



# HOW ASSET MANAGERS CAN SEIZE THE LEAD IN SUSTAINABLE INVESTING

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**F**INANCIAL MARKETS ARE UNDERGOING a profound transformation: investors are increasingly incorporating the environmental, social, and governance (ESG) performance of companies into asset allocation and management decisions.

The growing demand for sustainable investing creates a major opportunity for forward-thinking asset managers. However, several obstacles may make it difficult for asset managers to capitalize on the sustainable investing wave. These include a lack of clarity about what to measure and where to get the data, difficulty expanding sustainable investing beyond equities, concerns among investors around greenwashing (overstating an investment's impact), and the need to develop new talent and capabilities. This last obstacle includes challenges in transforming the ESG function into a center of excellence that can drive change across the organization. The asset managers who can most creatively and effectively overcome those hurdles will emerge as the leaders in this burgeoning market.

As a result of our extensive work in the area of sustainable investing and research on the topic, we have identified a series of actions that address each of those challenges. Asset managers should move decisively in these areas to develop credible offerings in sustainable investing. That is the only way to stand out in an increasingly noisy and crowded field.

## The Opportunity and Challenges for Asset Managers

The shift toward sustainable investing is driven by a number of trends. Regulators increasingly require more transparency into how companies—and the investors that finance them—perform on environmental and social factors. In addition, stakeholders such as employees and retail clients have much higher expectations for the role that the private sector, including financial firms, should play in creating a better world. At the same time, according to a growing body of research that includes [BCG's study on total societal impact in 2017](#), investments that incorporate

specific ESG factors outperform those that do not, and avoid risks that may not have been uncovered otherwise.<sup>1</sup>

As those forces drive increased demand for sustainable investing, the field continues to evolve. While the most common strategy for sustainable investing continues to be so-called negative screens (avoiding holdings that have a negative impact on society, such as tobacco and industries that cause heavy pollution), other approaches are gaining traction. These include the use of positive screens to identify companies that are best in class in terms of ESG performance as well as the use of ESG themes, such as climate and diversity, to identify companies whose asset prices do not fully reflect these factors.

Asset managers are also increasingly enhancing their engagement capabilities by developing more effective dialogue with companies, which enables them to participate in discussions with businesses about their practices. Ultimately, the goal is for asset managers to translate that dialogue into true influence that leads to changes in business practices.

Depending on which of the various approaches one includes under the umbrella of sustainable investing, the total size of the market varies. (See the sidebar, “Sizing the Sustainable Investing Market.”) Regardless of the definition, however, it is clear that the pool of assets managed under sustainable strategies will continue to expand rapidly. A 2018 Morgan Stanley survey found that 84% of asset owners are pursuing or actively considering integrating ESG into their investment process, and 60% of them have begun doing so in the past four years.

Despite the ongoing strong momentum toward sustainable investing, our work with asset owners reveals that it is difficult for many to find asset managers that meet their expectations for sustainable investing. That gap is not surprising. Asset managers face four significant challenges in meeting the demand for sustainable investing offerings:

- **Lack of Standardized Data.** The volume of data related to ESG performance has grown significantly in recent years. However the ESG information that is available is often too complex, unreliable, and not standardized. In addition, investors still struggle to identify which indicators to actually track, depending on a company’s industry, maturity, and investment strategy. While there are many useful starting points, including guidance provided by organizations such as the Sustainability Accounting Standards Board and the Global Reporting Initiative, the issues that are material—meaning they can affect a company’s core business value—vary significantly by company. Materiality also differs by geography, and it evolves over time in step with factors such as changes in business models, regulation, and consumer sentiment. These data challenges are even more significant for non-public-equity asset classes, including private companies and commodities, for which ESG data is generally less available.
- **Demand for Investments Beyond Equities.** The limited data available for asset classes outside of public equities creates difficulties for asset managers looking to expand their sustainable investor portfolio to include a range of asset classes. This creates an obstacle for investors who have a healthy appetite for sustainable investing strategies in asset classes that include fixed income, real estate, and commodities, according to our research.
- **Difficulty in Defining a Credible ESG Integration Approach.** Many asset owners and allocators who deploy a sustainable investing approach worry that asset managers may be engaging in greenwashing. It can be difficult to know whether an investment offering or portfolio is integrating ESG factors into its core decision making or whether the asset manager is simply using an ESG marketing message to sell an existing product. The result is a high

## SIZING THE SUSTAINABLE INVESTING MARKET

A significant nomenclature challenge faces the industry at the moment. Multiple terms exist to describe approaches to investing that factor in the overall impact on society—with different terms sometimes encompassing similar, or even identical, approaches. Among the most commonly used terms are:

- **Negative Screening.** Under this approach, investors steer clear of assets that have a negative impact on society, such as tobacco, thermal coal, and controversial weapons. The Global Sustainable Investment Alliance (GSIA) estimates that assets in this category in 2018 totaled \$19.8 trillion. A related approach, called norms-based screening, excludes companies that break international conventions.
- **ESG Integration.** This involves factoring ESG performance into traditional investment analysis and decision making at the individual security level, and is estimated to account for \$17.5 trillion in assets. A related approach, known as best-in-class ESG overlay, requires specifically selecting companies or tilting entire portfolios toward higher ESG performance either based on highest ESG scores in the market overall or relative to peers at the industry level. This approach is often used for passively managed portfolios and, according to GSIA, accounted for \$1.8 trillion in assets in 2018.
- **Thematic Investing.** This approach uses sustainability themes, such as climate and diversity, as the basis for allocation toward industry sectors or companies. The motivation for this kind of investing can either be financial—premised on the thesis that companies that perform well on these themes will also drive strong performance for investors—or as a

way to align assets with specific values that clients prioritize. Roughly \$1 trillion is invested under this approach, according to GSIA.

- **Impact Investing.** This typically focuses on investing in entities that intentionally seek to generate measurable social or environmental impact while also delivering a financial return. Estimates from a variety of organizations, including GSIA, the International Finance Corporation (IFC), and the Global Impact Investing Network, put this category at close to \$500 billion.

In line with the definition outlined by the GSIA, we've chosen to refer to the entire field as “sustainable investing.” Sustainable investments encompass all assets that incorporate some combination of the investing methodologies mentioned here, including negative and norms-based screens, best-in-class, ESG integration, and impact or thematic investing. Active ownership, under which asset owners and allocators engage with companies to drive improvement in their ESG performance, is often done in concert with these sustainable investment approaches. We anticipate that as the field evolves and matures, definitions will as well.

Of course, sustainable investments span all asset classes. They include not just publicly listed or privately held securities but also asset classes that can sometimes be overlooked in market-sizing efforts, including supranational debt (fixed-income instruments issued by agencies such as the World Bank) and real estate, given the challenges of gathering ESG information on them.

degree of skepticism in the market and the need for asset managers to prove that their investment processes are integrating ESG in an intelligent, effective, and meaningful way—and to demonstrate the financial value that comes from this approach.

- **Need for Increased Expertise and Capabilities Across the Organization.**

As asset managers seek to integrate ESG into core portfolio management and investing processes, they are confronting the fact that they do not have the required capabilities and expertise across the full range of investment and research activities, as well as in key functions such as communications, investor relations, and public affairs. In addition, they need to recruit new types of talent to accelerate their ESG capabilities, including data scientists, experts in major ESG challenges, and investment professionals who understand both financial markets and sustainability issues. However, the pool of talent today is not large enough to meet the spike in demand. Finally, asset managers face a cultural and mindset challenge, as too often employees throughout the organization still view ESG performance as part of a compliance-oriented exercise and not as a primary lever for value creation.

## Capitalizing on the Sustainable Investing Opportunity

Although the challenges are significant, there is a clear roadmap for asset managers who want to become leaders in sustainable investing. Those who take action in four areas can build a foundation that will help them compete—and stand out—in an increasingly contested market.

### Invest in new tools to harness ESG data.

Asset managers should develop proprietary tools to screen and assess the ESG performance of investments—both at the individual security level and for the entire portfolio. These tools may use a mix of existing ratings, new data sources, and proprietary information, but they should be transparent

to clients and consistent with their investment approach and philosophy. Leading asset managers are investing in artificial-intelligence capabilities as a way to tap new and better sources of data—notably using natural language processing for accessing unstructured data sets across multiple languages and formats—to detect ESG signals better.

Many leading firms have already made such investments. Some have leveraged their capabilities across data and analytics to develop new methodologies and standards that are hard to replicate. Others have partnered to develop proprietary ESG-investment methodologies to lend further credibility to their products in this space. Such capabilities can allow asset managers to demonstrate to investors how they measure ESG performance and use that knowledge to drive investment decisions, creating transparency that can deepen the relationship with clients. Furthermore, asset managers who do this well have the opportunity to contribute to new standards to guide this nascent market.

**Expand sustainable investing to all asset classes.** Asset managers need to differentiate themselves on the basis of innovative approaches in asset classes such as sovereign debt, real assets, and derivatives. Success will require a robust understanding of ESG themes and materiality as well as portfolio construction capabilities for evaluating, building, and offering ESG investment options from across different asset classes.

Fixed-income assets in particular are often excellent vehicles for driving societal impact. Green bonds, for example, are a growing asset group, with issuances exceeding \$100 billion in both 2017 and 2018. Definitions, standards, and certifications for green bonds are also maturing worldwide, bolstering their credibility in the market. Similarly, supranational debt—fixed-income instruments issued by mission-driven agencies such as the World Bank, the International Finance Corporation (IFC), and the Asian Development Bank—has increasingly been recognized as a credible ESG

asset. These assets are also typically highly rated by debt-rating agencies, providing a large existing pool of high-quality options for incorporation into ESG portfolios.

**Develop an authentic and credible investment approach.** It is critical for asset managers to articulate how sustainable investing is rooted in the core of their investment philosophy. Both institutional and retail clients look to ensure that ESG considerations are not merely tangential, but rather are truly integrated into investor decision making. As new methods to evaluate credibility and true sustainability arise, the bar is being raised on demonstrating proof of sustainable investing approaches. To demonstrate credibility, asset managers must have evidence-based proof of the integration of ESG into their investing approach, process, and outcomes. They should ensure, for example, that investment analysts and portfolio managers—not just members of the ESG team—have deep expertise in assessing ESG data. Their approach should be tailored to both active and passive investments, and to their voting and engagement activity. Asset managers should also be prepared to use data and outcomes to move beyond measuring ESG performance and toward assessing the actual impact of their investments.

**Build the right talent and capabilities.** The talent requirements for sustainable investing are significant. Asset managers need portfolio managers and analysts who can effectively harness ESG data and analytics. To build these capabilities, asset managers must retrain existing portfolio managers and analysts on technical topics such as methodologies for factoring ESG into investment decisions and how to use ESG as a lens for value creation. They will also need to expand capabilities in internal research to include ESG expertise and to produce thought leadership on key ESG topics and the way their firms address them.

In many cases, asset managers will need to hire new talent. Hiring managers will need to increase their efforts to attract new experts, including those capable of developing innovative ESG scoring methodologies,

investment strategies, and products, and then training distribution partners on how to market those offerings. At the same time, leaders within the organization must build an effective change management effort to shift attitudes and norms toward a view of ESG as a central driver of value creation.

Finally, the role and function of the ESG team needs to evolve. Forward-looking asset managers are repositioning what was once a thinly resourced function focused more on compliance to become a center of excellence, with a mandate to activate, enable, and equip portfolio managers and analysts with the skills and tools they need to make smarter investment decisions using an ESG lens. This center of excellence should also develop capabilities in impact reporting to assess both the positive and negative impacts that portfolio companies have.

## Looking Forward

Sustainable investing is going mainstream and presents a must-win opportunity for both established and specialist sustainable investing players. Larger asset managers will need to demonstrate credible sustainable investing strategies to compete for and win large mandates. Specialist firms that have focused on sustainable investing must find an effective way to compete amid the increasing price pressure triggered by the entry of larger players into the space.

Both groups must address sustainable investing challenges surrounding data, the appetite for options across asset classes, issues related to credibility, and the new talent required to compete. Those that surmount the obstacles can drive meaningful market share growth and enable much richer engagement with clients—while also holding out the promise of robust returns for both investors and society as a whole.

1 Kahn, M., Serafeim, G., and Yoon, A., “Corporate Sustainability: First Evidence on Materiality,” *The Accounting Review*, November, 2016; Amel-Zadeh, A., Serafeim, G., “Why and How Investors Use ESG Information: Evidence from a Global Survey,” *Financial Analysts Journal*, December 2018, cfainstitute.org.

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