FOR PROFESSIONAL INVESTORS ONLY

Adviser Guide to Sustainability

February 2021

SQUARE MILE
INVESTMENT SERVICES

Contents

"As custodians of their 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 advisers 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 Capital 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 the planet and for society's ability to function in the interest 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.

Progress which 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, which essentially act as a blueprint for countries to meet and solve some of the world's most pressing issues and are critical to the achievement of the UN's Agenda for Sustainable Development.

The second factor has been the gradual realisation from fund managers that environmental, social and governance factors can, and likely will, have a material impact on the share price and viability of companies moving forwards and, as such, 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.

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.

Defining 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 ESG and Responsible investment, we are also keenly aware that there has been an 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.

Therefore, we felt it important to clarify how we think about and define ESG and Responsible investment to the market and to our clients.

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 fund 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
- Water scarcity
- Waste management
- Pollution mitigation

Social

- Diversity & workplace policies
- Labor standard
- Supply chain management
- Product safety
- Community impact

Governance

- Board diversity
- Executive compensation
- Political contributions
- Bribery & corruption
- Accounting & reporting

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 stems 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.

Types of Responsible Investment

Ethical exclusion

Avoids industries and company practices that cause harm to people or the planet.

Responsible practices

Considers the operational practices of the companies in which they invest and supports 'best practice', as well as encouraging them to improve their environmental and social performance.

Sustainable solutions

Seeks to invest in companies that are providing solutions to social and environmental challenges and believes in the long-term financial benefits of doing so.

Impact investing

Wants to use their money to make a wider positive social or environmental impact as well as meeting their financial needs and wants to see evidence of this impact.

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 fund management groups in their client or investor focused communications. It helps fund 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 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.

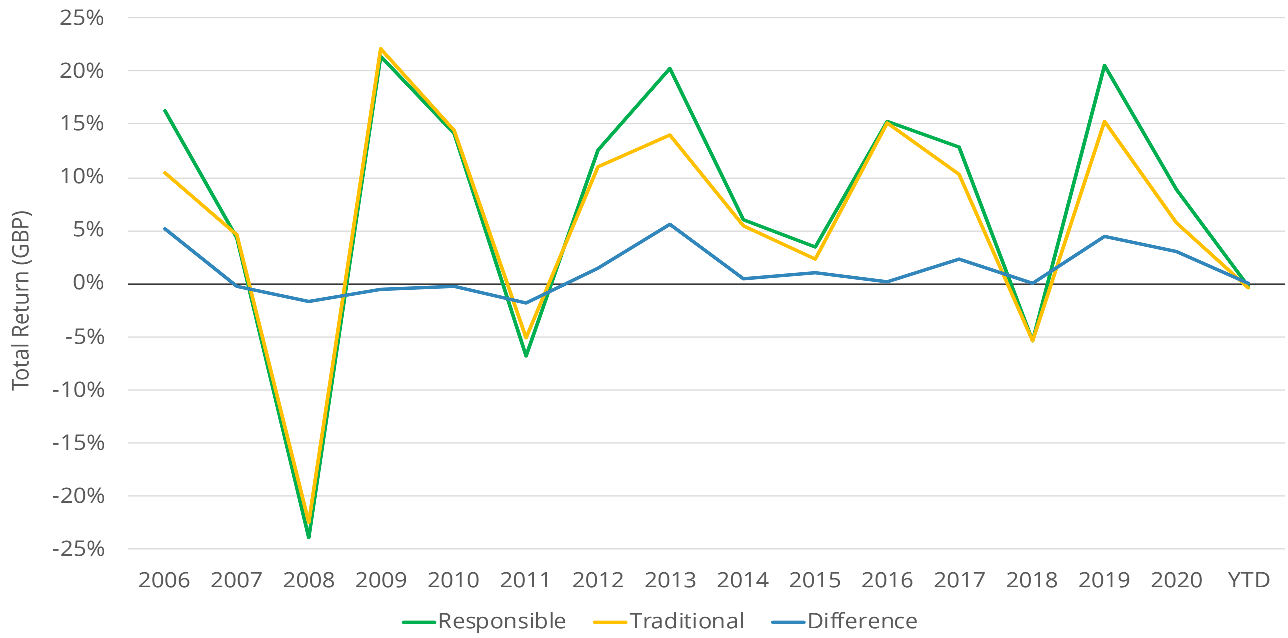
We would note though that it is important to remember that this area of investment is also a very personal one, as it connects our daily lives and convictions with what we do with our savings - two areas which have traditionally been kept separate. However, the autonomy now lies with the investor, enabling 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 shown above. 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.

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 company's share 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

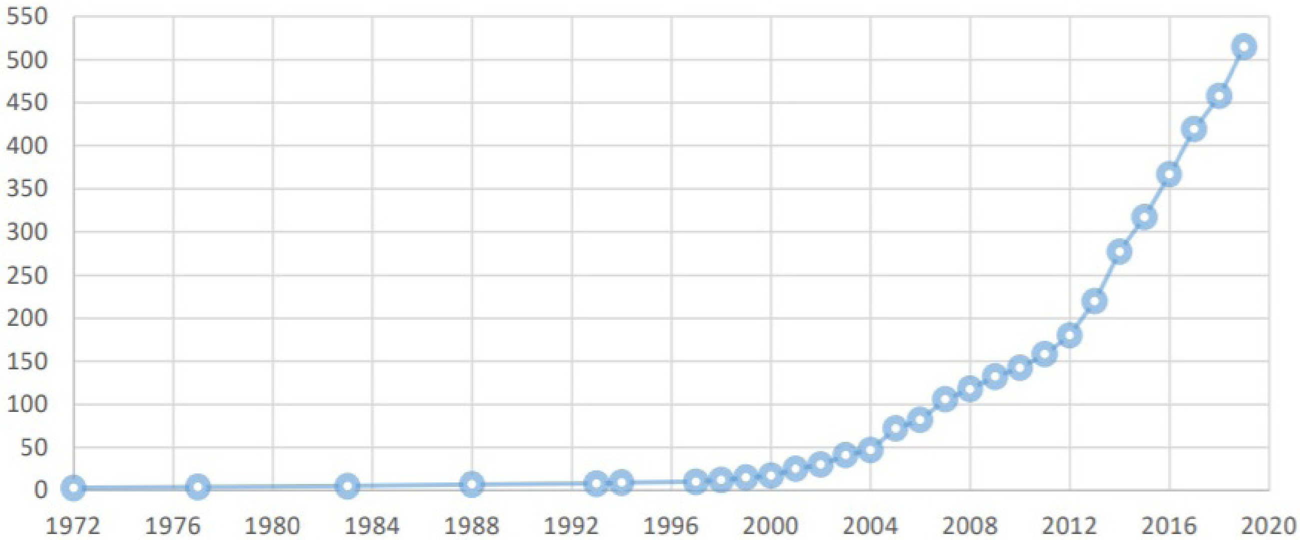


Source: FE Analytics as at 31st December 2020
Past performance is not a guide to future returns

The regulatory changes

Regulatory initiatives supporting Responsible investment were virtually non-existent prior to 2000. Since then, however, 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.

Cumulative number of policy interventions per year



Source: PRI Responsible investment regulation

Prior to Brexit, the 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.

What this means for you

Although there is currently no timescale as to when they 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).

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 needs of the changing client requirements without sacrificing the operational efficiency that the business has achieved by its introduction.

Opt in or Opt out?

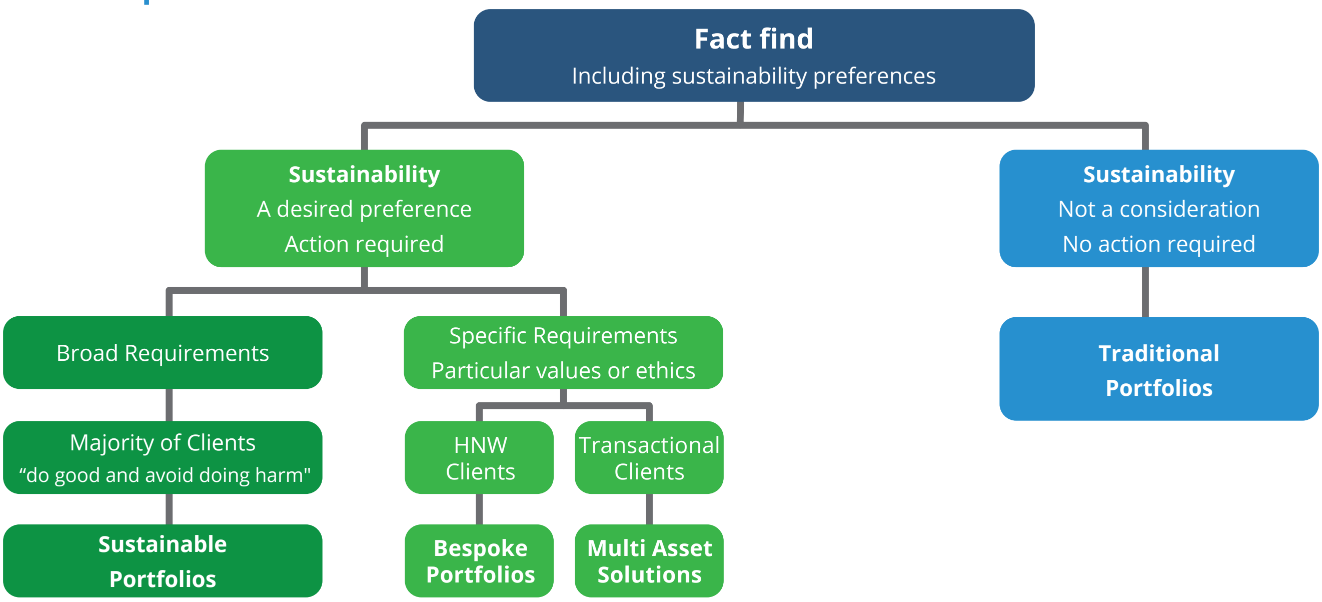
The Responsible investment movement is not just about client choice, it is also a choice for adviser businesses.

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 afoot, 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

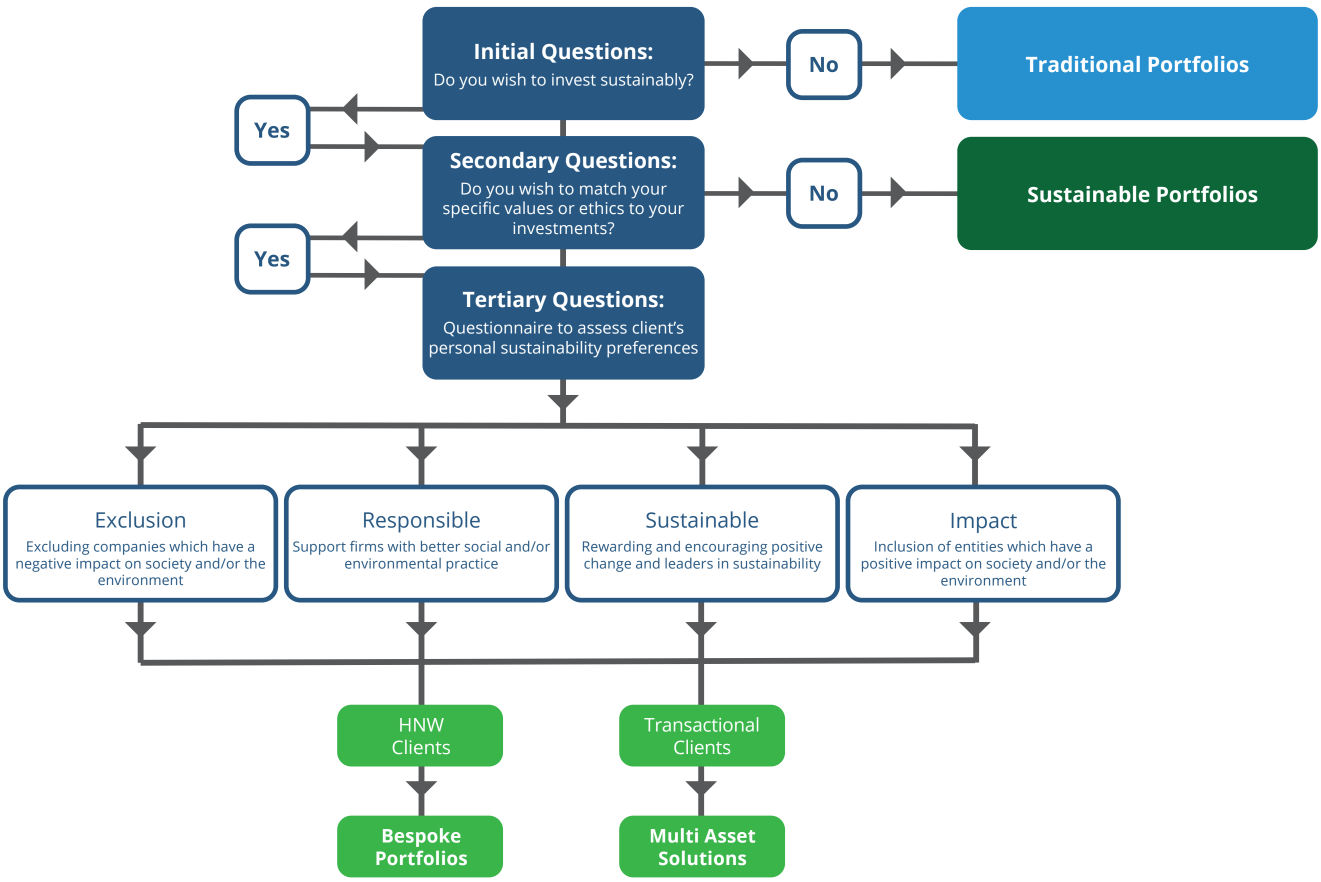


Practical application within the Adviser Suitability Process

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 gleaned 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 adds 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.



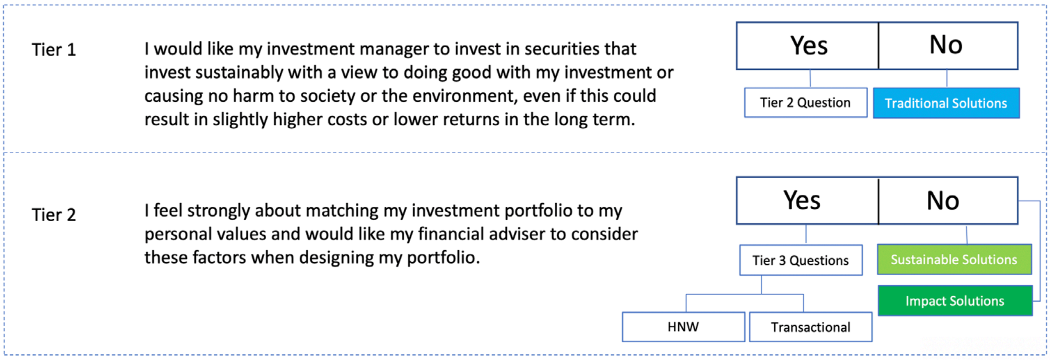
- Clients not interested in investing responsibly will continue to invest in traditional portfolios.
- Clients that wish to see their investment do some good, avoid doing harm and lead change when it comes to social and environmental themes will, in most cases, be happy to invest in a broad Responsible investment portfolio of which a Sustainable portfolio or fund could be an option.
- Clients 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.

For assistance in identifying the types of clients, please refer to the Square Mile brochure, '**What Type of Responsible Investor are you?**'

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

There are many ways to adapt the fact find to enable an adviser 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.

	Less important				Strongly agree
Ethical exclusion 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?

	Less important				Strongly agree
Responsible practices Would you prefer fund managers to support better social and environmental practices?	1	2	3	4	5
Sustainable solutions 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 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 practives	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, an adviser 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 sustainably

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**
- **3D Oversight and Impact Reporting:** Granular, stock level analysis for specific client requirements.

Square Mile and 3D Investing recognise that investors have broad and differing needs in this space, with some seeking guidance or opinion and others requiring independent and objective verification of a fund's credentials and credibility. As such we have maintained Square Mile and 3D Investing's distinct approaches to fund research, with the former offering an in-depth qualitative analysis of funds and fund groups and the latter an extensive and evidence-based audit.

Selection of Scores and ratings

Square Mile ESG Assessment

An assessment of ESG integration for all funds in the Academy of Funds.

Square Mile Responsible Ratings

A combined financial and responsible rating.

3D Corporate Certification

An asset manager level verification of commitment to Responsible Investment (RI) and the RI capability across the group.

3D Fund Certification

An independent audit of a fund's standing on doing good, avoiding harm and leading change. No financial assessment.

3D Impact Rating

A subset of 3D Fund Certification for funds focussed on positive impact. Same process as fund certification but with an additional impact rating.

Contact

Steve Kenny
Chief Distribution Officer
Tel: +44 (0) 7703 642286
Email: steve.kenny@squaremileresearch.com

Area: London, North England, Scotland, Northern Ireland

Jamie Farquhar
Business Development Director
Tel: +44 (0) 7776 224408
Email: jamie.farquhar@squaremileresearch.com

Area: South West England, Midlands

John Lester
Business Development Director
Tel: +44 (0) 7786 074804
Email: john.lester@squaremileresearch.com

Area: South England

Sophie Martin
Business Development Manager
Tel: +44 (0) 7468 692827
Email: sophie.martin@squaremileresearch.com

Area: London, North England, Scotland, Northern Ireland

SQUARE MILE
INVESTMENT SERVICES

Important Information

This report is for professional advisers and other regulated firms only. The content on this report is provided for general information only and is not intended to amount to advice on which you should rely. You must obtain professional or specialist advice before taking, or refraining from, any action on the basis of the content of the report. This report has been approved by Square Mile Investment Services Limited, which is authorised and regulated by the Financial Conduct Authority under Firm Reference Number 625562.