Sustainable finance: the real demands

Sustainable finance, which aims to include environmental, social and governance (ESG) issues in investment decisions, is both demanded and promoted by all. Especially as a result of new political, environmental and behavioural "emergencies". Sustainable finance is promoted in particular by many banks, along with asset management and insurance companies, who together offer private and institutional investors a wide range of investment vehicles branded as "responsible", "sustainable" or "climate-friendly".

ESG investment concepts often rely on approaches based on exclusion, selection and impact, usually supplemented by shareholder participation or dialogue. From zero carbon to sustainable real estate to green corporate bonds, investor attention is drawn to ESG funds or mandates, with the investment vehicle at the centre of discussions. All these developments represent progress, but are they the only real demands for responsible and sustainable finance? In reality, the value added chain is not limited to investment instruments. The obligations that give structure and a framework to asset management also play an essential role. What are they exactly? In our view, there are six:

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1. Transparency

Sustainable finance must be built on products that are perfectly clear. This is where the principle of simplicity enters investment. Ambiguous terms such as hedge funds should be avoided, the number of asset classes should be limited (e.g. to cash, bonds, equities) and performance should be calculated accurately and comprehensively. As such, every institution that manages assets should regularly present clients with individual performance results, as well as with comparable results of other clients who have the same investment profile. This enables clients to compare their mandate not only with the benchmark, but also with other similarly positioned investors. To this end, the managing institution must be certified in accordance with recognised standards, such as the GIPS standard[1], as regards the centralised management of its private and institutional mandates.

2. Consistency

The ethical basis of sustainable finance requires that the institution claiming ESG status manage the assets of its clients as its own. To ensure that this requirement does not remain a dead letter, internal rules must be introduced to oblige the bank or the promoter of investment products to work on the same economic forecasting scenarios; to manage its cash position and even more so its own ALM[2] position (asset-liability management), including foreign exchange, in the same direction as that induced in client portfolios. This requirement for consistency requires a high degree of internal discipline. It also provides a better performance over the long term.

1 GIPS (Global Investment Performance Standards) certification falls under the supervision of the CFA institute and is subject to an annual compliance audit by an independent auditor
2 The ALM Committee oversees the bank's financial management, including balance sheet management and interest rate and liquidity risks

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3. Active asset management

Sustainable finance can only truly be practised through active management. First of all, this is because active management is characterised by freedom of movement. It is not mechanically tied to an index, no matter how virtuous that index may be. This independence enables asset managers to select or exclude investments on the basis of their own methods and convictions – or even their own intuition. Secondly, by active management we mean truly active management and not pseudo-active management. Truly active means that managers dare to take positions that differ from the composition of the benchmark index. Pseudo-active management, on the other hand, which tries to protect itself from criticism by hiding behind an index and taking very few active bets, is contrary to the fundamental ethics of sustainable finance.

4. Loyalty

The asset manager entrusted with the management of an investment portfolio has a duty of loyalty towards his client. The loyal management expected of him implies that management decisions are taken exclusively in the interest of performance. With this primary objective in mind, the asset manager will take into account ESG parameters insofar as they facilitate and contribute to the achievement of this objective. The further away the criteria for measuring the performance of a portfolio are from a pure mathematical calculation, the more difficult it will be to assess an asset manager's contribution. Similarly, "the interaction of ESG parameters cannot be used as an excuse for underperforming management", to paraphrase Alan Murray, the editor of Fortune magazine. The situation is quite different if the investor takes it upon himself to introduce ESG-type restrictions which could reduce expected returns, or if he pursues a philanthropic strategy. This approach sets social or ideological objectives that contradict the very notion of performance.

5. No conflicts of interest

Building a securities portfolio requires multiple skills. It is rare for an asset manager to possess all of them. He must therefore act as an integrator by bringing together knowledge from different specialist fields. Strategic allocation is his job, but certain specialised asset classes (such as Asian equities or North American small caps) must be managed by third parties. Using an open architecture system means the subfunds of a mandate are entrusted to those who are best able to manage them. This concept is the opposite of a portfolio that only includes funds or investment vehicles from a single issuer and exposes the investor to the risk of lower performance.

6. ESG performance assessment by an independent third party

Rather than labelling its investment instruments itself, the Bank has opted for a policy of external rating in terms of ESG criteria. This is to avoid any accusation of a lack of objectivity, or even the risk of overly optimistic rhetoric about the supposed environmental effects of an investment approach. The Bank has selected a very advanced and comprehensive rating system. It is gradually extending this rating principle to all its investment products, first funds and certain types of mandates. This will provide clients with a tool for monitoring and measuring "ESG performance" on a regular basis for the products concerned. As a result, investors can have an open and honest conversation with their adviser about adjusting their portfolio to qualitative ESG objectives.

Sustainable finance imposes high ethical requirements on the assets it manages, but also on the way in which they are managed. These ethical requirements are less spectacular than the exclusion of sectors that are too carbon-intensive or are open to criticism in one way or another. They are also more difficult to apply as they require a high level of management discipline. And yet they are essential for distinguishing truly sustainable management from the mere implementation of a style...