

Investment Fund ESG Rating Review 2024

Managers diverging on
ESG and climate change
risk management

November 2024

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About the Survey

To help our clients identify whether ESG considerations are appropriately embedded within their investments, we conduct an annual review of our clients' funds. This, is our fourth annual report, provides a summary of our analysis and conclusions and illustrates how managers across asset classes are progressing in terms of their ESG approach.

This year we have analysed detailed information provided by 43 investment managers covering 184 funds to understand their current approach towards incorporating ESG factors and climate change risk management into their funds.

Key findings

1

ESG risk management improves but mixed across asset classes

- Overall Green ratings increased to 40% (2023: 36%), however progress is mixed across different asset classes.
- 26% of all managers could not provide any examples of taking into account ESG risks in practice, this was worst in active equity managers.

2

Passive equity leads on stewardship

- Stewardship improved across most asset classes, with passive equity funds in particular improving to 45% rated Green (2023: 10%).
- Private market funds lag with 33% Red on Stewardship, with notably poor responses on engagement by private debt managers.
- We have seen a number of investment managers withdraw from industry initiatives such as Climate Action 100+ and this has led to downgrades in ratings.
- Engagement on social issues remains less common than governance or environmental aspects.

3

Progress on climate change across asset classes

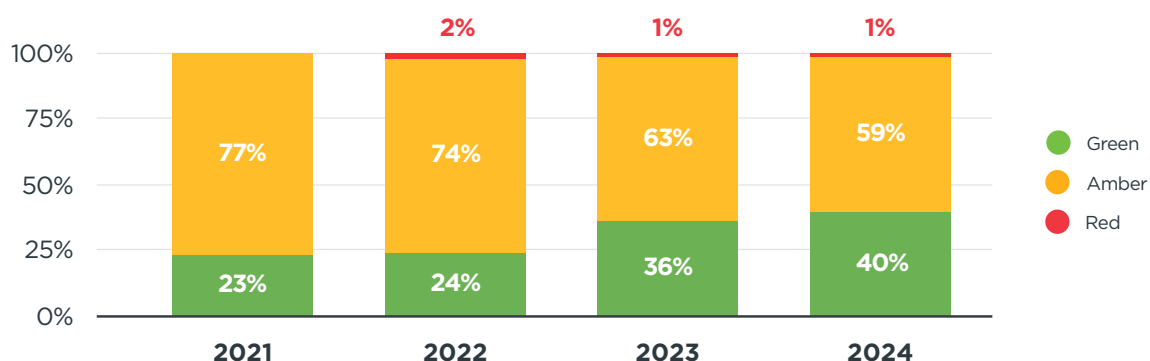
- We have observed a trend of many managers embedding net zero targets into their existing funds. We support this direction of travel, but it's important that the targets have sufficient focus on transition alignment not just carbon reduction through divestment.
- In private markets, the ability to report on carbon emissions data has improved albeit from a low base, and we saw the first Green ratings on climate change, but still a minority.

4

Divergence in ESG reporting

- Reporting was mixed across asset classes. Over half of secure income and private markets managers were rated Red for reporting.

XPS ESG ratings



Source: XPS Group

XPS approach to assessing ESG

XPS assess and rate funds either Green, Amber or Red overall based on the following eight key aspects: Parent, People, Product, Process, Positioning, Performance, Pricing and ESG. We refer to this as the 7Ps and ESG.

Any fund rated Red on ESG cannot be Green rated overall or recommended to clients.

We assess the quality of ESG risk management, utilising the five key areas that we consider to be fundamental when assessing ESG practices:

Key ESG areas Explanation

1. Philosophy	Firm-level philosophy relating to ESG, stewardship and broader sustainability issues.
2. Integration	Implementation of the firm's ESG philosophy within research and portfolio construction.
3. Climate change	Explicit climate change considerations within the investment and stewardship processes.
4. Stewardship	Approach to voting and engagement to drive positive change in invested companies and underlying managers.
5. Reporting	Transparent communication of activity to stakeholders.

Note: Within passive mandates we do not assess managers on ESG integration or climate change as these managers have less control over stock selection. For these funds our focus is on stewardship.

We request completion of a detailed ESG questionnaire involving over 70 questions.

We score each question +1, 0 or -1 with the scores weighted appropriately to inform a rating for each sub-area and overall based on the below formula, with qualitative oversight to ensure that overall ESG ratings are appropriate:

Weighted score	Rating
Below -0.2	Red
Between -0.2 and +0.7	Amber
Above +0.7	Green

We do not award overall Green ESG ratings to funds which score Red on any individual sub-area, irrespective of how well the fund has scored on other areas.

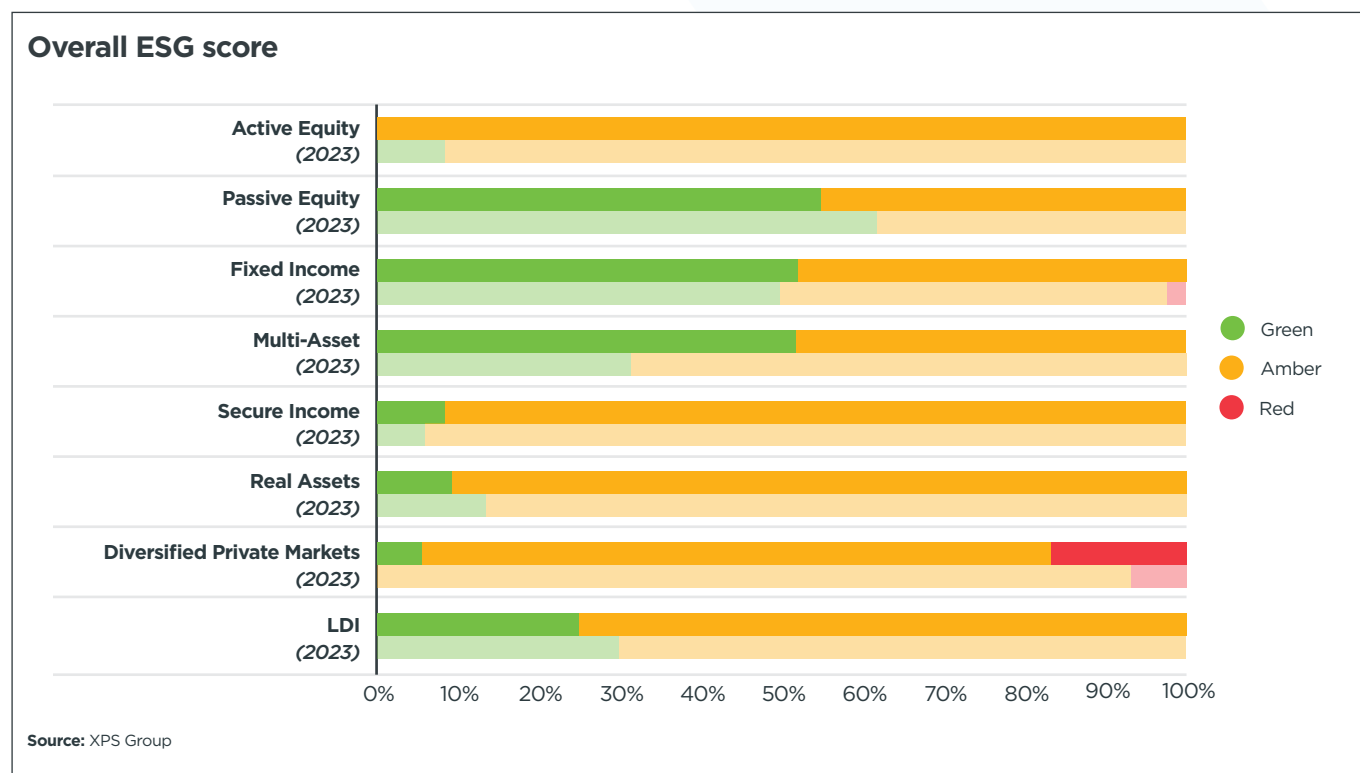
We provide tailored feedback to every fund manager on their ESG rating to highlight strengths and areas for improvement.





Survey findings and analysis

1. ESG risk management improves but mixed across asset classes



Green ratings increased to 40% (2023: 36%) in keeping with the trend upwards we observed last year. Whilst this appears to be a trend in the right direction, the picture is mixed when looking at the underlying asset classes.

Last year we found a significant improvement across multi-asset funds, which continued this year. Where active and passive equity, real asset, and LDI funds saw a reduction in Green ratings, this is due to change in funds in the sample (no funds saw a year on year downgrade) but nonetheless indicates a weak approach by those managers.

Integration improves, but lots of managers still unable to demonstrate approach in practice

Overall, Integration Green ratings slightly increased to 58% (2023: 54%).

One of the key aspects of our review is looking for examples of managers making decisions taking into account ESG issues. This does not necessarily mean selling a company because of some environmental issue, but simply recognising that issue as a risk and taking it into account.

Multi-asset funds showed strong Integration with 68% of funds achieving a Green rating while diversified private market funds lag slightly with only 28% of these being rated Green.

The multi-asset fund managers scored better because the vast majority were able to provide specific examples of ESG integration within the fund that had taken place over the last 12 months.

Across other asset classes, we were disappointed again to see a large number of funds unable to provide compelling examples of factoring ESG issues into decisions. Overall, 26% of funds provided no examples (worsening slightly from 23% last year).

% funds unable to provide any form of example of ESG factors being taken into account:

	Active Equity	Fixed Income	Multi-Asset	Secure Income	Real Assets	Private Markets
Total funds	5 (-7)	71 (-15)	28 (-7)	12 (-5)	11 (-4)	18 (+3)
Environmental	67% (+50%)	24% (+3%)	12% (-19%)	8% (-4%)	50% (+3%)	47% (+14%)
Social	67% (+42%)	29% 7%	12% -25%	8% -39%	50% 3%	47% 0%
Governance	83% (+58%)	25% (+2%)	8% (-21%)	8% (-16%)	64% (+18%)	53% (+6%)
Any of ESG	67% (+67%)	24% (+3%)	8% (-18%)	8% (-4%)	50% (+10%)	41% (+8%)

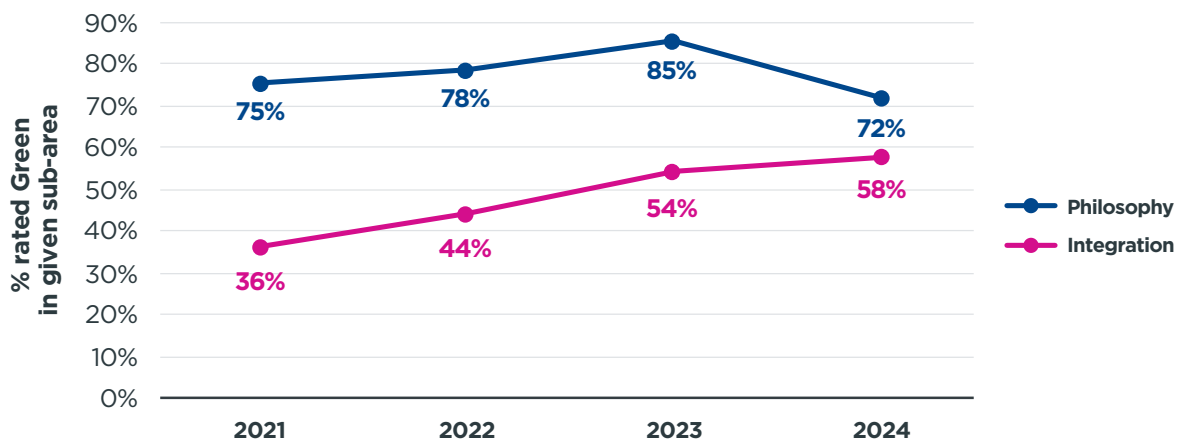
In particular, in active equity we found 67% of the funds not able to provide any example of ESG integration; last year, all active equity funds provided an example. It is a concerning result that so few active managers – who are making regular decisions on stocks all the time – could provide evidence of incorporating ESG into those decisions.

Comparing firm-level approach to ESG integration within the funds

We continued to monitor the gap between firm level ESG philosophy and fund level integration, to ensure that managers are embedding their firm-level commitments in the fund approach. Overall, the stronger performance on integration suggests this is happening more and more.

However, we note that the number of funds where the scored Green for Philosophy decreased to 72% (2023: 85%), driven by the downgrade of one large investment manager due to their limited commitment to industry initiatives over the year and lack of clarity on internal sustainability targets.

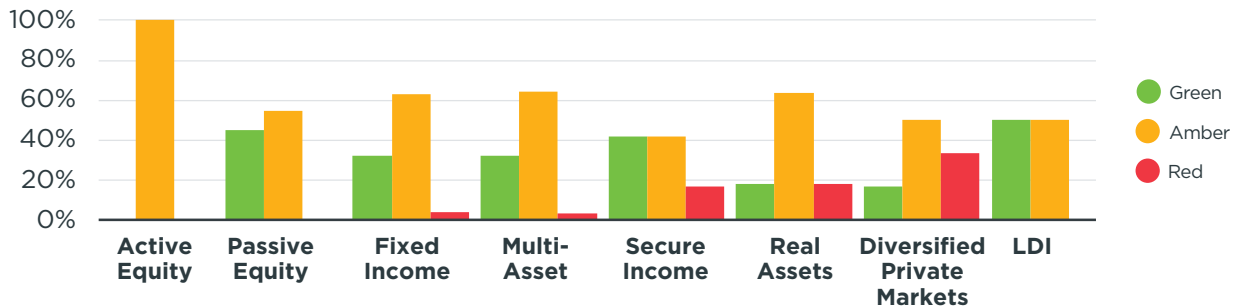
Philosophy and Integration % Green



Source: XPS Group

2. Passive equity leads improvement on stewardship

Breakdown of stewardship rating



Source: XPS Group

The proportion of funds rated Green on Stewardship increased to 33% (2023: 27%).

The largest year-on-year improvement came from passive equity funds where 45% achieved a Green Stewardship rating this year in comparison to only 10% last year.

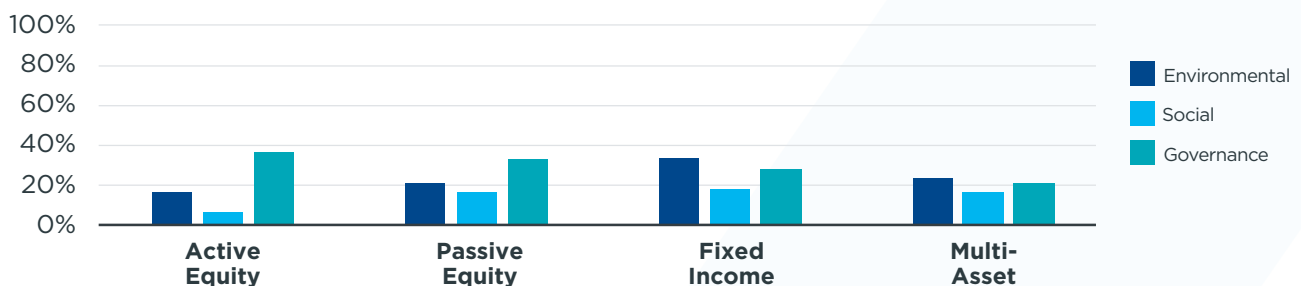
In diversified private markets 33% of funds received a Red rating for stewardship. For the most part it was managers in private debt that indicated that engagement on ESG was not a consideration within their investment process.

Engagement by LDI managers has received increased media attention, with many suggesting LDI managers need to do more to engage with the government or related agencies on ESG issues. We saw good evidence of this increasing, alongside engagement with counterparty banks to manage credit risk.

We are also hearing more positive stories from real asset managers (e.g. property and infrastructure) of effective engagement with tenants and property managers. This is critical, as in this asset class in particular there is a direct regulatory consequence of not managing climate risks properly; all rental properties in the UK must be EPC band C rated by 2030, and any that are not will be uninhabitable.

Governance remains the hot topic for engagement

Average proportion of holdings engaged with on ESG issues



Source: XPS Group

As has been the trend in previous years, engagement on governance issues was the most common across all funds, and engagement on social issues remains the least popular. We would like to see more engagement on social issues, particularly as the impacts of social factors in investing are trickier to measure quantitatively than, say, environmental aspects due to a lack of standard data in this area.

Engagement overall remains most prevalent in active equity, with an average of 50% of holdings engaged with on any ESG issue (noting this is down slightly versus 61% last year).

We do note that quantity of engagement does not always translate into quality of engagement, and the lack of effectiveness / detail in the examples of engagement provided by active equity managers meant they scored Amber, so this is an area for improvement.

Industry initiatives in the spotlight

During the year we saw several major investors pulling out of the Net Zero Asset Manager Initiative, and Climate Action 100+, the latter in particular following new requirements for the members to **encourage companies** to implement climate transition plans (where previously members had only been asked to **engage with companies** on what they were doing to reduce emissions).

Whilst the managers provided a range of justifications for their withdrawal, we feel this is a step backwards, and will scrutinise those managers who have exited the initiative.

3. Private markets make progress on climate change

We expect managers to be proactive and clear around their assessment of climate risks, as physical risk outcomes happening in the world right now (hurricanes, floods, droughts) have immediate impact on asset values and create more potential for disruptive policy intervention and transition risk for those companies and investors who do not adapt or contribute to addressing climate change.

While some managers may have climate related objectives, such as a net zero target, all managers should be at a minimum considering climate change as a risk factor.

Key climate change indicators 2024

	Active Equity	Passive Equity	Fixed Income	Multi-Asset	Secure Income	Real Assets	Diversified Private Markets	LDI
Total funds	5 (-7)	31 (-11)	71 (-15)	28 (-7)	12 (-5)	11 (-4)	18 (+3)	8 (-2)
% Rated Green on Climate	33% (+17%)	n/a n/a	51% (+2%)	56% (+4%)	8% (-9%)	36% (+3%)	6% (+6%)	n/a (n/a)
Able to report carbon emissions	100% (+25%)	100% (+7%)	92% (+2%)	88% (+2%)	38% (+20%)	64% (+4%)	59% (+26%)	67% (n/a)
Average coverage for carbon data	89% (+4%)	93% (+1%)	80% (+8%)	66% (0%)	63% (-10%)	82% (-15%)	54% (-30%)	100% (n/a)

Note:

- Year on year change indicated where data was collected in 2023.
- LDI and passive equity are not rated on Climate sub-rating.
- Data on LDI was not collected in 2023 hence no comparison.
- Coverage means the proportion of the underlying holdings for which the given fund has emissions data available.

Climate change Green ratings increased to 41% (2023: 31%) with improvement across most assets classes. Overall, we're seeing better modelling capability from managers to project climate risks forward for their portfolios (assessing transition alignment) and incorporate that into top-down and bottom-up analysis. Reporting carbon emissions is now firmly the norm within listed markets.

Private markets continue to make progress albeit from low base. This is reflective of effective industry collaboration around standardised data collection templates which have been developed in recent years.

4. Divergence in ESG reporting capability

It's important for clients to be able to regularly monitor ESG risks, including exposure to harmful activities, engagement and climate data. We expect managers to provide this information in their 'standard' reporting (regular factsheets).

	Active Equity	Passive Equity	Fixed Income	Multi-Asset	Secure Income	Real Assets	Diversified Private Markets	LDI	Total
Total funds	5 (-7)	31 (-11)	71 (-15)	28 (-7)	12 (-5)	11 (-4)	18 (+3)	8 (-2)	184 (-43)
Green	0% (-17%)	55% (-2%)	56% (+9%)	41% (+4%)	8% (-9%)	18% (-2%)	6% (+6%)	25% (+15%)	40% (+2%)
Amber	67% (0%)	45% (+38%)	31% (+1%)	52% (+20%)	25% (-4%)	55% (-12%)	17% (-17%)	63% (+43%)	39% (+8%)
Red	33% (+17%)	0% (-36%)	13% (-9%)	4% (-28%)	67% (+14%)	27% (+14%)	78% (+11%)	13% (-58%)	21% (-11%)

This is an area where we have seen mixed progress, with the overall number of funds with a Green sub-rating increasing slightly to 40% this year (2023: 38%), while the number of Red ratings (i.e. no reporting provided) has decreased to 21% (2023: 32%). However, there was a mixed picture looking across the underlying asset classes, and within asset classes – for example we saw more Greens but also more Reds in private markets.

We saw good improvement from LDI managers, where reporting on climate issues is becoming more readily available. We note the active equity funds scoring poorly again, with 33% Red due to not providing any evidence of ESG reporting.



This year we saw continued divergence between managers, across ESG and climate risk management and on stewardship, with some doing well but laggards remaining in all areas. Investors must ensure their managers are effectively managing these key sources of risk.

Alex Quant
Head of ESG Research



Conclusion and next steps

Our 2024 ratings review demonstrates that ESG capabilities are improving across the industry. While the more mainstream asset classes (equity, fixed income, and multi-asset) are still leading the way, we are seeing signs of more meaningful consideration of ESG in private markets albeit from a low base. Evidently investment managers are continuing to invest into their ESG capabilities more than ever.

Over the next year we'll be looking to see specific attention in the following areas:

Climate analysis to improve, particularly in illiquid asset classes

- **Better emissions reporting:**

While the ability to report on carbon emissions and emissions coverage has generally improved, coverage in real assets and private markets coverage remains low. This is not reporting for reporting's sake, but so that managers have that data available to inform more effective decision making.

- **Consider both physical and transition risk:**

Whilst there has been greater emphasis on climate change across most assets classes this year, we still get a sense that a lot of managers are not considering this as fully as they should. Managers that perform well in this area were able to evidence that both transition and physical risk are considered and factored into top-down and bottom-up investment decisions.

Respond to demands of asset owners on engagement

- There is an ongoing debate around the effectiveness of engagement in delivering real change, but we believe it is an essential part of good investment management.
- We are disappointed to see managers pulling out of key initiatives such as the CA100+ over the year. ESG issues are highly politicised issues in the current environment, however the global challenge remains and will only have a more pronounced impact on financial markets. We encourage all investors to challenge their investment managers on the engagement being done on their behalf; investors will increasingly be setting bespoke engagement priorities and looking to managers to act on these.

Next steps for investors

We have a clear framework to help investors enhance their responsible investment approach:

1. Take our free ESG beliefs questionnaire to gather your views and priorities

2. Define your objectives and what you want to achieve with regards to ESG and sustainability

3. Review the ESG rating of your managers and carry out climate analysis on your portfolio to understand their approach and key sources of risk

4. Engage with your manager and if necessary consider alternative investment funds which are better aligned to your objectives.

5. Ongoing monitoring using XPS ESG Ratings and sustainability dashboard report.

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Our investment team advises over 350 clients with assets of over £100bn.

Find out more

If you would like to find out more on sustainable investment and ESG please contact **Alex Quant** or speak to your usual XPS Group contact.



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