February 2024

A Cohesive Approach to Sustainability

Introduction to setting sustainability priorities

isio.

With a large shopping list of social and environmental issues to be considered, addressing these sequentially may not necessarily be the answer.

rights equality
adaptation deforestation resources
equality remuneration
labour diversity
biodiversity slavery pollution
decarbonisation safety disclosure
health inclusion
circularity transparency waste

As environmental and social concerns rise in prominence, we are increasingly aware that **our investments do not live in isolation of real-world impacts**. Sustainability risks are impacting on portfolios and multiplying beyond the climate emergency. Over the past few years, in response to global events such as the Covid-19 pandemic and the Russian invasion of Ukraine, financial markets have faced recessionary forces, soaring prices and volatility.

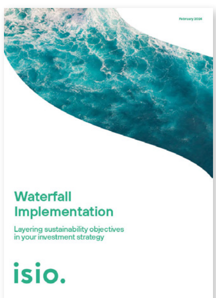
This is a two-way street, with investments compounding today's sustainability challenges. **We are becoming increasingly aware of the rising externalities of the modern financial system**, from a sustainability perspective, in contributing to the climate emergency and nature degradation, for example. (We define an externality as a cost not internalised into the price of goods and services, for example, fossil fuels not accounting for the socioeconomic cost of pollution.)

Whilst we live in a complex world, we need simple solutions for investor action. With a large shopping list of social and environmental issues to be considered, addressing these sequentially may not necessarily be the answer. Given the urgency of these risks, individually and collectively, as well as the synergies and trade-offs in prioritising these risks, a cohesive approach is required. In this paper, we provide a brief introduction on the importance of a cohesive consideration of sustainability factors, today.

This is the first paper in a three-part series, and lays the foundations for a implementing a sustainable investment strategy, in practice:

1. **A cohesive approach to sustainability: introduction to setting sustainability priorities;**

2. Waterfall implementation: integrating environmental and social objectives in the portfolio; and,



3. Market sustainability evolution: best practice climate, nature and social solutions.

The sustainability crisis

According to the United Nations, we are **seriously off track for delivering on global sustainability goals**. Despite the Paris Agreement and its ambitious target to limit global temperature rise to 1.5°C, there is a high likelihood that we will achieve this level of global warming by 2027. We are also remarkably off track for delivering the Sustainable Development Goals (SDGs). (See box on the left)

With investors looking to governments to set the tone on global sustainability action, governments lack the scale of financing needed to deliver global social and environmental objectives, to 2030 and beyond. It is estimated that the cost of delivering the SDGs is equivalent to between $5 and 6 trillion, a year, to 2030. Therefore there is a clear opportunity for investors to contribute to tackling today's sustainability challenges.

As investors, there is rising **momentum to integrate environmental and social risks and opportunities towards better portfolio risk-adjusted returns**, including as a response to a changing world. Much of this boils down to savvier portfolios that better integrate social and environmental considerations (and we consider the "how" in subsequent papers). But as investors, we will ultimately need to decide which side of the coin to occupy: rising emissions or increasing low carbon deployment; nature exploitation or investing in nature-based restoration; rising inequality or social inclusion. This is not to discount the significant investor momentum to support action across various sustainability issues. However, the negative impact of human activity continues, with more needing to be done to ensure we remain on track (see below).

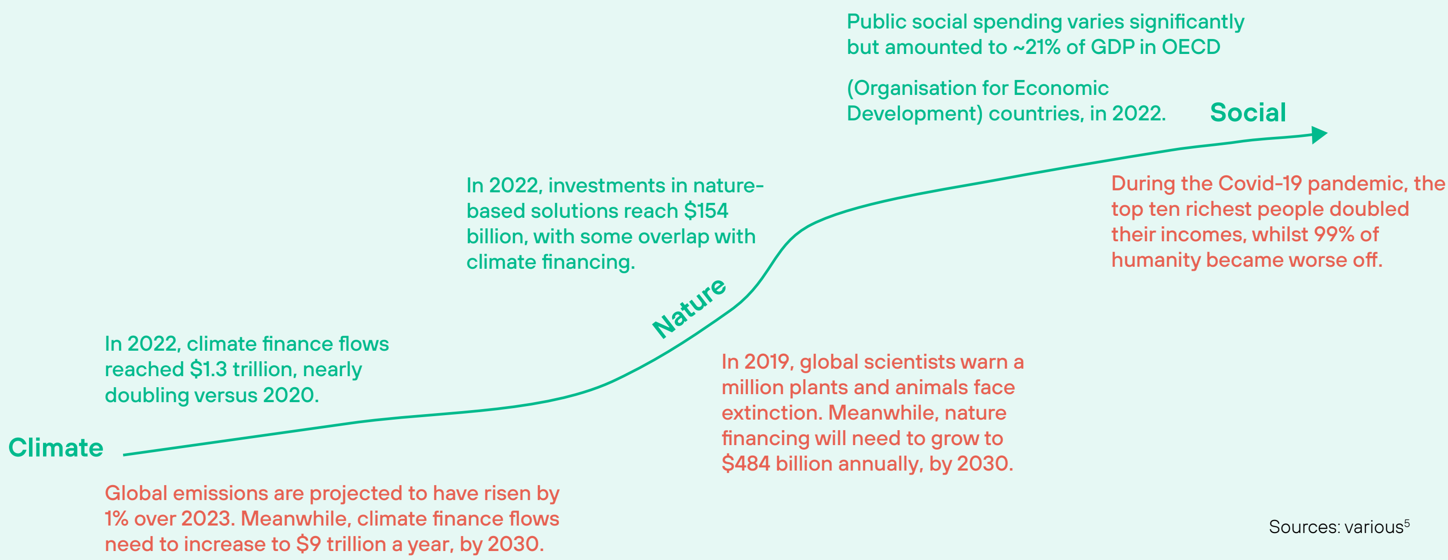
Social SDGs: Examples on progress[4]

SDG Goal 1: End poverty in all its forms

The Covid-19 pandemic, conflicts and cost-of-living crisis have pushed an additional up to 95 million people into extreme poverty (those living on less than $1.90 a day).

SDG Goal 2: End hunger

These forces, alongside environmental degradation, have also caused a regression in food security. In the two years to 2021, people living with hunger increased from 8% to 10%.

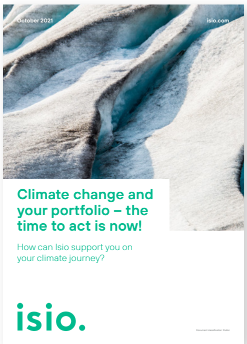


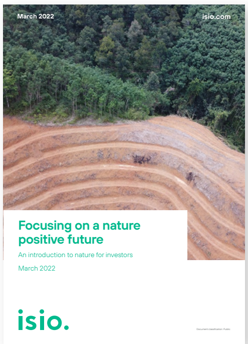
Sources: various[5]

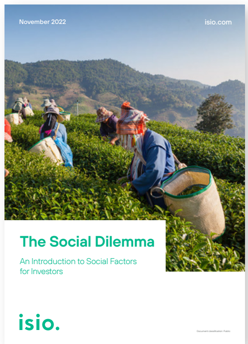
[1] World Meteorological Organization (WMO). Global temperatures set to reach new records in next five years.
[2] United Nations. Global Sustainable Development Report 2023.
[3] United Nations Conference on Trade and Development. UNCTAD counts the costs of achieving sustainable development goals.
[4] United Nations. Global Sustainable Development Report 2023.
[5] Climate references: Climate Policy Initiative. Global landscape of climate finance 2023.
& Global Carbon Project. Key Messages: Global Carbon Budget 2023.
Nature references: United Nations Environment Programme. State of Finance for Nature 2022.
& Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services. Global Assessment Report on Biodiversity and Ecosystem Services 2019.
Social references: Oxfam, referenced in: United Nations. Global Sustainable Development Report 2023.
& OECD. Social Expenditure Database.

The Climate, Nature and Social Inequality Crises

This paper series follows Isio thought pieces on climate, nature and social factors, which provide further focus on the impact of the climate emergency, nature degradation and social inequality on economic financial outcomes. Please refer to these papers for an introduction to these thematic issues.







Investor response

From a client perspective, the first step is to understand the priority **sustainability areas that matter most to you** as an investor. With an ever-growing list of sustainability considerations, this will be essential to narrow down the universe.

Approaching prioritisation

The prioritisation process should begin with **training** on the most pressing sustainability challenges of today. Priorities could be set based on alignment with the Sustainable Development Goals (SDGs) framework, for example, or seeking to align with the Paris Agreement goals, or otherwise the post-2020 global biodiversity framework (see below table). These objectives would ultimately help to drive portfolio processes, from investment strategy and decisions, to monitoring and reporting, as well as stewardship activities.

Example investor priorities

Climate

Contribute to the Paris Agreement objectives of:

- Align with a well below 2°C scenario, with ambition towards 1.5°C.
- Enhancing adaptive capacity, strengthening resilience and reducing climate vulnerability.

Nature

Contribute to Global Biodiversity Framework objectives to:

- Restore one-third of lands, oceans and freshwater systems.
- Ensure the sustainable management of agriculture, aquaculture, fisheries and forestry, as well as wild species.

Social

Contribute to the social SDGs, with a focus to:

- Reduce inequality within and among countries (e.g. access to education, healthcare & jobs).
- Achieve gender equality and empower all women and girls.

Questions to support prioritisation

When looking to understand sustainability priorities for the investment strategy, there will be some push factors determining action (e.g. climate regulatory requirements of investors) as well as pull factors (e.g. investor beliefs with a desire to demonstrate positive sustainability impact).

Pull factors

- What are the sustainability issues the investor cares most about?
- For pensions, is there a desire to align with sponsor sustainability priorities?

Push factors

- Are there regulatory requirements to consider (e.g. climate disclosure requirements, necessitating a focus on climate change?)
- What are the most material sustainability concerns, based on the asset class and sector exposures in the investment strategy?
- What are the priority sustainability issues investment managers are tackling, and does the investor want to align with those?

There are various **approaches to setting the sustainability tone,** moving forward. We would recommend a combination of belief sessions, discussions with your investment managers, and understanding the views of stakeholders (e.g. pension sponsor) to help to draw out answers to these questions, to support setting the strategic sustainability direction for the portfolio, as a whole.

The setting of sustainability priorities further aligns with the Department for Workplace and Pensions (DWP)'s best practice guidance for pension scheme stewardship (focusing on stewardship priorities), which many investors are already engaging with. Prioritisation of engagements with your investment managers can ensure mandates align with these priority themes, in the way they vote and engage. It should also inform how managers conduct investment due diligence and risk management within the portfolio's mandates. **Collaboration with the wider market to influence real-world outcomes will also be essential**, with a need to identify those initiatives that target the same priorities as the investor.

Synergies and trade-offs

There will be **synergies and trade-offs amongst sustainability issues when setting sustainability priorities**. These will need to be reconciled within the portfolio, within and across mandates, to understand acceptable (versus unacceptable) trade-offs.

One example would be where reforestation investments may first and foremost seek to respond to an investor's net zero goals but could also create trade-offs with biodiversity. A pureplay biodiversity lens may tackle the broad regeneration of landscapes, with the restoration of associated plant and animal species – whilst a siloed net zero focus could result in a more simplistic approach to monocultures of a single tree species capable of absorbing maximum emissions. But there will also be synergies. For example, reforestation projects may involve local or indigenous communities in livelihood opportunities, creating jobs and income as a side-benefit, in addition to any nature-related gains.

There can also be **unintended consequences**, when implementing portfolio sustainability priorities. Best practice approaches to sustainability tend to result in more concentrated investments, for example:

- An increasing proportion of the universe fails to achieve increasingly stringent sustainability thresholds, creating trade-offs with diversification;
- Influencing sector and region exposure biases. For example, indexes may tilt towards higher impact sectors or regions with the greatest potential impact in the chosen priority areas. Or, decarbonisation may be most impactful in emissions-intensive emerging and frontier markets; and,
- Asset classes biases introduced where select asset classes may best represent chosen sustainability propositions. For example, reforestation solutions have typically been a relatively illiquid real asset proposition.

Paper series

In the following paper, we set out a "how to" for investors seeking to layer multiple sustainability priorities within the portfolio, therefore this paper only serves as an introduction to lay the foundations. For example, in the second paper in this series, we address concerns around delivering sustainability impact, monitoring and reporting of sustainability outcomes, as well as demonstrating some portfolio examples of sustainability transitions for different types of investor (with different types of risk appetite).

We have provided a whistlestop tour on the introductory considerations for investors when implementing (multiple) sustainability objectives. This aims to lay a foundation to the following two papers focused on further exploring the "how to" of sustainable investment implementation, focusing on:

2.

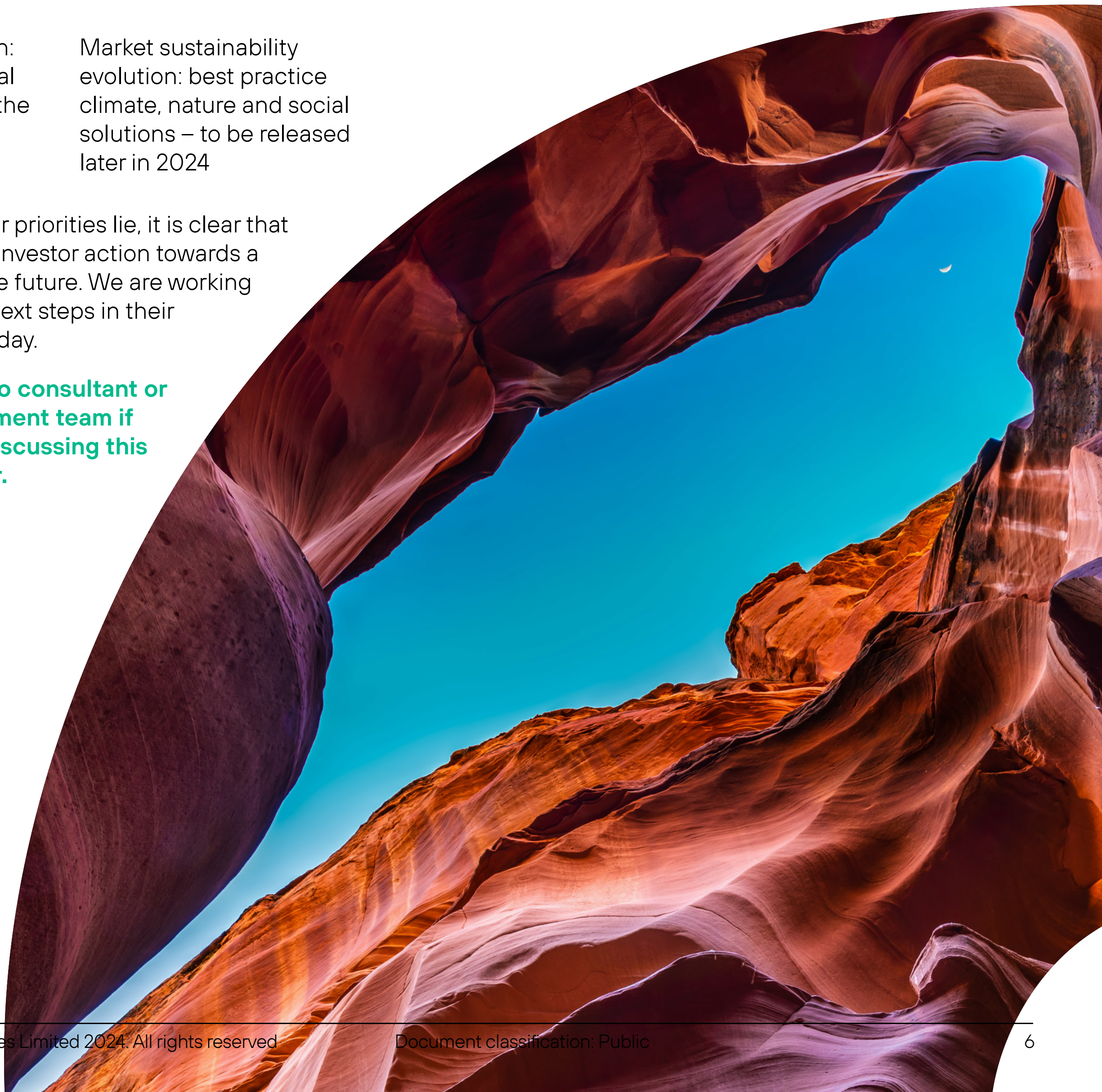
Waterfall implementation: integrating environmental and social objectives in the portfolio

3.

Market sustainability evolution: best practice climate, nature and social solutions – to be released later in 2024

Regardless of where your priorities lie, it is clear that there is urgent need for investor action towards a sustainable and inclusive future. We are working with clients to take the next steps in their sustainability journey, today.

Please contact your Isio consultant or our Sustainable Investment team if you are interested in discussing this important topic further.



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This paper predates the recent FCA anti-greenwashing regulatory changes effective from 31st May 2024.