Discussion Paper

Institute of Business Ethics

Ethics: the missing 'E' in ESG investing?

Perspectives from the asset management industry

The use of Environmental, Social and Governance (ESG) criteria is changing the way that capital markets operate, offering the prospect of business that's better for people and planet. So does this make room for ethics in investment decision-making? As this report shows, whilst asset managers may prefer not to talk about ethics per se, it is clear that they are concerned with aspects of investee companies, such as culture and behaviour, that are ethically significant.

Read on for the details behind the headline and our recommendations for asset managers and companies.

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Summary

- The incorporation of Environmental, Social and Governance (ESG) factors into investment decisions is growing rapidly and changing what markets measure and value
- Interviews with 28 experts from the UK investment industry suggest that real change is here to stay
- However, asset managers are drowning in data and finding some of the regulatory and other pressures counterproductive
- They are also reluctant to address *ethics* as part of a broadened approach to investment
- Nevertheless, many are keen to assess aspects of companies, such as their culture, that are ethically significant
- However, they find cultural/ethical assessment challenging, because they lack adequate training or usable models, and the timeframes they work to make this difficult.

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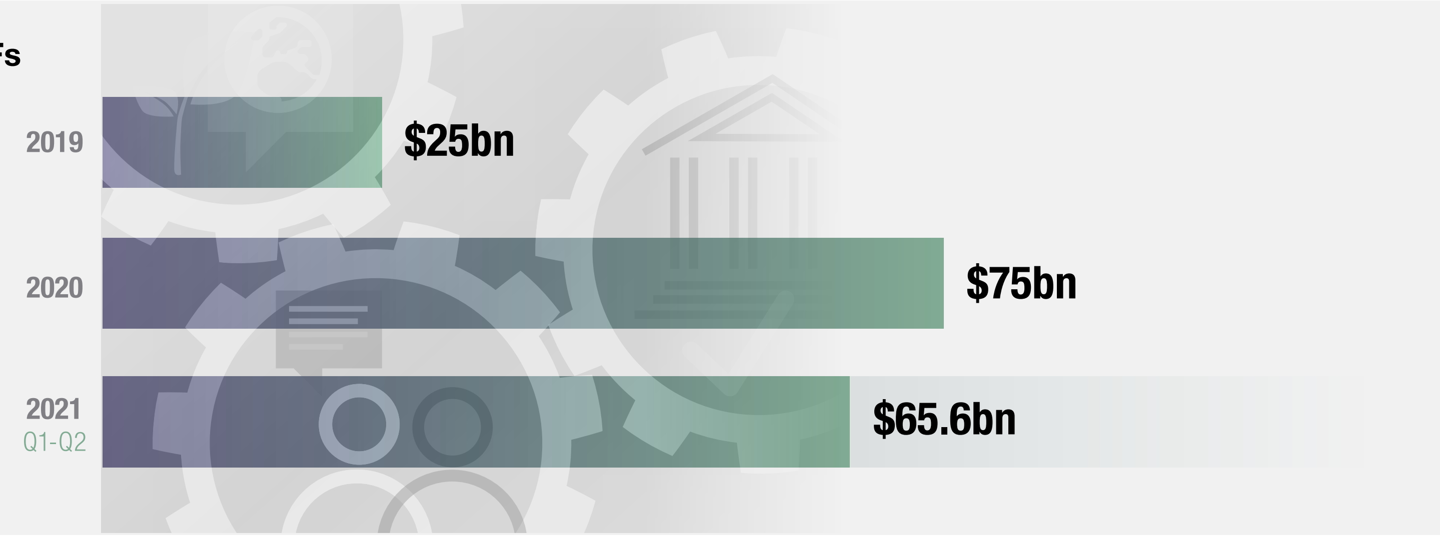
ESG: a growing phenomenon

- There's currently huge discussion and activity around 'ESG' investment: investing that takes account of environmental, social and governance factors
- ESG-related investment strategies have seen exponential growth recently
- This challenges asset managers to expand the scope of their investment analysis and client reporting
- But it also provides an opportunity for active managers to demonstrate their value to clients…
- … and to society, if ESG investing results in business that's better for people and planet.

Investment in ESG ETFs

(exchange-traded funds)



Source: Morningstar

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ESG: broadening horizons

E Concern about climate change has become mainstream, while climate predictions have begun to coincide with pension savers' retirement timelines

S Social factors, amplified by the climate crisis, are increasingly likely to be drivers of public opinion and corporate reputation

G 30 years on from the Cadbury Report's focus on financial aspects, corporate governance has broadened to the point that the board must promote a culture that is aligned with the company's purpose, values and strategy (UK Corporate Governance Code).

This change of perspective has reframed how companies are held to account by analysts, who are assessing the vulnerability of businesses to 'externalities' that arise from their actions

- However, do asset managers think about the culture that drives company behaviour when they are deciding whether to invest?
- Indeed, is it possible to do ESG investing properly without considering the ethical and other values that shape company decision-making?

> *"We have a situation with climate change which will involve every country in the world and from which we can't self-isolate"*
>
> *Mark Carney, former Governor of the Bank of England*

continues

What we did

We asked leading players in the UK investment industry about the place of ethics* when analysing companies' ESG credentials

- Is ethics part of ESG? If so, where? If not, why not?
- What measurements are useful?
- How does it relate to corporate engagement?
- How does asset management stack up?

28 experts were interviewed:

- 16 asset managers
- 3 asset owners
- 4 investment consultants
- 5 independent bodies and advisers
- A list of the participating organisations can be found on **page 14**

** The IBE defines business ethics as the application of ethical values to business behaviour*

ESG is here to stay

Our participants generally agree that:

- ESG is not a fad or niche strategy; it’s a measurement framework for capital markets to revise valuation models so that they recognise externalities and longer time frames, and permit a more holistic assessment of material risks
- With flows into ESG funds growing exponentially, this will be an essential element of almost all active management in future
- The pace of development is extremely rapid, with regulation amongst the pressures driving the nature of implementation
- Asset managers, as shareholders, drive corporate behaviour, so the way they assess companies’ ESG credentials has real effects
- There can be merit in linking ESG metrics with executive pay, but careful design is needed
- The ESG framework is a stepping-stone on the journey to ‘Capitalism 2.0’.

“The mainstreaming of sustainability is the recognition of real risks that might affect future cashflows”

Asset manager

continues

Ethics

A variety of views

However, there are differences of opinion about ESG and how it might relate to ethics:

- Some interviewees are suspicious when companies talk about prioritising anyone other than shareholders, or anything other than financial returns
- Some are concerned it will be costly, with an ESG bubble forming for highly scoring companies
- Many see an ethical dimension to E and S, but do not believe it is the job of asset managers to take a moral position
- Those who have most developed their thinking on culture believe it offers a meaningful signal to gauge whether a company will deliver on its ESG commitments
- However, while all think that assessing the culture of a company is important, most do not explicitly associate it with ESG
- … and they are reluctant to talk about *ethics*, because they find it hard to define and don't want to make a moral judgment.

"It's about how you run your business and what is core to your purpose"

Asset manager

continues

Ethics

Ethics: the silent 'E'?

Nevertheless, something very like ethics does get factored into asset management

1. 'Who do I trust with the money?' has always been an important consideration in making a responsible investment decision – company **values and culture** matter
2. When it comes to ESG, asset managers want to be able to **trust** companies not to just **chase the numbers**, i.e.
   - not to treat ESG targets as a tick box exercise
   - not to game the system, e.g. by engaging in damaging behaviours that won't harm ESG numbers – for now
   - not to engage in greenwashing, overselling or overpromising ESG effects
3. Some see best practice as the ESG agenda being **owned by the board** and **embedded in the culture**
4. Asset managers are also aware that, as active **stewards** of client capital, they have a role in governance, oversight and accountability – all of which are ethically significant
5. Most asset managers also believe that their own firms should aspire to the same high standards they expect of companies.

"Cultural aspect is long term guarantee"

Asset manager

continues

The challenges

- There is a mass of data for analysts who
  - have to navigate conflicting signals and data providers scoring the same companies differently
  - find themselves under cost pressures as margins for active management are squeezed
- Well-intended regulatory changes and other pressures can be counterproductive by rewarding the wrong behaviour. Participants strongly favour engagement over divestment (funding improvements over perfection), but this is getting harder
- Demands for corporate board engagement and accountability to clients are significant and growing
- Many asset managers feel under pressure to focus on short term returns
- … and the ESG agenda itself often feels at odds with their own firms' priorities and culture
- Meanwhile, an assessment of ethical culture and trustworthiness could help address some of these challenges, but
  - analysts lack specialist training or a clear methodology that fits with investment analysis
  - those who work to a longer-term time frame have most developed their thinking and practice, but few have that luxury.

"The time horizon of decision-making does not reflect client or stakeholder timelines - we need a longer perspective"

Asset manager

"The incentive structure doesn't support long-term engagement"

Investment consultant

"Ethical culture is everything - getting into the culture is the holy grail of analysis"

Asset manager

Analysing ethical culture

There is no consensus or formal training, but some asset managers attempt to assess firms' ethical culture – identifying both quantitative and qualitative insights. Those most advanced in their thinking stress the importance of looking at trends and lifecycles rather than headlines, forming a balanced picture across the different signals. Examples provided include:

- Staff turnover: departures from particular areas of the business, or changing trends
- Tech verification: using social media, satellite imagery
- Glassdoor (with a pinch of salt)
- Tracking management promises - the say/do gap
- Diversity – beyond the top team
- Fines, regulatory inspections and sanctions
- Adherence to external codes – minimum vs best practice
- Code of ethics – statement, training, reinforcement
- Stakeholder treatment – e.g. suppliers, recruitment
- Tax rates and accounting practices
- Openness to questioning and challenge
- Body language and subtext in meetings
- Whistleblowing approach and response
- Incentive structures – by design and in comparison
- Reporting lines
- Response to things going wrong
- Proactive vs reactive shareholder communication
- External vs internal reviews and hiring
- What have they shown commitment to – does it map to stated purpose or short-term share price gains?

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What we conclude

- ESG is profoundly changing the way that companies are assessed and analysed
- Although they prefer not to talk about *ethics*, asset managers are interested in several aspects of investee companies' culture and behaviour that are ethically significant, such as how authentically companies are responding to the ESG agenda
- However, asset managers face several practical challenges – relating to data, analytical skills, models, targets and their own firms' priorities and culture – that potentially undermine the credibility of what they are offering in the ESG space.

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Recommendations for asset managers

Just as asset managers have concerns about authenticity when assessing companies’ ESG profiles, so clients are increasingly likely to look closely at asset managers’ own ESG credentials

1. In order to ‘quality control’ their ESG measurements asset managers must recognise that they can benefit from analysis of companies’ ethical culture to understand their real priorities and motivations
2. Asset managers need to develop methodologies to assess culture. Managers who do this can create an opportunity to exploit inefficiencies and harvest a return premium. These methodologies are beginning to develop, even if not yet in widespread use within the industry
3. To be credible, trustworthy and sustainably competitive in ESG, asset management firms should ensure that they have a board-led, organisational response to the ESG agenda that builds a culture that is consistent with their offering.

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Recommendations for companies

1. Companies shouldn't just tick boxes or chase the ESG numbers, but provide a convincing, authentic narrative of what the company is about, reflecting its purpose and values
2. Companies should take advantage of opportunities to give an account of how their values are embedded in their culture and reflected in both important decisions and day-to-day behaviours throughout the organisation
3. Companies should consider how the ethics function can support this agenda, e.g. by providing a dashboard of cultural indicators for the board to monitor or by overseeing the integrity of reported ESG numbers.

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The IBE wishes to thank those who agreed to be interviewed…

Asset Managers

Abrdn
Aviva
Baillie Gifford
Bluebay
CCLA
Fidelity
Hermes
Impax
Invesco
M&G
Newton
Ninety One
Pictet
Royal London
Schroders
SSGA

Asset Owners

Church of England
Coal Pensions
NatWest Pension Scheme

Investment Consultants

Hymans
Mercer
Redington
Willis Towers Watson

Independent Bodies and Advisers

CFA UK
Gordian Advice
Investor Forum
Partners on Demand
Stephen Beer

continues

The author – **Annabel Gillard**

Annabel spent over 20 years building institutional business and working with clients to develop innovative strategies at a range of asset managers. She has also volunteered in various roles for CFA UK and CFA Institute, and she is a member of the IBE's International Advisory Council.

An advocate for the power of ethics in delivering sustainable growth and enabling talent to flourish, Annabel is also investigating the place of ethical values and organisational culture in an AI-driven future workplace, and its impact on the changing nature of work and society. She recently completed an MA in Philosophy and AI at New College of the Humanities and is currently at the LSE studying Behavioural Science, alongside working with CFU, a not-for-profit dedicated to improving ethics in technology and equipping investors with the stewardship tools they need to ensure tech is a force for societal good.

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We hope you found this report interesting and useful.

For further information about the research that underpins the report, please email us at **info@ibe.org.uk**

If you would like to discuss how we can help you with your ethics agenda, please contact **engagement@ibe.org.uk**

For further information about the IBE, its services or becoming a Supporter, please visit **www.ibe.org.uk** or email us at **info@ibe.org.uk**

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