emissions and aligning group and financed emissions with Paris climate goals.

Although net zero commitments and science-based targets are growing in popularity, for asset managers especially t**hese commitments are extremely dependent on decarbonisation by investee companies and regulatory changes from governments.**

Hence there is a lot of uncertainty surrounding their ability to achieve these goals.

> ***On net zero, there is a lot of "green wishing"!***
>
> Hortense Bioy, Global Director of Sustainability Research, Manager Research, Morningstar

For an institutional investor, there are a few strategic actions at their disposal to accelerate their investment decarbonization:

INSTITUTIONAL INVESTOR PERSPECTIVE

- Allocate more to low carbon emission strategies and less to high-carbon emission strategies across asset classes (with itinerant implications on tracking error, risk and and return assumptions).
- Engage with their investment providers to encourage them to allocate their existing investments into Net Zero companies, or engage with their underlying companies to advance decarbonisation.
- Advocate for policies to encourage a Net Zero transition.

From a due diligence perspective, an asset manager's Net Zero commitment needs to be examined along the following lines:

DUE DILIGENCE PERSPECTIVE

- What is the actual coverage of the commitment in terms of asset coverage? Is it related only to emissions intensity or actually committed to absolute reduction in emissions? The former prioritises asset growth, the later prioritises the environment
- What is the impact of the commitment on investment strategies, voting and engagement campaigns?
- Does the manager have contingency plans in case the real world doesn't decarbonise at the same pace as their own target? This is far from an unlikely scenario!

As with many aspects of sustainable investment, there is an element of putting a target in place before having complete visibility on how it is to be achieved, however this is driven by the urgent need to act in order to mitigate climate change.

"A Net Zero commitment is a signal a company is on the journey" Hortense Bioy, Global Director of Sustainability Research, Manager Research, Morningstar

Greenwashing

There is no standard definition of Greenwashing as far as we know and investors would have different views if asked.

Having said that, we can try to specify two areas for Greenwashing:

- **ESG credential of a strategy being exaggerated**
- **Investment impact is neither sustainable nor beneficial.**

The BNY Mellon and DWS scandals showed that it is important for investors to focus on this area in order to avoid both reputational and legal risks.

It has also raised the lack of standards and/or frameworks in the ESG world and agreement in the scores between the different data providers.

Greenwashing was the buzzword last year, everyone was accused of greenwashing, including the European commission for having natural gas and nuclear in the EU Taxonomy.

Some claims are legitimate though and this has prompted asset managers to tone down their claims.

I am confident that new disclosure regulations and green taxonomies across the world will help combat greenwashing.

Hortense Bioy, Global Director of Sustainability Research, Manager Research, Morningstar

Investors could focus on the following areas to reduce the greenwashing risks:

- Voting record of the management company, to check alignment of voting intent with ESG strategies and objectives
- Clear ESG internal company strategy, precisely defined and applied consistently across the various investment strategies
- Clearly defined, measurable and impactful sustainability objectives
- Ability of the asset manager to explain the investment strategy and the reasoning behind its ESG factors used to select the portfolio. For systematic strategies, it is usually more transparent as the selection steps are clearly defined at the outset and change rarely. Understanding the ESG goals of a strategy is key for the investor in order to reduce the risk of greenwashing.

Engagement

There is clear evidence that engagement with companies on ESG issues can create value[3].

Understanding and challenging an asset managers' engagement approach is likely to be consistent with an investor's fiduciary duties to preserve long term value.

For asset managers, engagement is usually core to their stewardship efforts as it provides them with the opportunity to improve their understanding of the business risks and opportunities that are material to the companies in which they invest, including ESG matters.

It is usually known for the risk reduction but engagement is also a way to increase return.

There is a clear sense that critical thinking is needed to develop engagement methodologies more systematically, to strengthen the attribution between engagement and real-world results, and encourage effective collaboration.

Escalation processes should be examined closely. Is there a real, time bound 'sticks' (such as divestment or agitating to replace directors) or are managers content with vague promises made over many meetings?

Beware of anecdotal stories of success and ask for more robust figures of engagements and actual results delivered.

> “
>
> ***Asset managers have to be more disciplined when signing collaborative engagement and follow up on their actions. It is difficult to attribute a company change in strategy into a single engagement, perhaps, we need a standardized engagement framework common to asset managers, including collaboration*.**
>
> Brunno Maradei, Global Head of RI at AEGON

Engagement is a long-term endeavour and requires focus and clear objectives.

It is preferable for a manager to focus on a few key issues, collaborate with other like-minded managers on them, and deliver results, than spend valuable time and resources on meetings that ultimately deliver very little, over a long time period.

Product level due diligence

Product level due diligence should focus on the following areas to minimise greenwashing risks and help identify more advanced ESG strategies and approaches:

Strategy definition should be clear and include the firm's definition of sustainable investment.

In addition, the **fund's objectives need to be clear and measurable**, and based on empirical evidence.

> ***Impact is challenging to ascertain especially with an unfinished EU taxonomy, no social taxonomy nor consensus on double materiality – we need an agreed social definition of sustainable activity.***
>
> Brunno Maradei, Global Head of RI at AEGON

Impact objectives especially – can the fund actually prove real world impact, along with additionality, which is a key component of impact strategies?

The real-world impact claims of ESG tilt strategies need to be treated with suspicion.

It is a valid criticism that transactions in the secondary market have little effect in the real world, beyond potentially affecting a firm's cost of capital.

There should be a **transparent explanation of methodologies and discussion** of data coverage limitations and how they are dealt with.

Clients should have a clear idea of where the knowledge gaps are, how big they are as a percentage of assets managed, and to what extent the manager is utilising estimates and models to fill in the blanks.

In multi asset contexts, where there is little agreement on how to handle even the basics of emissions accounting for derivatives, government bonds or commodities, these discussions are key.

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Objectives for sustainable activity must be examined closely.

How tight are the definitions? Are they based on the SDGs/EU taxonomy and driven by a robust measurement methodology? Are activity thresholds low and easily overridable?

Are 'Do no significant harm' considerations taken into account?

How do the underlying holdings reflect the top-level ambitions?

Are there any obvious exceptions and how does the manager explain them?

Beware of poorly thought-out methods designed to give an appearance of efficacy but allowing, in actuality, the portfolio to hold names that are involved in non-sustainable activities.

Focus especially on thresholds that determine whether the portfolio, or a certain company is deemed 'sustainable' overall and ensure it ties with expectations and objectives.

A fund is truly sustainable if it needs to have only 50% of its holdings in sustainable activities?

Managers should also be able to **clearly demonstrate an understanding of the effect of various ESG constraints** (whether sector based, emissions based, diversity based etc.) on the investment universe and what the implications on the risk/return profile of the strategy is.

Ultimately, sustainable investment involves incorporating various externalities (primarily climate change but also biodiversity loss and other negative externalities) that have hitherto not been priced into security values.

Hence, incorporating them into valuations, and measuring the risk that they bring into portfolios will not on balance be a positive in aggregate.

Managers should be able to clearly demonstrate an understanding of the effect of various ESG constraints.

Managers should be able to give a quantitative analysis of the effect of these changes on their strategies and cease to insist that 'being good doesn't need to hamper returns'.

In some sectors and over some time horizons it may well do, but not all the time[4].

Net Zero commitments are important to parse on a product level to understand the implications on portfolio construction and sector exposures.

Aggressive reduction targets in financed emissions by asset owners and asset managers that are not reflected in real world decarbonisation could entail either material changes in portfolio composition and tracking error from benchmark (for example by necessitating large divestment from dirty sectors), changes in strategy, or ultimately, a walk back from aggressive commitments.

In addition, decarbonisation by portfolio adjustment does not drive decarbonisation in the real world, it merely shifts emissions to the buyers of the polluting securities.

Investigating the link between decarbonisation targets and related engagement campaigns by the manager are important to distinguish between divestment driven versus engagement driven decarbonisation paths.

Analyzing the different ESG factors and risks, due diligence could be split into the following sections.

Company level due diligence:

- **Is tracking error away from market cap benchmark sufficient to explain ESG tilts?**
- **Are all names held in line with the sustainability objectives? If not, is there a good explanation and clear process to deal with outliers that are aligned with sustainability objectives?**
- **Is the exclusion policy consistent with sustainable objectives?**
- **Is the manager aware of recent controversies associated with held stocks and how do they track and manage them?**

REFERENCES

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CONCLUSIONS

We believe that we are **still in the mid stages of ESG integration**, the focus on investing in a responsible way will continue to increase in the coming years. Asset managers and asset owners will also increasingly focus on managing their ESG reputation. The increased regulatory focus and evolving public perceptions on the centrality of finance in mitigating climate change should drive this practice into the mainstream of investing in the coming decade.

Regulation must catch up in order to help investors identify sustainable products. Due to the lack of standardisation, investors must do their own research and perform a thorough due diligence for the time being. To invest in strategies that reflect investor's values, it is important to take the time to learn about the investment manager, their ESG strategies and the types of funds available.

Investment managers need to step up and improve transparency across the board on methodologies, objectives and real-world impacts, thus helping clients understand and better assess their sustainability credentials.

Where are we heading from here?

We think that there will be a greater focus on trying to implement change in many ESG linked areas. We believe we are still not on track for many climate and ESG initiatives, and most investor’s portfolios are threatened by that.

We would hope that it will be a rapid and impactful transition, that regulators and asset managers will build on what has been done in the next few years and drive a coordinated and speedy shift. Inaction would trigger heavy climate risks across the whole economy.

About Blackwater

Blackwater is the leading ETF and Digital Assets consulting and talent management firm globally.

We are specialists in helping companies find the best strategy to enter the marketplace, improve their reputation and sourcing the very best of talent across the ecosystem.

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