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# Fund selection gets a new lens

## What the PRI's new Reporting Framework means for the funds industry

- Following the complete overhaul of the UNPRI reporting and assessment framework, it will now be mandatory for all signatories to disclose more detail about their responsible investment practices.
- By combining more prescriptive answer options with granular strategy classification, the revamped framework creates a new dataset offering a myriad of new opportunities for fund allocators to rethink established manager selection processes with significant implications for business models across the funds value chain.
- In this report, we look at how datasets are being enriched with the inclusion of sustainability outcomes, increased scope of engagement to all asset classes, and widened scrutiny of mainstream assets and alternative investments. The new UNPRI reporting framework makes a significant contribution to industry efforts for greater data standardisation and comparability, and will help align capital allocations accordingly.

## Key takeaways

Allocators can now tailor their own responsible fund selection strategy, enabled by a **new granular dataset.** Screening tools can be created around key questions.

Capturing how managers **shape outcomes** helps allocators align their strategic asset allocation, and supports the redesign of fund solutions around their outcomes rather than competencies.

Broadening **engagement data across asset classes** creates a dashboard that enables allocators to tailor how they can align their capital to their goals.

Adding a **$10bn minimum reporting threshold** rather than 10% of AUM, brings into scope a significant number of alternative managers previously ignored.

**Intensifying adoption by fund allocators**

Capturing broader, deeper, clearer and more focused data can enable more forward thinking allocators to better integrate ESG into the manager selection process .

The new PRI scoring mechanism intensifies their motivation to do so, by applying a more detailed points system when assessing allocators on how they select managers along with revised minimum for all signatories.

**Knock on effect for Asset Managers**

When combined with changes in regulations, technology and market pricing dynamics, managers may need to take a step back from incremental efforts and look at how they can genetically engineer their investment DNA and business models. Those most agile in calibrating their value proposition can protect their margins and remain on the front foot through timely product innovation. We are working closely with our clients in doing just that.

# Preface

2020 has catapulted sustainability to the top of the agenda across the financial services industry. We have seen an impressive, synchronised and structural focus on sustainability across the majority of mainstream investment firms. However, if there is one thing that has contributed the most to holding back the implementation of this agenda, it is the perception of greenwashing. It is often far less risky for a business to do nothing than risk taking a thoughtful step in the right direction only to fall foul of a loud and often emotionally charged minority of stakeholders entrenched in their own interpretation of what it is to be "responsible". **One investor's definition of "*greenwashing*" can be another's of "*transition*".**

There is no one size fits all approach to sustainable investing. Whilst the wave of regulations lays out concrete expectations of what sustainability linked disclosures will need to be made, neither regulators nor the PRI take a black and white view of how fund managers should invest**. What the new reporting framework does however, is reduce the scope for debate on the grey zone by shining a spotlight under the bonnet of how signatories incorporate responsible investing across a wide spectrum of shades and colours.**

***There will be less scope for greenwashing and greater opportunity to explicitly demonstrate what a manager does and does not do with less fear of being misunderstood.*** We expect this will prove of particular value for Alternative Investments and as these are rapidly being brought under the microscope through adjustments to PRI adjustments to its reporting criteria.

The redesign aims to ensure the reporting remains fit for purpose and relevant to evolving responsible investment practices and PRI guidance. In an attempt to address industry concerns around greenwashing and accountability, most of the mandatory questions were redrafted with a more prescriptive multiple choice approach to assess how signatories incorporate responsible investing in each asset class.

**This new approach aims to bring greater transparency and comparability to the market whilst promoting standardisation on what constitutes "responsible investment" within different investment styles**. This relies on a delicate balance between keeping answer options generic enough to be publicly disclosed and cover most investment approaches, all whilst having sufficient depth and granularity for assessment to be challenging, scorable and relevant.

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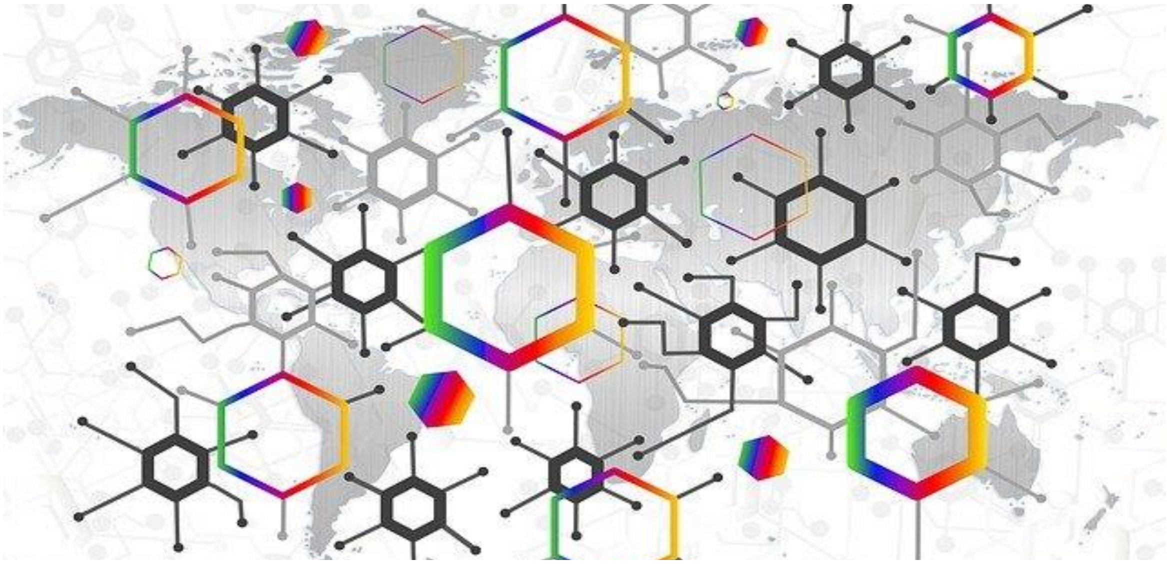
# Driving meaningful fund data

The resulting PRI dataset offers a myriad of new opportunities for fund allocators to rethink established manager selection processes. From private wealth platforms to large institutional allocators, digitisation is rapidly disrupting how the funds value chain addresses evolving client needs across all segments. It is no surprise that those needs are increasingly nuanced as the more emotive facets of “responsibility” shines a Technicolor™ light across the full spectrum of investor perception. This represents a monumental challenge for an industry that has evolved by scrutinising funds through the black and white lens of financial risks and returns.

Building on the PRI’s Driving Meaningful Data programme, fund allocators will significantly benefit from the depth of colours that can now be incorporated into their manager screening through the PRI signatory dataset.

The new Reporting Framework’s scoring approach will also propel the PRI’s close to 600 Asset Owners to streamline how they select, appoint and monitor (SAM) all external managers beyond just vehicles categorised as sustainable. Greater asset class alignment has been weaved between how allocators and managers are assessed providing a common language for how they can harmonise their philosophies. This will also trigger conversations with managers that are not PRI signatories and may not have been as compelled to adapt their investment approaches otherwise.

**Having a dataset that allows differentiation within a peer group of managers can support allocators as they develop their own responsible investing strategy for fund selection.** As investors become more sophisticated in how they consider sustainability when screening their fund universe, this dataset will enable them to apply specific binary filters.



## Retooling fund selection

The skill lies in knowing how to triangulate such specific manager attributes according to those that may be deemed most relevant within different investment styles. This is an important building block for asset owners looking to integrate their responsible investment policy into their strategic asset allocation, or for advisors to more efficiently match their client priorities

***When new data sets allow innovative tools to be created, disintermediation surely always follows***. As with all creative destruction, those most agile in their digital transformation will thrive.

## *How can I better screen managers ?*

*"My trustees want to ensure we follow through on our net zero public commitment. I can efficiently narrow my manager searches to those that use scenario analysis to assess climate-related investment risks in line with an orderly transition to a 2°C scenario "*

*"Due to my benchmark constraints, I am less concerned with exclusions but would like to find a corporate credit manager whose approach anticipates the evolution of ESG factors for the majority of issuers in their portfolio"*

*"As a responsible owner, I have adapted my Private Equity allocation process to only screen managers that have formally linked their portfolio manager's variable compensation to ESG performance objectives"*

*"When considering an allocation to infrastructure managers I can quickly filter out those unable to identify which assets are at risk of being stranded after 10 years"*

# Widening the field of vision along the impact spectrum

The new "sustainability outcomes" dimension of the UNPRI Reporting Framework goes beyond ESG from a risk/return perspective to focus on how signatories manage the real-world impacts of their investments. This lays the foundation ***for a broader fund data-set to support allocators in aligning their own approach to shaping outcomes according to the type of managers available for consideration.*** This triggers a step change in how different investment approaches and asset classes are able to cause, contribute or be linked to certain outcomes given the different levers and degrees of influence available to them.

Applying this outcome lens at an asset allocation level will help asset owners move towards a more holistic approach towards various investment strategies such as taking a different view on primary financing or secondary trading.

***The context provided by such a dashboard could not be better timed given the need for more meaningful allocations to private market strategies*** as negative yields, return free risks and a breakdown in long stablished Equity / Bond correlations invalidates the sacrosanct 60/40 investment model.

*For example, an asset owner looking to prioritise their negative outcomes linked to emissions may consider integrating this into their Strategic Asset Allocation. They may consider their exposures to primary market strategies such as Private Debt where they screen managers prioritising a robust exclusion approach.*

*On the other hand they may choose to emphasise more thoughtful engagement when appointing Listed Equity managers and focus their search on identifying those that are most likely to wield influence through a thoughtful approach in encouraging some utilities in their transition towards other sources of energy.*

*For their liquid credit managers they may favour searching for managers that demonstrate greater sophistication in integrating ESG risks into their estimates of fair value at different points along the yield curve. That same utility may appear to have a grossly under-priced 10 year CDS that ends up being bid up through this allocation thereby contributing more directly towards a higher cost of funding when they come to market unless they accelerate their transition.*

We have seen a significant advance in the necessary technological innovation needed to measure outcomes, especially in specific areas such as carbon accounting, however there is still a significant way to go yet. This is likely to be accelerated by wide reaching regulations such as **SFRD that will require fund managers to disclose potentially negative outcomes.** As more is measured more will continue to be managed. Initially this will be done through expanded monitoring of existing approaches to traditional fund solutions. As this becomes common language, allocators will be able to go beyond just thematic funds when looking to fund selection as a means to shape their own portfolio level outcomes.

Traditional bottom up fund research focuses on assessing competence to fit within strategic asset allocations whilst scrutinising outcomes as a essential consequence. We are now seeing **an evolution towards redesigning fund solutions around targeted outcomes where competencies are just another essential enabling building block.**

We expect such improvements in fund data and underlying holding analytics to significantly widen the choices and transparency offered to clients.

This is particularly relevant in wealth management given the accelerating transfer to the next generation. Their first-hand exposure to the consequences of their allocation decisions goes beyond a concern for the world they inherit and the capital they will need to continue enjoy it. Their time horizon implies the need to consider longer term outcomes as part of prudent financial risk management, as the market discounting mechanism increasingly prices these in during their holding period.

Having the transparency and appropriate context to understand how their managers prioritise and shape outcomes becomes a critical investment consideration. **Private Banks will need to weave how outcomes permeates their overall value proposition beyond an impact fund offering.**

The more agile players have an opportunity to use the new MIFID II suitability rules to redesign their internal distribution models.

## Aligning engagement

Allocators will have an opportunity to delve deeper in their manager research approach thanks to a richer dataset that highlights how priorities are set when managers engage with companies on ESG topics that go beyond just managing risks to financial performance. The scope of engagement is addressed across asset classes in such a way as to bring out how investment approaches contribute to shaping outcomes thus **providing allocators a clearer dashboard to navigate how they can align their capital with purpose.**

This also moves the needle by encouraging portfolio managers to embed engagement within their investment style as opposed to relying purely on a parallel activity to drive desired outcomes. All too often managers pursue parallel efforts in their engagement and investment activities. By assessing managers on how engagement activities are designed to improve practices beyond just dialogue driven by risk and return considerations, **the new framework supports allocators in selecting managers that are most adapted to helping them achieve their outcome ambitions.**

# Tightening the net for Alternative Investments.

A significant number of strategies had been ignored in the previous reporting framework having fallen below the 10% of total AUM reporting thresholds. This is particularly the case for alternative investments such as Hedge Fund allocations which are unlikely to ever represent anywhere close to 10% of an asset owner's strategic asset allocation.

Mandatory reporting requirements will now be expanded to include asset classes with a minimum of $10bn. This applies equally to asset managers as well as allocators and will bring a significant number of managers in scope. **This is particularly welcome in the case of alternative investment strategies given their disproportionate scope for influence as outcomes, climate risks and engagement take centre stage.**

## Liquid alternatives

Assessing the wide spectrum of investment approaches within Hedge Funds is an ambitious target. Whilst there is quite a way yet to go, the strategy level indicators are a significant leap in the right direction. The data sets created by providing different answers to be adapted to most of the principle alternative investment strategies is an opportunity for a step change in how Fund of Hedge Funds can design coherent ESG integrated solutions for their clients.

The granularity of answers will provide **tools for fund selectors to align to managers that most closely align to the way they would like to see their assets managed**. When evolving their emphasis beyond ESG from a risk and return perspective to considering outcomes, AUM on its own is no longer an adequate proxy for the footprint a manager can have: Leverage and turnover can significantly alter the actual volume deployed and investment approaches unique to different strategies can place the emphasis on different ESG outcomes.

## Private markets

Bringing more private market allocations into the scope of scrutiny, especially in niche areas like infrastructure can have a significant effect on directly shaping long term outcomes. The permanent nature of investments in real assets amplifies the necessity of going beyond AUM as a proxy for where most scrutiny deserves to be placed. The increased focus on how outcomes are shaped requires an examination of the far more influential transmission mechanisms available to strategies dedicated to primary market financing. As infrastructure now becomes mandatory as well, longer term outcomes are further put into focus, particularly on climate related issues.

**If combined appropriately, the granularity created by the new PRI reporting framework offers deeper insights into the breadth, depth and scope for influence and allows for a richer dataset to identify those best able to direct capital to companies, properties or projects that are most likely to best manage ESG risks.**

# Intensifying adoption by fund allocators

**If enabling fund allocators to better integrate ESG into the manager selection process is important, motivating them to do so is essential.**

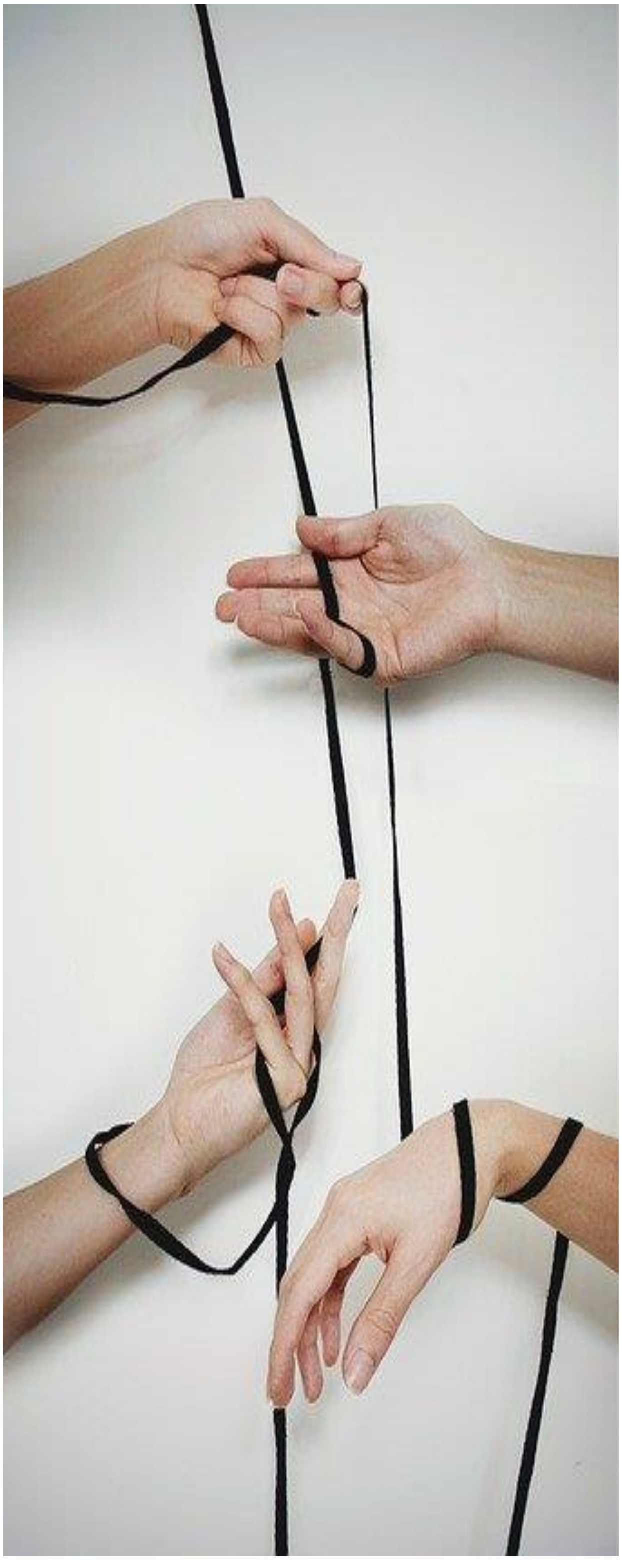
40% to 50% of signatories scored A/A+ on how their fund selection approach in 2019. The [new numerical scale scoring approach] will force a wider distribution between those that have not considered responsible investing into manager selection broadly, deeply or widely enough.

This raises the bar internally for more advanced allocators, intensifying their "interest" in how managers integrate ESG for risk return purposes, how they consider the positive and negative outcomes from their investments, and what they choose to do about it.

With common indicators skewed towards enforcing confidence building measures such as public disclosures of detailed responsible investing policies and governance oversight, it would not be surprising to find many allocators scrambling to rapidly tighten their processes and reporting expectations across asset classes.

2020 was the first year that the PRI delisted signatories publicly. The gradual tightening of [minimum requirements] should also broaden the number of allocators that will need to ensure they make the required step changes, especially amongst the more recent and potentially less advanced signatories once their grace period is over.

The PRI counts over 3000 signatories representing over $100 trillion in assets globally. Having reached critical mass, publicly disclosed indicators in the mandatory core section of the reporting framework becomes business critical for any asset manager or asset owner's image.



## Manager selection case study

*To illustrate this, let us take the new [SAM4 indicator]* which examines which responsible investment practices are required as part of external manager selection, counts for double points. Should a signatory allocate over 10% or $10bn of their AUM externally to any asset class, they will be scored for which responsible investment practices they require as part of their manager selection criteria in each of them.

*These scores will depend not just on verifying they incorporate material ESG factors in all their investment analyses and decisions, comply with whatever exclusion policies they may have and have the adequate resources to do so.*

*To gain more points, they will also need to require more from their managers such as: incorporating Responsible Investments into their asset allocation and portfolio construction, engaging with underlying assets on ESG risks and opportunities, tracking the positive and negative sustainability outcomes of their activities, embedding ESG considerations in contractual documentation, implementing adequate disclosure and accountability mechanisms or working with the PRI to develop their approach and include other measures.*

*These scores will also depend on what proportion of managers in each asset class covers. So fully applying this to just funds that are labelled as "sustainable" or "ESG" will not be enough if those only represent a minority of their allocations.*

*For example a large Asset Owners with over $200bn whose >$10bn allocation to external Private Equity or Hedge Funds only represents <5% of their AUM would now be scored on their manager selection process for the entire allocation and not just a minority of funds within their portfolio where some efforts may have been made so far. For those that outsource these allocations to fund of fund providers this will rapidly become more than just a preference when considering their mandates.*

# Knock-on effects for Asset Managers

The launch of the new PRI reporting framework in 2021 coincides with various regulations and industry initiatives that share the common ambition of going beyond verifying the "what" to driving the "how".

Managers that have so far contended with incrementally taking minimal cosmetic steps towards ESG integration will no longer be able to avoid taking a step back and structurally adapting their investment processes and business models. Having the right data inputs, resources, skills and oversight will require courageous capital reallocations. Adapting the core investment DNA to the most suitable approaches will require skilful calibration that is likely to meet most resistance from less agile incumbents. ***The key for those with a longer term vision lies in adapting external incentive structures, organisational structures and internal compensation models around a transparent and coherent vision.*** Embracing a more circular economy model to how asset managers have historically been run will prove critical to aligning, retaining and mobilising their internal talents. Siloed structures will struggle longer term when opting to delegate ESG responsibility to a separate team or simply plug in external data inputs. Portfolio managers, analysts, risk management and quant functions will all face a greater workload and more punitive consequences for ESG failures. The new scoring mechanism sharply places the emphasis on how the soup is made.

Regulations such as SFDR, require funds in Europe to disclose the potential negative outcome from their investments. This is likely to trigger heated debates between portfolio managers, whose incentive structures may motivate them to resist making structural style changes, and their investor relations colleagues who may be incentivised to resist shining a bright light on complex attributes that may be prone to misinterpretation further up the funds value chain. This emphasises the reliance and burden on reporting and internal oversight structures.

**Coherent, aligned and relevant messaging will be crucial in remaining credible in front of investors.** This places a greater onus on how fund distributors balance how they position investment solutions and not risk expensive misperception. Asset raising and retention will always rely on the trust in the messenger but will increasingly be driven by the trust in the message.

**Asset Management executives will benefit from the PRI reporting framework as a tangible roadmap to support these difficult reorganisation choices. Particularly in how to genetically engineer their investment DNA to build on rather than threaten their USP and remain on the front foot on product innovation.**

# Conclusion: When compliance turns to reliance

***Covid 19*** gave us the time to take a step back and recognise the need for systemic change in the road ahead. ***Political systems*** are rapidly adapting accordingly. The investment landscape is being illuminated through ***Technology*** and mapped out by broader measures of value .

If ***Regulators*** have turned the ignition on for a strategic rethink of what journey to embark on, ***the PRI*** is now is shifting gears to show us how we can use different vehicles to drive forward.

The new reporting framework forms the basis for allocators to adapt how they can align their sustainability philosophy with the DNA of their managers. It may appear to have more boxes to tick but PRI reporting is now far less of a box checking exercise and closer to an indispensable tool in accelerating critically needed capital flows.

**As these forces converge in 2021 we could be witnessing a structural change in the dynamics driving the price discovery mechanism itself. This closes the loop through a self reinforcing mechanisms that helps keep finance sustainable.**