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Building a better working world

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It's because we have minds made for shaping financial services that we ask better questions. Better questions lead to better answers that benefit our people, our clients and our communities. It's how we play our part in building a better working world.

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The road to long-term investment

To define long-term or sustainable investment in the latter half of 2018 is to pin down an ever-moving target that represents a whirling kaleidoscope of colours.

An alphabet of anagrams – such as environmental, social and governance (ESG), socially responsible investing (SRI), sustainable investing (SI) and ethical investing (EI) – serve to illustrate its various facets, but such terms often confuse both investors and their asset managers who are trying to navigate a way that works for them in this new era.

Cynicism and claims of 'following the crowd' in some quarters are rife, but one thing seems certain: there is likely to be no turning back from this journey towards investing with a long-term mindset.

In recent years, there has been a sharp increase in the assets under management (AUM) of ESG assets. The Global Sustainable Investment Alliance (GSIA) reports that there are now US$22.9tn (€19.2tn) of assets managed under responsible investment strategies. This is an increase of 25% since the 2014 review.[1] Inevitably there has also been a significant increase in the number of managers offering ESG strategies.[2]

Whether the push is coming from generations who are new to – or as yet not present in – the financial system, or it is a pull from the largest asset owners on the planet who realise the power they wield, the move to ensure that investing does more than purely increase short-term wealth has taken a firm hold.

A recently awoken societal conscience has begun to fear environmental catastrophe. It has also realised how recent corporate strategy may be overlooking both long-term public good and a sustainable business model in an effort to produce short-term profits.

This conscience is demanding change.

Global politicians and regulators – for the most part – have picked up on this change and have committed to align with this push towards becoming better global citizens. Some have gone as far as mandating those with the most economic might to commit financially too.

At EY, we have always known the value of investing for the long-term, and have strived to connect businesses with key stakeholders – including their investors – to put together well-articulated strategies that work for all sides.

We have been working with our clients to help research, establish and implement policies that take a long-term view – without forgetting the need to deliver in the present too.

[1] "ESG: Evolution of sustainable investing and modern practice," *IPE website*.
[2] The 2018 Annual Impact Investor Survey from the Global Impact Investing Network (GIIN) reports that numbers have grown 400% in the last 20 years. "2018 Annual Impact Investor Survey – The GIIN," *The GIIN website*.

Where are we now?

Red lorry, yellow lorry

Look at any road or highway, anywhere in the world. Despite many of the vehicles looking similar and all moving the same way, not one of them is alike. From heavy goods traffic, coaches and large family saloons through to roadsters, hot hatches and even mopeds, the passenger makeup, speed and ultimate destination are all unique.

It is the same with long-term investing.

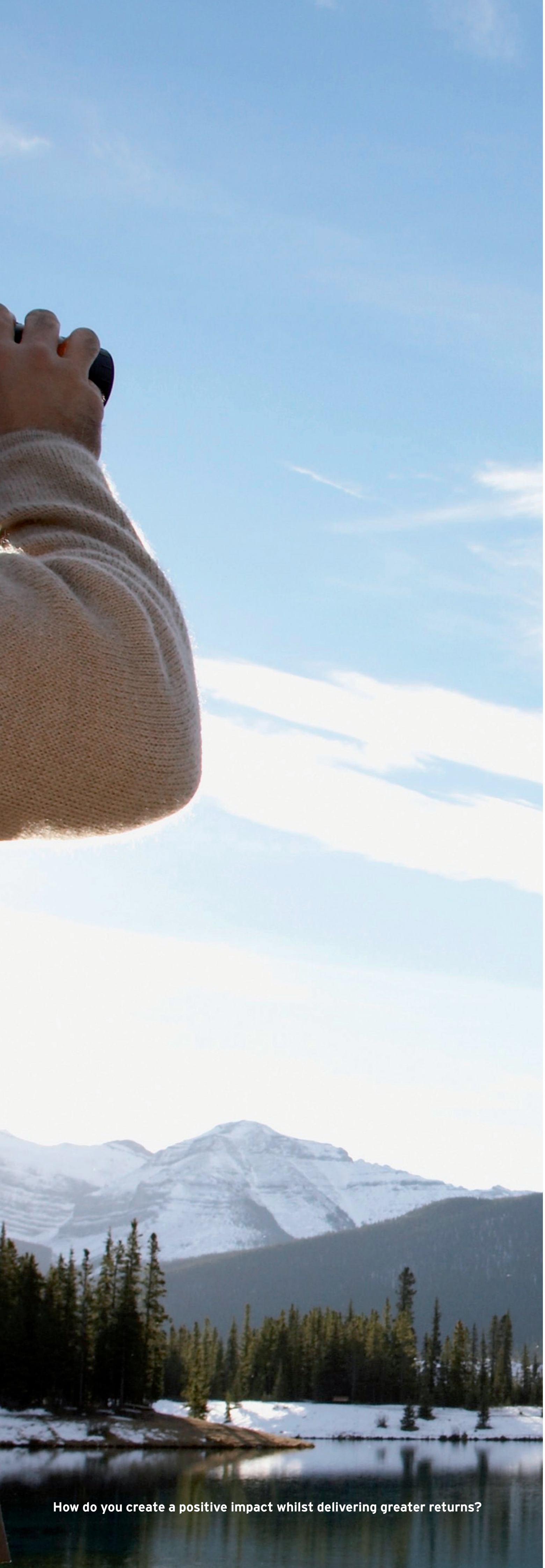
There is no single investor that has exactly the same destination in mind as his or her peers – or a method to get there. Defined benefit pension funds have corporate sponsors, trustee boards and varying levels of solvency to obey, whilst family offices target a whole universe of different outcomes. Defined contribution pension funds, although at an earlier point in their overall journey, have many vocal passengers, dictating their ultimate destination, speed and method of travel.

Within a normally slow-moving sector, recent and relatively fast-paced change has meant that asset and wealth managers across all styles, sectors and geographies have found themselves at different stages on this journey. Some are already well-established, having carried this belief for some time, whilst others are catching up, not wanting to be trapped on the wrong side of this global movement.

Rather than just doing the right thing, investors are increasingly seeing ESG issues, alongside taking a sustainable, long-term investment view, as sitting within their basic risk analysis framework. Indeed, 40% of asset owners are now considering ESG risks in investment decisions.[3]

> "You have to make your manager understand why you are investing in this way. There is no room for emotion in a financial contract."
>
> Large UK pension fund

[3] "Mercer European Asset Allocation Survey 2018," *Mercer website*.



Whilst the largest investors have taken the lead on demanding change from their managers, smaller defined benefit pension funds have come together under the wings of trade associations to voice their opinion.

> "Having a sustainable investment slant used to be seen as a selling point or differentiator, now it is more of a 'comply or explain' thing for many institutional investors."
>
> Large Dutch pension fund

Fiduciary managers, who have taken on many of these smaller funds' assets, have built up the might and mandate to ask probing questions about managers' actions.

Many large investors – and their consultants – cite not being able to adequately answer questions on ESG or sustainable investing through their products as amounting to a roadblock.

Just being a signatory to the UN Principles of Responsible Investment will no longer be enough to get past the request-for-proposal stage.

In the Netherlands, Scandinavia and certain other large institutional investment markets, fund managers have faced this pressure for some time. In the UK, some of the largest pension funds have become leaders in this field and are also pressing for change.

> "It is not about pleasing clients, it's about using ownership rights. We have said to managers before: 'You have to change what you're doing, or our money is coming out.'"
>
> Large UK pension fund

Pick a lane

When starting out on the long-term or sustainable investment journey, there are many routes to take. Some routes have been favoured more than others over time and have evolved as investors have matured into their approaches and realised what could be achieved.

One of the first routes taken by investors is to exclude or screen out certain stocks or industries. Fossil fuels have been a favourite target, along with weapons manufacturers and commodities companies with questionable human rights records.

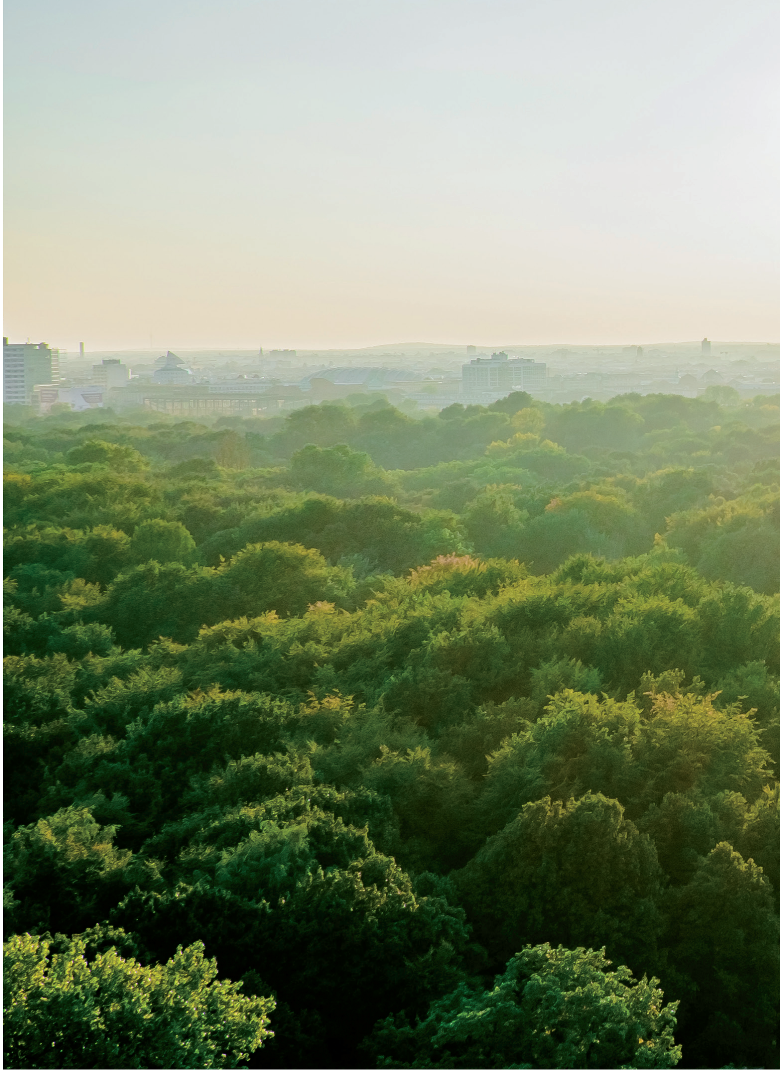
> "Ten years ago, we had to bend over backwards for our clients to allow us to abstain on a company vote. Now they demand we vote against the board on a regular basis — and question our motives when we don't!"
>
> Listed UK fund manager

Many investors are still on this section of the road, so a range of fund managers have created products to meet their needs. Active managers, who can pick their own securities, and passive funds that employ a range of programmes to cut out what is not wanted, have flourished by catering to this audience.

The next stage is to engage with companies, rather than drop them completely, and try to push for change as a shareholder. There are now globally more than 285 index funds and exchange-traded funds (ETFs) with ESG mandates.[4] Active managers have claimed to have the leading edge on this approach, making it part of their overall company analysis and cooperation, whilst passive funds have stepped up their proxy voting activity to show investors that they are able to engage.

> "We demand our fund managers take a harder line with companies we invest in. We understand they may work with them on other capacities, but we are looking long-term — and it is our money they are managing."
>
> Large UK pension fund

Additionally, some active managers have recently begun to claim that they have been using this sustainable approach, but without giving it the label as the very basis of their investment strategy.



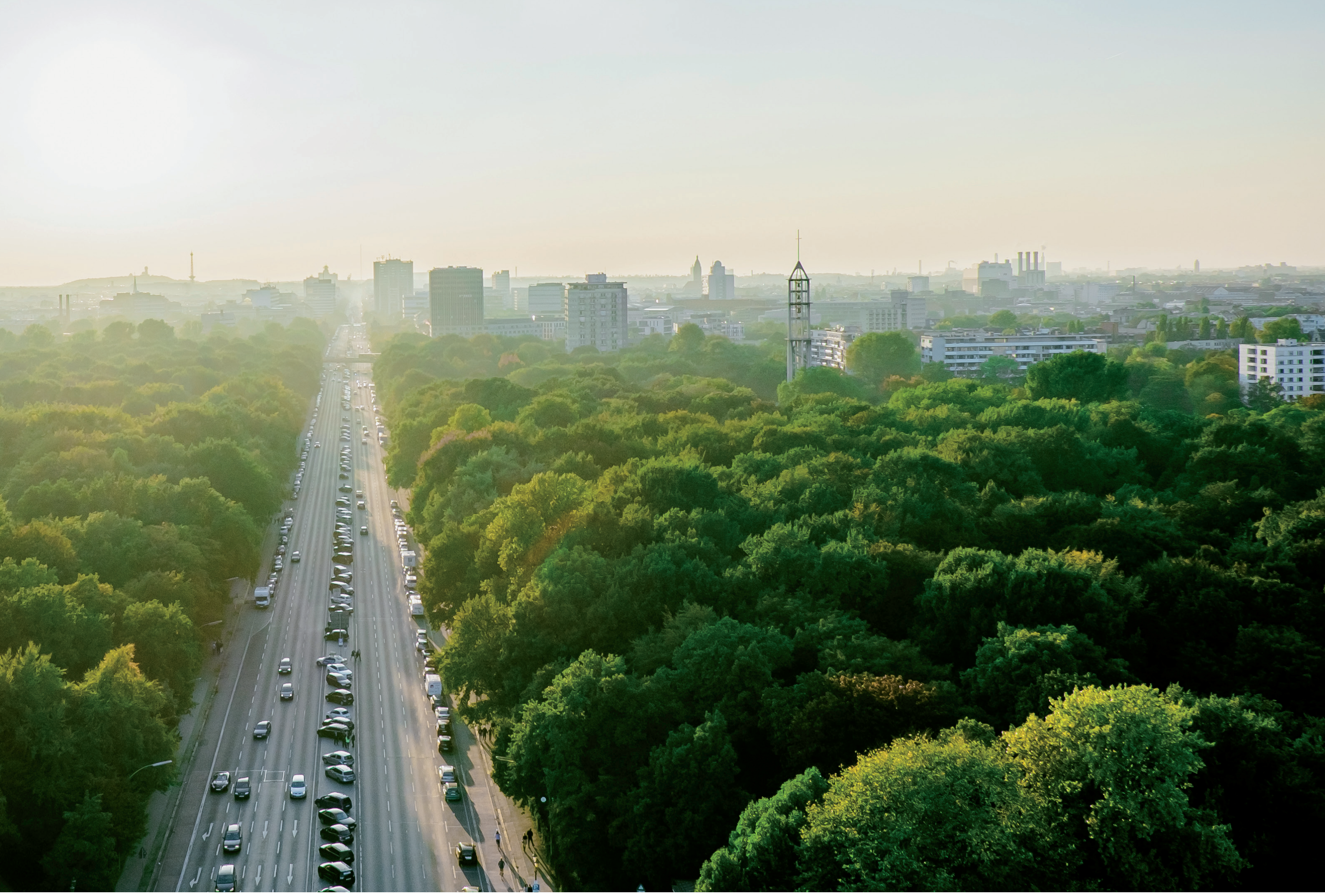
> "Our passive fund manager initially said they couldn't separate out our assets to make the proxy vote, so we asked for the tools to do it ourselves."
>
> Large UK pension fund

In spite of some cynicism, many investors believe a lot of these claims to be true as the reasons given by managers hold up to close scrutiny. Despite the increasing popularity of sustainable investing, plenty of fund management houses were previously wary of being classified within the 'ESG', 'SRI' or 'ethical' categories; in case it turned investors off or 'pigeon-holed' them.

Investors and their consultants are also pretty confident they can spot any 'greenwashing' from a fund manager within a couple of questions. They say that the tone of the whole organisation must authentically come from the top.

> "I know within 30 seconds of speaking with a fund manager whether the company has proper ESG credentials and I know within the same time whether a CEO has been told by his marketing team to put the Sustainable Development Goals (SDGs) in his speech at an industry conference."
>
> Large UK pension fund

[4] "ESG Special Report 2018 — BNY Mellon," *BNY Mellon website*.



Switching lanes

What has changed? From a small group of managers or token SRI funds being marketed by large fund houses, how did the industry get to embracing – and marketing – such vehement long-term investment strategies?

Data.

For many years, fund managers who claimed taking ESG concerns into account – when buying corporate debt or equity – would not hit performance, faced investors telling them to prove it.

Without a significant mass of funds managed in this way with a substantial track performance, many pension funds, family offices or other large investors with fiduciary responsibilities would just not take the risk.

Today, an explosion in data providers and funds dedicated to long-term investment – along with several high-profile corporate collapses and disasters – has pushed the pendulum the other way.

This data pile is growing as both fund managers and large institutional investors have begun recruiting specialists to work on finding the secret ingredient to long-term investing: performance without being hit by a negative impact for doing the right thing.

> "As a company, we want to spot the risks and opportunities that become material over time."
>
> Large international fund manager

However, this has to be met on the other side by companies that are willing and able to produce this data through clear, concise reporting. Without it, they may find themselves unable to access fair value capital on the open market.

Whilst advisors, including EY, have been working with companies of all sizes to help them produce what investors need to make informed decisions and engage where they see necessary, the international regulatory community has also stepped in.

> "Investors want more than just a data feed or ESG score. They need to see how it is impacting their portfolio – increasingly we have the data to show them that data is positive."
>
> Medium-sized UK wealth manager

Traffic police

For those not yet convinced by the value of long-term investing, international regulators have begun to change their minds for them.

In 2018, the European Commission published its first sustainable finance proposals, outlining how it wanted investors to allocate capital, considering the long term. To allow this to happen, the commission said it would require companies to prove their ESG claims were more than just rhetoric.

Some investors have demanded the company bosses' executive packages are linked to how well the organisation does on an ESG score.

> "It is still tricky for managers to get all the data they need from companies, but many realise that the market is shifting and if they want access to capital, they are going to have to move with the times."
>
> Large European fund manager

Aside from legislation on a European level, individual countries are implementing their own rules to ensure investors are able to consider what impact their money has on the wider world.

In the UK, the Department of Work and Pensions has, for the first time, enshrined considering ESG into a trustee's fiduciary duty, echoing moves already made in the Netherlands and other parts of Northern Europe.

Whilst plenty of the largest pension funds in the UK already study the long-term impact and outcome of their actions, smaller investors – with both less money and time on their hands – may initially struggle to fit these new considerations into their schedule. But, as managers start including sustainable finance into their general investment decisions, it should become less difficult.

> "For some trustees, it is just further down their priority list than a deficit or worries with the covenant — but they must come to realise that including these measures could actually help them."
>
> Large UK pension fund

Next exit

The next stage of the investor journey is to spot opportunities by investing with a long-term mindset. This approach includes picking the most forward-looking companies in an unfavoured sector – e.g., the traditional oil company increasing its solar energy investment – to spotting future winners from an entirely new area – e.g., companies operating public transport in emerging economies that run on entirely renewable means to mobilise a workforce.

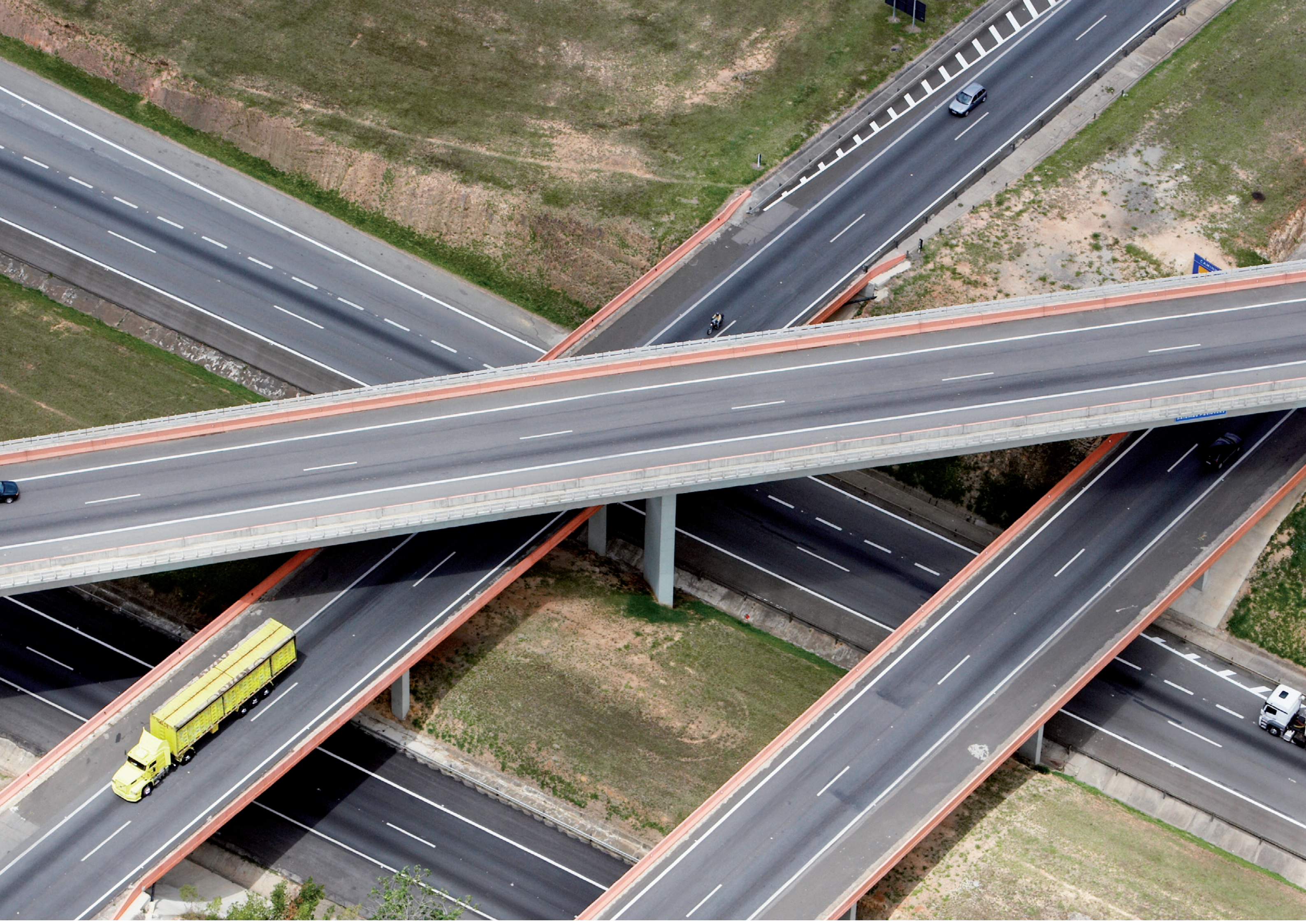
In particular, the investment and issuing of 'green bonds' has seen a dramatic increase in recent years. According to Moody's and the Climate Bond Initiative, the total value of green bonds (bonds used for environment projects) issued in 2017 reached $161 billion, an increase of 74% from 2016.[5]

There seems to be the most innovation here, but also a lot of investor scepticism. Some of this is a result of the labelling used in this industry. Whilst there are managers that have created specific funds for targeting specific outcomes – often related to the UN's SDGs – some in the industry are challenging whether the long-term mindset is an innovation.

> "It doesn't have to be labelled as a 'green' fund anymore — investors are just looking for opportunities."
>
> Large UK pension fund

> "I hear the term impact investment and I think 'old wine, new bottles.' Every investment has impact, doesn't it?"
>
> Large UK pension fund

[5] This number is forecast to increase to US$250 billion in 2018. "Ten Years In, the Green Bond Market Is Poised for Growth," *Morgan Stanley website.*



Spaghetti junction

One of the frequent complaints from investors — and managers — is the lack of standardisation in the terms used by everyone in the industry.

Unlike many areas of finance that have strict definitions — credit, loss and tax — SI, ESG, responsible investing (RI) and impact mean a litany of different things to every investor.

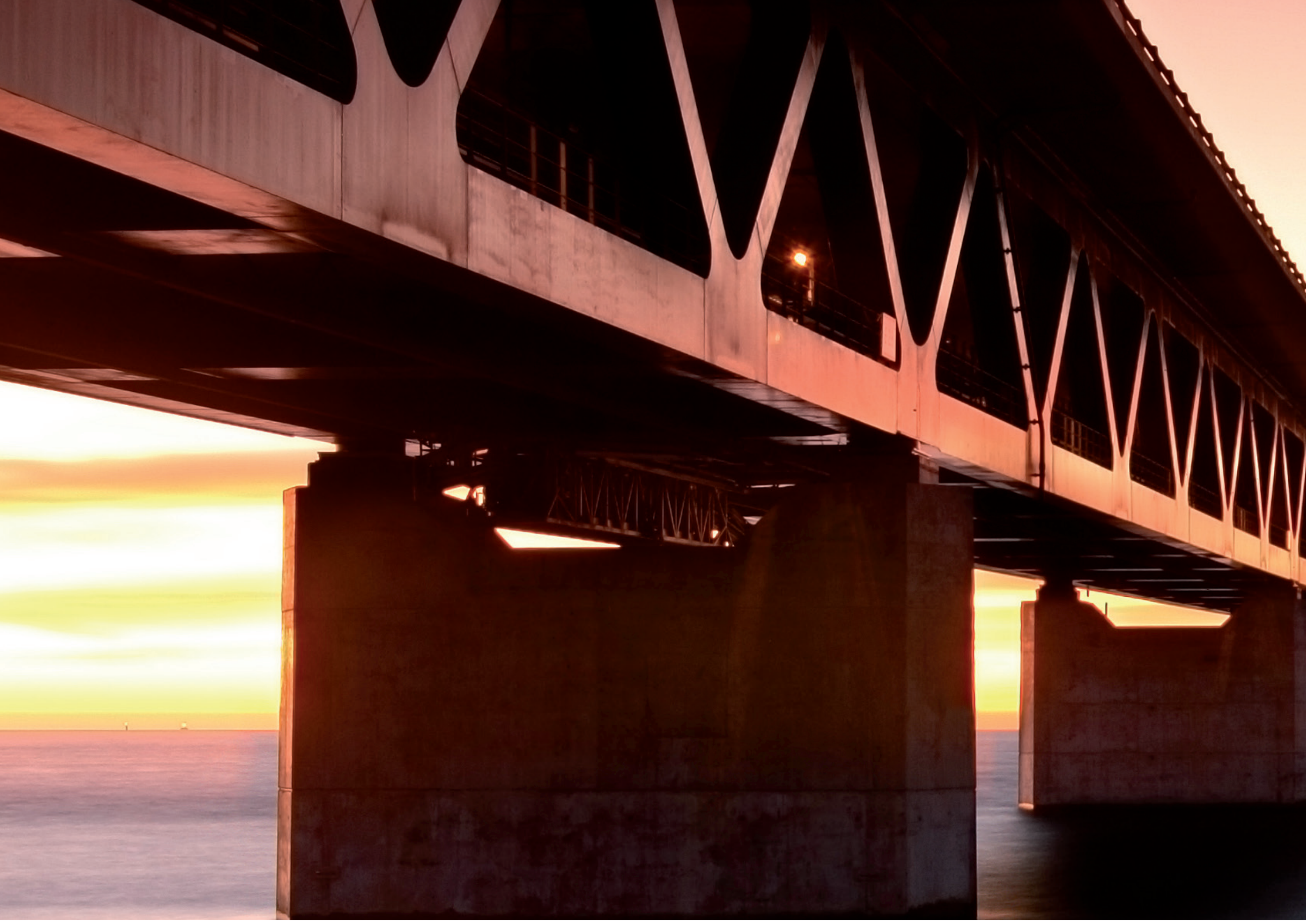
> "It is important that investors and fund managers understand what each other mean — and what each other's objectives are."
>
> Large UK pension fund

So far, there is no set framework or principles around how to describe what is required or on offer. Trustees and investors complain it is confusing to switch between definitions whilst figuring out if two funds labelled in the same way will produce the same result.

As there is no one officially 'in charge' of this global movement towards long-term investing, it's difficult for any one party to set out terms and definitions that can be used across the industry. However, the European Commission has taken a step towards creating some sort of a standardisation. As part of its sustainable finance initiative, the outline of which was published earlier this year, the Commission set out plans to establish a taxonomy that it claims will determine whether an economic activity is environmentally sustainable. Thought it does not break down the various labels used by different sections of the industry, it is at least an acknowledgement of the issue and an attempt to both create comparability of approaches and clarify classifications.

However, all agree that there needs to be a diversity of approaches from fund managers, due to the variability of what investors want, so one simple term will not do.

> "There is no right way to do it. Not everyone wants to be dark green, but managers need to listen to what investors want."
>
> Large European pension fund



Bridging the gap

Some investors and managers, who have been advocating this type of investment for some time, think there is a clear way to solve the issues around definition — and many think this is where the sector is going.

By shining a light on how capital deployment is linked to the end user, who can be both the investor and beneficiary, there is a way to differentiate what an investment is for.

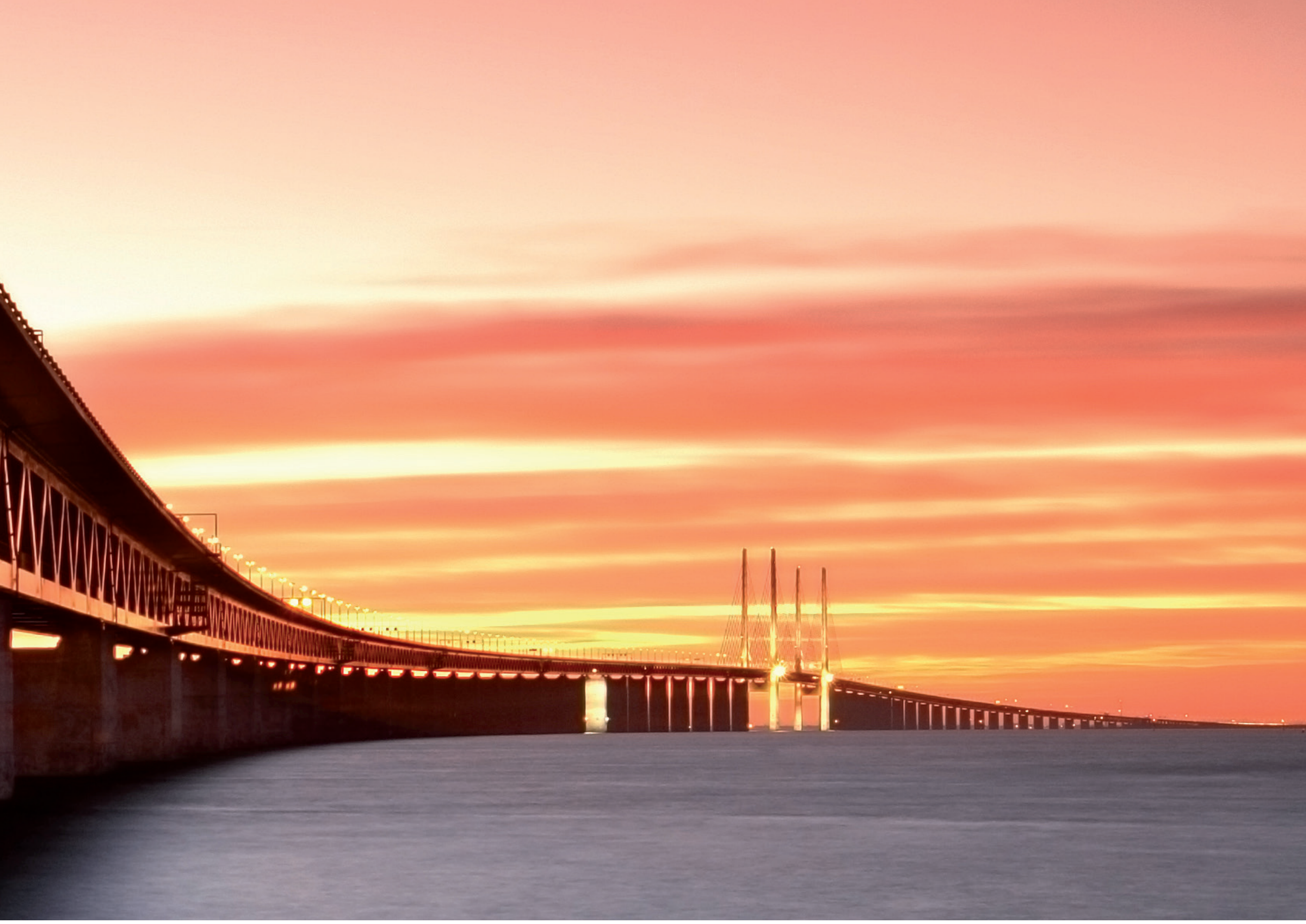
Ethical investment has a clear message of doing the right thing, whereas impact investing is intended to have a specific outcome. In its 2018 Annual Impact Investor Survey, the GIIN reported that 225 investors (which included pension funds) invested US$35.5 billion across 11,136 impact investment deals in 2017.[6] Some in the industry think that they can solve the jargon problem by showing the direction and function of the capital invested.

Long-term investing signifies how capital is not deployed to make a quick return, and takes care with how a company's business is sustainable throughout many periods of change.

> "By showing how capital links to the end user, real economy and society, we can empower the citizens on whose behalf we invest."
>
> Large European pension fund

> "Trustees might understand how their investments and finance works, but most of their members don't. We don't have anything like the Fairtrade Mark [for finance] but imagine if we taught how it worked in schools."
>
> Large European fund manager

[6] That is an increase of 58% from US$22.1 billion across 7,951 deals in 2016, "Impact investing deals soar in 2017 — GIIN," *Pensions & Investments website.*



Lights up ahead

But even with confusion about how the investment market is shifting, change seems to be accelerating.

Though still relatively small, defined contribution funds have also added their voice to the call for change. The 'ace card' these investors have to play is their growth potential, as auto-enrolment and auto-escalation rapidly increases the assets they will have under their control.

A generation of socially aware, engaged investors is growing, not just in the UK and mainland Europe, but around the globe.

> "Millennials do not have that much money now, but it is coming, and managers should be planning to be on the right side of the megatrend."
>
> Large UK pension fund

These large defined contribution funds communicate with their members about their potential investment options much more frequently than traditional defined benefit schemes. Surveys by the UK's largest funds show great appetite for both sustainable investment options and include these factors in overall portfolio theories from younger savers.

> "We have to show our membership we understand what their future is going to be. We want — and need them — to trust us so they stay invested."
>
> Large UK pension fund

Wealth managers, too, have been rapidly adjusting to the changing outlook of the client group they are about to inherit. Some of the largest investors in the sector have committed to ensuring that the passing of intergenerational capital goes beyond just the transfer of money.

> "For someone like me, climate change is a real risk. For my daughter, it is going to impact at least half of her life — and she will want to know what she can do to stop it."
>
> Large UK pension fund

End of the road?

Despite the confusion over terminology and potential for some managers to 'greenwash' their way into investor portfolios, few in the whole sector think that the sustainable, long-term investment road will U-turn.

> **"Investing purely for alpha is going to seem amoral to the next generation."**
>
> Large European fund manager

The next steps are to focus on what the trillions of pounds, dollars, euros and yen invested in pensions and other savings schemes could achieve – and by when. The industry also needs to work with companies and regulators to create a schedule and system to monitor corporate activity, in a way that is fairly rewarded and punished by capital markets.

However, the industry must not get carried away, thinking that 'one size fits all'. Investors' needs and outlook, although shifting further out, will never be uniform, and what they are presented with needs to reflect it.

Optionality is going to be key to onboarding investors across the spectrum, supporting some and encouraging others to put their capital to work.

Some investors and managers may never fully embrace the long-term investment vision, but they are more likely to end up as the minority.

Victory lap

For the sustainable investment enthusiasts, the race may seem to be almost won. But rather than sitting back and admiring a long-term investment landscape, they are likely to be looking at what comes next.

Issues being brought to the public attention with the SDGs are likely to make their way into investor portfolios as people make the connection about what their money can do.

The advent of alternative intelligence and increased use of technology in investment will only provide deeper insights into how capital can be deployed more effectively – and engage a wider audience of investors.

Recent developments reflect how the industry is changing. The government appointed Elizabeth Corley, Vice Chair of Allianz Global Investors, in 2016 to chair a new Advisory Group of senior representatives from across the investment industry to consider how to grow a culture of social impact investment and savings in the UK. The group's initial findings were published in 2017.[7]

The Embankment Project for Inclusive Capitalism (EPIC) brought together 31 global companies over 18 months to develop new metrics and methods for businesses to measure and report on the value they create for stakeholders. A key element of this project was the further development of the EY Long-Term Value (LTV) framework that was tested and validated by asset owners, asset managers and companies, with the aim of becoming a global tool to measure how companies deliver value for all stakeholders and how this creates and protects long-term financial performance.[8]

EY are now embarking on a survey of asset management chief investment officers to understand their plans for sustainable investing. If you're interested in participating, please get in touch with Paul Stratford at pstratford@uk.ey.com.

The long-term investment journey is not over – for many investors and their partners, it has only just begun.

[7] "Growing a culture of social impact investing in the UK," *GOV.UK website*.
"Advisory Group launched to look at how individuals can make a social impact with their investments," *GOV.UK website*.

[8] "EY - Long term value", *EY website*.

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