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Evolution of ESG investing

Near-term implications and strategies for asset managers

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Evolution of ESG investing

The concept of investing in environmental, social, and governance (ESG)-centric products is not new. Institutional investors have long modeled their investment strategies around socially responsible themes such as clean air and water, diversity, human rights, and workplace fair practices. However, sustainable investing in its current form has recently experienced considerable market momentum, driving large inflows into ESG-focused products, resulting in an average compounded annual growth rate (CAGR) of 27 percent[1] in global assets under management (AUM) over the last six years (see Exhibit A below).

Exhibit A – ESG-centric products experience big jump in AUM

There's been a significant jump in AUM for ESG-centric products, particularly during the past two years of the COVID-19 pandemic.

Regions	Growth 2015–2017	Growth 2017–2019	Growth 2019–2021	CAGR 2015–2021
Australasia	14%	14%	31%	**9%**
Canada	29%	33%	289%	**37%**
Europe	25%	32%	114%	**23%**
Middle East and Africa	82%	44%	-16%	**14%**
South and Central America	60%	30%	154%	**32%**
U.S.A.	24%	44%	135%	**27%**
Asia (excluding Japan)	-11%	49%	-15%	**2%**
Japan	36%	191%	545%	**71%**

Source: Lipper, a Refinitiv Company, January 2022

Asset managers are racing to address market demand but continue to face challenges with evolving regulatory and reporting frameworks, lack of foundational infrastructure needed to scale, and absence of trusted data to drive their product and operational strategy around ESG. These challenges are limiting their speed-to-market capabilities.

Market interest is undeniable and growing globally, driven by socially conscious investors. Bloomberg Intelligence[2] predicts that by 2025, more than a third of the projected $140.5 trillion of global AUM will be sustainable investing assets. In addition, multiple surveys over the past 18–24 months confirm that climate and social factors continue to dominate the investing philosophy of institutional and retail investors; however, these are qualitative and may have regional biases or be pandemic related. There is also considerable marketing around the primacy of investment returns from ESG-themed products, but these causal relationships will need to be assessed and confirmed over a longer time horizon.

Regardless of these caveats, it appears that "sustainable investing" will continue to form a significant part of asset managers' go-to-market strategy over the remainder of this decade. In

[1] Approximate CAGR is based on annual snapshots of Q4AUM for the universe if ESG vehicles comprising approximately 3,700 funds. Relevance to ESG is determined by textual search and filter of ESG-related key words within ETF and mutual fund source databases.

[2] Source: Bloomberg Professional Services, ESG assets may hit $53 trillion by 2025, a third of global AUM (2021).

an environment where investors and regulators expect increased transparency into investment decisions regarding sustainability, fund managers are adopting several strategies to not just appear "green," but also to establish concrete and clear messaging around their commitment to active, responsible investing practices.

We believe the key to success for asset managers will be to establish foundations that drive true long-term commitments to sustainable investing practices and not approach the space from a predominantly regulatory compliance perspective.

In this series, we explore three strategic areas asset managers must get right in the near-term to give them the best opportunity for success in this evolving landscape.

Three strategic ESG-related focus areas for asset managers

Product strategy

Align the strategy to your key differentiators, client segments, and geographical footprint.

Reporting frameworks

Prepare for the evolving regulatory and reporting requirements.

Data capabilities

Enable robust, foundational data capabilities while allowing flexibility for evolving new data in various types and formats to drive reporting and analytics.

In this article, we'll take a deeper look into some important considerations that can inform your product strategy. In our next articles, we'll discuss reporting frameworks and data capabilities.

"We've seen a significant inflow into ESG-centric products, particularly ETFs, during the past two years, and we expect that trend to continue and accelerate."

—**Murali Sreedhar**, Managing Director, Advisory, KPMG LLP

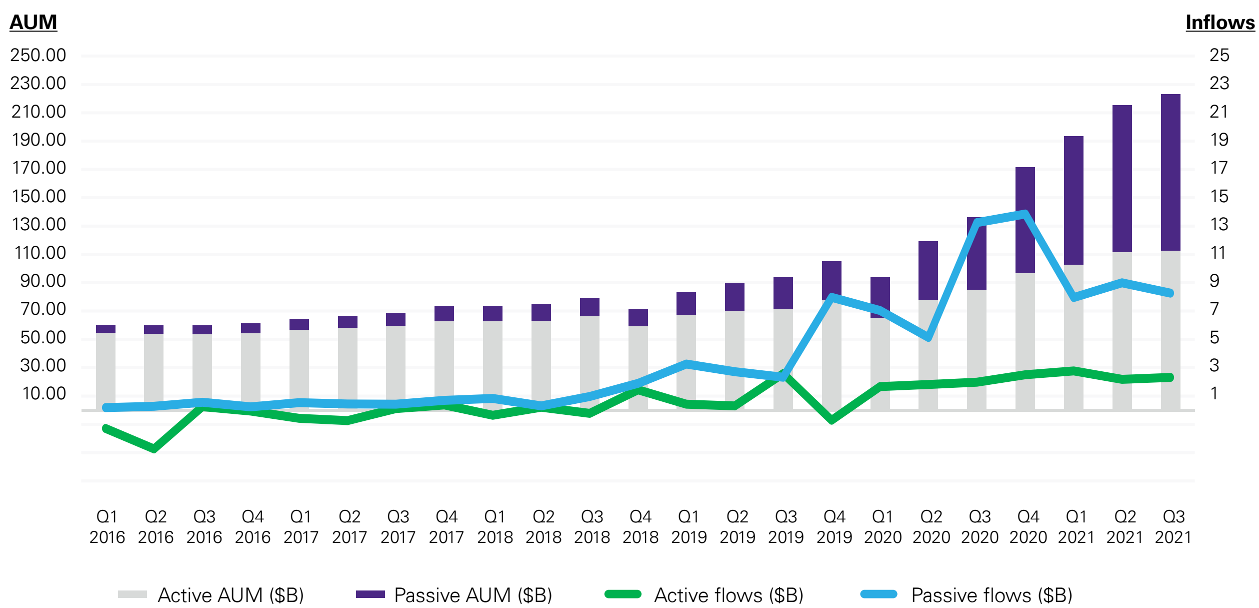
Product strategy

Passive and active managers are taking different approaches in terms of providing ESG-friendly investment products. This can range from integrating ESG-focused vehicles into an existing product framework to screening techniques that select suitable ESG offerings, to creating new ESG-themed investments.

Bloomberg Intelligence predicts[3] that passive investing will overtake active investing in the U.S., and eventually will do the same in non-U.S. markets (although at a slower pace). We believe this growing demand for passive products will result in an increasing number of passive ESG-based product offerings in the marketplace, especially in the U.S. where mutual funds and exchange-traded funds (ETFs) are attracting huge investment flows.

Exhibit B – Passive ESG products pull ahead of active ESG investments in the U.S.

Passive ESG investments have overtaken active ESG investments in the United States in terms of AUM and inflows.



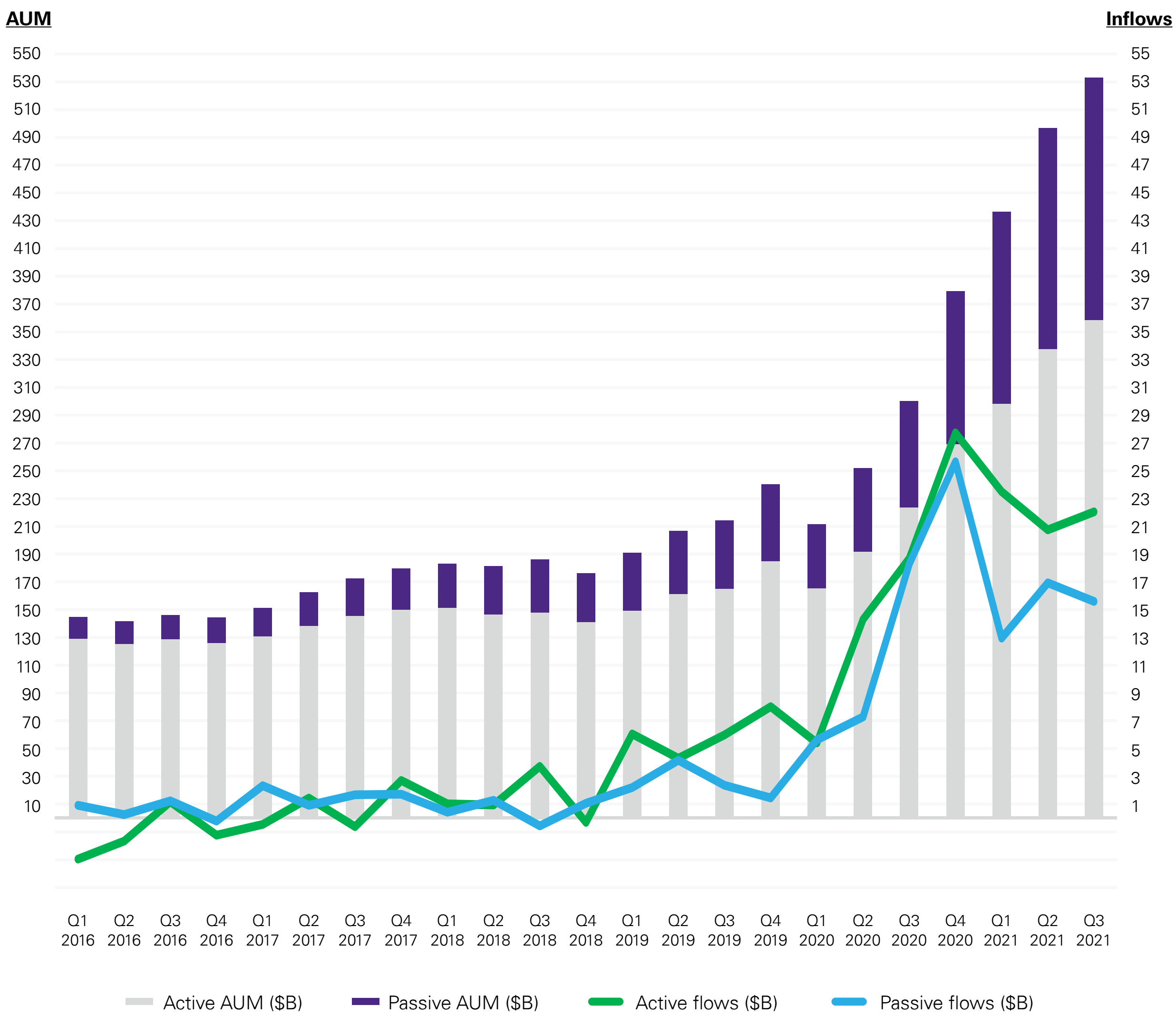
ESG AUM and flows ($B) – Active versus passive – **U.S. funds**

Source: Lipper, a Refinitiv Company, January 2022

[3] Source: Bloomberg Professional Services, Passive likely overtakes active by 2026, earlier if bear market (2021).

Exhibit C – Active ESG products lead passive ESG investments in non-U.S. markets

But in non-U.S. markets, active ESG investments continue to outperform passive ESG investments in terms of AUM and inflows.



ESG AUM and flows ($B) – Active versus passive – **Non-U.S. funds**

Source: Lipper, a Refinitiv Company, January 2022

ESG product strategies

There are many specific or hybrid approaches managers can take toward developing an ESG product strategy. Below are some key strategies being adopted to provide ESG-themed investment offerings:

1. **Screening investments for ESG-specific characteristics**: Negative screening means excluding one category or sector of stocks from a portfolio, for example companies associated with tobacco, alcohol, or weapons or that engage in certain practices such as animal testing or coal mining.

   Positive screening means including one category or sector of stocks within the portfolio that meet defined scorecard thresholds and exceed industry standards in regard to ESG performance.

   Norms-based screening means excluding companies that fail to comply with international standards established by organizations such as the Organisation for Economic Cooperation and Development (OECD), the United Nations (or one of its subagencies, such as the International Labor Organization (ILO)), or specified nongovernmental organizations (NGOs).

2. **Integrating ESG investments into their existing models**: While the primary factor in ESG integration is still financial performance, investors take into consideration a company's ESG activities and "scores" when deciding whether to invest.

3. **Investing based on defined sustainability themes**: This approach enables investors to invest in specific aspects of ESG. Typically, these would be companies focused on environmental solutions (e.g., clean air or water, sustainable agriculture) or social issues (gender/racial equity, diversity, transgender rights).

4. **Impact investing**: These are investments intended to accomplish or have the most impact on social or environmental issues, including underserved individuals or communities. To succeed in this approach, you'll need to be able to measure and report on the impact the investment has on the intended goals.

5. **Influencing ESG-friendly corporate behavior**: Managers are leveraging their shareholder positions to influence corporate behavior to align with their ESG-based agenda. This includes communication with executives, filing shareholder proposals, and proxy voting.

Source: Global Sustainable Investment Alliance, Global Sustainable Investment Review 2020

Three key steps for a successful launch

Consider adopting the steps set out below to better position your ESG product for a successful launch.

1 Align product strategy to your strengths

For passive managers, the market looks to be bright in the near future given the current upward trend of inflows ESG products are experiencing from both institutional and retail investors. It makes sense to ride this heightened interest in sustainable investments and focus on developing and introducing ESG-themed and screened mutual funds and ETFs.

Considering this current trend favoring passive product inflows, traditional active managers may be tempted to radically change the direction of their product development strategy toward the passive market. However, we feel that this may be hasty at this point; they may be better off staying focused on differentiating themselves in the active management space.

Regarding active management, many investors are looking for more sophisticated customization of their ESG portfolios. In addition, as passive ESG-themed products begin to saturate the market, investors will need guidance in understanding and differentiating between them. They'll also need help in selecting investments that align with their sustainability objectives and offer the best chance of positive returns.

Key takeaways

— Align your ESG product strategy to your investment management strengths in the near term, allowing you the fastest time to market and service differentiation.

— ESG ETFs in the passive space continue to grow, but potential risk exists for oversaturation in the marketplace, leading to increased competition for product differentiation.

— Active managers will find success through customized investment offerings tailored to sustainability-focused investors.

2 Determine your target client segment

Firms serve various client segments, such as institutional, retail, multiple wealth management tiers, and fixed income and equity investors. There are varying levels of sustainability awareness, theme interests, and expectation of returns that these segments have from ESG-related offerings. Demographics add another dimension to this equation, with several studies showing younger investors having a higher propensity toward sustainability within their investment strategy.

Each client segment will have its own key objectives and needs. Asset managers will need to drive more personalization and insights to meet these needs, requiring analysis of broader and deeper data sets.

In the active management realm, SMAs and model portfolios are gaining popularity in the retail space via financial advisers. This in turn may require further flexibility in allowing construction and customization of portfolios using powerful intelligent automation (IA) technology and data and analytics (D&A) capabilities that meet the investors sustainability objectives (e.g., the ability to continuously reevaluate models based on updated information about the investments that may change frequently). On the institutional side in the retirement space, ESG products have not been widely used thus far in 401(k) and other qualified investment plans. This is due, in part, to prior Department of Labor (DOL) rules that suggest that ESG factors can't be used in selecting plan investments. However, there is a DOL rule that is currently in the public comments phase, and we expect the passing of this rule to kickstart ESG investments in retirement plans.[4]

[4] Source: U.S. Department of Labor, U.S. Department of Labor proposes rule to remove barriers to considering environmental, social, governance factors in plan management (2021).

Key takeaways

- Client segment focused personalization and insights will require analysis of broader and deeper datasets.
- Demand for ESG-friendly investments in retirement plans is likely to take off once the DOL clarifies the rules.

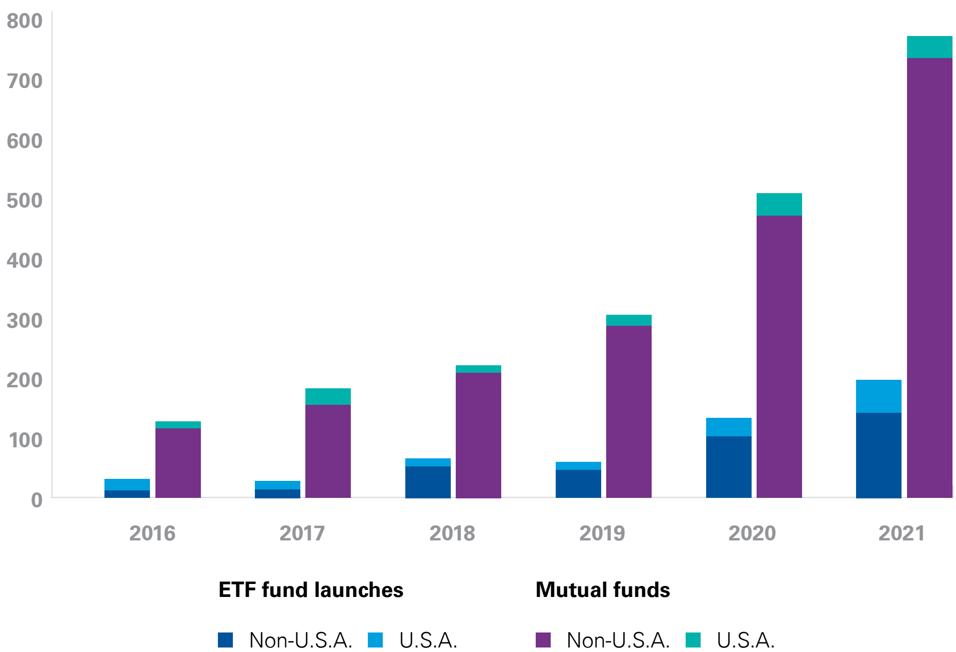
3 Factor in geographic location

During the past year and a half, there have been heavy asset flows into ESG ETFs compared to mutual funds, as investors search for lower-cost investments that offer access to new strategies.

In addition, the number of ETFs launched in 2021 increased by more than 47 percent compared to the number launched in 2020. Further, in the U.S., we're seeing top investment management companies offering more ESG ETFs, with 44 percent of their ESG AUM parked in ETFs (see Exhibit D below).

The number of ESG ETFs launched in 2021 increased at a faster rate than mutual fund launches.

Exhibit D – ESG mutual funds are still the preferred launch vehicle but ETF launches are starting to take off



Source: Lipper, a Refinitiv Company, January 2022

In the U.S., 44 percent of ESG AUM is parked in ETFs, closing the gap on ESG money invested in mutual funds.

When evaluating the global marketplace, ESG-based ETFs have been leading in terms of investors' inflows, primarily in the U.S., while ESG-based mutual funds are more common in Europe and Asia, where regulations are more prevalent. It's important to understand the implications the geographical footprint has on an ESG product strategy.

For example, U.S. asset managers that want to offer a European ESG ETF product will be subject to European regulatory reporting. This raises the complexity of what is required in terms of data collection and regulatory reporting requirements as there are no global standards in place yet.

The geographic location in which you're planning on launching your ESG-based products will influence your decision in terms of:

— Which vehicles to use in your product strategy

— What regulatory reporting requirements you will be facing

— The complexity of infrastructure and operational changes you'll need to be making.

Key takeaways

— ESG ETFs, specifically in the U.S., are trending up compared to ESG mutual funds that are primarily more prevalent in Europe and Asia.

— Sustainability strategies in the EU are focused primarily on climate, while the U.S. is leading with themes around diversity and equity.

Stepping up to the ESG challenge

Asset managers must prepare their people, processes, technology, and data to incorporate ESG-friendly investments into their product offerings. Here are five questions you need to ask yourself to see if you're ready to meet this challenge:

— Do you already offer ESG-friendly products?

— Do you have a strategy for developing and offering ESG-friendly products?

— Do you have the technology and operational infrastructure in place, complete with D&A capabilities, to comply with current as well as future data governance, transparency, and reporting requirements?

— Have you collborated or thought about collaborating with another firm or vendor to enable your strategy to create and offer ESG-themed products

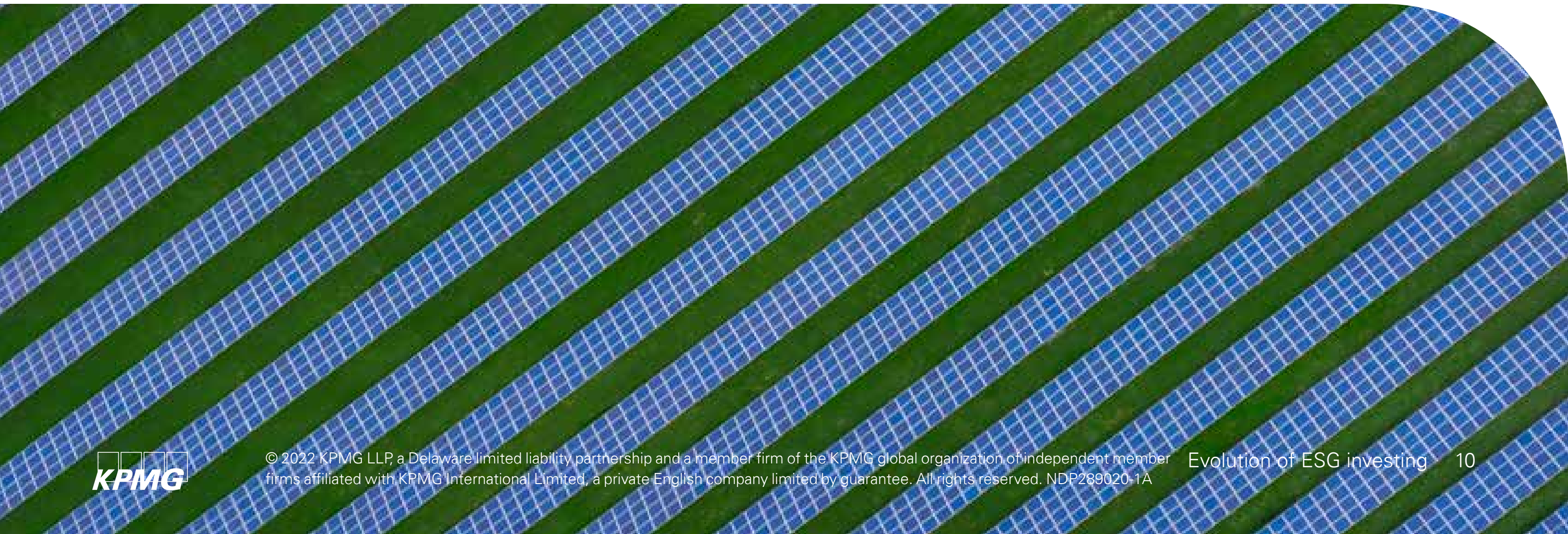
KPMG is helping global asset managers navigate this increasingly complex and evolving landscape. We would be delighted to work alongside you on your ESG journey.

How KPMG can help you

Increased transaction volumes. Demanding investors and customers. Game-changing technologies and platforms. Escalating governance, transparency, and fee pressures. A complex regulatory environment. Greater focus on cost-efficiency. These are the challenges asset and wealth managers face as they navigate to the new normal.

With more than 3,500 professionals, including approximately 400 partners, the KPMG Asset Management practice can help you succeed in this new environment. We marry global reach with local enablement to help ensure you have the right experience and skill sets wherever you want to operate. Our industry focus enables us to ask the right questions and align our resources with your needs. And, with our broad spectrum of service offerings, including industry-leading technology, we can serve these needs throughout the organization as your strategy and marketplace evolve.

Learn more at **https://www.kpmg.us/industries/asset-management.html**.



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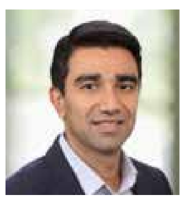

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