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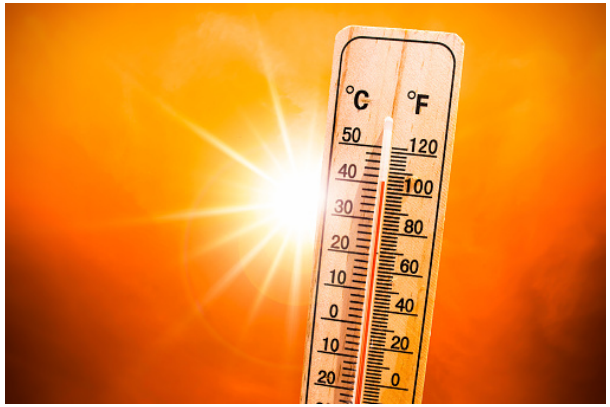
Get the jump on ESG metrics

'A lot of people use the ESG brand to distract from having high fees'

By **Bill Myers** - November 5 2021



The **SEC** is scheduled to publish proposed new rules on ESG metrics any day now, but neither registered investment advisers nor private fund advisers must wait for regulators to build up sustainable investing tools, experts say.

Start by asking your clients or your funds what they hope to achieve, says **Tanay Tatum-Edwards**, founder and CEO of **FreeCap Financial**, a data consulting firm.

"It's incredibly important to determine what your goals are," she says. "It will help you screen what ESG metrics you're looking for. Are you focused on mitigating risk or doing an impact-first type of portfolio? That question alone can determine where you start to look for information."

Much is already at stake here. In the third quarter of this year, self-described sustainable funds saw $15.7 billion in net inflow, according to data tracked by **Morningstar**. That's down from the $21.5 billion record set in the first quarter, but still much better than the rest of the public markets. Active investors are beginning to assert themselves in the market. Passive funds still dominate—they drew more than 61% of inflows in the third quarter, but that's down from 83% the same time last year, Morningstar reported.

Measure for measure

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Tatum-Edwards

One difficulty is that no one can be sure that they're comparing like with like.

"Many funds these days brand themselves as 'green,' 'sustainable,' 'low-carbon,' and so on," **SEC** Chairman **Gary Gensler** told the **European Parliament Committee on Economic and Monetary Affairs**. "I've directed staff to review current practices and consider recommendations about whether fund managers should disclose the criteria and underlying data they use to market themselves as such."

Whatever regulatory price firms may pay for "greenwashing," they're already paying reputational prices. In April, for instance, celebrity venture capitalist **Chris Sacca** called out **BlackRock's** Carbon Transition Fund for lacking "any creative ideas for deploying climate crisis capital" (***RCW***, April 15, 2021). Two months later, BlackRock got dragged through the ringer again, when a coalition of activists said the presence of **Murry Gerber** on the advisory titan's board belied its claims of sustainable investing.

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'Simply a rebranding'

"I think a lot of people use the ESG brand to distract from having high fees," says **Alexandria Fisher**, a senior strategic analyst for Alberta's provincial government. "The problem is kind of vexing, especially on the mutual

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fund side. It's just simply a rebranding of old funds."

Critics of mandatory ESG disclosures have wielded this very point in their brief against government "overreach." Why let some bureaucrat work up rules from what is basically a marketing gimmick?

Fisher says she's sympathetic to that argument, up to a point. "If they're going to mandate reporting and they're going to bring people in who are the usual big consultancies, they're not going to meet investors' expectations," she says. "A lot of times when people get caught in the greenwashing, it's because they're hiring people who don't have expertise in the field. There needs to be education of RIAs to not sell crappy funds and to know the indicators of what makes a crappy fund."

Government pressure

The matter can't wait, Fisher says. A changing environment is already wreaking havoc on markets, she says, and investors and executives need ways of understanding and coming to terms with it. Up to 70% of firms misstate the material impacts of environmental, social and governance problems, she says.

For now, governments aren't waiting. On Nov. 3, the U.S. and **EU** announced the **Global Methane Pledge**. It's a commitment by 103 world governments to reduce carbon methane emissions by at least 30% by 2030.

In March, European regulators enacted the Sustainable Finance Disclosure Regulations. It measures sustainable investment goals along 32 different data points. That in and of itself will drag American funds with European portfolios into the ESG market, whatever the SEC does.

The U.S. is catching up. The **Biden Administration** has promised to make climate change the pack horse of its policy. The **DOL** has already skinned back a Trump-era rule that required pension fiduciaries to put investment returns ahead of any other considerations. Gensler has tasked SEC staff to come up with

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"consistent, comparable and decision-useful" ESG disclosures for public companies. He's focused on public companies for now, but he's being pressured—by **BlackRock** among others—to expand any new rules to private funds, too (***RCW***, June 27, 2021).

Industry moves

Funds and investors aren't waiting, either. In September, the **Carlyle Group** ($293B in AUM) and the **California Public Employees' Retirement System** ($490B in AUM) announced the ESG Data Convergence Project, a consortium of fund advisers and fiduciaries with more than $4 trillion in assets under management.

It's still a tentative effort. The project will tackle six ESG measures—scopes 1 and 2 greenhouse gas emissions, renewable energy, board diversity, work-related injuries, net new hires and employee engagement.

"We found it challenging to effectively measure impact in our private equity portfolio because of the multitude of frameworks and definitions used by GPs and LPs," CalPERS Chief Executive **Marcie Frost** told sister title ***Private Equity International***.

'A big tell'

Fisher

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So as government and industry feel their way toward a universal measure for sustainable investing, how do funds and their advisers make sense of all this?

Experts say that you can think about the difference between "socially responsible" and "impact" investing as the difference between positive and negative poles. "Socially responsible" investing focuses on what *shouldn't* be done: for example, not investing in tobacco or oil and gas companies. "Impact" investing focuses on what *should* be done: for example, backing electric car companies to help reduce pollution.

Alberta's Fisher says, whatever your goals are, there is no such thing as too much specificity. A "carbon reduction fund" is usually more promising than a "green fund," she says.

Fisher says that examining a fund's governance is another tell. "Who's responsible for ESG at the company?" she asks.

You should also review a firm's personnel for their "proximity to the problem" that they are trying to solve, Tatum-Edwards says. "If you have a set of metrics on gender equity that were designed by an all-male team, that might be an indication that there's not enough self-awareness in the room," she says.

'Easy to check a box'

Make sure the staff tasked with achieving ESG goals are subject-matter experts. "It's very easy to check a box," Fisher says, so you need to go deeper than hiring people with the right credentials. "I would give them an analytical test on a given company and see what they come up with over a given amount of time," she says.

This can all be frustrating, Tatum-Edwards acknowledges. ESG metrics are still developing. Just because we don't yet have the measures, though, doesn't mean it's unmeasurable, Tatum-Edwards adds.

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"We're in a messy space right now," she says. "But it's an awesome opportunity."

Bill Myers *covers private fund policy and enforcement from Washington, DC.*

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