



JULY 2022

# Integrated financial products: Review of managed fund documentation

Findings from a review of the effectiveness of disclosure information from a sample of managed investment funds labelled or marketed as being integrated financial products (e.g. sustainable, ethical, green)

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# Executive summary

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Managed funds that look beyond financial returns and integrate non-financial factors are becoming more common.<sup>1</sup> This reflects that New Zealanders are increasingly seeking investments that match their ethics or values.

However, research by the Financial Markets Authority – Te Mana Tātai Hokohoko (FMA) indicates that investor due diligence is still brief, and formal disclosure may not currently be useful to investors. The lack of close engagement by investors reinforces the information advantage fund Managers have over investors.<sup>2</sup> The funds management industry needs to provide accurate, well-placed and high-quality information to explain and support claims that their products incorporate non-financial factors.

## What are integrated financial products?

'Integrated financial products' refers to financial products incorporating non-financial factors alongside financial factors. Our choice of the term 'integrated financial product' (IFP) reflects that other terms for the concept, while commonly used, do not have commonly shared meanings (e.g. 'ethical', 'responsible', 'sustainable', 'green' and 'Environmental, Social and Governance' (ESG)). The FMA supports New Zealand's transition to an integrated financial system – one that looks beyond financial returns to also consider non-financial factors. For more information see our website: [Our role in an integrated financial system](#).

## About our review

This report focuses on a review we undertook of disclosure practices for a sample of managed funds (including KiwiSaver funds) that use an IFP label in their name or description. We wanted to better understand how Managers of IFP Funds provide information to help people make investment decisions, including information about the risks and benefits of IFP Funds.

In September and October 2021 we reviewed 14 KiwiSaver and non-KiwiSaver funds we identified as being IFP Funds, based on their name or how they were described on the Disclose Register (e.g. including terms like 'sustainable', 'responsible' or 'ethical'). We looked carefully at the information Managers provide to investors about the funds.

Our 2020 publication [Disclosure framework for integrated financial products](#) (IFP Guidance) sets out ways for Managers to meet the particular disclosure challenges of IFP Funds, to help investors make informed decisions and be confident that IFP products are true to their labels. This review also considered the uptake of the IFP Guidance across the different information sources provided to investors.

The information we reviewed included:

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<sup>1</sup> We refer to these funds as integrated financial product funds (IFP Funds). In this report, this means funds that hold themselves out to investors as integrating non-financial factors. We note that some funds integrate non-financial factors without advertising themselves as such.

<sup>2</sup> In this report the term 'Managers' refers to licensed managed investment scheme managers that make regulated offers of IFP Funds.

- Product Disclosure Statements (PDS) – these provide investors with information, prescribed by law, to help them decide whether to invest in the funds under a managed investment scheme (MIS). This includes details about how the Manager works, fund offered, risks, expected returns, and fees and charges.
- Statements of investment policy and objectives (SIPO) – these provide investors with information on the investment governance and management framework, philosophy, strategies and objectives of a MIS and its investment funds. All Managers must have a SIPO for each MIS they manage.
- Other material information (OMI) documents – these contain information that is material to an investor's investment decision, but that is not in the PDS. Like other disclosure documents, this is lodged on the Disclose Register where investors can find it.
- Separate policy documents (IFP policy statements) – these are typically on the Manager's website, with material policy documents lodged on the Disclose Register. They could include a responsible investment policy or an environmental, social, and corporate governance policy.
- Websites and advertising – the content of this information is not prescribed by law, but there are restrictions on what statements can be made. See our guidance note [Advertising offers of financial products under the Financial Markets Conduct Act 2013 \(FMC Act\)](#).

Our review mainly focused on the PDS, which must be provided to investors. We also looked carefully at the SIPO, as this was a good place for IFP strategies to be explained in more detail.

We did not attempt to verify specific claims made by Managers about their products. Instead, we focused on whether and how Managers disclosed the types of information noted by the IFP Guidance as being material, and how Managers factually supported IFP labelling or marketing.

Following our review, we communicated our findings to each of the 14 funds and, where appropriate, offered feedback about how fund documentation could be improved to meet the IFP Guidance expectations.

## Findings

All of the funds we reviewed had weaknesses in information disclosure in at least one area. Most funds had multiple areas where improvement was needed. Managers need to improve the quality, utility and accessibility of the information they provide to investors about their IFP Funds.

We found deficiencies in both the information that IFP Funds provide to investors, and the way in which that information is presented. These deficiencies mean that it is difficult, or in some cases impossible, for an investor to fully understand the nature of the investment they are making.

- Overall, we noted it would be difficult for investors to decide on which IFP Fund to select, because relevant information is scattered across different sources, and information that is provided often doesn't give a complete picture, or lacks sufficient detail.
- We observed some “blurring of the line” between financial and non-financial factors, as many factors regarded as non-financial will have a financial impact over time. For example, it is commonly argued that failing to address climate change will eventually affect company returns, or that a diversity or inclusion policy will reduce a company's staff turnover. This blurring complicates comparing funds and makes clear disclosure even more important.
- Managers need to do more to clearly explain what investments their IFP Funds will exclude and why. Funds often failed to adequately explain the scope of the exclusions and relevant thresholds, and how their exclusion policies apply to incidents (like Russia's invasion of Ukraine) or to derivatives.

- Managers of IFP Funds using a ‘positive screening’ approach (where an IFP Fund ‘tilts’ investment toward activities it regards as contributing to positive non-financial objectives or outcomes) need to do more to explain how the fund will select investments consistent with their approach, including using more specific language, and providing clarity about weightings between financial and non-financial outcomes or between competing non-financial outcomes.
- Managers need to provide better information to help investors understand any risks arising from integrating non-financial factors into the fund’s investment decisions.
- In some cases, descriptions of the fund’s non-financial benefits or objectives were so high level or subjective that they provided almost no value, for example saying that “the fund’s returns will be financial and a reduced climate impact”, or that the fund will have a “climate impact” or engage in “active ownership”.
- Consequences of breaches, measurement of performance, and reporting were all areas where a significant majority of IFP Funds failed to provide adequate information. Investors would find it difficult to understand what a fund would do in the event of a breach of its IFP policies, and how, or even if, a fund is meeting its IFP objectives.
- Managers frequently market their IFP Funds with reference to some external provider that may provide measurement standards, endorsement and even assurance, relevant to the fund’s IFP characteristics. However, we found most funds fail to explain what these external provider references mean in practice or their value to investors.

Based on our assessment of the quality, utility and accessibility of the information that Managers provide to investors, and considering IFP funds are a relatively recent innovation, we consider that Managers have not developed mature approaches to disclosure of the features, risks and benefits of IFP Funds.

Although we did not assess if there was ‘greenwashing’ in the funds we selected for review, we believe this lack of maturity risks exacerbating investor disengagement and a ‘race to the bottom’, where minimal effort is applied to achieving non-financial objectives and the distinction between IFP Funds and ‘vanilla’ managed funds eventually disappears.

We have clearly stated our expectations for IFP Funds, and the reasons for those expectations. This report has established that Managers of IFP Funds have a lot of work to do and we now expect them, assisted by their supervisors<sup>3</sup>, to take the necessary care not to mislead or confuse investors with greenwashing. This is an area the FMA will continue to monitor to prevent complacency and the entrenchment of poor disclosure.

### Helping investors

We have used insights from this report to expand and improve our [guidance for investors](#) on how to take a deeper look at ethical funds, and factors they may need to consider in making an ethical investment decision.

We have also published [findings from a focus group of New Zealanders](#), which provides insights into the challenges of choosing IFP Funds. This research has helped us identify areas for improvement in how IFP Funds provide information to investors.

<sup>3</sup> ‘Supervisors’ are entities appointed to look after investor interests and supervise managed investment schemes, including KiwiSaver schemes.

# What we found

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## Investor decision-making is complicated by relevant information being scattered, partial or lacking

Information provided by Managers should make it as simple as reasonably possible for an investor to select a fund to match their values or ethics. One investor might be satisfied with a fund that simply excludes investments in certain industries (e.g. tobacco). Another investor might be seeking a fund that targets investments in certain sectors or industries to have a beneficial impact (e.g. new clean energy projects).

Our [investor research](#) found investors choosing between different IFP Funds do some research through provider websites, product information and the PDS, before deciding to invest. However, it also found this process is more difficult than it should be, due to complex or vague language, insufficient information, and information spread across multiple documents and webpages.

This was supported by our review, which showed information about the approach taken by an IFP Fund is often not disclosed upfront in the PDS, but might be contained in other documents or on the scheme's website. Fully understanding a fund's investment approach will often require an investor to refer to several separate information sources – and there is no guarantee, even after going to that effort, that the investor will have a complete picture.

This means:

- investors cannot be confident the fund they are looking at invests, and will continue to invest, in a way that is aligned with their values; and
- it is hard for investors to compare one fund with another, even if the investment strategies are broadly similar (e.g. both funds are passive, well-diversified KiwiSaver growth funds).

The investor research indicates that, faced with this, investors will likely abandon direct comparisons between the investment approaches of different funds. Instead, they will often select a fund based on less-reliable information resources such as internet searches, asking friends, or using social media. The chosen fund may not meet their needs, or it may meet their needs at first, but cease to do so over time, perhaps because of a change in strategy or ownership.

We strongly recommend Managers improve the level of detail and clarity of information about their IFP approach. This could include consolidating all relevant information into one easy-to-read source, which is updated to reflect any changes in the fund's approach. This information could be linked or included in the PDS to ensure investors will find it before making an investment decision.

## Investors need better information about what IFP Funds exclude and why

IFP Funds typically exclude certain investments. Managers of IFP Funds will provide rationales for these exclusions depending on the particular approach, e.g. a fund excludes an investment in a fossil-fuel-intensive company on the belief that the risk of holding the investment is not sufficiently compensated with return, or a Manager's ethical framework does not support profiting from certain activities such as adult entertainment.

In looking at exclusion practice, we reviewed whether fund disclosures:

- clearly described the features of assets the IFP Fund will or will not invest in

- prominently set out thresholds or exceptions permitting investment in an asset that would otherwise be excluded
- described the process the IFP Fund manager will use to decide whether to invest in (or exclude) an asset
- explained any balancing or weighting the IFP Fund manager undertakes between financial and non-financial factors, and between different non-financial factors
- explained clearly how the fund's IFP policies<sup>4</sup> apply to derivatives (if applicable).

All the IFP Funds we reviewed excluded investment in certain assets based on IFP factors (e.g. tobacco, weapons, gambling), which we refer to as a 'negative screening' approach. Eight of the 14 IFP Funds clearly set out for investors their exclusion categories, thresholds, and exceptions. The remainder had ineffective disclosure in this regard.

As noted in the FMA's guidance on SIPO requirements, the SIPO for the IFP Fund should set out all the types of investments which are expressly prohibited.<sup>5</sup>

Managers should very clearly disclose what investments are excluded from an IFP Fund, and why. This transparency makes it simple for investors to decide whether or not they agree with what a Manager has excluded, and ultimately whether they want to invest (or stay invested) in the fund. It also helps investors anticipate how a Manager might respond to a given situation, and determine if the Manager's approach aligns with their beliefs and expectations.

Additionally, exclusions reduce an IFP Fund's investment options and therefore its ability to be diversified. Diversification benefits investors, so excluding certain investments is unlikely to be in investors' interests, unless they are clearly aware of those exclusions.

The following focus areas provide further details on our findings and expectations related to exclusions.

## Disclosure of the scope of the exclusions

Managers of IFP Funds should be clear about the scope of their investments. Where companies they invest in have indirect or insignificant involvement in excluded sectors, some Managers use thresholds or narratives to provide more detail on the scope of what they are and are not excluding.

For example, a Manager might disclose a minimum revenue threshold, which excludes only those companies that significantly benefit from adult entertainment relative to their overall business activities; but does not exclude companies – such as large technology companies, conglomerates, and entertainment streaming services – that may provide access to adult entertainment but do not significantly profit from that activity relative to their core business.

Another example is a Manager disclosing that its nuclear exclusion relates to the production and maintenance of nuclear weapons and nuclear weapons testing sites. The narrative clearly explains that this approach does not exclude companies indirectly involved in the nuclear weapons supply chain, such as companies making equipment incidentally used for manufacturing components of nuclear weapons, or delivery systems such as submarines, missiles and aircraft that can be adapted to deliver nuclear weapons.

Clear explanation of revenue thresholds and narratives help investors understand the comprehensiveness of exclusions, select funds that meet their expectations, and avoid confusion about the IFP Fund's investment decisions. Lack of clarity in scope was an issue among funds we reviewed. Representations that are true and verifiable in isolation may nonetheless leave a misleading, deceptive or confusing

<sup>4</sup> In this report the term 'IFP policies' refers to the fund's IFP policies and practices in general (rather than to a fund's IFP policy statement).

<sup>5</sup> *Statements of Investment Policy and Objectives under the FMC Act*, November 2014



impression overall. This may be the case where material information or qualifications to a representation are in fine print. We recommend that funds better explain the scope of their exclusions policy through explicit thresholds and/or clear narratives.

## Exclusions due to incidents

During the course of this review, several Managers excluded Russian securities following Russia's invasion of Ukraine. Some Managers excluded Russian securities before formal New Zealand government sanctions on Russia, strongly suggesting this was based on the Managers' judgement, likely influenced by public outcry and criticism of Russia.

We welcome Managers in New Zealand broadening and deepening their perspective on what might be inconsistent with their investors' values. However, they should be cautious when deciding whether to exclude an investment based on an incident not anticipated by their exclusion policy – especially where there is external pressure to exclude, and an associated perceived reputational benefit.

Managers cannot anticipate every scenario, but they can anticipate and articulate the need to make such judgements. As well as describing 'foreseeable' exclusions (such as tobacco manufacture), Managers should seek to reduce ambiguity in their decision making by disclosing how they will apply judgement to unforeseen circumstances that connect with their IFP policies. This could include:

- examples of the types of incidents that may require the Manager's judgement
- explaining how judgement will be applied and by whom, and reference to any standards or criteria that would apply. For example, some index providers such as MSCI and Standard & Poor's categorise incidents by degree of severity, and some MIS managers have a policy of considering for exclusion any company flagged for severe incidents or for a pattern of incidents
- setting materiality thresholds (such as a minimum portfolio impact of exclusions)
- if the decision involves divesting (selling existing investments rather than deciding not to buy assets), explaining how the divestment will happen, over what period, and how the financial interests of investors will be considered. For example, a rushed sale may involve significant transaction costs, impacting fund unit price and return
- an undertaking to publish decisions that have been taken. This will help investors, the scheme supervisor, and the FMA to understand how the MIS manager has applied its IFP approach and how it may be applied in the future.

Disclosing how the Manager will apply judgement in unforeseen circumstances will also help the Manager to:

- implement its investment strategy, as any exclusion decisions will be made subject to a clearly defined decision-making process, rather than a reaction to public pressure
- avoid unintended practical and reputational consequences (e.g. unintentionally setting a precedent) arising from a poorly defined decision-making process. For example, a Manager claiming an ethical basis for promptly excluding Russian securities prior to New Zealand sanctions may find it difficult to explain a decision not to similarly exclude the securities of another country also subject to strong public criticism, but which has far greater index weight than Russia and where exclusion would more substantially reduce what the Manager could invest in.

## How exclusions are reflected in any derivatives used in the fund

Many managed funds use derivatives, often to hedge or to get cost-efficient exposure to markets, sectors, or assets. One of the reasons derivatives are attractive is they may provide an inexpensive means to implement an investment strategy, often because they simply replicate the investments within a market, sector, or asset. This means a derivative can include indirect exposure to investments that an IFP Fund is excluded from holding directly.

Indirect exposure means the IFP Fund does not physically own the investments involved in the derivative, but will be impacted by changes in the value of the investment. However, someone else – usually the counterparty to the derivative contract – is required to own the investments directly.

From the perspective of an investor, their fund does not own excluded investments. However, the investment choices made by the Manager have created demand for those excluded assets. Consequently, the use of derivatives may allow investors to profit from excluded activities.

Therefore, it is important investors are clear on how the Manager of the IFP Fund can use derivatives. While all 14 funds we reviewed could invest in derivatives, only four explained how the fund's IFP policies or approach applies to derivatives and disclosed that investing in this way could indirectly expose their IFP Fund to excluded investments.

Some Managers of the IFP Funds we reviewed recognised even indirect exposure to excluded investments as a breach, but addressed this by specifying an exception for derivatives (so it was no longer a breach). One Manager explained further, saying tailoring derivatives to comply with their IFP policies was so complex and expensive that doing so would have a worse impact on members' interests than some indirect exposure to excluded investments.

Other Managers of IFP Funds we reviewed said their derivatives were compliant with their IFP policies and did not need an exception from the policy on the basis that derivatives do not require them to *own* the underlying assets, meaning they could invest in derivatives of an excluded company.

We acknowledge there is no established industry standard for how derivatives should be treated by an IFP policy. We encourage providers to carefully consider, and clearly disclose, how their integrated approach treats derivatives, and to keep abreast of developments in thinking and practice on how to best meet investor needs – especially as increasing numbers of derivatives incorporate ESG features. This is particularly important where an IFP Fund makes extensive use of derivatives.

## Approaches to positive screening ('tilts')

In addition to using exclusions, eight of the funds we reviewed also sought to invest in line with broader ESG policies. These policies would typically be used for desired outcomes where a direct exclusion policy might not be suitable, for example promoting clean energy or worker wellbeing/human rights. Additionally, some of these funds claimed to be activist, engaging with companies to try to improve their ESG characteristics. We refer to these features as 'positive screening', alongside the funds' underlying negative screening approach.

Positive and negative screening both require trade-offs, which the Manager should carefully explain. This can be more complex for positive screening because in addition to balancing financial and non-financial factors, the Manager is applying weightings to different non-financial factors.

Only two of the eight funds provided adequate disclosure about how they selected investments to be consistent with their positive screening approach. For the six funds that failed to provide adequate information to investors, the main shortcoming was broad and non-specific language, which made it unclear what the approach was supposed to achieve or how it worked.

One fund's IFP policy statement simply said it would consider "impact on climate change" without defining "impact" and "climate change", or explaining what 'consider' meant in practice. Another IFP Fund's website advertising stated it would invest in companies with policies and practices that "address" climate change and pollution, without explaining what 'addressing' either issue would look like, or how this would influence the relevant IFP Fund's investment decisions and portfolio. One fund's IFP policy statement said that the Manager would "engage and vote as a shareholder to bring about positive change", without explaining which companies it would engage with, when, and what 'positive change' meant in that context.

Another issue with positive screening funds was a lack of clarity about weighting between financial and non-financial outcomes, or between competing non-financial outcomes.

One fund's IFP policy statement said it would consider "the impact on climate change" and also the "impact on social/human capital" (both broad terms subject to a variety of definitions) and that these factors were both considered using an assessment model. However, the model and how it weighted between financial and non-financial outcomes, and between competing non-financial outcomes, was not disclosed. This complicates an investor's understanding of what to expect from the model.

We recommend funds that use positive screening ensure they are clearly explaining their IFP policies, and how those policies translate into investment decisions, with a particular focus on making any weighting or assessment transparent, and avoiding imprecise language. Where terminology or jargon is used, Managers should endeavour to explain what they mean. For example, the Treasury - Te Tai Ōhanga has explained what it considers the term "human capital" means.<sup>6</sup>

## Investors need better information about risk and return trade-offs

IFP Funds seek to achieve both financial outcomes (returns for investors) and non-financial objectives (such as natural, social, and human capital impacts), and there can be a conflict or trade-off between the two.<sup>7</sup> For example, a Manager may have to sell a profitable investment in a company that has begun producing firearms, affecting potential returns. Or a Manager may prefer to invest in a company with substantial debt and high volatility, but which is a very low emitter of greenhouse gases, again affecting returns and/or fund risk.

Achieving financial outcomes and non-financial objectives typically involves trade-offs, so Managers need to provide investors with information to help them understand any risks arising from these judgements. There may be financial performance implications (positive or negative) from integrating non-financial factors into the fund's investment decisions, e.g. risks from a reduced investment universe, risks from competing with traditional quantitative financial analysis, and risks from non-financial factors themselves.

The Financial Markets Conduct Regulations 2014 (FMC Regulations) require funds to summarise the risk factors affecting a fund's risk indicator, and to describe other specific risks not affecting the risk indicator, but which are particularly significant for the scheme or fund. Additionally, the IFP Guidance notes IFP Funds should describe the risk and possible implications of non-financial objectives not eventuating. If these non-financial risks are described in the PDS they may need to be distinguished/separated from descriptions of strictly financial risks.<sup>8</sup>

Our review found all 14 Managers failed to adequately explain the financial performance implications (positive or negative) of integrating non-financial factors into investment decisions. Most fund documentation said nothing about financial performance implications at all, although two funds at least noted there were risks arising from the reduced investment universe, and one noted that the "fund may be

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<sup>6</sup> [Speech: Human Capital and the Living Standards Framework - 21 June 2018](#)

<sup>7</sup> There may also be conflict or trade-offs between different non-financial objectives.

<sup>8</sup> The FMC Regulations sets prescribed wording around risks to financial outcomes – see clause 27, schedule 4.

impacted by ESG issues impacting companies”, an explanation which is too vague to provide assistance to investors.

None of the Managers of IFP Funds disclosed any risks of failing to achieve non-financial objectives or outcomes. Given that investors in an IFP Fund are seeking both financial and non-financial results, Managers should explain any risks to the fund achieving its desired non-financial outcomes or objectives, and how it monitors for and manages that risk.

None of the Managers of IFP Funds we reviewed explained the fee implications of integrating non-financial factors into investment decisions, such as additional external assurance costs, additional operational costs, or extra fees required for non-financial analysis.

## Investors need better information about the benefits of an IFP Fund

In contrast to describing the risks, we found Managers did somewhat better at explaining the non-financial benefits and features of their IFP Funds, at least in terms of supporting the fund’s label.

The IFP Guidance asks Managers to provide information to investors describing the specific non-financial features of the IFP Fund that differentiate it from a standard managed fund. This allows investors to understand the basis for the marketing label and assess whether the IFP Fund will meet their needs. This also connects to the requirements in the FMC Regulations for the fund’s PDS to describe the significant benefits of investing in the fund and summarise its significant features.<sup>9</sup>

Eight of the 14 IFP Funds’ PDSs contained an effective description of the IFP label that conveyed the benefit or features of the product, or referred to where information about this is located (e.g. an IFP policy statement or the Manager’s website).

The remainder were either missing the prescribed benefits and features disclosure, or the relevant information was in our view ineffective, meaning that an investor would have difficulty understanding the benefits and features of the fund from reading the PDS.

In some cases, the Manager’s descriptions of non-financial benefits or objectives were so high level or subjective that they provided almost no value, for example saying that “the fund’s returns will be financial and a reduced climate impact”, or that the fund will have a “climate impact” or “actively engage [with companies it invests in]”. This reflects a broader issue of a lack of clear objectives or desired outcomes; it is difficult for an IFP Fund to set out its non-financial benefits without clearly identifying the non-financial objectives or outcomes it seeks to achieve in the first place.

We also found six of the IFP Funds did not disclose benefits in the SIPO. In most cases we did not identify any obvious inconsistencies between fund labels and the disclosure of investment strategies and objectives. However, a significant number of PDSs did not establish a connection between the label, the purported benefits and features, and the investment strategy, objectives, or policies of the fund.

Despite shortcomings in the PDSs and SIPOs, we were pleased to see information provided on issuer websites was generally more effective at communicating benefits to investors. However, Managers should not assume investors will only look at the issuer’s website, and should bear in mind that website content is not a substitute for a PDS, especially as some information (like benefits and financial risks) is legally required to be disclosed in the PDS.

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<sup>9</sup> Clause 21, schedule 4, FMC Regulations.

## For non-financial outcomes to be meaningful, the consequences of failing to achieve them should be clear

Typically, IFP Funds offer investors something more than just a financial return. Accordingly, an IFP Fund should explain what happens when it fails to deliver on its intentions, whether those intentions are implicit or explicit.

None of the 14 IFP Funds we reviewed set out any significant consequences (e.g. loss of label, or returning funds to investors) if non-financial outcomes or objectives are not achieved. Three funds at least explained that there were no consequences for failing to achieve non-financial outcomes/objectives, which enables investors to make an informed decision on whether they are with the right fund.

Managers should describe for investors any consequences of their IFP Fund not achieving its non-financial outcomes or objectives. This description will differ depending on the IFP Fund and its approach.

Depending on the breach, consequences of failing to achieve non-financial outcomes or objectives might be significant, for example a redemption or return of funds to the investor, or the removal of the fund's IFP label (e.g. ethical, green, climate). Significant consequences may be appealing to investors as the Manager will be motivated to ensure that non-financial outcomes or objectives are achieved. The Manager's removal of the fund's IFP label may also be necessary to avoid misleading investors.<sup>10</sup>

Alternately, there might be no consequences. But investors should be informed so they can make their own judgements on whether the non-financial features are sufficiently meaningful to invest in, or stay invested in, the fund.

### Managing breaches

As previously mentioned, non-financial outcomes or objectives often involve exclusions and positive screening. It is particularly important for a Manager of an IFP Fund to explain what it will do if it identifies that:

- it has included or incorrectly weighted an investment in breach of the fund's IFP policies
- an investment no longer meets the fund's IFP policies because its IFP policies changed
- an investment no longer meets the fund's IFP policies because the nature of the investment changed (for example, a company the IFP has invested in has begun producing certain types of firearms or offering gambling operations).

Disclosure related to breaches of the fund's IFP policies should reduce ambiguity or uncertainty that accompanies decision making, while acknowledging that Managers often need discretion. Managers should ask themselves whether an investor who reads their fund documentation will be able to reasonably predict what the Manager will do in the event of a breach. In particular, investors who have read the fund documentation should be able to predict:

- how the fund will decide that the investment does not meet, or no longer meets, its IFP policies;
- what the fund will do with the investment (e.g. avoid/blacklist, hold, reduce position size, sell/divest); and
- if its policy is to sell the investment, when the fund will do that, what factors will be considered and whether the decision to sell is balanced against any potential financial impact;

The documentation should also explain whether there will be any consequences for the fund's IFP policies (or practice) arising from the breach.

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<sup>10</sup> For example, if the fund has consistently and/or materially failed to implement its IFP policies.

As the management of breaches is relevant to a IFP Fund’s strategy and objectives, it would be appropriate to include policies related to breaches in the SIPO.

With respect to what the Manager would do if it identified there was a breach of its fund’s IFP policies, five funds we reviewed provided some disclosure on their policy for where a breach is identified. Only one provided a useful explanation for investors on what steps it would take if it determined an investment no longer complied with the fund’s IFP policies. The remaining nine funds provided either no information, or ineffective information. Where this information was provided, it was only in the relevant IFP policy statement and not included in the PDS or SIPO.

Where the information provided was ineffective, the main reason was that the disclosure was ambiguous, and it would be difficult, or in most cases impossible, for an investor to reasonably predict what the Manager of the IFP Fund would do in the event of a breach of the fund’s IFP policies.

One fund signalled in its responsible investment policy it “might” sell existing investments if the Manager decided the investment no longer met the fund’s responsible investment policy. The decision-making process was described at a high level in fund documentation, which also said the Manager took an “engagement-first” approach, without specifying who would be engaged, how, and what actions would be taken if engagement was not effective (including when that “might” trigger divestment).

Another fund’s IFP policy statement said that investments no longer meeting the fund’s non-financial criteria would be reviewed, following which the Manager “might continue to hold the investment, or might divest from the investment”, without disclosing the criteria for deciding whether to hold or (partially or fully) divest.

Fund documentation commonly stated the Manager would divest “as soon as it is practical and cost effective to do so” (or words to that effect), without explaining what this meant in practice. This is particularly problematic if the share price of a company has dropped following some incident relevant to the IFP Fund’s responsible investment policy.<sup>11</sup>

Managers of IFP Funds need to describe the approach they will take in deciding if and how they will divest from an asset, especially when that may result in an impact to fund returns. This could include describing any thresholds for when they will always sell or always hold an asset, and any process for deciding what to do with assets that sit between these thresholds, as well as any relevant timeframes. If the decision process may result in the IFP Fund continuing to hold assets that violate its policy, this should be explained to investors.

## Measurement and reporting

If a Manager is not failing to meet the objectives or outcomes of its IFP Fund, then presumably it is making progress toward achieving those objectives/outcomes, which the Manager should be able to measure and report on. This is important for several reasons:

- When investors can see the outcomes or objectives the fund has achieved, they can better understand how the fund manages trade-offs.
- It enables investors to easily compare different IFP Funds in terms of real-world results.
- Investors are unlikely to be able to identify such results for themselves, so reporting will demonstrate whether the fund is consistent with the investor’s needs, is ‘true-to-label’, and avoids greenwashing.
- It avoids a ‘race to the bottom’ where minimal effort is applied to achieving non-financial outcomes or objectives, when it is this effort which differentiates IFP Funds from “vanilla” funds which might market themselves as being IFP Funds.

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<sup>11</sup> See *Exclusions due to incidents* (page 8)

We looked at whether Managers provided clear, measurable objectives or outcomes and, if they did, whether they reported progress on these on an ongoing basis (e.g. monthly, quarterly, annually). Overall, the quality of objectives, measurement and reporting of the IFP Funds we reviewed was disappointing on a fundamental level:

- Only two of the 14 funds disclosed their portfolio holdings accessibly on their websites. This was despite reporting of portfolio holdings being a straightforward, low-cost method to provide some assurance to investors that the fund is achieving its non-financial objectives in line with its negative/positive screening approach.
- Eight IFP Funds we reviewed used positive screening approaches, but only one provided a measurable objective and then assessed their progress against that objective. The fund sought to have lower carbon emissions across their portfolio relative to a benchmark and then reported annually on their progress in reaching that objective. However, that fund also had other non-financial outcomes, besides lower carbon emissions, which it did not measure or report on.
- Three IFP Funds we reviewed appeared to provide email updates to their existing investors related to ESG subjects, but this material was not publicly accessible and would not be useful to a potential investor attempting to choose an IFP Fund.

It should be easy for investors to distinguish between IFP and non-IFP Funds, and between effective and ineffective IFP Funds. The most meaningful way for Managers of IFP Funds to do this – which is in the interests of both investors and the Manager – is by transparently delivering on the IFP Fund’s objectives.

Based on the findings of our review, we strongly encourage the Managers of IFP Funds to, at a minimum:

- regularly and accessibly disclose their portfolio holdings (largely for accountability)
- importantly for investors, clearly and effectively explain how their holdings have delivered on their non-financial objectives or desired outcomes – whether those are negative or positive screening, impact, other objectives, or (most likely) a mix – ideally with reference to objective benchmarks.

## Investors must be able to understand the purpose and value of organisations providing assurance, measurement standards or endorsement

Managers of IFP Funds frequently market their funds with reference to some separate organisation (external provider) that may provide measurement standards, endorsement and even assurance, relevant to the fund’s IFP characteristics, e.g the Responsible Investment Association of Australasia (RIAA). Investors are unlikely to have the time to review the purpose of an external provider or, more importantly, the value of their service to investors.

In the absence of easily accessible information, investors may misapprehend the nature or significance of an external provider’s involvement. They may assume it is checking whether the IFP Fund is meeting its objectives on an ongoing basis when no such assurance or approval has occurred. Or, if there has been some manner of approval, the robustness of that process may be unclear.

We looked at how well IFP Funds explained the nature of any associations with external providers they disclosed in their marketing or advertising.

- Eight of the 14 IFP Funds disclosed that they are members of RIAA or certified by RIAA, but only one explained what membership or certification meant in practice. In some cases, funds attached a RIAA logo to the webpage containing their IFP policy statement without any further explanation.

- 10 funds cited being signatories of the United Nations Principles for Responsible Investment (UNPRI). Nine of those described what that meant, typically at a high level; only four provided a summary of and link to the reporting required by UNPRI signatories.

Where an IFP Fund cites its membership or association with an external provider as a positive feature for the fund and its investors (whether explicitly or implicitly), it should provide clear and accessible disclosure to avoid potentially misleading or confusing an investor. That disclosure should describe the following:

- The nature of the service provided by the external provider. Funds may wish to consider questions such as:
  - What is the structure of the external provider? For example, is it simply membership of a group of likeminded IFP Funds?
  - What standards or commitments does the external provider require? Are these standards or commitments enforceable?
  - Does the external provider audit the fund's performance or require public reporting to maintain the IFP Fund's membership status?
- Why was this particular external provider selected or cited? What is the value of the association to investors?
- If there is a review or assurance process involved, what is it? Are there consequences for not meeting the external provider's standards? If so, what are they?
- When does the association expire? Are there any implications of expiry?



# Appendix

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This section discusses issues with fund documentation that will be of greater interest to Managers as it covers technical aspects of how information is provided to investors.

## Fund documentation

### Product Disclosure Statements

A broad conclusion from our review is that there is simply not enough information provided in the PDSs of IFP Funds to meet the expectations set out in our IFP Guidance.

A possible reason is that Managers are limited in what they may disclose in a PDS by length restrictions – a managed investment scheme's PDS is restricted to no more than 12 pages, or 6,000 words.<sup>12</sup>

However, where a Manager is constrained by length restrictions, information may instead be incorporated into the PDS by reference to where it can be found in separate documents/sources (the OMI), which in turn is lodged on the Disclose Register.

We have found that Managers are typically not supplementing their PDSs by using OMI to provide information on their IFP policies – which we would expect to see if the word limit was the reason for not meeting the disclosure expectations set out in the IFP Guidance. The fact that we often have not seen this indicates that Managers have not adequately attempted to meet these expectations.

We noted that 7 of 14 of the PDSs we reviewed referred readers to a website of the issuer where further information about responsible investment can be found. It is important to note:

- Information on the issuer's website will not meet a fund's disclosure obligations under the FMC Act, and investors cannot be expected to review this information. Information on a website can be easily changed, but investors have no ability to reliably retrieve historical versions of the wording. While this information can be made available on a website, funds should lodge additional disclosure as OMI on Disclose.
- Only 4 of the 7 funds provided specific links to the relevant website material. This means for the other 3 funds, investors would have to search the issuer's website to find the relevant information, increasing their research burden.

We recommend that if Managers cannot include all relevant information on their IFP approach in their PDS then they should:

- separately lodge this information as Other Material Information; and
- include a hyperlink in the PDS directly to this information.

### Statement of Investment Policy and Objectives

While we published [SIPO guidance](#) in 2014, the contents of a SIPO are not prescribed to the extent of a PDS. The IFP Guidance acknowledges that some material information is likely to be in the SIPO lodged on

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<sup>12</sup> Section 24(2) FMC Regulations.

the Disclose Register, given that the SIPO should provide a complete, standalone picture of the investment policy and objectives of a MIS.

We expect a SIPO to be clear, concise, and effective in providing disclosure about the investment strategy, objectives, and parameters of a MIS and the funds that it contains.

We have found that SIPOs are used by Managers to articulate their responsible investment policy to investors and are often supplemented by a separate IFP policy statement.

Although SIPOs generally rated well in how effectively they conveyed information, we encountered some instances where a SIPO:

- did not set out what types of investments are expressly prohibited
- did not provide an adequate link between the stated objectives of a fund and the investment strategy
- provided only limited information on the Manager's approach to ESG integration
- did not provide sufficient information about, or link to, the Manager's responsible investment policy. For example, many IFP Funds did not define permitted investments or rule out certain investments in their SIPO.

We note that the SIPO is an appropriate place to describe any policies related to breaches of the fund's IFP policies that would result in a fund divesting an asset (much like a limit break).

These are all areas Managers need to improve with respect to their SIPOs.

## Labelling, description and marketing

As at 31 March 2021, there were 1,029 managed funds registered on Disclose: 304 KiwiSaver funds and 725 non-KiwiSaver funds.

- About 5% could be identified as an IFP Fund by name alone (e.g. 'Ethical', 'Responsible', 'Environmental').
- But 17% could be identified as an IFP Funds from their detailed fund descriptions on the Disclose Register.

Our investor research indicates many investors do not closely read detailed fund descriptions. If they focus solely on the fund names, investors may unknowingly be excluding many funds that might meet their needs.

Offsetting that, and adding to the confusion between rhetoric and reality, a number of Managers use terms such as 'Ethical' and 'Responsible' in their marketing, even if the same fund is not labelled accordingly or described that way on the Disclose Register.

We recommend funds with IFP characteristics make those features more prominent, most likely in the fund's name – *provided* those characteristics are appropriately explained and substantiated as discussed in this report and the IFP Guidance.

