February 2024

Waterfall Implementation

Layering sustainability objectives in your investment strategy

isio.

Summary

Introduction

We live in a complex world, but we need simple solutions for investor action on multiplying sustainability challenges. In this paper, we present a framework for layering multiple sustainability objectives in the portfolio, as well as the challenges that can arise from doing so.

Waterfall implementation

We present a framework for layering environmental and social priorities in the portfolio, starting from the strategic direction of the portfolio, feeding into the asset class perspective, and ultimately integrating sustainability considerations within the investors' individual investment mandates. Regardless of the approach, there will be synergies and trade-offs to be addressed. The key considerations for investors include:

1. **Understanding the sustainability priorities of the investor.** A beliefs session can help to aid understanding of the key sustainability priorities the portfolio would like to tackle (we cover this in paper 1 in this series);

2. **Seeking out sustainable opportunities within asset classes.** The specific sustainability priorities identified may create biases, in terms of the asset classes that can best serve the chosen sustainability areas (and tying these in with the investment goals). Beyond the asset class concentration of sustainability solutions, regional and sectoral concentrations can also arise;

3. **Setting social and environmental priorities for individual mandates.** This would ultimately help to determine the allocation decisions and quantitative objectives being pursued; and,

4. **Monitoring sustainability impact.** To understand the positive outcomes for sustainable investments.

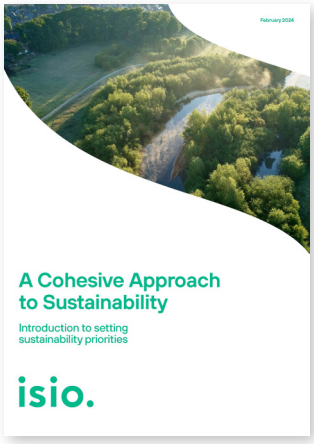
The impact agenda itself can create a bias towards actively managed products, which can demonstrate improvements in sustainability outcomes (additionality, as compared with today's baseline) – an active bias is itself beginning to be embedded within UK regulatory developments. This is juxtaposed against a growing trend of passive investments, globally, and needs consideration.

Case studies

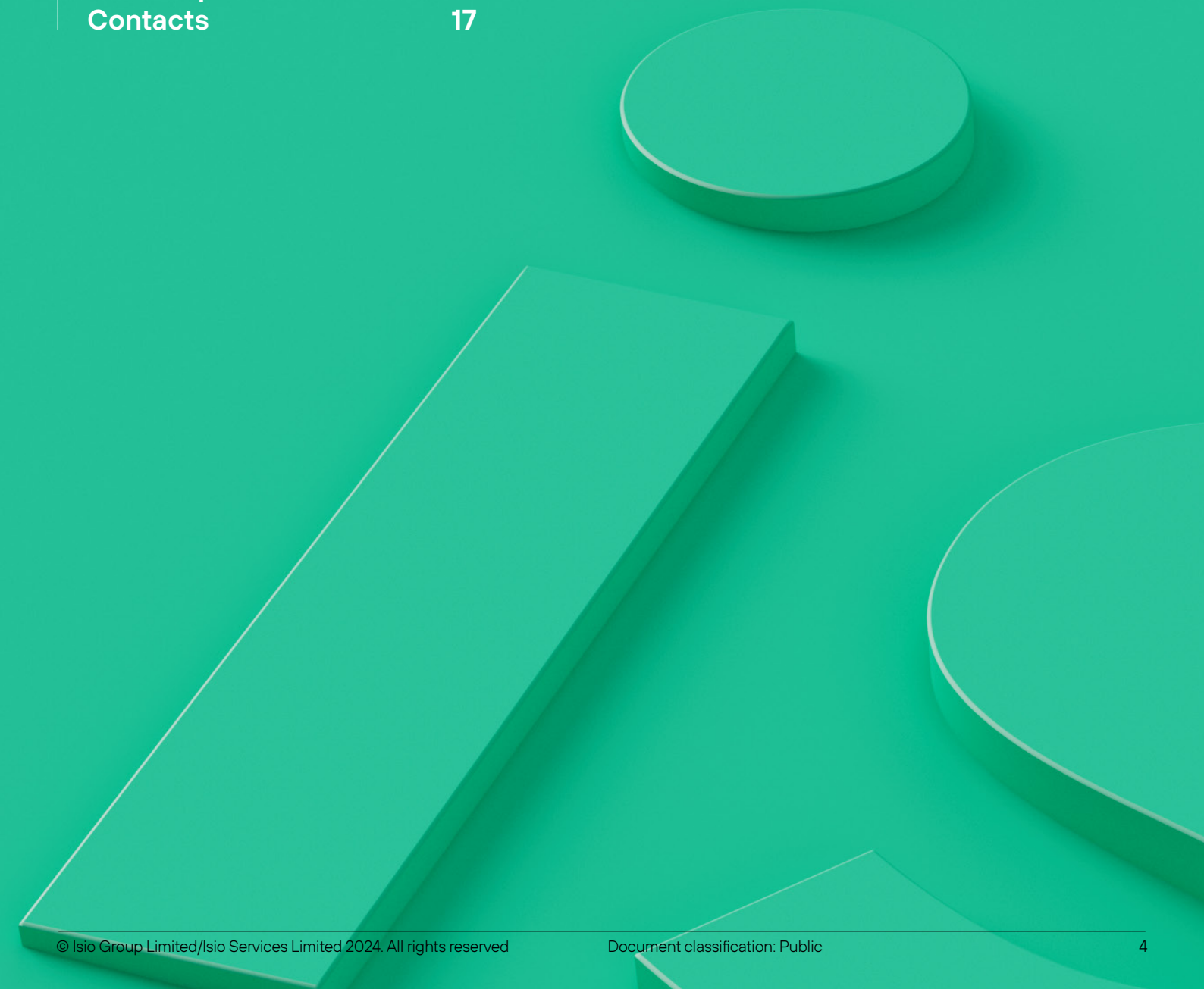
Following the presentation of the conceptual framework, we set out some concrete examples of portfolio adjustments that can be made to boost the sustainability credentials of the portfolio. We present examples for two different types of investors, corporate UK pension schemes and private capital investors, which, whilst being diverse types of investors in and of themselves, typically represent different ends of the risk-taking spectrum.

We also briefly address some of the best practice thematic solutions that we are seeing evolve in the market, across the climate, nature and social spheres. This is a precursor to the following paper in this series, which focuses on the fact that there will always be synergies and trade-offs that can be considered to holistically address various sustainability risks and opportunities, even within individual mandates.

This paper follows on from Isio's introductory paper on a cohesive approach to sustainability (see below). It also follows on from our thematic series on climate, nature and social factors, which set out what these issues are, why investors should care, and how to integrate these within the portfolio. (Please take a look at those papers for an introductory understanding of those topics). Please get in touch if you would like to pursue these opportunities in your portfolio.



Contents



Background

Whilst we live in a complex world, we need simple solutions for investor action. In the context of multiplying environmental and social concerns, investors will need to understand where their priorities lie, to target portfolio action in the areas they care most about. Whilst there is no right way to address this, we present the Isio view on how investors can think about creating sustainability layering within the investment strategy.

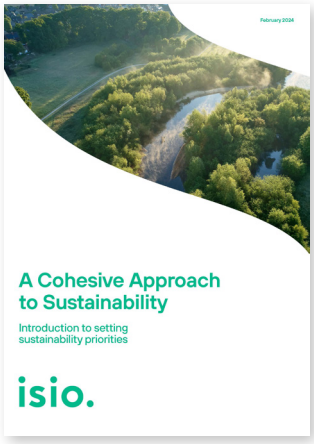
The approach will necessarily be grounded in the individual views of individual investors. These beliefs will be the impetus for developing the sustainable investment strategy, targeting action within mandates and across asset classes. Some types of assets may be generally predisposed in their ability to respond to specific social and environmental issues, and we will touch upon these in this paper.

Paper overview

In this paper, we consider a waterfall implementation framework to guide investors in layering sustainability objectives in their investment strategy – from understanding your priorities, to identifying relevant sustainability opportunities, to monitoring and reporting. We also provide case studies, relevant for pension schemes and private capital clients, investing across the passive to active investment spectrum. It is the second paper in a three-part series, focused on the following topics:

1. A cohesive approach to sustainability: introductory concepts in sustainability;
2. **Waterfall implementation: layering sustainability objectives in your investment strategy; and,**
3. Market sustainability evolution: best practice climate, nature and social solutions.

This paper follows the first part in this series, focused on an introduction to thinking about a cohesive approach to sustainability (see below).



Waterfall implementation

Framework

In this section, we will present the framework for sustainability waterfall implementation, running through the following considerations:

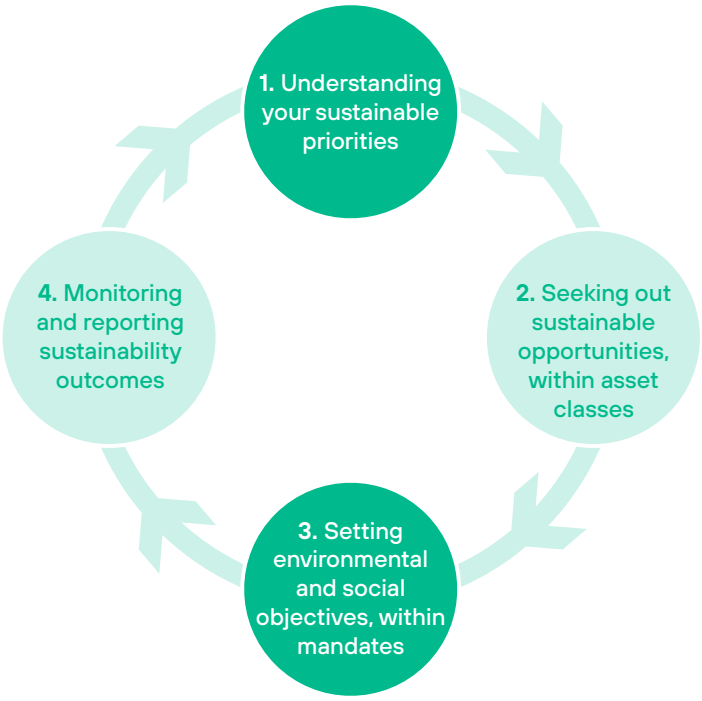
1. Understanding your sustainability priorities

The first step is to identify the sustainability priorities that investors will target action upon, to set the tone for portfolio sustainability prioritisation, by identifying the issues investors care most about. We laid out the foundations for this in our first paper in this series, from training to understand today's sustainability challenges, to engaging in belief sessions and conversations with your investment managers to determine the focus. Please see the previous paper for further details.

2. Seeking out sustainable opportunities, within asset classes

Ensuring investments align with sustainability objectives can help to delineate the eligible investor universe, or the asset classes that can offer the desired sustainability exposure. To narrow down the universe to a few possible investment options, a market search should focus on ensuring the asset class offers solutions responding to the chosen sustainability objective(s). Different asset class allocations could be thought of as building blocks, each lending themselves more to different (or similar) types of sustainability objectives. (We however note from our market-wide searches that you can access sustainability themes in nearly any asset class (we will touch on this in the final paper in this series, to be released in later this year)).

Such decisions should all be framed within the context of the risk/return preferences of investors, and any liquidity (or other) constraints. For example, a private pension scheme looking to insurance buy-out, which is unlikely to invest in an illiquid mandate with long lock-up periods. But may instead pursue available solutions in more liquid asset classes.



Asset class examples: sustainability objectives

Public markets

- Active or passive solutions targeting public companies whose revenues align with an array of climate, social or nature-related outcomes

Private equity & private credit

- Private companies delivering early stage investment in sustainability solutions, to align with an array of climate, social or nature related outcomes

Infrastructure & property

- Typically social infrastructure (e.g. buildings for social housing, education and health)
- And/or low carbon infrastructure (e.g. low carbon transport and energy and grid solutions)

Natural capital

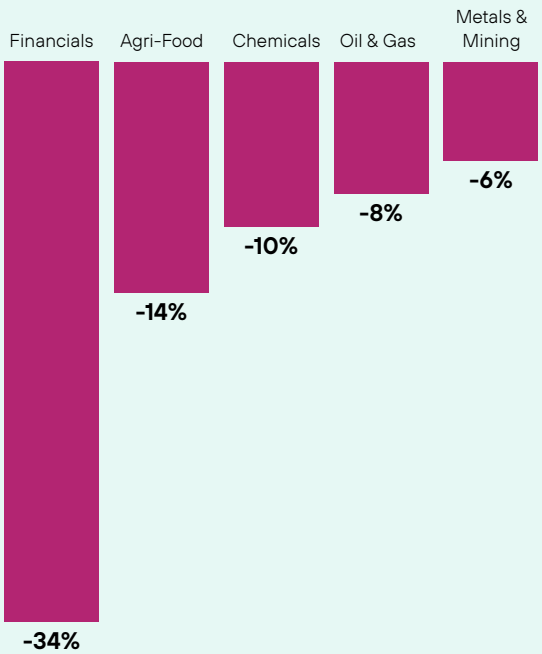
- Nature thematic strategies, such as in timberland, forestry, agriculture or oceans solutions

Sector bias in focus

Beyond the asset class bias in selecting sustainability solutions, it is also worth noting the potential sector bias. This will be a function of the stringency of the sustainability filter. Seeking only best practice examples could make the sector swings more severe, and also lead to significant concentration of mandates, for example.

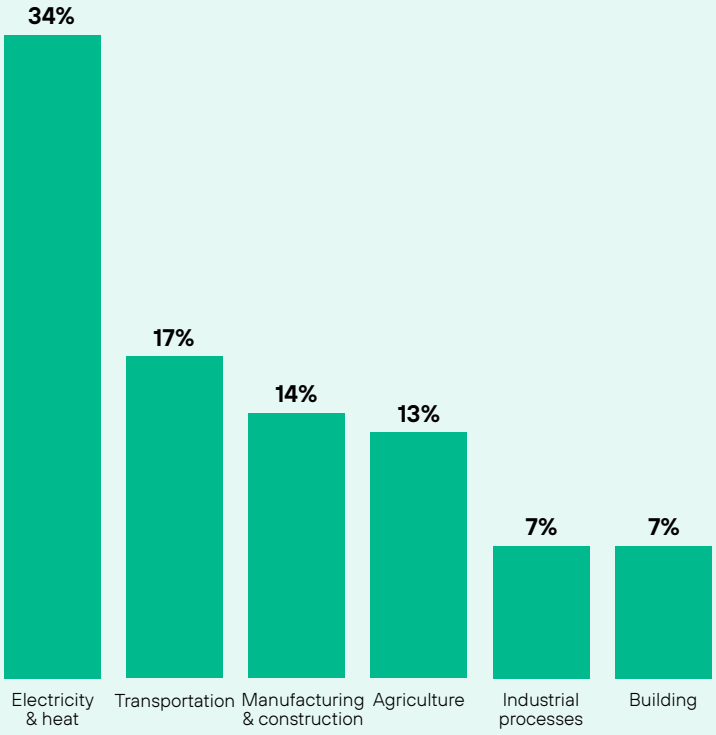
To demonstrate this in practice, we set out an example of trade-offs between sectoral allocations for optimising climate outcomes (Climate Watch) and biodiversity outcomes (Iceberg Data Lab), showing the sectors with the most impact in these respective areas. Whilst climate change optimisation is based on absolute emissions attribution (million tonnes of carbon dioxide equivalents), the biodiversity optimisation focuses on the mean species abundance impact (per square kilometre). To reduce sector bias, the holistic targeting of multiple sustainability objectives could be helpful.

Biodiversity: net impact on mean species abundance across key sectors



Source: Iceberg Data Labs

Climate change: proportion of global emissions across key sectors



Source: Climate Watch

3. Setting environmental and social objectives, for mandates

Flowing from investor sustainability priorities, it will be important to set specific mandate-level objectives to guide sustainability progress. A dedicated Key Performance Indicator (KPI) dashboard can help to track progress against any mandate-level sustainability targets. We set out some mandate-level suggestions on objectives and targets in the below table.

As we have already noted in the first introductory paper in this series, there will be trade-offs and synergies when implementing multiple sustainability objectives, within any given mandate. Beyond engagement to improve outcomes, there may also be a role for exclusions where trade-offs become significant. There are frameworks for this, and for example, the European Union (EU) Sustainable Finance Disclosure Regulations sought to redress these trade-offs via "principal adverse indicators," which can ensure no significant harm in other non-focus areas when implementing your priorities (e.g. ensuring no exposure to activities in biodiversity sensitive areas, or gender pay gap concerns). We provide a mandate-level implementation example above.

Sustainability objective-setting: mandate examples

	 **Climate**	**Nature**	 **Social**
Primary objectives	Contribute to the Paris Agreement e.g. align with a well below 2°C (or 1.5°C) scenario.	Align with the Global Biodiversity Framework to e.g. restore one-third of lands, oceans and freshwater systems, and sustainably manage agriculture, fisheries and forestry.	Contribute to the social SDGs, with a focus on e.g. reducing inequality (e.g. in terms of access to education, healthcare & jobs).
Secondary targets	Reduce portfolio emissions intensity (by 42% to 2030, vs 2022), and achieve net zero emissions by 2050 (inc. offsetting 10% of emissions).	Ensure investee companies have a biodiversity policy in place and zero exposure to deforestation, by 2030.	Aim for 10% of portfolio investee company revenues to be aligned with the social SDGs.
Allocation implications	Invest in a low carbon infrastructure fund (inc. low carbon energy and transport solutions). Or, passive Paris Aligned Benchmark (PAB) index.	Invest in a forestry fund (with a third allocation to biodiversity impact sleeve e.g. oceans, freshwater, and land biodiversity aims). Or, Long-Term Asset fund equivalent.	Allocate to a social infrastructure fund (inc. social housing, and buildings dedicated to education and/or healthcare use). Or, a social bond fund.
Trade-offs & synergies	Ensure Do No Significant Harm of low carbon infrastructure, e.g. avoiding biodiversity sensitive areas, with just transition policies in place.	Engage to ensure natural capital projects do not conflict with indigenous land rights.	Ensure Do No Significant Harm of social infrastructure to ensure emissions reduction plans, over time (e.g. minimum energy ratings).

4. Monitoring and reporting of sustainability outcomes

Monitoring investment managers to ensure sustainability objectives are being delivered on, moving forward, will be essential to keep them accountable. With central fund reporting used to demonstrate to pension members or private capital stakeholders, progress towards set objectives.

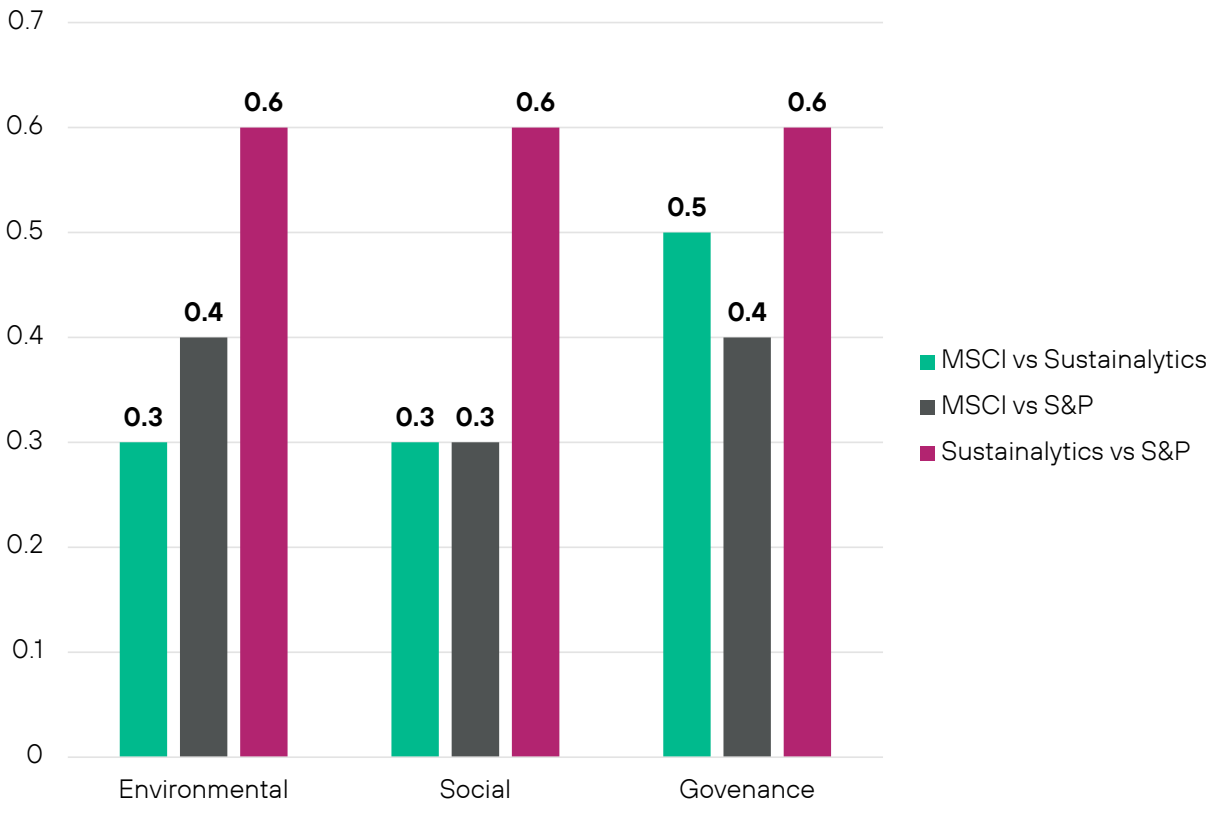
Sustainability reporting itself presents a number of challenges to investors. For example – taking an illustrative passive mandate – even with best practice examples in passive sustainability, challenges remain in seeking to understand the environmental and social impacts (both positive and negative) of a thousand or more companies, monitoring developments on an ongoing basis, and doing so in a cost-effective manner. Passive investment will necessarily have a place in the future of sustainability, and this a key area of the market to engage with.

Anecdotally, investment managers and index providers generally agree that companies with a strong governance approach will typically also have higher environmental and social credentials. This is given that effective risk management frameworks will integrate a wide variety of risks, including systemic environmental and social risks. Such companies may offer better risk-adjusted returns, in addressing multiple sustainability issues, and be best placed to respond to emerging or unanticipated sustainability risks.

Many industry stakeholders, however, regard Environmental, Social and Governance (ESG) scores as unreliable, differing significantly amongst data sources, with subjective views on sector materiality. Investors could instead consider tracking meaningful KPIs that reflect their sustainability priorities, through a personalised KPI dashboard. For example, a sustainable investment strategy prioritising decarbonisation and nature restoration may focus on emissions intensity, area of land restored, as well as indirect social benefits, such as potential contributions to low carbon employment, or engaging local or indigenous communities.

ESG scoring: correlation of scores across data providers

Source: Schroders



Other considerations

Implementation challenges

Whilst this section presents an idealistic view of sustainability implementation, implementation challenges will no doubt result when wider factors come into play, such as portfolio risk/return constraints, or liquidity and diversification constraints. These should be discussed in depth with your investment advisor. However, it presents a framework against which to begin your investor journey.

Adopting an impact focus

Impact investing will be front and centre of any sustainability agenda, seeking to demonstrate intentionality (a sustainable theory of change) and additionality (improving real-world outcomes versus a baseline, through the process of investing). As a result of these criteria, the impact agenda has traditionally been accessed primarily via actively managed public or private market investments.

There may be a potential disconnect between the sustainability impact agenda and the fact that passive investments are on the rise and are expected to dominate global markets by 2026 (Bloomberg). This is due to various factors, including cost constraints, the growing prevalence of Defined Contribution (DC) schemes in the pension scheme landscape, and the risks of active underperformance. Aligning sustainable impact and passive investment agendas may need a re-think. Including an emphasis on the practice of active ownership in passive investing, which we know is possible, as many of the UK's largest passive managers have compelling engagement programmes (ShareAction).

Passive investments, however, face challenges in accessing additionality, with limited opportunity for market disruption (assuming broad market exposure), in being inherently backward-looking (typically optimised using historic data), and subject to tighter cost margins impacting on resourcing (resulting in the potential for reduced staff to support social and environmental research, voting and engagement activities, as well as sustainability reporting). This message has filtered through into the Financial Conduct Authority (FCA) Sustainability Disclosure Requirements, with limited overlap for traditional passive investments with the "sustainable impact" label in requiring the deployment of new and additional financing to demonstrate positive impact (i.e. typically seen in private markets). The "sustainable focus" label also requires 70% exposure to sustainable assets, which may be challenging for broad market passive investors.

FCA Sustainability disclosure requirements labels

Sustainable focus

- Assets that are environmentally and/or socially sustainable
- Target >70% of investments to a sustainable focus (alignment with a credible standards or thematic opportunity) (unclear if at the underlying assets or fund level)

Sustainable improvers

- Improve the environmental and/or social sustainability of assets over time, including via stewardship
- Include a measurable target for improvement, for investments to be held account for performance over time

Sustainable impact

- Solutions to environmental or social problems, to achieve positive real-world impact
- Deploy additional capital, which demonstrates positive impact (which would not have resulted without the investment)

Sustainability mixed goals

- Adopts a mix of sustainability objectives and approaches
- Must include the proportion of assets invested in accordance with each of the relevant (other) labels

In the following box, we set out what best practice passive investment might look like in public markets, today.

We also note that Long-Term Asset Fund (LTAF) offerings are enabling traditionally passive investors to access impact opportunities in private markets, which offer open-ended fund structures (with shares priced according to the fund's value).

Delivering sustainability progress in passive

There are various considerations when considering sustainability in passive markets, the below acts like a shopping list of best practice elements investors can currently draw on from the market:

Selection & construction – investors can review the universe of available sustainability indexes, selecting the existing indexes aligned with primary environmental/social objectives, or otherwise opting to construct bespoke solutions with index providers. For example, we have seen index providers develop indexes which align with both Paris Aligned decarbonisation and best practice approaches to managing nature-related risks and opportunities.

Integrating sustainable allocations – investing directly in social, green or sustainability bonds, which should earmark proceeds exclusively for sustainability projects. This would demonstrate some additionality in investing in use-of-proceed bonds contributing positively to social or environmental outcomes.

Additional capital – similar to use-of-proceed bonds, but in equity markets, with the raising of new and additional capital; therefore, indexes could consider those equity companies generating capital via IPOs in the equity market (and selecting companies with convincing environmental and social strategies) or issuing new green and social bonds. (However, IPOs tend to be only a small proportion of investments and may not support widespread investor demand for passive impact).

Addressing trade-offs & synergies – develop transparent reconstitution requirements aiming towards investee company improvements, over time. For example, a low carbon index that requires, by 2030, all companies to have met interim science-based decarbonisation targets, ensure investee companies have a biodiversity policy in place, and at least 30% female board representation. With the threat of disinvestment at reconstitution dates if these targets are not met by the investee companies. This may, however, present significant challenges for many managers to implement in practice.

Active ownership – with the increasing emphasis on passive asset managers adopting an active ownership approach (particularly in the UK market), and acceptance of higher fees to support stewardship and sustainability reporting activities, which may support strong risk-adjusted performance. (We note that stewardship also has the potential to deliver additionality, from engagements promoting stronger sustainability, over time).

Selective exclusion of laggards – where engagement is ineffective in bringing about desired outcomes, indexes should consider the selective exclusions of key names, for example, the most emissions intensive companies without credible low carbon transition plans. This can be part of escalation plans, where engagements are deemed unsuccessful and may mean select investee companies fall out of scope (e.g. at reconstitution dates).

Portfolio case studies

We set out some examples of investor portfolios, focusing on sustainability optimisation, but with the understanding that these would need to be tailored to investors' individual sustainability priorities, as well as risk/return and other constraints. Only some of the investment solutions are currently available in the market, with others being solutions we believe to be possible when partnering with asset managers and/or index providers to develop these (following discussions with various stakeholders in the industry).

We take a look at two types of investors, with varying levels of risk appetite, focusing on pension schemes versus private capital investors (e.g. private wealth, charity, endowments and foundations) (and typically expect the latter to have a higher risk appetite, in general).

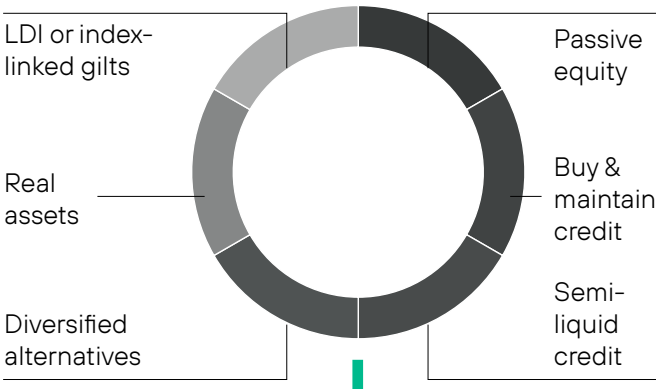
We also expect sustainability offerings to continue to evolve over time, with an ever-expanding selection of opportunities in the sustainability space, therefore a regular review of best practice would be essential to continue to assess the sustainability of mandates, asset class allocations, and the ultimate sustainable investment strategy. Each investor's sustainability ambition will therefore be an ongoing journey.

Pension schemes

Pension schemes have the primary responsibility of meeting member pension payments when they fall due. The risk appetite may differ significantly amongst pension schemes. For example, mature Defined Benefit (DB) schemes considering buy-ins and buy-out, with a low-risk appetite, and who might ultimately hand over the assets' sustainability journey to insurers. However, this is not stopping many DB schemes in leading the way on sustainability. Meanwhile, for DC schemes, there may be a wider array of sustainability opportunities, which members can self-select into, or embedded within default arrangements, and higher risk appetite, particularly for schemes composed of young members.

Other issues might arise from sustainability views themselves. For example, Local Government Pension Schemes (LGPS) consolidating their assets into pools, which can result in divergent views on sustainability and risk appetite across participating schemes in a pool, and potentially lead to a ramping up (or otherwise watering down) of environmental and social ambitions, in light of divergent views.

Regardless of the ultimate sustainability end game, from an implementation perspective, most pension schemes will have already considered sustainable opportunities in the liquid space and are now moving progressively into the semi-liquid and illiquid asset classes, as appropriate to the individual scheme (with the latter also necessarily requiring longer lead-in timeframes).



Case Study: Implementing sustainability in pension scheme portfolios

Once the Trustees have determined suitable sustainability objectives, the next step would be to incorporate these into the Scheme's overall investment strategy. We present below an example client portfolio transition for a lower risk (DB or LGPS) pension scheme (although equivalent considerations exist in the DC space). The case study demonstrates some of the existing sustainability transitions we are seeing amongst our clients, and additional best practice considerations for each of these to continue to push their investment managers forward.

LDI or index-linked gilts: including exposure to green gilts.

Could also consider:

- Engaging with governments and debt offices around earmarking of revenues for green projects

Real assets: targeting social infrastructure or nature-based solutions.

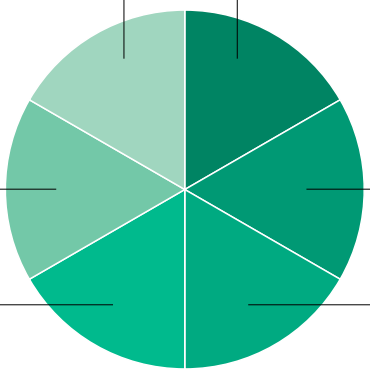
Could also consider:

- Integrating a biodiversity impact sleeve in forestry solutions
- Ensuring no significant harm, e.g. living wages on projects

Private markets: targeting low carbon value chains.

Could also consider:

- Allocations to assets seeking to provide resiliency to a physically changing climate
- Small sleeves dedicated to e.g. social infrastructure or biodiversity solutions



Passive equity: Paris Aligned Benchmark, aligning with a 1.5°C scenario.

Could also consider:

- Integrating biodiversity optimisation in index construction
- Reconstitution constraints, e.g. 30% female board representation by 2030

Buy & maintain credit: science-aligned climate targets, with sustainable bond allocations.

Could also consider:

- Social impact bond allocations, e.g. targeting SDG-aligned education or healthcare aims
- Ensuring no significant harm on e.g. biodiversity sensitive areas

Semi-liquid credit: science-based decarbonisation targets, with sustainable bond allocations.

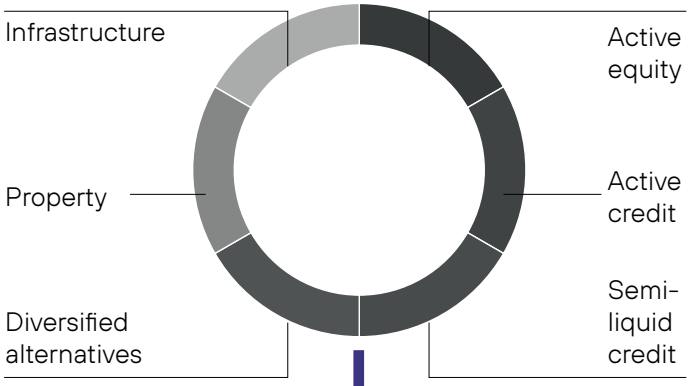
Could also consider:

- Social impact bond allocations, e.g. targeting education or healthcare provision
- Or, exposure to green building

There will of course be some interchangeability between the two case studies presented in this section, with some pension schemes with longer time horizons more willing to take on more active and riskier investments.

Private Capital

As compared with pension schemes, potentially longer-term timeframes are adopted by private capital investors (including ultra-high net worth individuals, charities, endowment and foundations). This permits a greater focus on growth opportunities and a potentially higher level of risk to be taken on by private capital investors. Whilst the opportunity set might not differ, in practice, the increased risk tolerance opens investors up to a swathe of sustainable investment opportunities that may exceed the risk appetite of other investors.



Case Study: Implementing sustainability in endowments and foundations

With the higher risk appetite of private capital investors, actively managed mandates may be more accessible, in being able to tolerate a higher level of concentration on sustainability solutions (with the e.g. sector biases that presents), and the associated volatility this entails. We present an example portfolio transition, below.

Infrastructure: fund with building blocks targeting sustainable and social infrastructure.

Could also consider:

- Ensuring no significant harm, e.g. greenfield developments are not in biodiversity-sensitive areas
- Exploring co-benefits, such as development of social spaces for local communities

Property: real estate fund aligned with national decarbonisation policy .

Could also consider:

- Includes some allocation to social housing
- Adopts a forward-looking approach, in adapting to physical risks from climate change

Active equity: Climate impact fund, focused on low carbon energy and transport companies.

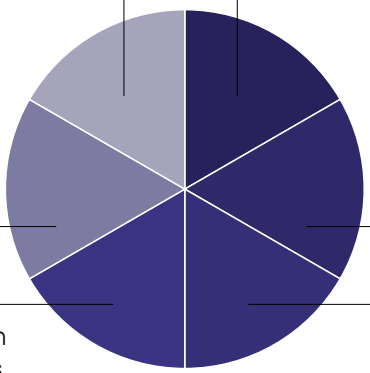
Could also consider:

- Integrating exposure to companies developing solutions to the nature crisis
- Engagements with companies on ensuring living wages, across their value chains

Active credit: Fund investing in sustainability, green and social use-of-proceed bonds.

Could also consider:

- Ensure verification by third parties, such as the Climate Bonds Initiative
- Introduce sustainability ratchets to improve sustainability outcomes over time



Diversified alternatives: diversified fund, with exposure to natural capital and carbon credits.

Could also consider:

- Include allocations to renewable energy
- Ensuring social co-benefits, e.g. local employment opportunities from natural capital projects

Semi-liquid credit: sustainable loan fund, targeting decarbonisation.

Could also consider:

- Social use-of-proceed bond allocations, e.g. targeting education or healthcare provision

Emerging themes

In the third paper in this series (due to be launched later this year), we will cover off best practice sustainability opportunities from the market. Above, we provide a high-level overview of a sample of the newer themes we have identified in the industry and have been working on with our clients, as part of the above case studies. We however note the range of innovative solutions continues to grow, at pace.

In this paper, we have focused on development of bespoke sustainability solutions, pushing managers further in their sustainability layering, using the waterfall framework. This will inevitably create considerations in terms of cost, which the industry will need to consider. The hope is that premiums for sustainability funds will however, on the whole, decline, as the world transitions to meet global sustainability challenges head-on.

Next steps

As we outline in the previous paper in this series, there is an urgent need for investor action towards a sustainable and inclusive future, and we need to bring all investors along the journey. This requires the development of solutions, across the active to passive investment spectrum.

In this paper, we have provided a framework for implementing a sustainable investment strategy. This focuses on a waterfall prioritisation process, to understand the priority social and environmental objectives for the individual investor. It also addresses the challenges that can arise, along the way. With a focus on high-level takeaways for investors, there is a need to drill down into individual portfolios to solve sustainability challenges alongside associated investment journeys and constraints. Without a doubt, however, adopting a bespoke approach, from the ground up will, in turn, result in cost implications.

In the following paper in this series, we focus on best practice in climate, nature and social solutions, looking at the cutting-edge solutions being provided by investment managers and index providers, continuing to redress the interlinkages (through assessing and redressing synergies and trade-offs, respectively).

Please contact your Isio consultant or our Sustainable Investment team (contact information overleaf) if you are interested in discussing this important topic further.

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This paper predates the recent FCA anti-greenwashing regulatory changes effective from 31st May 2024.