HAWKSMOOR
INVESTMENT MANAGEMENT

SUSTAINABLE WORLD INVESTORS' REPORT

Winter 2023

Delivering Change

Welcome to the Sustainable World Investors' Report. This quarter we highlight sustainability items in the news, a deep dive piece on the SDR consultation, and on this occasion conclude with a fund focus piece on Royal London Sustainable Leaders fund.

2023 has in general been another difficult year for sustainable investing, and broadly the darker green the fund, the more it is likely to have struggled. In Q3 2023 in particular, there was a large sell off in renewable energy. Several renewable energy ETFs fell around 17%, driven by heightened concerns over the cost of capital for some long-term renewable energy projects.

Global ESG Leaders were up 26% in 2023 in USD, outperforming the global index which increased by 22.8%. Energy was the worst performing sector amongst global equities in 2023, helping the outperformance of ESG leaders. Growth also outperformed value in 2023, which should help funds like these.

However, a sustainable impact benchmark returned just 5.4%. This is largely because ESG leaders is led by Microsoft, NVIDIA and other members of the Magnificent 7. The sustainable impact benchmark is led by Vestas, Umicore and other enablers of impact and change, rather than companies whose ESG criteria mostly relates to a relatively low carbon footprint.

S&P estimates there will be $700bn per year of renewable energy funding per year through to 2050. It also estimates this is $700bn per year short of what is needed to reach net zero. 2050 is still a long way away, and it seems likely these kinds of disputes around who picks up the tab are likely to continue.

COP 28 took place in the quarter. The key outcome was an agreement from nearly 200 participants to a "global stocktake" which recognises the science that global greenhouse gas emissions need to reduce by 43% by 2030 vs 2019 levels to limit global warming to 1.5C. This will involve tripling renewable energy capacity and doubling energy efficiency improvements.

Geopolitical tensions are still high. To add to the conflict in Israel, there is increasing environmental fall out from the Red Sea. Hundreds of ships are being sent on a 4,000 mile detour to avoid it. This costs an estimated $1m extra in fuel, per ship. Oil tankers which can carry one million barrels of flammable oil are among those being diverted, and shipping company Maersk re-routed four out of five container vessels.

"2024 must be a year for rebuilding trust and restoring hope. We must come together across divides for shared solutions. For climate action."

UN Secretary-General, António Guterres, December 2023. (Source: https://www.un.org/sg/en/content/sg/statement/2023-12-28/secretary-generals-video-message-for-new-year-2024-scroll-down-for-french-version)

IN THIS ISSUE:

Here we highlight snippets from sustainability items in the news from the fourth quarter of 2023.

Last year at COP27 there was a breakthrough with the establishment of a loss and damage fund, which would be dedicated to finance assistance to countries “most vulnerable and impacted by the effects of climate change.” This refers to the impacts climate change events have on a country’s infrastructure, society and economies, such as rising sea levels, heatwaves, species extinction, crop failures, desertification, and brushfires. But since then, there has been disputes over which nations should pay into the fund and which should be the beneficiaries. However, COP28 gave new hope, with UAE and Germany each pledging to pay in $100m, the UK will pay $40m, the US committed $17m and Japan $10m to the fund. And The World Bank committed to administering the fund for at least the first 4 years. This is a huge breakthrough and one which was desired but not expected at this COP. The US, UK and EU have been named as nations that should pay into the fund, and other wealthy nations have been encouraged to pay. Many have stated the disappointment with some of the pledge amounts, particularly the US, however many are viewing this as just the beginning. Developing nations believe the annual cost for loss and damage will be $400bn by 2030 so still see a long path ahead. (Source: www.edie.net)

Water is an extremely important resource and commodity, one which is becoming ever more scarce. In many urban areas up to 30-40% of total water supply can be lost due to leakage in old and inefficient piping systems, in the UK we lose around 25% of our water to leakage through old pipes. Water companies in England and Wales have recently submitted a proposal to Ofwat to invest nearly £ 100bn to improve infrastructure and cut leakage by a quarter by 2030. The investment funds will mainly come from increasing the public’s water bills between 2025 and 2030. The water industry has had a lot of negative light in the past few years, over pollution and storm overflow spills. This is obviously a step forward in securing the UK’s water supply but only if Ofwat approve the proposal and deadlines of 2030 are met. (Source: www.edit.net & www.hawksmoorim.co.uk)

Last quarter we wrote about how disposable vapes were fast becoming a health and environmental concern. Disposable vapes contain single-use plastic, nicotine and lithium-ion batteries, which make them tricky to recycle, and in a lot of cases consumers litter them or incorrectly dispose of them (around 70% of vape users dispose their vapes as they are not aware of recycling options). Research has shown a minimum of 1.3 million disposable vapes are thrown away every week in the UK. Now the UK’s Advertising Standards Agency has recently banned an Elf Bar single-use vape campaign because it misled users over the product’s recyclability. The adverts contained quotes like “Recycling for a Greener Future” and “Green Awareness” which would imply the products can be recycled easily and at home, which is not the case. The vape company was referring to its recycling bins at 70 vape shops in the UK, which is nowhere near enough to scratch the surface. The full environmental impacts are not yet known but the fact the ASA has banned this advert means these brands won’t be able to greenwash and will hopefully come up with sustainable recycling options for consumers which are easy to comply with. (Source: www.edie.net)

Research has found coffee pods will take 500 years to decompose, and with almost 350,000 pods ending up in landfill each year, recycling schemes are much needed. Nespresso sells around 14bn aluminium pods a year, and under 30% of that is recycled. In order to take steps to improve this Nespresso and Royal Mail launched a partnership to boost the recycling of their aluminium coffee pods in the UK. There is now a free door collection or pods can be packaged and taken to any Royal Mail drop off location in the UK. This has been done to make recycling easy and convenient for all consumers across the UK. Nespresso now use 80% recycled aluminium in its capsules. Hopefully this is just the beginning, with supermarkets trialling pod collection points in stores, Morrisons trialled this in the summer in over 25 of their stores. (Source: www.edit.net & www.independent.co.uk)

Sustainability Disclosure Requirements (SDR)

In Q4 2023, the Financial Conduct Authority (FCA) published its final policy statement on Sustainability Disclosure Requirements (SDR), having consulted extensively since October 2022.

They estimate global assets in ESG orientated funds will increase to $34tn by 2026. Their own research showed 81% of adults surveyed wanted their money to do good as well as provide a financial return. 76% would like to invest in a way that protects the environment, 74% want to invest with a positive social impact. However, they also report a Boring Money survey from 2022 which showed 7 out of 10 retail investors believe that lots of investments which claim to be sustainable actually are not. The FCA concludes that trust needs to improve in some areas and the key purpose of the regulation is to inform and protect consumers in line with objectives set by Parliament.

There is also an anti-greenwashing rule designed to ensure sustainability claims are fair, clear, not misleading and consistent with the sustainability profile of the product or service. These sustainability claims can be in but are not limited to statements, assertions, targets, policies, information and images. There is further consultation on what the rule means with responses due on 26th January 2024.

This will come into force on 31st May 2024 and affects any FCA authorised firm making any claims about sustainability. More consultation is taking place into January 2024 to finalise exact expectations for this.

The key headline issue is labelling, which will come into force on 31st July 2024. You will likely be aware that terms such as ESG, sustainable, responsible or impact are used almost interchangeably at times. It matters that these terms are defined and understood by everyone, as they are not the same.

There are four labels in the policy statement (below)– the FCA is keen to avoid them being seen as a hierarchy and they just reflect different investment goals. Any fund using any of the four labels must have a sustainability goal to be able to use one of the labels and at least 70% of the fund must meet this objective. The reason the FCA allows 70% and does not insist on 100% is to allow room for e.g. liquidity or risk management. Funds also need to identify specific KPIs they are going to report to measure progress, maintain appropriate resources and governance to support delivery of these objectives and they must also identify and disclose a wider stewardship strategy.

1. Sustainability impact – funds investing in solutions to problems affecting people or the planet to achieve real world impact. There needs to be an explicit objective to reach a positive measurable contribution to sustainable outcomes. All labels have to show and carry out an escalation plan where assets are not making enough progress towards the goal, but this is perhaps the one where this is most likely to be an issue. The FCA does not demand the sale of these assets if they fail to make progress.
2. Sustainability focus – funds investing in assets that are sustainable for people and/or the planet. Sustainability needs to be to a robust evidence-based, absolute standard – for example a percentage of revenue associated with sustainability, or minimum threshold of greenhouse gas emissions.
3. Sustainability improvers – the objective must be consistent with an aim to invest in assets that have the potential to improve environmental and/or social sustainability over time with a robust evidence-based standard which is an absolute measure of environmental and/or social sustainability. Funds need to specify a time period expected for the improvement.
4. Sustainability mixed goals – this fourth label was in response to feedback around funds that have more than one approach to sustainability. Funds using this label must meet all the criteria of whichever of the other three labels they are mixing.

Individual firms will remain responsible for any labels they use. The FCA may review and challenge them if they feel the need, but the FCA are keen to stress they are not “approving” or endorsing funds which use the labels.

There are sometimes complaints that sustainability regulation is uncoordinated across different jurisdictions. Labels are different for example with no like for like equivalent in different parts of the world. The FCA believes its labelling regime is compatible with the EU SFDR and funds should be able to use a lot of the same information they already use under SFDR.

The FCA also references its support for International Financial Reporting Standards (IFRS) Sustainability Disclosure Standards. This refers to company reporting but the FCA directs asset managers towards it as a basis for standardising their fund level disclosures, for example. Standardised reporting through the investment chain is one of their key goals.

Royal London Sustainable Leaders

The Royal London Sustainable Leaders is a UK equity fund which holds between 40-50 stocks and is over £3bn in size. It sits in the IA UK All Companies sector which allows up to 20% of UK equity funds to hold overseas equities, which this fund does do as they see good opportunities outside the UK. Usually the fund sits between 80-90% in UK stocks and the rest in Europe or US.

The fund philosophy is focused on 3 key areas: alpha generation, engagement and social & environmental improvement. The team have both a negative screening process - no armaments, tobacco, nuclear power, animal testing for non-medical purposes or unacceptable corporate governance; and 10% revenue limits on gambling, pornography, animal fur and military – but also a positive screen alongside. The fund has 4 key principles, two of which are sustainable in nature (sustainable products and services and ESG leadership) and two financial (value creation and valuation), meaning the positive screening ends up being much more important then the negative screening.

This process leads them into generally high-quality global leadership companies – the companies have to generate cash so generally leads them to large cap companies. They do have some small and mid-caps but no early-stage businesses or future speculation. As they put it themselves, they try find exciting parts of the market, then boring ways to get exposure.

The fund has had strong performance over a long period and ranks highly against its non-sustainable counterparts. Not owning energy and materials in recent years has been tough, but it ranks easily in the top decile of over 200 funds in the IA sector over both 5 and 10 years – this is the whole sector, not just sustainable funds. It has achieved this with consistent annual outperformance and has beaten some very well-known names at the same time.