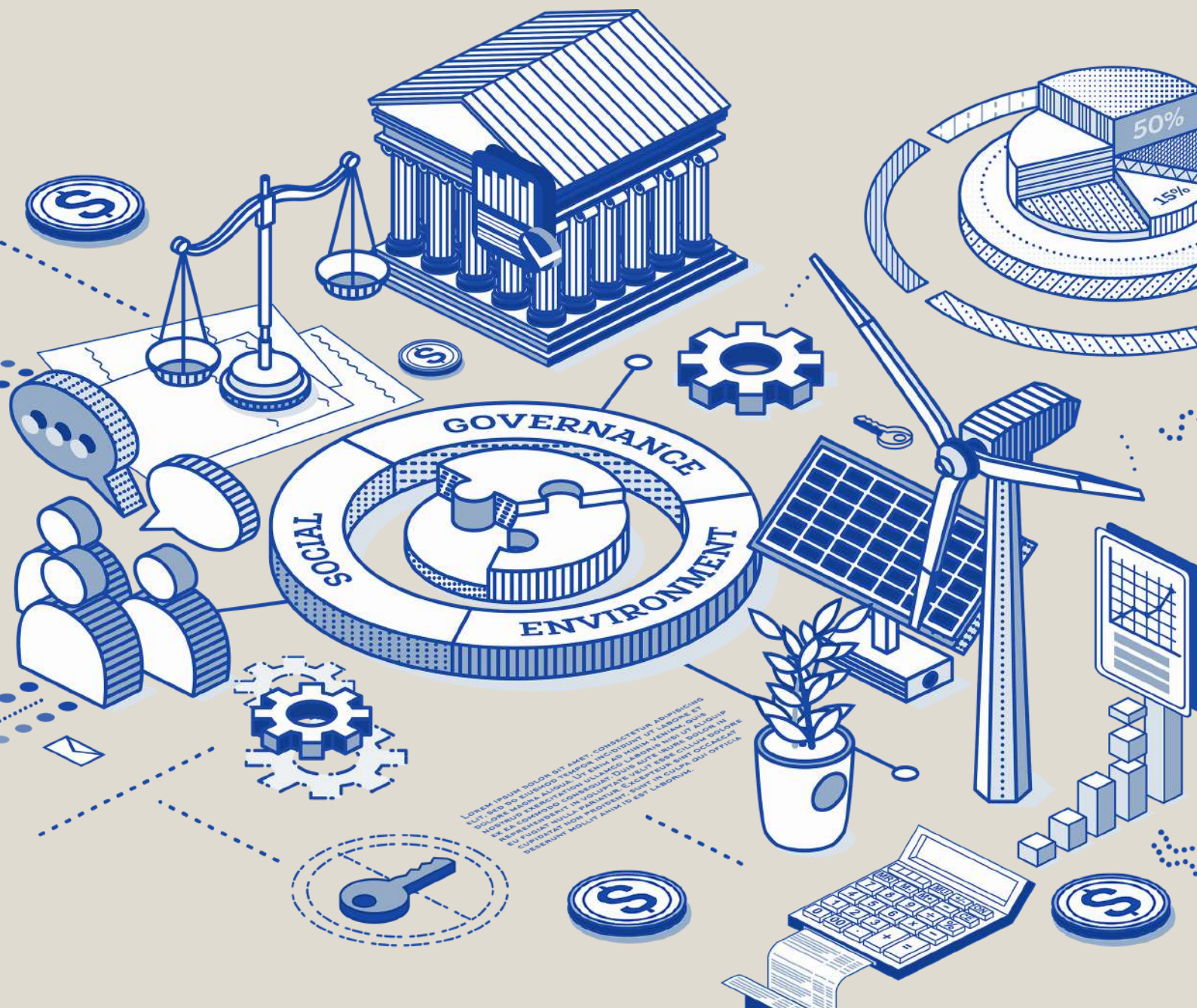


ESG and US asset management: THE FUTURE IS NOW





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About Mazars

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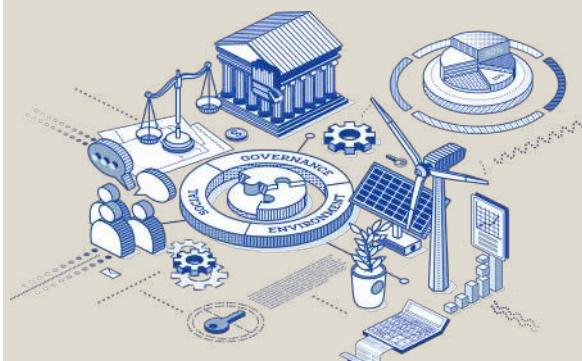
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FOREWORD

Why ESG requires a long-term approach

All sides of the industry must listen to and learn from each other to achieve a sustainable transformation, explains Charles V Abraham, US financial services practice leader, Mazars.

As we enter 2022, there is no shortage of opportunities and challenges facing the US asset management industry. Mergers and acquisitions, digital transformation, emerging technologies, the battle for talent, the continued impact of Covid-19 and navigating market and geopolitical volatility continue to be themes we often hear about from our clients and stakeholders.

But perhaps more than anything else, environmental, social and governance and sustainability factors are driving decision-making at the highest levels. From supporting diversity, equity and inclusion initiatives to developing meaningful investment screening mechanisms, asset managers of all shapes and sizes are betting big on ESG in an effort to differentiate themselves in a crowded space. And while the contours of the industry's ESG roadmap are still being drawn, one thing about our journey is certain: ESG-related regulations and initiatives will continue to rapidly accelerate, supported by a generational transformation of ethos that has reached critical mass.

At the same time, asset managers must evaluate their ESG efforts to assess whether it is truly providing investment opportunities and value to their investors, or whether the efforts are merely 'marketing-speak'. Economist Milton Friedman famously said: 'There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.' In our view, focusing on an ESG investment strategy does

not mean that an investor is throwing out Friedman's views.

The argument for an ESG investment strategy is more nuanced than just being 'socially responsible.' It is the pursuit of an investment strategy that will lead to long-term returns for shareholders because of the focus on resilient, sustainable and responsible business models.

While regulators, scientists and thought leaders can provide much-needed direction and forethought,

each market participant has its own critical role to play in tackling the emerging challenges and opportunities facing asset managers.

At Mazars, we are doing our part to help constituents across the industry achieve their tactical and strategic objectives. We are responding to an industry movement with a company-wide effort to design meaningful solutions that address our clients' needs and help de-risk their organisations. As a global firm with European roots and a diverse client base in over 90 countries, Mazars is aptly suited to weigh in on ESG considerations, the state of our industry and what is coming next.

But it all starts with listening

– to what is important to our clients (and our clients' clients), and to the range of challenges impacting key stakeholders, from the small asset manager in a niche market to the global conglomerate addressing regulatory overload.

It is through this lens that our report was conceived. It is a wide-ranging but focused snapshot through the eyes of some of the industry's top managers, experts and thought leaders. We are excited to share what we have learned. ■

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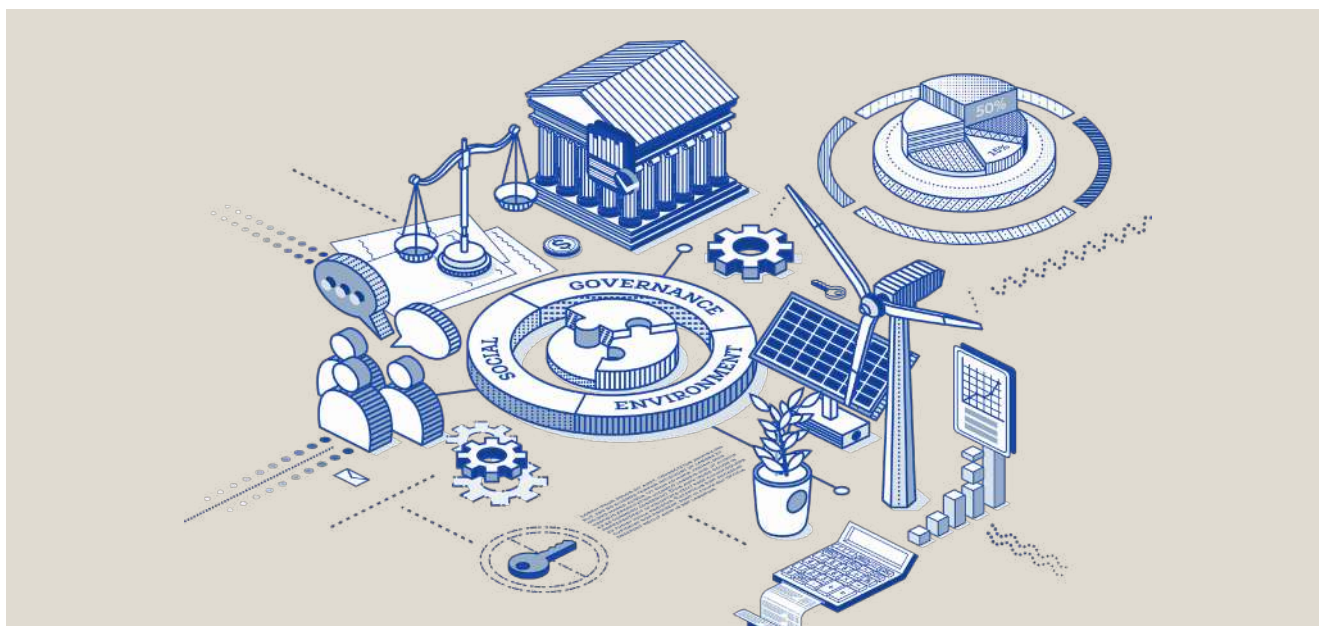
While regulators, scientists and thought leaders can provide much-needed direction and forethought, each market participant has its own critical role to play in tackling the emerging challenges and opportunities facing asset managers.

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INTRODUCTION

Recognising ESG potential

Forward-thinking asset managers in the US are accelerating their ESG credentials at pace, incorporating a sustainable lens across their portfolios. They can and want to do more – but they need better data, engagement from regulators and more clients to join them on the journey.



ACCELERATED. Rigorous. Nuanced. Engaged. These are some of the words leading US asset managers use to describe how their environmental, social and governance investment approaches – as well as the sustainable investing industry as a whole – have evolved over the past three years.

While ESG criteria have been on the agenda of the most sophisticated asset managers for some time, the key issues impacting investing decisions have changed in recent years.

Some of the top US asset managers reported that they continue to refine their approaches in what can still be considered a nascent industry – the term ‘ESG’ was only coined in 2004 in a United Nations study entitled ‘Who Cares Wins’. A year later in 2005, a voluntary set of rules was introduced by the UN-backed Principles for Responsible Investment to guide institutional investors as they incorporated ESG criteria into investment decisions (see box 1). The goal was and still is to build a more sustainable global financial system – one that not only manages risk but generates long-term value.

But what began as a slow burn more than a decade ago is now approaching fever pitch. While the US fund

industry came late to the ESG table and often lags its European peers, the amount of money managed in ESG assets has reached over \$51tn, or 33% of the total US assets under management¹. Green bond issuance – after hitting a record high of \$290bn in 2020 – is on track to reach \$500bn this year. While issuance in the US is largely driven by corporations and was gaining momentum before Covid-19, the pandemic has underscored the need for a global sustainable recovery and has upped the total size of the green bond market to more than \$1.2tn².

As institutional investors increasingly recognise the potential in ESG, asset management is undergoing a sea change in approaches to investment. There has been an explosion in client and consultant demand for information regarding firms’ ESG approaches. Until recently, much of the ESG focus has been on environmental factors, but there is increasing awareness of the importance of social and governance issues as well.

The growth in initiatives for data, metrics and standards brings new opportunities and challenges for asset managers as they make efforts to reduce

their carbon footprints. Considerations around data and regulation are more important than ever as new technologies make processes more open and efficient.

As one asset manager puts it: 'What I like about this space is that you can actually talk candidly about challenges and people respond to it. There is an agreement that ESG data is a problem, and yet it's not a clean black-and-white answer, it's messy. Being able to have that honest conversation, one, with yourselves and, two, with your clients to understand the end objective is the priority.'

ESG in asset management has moved from a box-ticking exercise to thinking about what is crucial to both investment and sustainability-related objectives and creating solutions that work. But there is no one-size-fits-all approach.

The asset managers interviewed for this report agree. Their ESG approaches all vary based on their unique investment strategies, risk management and diverse client bases. But one overarching theme prevails: whatever you are doing, you must do something – for your firm, your clients and the planet. ■

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The pandemic has underscored the need for a global sustainable recovery and has upped the total size of the green bond market to more than \$1.2tn

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1. The six principles for responsible investment

IN early 2005, a group of the world's largest institutional investors – along with 70 investment industry, intergovernmental and civil society experts – gathered with then-UN Secretary-General Kofi Annan to draft the PRI. They were launched in April 2006 at the New York Stock Exchange and have secured more than 4,000 signatories since then.

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the principles.
6. We will each report on our activities and progress towards implementing the principles.

1. US SIF Foundation, 'Report on US Sustainable and Impact Investing Trends', November 2020

2. Climate Bonds Initiative, '2021 Green Forecast Updated to Half a Trillion – Latest H1 Figures Signal New Surge in Global Green, Social & Sustainability Investment', August 2021

CHAPTER 1:

The evolution of ESG approaches

From screening strategies to impact investing and active ownership, approaches to ESG investment are constantly developing.

‘TO characterise it broadly for our firm and across the broader industry, it’s just been an incredible acceleration,’ says Adam Heltzer, managing director and global head of ESG for Ares Management Corporation, on the changing landscape of ESG investment. ‘This is a field that started with a private equity focus, given the amount of influence and control firms had in private equity. But then, in very quick succession, infrastructure, real estate, credit and all different asset classes came into scope,’ he added.

The industry has changed tack from policies and case studies showing how ESG was being integrated towards a much more systematic and scaled demonstration of the effort. ‘That’s one overall change,’ he said. ‘Systematising it, making it reportable and making it more transparent.’

When Heltzer reflects on the evolution of Ares’ business over the past three years, he notes two things: the first is how the firm has strengthened and built rigour around its integration processes. Second, how it has evolved its culture in this area. ‘This used to be a function where a set of technical specialists were responsible for the work,’ he said, adding that Ares had its first dedicated ESG hire in 2012. ‘But what we have now, especially for the last three years, is a real democratisation of the ESG effort. We’ve been focused on scaling the programme well beyond a few technical specialists to a broad network of more than 100 ESG champions across the organisation.’ Embedded in Ares’ investment strategies, the ESG champions are representatives who have volunteered to support the tailoring and application of the global ESG approach to the specific dynamics of their respective asset classes.

Another consideration is how to collect and use ESG data. Like many firms, Ares’ ESG efforts tended to be localised and organic. ‘Part of my mandate was to consolidate that into a unified vision,’ Heltzer said on his joining the firm. ‘We had a lot of ESG activity across different strategies, but we saw an opportunity to formalise them under a vision and set of principles.’

Ares set out to execute this. ‘We asked ourselves what the standards of a good ESG integration plan has and data was core to that,’ he said. It was central to clarifying what the objectives of the firm’s plan were, how Ares was going to build processes to meet those objectives and, lastly, how it was going to capture the data it would need for all stakeholders – investors included.

Screening strategies

ESG and responsible investing has been very important for a long time. Firms are increasingly using screening strategies to mitigate risk and align investments with sustainable objectives. At one end of the screening spectrum is positive screening, where investments are chosen based on a firm’s ability to meet ESG criteria, and at the other end is negative, where opportunities are disregarded due to poor ESG credentials.

ESG investing started originally at the lighter green or negative end of the screening spectrum, according to one asset manager interviewed. ‘There’s always been a degree of ESG integration, but maybe not as much process around how the policies worked,’ they said. ‘Now there’s much more impetus for the darker green end of the spectrum, moving beyond positive screening, but trying to find sustainability thematic objectives.’

‘I think the processes have become more defined, and we are seeing a lot more rigour in terms of gathering of data, and the understanding of the data when it comes to the ESG factors,’ they added. The firm has also launched funds that have a sustainable theme or objective, aligning with both regulatory demands and client interests.

The approach at Barings has been relatively consistent and is also focused on meeting client demand, according to Sarah Munday, director of sustainability. ‘When we think about ESG at Barings and how that affects different asset classes, a lot of our clients three years ago were probably focused primarily on that negative screening approach,’ she said. ‘And it’s really hard to do that when you’re thinking about some of those smaller, not publicly listed companies that don’t have large sustainability teams. Data is a huge challenge.’

Screening out entire sectors was never the firm’s approach and the industry as a whole has moved away from negative screening. ‘There is much more of a focus on stewardship and engagement, which is something that we’ve always prioritised,’ she added. Munday has recently added to her team in London to focus on that key stewardship role and support the investment teams on engaging with companies.

Impact investing

The ESG approach of Neuberger Berman – which invests across equities, fixed income, private markets and globally in emerging and developed markets – involves a lot of nuance and is dependent on the asset class. ‘We have taken in the last three years the position of a universal value across all of our co-mingled funds, which was around

thermal coal,' according to Jonathan Bailey, the firm's head of ESG investing. 'And we did that because we felt that there was no longer an economic or an environmental rationale to build new thermal coal power-generating assets. For the first time we actually took a view across the whole platform that we would not be investing in those issuers, those assets.'

While that is an exclusion that didn't exist three years ago for NB, most of the firm's focus and the focus of its clients has been less about exclusions over the past few years. 'It's been more about the integration of ESG factors into investment processes and then the development of portfolios that have sustainable and impact objectives alongside their financial objectives,' he said. NB tracks and reports the percentage of client assets under management that integrate ESG every year. Five years ago, it was around 30% or \$200bn. At the end of last year, it was 84% (almost \$400bn).

'We've seen a sort of steady increase in the proportion of the investment strategies that we run that formally integrate ESG,' said Bailey. 'And that's a function of us working with individual investment teams to incorporate ESG into their process in a way that is intended to enhance their ability to deliver on their investment objectives.' This could include proprietary ESG ratings for all sovereign debt issuers, or for securitised debt, or the work the firm has done in private credit to build ESG into its diligence frameworks.

'We've also been building investment strategies with sustainable and impact objectives over the last three years and, for example, successfully raised a private equity impact strategy,' he added. Over the last 12 months, there has been a large focus on net-zero investing and strategies that have an explicit net-zero objective in multi-sector credit, equities and private markets.

Eoin Murray, head of investment at Federated Hermes, says his firm's approach has evolved 'in the sense that

it is more exacting than it once was.' This is driven by two things: clients and portfolio managers. The firm thinks of its strategies in three buckets: the biggest of which is ESG-integrated, which considers ESG metrics alongside financial considerations in the investment decision.

The second is big 'S' sustainable, which is more values-driven with elements of negative and positive screening or a best-in-class approach. 'There's a desire to pick more of a combination of those firms that are leading on sustainability issues, as well as a balance of some that are transforming,' he said. 'And that transformation piece is important because I would say that our secret sauce across everything that we do is engagement or stewardship.'

The last bucket is what the firm would call 'genuine impact investing' where there is a material objective for products and services that goes above and beyond what currently exists. 'It's quite a niche market,' Murray adds.

Integrating ESG across portfolios

BlackRock has evolved and strengthened its ESG business over the past three years and built rigour into its investment processes. In January 2020, the firm made a public commitment that it would achieve 100% ESG integration across its active platforms, inclusive of both public and private markets, by the end of 2020 – a goal it was able to meet, according to Kaitlin Bergan, director and senior platform strategist for the asset manager's sustainable investing team. In addition, the firm launched its climate data and analytics solution, Aladdin Climate.

But before that, Bergan describes a journey that started a little more than three years ago as the asset manager found its footing in what was and still is considered a 'newish' industry. The firm has a dedicated team within its broader sustainable investing team that focuses exclusively on the integration process. 'They work with our portfolio managers and active platforms to get

them to incorporate what we deem financially material ESG drivers of risk and opportunity into their investment process holistically.'

This is after the firm assessed each of its own investment platforms several years back to understand just how ESG-aware they were and worked with them over several years to get them up to speed. This involved: equipping the platforms with the data and analytical tools they need and incorporating those into its portfolio management systems; rigorously incorporating ESG risk considerations into the fund's risk management process; and writing policies governing its investment platforms and how they are ESG-integrated.

'One thing to clarify is that it is about this incorporation of financially material ESG factors,' Bergan said. 'What it is not is our dedicated investment strategies that incorporate sustainable or impact or ESG objectives alongside their financial objective. This is not about any sort of blanket screening of anything. It is about equipping our investors with the tools they need to better make decisions.'

In January 2020 the firm announced it would grow its dedicated platform to \$1tn assets by 2030. At the time, it was about \$150bn dollars in assets. At the end of Q3 2021, it was at \$434bn in assets. 'So, while we are well on our way, it is clear that this is an industry shift,' she said. 'The growth is across asset classes, with index, active and alternatives all seeing momentum.'

One firm has been spending a lot of time over the past 18 months growing the active portion of assets. Within the private markets, the firm is expanding its focus on thematic and impact strategies. For several years they have had a large platform around renewable power business as the firm's only impact-orientated private market franchise. 'But what we've done over the past couple of years is to launch strategies that we've had client appetite for such as multi-asset alternatives focused on racial equity in the US,' they said. ■

The rise of 'S' and 'G'

While the 'E' in ESG is often the most focused on and discussed area, events of the past two years have put the spotlight on social and governance factors. How are asset managers differentiating themselves in these two categories?

THE events in summer 2020 after George Floyd was killed in police custody in the US ignited an unprecedented outpouring of support from the financial services community around social and racial justice. Estimates put the financial pledges at more than \$50bn.

Most asset managers report that they have been focusing on these factors for some time or recently increased their initiatives, all while acknowledging that the 'environmental' factor in ESG still gets the most attention.

'Definitely last summer helped catalyse the focus on the 'S' component, but unfortunately not quite to as high prominence as it deserves, says Barings' Munday. 'There's not a global UN convention on diversity and the importance of social justice quite yet, hopefully there will be something similar to COP26 soon.' While 'E' still dominates, Munday reports they are beginning to see clients set diversity targets within their portfolios as well as firing managers that do not have adequate representation within the asset manager themselves.

Away from the environmental narrative, NB reported that issues of diversity, equity and inclusion are material for the firm. Eighteen months ago, NB became the first North American financial services firm to tie its own cost of borrowing to sustainability characteristics, including hitting specific targets around diversity and inclusion. For example, if NB increases the proportion of women in senior roles and across the firm as a whole, and the proportion of diverse individuals in North American roles, then borrowing costs will be adjusted down. 'And obviously, if we don't hit those, then the opposite will occur,' Bailey said.

'We felt that was really important because we are talking to companies about diversity and inclusion and encouraging them to disclose data and to take action and to improve their diversity characteristics. So, we wanted to do that ourselves,' he said, adding that a few major asset managers have also followed suit.

While the increased focus on DEI by corporations since last year is noteworthy, it cannot be overlooked that this is a 'deeply ingrained systemic issue, which requires operational ground game type effort,' according to Ares' Heltzer.

While Ares has portfolio board diversity targets, it realised it needed engagement with management teams about creating more inclusive cultures. Ares hired its first Chief DEI Officer, Indhira Arrington, in January 2021. In April 2021, Ares and around 10 controlled portfolio companies went through a comprehensive DEI assessment to assess how included different groups feel within the organisation.

NB has also built a set of metrics and targets around its DEI programme, specifically around inclusion. 'It's really important that they aren't just about hiring numbers or output of diversity statistics, but are actually trying to quantify inclusion,' Bailey said.

'Diversity isn't representation numbers only. You can have a diverse firm, but if no one feels included or empowered, you don't actually capture the value from diverse perspectives,' Heltzer added.

In June 2021, the firm announced the launch of the Ares Charitable Foundation, which through strategic

investments will provide career preparation and reskilling, encourage entrepreneurship and improve financial education. One investment, alongside Apollo Global Management and Oak Tree Capital Management is 'AltFinance', an initiative aimed at getting more diverse – and specifically Black Americans – into the pipeline for the alternative investment industry. Ares expects to contribute \$30m over the next 10 years

in a partnership with historically black colleges and universities to and train the next generation to come into the private markets and asset management industry.

Governance and social factors remain of the utmost importance to ensure that firms are living the values they demand of their investee companies. BNY Mellon has a new diversity council to increase hiring diversity at all levels and they are also doing work in the wider investor community – all the way to the end investor. In addition, they are focused on the many studies that have shown that fewer women invest than men.

'We're looking at some of the reasons behind that to start projects that will reach out to female investors,' one asset manager said. 'How can we make this more accessible and ensure that there are opportunities across the spectrum?' ■

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You can have a diverse firm, but if no one feels included, you don't actually extract the value of it.
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CHAPTER 2:

The explosion in client demand

Over the past decade, client and consumer demand for information on a firm's ESG credentials has grown exponentially.

BACK in 2016, Munday was Barings' request for proposal writer responsible for all of the ESG questionnaires at her firm. There were around 30. 'This year, every single RFP we've done has an ESG section if not a standalone ESG RFP,' she said, and her team is on track to complete 200 ESG questionnaires alone.

Demand has definitely become less about box-ticking and much more specific – from quantifying portfolio carbon emissions to TCFD disclosures. The questionnaires, not just the number or frequency of them, have become much deeper.

Barings is not alone. Asset managers report that client and consultant demand for information regarding their ESG approach has expanded exponentially over the past three years. 'It's become much more voluminous, much more sophisticated,' said Ares' Heltzer, 'and something I really welcome as it's paired with more meaningful engagements now.'

Neuberger Berman has been 'thrilled' by the increased interest from clients and is also experiencing an uptick. 'Existing clients are asking about ESG that never did before and that's really important because it means that might be a mandate that we might have been running for them for a decade or three or five, and they now expect that it's part of our investment process – which it is.'

In addition to the shift from existing clients asking about ESG and how it's incorporated into their portfolio, clients are coming to NB with specific ESG objectives such as building a net-zero multi-sector credit, or a net-zero investment grade credit portfolio. 'We've seen sort of both of those two things happen:

existing clients start to embrace ESG and expect us to be incorporating it and new clients coming and saying, we have a new approach that we want to see implemented, can you help develop that with us?'

Federated Hermes has seen a divergence in requests between more wholesale category of investors content with summary statistics versus the institutional investors who are looking for granular detail on portfolio holdings and ESG metrics. 'Clients and consultants are getting more and more demanding, but quite frankly, I think that's a good thing,' Murray said.

The demands are definitely getting stronger, according to one asset manager. The RFPs that they receive are a lot more focused and it does differ geographically. 'In Europe we would never see any inbound request from clients or consultants that didn't have some level of responsible investing focus,' they said. 'In the US, it's still potentially an aside at the end, but I do think that that's changing. It's beginning to become more and more integrated and more normal.'

One respondent agrees that this has been the case in Europe for some time, but that their firm has seen a major uptick in engagement on the issue in the US and Canada. Previously it was only certain client segments, like some family offices, endowments and foundations that had a particular climate or social mission and wanted their investments to reflect that.

'What we've seen now is a real uptick from clients who, even two years ago, weren't engaging on this topic at all,' one respondent said. 'And even before they're ready to make an investment, they are coming to us and asking us how they should be thinking about ESG and to explain to them how this is within their fiduciary guidelines even if they are not ERISA plans.' The firm is seeing this among corporate pensions, certain public pensions and insurers, particularly the big global ones, which have been at the forefront of this for a while. In the wealth market, there has also been a big acceleration into sustainable ETFs and mutual funds reflected across the industry over the past 18 months. ■

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Existing clients are asking about ESG that never did before and that's really important because it means that might be a mandate that we might have been running for them for a decade or three or five, and they now expect that it's part of our investment process – which it is.

Jonathan Bailey, Head of ESG Investing,
Neuberger Bergman

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Treading lightly

Asset managers are taking measures to reduce their own carbon footprints.

ASSET management firms have realised that if they are asking their investments and corporates to make sustainable change, then they have to be looking at their own operations.

From net-zero pledges to bespoke apps for employees and examining their own board diversity, US asset managers are all making significant efforts to reduce their carbon footprints, but scope 3 is a catalyst for them to do more (see Chapter 3).

This has certainly changed during the last three to five years, according to Ares' Heltzer. During an initial orientation on ESG programmes, limited partners would want to know about the portfolio companies – while the firm's own corporate sustainability programme was less in focus.

'At Ares, we understand that that doesn't really work. You need to lead by example,' he said. 'If you're going to ask all these portfolio companies to prioritise this, how are you demonstrating the same conviction about your own practices? That it can be a value creation driver and have risk management benefits.'

The firm measured its own carbon footprint for 2020 in the first quarter of this year to achieve a baseline. It has been training its executives to 'democratise the ESG efforts' so that everyone understands scope 1, 2 and 3 categories and how the firm can reduce emissions.

In the financial services industry, it is well acknowledged that the vast majority of emissions comes from financed emissions. A study by CDP in April 2021 found that portfolio emissions of global financial institutions are more than 700 times larger than direct emissions³.

'Our own corporate operations of more than 30 offices around the world is meaningful, but relatively small when compared to the 3,000 plus companies that we work with in some way,' Heltzer said. 'That's where we have to plan for a long-term effort for each of our investment strategies to figure out what is the most pragmatic way to help manage a carbon footprint.'

Asset managers are continuing to evolve and think about what their footprint means in terms of scope 3 emissions related to investment portfolios. 'Scope 3 goes a step further because you're not just looking at the individual scope 1 and 2 emissions of the portfolio

holdings anymore,' said one asset manager. 'You're looking at the corporates, which on a sector-by-sector basis varies hugely. But starting to figure out and disclose this is the next step for us.'

'Barings is taking that next step as well. This year the firm made an operational commitment to reach net zero by 2030, while its parent company, MassMutual, committed to net zero by 2050 across its entire investment portfolio – of which Barings manages 95%, representing half of its AUM.

'By that token, about half of our assets are on that net-zero pathway,' Munday said. While some clients may not want to be on a net-zero transition pathway, Barings is 'definitely balancing fiduciary responsibility versus what we think we have to do and what we believe in as a firm. That's been one of the more challenging areas, but it's great to have your parent company being really supportive and sort of that

catalyst for change.' The firm is also committed to carbon neutrality by 2022.

Other asset managers continue to tackle this on a corporate level as well. BlackRock has been carbon-neutral for years, using offsets for things like travel and incorporating renewables and clean energy sources when possible for their buildings and infrastructure.

More than 100 asset managers have pledged to the Net Zero Asset Managers Initiative – a global group with the goal of net-zero emissions by 2050 or earlier

to limit warming to 1.5 degrees and support investing aligned with these goals. There is also the Net-Zero Banking Alliance, which currently represents over 40% of worldwide banking assets.

Some efforts are more serendipitous. A chance discussion at the beginning of the Covid-19 pandemic with the head of IT at Federated Hermes led to the discovery that a Microsoft Teams message represents roughly one-tenth the carbon footprint of an email. 'It may not be a massive footprint on a global scale, but every single bit matters,' says Murray.

Federated Hermes has also rolled out GIKI Zero, a carbon footprint calculator made available to all employees. 'It has just been a really fun way to get the workforce aware and involved in reducing our carbon footprint,' he added. ■

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More than 100 asset managers have pledged to the Net Zero Asset Managers Initiative – a global group with the goal of net-zero emissions by 2050 or earlier.

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3. CDP, 'Finance sector's funded emissions over 700 times greater than its own', April 2021

CHAPTER 3:

ESG data: separating signal from noise

The meteoric growth in initiatives around data, metrics and standards has impacted US asset managers' ability to implement ESG initiatives.

WHILE obstacles remain, there is an overall feeling that the industry is on the right path towards sustainable investing, thanks to a coordinated effort by third parties and firms. But there is still much work to be done.

'What has become more challenging is that we went from little data a decade ago to now a proliferation of data, which is great, but then how do you use it?' said BlackRock's Bergan. 'It's being disclosed, but not from a regulatory lens and there is not much consensus.' The growth of third-party frameworks has improved this, and many asset managers hope it continues in this direction.

Third-party frameworks and standardisation

In the absence of a globally agreed upon way to measure ESG metrics, organisations like the Financial Stability Board's Task Force on Climate-related Financial Disclosures have been hugely helpful in focusing on what is material from a client perspective.

Bergan said BlackRock publicly asks all of their company holdings – which are most of the companies that are publicly traded in the world – to disclose according to the TCFD or their own net-zero business plans. 'A framework like that is great for us because it gives us one framework by which to look across the different datasets we're getting,' she said.

Asset managers are also encouraged by the Sustainable Accounting Standards Board, 'an ESG guidance framework that sets standards for the disclosure of financially material sustainability information by companies to their investors.' It currently tracks more than 77 industries and is used by

large firms such as BlackRock, Goldman Sachs and Morgan Stanley. 'We think that is making it easier and there's more consensus now around what is actually material from a sustainability perspective across different sectors,' Bergan said.

Regulatory actions around corporate disclosure, particularly in public markets, will also be particularly helpful to the market. In June the US Securities and Exchange Commission published a request for information around climate-related disclosures, including whether certain climate metrics should be incorporated into audited financial statements.

'It's a bit of a complex web because before you can do that, you need consensus over how to measure those metrics,' one respondent observed. While there may be consensus over, for example, scope 1 (direct emissions

from controlled or owned sources) and scope 2 (indirect emissions from the purchase of electricity, steam or cooling), agreement can get thornier around scope 3 which includes all other indirect emissions in a company's value chain (see box 2). 'But that is the future,' they said.

'The challenge is not just having a regulatory regime or a third-party framework in place, but also consensus over how to measure some of these metrics and how to encourage companies to disclose,' they added. 'It's getting better, but still a lot to be done.'

NB has also been a large supporter of these efforts and has engaged with the SEC as well, according to Bailey. But the firm has depended on voluntary disclosure and engagement for most of its sustainability investing so far and will continue to do so. 'We are certainly big, big proponents of

2. Greenhouse gas protocol: scopes 1, 2 and 3

GHG emissions are categorised using this international accounting tool protocol

Scope	Definition	Examples
1	Direct emissions from owned or controlled sources	- Fuel combustion - Company vehicles - Fugitive emissions
2	Indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company	- Purchased electricity, heat and steam
3	All other indirect emissions that occur in a company's value chain	- Purchased goods and services - Business travel - Employee commuting - Waste disposal - Use of sold products - Transportation and distribution (up- and downstream) - Investments - Leased assets and franchises

Source: Carbon Trust

standards for disclosure and reporting that enable us to incorporate this data into our investment decision-making more accurately,' said Bailey. 'Where we don't have good disclosure, we have to estimate, we have to engage with the companies to try and evaluate their performance on ESG topics. While disclosure is going up, which is great, it's still not where ideally it would be. We don't get data on things that we would like to have and that we think is useful to the investment decision.'

Federated Hermes' Murray agreed that there is improvement on the data side, but that it is still far from perfect. As an active share manager with quite concentrated portfolios, these gaps are not huge obstacles for the firm since it relies on their analysts and portfolio managers more than third parties. 'We're quite happy for our analysts and PMs to do the legwork, to really drill into the most important material metrics and do that work themselves,' he said. 'In essence, much of our investment process is around making up for the current inadequacies.'

When it comes to metrics and standards, Murray believes these are imposed on the industry from the outside as a response to a failure in the market. 'Our industry has not transformed either quickly enough, or in a way that it needed to, to give regulators comfort that there has been a general uptake in standards that are transparent and understandable for investors,' he added.

Now the industry is dealing with the unintended consequences. 'But that's for the industry to work out because we brought it on ourselves through combinations of greenwashing or simply changing the label of a product,' he said. 'So, we have to hold ourselves to a higher standard,' he said.

Data availability

One asset manager concurred that the data is moving too slowly. 'The regulatory environment has leapfrogged the data availability,' they said. 'I think there is a desperate demand for more forward-looking data points.' There have been gains in backwards-looking factors on ESG – such as alignment with net zero and

3. A plethora of providers

The common databases and frameworks currently used by asset managers to benchmark ESG strategies are:

- MSCI
- Sustainalytics
- World Economic Forum's Stakeholder Capitalism Metrics
- SASB Standards

temperature goals – but there are still enormous gaps in data requirements. Asset managers agreed that it varies among asset classes and is better in some 'easier' ones such as equities. Others like fixed income and multi-asset private markets are far behind.

'It links into the problem with some of the regulations,' they added. 'The onus has been more on the asset management community to report, but we need to see more onus on the companies and the corporates themselves, and to move away from voluntary reporting to a legal requirement.'

Asset managers were hoping that the industry would have received more guidance out of COP26 in November. But while there was a small focus on that from the UK side, 'it was not quite enough to enable firms to get the data we want to see,' said one asset manager. They acknowledged that there is a huge number of third-party data providers springing up, and while 'a lot of them are very high quality, it takes a lot of work to really understand what is available, where are the gaps and then really understand the quality of the data.'

For Barings, data is only useful if it is helping them add value to their clients. Munday estimates that third-party data providers only cover about 25% of the firm's investment so it is not the most useful tool other than as a

proxy, flagging material issues, or for screens with specific mandates. The firm prefers to focus on the forward-looking component. 'Typically, some third-party datasets tend to be very backwards looking and if they are only updated once a year, the coverage is not comprehensive,' she said. 'So, our position has always been, how do we actually add value to our clients?'

Barings believes the answer is by thinking through those nuanced issues and engaging with its investments to help them improve. 'You can also find much more relative value for clients when you're not just taking that approach of taking everything MSCI or Sustainalytics has rated in the top 25% of the industry,' Munday said. While that may work for a passively managed exchange-traded fund, it has been more important for the firm to think through relative value decisions, especially when it comes to ESG.

Benchmarking

As a public company themselves, Ares looks at how ESG ratings have evolved in the public markets – all the inconsistencies, changing methodologies and potential shortcomings – as the private markets progress towards standardising measurements for ESG metrics. Private markets have a similar standardisation imperative to make ESG impact and outcomes more measurable and comparable across thousands of companies. That said, it can be difficult to assess the ESG topics that matter most to a specific company when standardisation tends to focus on lowest common denominator topics and metrics. 'I think we're entering an important moment for private markets, which is: how do you take the best of the public markets path and other bespoke approaches while avoiding the potential traps?' asked Heltzer.

Heltzer added that many CEOs of portfolio companies ask for objective ESG benchmarking data when setting targets but unfortunately the data is in its nascent phase. 'That's why these standardisation efforts are useful, though I think the challenge is that it's going to take years to get there.' ■

CHAPTER 4:

A regulatory lag

The US has lagged behind European ESG investment and regulation, but the gap is narrowing.

THANKS in large part to a new administration, there have been noteworthy changes in the US political and policy environment – from an SEC-launched ESG task force to measures in the infrastructure bill to combat climate change. But lags in the country's regulatory framework have leading asset managers thinking globally.

'In terms of the regulatory environment, we're driven by Europe, which is much further ahead than the US around ESG and responsible investing, said one asset manager. A lot of the firm's time is spent on European regulations and anticipating the UK's regulations. 'That said, we are heavily involved in following the direction of the SEC, providing our feedback on the DoL [Department of Labor] letters. We're certainly watching the regulation closely.'

Most asset managers reported that they are more driven by client and environmental demands than regulatory. 'Obviously we will always follow regulatory requirements, but often the regulation is a little bit lagging, particularly in the US given the prior administration was less focused on the ESG area,' said one asset manager. 'It's exciting to see that there will be more opportunities for some of our clients to invest

responsibly if the new regulations are passed, but we are really being driven in terms of our product development, our new ideas and by our own ethos and our own values.'

Some asset managers indicated interest in a joined up global regulatory environment – something that was discussed at COP26 with little traction. 'It may not be realistic to think that all the regulations will be fully aligned, but there certainly seems to be a bit more of an impetus towards some global standards on disclosures, which we would very much welcome,' one manager added.

Data reporting

Many asset managers interviewed are hoping to see regulatory change with regard to data. 'If we can get better, more uniform data, thanks to kind of a regulatory push in that direction, then we can take more investible insight,' said one asset manager. 'If we have better data that's more uniform, we can compare it better and take better insights from it.'

From a fund reporting standpoint frameworks like the EU taxonomy, Sustainable Finance Disclosure Regulation or any action by the SEC could affect how asset managers market their funds. 'We aim to

have more rigour in the way that we define, name and market our funds than we'd see in a regulatory landscape,' said one.

'We can be confident that if a new regulatory framework comes into place, our funds that we've been marketing as sustainable are within that already.' The high bar BlackRock and other asset managers interviewed have set for themselves helps eliminate the risk of greenwashing, which is quite high in the industry.

Regulation can affect asset managers' clients and their appetite for sustainability. Take the UK, for example, where the Department of Work and Pensions mandated as of 2021 that defined-contribution plans in the country with more than £5bn will have to begin considering and reporting climate metrics.

Asset managers reported clients as having much more of an appetite for ESG-orientated strategies, particularly those that were closely constructed and have low tracking error compared to their own core exposures.

In the US, the back and forth between the DoL has definitely had a chilling effect on DC pensions' ability to consider ESG. But the industry is anticipating a new rule that would say ESG factors can be material and

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We are very excited that regulators are stepping in to ensure that we are all speaking the same language. When you say sustainable, your client knows exactly what you mean and it helps eliminate some of that greenwashing.

Sarah Munday, Director of Sustainability, Barings

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can be considered either as part of an integration process or where there is no sacrificing of return. While the rule is not final yet, we suspect that we'd see more ERISA [Employee Retirement Income Security Act] plans open up to this type of investing as a result.'

NB has also engaged with the SEC for a number of years on the topics of reporting, carbon emissions, diversity and data privacy, which are likely to make the final rule. 'We think it's a good step because at the end of the day, markets are already trying to incorporate those data points into investment decision-making and we're doing it on the back of imperfect data,' said Bailey.

Federated Hermes has found that the overlap of engagement with fiduciary duty seems the biggest concern from the SEC's perspective. ESG data may be considered non-material from a financial perspective and therefore not eligible for consideration. 'We would suggest that actually, if you are looking at material ESG issues – those which are definitely going to affect the enterprise value of the company looking forward – and you are looking at engagement, which will encourage corporate strategy to change, then those are things which affect the systemic risk that companies face. And that is absolutely front and centre and a matter for fiduciary duty,' said Murray.

Barings also describes itself as 'led by Europe' over the past three years, in particular with EU regulations informing the firm's approach to fund disclosure and defining 'green' and 'sustainability'. 'We are very excited that regulators are stepping in to ensure that we are all speaking the same language. When you say sustainable, your client knows exactly what you mean and it helps eliminate some of that greenwashing,' said Munday.

'The mission behind ESG is such a positive one and it's really necessary to effect change, but if you get caught up in the marketing exercise

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and then the criticism around that is valid and a big issue,' she added.

Sustainability leadership: Europe versus US

Within this regulatory backdrop, it is worth noting that many large US asset managers base their ESG and sustainability leadership – and are expanding their teams – in the UK and Europe. But this may not be the case forever.

'At the moment the expertise is more focused in Europe because it's further ahead,' said one asset manager. 'Because the regulations moved so much faster in Europe there is a scramble to catch up.'

This doesn't necessarily mean there is more ESG expertise in Europe. If anything, in terms of personnel in the last few years, many European asset managers hired climate scientists or governance experts. 'They're now beginning to realise what they need as people with fund management experience and the financial side who also have some knowledge, quick to learn on the sustainability side,' she added.

Europe spent a significant portion of time focusing on ESG metrics that could be described as slightly backwards-looking, static measures. 'The next leg in Europe is much more of a push towards forward-looking data that requires much more in-depth, rigorous analysis,' observed one asset manager.

The US may learn from some of Europe's pitfalls and move towards a smarter way of looking at sustainability. More US-focused teams and expertise will be required. Much of this deficit can be attributed to the prior administration. The lack of focus around the inability to invest for many schemes in anything with ESG factors meant that there was as much focus at senior management levels, but this is all poised for change. 'The last two years in Europe has been exponential growth, and I think the US is still at the learning stage,' concluded one manager. ■

CHAPTER 5:

New opportunities in ESG

As global demand for ESG investment rises, a wide range of new opportunities for asset managers are appearing.

FEDERATED Hermes' Murray does not think you have to look too hard for the plethora of new opportunities in ESG. Most of the asset managers interviewed had different answers when asked.

Murray is focused on areas around fixed income and the fact that \$1.2tn of sustainable debt was issued this year, practically doubling last year. 'That's a drop in the ocean, but imagine that it's increasing exponentially,' Murray said. 'And if that carries on, it won't be too long before all debt will be issued in a sustainable way.'

For Ares, climate change and diversity, equity and inclusion are two opportunities they are focused on. 'This is about using our resources and influence to achieve things that are good for business and good for the world,' Heltzer said. 'As we begin to turn this apparatus towards topics like climate change and DEI, which are very complex, this is exciting. How can you make that whole approach have a meaningful and measurable impact? It is a great opportunity.'

The move away from negative screening is an opportunity at Barings, according to Munday, with stewardship by far the hottest topic globally in terms of regulation and disclosure as the industry moves away from greenwashing.

But the biggest opportunity is around impact and thematic funds as people move away from caring 'just about the amorphous blob of ESG' and begin thinking through niche products that really align to goals and objectives from specific clients, she said.

'You can see that, particularly in the private sector, there's huge opportunity because we've got more tolerance for concentration risk and those funds are closed-ended. Typically when you think about a theme like renewable energy, eventually you meet that theme,' she said. 'Sometimes it doesn't make sense to have an open-ended product in that

space because the goal is that eventually all energy is going to be renewable.'

New technologies, new processes

Asset managers are closely monitoring and involved in the development of technology – both at the firm level and industry-wide – and how it impacts ESG processes.

From the environment angle, as technology improves, there will be more scope to invest in areas that today are not viable commercially in the green energy and hydrogen arena. 'From an investment point of view, there'll be more and more opportunities in the space to really find value,' said one asset manager.

There are substantial opportunities in these emerging technologies that are going to lead the charge on pursuits like electrification, clean tech, decarbonisation and carbon capture. As BlackRock's Bergan observed, 'It's a huge growth area.'

From an analytical perspective, BlackRock's Aladdin Climate calculates and surfaces the climate risk in portfolios, so investors can take action to reduce their exposure. It deploys a set of climate analytics across the investor workflow, so portfolio and risk managers can see climate-adjusted analytics alongside their standard datasets as they make decisions. 'Our approach uniquely bridges climate science with asset-specific modeling to arrive at a set of climate-adjusted security valuations and risk metrics,' says BlackRock.

Barings also credits its in-house platform for its ability to scale up and help clients across asset classes since it has historically been difficult to do that for ESG. 'The ability to have all that information in one place, and to drill down into specific metrics to meet objectives, I think is going to be so crucial,' Munday said.

The idea of emerging technologies – like blockchain and its impact on carbon offsets – and how they can impact the climate crisis remains interesting. But the ability to report back on those challenges and opportunities will be crucial in terms of new product development and mobilising capital in the right direction.

For other asset managers, it all comes back to the data. One manager anticipates additional data providers entering the market but using artificial intelligence, geospatial analysis and other smarter technologies. 'This will enable some of this forward-looking scenarios-based analysis, for which there is no right answer,' they said. 'Capturing huge swathes of forward-looking data is very exciting and is really going to enable a huge scaling of understanding responsible investing.'

NB has partnered with its data science team and chief data scientist to look at ways in which it can estimate performance of companies and countries from an ESG perspective, using data science approaches from machine learning to big data sets 'to answer questions that we just couldn't do a decade ago.'

'It also enables us to bring insights together in a more timely fashion,' Bailey added. Since NB invests across markets and capital structures, it makes it easier for its analysts to share insights around the company and engage in dialogue and scenario analysis, such as how a company may perform under different extreme weather patterns. 'There's a lot that we're doing to try and put those tools in the hands of our analysts and our portfolio managers,' he said. 'And I think over time those will be where asset managers differentiate themselves.' As regulation drives more basic ESG data disclosures, it will become much more about asset managers insights. ■

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