# A Roadmap to ESG

## A guide to getting it right

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For financial advice professionals

Within five years, ESG shouldn't be a discussion we have with clients – it should be a given. This is the direction of travel."

**Adrian Murphy** - Murphy Wealth

# Foreword

**Our planet and the impact our actions have on it have never been more under scrutiny. Add a heightened awareness of the need to respect people and their human rights, and it's no wonder that the spotlight is shining on Environmental, Social and Governance (ESG) issues in relation to investing.**

When it comes to financial advice, some financial planners are ahead of the curve ensuring their clients are fully informed, aware of investment options, and have portfolios that perfectly align with their specific requirements.

However, it's fair to say that many involved in the financial advice profession are only just beginning to engage with ESG topics. It's a complex area that takes time to understand fully, let alone formulate a roadmap for handling it with multiple clients.

That's why we've put together this guide with the help of research firm NextWealth. We want to share the insights and experience we've gleaned from financial advice professionals alongside information and data about the ESG process to help financial planners formulate and implement their own robust ESG approach.

NextWealth conducted in-depth interviews with eight financial advice professionals from six firms of varying sizes for this guide. All are at various stages of their ESG journey. What we've learned from them, together with existing NextWealth research, has proved invaluable in setting out this roadmap, and we'd like to thank all the contributors for making it possible.

Wherever you are on your ESG journey, I hope this guide helps you move ahead in the right direction.

# Contents

# Industry **overview**

## The latest research into ESG investing carried out by NextWealth shows that:

- Including ESG in the Know Your Client process is becoming the norm – in 2021, just 6% of advice professionals did not include it, compared to 17% in 2019.
- There is some confusion about whether ESG is part of a product recommendation. One in five (20%) surveyed said they 'don't know', reflecting ambiguity and uncertainty about the rules.
- The percentage of clients raising the topic of ESG is increasing: up from just 7% in 2019 to 20% in 2021. Advisers in larger firms with more than 50 employees said it comes up even more often, at 26%.
- Just 3% of those surveyed had no client assets invested in ESG funds or solutions, compared to 10% in 2020 and 7% in 2019.
- Advisers expect two-thirds of their client money to be invested in conventional funds with no specific ESG, ethical impact or sustainable criteria.
- Advisers expect one-fifth of assets will be in full ESG integration funds, and 13% will be in badged funds or solutions with specific sustainable investment or carbon reduction objectives.
- Among financial advice professionals using badged funds, there is a strong preference for those badged as 'ESG', 'Ethical' and 'Sustainable.

# The foundations **of an ESG approach**

## While many financial planners include a question about ESG in their fact find, in 2020, two-thirds (64%) asked about ethical considerations rather than broader issues relating to sustainability or environmental concerns.

With legislation on the cards that will mandate financial advice professionals to ensure clients are suitably invested in ESG-related options, it's clear a 'tick-box' approach will not be enough. More importantly, with growing consumer awareness of ESG issues, your clients will expect you to take the lead and ensure they can make choices that align with their preferences.

Laying the foundations for your ESG approach is the best way to start. Building a solid framework needs to be done from the bottom up and, at the outset, you will need to consider:

- How much do you and your firm know and understand about the topic?
- How do you and your firm's principles match up to scrutiny? Can you 'walk the talk' regarding sustainability, governance and social responsibility? As one financial adviser told us, "you can't hand your client a plastic water bottle and then spend the meeting talking about sustainable investing."
- How do you approach ESG investment options? How do you test what you are told is true if you outsource? If you build portfolios yourself, how do you manage integration and diversification?
- How do you tackle conversations with clients? What happens if they decide they want a high impact portfolio, but the cost is far greater than they are prepared for? How do you manage expectations?
- How do you track progress and manage MI? You will likely be taking your clients on a journey to making their investments a force for good, but how do you track who wants what?

# Five stages **of implementation**

## At the outset, it's worth looking at the five key stages of implementation:

**1. Exploration**

**2. Installation**

**3. Initial implentation**

**4. Full implementation**

**5. Expansion and scale up**

However, even before the exploration stage, you need to decide who will lead in developing an approach that the whole firm can buy into. Set aside time and allocate specific tasks that have end dates attached. Regularly review progress and clarify what must be achieved and when.

If you follow a clear process, you will save time and achieve a better overall outcome that your clients will appreciate.

Does your business 'walk the talk'?

# How aligned to ESG principles **is your firm really?**

You may place higher importance on the need to provide clients with ESG investment options and haven't spent a huge amount of time considering what happens within your firm. This is understandable, but there are several benefits to spending time thinking about your operations before you commit to a strategy for clients.

**Why you should make time for exploration:**

1. Better understand your business's impact on the environment and how partnerships with third parties can lead to improvements.
2. Focus on diversity and inclusion, both within the workplace and with clients.
3. Formulate clear ideas about how you want your firm to be regarded within the community.
4. Better communicate your approach to clients who may ask for your firm's credentials on ESG-related matters.

Does your business ‘walk the talk’?

# The need **for improvement**

In our research, we heard so much frustration around the amount of paper and energy wasted. As a customer of these services, are you voicing your frustrations?

In March 2021, NextWealth published its ESG Tracking Study Update that analysed 23 platforms as part of a tracking survey. It found that platforms requiring a paper form signed by a client for fewer than 10% of processes almost doubled within six months, most likely due to the pandemic, hailing these companies as ‘digital process champions’.

Progress is being made, and advisers have a role in ensuring the momentum continues for the good of their businesses and the environment.

“We could save a huge chunk of the Amazon rainforest if we could move away from paper to electronic mandates.”

**Adrian Murphy** - Murphy Wealth

Does your business ‘walk the talk’?

# Doing the **right thing**

According to the Financial Advice Business Benchmarks 2021 report published by the Personal Finance Society and NextWealth, philanthropy has long been a focus for financial advice firms to give back to the communities in which they operate.

In the report, two in five (41%) firms said they participate in philanthropic activities. The most common means is via a named corporate charity, firm-wide volunteering and matching employee donations. A similar number (42%) of firms that support philanthropy undertake pro bono work.

As we see ESG become the norm rather than a specialist area, NextWealth research shows virtually all (98%) financial advice professionals are now using ESG, ethical, sustainable, or impact funds or portfolios to some extent, compared with 89% a year ago.

Thinking about your firm’s philosophy and approach to supporting the communities in which you operate will set you up for the next step.

“People want to do the right thing – to be seen to do the right thing. ESG is not a fad or a con. It’s the long-term direction of travel.”

**Alex Reynolds** - Advies Private Clients

# What's stopping your ESG **strategy from moving forward?**

From the discussions we've had with financial advice professionals for this series, it's clear that most have found agreeing on an ESG strategy difficult and that it takes a very long time. Some have been working towards formulating a strategy for 18 months to two years and have yet to commit the strategy to paper.

Why? Many blame the highly complex nature of ESG investing and the lack of robust data to inform decisions. The issue seems to be that many firms are looking at the subject matter and getting bogged down.

What can help is being clear about what a strategy is and what it isn't.

> We would like ESG to be part of our core offering. I don't like having 'good' or 'bad' portfolios that don't fit our values."

**Adrian Murphy** - Murphy Wealth

# Don't confuse **strategy and process**

## A strategy is a statement of what you want to achieve. It should inform the next step: the process. Mixing the two up can lead to wasted time and frustration.

For example, let's consider something we touched on in part two. Most firms are constantly asked to donate money to charitable causes, often by employees, friends and clients. Having a clear strategy or policy for managing this written down and shared with all stakeholders can remove the headache of having to say 'sorry but no'.

**Here's an example.**

**Philanthropy strategy**

For the strategy, you may decide that your firm will donate money over 12-months to one chosen national charity and one chosen local one. That's it – strategy sorted. Deciding this doesn't take long, making it easier to go to the next stage – formulating a process.

**Philanthropy process**

The process stage will likely take longer, but it will be easier to achieve because you have a clear focus. For instance, it may involve asking employees to nominate national and local charities. This would be converted to a shortlist of three national and three local charities, and clients asked to vote for the ones they would like to see the firm support. This works two-fold: it tells clients you are 'giving something back', and it also informs them that you are focused on specific charities so will not be able to donate to others.

**ESG investing strategy process**

Similarly, separating the ESG investing strategy from the process should be much more efficient and rewarding.

# Figuring out the best ESG **strategy for your business**

Perhaps one way of considering the best ESG strategy for your business is to break it down into options.

**Here are three (rather simplistic) examples of how you might think about your strategy:**

**1**

**Example option 1**
Perhaps you are passionate about ESG considerations, and the firm is active in doing all it can to be sustainable, socially responsible and focused on making a positive impact. You may decide that your ESG investing strategy should be designed to embrace ESG across all the investment options you offer. You may want to educate clients about the good their investments can do and help them invest in ways that will positively impact them.

**2**

**Example option 2**
As a firm, you may feel that your primary duty is to serve clients by getting them the best return for their investment, regardless of ESG considerations. However, as part of your standard service, you may want to offer clients options to invest in ESG-specific funds or portfolios, guided by their attitude to making their investments an active force for good.

**3**

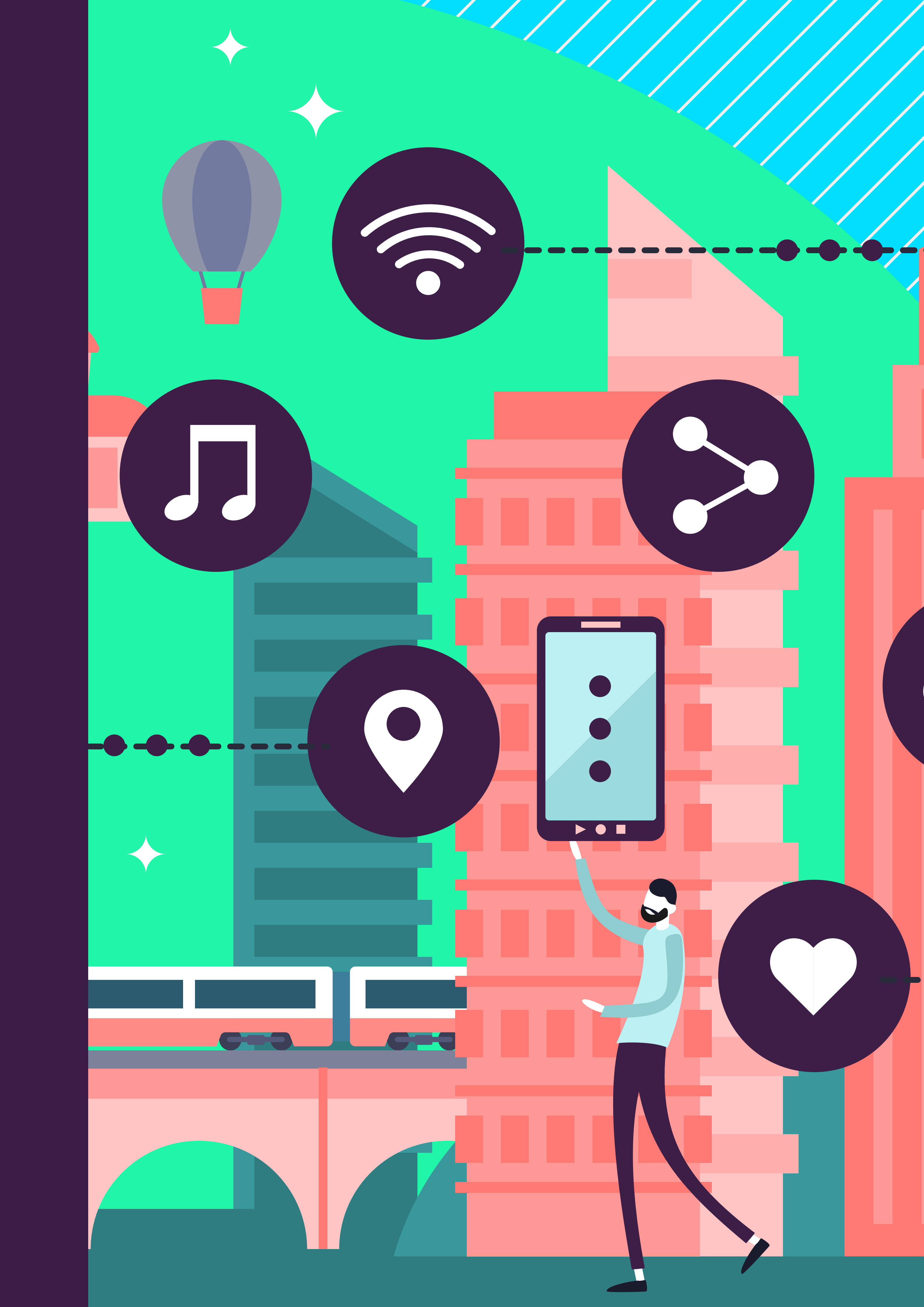
**Example option 3**
You may decide that your firm focuses entirely on getting clients the best return for their investments, regardless of where they are made. You may decide that clients who express a desire for ESG investing are offered a 'premium' service tailored to them and, as such, requires a higher level of research and monitoring.

Formulating an ESG strategy the easy way

# Strategy first, **process second**

Working out what overall strategy you want to take as a firm should not take long to agree. However, it's important that the whole firm buys into the strategy and is clear about what it means in terms of process and outcomes.

Having a strategy is essential to move to the next step: the process. This is likely to take more time, but the fact that the strategy has been defined should cut down on wasted research and remove some of the frustration of trying to decide what to do for the best.



# What are other **advisers doing?**

According to NextWealth's ESG Tracker Studies in 2021, one-fifth of financial advice professionals plan to fully integrate ESG investing into clients' portfolios, most preferring a core/satellite approach that uses badged ESG solutions.

### Other key findings include:

- Financial advisers expect two-thirds of their client money to be invested in conventional funds with no specific ESG, ethical, impact or sustainable criteria.
- One-fifth will be in funds that have full ESG integration.
- 13% will be in badged funds or solutions with specific sustainable investment or carbon reduction objectives.

# How to see through **the green washing**

**Once you are clear about your firm's ESG strategy, the next stage involves developing the framework for delivering your vision to your clients.**

This is the hardest part from the research we carried out with financial planners. The number one issue relates to data – or rather lack of it, particularly for those managing investments in-house. The other relates to the information being presented to them by investment providers and a scepticism that what they are told is over-inflated and even misleading, known as 'greenwashing'.

Investment providers have been quick to embrace ESG promises, but many financial advice professionals believe the marketing hype is not aligned with reality. This discord adds to advisers' stress in committing to ESG solutions for clients. No one wants to offer options to clients that later turn out to be less accurate than the marketing blurb suggested.

Many UK advisers are looking to the FCA to help with the confusion around terminology and hope greater clarity can be achieved.

> "Terminology is a real issue – greenwashing is rife."
>
> **Alex Reynolds** - Advies Private Clients

# How ratings providers **measure ESG performance**

**There is a lot of concern among advisers about the quality of the data that exists for ESG. Ratings providers should help simplify the process, but there is a lack of consistency in measuring ESG performance.**

The fact is, evaluating ESG performance is complicated. Nic Spicer, UK Head of Investments at PortfolioMetrix, explains it like this in his paper 'ESG in Investing':

"[ESG ratings providers] collect and aggregate a range of information on a company's ESG performance: its disclosures, third-party reports (e.g. from NGOs), news items, and proprietary research through company interviews and questionnaires.

"They come up with an overall ESG score and scores for the individual components (E, S, and G). The problem with ratings providers (and indeed with active managers who do it themselves) is that evaluating ESG performance is complicated.

"Different analysts and providers will measure the same attribute differently, perhaps by analysing diversity (as part of the S in ESG) via gender pay gaps, while others will look at female & ethnic minority board representation. Then there is the problem of scope. One ratings agency may include electromagnetic radiation in evaluating a company's environmental record. Others may not.

"Then there is the problem of weight. Different agencies will place different weights on individual components. Combine these differences with the inevitable human biases involved, and some quite stark differences in ESG ratings appear.

He concludes that, although there is a lack of consistency in their approaches, it doesn't mean the ratings are "useless" or that the providers are "biased or incompetent". It does mean that financial advice professionals need to look in detail at how the ratings are constructed before using them and then use them consistently across client portfolios.

# Measuring **up**

With such rapid growth in the number of providers offering ESG investment options, the financial advice professionals we spoke to believe there is even more need to scrutinise what they are offering and how that measures up to promises.

# Understanding **what clients want**

## Opening up a conversation around ESG with clients requires careful thought and preparation to enable you to provide investment solutions that meet all client expectations.

Most people, if asked, would want to do their best for the planet, but it doesn't always follow that they would be prepared to pay more to do so or that their preferences align with what you can offer.

As we referenced in the first chapter, most financial advisers include a question about ESG in their Know Your Client process - just 6% did not in 2021, according to NextWealth research.

However, to understand what clients want, it's necessary to dig a bit deeper and having a well thought out questionnaire is a structured way to do this.

Before you begin, it's worth considering terminology.

Over the years, many different terms have been used to describe ESG-related investing. Such terms include:

- Ethical
- Green
- Socially conscious
- Sustainable
- Socially responsible investing (SRI)

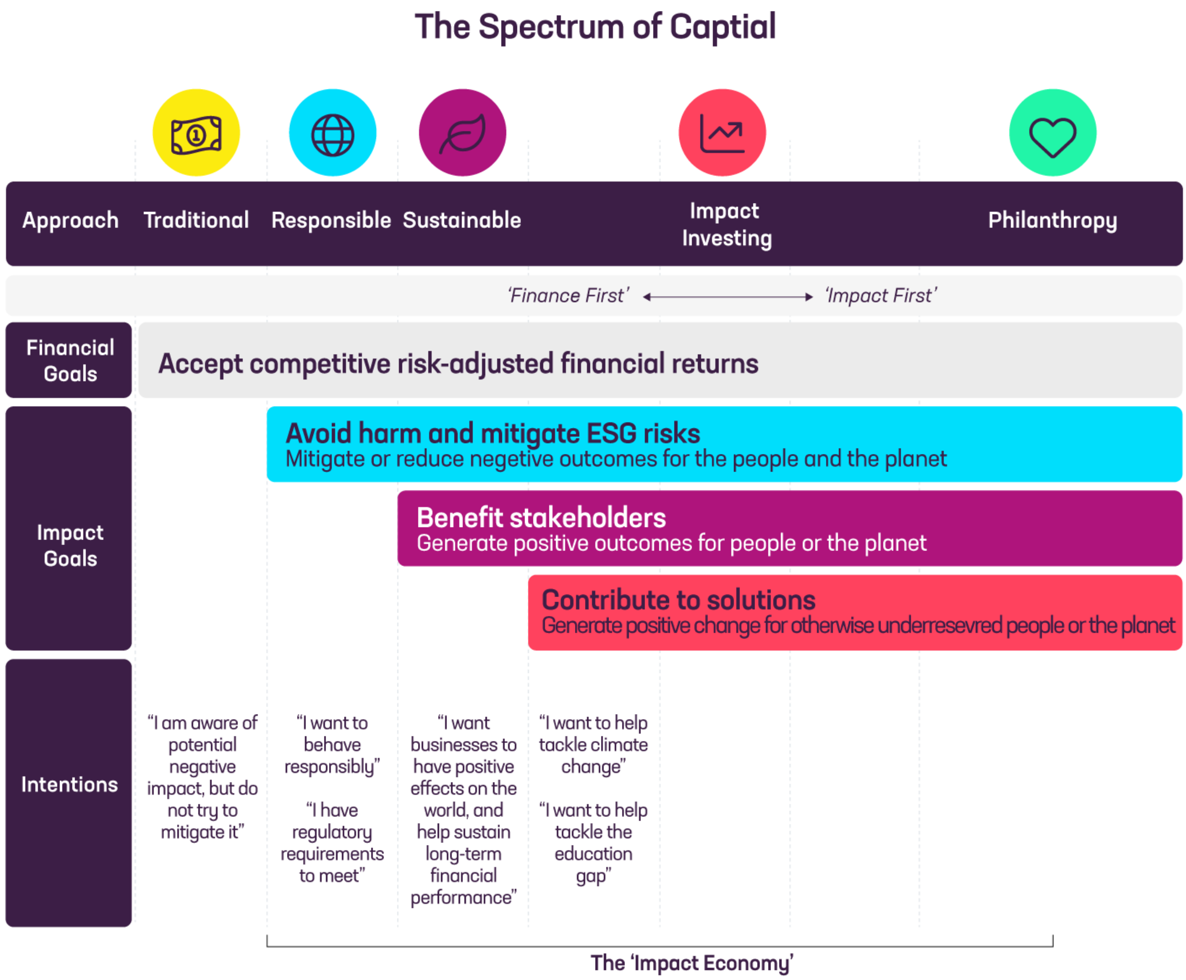
Unfortunately, none of these are broad enough to encompass all elements of ESG. It's easy to focus on sustainable or 'green' investments, but what about the social aspects of diversity or employee exploitation (such as child labour in third world countries)?

The Investment Association (IA) uses the term 'Responsible Investment', and this can be a helpful one to use with clients.

> We use the term 'responsible' rather than 'ethical' when discussing ESG with clients. 'Ethical' can put clients in a difficult position if they don't have strong preferences. It can make them feel uncomfortable." Roy Coulson, Attivo Group
>
> **Roy Coulson** - Attivo Group

# Guiding client **conversations**

Several advisers we spoke to have used a spectrum such as this one from the Impact Investment Institute to help guide them with client conversations. Talking it through with clients can help both parties understand where the client currently sits in terms of expectations.




**Source:** Bridges Fund Management and Impact Management Project

# Key **questions**

The way you ask questions will directly impact the direction the conversation takes. For example, if you start by asking, “is there anything you wouldn’t want to invest in” you could find yourself presented with a list of things that are impossible to manage within your firm’s ESG strategy. Animal testing, tobacco, oil, plastics, and human rights all have negative connotations on the face, but it’s rarely that straightforward.

For example, pharmaceutical companies have a legal requirement to test on animals before testing cancer drugs on humans.

Starting the conversation with such a broad question could open up a can of worms and lead to making investment decisions that might not be in the client’s best interests.

A better way to phrase a question might be, “tell me what’s important to you concerning climate change, religious beliefs etc.”.

A couple of planners mentioned that they reference David Attenborough’s influence on raising awareness of climate change as an excellent place to start. Such discussions allow you to feel how connected and passionate a client might be on the issue and opens the door to discuss other matters.

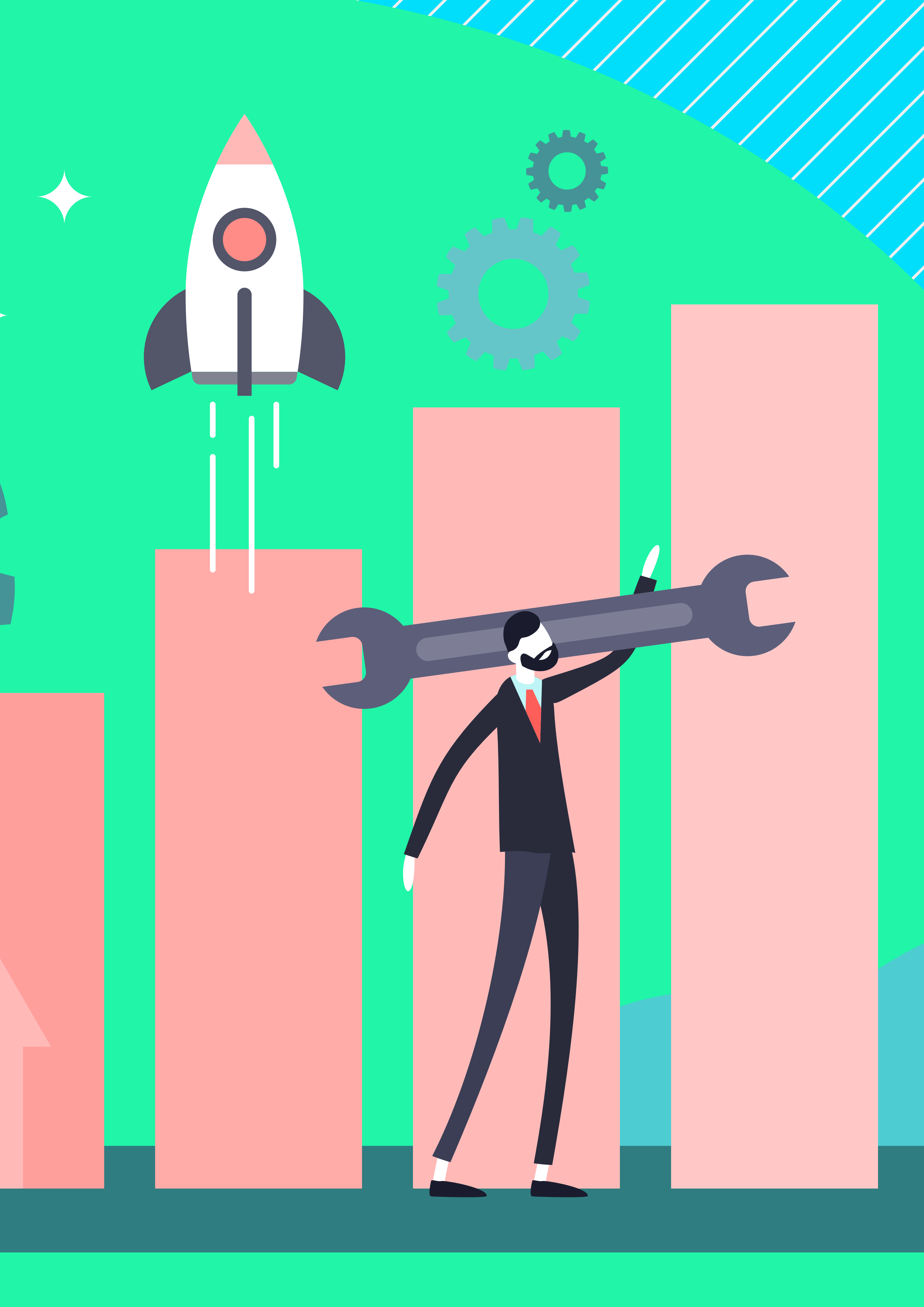
# Best **practice**

## Some planning firms we spoke to leave it up to individuals to formulate their questions to investigate clients' preferences for ESG.

**Those that have a more structured process believe they get better outcomes for several reasons:**

- The conversation must be had – it's part of the overall process.
- Such a process removes any bias the planner may have on the topic – some planners are 'eco-warriors', some are ambivalent, and some regard it as less relevant than achieving stellar returns. A standardised approach to questions means the focus sits squarely with the clients.
- It helps with regulatory reporting.

All the advice professionals we spoke to underlined the importance of preparation. A few had learned the hard way, creating added complications to the investment process by asking the wrong questions.



Where does it go from here?

# Making progess **with ESG**

As part of the research for this guide, we spoke to various financial planners, some who were very advanced in their ESG offerings and some who were still in the strategy planning phase.

They were all asked to rate their progress on a scale of one to ten, with one meaning they were at the very early stages and ten meaning they are completely satisfied they have done all they could. Interestingly, they scored somewhere between a four and a six.

At first glance, this seems odd, considering they are all at very different stages. However, what is apparent is that the more involved with ESG an advisory firm gets, the more it realises there is so much more to do.

Where does it go from here?

# Building on **a firm foundation**

## Agreeing on a strategy, finding investment solutions and having the tools to have meaningful conversations with clients is just the start.

Some of the following steps that firms who are advanced in their offering told us to include:

- Make sure the firm is aligned to ESG principles. A couple of planners said they are auditing all their processes to see where they can make them more environmentally friendly and sustainable.
- Doing more research with investment options. Even those who are outsourcing have some nervousness around whether clients really are getting what is promised by investment providers. ESG specialists who have a good track record over time are the ones most likely to be considered, although currently the pool of these is small.
- Educating clients. Many planners see it as their duty to inform their clients about responsible and sustainable investing. Those already doing so are seeing some clients progress from investing a portion of their assets in a badged ESG portfolio to embracing ESG principles for their total assets.

> All our financial planners now drive electric cars and I am constantly asking everyone to look at ways we can improve our environmental impact. We have made great strides over many years. We are also working on achieving BCorp accreditation in the not too distant future”

**Stephen Harper** - Attivo Group

# The 'social' challenge **in financial advice firms**

While all the financial planners we spoke with were well advanced in ticking the environmental and governance boxes of ESG for their firms, some identified that the 'social' aspect still requires work.

Typical clients for all the firms we spoke with fell under a broad 'middle-aged, middle class' category, and there was some acknowledgement that work could be done within the firms to make them more accessible to a broader range of people.

Younger clients and those from different ethnic backgrounds, cultures and religions are welcomed. Still, it's not always evident from the marketing material or websites of the firms that this is the case.

Reviewing how the firms are perceived by potential clients was highlighted as one of the next stages for those firms who are already well underway with their ESG offering.

Educating clients. Many planners see it as their duty to inform their clients about responsible and sustainable investing. Those already doing so are seeing some clients progress from investing a portion of their assets in a badged ESG portfolio to embracing ESG principles for their total assets.

Clearly, ESG is a topic that requires time and focus from financial advice firms, to ensure they are getting it right.

However, some planners expressed frustration that they are still waiting for clear guidance from the regulator. In the next chapter, we look at what we know about the FCA's plans and what this might mean for firms.

> It's fair to say that getting involved in developing our ESG offering has started to challenge views within the firm. There is a recognition that we need to ensure we appeal to a broader demographic, and this is something that we have on our agenda."

**Dean Ritchie** - HFL Financial

# FCA ESG **strategy**

## An updated version of the FCA's 'A strategy for positive change: our ESG priorities' was published in November 2021, before the United Nations Climate Change Conference (COP26).

The paper sets out the regulator's ESG strategy, which focuses on critical themes. These have expanded beyond its previous 'transparency' and 'trust' themes and now include three new headings: tools, transition and team.

This is how the themes are defined in the paper and the aims for each one:

**Transparency**
Promoting transparency on climate change and broader sustainability along the value chain.

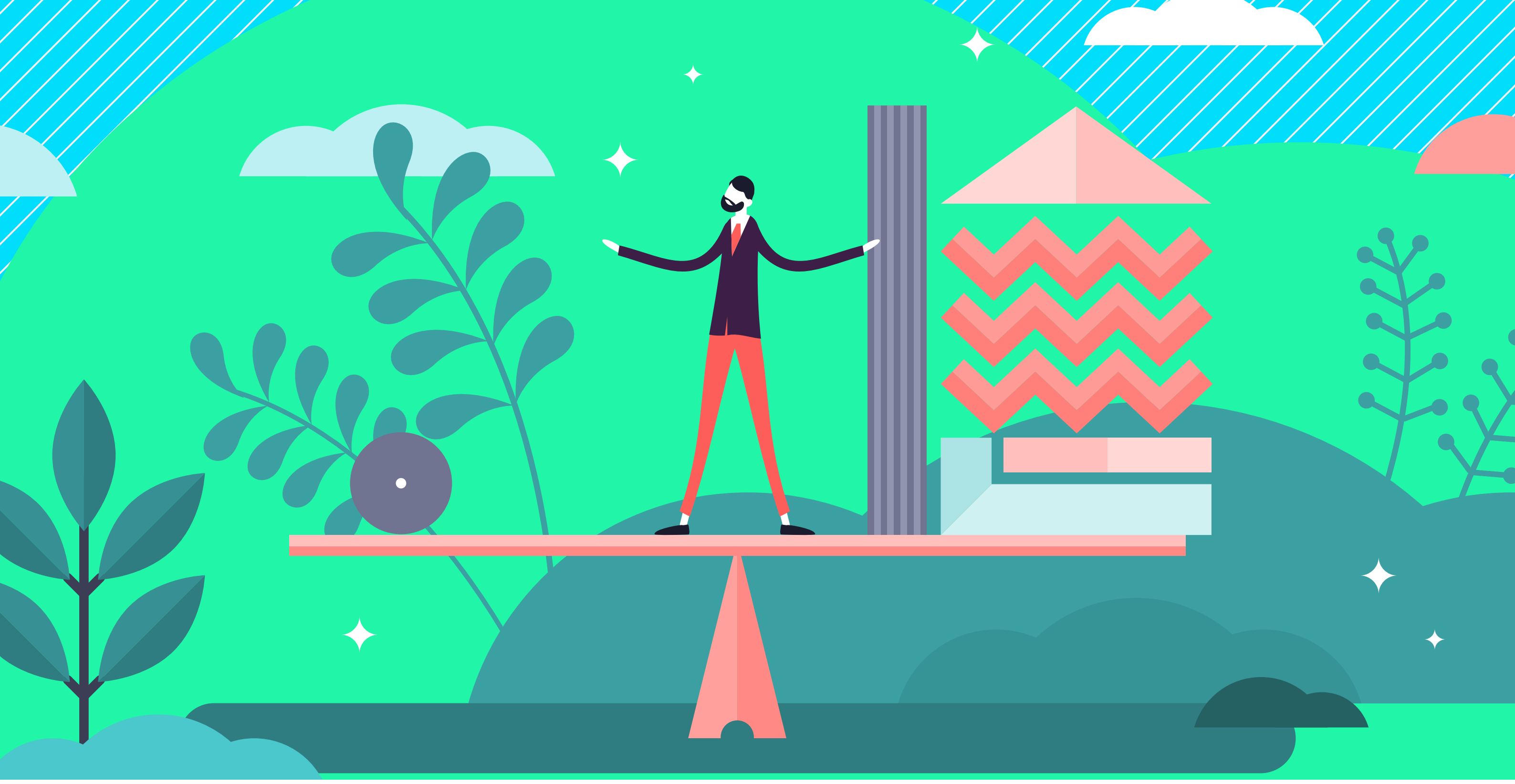
**Aims**

- Enhance climate-related financial disclosures
- Promote global standards for sustainability reporting
- Improve transparency of performance on diversity and inclusion (D&I)

**Trust**
Building trust and integrity in ESG-labelled instruments, products and the supporting ecosystem.

**Aims**

- Support fair and effective integration of ESG into financial market decision making and trusted delivery of ESG-labelled securities, products and services



**Tools**

Working with others to enhance industry capabilities and support firms' management of climate-related and broader sustainability risks, opportunities and impacts.

**Aims**

- Influence internationally consistent outcomes in ESG
- Deliver an ambitious innovation programme
- Work closely with industry
- Collaborate with UK regulators and the Government

**Transition**

Supporting the role of finance in delivering a market-led transition to a more sustainable economy.

**Aims**

- Intervene to underpin a market-led transition to a more sustainable future
- Encourage effective investor stewardship

**Team**

Developing strategies, organisational structures, resources and tools to support the integration of ESG into FCA activities.

**Aims**

- Embed ESG considerations, and net zero 'have regard'
- Communicate and 'role model'
- Continue 'systems thinking' research on the ESG landscape

As part of the strategy, the FCA wants the UK financial services and UK regulatory regime to be at the forefront of ESG internationally and it is collaborating with the Government, other UK regulators, industry and other stakeholders to achieve this.

Emission reduction is on everyone's agenda, with technology playing a critical role in delivering reductions aligned with the goals of The Paris Agreement - limiting warming to 1.5 degrees.

# What this means **for the advice profession**

## From the research we've conducted, it's clear that many financial advice professionals are hoping for a clear and definitive set of rules from the FCA soon.

Whether the FCA will make it so cut and dried is debatable. They are certainly focusing on the investment providers and the issue of greenwashing, which should hopefully make it easier for financial planners to have confidence in the investment options available to their clients.

While it doesn't list rules for financial advisers, the FCA's paper does give strong indications as to the direction of travel. It is introducing its own Sustainability Disclosure Requirements for firms involved in investment management and decision-making processes, with the key aim that financial advice professionals should take sustainability matters into account in their investment advice. It also expects advisers to "understand investors' preferences on sustainability to ensure their advice is suitable."

Specific proposals for the financial advice profession are currently in development and will be published "in due course, working with government". In the meantime, the FCA is inviting views about the approach and any particular considerations that they need to take into account.

# Beyond **climate change**

Something that stood out from our research with financial advice professionals was the intense focus for ESG to be about 'green' issues, fuelled by climate change and the need to have a more sustainable world.

While this is an important issue, ESG is more than this and the social aspect (the 'S' in ESG) is something the FCA says it is keen to see addressed by the entire financial services industry.

The FCA paper states that they are "committed to building resources and capabilities on ESG beyond climate change, and ensuring that our regulation takes a broader ESG perspective". They list diversity, culture and purpose, as well as governance as areas they will leverage, which means any organisation within the financial advice chain will need to look to their own working practices, as well as being mindful of the practices of the organisations they work with or invest in.

**Time to act**

It's clear from the research we've carried out for this guide, plus other ESG research carried out by NextWealth with financial planners, that the advice profession is moving towards embracing ESG with increasing urgency.

What is also clear is that this new focus brings with it many challenges and no firm we have spoken with feels they are anywhere near completing their ESG journey.

ESG is an evolving landscape, with increasing expectations on reducing impact and transparent reporting.

Summary

# Key **takeaways**

### Your business

- Think about your firm's credentials in the ESG space – how does the way you do business stack up against the principles of ESG?
- Don't just focus on environmental – think about diversity and inclusion. It's a topic that the FCA has stated it is actively looking at. How accessible as a firm are you to all members of society? What about your website – does it reflect an accessible image?
- Question providers about how they operate – for example, some are working hard to become more sustainable by using tech to reduce reliance on paper.

### ESG Strategy

- Agree a strategy before you start a process that looks at investment decisions.
- Think about how you want to operate as a firm so you can be proactive with clients about what you are offering.
- A strategy should not take too long to develop – the process that follows is likely to be the time-consuming part.

### Investment choices

- Don't underestimate the time it will take you to set up ESG investment options, particularly if you plan to do research and run portfolios in-house.
- The firms we spoke to who have outsourced their ESG portfolios to specialist DFMs have got up and running much faster than firms who opt to manage investments in-house.
- Planners who outsource say any extra cost to use a specialist is countered by the value it offers – giving their clients access to specialist expertise plus allowing the planners more time to see more clients and focus on their own specialism: planning.


**Client conversations**

Thorough preparation is essential before introducing ESG into the discussion.

A badly-constructed questionnaire can lead to difficult conversations and create a misleading picture of what a client really wants.

In firms with multiple planners, it helps to agree the questionnaire centrally and have all planners use the same one, rather than leaving individuals to 'freestyle'. Adopting a 'best practice' approach will ensure all clients receive the same standard of service.

Don't underestimate how much additional time having the ESG conversation will add to a review meeting

**Regulation**

The FCA has a well-defined strategy for ESG and is focused on improving access to responsible investing for all.

They expect financial advice professionals to play their part in encouraging clients to invest responsibly.

They are not just focused on environmental and sustainable investments – they want to see firms demonstrate socially responsible practices, including more diversity and inclusion.

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