SUNSET ON THE ERA OF FUND GREENWASHING?

Old time Western-themed movies in the U.S. often are about a bunch of cowboys riding in to fix situations out of control and to "tame the Wild West". A common ending in these cowboy movies is the image of a group of wranglers proudly riding their horses off into the sunset, headed west to new towns that need taming.

The popular press has at times compared ESG investing to the 'Wild West'. Given the recent actions by regulators in Europe and the US, it seems fitting to ask: are we starting to see the sun set on the era of fund greenwashing?

Ramp up in regulatory scrutiny over funds marketed as ESG

Most recently, reports claimed the US Securities and Exchanges Commission (SEC) was investigating Goldman Sachs' asset management arm over ESG claims made around its funds.

That the regulator would circle a big-name asset manager isn't that surprising. The SEC – and indeed regulators in other geographies – are increasingly allowing less leeway when it comes to making ESG claims about investments.

Let's look at a cluster of recent events:

- In March 2022, the SEC showed its intention to provide more transparency to investors on climate risk and require listed US companies to disclose the greenhouse gas emissions from their operations – and their supply chains and products if these are "material".
- In May 2022, the regulator fined BNY Mellon $1.5m for misleading statements made over ESG products.
- The same month, it announced new ESG fund disclosure and naming proposals.

And then, of course, there's the recent police raid of DWS's office, which was reportedly prompted by accusations of greenwashing.

All of this shows that regulators – and even law enforcement – aren't accepting asset managers simply paying lip service to ESG. And it likely won't just be funds facing scrutiny. Index providers and ESG ratings firms are expected to come under the microscope.

Why is this important?

Investors now have several thousand ESG funds to choose from.

When choosing a fund, investors rely heavily on a fund's name. For example, an investor would expect that a fund with ESG in its name would have better performance on impact or ESG measures than its benchmark. But unlike financial performance, there has been no requirement for a fund to show how its ESG performance compares to its benchmark. New European rules for funds are edging toward this type of disclosure under the SFDR and Taxonomy rules. But standard practice is for an investor to trust that the fund is true to its name – it contains what it says on the tin.

Many funds now also claim to "integrate ESG data" as part of the investment process. The ESG integration process is described on the company website or in legal filings. The anonymized example below highlights the vague and confusing language investors face when evaluating a fund.

[Company Name] aims to create funds with a positive environmental and social impact. However, we are largely focused on performance in areas most material to each company. This concept of materiality allows us to engage meaningfully with our portfolio to directly link ESG with bottom-line investment returns.

How does an investment strategy that focuses on avoiding financially material risks for a company create positive impact for society? How does engagement with companies create a direct link between ESG and return?

If we at Impact Cubed who are experts in sustainable investing can't explain this, it is no wonder investors are confused.

Factual data builds trust, reduces greenwashing risks

As long as subjective ESG ratings with proprietary scoring recipes are used to rate funds, investors will be confused. Would environmentally focused investors be pleased if they were exposed to ExxonMobil after investing in an ETF being marketed for its ESG credentials? Likely not, yet they may well own ExxonMobil depending on the ESG rating provider used for index construction.

Better transparency can be achieved using factual data on ESG metrics– rather than subjective opinions – which will reduce confusion and build trust.

What does this mean for investors?

Regulations on fund managers' naming conventions and enforcement actions on ESG marketing claims will have several implications for investors. Managers can expect the following:

- More investors asking to see how their portfolios' impact is different from the index. (*Spoiler alert:* more ah ha moments ahead for investors!)
- Demand for factual data to back up marketing claims as regulators tighten the screws on greenwashers. In addition to a qualitative description of its ESG integration process, a fund manager should expect more scrutiny into the ways they measure ESG and impact.
- Less frenzy over funds that use ESG integration as their main strategy. Afterall, if ESG integration means considering environmental and social issues that may have a material impact

on financial performance - isn't that just good fundamental investment analysis?

If it is true that fund greenwashers are riding off into the sunset, that also means there is a sunrise and new opportunity. Tech-savvy managers can take advantage of these trends to create highly customized strategies aligned with investors' ESG goals, which also let investors see how positive impact is being measured.

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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