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Exploring rules and rhetoric

Shifts in direction and sentiment are not new in sustainable, investment, however, recent shifts both in the UK and in the USA have been much more than a change of gear. Julia Dreblow suggests that we are moving into a 'new normal'

With both actual and cultural wars raging, it is more important than ever to understand what clients want and what funds, and what fund assets, do - and to have rules and guidance that work. The diversity of sustainable, responsible and ethical investing strategies offers unique opportunities for advisers to have wide ranging conversations with clients about their diverse points of view – however, it is becoming apparent that the overlap between 'financials' and 'sustainability issues' is not discussed enough.

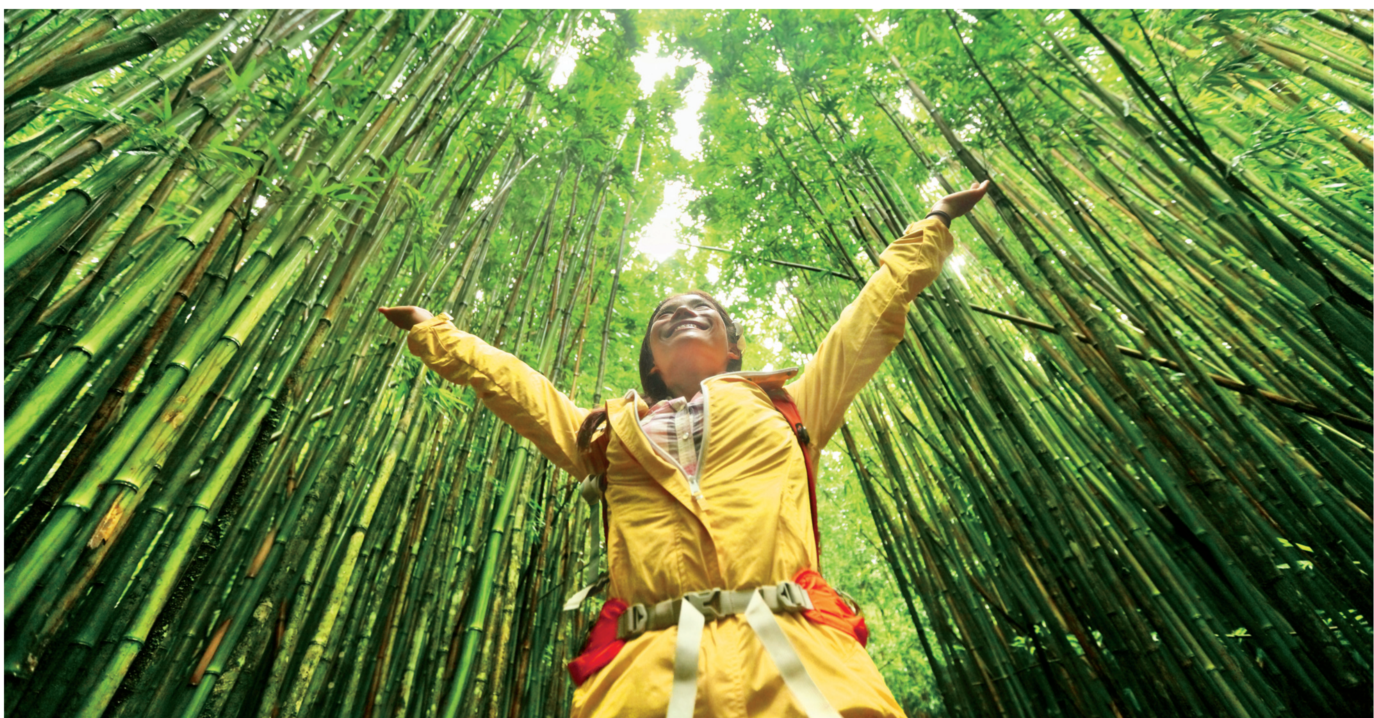
People who have worked in the area for more than a few years will know that this is a complex dynamic. Above all else – these are investments. Funds and portfolios must attract and retain clients, like any other fund. And while a fund manager may stick with their fund through thick and thin – and although sustainable and ethical investors are known for their high persistency – they are not obliged to do the same.

And this is why although SDR focuses on sustainability objectives, financial objectives need to be understood also as getting this wrong adds fuel to anti-ESG rhetoric. Fund managers design financial and sustainability strategies together – ensuring funds make sense from both perspectives. They must work together. This means that within the financial and sustainability design and management of the product a manager will consider investment selection, retention, engagement and disposal options. Some have different people guiding these aspects, others are fully integrated. Either way, assets are not retained because they are 'nice and green' and engagement does not take place if doing so would hinder performance. Sustainable and ethical fund managers often look further into the future than others – but they are not NGOs.

Regulatory challenges

Both anti-ESG rhetoric and some of what we are hearing about the FCA's implementation team's requirements appear to miss this point. Companies research ESG to improve performance - and funds' sustainability profiles shift constantly, holding only assets that are both financially attractive and in line with their sustainability strategies. And this is why digging too deep, building multiple granular 'permanent' metrics - that are devoid of nuance - into fund labelling risks misleading clients. Assets need to be able to change over time, in order for the fund to be viable, so static data can mislead.

Some of these misunderstandings will have originated from when poor communication was rife. Some funds were promoted as being 'sustainable', when they paid little or no attention to real world enviromental or social risks and opportunities. The FCA, and others, are not seeking to end 'lighter touch' strategies - but clients must know what they are signing up for - and words matter. Using the term 'sustainability' incorrectly was always going to upset people who understood environmental and social issues – and helped extend the reach of the ESG backlash. Overreliance on metrics aside - the FCA's anti-greenwash, naming and



marketing rules are helping with this, and which is welcome in 'the new normal' - where misinformation is all too common.

And to their credit, many UK managers started to align to SDR before it was finalised - in particular the relevance of the 'anti-greenwash rule', and the concept of sustainable funds 'intentionally' supporting positive real world environmental and social outcomes.

Labelling has been slower. Although initially welcomed, many fund managers have struggled with the FCA's labelling implementation processes because the granular approach that is being applied does not work with how they operate. Some fear unintended consequences as the sustainability / financial dynamic - the fact that assets and sustainability profiles change, so metrics can be misleading. The realities of running a fund appear to be overlooked all too often. Many argue the process is too prescriptive and ill informed, some fear clients be misled by their regulator driven acrobatics. So although labelling is advancing, it is not progressing as fast as it might.

SDR fund labels snapshot

The UK's SDR regime aims to help interested clients find sustainable funds, with different labels indicating different approaches.

We cannot show all the funds that have been approved to use labels on our (open access) Fund EcoMarket fund tool yet because many managers have asked us to wait until they go public (which has started) - but our research indicates the following will soon be available:

- 60 'Sustainability focus' labelled funds
- 27 'Sustainability impact' labelled funds
- five 'Sustainability improvers' labelled funds
- one 'Sustainability mixed goals' labelled fund.

However, importantly, the cohort of funds that have chosen to be 'Unlabelled with sustainability characteristics' – is even larger at 157 funds. These funds still have to publish client disclosures – but won't be able to use a label.

We are also aware of many other funds that are 'Working towards' adopting a label. Their situations vary. Some reputable funds have been stuck in the system for many months, others have withdrawn because of procedural challenges and plan to resubmit. As well as there being hundreds of funds that are out of scope, notably offshore funds and pensions, we are also aware of 37 (relevant) funds that have closed, and 82 funds that have changed their names since June 2024. So things are clearly changing.

Beyond SDR labelling

This picture explains why we welcome the FCA's decision to hold back on extending SDR labels to portfolios. Once this settles down, the FCA will be better placed to revisit how labelling might work for different portfolio, service and business types.

My suggestion for funds, any future SDR portfolio rules, and indeed whether or not we need a UK Green Taxonomy – is to prioritise, keep things as simple as possible – and put clients first, so they can make better informed decisions. Getting this right arguably matters more now than ever – particularly as greenhushing (not talking about sustainability) is widely regarded as a greater risk now than greenwash.

A shifting backdrop

Some of the challenges that are making headlines, often as a result of what is happening in the USA, include:

Climate. Not new - but as global temperatures have increased beyond the level agreed by scientists to be relatively safe (+1.5 degrees C above preindustrial levels) we should be increasing, not decreasing, efforts to reduce emissions. Floods in Florida and fires in California indicate why. Investors are well aware of this – working out what to do next is the tough bit.

DEI. A core strand of many funds' social policies - diversity, equality and inclusion – is clearly out of favour in some quarters also. Although views on 'what good looks like' vary, investors and others look at DEI policies because they believe they make sense and contribute to better real world and financial outcomes.

Collaboration. Investors have been working together on ESG issues for around two decades. Doing so makes sense as it is more efficient than multiple investors asking similar questions, and making similar suggestions, of companies. Yet political events are putting this at risk and have led the popular Net Zero Asset Managers Initiative (that emerged out of COP26) to review their strategy and remove their membership list from their website.

Listing rules. The SEC has been under pressure also. A recent rule change means that ESG engagement is now viewed as 'activism' and subject to more regulatory requirements than before. This led BlackRock and Vanguard to immediately pause their engagement activity. (This is breaking news at time of writing - readers may like to search 'SEC's schedule 13G changes' for an update).

Indirectly relevant

Defence. The need to increase defence spending may not directly impact sustainable funds, as it is the other side of the coin, however, clients may. Key points include that many funds have defence-related exclusions and fund strategies can not be significantly changed without consulting clients – so this rarely happens. In addition, defence companies are (understandably) not renowned for their transparency, so trying to identify armaments companies that only sell to 'good guys' is not realistic. Our research does, however, indicate that at least 83 retail funds (in the Fund EcoMarket universe) hold gilts while 54 have gilt exclusions – so advisers should check fund and portfolio strategies if clients have strong opinions on avoiding or supporting defence spending.

Shifting business environment. These issues point not only to political differences and strategy variations but also issues for fund managers either based in, or owned by, US firms. Their views vary – but as regulation shifts differences are likely to emerge that may impact portfolio managers, advisers and clients. So while I would caution against knee jerk reactions, I'd recommend keeping an eye on stewardship strategies.

Looking forward

To my mind the most important factor is that emissions continue to rise, resources continue to be depleted, and vulnerable people are still being mistreated.

The cost of living crisis, wars and political upheaval may make some of these issues lower priority for some, but that does not reduce real world or investment related sustainability risks. Scientists are scared of climate change. Investors should be too.

It will also be interesting to see how sustainable investors respond to these changes. Engagement and voting have become central to many sustainable, responsible and ethical strategies over the last two decades. What happens if investors struggle to encourage improvements they believe are in their clients' best financial interest – either alone or with others? And when company data disappears? Might some managers focus more on what companies do and make today – as opposed to their policies, promises and potential? How far might that go – if anywhere? What might that mean for performance – and real-world outcomes? And would clients, advisers - or markets - care?

Far clearer is the need to ensure client information remains is 'clear, fair and not misleading' in 'the new normal'. This is in part why I am pleased the British Standards Institute (BSI) sustainable fund standard PAS 7342 will soon be published. The standard is a collaboration between industry and government (DESNZ). It aims to describe what good sustainable fund practices and communication look like, complimenting SDR. And with luck, its messages might flow through to the Advisers Sustainability Group report we are working on.

Julia Dreblow is a founder of SRI Services and Fund EcoMarket, FCA DLAG member, BSI fund standard lead author and Vice Chair of the new industry-led 'Advisers' Sustainability Group'