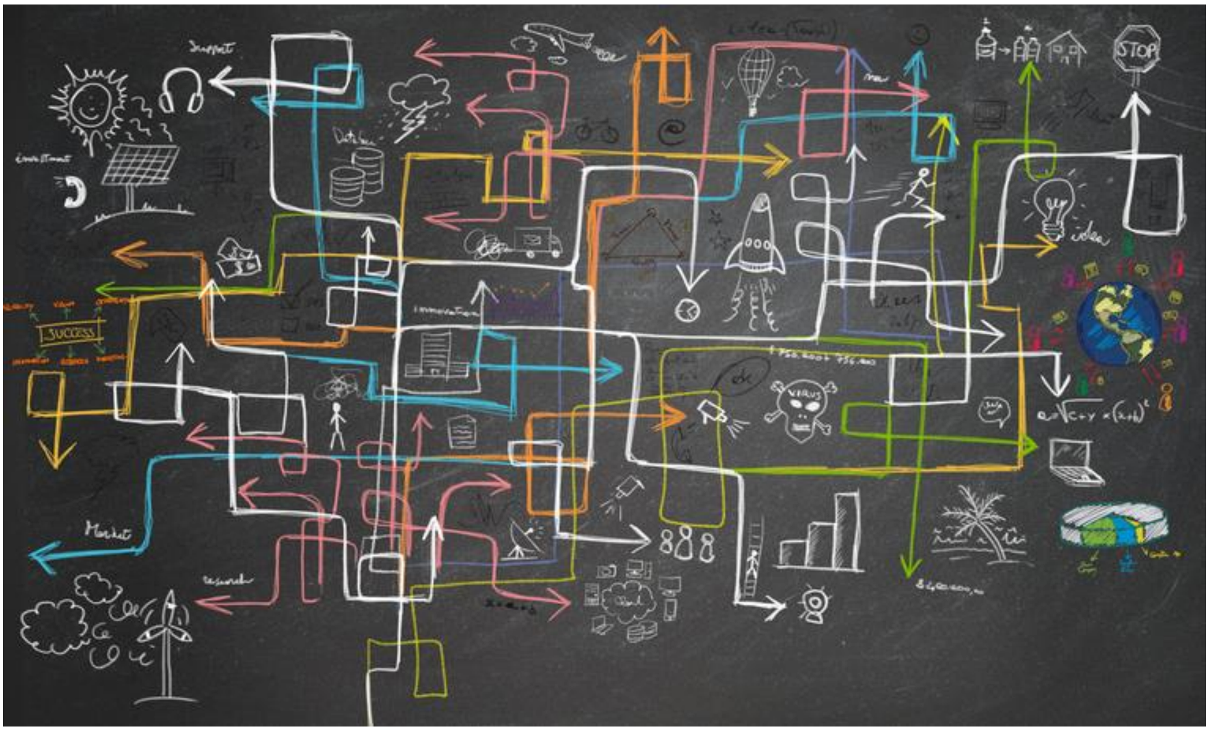

Impact Cubed

EU TAXONOMY: AMBITOUS. COMPLEX. A WORK IN PROGRESS.

Being ambitious, complex and slow burning is often something to strive to in the world of the arts. Take in one of Mozart's symphonies or Christopher Nolan's films. Magnificent.

It's not so magnificent, however, when those words are applied to financial regulations. Yet, that's exactly how we view the EU's Sustainable Finance Taxonomy – an ambitious work in progress.

The spirit of the Taxonomy is good. It will, in time, provide investors with greater clarity around their sustainable investments and ESG performance.

Over the past year we've held workshops with investors about what is required and how to practically respond. It's been the subject of discussions about the reporting requirements for our own equity long/short ESG strategy.

Here, we offer our views on the challenges implementing the Taxonomy, some uncertainties, and the implications for investors.

The EU Taxonomy for sustainable activities: a brief overview

The EU Taxonomy – adopted in June 2020 – identifies whether certain business activities are "green" or sustainable.

At its heart is the "Green Asset Ratio". This is the proportion of exposure financial institutions have to sustainable activities in comparison with exposure to activities that aren't classified as sustainable. Institutions offering financial products in the EU are required to disclose this performance indicator.

In terms of determining whether activities are "green" or not, the Taxonomy sets performance thresholds for economic activities, addressing whether they:

- make a substantial contribution to one of six environmental objectives;
- do no significant harm (DNSH) to the other five objectives, where relevant; and
- meet minimum safeguards (i.e., OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights).

EU Taxonomy reporting timeline

- ***As of 1 January 2022***: for the reporting period 2021, only qualitative information and the proportion of *Taxonomy-eligible* activities in relation to total activities must be disclosed.
- **As of 1 January 2023**: for the reporting period 2022, full Taxonomy *alignment* disclosures will apply to non-financial undertakings.
- ***As of 1 January 2024***: for the reporting period 2023, full Taxonomy *alignment* disclosures will apply to financial undertakings.

How do you disclose performance of a fund when companies in the fund have not yet disclosed?

One major challenge is that European companies aren't yet required to report their EU Taxonomy data. While firms will do so in the near future, fund managers are currently, for the most part, without this information. That means there's immense difficulty aggregating and interpreting the very limited company level data at a portfolio level.

In other areas of sustainable investing, when there is no disclosure data from companies then fund managers rely on estimation or imputation models – some more rigorous than others - based on industry average data built up over the past two decades.

This difficulty is compounded by some reasonably confusing guidelines offered by the European Commission. Funds should only claim alignment with the Taxonomy when this is based on reliable data, it says. But, as established above, portfolio companies aren't yet mandated to provide this.

A balancing act

While estimates can be used to make up for a shortfall in data, the Commission has indicated such a step "should only compensate for limited and specific parts of the desired data elements and produce a prudent outcome".

As an example, it is somewhat straightforward to estimate revenue that is *eligible* for Taxonomy alignment using standard industry classifications. But estimating which of those revenues are aligned to the Taxonomy based on the DNSH threshold involves many more assumptions, and dare we say may be more art than science and somewhat speculative in these early days of reporting? The investor is caught in a balancing act: err on the side of less than complete reporting and exclude alignment estimates or err on the side of complete reporting and include the more uncertain alignment estimates.

We see the current state of play in our own data. Impact Cubed's Taxonomy dataset covers all listed companies, and not surprisingly shows very few are aligned with the Taxonomy. This is also due to the narrow scope of activities in the Taxonomy, which are currently limited to those that are climate related.

Ultimately, it is companies themselves that are best placed to confirm when their eligible business activities are aligned to the Taxonomy. Mandated disclosures will have a significant bearing on the usefulness of the Taxonomy.

Is CapEx king?

We've heard a number of investors share their view that Capital Expenditure (CapEx) data is a vital piece of missing information in the sustainable investor's toolkit. What a company is investing in can provide a forward-looking window into its business strategy - and the validity of performance targets it has set.

Let's take the example of a commercial real estate company, which has set a net zero carbon target for 2025, and whose existing buildings' heating and cooling systems are the source of most of its carbon emissions. If its investments are devoted to constructing new buildings, rather than renovating the heating and cooling systems in existing buildings – is that ambitious carbon target really viable? In that sense, CapEx data may be king when it comes to researching individual companies or engaging with them about their performance targets.

But we also point out that within a sector, the CapEx/$ sales ratio changes very little, so CapEX data at an aggregated portfolio level may not be the silver bullet asset managers are looking for.

More questions than answers

For now, we expect there will be a host of new questions that surface as more companies begin to disclose data and fund managers begin to aggregate the data at a portfolio level. Here's some of the questions managers are already grappling with:

- How should the Taxonomy be used? As the "gold standard" for assessing financial products - or as one of several tools used to address and make decisions on investment allocations?

- Is there value to compare funds to benchmarks? (We believe there is lots of value in this approach.)
- Can we agree that the current industry approach to using high level GICS sector classifications on business activities is not adequate for sustainable investors? Is the outdated NACE under the taxonomy any better?
- Will the divergence in regulatory agendas in the EU and US result in a more bifurcated asset management industry?

The upshot for investors

In the meantime, we offer the following observations for asset managers:

- **Expect the unexpected:** Managers would be wise to run an EU Taxonomy portfolio report as soon as possible for internal use to begin to understand and digest its implications. In our experience, comparing a portfolio to its market benchmark yields valuable insights.

- **Don't let your socially-focused strategy get lost in the shuffle.** For managers with intentional strategies that focus on social impact – rather than climate – alignment to the current climate focused Taxonomy will be very low. Be prepared to show factual data on social impact to validate your strategy and stand out from the climate funds.

- **Take advantage of opportunities to innovate on climate.** Climate mitigation funds - ones that hold companies with lower carbon emissions – have been a primary focus for sustainable investors. Impact Cubed's low carbon overlays are an example of this type of strategy. The Taxonomy also includes climate adaptation activities, like building resilience to sea level rise. This opens doors for fixed income investors, for example, to include bonds that finance local infrastructure projects. But the Taxonomy also includes transitional business activities, which may have high carbon emissions but are needed to support the change to a low carbon economy. Portfolio managers may ultimately have more flexibility in creating climate strategies by drawing on low carbon or transition aligned business activities such as what is available through Impact Cubed's highly detailed impact classifications.

ABOUT IMPACT CUBED

Impact Cubed provides ESG analytics and investment solutions for building more sustainable portfolios with greater impact. It combines an award-winning approach to integrating impact into risk and return with technology-enhanced portfolio design and management. The outcome is a seamless approach to customised sustainable investing.

You can find out more about our data and portfolio models at www.impact-cubed.com and if you would like to contact us at info@impact-cubed.com we would be happy to hear from you.

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