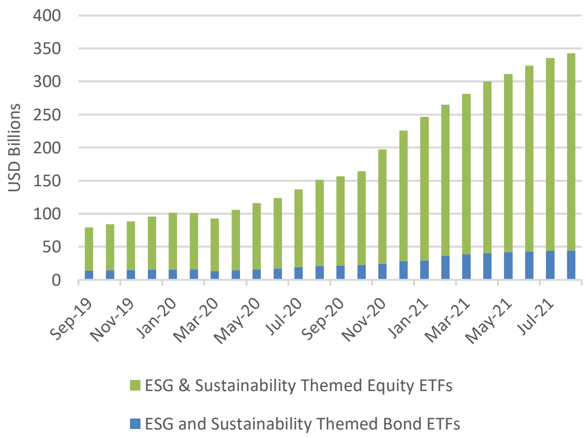
Green Ash Primer on ESG Investing

Introduction

September 2021

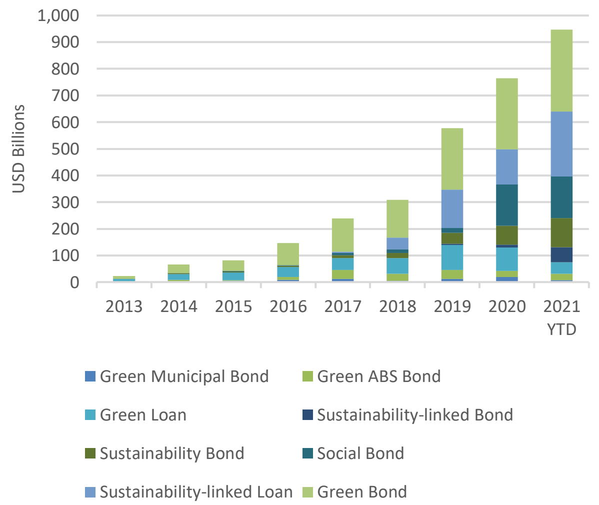
ESG investment integrates an evaluation of a company's environmental, social, and governance impact into the analytical process. This approach has had its supporters for a long time, however it has really gained momentum since the onset of the pandemic driven by increased shareholder engagement and policy support. Bloomberg estimate ESG assets are set to reach $50 trillion by 2025, including a $3 trillion market in ESG ETFs and a $11 trillion market in debt.

ESG ETF AUM has more than tripled since the pandemic



Source: Bloomberg Intelligence

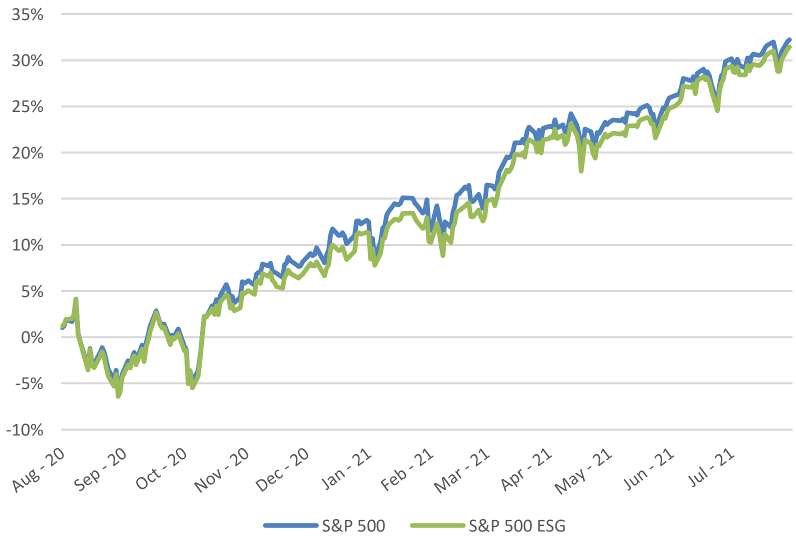
ESG related debt issuance is set to top $1TN this year



The industry is still evolving to establish what ESG investing actually means (and what ESG conscious investors want it to mean). At its most simplistic, it can mean simply screening out certain companies based on a set of sustainability criteria. Below is a comparison of the iShares S&P 500 ESG ETF versus the S&P 500. The ETF has 316 holdings, so has whittled away about a third of the index; on a one year basis, the returns are nearly identical (see below). This could be seen as a good thing (I, as an investor, can take a principled stance on certain ideals without harming my returns), or perhaps more cynically (We, as investment managers, can package products easily and opaquely, to take advantage of investor interest in ESG and gather AUM, while still tracking an index).

	Top Weights	S&P 500	iShares S&P 500 ESG ETF
1	Apple	6.17%	8.17%
2	Microsoft	5.99%	7.93%
3	Google	4.36%	5.78%
4	Amazon.com	3.73%	4.96%
5	Facebook	2.30%	0.00%
6	Tesla	1.44%	1.90%
7	NVIDIA	1.43%	1.89%
8	Berkshire Hathaway	1.43%	0.00%
9	JPMorgan Chase	1.26%	1.66%
10	Johnson & Johnson	1.21%	0.00%

Source: Bloomberg



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By the Letters

E

The ‘E’ in ESG tends to get the most attention. Addressing climate change has become one of the top priorities amongst voters (and therefore policy makers), and this has coincided with several enabling technologies finally reaching maturity in terms of both capability and unit economics. For example, we now have options in renewable energy generation that are cost competitive with fossil fuels, we have rapidly declining energy storage costs, and we have new tools to create smart grids through machine learning and AI. There are also opportunities to effect change in carbon intensive industries, which will still play a major role in the economy for years to come. The same is true of agriculture, where deforestation and water use take a heavy toll on the environment. Pollution and waste is another important consideration, especially given so much of our waste is non-biodegradable. No matter the sector, all companies have some scope to improve their environmental footprint, and progress in this area can be monitored by their stakeholders. That said, understanding and measuring the environmental impact of a large corporate entity is complex, and disclosures are not yet fully standardised in the public markets.

S

Social concerns are also rising in prominence. How companies treat their employees is an important part of corporate culture, and while there has been a lot of legislative progress on equal treatment, and health & safety in the workplace, the rise of gig work has opened a loophole allowing employers to sidestep many of these worker protections. Diversity and inclusion reporting is becoming more commonplace, and the SEC added additional human capital disclosure requirements in August 2020. Increasingly, stakeholders are looking for these considerations to extend to supply chains as well as just the corporations themselves.

Moving on to consumers, often the services provided by the largest technology companies are offered for free and have become essential to our lives, however, in return, we as consumers have at least partially surrendered ownership of our personal data and rights to privacy. In the digital age, all companies collect customer data in some form, creating a huge attack surface for hackers and cybercriminals. Stakeholder controversies, consumer protections, community relations, and corporate responsibility are all issues that would fall under the ‘S’ in ESG. Many of these issues are qualitative and subjective in nature which poses challenges to quantitative scoring.

G

Governance has arguably always featured fairly highly in a fund manager’s investment process, as bad management rarely develops a successful company. An independent and diverse Board to provide oversight, as well as transparent ownership & control are important to ensure the interests of all stakeholders are aligned. Equally, good accounting practices and ethics help reduce the risk of fraud. Monitoring management’s remuneration and bonus awards is also part of the ‘Governance’ evaluation, as these packages need to be well constructed to avoid perverse incentives. As these considerations have been in focus for a long time, there routine standards of transparency and disclosure, at least in public markets, which are reasonably straightforward to track.

Styles

The industry is still finding its feet when it comes to categorising responsible and sustainable investment, which can include:

Socially Responsible Investing – This is arguably one of the weaker approaches, as it involves simply applying negative screens to weed out investments based on defined ethical guidelines. Examples include investments in alcohol, tobacco, gambling, or weapons manufactures or perhaps companies that cause environmental damage such as coal producers.

ESG Investing – As outlined above, this approach seeks to incorporate ESG considerations into the investment process, while still retaining significant flexibility in terms of the universe of investments available to allocate to. The broad subset of values and practices housed under the ESG umbrella are desirable on their own merits, and in theory this should translate to better financial performance. The development of more sophisticated scoring methodology by independent agencies allows managers to apply a more analytical process and there is scope for nuance via an additional layer of qualitative assessment.

Impact Investing – This is more of an investment theme in its own right, as it has a specific aim to invest only in companies that have a positive impact on society or the environment. As such it is restricted to a smaller subset of qualifying business areas or sectors.

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Methodology

ESG scoring in the public markets is a huge task which relies on standardisation of reporting from corporates (much like financial accounting), review by independent agencies (akin to credit ratings in the corporate bond market), and some kind of regulatory guidelines governing related financial products.

By way of an example, here is a brief summary of the methodology used by MSCI. As the producer of some of the most widely used indices in the world, with over 3,000 employees (200 on the ESG team) and a market cap of over $50BN, they are well placed to offer this kind of scoring to the industry. MSCI ESG Ratings covers more than 14,000 equity and fixed income issuers, linked to over 600,000 equity and fixed income securities.

MSCI ESG Key Issue Hierarchy

3 Pillars	10 Themes	35 ESG Key Issues	
Environment	Climate Change	Carbon Emissions Product Carbon Footprint	Financing Environmental Impact Climate Change Vulnerability
	Natural Capital	Water Stress Biodiversity & Land Use	Raw Material Sourcing
	Pollution & Waste	Toxic Emissions & Waste Packaging Material & Waste	Electronic Waste
	Environmental Opportunities	Opportunities in Clean Tech Opportunities in Green Building	Opportunities in Renewable Energy
Social	Human Capital	Labour Management Health & Safety	Human Capital Development Supply Chain Labour Standards
	Product Liability	Product Safety & Quality Chemical Safety Consumer Financial Protection	Privacy & Data Security Responsible Investment Health & Demographic Risk
	Stakeholder Opposition	Controversial Sourcing Community Relations	
	Social Opportunities	Access to Communications Access to Finance	Access to Healthcare Opportunities in Nutrition & Health
Governance	Corporate Governance	Ownership & Control Board Composition	Executive Compensation Accounting
	Corporate Behaviour	Business Ethics Tax Transparency	

MSCI use 100+ datasets from governments, NGOs, and academia, monitor 3400+ media sources, as well as scouring 10-Ks/company disclosures. Analysts then prepare company and industry reports. They also engage with company management teams and allow the right of reply to their reports. The final score is the product of a model that places weights on each ESG issue, which vary by industry. This creates relative ESG ratings winners and losers within each industry – e.g. you can be an oil and gas producer and achieve a AAA rating if you score better than the peer group in the O&G sector model. Equally a company can operate in an industry that has a positive impact on the environment, such as renewable energy, and yet receive a poor rating due to low relative scoring according to the methodology in that particular industry.

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Other Providers

Credit Ratings Agencies	Financial Data Companies	Independent Research	Pureplay
S&P Global Ratings, Moody's ESG Solutions, FitchRatings	Refinitiv, FactSet, Bloomberg, MSCI, FTSE Russell	CreditSights	Sustainalytics a Morningstar company, Climetrics The Climate Rating for Funds
It is a rational step for S&P Global (covers 7,300 companies), Moody's (5,000+), and Fitch to append ESG scoring to their credit ratings reports, and that is what they are doing	Refinitiv, Factset, FTSE Russell, and Bloomberg all have an ESG offering, though some are less focused on scoring individual companies	There are independent providers starting to include ESG scoring in their company research, especially on the corporate bond side of things (e.g. CreditSights)	Sustainalytics was the first pure ESG ratings companies. They cover >4,000 companies. Their approach is a little different as it gives much more credit to ESG friendly industries, and lower credit to polluting ones. In this regard it is a step closer to the 'Impact Investing' ethos

The United Nations' Sustainable Development Goals (SDGs)

In 2015, the UN General Assembly agreed a resolution outlining 17 global goals to provide a "blueprint to achieve a better and more sustainable future for all", which includes a detailed set of targets to be achieved by 2030. Known as Agenda 2030, 193 countries have signed up to the resolution. Agenda 2030 provides a framework for managers building strategies around impact investing – normally a given strategy would focus on a subset of these goals.

- No Poverty
- Zero Hunger
- Good Health & Wellbeing
- Quality Education
- Gender Equality
- Clean Water & Sanitation
- Affordable & Clean Energy
- Decent Work & Economic Growth
- Industry, Innovation & Infrastructure
- Reducing Inequality
- Sustainable Cities & Communities
- Responsible Consumption & Production
- Climate Action
- Life Below Water
- Life on Land
- Peace, Justice, & Strong Institutions
- Partnerships for the Goals

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The Sustainable Finance Disclosure Regulation (SFDR)

The Sustainable Finance Disclosure Regulation (SFDR) was devised by the European Commission following two years of expert consultation between 2016-2018, and came into effect on 10th March 2021. It applies to all financial participants and advisers operating in EU jurisdictions, and its goal is to prevent 'greenwashing' in financial products. SFDR is quite wide-ranging – the full legal text can be found HERE. The provisions that are most applicable to investment managers such as ourselves are:

Article 6: Transparency of the integration of sustainability risks

This requires:

- The manner in which sustainability risks are integrated into their investment decisions; and
- The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.

Article 7: Transparency of adverse sustainability impacts at financial product level

This requires:

- A clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors
- A statement that information on principal adverse impacts on sustainability factors is available in the information to be disclosed

Article 8: Transparency of the promotion of environmental or social characteristics

This requires:

- Information on how those characteristics are met
- If an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics

Article 9: Transparency of sustainable investments

This requires:

- Information on how the designated index is aligned with that objective
- An explanation as to why and how the designated index aligned with that objective differs from a broad market index

The Green Ash Approach

In layman's terms, Articles 7, 8, and 9 have created three categories of ESG financial products, which somewhat mirror the three styles of ESG investment outlined on Page 2:

- **Article 7 Funds** – Funds with this designation incorporate ESG considerations into their investment process, and perhaps employ some negative screening to avoid certain industries

- **Article 8 Funds** – These go one step further, aiming to actively promote pre-disclosed social or sustainability-linked characteristics

- **Article 9 Funds** – More akin to impact investment, these funds have sustainable investment as their main objective

All other, or non-ESG funds are essentially categorised as Article 6 funds under EU regulations.

Over the last 18-24 months, we at Green Ash have sought to formalise our commitment to promoting ESG characteristics and incorporating them into our investment process. In the last year or so, we have launched two funds which are designated Article 8 products under SFDR.

Green Ash incorporates negative and positive ESG screening and selection criteria to overweight portfolio exposure to companies that are taking positive steps to improve their ESG characteristics

Green Ash has developed its ESG Integration policy by combining internal analysis with external industry expertise from providers such as MSCI, and applying both quantitative and qualitative elements to the process

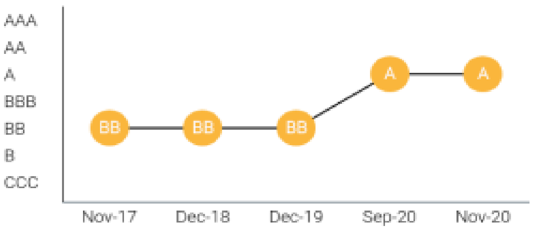
The firm's ESG investment methodology excludes sectors and companies that score poorly in terms of key ESG criteria including tobacco, weaponry and coal

As well as integrating ESG considerations into our investment process, we also engage in two-way dialogue with our investee companies and the ratings providers themselves. In the case of the ESG providers, the huge universe of companies in their coverage and the number of datapoints that need to be tracked can lead to anomalous results.

By way of an example, we have been long term investors in Hannon Armstrong on both the equity and credit side. Hannon Armstrong is a specialty REIT focused on financing renewable energy and sustainable infrastructure projects. Management estimate their climate solutions are mitigating 5.4MM tonnes of CO2 per annum. Despite this positive impact, the company received a low Environmental score from an ESG ratings provider as they had miscategorised them as a traditional REIT. After some discussions, the rating was reviewed and upgraded by two notches. This illustrates the role investment managers can play in the evolution of ESG scoring.

Hannon Armstrong Sustainable Infrastructure Capital, Inc.

ESG Rating history



ESG Rating history shows five most recent rating actions

Green Ash Sustainable Short Duration Credit Fund

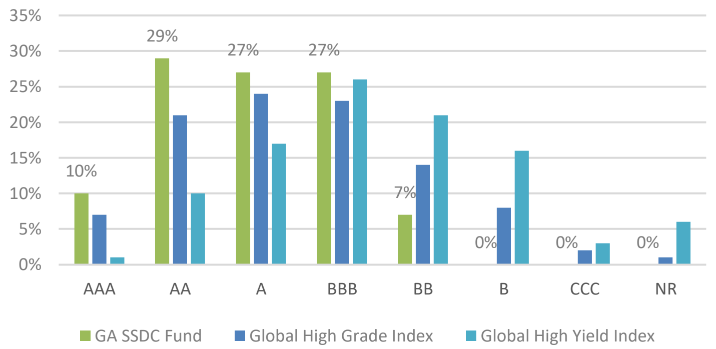
The charts on the left show the ESG ratings distribution for the Green Ash Sustainable Short Duration Fund, compared to both the Global High Grade Bond Index[1] and Global High Yield Bond Index[1].

This shows that the high yield bond market has considerably weaker ESG characteristics than in high grade.

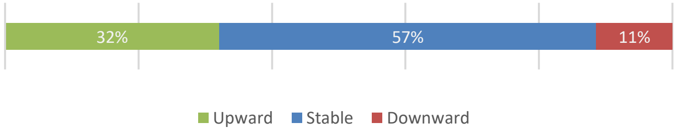
Incorporating the Green Ash ESG methodology into the investment process has achieved a significantly better ESG ratings distribution than the broader indices, with an overall portfolio rating of **AA**. This compares to an ESG rating of **A** for the Global High Grade and **BBB** for the Global High Yield Index. In addition, the fund's holdings show strong positive ESG ratings momentum of +20.6% on a net basis.

More information on the Green Ash Sustainable Short Duration Fund can be found HERE.

ESG Ratings Distribution[2]



ESG Ratings Momentum[2]



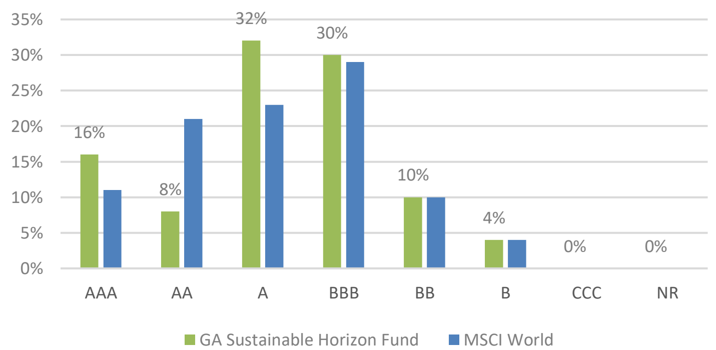
Green Ash Sustainable Horizon Fund

The Green Ash Sustainable Horizon fund's overall ESG score of **AA**[3] compares to **A** for the MSCI World Index. Though the positive ESG ratings distribution pattern is less pronounced versus the MSCI World Index than the GA Sustainable Short Duration Credit Fund against its respective bond indices, the Horizon fund benefits from similarly positive ESG ratings momentum.

Being an equity fund that focuses on disruptive innovations, the Green Ash Sustainable Horizon Fund also provides significant direct and indirect exposure to technologies that address environmental degradation and climate change. These span key investment themes from renewable energy and associated materials, AI, digitalisation, and connectivity, as well as the electrification megatrend.

More information on the Green Ash Sustainable Horizon Fund can be found HERE.

ESG Ratings Distribution[2]



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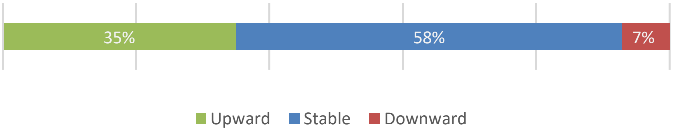

[1] *Global High Grade Index: LEGATRUU, Global High Yield Bond Index: H23059US*
[2] *ESG ratings are portfolio weighted, based on MSCI ESG scoring methodology; as at 26/08/21*
[3] *Excludes 9% of the portfolio that does not have an ESG rating, due to being comprised of smaller or earlier-stage companies*

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