TIME TO GET PERSONAL

Advisors need to understand their clients' ESG goals thoroughly if they're going to deliver more than just returns

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Intimacy. It's a word that makes most of us squirm – particularly in financial services.

Some of the most effective financial advisors and consultants are those who can establish contextual intimacy with their clients and then constantly keep in mind that they must not betray this trust by being cavalier or self-serving in search of business. This requires attentiveness to the interests, priorities and passions of individuals, families and institutions. Trivializing or disrespecting those interests can destroy credibility and kill relationships.

As ESG investing has moved toward the mainstream, a fair number of asset managers have focused solely on the investment case and have steered away from discussing the personal or mission-driven aspects of the investment experience. It seems like an allergic reaction to real and imagined fiduciary concerns stemming from incorrect assumptions about performance. It ultimately leads to ESG offerings in service of risk and return alone.

And yet clients are actually going to greater lengths than ever before to figure out and explain their intentions when it comes to aligning their portfolios with their goals, using both financial and non-financial language. So why aren't advisors interested?

CHOOSING THE RIGHT WORDS

I have realized recently that I have not always understood how the financial services industry was seeing and experiencing the ESG movement. If you read previous articles of mine in this magazine, you will find regular references to the idea of 'ESG integration.' My understanding of integration has always been that it is both possible and beneficial to weave ESG criteria into the investment process at every stage, making it part of the affirmative case for owning a security, rather than treating it purely as an ex ante or ex post screen completely divorced from the decision making. It is totally possible to address social, economic and environmental challenges proactively and to be a good investor without any inherent conflict. Essentially, I have been advocating the have-your-cake-and-eat-it approach.

However, what I have seen emerge recently – and quite broadly – is an investment-only treatment of ESG integration that positions it as part of the norm for investment analysts, but without any overarching social or environmental policy. Of course, there is a strong case to be made that financial risks can be mitigated and opportunities uncovered by considering ESG factors in any strategy. That is not the issue. Selling that as a genuine ESG strategy is.

This gets back to my original point on intimacy. An intimate client conversation is necessarily rooted in the more personal or institutional motivations around social and economic justice, environmental concerns, ethical business and doing some good – or at least doing less harm – with a client's investments. A family might come in and tell their advisor that they really care about human rights. I am yet to hear of a family telling their advisor, 'As a family, we are deeply passionate about free cash flow.'

KEEP YOUR EYES ON THE PRIZE

The problem, strangely enough, is that ESG demand is climbing. Fortunately, the industry is stepping up to meet this demand. But in the rush to satisfy, there is more box-checking and incorrect positioning of otherwise well-conceived traditional strategies. Just because a manager looks at valuation when making investment decisions does not automatically make them a value manager. And likewise, ESG is diffuse enough as a concept that it has been possible for some managers to cast or re-cast a strategy as ESG-compliant simply because it employs aspects of ESG criteria. Perhaps it only applies a single factor such as diversity, or maybe it uses a broad ESG screen at a such a subordinated level that it does not actually drive portfolio decisions.

The consequence of this investment-led form of ESG is that asset owners are at risk of ending up with securities in their portfolios that do not actually align with their expressed goals. They are looking for quantifiable as well as anecdotal evidence that their portfolios are doing some good while also providing a market-like financial return. The best framework for measuring and communicating this in a relatable way is probably the UN Sustainable Development Goals (SDGs). In referring to them, a truly comprehensive ESG strategy should be seeking positive change in most – if not all – of the 17 SDGs. It won't just settle for one or two accidental by-products.

It therefore falls to the gatekeepers to conduct comprehensive critical analysis. In the past, even some hardcore ESG firms would understate or entirely omit the sustainable aspects of their products in their marketing materials for fear of being excluded from searches. Now though, we have the opposite problem. ESG and impact investing are coming into vogue, and the real work begins for manager research analysts, consultants and advisors. It's up to them to find the authentic strategies that will fully and consistently align with and respect the very personal principles and priorities of their clients. ■