



Ingraining sustainability in the next era of ESG investing

New opportunities are emerging for investment managers
to adapt as investor preferences evolve

KEY MESSAGES

- As regulators around the world continue to receive input from investors and move toward adopting ESG investing standards in their own jurisdictions, the debate is shifting from whether ESG investing is a niche to how investment managers should respond.
 - At their current growth rate, ESG-mandated assets (defined here as professionally managed assets in which ESG issues are considered in selecting investments or shareholder resolutions are filed on ESG issues at publicly traded companies) are on track to represent half of all professionally managed assets globally by 2024.
 - The majority of new ESG fund launches over the next 18 months are expected to be in line with principles similar to Article 8, or in other words, with ESG characteristics playing a meaningful role in the investment decision-making process.
 - Investment managers may alleviate concerns from regulators and investors by conducting a holistic review of ESG investing related disclosures and implementing related compliance policies consistently throughout the firm.
 - Responsible digital transformation may provide a path forward to adopt sustainability initiatives and improve client engagement. More and more stakeholders are including societal impacts in addition to financial metrics when measuring the performance of financial institutions. In order to provide the data needed to perform this type of assessment, investment management firms may benefit from verification or assurance by an independent third party.
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Consideration of ESG metrics in investing is now standard practice

SOME BELIEVE THAT we are entering the watershed moment where the growth of professionally managed assets with an environmental, social, and governance (ESG) mandate will only accelerate until it encompasses the vast majority of all professionally managed assets. While others are more skeptical of such a pronounced shift and note that ESG or similarly aligned investing philosophies have been maturing for decades, and therefore are unlikely to ever become more than a niche.¹ Some still debate whether ESG has officially moved from the fringes of investment philosophies into mainstream acceptance by global investors; however, evidence from fund prospectuses suggests that ESG has moved into the mainstream. Investment fund prospectuses that do not mention sustainability statements are becoming increasingly harder to find. In the European Union (EU), even funds that lack ESG characteristics or objectives and are therefore categorized as “non-ESG,” or Article 6 funds, are required to disclose how sustainability risks are considered in the investment decision-making process.² As regulators around the world continue to receive input from investors and move toward adopting ESG investing standards in their own jurisdictions, the debate is shifting from whether ESG investing is a niche to how investment managers should respond.

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This continued rise in sustainability-mandated investment demand from investors across the globe presents an opportunity for investment management firms to retool their investment decision engine, fine-tune customer reporting capabilities, and augment their internal stewardship processes to meet and potentially exceed client expectations. Firms increasingly recognize the risk of inaction related to ESG investing and have less strategic reason to take a “wait-and-see” or “do-nothing” approach. A look at how ESG product growth has evolved over the past several years can give insights into the strategies that are meeting client demand to help investment managers decide which ESG themes may be considered in their product offerings. Firms slow to react allow others to make the decision for them as clients could move their assets into a product which they deem more suitable and credible. To capitalize on the increasing investor allocations to ESG-aligned investments, some firms are strengthening their credibility by placing sustainability at the core of their decision-making to respond to the growing expectations of regulators, investors, and employees. Engaging with employees about the firm’s purpose, increasing transparency around the firm’s ESG investing practices, and streamlining disclosures about the firm’s impact on ESG-related objectives

may provide investment managers with additional credibility in the eyes of stakeholders.

The global professionally managed ESG assets landscape continues to expand

GLOBAL INVESTOR DEMAND for ESG products continues to provide opportunity for organic AUM growth. Recent surveys indicate that client demand continues to be a catalyst for investment managers' consideration of sustainability investment metrics in their decision-making processes.³ This report focuses on the entire professionally managed ESG universe. For a look at dedicated sustainable investments, a subset of this ESG universe, read the Casey Quirk by Deloitte paper: *It's not easy being green: Managing authentic transformation within sustainable investing*.

At their current growth rate, ESG-mandated assets (defined here as professionally managed assets in which ESG issues are considered in selecting investments or shareholder resolutions are filed on ESG issues at publicly traded companies) are on track to represent half of all professionally managed assets globally by 2024 (see figure 1).⁴

Much of this growth in global ESG-mandated assets will likely be driven due to the adoption of new disclosure regulations in the EU. The implementation of the Sustainable Finance Disclosure Regulation (SFDR) in March 2021 effectively created three fund designations (Article 6, Article 8, and Article 9) based on the level of the

investment manager's incorporation of ESG characteristics in the investment decision-making process (see sidebar, "SFDR: An overview of Articles 6, 8, and 9"). At the end of Q1 2021, assets in discretionary mandates with an ESG investment approach, Article 8, and Article 9 funds in the EU totaled US\$13 trillion, representing 40% of the total assets under management.⁵ The progress in articulating the level at which ESG is incorporated in the investment decision-making process under Article 6, 8, and 9 demonstrates the EU's leadership from a regulatory perspective. This progress may lead to increased investor awareness and foster ESG investing adoption globally.



FIGURE 1

ESG-mandated assets are projected to make up half of all professionally managed assets globally by 2024

Global assets under professional management (\$T)



Note: All amounts are in US dollars.

Source: Proportion of ESG-mandated data through 2020 from Global Sustainable Investment Alliance; DCFS analysis through 2025.

In Europe, 2022 will likely bring additional clarity to how investment managers choose to designate their funds under Article 6, Article 8, and Article 9 of the SFDR. The new regulations require certain disclosures from investment managers about the implications of sustainability risks on both funds and their firms, yet the exact implications of these requirements remain under discussion.⁶ Through the first nine months of 2021, there were 1,805 primary share launches in the EU, of which 44% (786) lacked a designation under SFDR (see figure 2).⁷ Despite the lack of clarity surrounding the disclosures required under each designation, funds

that classified themselves as either “light green” or “dark green” still represented more than half (54%) of funds that launched with an SFDR designation.⁸ These “green” fund launches follow the trend seen during 2020, when more than half of total investment fund flows in Europe were directed to sustainable funds.⁹

In 2022, the number of funds categorized as Article 8 or Article 9 may see a large increase as disclosure requirements become clearer and more investment managers choose a product designation label at launch.

SFDR: AN OVERVIEW OF ARTICLES 6, 8, AND 9¹⁰

Article 6 requires the following:

“Financial market participants shall include descriptions of the following in pre-contractual disclosures:

- The manner in which sustainability risks are integrated into their investment decisions; and
- The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.

Where financial market participants deem sustainability risks not to be relevant, the descriptions referred to in the first subparagraph shall include a clear and concise explanation of the reasons therefore.”

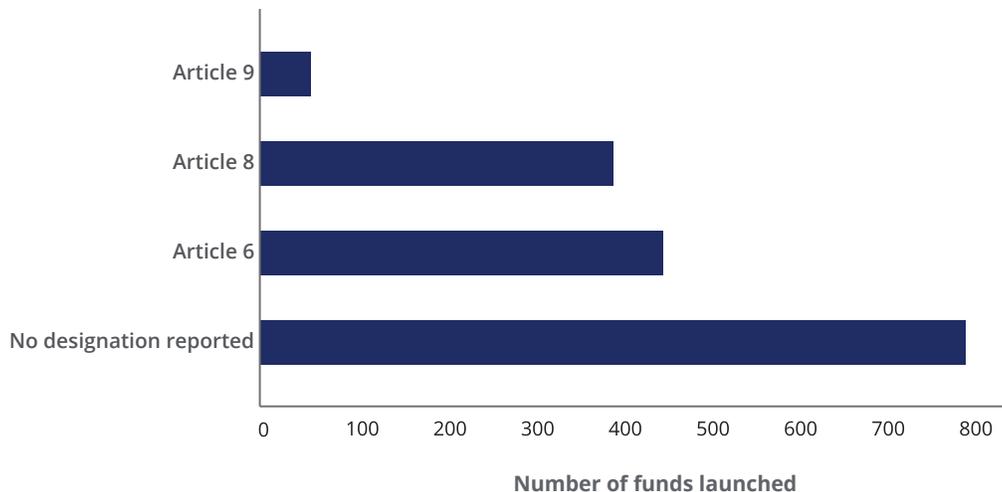
An **Article 8** (also referred to as “light green”) fund under SFDR satisfies Article 6 sustainability risk requirements as well as “promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.”

In addition to meeting the requirements of Article 8, a fund identifying as **Article 9** (also referred to as “dark green”) under SFDR is defined as “a Fund that has sustainable investment as its objective or a reduction in carbon emissions as its objective.”

FIGURE 2

Article 8 and Article 9 funds represented more than half of SFDR designated funds in the first nine months of 2021

Primary share launches in the EU (Q1–Q3 2021)



Source: DCFS analysis and Refinitiv data.

Investment management firms globally are responding to the growing investor interest in ESG-aligned products by rebranding existing funds and by launching new ones that target specific sustainability objectives. In 2021, exchange-traded funds (ETFs) and mutual funds that are managed with ESG characteristics or objectives similar to the principles of Article 8 or Article 9 grew over 35% from the prior year to set a new record with over 1,600 new launches spread across 48 jurisdictions (apart from the United States), making up about 12% of all fund launches.¹¹ In the United States, fund managers launched 149 mutual funds and ETFs with ESG characteristics or objectives in 2021, comprising about 22% of all fund launches.¹² The one-year growth rate of ESG fund launches in the United States is more than

twice that of funds without, 80% versus 34%, respectively.¹³ Further, fund flows may support the case for investment managers to consider ESG-aligned fund launches. Investor preferences for an ESG strategy continued to drive inflows in actively managed ESG funds, while their non-ESG actively managed counterparts continued to experience outflows.¹⁴ The estimated net outflows from actively managed US diversified equity funds was US\$204.5 billion for the trailing one year ending September 30, 2021, compared to a net inflow of US\$8.1 billion for actively managed US diversified equity funds with an ESG mandate.¹⁵ Actively managed mutual funds and ETFs with an ESG objective are expected to capture a greater share of the active fund launches coming to market globally in 2022.

Sustainable investment products that are meeting client demand

THE ESG PRODUCT landscape is shifting. Investment managers continue to diversify their product offerings away from negative screening.¹⁶ Firms are launching products that integrate sustainability factors and quantify the investment's impact on individual E, S, and G factors.¹⁷ This approach satisfies client interest for product with finer focus on E, S, and G factors.¹⁸ As the scope of ESG fund objectives expands, investment products with different sustainability objectives attract fund flows at differing rates. In the United States, a review of 13F and Form D SEC filings provides some insights into how investment managers are meeting client demand for investments that align with their preferred sustainability objectives. While this deep dive is somewhat limited because the disclosure by institutional investors of their holdings of mutual funds are not required in Form 13F, ETF holdings are included. These may be a sufficient proxy to provide a direction of which sustainability outcomes are gaining traction inside investor portfolios.

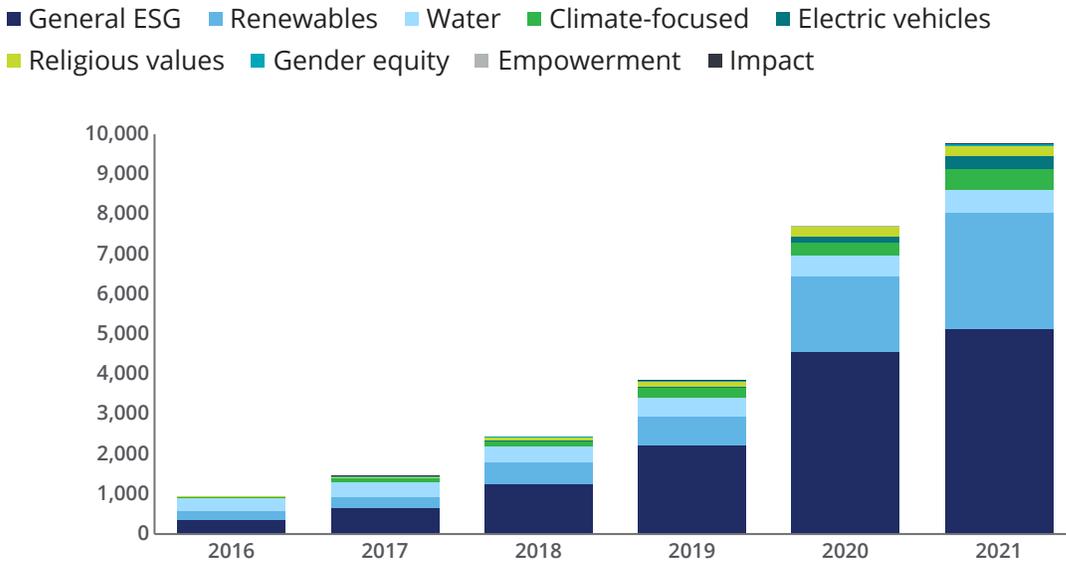
The number of institutional investment managers reporting at least one ESG-aligned fund in their holdings has grown almost 300% since 2016 and these funds can be found in 24% of all 13F filings for the period ending Q3 2021.¹⁹ Within the universe of all ESG funds held in portfolios, those with a general ESG mandate grew from

representing 38% of all ESG-aligned funds found in 13F filings in 2016 to 53% as of Q3 2021.²⁰ Over the same period, 13F filings with water-focused funds increased from 308 to 584 while at the same time their percentage of all ESG funds fell from 32% to 6%, demonstrating strong overall ESG-aligned fund growth and slower growth for specialty water-focused funds (see figure 3).²¹ Of the 207 different ESG-aligned funds identified across 13F holdings at the end of Q3 2021, 66% can be described as general ESG funds.²² This suggests that US retail and institutional investors have a sufficient supply of general ESG funds from which to choose, and it may be more difficult for new general ESG funds to gain traction. The majority of new ESG fund launches over the next 18 months are expected to be in line with principles similar to Article 8, or in other words, with ESG characteristics playing a meaningful role in the investment decision-making process. In addition to incorporating ESG characteristics into the investment decision-making process, some firms are developing more specific ESG strategies with targeted objectives. Looking at ESG objectives where demand may outweigh supply, opportunity may exist for new fund launches in the renewables category. These funds represent 30% of all sustainability holdings in 13F filings yet account for only about 8% of the 207 ESG-aligned funds identified in the analysis of 13F filings at the end of Q3 2021.²³

FIGURE 3

ESG-aligned funds have seen strong growth across all 13F filings since 2016

Total number of ESG funds in 13F filings



Note: 2021 as of September 30, all other years as of December 31.

Source: DCFS analysis of SEC filings.

Alternative investment managers are providing a greater number of ESG-aligned strategies as detailed in Form D filings. These filings show that exempt offerings with ESG-aligned themes grew 50% in 2021, outpacing the 33% growth in total Form D filings.²⁴ Private fund offerings aligned with the “impact” theme within ESG, which include opportunity zone funds, surpassed general ESG-themed funds in 2018 to represent the largest percentage of sustainability funds (45%) and remained at the top in 2019 and 2020 (45% and 44%, respectively).²⁵ However, in 2021 a different theme gained traction with alternative investment managers: climate-focused funds. Fund offerings with this theme jumped to represent 27% of all ESG-aligned themes in 2021, up from just 1% in 2020.²⁶ This recent attention given by investors to

climate-focused private funds is consistent across other alternative investment products. Much of the focus for recent hedge fund offerings is also related to carbon reduction and the transition to clean energy.²⁷

Alternative investments are demonstrating more ESG specificity than ETFs. This finding is likely due to the qualified nature of alternative investors, which typically have significantly larger portfolios than retail investors. The large differences in portfolio size may allow alternative investors to be more specific and targeted in their ESG approach. However, overall, both the general ESG funds and their more targeted counterparts are experiencing strong growth in both the ETF and alternative investment space.

Adopting a sustainability ethos as a differentiator

INVESTMENT MANAGEMENT FIRMS such as Candriam and T. Rowe Price are adding an ESG lens to the investment process and integrating ESG research into the investment decision-making process. ESG incorporation may no longer be a differentiator for investors, but rather a standard input for consideration in the investment decision-making process. Also, regulators around the globe may follow in the footsteps of the EU and require categorization of all funds to help investors more easily determine the level of ESG incorporation. As more and more funds are labeled with any degree of sustainability, it will likely become more difficult for investment managers to stand out from the crowd solely on their product lineup. Moving beyond bespoke ESG products to developing a sustainability ethos within a firm may help align with regulators' objectives, create credibility with investors, satisfy employees, and ultimately allow a firm to obtain a greater share of ESG-mandated AUM.

Authenticity may provide additional benefits to a firm by reinforcing the firm's vision and building comradery. As a result, talent retention and productivity may improve as shown in the 2022 investment management outlook. People generally want to work for firms with values that align with their own.²⁸ Disclosing ESG objectives with specific goals at a firmwide level may help drive collaboration across different functions by aligning sustainability goals across functions. Without a cohesive message from leadership, some

firms have seen tensions rise between sales and compliance teams as a result of uncertainty surrounding the impact of regulations such as SFDR.²⁹ One solution may be for firm leadership to show a top-down commitment by tying executive compensation with meeting specific ESG targets. Leading firms are communicating their vision and backing that vision with incentives.

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As many investment management firms more fully integrate ESG within the investment decision-making process, collaboration between ESG specialists, whose sole responsibilities involve conducting ESG analyses, and traditional portfolio managers will likely become an important component of successful implementation of the sustainability ethos that employees are seeking. Vision and purpose are an important aspect for talent retention and hiring. The financial services industry is currently experiencing high turnover. Data from the US Bureau of Labor Statistics indicates that the September 2021 rate of voluntary separation within the finance and insurance sectors reached its highest level since January 2008.³⁰ Not only are employees today more willing to explore

new opportunities, a shortage of investment professionals with ESG skills also currently exists.³¹ The talent pool of professionals with the necessary skill sets has not kept pace with demand.³² By disclosing their firm's progress toward its sustainability objectives, investment managers may gain increased credibility with its employees, which may help reduce voluntary turnover.

Transparency to increase authenticity

Around the world shareholder proposals related to environmental and social issues are on the rise.³³ Many ESG funds have voted against almost all environmental resolutions over the past 14 years, causing some to question if these funds are truly committed to ESG issues.³⁴ For example, some funds have voted against proposals requesting the disclosure of board diversity and qualifications despite their statements that the fund has long held that diversity in the boardroom is important.³⁵ Some ESG funds also voted against the disclosure of sexual harassment policies and gender pay gap even as they claim to promote social issues.³⁶ While fund managers may have legitimate reasons behind these votes, the lack of transparency around the reasoning may cause investors to question their commitment to these issues. Evidence suggests that some investment management firms may benefit from a strategic review of the proxy voting processes. In the United States, the SEC released a risk alert in April 2021 that highlights the manager's proxy practices as one of its areas of focus (see sidebar, "ESG Risk Alert").³⁷ Investment managers have an opportunity to differentiate themselves through ESG-aligned proxy voting that

is both justified and transparent. By ensuring the fund's proxy votes align with the stated sustainability objective, managers can demonstrate genuine commitment to regulators and investors.

Recent action from the SEC indicates that the regulator continues to evaluate investment management firms' statements regarding ESG investing practices.³⁸ The SEC sent letters to investment advisers requesting detailed information on their ESG screening processes, as well as their approach to abiding by the various jurisdictional requirements in the countries where they operate.³⁹ As investment management firms await additional regulatory guidance over coming months, managers may benefit from a comprehensive review of language in existing marketing materials as well as further educating clients about the role of ESG metrics in the investment decision-making process.⁴⁰ The SEC noted that some effective practices include:

- Disclosures that are clear, precise, and tailored to firms' specific approaches to ESG investing, and which align with the firms' actual practices.
- Policies and procedures that address ESG investing and cover key aspects of the firms' relevant practices.
- Compliance personnel that are knowledgeable about the firms' specific ESG-related practices.⁴¹

Investment managers may alleviate concerns from regulators and investors by conducting a holistic review of ESG investing related disclosures and implementing compliance policies consistently throughout the firm.

ESG RISK ALERT⁴²

The ESG Risk Alert from the SEC details areas of focus for investment management firms when considering ESG investing practices. Observations of potentially concerning practices include:

- Portfolio management practices inconsistent with disclosures about ESG approaches.
- Controls inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.
- Proxy voting inconsistent with advisers' stated approaches.
- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches.
- Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices.
- Compliance programs that do not adequately address relevant ESG issues.

Disclosures for differentiation

In addition to demonstrating an authentic ethos through proxies and employee engagement, process improvements throughout an organization may strengthen the firm's commitment to sustainability in the eyes of investors and create an avenue for differentiation in the ESG investing landscape. Many investors are seeking greater detail about firms' holistic incorporation of ESG practices. Due diligence questionnaires are focused on an increasingly greater amount of ESG criteria, leading many investment managers to examine how to successfully incorporate ESG practices across the organization.⁴³ For example, Envestnet's due-diligence team focuses not only on the investment decision-making process, but also on the firm's own actions, reporting, and active ownership when assessing its commitment to sustainability issues.⁴⁴ However, only 15% of investment management industry respondents to a recent Deloitte survey indicated that their firms have fully quantified the impact of diversity and inclusion initiatives in their financial statements.⁴⁵

As more firms adopt more detailed sustainability goals, reporting progress to investors is becoming more challenging. UNPRI's reporting and assessment framework can help signatories monitor their responsible investment activities and progress and give investment managers transparency on investment managers' progress toward sustainability goals.⁴⁶ Leading investment management firms internalize ESG principles and make regular disclosures about the firm's progress in achieving stated sustainability goals to the public. However, in the absence of well-defined regulatory requirements, often the appropriate level of disclosure is unclear. While regulators in the United States have yet to implement required disclosures such as those in the EU, some clients nonetheless are asking for great transparency concerning sustainability risks and factors. Responsible digital transformation may provide a path forward to adopt sustainability initiatives and improve client engagement. More and more stakeholders are including societal impacts in addition to financial metrics when measuring the performance of financial institutions.⁴⁷ In order to provide the data needed to perform this type of assessment, investment management firms may benefit from verification or assurance by an independent third party.⁴⁸

Sustainability and the drive toward a more human-centric investment management industry

AS ESG INVESTING achieves new heights, investment managers have an opportunity to achieve a more sustainable world in which people are placed on par with profit for the benefit of stakeholders.⁴⁹ Investment managers may capture a larger share of ESG investing AUM by building products with sustainability at their core. A clearly defined fund strategy concerning sustainability risks and sustainability outcomes may reduce scrutiny from regulators and better inform clients. ESG investing performance assurance adoption, proxy activism, and increased disclosure requirements could accelerate ESG-mandated AUM over the next 12 months. The year 2022 will likely see increasing adoption of sustainability investing by retail and institutional investors. Taking action by engaging with talent, increasing transparency, and disclosing progress on sustainability outcomes can be paramount to firms' delivering on the expanding expectations of today's clients.



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