Should financial advisors consider ESG factors when advising their clients?

By Jessica Blumenthal and Talia Cullinan

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South Africa has a large advisory and financial-planning industry serving the retail public, but is this industry evolving quickly enough to provide advice cognisant of emerging risks?

Source: Pexels

Will advice ignore the effects on investment portfolios of climate change, biodiversity loss and water scarcity, among other Environment, Social and Governance (ESG) factors? Or will financial advisors and planners become the missing link between sustainable finance products and customers?

With all the noise around ESG investing it can be difficult for customers and their advisors to distil what is relevant. Certainly, ESG investing has become mainstream, being discussed around boardrooms and dining-room tables.

There are a growing number of investors wanting to align their investments with their values by investing in companies that prioritise ESG factors and outcomes, and arguably all investors are increasingly becoming aware that to ensure long-term financial value they need to invest in companies pursuing a sustainable strategy and managing ESG-related risk ensuring resilience.

This change in investor sentiment has led to the development of investment products labelled by product houses as “green” or “sustainable”, designed to soak up this increasing demand.

Unfortunately, not all of these labels accurately reflect the real world impact of the packaged portfolios, leading to distrust and accusations of greenwashing. Unhelpfully, the ESG discussion in the United States has become politically charged, suggesting that savers’ and investors’ funds should be invested with no other objective than targeting financial returns.

Complicating factors such as lack of data available in respect of portfolio companies, inconsistent disclosure and reporting, multiple divergent frameworks categorising projects and portfolio companies, and philosophical difficulties in addressing transition in certain sectors, make it almost impossible for a retail investor, or even institutional investors like pension funds, to know how best to invest to ensure the long-term sustainability of their investments and to align their money with their values.

Pension funds as a socially responsible investment

From as early as 2011, Regulation 28 of the Pension’s Fund Act, 1956 has required pension funds to adopt socially responsible investment approaches that promote and give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors falling under the ESG umbrella.

This regulation recognises that ESG matters may impact the long-term performance of an asset and should be explicitly considered in a due diligence assessment because a failure to do so could mean under or over-estimating the expected returns to be generated by the asset.

This reflects an acknowledgement by South African authorities that to meet at least the first aim of an investor requires consideration of ESG factors. But notwithstanding that, pension-fund trustees have been required to act in accordance with this duty for more than a decade, uncertainty
remains and we continue to see pension funds investing in assets with dubious sustainability strategies (with potential risk to long-term return) to realise a short-term gain.

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Asset consultants and asset managers are not routinely mandated by pension-fund clients to weigh ESG factors pertaining to a portfolio company equally against the expected financial returns posed by the investment. This means that even though service providers may consider ESG metrics when evaluating an investment, they remain incentivised by short-term financial return and in some instances prohibited from disinvesting from an asset providing a short-term financial gain, but scoring badly against ESG metrics.

Against this backdrop, imagine then the position of a retail customer either wanting their discretionary investments or pension fund to align capital with positive sustainable impact or even if indifferent to impact, wanting their investment to deliver sustainable long-term performance. Should an advisor to such a customer be required to talk about ESG and sustainability when advising them?

South African law and incorporation of this duty

South African law does not currently impose this specific duty on financial-services providers (FSPs) and their representatives in so many words, but arguably existing obligations could incorporate this duty.

Board Notice 80 of 2003 (General Code of Conduct for Authorised FSPs and representatives) published under the

Financial Advisory and Intermediary Services Act, 2002, imposes a duty on financial services providers to render services in accordance with reasonable requests or client instructions, with due regard to the interests of clients which must be accorded appropriately over any interests of the FSP and to provide a client with "appropriate" advice concerning the client's needs and objectives.

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The latest draft of the Conduct of Financial Institutions Bill, 2020 confirms this principle by requiring advice to be given in respect of appropriate financial products and services to targeted financial customers and requiring financial institutions to monitor and review the suitability of their financial products and services on an ongoing basis.

As such, where a client's interests, needs, objectives and instructions require that their capital be invested either to achieve long-term sustainable growth or align with their values a FSP would have a duty to take ESG factors into account when advising their clients. This is in line with the laws of other jurisdictions, which impose similar duties on their financial services firms.

In the UK, guidance on the Consumer Duty issued in 2022 requires firms to consider the diverse needs of customers and ensure that financial products and services are suitable to meet such needs and in the European Union, MiFID II, the legislative framework instituted by the European Union to regulate financial markets and improve investor protections, has recently been amended to incorporate sustainability and impose an obligation on firms to assess the suitability and appropriateness of investment products and services which are provided to clients.

ABOUT THE AUTHOR

Jessica Blumenthal is the executive of banking and finance at ENSafrica, while Talia Cullinan is an associate in banking and finance at the firm.