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Strategy review

SHELLY MEEROVITCH AND JENNIFER B GOODE PRESENT A GLOBAL ROADMAP FOR OFFSHORE TRUSTS AND ESG INVESTING

KEY POINTS

What is the issue?

Environmental, social and governance (ESG) strategies often give pause to the fiduciaries of offshore trusts (or their designees for investment decision-making purposes).

What does it mean for me?

With the right tools, an ESG-related investment strategy can be evaluated with an eye toward meeting fiduciary obligations and satisfying beneficiary demand.

What can I take away?

By thoughtfully analysing stated objectives and underlying processes, fiduciaries can gain greater comfort in engaging with ESG-related strategies.

Fiduciaries of offshore trusts are increasingly being asked to engage with investment strategies incorporating environmental, social and governance (ESG) considerations. However, these fiduciaries may struggle with little guidance from an outdated trust instrument and competing interests among multi-generational, multi-jurisdictional beneficiaries. These complexities may create uncertainty around engaging with an ESG-related strategy and trigger concerns about resulting liability.

This article outlines the tools necessary to evaluate an ESG-related investment strategy while striving to meet fiduciary obligations and satisfy beneficiary demand. There are two common types of active ESG-related strategies, namely:

- ESG integration, which integrates ESG considerations alongside traditional financial metrics to achieve greater risk-adjusted returns; and
- ESG-focused strategies, which are those incorporating ESG considerations into both their mandates and implementation to support financial and non-financial goals.

ESG INTEGRATION

ESG integration refers to a manager's use of material ESG considerations to better gauge future financial performance and enhance risk-adjusted returns. After identifying a material ESG issue, managers evaluate the way in which the company engages with the concern. For example, a failure to address the issue may highlight a future financial risk (e.g., a fine or lawsuit), while a proactive approach (e.g., the creation of industry-leading practices) may put the company at a financial advantage. Notably, ESG integration does not prohibit ownership of companies in any industry. The goal is not exclusion based on a non-financial motive but better informed financial decision making.

ESG integration's effectiveness depends heavily on the selection of material ESG issues. Managers differ in their approach, with some relying on third-party ESG ratings. Such rating agencies collect and weigh various data based on materiality to the company's core purpose. However, third-party ratings suffer from certain limitations, offering a static look at ESG-related attributes based on current conditions and the recent past.[1] Further, agencies frequently disagree on a given company's material ESG issues and rating. Fundamental research can address these concerns (and sometimes supplant the use of third-party ratings), allowing managers to project how the ESG consideration might evolve in the future (e.g., cutting-edge technology practices may prove less beneficial as they become industry standard). Additionally, a manager may use hands-on research to evaluate

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the financial materiality of attributes underlying a company's ESG score. For example, a manager may downgrade an ESG score based on a diversity and inclusion policy if the company fails to effectively implement it, thereby undermining recruitment and retention.

Fiduciaries, or those they delegate investment decisions to, who are evaluating an ESG integration strategy should focus on its methodology and historical financial performance. First, it is advised to examine how a manager quantifies ESG performance and whether it is indeed material to the company's long-term value. For example, if the manager relies on third-party ESG ratings, ask whether fundamental research is used to supplement them. Additionally, as ESG integration seeks a purely financial objective, success may be evaluated through comparison with the strategy's identified benchmark (e.g., the S&P 500).

ESG-FOCUSED STRATEGIES

Unlike ESG integration, ESG-focused strategies pursue both financial and ESG-related goals. Managers begin by selecting opportunities based on an ESG-related theme (e.g., industries impacted by one or more of the UN Sustainable Development Goals (SDGs)).[2] Managers can then use a combination of quantitative and qualitative analyses to select companies producing profitable products within each targeted industry. Within the narrowed opportunity set, fundamental research can help identify companies most likely to deliver the desired ESG-related impact without sacrificing return or increasing risk.

Notably, managers can implement ESG-related themes while limiting the impact on portfolio diversification and volatility. For instance, a strategy emphasising SDG-aligned investments may still cover a wide range of industries and countries. Additionally, limiting the investment universe through ESG-related screening may only modestly impact total return.[3] To illustrate, the authors built seven different portfolios, applying a different ESG-related exclusion to the S&P 500 in each case.[4] Tracking the portfolios over a ten-year period, six out of the seven were found to have performed within 0.2 per cent of the S&P 500, with three of those six outperforming and one matching it. Further, five of the seven portfolios produced annualised volatility equal to or less than the index. Although this does not mean exclusions ensure a better risk-adjusted return, the results demonstrate that an ESG-related exclusion alone does not necessarily dampen returns or heighten volatility.

Fiduciaries evaluating an ESG-focused strategy should first determine whether it is non-concessionary (i.e., whether it is designed to deliver financial performance comparable to its non-ESG peers while supporting an ESG-related objective). To do so, look to the strategy's historical performance compared to its selected benchmark and that of available alternatives. When selecting the latter for comparison, fiduciaries should consider the investment's role in the overall portfolio. For example, if a strategy assumes increased risk but offers greater return potential, it should be compared to non-ESG peers designed to fulfil the same overall objective and in the context of the portfolio's risk-mitigating investments.

> *'The more ill-defined a social or environmental goal, the harder it may be to measure a strategy's success'*

Fiduciaries should also evaluate an ESG-focused strategy's impact on diversification and time horizon. Historically, ESG-focused strategies have a higher likelihood of tilting toward certain factors and sectors (e.g., growth and technology, respectively) and fiduciaries should consider how any such tilt interacts with the rest of the portfolio and the beneficiaries' needs. They should also consider whether the ESG considerations are likely to unfold slowly as the market awakens over time to emerging failures or inefficiencies in a sector or industry, thereby extending the investment's time horizon.[5]

To evaluate an ESG-focused strategy's non-financial performance, fiduciaries, or those who invest on their behalf, must first determine the strategy's desired impact and a benchmark by which to assess progress. The more ill-defined a social or environmental goal, the harder it may be to measure a strategy's success. For this reason, fiduciaries should seek out ESG-focused strategies that provide clear and measurable non-financial objectives and consistent progress reports.

BENEFICIARY INVOLVEMENT

Fiduciaries of offshore trusts may struggle with certain liability concerns due to the trusts' long duration and varied beneficiary interests. As such, an offshore fiduciary may derive special protection from beneficiary involvement in the trusts' investment strategy. For instance, a fiduciary may seek prior written approval, under which the beneficiaries agree to release the fiduciary from liability for, and/or ratify, an investment. Alternatively, the trustee could seek beneficiary approval after the fact, while presenting a history of positive performance for the beneficiaries' consideration. In each case, the fiduciary must account for hard-to-reach or unborn beneficiaries and make use of any representation provisions available under applicable law. For example, most US states permit some form of virtual representation, whether via a parent representing the interests of minor or unborn children or one member representing the remaining beneficiaries from a class with identical interests.

Fiduciaries may also seek ongoing involvement to ensure that investment decisions match the beneficiaries' expectations and needs. For instance, a fiduciary may organise an annual meeting with the beneficiaries. Additionally, a fiduciary may facilitate the development of an investment policy statement to address:

- the impact of the trust's time horizon and distribution requirements;
- the beneficiaries' risk tolerance;
- desired monitoring and reporting requirements;
- guidelines regarding diversification and concentrated positions;
- rebalancing requirements; and
- the role of ESG-related strategies in the trust's overall portfolio.

Fiduciaries of offshore trusts need not always avoid ESG-related investment strategies for fear of liability. Rather, such fiduciaries should engage with ESG-related strategies in the same way as a non-ESG approach: by thoughtfully analysing the stated objectives and underlying processes. ESG-related investing is an evolving tool that reflects the interconnectedness of the world in which we live: an especially relevant concept for today's offshore fiduciary.

#BUSINESS PRACTICE #INVESTMENT #TRUSTS

1 Simon Glossner, 'Repeat Offenders: ESG Incident Recidivism and Investor Underreaction,' 1, 3 (11 October 2021), bit.ly/401Nsdk **2** The Sustainable Development Goals are a 17-point blueprint to achieve a more sustainable future by 2030. See sdgs.un.org/goals **3** A portfolio manager may further reduce any potential impact from an ESG-related exclusion, whether positive or negative, by employing a materiality threshold. If one was to apply to the example of a 5 per cent revenue threshold to the non-energy exclusions and focus the energy exclusion on the highest emitters in the potential investment pool, the resulting portfolio would exclude only 11 per cent of the S&P 500, rather than 33 per cent. **4** Source: Bloomberg, MSCI and AB. Exclusions remove companies with revenue exposure to one or more of the seven areas noted (tobacco, alcohol, gambling, weapons, nuclear, adult entertainment and energy) from the S&P 500 index. Returns and risks are calculated from 1 January 2012 to 31 December 2021. **5** L. Lee, G. Giese, Z. Nagy, 'Is ESG All About the "G"? That Depends on Your Time Horizon' (15 June 2020), bit.ly/3KQMIDB