Should Financial Advisers pro-actively include Responsible Investing in the advice process?

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Over the years, I've had many a discussion with the financial advisory community on the merits (and otherwise) of responsible investing. Sometimes the discussion has been very constructive, and sometimes very short. As the years have rolled by, the subject has become more topical and common. Attend any adviser briefing these days and ESG will almost certainly loom large (though whether this is through genuine adviser interest, or fund manager enthusiasm is a point of conjecture). However, responsible investing is now mainstream and to ignore it as a fundamental part of investment advice could be viewed as arguably nonchalant. Having reflected on this matter for some time, I have outlined below 5 key reasons why Financial Advisers should pro-actively include Responsible Investment in the advice process.

Consumers want it - According to consumer polling carried out by the Responsible Investment Association of Australasian (RIAA) and Mindful Money in 2020...

- Over three quarters of New Zealanders expect their KiwiSaver funds and other investments to be managed responsibly and ethically
- Almost 60% with KiwiSaver funds or other investments would consider moving to another provider if their current provider did not align with their personal values
- A large majority (93%) who do not already consider that they invest ethically or responsibly intend to do so, most of them in the next year
- More than three-quarters of New Zealanders with KiwiSaver funds or other financial investments expect ethical or responsible investments to perform better in the long term.

It better reflects client values - It's as much as anything human nature to have greater ownership, passion, and empathy with something that aligns to your values, which implies that responsible investors are more loyal. Academic and empirical evidence would appear to back this up. For example, in a 2013 paper entitled "Fund Loyalty Among Socially Responsible Investors: The Importance of the Economic and Ethical Domains", research indicated that "dual investors (i.e., those who invest in both SR - socially responsible - and conventional funds) are more loyal to their SR fund than to their conventional fund". In the recent NZ consumer polling mentioned above, six in ten New Zealanders with KiwiSaver funds or other investments say they would be motivated to save and invest more money to make a positive difference.

It's consistent with best practice (and is the shape of things to come) - The Code of Professional Conduct (recently updated in March of this year) sets standards of competence conduct and client-care for the whole financial advice industry with a focus on those offering advice to retail clients. Whilst not explicit, the code features several individual standards which arguably imply financial advisers should consider ethical, sustainable and ESG factors as part of the advice process. In particular…

- Code Standard 1 – *A person who gives financial advice must always treat clients fairly.* This includes “listening to clients, considering their views and responding to their concerns and preferences.” This implies that financial advisers should enquire, as part of their fact find process, about the client’s ethical views and any ethical concerns or preferences
- Code Standard 3 – *A person who gives financial advice must ensure that the financial advice is suitable for the client, having regard to the nature and scope of the financial advice.* This includes consideration of “the client’s circumstances that are relevant to the financial advice, such as their financial situation, needs, goals, and risk tolerance.” Like code 1, this implies that financial advisers should enquire as to any ethical values that need to be incorporated into the advice given
- Code Standard 4 – *A person who gives financial advice must take reasonable steps to ensure that the client understands the advice given.* This standard relates to the financial advice itself and includes “the client having sufficient comprehension of the content, risks and consequences of the financial advice….” Irrespective of whether the client has expressed ethical concerns or preferences, this implies that, at the very least the client be given a clear explanation of the extent of ethical considerations taken into account within the portfolio as a whole and within individual funds.

Outside of the Code, there is further legislation and guidance either in place or coming that sets the tone around the importance of responsible and sustainable investment related issues. This includes (but is not limited to) requirements around responsible investment for default KiwiSaver providers, the FMA's recent guidance on the Disclosure Framework for Integrated Financial Products and draft legislation that will make climate change disclosure mandatory for larger (financial) institutions including fund managers. Recent legal opinions from Chapman Tripp on Fiduciary’s and Trustees’ duties in relation to climate change have further re-iterated the importance of taking into consideration environmental (climate risk) issues. Developments in NZ are consistent with happenings overseas (e.g., the EU's taxonomy in relation to sustainable investing), all of which point towards a changing regulatory environment and the shape of things to come.

Responsible Investment-related themes are likely to be dominant - As the world's economy moves to a more sustainable footing in response to climate and other related issues, it is likely that certain sectors and industries will benefit from investment and demand. The recent UN climate change conference, COP 26, whilst still falling short, re-iterated the importance of striving for no more than 1.5 degrees of warming. The Conference featured a slate of financial initiatives and commitments including the Glasgow Financial Alliance for Net Zero (announcing that it would deliver more than $130 trillion in financing to transition global economies to net zero by 2050). Climate disclosure through the Task Force for Climate Related Disclosure (TCFD) is gradually being adopted around the world (NZ is the first country to mandate it). In its 2021 report, the International Energy Agency highlights renewable energy will dominate investment in new power generation and are expected to account for 70% of 2021's total of USD 530 billion spent on all new generation capacity.

And the focus is not just on climate change and the environment. The UN Sustainable Development Goals (SDGs) were established in 2015 to be a blueprint to achieve a better and more sustainable future for all. They were further developed in 2017 and made more actionable with specific targets to be achieved before 2030. 193 countries of the UN adopted the agenda in 2015. The UN SDGs include such objectives as No Poverty, Zero Hunger, Good Health and Well-Being, Quality Education and Gender Equality to name a few. In the RIAA & Mindful Money survey mentioned above, 3 out of 4 of the topmost importance issues for avoidance were socially orientated including labour rights abuses, human rights violations and social media privacy breeches.

Governments, business, and consumers are reacting to this sea-change in a number of ways (some of which have been mentioned above). In late 2020, the Aotearoa Circle's Sustainable Finance Forum published a roadmap and a series of recommendations to move the NZ finance sector to a more sustainable footing. This was followed this year by the establishment of the Centre for Sustainable Finance which will help co-ordinate the Forum's recommendations. Other countries around the world have developed similar initiatives (including in Australia, Canada, the UK, and the EU).

One manifestation of this trend is the growth in Responsible and Sustainable investing. According to the Global Sustainable Investment Review (which captures RI trends in a number of jurisdictions including Australasia, the US, EU, UK, Canada, and Japan) funds invested in a sustainable or responsible manner stood at US$35.3t in their 2020 report, that's up from 30.6 tr in 2018 and 22.8tr in 2016. This is estimated to be 35% of all professionally managed funds in the regions surveyed. And in New Zealand, $142bn were invested in a responsible manner at the end of 2020, representing 42% of total industry funds.

In summary, Responsible and Sustainable investing is a global trend that looks set to experience continuing growth.

It doesn't detract from performance - One of the age-old arguments thrown at Responsible Investing is that there is a cost to incorporating environmental, social and ethical issues into the investment process. There is now wide-ranging evidence to suggest that this is not the case and that in fact responsible investing can enhance risk-adjusted returns. For example:

- In RIAA's 2020 Benchmark Reports for both Australia and New Zealand, a survey of the performance of both responsible and mainstream funds shed some favourable light on the returns from the responsible sector. In Australia, and "despite economic setbacks in 2020, responsible investment funds outperformed both the international share and multi-sector growth funds in 2020, performed on par with the Australia Fund Equity Large Blend, but under-performed compared to the S&P/ASX 300 over three and five years". In New Zealand, "the average performance of responsible investment funds was higher or similar to the performance of the S&P/NZX50 on all time horizons (while in the multi-sector growth fund category, the responsible investment average was on-par or slightly below Morningstar's NZ Multi-sector Growth category)".
- There's a growing list of international research studies demonstrating that companies with strong corporate social responsibility policies and practices are sound investments. Studies with such findings have come from Oxford University, Harvard Business School, Morgan Stanley Institute for Sustainable Investing, and Deutsche Asset & Wealth Management, among others.
- Interesting, in RIAA's 2020 NZ benchmark report, growing acceptance that ESG factors impact the financial performance of investments has become the second-largest driver of growth in responsible investment funds, up from 18% in 2019 to 37% in 2020. This is based on a survey of fund managers and asset owners in NZ.

It would of course be disingenuous to suggest that responsible funds out-perform their mainstream counterpart's period. There may well be times in the economic cycle for example when energy and resource stocks (not a known focus for responsible funds) will out-perform. In addition, the ongoing importance of good investment management practices (including fees) need to be considered. However, there is growing evidence to suggest that ESG factors are consistent with good investment practice.

One or two final thoughts. I have over the years been challenged on the benefits of Responsible Investing. A key concern from some of the advisers I have spoken to is that if they pro-actively ask clients the question (on RI issues), it can open a "can of worms" and lead to client preferences and demands that are difficult to satisfy. Irrespective of the merits of this argument, a well framed discussion may solve this issue. Most managed funds for example now include some form of responsible investing (such as norms-based exclusions and ESG integration). For a lot of investors, this approach may well suffice. For those that have greater demands, there is now a growing number of "greener" options available.

The other objective is around lack of products, and standards; that there aren't enough RI products, and to do meaningful research on them, to compare apples with apples is difficult. On the first point, I'd argue that there is a already a large number of RI options of good quality (refer this year's RIAA benchmark report), that this is growing year by year, and that the choice across the RI Spectrum is becoming wider (for example, RI focussed funds in New Zealand are now available that focus on Impact Investing, Sustainability-themed investing, the carbon market, water etc).

The final objection, and in relation to standards and being able to discern good RI practice from bad (particularly via independent research) is also progressing. For example, RIAA runs a product certification program (over 60 NZ products are certified by this program). Websites such as RIAA's Responsible Returns and Mindful Money allow investors and advisers to filter out product by (for example) issues of concern.

In concluding, the path towards a more sustainable future and financial system is well set, the investing public is more empowered and has a much greater awareness of and places more value on social and environment issues when investing; and the financial system (including the investment world) is becoming much more aligned with ESG factors (and active engagement). All of this would suggest strong reasons for the financial advisory industry to be pro-active when it comes to Responsible Investing.

Disclosure - I am a board member of RIAA and on the advisory board of Mindful Money. In 2019 and 2020, I was a member of the Technical Working Group of the Sustainable Finance Forum (an initiative of the Aotearoa Circle). I am not paid for this work.

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