DISAPPEARING DOLLARS

THE SIZE OF THE ESG MARKET IS MEANT TO BE $12TN TODAY — BUT IT DOESN'T FEEL LIKE IT. WE EXAMINE WHERE THESE ASSETS REALLY ARE AND WHY THE TOTAL SEEMS SHORT

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'If, by the end of 2017, already one in every four professionally managed dollars in the US was identified as sustainably, responsibly and/or impactfully invested, who has all those assets? Because we don't.'

This is a question that has, in some variety, been put to just about every champion of sustainable investing at internal meetings.

Other versions of this same question have included asking, based on the one-in-four number, why dedicated ESG shops are not bigger? Or why the adoption rate by financial advisors is still so low? In short, where is the money?

Let's start with that one-in-four number, or $12tn in ESG assets. It is from the bi-annual trends report prepared by the Forum for Sustainable and Responsible Investment (US SIF), which, in its 2018 issue, says that a quarter of professionally managed dollars would be identified as sustainably, responsibly and/or impactfully invested.

The total figure is very inclusive, pulling together managed assets incorporating ESG for retail and institutional investors, as well as money managers filing shareholder resolutions, and then correcting for overlapping assets.

The slope of the curve is dramatic, achieving the proverbial 'hockey stick' moment around 2012 when the totals leapt from less than $4tn to where we are now. The overwhelming majority of that growth resides in assets that incorporate ESG.

The Sustainable Funds US Landscape report, published in February by Morningstar's director of sustainability research, Jon Hale, looks at the mutual fund and ETF marketplace. It shows a four-times increase in flows toward what he defines as 'ESG consideration' funds (as opposed to sustainable funds) from 2018 to 2019, and a relative explosion in the number of such funds, from 81 to 564 in the span of a year.

WHAT'S IN A NUMBER?

Why, then, the pushback? Why is advisor uptake still a challenge, and where are the firms that measure ESG in billions and trillions? Are these assets and flows overcounted or underappreciated?

Anna Snider, Bank of America's head of CIO due diligence, is a vocal champion of ESG and a standard-bearer within her firm for a deeply disciplined and research-driven approach to vetting (and counting) ESG strategies.

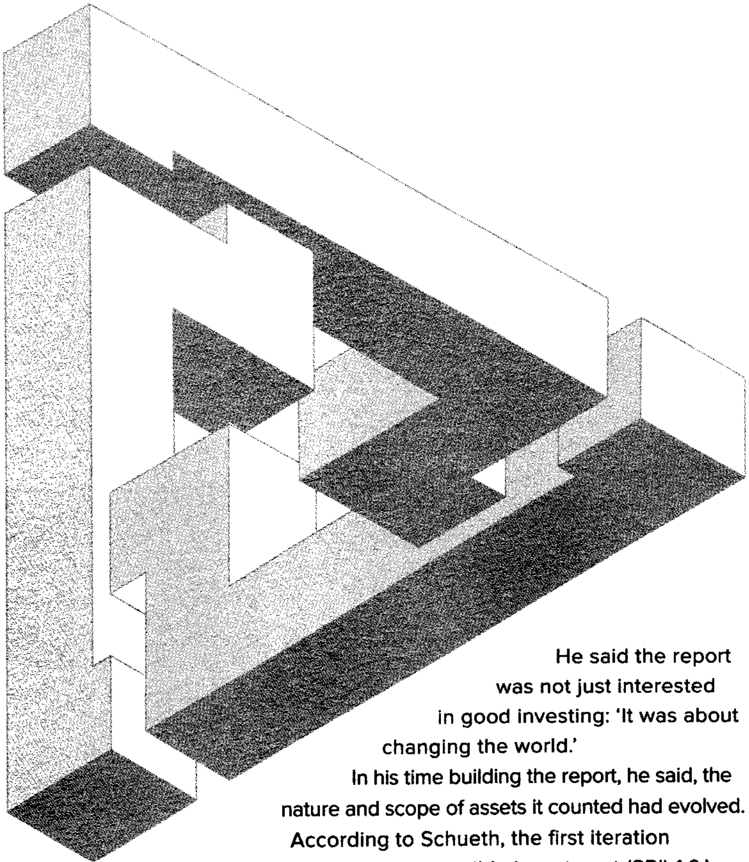
Her firm identifies roughly $25bn in ESG assets against a total asset base of around $3tn for the entire bank, which clearly tells a different story than one in four dollars for ESG.

Snider believes that sizing the market is about defining the market. What one person may call ESG another may not.

She highlighted the concept of ESG integration as being particularly problematic. Integration could mean that no investment decision is made by a manager without thorough and intentional consideration of material ESG factors, or it could mean that ESG data is included as part of a broad research framework but without any consistent expectation that that data will drive portfolio construction.

She said it was also difficult to measure intentionality to distinguish between ESG and other motivations for blocking certain securities, industries or sectors, such as conflicts of interest.

WHERE ARE THE FIRMS THAT MEASURE ESG IN BILLIONS AND TRILLIONS?



KEEPING COUNT

At the industry level, there are some serious challenges to tabulating ESG-aligned assets that have little to do with the degree of intentionality and are more structural to how we think about the financial supply chain.

A multi-fund model manager may report ESG assets based on what is invested in their models, while a wealth manager that utilizes those models may also report those assets, and then the constituent mutual funds and ETFs similarly report. So already the same dollars could be reported three times.

But it would not stop there. Those mutual funds are managed by asset management firms also reporting their ESG assets. It would be impossible to trace the provenance of every reported dollar committed to ESG to make sure it was only counted once, so simplifying assumptions have to be made to adjust for the risk of an overcount.

Steve Schueth, most recently founder of Thrize Partners, served for 11 years as the chair of the board of US SIF, and was instrumental in the launch of the aforementioned trends report.

Explaining how the report was constructed, he said: 'We debated and included screened assets as well as advocacy (related to the Interfaith Center on Corporate Responsibility, for instance) where they were actively working on global change or championing resolutions, but the assets would not have been screened.'

He said the report was not just interested in good investing: 'It was about changing the world.'

In his time building the report, he said, the nature and scope of assets it counted had evolved.

According to Schueth, the first iteration was 'socially responsible investment (SRI) 1.0,' which came, not from Wall Street, but from the grassroots. It was rooted in the belief 'that if we avoided bad companies, we were going to end up with better portfolios.'

After that came ESG, which he describes as 'SRI 2.0,' bringing market-based disciplines and frameworks such as the Sustainability Accounting Standards Board and stepping beyond the values-driven intentionality of 1.0 to include

ESG SELF-IDENTIFICATION BY MANAGERS IS A STRICT NO-NO

material investment rationale. This broader definition meant a bigger circle was drawn and more assets were counted.

He described the moment we are now in as SRI 3.0, which brings the intentionality of 1.0 together with the materiality and alpha discipline of 2.0, seen through the lens of the UN Sustainable Development Goals (SDG).

In order to get to a more substantive count of assets, Schueth suggested using SDG alignment as a new threshold for inclusion.

How to define and categorize ESG assets is not a new challenge for this market. It is one fund buyers and advisors face on a daily basis.

Brett Wayman, vice president of impact investing at Envestnet, explained his approach. Envestnet's 30-person research team starts by identifying strategies using data and research from the likes of Morningstar and Veris Wealth Partners. The team categorically does not accept mere self-identification by managers. Wayman called this 'a strict no-no.'

He added that the firm also eschews high scores from ESG ratings that look at portfolios but do not look at the underlying investment processes. 'We are moving away from coincidental scoring and toward intentional scoring,' he said, as means to distinguish between accidental and deliberate outcomes.

Wayman said that the firm tracked the growth of ESG assets by looking at 'same-store growth' and has found assets growing 'at astounding rates.' He pointed to the rising tide of product launches as evidence that there is substance to the magnitude and rate of change in ESG adoption.

DEFINING ERA

Wayman's point about the value of self-identification is critical and intersects with Hale's partitioning of 'ESG consideration' as distinct from truly sustainable funds. It may also explain the drama in the headline numbers. Without an industry or regulatory framework for defining what ESG is and is not, there is the risk of overreporting.

SIZING THE MARKET IS ABOUT DEFINING THE MARKET. WHAT ONE PERSON MAY CALL ESG, ANOTHER MAY NOT

Until quite recently, it was deemed unfashionable to be identified as an SRI investor. In the age of Greta Thunberg, the attitudes of asset owners have dramatically shifted, and the downside risk of being perceived as ESG-adjacent is minimal.

Across all of the perspectives from Snider, Schueth and Wayman, a recurring point emerges. In varying ways, they all agree that ESG has evolved to a point where it is time to refine definitions, set thresholds, and create new bins for classifying and counting strategies and assets.

Wayman described SDG versus ESG as being like squares versus rectangles – all squares (SDG) are rectangular (ESG) but not all rectangles are square.

In Schueth's framework, the boundaries may be set by how SRI 3.0 is ultimately defined. It is apparent that the industry is ready for wealth and asset managers, academics, NGOs, trade organizations and regulators to acknowledge the dramatic increase in adoption and sharpen the pencil to better characterize what has become a massive and growing part of the investment market. ◇