



Asset management and sustainability

BRIEFING NOTE (SMI)

The background is a solid blue color with a white line-art illustration of a ship's deck and a large, stylized wave. The ship's deck is at the top, and the wave is in the center, with a small eye-like shape within it. The overall style is graphic and modern.

Summary

- Sustainability, or ESG, is a broad and multi-faceted concept.
- Investor interest has skyrocketed in recent years, driven primarily by environmental concerns.
- The transition to a low-carbon world is a source both of risks and opportunities to investors.
- Asset managers are playing an increasingly active role in driving the decarbonisation process.
- Harmonisation of ESG-related disclosures and data will do much to spur the sustainability agenda.

Background

Environmental, governance, and social (ESG) – a broad and evolving concept of sustainability, encapsulating factors from climate change and sustainability, to diversity, human rights, consumer protection, and corporate governance – has moved squarely from the ‘feel-good’ fringes to mainstream decision making, in business, finance, and elsewhere.

There is wide variability in interpretation as to which factors to include under each category, and how to measure performance, let alone how best to aggregate results to yield a summary ‘ESG score’.

At the same time, and notwithstanding it being a rather ‘woolly’ term, growing awareness of ESG-related issues is leading to a regime change in investing; and business leaders, finance providers, and asset managers, among others, are coming under increasing pressure to demonstrate their ESG credentials.

Figure 1: Examples of Environmental, Social and Governance issues

Environmental issues	Social issues	Governance issues
Climate change and carbon emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committee structure
Biodiversity	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Community relations	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labor standards	Whistleblower schemes

Source: CFA (2015)

The ‘E’ in ESG

Momentum is being driven primarily by the powerful and inexorable forces of ‘E’. (‘S’ and ‘G’ however now too are fast gaining traction, intensified by the COVID-19 and other events of 2020, and fiduciary duty responsibilities extending across the whole of ESG.)

Global warming, extremely hard to slow, let alone reverse, is having potentially existential consequences for the environment, humans, and whole areas of economic activity.

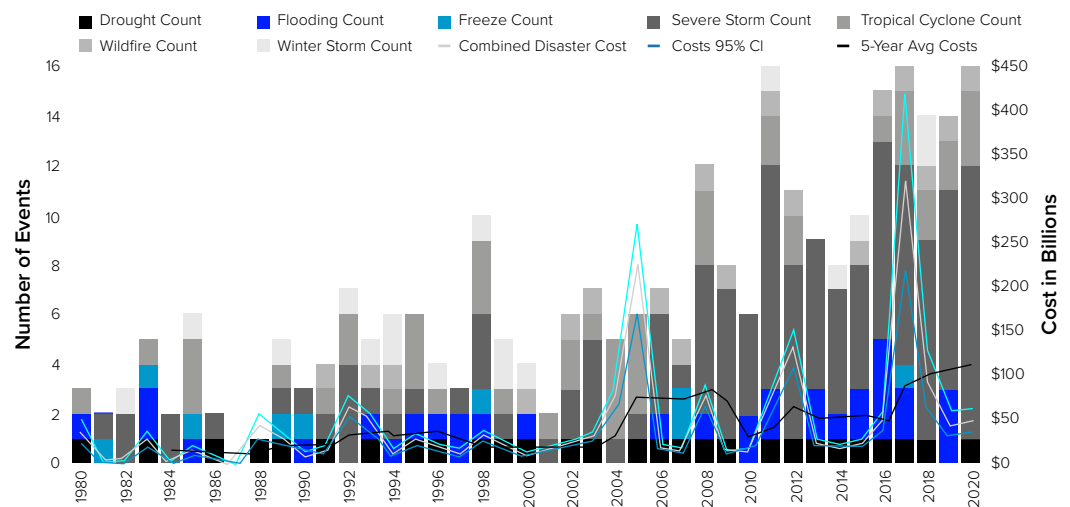
- Extraordinary weather events with significant human and financial consequences are increasing in frequency. (See figure 2).
- With the current pace of global warming, these events stand to become ever more common and severe.
- The World Economic Forum predicts that half of the top-ten risks deemed most likely to occur – as well as expected to have the biggest impact over the next ten years – will be environmental in nature.

Green policies have been led by the EU, but in Q4 2020, the world's other two key players, the US and China, apparently have come on to the same page:

- The US President-elect Biden has stated that re-joining the Paris agreement will be a US priority; and
- China has pledged to go emissions-neutral by 2060.
- Furthermore, nearly 130 countries now – collectively responsible for just over 60% of global emissions– are considering, or have adopted, net-zero targets.

These developments are potentially significant. Amongst their implications, they point to a more active role that asset managers and the financial sector more broadly can and will play in the transition to low-carbon economies. (For more see *Global Letter – Climate change – mind the gap – December 2020*).

Figure 2: US billion-dollar disaster events, 1980-2020



Source: National Centers for Environmental Information
 Full link to data: <https://www.ncdc.noaa.gov/billions/time-series>

Sustainable investing

Some observers suggest that skewing investment portfolios away from assets that are, for whatever reason, considered ‘environmentally, or more broadly ESG, unfriendly’ will have little effect – that all that will happen is that other investors will buy up the abandoned stocks and bonds and thereby sustain their value. This, it is sometimes suggested, is particularly the case in the context of the widespread growth of passive, index tracking, investment strategies.

Such arguments hold little water, however. Various related mechanisms are in play:

- **Divesting.** To the extent that asset managers sell substantial holdings in environmentally-unfriendly companies, this in and of itself depresses the affected companies’ share prices. This reduces the ability of these companies to raise capital, and crimps their future plans. There is already evidence of this happening to the share values of oil majors. And correspondingly:
- **Disclosure.** Increasing demand for better corporate ESG disclosure and risk management implies that assets that fall outside the ESG category will not be bought by large asset managers, causing these stocks progressively to underperform, fall out of favour, and hence over time drop out of many standard indexes.

- **ESG as a source of alpha.** There is already some evidence that the share prices of ‘best in class’, ESG-friendly companies, and thereby asset managers that invest in them, tend to outperform. It is not yet clear whether this is due to the ‘green’ (sustainability-related) decisions taken by these companies, or whether their managements not only take good sustainability-related decisions but also take particularly good decisions overall. Most likely, it is a combination.

That said, the speed with which these processes occur will be influenced importantly by the coherence and credibility of climate policies. Financial market evolution will complement and potentially amplify, but probably never substitute, for climate policy action on the part of governments

Risks and opportunities

There now appears to be a broad consensus that climate change is not only a threat to the health of the planet, but also to the wealth of investors – it is no longer just an ‘ethical’ concern for a niche group of investors aiming to ‘do the right thing’, but an increasingly widespread business consideration, both in terms of risks, and opportunities.

Demand for ESG-compliant stocks is growing fast, and today some 80% of portfolio investors factor in ESG into their investment process.¹

- **ESG funds as a share of the overall universe** have more than doubled in fewer than three years to about 3.5% of all equity funds and about 5% of all global funds. **The share of ESG funds** in total Europe equity funds assets under management had almost tripled to 9% since early 2019.²
- Since the first ESG ETF launch in 2002, the **number and diversity of products** has increased steadily: today the global ESG ETF/ETP industry comprises 393 products with over 1,000 listings, from over 90 providers, on 31 exchanges, in 25 countries.
 - In July 2020 alone, **assets in globally listed ESG ETFs and ETPs** increased from \$88bn to \$101bn, with over 50% of those assets accounted for by European-domiciled ESG vehicles, and 40% US-domiciled.
 - In the first seven months of 2020, global ESG ETFs and ETPs received nearly \$40bn of net new inflows, far more than the \$12.4bn in the same 2019 period and the \$26.7bn over the entire of 2019. (*Financial Times*, 25 August 2020)
- At the end of July 2020, **overall assets in the European ETF/ETP industry** (i.e. all ETF/ETP assets not just those that are ESG) stood at some at \$1.08tn.
- **There are now over 600 ESG ratings globally:** a more than five-fold increase since 2012.

[To better understand how investors think about ESG/environmental issues and what drives their investment decisions, see the survey results in the Appendix from Krueger et al. (2020).]³

The risks

The potential risks that investors face by ignoring the ESG-related issues include:

- Systemic;
- Individual investment/portfolio;
- Regulatory;
- Reputational;
- Litigation.

Systemic financial sector risk

- Financiers and chief executives are now realising that there are big potential losses that need to be avoided. Former Bank of England Governor Mark Carney, who through as Chair of the international Financial Stability Board spearheaded work in the area of climate change, recently warned of a “*climate Minsky moment*”.⁴
- Central banks globally are getting increasingly concerned about the potential risks from climate change to the global economy. The US FED has now also joined a consortium of central bankers (Network for Greening the Financial System) supporting the Paris climate goals.⁵
- Investment portfolios of insurance companies and pension fund managers are particularly susceptible, as environmental rules bite, to future declines in the value of carbon-linked assets and businesses.

Individual investments/portfolio risks

- **Physical.** Due in part to climate change, the cost of ‘physical climate risk’ (i.e., natural disasters and extreme weather events) will continue to rise.
 - Already, 2010-2019 was the costliest decade in the modern history of natural disasters, with total direct economic damages and insured losses tallying \$2.98 trillion USD globally, \$1.1 trillion USD higher than in the previous decade.⁶
 - According the IMF, Climate change physical risk does not appear to be reflected in global equity valuations. (IMF Global Financial Stability Review, April 2020)
- **Stranded assets.** Assets that turn out to be worth less than expected as a result of changes associated with the energy transition (e.g., oil and gas sector).
 - Moody’s cites research that suggests that, by 2050, Europe’s financial sector will have \$5tn of these so-called ‘stranded assets’, with another \$3tn in America, and \$1tn in Japan.⁷
- **Transition.** In the process of moving to low-carbon economies there stand to be large changes in the relative fortunes of the ‘winners’ (e.g., renewable energy producers) and the losers (e.g., oil and gas sector).

Regulatory

Increasingly important risks to companies and investors as the scope of ESG-related disclosures becomes clearer, and as/when reporting becomes mandatory.

Reputational

Investors are progressively more aware of the reputational risks of their investments, e.g., Boohoo sweatshop scandal and the resulting sharp falls in the company share price; investors shunning companies continuing to rely on environmentally-damaging supply chains, etc.

Litigation

Increasingly topical e.g. pension funds being sued for not accounting for climate change risks in their portfolios.

The opportunities

On the other side of the coin, climate change offers big potential opportunities for companies to re-direct their in-house expertise to production of renewable energy, using current energy sources more efficiently, developing new products and markets, and more.

It is now increasingly being recognised that climate-aware investing – and sustainable investing more broadly – is more than just an altruistic initiative. It can offer competitive commercial returns. And earlier assertions that being sustainable and making a profit were mutually exclusive have now been proven wrong.

- Recent survey data from Deloitte indicate that social impact has been rated the most important factor in assessing firm annual performance, and by some margin over customer satisfaction, employee satisfaction/retention, and financial performance. The data also indicate a distinct correlation between company growth and company concern about ethics.⁸
- An evaluation by Deutsche Bank Group of 56 academic studies, looking at long-term value and performance, found that 89% of firms with high ESG factors outperformed the market in the medium (3–5 years) and long term (5–10 years).⁹
- *“Average returns and success rates for sustainable funds across seven Morningstar Categories suggest that there is no performance trade-off associated with sustainable funds. In fact, a majority of sustainable funds have outperformed their traditional peers over multiple time horizons.”*¹⁰

What can be done to advance sustainability in asset management?

Asset managers to play a more active role

Asset managers (and financial sector more broadly) are already engaging, and will engage more, in the global drive to decarbonise economies. They can:

- Engage in 'negative screening';
- Pursue stewardship practices/engagement with investees;
- Use their voting rights to drive sustainability agendas;
- Explicitly support green/sustainable company initiatives;
- Engage in 'relative screening'/best-in-class screening.

A number of initiatives have been launched for asset managers to coordinate and cooperate in their drive to lower-carbon portfolios and economies more broadly.

- Last week's launch of the Net Zero Asset Managers Initiative brings together 30 of the world's biggest asset managers, which collectively oversee \$9tn, in their goal of achieving net zero carbon emissions across their investment portfolios by 2050. Through the reach of these asset managers this commitment is likely to have significant ramifications for businesses globally.
- Similar investor initiatives include: UN-Convened Net-Zero Asset Owner Alliance, Climate Action 100+, etc.

ESG-related disclosures and data to be harmonised

One of the sector's key underlying issues is the lack of common definitions, accounting, and disclosure standards.

- The problem does not come from a lack of initiatives to establish universal standards: quite the opposite. There are currently too many organisations essentially trying to do the same thing, leading to myriad acronyms and often leaving reporting companies, as well as potential investors, confused and overwhelmed by the thicket of disparate ESG metrics.
 - KPMG has identified nearly 400 different sustainability regulations, guidelines, codes of conduct, frameworks, and other reporting tools being used across 64 countries.¹¹

With companies not reporting their data within a common framework, investors struggle to make apples-with-apples comparisons.

- Essentially, any company or fund can market itself as 'socially conscious' and/or 'environmentally sustainable', but there appear to be no common definitions or criteria as to what these terms mean.
- Establishing the necessary templates of taxonomy and data disclosure is arduous, given the intangible nature of many of the ESG concepts, and the fact that many companies already consider themselves overburdened with reporting requirements.
 - The development by the EU of its green investing 'taxonomy' is potentially a major step forward, provided that it is taken up, or used as a point of departure, by other jurisdictions.¹²
- Not surprisingly, the lack of standardised disclosures is not only holding back the sector, but is also giving rise to the so-called '*greenwashing*',¹³ dubbed as the next potential mis-selling scandal in the investment industry.¹⁴

Company disclosures need to be mandatory and part of 'normal' financial reporting.

At a minimum, ESG-related disclosures should aim to be:

- Measurable, comparable, and timely.
- Material, and with scientific underpinnings where applicable.
- Consistent, but allow for relevant industry-specific differences.

While progress is being made to harmonise the various ESG metrics and disclosures, it stands to remain an evolving concept.

The recent surge in investor interest is likely to nudge the regulators along, but more cooperation is needed on the international front.

Useful sources

Principles for Responsible Investment (PRI): <https://www.unpri.org/>

Task Force on Climate-related Financial Disclosures (TCFD): <https://www.fsb-tcfd.org/>

Environmental, social, and governance issues in investing: <https://cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx>

Appendix

Figure 3: Motivations to incorporate Climate Risks Into Investment Process

	% with 5 ('strongly agree') score	Mean score	N	H0: Mean Score = 3	Significant differences in Mean Score vs Rows
Motivation to incorporate climate risks into the investment process	(1)	(2)	(3)	(4)	(5)
1 Protects our reputation	29.5%	4.03	417	***	2-11
2 Is a moral/ethical obligation	27.5%	3.88	415	***	1, 8-11
3 Is a legal obligation/fiduciary duty	27.0%	3.87	415	***	1, 8-11
4 Is beneficial to investment returns	25.2%	3.85	417	***	1, 9-11
5 Reduces overall portfolio risk	23.5%	3.85	417	***	1, 9-11
6 Reflects our asset owners' investment	22.6%	3.88	416	***	1, 8-11
7 Reduces tail risks	21.4%	3.81	416	***	1, 9-11
8 Allows us to address negative spillovers	19.7%	3.77	412	***	1-3, 6, 10-11
9 Helps attract fund flows	18.5%	3.69	411	***	1-7
10 Is increasingly stressed by proxy voting advisors	18.2%	3.68	390	***	1-8
11 Follows the concerns of other institutional investors 15.6%	15.6%	3.68	416	***	1-8

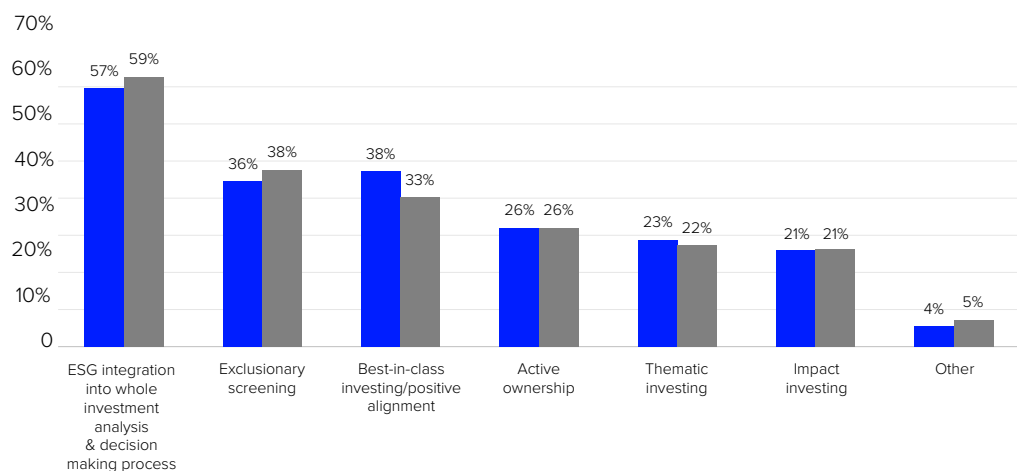
Source: Krueger et al. (2020)

Figure 4: Percentage of Respondents That in the Previous Five Years Took a Given Approach to Incorporate Climate Risks Into the Investment Process

	Percentage that took this measure	N	Significant differences in MeanResponse vs Rows	Classification of approaches for Table 5
Motivation to incorporate climate risks into the investment process	(1)	(2)	(3)	(4)
1 Analyzing carbon footprint of portfolio firms	38.0%	410	4-14	Passive
2 Analyzing stranded asset risk	34.6%	410	5-14	Passive
3 General portfolio diversification	33.9%	410	6-14	Passive
4 ESG integration	31.7%	410	6-14	Passive
5 Reducing carbon footprint of portfolio firms	29.3%	410	1-2, 10-14	Active
6 Firm valuation models that incorporate climate risk	25.9%	410	1-4, 12-14	Passive
7 Use of third-party ESG ratings	25.6%	410	1-4, 12-14	Passive
8 Shareholder proposals	25.1%	410	1-4, 12-14	Active
9 Hedging against climate risk	24.6%	410	1-4, 13-14	Passive
10 Negative/exclusionary screening	23.7%	410	1-5, 13-14	Active
11 Reducing stranded asset risk	22.9%	410	1-5, 13-14	Active
12 Divestment	20.2%	410	1-8, 12-14	Active
13 None	7.1%	410	1-12, 14	n/a
14 Other	3.7%	410	1-13	n/a

Source: Krueger et al. (2020)

Figure 5: Percentage of Respondents using a specific method to Incorporate ESG Considerations in the Investment process



Source: CFA (2017)

¹ MAN Institute (2020). *A look at what the research – both from academics and practitioners – says on ESG investing*. Available at: https://www.man.com/maninstitute/esg-investing?pcid=C000024249&utm_source=miauto&utm_medium=email-d&utm_campaign=ri-ar

² Reuters, Oct 2020 <https://uk.reuters.com/article/us-global-esg-column/column-esg-thrives-in-pandemic-but-amplifies-growth-value-split-idUKKBN2710QA>

³ Ibid.

⁴ Tett, G. et al, 2019. Carney warns companies: get involved or get left behind. *Financial Times*, 17 July 2019. Available at: <https://www.ft.com/content/45da5634-a7d1-11e9-b6ee-3cdf3174eb89>

For more, see also:

Carney. M. 2019a. *A new horizon*. Bank of England. 21 March.

Carney. M. 2019b. *TCFD: strengthening the foundations of sustainable finance*. 8 October.

Carney. M. 2019c. *Remarks given at a panel to launch the third annual America's Pledge report, at the 25th anniversary of the Parties*. 10 December.

⁵ Arnold, M. (2020). Fed joins central bankers backing Paris climate goals. *Financial Times*. Available at: <https://www.ft.com/content/008a12d2-7736-4db0-af9c-e063a0bccd7a>

⁶ <https://www.intactcentreclimateadaptation.ca/wp-content/uploads/2020/12/AlphaCRM.pdf>

⁷ Tett, G., 2019. Hot enough for EU? The worst is yet to come. *Financial Times*, 3 July 2019. Available at: <https://www.ft.com/content/fad4b910-9cd9-11e9-b8ce-8b459ed04726>.

⁸ Deloitte, 2019. *Success personified in the Fourth Industrial Revolution: Four leadership personas for an era of change and uncertainty*. [online] <https://www2.deloitte.com/cn/en/pages/energy-and-resources/articles/success-personified-in-the-fourth-industrial-revolution.html>

⁹ Deutsche Bank Group, 2012, *Sustainable Investing: Establishing Long-Term Value and performance*, June.

¹⁰ Morningstar Management Research, 2020, *How Does European Sustainable Funds' Performance Measure Up?*, June.

¹¹ KPMG, 2016. *Carrots Sticks Global trends in sustainability reporting regulation and policy*. Available at: <https://assets.kpmg/content/dam/kpmg/pdf/2016/05/carrots-and-sticks-may-2016.pdf>

¹² For more, see European Commission (2020). *EU taxonomy for sustainable activities*. Available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

¹³ Greenwashing is marketing that portrays an organisation's products, activities, or policies as producing positive environmental outcomes when this is not the case. For more, see Edwards, C., 2018. *What Is Greenwashing?* Business News Daily, 6 July 2018. Available at: <https://www.businessnewsdaily.com/10946-greenwashing.html>. [Accessed 3 September 2019]

¹⁴ Thompson, J., 2019. 'Green' funds can fall short of buyers' expectations. *Financial Times*, 13 May 2019. Available at: <https://www.ft.com/content/644c1ec4-39d9-11e9-9988-28303f70fcff> [Accessed 4 September 2019]



Produced in association with



For follow up information, please contact:

Patrick Meyer
Data & Analytics
LSEG
patrick.meyer@lseg.com

London Stock Exchange Group

10 Paternoster Square
London
EC4M 7LS

+44 (0)20 7797 1000

