Index Industry Association

Measurable Impact: Asset Managers on the Challenges and Opportunities of ESG Investment

IIA 2021 International Survey of Asset Managers

iia index INDUSTRY ASSOCIATION

Introduction

Environmental, social and governance (ESG) investing has surged in recent years, with global sustainable fund assets reaching US 1.94 trillion in the first quarter of 2021, almost doubling in value compared with the same period in 2020[1] With ESG funds rising rapidly, the asset-management industry appears poised to play a powerful role in the achievement of ESG goals for business and society, both as an allocator of capital and as force for improved ESG corporate performance.

To gain a deeper understanding of the evolving role of ESG in the asset management industry, the Index Industry Association (IIA) commissioned Opinium to survey 300 asset-management companies in four major economies—France, Germany, the United Kingdom and the United States. These were among the largest firms in the sector: for the US, for example, 56% of companies had between USD 1 billion and USD 100 billion in assets under management (AUM); 10 percent had more than USD 100 billion in AUM. Our sample base covered a broad spectrum of fund types, including actively managed funds, active and passive exchange-traded funds, smart beta and quant strategy. In terms of role, 39% of respondents were Chief Investment Officers, 29% Chief Financial Officers, and 32% portfolio managers or equivalent. We asked asset managers about the factors driving their ESG investment decisions, the challenges and barriers they face, and their views on the future development of ESG investing. Fieldwork for the survey was carried out in March 2021.

Figure 1

Distribution of US companies by size of AUM (USD $)

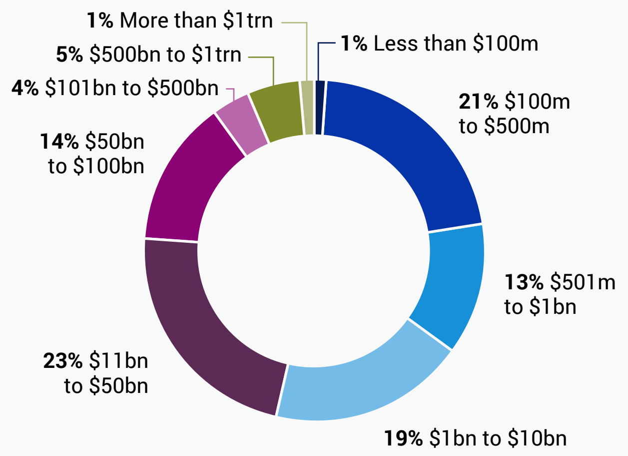
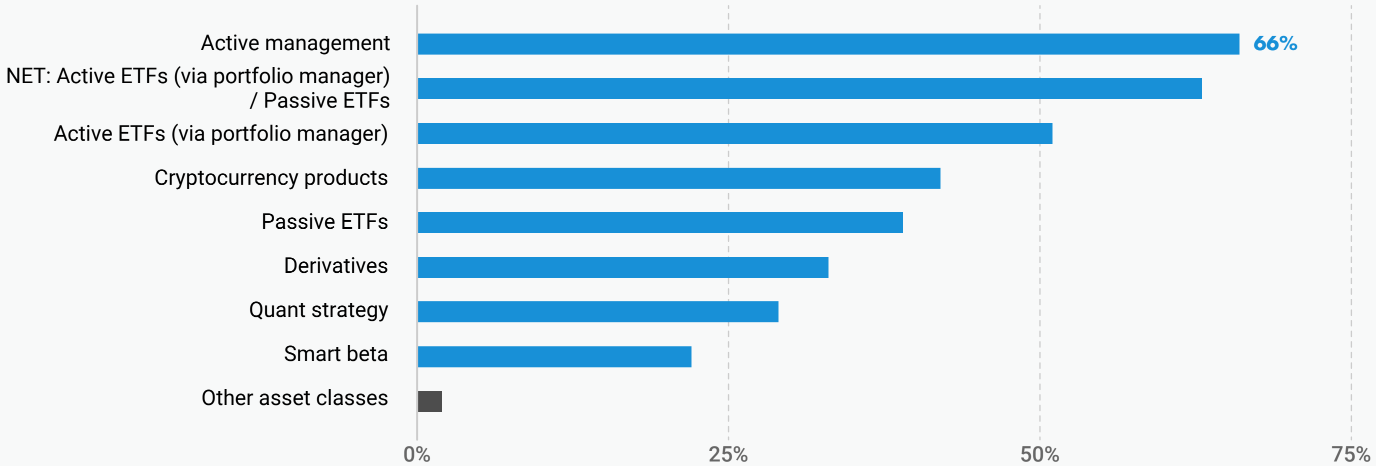


Figure 2

Fund types offered by respondent companies



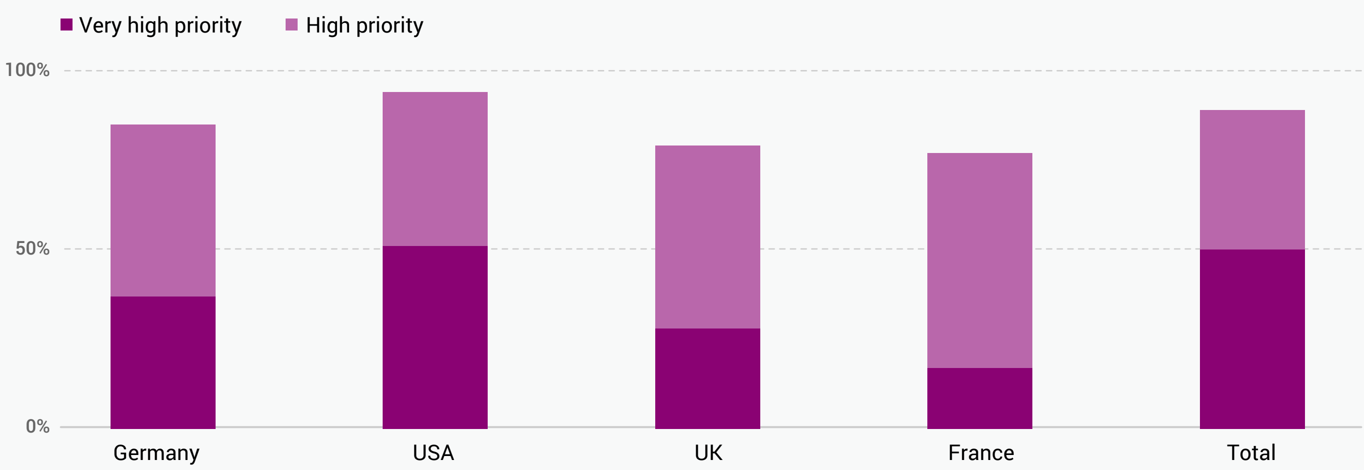
[1] Morningstar Direct, Manager Research.

ESG investment is set to grow rapidly

The survey confirmed both the centrality of ESG factors to asset-management decisions and the strong prospects for future growth. Eighty-five percent of fund-management companies surveyed say ESG is a high priority for their companies. For US fund managers, the proportion is even higher, at 94%. The high priority attached to ESG holds across both actively-managed funds (83%) and passive exchange-traded funds (85%). And they expect ESG to become even more important to their company in the future, with the proportion of ESG assets in their portfolios set to rise from an expected 26.7% in twelve months' time to 43.6% in five years' time.

Figure 3

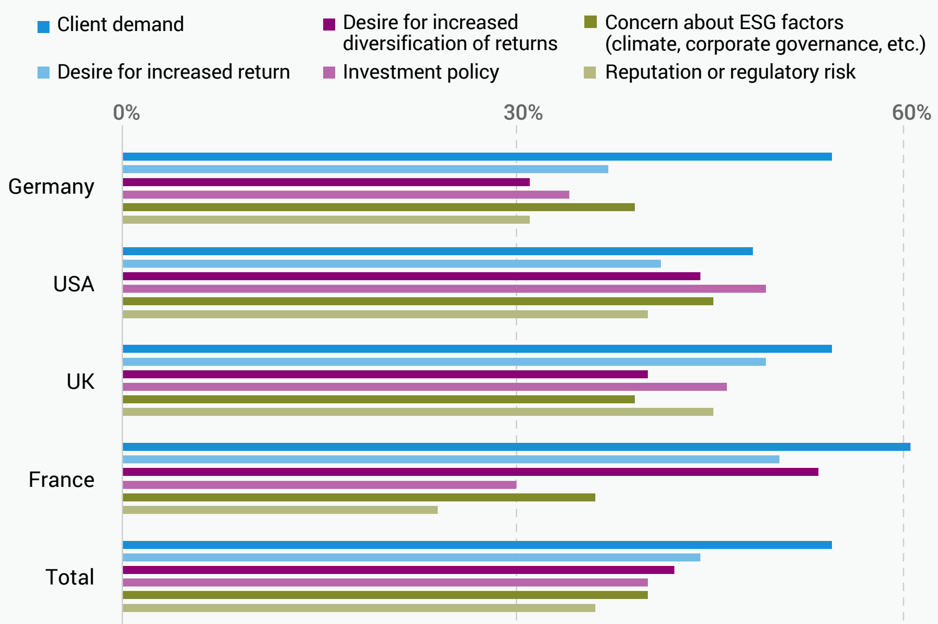
Priority of ESG within your company's overall investment offering or strategy



What's driving the surge in ESG investment? According to our survey, the main factor is client demand, cited by over half (54%) of investment companies we talked to. However, it is also clear that ESG momentum reflects a strong alignment between financial and societal goals, with 44% highlighting a desire for increased return and 40% a concern for ESG factors as the main factors driving their adoption of ESG products and services.

Figure 4

Main factors driving your adoption of ESG products and services



Survey Snapshots: Drivers of ESG investing

"Acceleration is driven by social and consumer attention, as well as investors and executives."

"ESG factors are considered, by market agents, as a good proxy for firms' financial soundness. Companies with better sustainability practices tend to have better operational performance and often better price range."

"Much of the growth in ESG investing is done by millennial investors, who are more likely to seek socially responsible investment types. Within the next thirty years, millennials will have more capital for investments. They could provide fifteen-to-twenty trillion Dollars for ESG investments in the United States alone."

"The development of post-Covid markets will accelerate ESG investment."

Challenges of ESG implementation

Despite the recent impressive growth in ESG investing, asset-managers we surveyed pointed to some significant challenges in ESG implementation that could jeopardize future progress in the sector. These are: insufficient data and standardization; a regulatory-industry disconnect; uneven geographic development; lack of ESG asset diversification; and the challenge of keeping up with changing societal views of ESG.

Need for better data and standardization

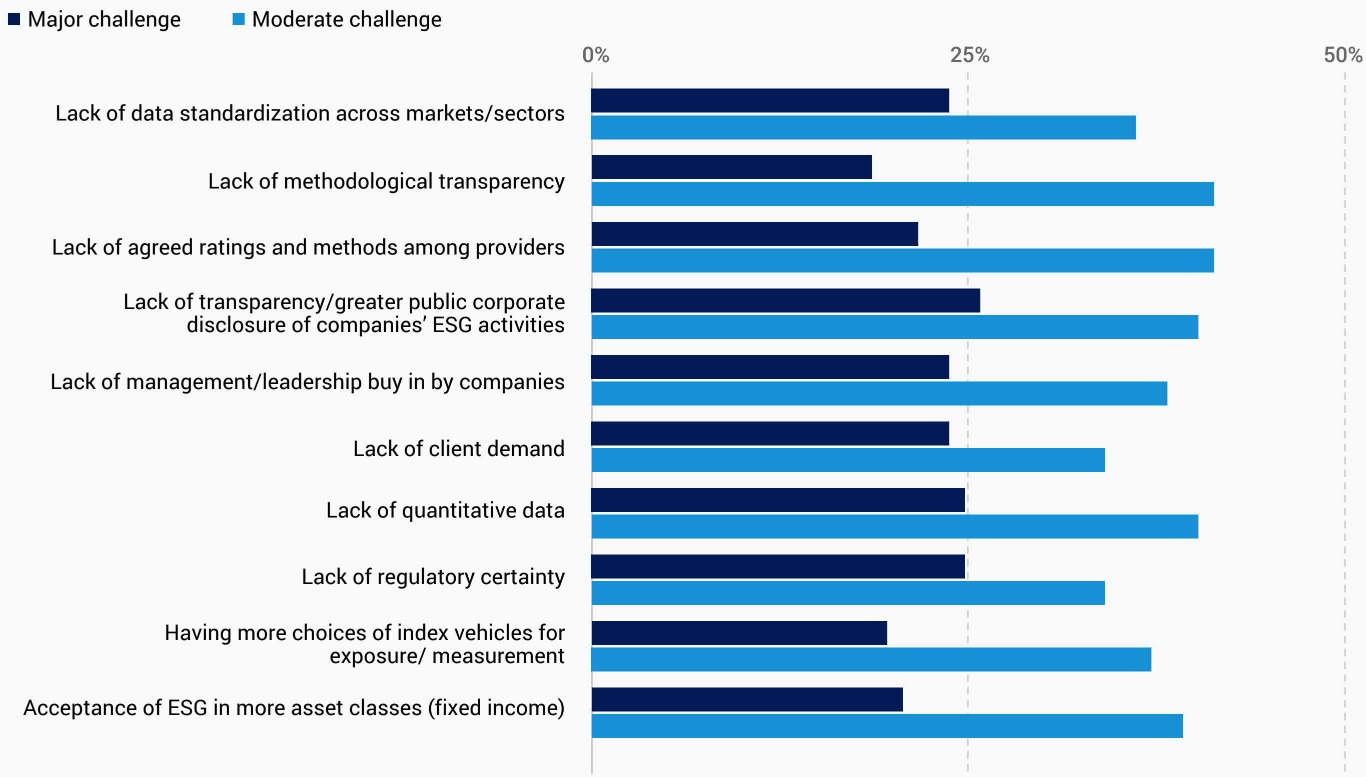
High-quality data are critical to ESG investing. Better data lead to better benchmarking and comparability of ESG corporate performance, which in turn drive better ESG investment products and societal outcomes. However, as Figure 5 shows, our survey reveals major gaps in the quantity and quality of ESG information available to investment managers:

63%
of investment companies highlight a lack of quantitative data as a major (24%) or moderate (39%) challenge to ESG implementation.

64%
cite a lack of transparency or insufficient corporate disclosure in relation to firms' ESG activities.

Figure 5

To what extent are the following aspects a challenge to ESG implementation for fund and asset managers?



More fundamentally, there is no common agreement on how ESG performance should be defined and measured. In our survey, 61% of respondents pointed to a lack of agreed ratings and methods among providers as a major or moderate challenge to ESG implementation for fund and asset managers. A similar proportion (58%) highlighted a lack of data standardization. Internationally, there is a dizzying array of different ESG reporting organizations and ESG benchmarks—for example, the UN Principles for Responsible Investment (UNPRI), the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), to name but a few. By one estimate there are over one hundred different organizations producing ESG ratings. The result is that companies vary widely in terms of how they choose to report their ESG activities and metrics.

Survey Snapshots: ESG data and standards

> "Data standardization across markets/industries is likely to be lacking in the next five years"

> "ESG evaluation criteria are diversified, and different evaluation agencies have great differences in the evaluation results of the same subject."

> "I think an interesting observation is going to be when we look out over the next two, three years, we're going to see increasingly a shift from the inputs to ESG integration and what those are, to really measuring what are the outputs and the outcomes, the impact of the investments that we make."

The regulatory disconnect

Recent years have seen a wave of new ESG regulations, especially at the EU level. Examples include the EU's Non-Financial Reporting Directive, setting out requirements for firms to report on ESG performance, and the Sustainable Finance Disclosure Regulation governing ESG reporting by asset-management companies within Europe.

For the most part, fund managers recognize the role of regulators in advancing ESG standards and trust them to do the job: 83% say they trust regulators a lot (36%) or somewhat (47%) to push financial services ESG innovation and standards. Yet at the same time they also see a growing regulatory disconnect (see Figure 6). For example:

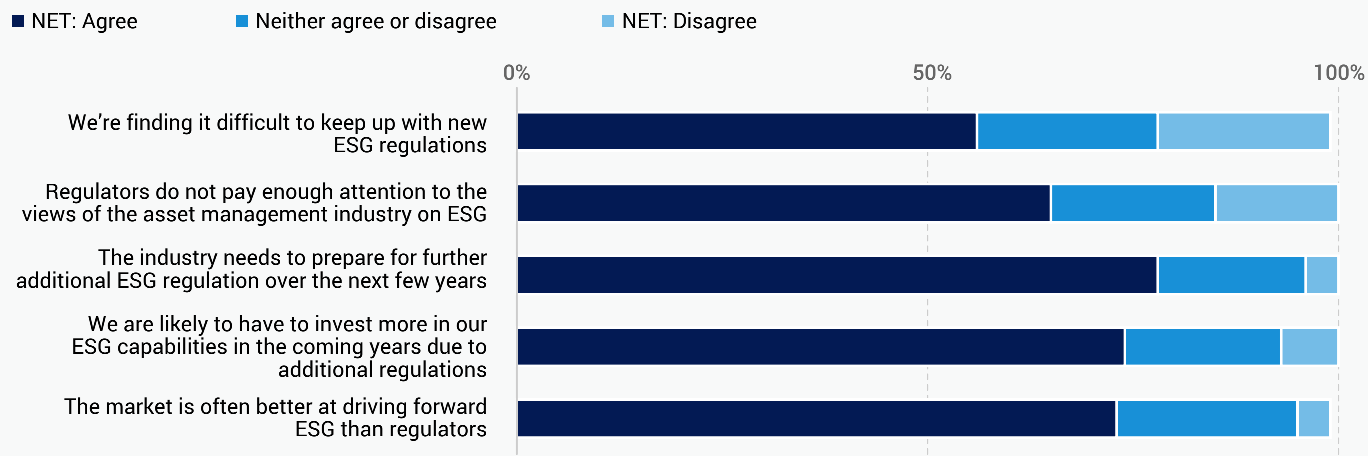
56%
of respondents say they are finding it difficult to keep up with ESG regulations.

65%
say regulators do not pay enough attention to the views of the asset management industry on ESG issues.

78%
agree that the asset-management industry needs to prepare for additional ESG regulation over the next few years.

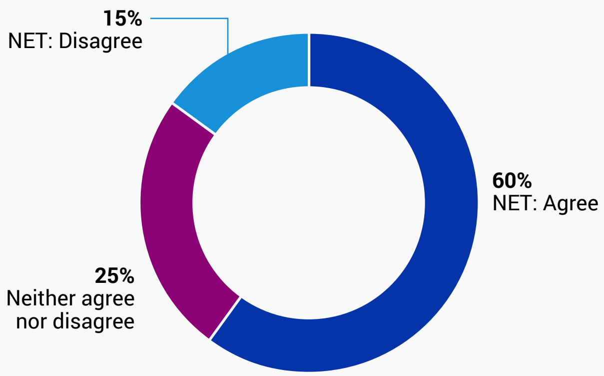
Figure 6

Impact of regulation



Brexit adds an additional twist to the evolving regulatory picture (Figure 7). On balance, asset-managers in the UK, France and Germany felt that the impact of Brexit on ESG investing would either be neutral (41%) or positive (44%). However, 60% of all respondents also agreed that Brexit would make their ESG reporting responsibilities more difficult.

Figure 7
Brexit will make our ESG reporting responsibilities more difficult



Sample base: 220 asset managers in the UK, France and Germany.

Survey Snapshots: The regulatory challenge

"Regulations will be the biggest driver towards change, moving the markets and investors towards certain types of investments."

"I think they there will be more scrutiny of ESG investing and the regulatory changes will make this more challenging."

"British retreat (from the) EU will make our ESG reporting responsibilities more difficult."

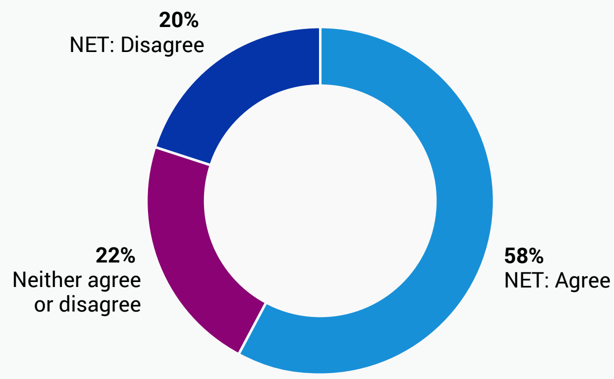
"ESG investments are becoming more complex and riddled with obstacles. Some different rules and regulations differ significantly from each other, which slows down investments. Technologies are held back from both sides."

Keeping up with ESG

Given the kaleidoscopic and fast-changing nature of ESG, 58% of fund managers reported finding it difficult to keep up with changing societal views and expectations around ESG (Figure 8).

Figure 8

We're finding it difficult to keep up with changing societal views and expectations around ESG.

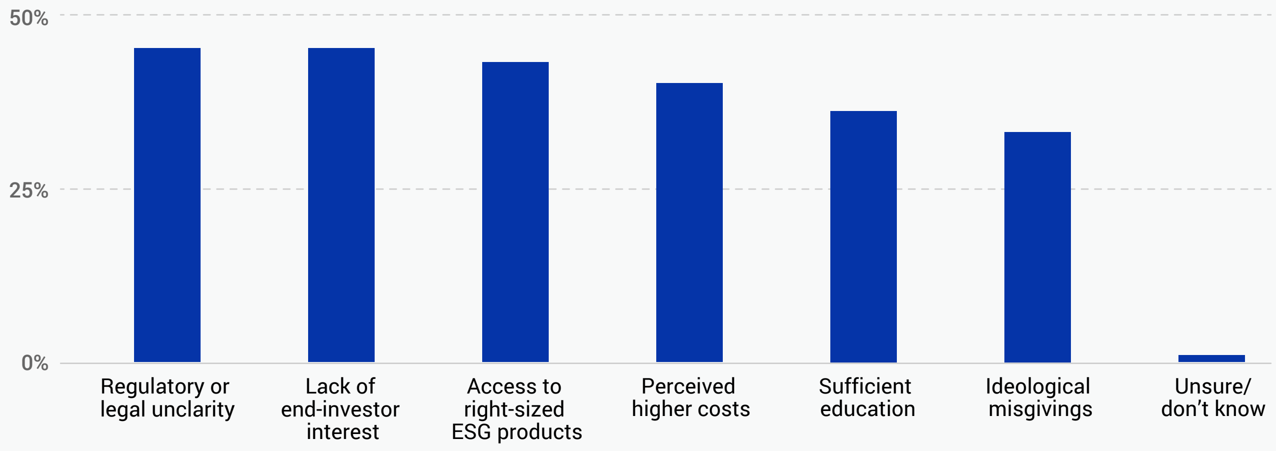


Uneven geographic development of ESG

A fourth challenge lies in the uneven geographic development of ESG investing. The lion's share of ESG funds (79%) still goes to European portfolios, with the US lagging some way behind with a share of just under 12%.[2] The main factors accounting for this lag, according to US respondents to our survey, were regulatory or legal uncertainty (45%), lack of end-investor interest (45%), access to right-sized ESG products (43%), and perceived higher costs (40%) (see Figure 9).

Figure 9

Why does the US appear to be trailing Europe and the UK on ESG investment (US respondents only)?



Sample base: 80 US respondents

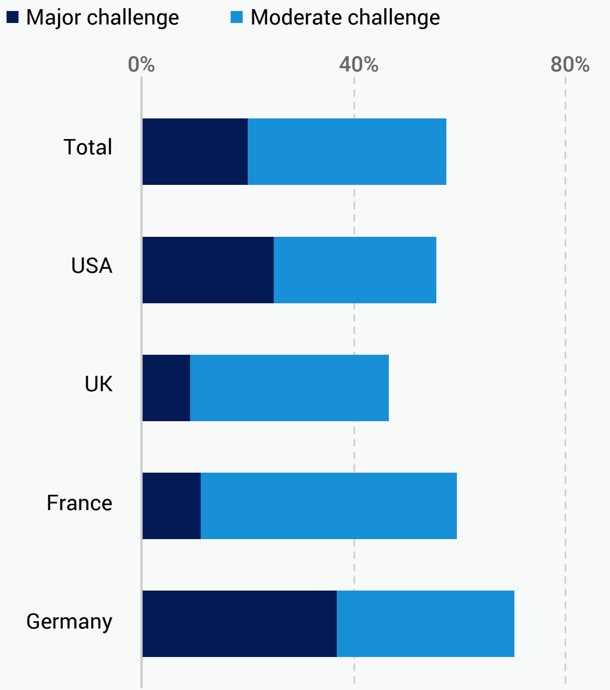
[2] Morningstar Direct, Manager Research.

Lack of ESG diversification across asset classes

In terms of asset class, ESG investing is still heavily concentrated in equities. In Europe about 68% of ESG funds went to equities in the last quarter of 2020, with about 18% going to fixed income. For the US, the allocation was even more lopsided, with equities attracting about 90% of sustainable funds flows.[3] According to our survey, 58% of fund managers agree that lack of acceptance of ESG in more asset classes is a challenge to ESG implementation, a proportion that rises to 71% for German fund managers (Figure 10).

Figure 10

Extent to which acceptance of ESG in more asset classes is a challenge to ESG implementation



Survey Snapshots: ESG asset diversification

"Clients will demand more assets held in ESG investments."

"Diversity of asset classes is needed to meet customers' long-term investment plans, open up markets and increase the rate of return."

"(ESG must evolve) into much more diversified areas to generate greater acceptance."

[3] Morningstar Manager Research, 28 January 2021.

The role of indexes in ESG investing

What kind of data are investment managers using to guide their ESG investment decisions? According to the IIA 2021 survey, the vast majority of asset-management companies, 64%, draw on both quantitative and qualitative sources of data. However, a significant minority, 19%, use only qualitative data; and a similar proportion, 16%, use only quantitative data (See Figure 11).

For qualitative data, companies typically rely on analyst reports (63%), direct engagement with companies (49%), company shareholder reports (45%), external vendors (41%) or regulatory filings (41%). Media coverage is followed to some extent (28%). Just under a quarter of companies reported using non-governmental organizations as a source of qualitative data to track ESG strategies.

The survey results also confirm the important role played by market indexes in ESG investment decisions (Figure 12). Market indexes are often poorly understood in popular discussion of financial markets. Their core purpose is to reduce the informational haze and complexity in financial markets by measuring and tracking the performance of different asset types over time—equities, bonds, commodities etc. At the most recent count in 2017, there were 3.288 million indexes globally, of which 95% were equity indexes.[4] Indexes are therefore distinct from the actual funds or asset portfolios managed by investment companies, pension funds and other financial institutions.

For those asset managers using quantitative data, over half (55%) use market indexes that track ESG factors. Exactly the same proportion also report using their own internal data and market research. Forty-four percent draw on third-party providers of raw ESG data. The significant role of market indexes holds across different investment strategies—active, passive, quant—as well as for different asset types such as cryptocurrencies and derivatives.

Figure 11

Does your company use quantitative or qualitative data to track and monitor ESG strategies?

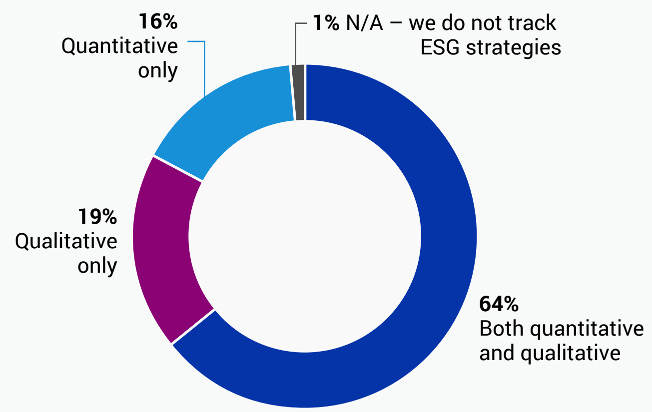
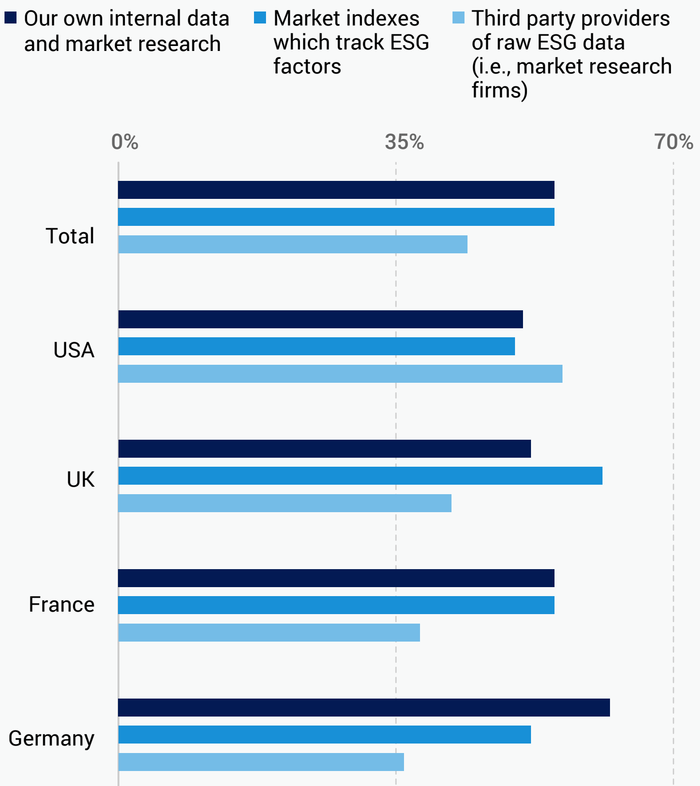


Figure 12

Which of the following sources of quantitative data do you use to track and monitor ESG strategies?



[4] Businesswire, 2017, "Index Industry Association surveys the index universe."

Indexes are used almost equally for measurement / benchmarking purposes (40%) and for investment strategies (39%). The use of indexes for investment strategies is especially prevalent among funds where ESG is a core part of all of their activities (56%). And they are highly trusted to do the job: 84% say they trust index providers a lot (33%) or somewhat (51%) to push financial services ESG innovation and standards, just slightly behind the asset-management industry itself (88%).

As shown in Figure 13, fund managers point to a range of advantages from using indexes. Four-fifths of respondents agreed that indexes help them direct investment quickly to companies and sectors with strong ESG performance. Seventy-three percent agreed that indexes improve comparability in ESG performance, and 78% agreed that indexes give them greater confidence in the reliability of ESG data. Importantly, given the fast-evolving nature of many ESG issues, three quarters agreed that indexes help them respond quickly to new ESG concerns and issues. Just under three-quarters of respondents indicated that they would welcome more help from Indexes in improving their ESG capabilities (see Figure 14).

Figure 13

Thinking specifically about ESG indexes, do you agree with the following statements?

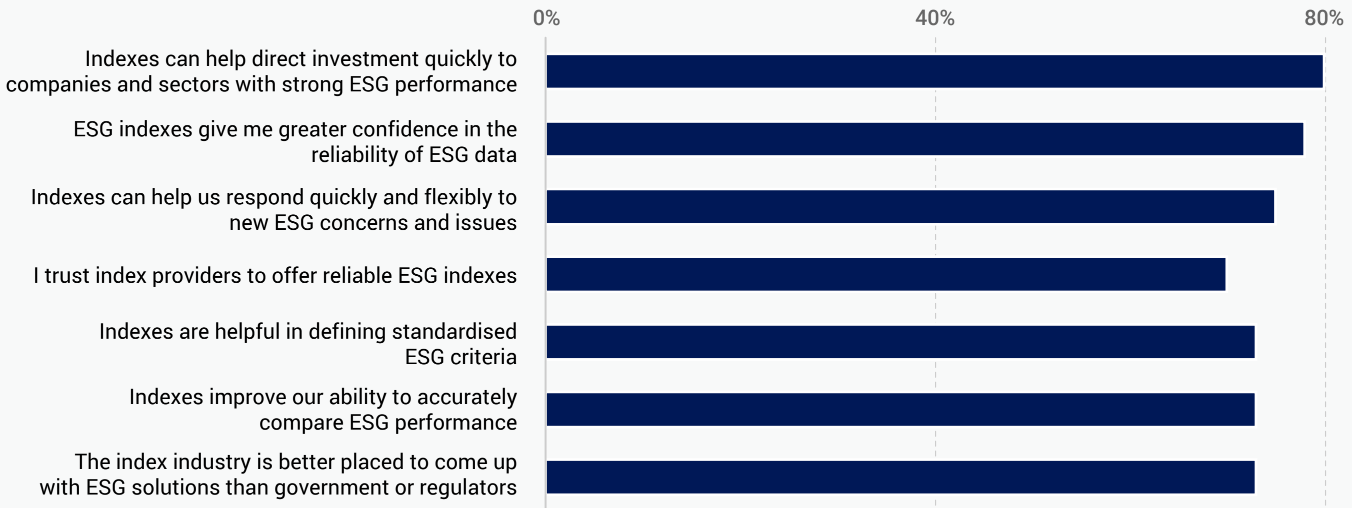
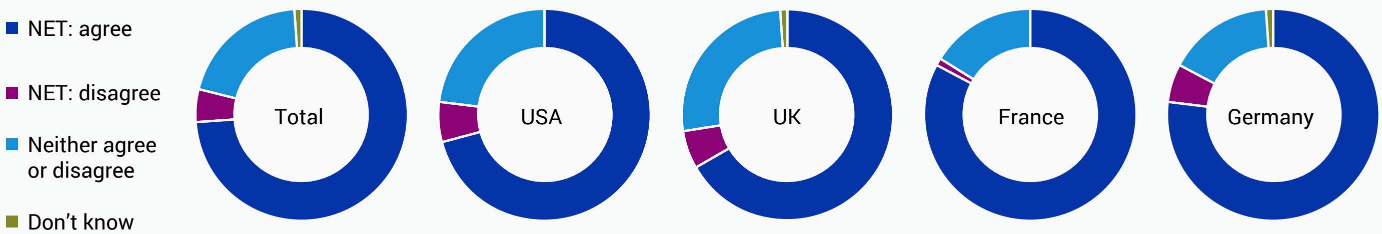


Figure 14

We would welcome more help from Indexes in improving our ESG capabilities



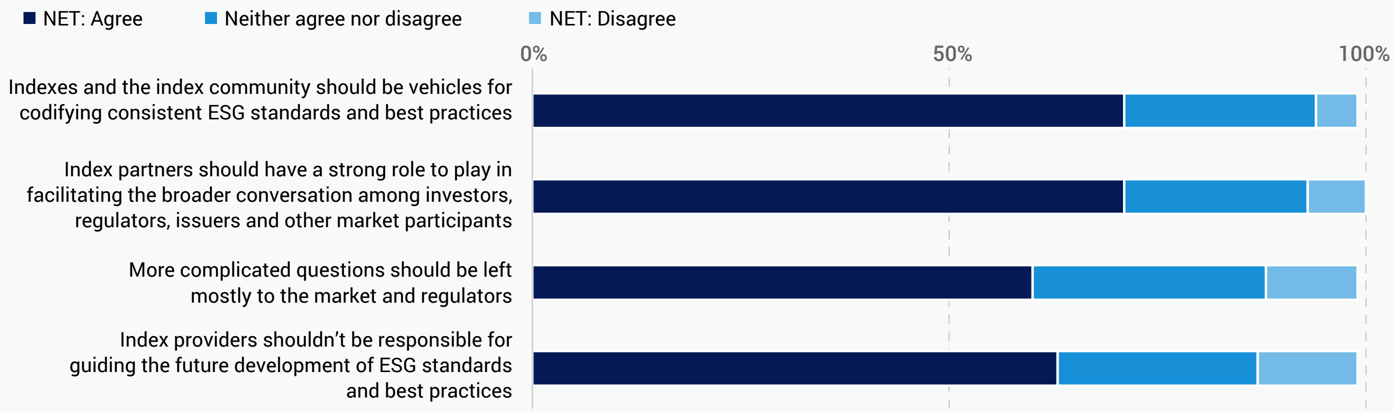
Views on the market / regulatory mix

In terms of the appropriate balance between regulation and market-driven approaches to ESG development, asset managers generally favor a market or industry-driven approach. Seventy-three percent of respondents to our survey agreed that the market is often better than regulators at driving forward ESG (see Figure 6). Market-driven approaches are better able to allocate or re-allocate capital, provide incentives for improved corporate performance, and respond flexibly and quickly to changing ESG priorities.

In line with their generally market-led approach, asset managers see indexes playing an important supportive role in codifying standards and best practices, and generally facilitating the broader debate around ESG in the investment community: 71% say indexes and the index industry should be vehicles for codifying consistent ESG standards and best practices; the same proportion agree that index partners should have a strong role to play in facilitating the broader conversation among investors, regulators, issuers and other market participants. However, they did not see the role of indexes extending to include the development of ESG standards themselves, and 60% agreed that more complicated questions should be left to the market and to regulators to address (See Figure 15).

Figure 15

Future development of ESG standards and best practices.
To what extent do you agree or disagree with the following statements?



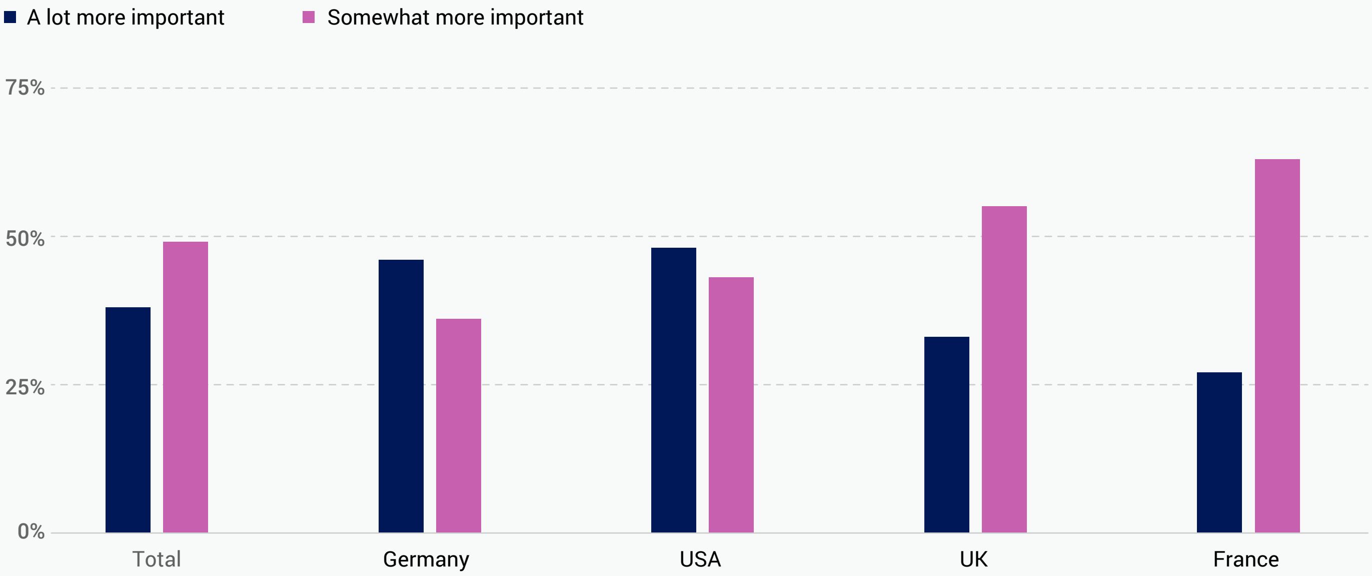
Looking ahead: future developments in ESG investing

How do asset-management companies see the ESG landscape developing over the coming years? Our 2021 survey helps pinpoint some of the key directions of change in ESG investing.

First, the overwhelming majority of respondents, 87%, indicated that ESG was going to become a lot more important (38%) or somewhat more important (49%) over the next three years (Figure 16). US respondents (48%) and German respondents (46%) were more likely to say that ESG will become a lot more important in the next three years. This growing importance is mirrored in investment intentions. The asset-management companies we surveyed expect the proportion of ESG elements in their portfolios to climb from an average of 26.7% 12 months from now to 43.6% in five years' time. By the end of the decade, the average proportion of ESG elements in fund portfolios is expected to be over half (52.3%).

Figure 16

Overall, do you expect ESG to become more or less important to your company over the next three years? (by country)



Second, the open-ended questions in our survey offer some glimpses of the future from the asset-manager perspective on ESG. Among the comments: ESG will continue to change in response to client demand and government policy; source data will become much more granular; there will be a shift to measuring ESG outputs rather than inputs; the experience of the covid pandemic will bring a new urgency to ESG issues. Technology is seen as playing a pivotal role, both in terms of creating new ways to automate and measure ESG (e.g. through AI and machine learning) and in terms of its wider societal impacts.

Survey Snapshots: Future developments

“However, the next wave of ESG investing will go much further than relying on the much-simplified ratings, which currently dominate the landscape. In the future, investors will access source data with much greater granularity. Corporate reporting – these are currently the different and often highly simplified overall scores of the rating agencies.

“I expect ESG to change massively in the next 5 years due to technological developments.”

“The biggest task of ESG in five years is to integrate new and more accurate data and information sources.”

“ESG consideration will become the norm when investing. On the portfolio management side, we can expect the vast majority of managers to integrate ESG factors into the investment process and at the same time, we’re also going to see higher flows into ESG-focused and thematic and impact funds, helped by the fact that product disclosure will start improving, especially in Europe, thanks to a new regulation that requires asset managers to provide more information on how ESG factors inform the investment decisions and strategies”

“ESG will be heavily influenced by regulations for AI/automation technologies”

“Technologically advanced tools will provide the opportunity for every portfolio to hold ESGs.

“(ESG evaluation) will be more automated.”

“ESG will continue to rise on the public and corporate agenda. If there was a silver lining in the coronavirus pandemic, it is that it has forced many people and companies to think about sustainability issues and climate change in particular.”

“I see ESG changing significantly in the next five years as a result of government policy and more importantly due to the rapid technology advance evident in the business sector currently.”

“I think an interesting observation is going to be when we look out over the next two, three years, we’re going to see increasingly a shift from the inputs to ESG integration and what those are, to really measuring what are the outputs and the outcomes, the impact of the investments that we make.”

Conclusion

Our survey of 300 fund managers confirms the increasing centrality of ESG factors to the asset-management industry in Europe and the United States. Fund managers expect the importance of ESG within their portfolios to grow rapidly over the next five years.

However, fund managers also highlighted several major obstacles that could jeopardize future progress in ESG investing: insufficient data and measurability, a significant regulatory disconnect, and the need to broaden ESG to a larger set of assets and geographies. The survey also confirmed the key role of market indexes in improving comparability and benchmarking, helping fund managers direct investment to areas of strong ESG performance and respond rapidly to new societal concerns and issues. For ESG investors, the biggest drivers of future change are likely to come from new government policies and regulations, new data sources, and technology developments such as AI and automation.

The Index Industry Association (IIA) plans further work to understand the changing role of ESG investing over the coming months, including podcasts, further data releases and seminars and panels.
For further information, please see the IIA website.

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About the IIA

The Index Industry Association (IIA) is the global trade association for the index industry. A not-for-profit organization serving the global community of index providers, IIA membership is open to independent index businesses worldwide.
For more information about membership, please contact CEO Rick Redding.

Our Purpose

The purpose of the Index Industry Association (IIA) is to represent the global index industry by working with market participants, regulators, and other representative bodies to promote sound practices in the index industry that strengthen markets and serve the needs of investors.

About the Author

Mark Purdy is managing director of Purdy & Associates, an independent advisory and thought leadership firm focused on issues at the intersection of economics, technology and business. He has over 25 years' experience as an economist in business and government.

His recent work has focused on ESG and the economic and business impact of next-wave technologies such as AI. He has published widely in tier-1 media and business publications such as Harvard Business Review and Sloan Management Review. He speaks on economics and technology issues at conferences, client workshops and seminars around the world.

https://purdyassociates.com/

This survey of asset management companies was conducted by independent research agency Opinium, commissioned by the IIA. Opinium is an award-winning, independent strategic insight firm built on the belief that in a world of uncertainty and complexity, success depends on the ability to stay on pulse of what people think, feel and do.

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