

The Evolution of ESG in Asset Management

Should Regulation or the Free Market Guide us?

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of asset management..

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, a traditional “client-centric” approach has enabled entrepreneurial, owner-managed firms to emerge as an important force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author



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Contents

Foreword	5
Executive Summary	6
Introduction	6
Definitions	7
New Terrain	8
ESG as a Risk Management Tool	10
Give the Investors What They Want	10
More Understanding, More Flows	11
Is Regulation the Answer?	12
The EC defines ESG: Potential Challenges	13
Integrating and Reporting Sustainability	14
ESG Reporting Faces an Uphill Battle	14
Should Industry or Regulators Drive ESG?	15
Conclusion & Recommendations	16
New City Initiative Members	18

Foreword



There has been increasing information and debate about the role environmental, social and governance (ESG) factors could, or should, play within investment strategies. The sheer variety of approaches to, and interpretation of, ESG and its evolving nature, has led to confusion amongst potential customers. The European Commission has announced it will step in to provide clarification through regulation.

This paper takes a closer look at how ESG is being integrated into the investment strategies managed by NCI members, which are specialist, independent, owner-managed boutiques, and whether regulation or the free market will provide the right framework for fostering deeper understanding and facilitating continued innovation in ESG. A survey of NCI membership suggests ESG considerations are already firmly embedded in decision-making.

NCI's recommendations focus on the need for clarity and transparency, but with free market choice through industry-led solutions. While many asset managers welcome the regulators' decision not to adopt a prescriptive approach towards ESG integration, NCI believes it should be the industry that is leading the reform initiative.

Jamie Carter

Chairman, New City Initiative

Chief Executive, Oldfield Partners

Executive Summary

Over the last five years, ESG investing has matured from being primarily an esoteric capital allocation tool to becoming part of the fabric of modern-day asset management. There have been a number of reasons why ESG is becoming so popular among managers of all sizes ranging from retail and institutional investor pressure right through to the potential return benefits. With EU regulators now actively pushing investment firms into adopting ESG, NCI analyses how boutique asset managers are applying sustainability in their businesses.

Introduction

In 2015, world leaders gathered in Paris to thrash out a landmark agreement – COP 21 – whose end goal was to create a framework to mitigate greenhouse gas emissions in order to limit global warming to below 2 Celsius above pre-industrial levels. At the same time, the United Nations (UN) produced its own Sustainable Development Goals (SDGs), a blueprint outlining how countries can remedy some of the global challenges currently being faced in areas such as poverty, inequality, climate change, and environmental degradation.¹

The role of financial institutions including banking and fund management is viewed by the framers of these international agreements as being pivotal towards achieving many of their ambitious objectives and targets. In addition to regulators and supranational entities driving change, so too are institutional and retail investors, a number of whom believe that performance can be materially improved by incorporating ESG research into portfolio decision making, encouraging some managers to introduce changes to their businesses.

This paper looks at how boutique asset managers are applying ESG into their investment mandates and assesses some of the implications which new regulation may have on the industry, including whether it will unintentionally stifle sustainable investing. It aims to provide unique insights from boutiques about general ESG trends and looks at some of the primary drivers behind its implementation across the industry. The paper's conclusions and policy recommendations are based on the results of an internal survey of NCI membership, along with interviews with a diverse range of asset managers and service providers.

1 UN SDG

Definitions

VALUES-BASED INVESTMENT

Exclusionary or Negative Screening: Avoiding Securities on the basis of traditional moral values, standards and norms. This type of strategy is the oldest and most popular type of ESG investing. Faith-based finance is an example of this type of strategy.

Impact Investing: Investing with the disclosed intention to generate and measure social and environmental benefits alongside a financial return. It's also considered a type of values-based investment, even though a financial gain is expected from this strategy.

VALUE-BASED INVESTMENT

Best-In-Class Selection: Preferring companies with better or improving ESG performance relative to sector peers.

Thematic Investing: Investing that's based on trends or structural shifts, such as social, industrial and demographic trends, including clean tech, green real estate, water security, etc.

Full ESG Integration: Investing with a systematic and explicit inclusion of ESG risks and opportunities in investment analysis.

ENGAGEMENT

Active Ownership: Entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change.

2

2 State Street – The Investing Enlightenment

New Terrain

Asset managers are developing innovative strategies and launching products aligned with some or all of the priorities discussed in COP 21 and/or the SDGs, through the establishment of bespoke sustainable investment funds, impact investment funds and socially responsible investment (SRI) solutions. Others have simply applied ESG into their portfolios by screening and excluding certain securities, which may not meet their ethical criteria, such as big oil, tobacco companies and munitions.

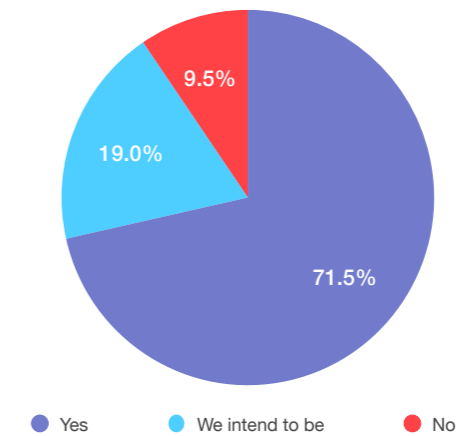
ESG is now firmly rooted in asset management, and it is an increasingly important dynamic during the investment process at boutique asset management firms, according to a survey of the NCI membership.



NCI's findings are supported by analysis produced by BNP Paribas Securities Services of 461 asset managers and asset owners in 2017, which said 79% of respondents presently apply ESG into their investment decisions or in terms of the products they market.³ Actions, however, speak louder than words. Conscious of the changing attitudes to ESG, a number of NCI respondents to the survey confirmed they have either signed up to or intend to sign up to the UN PRI (Principles for Responsible Investment), a voluntary investment code.

³ BNP Paribas Securities Services (September 7, 2017) Great Expectations: ESG

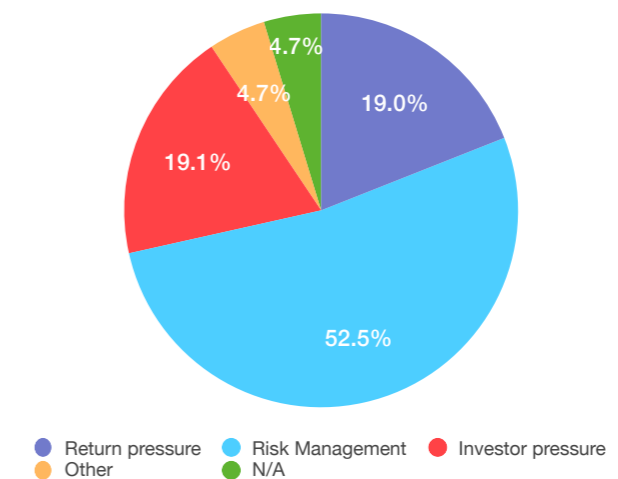
Are you a signatory to the UN PRI?



Explaining ESG Incorporation

According to the NCI membership survey, 52.5% of respondents said risk mitigation was the primary reason why they began to integrate ESG into their portfolio decision-making processes. Meanwhile, 19% respectively said that the return opportunities provided by ESG and investor pressure were the main contributors to their change in policy. Interestingly, not one single respondent cited regulation as a driving force behind their adoption of ESG.

What is the biggest driver behind your adoption of ESG in the portfolio decision-making process?



ESG as a Risk Management Tool

Some investors argue ESG is a useful tool to mitigate long-term risks. Stranded asset risk is one of those, whereby an asset is subject to a write-down or devaluation or simply becomes obsolete as a result of regulatory change or shifting consumer behaviour. Fossil fuels are a prime candidate for this as they could become redundant either through a transition in government energy policy or a tectonic transformation in demand as customers pivot towards renewable energy sources because of ethical concerns or perceived cost benefits.⁴

It is not just companies involved in fuel production which are at risk, but the organisations heavily dependent on pollutant energy sources as inputs of production.⁵ Entities including asset managers which own bonds or securities in such companies could see the value of their investments sharply decline or wiped out if organisations do not factor such threats into their future business strategies. This is leading to greater investor engagement at companies, whose operating models are perceived to be vulnerable to such disruption.

One asset manager interviewed says that while stranded asset risk could not be ignored, he believes most corporates are adapting to change. “Stranded asset risk is a 50-year problem as opposed to a five-year problem, although we understand why it is driving some long-term institutions to divest from certain industries. The companies we have spoken to about this issue are making enormous efforts to change their business models if necessary, so I do not have many concerns about stranded asset risk in our portfolios,” he says.

Give the Investors What They Want

ESG investing at asset managers has steadily evolved over the last decade. “Investors have always considered the G in ESG when evaluating companies. The last five to ten years has seen the E and S elements receive greater focus from institutional clients such as pension funds and endowments,” says one manager specialising in value investing. Others concur. “We are certainly fielding more questions focused on ESG in our RFPs from prospective clients, who are predominantly European-based,” explains one fund manager.

Owen Lysak, a partner at Clifford Chance, also acknowledges that most of the pressure on managers to deliver ESG solutions has come from the investors. “Investor demand for ESG is strong, mainly because they now have their own ESG requirements. A lot of the investors developing ESG portfolios are institutions based in Europe, and we are observing a growing number of allocators incorporate ESG questions into their due diligences,” he says.

4 London School of Economics (January 23, 2018) What are stranded assets?
5 London School of Economics (January 23, 2018) What are stranded assets?

Demand for ESG is not just a European-centric phenomenon. Stephen Ross, partner at Sidley Austin, says there has been a noticeable trend at sovereign wealth funds (SWFs) in resource rich markets in the Middle East attempting to diversify into new investment products, a number of whom are increasingly applying ESG into their portfolio selection.

High-net-worth investors and retail clients are also insisting managers take sustainability and ESG more seriously. A survey of 22,000 investors located in 30 countries by Schroders found 78% of respondents said sustainable investing is more important to them now than what it was five years prior.⁶ The majority of this demand is also coming from millennials. According to the findings, 52% of all millennial investors already invest sustainably.⁷

“My client base is predominantly charities and HNWIs. On the private client side, the next generation of investors – which are individuals in their late teens or 20s – are definitely very attuned to sustainable investing and ESG. Many of these investors impose ethical restrictions on their portfolios, and this is a trend, which is coming at the funds’ industry like a freight train, so managers need to be on their toes,” explains a wealth advisor. As client demand grows, managers will have little choice but to acquiesce on ESG.

More Understanding, More Flows

One of the biggest barriers to ESG integration has been the widely-held belief among allocators that it can result in financial returns being sacrificed or undermined, as it imposes restrictions on the ability of managers to freely invest capital without constraint. This perceived loss of financial returns historically made it very difficult for fund trustees to justify any ESG allocations as it risked putting them in breach of their fiduciary duties.⁸ Such views were common five to six years ago, but the debate has shifted markedly.

Rather than seeing ESG as an impediment to returns, there is a growing belief among many investors that ESG considerations may actually enhance performance, a hypothesis supported in a number of academic studies. Research conducted by Axioma in 2018 found companies with better ESG scores typically recorded stronger financial performance and beat their benchmarks.⁹ The research said a portfolio weighted for all top-scoring ESG companies in the US irrespective of size outperformed their benchmarks by 175bps, while corporates in emerging markets did so by 129 bps in the four years leading to March 2018.¹⁰

6 Schroders (September 28, 2017) Global Investor Study 2017: Sustainable investing on the rise.
7 FT Advisor (May 31, 2018) Millennials driving demand for ethical funds
8 State Street – The Investing Enlightenment
9 FT (August 12, 2018) Companies with strong ESG scores outperform, study finds
10 FT (August 12, 2018) Companies with strong ESG scores outperform, study finds

Despite the abundance of research indicating positive correlations between ESG and performance, some managers are exercising caution about reading too much into the results. “Studies have been circulating which suggest companies with ‘strong’ or ‘good’ ESG scores or credentials have better performance. The problem, however, is that the studies typically go back 10 to 20 years which is a period when certain sectors and types of companies have performed very strongly. It is difficult with insufficient data to isolate the impact of ESG and reach informed conclusions,” says one manager.

Is Regulation the Answer?

At present, there is no hard and fast regulatory requirement on financial institutions to define or apply ESG criteria. This will change in the next few years. Central Bank governors from the UK, France and the Netherlands have said regulatory oversight of banks may be necessitated to ensure they properly address climate-related risks in the financial system, something which may be a prelude to mandatory carbon foot-printing and stress-testing, disclosure of climate related risks and penalties for investing into high-emission assets.¹¹

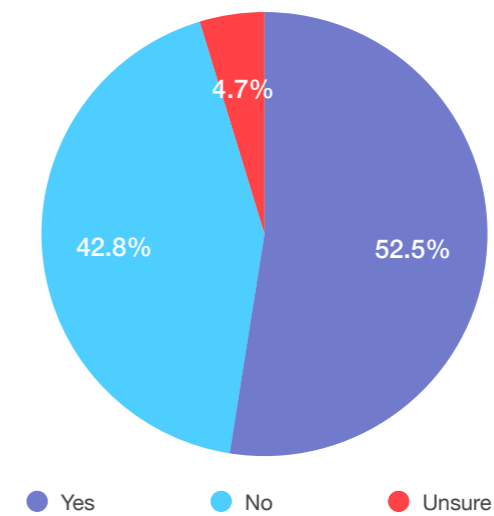
The Financial Stability Board (FSB) went further, launching a voluntary climate financial risk reporting template known as the Task Force on Climate Related Disclosures (TCFD), a document which is being increasingly adopted by market participants. While filing a TCFD is not a legally binding requirement, asset managers are fielding more requests from institutional investors to publish their climate-related financial risks. However, proposals being discussed at an EU-level are likely to further entrench ESG in asset management.

In 2018, the European Commission (EC) published its “Action Plan: Financing Sustainable Growth”, the contents of which included proposals recommending the establishment of an EU classification system for sustainable activities and mandating that sustainability considerations be factored into institutional investors and asset managers’ fiduciary duties. It also stated there needed to be improved disclosure of non-financial and climate related information by asset managers and investors.¹²

That ESG is now being discussed by regulators is welcome although there is understandable trepidation from a majority of the respondents to the NCI survey – which was conducted in November and December 2018 - about the prospect of having to comply with more rules at further cost.

¹¹ FT (April 9, 2018) Central bank chiefs sound warning on climate change
¹² Clifford Chance – EU Sustainable Finance Action Plan: What you need to know

Are you concerned about the EU's regulatory proposals on ESG?



Creating a definition of ESG

The EC’s proposal to define ESG is understandable and even laudable. A robust classification system would give investors more clarity about managers’ approaches to ESG during the selection process. This is a response to growing concerns that some asset managers purporting to be ESG are actually misleading clients about the extent and nature of their sustainable investments, a ruse commonly known as greenwashing.

By producing a taxonomy, the EC hopes to stamp out the practice. “Creating a taxonomy is a rational approach by the EC as it wants to establish some sort of ESG commonality. Benchmarking and measuring the ESG credentials at financial institutions can only be done by investors if there is a classification system in place,” says Lysak. Fortunately, it appears that European regulators are taking a pragmatic approach to the ESG debate.

In a December 2018 consultation, the European Securities and Markets Authority (ESMA) said it had a duty of care to avoid being inflexible or overly prescriptive, as it risked putting Europe at a competitive disadvantage. This statement by ESMA has been welcomed by NCI members, a number of whom had expressed serious reservations about regulators introducing binding or unbending requirements, which risked constraining or homogenising asset managers’ approaches to integrating ESG into their investment processes.

Integrating & Reporting Sustainability

Most controversial was the EC's proposal to embed sustainability into the fiduciary duties of asset managers and institutional investors.¹³ The EC wrote that "requirements to integrate ESG factors in investment-decision making processes, as part of their duties towards investors and beneficiaries will be further specified through delegated acts." This follows comments made by the EC, where it said asset managers and institutional investors did not systematically consider sustainability factors and risks during the investment process.

That statement by the EC subsequently earned it a rebuke from some industry bodies including the European Fund and Asset Management Association (EFAMA). ESMA has since clarified that integration of sustainability into the AIFMD and UCITS regulations be done through a high-level principles-based approach similar to how firms manage other risks such as interest rate risk or credit risk. In other words, firms need to scrutinise sustainability risks of their investments during their due diligence, a practice which a number of NCI members already adhere to.

Critically, ESMA has also acknowledged it will take a proportional approach on this matter although the proposal will require some firms to make changes to their organisational structures, systems and procedures, and ensure that sufficient resources are allotted to managing sustainability risks. Equally, sustainability risk provisions must be incorporated into the roles and responsibilities of senior management, a stipulation which may compel for internal adjustments to be made at some asset management companies.

ESG Reporting Faces an Uphill Battle

Enhancing transparency and reporting of sustainable investing is also contentious for some managers. While a number of large asset managers have consented to the move, smaller firms are alarmed at the idea of yet more reporting on top of existing regulations such as MiFID II, EMIR and AIFMD. "If the sustainability reports are concise and straightforward, then we will fully support it. If the reports are very detailed and complex, then that would be more difficult for boutique asset managers," says one boutique manager.

Given its recent pronouncements, it is unlikely ESMA will impose prescriptive ESG reporting, although a number of NCI members believe that further standardisation of ESG reporting is necessary. "A lot of asset managers already report to the UN PRI while French firms are subject to disclosure obligations concerning their carbon emissions. I think there needs to be more standardisation, so the EU needs to ensure its sustainable finance reporting provisions do not duplicate what is currently produced by fund managers." says a manager.

13 Clifford Chance – EU Sustainable Finance Action Plan: What you need to know

Should Industry or Regulators Drive ESG?

While NCI membership recognises the authorities should clamp down on asset managers distributing products under misleading ESG or sustainable banners when they are in fact nothing of the kind, it is crucial that regulation does not have any unintended consequences which could dis-incentivise asset managers from investing sustainably. NCI membership is unanimously opposed to ESG becoming an issue driven by regulators, instead preferring industry-led initiatives to support the development of sector standards.

Conclusion & Recommendations

- A number of boutique asset managers have mature ESG practices, with many viewing it as an effective way to check risks, enhance performance and meet evolving customer demands and expectations.
- The EU's reporting requirements need to ensure they do not contradict or duplicate existing obligations such as those outlined in the TCFD. This will do nothing but confuse clients. A better solution could be for the industry to self-regulate and adopt one of the most comprehensive standards like TCFD on a universal basis.
- ESMA has confirmed it will not adopt a prescriptive approach to ESG regulation which is a welcome announcement. By focusing on principles, this area can continue to evolve and managers and products can innovate. NCI believes the industry should lead the charge.
- ESMA must give further clarity, or examples, in terms of what it means by “changes proposed in this Consultation Paper should all be applied by authorised entities with the principle of proportionality in mind, by taking into account the size, nature, scale and complexity of their activities and relevant investment strategies pursued.”¹⁴
- Once the relevant Directives are in place, NCI encourages ESMA to publish a regular summary of what it considers to be best practice under the principles-based approach, to encourage greater harmonisation and higher standards across the industry.

¹⁴ ESMA (December 19, 2018) Consultation paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD

New City Initiative Members

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