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SECTOR IN-DEPTH
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Asset Managers – Global

Beyond passive, ESG investing is the next growth frontier for asset managers

ESG investing incorporates sustainability factors and sometimes ethical impact into investment decisions. Although today only a small portion of invested assets are in funds that use ESG principles in their core investment process, ESG assets could grow exponentially because the investment strategy benefits from rising social interest in sustainability, attractive investment product characteristics, and favorable regulatory trends.

Consumer preferences and regulations lay the foundation for enduring growth in ESG investing. Increased retail and institutional demand for ESG products is not cyclical, but rather reflects an enduring shift in consumer preferences as younger and more socially conscious clients begin to invest. As active products lose traction among investors, asset managers have tried to boost growth through numerous offerings, from alternative investments and non-transparent ETFs to quantitative factor investing. However, unlike traditional investment products that aim to deliver value through the promise of investment outperformance, which is largely unachievable in aggregate, ESG products aim to deliver a utility beyond investment return, a more achievable goal. In addition, managers that prioritize ESG strategies tend to exhibit above-average organic growth versus peers, according to our survey of rated asset managers. Regulations related to ESG compliance, meanwhile, are leading to greater transparency in corporate disclosures, giving managers data they can use to integrate ESG into their analysis and allowing clients to better understand ESG risks in their investments.

Share of ESG assets under management is small, but potential growth is large. Despite increased publicity around ESG products and numerous product launches, AUM remains small as a percentage of overall invested assets. According to our survey, ESG penetration averaged 6.5%, while the median penetration was 1.8%. Meanwhile, the total assets managed by UN Principles for Responsible Investment (UN PRI) signatories is nearly $89 trillion, suggesting the total addressable market size is quite large.

Two key hurdles to growth are perceived return tradeoff and lack of standardization. Definitions within ESG are not standardized, a key impediment to product growth. Investor fear of giving up returns because of constraints on investing mandates is also slowing wider adoption of ESG products in the US. However, ESG products' risk/reward characteristics are similar to those of other investment products. Investors' choice between high-fee active and low-cost passive products will have a far bigger effect on returns than any ESG consideration. Although studies of the effects of ESG incorporation on returns reach mixed conclusions, at a minimum, they suggest ESG constraints will not detract from returns. We expect that both hurdles to growth will gradually be overcome.

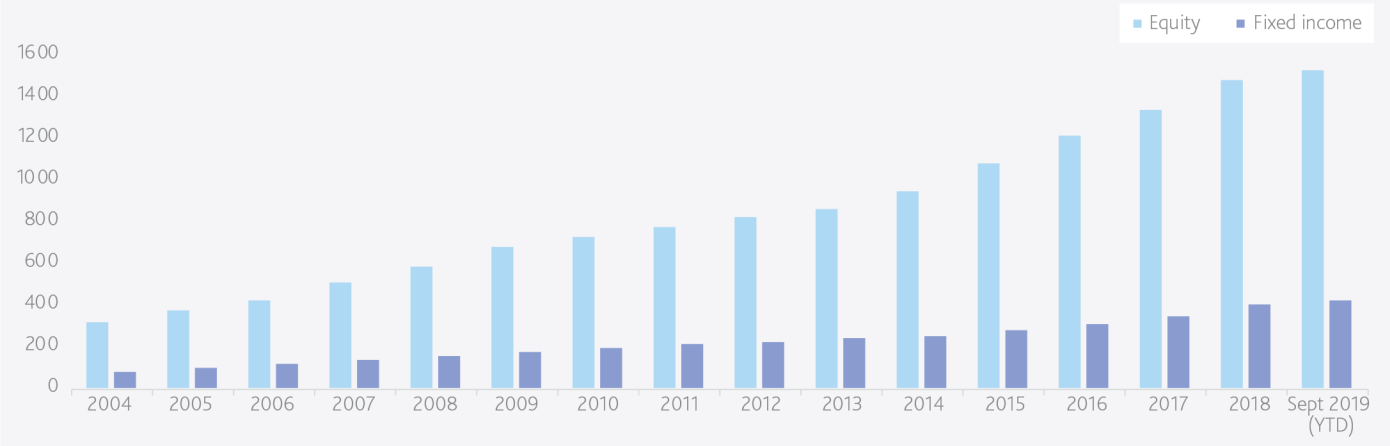
Consumer preferences and regulations drive enduring growth in ESG investing

Asset management has witnessed several product development milestones over the decades, from the pooled mutual fund to index funds and ETFs. Throughout this time, both active and passive investment products have aimed to create value by delivering the best achievable financial returns on investment to clients. Now, the central value proposition of asset management products is expanding as a result of the groundswell of interest in ESG, as investors, in a more holistic view of investment utility, seek to influence societal and environmental outcomes through their investment choices. Through ESG funds, clients are seeking value that extends beyond financial gain. And, crucially, this is a value proposition that asset managers are able to deliver, in stark contrast to the promise to deliver consistent investment outperformance. Likewise, with greater recognition of the risks and opportunities arising from ESG considerations, such as climate change, investors are increasingly focused on avoiding investment losses connected to these risks, and on positioning themselves to profit from correctly anticipating climate and social trends. According to a survey conducted by Natixis Investment Managers, approximately three quarters of participants across generations said it was important to have their investments match their personal values[1].

Exhibit 1

ESG product demand accelerating in the past five years

Growth in the number of ESG investment funds by asset class



Source: International Monetary Fund: Global Financial Stability Report, October 2019, Moody's Investors Service

To some investors, ESG investing means maximizing their total return on capital

ESG investing has gained strong momentum from some of the largest investors in world, such as Government Pension Investment Fund, Norges Bank Investment Management and APG Group N.V. Some of the largest asset owners, sovereign wealth funds and endowments, in particular, are exposed to systemic and societal risks that they cannot hedge given their size and perpetual time horizon. Because of their scale, they are also acutely aware that they can effect environmental and social change by allocating capital to entities operating in a responsible and sustainable manner and by engaging with entities whose behavior they would like to change. Financial returns on their capital are one component of the total returns that they can achieve with their invested capital, others being social, environmental and shareholder influence. The actions of these and other pioneers have laid the foundation for ESG products and strategies, which are now also rapidly gaining in popularity among retail investors. Retail investors' and consumers' realization that their investment choices can have broad social impact is creating demand for a new type of asset management product. There is a growing realization among investors that financial returns are one component of total long term returns that capital can offer its owner.

Regulators are also facilitating the growth and acceptance of ESG products by encouraging more transparency, disclosure and compliance around these products, just as they did earlier with passive products. The passive revolution accelerated after regulators and financial media helped draw attention to the consistency and regularity of active manager underperformance, net of fees. A similar dynamic is underway with respect to ESG: greater transparency around ESG factors is making consumers more knowledgeable

about what they are buying, and global regulations are making ESG considerations have a real economic impact on businesses and investment returns. For example, environmental disclosures give fund investors a more accurate picture of the carbon footprint associated with their investments, while the new fuel standards mandated by the International Maritime Organization in 2020 can impact the investment returns of shipping stocks.

Investing in values to create value

Regulatory forces, along with increased consumer demand, are pushing ESG products to be a significant growth area for asset managers, a credit positive. In addition to financial regulation, environmental regulations are increasing the impact of ESG considerations on corporate financial performance. These forces will create new investment opportunities, as companies develop and acquire innovative technologies and new companies are created to help meet higher ESG standards. For example, China has effectively banned new factories that make only fossil-fuel cars, providing growth opportunities for electric vehicle companies. Similarly, governments in the EU have enforced stricter emissions standards in automobiles and shipping. New technology and industry disruptions create the potential for explosive investment growth. Tesla, a leading electric vehicle manufacturer, for example, has seen its stock price multiply as much as 56 times since its IPO, while conventional internal combustion automaker equities have languished. Meanwhile, legal risks for companies that operate unsustainably are rising; in recent years there has been a growing number of lawsuits against fossil fuel companies, tobacco and opioid companies. These regulatory changes and a societal shift in favor of greater sustainability will increasingly drive corporate financial performance and further fuel interest in ESG, as investors seek to invest in innovative companies and those that are compliant with global standards.

ESG-compliant mandates are feasible and readily achievable, in contrast to many traditional fund products

Firms investing in developing ESG tools and capabilities have a higher likelihood of reaping returns on their investments than do those investing in attempts at outperforming the index. Asset managers that invest solely in the pursuit of excess returns – or alpha – are betting on an expensive and unpredictable outcome.

For active managers, large salaries paid to poach 'star managers' or build large investment teams can place financial stress on a firm if investment outperformance and new capital raising does not follow expensive talent acquisitions. Likewise, costly investment in big data, AI and other quantitative tools to enhance alpha generation capabilities will likely lead to uneven and intermittent results, because it places traditional asset managers in direct competition with some of the savviest quantitative hedge funds in the investment industry.

In addition, asset management companies face broad industry challenges such as investors' shift into low-cost index products and the steady erosion of asset management fees. As a result, asset managers have been seeking new products to help them grow, ranging from non-transparent ETFs to alternative investments. However, all these products implicitly promise investment outperformance. ESG is the first major product category that does not solely rely on beating a benchmark index – a proposition that in aggregate over the long term does not work for the industry – to create value, and delivering on the promise of ESG products is therefore much more achievable for asset managers.

ESG facilitates maintaining relevance with clients

The process of building out ESG capabilities will allow asset managers to learn more about the wants and needs of their existing and future clients, which is positive for client engagement and competitive relevance, particularly with younger generations accumulating wealth. This could drive brand reputation and improve trust with investors, a weakness among traditional active asset managers who raise much of their assets through intermediaries.

Connecting with clients and maintaining relevance with them is crucial for the growth prospects of an asset manager. Based on a recent survey we conducted of asset managers with aggregate AUM totaling approximately $19 trillion, we observe a strong correlation between organic AUM growth and ESG prioritization. Managers that consider ESG a Top 3 and above priority – companies that tend to have more innovative business strategies overall – have an average AUM replacement rate of 117% over the past three years. This means that they were able to more than replace redemptions – that is, they experienced organic AUM growth – in the face of an active fund industry seeing net redemptions. Conversely, firms that did not consider ESG to be a Top 10 priority had AUM replacement rates averaging 73% and experienced organic AUM declines. This result is not solely due to having high-demand ESG products for sale, since the overall level of ESG AUM among these managers is very small. However, an asset manager's focus on ESG could be a proxy for an

innovative, forward-looking approach to product development that correlates with maintaining relevance with clients and success in organic growth.

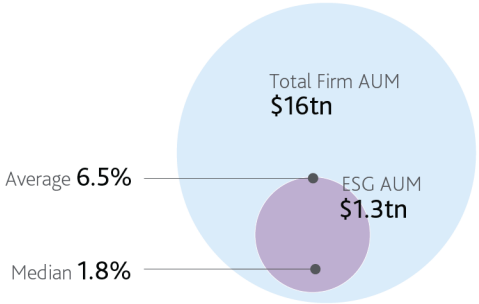
Exhibit 2
Correlation between ESG prioritization and organic growth

Source: Moody's Investors Service

Share of ESG AUM is small, but growth potential is large

According to JPMorgan, dedicated sustainable strategies reached $8 trillion out of a total $78.9 trillion invested assets[2]. Our own estimates based on our survey of rated global asset managers confirm this: ESG penetration averages 6.5% across our asset managers, and the median is significantly lower at 1.8%. Our survey results are lower than other industry estimates because we define ESG AUM as only those funds reported by managers as having an explicit ESG mandate defined in their prospectus or investment management agreement. The survey sample consisted of 27 managers representing approximately $19 trillion in AUM, of which a subset with assets totaling $16 trillion gave estimates for their ESG assets[3].

Exhibit 3
ESG AUM as a % of total AUM is still small



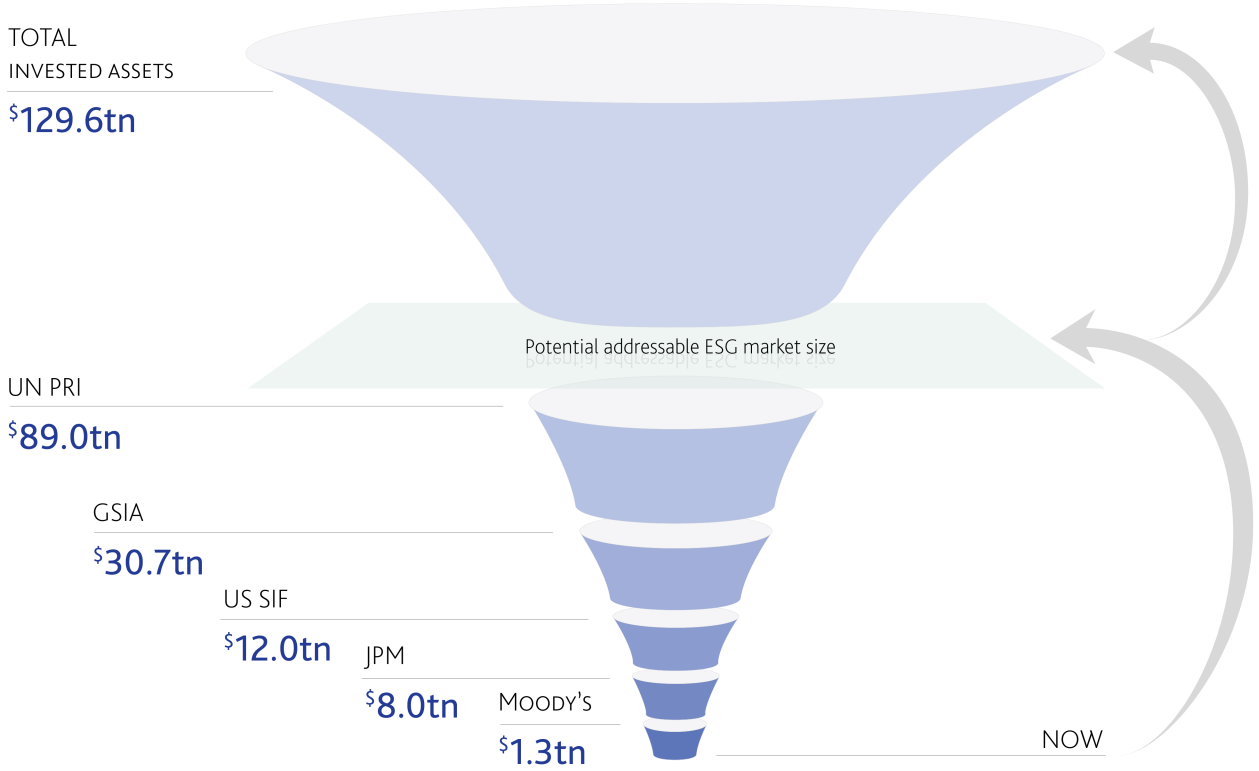
Source: Moody's Investors Service

Given the low penetration rates of ESG products currently, particularly low median levels, the potential for growth is very large. We believe that most of the traditional asset management industry AUM will be an addressable market over time: ESG as a style or overlay could represent more than half of total invested assets, echoing the market share growth of passive products. Currently, there is no standard definition of ESG assets. However, the total AUM of UN PRI signatories is approximately $89 trillion[4]. Since the institutions that are signatories are all in varying stages of implementing ESG, we estimate that the potential addressable market for ESG products is $89 trillion, more than half of the asset management industry.

Exhibit 4

Potential addressable market for ESG products is $89 trillion

ESG AUM as estimated by various organizations[5]



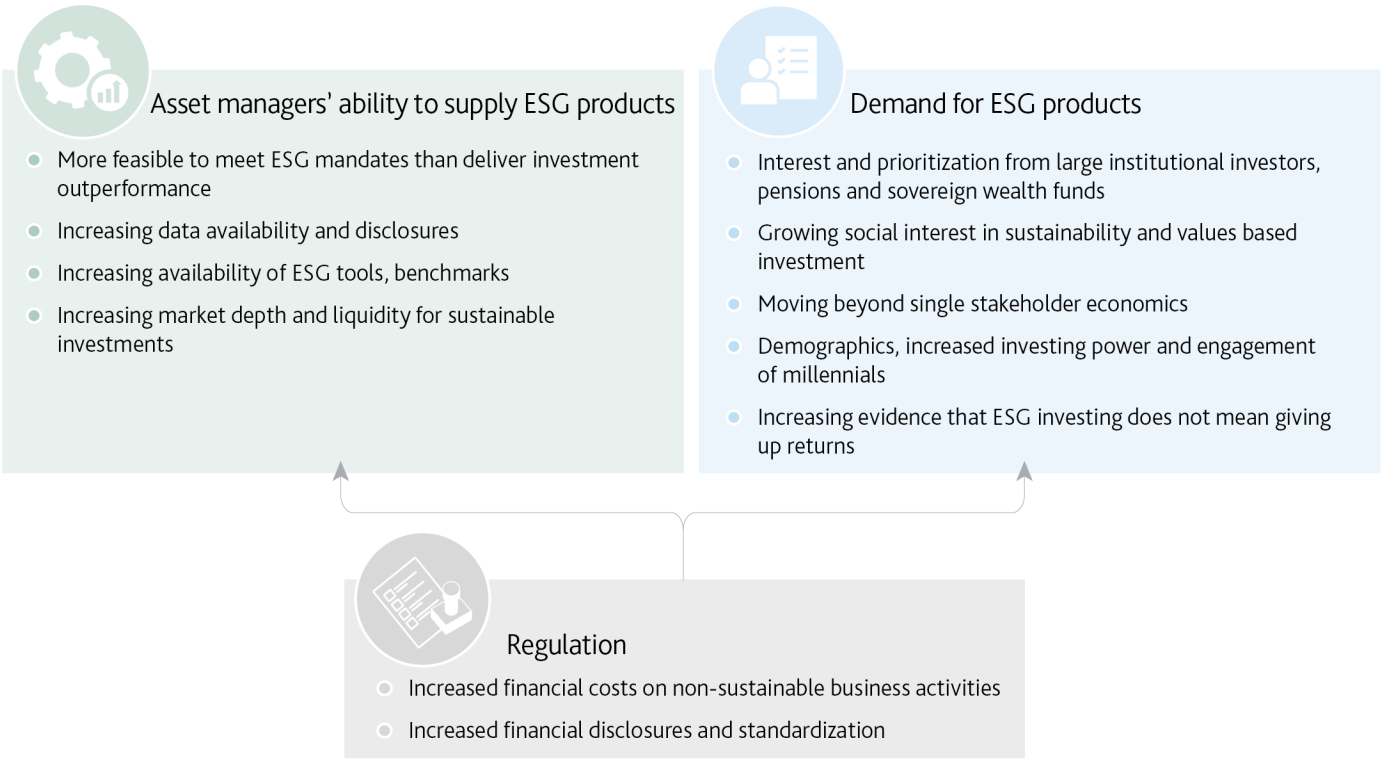
Source: Willis Towers Watson Thinking Ahead Institute, OECD, Preqin, UN PRI, Global Sustainable Investment Alliance (GSIA), US SIF, J.P. Morgan Asset Management, Moody's Investors Service

Market dynamics could also increase the influence of ESG factors from a flow perspective

ESG indexes are also attracting more interest, and as ESG factors become incorporated into index products, passive ESG is likely to be a strong growth area, alongside traditional active ESG funds.

Indexing behavior acts as a funnel for capital flows as funds are directed toward companies that are included in an index. As ESG increases in popularity, ESG factors are likely to be added on top of current index construction methodologies. We have seen similar overlays on top of traditional indexes with the rise of smart beta and factor-weighted indexes. Importantly, and distinct from value, size or other traditional financial factors, ESG is not cyclical, and investors request it for other reasons besides investment outperformance. Therefore, the inclusion of ESG considerations into indexing will grow more consistently over time, because it is not subject to the inevitable periods of out- and underperformance characteristic of traditional financial factors. As more and more money flows into ESG, it will flow to companies and sectors that are deemed more sustainable, raising the valuations of those companies, creating a positive feedback effect. Ultimately, investors and funds could risk underperforming by investing in a manner that does not effectively incorporate ESG considerations.

Exhibit 5
Summary of factors driving ESG product growth
Demand side and supply side factors for ESG



Source: Moody's Investors Service

Two major hurdles to growth are perceived return trade-off and lack of standardization

We see two major hurdles to further growth in ESG: lack of standardization of definitions and process in the industry, and investor perception that there is a tradeoff between doing good and maximizing investment return.

Lack of standardization and market fragmentation may hold back growth for some time

The differences in definitions of ESG as well as regional heterogeneity in norms makes for a currently fragmented ESG product marketplace. Although some organizations, such as the United Nations and the Forum for Sustainable and Responsible Investment (US SIF – formerly known as the Social Investment Forum), are making efforts to create broad standards, the market is still at an early stage and will take some time to mature. Not only is there a lack of standards in the underlying definitions of E, S and G, but within ESG investing, the extent to which ESG is incorporated into the investment process varies (see Exhibit 6), causing confusion for clients. Over time, regulators, particularly in the EU, are likely to set guidelines defining taxonomy and improving standardization in the marketplace.

Despite the lack of standardization, product sophistication has advanced as institutional and retail investor demand have become more widespread. Many firms have moved beyond solely using negative screening – the application of ethical and moral criteria to exclude certain businesses from their portfolios – to creating investment theses and selection processes based on ESG themes, trends and attributes. The leading ESG managers view sustainability as a core consideration underpinning their investment philosophy and process, and believe that it leads to investment outperformance. Asset managers' ability to deliver more sincere, thorough and rigorous ESG products will likely resonate with consumers and become an important determinant for product sales.

Exhibit 6
Common examples of ESG incorporation

POSITIVE / BEST IN-CLASS SCREENING	Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers. This also includes avoiding companies that do not meet certain ESG performance thresholds
NEGATIVE / EXCLUSIONARY SCREENING	The exclusion from a fund or plan of certain sectors or companies involved in activities deemed unacceptable or controversial
ESG INTEGRATION	The systematic and explicit inclusion by investment managers of ESG factors into financial analysis
IMPACT INVESTING	Targeted investments aimed at solving social or environmental problem
SUSTAINABILITY THEMED INVESTING	The selection of assets specifically related to sustainability in single- or multi-themed funds

Source: US SIF

Skeptics of the application of ESG principles use the term 'corporate greenwashing' to describe organizations that claim they are applying environmentally sound practices when their actions are so superficial that they cannot support any such claim. Applied to funds, 'greenwashed funds' are those which are labeled as ESG, but apply minimal investment judgment based on ESG factors, with little value-add to the investment process. For example, many ESG funds have been criticized for holding sizeable investments in fossil fuels or perform minimal analysis of ESG considerations by performing simple negative screening. As investors become more informed about the firms' product offerings, companies that are viewed as using ESG merely as a marketing gimmick may find their reputations tarnished, and their ESG efforts could actually detract from raising assets. An authentic approach will likely resonate with consumers, while the superficial application of ESG considerations into fund products will likely expose asset managers to reputational risk. Given current social media monitoring and increasingly activist shareholder base, companies announcing ESG initiatives and prioritization will be under constant public scrutiny to follow through on the sincerity of their proclamations. However, until there is more standardization around terminology and practices, 'greenwashing' is still likely to remain prevalent.

Asset managers likely to benefit most from ESG will be those that incorporate it fully into their investment philosophy and process. For some of these managers, this could lead to a period of investment outperformance, and crucially, to uncorrelated outperformance; since not all ESG factors are traditional financial and valuation metrics, their informational content is just now being incorporated into the market's pricing of securities. There is already evidence of some managers' ability to do this, which we will cite below. And, just as with any attempt at investment outperformance, only a small minority of active managers will deliver consistent outperformance above frictional costs and fees.

Fear of return tradeoff likely misplaced

When it comes to investing, investors, and more commonly retail investors, often wonder whether upholding sustainability or ethical principles might compromise investment returns by subjecting their investment opportunity set to a group of constraints. According to Cerulli Associates, one of the top three factors limiting the adoption of ESG investment strategies is the market perception that returns will be hurt by ESG constraints. Senior executives at various asset managers, both large and small, have also anecdotally cited investors'

belief of a tradeoff between pursuing an ESG mandate and investment returns, as well as a breach of fiduciary duty if ESG products underperformed their non-ESG counterparts, as key impediments to mass adoption of ESG products.

However, concerns about such a tradeoff are likely misplaced, for several reasons. One reason is that constraints are simply an operational reality of investing. Institutional investors are constantly under any number of stated and unstated constraints at any given time, ranging from liquidity and investment style to the job security risk of individual portfolio managers, and all these constraints can cause them to choose certain investments and avoid others. ESG is just one of a number of many possible operating constraints for asset managers.

Secondly, studies show that ESG products have risk/reward characteristics that are similar to other products. A meta-study conducted by Arabesque Asset Management, which reviewed over 200 different sources, found that 80% of the reviewed studies indicated that thoughtful sustainability practices had a positive impact on investment performance[6]. Morgan Stanley, after reviewing the performance of nearly 11,000 mutual funds across different asset classes from 2004-18 also found that sustainable funds provided returns comparable to their traditional peers, while lowering downside risk[7]. The International Monetary Fund (IMF), in a review of the literature on sustainable finance, said there was no conclusive evidence of outperformance or underperformance by sustainable funds[8]. The number of studies performed with a result of no conclusive proof of a return tradeoff suggests that if there is any tradeoff at all, it is incredibly small.

More importantly, we would argue that any return tradeoff, whether positive or negative, is secondary to the more impactful investor choice of which level of fees to pay on an investment product or how much activity a portfolio should exhibit. For example, the difference between the MSCI World SRI Index and the non ESG-compliant MSCI World's return was positive 5 bps over the past 10 years and positive 76 bps since inception [9]. These deviations are small relative to the historical average return drag from active management fees and transactions costs, which we estimate at approximately 200 bps per annum[10].

Rather than detracting from returns, more recent studies have even shown that ESG considerations applied to investment analysis may improve risk-adjusted returns by minimizing downside risk[11]. As BlackRock's CEO, Larry Fink, wrote about climate risk in his 2020 annual letter on corporate governance, "climate risk is investment risk," and "over time, companies and countries that do not respond to stakeholders and address sustainability risks will encounter growing skepticism from the markets, and in turn, a higher cost of capital."

Morgan Stanley's analysis of nearly 11,000 mutual funds highlighted that while sustainable funds provided returns similar to those of traditional funds, ESG funds tended to be less volatile during periods of market stress. For each and every year, from 2004-18, the sustainable funds experienced less downside deviation relative to traditional funds by 22 to 182 bps, with all but one year with a result statistically significant above the 90% confidence interval and all years after 2013 statistically significant at the 99% confidence interval.

In a broader sense, ESG is just one of many possible ways to filter investments by a given factor – investors can sort investments by market capitalization or value, for example. Any single factor choice, particularly one so broad and conceptual as ESG, is likely to have far less impact on investment returns than the bigger overall decision between low versus high cost and level of investment activity. The approximately 200 bps return drag from active management overwhelms most estimates of ESG tracking error. The MSCI World SRI Index, which includes large and mid-cap stocks across 23 developed markets countries, has a tracking error of 1.79% from September 2007 to January 2020. On the other hand, the median tracking error for a variety of active managers in different markets from 2004 to 2018 ranged from 250 bps to 550 bps [12].

Lastly, there are also empirical cases of strong outperformance in ESG funds, again, just as there are with any other investment style, be it growth, value, public, private, quantitative, fundamental, macro or micro. Among traditional asset managers, Eaton Vance, which acquired the ESG firm Calvert, has integrated ESG into many of its investment processes within its active funds. Currently, 29% of their strongest performing four-star and five-star Morningstar funds are Calvert-branded ESG funds[13]. A more unconventional example is the equity manager Generation Investments, founded in 2004 with a mission to invest by incorporating sustainability research and traditional financial analysis with a long-term investment horizon. The firm's practice of investing in 'sustainable capitalism' has led to industry-leading results – the Lombard Odier Generation Global Fund ranked 17 out of 1643 Global funds over the past 120 months

in total return, while ranking 196 out of 1643 in terms of standard deviation during the same period[14]. Outperformance relative to its sector average over the past five years is estimated to be in excess of 500 bps per annum[15].

Endnotes

1 Natixis Investment Managers, Mind shift: Getting past the screens of responsible investing, June 2017

2 J.P. MorganAsset Management, How is ESG affecting the investment landscape?, September 2019.

3 We conducted a survey of rated asset managers which consisted of both investment grade and non-investment grade firms. The aggregate AUM of the managers from which we received responses to the survey totaled an estimated $19 trillion. The survey included questions about the scale and depth of the firms' ESG activities, as well as qualitative information about their ESG strategies, their forward-looking expectations and their views on key ESG issues. We used the most recent financial data available to us for our financial calculations. Differences in cited AUM for certain exhibits may arise due to partial responses received.

4 UN Principles for Responsible Investment, PRI update Q1 2020

5 Our estimate for total invested assets includes assets under management and institutional assets such as pension funds and sovereign wealth funds. The $129.6tn of invested assets is comprised of discretionary assets from the 500 managers in 2018 as reported by Willis Towers Watson Thinking Ahead, pension assets in 2018 from OECD and sovereign wealth funds as of March 2018 from Preqin. In order to minimize double counting, we excluded the sovereign wealth funds and retirement plans as reported by the fund managers in the Willis Towers Watson publication. UN PRI represents total assets under management as of 2019. Global Sustainable Investment Alliance (GSIA) represents global sustainable investments as of the start of 2018. US SIF represents sustainable, responsible and impact investments as of 2018. J.P. Morgan represents dedicated sustainable strategies as of September 2019. See Willis Towers Watson Thinking Ahead Institute: The world's largest 500 asset managers, OECD: Pension Markets in Focus 2019, Preqin: Special Report: Sovereign Wealth Funds, GSIA: 2018 Global Sustainable Investment Review and US SIF, Sustainable and Impact Investing - Overview

6 Arabesque Partners, From the Stockholder to the Stakeholder, March 2015

7 Morgan Stanley, Sustainable Reality Analyzing Risk and Returns of Sustainable Funds, August 2019

8 International Monetary Fund, Global Financial Stability Report: Lower for Longer, Chapter 6, October 2019

9 MSCI World SRI Index, Fact Sheet, Data as of 31 January 2020

10 See Sector-in-depth Asset Managers-Global Industry Flows Actively Moving to Passive, July 2016

11 See for example, Deconstructing Risks in Impact Portfolios, Bank of America Merrill Lynch, September 2019 and Cracking the ESG code, Nordea Equity Research, September 2017

12 Gupta, Abhishek, Raina Oberoi, and Raman Aylur Subramanian (2019). "Evaluating opportunities in active management," The Journal of Investing, Volume 29 Number 1

13 Eaton Vance Corp., Fourth Quarter Fiscal 2019 Earnings Presentation, November 2019

14 LO Funds Generation Global Fund, Fact Sheet, Data as of 20 February 2020

15 Barron's, Al Gore is Winning at Investing, March 2017

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