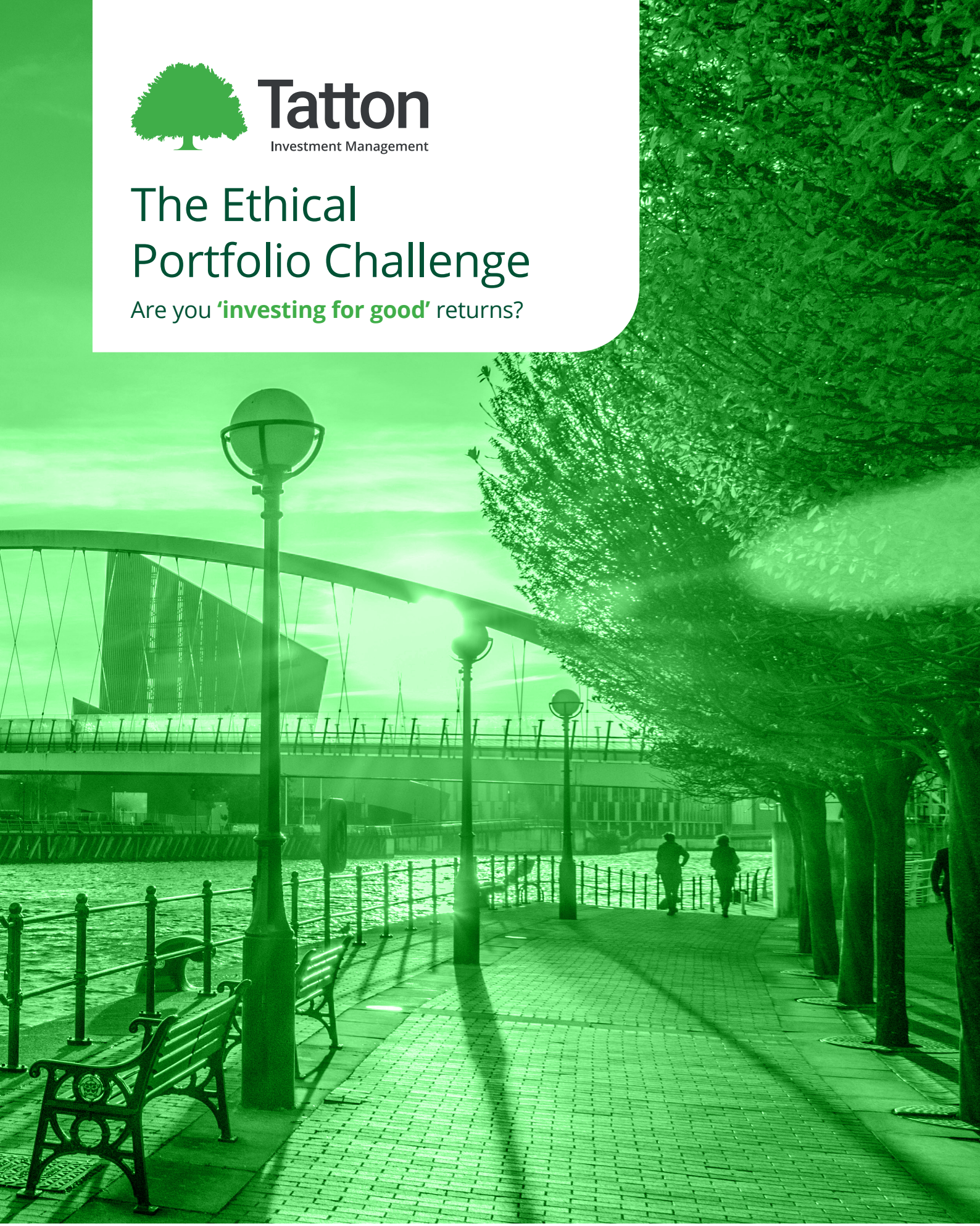
Tatton
Investment Management

The Ethical Portfolio Challenge

Are you **'investing for good'** returns?



www.tattoninvestments.com

Introduction

Tatton Investment Management was one of the first discretionary fund managers to introduce a complete range of risk profiled Ethical Portfolios as part of its managed portfolio service.

This year the UK is playing host to the UN's Climate Change Conference, and with the US re-entering the 2015 Paris Agreement, climate change has once again been thrust into the limelight.

The appetite for responsible investing is also growing, despite the wider pressures presented by the global pandemic and numerous political events that shook the world over the past 12 months. In April 2020, during the peak of the COVID-19 lockdown, investments into responsible investment funds reached a £1bn. The first half of the year saw four times as much being plunged into this area of the market than in the same period a year earlier.

A wave of new ethical fund launches last year also broadened out the options for investors, with close to 3,000 ESG or ethical funds now available to investors.

Fuelling the surge in demand for more 'climate aware' approaches are the millennials with a recent survey from KPMG suggesting that 81% of this group are demanding to know more about responsible investing.

Most company executives, too, are beginning and understand and improve the role they play in ensuring that the ESG policies of their businesses are in line with the values of their customers.

The ESG and responsible investing landscape is changing so much and so fast that it is likely where it simply becomes the norm and funds, by default, will be ethical in nature from the get-go.

While this mainstreaming is largely welcomed by the industry and investors, it does present some challenges, such as the definitions of what is 'ethical' and whether investing responsibly ultimately detracts from performance.

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ETHICAL, SOCIETAL OR ENVIRONMENTAL?

As is currently stands, there is no industry standard or set in stone rulebook as to how asset managers or investors should apply ethical criteria. Much is based on an individual's, or group's, understanding of what is 'good' versus 'bad'.

That's not to say that one is better than the other, it is simply a question of what the investor is comfortable with in terms of that product's approach and concerns.

In the early days, for example, a common approach taken by fund managers was to work from an exclusion list – not investing in any companies related to arms or nuclear weapons. Over recent years, however, a broader approach has evolved which looks more at responsible businesses, diversity in the workplace and long-term sustainability.

The overarching message here, however, is that the societal impact of investing carries just as much importance when making portfolio allocations, above the more general environmental concerns such as oil and gas, nuclear energy and tobacco, for example.

BENEFIT OR BLOW TO PERFORMANCE

The entrenched belief that by 'investing for good' you are forfeiting the potential for amazing returns on your investment is, simply put, a myth. Stock markets suffer highs and lows whether you are investing ethically or not.

What is true is that by taking an ethical or responsible approach you will be ruling out some areas of the market based on how strict those ethical principles are. A strict UK ethical fund, for example, could see more than 60% of stocks disappear from their investment universe, while those that have a less severe approach may only have to avoid 5% of the stock available.

KPMG data shows that over the last five years, more than half of UK investors up their allocations to ethical funds – which suggests that the argument that returns are sacrificed when taking an ethical approach has already significantly diminished.

This isn't a fluke, or one-hit-wonder. Back in 2018, Morningstar figures showed the performance of 63% of sustainable funds saw them positioned in the top half of their respective categories. [PERIOD]

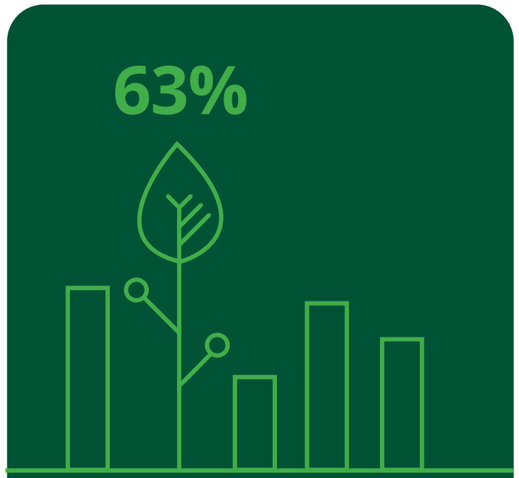
It's not just the end investor that has benefited from being more ethically minded or socially responsible in their approach.

Companies that have engaged with ESG principles and altered their business models have seen a positive impact on their corporate financial performance. In 2019, and MSCI study found a direct correlation between improved profits and higher dividends being paid to shareholders at companies that had high ESG ratings.

With evidence like this, investors and businesses alike will find it more difficult to ignore ESG investing, especially as it becomes less niche.

There may well be just 2,739 ESG or ethical funds compared to a near 18,000 'regular funds' to choose from at the moment, but the next decade in which companies will increasingly align themselves with the Paris Accord and offshore wind will become a primary fuel for UK households, those that ignore this segment of the market risk missing a great investment opportunity.

As a pioneer in Ethical investing we have prepared this extended Q&A to show how we, as investment managers build and manage our Ethical Portfolios.



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How have our IFAS shaped our thinking

Our aim is to invest in best-in-breed ethical funds that have standards similar to those we aspire to. We match the different style approaches of investment managers from across the world to create and manage an ethical portfolio that will suit investors who are seeking to include ethical factors within their long-term investments.

The creation of Ethical Portfolios and the selection of the funds we buy within them is ultimately a judgement we make in our investors' behalf. It is important that the decisions we make are therefore in line with their Ethical considerations.

To understand our investor's requirements we surveyed the IFAs that use Tatton to understand what their clients' most important ethical considerations are. The results allow us to manage our Ethical Portfolios as closely to our investors expectations as we can whilst balancing the wider impact of Ethical investing on areas such as climate change and meeting energy demands, for example.

Most frequently, clients were concerned with animal testing for cosmetics and the fur trade, as well as armaments and pornography

Investing in armaments, animal testing for cosmetic purposes, the fur trade and pornography were of the highest concern to our investors with on average 94.7% of investors being concerned about investing in these contentious industries.

58% of advisers said investment in these sectors should only be made in those companies which exhibit the best Environmental, Social, and Governance characteristics. One in four advisers said these industries are a red line and should not be invested in under any circumstances.

Investing in oil and gas, nuclear energy and tobacco are of medium to high are of concern to more moderate numbers of our investors, with investing in the drinks industry being of least concern to our advisers with 70% felt it be of low or no concern to their clients.

The findings tell us that our investors are concerned primarily concerned about the societal impact of investing above the 'givens' of environmental concerns. It also shows that ethical investing is clearly centred about human behaviour and our collective ability to make the world a 'better' place to inhabit.

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How does Tatton select fund managers for the Ethical Portfolios?

Is the fund universe smaller?[1]

643
ESG focused funds US

2405
ESG focused funds Europe

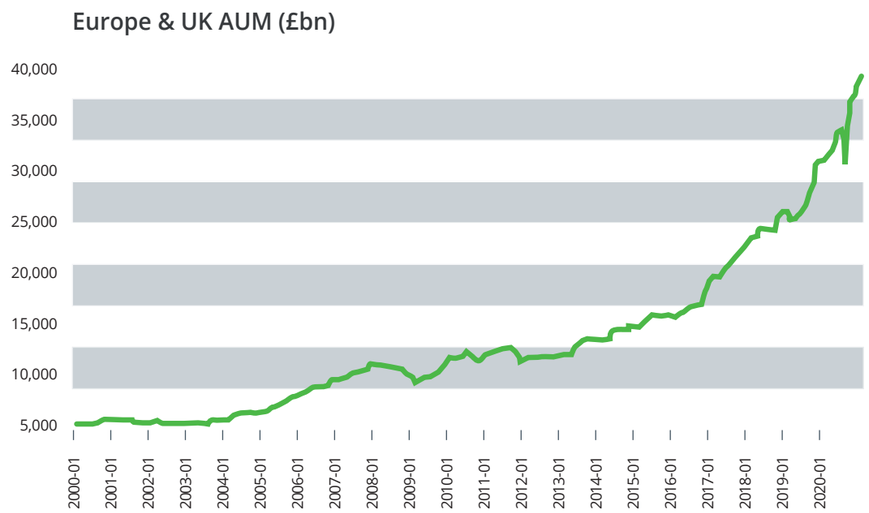
35k
Normal funds

Primarily, we select fund managers for all of our portfolios on their process and performance through our own due diligence. This is the same process for our Ethical Portfolios with the additional focus on how they integrate ethical investing into their investment process.

Fund managers are very different in their approach to all types of investing and this is no different for ethical funds. Since there is no no benchmark that would work for all approaches, we research each fund manager on a firm by firm and fund by fund basis – individual funds within the same firm can also be managed very differently so we have to get under the bonnet before we can select a fund.

We examine the managers' use of data, the culture of the firm and the fund management team themselves. It is not good enough simply to buy from an 'ethical' fund universe. We always meet the managers and, since we are agnostic in fund selection, ask the difficult questions our investors need answering.

HOW MUCH MONEY IS INVESTED IN ESG FUNDS ACROSS EUROPE & THE UK?



How do we decide if a fund is 'ethical enough'?

HOW WE DO IT

This is the biggest challenge in constructing an ethical portfolio and is centered on a clear understanding of the objective of a fund and adopting some practical realism in how far we can go in assessing ethical investment criteria. In the global economy the interconnectivity of business means that at some level all firms, no matter how hard they try, can be challenged on their ethical standpoint.

A simple, if blunt, example: since national governments engage in wars and the proliferation of militarised weaponry, we currently do not buy government-issued bonds for the portfolios, since they could be used to fund war. However, we all pay tax and we cannot stipulate that our taxes are only spent on health care or education, so should we exclude all taxpaying firms from our portfolios? Of course not, but we have to be satisfied that the manager and their fund are working as far as possible within some clear constraints to invest ethically.

To do that, we have identified seven industry sectors that we believe should have limited exposure in our portfolios and so look for these to be excluded our fund managers - or accounted for in a fund manager's process. Frequently, they may take a best-in-class approach and only invest in the very best companies on ESG metrics in certain industries. Equally, some managers employ a focus on engagement and actively improving companies through their voice as a shareholder. We don't believe there is one single approach that is correct and we assess the merits of each approach and a fund house's ability and consistency at applying it.

Google committed to carbon neutrality back in 2007 and since 2017 has matched 100% of its electricity consumption with renewable energy purchases. Google aims to operate completely carbon free by 2030.[2]

Investor group Climate Action 100+, which has recently written to 161 companies asking to set a medium-term objective to cut emissions by 45% by 2030 compared to 2010 levels.[3]

2. Source: https://sustainability.google commitments/#leading-at-google
3. Source: From <https://embed.scribblelive.com/Embed/v7.aspx?Id=2920064&ThemeId=40182>

1. Source, Morningstar 2019

Will I lose out on Investment performance if I invest ethically?

WILL I COMPROMISE ON INVESTMENT RETURNS?

Investing money, rather than saving cash, provides longer term returns. As we know, there are natural highs and lows with stock markets and investors normally accept a minimum five year time horizon to smooth these changes out. Investing ethically is no different, there will be times when ethical investments do very well and time when they will not. What is not true is that investments only "do well by doing good" – good businesses do well, and the weaker firms will sadly fail.

Yes, Ethical investing does promote the greater good will, but the companies that are working in those sectors provide good returns for investors in five years, 10 years or 20 years?

It's true, some ESG funds have performed exceptionally well over the past few years – outperforming many non-sustainable funds. However, if you examine the holdings within a leading ESG fund the seven biggest in November 2020 are Apple, Microsoft, Amazon, Facebook, Google and Tesla – the US technology giants and not possibly what you would expect.

If US technology firms are broken up or perform badly that fund's performance will fall, but that does not mean Ethical investing is a bad strategy. So long as the fund manager selects companies based on their business fundamentals and market potential it should be as sound as any other investment.

The Tatton team examine each of the funds not only on their ethical criteria but also on the fund management team's process, stock selection and the prospect of creating superior returns. What is important to understand is the investing ethically does not hamper the potential for investment returns, but it does not automatically boost them either. As more funds and fund management firms adopt Ethical strategies and more firms develop their businesses along sustainable activities, the differences between Ethical and non-Ethical funds will inevitably narrow.

Ethical investors, however, will benefit from the positive change that their portfolios are making, as well as providing for their financial future.

Investing ethically does not hamper investment returns.

MSCI ACWI VS ACWI ESG LEADERS & ACWI SRI - RETURN SINCE 2012

Source: Placeholder

The chart shows how closely ESG companies have performed relative to the rest of the market.

Ensuring a portfolio remains Ethical

If the fund doesn't have 'ESG' or 'Ethical' in the name, can it still be ethical and how do we know this?

It can, and whilst most do make a reference in the name, not all funds do. Some fund management firms have integration across their business and so by default their funds are worthy of inclusion in an ESG-focused portfolio even if the fund name isn't named as such. Funds that invest around around a 'theme', called Thematic Funds, focus only on the specific area they invest in - for example, climate change. We assess it to be ethical or not during our due diligence process. For example, Hermes Investment Management pioneered integrating ESG investment principles throughout its business in the early 2000s. Other fund managers such as Schroders and Liontrust have developed dedicated ESG teams to run specialist funds. It is Tatton's job to filter through these firms' funds and decide whether they are suitable for an Ethical Portfolio.

Sky became the first CarbonNeutral media company in 2006 which has been maintained ever since.

Are the fund managers ESG friendly? Are bigger institutional fund managers ESG compliant?

Fund houses and fund managers all have different approaches to ESG and what they deem to be important metrics and unimportant metrics. To say all fund managers are ESG friendly is incorrect; some fund houses do not prioritise it, whilst for others it is at the core of what they do. The largest asset managers are recognising the important of this within the industry and have in most cases set up teams to focus on ESG data, engagement and reporting. This has often led to them having products that are ESG compliant. However, to take any of them for granted would be a mistake and our due diligence interrogates them the same way, whether they are large or small.

Does Tatton rate E, S & G separately? Can one be more important than the other

We do not prioritise any one of Ethical, Social or Governance factors over another and we do not explicitly rank funds on how strong they are against each. We do recognise the differing challenges faced in being compliant within each of the three, which is primarily driven by data access and availability. It is becoming increasingly common that carbon emissions are reported by companies, but the diversity of their workforce can still be very hard to capture.

How does Tatton rank fund managers? Do you have an Ethical scoring system that puts some fund managers above others?

Tatton does not explicitly rank fund managers on their ESG credentials. We understand there are houses that are particularly focused on Ethical and ESG funds and as a result may have teams dedicated to engaging with companies and exploring data. However, that does not mean that robust, well-performing, ESG compliant funds cannot be found elsewhere. We look for fund managers with good ESG integration within the investment process, which is often embedded into the technology they are using as well as good corporate engagement and so it is more likely that our funds will be run by these ESG focused fund houses.

4. Source: https://insideclimatenews.org/news/15072020/oil-gas-climate-pledges-bp-shell-exxon

What if a company's ethical standpoint changes?

We invest in funds where the manager has robust ethical frameworks and processes. Alongside this, we consider it a plus for fund managers to have separate ethical oversight functions that will screen out companies with high controversies and take managers to task on companies where issues could arise. Based on this, we expect our fund managers to act – and act quickly – when a company's circumstances significantly change in relation to any of the E,S & G pillars. We also receive holdings data from our fund managers, so we are able to see aggregated exposure to companies across the portfolios. Based on this, if we see news stories of concern, we have a direct line to the fund houses to be able to query individual holdings.

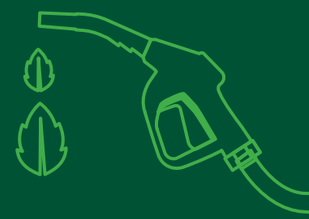
How can you trust a fund managers view?

Our extensive due diligence, including face to face meetings with fund managers enables us to question them on their their views and beliefs. A history of a consistent approach aligned with those views is important. Where possible we look for integration of the ESG principles from elsewhere in the asset manager or an oversight committee, as well as in the investment team. For example screens being implemented by compliance, whether on companies in certain industries, or those that exhibit particularly poor ESG credentials. It becomes far clearer in conversation which of the fund managers are passionate and consistently apply ethical practices.

How can you be confident if a fund manager checks the companies?

The Research of companies will come down to the type of fund in question. A tracker fund that follows an ESG index that screens certain industries will not require the managers to do extensive research of the companies. A fund manager who invests in a company to then improve its ESG metrics through engagement must be extremely thorough in their understanding of the business and have a clear plan in place about how they expect to help a company transition. We have confidence our managers do this because we believe in our due diligence process and regularly have update meetings with the managers where we are able to question them on any particular holding and their rationale for its position in the portfolio.

BP CEO Bernard Looney declared BP would achieve net-zero greenhouse gas emissions by 2050. Along with Shell and Total.[4]



Do you look into all companies a fund holds or trust the managers judgement?

Our investments are only made when we know that there is a sound process and culture in place in order for a fund to be described as ESG compliant. We trust our managers to stick to their mandate and principles day to day. We do have an ongoing method of monitoring exposures to our "unethical" industries and we do investigate any large changes with these with our fund managers. As an additional step we receive fund holdings, which we aggregate in third party systems to give us oversight of exposures and companies.

Will my investments make a difference?

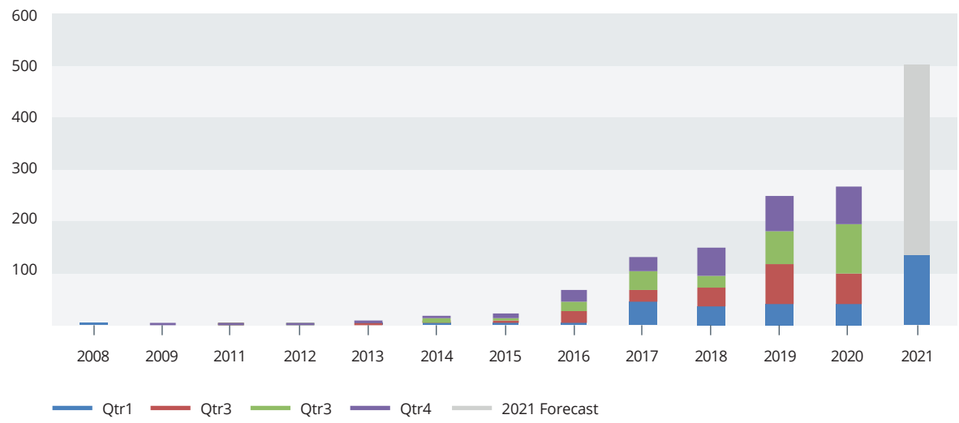
This is the reason why people choose to invest ethically. In simple terms investing in companies that have higher ESG behaviours allows them to grow thereby creating change.

If only it were that simple in terms of effect. Looking at environmental impact of human activity we are still wholly dependent on fossil fuels for our societies to function and despite very high publicity, plastic use is not declining significantly. Similarly, in terms of governance, Amazon, a firm many have adopted into their daily lives, is notorious for the poor treatment of its workers and shows no real desire to change. For example, it is opposed to union representation of its workers in the US and has even had to admit it does not factor in toilet breaks for its delivery drivers.

However, as this document shows, companies are changing and so are the expectations of society. If the behaviour of some major corporations is slow it appears the positive changes are, in some areas, irreversible.

Reassuringly the difference in investment performance over the long term is not markedly different between Ethical and non-ethical investments - investing ethically should not therefore automatically change expected investment performance. Further, the practices of companies that are listed on the stock exchange are ultimately controlled by the shareholders and their expectations over share price. In supply and demand terms the share prices of firms that have future negative ESG consequences or are not addressing ESG legacy issues (in particular environmental concerns) can be affected negatively – some of the statements from BP we refer to are evidence of change.

GREEN BOND ISSUANCE



5. Source: From <https://embed.scribblelive.com/Embed/v7.aspx?Id=2920064&ThemeId=40182>

It is critically important for businesses to adapt to future trends so it makes sense to adopt changes that can have to protect a company's future profitability or its very existence. So, over the long-term investing ethically could be a way to avoid damaging future performance by not investing in firms that may eventually fail due to societal ESG pressures.

There is also direct evidence of change. The listing of Deliveroo on the stock exchange was not supported by some large investment firms because of the way it treated its drivers and their welfare, which may feel contributed to the poor performance of its shares.

There is also evidence of structural shift in capital markets. For example, Green Bonds. Companies raise money to expand and develop their operations by issuing bonds.

We looked at the issuance of Green Bonds those aimed specifically at raising for sustainable and climate related projects. Their rise, in particular, from companies trying to transition from legacy operations has been dramatic as the chart shows.

We are predicting over €500 billion of Green Bonds will be issued in 2021 alone a near 100% increase of those issued in 2020. It's important to also note that the EU recovery funds program promised €225bn worth of Green Bonds as part of its financing package for this year. Market pressures would also indicate that the increased risk of not addressing ESG considerations in business would make raising capital through bonds riskier to institutional investors and so more expensive for the issuing companies and so create further pressure for change.

So, from an investor perspective investing Ethically can collectively make a difference to how companies behave since their ability to raise capital and expand is being controlled by investment markets. It is clear we are in period of change and that the more investment funds, and the money they invest, that operate under ESG principles will turn the tide towards more widespread benefits to us all and the value of the companies they own.

For example, within the Liontrust Sustainable futures fund:

- **Investments in the fund emit 71% less carbon emissions.**
- **It has zero exposure to fossil fuels: 0% to any fossil fuel reserves, 0% exposure to thermal coal reserves, 0% exposure to natural gas reserves and 0% exposure to oil reserves.**
- **Holds 22.4% of companies that MSCI have determined are providing clean technology solutions helping reduce emissions.**

The European Commission has announced a new ambitious target to cut carbon emissions by 55% by 2030, up from an original target of a 40% reduction over the same timeline.[5]

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