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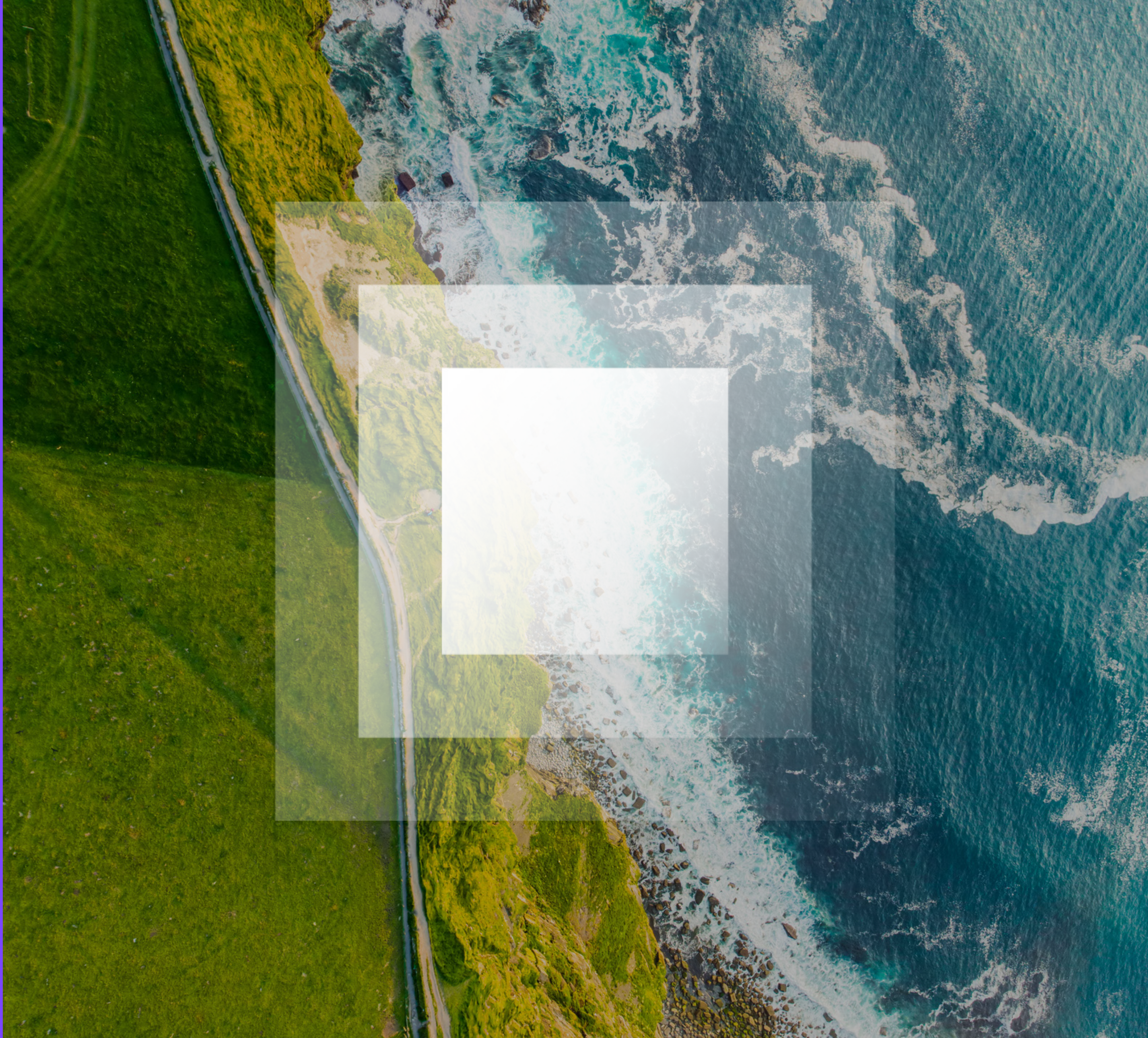

How to Build a Better ESG Fund Classification System

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EXECUTIVE SUMMARY

The term "ESG," an acronym of the phrase "environmental, social, and governance," began appearing in fund names as early as 2010. By 2019, hundreds of "ESG funds" had been created. It remains unclear, however, exactly how ESG funds are distinct from other groups of funds. Despite efforts to define and clarify the meaning, the ambiguity of ESG funds stubbornly endures.

This paper explores the meaning of ESG funds through the lens of fund classification, which involves sorting funds into groups defined by boundaries. The funds of interest in this paper include those funds that take ESG information, issues, and/or conditions into account—in any way, for any purpose, and to any extent. The focus is on defining groups and boundaries rather than debating which words should be used to refer to those groups. In fact, we use generic references such as "Feature 1" and "Group A" to avoid the traps of terminology. Decisions about a group's boundaries and decisions about a group's name can be separated; the scope of this paper is the former.

Numerous ESG fund classification frameworks have been created by asset managers, industry associations, and regulators—some intentionally, some unintentionally. In this paper, we analyze regulatory frameworks proposed or enacted in the European Union, United States, and United Kingdom, as well as the collection of "ESG approaches" that often form the basis for industry–practitioner frameworks. We conclude that all of these frameworks are largely inadequate for making categorical determinations in practice because they are not based on observable features, are not rigorously defined, and/or do not contain the logic necessary for sorting funds into mutually exclusive groups that are useful in the marketplace.

To help remedy these deficiencies, this paper rigorously defines three observable fund features that can serve as a common and robust foundation for ESG fund classification systems:

- **Feature 1:** The existence of one or more processes that consider ESG information with the aim of improving risk-adjusted returns.
- **Feature 2:** The existence of one or more policies that control fund investors' exposure and contribution to specific systemic ESG issues.
- **Feature 3:** The existence of an explicit statement of intent, and an action plan, to help bring about a target future state in environmental and/or social conditions and a process to measure progress.

We show how these features can be used to create a variety of mutually exclusive groups, including two important groups of funds that are conceptually at opposite ends of a spectrum. The first group consists of funds that have only Feature 1. These funds use ESG information solely to inform decision making in a manner consistent with the belief that careful analysis of all material information can contribute to higher risk-adjusted returns—at least when

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compared with a less informed analysis. Such funds are currently unpopular in some regions but remain popular in others.

The second group consists of funds that have Feature 3, irrespective of whether they have Features 1 and 2. We recognize that in practice, funds that have Feature 3 are very likely to have the other two as well. Funds that have Feature 3 are highly specific about the environmental and/or social outcomes they intend to help bring about, have plans for achieving those outcomes, and measure their progress. Such funds exist but are not prevalent, based on our limited research. Still, it is important to recognize this group because these funds promise to help bring about some *specific* environmental and/or social outcome. This promise differs substantially from a typical funds' promise to seek a target risk–return profile, invest in assets that meet specified criteria, or construct and manage a portfolio with target aggregate characteristics.

Excluding these two groups leaves a final group of funds that have policies that control fund investors' exposure to, and simultaneously their contribution to, systemic ESG issues (i.e., funds with Feature 2). ESG issues are important and often unsettled matters related to the environment, society, and the governance of investees. Systemic ESG issues are those that are inherent in the real economy and the real-world contexts in which investees operate. Systemic issues are not idiosyncratic, affecting only a single company or asset, but rather affect a swath of companies or assets. Investees are affected by systemic ESG issues, and systemic ESG issues may be influenced by investees' actions. Through their investments, investors enable investee activities, and as a result of their investments, investors are financially exposed to those systemic ESG issues that affect investees.

We recognize that this final group of funds is quite heterogeneous, but we can trace the variation to a single source: policies. Like DNA, policies are both the blueprint for an individual entity and the mechanism that gives rise to distinct groups. This powerful insight puts the focus of classification decisions on policies (a key driver of differentiation) instead of on the rationale for those policies (which are largely unobservable) or the processes by which those policies are implemented (which require a certain level of technical expertise to understand). We suspect there is a need in the marketplace to further subdivide this group of funds, and we may undertake that work in a subsequent paper.

Unlike many previous efforts that present only conceptual frameworks or short definitions for distinguishing between different types of funds, we examine the challenges that arise in practice when evaluating funds against categorical criteria. We offer guidelines, examples, and case studies to help overcome those challenges.

Fund classification is more complex and more difficult than it appears to be. Efforts to "make it simple" are well intentioned but have not resulted in a system that works well in practice. Often it is necessary to work through complexities before arriving at an elegant solution. The technicality and detail in this paper

will not appeal to all readers, but this level of rigor is needed to design and implement more effective ESG fund classification systems.

We do not see this paper as the end of the process to improve ESG fund classification; rather, we see it as the beginning. We outline our ideas for next steps in the conclusion. We hope this paper spurs additional ideas, and we look forward to engaging with others who are interested in advancing knowledge and practice on this topic.

CONTENTS

Introduction 1

1. The Problem with “ESG Funds” 3

2. Product Classification Basics 7

3. Design Objectives for an “ESG Fund” Classification System 11

4. Analysis of Relevant Classification Systems 14

5. Classification System Design: Feature Specification 23

6. Classification System Design: Group Specification 31

7. Classification System Design: Evaluation and Comparison 36

8. Implementation: Determining the Existence of Features (Guidelines and Examples) 43

Conclusions and Next Steps 65

References 69

Appendix A: Case Studies 70

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INTRODUCTION

The phrase "environmental, social, and governance," made into the acronym "ESG," first appeared in a 2004 publication titled "Who Cares Wins," a joint initiative undertaken by 20 financial institutions at the invitation of the United Nations. The report argues that the integration of environmental, social, and governance issues into investment analysis could result in better long-term returns for investors and produce a positive externality for society: "Companies that perform better with regard to these [ESG] issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate" (United Nations 2004, p. i).

The term ESG fuses concepts that are typically juxtaposed. It is no wonder, then, that it often results in confusion and debate. Nowhere is the confusion greater than where ESG is used in the name of a fund or as a categorical description for certain types of funds. The term began appearing in fund names and indexes as early as 2010, and by 2019, hundreds of ESG funds had been created. It remains unclear, however, what exactly an ESG fund is, despite efforts to define and clarify the meaning.

This paper delves into the challenges of defining a distinct class of ESG funds as well as the challenges of categorically distinguishing among different kinds of ESG funds. We look at the problem through the lens of product classification system design, which allows us to understand and analyze existing classification systems and design a novel classification system based on three value propositions for taking into account ESG information, issues, and/or conditions.

Our exploration into fund classification is intended for several audiences. First, it is for investors who want to select funds that take ESG information, issues, and/or conditions into account, as well as advisers, consultants, and product databases and platforms that support fund selection. At the same time, this work can be useful for investors who wish to avoid such funds. Second, we believe our work will be of great interest to regulators who want to establish and tailor regulatory rules for ESG funds or different types of ESG funds. Third, it may be helpful to researchers who need to separate funds into groups to explore differences in performance and other characteristics. And finally, this paper may be of interest to people who simply want to better understand the landscape of funds that may be referred to as ESG funds.

This paper moves sequentially through the process of classification system design, and it is broken into chapters so that readers can skip to the material that interests them most. In **Chapter 1**, we explore different ways that people understand the ESG funds category and establish that we are interested in classifying all funds that take ESG information, issues, and/or conditions into account—in any way, for any purpose, and to any extent. In **Chapter 2**, we introduce basic classification terminology and concepts and give an overview

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of the classification system design process. In **Chapter 3**, we set out design objectives for the sort of ESG fund classification system that we believe would be useful for investors, regulators, and researchers. In **Chapter 4**, we analyze ESG fund classification systems that have arisen out of regulation and that have been proposed by market participants. We assess the extent to which they align with our design objectives, concluding that none fully satisfies our needs. In **Chapters 5 and 6**, we design a classification system that meets our design objectives, and in **Chapter 7**, we show that our system has many similarities with existing classification systems but is more rigorous in its design and more integrated and flexible with respect to the needs of different user groups. In **Chapter 8**, we turn from design to implementation, focusing mainly on how to make determinations about the features that a given fund may have. We then present our **Conclusions and Next Steps**. We end with **Appendix A**, which contains case studies showing the application of our classification system to three funds currently offered in the marketplace.

1. THE PROBLEM WITH “ESG FUNDS”

Globally, asset management has a vexing problem: widespread use of the phrase “ESG funds” with little agreement about what that term means, resulting in significant confusion and miscommunication. At the core of the problem is a conundrum: What makes a fund an ESG fund? Based on our experience, people seem to interpret the term in one of three ways.

1.1. A Fund That Predominantly Makes ESG Investments

People who perceive ESG funds as funds that predominantly make ESG investments see the modifier “ESG” as an indicator of portfolio composition. In this line of thinking, ESG is analogous to other modifiers that signal the predominant type of investment in a fund’s portfolio. For example, the term “equity funds” is well understood in the investment industry to mean funds that predominantly make equity investments. In many cases, however, such modifiers do not refer to the predominant type of investment in a fund’s portfolio. For example, the term “hedge funds” does not refer to funds that predominantly make “hedge investments.” The word hedge in this case refers to various investment strategies. Thus, the interpretation of ESG funds as funds that predominantly make ESG investments has a logical basis, but it is certainly not the only way to interpret the term.

Assuming for the moment that ESG funds are funds that predominantly make ESG investments, we run into another definitional question: What makes an investment an ESG investment? Many investment professionals say that there is no such thing as an ESG investment because ESG is not an asset class. At best, we might be able to say that an ESG investment is one selected for its ESG characteristics. This is analogous to saying that a growth stock is a stock selected for its growth characteristics. In neither case, however, can we precisely identify those characteristics because opinions vary widely.

Incorporating the notion of an ESG investment, we might now say that an ESG fund is a fund that predominantly selects investments for their ESG characteristics. Or, we could say that an ESG fund has an “ESG focus” in asset selection, portfolio construction, or both.

This line of thinking may be sufficient to gain a conceptual understanding of an ESG fund, but it is insufficient for practical applications where there is a need to reliably identify an ESG fund—such as in the context of fund classification and selection, academic research, and regulation. Defining an ESG fund as one that “has an ESG focus” or that “predominantly selects investments for their ESG characteristics” leaves too much open to interpretation. The ambiguity in the definition makes it likely that different people will come to different conclusions when trying to determine if a particular fund is an ESG fund. In short, the problem is fuzzy boundaries.

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1.2. A Fund That Is Good for the Environment and Society

People who perceive ESG funds as funds that are good for the environment or society see the modifier "ESG" as an indicator of environmental or social merit. In this case, environmental or social merit is a measure of utility that is independent from risk and return (note that independent does not necessarily mean uncorrelated). When someone expresses shock or outrage that an ESG fund is invested in a certain company or industry that they find objectionable, it is likely that person understands ESG funds as a special term that should be used only to refer to funds that are good for the environment and society.

Once again, we run into another definitional question: What is "good" for the environment and society? Naturally, opinions vary. Sometimes, they are even diametrically opposed. For example, some people believe that a higher minimum wage is good for society, while others believe a lower minimum wage is good for society. But views of "goodness" are often nuanced. When people say something is "good" for the environment and society, they often mean that it is good *overall* (i.e., the benefits outweigh the drawbacks) for *most* stakeholders. Individuals that are negatively affected by an issue often do not embrace the utilitarian view that the best course of action is the one that maximizes benefits for the maximum number of people. Many funds that are marketed as ESG funds have utilitarian views on ESG issues so that the fund appeals to the maximum number of investors. When many funds in a market take this approach, it can appear to some people that fund managers have a political agenda. The view that an ESG fund is "good" for the environment and society, combined with the commercial rationale to align fund ESG characteristics with majority viewpoints, has inadvertently turned ESG into a politically divisive issue in some markets.

Assuming for the moment there is consensus as to what is "good" for the environment and society—and in some markets, such consensus does seem to exist—the next challenge is how to determine whether, or to what extent, a particular fund meets the standard of "goodness." Typically, this determination occurs through the establishment of measures and specifications. But just as there are many views about what is "good," there are many views regarding the technical details of measurements and specifications. When there are many divergent views about criteria, we usually see either (1) the emergence of multiple standards or (2) no emergence of standards. Emergence of a single standard is the rarest outcome, because it is very difficult to achieve consensus when there are many divergent views.

In summary, the normative view of ESG funds is problematic because of the practical difficulties of gaining consensus about what is "good" and how to evaluate the "goodness" of a fund, as well as the risk that the standard-setting process and ESG funds themselves become embroiled in politics. In short, the problem is differing views of morality.

1.3. A Fund That Takes ESG Information, Issues, and/or Conditions into Account

People who perceive ESG funds as funds that take ESG information, issues, and/or conditions into account interpret the modifier ESG as an indicator of functionality. In this line of thinking, there are no expectations about the composition or character of an ESG fund's portfolio and no normative judgments about its environmental or social merit. This view does not preclude the former two views of ESG funds, however. On the contrary, it encompasses them as well as other sorts of funds. For example, this view of ESG funds includes funds that use ESG information to reduce risk and/or enhance return, funds that are not deemed "good" for the environment or society at the moment but are seeking to improve environmental or social conditions in the future, and funds that define "good" to be something different from the majority view.

Once again, we need to probe deeper. First, what are ESG information, issues, and conditions? Modifiers placed in front of these words mean "related to." For example, a "health issue" is an issue related to health. ESG stands for environmental, social, and governance, so ESG information, issues, and conditions are "information, issues, and conditions related to environmental, social, and governance." Information, issues, and conditions need no further explanation because they carry their commonly understood meanings. Environmental and social also need no explanation. Governance can cause some confusion, however, so we will briefly explain what we mean.

Governance simply refers to the process of making decisions and overseeing an organization. For equities and corporate bonds, we can say more specifically that governance is corporate governance. For sovereign and municipal bonds, governance refers to the decision-making and oversight structure of a government. A decision-making structure is different from the individual decisions made through that structure. A decision-making structure is also different than government policy, which articulates the general goals sought by a government and the sorts of actions that will be taken to achieve them.

Second, what does it mean "to take something into account"? This idiomatic phrase means to consider, to contemplate, or to give weight to when deciding on a course of action. ESG information, issues, and conditions might be taken into account when setting a fund's objectives or policies. If so, we would expect to see a pattern in the fund's decisions and actions related to ESG information, issues, and conditions. ESG information, issues, and conditions might also be taken into account on a case-by-case basis. If so, there may be no patterns in a fund's decisions and actions that indicate the consideration of ESG information, issues, and conditions, but there might be evidence in policies, process documentation, and internal records that such factors are considered on a regular basis.

This third view of ESG funds improves on the first two views in several ways. First, it does not suffer from the "fuzzy boundaries problem" or the "morality definition problem." Second, it inherently points to a way to determine whether a particular fund is an ESG fund. Third, it is useful for practical applications—in particular, it is a very good working definition for the development of disclosure requirements. Although neither the Sustainable Finance Disclosure Regulation in the EU nor the Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices rule proposed in the United States defines ESG funds, they both apply to the broad range of funds that take ESG information, issues, and/or conditions into account. In addition, the CFA Institute Global ESG Disclosure Standards for Investment Products were built on the principle that if a fund considers ESG information, issues, and conditions—in any way, for any purpose, and to any degree—then certain essential information about how that is done should be provided to investors.

The problem with this functional view of ESG funds is large in-category variation—that is, there is so much variation that the category is not useful for identifying particular kinds of ESG funds.

This paper seeks to solve this problem by defining subclasses within the broad universe of funds that take ESG information, issues, and/or conditions into account. To avoid confusion and the presumption that all funds that take ESG information, issues, and/or conditions into account are in fact ESG funds and should be referred to as such, we will simply refer to funds that take ESG information, issues, and/or conditions into account as our classification universe. Many funds lie outside our classification universe. We have no bias against such funds; they are simply outside the scope of this study.

2. PRODUCT CLASSIFICATION BASICS

In this chapter, we define several key terms and concepts that are vital for understanding the technicalities of classification. We also briefly describe the process for designing a classification system.

2.1. Terminology

- A *product* is an item that is designed, produced, and sold by a manufacturer and then purchased and used by a consumer. For the purposes of classification, it is useful to think of a product as a collection of features. In the context of investment funds, an investment fund is a product that is designed, produced, and sold by a fund sponsor and then purchased by fund investors. Some jurisdictions may use different terminology, but we can nonetheless map all such terminology to our conceptual framework of manufacturer, product, and consumer.
- A *feature* is a distinctive functionality or characteristic that a manufacturer has designed into a product with the intent to provide value to consumers. A feature could be, for example, a screen that excludes certain types of assets, a policy for a minimum percentage of the fund's portfolio to be invested in certain types of assets, or a policy to engage portfolio companies on a specific topic.
- A product's *value proposition* is the overall value profile produced by the product's features. The value proposition defines what a consumer can reasonably expect the product to deliver. Investment professionals are familiar with the term "risk–return profile." A fund's risk–return profile is useful for setting expectations with respect to the level and variability of returns. The concept of "overall value profile" builds on the concept of "risk–return profile" by allowing for additional dimensions of value that fund investors may derive from funds' features.
- *Classification* refers to the activities involved in designing a system of groups having defined boundaries and relationships, as well as the process of assigning entities to those groups. Categorizing, sorting, and grouping are conceptually close to classification in that they refer to grouping entities based on similar characteristics. The definitions of these other terms, however, often do not contain the systematic element that is included in highly technical definitions of classification.
- A *classification system* is a particular set of groups and a particular method for assigning entities to groups.
- A *group* is a collection of entities that are similar in one or more ways. We use "group" instead of "class" because "class" can sometimes imply a hierarchical or ordinal relationship. For example, "Class A products" might be inferred to mean the "best" products, whereas "Group A products" poses less risk of misinterpretation.

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- *Specification* refers to a precise set of requirements or the establishment thereof.
- *Labeling* refers to words, marks, symbols, or information that appears on a product. Product labels may include classification information, such as "grade A large eggs."

2.2. Designing a Product Classification System

The first step in product classification system design is to understand the need for classification: Why do products need to be assigned to groups, and how will those assignments be used? For example, regulators may want to classify products to facilitate rulemaking, whereas manufacturers may want to classify products to facilitate marketing and sales. Different classification needs are likely to produce different classification systems, and a classification system designed for one set of needs often does not work well for another. There is no "one size fits all" or "universally best" classification system.

The second step in product classification system design is to establish design parameters for the system. Classification needs and characteristics of the classification universe may influence the acceptable minimum or maximum number of groups, the absolute number of products in a group, the distribution of products among groups, and the relationship between groups. This final consideration warrants additional discussion.

Four important relationships must be considered when designing a system of groups: hierarchy, exclusivity, completeness, and ordinality. A hierarchical relationship exists when a group is a subgroup of another group. This may also be referred to as a parent–child relationship. Hierarchical relationships are useful when multiple levels of granularity are needed or for smaller or more-balanced groups. They can be problematic when different branches of a hierarchical tree have a different number of levels. Exclusivity exists when an entity can be assigned to only one group in each hierarchical level. Exclusivity does not prevent an entity from being part of a parent group and child group. Completeness exists when every entity is assigned to at least one group in every hierarchical level; the assignment process would never end with an entity not being assigned to a group. Ordinality exists when there is an ordered relationship among groups at a given hierarchical level (e.g., good, better, best).

The third step in product classification system design is to specify criteria for the assignment of entities to groups. Criteria serve to define boundaries among groups. Criteria are constructed by combining:

- conditional and logical operators (if/then, and, or, not, etc.),
- characteristics of the products to be evaluated (typically product features, product performance dimensions, and product uses),

- comparators (equal to, greater than, has/has not, is/is not, etc.),
- one or more conditions that the characteristics may or may not satisfy, and
- group assignments, or other actions to be taken, for when conditional logical statements are true or false.

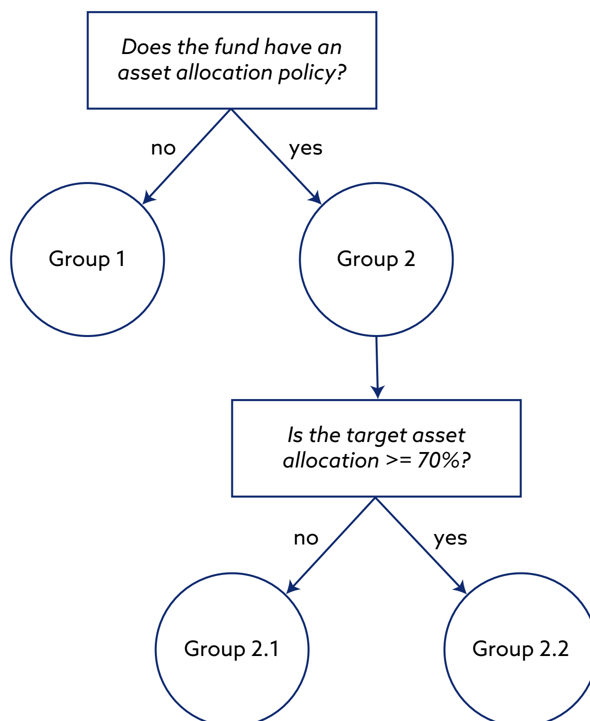
Characteristics can be discrete (e.g., a car either has or does not have a sunroof, a car's steering wheel is on either the left or right side) or continuous (e.g., a car's fuel efficiency or acceleration). When a characteristic is continuous, the classification system designer must select cutoff points (i.e., thresholds). Data and judgment can inform cutoff point selection, but these decisions will always be arbitrary to some degree. For this reason, it is sometimes difficult to reach consensus on cutoff points. Regardless of where they are placed on a continuous scale, cutoff points can result in a categorical distinction when there is a relatively small difference in the continuous measure, as well as no categorical distinction when there is a relatively large difference in the continuous measure.

Sometimes, a characteristic can be both discrete and continuous—that is, products within the classification universe may or may not have the feature, but if a product does have the feature, then a continuous measure is associated with it. An example of this is fund allocation policies: Not all funds have a policy to allocate a certain portion of the portfolio to a specified type of asset, but those that do have a minimum allocation target somewhere in the range of 1%–100%. This can be a tricky scenario for fund classification system designers. If funds that have no minimum allocation target are set to a default value of 0% and a cutoff point of 80% is selected, then funds that have no allocation policy are assigned to the same group as funds that have asset allocation policies of <70%.

A 70% allocation cutoff works well for distinguishing between funds having high allocation targets and those having low or no allocation targets, but it does not work well for distinguishing between funds having an allocation target and those having none. Both distinctions could be made if a second cutoff point were added just above zero, assuming funds with no allocation policy are assigned a default value of 0%. It is not always easy, however, to assign a default value. A more general and robust approach is to design a hierarchy where the parent-level criterion evaluates the existence of an allocation policy (a discrete characteristic) and the child-level criterion for the group that has allocation policies evaluates the allocation percentage (a continuous characteristic). **Exhibit 1** presents this dynamic graphically.

The fourth step in product classification system design is to test the criteria and make adjustments as needed. If criteria cannot be constructed to meet the target group parameters or the classification needs, the earlier steps may need to be revisited as well.

Exhibit 1. Illustration of a Hierarchical Classification System for Allocation Policies



The fifth and final step in product classification system design is to name the groups. Group names often reflect the criteria or, equivalently, the characteristics of the entities within the groups. However, a descriptive group name is not strictly necessary. In some cases, non-descriptive or generic names or indicators—such as "A, B, C" or "1, 2, 3"—may be more appropriate.

3. DESIGN OBJECTIVES FOR AN "ESG FUND" CLASSIFICATION SYSTEM

In this chapter, we follow the classification system design process described in the previous chapter, identifying choices along the way and giving our rationale for our design decisions.

The first step in product classification system design is to understand the need for classification. Thus, we start with an exploration of why people may want to distinguish between funds that take ESG information, issues, and/or conditions into account and those that do not. We also explore why people may want to make distinctions among funds that take ESG information, issues, and/or conditions into account in different ways or for different reasons.

Fund classifications can help investors select funds that match their needs and preferences. In the context of fund selection, *needs* correspond to "must have" fund characteristics, and *preferences* correspond to "nice to have" fund characteristics. All investors have risk–return-related needs and preferences, but some also invest with consideration to their *moral* needs and preferences. We use the term *moral* to encompass (1) the consideration of standards of conduct (aka "norms") and (2) the consideration of the impacts of one's actions on others. Conversely, because of fiduciary duty laws in some regions, some investors need to avoid funds that would even give the appearance that moral considerations enter their investment decision-making process.

It is thus helpful for all investors to be able to distinguish between funds with features that may satisfy moral needs and preferences from funds that have no such features. Because funds in our classification universe may meet investors' risk–return-related needs and preferences *and* their moral needs and preferences, this distinction requires more than just separating funds that take ESG information, issues, and/or conditions into account from those that do not. And for investors who invest based on moral needs and preferences, it is helpful to be able to distinguish among funds with different types of moral value propositions. Tailoring our definition of value proposition from the previous chapter, a fund's moral value proposition is the overall moral value profile produced by the product's features. A fund's moral value proposition defines what a consumer can reasonably expect the product to deliver with respect to the moral considerations described earlier.

Fund classifications can help legislators and regulators create and enforce rules. It is clear from rulemaking activities during the past five years that many regulators want to tailor disclosure and naming rules for funds that take ESG information, issues, and/or conditions into account, sometimes distinguishing among different types of funds in this universe. In most cases, regulators have not intentionally or formally designed a fund classification system but rather have constructed definitions and written requirements in such a way as to allow a de facto classification system to emerge. In addition to rulemaking,

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some regulators and legislators desire fund classifications that indicate the extent to which funds contribute to, or align with, their policy objectives.

Fund classifications also can improve the quality and usefulness of academic and industry research. There are thousands of studies investigating the financial performance of funds that take ESG information, issues, and/or conditions into account, but they do not consistently distinguish among the different types of these funds. Thus, it is difficult to draw conclusions from this large body of research.

We aim to design a classification system that is useful for the needs of investors, regulators, and researchers and that can be used for all types of funds. For the scope of this paper, however, we limit our focus to funds that invest in securities, contracts, and real assets—excluding funds that invest in other funds (i.e., funds-of-funds.) In addition, we focus only on funds that are offered "as-is," as opposed to funds with features that can be customized by clients.

We now move to the second step in product classification system design: creating group parameters. We aim to create a classification system with the following characteristics:

- Mutually exclusive, completely exhaustive groups. In other words, each fund will be in one group, and only one group, at each hierarchical level.
- No more than seven groups at any hierarchical level.
- No minimum or maximum number of funds within a group, and no target distribution of funds among groups.
- No subjective ordinality. In other words, we will not impose subjective bias to produce groups that are ordinal on any scale, such as quality or sustainability. Any ordinality that emerges will reflect an inherent pattern across funds.

The third step in product classification system design is to specify criteria for the assignment of entities to groups. We will tackle the development of criteria in later chapters, but at this point, we set out two principles that we will follow.

- We will classify funds solely on their features. Recall that we defined a feature to be a distinctive functionality or characteristic that a manufacturer has designed into a product with the intent to provide value to consumers.
- We will assume that funds perform as intended. Our objective is to distinguish between funds as they are designed to function. We are *not* aiming to assess how well funds perform with respect to their intended value proposition or how well they satisfy investors' needs and preferences.

The fourth step in product classification system design is to test the criteria. In Appendix A, we classify several funds currently offered in the marketplace using the features and groups we define in later chapters.

The last step of product classification system design is to choose group names. We choose to use generic names for groups rather than descriptive names. We do so to avoid unconscious bias. When descriptive names are used during classification system design, it is impossible to avoid preconceived associations that risk introducing bias and subjectivity into the design process. We also want to avoid, as much as possible, further adding to confusion around ESG terminology. Finally, generic names could serve as a "universal translator" if people ultimately want to use particular descriptive names for groups but different markets want to use different descriptive names for the same group.

4. ANALYSIS OF RELEVANT CLASSIFICATION SYSTEMS

In this chapter, we analyze existing classifications systems to determine whether any meet the design objectives that we set forth in the previous chapter, and more broadly, to understand their relative strengths and weaknesses.

4.1. Sustainable Finance Disclosure Regulation (EU)

The European Parliament and the Council of the European Union approved the Sustainable Finance Disclosure Regulation (SFDR) in November 2019. The purpose of the regulation is to provide sustainability-related information to the marketplace (see European Parliament and the Council 2019). EU legislators and regulators have stated that they did not intend SFDR to be a fund classification system, but the definitions and requirements were constructed in such a way that they enabled a de facto classification system to emerge within the marketplace.

Soon after the issuance of SFDR, people began categorically referring to funds as Article 6 Funds, Article 8 Funds, and Article 9 Funds. Some people referred to Article 6 Funds as non-sustainable and to Article 8 Funds and Article 9 Funds as "light green" and "dark green," respectively. To understand these groups, we must examine SFDR Articles 6–9.

Articles 6, 7, 8, and 9 establish pre-contractual, fund-level disclosure requirements. These disclosure requirements are constructed in such a manner that we can determine whether:

- sustainability risks are integrated into a fund's investment decisions (Article 6);
- a fund considers principal adverse impacts on sustainability factors (Article 7);
- a fund promotes environmental or social characteristics (or a combination thereof), provided that the companies in which the investments are made practice good governance (Article 8); and/or
- a fund has sustainable investment as its objective, and an index has been designated as a reference benchmark (Article 9).

Articles 6 through 9 describe four possible features that a fund might have. The disclosure requirements are constructed such that for any given fund, we can use SFDR disclosures to make a binary determination about the presence of each feature. The four non–mutually exclusive features each have two options (present or absent), thus 16 combinations are possible.

These four features are not independent, however. They are designed to be ordinal indicators of a fund's power to contribute to the EU vision of sustainability. For example, if a fund triggers the disclosure requirements of Article 8, it will very likely trigger the disclosure requirements of Articles 6 and 7 because EU investors and regulators expect a more sophisticated

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sustainability fund to do everything that a less sophisticated fund does and more. If we assume the existence of a feature implies the existence of all "less sophisticated" features, then the number of possible combinations drops to five, one of which is outside our classification universe. **Exhibit 2** maps the features defined by Articles 6–9 to the de facto SFDR fund categories.

There is no column for "Article 7 Funds" in Exhibit 2 because, interestingly, no category for Article 7 Funds emerged. We hypothesize that this is because, in practice, virtually no EU funds consider principal adverse impacts on sustainability factors (Article 7) without also promoting environmental and social characteristics (Article 8).

At this point, we conclude that the de facto fund categories of SFDR are ordinal indicators of the extent to which a fund contributes to, or aligns with, the EU vision of sustainability, which can largely be understood as the goal to make the EU a circular, climate-neutral economy. This is different from our main objective, which is to classify funds according to their value proposition with respect to their consideration of ESG information, issues, and/or conditions. Thus, the de facto SFDR classification system is not fit for our purposes.

Before moving on, we address two more questions: (1) Does SFDR apply to the same universe of funds that we intend to classify? (2) Is the use of "sustainability" in SFDR the same as our use of "ESG"? To answer these questions, we need to look at three key definitions from SFDR Article 2 (see European Parliament and the Council 2019):

- "'Sustainability factors' mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters."
- "'Sustainability risk' means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment."

Exhibit 2. Mapping of SFDR Features to Categories

	Article 6 Funds	Article 8 Funds	Article 9 Funds
Are sustainability risks integrated into the fund's investment decisions? (Article 6)	yes	yes	yes
Does the fund consider principal adverse impacts on sustainability factors? (Article 7)	no	yes	yes
Does the fund promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices? (Article 8)	no	yes	yes
Does the fund have sustainable investment as its objective, and has an index been designated as a reference benchmark? (Article 9)	no	no	yes

- "'Sustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance."

In these three definitions, the term "sustainability" is used inconsistently. In the first two, it is synonymous with "ESG" and connotes "type." In other words, sustainability factors/risks are distinct from other factors/risks. In the third definition, "sustainable" takes on a normative meaning. Essentially, it means "good for people and planet." Because Articles 6 and 7 pertain to "sustainability risks and factors," which are synonymous with "ESG risks and factors," we conclude that SFDR pertains to the same universe of funds that we intend to classify.

4.2. Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (US)

On 25 May 2022, the US SEC proposed a rule titled "Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices" (hereafter, the "Enhanced Disclosures Rule"; US SEC 2022). At the time of this paper's publication, this proposed rule was still in process. It remains an open question as to whether this rule will be passed, and if so, how the final rule may differ from the proposed rule.

The proposed rule defines three different types of funds:

- An Integration Fund, which is "a Fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio."
- An ESG-Focused Fund, which is "a Fund that focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting

investments or (2) in its engagement strategy with the companies in which it invests."

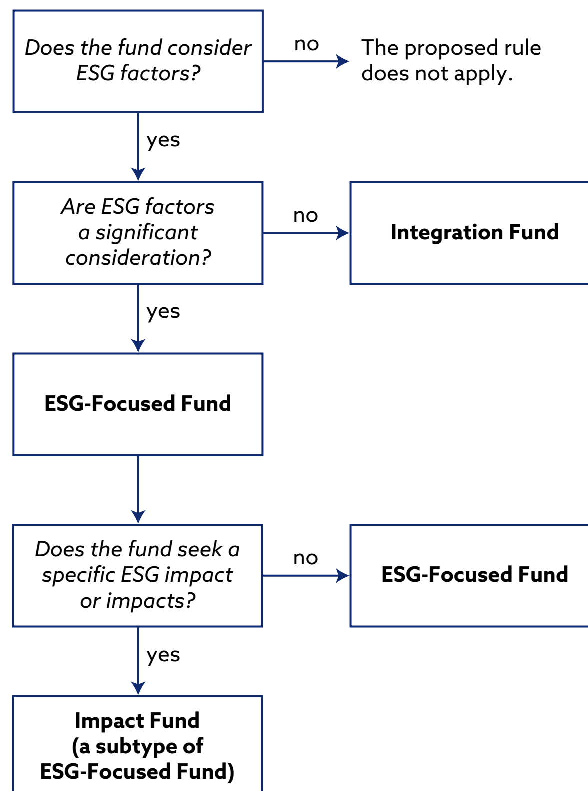
- An Impact Fund, which is "an ESG-Focused Fund that seeks to achieve a specific ESG impact or impacts."

The three definitions specify three possible features that funds might have. The purpose of specifying these features is to trigger various disclosure requirements when they are present in a fund.

The Enhanced Disclosures Rule defines three groups of funds with distinct value propositions—although we believe some refinement and clarification are needed to say precisely what those value propositions are. Still, these groups are designed such that they are appropriate for our objective to classify funds by value proposition.

Now, we analyze the characteristics of these groups and their relationships. The flowchart in **Exhibit 3** illustrates a process for assigning funds to the Enhanced Disclosures Rule groups and is intended to help draw out several key points.

Exhibit 3. Flowchart for Assigning Funds to the Enhanced Disclosures Rule Groups



We observe the following about the groups defined in the Enhanced Disclosures Rule:

- The Integration Fund and ESG-Focused Fund categories are mutually exclusive. A fund could not be both an Integration Fund and an ESG-Focused Fund.
- The ESG-Focused Fund and the Impact Fund categories are not mutually exclusive. A fund could be both an Impact Fund and an ESG-Focused Fund. A fund could be an ESG-Focused Fund but *not* an Impact Fund. It is not possible, however, for a fund to be an Impact Fund and not also an ESG-Focused Fund.
- There is no defined term to uniquely and specifically refer to ESG-Focused Funds that are not Impact Funds. An ESG-Focused Fund that is not an Impact Fund is an ESG-Focused Fund, but ESG-Focused Funds, by definition, include Impact Funds. Equivalently, we could say that the term ESG-Focused Funds is ambiguous because it might refer to a hierarchical classification group (i.e., a group that can be divided into subgroups) or a terminal classification group (i.e., a group of funds that cannot be divided into subgroups).
- The boundary between Integration Funds and ESG-Focused Funds is based on "significance," which is, conceptually, a continuous characteristic. The determination of whether a fund is an Integration Fund or an ESG- Focused Fund hinges on whether ESG factors exceed some level of importance that is deemed "significant." The Enhanced Disclosures Rule offers no criteria or guidance for how we might determine whether ESG factors are "significant." Although the words "significant" and "insignificant" imply a binary distinction, it remains unclear where that boundary would lie.
- The boundary between the Impact Fund and [Non-Impact] ESG-Focused Fund categories is based on a discrete characteristic. A fund either seeks a specific ESG impact or impacts or it does not.

We conclude that these groups meet some of our target parameters—but not all. In particular, the groups are not all mutually exclusive, and the names chosen for the groups are likely to cause confusion in the marketplace because of pre-existing definitions and understandings.

We also conclude that the Enhanced Disclosures Rule applies to the same universe of funds that we intend to classify. The Enhanced Disclosures Rule does not explicitly define the term "ESG funds," nor does it suggest any characteristics or criteria that might be used to distinguish ESG funds from non-ESG funds. The proposed rule, however, states: "The proposed rule's disclosure framework achieves this by requiring different degrees and types of disclosure across two main types of ESG funds: Integration Funds and ESG-Focused Funds (including Impact Funds)" (US SEC 2022, p. 36708). If ESG factors are a significant consideration in ESG-Focused Funds and no more of a significant

factor than other factors in Integration Funds, then it seems together the two categories comprise the universe of funds that take ESG information, issues, and/or conditions into account.

4.3. Sustainability Disclosure Requirements and Investment Labels (UK)

The UK Financial Conduct Authority (FCA) issued "Policy Statement PS23/16: Sustainability Disclosure Requirements (SDR) and Investment Labels" (hereafter, "SDR") on 28 November 2023. SDR establishes requirements that funds must meet to carry one of the following four sustainability labels.

- **Sustainability Focus:** Invests mainly in assets that focus on sustainability for people and/or the planet.
- **Sustainability Improvers:** Invests mainly in assets that may not be sustainable now, with an aim to improve their sustainability for people and/or the planet over time.
- **Sustainability Impact:** Invests mainly in solutions to sustainability problems, with an aim to achieve a positive impact for people or the planet.
- **Sustainability Mixed Goals:** Invests mainly in a mix of assets that either focus on sustainability, aim to improve their sustainability over time, or aim to achieve a positive impact for people or the planet. (See UK FCA 2023, p. 111, for a summary of these four labels' key attributes.)

SDR states that the labels are "only for products seeking positive sustainability outcomes" (UK FCA 2023, p. 26)—that is, products that have an objective to invest "with the aim of directly or indirectly improving or pursuing positive environmental and/or social outcomes" (p. 93). Thus, we see that SDR does not address the same universe of funds that we want to classify. The FCA considered labels for other types of products that take ESG information, issues, and/or conditions into account but chose not to include them in the final rule.

The SDR labels have multiple functions. First, they establish specifications that a fund must meet to carry the label. Second, they enable disclosure requirements to be tailored to different types of products. Third, they provide a distinct characteristic that can be used for fund classification.

The groups defined by the SDR labeling requirement partially meet our target design parameters for fund groups. The SDR labels are mutually exclusive because a fund cannot carry more than one label, and the SDR labels are not ordinal—that is, no one label is necessarily any "better" than any other. The gap for our purposes is that the labels do not cover the full universe of funds that take ESG information, issues, and/or conditions into account and their associated value propositions.

4.4. Classification Systems Based on ESG Approaches

Numerous organizations have created classification systems that distinguish among funds based on their ESG approaches. An ESG approach is any one of a variety of methods for incorporating ESG information, issues, and/or conditions into a fund's objectives, investment process, and/or ownership activities. **Exhibit 4** presents what we believe to be a comprehensive list of ESG approaches that are used in practice.

The ESG approaches in Exhibit 4 describe *how* funds take ESG information, issues, and/or conditions into account. Thus, we can say that any fund that uses one or more of these ESG approaches is within our classification universe.

Each ESG approach can be viewed as a non–mutually exclusive feature that a fund might have. It is trivial to distinguish between funds based on the existence of any *single* approach. For example, it is easy (at least in theory) to create two groups of funds where one group has ESG-related screens and the other does not. But if we want to group funds based on the presence or absence of *all* approaches, we need 256 (2^8) groups. And if we try to incorporate different types of screens, themes, targets, policies, and/or objectives, the number of groups needed is even larger.

Descriptive group naming is a problem when distinguishing between funds using two or more ESG approaches. For example, if we put funds that have both ESG screens and ESG integration into a group, what should we call that group?

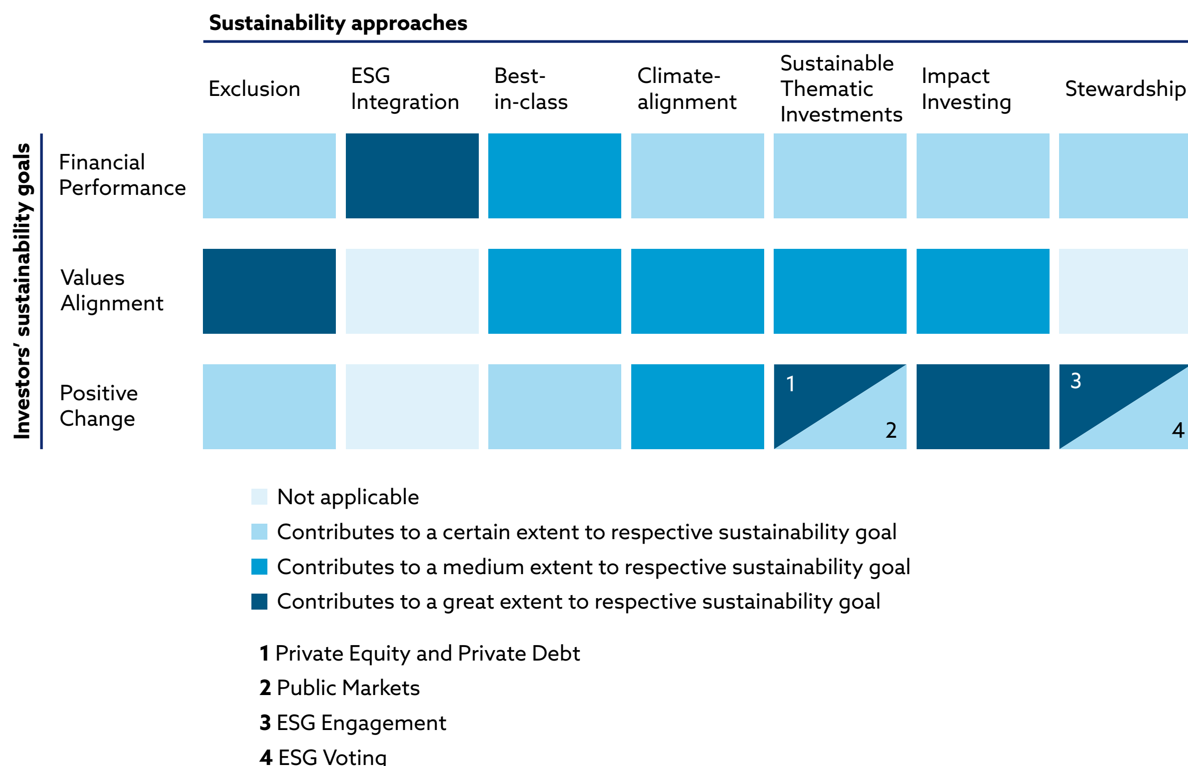
Another challenge with using ESG approaches for fund classification is defining criteria that can be used to determine whether a fund uses each ESG approach. The specifics of implementation vary widely, and people disagree about where to draw the lines. A complication in these debates is the ambiguity and inconsistency in ESG terminology and definitions, although this problem might be addressed with the use of "Definitions for Responsible Investment Approaches," a paper jointly published by CFA Institute, Global Sustainable Investment Alliance, and Principles for Responsible Investment (CFA Institute, GSIA, and PRI 2023) that harmonizes many of the terms and definitions in Exhibit 4.

A final challenge with using ESG approaches for fund classification is explaining them to investors and how they relate to investors' risk–return and moral needs and preferences. Except for ESG integration, all other ESG approaches may contribute to both risk–return and moral needs and preferences. **Exhibit 5** illustrates the overlap.

Exhibit 4. List of ESG Approaches

Approach for Taking ESG Information, Issues, and/or Conditions into Account	Relevant Investment Process Step or Activity	Terms Used to Refer to the Approach
Design and implementation of the investment analysis and decision-making process such that there is ongoing consideration of ESG factors with the aim to improve risk-adjusted return.	Investment analysis and decision-making steps of the investment process	ESG integration
Establishment of rules based on defined ESG criteria that determine whether an investment is permissible.	Definition of the investment universe; asset selection step of the investment process	ESG screening, negative screening, positive screening, best-in-class screening, norms-based screening, exclusion, inclusion
Tracking of an index that has rules based on defined ESG criteria as part of its construction methodology.	Benchmark selection; asset selection and portfolio construction steps of the investment process	ESG index/ESG benchmark
Establishment of portfolio-level allocation targets (and/or constraints) for investments that have ESG characteristics or are associated with ESG trends.	The portfolio construction step of the investment process	ESG focus fund, ESG thematic fund
Establishment of targets (and/or constraints) for aggregate portfolio-level ESG characteristics.	The portfolio construction step of the investment process	ESG focus fund, ESG thematic fund
Establishment of policies to engage current or potential investees, policymakers, standard setters, and/or non-issuers with the aim of improving practice on an ESG issue, changing an environmental/social outcome, or improving public disclosure.	Ownership policies, processes, and decisions	Engagement, active ownership, shareholder action, advocacy
Establishment of policies to use investor rights and influence to protect and enhance overall long-term value for clients and beneficiaries, including the common economic, social, and environmental assets on which their interests depend.	Ownership policies, processes, and decisions	Stewardship
Setting an objective to generate positive, measurable impact alongside an objective to deliver a certain risk and return profile.	Definition of the fund's objective; the investment process; ownership activities	Impact investing, community investing

Exhibit 5. Matrix Illustrating Suitability of Different Sustainability Approaches for Different Investors' Sustainability Goals



Source: Swiss Sustainable Finance, adapted from Asset Management Association Switzerland and Swiss Sustainable Finance (2021).

4.5. Conclusions about Existing ESG Classification Systems

Our analysis shows that several classification systems meet some, but not all, of our design objectives for classifying the funds in our classification universe. More generally, we conclude that existing ESG fund classification systems are lacking—primarily because they are not based on observable features, do not have rigorously defined group boundaries, and/or do not contain the logic necessary for sorting funds into mutually exclusive groups. In the next two chapters, we specify the feature and group criteria that together form a new classification system. We expect that our classification system will have both commonalities and differences from the ones analyzed in this chapter.

5. CLASSIFICATION SYSTEM DESIGN: FEATURE SPECIFICATION

Recall that our goal is to design a classification system for different types of users with different types of needs. We want to build a classification system that helps investors select funds that match their needs and preferences, helps regulators create and enforce rules, and helps researchers produce higher-quality research. We hypothesize that all these needs can be met with a classification system based on three value propositions:

- More informed decision making that may result in improved risk-adjusted returns.
- Control over the degree of financial and reputational exposure to—and reciprocally, contribution to—specific systemic ESG issues.
- The opportunity to help bring about specified environmental/social conditions or outcomes.

We cannot use value propositions directly, however, to classify funds. We need to define observable features that are indicative of these different types of value, such as explicit statements, policies, and processes. Thus, we propose the following possible features for the purposes of classifying funds that take ESG information, issues, and/or conditions into account, connecting observable characteristics with the value that they provide.

- **Feature 1:** The existence of one or more processes that consider ESG information with the aim of improving risk-adjusted returns.
- **Feature 2:** The existence of one or more policies that control fund investors' exposure and contribution to specific systemic ESG issues.
- **Feature 3:** The existence of an explicit statement of intent, and an action plan, to help bring about a target future state in environmental and/or social conditions and a process to measure progress.

Feature 1

A fund has Feature 1 if it has one or more processes that consider ESG information with the aim to improve risk-adjusted returns.

- *Processes* include both investment analysis and decision-making processes (e.g., buying and selling investments) and ownership processes (e.g., proxy voting, engagement, or other ownership-related activities).
- *Consider* means to think about carefully.
- *ESG information* is quantitative or qualitative information pertaining to environmental, social, or governance topics, including but not limited to

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> raw data, statistics, estimates, assessments, analyses, rankings, and/or scores that reflect environmental, social, and/or governance characteristics of an investee, industry, sector, market, nation, region, and/or system. The characterization of any given piece of information as ESG information is somewhat subjective.

Feature 1 represents a certain functionality that a fund might have—specifically, to take a certain type of information as an input and to integrate that information into its analytical and decision-making processes alongside other types of information. A fund can be thought of as a system. A fund's inputs are various streams of information, and its outputs are a portfolio of investments and ownership decisions and actions, such as proxy voting and engagement. Funds are complex systems, which means we cannot predict how a change in the inputs will affect the outputs. Feature 1 is the addition of an input, and as such it offers no assurance as to how, or how much, ESG information will influence the fund's outputs.

The value of Feature 1 for fund investors is the assurance that a category of information that may be relevant to decision making in some instances is not systematically overlooked. In principle, more informed decision making makes it more likely that a fund will achieve its risk–return objectives than if relevant information was ignored or not adequately investigated. The only promise that Feature 1 makes is that ESG information is considered. Feature 1 does not promise that any particular ESG issue will be considered in any particular way, nor does it promise that any specific negative impacts to environment or society will be avoided. ESG risks and negative impacts will be accepted so long as "the price is right." Feature 1 offers a value-add service to investors who believe that the market is not efficient with respect to ESG information. It ensures that relevant ESG risks and opportunities are priced.

Technical Notes

Many similarities exist between the definition of Feature 1 presented above and the definition of ESG integration in "Definitions for Responsible Investment Approaches" (CFA Institute, GSIA, and PRI 2023). One key difference, however, is that the definition of Feature 1 allows for ESG factors to be considered in (1) the investment analysis and decision-making process and/or (2) ownership activities, whereas the definition of ESG integration only allows for the consideration of ESG factors in the investment analysis and decision-making process.

All funds that have a process that meets the definition of ESG integration in "Definitions for Responsible Investment Approaches" (CFA Institute, GSIA, and PRI 2023) meet the definition of Feature 1, but not all funds that meet the

definition of Feature 1 will meet the definition of ESG integration. For example, an index-tracking fund that does not use ESG information in the investment process but does use material ESG information when voting proxies would be classified as having Feature 1, but it would not meet the definition of ESG integration. Thus, despite the closeness in the definitions of Feature 1 and ESG integration, we will not refer to Feature 1 as "ESG integration," nor will we refer to funds that have Feature 1 as "ESG integration funds," in order to avoid any potential confusion.

The definition of Feature 1 differs from the definition of an Integration Fund in the rule proposed by the SEC (US SEC 2022). The proposal defines an ESG integration fund as "a Fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio" (p. 36747).

Feature 2

A fund has Feature 2 if it has, or is subject to, one or more policies that control fund investors' exposure and contribution to specific systemic ESG issues.

- *Policies* are predetermined courses of action that prescribe and/or prohibit certain actions, limiting the discretionary decision-making authority of individuals who manage the fund's investment process and/or ownership activities. *Policies* include investment policies, ownership policies, fund-level policies, fund-family policies, and firm-wide policies.
- *Control* means to intentionally increase or decrease.
- *Exposure* refers to the effect that systemic ESG issues have on fund investors' financial position or reputation. *Contribution* refers to the effect that fund allocation and ownership decisions have on systemic ESG issues. Exposure and contribution are inseparable aspects of investing. When an investment is made, the investor simultaneously enables real-world activities (which can be positive or negative) and takes on financial—and sometimes reputational—exposure (which also can be positive or negative).
- *Systemic* means related to a system, which in the context of Feature 2 could be an industry, sector, market, ecosystem, group of people, country, or region.
- *ESG issues* are important, and often unsettled, matters relating to the environment, society, and/or corporate/issuer governance. The characterization of an issue as an ESG issue is subjective, and ESG issues often do not fall neatly into well-defined, mutually exclusive categories.

Feature 2 represents a certain functionality that a fund might have—specifically, rules that ultimately have the effect of increasing or decreasing fund investors' exposure and contribution to certain types of issues that arise in the real world. In our mental model of a fund as a system, Feature 2 pertains to the inner workings of the system that control, shape, and govern the outputs.

The value of Feature 2 for fund investors is that it enables a range of exposure/contribution profiles with respect to specific systemic ESG issues. As a result, investors can choose a fund with an ESG exposure/contribution profile that suits their needs and preferences. A specific ESG exposure/contribution profile can help investors satisfy their risk–return-related needs and preferences. For example, if a fund investor believes that policymakers are likely to pass a carbon tax, she might choose to invest in a fund that has a low carbon intensity target. Similarly, a specific exposure/contribution profile can help investors satisfy their moral needs and preferences. For example, an investor who wants to mitigate climate change for future generations might also choose to invest in a fund that has a low carbon intensity target.

The only promise that Feature 2 makes is that certain actions will or will not be taken. This does not imply, however, that Feature 2 cannot or will not contribute to environmental and/or social outcomes, because actions taken by funds have real-world consequences, whether individually or collectively.

Technical Notes

Because different investors can have different reasons for choosing the same fund, it is not necessary to know why a fund manager decided to adopt a policy. We need to know only that the fund has, or is subject to, a policy that controls fund investors' exposure and contribution to specific systemic ESG issues. We acknowledge that investors—and sometimes politicians—very much want to understand the motives behind a fund's policies—so much so that many have proposed classifying funds according to such motives. Nonetheless, we believe this line of thinking is impractical because fund managers often do not disclose the rationale for their policies. Policy decisions typically involve many considerations, making it difficult to tease out exactly how much each plays into the final decision.

Consider a fund that has a policy to exclude thermal coal mining companies from the fund's portfolio. Was this policy adopted because the fund manager believes the financial prospects for the industry are poor? … Or because of a belief that investing in the thermal coal mining industry is a reputational risk for the manager and/or the fund's investors? … Or that the manager is seeking to satisfy the target investor segment's sustainability preferences—and, in turn, increase its assets under management (AUM) and ultimately its revenue? … Or that investing in the thermal coal mining industry violates the manager's own ethics? … Or some combination thereof?

Ideally, fund investors would want a fund's motives to exactly match their own. But when asked directly, many investors struggle to articulate exactly why they want to avoid certain kinds of assets. They, too, often have mixed motives. Thus, we assert that it is sufficient to know that a fund *has* policies that control fund investors' exposure and contribution to specific systemic ESG issues—irrespective of *why* such policies were chosen. Indeed, consumers buy products every day that serve their needs and preferences without understanding the manufacturer's rationale for why it designed the product the way it did.

We urge readers not to refer to Feature 2 as "values alignment." Feature 2 can in fact help align investments with investors' values, but it can also help align investments with investors' risk–return objectives. Referring to funds with Feature 2 as "values alignment funds" mischaracterizes the motivations of some investors who invest in such funds.

Feature 3

A fund has Feature 3 if it has an explicit statement of intent, and an action plan, to help bring about a target future state in environmental and/or social conditions and a process to measure progress.

- An *explicit statement of intent* is a clear and unambiguous declaration of one's goals or aspirations to help bring about a target future state in environmental and/or social conditions.
- An *action plan* is a summary of intended actions that the fund will take to help bring about the target state and an explanation of how those intended actions will help bring about the target state.
- A *target future state* is a desired state that has not yet been achieved.
- *Environmental and/or social conditions* are circumstances affecting the health and well-being of people and natural ecosystems.
- A *process to measure progress* is a process that regularly assesses and reports progress toward the specified target state using relevant, pre-specified measures.

Feature 3 represents a certain functionality that a fund might have—specifically, a strategy (i.e., integrated goals, plans, and measures) designed to help bring about a specific envisioned real-world target state. If the target state is attained, it could retrospectively be referred to as an outcome. In our mental model of a fund as a system, Feature 3 primarily relates to the goals of the system.

The value of Feature 3 for fund investors is the opportunity to help bring about a specified target state in environmental and/or social conditions and the rigor

that a strategic approach imposes on the process of bringing it about. In many cases, the value of Feature 3 for investors is its ability to satisfy their moral needs and preferences. It should not be assumed, however, that changes in environmental and/or social conditions cannot or will not contribute positively to the attainment of an investor's risk–return objectives in the future. The value of Feature 3 for some investors may be in its ability to satisfy their risk–return needs and preferences, irrespective of whether they invest based on moral needs and preferences.

To underscore some of the important elements of our definition of Feature 3, we draw distinctions between different types of objectives that funds present under the heading of "investment objectives" in regulatory disclosures and/or marketing materials. The first distinction we make is with respect to the types of outcomes toward which effort is directed, and we discuss three types of objectives in the following: (1) portfolio composition objectives, (2) portfolio performance objectives, and (3) environmental/social outcome objectives. The second distinction we make is between qualitative objectives and quantitative ones. **Exhibit 6** summarizes the discussion that follows.

Some funds have objectives that are stated in terms of portfolio composition. For example, a fund that has an objective to "invest in Asian equities" or "invest in green bonds" or "invest in companies whose products and services can contribute to the UN Sustainable Development Goals" frames its investment objective in terms of portfolio composition. Because a fund has control over the composition of its investment portfolio, it is almost certain that the fund will achieve its portfolio composition objective—assuming the specified investments are available and normal market conditions prevail. For our purposes, an ESG-related or impact-related portfolio composition objective is equivalent to an investment policy that controls fund investors' exposure and contribution to specific systemic ESG issues. Thus, we deem ESG-related or impact-related portfolio composition objectives as indicative of Feature 2 rather than Feature 3, because Feature 3 requires intention be stated in terms of a target state in environmental and/or social conditions.

Some funds have objectives that are stated in terms of portfolio performance. For example, a fund that has an objective "to beat the benchmark by 1%"

Exhibit 6. Relationship between Feature 3 and Various Types of Investment Objectives

Type of Investment Objective	Qualitative	Quantitative (or otherwise Specified in Sufficient Detail)
Portfolio composition	Not Feature 3	Not Feature 3
Portfolio performance	Not Feature 3	Not Feature 3
Environmental/social outcomes	Not Feature 3	Feature 3

or "to earn a 5% absolute return" or "to achieve capital appreciation" frames its investment objective in terms of returns. Relative to a portfolio composition objective, there is a greater chance that a fund will not achieve a portfolio performance objective because portfolio performance is not fully in the fund manager's control. For legal, compliance, and business reasons, fund managers generally prefer to set fund objectives that are within their control versus fund objectives that are out of their control. Portfolio performance objectives are not indicative of any of the three features we have defined, but there are corollaries to environmental/social outcome objectives, which we discuss next.

Some funds have objectives that are stated in terms of environmental/social outcomes. For example, a fund that has an objective to "provide 20 billion liters of safe drinking water by 2030 to 30 million people" or to "provide more low-income housing" frames its investment objective in terms of an environmental/social target state or desired outcome. To have Feature 3, a fund must have an objective or otherwise explicitly state its intent to help bring about a target state or desired outcome in environmental and/or social conditions. Like portfolio performance objectives, there is a risk that a fund will not achieve an environmental/social outcome objective because environmental/social outcomes depend on events that are outside of the fund manager's control.

A fund objective can be qualitative or quantitative, regardless of the type of objective. For example, a portfolio composition objective to "invest at least 80% of the fund's assets in green bonds" is quantitative, whereas a portfolio composition objective to "invest primarily in green bonds" is qualitative. A portfolio performance objective to "beat the benchmark by 1%" is quantitative; a portfolio performance objective to "produce income" is qualitative. An environmental/social objective to "provide 20 billion liters of safe drinking water by 2030 to 30 million people" is quantitative; an environmental/social objective to "provide more low-income housing" is qualitative. Our definition of Feature 3 does not *necessarily* require that a fund have a quantitative objective, but it does require that the objective be a target future state, stated in advance of actions and described in enough detail that it allows for (1) a determination of the general sort of actions that may be conducive to achieving it and (2) an evaluation of progress from the current state to the target future state.

We conclude by reminding readers that we are not attempting to define "impact funds"—rather, we are distinguishing between different value propositions. There are distinct differences in both features and investors' expectations between (a) funds that have an objective to help bring about pre-specified environmental/social outcomes, a plan to achieve those outcomes, and report on progress in relation to the objectives and (b) funds that have an objective or policy to make certain kinds of investments and report on the environmental/social effects of those investments *ex post*. We are not opining on whether one, the other, or both types of funds should be named, labeled, categorized, or referred to as "impact funds." We do hope, however, that the rigorous distinction we have made here provides useful concepts and language to more productively debate that question.

Technical Notes

If a fund intends to help bring about a target state in environmental and/or social conditions, this aim will always be alongside, or concurrent with, risk–return objectives. This is because all funds seek some risk–return objective. Thus, we conclude that it is unnecessary to explicitly say "alongside a risk–return objective" in the definition of Feature 3. Our definition of Feature 3 makes no assumptions about the relative priority or relationships between risk–return objectives and an intent to help bring about a target state in environmental and/or social conditions. Furthermore, our definition does not require that risk-adjusted return be concessionary in any way.

The definition of Feature 3 does not require that the change from the current state to the target state in environmental and/or social conditions be "positive," because such a requirement would be highly subjective. For example, construction of a hydroelectric dam may be positive with respect to renewable energy but negative with respect to the people and wildlife living in the region. The intention of Feature 3 is to identify funds whose value proposition includes the pursuit of a specific target state in environmental and/or social conditions—and not to determine the worth of any specific state that a fund aims to help bring about. We leave it to investors to decide whether a fund's target state is "positive" and/or "ambitious enough" for their needs and preferences.

The types of policies described in Feature 2 may outline intended actions, and those actions may imply an intent to generally improve environmental/social conditions. This alone is insufficient to meet all the criteria of Feature 3. Furthermore, the construction and management of an investment portfolio in accordance with policies that dictate the composition and/or character of the portfolio are an outcome of the investment process. Construction of an investment portfolio does not, in and of itself, necessarily result in a change in environmental/social conditions.

The definition of Feature 3 does not require a fund to prove, or put forth an argument, that the target future state would not have been attained, or will not be attained, in the absence of its actual or intended actions.

A fund having Feature 3 is likely to meet the definition of impact investing in "Definitions for Responsible Investment Approaches" (CFA Institute, GSIA, and PRI 2023). It is not our intent, however, for Feature 3 to be used for naming or referring to funds as "impact funds." We want to avoid creating further confusion with respect to existing naming, labeling, or certification requirements, and we do not wish to imply that funds that do not have Feature 3 do not, or cannot, have an impact on environmental or social conditions.

6. CLASSIFICATION SYSTEM DESIGN: GROUP SPECIFICATION

We now look at various ways that we can create groups using Features 1, 2, and 3. The first and perhaps simplest way is to make a distinction based on any single feature—for example, distinguishing funds that have Feature 1 from funds that do not have Feature 1. If we do this for all three features, we get three non-mutually exclusive groups, illustrated by **Exhibit 7**. We will arbitrarily name these groups I, J, and K:

- Group I: Funds that have Feature 1
- Group J: Funds that have Feature 2
- Group K: Funds that have Feature 3

This method of grouping works well for several use cases. It would be a useful classification scheme for investors when a single feature is a "must have" and the other two features are "nice to have." It would also be useful for triggering disclosure requirements related to each feature, albeit not strictly necessary to put funds into groups for this purpose. For example, a disclosure requirement could be written as "If a fund has one or more processes that consider ESG information with the aim of improving risk-adjusted returns, then the following information must be disclosed. …"

A second way to group funds is by the unique combinations of all three features. This approach produces eight mutually exclusive groups, as shown in **Exhibit 8**. We will arbitrarily name these groups Q through X:

- Group Q: Funds that have Feature 1 and only Feature 1
- Group R: Funds that have Feature 2 and only Feature 2

Exhibit 7. Non-Mutually Exclusive Groups Based on the Existence of Each Individual Feature

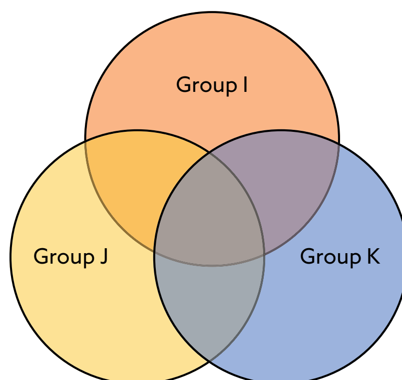

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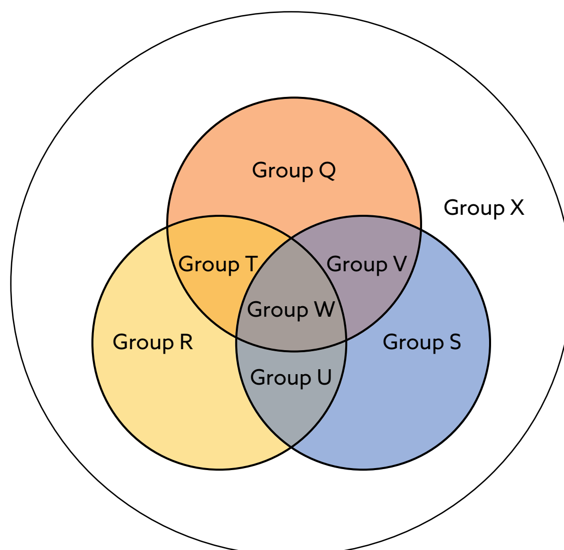
Exhibit 8. Mutually Exclusive Groups Based on Unique Combinations of Features



- Group S: Funds that have Feature 3 and only Feature 3
- Group T: Funds that have Features 1 and 2 but not Feature 3
- Group U: Funds that have Features 2 and 3 but not Feature 1
- Group V: Funds that have Features 1 and 3 but not Feature 2
- Group W: Funds that have Features 1, 2, and 3
- Group X: Funds that do not have Features 1, 2, or 3

This approach also would be useful in several cases. It would help investors who are looking for an exact combination of Features 1, 2, and 3. It would also help researchers because it uniquely identifies combinations of fund design variables that may affect the composition and characteristics of portfolios, risk–return performance, and environmental and/or social outcomes.

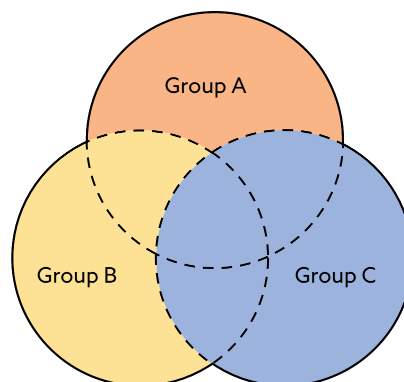
A third way to group funds would be to create mutually exclusive, ordinal groups based on the noteworthiness of Features 1, 2, and 3, with respect to the overall value proposition for taking ESG information, issues, and/or conditions into account. We assert that Feature 1 is the least noteworthy because ESG information is an input into analysis and decision-making processes along with other types of information; there is no certainty about how ESG information will affect analyses and decisions—individually or in aggregate. Feature 2 is more noteworthy than Feature 1 because ESG considerations are incorporated into policies, and policies (ideally) produce consistent actions and/or outcomes. Feature 3 is more noteworthy than Feature 2 because Feature 3 indicates that a fund explicitly seeks a specified target future state in environmental and/or

social conditions. This additional outcome-oriented real-world objective makes the fund distinctly different from "conventional" funds, which seek only to deliver a certain risk–return profile, use a certain strategy, make investments in certain types of assets, or construct a portfolio with certain characteristics. Using this logic, we can define three groups that we will arbitrarily name Groups A, B, and C, illustrated in **Exhibit 9**.

- Group A: Funds that have Feature 1 and only Feature 1
- Group B: Funds that have Feature 2 and only Feature 2; and funds that have Features 1 and 2 but not Feature 3
- Group C: Funds that have Feature 3 and only Feature 3; funds that have Features 2 and 3 but not Feature 1; Funds that have Features 1 and 3 but not Feature 2; and Funds that have Features 1, 2, and 3

This method of grouping funds may be the best among all methods considered here for the purposes of fund selection. Investors who do not invest based on moral needs and preferences—and who want to avoid funds that would even give the appearance that they do—would choose funds from Group A. Similarly, investors who invest based on moral needs and preferences would know that funds in Group A are not likely to *consistently* meet those needs and preferences—even though some funds in Group A may, at times, do so. Investors who want to invest in a fund that is helping to bring about a specified target future state in environmental and/or social conditions would choose funds from Group C. Investors who do not desire to bring about a specified target future state in environmental and/or social conditions but nonetheless want the funds they invest in to have some influence on systemic ESG issues will choose funds from Group B. Group B funds would also be chosen by investors who want funds that have policies that align with their personal moral principles and objectives—irrespective of whether, how, or to what extent those policies impact other people and the planet.

Exhibit 9. Mutually Exclusive, Ordinal Groups Based on Noteworthiness of Features



Some readers may worry that an average retail investor would not understand the groups or the features we have developed here. Fortunately, investors need not be exposed to all the inner workings of the system and the academic language needed in this paper to rigorously define features and groups. The purpose of the fund grouping in Exhibit 9 is to facilitate the selection of funds that suit the full set of an investor's needs and preferences. A simple question, such as the following, is all that is needed to determine which group of funds an investor is most interested in:

Which fund would you most prefer?

a. A fund that considers environmental, social, and governance information *if and only if such information is relevant to the fund's risk and/or return objectives*;

b. A fund that has committed to *take, or refrain from, specific actions* related to certain environmental, social, and governance issues;

c. A fund that has an objective to help bring about *pre-specified environmental and/or social outcomes* in addition to a financial return; or

d. A fund that does not consider environmental, social, and governance information, issues, or conditions in any way or for any purpose.

At this point, we expect many readers will ask: Do the groups in Exhibit 9 somehow identify impact funds? It is impossible to answer this question without first defining "impact funds," which is difficult to do because people define or understand that term differently, as they do with "ESG funds." Our definition of Feature 3, which underpins Group C, is largely consistent with the definition of impact investing in "Definitions for Responsible Investment Approaches" (CFA Institute, GSIA, and PRI 2023). Still, we recommend that readers not refer to funds having Feature 3 as impact funds—if only to avoid confusion with existing naming, labeling, or certification requirements. It also avoids implying that all funds that do not have Feature 3 categorically do not, or cannot, impact environmental or social conditions.

Setting the naming question aside, however, Groups B and C reveal an important difference. Group B funds promise only to take (or refrain from) specified actions. The impact of any one fund's policies is inconsequential in most cases. If enough funds, however, adopt the same policy, then collectively these decisions may add up to a noticeable result. Group C funds, on the other hand, promise to implement an action plan aimed at achieving a target future state in environmental and/or social conditions and to measure progress toward the target.

Another question that we expect many readers to ask is, "Should Group A funds be considered ESG funds or conventional funds?" We will assume a "conventional" fund is a fund that (1) has only risk–return objectives and (2) is not constrained by policies that systematically control exposure and

contribution to ESG issues. Funds in Group A are no different from conventional funds in either of these two respects. This fact does not mean, however, there is no reason to distinguish between funds that have Feature 1 and those that do not. Investors want to make that distinction so that they can assess funds' value propositions. Funds with Feature 1 provide value to investors because they price ESG risks and opportunities, whereas funds without Feature 1 do not (at least not explicitly). Similarly, regulators might want to make the distinction to trigger disclosure requirements related to the ESG information that Group A funds use and/or the way they use it. We will not opine on whether Group A funds should be considered ESG funds because there is more than one reasonable definition of the term. Some definitions of ESG funds include Group A funds, and others do not.

Finally, some readers may ask, "Are Group B funds values alignment funds?" Policies that control fund investors' exposure/contribution to specific systemic ESG issues may be important to investors for risk–return reasons, reputational reasons, moral reasons, or a combination thereof. Although such policies are a useful input for selecting funds that align with investors' values, the moniker "values alignment funds" potentially mischaracterizes some investors' reasons for selecting funds in Group B.

7. CLASSIFICATION SYSTEM DESIGN: EVALUATION AND COMPARISON

In this chapter, we will evaluate whether we met the design objectives we set for ourselves in Chapter 3 and make comparisons with the classification systems that we analyzed in Chapter 4.

7.1. Evaluation of Design Objectives

We achieved our objective to create a classification system that integrates the needs of multiple stakeholder groups, most importantly:

- The need of investors, advisers, distributors, platforms, and researchers to distinguish funds that have structural features that may satisfy moral needs and preferences from funds that have no such features, as well as to distinguish among different types of moral value propositions.
- The need of legislators and regulators for rigorously defined, observable functional features that are appropriate for triggering different disclosure requirements, and possibly other types of requirements.

We achieved our objective to create a classification system that has certain characteristics related to quality, rigor, complexity, and usability:

- Classification criteria are based on observable functional features that provide different kinds of value to investors.
- Multiple grouping schemes serve different needs, with no loss in the ability to map funds from one grouping scheme to another.
- Groups are mutually exclusive and completely exhaustive (though we also show the potential value of a non-mutually exclusive grouping scheme).
- No grouping scheme has more than seven groups (although one extra group is needed for funds outside the classification universe).
- Features and groups are not ordinal, except for one grouping scheme that reflects the inherent noteworthiness of Features 1, 2, and 3 with respect to the overall value proposition for taking ESG information, issues, and/or conditions into account.
- Features and groups have generic names that could serve as a universal translator if different markets or organizations choose different descriptive names for features and groups.

7.2. Comparison with the Sustainable Finance Disclosure Regulation (EU)

We begin by comparing the features that are defined by SFDR Articles 6–9 (see European Parliament and the Council 2019) with Features 1, 2, and 3.

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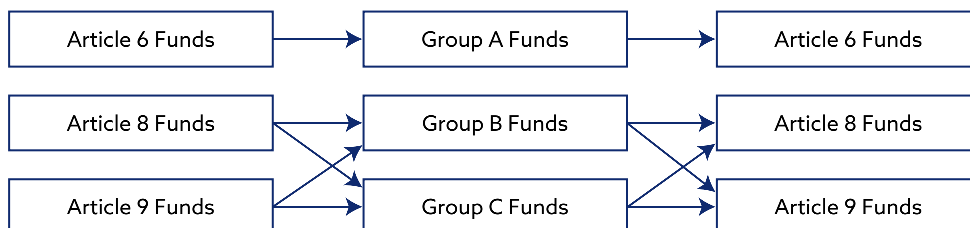
- Article 6 and Feature 1 essentially define the same feature (use of ESG information for financial risk management).
- Article 7 does not map to any feature in our classification system, and vice versa. Article 8 and Feature 2 essentially define the same feature (design and implementation of policies that result in marketable ESG characteristics).
- Article 9 may map to Feature 3, depending on the interpretation of the SFDR definition of "sustainable investment" in Article 2.

If we assume that the phrase "contributes to an environmental or social objective" means to bring about a future state that is different from the current state, then Feature 3 and Article 9 are oriented toward the same feature (contribution to real-world outcomes). However, if that phrase means to have an objective or policy to invest a significant percentage of the fund's assets in economic activities deemed to be already sustainable per the classifications and rules in the EU taxonomy, then Article 9 maps to Feature 2. There is evidence that EU legislators meant the latter, because when SFDR was initially released, it was criticized for not having a "transition" category, and legislators are presently considering adding such a category.

But even if Feature 3 and Article 9 are similar in identifying funds that have an objective to contribute to real-world outcomes, Feature 3 has additional definitional criteria related to action plans and measurement of progress. For these reasons, we must allow that some Article 9 funds will meet all the criteria for Feature 3, while others will not. And vice versa, funds that have Feature 3 may not satisfy the SFDR definition of "sustainable investment." For example, a fund's target future state in environmental and social conditions may be something other than the six environmental objectives defined in the EU taxonomy.

We now compare the SFDR groups to Groups A, B, and C by mapping the SFDR fund groups to Groups A, B, and C, and vice versa. **Exhibit 10** illustrates this process. The mappings of fund groups reflect the similarities and differences in feature definitions between the two systems.

Exhibit 10. Mapping Between SFDR Groups and Groups A, B, and C



There is a one-to-one path from Article 6 funds to Group A funds and from Group A funds to Article 6 funds. There is a path where Article 8 funds map to Group B funds and Group B funds map to Article 8 funds. But funds that have policies that produce marketable ESG characteristics (and that do not have sustainable investment as an objective as defined in SFDR) may also have an objective to help bring about a target future state in environmental and/or social conditions. Thus, some Article 8 funds could be Group C funds, and vice versa.

It is also possible for a fund to have sustainable investment as an objective and to have an objective to help bring about a target future state in environmental and/or social conditions. Therefore, some Article 9 funds could be Group C funds, and vice versa. Finally, a fund could have sustainable investment as an objective but no objective to help bring about a target future state in environmental and/or social conditions. Thus, some Article 9 funds could be Group B funds, and vice versa. The variants in mapping from Article 8/9 funds to Group B/C funds, and vice versa, arise from the fact that Article 9 and Feature 3 may describe two different and independent features.

Having thought extensively about fund classification and disclosure issues, we conclude that although Articles 6–9 are appropriately designed for triggering fund-level ESG disclosures, they should not be used as a basis for a sustainability classification system. The disclosure requirements of Articles 6–9 are triggered by features that a fund might possibly have, and they do so without naming those features or categorizing different types of funds. We believe these are good principles to follow when designing conditional disclosure requirements. The clarity of the triggering criteria, however, is not as good as it could or should be, and this lack of precision has created confusion and frustration in the marketplace.

Although functional features of funds are appropriate for triggering disclosure requirements, they are not the best basis on which to build ordinal groups that reflect an increasing degree of sustainability. This is because functional features do not directly translate to sustainability.

For example, simply having an exclusionary screen does not make a fund sustainable. A determination of sustainability would need to consider exactly what the fund excludes or includes. If the degree of a fund's sustainability is thought of as the percentage of the fund's portfolio that is invested in sustainable economic activities, then a better approach for classifying funds based on their degree of sustainability would be to define groups by selecting cutoff points for the percentage of a fund's assets that are invested in sustainable economic activities. For example, a group called "sustainable funds" might be defined as funds that have >X% of their assets invested in sustainable activities. All sorts of technical details would need to be considered in defining the metric and establishing cutoff points, which we will not go into here.

Alternatively, if a fund must meet some larger and more complex set of criteria for it be to "light green" or "dark green," then classification would best be achieved by first establishing a labeling specification and then classifying funds based on their labels.

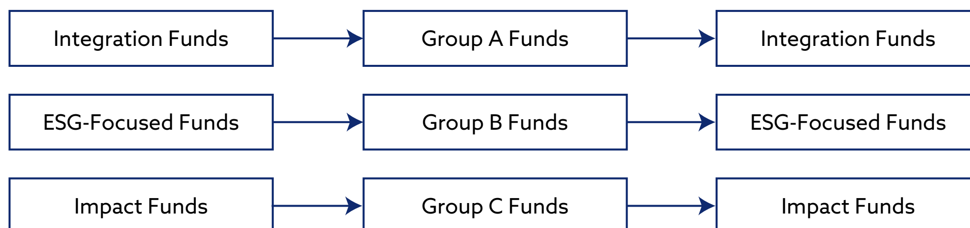
7.3. Comparison with the Enhanced Disclosures Rule (US)

Again, we begin by comparing the features that are inherently defined by the terms Integration Fund, ESG-Focused Fund, and Impact Fund with Features 1, 2, and 3. The definition of Integration Funds is similar to Feature 1, and the definition of ESG-Focused Funds is similar to Feature 2. The non-determinative use of ESG information in the investment process is not, however, mutually exclusive to the determinative use of ESG criteria in investment policies. If the Enhanced Disclosures Rule definitions were corrected for this fact and if the basis for distinction was process versus policy instead of a vague cutoff point of significance, we could say that the definition of Integration Funds is identical to Feature 1 and the definition of ESG-Focused Funds is identical to Feature 2. The definition of Impact Fund and Feature 3 essentially define the same feature.

We now map the Enhanced Disclosures Rule groups to Groups A, B, and C, and vice versa, shown in **Exhibit 11**. We see that there is an exact one-to-one correspondence between the groups in each system.

We conclude that the fund groups in the Enhanced Disclosures Rule are directionally correct because they reflect marketplace distinctions as to why and how ESG information, issues, and conditions are taken into account, but their definitions are problematic with respect to the design principle of mutual exclusivity. Moreover, their names are potentially confusing because they use the same descriptive terms that have been used previously by others and that already carry certain connotations in the marketplace.

Exhibit 11. Mapping between Enhanced Disclosures Rule Groups and Groups A, B, and C



Rather than fix these problems, we suggest that the terms and definitions be eliminated for the purposes of triggering disclosure requirements. Disclosures can be triggered by a conditional clause within the disclosure requirement.

For example, a disclosure requirement could be written as, "If a fund seeks to achieve a specific ESG impact or impacts, then the fund must disclose an overview of the impact(s) the fund is seeking to achieve and how the fund is seeking to achieve the impact(s)." This example shows that it is not necessary to define Impact Funds because the definition can be integrated into the disclosure requirement. Experience in the EU, however, shows that market participants will use conditional disclosure requirements to classify funds even when that is not the regulator's intent. Therefore, regulators must be very careful about how they define features in disclosure requirements.

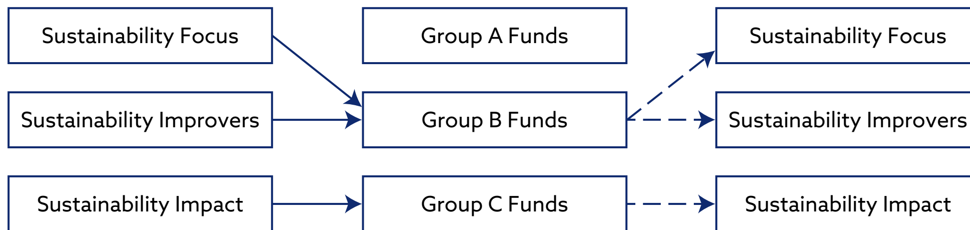
The preceding example is a well-designed and useful disclosure requirement because it elucidates whether a fund has an important feature (a specific ESG impact objective) and if so, what the objective is and how the fund seeks to achieve it. Similarly, the Enhanced Disclosures Rule could move the definitions of ESG-Focused Funds and Integration Funds into conditional clauses of disclosure requirements for specified features. Those conditional clauses, however, should not be based on a vague and subjective measure such as significance but rather on observable features such as the use of ESG information in processes, the existence of ESG policies, and declarative statements to help bring about a target future state in environmental and social conditions.

7.4. Sustainability Disclosure Requirements and Investment Labels (UK)

SDR is a labeling specification rather than a classification system. SDR has general requirements that are common to all labels and specific requirements that are unique to individual labels. There are no requirements to use ESG information for financial risk management and thus no relationship between SDR and Feature 1. SDR has general and specific requirements for investment and stewardship policies that generally map to Feature 2. However, SDR requires not only the existence of policies but also that those policies have certain elements, whereas Feature 2 requires only their existence. Several of the specific requirements for the Sustainability Impact label map to Feature 3.

Exhibit 12 maps the SDR sustainability labels (we omit the Mixed Goals label, because it combines the other three) to Groups A, B, and C. We see that no sustainability labels map to Group A, and vice versa. The Sustainability Focus and Sustainability Improvers labels map to Group B because the SDR labeling specifications would definitively place funds with those labels in Group B.

Exhibit 12. Mapping between SDR Labels and Groups A, B, and C



Not every fund in Group B, however, will meet all the requirements for the Sustainability Focus or Sustainability Improvers labels. This is consistent with our observation in Chapter 4 that SDR classifies a smaller universe of funds than our classification system. Similarly, the labeling specifications for Sustainability Impact definitively place funds with that label in Group C, but not all funds in Group C will carry the Sustainability Impact label.

We conclude that the SDR labels will likely be used by the marketplace to distinguish "sustainability funds" from "non-sustainability funds." The SDR labels can also be used to distinguish between (a) funds that promise only to take (or refrain from) specified actions and (b) funds that have a "theory of change" that explains how they will help contribute to environmental and/or social outcomes. Because SDR is not a classification system, however, it is of no help in identifying non-sustainability funds that take ESG information, issues, and/or conditions into account for risk and return reasons—and that is where our classification system could serve a complementary purpose.

7.5. Comparison with ESG Approaches

ESG approaches are possible features that a fund may have, rather than fund groupings. We will therefore compare ESG approaches with Features 1, 2, and 3. We see in **Exhibit 13** that there is a one-to-one correspondence between ESG integration and Feature 1 and a one-to-one correspondence between impact/community investing and Feature 3. All the other ESG approaches, which are effectuated via investment and ownership policies, map to Feature 2.

It is certainly useful to know all the ESG approaches that a fund uses, but it is also useful to combine ESG approaches for the purposes of classification such that we have a manageable number of groups. Our classification system took advantage of a commonality among six of the eight ESG approaches to reduce the number of possible combinations from 256 (2^8) to 8 (2^3). Because there is a clear mapping of multiple ESG approaches to Feature 2, we could use the ESG approaches that map to Feature 2 to create a hierarchical classification layer under Feature 2. To do that, we would need to repeat the classification system design process outlined in Chapter 2.

Exhibit 13. Mapping between ESG Approaches and Features 1, 2, and 3

Approach for Taking ESG Information, Issues, and/or Conditions into Account	Relevant Investment Process Step or Activity	Terms Used to Refer to the Approach	Feature
Design and implementation of the investment analysis and decision-making process such that there is ongoing consideration of ESG factors, with the aim to improve risk-adjusted return.	Investment analysis and decision-making steps of the investment process	ESG integration	1
Establishment of rules based on defined ESG criteria that determine whether an investment is permissible.	Definition of the investment universe; asset selection step of the investment process	Screening, negative screening, positive screening, best-in-class screening, norms-based screening, exclusion, inclusion	2
Tracking of an index that has rules based on defined ESG criteria as part of its construction methodology.	Benchmark selection; asset selection and portfolio construction steps of the investment process	ESG index/ESG benchmark	2
Establishment of portfolio-level allocation targets (and/or constraints) for investments that have ESG characteristics or are associated with ESG trends.	The portfolio construction step of the investment process	ESG focus fund, ESG thematic fund	2
Establishment of targets (and/or constraints) for aggregate portfolio-level ESG characteristics.	The portfolio construction step of the investment process	ESG focus fund, ESG thematic fund	2
Establishment of policies to engage current or potential investees, policymakers, or standard setters, and/or non-issuers with the aim of improving practice on an ESG issue, changing an environmental/social outcome, or improving public disclosure.	Ownership policies, processes, and decisions	Engagement, active ownership, shareholder action, advocacy	2
Establishment of policies to use investor rights and influence to protect and enhance overall long-term value for clients and beneficiaries, including the common economic, social, and environmental assets on which their interests depend.	Ownership policies, processes, and decisions	Stewardship	2
Setting an objective to generate positive, measurable impact alongside an objective to deliver a certain risk and return profile.	Definition of the fund's objective; the investment process; ownership activities	Impact investing, community investing	3

8. IMPLEMENTATION: DETERMINING THE EXISTENCE OF FEATURES (GUIDELINES AND EXAMPLES)

The classification system that we have created relies wholly on the identification of three features. In this section, we investigate the practical challenges of determining whether a given fund has those features and identify ways these challenges might be addressed. The process for determining which features a fund has, if any, can be broken down into two steps: (1) information collection and (2) evaluation.

8.1. Information Collection

The goal of the information collection step is to identify and collect the information that is necessary, or potentially useful, for determining whether a fund has any of the three features defined in Chapter 5. This step is challenging because the information we seek is (1) narrative, as opposed to quantitative or categorical; (2) dispersed within a large volume of narrative information, the vast majority of which is not relevant or necessary for our purposes; (3) dispersed across multiple documents and/or sources; and (4) related to decisions and activities at both the fund and firm level. In addition, differences in regulations across markets result in differences in the availability, methods, locations, scope, and depth of disclosures.

We can focus our search for information by specifying the type of information that is needed. **Exhibit 14** presents a list of key inputs and the likelihood of their relevance for determining the existence of Features 1, 2, and 3. The inputs are rated on a scale from "unlikely to be relevant" to "likely to be relevant" with respect to their value for determining the existence of the feature of interest. The type of information that we seek may be at the fund level, the fund-family level, and/or the firm level. Fund-level information is unique to a specific fund. Fund-family-level information is relevant for a group of funds that have similar investment objectives, investment styles, or other characteristics. Firm-level information applies to all funds that the firm manages or to the actions of the firm as an entity.

The information described in Exhibit 14 is often found in more than one document or source. Furthermore, the level of detail often varies across different documents and sources. Therefore, it is advisable for evaluators to examine as many of the following documents and sources of information as possible:

- Legally required documents and disclosures, including but not limited to prospectuses, private placement memorandums, partnership agreements, offering agreements, offering memorandums, statements of

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Exhibit 14. Relevance of Different Types of Information to the Determination of Features

Input	Level	Relevance to the Determination of Features		
		Feature 1	Feature 2	Feature 3
Fund name	Fund level only	May be relevant	May be relevant	May be relevant
Fund objectives	Fund level only	Unlikely to be relevant	May be relevant	Likely to be relevant
Benchmark	Fund level only	Unlikely to be relevant	May be relevant	Unlikely to be relevant
Investment policies for screening and portfolio construction	Fund level, Fund-family level, or Firm level	Unlikely to be relevant	Likely to be relevant	Likely to be relevant
Descriptions of the investment strategy and/or investment process	Fund level, Fund-family level, or Firm level	Likely to be relevant	Likely to be relevant	Likely to be relevant
Proxy voting and engagement policies	Fund level, Fund-family level, or Firm level	Likely to be relevant	Likely to be relevant	Likely to be relevant
Reports regarding the ESG characteristics of the fund's portfolio	Fund-level only	Unlikely to be relevant	Likely to be relevant	Unlikely to be relevant
Reports regarding proxy voting activity	Fund level, Fund-family level, or Firm level	May be relevant	May be relevant	May be relevant
Reports regarding engagement activity	Fund level, Fund-family level, or Firm level	May be relevant	May be relevant	Likely to be relevant
Reports regarding the incidental environmental and/or social impacts of investees or assets	Fund level, Fund-family level, or Firm level	Unlikely to be relevant	May be relevant	Unlikely to be relevant
Reports regarding progress toward a target state in environmental and/or social conditions	Fund level, Fund-family level, or Firm level	Unlikely to be relevant	Unlikely to be relevant	Likely to be relevant

additional information (SAIs), key investor information documents (KIIDs), key investor documents (KIDs), annual reports, and disclosures required by ESG/sustainability-related regulations, such as the EU's Sustainable Finance Disclosure Regulation (SFDR) and the UK's policy on Sustainability Disclosure Requirements and Investment Labels (SDR).

- Marketing materials, including but not limited to fact sheets, webpages, and pitch books.
- Information and documents obtained through research and due diligence, such as responses to due diligence questionnaires, requests for proposals, and information contained in third-party databases.

The burden of information collection is reduced when fund managers disclose the necessary information in a single document, as is required by the CFA Institute Global ESG Disclosure Standards for Investment Products (CFA Institute 2021).

8.2. Evaluation

The goal of the evaluation step is to make an evidence-based assessment of the existence of Features 1, 2, and 3. The outcome of this step depends on the quality of the informational inputs and the evaluator's interpretation of those informational inputs.

The information needed to evaluate will naturally fall somewhere on a spectrum of quality, where *high quality* is defined as complete, accurate, consistent, and unambiguous; and *low quality* is defined as incomplete, unreliable, inconsistent, and/or ambiguous. The inputs may be of such low quality that an evaluator cannot determine whether the fund has one or more of the three features of interest. Numerous factors influence input quality, including but not limited to laws and regulations; the knowledge, skills, abilities, and decisions of persons involved with the preparation of legally required documents and marketing materials; and the design and implementation of the processes and controls through which legally required documents and marketing materials are created.

Despite the implementation of new ESG-related disclosure regulations for investment products, the quality of information regarding how ESG information, issues, and/or conditions are taken into account remains far from ideal. Information quality can be improved by using industry standards, such as the CFA Institute Global ESG Disclosure Standards for Investment Products (CFA Institute 2021), which was developed in consultation with investment managers, asset owners, consultants, and service providers. Information quality can also be improved by using "Definitions for Responsible Investment Approaches" (CFA Institute, GSIA, and PRI 2023).

Regardless of input quality, there is an inherent risk that different evaluators might interpret inputs or criteria differently, leading to disagreements about which features a fund has. This risk cannot be eliminated, but it can be mitigated through guidelines, examples, and case studies.

In the remainder of this chapter, we present guidelines and examples. All examples are illustrative. It should not be assumed that examples describe a minimum requirement that an investment product must meet to be classified as having Features 1, 2, or 3. Additionally, it should not be assumed that every investment product that is described or classified as having Feature 1, 2, or 3 has the specific characteristic illustrated in an example.

8.3. Guidelines for Determining the Existence of Feature 1

Recall that a fund has Feature 1 if it has one or more processes that consider ESG information with the aim to improve risk-adjusted returns.

Our objective is solely to determine if ESG information is considered in one or more processes with the aim to improve risk-adjusted returns, not to make assessments about the value of considering such information generally or the effectiveness of a fund's processes.

8.3.1. Evaluating Descriptions of the Investment Strategy and/or Investment Process (likely to be relevant)

When evaluating descriptions of the investment strategy and/or investment process, the goal is to determine (1) whether ESG information is considered in the investment strategy and/or process; and (2) whether ESG information is considered with the aim to improve risk-adjusted returns. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 1:

- An explicit statement indicating that ESG information is considered with the aim to reduce risk, improve returns, or both.
- An explanation of how ESG information is relevant to the fund's risk and return objectives and to the overall investment strategy.
- A description of the sources and types of ESG information used in the investment process.
- A description of the systems and processes used to collect, store, maintain, and manage ESG information.
- An explanation of how financially material ESG information is identified.
- An explanation of how financially material ESG information is used in investment research and analysis.

- An explanation of how financially material ESG information ultimately influences asset allocation, security selection, portfolio construction, and/or risk management decisions.
- The use of scores that are based on an investee's exposure to, and management of, ESG risks and opportunities (versus scores based on an investee's impact on the environment and society.
- The use of third-party research reports that include analysis of an investee's exposure to, and management of, ESG risks and opportunities.

Statements within an Investment Strategy Description That Are Indicative of Feature 1

Example 1

The fund considers ESG risk ratings in its investment analysis and portfolio construction to assess risks affecting the financial performance of a company or investment.

Example 2

The portfolio manager uses a proprietary ESG Risk Dashboard that combines multiple ESG data sources in order to identify companies with ESG risks that may affect their financial performance.

8.3.2. Evaluating Proxy Voting and Engagement Policies (likely to be relevant)

When evaluating proxy voting and engagement policies (or policies pertaining to other types of ownership activities), the goal is to determine (1) whether ESG information is considered in decisions and actions related to the ownership of securities and assets; and (2) whether ESG information is used with the aim to improve risk-adjusted returns. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 1:

- An explicit statement indicating that financially material ESG risk and opportunities will be considered when deciding how to vote a proxy.
- An explicit statement indicating that financially material ESG risk and opportunities will be considered when deciding to undertake an engagement or when setting the objective for that engagement.

- An explicit statement indicating that financially material ESG risk and opportunities will be considered in decisions pertaining to the management of directly owned real assets.
- An explanation of how the consideration of ESG information in ownership decisions and activities is relevant to the fund's risk and return objectives and the overall investment strategy.

Proxy Voting and Engagement Policy Statements That Are Indicative of Feature 1

Example 1

We prioritize engagement on issues most likely to have a financial impact on companies or affect their operations, including environmental, social, and governance issues.

Example 2

We will generally vote for environmental and social shareholder proposals that request additional disclosures related to environmental, social, and governance issues.

8.3.3. Evaluating the Fund Name (may be relevant)

A fund's name alone is insufficient to make a conclusive determination about the existence of Feature 1. The presence of "ESG" or an ESG-related term in a fund's name indicates that the fund is likely in our classification universe, but the absence of such language does not necessarily imply the fund is outside our classification universe.

8.3.4. Evaluating Reports Regarding Proxy Voting Activity (may be relevant)

Some funds, or fund managers, report on proxy voting activity. Such reports may include whether the fund or manager voted for, against, or abstained from voting on specific proposed corporate actions. In addition, some reports provide an explanation for the action taken. If these explanations show evidence of the consideration of ESG information with the aim to reduce risks, improve returns, or both, then this evidence indicates that the fund has Feature 1. Feature 1 will not necessarily produce a pattern in proxy votes, and the presence or absence of a pattern is not conclusive evidence that a fund has Feature 1.

Statements in Proxy Voting Reports That Are Indicative of Feature 1

Example 1

The investment manager voted for a proposal requesting a third-party audit and disclosure of a report on warehouse working conditions for a company that has recently been charged with multiple workplace safety violations. Such violations can result in reputational risks and reduce a company's ability to attract employees.

8.3.5. Evaluating Reports Regarding Engagement Activity (may be relevant)

Some funds, or fund managers, report on engagement activity. Such reports may include the objectives of engagements and actions taken to achieve those objectives. If engagement reports show evidence of the consideration of ESG information with the aim to reduce risks, improve returns, or both, then this evidence indicates that the fund has Feature 1.

Statements in Engagement Reports That Are Indicative of Feature 1

Example 1

We engaged with portfolio companies to discuss their transition to cleaner renewable energy sources based on our belief that they are likely to face a new carbon tax.

8.3.6. Inputs Deemed Unlikely to Be Relevant

- **Fund objectives:** We believe it is very unlikely that a fund would state in its objectives that a certain type of information—ESG information in this case—is used in the investment process with the aim to improve risk-adjusted returns, because inputs into an investment process are distinct from the objectives of an investment process.

- **Benchmark:** There is no point of reference for simply using a certain type of information as an input to an investment process. In the context of funds, benchmarks are typically used as a point of reference for portfolio composition or investment performance.
- **Investment policies for screening and portfolio construction:** A fund or fund manager may have a policy that:
  - requires ESG information to be analyzed and/or considered within certain steps in the investment process but
  - does not dictate the inclusion or exclusion of any individual investment or asset, or the composition or characteristics of the portfolio, based on ESG criteria or characteristics.

  In this case, we refer the evaluator to Section 8.3.1. If an investment policy dictates the inclusion or exclusion of any individual investment or asset, or the composition or characteristics of the portfolio, based on ESG criteria or characteristics, this information is relevant to the determination of Feature 2 rather than Feature 1. We refer the evaluator to Section 8.4.1.

- **Reports regarding the ESG characteristics of the fund's portfolio:** Feature 1, as we have defined it, is the use of ESG information as an input. Feature 1 does not seek to produce pre-specified ESG-related portfolio characteristics. Thus, any information about the ESG-related characteristics of the fund's portfolio is not relevant to the determination of Feature 1.
- **Reports regarding the incidental environmental and/or social impacts of investees or assets:** Feature 1, as we have defined it, is the use of ESG information as an input. Feature 1 does not seek specific environmental and/or social outcomes. Thus, any information about environmental and/or social outcomes is not relevant to the determination of Feature 1.
- **Reports regarding progress toward a target state in environmental and/or social conditions:** Feature 1, as we have defined it, is the use of ESG information as an input. Feature 1 does not seek specific environmental and/or social outcomes. Thus, any information about environmental and/or social outcomes is not relevant to the determination of Feature 1.

8.4. Guidelines for Determining the Existence of Feature 2

Recall that a fund has Feature 2 if it has, or is subject to, one or more policies that control fund investors' exposure and contribution to specific systemic ESG issues.

Our objective is solely to determine if a fund has one or more policies that control fund investors' exposure and contribution to specific systemic ESG issues, not to opine on the appropriateness of the policy with respect to any objective.

8.4.1. Evaluating Investment Policies for Screening and Portfolio Construction (likely to be relevant)

When evaluating investment policies, the goal is to determine (1) whether the fund has, or is subject to, policies that prescribe and/or prohibit certain actions and thus limit the discretionary decision-making authority of individuals who manage the fund's investment process; and (2) whether the policy controls fund investors' exposure and contribution to specific systemic ESG issues. We do not need to know the reasons for the policy. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 2:

- Explicit ESG criteria that systematically exclude certain investments and/or ESG criteria that must be met for an investment to be considered for inclusion in the portfolio.
- Explicit portfolio-level allocation targets for investments that have specific ESG characteristics.
- Explicit targets for portfolio-level ESG characteristics.

Screening and Portfolio Construction Policies That Are Indicative of Feature 2

Example 1

The fund will invest in companies whose products and services can contribute to advancing one or more of the UN Sustainable Development Goals.

Example 2

The fund aims to invest at least 25% of the market value of its fixed-income holdings in labeled green bonds and Certified Climate Bonds.

8.4.2. Evaluating Descriptions of the Investment Strategy and/or Investment Process (likely to be relevant)

When evaluating descriptions of the investment strategy and/or investment process, the goal is to look for evidence that indicates that the fund has, or is subject to, policies that prescribe and/or prohibit certain actions—and thus limit the discretionary decision-making authority of individuals who manage the fund's investment process. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 2:

- Descriptions of process steps that include or exclude investment opportunities based on their ESG characteristics.
- Descriptions of process steps that indicate that assets' ESG characteristics are a factor in the weighting of assets in a portfolio.
- Descriptions of process steps that describe how portfolio-level allocation targets for investments that have specific ESG characteristics are attained.
- Descriptions of process steps that describe how portfolio-level ESG characteristics are attained.
- The use of scores that are based on an investee's impact on the environment and society.

Statements within an Investment Process Description That Are Indicative of Feature 2

Example 1

ESG considerations play a central role as securities need to be pre-qualified or pass a certain threshold based on climate, impact, or ESG factors before they can be considered for inclusion in the strategies. 80% of the portfolio must qualify and pass our impact assessment due diligence in our themes of climate change, community development, health and wellness, and education.

Example 2

Our investment process begins with excluding from our investment universe all issuers that are deemed to be in violation of one or more UN Global Compact principles. We then apply an ESG rating screen. Securities that have an ESG rating in the top third of their sector are considered for inclusion in the portfolio.

8.4.3. Evaluating Proxy Voting and Engagement Policies (likely to be relevant)

When evaluating proxy voting and engagement policies (or policies pertaining to other types of ownership activities), the goal is to determine (1) whether the fund has, or is subject to, policies that prescribe and/or prohibit certain actions and thus limit the discretionary decision-making authority of individuals who manage the fund's ownership activities; and (2) whether the policy controls fund investors' exposure and contribution to specific systemic ESG issues. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 2:

- An explicit statement indicating that the fund manager will generally vote for or against certain kinds of proposals related to systemic ESG issues.
- An explicit statement indicating that the fund or fund manager takes a position on specific systemic ESG issues when deciding to undertake an engagement and/or when setting the objectives for engagements.
- An explicit statement indicating the fund or fund manager will take a position on specific systemic ESG issues in decisions pertaining to the management of directly owned real assets.

Proxy Voting and Engagement Policy Statements That Are Indicative of Feature 2

Example 1

We will vote against directors who do not support the adoption of a net-zero emissions target and an associated action plan.

Example 2

For companies with a greater degree of exposure to environmental and climate-related issues, we will vote against compensation proposals if the company has not adequately incentivized executives to act in ways that mitigate a company's climate impact.

8.4.4. Reports Regarding the ESG Characteristics of the Fund's Portfolio (likely to be relevant)

When evaluating reports regarding the ESG characteristics of the fund's portfolio, the goal is to look for evidence that the fund is attempting to achieve pre-specified targets. The following indicators can increase an evaluator's confidence in concluding the fund has Feature 2:

- Statements or data that indicate a target ESG allocation and/or target ESG characteristics was or was not attained.
- Comparison of the fund's ESG allocation and/or ESG characteristics to a benchmark.

Reports about Portfolio-Level ESG Characteristics That Are Indicative of Feature 2

Example 1

The fund seeks to maintain a weighted average carbon intensity (WACI) target that is at least 50% lower than the WACI of its benchmark. Carbon intensity measures how efficiently a company uses its carbon resources to generate revenue and allows for carbon efficiency comparison among companies of different sizes. For the period ending 31 December 2023, the fund's WACI was 63% lower than the WACI of its benchmark.

Example 2

The fund targets a 1.5-degree Celsius warming limit, consistent with the Paris Agreement goals. To meet this warming limit target, the fund invests in fixed-income securities that are Climate Bonds Certified. These securities are compatible with a 1.5-degree Celsius warming limit, as determined by the Climate Bonds Taxonomy. As of 31 March 2024, 93% of the fund's assets are Climate Bonds Certified.

8.4.5. Evaluating the Fund Name (may be relevant)

A fund's name alone is insufficient to make a conclusive determination about the existence of Feature 2. The presence of "ESG" or an ESG-related term in a fund's name indicates that the fund is likely in our classification universe, but the absence of such language does not necessarily imply the fund is outside our classification universe. The use of key words in a fund's name may indicate the existence of one or more policies that control fund investors' exposure/contribution to specific systemic ESG issues and might increase an evaluator's confidence in concluding that a fund has Feature 2.

8.4.6. Evaluating the Fund Objectives (may be relevant)

When evaluating the investment objective, the goal is to look for evidence the fund has one or more policies that control fund investors' contribution and exposure to systemic ESG issues. The following indicators can increase an evaluator's confidence in concluding the fund has Feature 2:

- Explicit ESG criteria that systematically exclude certain investments and/or ESG criteria that must be met for an investment to be considered for inclusion in the portfolio.

- Explicit portfolio-level allocation targets for investments that have specific ESG characteristics.
- Explicit targets for portfolio-level ESG characteristics.

Fund Objectives That Are Indicative of Feature 2

Example 1

The fund aims to increase the value of your investment over a rolling period of any five years while having a reduced environmental footprint compared with the benchmark, as measured using carbon, water, and waste metrics.

Example 2

The investment objective of this Fund is to provide income while focusing on capital preservation and providing some potential for capital growth by investing primarily in fixed-income-oriented securities issued by companies whose products and services align with UN Sustainable Development Goals.

8.4.7. Evaluating the Benchmark (may be relevant)

A benchmark is a portfolio that serves as a relevant point of comparison, mostly for performance but sometimes for ESG-related characteristics as well. Fund benchmarks are typically indexes built to reflect the performance of a segment of a securities market. ESG indexes are indexes that include ESG considerations in their index methodologies.

Index methodologies are sets of rules for selecting and weighting securities. Index construction is analogous to the security selection and portfolio construction steps in an actively managed fund. An index methodology that uses securities' ESG characteristics in its rules to select and weight securities is equivalent to an investment policy in an actively managed fund that dictates rules for the consideration of ESG characteristics in security selection and portfolio construction.

Because benchmarks define, or at least strongly influence, security selection and portfolio construction, the choice of an ESG benchmark is effectively equivalent to having policies that control fund investors' exposure and contribution to specific systemic ESG issues. Thus, if a fund has an ESG benchmark, it is an indicator of Feature 2.

Benchmarks That Are Indicative of Feature 2

Example 1

The fund seeks to track the performance of the S&P 500 Fossil Fuel Free Index.

8.4.8. Evaluating Reports Regarding Proxy Voting Activity (may be relevant)

Some funds, or fund managers, report on proxy voting activity. Such reports may include whether the fund or manager voted for, against, or abstained from voting on specific proposed corporate actions, and in addition, some reports provide an explanation for the action taken. If these explanations show evidence that the fund manager took a consistent position on specific systemic ESG issues when voting, then this evidence indicates that the fund has Feature 2. The absence of a pattern, however, is not a conclusive indication that a fund does not have Feature 2.

Statements in Proxy Voting Reports That Are Indicative of Feature 2

Example 1

We voted against a board of director nomination at a company whose climate plans and disclosures meaningfully lag our expectations. We expect companies to have credible transition plans communicated using the recommendations of the Science Based Targets initiative (SBTi). Reporting on climate readiness will help stakeholders understand companies' ability to adapt to or mitigate climate-related risks.

8.4.9. Evaluating Reports Regarding Engagement Activity (may be relevant)

Some funds, or fund managers, report on engagement activity. Such reports may include the objectives of engagements and actions taken to achieve those objectives. If engagement reports show evidence of a consistent position on specific systemic ESG issues, then this evidence indicates that the fund has Feature 2.

Statements in Engagement Reports That Are Indicative of Feature 2

Example 1

We engaged with a US pipeline operator regarding its climate lobbying practices. Specifically, we urged the company to disclose its approach to managing relationships with trade associations, particularly concerning their stances on climate change. We shared an example of best practices for climate lobbying reporting. Additionally, we requested that the company demonstrate robust governance over its membership in trade associations, aligning with our overarching goal of achieving net-zero emissions by 2050.

8.4.10. Reports Regarding the Incidental Environmental and/or Social Impacts of Investees and/or Assets (may be relevant)

Some funds, or fund managers, report on the environmental and/or social impacts of investees and/or assets. If these reports are presented as evidence that the fund is following its investment policies to invest in investees and assets that are "good for people and the planet," and there is no evidence on how the impacts contribute to a pre-specified objective using pre-specified measures, then this evidence indicates that the fund has Feature 2.

Incidental Environmental and/or Social Impacts of Investees and/or Assets Reports That Are Indicative of Feature 2

Example 1

One of our portfolio companies, ABC Inc., reduced its CO_2e emissions in 2022 by 1,600 metric tons.

8.4.11. Inputs Deemed Unlikely to Be Relevant

- **Reports regarding progress toward a target state in environmental and/or social conditions:** Feature 2, as we have defined it, does not seek to attain a target state in environmental and/or social conditions. Thus, any information related to such an intention is not relevant to Feature 2.

8.5. Guidelines for Determining the Existence of Feature 3

Recall that a fund has Feature 3 if it has an explicit statement of intent, and an action plan, to help bring about a target future state in environmental and/or social conditions and a process to measure progress.

Our objective in this section is solely to determine whether a fund has Feature 3. It is not to opine on the likelihood or value of attaining the specified target future state in environmental and/or social conditions.

8.5.1. Evaluating the Fund Objectives (likely to be relevant)

When evaluating a fund's objectives, the following indicators can increase an evaluator's confidence in concluding the fund has Feature 3:

- An explicit statement of intent, or an explicit objective, to help bring about a target future state in environmental and/or social conditions.
- Specific information about the target future state in environmental and/or social conditions or desired outcomes (as opposed to investment process outcomes), who will benefit from attainment of the target future state, how progress toward the future state will be measured, and the time horizon over which the target state is expected to be attained.

Fund Objectives That Are Indicative of Feature 3

Example 1

The fund's primary goal is to enhance the livelihoods of 100,000 smallholder farmers in developing countries, addressing rural poverty and promoting sustainable and inclusive agricultural ecosystems. To achieve this goal, the fund provides a range of financial products specifically designed to meet the needs of smallholder farmers and agricultural small and medium-size enterprises (SMEs). These products are made accessible either directly to farmers' organizations and agricultural SMEs or indirectly through financial intermediaries. We will measure and report the impact attributed to our specific intervention.

Example 2

The fund's objective is to expedite access to renewable energy and provide electricity to 250,000 households in Angola over the next decade. To achieve this goal, specific impact metrics are established in close collaboration with

the investee company. These metrics align with the fund's impact framework, ensuring that the impact can be accurately measured. Additionally, the company commits to providing the necessary data at the agreed-upon frequency.

8.5.2. Evaluating Investment Policies for Screening and Portfolio Construction (likely to be relevant)

When evaluating investment policies, the goal is to look for evidence that the fund selects assets and constructs its portfolio in support of an objective to help bring about a target state in environmental and/or social conditions. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 3:

- Explicit criteria that systematically exclude certain investments that do not help bring about the target future state in environmental and/or social conditions; and/or criteria that must be met for an investment to help bring about the target future state in environmental and/or social conditions.
- A listing of specific investments or a description of the types of investments that will be made to help bring about the target future state in environmental and/or social conditions.
- An explanation of how the capital allocated by the fund to investees or projects plays a contributory and/or catalytic role, distinct from the investee's contributory and/or catalytic role.
- An explicit portfolio-level allocation target for investments that help bring about the target future state in environmental and/or social conditions.

Screening and Portfolio Construction Policies That Are Indicative of Feature 3

Example 1

The XYZ fund uses an impact framework to assess the potential impact of investment opportunities. If an investment opportunity does not have the potential to contribute to the fund's impact objective, the fund will not make the investment even if the investment has the potential to contribute to the fund's risk and return objectives. Thus, all investments, other than cash and cash equivalents, will contribute to the fund's impact objective.

8.5.3. Evaluating Descriptions of the Investment Strategy and/or Investment Process (likely to be relevant)

When evaluating descriptions of the investment strategy and/or investment process, the goal is to look for evidence that the fund chooses investments based on their ability to help bring about the target future state in environmental and/or social conditions. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 3:

- Descriptions of how a project's or investee's potential to help bring about the target future state in environmental and/or social conditions is assessed prior to investment.
- Descriptions of process steps that include or exclude investment opportunities based on their potential to help bring about the target future state in environmental and/or social conditions.
- Descriptions of process steps that indicate that an investment's potential to help bring about the target future state in environmental and/or social conditions are a factor in the investment's weight in the portfolio.
- Descriptions of process steps that describe how portfolio-level allocation targets for investments that have potential to help bring about the target future state in environmental and/or social conditions are attained.

Statements within an Investment Process Description That Are Indicative of Feature 3

Example 1

Prior to making an investment, the fund manager assesses potential investee companies first for the likelihood of achieving predetermined key performance indicators related to biodiversity loss mitigation and second for the ability to contribute to achieving the target internal rate of return over the life of the fund. To meet the fund's impact objectives, it may be necessary at times for the fund to prioritize investments with a greater potential for impact relative to financial performance.

Example 2

The fund aims to achieve its objective of creating 50,000 affordable housing units by providing direct, flexible loans that finance safe, affordable, quality housing in underserved communities. Prior to originating a loan, we assess the expected impact of each project, including the impact the project will have on the community, such as the number of housing units built or preserved and the number of people potentially housed.

8.5.4. Evaluating Proxy Voting and Engagement Policies (likely to be relevant)

When evaluating proxy voting and engagement policies (or policies pertaining to other types of ownership activities), the goal is to look for evidence that the fund uses its ownership rights and influence to help bring about the target future state in environmental and/or social conditions. The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 3:

- An explicit statement indicating that the fund will engage with issuers to help bring about the target future state in environmental and/or social conditions.
- An explicit statement indicating that the fund manager will generally vote for proposals that are conducive to helping bring about the target future state in environmental and/or social conditions and/or against proposals that have adverse consequences or effects with respect to bringing about the target future state.
- An explicit statement indicating the fund will use its rights and influence as an owner to help bring about the target future state in environmental and/or social conditions when engaging with the management of directly owned real assets.

Proxy Voting and Engagement Policy Statements That Are Indicative of Feature 3

Example 1

We systematically engage with companies to encourage them to implement decarbonization measures to increase the likelihood of meeting the fund's net-zero objective.

8.5.5. Evaluating Reports Regarding Engagement Activity (likely to be relevant)

Some funds, or fund managers, report on engagement activity. Such reports may include the objectives of engagements and actions taken to achieve those objectives. If engagement reports show evidence of engagement to achieve the target future state in environmental and/or social conditions, then this evidence indicates that the fund has Feature 3.

Statements in Engagement Reports That Are Indicative of Feature 3

Example 1

We engaged with the housing authority to ensure the revitalization of a severely distressed public housing complex would help meet our objective to develop sustainable and energy-efficient affordable housing for 2,500 low- to middle-income individuals. The housing was redesigned to be energy efficient to ensure lower utility costs and to provide a healthier living environment for low-income households.

8.5.6. Reports Regarding Progress toward Pre-specified Environmental and Social Objectives (likely to be relevant)

The following indicators can increase an evaluator's confidence in concluding that a fund has Feature 3:

- Quantitative or qualitative measures that evaluate progress toward attaining the target future state in environmental and social conditions.
- A narrative description assessing progress toward achieving the target future state in environmental and/or social conditions.

Reports Regarding Progress toward Pre-specified Environmental and Social Outcomes That Are Indicative of Feature 3

Example 1

Progress toward an emissions target is measured through the achievement of interim goals or by the measurement of greenhouse gas (GHG) emissions on a glidepath toward a targeted emissions level. The fund has achieved a 46% reduction in GHG emissions, versus its interim goal of 50% by 2030.

Example 2

The fund seeks to increase access to renewable energy and provide electricity to 250,000 households in Angola over the next decade. As of 31 March 2024, the fund has electrified 152,546 households in Angola, and it is on track to achieve its environmental and social objectives within its intended time horizon.

8.5.7. Evaluating the Fund Name (may be relevant)

A fund's name alone is insufficient to make a conclusive determination about the existence of Feature 3. The use of the term "impact" in a fund's name or the characterization of a fund as an impact fund is a weak indicator of Feature 3. This is primarily because "impact" is used to describe funds that aim to achieve some preconceived socioeconomic outcome (consistent with Feature 3) as well as funds that have an investment policy to buy and hold the securities of companies that have desirable ESG characteristics or are "doing good" for the environment or society (consistent with Feature 2). Therefore, evaluators should not rely solely on the fund's name for classification but instead should assess the investment objective in conjunction with other facets to ascertain whether the fund has Feature 3.

8.5.8. Evaluating Reports Regarding Proxy Voting Activity (may be relevant)

Some funds, or fund managers, report on proxy voting activity. Such reports may include whether the fund or manager voted for, against, or abstained from voting on specific proposed corporate actions. In addition, some reports provide an explanation for the action taken. If these explanations show evidence that the fund manager voted consistently with an objective to help bring about the target future state in environmental and/or social conditions, then this evidence indicates that the fund has Feature 3. The absence of a pattern, however, is not a conclusive indication that a fund does not have Feature 3.

Reports Regarding Proxy Voting Activity That Are Indicative of Feature 3

Example 1

We will generally vote for shareholder proposals that align with our objective to reduce GHG emissions. Over the last 12 months, we have voted 100% for shareholder proposals regarding the adoption of GHG emissions reduction targets aligned with the Paris Agreement goal and 100% for shareholder proposals regarding the adoption of independently verified science-based GHG emissions reduction targets aligned with the Paris Agreement.

8.5.9. Inputs Deemed Unlikely to Be Relevant

- **Benchmarks:** We deem benchmarks unlikely to be relevant because an inherent element of Feature 3 is a defined target future state. Thus, the target future state is the relevant point of reference for progress, rather than an index or some other point of reference.
- **Reports regarding the ESG characteristics of the fund's portfolio:** The purpose of Feature 3, as we have defined it, is the pursuit of a target state in environmental and/or social conditions; it is not the construction of a portfolio with pre-specified ESG characteristics. To achieve a target future state in environmental and/or social conditions, a fund may need to invest in assets or companies that have relatively unfavorable ESG characteristics. Any persistent ESG characteristics that a fund may have, either positive or negative, should be considered an indicator of Feature 2 rather than Feature 3. From our limited research, we believe that many funds that have Feature 3 will also have Feature 2.
- **Reports regarding the incidental environmental and/or social impacts of investees or assets:** We acknowledge that a fund's actions, or investees' actions, to help bring about a specific target future state may result in other incidental environmental and/or social impacts. Such incidental impacts, however, are not relevant to the determination of whether the fund has an explicit intention to help bring about a specific future state or outcome in environmental and/or social conditions.

CONCLUSIONS AND NEXT STEPS

Having explored the challenges of ESG fund classification, analyzed existing classification systems, designed a novel classification system, proposed guidelines and examples for applying classification criteria, and worked through case studies, we now highlight our key insights and conclusions.

- Product classification system design is a discipline that is useful for understanding and analyzing existing classification systems. It is also useful for designing better classification systems that avoid common problems, such as poorly defined group boundaries, the introduction of subjective views, and debates about group names.
- Fund classification is difficult—both in terms of designing a fund classification system and classifying individual funds according to a given system. Individuals who have no direct and practical experience with product classification may not fully appreciate the level of rigor and effort required to design and implement a fund classification system.
- The rigorous definition of observable, functional features that provide specific value propositions to fund investors is the key to creating a robust ESG fund classification system that simultaneously meets the needs of the marketplace, regulators, and researchers. Brief definitions that delineate different types of funds are sufficient for conceptual frameworks, but they are inadequate for regulation or making categorical determinations in practice.
- Guidelines, examples, and case studies are critical for achieving consistent classification across evaluators and over time. The classification process should be given as much attention as feature and group definitions.
- Product classification system design requires significant technical knowledge about the products in the classification universe, and classification systems need to be updated regularly to adapt to changes in products and the marketplace. Legislators and regulators should carefully consider whether they have the technical knowledge and capacity to develop and maintain product classification systems and the complementary role that independent standard setters may play.
- Product classification systems should be intentionally designed. The Sustainable Finance Disclosure Regulation in the EU and the proposed Enhanced Disclosures Rule in the United States should either (1) eliminate the elements that have resulted in, or are likely to result in, de facto fund classification systems, or alternatively (2) intentionally and fully incorporate product classification system design principles.
- The labels established in the Sustainability Disclosure Requirements and Investment Labels (SDR) in the UK are highly useful as inputs into a product classification system. SDR is not a classification system in and of itself,

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however, and thus the need remains in the marketplace for a classification system that goes beyond SDR labels.

- Product classification system design may not fully resolve the debate about what the term “ESG fund” means. Nonetheless, it does allow for better debate by defining groups of funds that people can refer to when articulating their position on what sorts of funds they believe should and should not be referred to as ESG funds.

Next Steps

We hope this paper can serve as a foundation for future work, and we outline several of our ideas below. We invite readers to send comments, feedback, and ideas for next steps to ESGStandards@cfainstitute.org.

Testing and Refinement

Organizations that offer fund selection support to clients may want to test the ideas in this paper to see if they are helpful with respect to educating their clients and helping them choose funds; selecting and presenting the funds offered on the organization’s platform; and/or educating staff who interact with clients.

Researchers may want to incorporate the ideas in this paper into their research when there is a need to distinguish between funds with different ESG-related value propositions. If multiple researchers find it useful, new fields might be added to fund databases used for academic research, such as the Survivor-Bias-Free Mutual Fund Database from the Center for Research in Security Prices (CRSP), an affiliate of the Booth School of Business at the University of Chicago.

Fund managers may want to test the ideas in this paper by classifying the funds that they offer. Classification could help fund managers better market their funds and better communicate to prospective investors the differences between funds, especially in markets where there is general confusion about what ESG means.

Adding Granularity to Feature 2

We acknowledge that many variants of Feature 2—and, therefore, any group of funds that have Feature 2—may appear rather diverse (i.e., not very homogeneous). We recognize that many investors likely want a more granular distinction as to what sorts of policies a fund has (or is subject to), what sorts of systemic ESG issues are addressed in those policies, and what sort of control the policies provide with respect to exposure and contribution to those ESG issues.

It is certainly possible to define criteria that would partition Feature 2 into subgroups, and we are considering tackling this challenge in a second paper. In subdividing Feature 2 according to the types of policies that funds have,

we hope to derive insight into the terms *sustainable funds*, *responsible funds*, and *ethical funds* in the way we have developed insights into the term *ESG funds* in this paper.

Meanwhile, we believe it is important for both investors and regulators to recognize that policies are often the common underlying mechanism by which funds differentiate themselves. For example, consider that "faith-based" or "ethical" funds typically have policies based on religious beliefs; "responsible" funds typically have policies based on secular societal norms; and "sustainable" and "impact" funds typically have policies based on the positive or negative impacts that economic activities impose on the environment and other people (i.e., externalities).

Investors and regulators can benefit from this policy-centric view. The implication for investors is that they need to carefully review fund-level, fund-family-level, and firm-level policies to evaluate the alignment with their personal needs and preferences. The implication for regulators is that they need not create special rules for these different types of funds but rather can address all of them simultaneously and consistently. To do so, regulators must create rules that ensure that all the underlying policies that affect the fund's characteristics and performance are accessible to investors and communicated in a complete, reliable, clear, and consistent manner—which in our opinion is currently not the case.

Extension to Other Types of Investment Products

In Chapter 3, we limited the scope of our classification system to funds that invest in securities, contracts, and real assets. We intentionally excluded funds that invest in other funds—in other words, "funds-of-funds." We believe, however, we could relax that constraint and extend our classification system to funds-of-funds through additional implementation guidance. For example, we might establish guidance that says an evaluator's confidence in concluding a fund-of-funds has Feature 1 if (1) it considers ESG information in the process of selecting investee funds with the aim of improving risk-adjusted returns, and/or (2) it has an investment policy that requires all investee funds to have one or more processes that consider ESG information with the aim of improving risk-adjusted returns.

The classification system could also be extended beyond funds to other investment vehicles, such as investment strategies by which individually owned accounts are managed. At least one additional challenge arises in this context: customization. Consider a strategy that is implemented identically for each client's portfolio except for investment exclusion criteria, which can be set by the client. Some clients choose not to exclude any assets, and others opt for different sets of exclusion criteria. How should a classification system reflect this situation? There are at least several options, but it is necessary to work through the classification system design process to determine which is best for various user needs. A system for classifying investment strategies could be developed in a future paper.

Classification Process Efficiency

Classifying funds according to features described in fund documents is labor intensive because it requires extracting relevant texts from numerous and lengthy documents and interpreting those texts. We wonder if a machine learning algorithm could accurately determine funds' features. As we noted earlier, once the combination of features is known, group assignment is trivial.

Closing Thoughts

We hope this paper has provided readers with a deeper understanding and appreciation of fund classification—in general, as well as specifically for funds that take ESG information, issues, and/or conditions into account. We hope it sparks additional insights and work from others and that these efforts allow the investment industry and its regulators to develop classification systems that are more effective and efficient.

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APPENDIX A: CASE STUDIES

Case Study #1: ClearBridge International Growth Fund

Goal

Determine the ESG-related features of the ClearBridge International Growth Fund and assign the fund to a group.

Process

We follow the process for determining the existence of features as outlined in Chapter 8. We halt our assessment either when we have enough evidence to make a determination about the fund's ESG-related features or when we determine we have insufficient data to make such a determination. We make no claim that the evidence presented in the supporting analysis section is the totality of evidence that an evaluator might consider when determining the ESG-related features of a fund.

Source Documents

After reviewing many documents presented on the fund's webpage[1] and the manager's website,[2] we determined that the following documents were the most useful and relevant for determining the fund's features. These documents may be updated on a periodic or ad hoc basis, and thus our determination of the fund's features is as of 1 July 2024, the date on which we accessed and reviewed the documents.

- Prospectus, 1 March 2024
- Statement of Additional Information, 1 March 2024
- ClearBridge ESG Policy, amended as of April 2024
- ClearBridge UN Global Compact (UNGC) and (OECD) Guidelines for Multinational Enterprises Monitoring Policy, amended as of 1 July 2024
- ClearBridge Investments Proxy Voting Policy, amended as of August 2023
- ClearBridge Engagement and Stewardship Policy, amended as of August 2023

[1]www.franklintempleton.com/clearbridge/mutual-funds/90096/AA2/clearbridge-international-growth-fund/LGGAX#regulatory-documents.

[2]www.clearbridge.com/.

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Summary Conclusion

Based on our interpretation of the information presented in the foregoing documents with respect to Features 1, 2, and 3 as defined in Chapter 5, we conclude that the fund has Features 1 and 2 but not Feature 3. This combination of features places the fund in Groups I, J, T, and B as defined in Chapter 6.

Supporting Analysis

Determination of the Existence of Feature 1

A fund has Feature 1 if it has one or more processes that consider ESG information with the aim to improve risk-adjusted returns.

The following statements clearly indicate that the fund considers ESG information in the investment process:

- "Environmental factors, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and acting as stewards of client capital." (ESG Policy, p. 6)
- "The manager's fundamental research analysts typically use their industry expertise to determine the material environmental, social and governance ('ESG') factors facing both individual companies and industry sectors. The fundamental research analysts may also engage with company management regarding the extent to which they promote best practices of such factors." (Prospectus, p. 10)
- "ESG considerations are one of a number of factors that the manager examines when considering investments for the fund's portfolio." (Prospectus, p. 15)

The following statements clearly indicate that the fund considers ESG information with the aim to improve risk-adjusted returns:

- "We believe companies that plan thoughtfully for the future and operate sustainably in relation to their customers, communities and the environment should have a long-term competitive advantage over their peers." (ESG Policy, p. 1)
- "While the manager views ESG considerations as having the potential to contribute to the fund's long-term performance, there is no guarantee that such results will be achieved." (Prospectus, p. 15)

Thus, we conclude that the fund has Feature 1.

Determination of the Existence of Feature 2

A fund has Feature 2 if it has, or is subject to, one or more policies that control fund investors' exposure and contribution to specific systemic ESG issues.

The fund's Statement of Additional Information (SAI) contains numerous fundamental and non-fundamental investment policies.[3] None of these investment policies, however, controls fund investors' exposure and contribution to specific systemic ESG issues. In addition, there is no information in the fund's prospectus that indicates that the fund has ESG-related criteria that systematically exclude certain investments or has ESG-related criteria that must be met in order for an investment to be considered for inclusion in the portfolio. The following statements indicate that the fund takes a discretionary, rather than a policy-based, approach to the consideration of ESG information and/or issues in the investment process:

- "… the issuers in which the fund invests may not be considered ESG-focused issuers and may have lower or adverse ESG assessments. The manager may not assess every investment for ESG factors and, when it does, not every ESG factor may be identified or evaluated. The manager's assessment of an issuer's ESG factors is subjective and may differ from that of investors, third-party service providers (e.g., ratings providers) and other funds. As a result, securities selected by the manager may not reflect the beliefs and values of any particular investor." (Prospectus, p. 15)

The firm's UNGC Monitoring Policy, however, states that the firm does not invest in companies that violate the 10 principles of the UN Global Compact (UNGC).

- "ClearBridge Investments supports the principles of the UN Global Compact (UNGC) and therefore we do not invest in companies that violate the ten principles in each of the four areas (human rights, labor, environment and anti-corruption) of the UNGC. ClearBridge also supports the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises as a comprehensive standard for responsible business conduct." (UNGC/OECD Monitoring Policy, p. 1)

We deem the UNGC principles focusing on human rights, labor, environment and anti-corruption to be ESG issues—that is, important, and often unsettled, matters relating to the environment, society, and/or corporate/issuer governance—and systemic issues because of the impacts that violators of the UNGC have on consumers, the environment, and society. We acknowledge this is a subjective determination but one that is widely made.

[3]The SAI explains the difference between fundamental and non-fundamental investment policies: "Fundamental investment policies of the Fund may not be changed without a 1940 Act Vote. The Board may change non-fundamental investment policies at any time without shareholder approval and upon notice to shareholders."

We do not know to what extent various considerations factored into the creation of the UNGC/OECD policy. As we stated in Chapter 5, however, the *reasons* for the policy are irrelevant. The only relevant fact is that the fund *has*, or in this case *is subject to*, a policy that controls fund investors' exposure and contribution to specific systemic ESG issues.

In addition to being subject to a firm-wide investment exclusion policy, the fund is also subject to a firm-wide proxy voting policy. The firm's proxy voting policy states whether the firm will vote for or against certain proposals or will consider them on a case-by-case basis.

Most of the topics addressed in the proxy voting policy pertain to corporate governance—for example, director independence, poison pills, dual class shares, and executive compensation. In isolation, any corporate governance issue at any single company is an idiosyncratic risk. It is our opinion, however, that over time and across portfolio investments, governance policies can reduce fund investors' exposure and/or contribution to systemic governance issues.

In addition to corporate governance, the proxy voting policy addresses several environmental and social topics. For the most part, the policies state the firm will typically vote for proposals that result in the provision of additional information. Additional information, however, in and of itself, does not have any effect on fund investors' exposure and contribution to systemic ESG issues. Thus, we would not conclude that a fund has Feature 2 solely because it has, or is subject to, policies designed to obtain additional information from companies.

The proxy voting policy, however, does have a clear voting position with respect to significant GHG emissions and board diversity:

- "We will generally vote against the Chair of the board and the Chair of the responsible committee for companies that are significant GHG emitters in cases where the company is not taking the minimum steps needed to understand, assess, and mitigate risks related to climate change to the company and the larger economy. Minimum steps include detailed disclosure of climate-related risks, such as the Task Force on Climate-related Financial Disclosures (TCFD); and, at this time, 'appropriate' GHG emissions reductions targets (i.e., short-term and medium-term GHG reduction targets or net zero by 2050 GHG reduction targets)" (Proxy Voting Policy, p. 5)
- "We withhold our vote from a director nominee who: … is a member of the company's nominating committee and there is no gender diversity on the board (or those currently proposed for election to the board do not meet that criterion) … is a member of the company's nominating committee and there is no racial/ethnic diversity on the board (or those currently proposed for election to the board do not meet that criterion)."[4] (Proxy Voting Policy, p. 5)

[4]This racial/ethnic diversity position applies only to Anglo markets, defined as the United States, Canada, United Kingdom, Ireland, Australia, and New Zealand.

In summary, we conclude that the fund has Feature 2 because it is subject to at least two firm-wide policies that we believe serve to reduce fund investors' exposure and contribution to systemic ESG issues.

Determination of the Existence of Feature 3

A fund has Feature 3 if it has an explicit statement of intent, and an action plan, to help bring about a target future state in environmental and/or social conditions and a process to measure progress.

The fund's prospectus states that the fund's investment objective is "long-term growth of capital." We find no evidence that the fund has an explicit statement of intent, or an action plan, to help bring about a specific target state in environmental and/or social conditions, or a process to measure progress toward such a state.

There are, however, several statements in the documents that we reviewed that indicate the manager is cognizant of the secondary effects its decision and actions may have and that it desires to create positive spillover effects:

- "We believe investors in public equities have a crucial role to play in addressing environmental and social challenges faced by society. Large public companies have a substantial environmental and social impact (both positive and negative) by virtue of their size and complex stakeholder relationships across supply chains, distribution networks and communities where they operate. We can amplify this impact through our allocation of capital and direct engagement with company managements." (ESG Policy, p. 2)
- "As an active supporter of the Paris Agreement, ClearBridge has an important role to play in mitigating the effects of climate change." (ESG Policy, p. 4)
- "When considering environmental and social (E&S) proposals, we have an obligation to vote proxies in the best interest of our clients, considering both shareholder value as well as societal impact." (Proxy Voting Policy, p. 21)

These statements—neither individually nor collectively—do not satisfy the criteria for Feature 3. Thus, we conclude that the fund does not have Feature 3.

Case Study #2: PGIM Total Return Bond Fund (US)

Goal

Determine the ESG-related features of the PGIM Total Return Bond Fund (US) and assign the fund to a group.

Process

We follow the process for determining the existence of features as outlined in Chapter 8. We halt our assessment either when we have enough evidence to make a determination about the fund's ESG-related features or when we determine we have insufficient data to make such a determination. We make no claim that the evidence presented in the supporting analysis section is the totality of evidence that an evaluator might consider when determining the ESG-related features of a fund.

Source Documents

After reviewing many documents presented on the fund's webpage[5] and the manager's website,[6] we determined that the following documents were the most useful and relevant for determining the fund's features. These documents may be updated on a periodic or ad hoc basis, and thus our determination of the fund's features is as of 1 July 2024, the date on which we accessed and reviewed the documents.

- Prospectus, reissued 17 April 2024
- Statement of Additional Information, 29 December 2023
- Who We Are: ESG at PGIM Fixed Income, 24 August 2023
- What We Do: ESG Annual Report 2022, August 2023

Summary Conclusion

Based on our interpretation of the information presented in the foregoing documents with respect to Features 1, 2, and 3 as defined in Chapter 5, we conclude that the fund has Feature 1 but not Feature 2 or Feature 3. This combination of features places the fund in Groups I, Q, and A as defined in Chapter 6.

Supporting Analysis

Determination of the Existence of Feature 1

A fund has Feature 1 if it has one or more processes that consider ESG information with the aim to improve risk-adjusted returns.

[5]See www.pgim.com/investments/mutual-funds/pgim-total-return-bond-fund.

[6]See http://www.pgim.com/fixed-income/.

The following statements clearly indicate that the fund considers ESG information in the investment process:

- "Our credit ratings incorporate analysis of credit-material risks and opportunities arising from ESG factors, alongside other risk factors, to reflect our overall fundamental credit view of the issuer. This is done for all credit strategies that we manage and is consistent with our fiduciary obligations." (ESG Annual Report 2022, p. 5)
- "We consider climate change and associated investment risk to be an important factor that should be incorporated in our credit assessment, especially where we deem the issuer's exposure to climate risk to be high." (ESG at PGIM Fixed Income, p. 14)

The following statements clearly indicate that the fund considers ESG information with the aim to improve risk-adjusted returns:

- "We consider credit-material ESG factors in our investment process as part of working towards our ultimate duty—searching for the highest risk-adjusted returns for our clients based on their return objectives." (ESG at PGIM Fixed Income, p. 4)
- "As a fundamental research-driven active fixed income manager, we believe ESG issues can affect the financial performance of investment portfolios. Therefore, we recognise the importance of integrating environmental, social and governance factors in our global investment research, decision-making, and portfolio management processes." (ESG Annual Report 2022, p. 5)
- "We believe ESG factors can impact investment performance, and we therefore integrate financially material ESG factors into the credit analysis processes used across all of our strategies." (ESG Annual Report 2022, p. 5)
- "Our rationale for owning credits where we observe credit-material ESG challenges is generally twofold. We see the company or country moving in the right direction to reduce these risks and/or we feel that spreads have sufficiently compensated us for the ESG risks." (ESG Annual Report 2022, p. 35)

Thus, we conclude that the fund has Feature 1.

Determination of the Existence of Feature 2

A fund has Feature 2 if it has, or is subject to, one or more policies that control fund investors' exposure and contribution to specific systemic ESG issues.

The Statement of Additional Information (SAI) contains numerous fundamental and non-fundamental investment policies.[7] None of these investment policies,

[7]The SAI explains the difference between fundamental and non-fundamental investment policies: "Fundamental investment policies of the Fund may not be changed without a 1940 Act Vote. The Board may change non-fundamental investment policies at any time without shareholder approval and upon notice to shareholders."

however, controls fund investors' exposure and contribution to specific systemic ESG issues.

The documents we reviewed provide information that certain PGIM Fixed Income–labeled funds with ESG impact objectives will have exclusions based on the ESG Impact Ratings and/or other ESG issues. The PGIM Total Return Bond Fund, however, does not have such objectives.

Thus, we conclude the fund does not have Feature 2.

Determination of the Existence of Feature 3

A fund has Feature 3 if it has an explicit statement of intent, and an action plan, to help bring about a target future state in environmental and/or social conditions and a process to measure progress.

The fund's prospectus states that the fund's investment objective is "total return." We find no evidence that the fund has an explicit statement of intent, or an action plan, to help bring about a target state in environmental and/or social conditions, or a process to measure progress toward such a state.

Case Study #3: Incofin Water Access Acceleration Fund

Goal

Determine the ESG-related features of the Incofin Water Access Acceleration Fund and assign the fund to a group.

Process

We follow the process for determining the existence of features as outlined in Chapter 8. We halt our assessment either when we have enough evidence to make a determination about the fund's ESG-related features or we determine we have insufficient data to make such a determination. We make no claim that the evidence presented in the supporting analysis section is the totality of evidence that an evaluator might consider when determining the ESG-related features of a fund.

Source Documents

The Incofin Water Access Acceleration Fund is a private equity, blended finance fund. We did not review or request access to the fund's offering documents or any other information. Our evaluation relies solely on the publicly available launch announcement, which we accessed and reviewed on 1 July 2024.

- Launch Announcement

Summary Conclusion

Without the necessary documents, we cannot make a conclusive determination for all three features. We were, however, able to determine that the fund meets at least some of the criteria for Feature 3.

Supporting Analysis

Determination of the Existence of Feature 3

A fund has Feature 3 if it has an explicit statement of intent, and an action plan, to help bring about a target future state in environmental and/or social conditions and a process to measure progress.

The launch announcement states, "The blended fund aims to provide 20 billion liters of water to 30 million people, mainly in Africa and Asia." We deem this to be an explicit statement of intent to help bring about a target state in environmental and/or social conditions. The target state is the point in the future when 20 billion liters of water have been provided to 30 million people, mainly in Africa and Asia.

The launch announcement also provides information about the intended actions that the fund will take to help bring about the target state:

- "W2AF invests in innovative water businesses that provide affordable, safe drinking water to underserved populations."
- "W2AF plans to invest in various decentralized solutions, such as water kiosks, which deliver safely treated drinking water in gallons to the home or to the local store. In addition, the fund will invest in water pipe infrastructure and water technologies. The investments will contribute to delivering safe drinking water to low-income communities around the world."

The launch announcement does not provide information about the process or metrics by which progress will be measured and reported, and so we cannot evaluate the final criterion for Feature 3.

Reflections and Observations from Case Studies

The case studies gave us valuable insights into the practical considerations of fund classification:

- Rigorously defined criteria are critical for making categorical determinations.
- Judgment cannot be completely removed from the process. The key judgment in the classification system that we have proposed is likely in the determination of exactly what sorts of information and issues are *ESG information and issues*. We acknowledge that others may disagree with the determinations we made in these case studies.

- Because inputs may be interpreted differently by different people, evaluators should be transparent about the evidence and reasoning that went into their analysis.
- Volume and dispersion of information greatly hinders and complicates the evaluation process. For example, some funds have firm-wide ESG policies or statements that outline their overall approach to ESG considerations across all funds. Additionally, certain ESG policies or statements may include fund-family-specific guidelines that do not uniformly apply to all funds, without explicitly specifying which funds are subject to those policies. This lack of clarity can result in confusion and inaccurate fund categorization. For instance, it is challenging to make a conclusive determination when a firm-wide policy indicates that only "ESG strategies" will incorporate exclusions related to ESG issues but does not specifically identify which funds have "ESG strategies."
- If an evaluator's objective is efficiency rather than completeness, the evaluation process can be halted once sufficient evidence to support a conclusion is found. It may not be necessary to evaluate all the potential sources of information or evaluate them in full.
- In our search for funds that could serve as case studies, it was difficult—but not impossible—to find funds that met the criteria for Feature 3. The funds that we found seemed to be private funds, partnerships, and/or blended finance vehicles. We found many retail funds that had an objective/policy to invest in assets that have positive impact—that is, there was evidence of "intent"—but none of those funds explicitly stated their intention in terms of a specific target state in environmental/social conditions or desired outcomes—that is, they did not give enough specifics such that an evaluation could be made about progress toward the goal or whether the goal had been achieved.
- We hypothesize that there are at least several reasons why we found specific targets for environmental/social outcomes in private funds and not in retail funds: (1) Retail fund managers generally prefer to state objectives using broad and flexible language; (2) retail funds do not know in advance exactly what investments they will make and thus do not know with precision the impact those investments will have; (3) retail funds tend to be larger and more diversified whereas private funds can be smaller and more targeted; and (4) private funds may need to have specific environmental/social outcome objectives to obtain grants, philanthropic support, and/or funding from development banks and governments.
- Because funds can communicate their intentions or objectives in a variety of ways, classification systems and regulators should not assume that the meanings of words and phrases such as "intent," "impact objective," or "seeks a specific ESG impact" are self-evident or can be fully explained by brief definitions. If such words and phrases are to be used to make categorical distinctions, they need to be supported by in-depth explanations, guidelines, and examples.

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