July 2024

The art of the possible – Annual Sustainable Investment Survey

Examining sustainable investing practices across our fund universe

isio.

How do your funds and asset managers rank versus peers?

This paper is our first annual Sustainable Investing Survey which aims to shine a light on where we see ESG opportunities across different asset classes and explore how investors can maximise opportunities to 'green' their strategies within each asset class.

Sustainable investing ('SI') has evolved significantly over recent years, including what is considered good practice due to developments in regulation and changes to investor attitudes. However, this varies across asset classes. So, the key question to many investors; what does good Environmental, Social, and Governance ('ESG') integration look like across asset classes?

We have been assessing and rating asset managers and products for several years through our Sustainability Integration Assessments. The results in this paper present a snapshot of the outcome and findings of our Sustainability Integration Assessments, where we have assessed a selection of c. 50 asset managers across over 120 funds.

We have developed in-depth, asset class-specific scorecards, breaking down key areas of focus, resulting in an overall ESG score as well as scores across individual categories. This enables us to analyse where asset managers and funds sit relative to peers within their respective asset classes as well as against what we consider good practice. In this survey, we look at firm-level ESG practices and then turn to fund-level aspects and have split the results across each of our SI assessment pillars: investment approach, risk management, stewardship, reporting, and collaboration.

We depict on the next page our view of what 'common' aspects of good SI practices look like across asset classes, so that you can determine how different asset classes in your investment strategy compare. This may potentially lead to considering further opportunities within the world of SI. This is only a snapshot of the results with further detail across each asset class provided within the main body of this paper.

All findings and comments in this paper are based solely on our assessment within our defined research universe and reflect our understanding and interpretation of the data we were provided by asset managers.

Key SI assessment criteria

		Overall potential	Fund-level ESG objectives	Fund-level ESG exclusions	ESG opportunities identified	ESG scorecard optimisation	Multiple ESG data sources used	Fund-level reporting of ESG metrics	
Public equity	Passive	🟢	🟠	🟢	N/A	N/A	🟢	🟠	We see strong ESG integration across both active and passive equity, especially with regards to company engagement and voting. There are greater opportunities within active management to access impact investing, due to its forward-looking approach.
	Active	🟢	🟢	🟢	🟢	🟢	🟢	🟠	
Public credit		🟢	🟠	🟢	🟠	🟢	🟢	🟠	The extent of ESG integration varies across public credit sub-asset classes, with 'buy and hold' strategies leading the way. On the other hand, funds invested in asset-backed securities tend to lag due to challenges with sourcing data for large pools of borrowers.
Private credit		🟠	🔴	🟢	🟠	🟠	N/A	🔴	Private credit mandates still have more SI integration progress to make, with data availability being one of the problems. Although some mandates have begun incorporating ESG ratchets, this is still a developing area, and the associated impact is somewhat muted at this stage.
Real assets		🟢	🟢	🟠	🟢	🟠	🟠	🔴	Real assets offer true sustainable and impact solutions due to the physical nature of the assets, (within such areas as renewable infrastructure and social housing). Whilst data challenges are clear, this space has also experienced strong innovation, within such areas as social infrastructure, climate adaption infrastructure and natural capital.

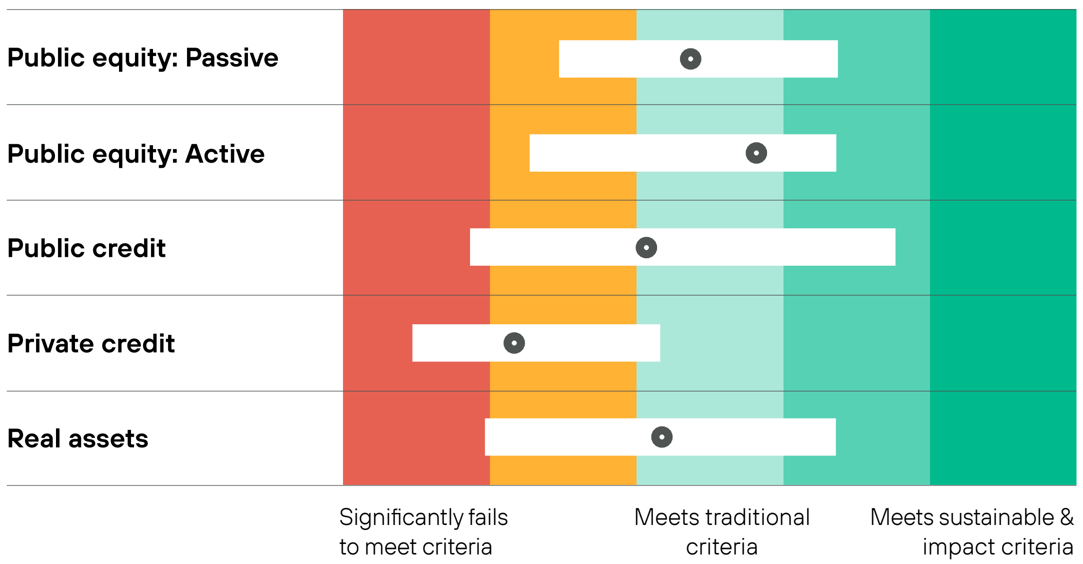
🔴 0-33% 🟠 34%-66% 🟢 over 66% of the products we've assessed meeting the criteria

Note: The colours above reflect how "common" the criteria is within that particular asset class. Refer to appendix for definitions and further details on asset classes covered.

Key findings

- Partnering with the right asset managers is important. A published ESG policy outlining key firm-level ESG objectives and priorities, as well as having an established dedicated SI resource are non-negotiable in our view. We believe continued industry improvement is required in the setting of Net Zero commitments with supporting robust interim decarbonisation targets.
- The setting of fund-level ESG objectives is becoming common across most asset classes, however the majority of these objectives remain climate focused. We also see red-line exclusions becoming common across asset classes.
- The majority of funds within our universe utilise an ESG scorecard within the investment process, with at least two independent ESG data providers used.
- Most public market funds are able to report ESG metrics (with a particular focus on climate-related metrics) with data quality having improved in recent years. Provision of social-related metrics is gaining some traction across asset classes, whilst nature-related reporting is still in its infancy.
- We expect asset managers to have strong voting and engagement policies and processes in place to exert influence on portfolio companies. We see good practice as having clear escalation processes in place, which may ultimately lead to selective disinvestment.
- Similarly, we would expect managers to be signatories to key collaborative initiatives such as the UK Stewardship Code and NZAMI.

The below chart reflects the overall results of our Sustainability Integration Assessments for those funds in which our clients invest, split by asset class. The range of scores within the asset class universe is shown by the white horizontal bars, and the median score within the universe is shown by the grey circle. Please see the appendix for definitions of asset classes and our ESG criteria buckets.



Next steps

We provide further detail on our view of good SI practices across asset classes over the following pages: investors could consider how best to align their own investment strategy with the leading funds in each asset class. There are many easy wins that can be implemented to improve the sustainability characteristics of investors' portfolios.

Contents

Firm-level practices

Whilst there are differences in expectations and implementation styles across asset classes, we can first look at firm-level commitments. The data below demonstrates the adoption of firm-level commitments that we expect to see across all asset managers.

Key findings

A published ESG policy outlining key firm-level ESG objectives and priorities, as well as having established a dedicated SI resource or team are non-negotiable in our view. The focus of our assessments is on the implementation of stated policies and priorities.

Similarly, we would expect managers to be signatories to key collaborative initiatives such as the UK Stewardship Code and NZAMI.

It is important to know the proportion of assets that are covered by a firm's Net Zero commitment, the interim decarbonisation targets and how this transition will impact your allocation.

Best practice should include the monitoring of DE&I metrics, in line with industry-wide guidance such as the Asset Owner Diversity Charter, along with targeted engagement programmes to drive change.

Investment approach

Our Investment Approach pillar is focused on assessing whether the fund has a clear approach and framework for integrating ESG factors, for example setting ESG objectives, identifying ESG opportunities and assessing the investment universe against ESG criteria, including climate, nature and social factors.

We report below the percentage of funds within our universe that were sufficiently able to achieve the stated key criteria (this is a subset of the broader criteria assessed).

Asset class	Fund-level ESG objectives in place	Fund-level quantifiable and forward-looking ESG objectives in place	Fund-level ESG exclusions are in place e.g. UNGC violators, thermal coal extraction	ESG-related opportunities are identified at the fund-level
Public equity: Passive	57%	43%	71%	N/A
Public equity: Active	83%	33%	67%	67%
Public credit	43%	20%	88%	63%
Private credit	12%	0%	72%	44%
Real assets	78%	48%	52%	85%

0-33% **34%-66%** **over 66% of funds we have assessed that meet the specific good practice criteria**

Key findings

Overall - The setting of fund-level ESG objectives is increasingly common across most asset classes, however with a clear climate focus. We also see a similar trend with red-line exclusions. The increasing recognition of the financial materiality of ESG factors has also led to the growing focus on ESG opportunities.

Equity – We increasingly see passive equity solutions with explicit ESG objectives, largely focusing on broad ESG tilts, climate targets and red-line exclusions. These aren't all quantifiable in nature, however decarbonisation targets are frequently incorporated. Active equity funds benefit from active stock picking allowing increased ESG integration, with some funds focused on UN SDGs alignment, most commonly SDG 13 (climate action).

Credit – Within public credit, results vary significantly between sub-asset classes though the majority use exclusions and we increasingly see green, sustainability-linked or use-of-proceeds bonds used. Private credit solutions remain a laggard for setting ESG objectives – a consequence of their closed-ended nature and data challenges. We note that newer vintages have begun to incorporate ESG considerations, with increasing usage of ESG ratchets (although evidence of assessing their effectiveness is currently mixed).

Real assets – Real asset solutions may provide true sustainable and impact opportunities due to the physical nature of the assets, for example within renewables, social housing and natural capital. We have therefore found a large proportion of funds set ESG objectives and identify ESG opportunities.

Risk management

Our Risk Management pillar aims to assess asset managers on their ability to identify and manage ESG risks. Asset managers should integrate ESG factors holistically in their risk management framework, through the use of high quality ESG data sources and scorecards as part of the due diligence and monitoring processes.

We report below the percentage of funds within our universe that were sufficiently able to achieve the stated key criteria (this a subset of the broader criteria assessed).

Asset class	ESG scorecard[1] used within company/asset assessment process	Use of multiple ESG data sources for risk analysis	Climate modelling used to quantify fund-level climate risk exposure	ESG specialists feeding into the risk management process
Public equity: Passive	N/A	100%	57%	14%
Public equity: Active	67%	67%	83%	100%
Public credit	93%	90%	55%	68%
Private credit	64%	N/A	12%	88%
Real assets	63%	52%	63%	93%

0-33% **34%-66%** **over 66% of funds we have assessed that meet the specific good practice criteria**

1) An ESG scorecard refers to the use of an ESG risk assessment framework as part of initial due diligence and ongoing review of underlying investments.

Key findings

Overall – 75% of funds within our universe utilise an ESG scorecard within the stock selection/due diligence process. We find it important that multiple ESG data sources are used within this process, in particular recognising industry-wide data challenges. At least two independent ESG data providers are used across the majority of funds assessed. We see asset managers increasingly building out dedicated SI teams which provide fund-level support.

Equity – Within passive management, the focus is on index construction and tracking error considerations. Consequently, stock level ESG analysis and SI specialist input is less relevant. However, it remains important to consider ESG risk management as part of index construction (as well as stewardship activities in managing portfolio risks). Within active management, we've seen that ESG risk assessments are central across the majority of funds assessed (with implementation differing across asset managers).

Credit – Within public credit, ESG risk management reflects similar progress to developments within equity solutions. Albeit climate modelling capabilities are impacted by specific nuances within credit sub-asset classes. Private credit remains a laggard especially with regards to climate modelling capabilities, again, primarily due to data constraints.

Real assets – We hope to see increasing use of asset-level ESG scorecards but recognise the challenges of using multiple data sources given most data is gathered directly. However, we are beginning to see other sources of data and information specifically for real assets being used by asset managers.

Stewardship

Our Stewardship pillar aims to assess asset managers on their stewardship policies and processes including ability to evidence the exercising of voting rights (where applicable) and ongoing engagement with investee companies and other stakeholders on ESG issues to drive change.

We believe that our clients, asset managers and the wider investment industry have significant influence in driving change on issues that we all care about across portfolio companies. We believe that proactive and targeted engagement with companies and the wider industry is more effective to drive change than an exclusionary approach.

We expect asset managers to have strong voting and engagement policies (with firm-level stewardship priorities) and processes in place and we seek to review the quality of these policies and key case study examples. We see good practice as having clear escalation processes in place, which may ultimately lead to selective disinvestment.

We show below the most common stewardship priority areas set by the asset managers we've assessed across **climate**, **nature**, and **social**.

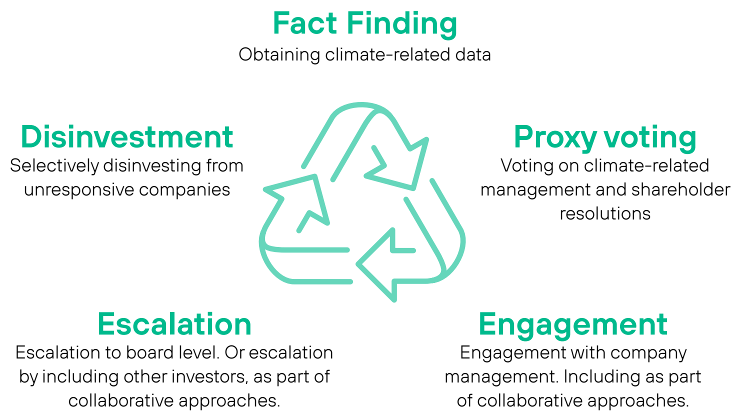
The PRI defines stewardship as "the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend."

Deforestation
Human Rights Carbon Transition
Board diversity Environmental Resources
Climate Change Labour Rights
Biodiversity Loss Education
Natural Capital
Water management Modern Slavery
Net Zero Commitment Nature Positivity
Corporate Governance Healthcare

Delving under the engagement bonnet

Whilst it's important to consider firm-level policies and processes, investors should focus on stewardship implementation within their specific funds. We have undertaken deep dive assessments of fund-level stewardship activity to ensure alignment with investors' priorities. From our experience, it is not uncommon to see misalignment between firm-level and fund-level stewardship activities.

We recently undertook a piece of research on the efficacy of engagement vs divestment in supporting the transition to the low carbon economy. We believe a best practice approach to engagement is through a cyclical, escalation approach.



Reporting

Our Reporting pillar aims to assess the extent that asset managers provide meaningful and regular reporting on ESG issues, including the provision of climate, social and nature-related metrics.

With an increasing demand for transparency from regulators, investors and society, the ability to report a range of ESG metrics is vital. We expect asset managers to report in line with the Taskforce on Climate-related Financial Disclosures ('TCFD') framework as a minimum and hope to see further progress on social and nature-related metrics reporting.

Asset class	Ability to provide fund-level TCFD metrics[1]	"Sufficient" fund-level coverage[2] of GHG emissions	Ability to provide fund-level social-related metrics	Ability to provide fund-level nature-related metrics
Public equity	62%	77%	46%	23%
Public credit	55%	43%	40%	8%
Private credit	16%	16%	4%	8%
Real assets	11%	54%	30%	11%

0-33% **34%-66%** **over 66% of funds we have assessed that meet the specific good practice criteria**

1. TCFD metrics capture an absolute emissions metric, an emissions intensity metric (Scope 1 & 2 and Scope 3), a portfolio alignment metric, and one additional climate change metric.
2. We have set a level as to what we would deem "sufficient" coverage of Scope 1 & 2 GHG emissions for each asset class: Public equity and Real assets – above 70% reported / verified; Public credit – above 50% reported / verified; Private credit – above 20% reported / verified or above 40% estimated. As an example, for real assets, full TCFD reporting is provided for only 11% of funds assessed, however 81% of funds assessed can report on Scope 1 & 2 emissions with 54% of funds having sufficient coverage of above 70% reported / verified.

Social-related metrics: The Taskforce on Social Factors gives four key examples:

- Number of full-time equivalent employee roles, % paid a living wage, employee turnover
- Gender and ethnic pay gap data
- Accident and fatality incidence rate
- Maximum supplier payment term and frequency exceeded

Nature-related metrics: TNFD-aligned metrics include:

- Mean species abundance
- Vulnerability to nature-related transition and physical risks
- Exposure to sectors with material nature-related dependencies and impacts Further information can be found here.

Key findings

The majority of public market funds are able to report TCFD metrics with data availability and quality having improved in recent years. Scope 3 emissions reporting remains challenging, with a number of managers unable to report (sometimes due to a lack of trust in the data).

Where asset managers can report, we see good levels of emissions data coverage for public equity funds given increased disclosure requirements and efforts by ESG data providers. Emissions coverage across public credit funds lag behind public equity, partly explained by the wide range of credit sub-asset classes (for example data challenges for asset backed securities).

ESG reporting within private markets remain restricted given the reliance on either sourcing data directly or on estimates.

Provision of social-related metrics is gaining some traction across asset classes. This is however largely limited to board diversity and independence, in addition to UN Global Compact violators.

Nature-related metrics reporting is still in its infancy, we expect further industry engagement with such frameworks as the Taskforce on Nature-related Financial Disclosures ('TNFD').

Collaboration

Our Collaboration pillar aims to assess evidence of asset manager engagement with other stakeholders and market participants to encourage best practice on various ESG issues.

We believe that collaboration is an important element of a rounded SI approach but can often be used as a tick-box exercise. Over the last few years, the number of SI-focused initiatives has grown exponentially, and we expect asset managers to be actively involved in several different initiatives to drive industry change.

As example leading initiatives, signatory status among the assessed asset managers to the UK Stewardship Code and Net Zero Asset Managers Initiative ('NZAMI') is 65% and 63% respectively, however, a further 23% and 20% respectively, provided a reasonable rationale as to why they chose to not become a signatory. The table below outlines the extent asset managers are engaged with environmental-related (over and above NZAMI) and social-related initiatives.

	Signatory of one relevant initiative	Signatory of two or more relevant initiatives
Environmental-related initiatives (e.g. TCFD, IIGCC, TNFD)	92%	88%
Social-related initiatives (e.g. TISFD, UN PRI initiative on social issues and human rights)	94%	67%

Key findings

There are a vast number of climate-related initiatives of which asset managers comprise a large portion of signatories, and collaboration among asset managers in such initiatives is relatively high.

In relation to social-related initiatives, most asset managers are signatories to one body, but a significant portion are not signatories beyond this. This may indicate a lack of credible or established initiatives or networks; however, we believe this will evolve over time as industry initiatives progress.

We anticipate that nature initiatives will continue to grow in popularity, particularly given the success of Nature Action 100.

Case study - Climate Action 100+ ('CA100+'):

CA100+ is an investor driven initiative aiming to hold the largest global emitters accountable for tackling climate change. During 2024, a handful of key US-based asset managers chose to withdraw for a variety of reasons. Whilst this topic is complex, investors should understand their asset managers' position; we believe climate change collaboration initiatives play a key role in the climate transition and we remain supportive of collective engagement, including investor commitment to CA100+.

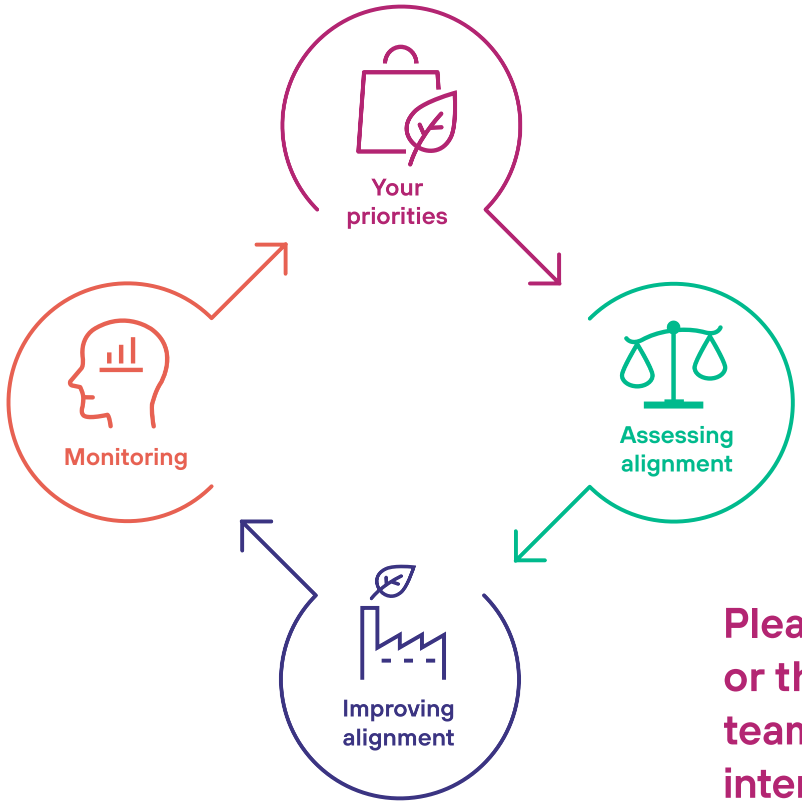
Next steps

The world of sustainability continues to evolve, and investor engagement has never been more important. Whilst the ability to achieve best practice will differ across asset classes, throughout this paper we have highlighted criteria that we believe investors can focus on across different areas of the investment process.

We expect SI integration to continue to evolve and we look to raise the bar as part of our annual monitoring process in line with market developments and regulations. In particular, we expect further integration of social and nature-related risks and opportunities, as well as the provision of social and nature-related metric reporting to evolve rapidly. While this is our first report of this kind, we have been researching best practice ESG integration and assessing asset managers for a number of years. We will use our Annual Sustainable Investment Surveys to highlight key industry trends and highlight areas for investors to increasingly engage with.

Our clients' SI journeys

We can help clients through all aspects of their bespoke SI journeys; from provision of training, to strategic discussions, to investment manager selections through to bespoke ESG reporting.



Please contact your Isio consultant or the Sustainable Investment team (see contacts page) if you are interested in discussing this further.

Appendix

Appendix A: Asset class definitions

Public equity: Where an investor owns a proportion or share of a listed company. Passive funds are designed to track a specific equity index, which can have ESG tilts or exclusions. On the other hand, active funds aim to utilise manager skill in constructing portfolios which are different from the benchmark index; these active tilts can include 'impact investing', with specific environmental or social objectives.

Note: At the time of writing, coverage of private equity mandates was limited and so has been included in the active public equity universe.

Public credit: Where an investor lends to governments or companies. Active funds have the ability to generate alpha from different sources e.g. sector rotation, off benchmark positions and top down allocations. We have a wide coverage of credit funds including segregated or bespoke mandates which integrate ESG guidelines and objectives within asset manager agreements.

Note: We have included passive funds, which track bond indices, within public credit, however, the majority of our universe is actively managed.

Private credit: Where an investor (typically alternative asset managers) lends to privately originated or negotiated investments. There are an array of strategies (direct lending, real estate debt and infrastructure debt) providing exposure across the capital structure. In recent years, we have seen the development of ESG ratchets within loan deals encouraging positive ESG disclosures and behaviour with associated borrower interest rate incentives or disincentives. However, this is currently a nascent feature of private credit loans.

Real assets: Where an investor directly holds a real asset (such as property, infrastructure, forests and agriculture), this typically involves sole ownership by the investor allowing for impact opportunities (such as social housing, renewable infrastructure and natural capital including forestry and agriculture) or direct management of ESG risks and opportunities.

Appendix B: Isio's ESG criteria buckets

Meets additional impact criteria: The fund qualifies as a specialist impact fund with specific environmental or social impact objectives being equal in importance to more traditional financial objectives such as risk and return targets. The fund will need to fulfil additional impact evaluation criteria.

Meets additional sustainability criteria: The fund qualifies as a specialist sustainable fund with ESG and/or climate-focused objectives being equal in importance to more traditional financial objectives such as risk and return targets. The fund will need to fulfil additional sustainability evaluation criteria.

Meets traditional criteria: The fund scores highly on our ESG scorecard and is in line with best practice in terms of ESG integration.

Partially meets criteria: The fund has scored strongly on some (but not all) of the ESG assessed criteria and ESG integration is on par with the majority of investors.

Significantly fails to meet criteria: The fund fails to meet most of the criteria on our ESG scorecard and is significantly behind best practice in terms of ESG integration.

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