Sustainable finance: the real demands

"Sustainable finance", which aims to include environmental, social and governance (ESG) issues in investment decisions, is both required of everyone and promoted by everyone. Proclaimed by all, through new political, environmental and behavioural "emergencies". Distributed by all, banks, asset management and insurance companies who together offer private and institutional investors a wide range of investment instruments branded as "responsible", "sustainable" or "climate-friendly".

ESG investment concepts include exclusion, selection and impact approaches, usually supplemented by shareholder commitment or dialogue. From zero carbon to green bonds to sustainable real estate, the attention of investors is drawn to the content of ESG funds or mandates, with the investment instrument at the centre of discussions. All these developments represent progress, but are they really the only real demands for responsible and sustainable finance? In reality, the value added chain is not limited to investment instruments. The obligations that give structure and framework to asset management also play an essential role.
We propose five of them:

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1. Transparency

Sustainable finance must be built on products that are perfectly understandable and clear. This is the principle of simplicity of the investment concept. Ambiguous terms such as hedge funds should be avoided, the number of asset classes should be limited (e.g. to cash, bonds, equities) and performance should be calculated accurately and comprehensively. As such, every institution that manages assets must regularly present its investment clients with their individual performance together with that of other comparable clients with the same investment profile. This enables clients to compare their mandate not only with the benchmark, but also with other similarly positioned investors. To this end, the managing institution must be certified in accordance with recognised standards, such as the GIPS standard, with regard to the centralised management of its private and institutional mandates.

2. Consistency

The ethical basis of sustainable finance requires the institution claiming ESG status to manage the assets of its investor clients as well as its own. To ensure that this requirement is fulfilled, internal rules must be introduced that require the bank or investment product provider to work with the same economic forecasts and to manage their cash flow and above all their own ALM (asset-liability management) position, including foreign exchange, in the same way as that reflected in their client portfolios. This requirement for consistency requires a high degree of internal discipline. It also provides a better performance over the long term.

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3. Active asset management

Only active management can truly claim to be sustainable finance. For one thing, active management is free to move freely. It is not mechanically linked to an index, no matter how legitimate it may be. This freedom of action and independence enables asset managers to select or exclude investments on the basis of their own methods and convictions – or even their own intuition. Lastly, by active management we mean real active management and not pseudo-active management. True active management means that managers dare to take positions that differ from the composition of the benchmark index. Pseudo-active management, on the other hand, tries to protect itself from criticism by hiding behind an index and taking very few active bets, and is therefore contrary to the fundamental ethics of sustainable finance.

4. Loyalty

The asset manager entrusted with the management of an investment portfolio has a duty of loyalty towards his investor client. The loyal management expected of him implies that management decisions are taken exclusively in the interest of performance. With this primary objective in mind, the asset manager will take into account ESG parameters insofar as they facilitate and contribute to the achievement of this objective. The further away the criteria for measuring the performance of a portfolio from a pure mathematical calculation, the more difficult it will be to assess an asset manager’s contribution.

Similarly, “the interaction of ESG parameters cannot be used as an excuse for underperforming management”, to paraphrase Alan Murray, the editor of Fortune magazine. The situation is quite different if the investor takes it upon himself to introduce ESG-type restrictions which could reduce expected returns or if he pursues a philanthropic strategy. This approach sets social or ideological objectives that contradict the very notion of performance.

5. No conflicts of interest

Building a portfolio of securities requires multiple skills. It is rare for an asset manager to possess all of them. He must therefore act as an integrator by bringing together knowledge from different specialist fields. Strategic allocation is his job, but certain specialised asset classes (such as Asian equities or North American small caps) must be managed by third parties. Open architecture entrusts the best managers with the management of each segment of a mandate. This concept is the opposite of a portfolio that only includes funds or investment instruments from a single issuer and exposes the investor to the risk of lower performance.

Sustainable finance imposes high ethical requirements on the assets it manages, but also on the way in which they are managed. These ethical requirements are less spectacular than the exclusion of sectors that are too carbon-intensive or are open to criticism in one way or another. They are also less easy to apply, as they require a high level of management discipline. Yet they are essential to distinguish true “sustainable” management from the simple implementation of a style...

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