Linedata

Accelerating ESG in Asset Management

Easing barriers to entry

In this Linedata whitepaper we examine the driving forces shaping the ESG market opportunity for global asset managers, and how firms are mitigating the challenges of regulation and data to stake out ESG differentiation for their companies and drive business growth.

Key takeaways

- Regulation, culture, and politics is propelling ESG assets under management to reach a third of the projected $140.5 trillion global total by 2025.
- Inclusion of "non-financial" disclosures is fast becoming the norm in investment portfolio reviews.
- Gen Z and millennial investors now exert more influence, seeking focus on S-Social and G-Governance driven by COVID and civil unrest.
- The impact of new ESG legislation, like the EU's SFDR, will reverberate globally as European investors demand more disclosure.
- The market for ESG data is on the rise given investor and regulatory requirements, up nearly 40% since 2019.
- Critical success factors for deploying ESG analysis in a firm's portfolios today include a robust process combining data, tools, and human insight with a transparent methodology, rather than industry standardization.
- Developing an ESG data proposition within an asset manager is often supported by third party providers whose objective standards build credibility.
- At Linedata, we work with clients to directly integrate independent ESG data and scoring into portfolio workflows, easing operational burdens and empowering ESG decision-making.

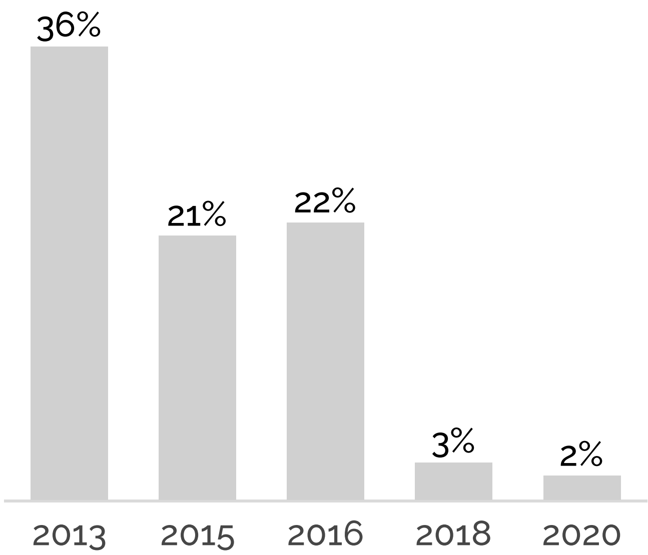
ESG shifts to core investment strategy

After years of being a niche area, environmental, social and governance (ESG) or sustainable investing has become mainstream. As the 2020 EY Climate Change and Sustainability Services (CCaSS) Institutional Investor Survey revealed, ESG information and data has never been more important, with the majority of asset managers, asset owners and investors surveyed signaling a move to a more disciplined and rigorous approach to evaluating companies' non-financial performance[1]. Information based solely on balance sheet figures and traditional number crunching statistics no longer suffice. Investors are also demanding the ESG disclosures that have a material impact on a corporate's operations.

Research from Bloomberg has year end 2021 ESG assets on track to reach $53tn, up from $37.8tn last year.[2] Covid-19 is only one reason and, in many ways, accelerated a trend that was already in motion.

The pandemic reinforced the view that non-financial factors such as the way a company handles climate change, boardroom diversity or supply chain issues can make a material difference. This was brought into sharper focus during the dramatic equity market sell off in the first quarter last year when the MSCI ESG Leaders index outshone their traditional peer group in most geographies, and investors sought more resilient options[3]. These indices target companies that have the highest ESG rated performance in each sector of the parent index.

Performance, of course, will fluctuate from quarter to quarter; however, analysis from MSCI reveals that ESG stocks, with their lower-risk profile, generate better risk-adjusted returns over time. This helps explains why six out of ten Morningstar European sustainable funds delivered higher returns than equivalent conventional funds over the past decade. This was also the case over three and five years of the sample of 745 Europe-based sustainable funds examined.



The percentage of investment teams that do not conduct reviews of non-financial disclosure has dropped dramatically since 2013.

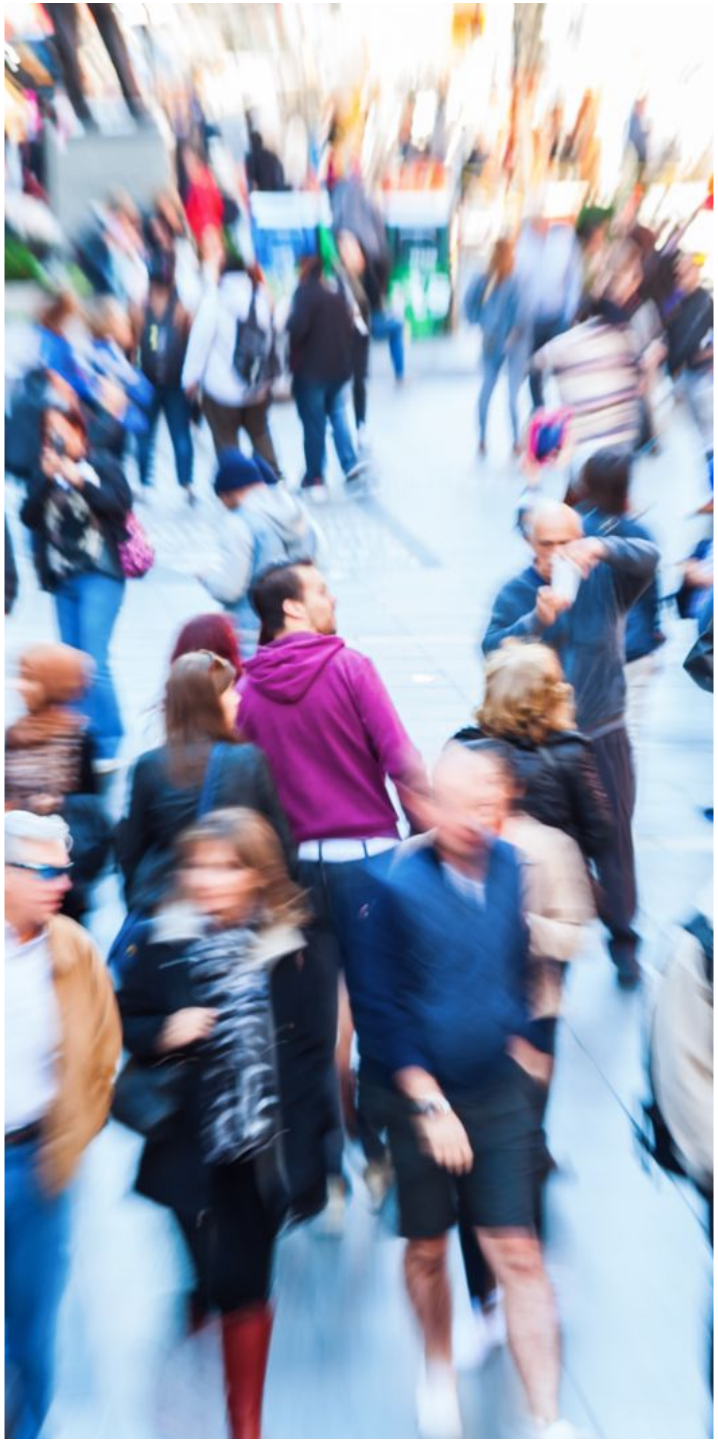
Source: 2020 EY CCaSS Survey

Seeking independent assurance of non-financial processes, controls and data outputs can help build trust and transparency with investors.

91%

Investors who said non-financial performance played a pivotal role in investment decision-making over the past 12 months

ESG is gaining momentum while asset managers face mounting demands from regulators and investors for more data, transparency, and reporting.



Generational influence

Another driver for change has been the Gen Z and millennial investors. They not only want companies with solid ESG credentials for their investment portfolios but also as brands and products to buy as consumers. In the past, the focus was on companies with strong environmental and governance ratings because they were more easily measurable, but more recently greater attention has been given to the S component of ESG. The pandemic and the switch to remote working coupled with the Black Lives Matter demonstrations, for example, has highlighted the role that investing has to play in impacting concerns such as systemic racism, as well as helping to promote equal pay, better treatment of employees and social equality[4].

While these generations are exerting greater influence, it would be wrong to underestimate the power of their parents and grandparents. A report by Allianz Global Investors found that in fact, baby boomers are more likely than millennials and Gen Xers to participate in ESG investing in order to encourage companies to be good corporate citizens[5].

Regulation gains steam

There is not only a cultural shift to ESG but also a regulatory impetus, which varies by region. Continental Europeans have tended to be ahead of the pack, especially in the Nordics, Netherlands, and France, where there is more of an embedded sustainable investment ethos in investment as well as legislative circles.

The ability to leverage independently validated ESG scores accelerates the development of sustainable investment products. This helps guide which companies consciously minded investors and consumers choose to support.

European regulators force disclosure

The European Union recently published its Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy as well as recommendations for the Non-Financial Reporting Directive (NFRD), outlining what information companies must disclose beyond traditional assets, liabilities and balance sheet data.

SFDR impact

In March 2021, the EU introduced SFDR with greater transparency requirements on the integration of sustainability risks and consideration of adverse sustainability impacts in fund manager processes. They must disclose sustainability features of their financial products and are obliged to classify them according to three primary categories:

1. Article 9 - Funds that specifically have sustainable goals as their objective, for example, investing in companies whose goal is to reduce carbon emissions.
2. Article 8 - Funds that promote E, S or G characteristics but do not have them as the overarching objective.
3. Article 6 - Funds that are not promoted as having ESG factors or objectives.

The industry view is that SFDR, with reporting required by Jan 2022, will raise the bar and require companies to act. Many market participants believe the impact will reverberate globally as European investors demand more disclosure from their investments around the world. The new rules will also make it easier for clients to compare products and gain more insight into how their money is used and for what purpose.

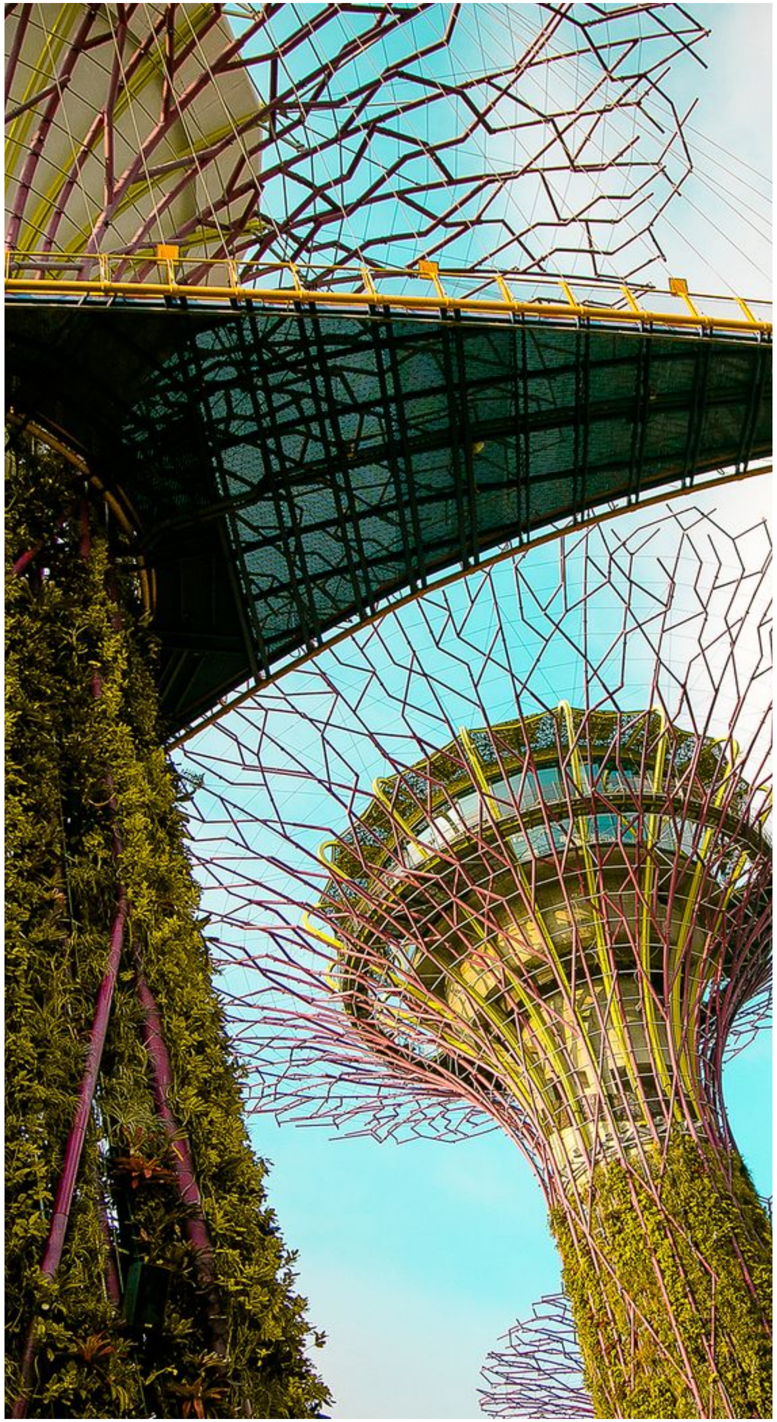
To date, preliminary data from Morningstar estimates the European ESG and sustainable fund market, based on SFDR definitions, could currently be worth as much as $3tn.[6] This figure is expected to grow as managers enhance existing strategies, reclassify funds, and launch new ones that will meet the more stringent requirements, and at the same time reposition them to capitalize on the growing market.

The EU Green Deal

EU Taxonomy, to be fully implemented by the end of 2022, is a European economic growth strategy to realize a climate neutral, competitive, and circular economy by 2050.

It is designed to be the world's first classification system for green financial products by establishing science-based criteria on what should count as truly sustainable economic activity. It is closely linked with the SFDR as it imposes measurement and reporting obligations on corporations, financial products and government bodies.

It has six environmental objectives: climate change mitigation, climate change adaptation, water and marine resources, circular economy, pollution prevention and control, and biodiversity and ecosystems.



Biden agenda

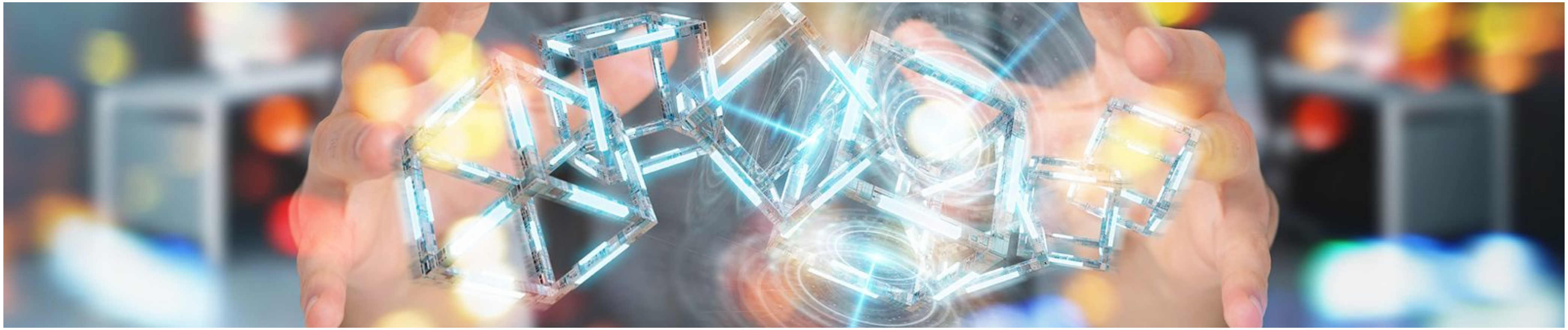
Change is also occurring at pace in the US with the Biden Administration's new ESG agenda and the US rejoining the Paris Climate accord.

Tackling climate change was a cornerstone of Biden's election campaign and early executive orders have covered a range of initiatives - creating a position for a special presidential envoy for climate, hosting an Earth Day climate summit and establishing a 30% protection of U.S. land and waters. The Administration also blocked new oil and gas leases on federal land.

President Biden's discretionary funding request for 2022 includes a record $11.2bn for the Environmental Protection Agency (EPA) and an increase of more than $14bn on fiscal 2021 for climate change investments overall. In addition, he launched a $2tn infrastructure program that aims to bolster investments in clean energy, electric vehicles and building homes resilient to threats posed by the climate crisis. The White House also plans to unveil a stricter emissions target for the Paris Accord on or before the summit of world leaders later this year in Glasgow, Scotland.

The Biden Administration's ESG ambitions include recommitting to the Paris Agreement, appointing key climate-focused personnel and pledging to achieve net-zero emissions by 2050.

One of Biden's first executive orders rolled back Trump era regulations that made it harder for asset managers to incorporate non-financial disclosures into investment selections.



Case Study
Tapping ESG Data insights for Compliance

Linedata's client is a global asset servicing company operating in Luxembourg as a ManCo, or Management Company, whose core business is to perform governance, risk, compliance and oversight of funds for investors and asset managers. Given fast-evolving ESG market regulations, the client identified a growing opportunity to integrate innovative ESG compliance reporting into their service offering.

With compliance core to their mandate, the ManCo will validate a client fund as "sustainable", per SFDR specifications, and report to the fund's legal auditor if needed. However, the compliance framework for such validation is still being developed, with new reporting requirements in effect from January 2022.

In partnership with the client's own team, Linedata created a new rule set within Linedata Compliance that looks specifically at ESG scores. To support the ManCo in interpreting ESG methodology and techniques, the rules process is validated by a qualified third party ESG data provider. Data is held against each asset – such as Carbon Footprint metrics, with a weighted average. For example, a fund mandate could specify the following: no asset can be below a score of 40 and the overall portfolio must be above 85. The fund objectives are reviewed and validated by the ManCo and then reported.

The ManCo benefits from easy compliance system integration, a tested and flexible solution, and expert, independent validation. With this in place, our client is well-positioned to report on whether the assets held in their clients' ESG portfolios are aligned with that fund's prospectus and mandate, and to position ESG Compliance Reporting as an integral component of their offering.

"Our agreement with Linedata empowers more asset managers to make better decisions for a sustainable future."

Georg Kell, Chairman of the Arabesque Group, and founding Executive Director of the United Nations Global Compact

Data and scoring from independent ESG data provider Arabesque S-Ray feeds directly into Linedata's software.

Holding companies to account on ESG issues more than doubled to 41% in Q2 2020 from 19% at the end of 2019 according to CoreData.

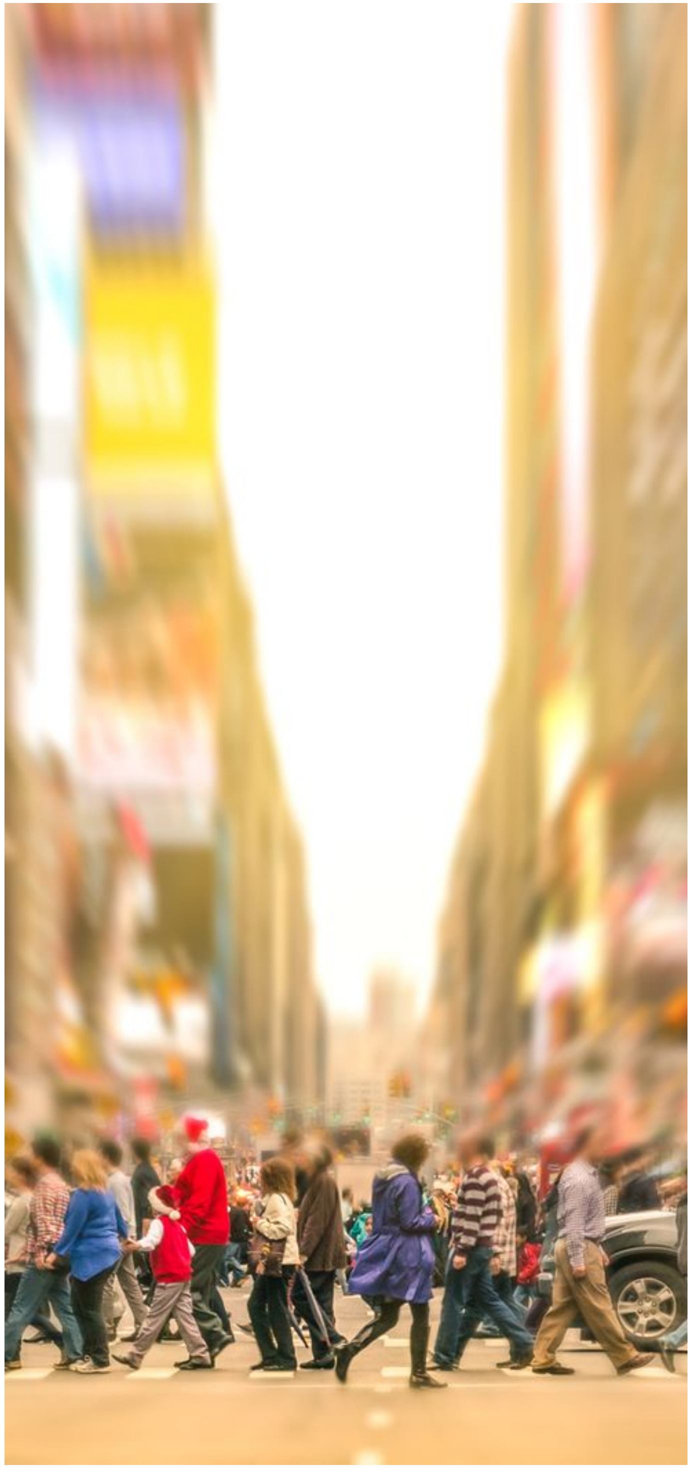
Taking a stance

Although regulation may be galvanizing the industry into action, ESG stewardship itself has become increasingly important for institutional investors. Global Initiatives, such as the UN Principles for Responsible Investment, encourage investors to actively engage and change corporate behavior. A survey of 500 global institutional investors in the second quarter of 2020 from CoreData found that holding companies to account on ESG issues more than doubled to 41% from 19% since the end of 2019.[8]

The issues are wide and varied, according to ShareAction, the responsible-investment charity. [7] Among the "13 most important ESG resolutions" of 2021:

- a proposal calling on General Motors to disclose its lobbying around climate change,
- a resolution calling on the board of Walt Disney to strengthen oversight of workforce equality issues including racial and gender pay equity,
- a vote on biodiversity at Amazon.

Again, as with regulation, levels of activity depend on the jurisdiction, but many institutional and retail investors are becoming more results-oriented. The new UK Stewardship Code 2020 is a case in point, in that the focus has shifted from policy statements to outcomes, demonstrating the need for these investors to show impact through their stewardship activity. Voting is a critical part as are private and collaborative engagements.



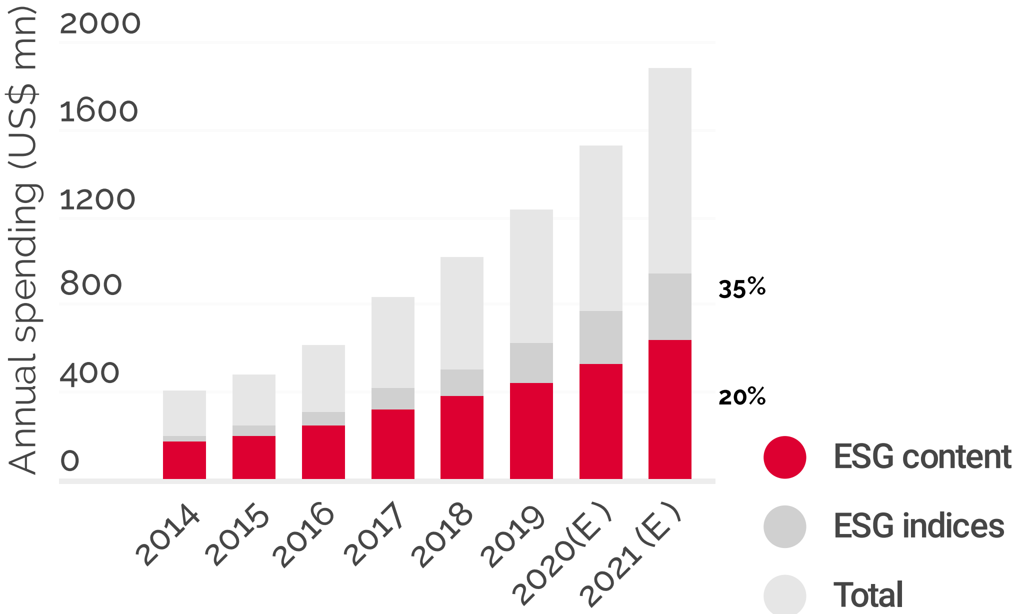
Responding to the data challenge

Against this changing backdrop, reliable and quality data and the analysis that supports it plays a pivotal role. This is what will enable the acceleration of capital towards companies better prepared to address ESG considerations.

The challenges of standardization in the ESG space have been well documented. A recent report by research firm bfinance found that 84% of the 256 asset owners surveyed, representing $7tn in assets, said it was problematic to obtain consistent reporting across asset managers and asset classes.[9]

Yet, as more players join EU regulators and raise their voices to the industry, data, standards, and disclosures can begin to coalesce. Throughout 2020, well-known ESG asset managers like Blackrock were joined by the Nordic Prime Ministers, the US Investment Company Institute (ICI), and Canada's leading "Maple 8" pension funds, among others, pushing for broad adoption of Sustainability Accounting Standards Board (SASB) standards.[10]

Demand for data, combined with a surge in regulations and reporting frameworks has contributed to a jump in data availability, with research firm Opimas estimating that the ESG data market, including content and indices, will reach USD$1bn this year.[11] While there is no overarching agreement on how to standardize data provider methodologies, there are now more than a few long-standing, quality providers who each deliver transparent data and scoring assessing ESG criteria. Technology tools like artificial intelligence and machine learning bolster efforts at both providers and asset managers to better gather and analyze the information.



Spending on ESG data continues to increase rapidly as customer demand becomes more sophisticated.

Source: Opimas Research

Qualitative and quantitative framework needed

As in other areas of investment research, ESG data does not have to be uniform to be effectively deployed in the investment process. More critical is a combination of data, scoring and tools, combined with human input to create robust processes, with meaningful insights and a transparent methodology. In other words, a qualitative as well as quantitative analytical framework.

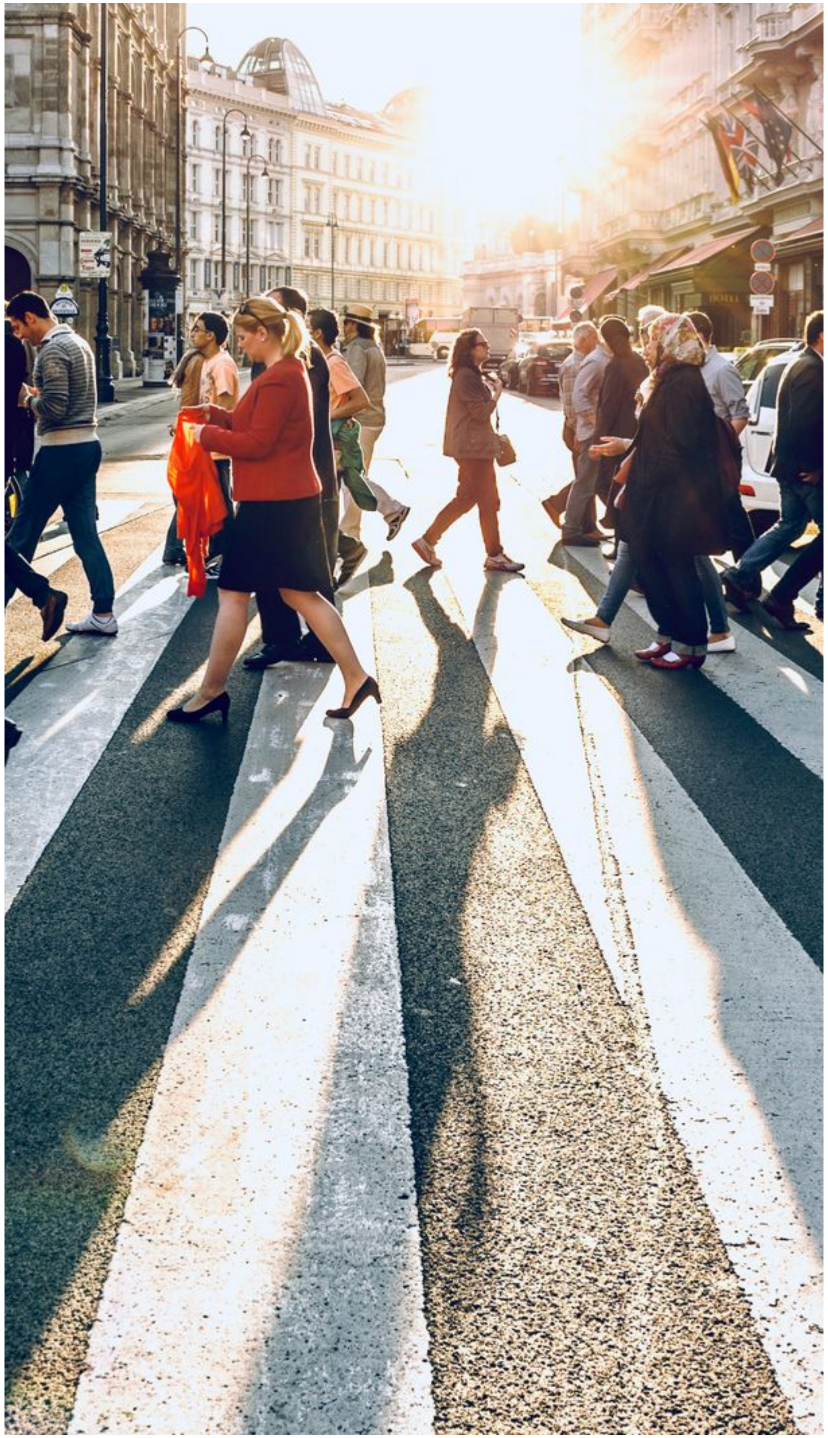
The ESG sector is no longer only about exclusion, such as “sin stocks” in decades past, but one where asset managers adopt a much more holistic, integrated approach to evaluating which companies are a fit for their ESG strategies and products. It means drilling down to assess the financial material impact ESG issues have on a company’s bottom line, revenue growth, margins and risk. Companies that develop a sustainable investment culture can significantly burnish their competitive edge and generate value to the end customer, as well as align with asset managers’ ESG portfolios.

Aligning resources and objectives

There are a handful of veteran sustainable asset managers with sizable businesses who have built their own proprietary models and research capabilities. Even these established firms would benefit from independent third party validation of their research, as publishing methodologies to investors becomes the norm.

Many more firms are early on in the journey. These firms’ ability to capitalize on the growing ESG opportunity will be dictated not only by regulation but also resources, governance, budget and company culture.

For many asset managers seeking to develop ESG offerings, finding the right partners is key. Fund managers have to ensure strategies are aligned, methodologies are understood and objectives defined. Instead of using several different data feeds, for example, it may make more sense to build a relationship with a trusted ESG data and scoring partner who is part of the sustainable ecosystem. These third parties should have their own internal processes, tools and scoring, and a sustainable culture embedded across the entire organization. This would qualify them to offer an independent, objective standard as well as the expertise to help drive and develop an ESG proposition within the asset manager’s business.



Taking ESG forward

There is much to be optimistic about as our asset management industry forges a path that offers opportunity for growth and differentiation, as well as effecting positive corporate change through ESG driven decision-making.

At Linedata, we are committed to accelerating this opportunity by helping more asset managers participate with easy and efficient access to credible ESG data and scoring.

We know clients often struggle with data selection and data integration, so we've simplified the process with directly integrated data and scoring, and lowered the costs, facilitating the use of various strategies with the same data set. These reduce the barriers to your firm doing more with ESG. While there will continue to be varied ways of constructing ESG portfolios, using both internal and external capabilities, you can inspire investors' trust by explaining your funds' objectives, measurement, and evaluation, supported with transparent use of data. Whatever your particular blend of ESG, it's the right time to move forward on the journey towards a more sustainable and inclusive future.

Building blocks for growing ESG within your firm

- Take stock of how evolving regulatory requirements impact your jurisdiction
- Evaluate your access to ESG research tools to assess externally and internally generated data
- Build internal cross-functional alignment around ESG objectives
- Identify who will lead engagement and stewardship: portfolio managers or ESG specialists? Is the approach collaborative?
- Evaluate advocacy and research in partnership with external organizations, such as academic institutions or think tanks
- Determine how both qualitative and quantitative analysis will be included in your firm's process
- Develop structures or key performance indicators to measure investment outcomes

Matthew Luff has spent the last 20 years working across a variety of buyside firms and ran his own consultancy focused on MiFID II and Brexit. At Linedata, Matt helps asset managers drive transformation in their operating models and within their ESG businesses.

Linedata Asset Management

Whether you are an institutional manager, hedge fund or wealth advisor, our Asset Management Platform – AMP – delivers all your business needs on a single platform to adapt nimbly to our changing world. Cloud-enabled software, collaborative expertise with integrated data analytics, and the flexibility of our modular design enables better decision-making, streamlines processes, and empowers your innovation.
Linedata.com/AMP

About Linedata

With 20 years' experience and 700+ clients in 50 countries, Linedata's 1100 employees in 20 offices provide global humanized technology solutions and services for the asset management and credit industries that help its clients evolve and operate at the highest levels.

Endnotes and sources

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