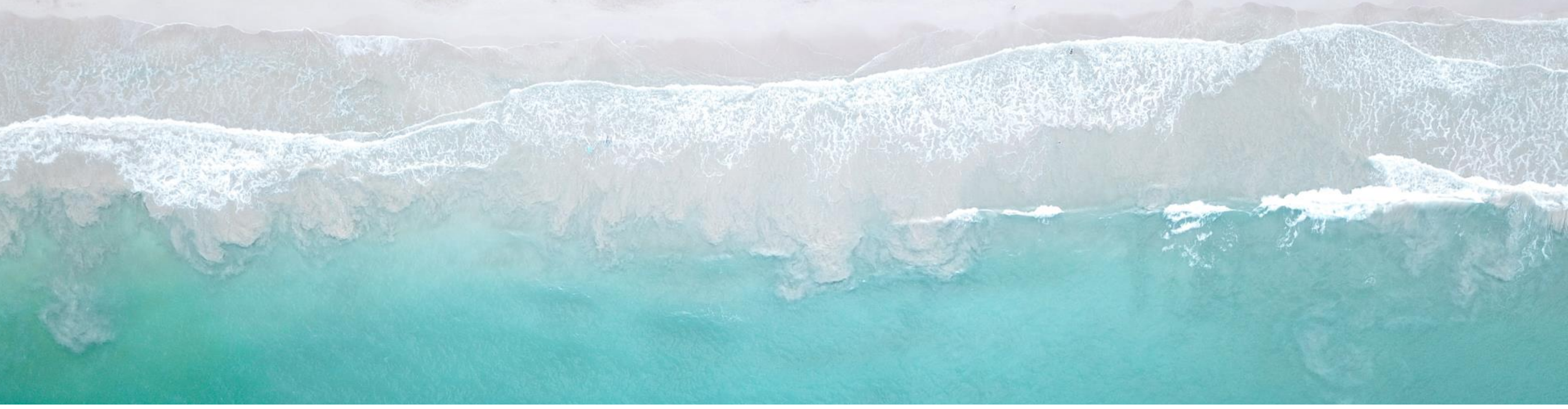

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SFDR AND ESG: IS IT WHAT IT SAYS ON THE TIN?

In the UK there is a rather famous advertising slogan, the Ronseal Phrase, which has now become part of the vernacular. The phrase "It does exactly what it says on the tin" means that the label on the tin container accurately describes the product's qualities and it will do what is promised.   If something does what it says on the tin, it does exactly what it is intended to do. When it comes to ESG, it seems to us that one aim of the European Union's Sustainable Finance Disclosure Regulation (SFDR) is to make sure that the ESG performance of an investment is what it says on the tin.

Amid the growing popularity of ESG-focused investment products, the SFDR came into force in March. It applies to any institution raising money for fund products in Europe, meaning multinational asset managers like those in the US will be impacted by it.

While the regulation is sprawling and complex, one of its core purposes is to divert assets to sustainable investments in line with European policy. To do that, funds must avoid "greenwashing" and give investors more information and transparency that can inform investing decisions. In other words, do exactly what it says on the tin.

The regulation arrived amid a surge in fund products being rebranded as "ESG" or "sustainable". Figures from Morningstar say 256 offerings rebranded or repurposed themselves as sustainable products in 2020 – up more than 40% from 2019. During the first three months of this year, 127 have already taken such a step.

Not all of this is superficial. Asset managers can, do and should integrate ESG factors as part of their "regular" investment process. Many have taken steps to increase the extent to which they consider sustainability in recent years. If investors are showing increasing demand for such products, it is appropriate that these are branded this way.

Of course, the sheer volume of funds being repurposed and the eagerness to be part of the goldrush of flows to ESG branded funds likely means some aren't living up to their labels. For example, a recent study from the SEC showed a number of funds with terms like "ESG" in their names didn't have a methodology for vetting investments according to sustainable criteria.

The SFDR looks to standardise – at least to some extent – the definitions of what is a sustainable and non-sustainable fund, putting stricter disclosure requirements on those choosing to market themselves as having ESG on the tin.

Asset managers should be familiar with the three categories of funds the regulation outlines:

- Article 8 funds may incorporate ESG considerations as part of the investment process, but do not seek specifically to have a sustainable impact.

- Article 9 dark green funds hold sustainable impact as their core objective. Under SFDR, both these categories of funds have to disclose the contribution their sustainable investments make while also explaining how these holdings do no harm to any other sustainable objective. Article 9 funds will also have to disclose whether carbon reduction is one of their goals.

- Article 6 funds, as defined by SFDR, are other investment products that can, if necessary, disclose why sustainable considerations are not relevant. These offerings will still need to publish the potential sustainability risk on their future returns.

Greater disclosure requirements, while a potential headache for fund sponsors, can be a positive. For example, a recent study indicates that mandatory ESG disclosures lower the probability of stock price crashes by 18%. The rationale is that when investors have more access to information, there are fewer "ESG controversies" which can arise, leading to a selloff.

The same logic could be applied to funds. Being aware of how sustainability is applied within each fund could lower the risk of mass redemptions in the event a manager's ESG process is called into question. The audience already knows what it's getting.

We have never met an analyst who isn't hungry for better data, and they should relish the additional data brought out by the disclosures. They potentially provide additional extra-financial information, meaning intermediaries with a genuine ESG focus can dig into funds' portfolios, conduct their own analysis and determine if what is inside the tin matches what it says on the label. For asset managers concerned about applying the new requirements, Impact Cubed pre-screening tool provides insights into how portfolios look under SFDR guidelines.

In summary, SFDR can provide some major positives for investors, giving them the tools to peel back the veneer on fund labels and getting more transparency on portfolio managers' commitment to ESG. Managers fully embracing sustainability will also be rewarded with an opportunity to differentiate themselves beyond just the name on the tin.

ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customized sustainable investing.

You can find out more about our data and portfolio models at www.impact-cubed.com and if you would like to contact us at info@impact-cubed.com we would be happy to hear from you.