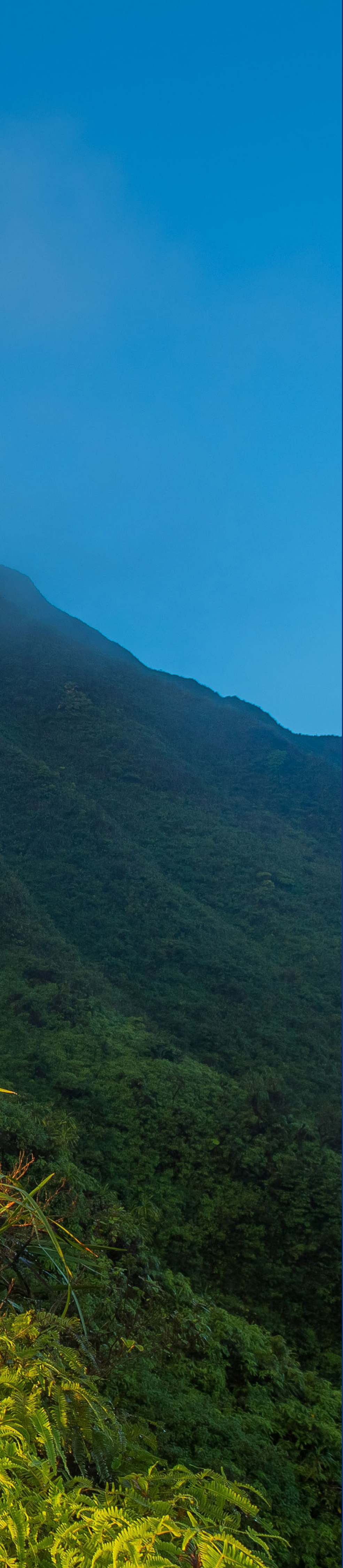
Marketing material for professional clients only

A practical guide to sustainable investing

Schroders



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Investing for a more sustainable world

Social and environmental change is happening faster than ever. Global warming, shifting demographics and the technology revolution are reshaping our planet. In this fast changing world, there are a growing number of investors who want to understand how social and environmental change is affecting their investments, and how the way they invest affects the environment and society.

Research indicates that the majority of investors believe they can contribute to a more sustainable world through their investment choices and that additional information from financial advisers would encourage them to allocate more of their investment portfolio to sustainable investments[1].

To help you meet your clients' needs, this guide covers the key things you should know about sustainable investing, including how to identify your clients' preferences.

Sustainability factors are a key consideration for people in the UK when selecting investments[1]

52%

of people consider sustainability factors when selecting an investment product

61%

of people who believe that individual investors can significantly contribute to a more sustainable world by choosing sustainable investment products

Factors that people think would be highly likely to encourage them to allocate

56%

If my financial adviser provided me with more, easy-to-understand information on sustainable investments

53%

If my financial adviser prompted me to put more money into sustainable investment

[1] Schroders Global Investor Study 2019

What is sustainable investing?

Sustainable investing is about generating returns that are sustainable into the future.

It involves considering more than just traditional financial analysis though. It's about also paying attention to how non-financial factors such as Environmental, Social and Governance (ESG) considerations may impact an investment's ability to generate long-term returns. The idea is that those actively preparing themselves for future risks and opportunities by recognising their social and environmental impact will have better long-term prospects than those that don't. Their ability to generate sustainable financial returns should therefore be superior to those that take a shorter term view.

Why has it become so important?

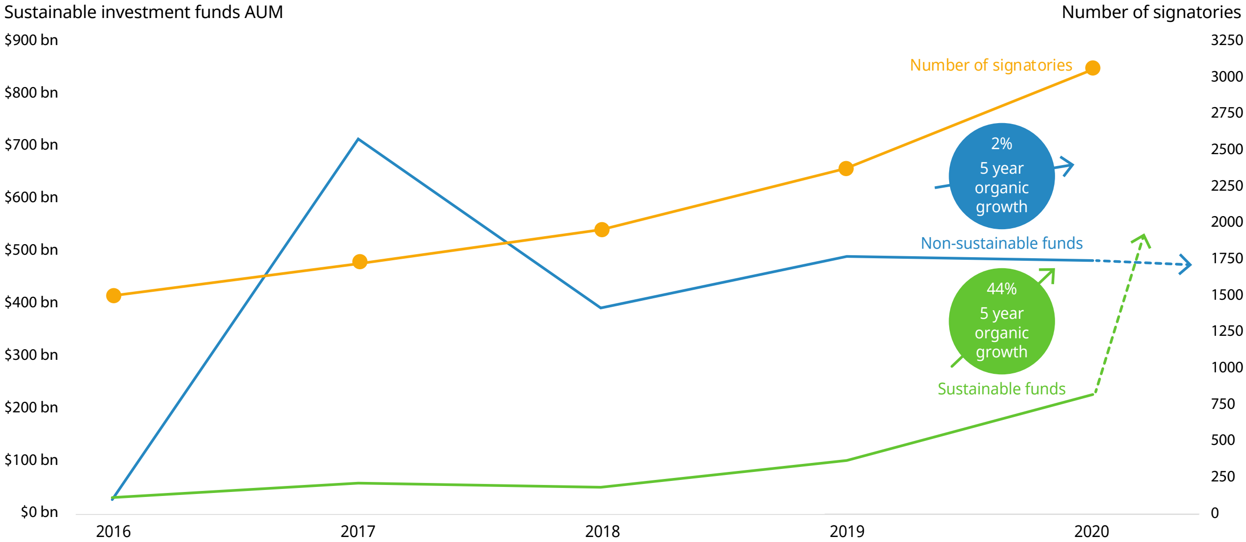
Social and environmental trends post increasingly significant risks to investments, to a point now where they can no longer be ignored.

The way in which capital is directed not only shapes the financial returns investors can achieve but also the type of impact they have on the world. The relationship between returns and impact has rapidly evolved as we see a fundamental shift in how companies are viewed and valued. It is increasingly being considered a normal part of fiduciary duty to clients to consider ESG factors.

Alongside capital allocation, active ownership is also a core part of sustainable investing. Engaging with companies and holding them to account through voting is critical to ensure they transition towards more sustainable, resilient business models that can support future growth over the long term.

As a result, investors are demanding more from their investments; more transparent reporting, greater commitment to tackling social and environmental issues, and more concrete evidence of them having done so.

Global growth of sustainable investment funds and PRI signatories continues to gather pace



Source: Broadridge as at December 2020, Fund Strategy: Active, Asset Class: Bond, Equity, Mixed Asset, Other. Sustainable includes: RI Embedded & RI Screened strategies, domicile: All. Source for PRI (Principles for Responsible Investing) signatories: PRI as at 31 March 2021.

How does this affect me as an adviser?

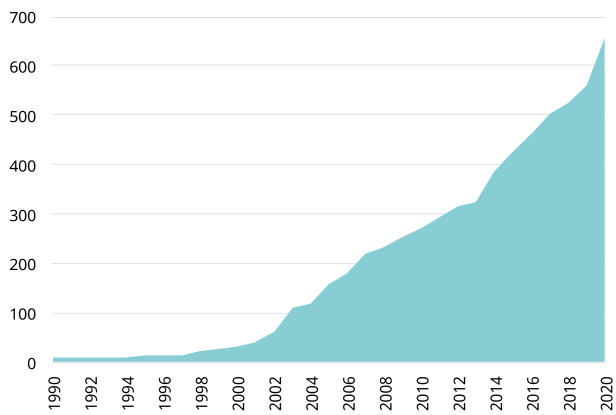
The rise in the popularity of sustainable investing has come with increased scrutiny from regulators in different global jurisdictions as the chart opposite shows.

It had appeared that the proposed amendment to MiFID II would have important implications for you as an adviser. This would have required you to take sustainability considerations into account during the advice process and to evidence this to the regulator.

However, with the UK's withdrawal from the EU on 31 January 2021, MiFID II will no longer affect UK financial advisers. There are no current regulatory requirements for UK advisers to take sustainability considerations into account during the suitability process. The FCA's Conduct of Business Sourcebook (COBS) requires advisers to take 'reasonable steps' to ensure that any personal recommendation is suitable, and to obtain the necessary information regarding a client's financial situation and investment objectives. Arguably, a client's view on sustainable investing could be deemed 'necessary information'.

This situation may soon change however. The FCA are currently reviewing the EU's MiFID II and the Sustainable Finance Disclosures Regulations (SFDR) requirements with a view to introducing the UK's own version. While we await guidance, we believe advisers should start including sustainable investment preference questions within their fact find now. This is considered good business practice and would highlight their commitment to understanding their client's needs.

Cumulative number of policy interventions per year



Source: PRI as at 31 March 2021.

Asking the right questions

While ascertaining your client's sustainability preference is an increasingly important part of the advice process, it's also crucial that you form a holistic view of their underlying needs and desires.

For example, investors don't just invest to make money; they also invest for expressive and emotional reasons. The questions you ask your clients should therefore delve deeper into understanding these reasons and try to address their need for financial security, for nurturing their families, for staying true to their values and for gaining social status. Understanding these aspects will help you establish a more realistic and meaningful view of what your clients want to achieve with their investments.

The below chart will help you start to have those conversations and understand where on the sustainable investing spectrum your client lies based on their priorities and sustainability preferences.

Which approach to sustainable investing is suitable for your client?

Does your client want to maximise their investment opportunity and ensure financially material risks relating to E, S or G issues are taken into account in the investment decision-making process? Does your client have a preference for engagement and encouraging better ESG performance over divestment?	Does your client only want to invest in those companies at the forefront of sustainability practices and stakeholder management? Are there specific sustainability themes they would like to gain exposure to/their investments to prioritise? Are there specific investments or areas of the market they wish to avoid?	Does your client have religious, ethical or personal values that they wish to be reflected in their investments? Are there specific investments or areas of the market they wish to avoid? Do they wish to exclude companies directly involved in those areas or also those that are indirectly involved?	Does the client want their investment to deliver a specific, positive, measurable social and/or environmental benefit alongside a financial return? Is there appetite to potentially invest in private markets to achieve this?	Is your client most focused on maximising their social impact? Are they willing to donate their money to good causes with no expectation of financial return?
If yes	If yes	If yes	If yes	If yes
Integrated	**Sustainable**	**Screened**	**Impact**	**Philanthropy**

Fund search considerations

Once you've determined your client's goals and which strategy is likely to best suit them, you can start to look for funds that meet their needs.

With a growing number of funds being launched under the broader "sustainable investing" umbrella, asking the right questions during this process to understand what different funds are trying to achieve is key. Here are some suggestions to start you off.

Integrated

Does the fund systematically consider ESG factors throughout the investment process, and if so, how does it do so?

Can the manager evidence this with examples rather than just using their status as a signatory to the UN PRI as proof?

Does the manager outsource the ESG analysis to a third party ratings provider or have they developed their own, more sophisticated approach?

How do they engage and what outcomes do they seek?

Do they have a voting policy? Is their voting record consistent with their voting policy?

Sustainable

Does the fund target a specific sustainability theme (e.g. environmental solutions, education, diversity) or outcomes (e.g. a lower carbon intensity)?

How does the fund positively select the best performing companies from a sustainability perspective?

How do the managers invest responsibly and hold companies to account?

Does the fund apply any exclusions? How are these determined?

Screened

Does the fund exclude investments in specific companies or activities?

How are these exclusions defined? For example, is a revenue threshold applied?

Are exclusions based on company exposure to a controversial activity throughout its entire value chain, or just during production?

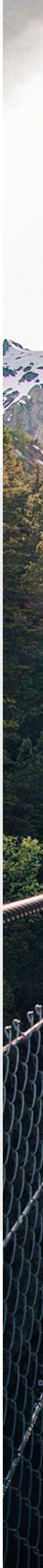
Roughly how much of the benchmark is excluded from investment? What impact might this have on the fund's performance and risk?

Impact

Does the fund target a specific social or environmental impact/outcome as well as financial returns?

Can the managers demonstrate a clear link between the capital provided and the positive social or environmental impact?

Do the managers clearly demonstrate and regularly report on the fund's impact?



Helping your clients make the right choices

Just because you've walked your client through these options, doesn't guarantee that they will make the right choices according to their overall outcomes.

You could consider the four-step EAST model to encourage positive and sustainable financial behaviour from your clients.

1. Make it **Easy**. Presenting your clients with default options helps; this has been proven effective in plans for pension contributions.
2. Make it **Attractive**. For example, encouraging a sense of civic duty in a client's plan can be very powerful, whilst being careful to attach financial incentive.
3. Make it **Social**. Within the constraints of client confidentiality, clients are more likely to support a plan if they have socialised it with the people most important to them. This is especially powerful in next generation family wealth transition planning, but it is rarely used.
4. Make it **Timely**. Immediate benefits encourage action. Just the feeling of having contributed to sustainability can help clients feel better very quickly.

Answering your client's questions

There are a number of myths surrounding sustainable investing. We expect your clients will want to know whether these are true or not, so here are some common questions and possible answers to support you with any 'difficult conversations'.

Is there a trade-off between performance and sustainable investing?

Sustainable investing does not come at the expense of financial returns. The goal is still to make money but in a more responsible, long-term way. While there are other influences (some of which may be outside a company's control) that will affect how well a company does over time, a wealth of academic studies have been published over the last few years evidencing a connection between sustainability factors and improved performance. One study (Friede & Busch 2015) found that companies focused on ESG enjoyed, on average, enhanced financial performance, while analysis by Arabesque Asset Managers and Oxford University show that good sustainability practices positively impact share prices. Morgan Stanley has also done research that shows sustainable funds can help protect investors against downside risk, while Morningstar analysis shows no performance trade-off for sustainable funds, with the majority outperforming their traditional peers over multiple time horizons.

Are sustainable funds expensive?

Historically, sustainable funds have been more expensive than their traditional counterparts because it used to be something of a niche area that required specialist skills. But now sustainable options have become more widespread and the skillset more prevalent. Sustainable funds have become more competitively priced compared to traditional funds, and in many cases cost the same as a traditional fund. A 2020 study by Morningstar found that, on average, the average fees charged by the European ESG funds was lower than their non-ESG peers.

Must I avoid 'sin' stocks?

This is entirely up to you. With such a wide range of sustainable funds on offer, there's no reason why you should have to invest in a fund that doesn't completely align with your values and beliefs. If you want to exclude such stocks, you should focus on funds that screen for these types of companies and actively avoid investing in them so that you have nothing to do with them.

Should I avoid fossil fuels given the scale of the global climate challenge?

Again, this is entirely up to you. If investing in such companies isn't in line with your beliefs then you can invest in funds which exclude investment in fossil fuels. If you don't want to exclude them entirely, but are still worried about the potential investment risks, you can always look at funds with an integrated approach to investing. Here, individual companies or activities are not excluded, but they are held at a weight that reflects their risk. Managers are usually committed to actively engaging with them to improve the sustainability of their business practices and corporate behaviour to mitigate potential risks arising from the negative impact they are having on the environment or society.

The important role of advisers

Sustainable investing is becoming increasingly popular as investors look for ways in which to align their investments with their personal beliefs.

As an adviser, you have an important role to fulfil; you can help your clients meet both their financial and sustainability objectives, and feel more engaged and emotionally connected with their investments.

This guide should help you navigate this growing field, understand your client preferences and recommend investment options that best suit their needs and circumstances.

Adviser checklist – Top 5 tips

1. Start
a conversation with your clients on sustainable investing

2. Ask
your clients the right questions – understand their sustainability preferences

3. Record
your client's sustainability preferences

4. Search
for a sustainable investment solution

5. Present
your client with a sustainable investment strategy

Demystifying sustainable jargon

The field of sustainable investing has become a sea of acronyms and technical terms, which can leave investors confused. We've put together a glossary of some of the key terms to know.

2°C limit or "2 degrees"

It is widely agreed that limiting the average rise in global temperatures to less than 2°C above pre-industrial levels by the end of this century may help stave off the worst of the natural disasters associated with global warming. See also "Paris Agreement".

Active ownership

Actively influencing corporate behaviour to ensure the companies we invest in are managed in a sustainable way. This helps to both protect and enhance the value of investments.

Carbon footprint

A measure of a group, individual, company or country's greenhouse gas emissions. Common metrics include total carbon emissions or carbon intensity.

Carbon pricing

Assigning a cost to emitting CO2 into the atmosphere, usually in the form of a fee per tonne of CO2 emitted, or limiting the total emissions firms can produce and issuing emissions permits. Putting an economic cost on emissions is widely considered to be the most efficient way to encourage polluters to reduce what they release into the atmosphere.

ESG

Environmental, Social and Governance.

ESG integration

An investment approach that incorporates ESG considerations into the investment decision alongside traditional financial analysis. ESG integration is about understanding the most significant ESG factors that an investment is exposed to, and making sure that you're compensated for any associated risk.

EU Green Deal

Apolicy framework and package of measures that aim to make Europe climate neutral by 2050, boosting the economy through green technology, creating sustainable industry and transport and cutting pollution.

Green bond

A bond in which the proceeds are used by the issuing company or government specifically to fund new and existing projects with environmental benefits such as renewable energy and energy efficiency projects.

Greenwashing

Falsely communicating the environmental credentials of a product, service or organisation in order to make a company seem more environmentally-friendly than it really is.

Impact investing

Investments that are made with the primary goal of achieving specific, positive social and environmental benefits while also delivering a financial return. Impact investments create a direct link between portfolio investment and socially beneficial activities, and historically most of the activity has occurred in unlisted assets. Not to be confused with impact measurement (see below).

Impact measurement

The measurement of how companies' activities affect the world both positively and negatively. Schroders developed SustainEx for this purpose. It measures the effect on companies' profitability if their negative social or environmental impacts or benefits were recognised financially.

Net zero

Unlike "carbon neutral", companies or countries that call themselves "net zero" usually have not had this validated or certified by a third party. Use of "carbon neutral" and "net zero" may vary by region. Not to be confused with "zero carbon".

Paris Agreement

A global commitment, agreed at COP 21 in Paris in 2015, to limit increase in the global average temperature to below 2°C above pre-industrial levels.

Sin stocks

Investments associated with activities considered to be "unethical" or "immoral" according to an investor's personal values or beliefs. Activities may include tobacco, alcohol, gambling and adult entertainment.

Social bonds

A bond in which the proceeds are used by the issuing company or government specifically to fund new and existing projects with social benefits such as affordable healthcare and housing.

Task Force on Climate-related Financial Disclosures (TCFD)

A voluntary standard for climate-focused disclosures that aims to create consistent and comparable reporting of climate-related risks. TCFD is widely used by companies, banks, and investors.

Thematic investing

Investing in companies that align to a particular investment theme such as renewable energy, waste and water management, education or healthcare innovation.

UN Principles for Responsible Investing (PRI)

A set of six principles under which asset owners and asset managers voluntarily commit to incorporating ESG issues into their investment processes, active ownership and reporting, and promote responsible investment across the industry.

UN Sustainable Development Goals (SDG)

A collection of 17 goals reflecting the biggest challenges facing global societies, environments and economies today. The United Nations describes the SDGs as a "blueprint to achieve a better and more sustainable future for all".

Schroders – an award-winning leader in sustainable investing

Schroders is a leader in sustainable investing and we have a number of awards to our name including Impact/ESG Manager of the Year (Magic Circle Awards 2020). We have an A+ rating from the Principles for Responsible Investment (PRI), a United Nations organisation[2]. Moreover, we are a founding member of Net Zero Asset Manager initiative and a signatory of the UN Global Compact.

If you've found our guide insightful, why not contact your usual Schroders representative to see how we can help you and your clients deliver sustainable long-term value in a fast changing world.

Schroders – impact/ESG manager of the year

'Advanced' recognition in Morningstar ESG Commitment Level Assessment

SustainEx™

SustainEx™

Schroders – best investor engagement

[2] A+ rating: Principles for Responsible Investment 2015-2020 assessment reports.

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