



Adviser Guide to Responsible Investment

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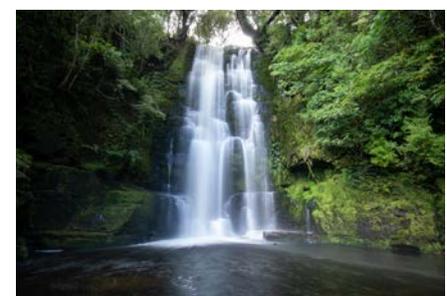
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As custodians of your clients' money, financial advisers are at the forefront of perhaps one of the greatest shifts in investor behaviour in a generation. Until recently, the primary focus for most investors was to ensure that the return on their investments met their financial goals. Today, of equal importance for many is a desire for those investments to be in line with their broader social conscience – a desire to do good, avoid doing harm and lead change.

It is now clear that these two goals are not mutually exclusive – quite the contrary. ESG and Responsible Investment have earned their position as compelling propositions for investors of all stripes. However, the challenge for the advisory community is navigating this brave new world of investing with a conscience. Square Mile's principal purpose has always been to help advisers make informed decisions on behalf of their clients and this guide sets out to help them meet that challenge

Richard Romer-Lee
Chief Executive Officer



The Age of Responsible Capitalism and Responsible Investment

There is no doubt that we live in a fragile world. Environmental and social issues are becoming more entrenched and harder to ignore, whilst people everywhere are growing increasingly concerned for the future of our planet and for society's ability to function for the greater good of everyone.

Activists, protest movements, issue focused campaigns, scientists, and the young people set to inherit this situation have been calling for change for a while now. However, over the last 18 months this voice has gained momentum with governments, regulators, and individuals globally calling for a kinder form of capitalism centred on the idea of conscious consumerism.

This progress has also been felt in the asset management industry. This has been driven by two factors, the first being investors who have begun asking questions about where their savings have been invested and why. This interest has been fuelled by initiatives like the Make My Money matter campaign, which encourages people to investigate where their pensions are invested, and the UN Sustainable Development Goals (UNSDG), which essentially act as a blueprint for countries to

meet and solve some of the world's most pressing issues. The UNSDG's are critical to the achievement of the UN's Agenda for Sustainable Development.

The second factor has been the gradual realisation from asset managers that Environmental, Social and Governance (ESG) factors can, and likely will, have a material impact on the price of a security and viability of companies and ultimately the success of their funds. Indeed, capital has already begun to flow aggressively towards companies which are focused on managing any environmental and social risk factors and behaving in a responsible manner towards all of their stakeholders, instead of just their shareholders.

The asset management community would claim that governance has always been a key part of any investment decisions.

In this document, we endeavour to explore what this means for you and your clients, starting with how to define ESG and Responsible Investment, moving onto the regulatory agenda and concluding with suggestions as to how to integrate this into your business.



ESG and Responsible Investment

At Square Mile, we are committed to helping our clients help their clients make the most informed investment decisions. Hopefully enabling them to meet their aspirations, liabilities and, in the case of Responsible Investment, stay true to their convictions. Critical to this is the ability to help investors understand the many facets of investment and how it relates to them.

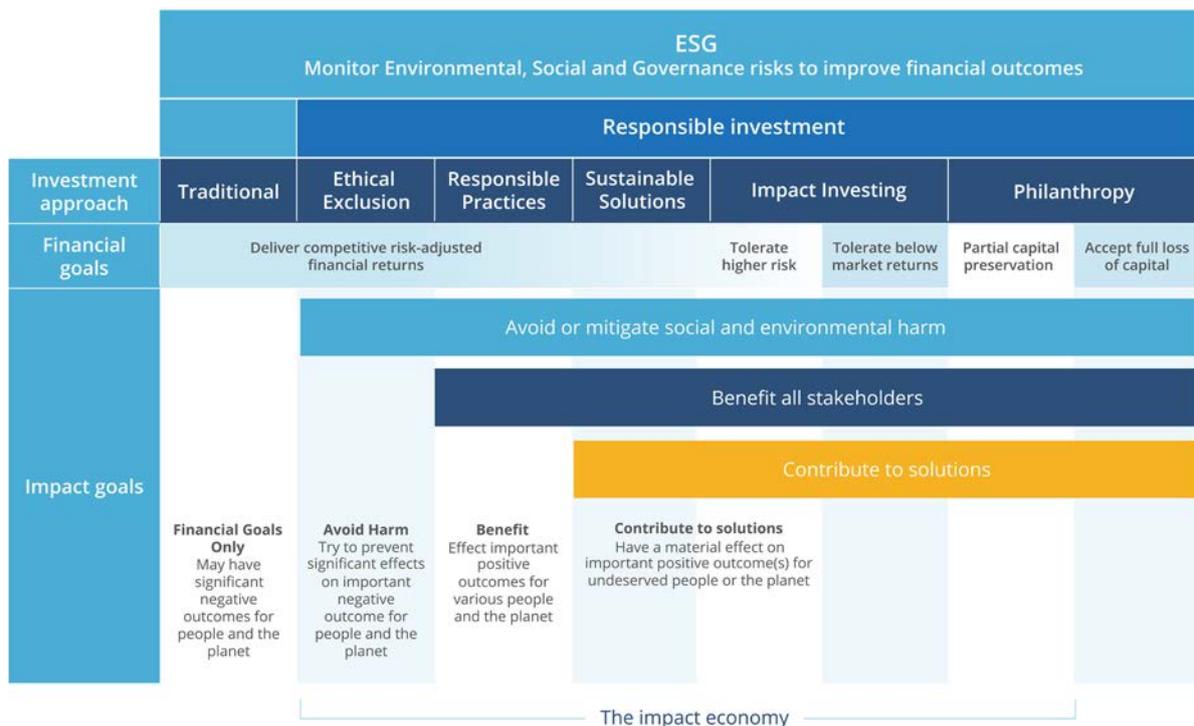
Although we firmly support the industry's embrace of Responsible Investment, we are also keenly aware that there has been a great deal of inconsistency when it comes to both the language and the approaches applied. Consequently, there have also been differences in the interpretation of what can be very subjective topics and what they constitute in terms of investment, as well as the terminology deployed, causing confusion amongst investors.

The FCA have revealed the overarching term they intend to use will be ESG across the Responsible Investment spectrum. Therefore, we felt it important to clarify how we think about ESG and Responsible

Investment to the market and to our clients.

We believe ESG is the overarching term that encompasses any and all funds. However, as illustrated in the Spectrum of Capital, we believe the next step on from ESG is Responsible Investment which identifies funds with a focus on meeting a Responsible objective.

This spectrum of approaches, also known as the **Spectrum of Capital**, can be seen below and is increasingly being used by the media and by many different asset management groups in their client or investor focused communications. It helps asset management groups to demonstrate where their products fit, in terms of attempting to map out the broad range of risk/return strategies available, how they relate to ESG and Responsible Investment approaches more generally and what clients can expect. Essentially, it can be used to demonstrate how one transitions from traditional fund management on the left to the opportunity to drive real change, in terms of investing in sustainable and impact strategies, on the right.



Source: Stylised adaptation from OECD (2019), "Social Impact Investment, the Impact Imperative for Sustainable Development.

We believe that **ESG integration** should be seen as an input into an investment process, rather than something which produces an output. Indeed, as we consistently say to our clients and to the market, the integration and active consideration of ESG analysis is a way for asset managers to mitigate risks and identify opportunities that could have an impact upon a company's share price or continued viability. Essentially, it gives them a broader and more detailed perspective of a company or companies, helping them to make the most informed investment decision possible.

That being said, we believe ESG analysis to be one of many 'hygiene' factors that can be integrated into the investment process applied to any and all funds, with the evidence clearly showing that the application of ESG analysis into investment processes is ultimately leading to better performance and better outcomes for investors.



Environmental

- Carbon emissions
- Energy efficiency
- Climate effects
- Water scarcity
- Waste management
- Pollution mitigation
- Resource erosion



Social

- Diversity & workplace policies
- Labor standard
- Supply chain management
- Product safety
- Community impact
- Health & Education
- Sustainable products



Governance

- Board diversity
- Executive compensation
- Political contributions
- Bribery & corruption
- Accounting & reporting
- Cyber security
- Trafficking and modern slavery

Responsible Investment, meanwhile, is where managers actively and intentionally seek to do good, avoid doing harm and lead change by investing in companies which are helping to meet the world's most pressing challenges, whilst avoiding or seeking to improve those which perpetuate our problems. At Square Mile, we see Responsible investment as an umbrella term from which spans a spectrum of differing investment approaches, ranging from those that exclude certain securities or sectors to those that are focused on delivering a positive and measurable impact to society and/or the environment.



Ethical Exclusions

An ethical exclusions fund manager seeks to avoid industries and company practices that cause harm to people or the planet.



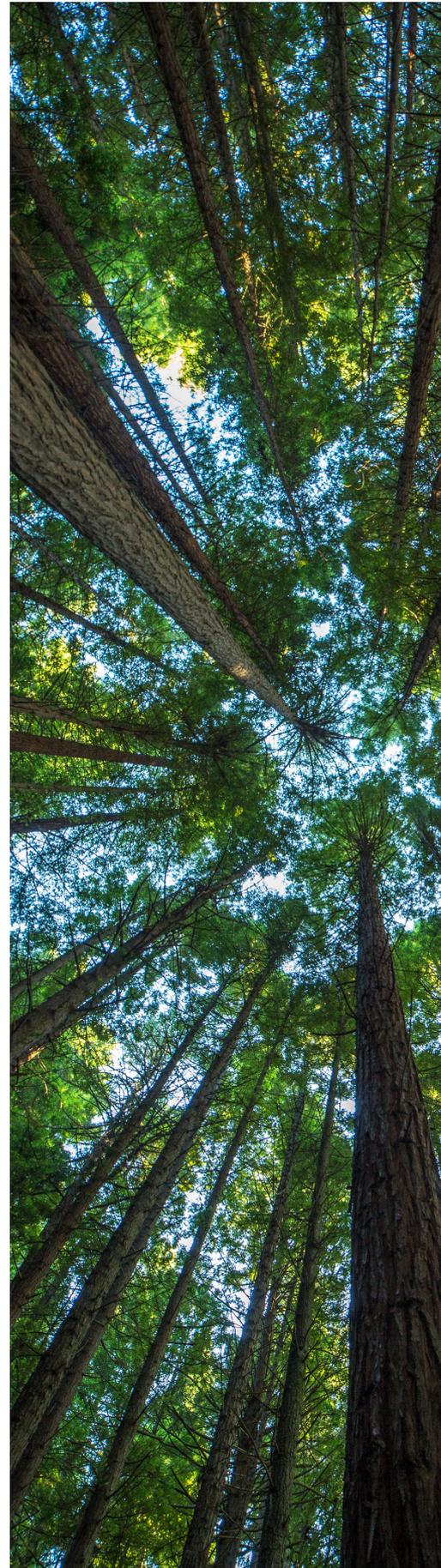
Sustainable Solutions

Sustainable funds are those which are helping enable the transition to a more sustainable world. Examples of this could include investment in companies which are enabling or delivering solutions to environmental, social and economic challenges, as well as those which are evolving their operations and products or services. It can also encompass thematic funds, which are focused upon a particular issue, such as the energy transition.



Impact Investing

Impact funds display a clear intent to deliver a positive social and/or environmental impact by investing in companies providing solutions to the world's most pressing challenges. This should be demonstrated through the achievement of measurable outcomes, which are clearly evidenced and reported on at least an annual basis.



We would note though that it is important to remember that this area of Responsible Investment is also a very personal one, as it connects our daily lives and convictions with what we do with our savings - two areas which have traditionally been kept separate. However, the autonomy now lies with the investor, enabling them to dictate what matters most to them and how they want their capital to be deployed.

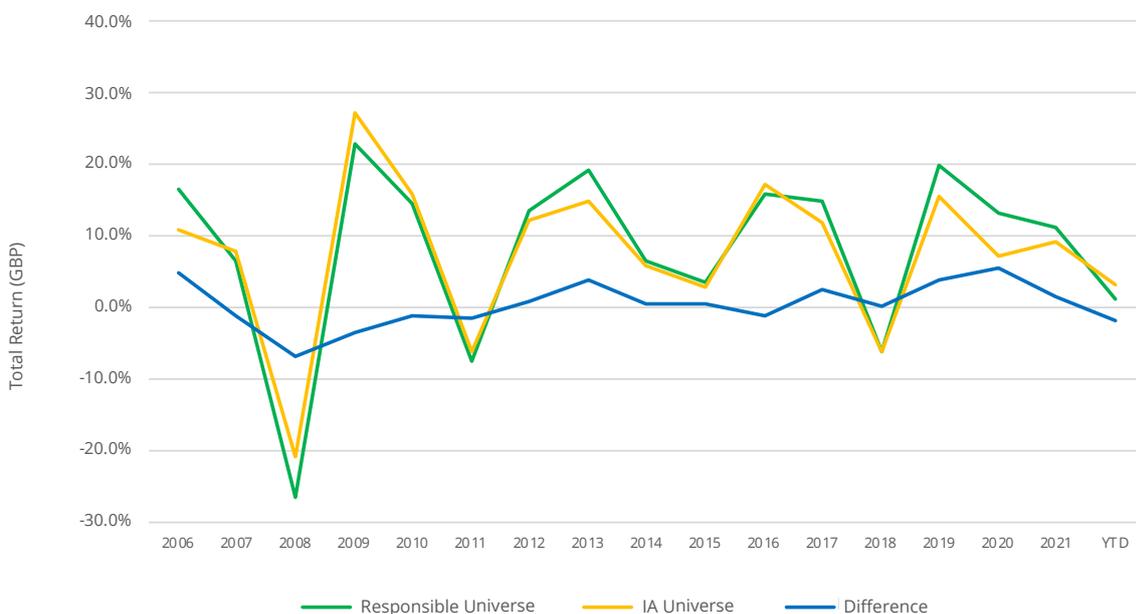
This requires a genuine understanding of what resonates with your clients and where they sit on the Spectrum of Capital. This in turn necessitates an honest and open conversation, which, given the confusion around terminology and approach, is not necessarily easy to have, in terms of being able to accurately explain what each term means in practice. That being said, to facilitate an authentic interaction, we would suggest adopting, and consistently using, a framework of terminology, such as the aforementioned. To assist in this discussion, we have produced a document. What **'type of investor'** to help explain the various areas.

When it comes to Responsible Investment funds, there is also a common misconception that applying one of the approaches in some way

limits investment opportunities or potentially compromises performance returns. However, research conducted over the past decade indicates that there is no longer a trade-off between investing responsibly and the growth potential. Instead, given the level of co-ordinated government and corporate support for development in these areas, this style of investing seemingly offers a growing and diverse universe of securities which is positive for long term capital growth and the performance of these funds.

We would also highlight that ESG analysis, which can be integrated into the investment process of any fund, can help to mitigate risks and identify potential opportunities that have an effect on a securities price and viability moving forwards. Therefore, funds that integrate ESG factors into their investment processes or are responsibly focused could naturally be expected to compound better returns over the long-term. Moreover, it is becoming increasingly evident that investors are beginning to discriminate between companies with good and bad ESG credentials, with capital flowing towards companies demonstrating positive or improving approaches to ESG and away from the laggards.

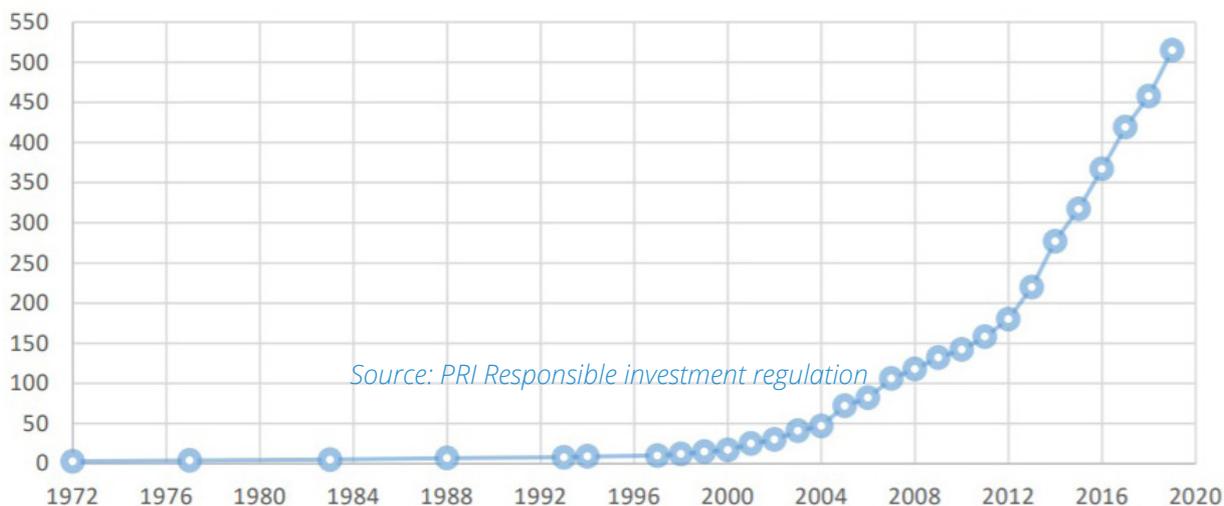
IA Universe of Funds: Traditional Vs. Responsible



Source: FE Analytics as at 23rd February 2022
 Past performance is not a guide to future returns

The regulatory changes

Cumulative number of policy interventions per year



Regulatory initiatives supporting Responsible Investment were virtually non-existent prior to 2000. Since then, Principles for Responsible Investment (PRI) policy has grown at a rapidly increasing rate. Indeed, the UN PRI estimates that globally some 80 policy initiatives were released in 2019 alone, with there now being over 500 different initiatives and pieces of regulation in place.

Prior to Brexit, the Financial Conduct Authority (FCA) and, in turn, UK Financial Advisers were obligated to adhere to the MiFID regulations. These regulations have recently been amended by the European Commission to ensure that European advisers ascertain and account for their clients’ sustainability preferences. However, as a result of Brexit, these changes are not being transitioned to the UK. Instead, the Treasury has embarked upon a review of the EU’s ‘green regulations’, with a view to preparing recommendations on how the UK can introduce comparable regulations.

These will likely be comparable to the EU’s, though some would suggest that the FCA believes the UK regulations will be more effective or rather less compromised than their European counterparts, as they reflect only one voice and agenda, rather than

those of multiple different countries. Moreover, they will need to facilitate the aim of Chancellor, Rishi Sunak, and his governmental colleagues to maintain London’s position as a global financial centre by securing its position as a green finance hub.

Whilst the UK has not released any regulatory framework relating to integrating Responsible Investment into the suitability process, the latest update in this space comes from the FCA and Investment Association (IA). The FCA have identified ESG as the overarching term to encompass all Responsible investment whilst the IA have determined the overarching term to be Responsible Investment. These two naming conventions still differ from the EU which has decided the umbrella term to be Sustainability. The recent consultation papers issued (CP21/17 and CP21/18) by the FCA are further evidence of the direction of travel within the Responsible Investment space. These two consultation papers are inviting feedback on the enhancement of disclosures for listed companies under CP21/18 and for asset managers under CP21/17 which details a staged approach to the publication of the specific disclosures starting in 2023.

Green Finance roadmap

The UK Government has issued a roadmap, outlining the way ahead for greening the UK finance industry. At 48 pages its not a short or an easy read, so this summary aims to detail the main points and how it impacts advisers and fund buyers.

The overall aim is to provide the information that investors and businesses need to properly understand the full range of environmental risks they face and create; to tackle greenwashing by defining what is sustainable; and to ensure that investors have access to reliable, high quality and intentionally comparable, and material ESG information.

The roadmap covers phase one and is directed at companies and asset managers. An update will be issued in 2022 following further consultation. There are three main elements of the roadmap:

- Sustainability Disclosure Requirements
- UK Green Taxonomy
- Stewardship



In many respects, ESG is already in scope when advisers give investment advice. Under existing rules, firms have to act in a client's best interest and collect all necessary information to understand the client's investment objectives. In that context, suitability, within our conduct of business rules, already requires the consideration of ESG preferences. The rules set out the objectives that a firm is required to consider but this is not intended to be an exhaustive list.

Mark Manning,

Technical Specialist, Sustainable Finance and Stewardship, FCA



What this means for you

Although there is currently no timescale as to when any potential rules on suitability will be implemented or an indication as to their extent, we believe it would be prudent for advisers in the UK to start preparing their businesses to capture and understand their client's preferences in respect of Responsible investment and ensure that they have made provisions for those clients within their Centralised Investment Proposition (CIP).

The direct impacts on advisers and fund buyers are limited, at least in the short term, but the Green finance roadmap gives a clear indication of the direction of travel. There are also several major implications for you – most notably the need to understand and explain the new reporting to clients, and to incorporate it into your decision making. According to the roadmap, 70% of the public want their money to go towards making a positive difference to people or planet. Investors will be asking you for these sort of investments and being able to respond positively will be critical in the years ahead. Furthermore, when the sustainability investment labelling regime comes into force, you will need to be able to understand what function different types of sustainable investment perform and how they relate to the needs of investors.

How to embrace and apply sustainability within your business

- Modify your CIP to meet the new opportunity
- Revise your suitability and fact find process to fit your CIP
- Maintain the operational efficiency that a CIP delivers
- Educate your staff to ensure they understand the terminology and the differing investment approaches
- Responsible Investment can be more personal:
It is important to recognise that you may have to develop options for non-standard clients who have specific requirements, such as not wanting exposure to Tobacco
- Evidence:
With the funds you choose, look for evidence as to how they are meeting their Responsible Investment objectives as clients will likely ask for proof of what their investment is achieving from a non-financial perspective
- The CIP is designed primarily to deliver consistent excellent client outcomes, whilst facilitating operational efficiency within an adviser's business. As such, the aim must be to evolve the CIP to meet the changing client requirements without sacrificing the operational efficiency that the business has achieved by its introduction.



Opt in or Opt out?

The Responsible Investment movement is not just about client choice, it is also a choice for adviser businesses.

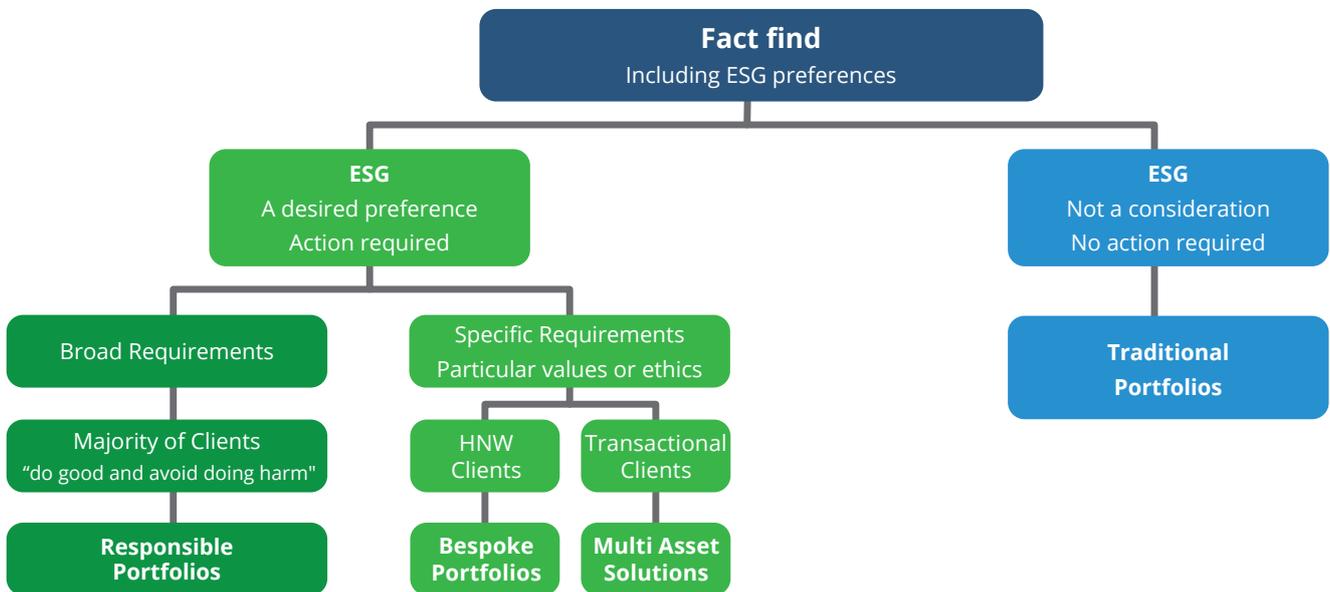
It is widely anticipated that Responsible Investment is going to drive the investment strategies of the future. Therefore, it makes sense for this to be front and centre within your offering, as well as becoming integrated within your culture and brand.

For those who are still uncertain of this change, we would suggest that you maintain traditional solutions as your core offering, but also introduce a satellite offering of Responsible Investment

solutions to facilitate the needs of those clients who are looking for that option.

Offering Responsible Investment solutions is a response to the societal change which is starting to gather pace, with more clients wishing to see their investments avoid doing harm, helping protect the environment and increasing the quality of living in society. Those with broad requirements or aspirations in this space will be best served by investments in a diversified portfolio of funds which have a clear mandate to invest across the responsible spectrum. However, there will be a small sub-set of clients with specific values and ethical requirements that will demand further evaluation.

An Example CIP



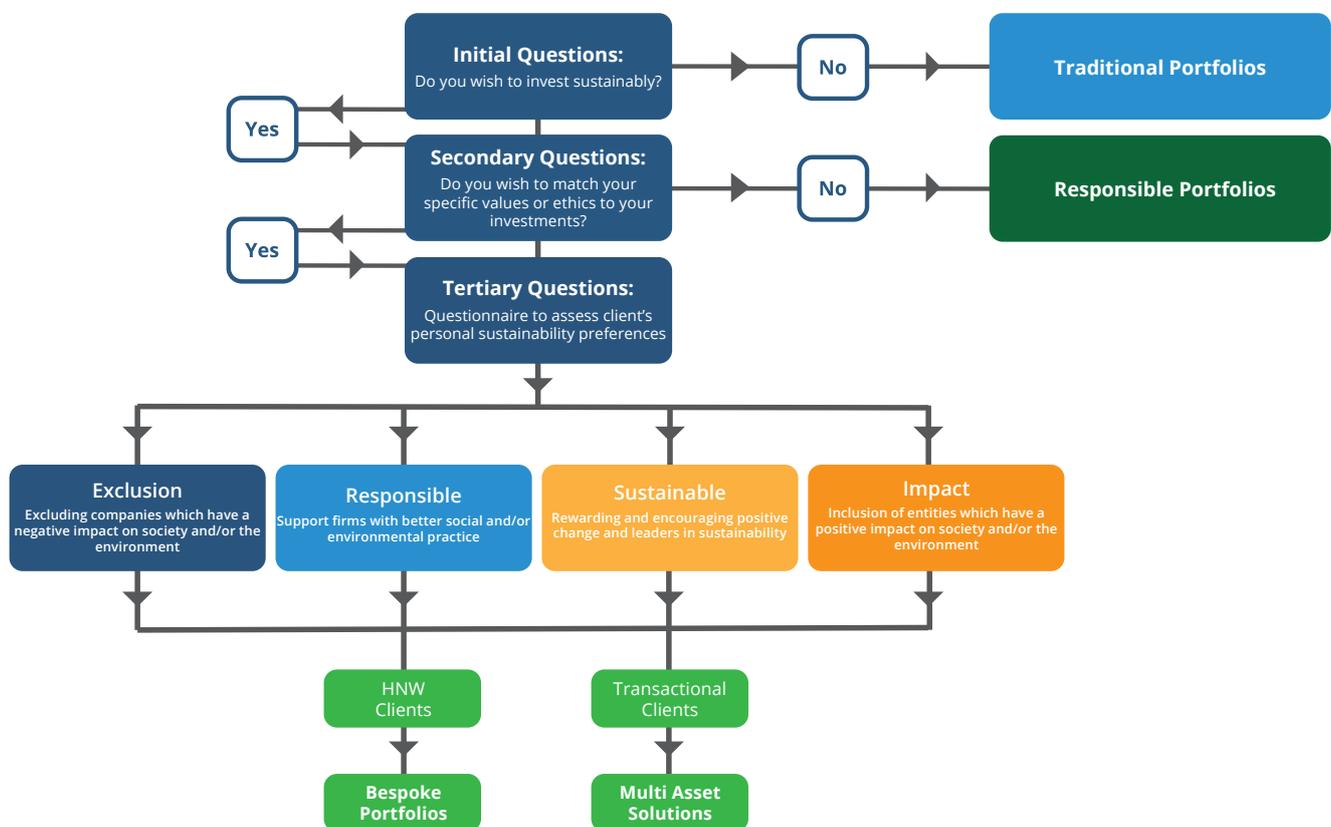
Practical application within the Adviser Suitability Process

The changes suggested are modifications but could over time become fundamental re-engineering in terms of outputs not process. This does not have to be complex and could be facilitated by the introduction of a few key questions which will enable the topic to be discussed and considered. The other option is to only offer Responsible Investment options and therefore have clients opt out of this stream, though this may be too dramatic a change at this moment in time and a more incremental approach may be preferred.

The regulations stipulate that there is a requirement for the adviser to assess the client's attitude to risk and capacity for loss, along

with a number of the other factors through the information gathered in the fact find process. It is expected that in the UK there is likely to be a regulatory requirement to capture a client's sustainability preferences (this is the term used in the EU regulations but it may well be reclassified as Responsible for a UK audience) as part of the initial and ongoing suitability process, which could add an additional layer of complexity for an adviser to deal with.

This diagram provides an example of how an adviser may consider identifying a client's sustainable investing preference.



Responding to your clients needs

Clients that wish to see their investment do some good, avoid doing harm and lead change when it comes to social and environmental themes will, in most cases, be happy to invest in a broad Responsible investment portfolio of which a Sustainable portfolio or fund could be an option.

Clients not interested in investing responsibly will continue to invest in traditional portfolios. However, you may want to look at traditional portfolios that have ESG embedded into their process.

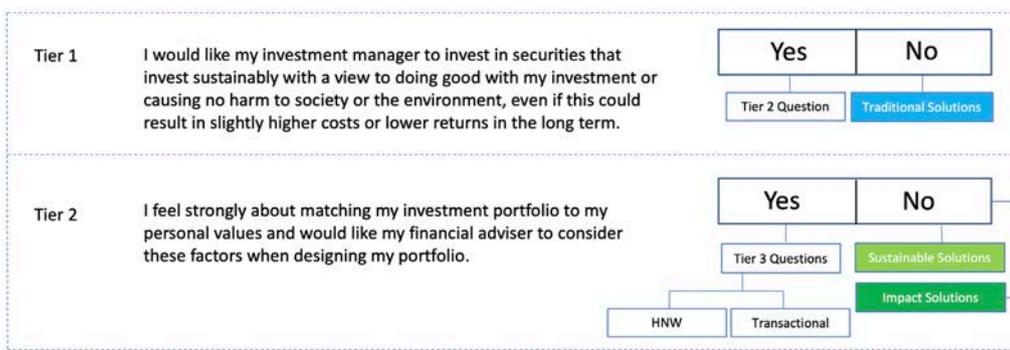
Clients with specific value or ethics-based investment needs will require greater consultation to determine the solutions that are best places to meet their needs and convictions.



Ensuring a match between input (fact find) and output (CIP)

There are many ways to adapt the fact find to enable advisers to incorporate sustainability into the suitability process. Below are examples of basic static questions.

For most clients who have indicated on their initial questionnaire that they would like to do some good or avoid doing harm through their investment, investing in a responsible style portfolio will meet their needs. The challenge for advisers comes when a client wishes to match specific values or ethics to their investment needs.



Static tables such as the one shown below can be a relatively simple way to assess what is most important to a client, and whether there are specific needs that the client is not willing to compromise on. It also evidences a consistent process when assessing clients' sustainability needs within the suitability process.

Ethical exclusion	Less important				Strongly agree
Would you like to require fund managers to avoid harmful activities and practices?	1	2	3	4	5
Are there any particular activities you would like to avoid?	<hr/> <hr/> <hr/>				
Responsible practices	Less important				Strongly agree
Would you prefer fund managers to support better social and environmental practices?	1	2	3	4	5
Sustainable solutions	Less important				Strongly agree
Would you like to focus on investments that help to solve major social and environmental challenges in the belief that they will generate superior returns in the long term?	1	2	3	4	5
Impact investing	Less important				Strongly agree
Would you like to see the social and environmental impact of your money helping to solve major social and environmental challenges?	1	2	3	4	5
Summary	Least attractive				Most attractive
Ethical exclusion	1	2	3	4	5
Responsible practices	1	2	3	4	5
Sustainable solutions	1	2	3	4	5
Impact investing	1	2	3	4	5

While using tables can be useful, advisers may prefer to lead with more open questions to get to the bottom of their client's wishes and expectations when it comes to their investment needs. The output from this approach needs to be clearly minuted and ratified by the client to ensure that the adviser is able to demonstrate a clear understanding of their needs, in order to assess the most suitable solution to meet that need.

How Square Mile can help advisers invest responsibly

Square Mile provides a wide range of services that put the needs of the advice firm and their clients firmly at the centre of their Responsible investment solution.

- **Academy of Funds:** A wide selection of Responsibly rated funds and ESG Integration assessments at both firm and fund level to help with your responsible portfolio construction.
- **Bespoke Consulting:** Independent input into your Responsible Investment proposition.
- **Square Mile Sustainable and Impact Managed Portfolios:** Available on select platforms.
- **Bespoke Responsible Managed Portfolio Service:** Designed to complement your suitability process.
- **Advisory Portfolio Service:** Designed to complement discussions you have on a day-to-day basis to achieve the best outcomes suited to your clients' needs.
- **3D Investing Oversight and Reporting:** Granular, stock level analysis for specific client requirements. The 3D analysis are awarded to Responsible Investment funds which have been assessed against the 3D framework of 'do good', 'avoid doing harm', and lead change'.



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