Sustainability

Redefining ESG & What this Means for Asset Management

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Sustainability – Redefining ESG & What this Means for Asset Management

The continued popularity of passive investment funds along with rising fees and lack-lustre performance continues to pressureise active asset fund management. However, there is a new challenge emerging which, while creating further issues to resolve, also offers a potential reversal of fortunes. Clients are increasingly demanding sustainable investment products – what’s known as responsible investing (RI) and/or incorporating environmental, social, and governance (ESG) factors into the investment process.

This paper looks at potential impact to the asset management industry when RI and ESG move from a stand-alone niche product to part and parcel of the mainstream investment process. There will be significant changes in research procurement and data consumption; liquidity formation will be impacted as sectors fall out of favour, necessitating shifts in trading strategies; as well as the need for increased governance in ensuring greeningwash is avoided and products are not inadvertently incorrectly sold as regulatory scrutiny increases. Managing this level of change across an organisation will be the catalyst to automate the investment process.

Incorporating additional considerations into the investment process at a time when the industry is under pressure may appear counter-intuitive, potentially increasing implementation costs and hurting performance. While the shift to more responsible investing is due to growing recognition of the need to invest in sustainable business models spear-headed by the move towards a future carbon neutral global economy, there is also a growing economic argument. According to a recent study by Nordea, companies with the highest ESG ratings outperformed the lowest-rated firms by as much as 40%. The ability to holistically understand a company’s future sustainability in a global 24/7 economy can have a substantial impact on future fund performance. Knowing when an investment decision is no longer optimal and being able to act on that information will be the differentiator between good and poor active managers at a critical time given the switch to index funds continues unabated.

While asset management firms are focused on meeting client demand to win mandates, there are a number of issues which will be exacerbated as the shift in investment process matures, leading to long term structural changes to the capital market eco-structure. Asset managers will be required not only to be far more engaged in the companies they invest in but also to be able to qualify and quantify their investment decisions to a greater extent than they do today. Questions that were inconceivable just a few years ago are now being asked, such as the sustainability of a business model in a carbon neutral world, or what impact the return on recyclable waste from emerging markets will have on future distribution models in the developed world. This also increasingly needs to be quantitatively demonstrated as part of the investment process in order to not only win mandates but keep them.

In addition, the industry is operating in an unknown regulatory future. Only a few countries are likely to be able to meet globally agreed carbon reductions, leaving investors and companies wary of exactly when draconian policy measures will become inevitable. ESA's 2019 report identifies areas of potential future financial instability; persistently low interest rates and flattening yield curves are putting pressure on asset managers, incentivising search-for-yield strategies and increased valuation risks. This situation will be exacerbated as the global economy transitions creating challenges for current business models and asset managers with high exposures to climate sensitive sectors. From the banks who currently lend $654bn to fossil fuel companies as well as the asset managers who invest in them, the shift to responsible investing will have far-reaching consequences and impacting all sectors. India plans to ban single use plastic across the country on October 2, 2019, with the goal of eliminating all such items by 2022, forcing firms such as Amazon to eliminate plastic in its packaging by June 2020. Global policy measures such as these will impact every sector from waste disposal to healthcare to food systems; transportation to infrastructure; data management to cyber security and anti-money laundering, forcing companies and those asset managers who invest in them to address current behaviours.

3. https://www.ft.com/content/5f1d9fd8-d96e-11e9-9c26-419d783e10e8
4. TheHead of ESG, US Asset Manager

"There is nowhere for a fund of our size to hide from climate change risks. As owners of companies, we need to pick up the responsibility of addressing these issues.”

Large US Asset Manager – Climate Action 100+ an initiative followed by more than 360 investors covering $34 trillion in AUM.

"Investment in sustainable/impact ESG has not been as focused on performance as it has been on environmental/social outcomes etc You need to look at the sustainability of the investment or it is not going to perform. And if it doesn’t perform, investors will most likely move their money. Investment under the traditional definition means you are expecting some sort of return and if you aren’t getting this then it is a donation.”

Head of ESG, US Asset Manager
Similar to the changes witnessed with unbundling, traditional buy & sell-side relationships will be impacted, creating the need for new products & services. Currently the investment process is often very manual and fragmented, prone to error and subject to change. Aggregating multiple cleaned data sources to build a more holistic overview, weighted according to SASB materiality factors per sector requires identifying which new data sources are accurate, as well as automating this information into the investment process real-time. Active investment may traditionally be over a multiple year time horizon but ensuring investments maintain their responsible investing accreditation in a 24/7 digital age requires automation of the evaluation and validation process. This not only impacts the volume and frequency of data consumption by portfolio managers, but also necessitates broader data consumption across the firm, from ESG analysts to corporate governance and risk management teams.

The switch in supply and demand of investable assets will not only alter the research and investment process but will have significant implications for how investment decisions are executed, as well as the services required for doing so. Pension funds looking for dividend yield amongst a concentrated pool of equities may switch to a greater propensity to buy and hold, more in line with traditional bond investment strategies potentially creating new liquidity challenges for equity trading. Ensuring adequate liquidity of holdings will be critical both from a performance as well as a regulatory perspective. The increased risk of stranded assets will mean that holding inventory in a stock deemed non-sustainable in the long-term will only increase the cost of capital as the risk profile deteriorates. Establishing which companies will become illiquid in the future and therefore harder to trade will require a different approach to both the data providers necessary to source relevant information, as well as the enhanced analytics now required to sift through the increasing noise.

The speed and depth of adoption of ESG and responsible investing will differ from firm to firm and region to region, but the long-term trajectory is now clear. From staffing, to accessing research and changing liquidity patterns, the challenges sustainable investing raises go far beyond the need to win mandates but also arguably offer the greatest opportunity for future active asset managers to automate the investment process as well as the brokers, data and technology providers who service them. To debate these issues, we spoke with 32 individuals comprised of Heads of ESG, RI, Stewardship and CIOs at firms representing 8.2 trillion US dollars assets under management as well as ESG data providers to understand how challenges are being addressed and where the greatest opportunities are unfolding as the sustainability revolution slowly redefines the active asset management industry.

Key Findings:

1. **Increasing client demand for ESG and responsible investing products**
   a. 48% of responding firms state that meeting client demand is the main driver for ESG and RI.
   b. 70% of responding firms see the greatest demand for ESG coming from Europe; 26% believe demand is now global.

2. **Integration with ESG and RI principals across firms and product offerings**
   a. Rather than stand-alone teams and products, 70% of responding firms have a commitment to incorporate ESG and RI across all investment products; a further 17% plan to do so within the next few years.
   b. 62% of responding firms see the incorporation of ESG and RI data as increasingly important to their overall investment process.
   c. For 48% of responding firms, ESG and RI strategies no longer represent a negative screening of “sin stocks” but rather a focus on increasing investment in alternative sectors; 57% are investing in green energy and renewables and 33% in technology companies looking to mitigate climate change.
   d. 77% of responding firms now have a formal policy in place for ESG and RI.
3. Increasing challenges with ESG implementation
   a. 61% of responding firms believe that industry-wide norms, frameworks and standards would be useful for the industry; 61% indicate that codified rules on ESG disclosures would be most beneficial.
   b. 57% of responding firms manage the risk of “greenwashing” internally, in part due to their perceived lack of sufficient external data providers.
   c. 50% of responding firms engage specialist data providers for ESG; increased demand is resulting in new challengers to the historic leader in the space.
   d. 77% of respondents cite a lack of internal education as the main barrier to broader ESG adoption and integration; to overcome this, 100% have implemented organisational training for internal sales and investment teams.

What is ESG?

Stand-alone ethical investment products have been in existence since the Renaissance (see Exhibit 1), however the emergence of new styles of RI to meet rising client demand – in particular, ESG – is moving from the exclusion of “sin stocks” to a broader investment strategy based on the future profitability and sustainability of company business models based on ethical, social and governance factors. Investment decisions are not only being impacted by shrinking global resources, a growing and ageing population and rising inequality, but an increased investor purchasing power, greater access to information and growing recognition that well-governed companies perform better over the longer term. This shift in investor attitude will not only impact company behaviour, but also the asset management industry and the brokers and vendors who service them, redefining capital markets in the process.

Exhibit 1: The evolution of ESG and responsible investing

<table>
<thead>
<tr>
<th>1500s</th>
<th>1950s</th>
<th>1960s - 1970s</th>
<th>1980s</th>
<th>1990s</th>
<th>2003</th>
<th>Present</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment decisions were motivated by religious inclinations.</td>
<td>During the Cold War, the arms race forced investors to reflect on their ideologies in relation to their investments.</td>
<td>With an increased awareness on AIDS and HIV, investors became increasingly concerned in factoring health into their investment decision.</td>
<td>Governance factors became increasingly popular.</td>
<td>UN releases Principles for Responsible Investing (PRI).</td>
<td>“Responsible investors” universally defined concept of investors who incorporate ESG factors into their investment process.</td>
<td></td>
</tr>
<tr>
<td>This era was defined by negative screening, or deliberately choosing not to invest in companies or industries that did not align with investor values.</td>
<td>Investing in companies operating in South Africa became ethically unacceptable due to Apartheid.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

“Access to information is ubiquitous and people are way more engaged and knowledgeable about things that they never would have known about 20 years ago. The impacts of climate change and inequality, the ability to track things, the ability to know who drives positive change or is responsible for negative change. All of that information is available. What we are seeing is that consumers, employees, in many cases shareholders, are all saying: ‘Hey, if you are not paying attention to these issues – there will be consequences’. Employees are leaving companies that do not mirror their values; consumers shun firms that they believe are bad actors; and shareholders or investors are saying ‘If you are not paying attention to this, I am not going to trust you with my money’.”

Head of Sustainability, Global Asset Manager

Source: Liquidnet Market Structure Outreach June – September 2019
Responsible investing represents an integrated investment approach that offers the potential for active fund managers not only to outperform their passive benchmarks, but also deliver meaningful value for clients which more than justifies the fees charged for their services. Sustainable responsible investing is about a more robust understanding of materiality – the factors that affect the long-term performance and value creation of an asset by offering more specific due diligence, varying by industry, based on factors that are material to the long-term financial performance of firms in each sector, creating a more holistic overview by incorporating both ways to reduce/mitigate risk as well as opportunity to increase returns. This can be incorporated in a number of ways:

- **“Negative screening”**: not investing in certain companies, industries, or geographies with especially weak ESG performance
- **“Positive screening”**: investing in companies with especially strong ESG performance
- **“Active Engagement”**: working with either ESG underperformers to make them better or ESG performers to ensure they stay that way (through private outreach with company management, public pressure on company management, and voting on proxy resolutions)

Exhibit 2

“...not just looking at how these companies operate today, but how they are preparing/transitioning themselves for challenges that could affect them, their marketplace, customer base as well as their employee base in the future. There are lots of material ESG factors that investors try to identify as long-term factors such as climate risk. From a food company to a food manufacturer compared to an automaker or a bank – each of these will have certain relevant drivers which will not only affect their growth of balance sheet strength, market share and capital allocation decisions, but also in terms of sustainability – how they will be in business for the next hundred years.”

**Head of ESG Investment, Global Asset Manager**
ESG: Today’s definitions
One of the industries greatest challenges is the conflict in interpretation between the different definitions of socially responsible investing, responsible investing, impact investing and now ESG (see Exhibit 2). Much of the terminology is often misinterpreted and used interchangeably by portfolio managers and end investors alike. The lack of standardization of definitions means the interpretation of what individual investment strategies actually represent can diverge greatly, making it a) more difficult to track performance; b) demonstrate compliance; and c) more likely for further regulation to stipulate what constitutes an ESG, RI, SRI or II fund.

While responsible investing has always formed part of good active management, as investing moves from individual stand-alone ethical products to an official firm-wide policy across all investment products, there is a growing blended approach to how the different approaches are being incorporated into investment decisions, depending on the underlying fund strategy or portfolio manager. While there is a legitimate argument that there can be no one-size fits all ESG or RI strategy, greater mainstream adoption potentially risks watering down truly responsible investing with strict adherence to ESG factors, as managers seek to meet performance as well as ethical demands. Just 17% of respondents in our market structure outreach manage 100% of their active assets according to ESG principles; the majority have ESG integration to a certain extent, weighted according to the underlying investment strategy; for the remainder, ESG incorporation is still strategy-dependent or treated as a specific stand-alone product (see Exhibit 3). For many organisations, the investment strategy is based on a broader, more pragmatic approach towards sustainability, responsible investing or improved stewardship based on the subjectivity of the manager or strategy, rather than a specific ESG or ethical focus (see Exhibit 4).

Exhibits 3 and 4: What proportion of your funds are solely ESG, partially ESG, or have an ESG overlay? / What do the terms ESG & RI mean to your organization?

![Diagram showing distribution of ESG strategies](source: Liquidnet Market Structure Outreach June – September 2019)

“We are pretty careful not to apply a ‘one-size, it is all ESG’ overlay. Instead it is the responsibility of every investment professional to determine what is material and relevant in their place and then apply them appropriately.”

Head of ESG/Responsible Investing, Global Asset Manager based in EU

“Our approach is RI – to get as much info as we can on a company to understand their ESG profile to help us understand their risk exposure. If we understand company risk, we can price it in, the timeframe in which it may materialise, or the extent that a company is able to manage that risk. We are still happy to have exposure to energy names but use ESG information to tilt portfolios to those companies who are more sustainable.”

Senior Analyst ESG, Global Asset Manager based in UK

“This isn’t about ESG – it is about active managers finding the next strategy. ESG is applying a positive or negative screening on certain companies to better understand the risks involved.”

ESG Data & Analytics Provider

“ESG integration is becoming the risk assessment of all funds – not just environmental social governance factors but being able to better understand holistically what our investments are exposed to. On the product side it is everything from ethical funds which are quite focused on exclusions to Sharia, sustainable and impact strategies which are more inclusive value-based propositions.”

Head of Sustainability, Global Asset Manager based in UK

“Investing in a company because it is promoting re-forestation should not erase the fact that it has a bad financial performance. An ESG fund is not looking to be greener but for performance through an eclectic range of criteria that include respect of humanity, environment and gender equality.”

Managing Partner, Global Asset Manager
These challenges are emphasised by the fact that for over a quarter of respondents implementation of policies remains a work in progress and a further 18% have no policy in place yet at all (see Exhibit 5).

Any investment approach may also need to vary according to multiple strategies if firms are operating ESG, socially responsible investing (SRI) and II funds, as the investment constraints will be different. There may be strict exclusions for ESG funds – such as controversial weapons, tobacco and coal; a “best in class” approach for those under SRI; whereas for impact investing there is a requirement for a social or environmental impact alongside the financial return. In addition, there may be specific regulatory requirements to negatively screen out certain sectors, for example the Luxembourg law forbidding the financing of cluster munitions.

Having a better understanding of the risks on a company’s future business model together with a more flexible approach to sustainable investing, enables asset managers to expand their investment criteria to include companies who may fail an ESG score today but are transitioning to address negative factors where greater stewardship may be deemed more appropriate rather than automatically screening out “sin stocks”, but this is often strategy or fund dependent (see Exhibit 6). For example, Norway’s $1 trillion sovereign wealth fund has chosen to de-invest in coal and energy companies that are not investing in renewable energy; whereas the Japanese Government Pension Investment Fund valued at $1.36 trillion believes fund managers should engage with companies and longer-term infrastructure projects to address climate change and change company behaviour through enhanced stewardship.

Exhibits 5 and 6: To what extent are your activities in line with your policy on ESG? / Is your investment strategy screening out/becoming underweight any sectors based on your ESG/RI strategies?

![Diagram](source: Liquidnet Market Structure Outreach June – September 2019)

“Head of ESG & Responsible Investing, Global Asset Manager based in EU”

“We have a dual policy. We have a full ESG implementation in 90% in our asset management, but we also have a sustainable or socially responsible range of funds, which currently is only 5% of our asset management. We have a strong exclusion policy across the mainstream portfolio or funds for tobacco and coal.”

“CIO, Global Asset Manager based in UK”

“We are more on the side of going long on those companies we feel would be good instead of those who are going short on companies we think would be negatively impacted. Most of our strategies are more ESG integrated where we are driven by a particularly alpha opportunity because of the style or opinion of a particular portfolio manager operating ESG into their process. But having said that we do have pretty strict boundaries, we specifically exclude certain stocks (coal, fossil fuels, tobacco stocks) but there are also strict guidelines on what the PMs need to meet in terms of performance.”

Source: Liquidnet Market Structure Outreach June – September 2019

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2. [Link](https://www.ipe.com/reports/special-reports/esg/investor-profile-japan-government-pension-investment-fund/10027999.article)
4. [Link](https://stopexplosiveinvestments.org/disinvestment/countries-best-practises/)
Regardless of the current level of ESG integration, increasingly respondents are looking at investment alternatives: for example, companies focused on renewable energy and looking to improve how existing energy is used, such as software for industrial trains to help to reduce the downtime of machines or green automation – and technology companies that offer alternative solutions to help mitigate climate change. Another area of focus is the healthcare sector – companies investing in solutions for current diseases such as diabetes or cancer, or new technology such as gene therapy, as well as healthy nutrition as consumers alter eating patterns (see Exhibit 7). Future investment strategies not only have a moral perspective but also an economic rationale for sustainable business growth in the long-term.

The impact of consumer change on certain sectors such as energy, utilities, construction, transport and weapons can appear more immediately obvious and these sectors are already witnessing a decline in investor appetite as witnessed in the decline in energy stocks. However, equally valid is being able to recognise when a company culture has addressed the relevant concerns, otherwise the opportunity for alpha is missed. Hence respondents are moving towards a better understanding of future rather than retrospective core risks to a particular instrument or portfolio to uncover opportunities. To achieve this, firms need to invest in greater use of technology, data and analytics to understand multiple factors in relation to company strategy now as well as future plans to effectively monitor portfolios. They must also assess the likelihood of success in the changing economic environment, as the range of factors switches from financial analysis on profit and loss and quarterly earnings statements to more fluid behavioural datasets in line with ESG methodologies.

From this outreach, it appears that larger asset managers are often adopting a dual policy strategy where they will have specific products based on ESG, RI and impact investing beneath a broader sustainable investing strategy to manage the balance of client requirements. Others have chosen to implement a more amalgamated firm-wide approach covering all investment strategies but nuanced differently according to sector and geography which is then assessed and used to verify or reject a PM’s original conviction.

Exhibit 7: Are you increasing investment in certain sectors based on your ESG/RI strategies?

<table>
<thead>
<tr>
<th>Sector</th>
<th>Respondents Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy/Fund dependent</td>
<td>67%</td>
</tr>
<tr>
<td>Green/Renewable energy</td>
<td>57%</td>
</tr>
<tr>
<td>Technology firms that help mitigate climate change</td>
<td>33%</td>
</tr>
<tr>
<td>Social justice</td>
<td>24%</td>
</tr>
<tr>
<td>Healthcare sector</td>
<td>14%</td>
</tr>
<tr>
<td>Vegan/Plant based diets</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: Liquidnet Market Structure Outreach June – September 2019

“We might avoid certain companies but because we don’t believe the risk profile matches the financial return – we aren’t making a moral argument but more of a pragmatic approach – e.g. tobacco, there is lots of regulation and consumers are moving to electronic smoking – that applies to everything, not just ESG.”

Senior Analyst, Global Asset Manager

“We would not short sin stocks because we are not playing in the good/bad ESG investor space. Strategies are different. It is more thinking about the future. Companies that are perceived as negative from an ESG perspective may struggle in the future and what would be the implications on the stock price if that was the case. But if management can get on top of it – if it was rated negatively by an ESG rating provider but we could say that actually this is a good investment opportunity, the turnaround is a good place to be.”

Head of ESG & Sustainable Investing, Global Asset Manager based in UK
Rising Investor Demand

With nearly three quarters of respondents to our market outreach having implemented a formal policy on ESG and RI, the predominant reason for doing so is to meet rapidly growing client demand (see Exhibit 8). While there have been a number of high-profile studies in relation to returns from ESG mandated funds being poor⁹, as the industry is slowly shifting focus to a broader mandate of RI around companies with future sustainable business models – the economic argument is gaining ground – any investment still needs to offer the potential of a return – otherwise it is nothing more than a donation.

While historically the demand for ESG centred on Europe, specifically the Nordics, the Netherlands and France, a quarter of respondents are now seeing global demand for ESG and RI (see Exhibit 9); and although the US remains a laggard in comparison, there still has been a 220% rise since 2012 in US assets under management that have adopted sustainable investing criteria¹⁰.

Exhibits 8 and 9: What is your main reason for investing in ESG? / What region has the highest demand for ESG?

Source: Liquidnet Market Structure Outreach June – September 2019

“Managers will not win mandates if they do not integrate ESG into their investment processes.”

CEO, Global Asset Manager

“The greatest client demand for ESG products is probably from the Nordics and the continentals. The French are very focused on climate change, whereas the Nordics and Scandinics are much more focused on the UN SDGs (sustainable development goals) etc.”

Head of Global ESG Investment Research, Global Asset Manager

“Five years ago it was a really big focus for the Nordic institutions, and they will not invest unless there is ESG. But now we have seen its development in Europe in general, in the UK – even in the US some of the big endowment funds are listening to this millennial drive. For us it is client driven but behind this is pressure from trustees and university endowments driving long-term change.”

CIO, Global Asset Manager based in UK

⁹ https://www.wsj.com/articles/calpers-dilemma-save-the-world-or-make-money-115606684601
¹⁰ https://www.morganstanley.com/ideas/sustainable-investing-asset-managers
This increase interest is set to continue. Seventy-seven percent of global asset managers who participated in this outreach have formal policies in place in relation to ESG, RI and II (see Exhibit 10). For certain respondents these policies are set to underpin every single investment product they offer; 70% of respondents have stated their commitment to ESG and sustainable investing publicly on company websites and in mission statements, incorporating this investment process across all products; with a further 17% looking to implement this change within the next few years (see Exhibit 11). The share of global assets operating on ESG principles is set to more than double from about 25% today to between 50-65% in the next five years\(^{11}\) as asset managers such as Amundi switch to running all €1.5 trillion in assets along sustainable investment principles by the end of 2021, up from €280 billion currently\(^{12}\).

“Europe is a bit of a honeypot market. There is interest in ESG/RI but it makes it very competitive to sell products as it is considered a mandatory requirement. There are parts of America where there will be no interest (Trump not believing in climate change etc.), but then there are parts where there is huge demand; it can be as high as other parts of the world where a lot is known about ESG.”

Head of ESG, Global Asset Manager based in the UK

Exhibits 10 and 11: Do you have a formal policy on ESG and RI?/ Commitment to ESG according to participants’ website

![Pie chart]  

**Source:** Liquidnet Market Structure Outreach June – September 2019

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\(^{11}\) https://www.ft.com/content/195232e7-07b7-36e3-a768-b8c63b6cc3fc

\(^{12}\) https://www.amundi.com/int/ESG/ESG-Amundi-s-3-year-action-plan
The Impact on Trading

While it is not unusual for stocks to be negatively impacted on bad news, poor economics or rule-breaking, what is becoming significant is the far broader range of issues that can have an impact over the performance of an instrument over a longer period of time, alongside keeping track of this information in a 24/7 digital age – and ahead of your peers. It is no longer enough to focus on earnings calls; screening across a wide variety of new metrics needs to take place frequently and in a timely manner for it to be of value and maximise the alpha opportunity. As stranded assets become an increasing concern, the ability and the timing of entering and exiting an investment strategy will become critical. This is leading some respondents to develop machine learning and natural language capabilities to screen news and trading signals to detect any need to respond to new information as it becomes available to either mitigate losses or take advantage of new opportunities.

Exhibit 12: Make-up of S&P500 2008–2019

Source: Bloomberg

Sectors which were once deemed liquid and easy to trade are becoming less liquid as stocks fall out of favour with investors. Energy stocks once made up 13% of the S&P500; they now represent just 4%, a decline of 63% in little more than a decade (Exhibit 12); and current trading strategies need to adjust and evolve as a result. Staying wedged to poor performers in order to track an index as companies adjust to energy transition risk is becoming a higher risk strategy; the Bank of England and the Intergovernmental Panel on Climate Change (IPCC) now estimate stranded assets will represent $20 trillion globally by 2050\(^1\). Conducting due diligence across a broader range of metrics will be essential not only to avoid adverse performance but also to ensure liquidity concerns are addressed as indices adjust to wider economic and societal changes. The impact on fund performance for those managers not able to react in a timely manner can be significant:

**General Electric (GE)**

GE appeared to misjudge the pace of the global energy transition and the potential of renewables to derail its business model, leading to a $23 billion write-down in 2018\(^4\) for the goodwill balance of the Alstom acquisition made just three years earlier. The lack of corporate governance and collapse of the gas turbine and thermal power construction market led to the company’s market cap declining by 74%, wiping $193 billion\(^1\) off shareholder value in just three years. The write-down of more than the original purchase price was considered highly unusual, as was the firm’s use of certain accounting practices, leading to an investigation by the US Securities and Exchange Commission (SEC) and the US Justice Department\(^6\). A recent investigation conducted by private financial investigator Harry Markopolos and published 15 August 2019 claimed that GE concealed $38.1 billion in potential losses and the company’s cash situation was worse than previously disclosed\(^7\). As a result of allegations of poor governance, GE’s stock price fell 11% on the same day registering the worst one-day loss in 11 years\(^8\) (See Exhibit 13).


\(^{17}\) https://www.bbc.co.uk/news/business-49352765

\(^{18}\) https://www.bbc.co.uk/news/business-49352765
Hikvision
The Chinese surveillance company attracted substantial flows from foreign asset managers and was the fourth-largest company in MSCI’s China A International Index in May 2018\(^\text{19}\). After an international outcry over Hikvision’s role in the mass surveillance of Uighur people, a Muslim ethnic minority group, many US fund houses began divesting\(^\text{20}\), and the stock price fell 49.92% between 12th March and 19th of October 2018 (see Exhibit 14).

The impact of MSCI increasing the weighting of Chinese Domestic A-shares from 0.71% to 3.3% of its emerging markets index by November this year\(^\text{21}\) will be particularly significant as the role of corporate governance in China comes into the spotlight. The MSCI Emerging Markets Index is tracked by $1.9 trillion of global funds which may no longer be able to justify investing in companies which do not meet human and employee rights standards\(^\text{22}\).

Pacific Gas and Electric (PG&E)
PG&E appeared to underestimate the high risks associated with aging high-voltage power lines. The company was aware that parts of its transmission system needed to be replaced as it could fail and spark fires yet failed to address the issue. On 8th November 2018, the failure of a century-old transmission line sparked a fire in California, in which 85 people were killed and thousands of people were made homeless\(^\text{23}\). Under pressure from $25 billion in claims related to the wild fires, PG&E filed for bankruptcy in January 2019\(^\text{24}\). As a result of the wildfires, between 8th and 15th November 2018 PG&E’s stock price fell by 64.76% (see Exhibit 15).

\(^{19}\) https://www.ft.com/content/10001b4c-82e8-11e9-b592-56e433b57a3b

\(^{20}\) https://www.ft.com/content/10001b4c-82e8-11e9-b592-56e433b57a3b?emailId=5cf118966748060004695d32

\(^{21}\) https://www.ft.com/content/10001b4c-82e8-11e9-b592-56e433b57a3b?emailId=5cf118966748060004695d32

\(^{22}\) https://www.thepfs.org/learning/learning-content-hub/articles/technical-news-update-26302019/74842

\(^{23}\) https://www.wsj.com/articles/pg-e-knew-for-years-its-lines-could-spark-wildfires-and-didnt-fix-them-11562768885

\(^{24}\) https://www.ft.com/content/9096b738-b769-11e9-8a88-a6628ac896c
Tesla

Tesla has revolutionised the electric automobile industry by introducing a luxury electric car to overcome the world’s dependence on fossil fuels and achieve a zero-emission future; however the company continues to suffer from a range of issues including production capacities, accusations of criminal activities and poor governance. On 6th July 2017, Tesla’s stock crashed on disappointing news about missed deliveries, costing the company more than $12 billion or about 5.6% of its value. In January 2018, Tesla was again unable to meet its production goals and only produced 2,425 Model 3 Sedans over the last quarter of 2017. The company reported a further loss of $408 million for the second quarter of 2019, resulting in the share price dropping by another 15.26%. But missed sales targets are not the only concerns; recent governance issues have left the market questioning the viability of the firm’s business model. In May 2018, the Tesla stock price slumped after CEO Elon Musk cut off a conference call with analysts asking about company finances, criticizing their “boring, bonehead” questions. Tesla lost $2 billion in stock market value as a result. In August the CEO tweeted about taking company private. The move sent Tesla stock soaring more than 10% before trading was halted. Musk later backed off the plans to go private. In the same month, Tesla security employee Karl Hansen filed a whistleblower complaint with the SEC alleging that Tesla suppressed an internal investigation into various criminal activities at its Nevada Gigafactory. All those concerns have had a serious impact on the stock price, sharply increasing volatility in the name. (see Exhibit 16).

Exhibit 15: PG&E share performance

Source: Bloomberg

Exhibit 16: Tesla share performance

Source: Bloomberg

**Volkswagen (VW)**

In September 2015, the US Environmental Protection Agency discovered that 482,000 VW diesel cars on American roads were emitting up to forty times more toxic fumes than permitted, negatively impacting the environment between 250,000 to one million extra tonnes every year. VW issued a recall for its 482,000 cars in the US and halted sales of its affected Audi A3, and VW Jetta, Beetle, Golf and Passat diesel models. During the subsequent, “Dieselgate”, VW admitted the issue affected 11 million cars worldwide. The subsequent investigations almost halved VW’s share price, costing the organisation roughly €28 billion (see Exhibit 17).

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**Exhibit 17: Volkswagen share performance**

![Graph showing Volkswagen share performance](Source: Bloomberg)

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**Sources:**


Automating the Investment Process

The rise in ESG and SI investment will dramatically increase the demand for more and more alternative datasets, necessitating increased use of technology and analytics to ensure accurate and smarter aggregation. The current investment process is often manual and prone to error, rising regulatory and end investor focus will require not only the ability to demonstrate “best execution” – but also “better investment” leading to the digitalisation of the investment process itself.

There is growing recognition of the importance of understanding the economic impact of a company’s future state in a carbon-neutral world to fully grasp the investment opportunity. The depletion of natural resources will impact global demographics as the population grows, ages and becomes more mobile – often as a result of climate change but also due to increased digitalisation which challenges traditional models of consumption, distribution and governance. All the factors are intertwined, requiring investment strategies to absorb a broader set of metrics from the carbon footprint of an organisation, executive pay, diversity and corporate governance, to child labour statistics, supply chains and waste disposal, to provide a sufficiently detailed holistic overview of an investment decision.

Not only does this increase the number of data points and analysis required, but given the variety of criteria now needed be taken into consideration ahead of an investment decision, respondents are having to look further afield than traditional methods of research providers and company engagement; specific ESG data is now viewed as of greater value by 62% of respondents (see Exhibit 18).

Exhibits 18 and 19: What weight do you attribute to ESG data scores vs. traditional scoring of companies (company visits/shareholder meetings)? / Do you incorporate alternative data sources to understand a company’s ESG risk and opportunities outside of voluntary disclosure?

“Traditional research providers are backward looking. If you had a change of management in the company and that change either brings you a lot of confidence or makes you unsure about the future, it doesn’t matter about what data is in the past. It is understanding that the world is changing, and that the risks associated with our investments have changed.”

Head of ESG, Global Asset Manager based in UK

“Increasingly, the sell-side is also producing more and more on this. Some brokers specialise in being more thematic like Barclays – trying to work out who is exposed to the different factors. HSBC has a very strong climate focus, you have Kepler Cheuvreux & Soc Gen who are taking European both thematic and stock specific data. UBS has incorporated the ESG elements into its mainstream stock notes. They are all pushing it at the moment.”

Head of ESG, Global Asset Manager based in UK

“We use the third-party ratings as a starting point but these are often not 100% covered in which case an internal review from our ESG research team will form a proprietary analysis and rating.”

Vice President ESG Analyst, Global Asset Manager

Source: Liquidnet Market Structure Outreach June – September 2019
While the bulge brackets are rapidly adjusting research offerings to meet the new demand, the majority all respondents are now using specialist data providers alongside public sources of data as well as traditional sources of research (see Exhibit 19). While engaging directly with a company is still seen as critical to the investment process, providing unique knowledge from day to day operations about current core risks, the ability to map this information to data drawn from a range of different sources enables analysts to filter out what factors require further interrogation to fully understand an individual company’s risk or opportunity. As a result respondents are increasingly relying on constructing a jigsaw of different data sources with which to build a holistic understanding of the investment decision – including alternative sources such as NGOs, academics and charity action groups and foreign news websites as well as social media.

One of the main concerns with current ESG data providers we spoke to is that ratings are often backward-looking and out of date. While backward looking data can be helpful in identifying controversies and core risks, this doesn’t allow for predictive analysis to incorporate management changes made to address risks or to show whether the risks associated with the investment themselves have changed. Examples given included BAE Systems which continues to be rated negatively on ESG scores for bribery and corruption issues despite addressing this in 2012; and Volkswagen which is still negatively impacted by Dieselgate and governance issues, yet the company is now committing €80 billion to the development of electric vehicles. The need to use a wider variety of sources of information to build up a more holistic view is particularly relevant for ESG strategies where traditional company research is often not yet available. In addition, respondents noted the need to constantly screen any available ratings to ensure these continue to meet ESG investment criteria.

Where respondents did see value in third party data providers was in the aggregation and verification of external information such as unaudited self-reported information from companies and NGO reports to establish what is reliable and useful information to incorporate, versus what is just noise and can be disregarded. New specialist research, data and analytics offerings are emerging to provide improved means of aggregating and quantifying information to identify future successful ESG and RI investments, facilitating a greater adoption of ESG in mainstream investment (see appendix).

However, the challenge for many remains cost of access to information versus accuracy and value. The higher quality third-party providers remain expensive to integrate into the investment process and continued data inaccuracy or gaps challenge the rationale of any integration. In addition, given the variety of sources, ESG screening criteria differs both in terms of time horizon and also sector categorisation, requiring analysts to adjust any interpretation sector by sector as different risks affect different industries.

“Up to what we find is that MSCI may be highlighting a company for their particular issue which is already priced in the stock, the issue is part of a lot of the ESG ratings, which are used for quite long. One of the examples is, BAE systems continued to achieve a bad reputation for bribery and corruption issues. Long after the issues have parted from them in 2012 they were still getting a red flag for bribery and corruption issues that were raised in the early 2000’s. You need a real-world assessment. If a fund manager thinks that something is priced in the stock, e.g. Volkswagen, you are now buying post the Dieselgate and governance issues. The company is trying to leave that behind it. It has been realistically successful in that but also forward looking now that are committing 50 million euros to the development of electric vehicles, which we think is a huge opportunity. I think the qualitative overlay is important.”

Head of Governance and Responsible Investment, Global Asset Manager based in EU

“You also have to screen constantly because the ESG universe is not something that is static so you can have companies that enter the ESG universe but also some that are no longer fit for ESG investments.”

Head of ESG, Global Asset Manager based in EU

“The scores from the different data providers are uncorrelated as they are integrating different factors. So you end up with a final score that is incorrect because everyone has a different view of ESG. To get a more unbiased view requires proprietary aggregation of financial news, social media reports etc, other stakeholders such as looking at employees and what they think of their own companies etc. We are looking to get objective view of a single company by aggregating multiple factors to create a more realistic picture.”

Chief Data Scientist, Data Provider

Benchmarking Performance

Accurately verifying risk mitigation is particularly challenging given the vast disparities in the different ESG ratings available today as well as the fact that the underlying companies themselves often self-report, requiring independent validation – often as a proprietary process by investing asset management firms to match individual firm, PM or fund strategies.

A further challenge identified from our conversations with various data companies is the different methodologies used by data companies themselves in screening ESG factors. As the data is not standardised, nor is it often audited or verified by a third party; therefore, collating and analysing information from different ESG data providers to benchmark performance is often viewed as a pointless exercise. It is more important for an individual portfolio manager to understand the methodology behind an individual ESG score to decide whether or not the data available is significant and should be incorporated into an investment decision. For those respondents who do choose to benchmark ESG performance, the only apparently successful manner to achieve this currently is using proprietary analysis and ratings (see Exhibit 20). All of which emphasises the need for respondents to access third-party data providers as a starting point to help build this analysis.

Exhibits 20 and 21: What industry benchmarks/indices do you typically use to measure your ESG performance?/ Are you engaging specialist research providers for ESG?

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<table>
<thead>
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<th>Data Source</th>
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<tr>
<td>MSCI</td>
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<tr>
<td>Alternative Third Party Provider</td>
<td>17%</td>
</tr>
<tr>
<td>No ESG Benchmark/PM reliant</td>
<td>39%</td>
</tr>
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<td>Sustainalytics</td>
<td>43%</td>
</tr>
<tr>
<td>Other Third Party Providers</td>
<td>30%</td>
</tr>
<tr>
<td>Broker reports</td>
<td>26%</td>
</tr>
<tr>
<td>TruValue Labs</td>
<td>22%</td>
</tr>
<tr>
<td>BBG</td>
<td>17%</td>
</tr>
<tr>
<td>Arabesque</td>
<td>9%</td>
</tr>
</tbody>
</table>
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Source: Liquidnet Market Structure Outreach June – September 2019

While MSCI ESG Fund Ratings still holds the top position in terms of alternative data providers, new challengers are fast emerging (see Exhibit 21) with higher frequency indicators necessary to scrutinise and flag news released on various stocks on a real-time basis. Although MSCI currently has the more extensive ratings system covering 32,000 equity and fixed income funds31, for which more than two hundred metrics create scores ranging from AAA (leader) to CCC (laggard), the ability to access this information early on is becoming increasingly significant.

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31 https://www.msci.com/documents/1296102/15388113/MSCI+ESG+Fund+Ratings+Exec+Summary+Methodology.pdf/ee622acc-42a7-158f-6a47-ed7aa4503d47t=156269846881

"We are more interested in being able to understand the raw data and the implications for investors than an ESG score per say.”

**Head of Sustainability, Global Asset Manager**

"We use the rating as a sanity check. Part of the issue is that company disclosures will already be eighteen months out of date – and you can’t make an eighteen-month-old disclosure the sole basis of your research, you need to look forward not back. That’s why we are looking at other companies – Truvalue Labs, Arabesque, Esray – which all have higher frequency indicators (?!). This is now critical to tell you when to get out of positions, particularly when you have closed-end structures. Look at Woodford/Natexis, if you have large holdings in illiquid names you need to have the flags early on.”

**Head of ESG, Global Asset Manager based in UK**

"We are creating robots that will screen the news and qualify against ESG criteria so that we have alerts in place – a machine can determine if a sentence has a positive or negative connotation and can be very well applied to ESG.”

**Managing Partner, Global Asset Manager**

"We have gotten past the point where an analyst can say that they are not going to do anything with ESG because the data is not complete. That no longer flies. There is a lot of data out there. The complicated part is that it is not standardized. It is often not audited or verified by an independent third party and it is hard to find.”

**Head of ESG, Asset Manager based in the US**
important in order to react in a time-sensitive manner, particularly where asset managers have large holdings in illiquid names when they will be judged on how quickly they are able to react to any potential scandal.

Accurate analysis is often time critical particularly if negative news breaks and the analyst needs to react quickly – requiring access to foreign news websites for example, rather than waiting for a traditional data provider to interpret the significance of a particular event or news story. New challengers are already adjusting offerings to meet this demand through innovation, such as use of machine learning to validate and rate the data providers themselves. Establishing which provider is most relevant enables firms to determine from the data that is available, what should be incorporated to get most value for money.

**Company Engagement**

Data provides insight into how a company is performing in relation to ESG factors, but reviewing this in terms of sustainable investing allows asset managers to refine how to engage with a company’s management. While all respondents have implemented an engagement strategy to include factors such as governance, board structure and remuneration, the manner in which firms are able to engage differs. The underlying company may not yet be aware of what is required by investors given the evolving nature of new factors now required to be incorporated into an investment strategy and improved stewardship facilitates resolution of these issues.

Different cultural considerations also need to be included in company engagement. For example, the presence of Communist Party committee members on the board of Chinese companies may not appear to be in the best interest for the end investors, but fund managers recognise Chinese corporate governance is likely to evolve over time as the economy becomes more open to international investments. What is clear is the need for firms to have an investment strategy which can be tracked and monitored in order to qualify and quantify the investment process for end investors.

In addition to working with companies to have a better understanding of business models, respondents almost unanimously engage in proxy voting (see Exhibit 22). Wherever an organisation has an economic interest, respondents look to vote; however, in certain situations setting up the ability to vote is not always economically viable, such as a single holding in an emerging market. Where an asset manager disagrees with a company’s management and votes against a specific resolution, providing the company with the underlying reason is almost as important as the vote itself; it allows investors to send a strong message to the company regarding their views on the future sustainability of the business model.

**Exhibit 22: Do you actively engage in the proxy voting process of your investments?**

![Proxy Voting Participation](chart)

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>96%</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: Liquidnet Market Structure Outreach June – September 2019

While proxy voting and engagement with companies’ management are paramount, being transparent about the integration of ESG factors is likely to become increasingly important in order to win future mandates. As a result, some firms have now decided to take the extra step and voluntarily disclose on their website real-time proxy voting resolutions and engagement results. This added transparency could ultimately make the difference between those firms that have fully integrated ESG into their investment strategies and those that could be perceived as implementing ESG more as a marketing tool.
Rising Regulation

Greenwashing

As sustainable investing moves to the forefront of what investors demand and becomes part of mainstream investing, the risks associated with green or social washing are not only becoming more prevalent, but also more complex. Investment firms are coming under increasing pressure to demonstrate just how they are adhering to sustainable investing principles in order to avoid the potential charge of greenwashing. Last year, in Europe alone, three hundred ESG funds were launched which had apparent examples of greenwashing, according to Morningstar32.

The challenge is that historically a fund would simply be labelled as ESG or SRI but now evidence is required to demonstrate a fund’s credentials. The means of demonstrating adherence to an investment policy include questions on how sustainable investing research is accessed, what data is used and how this is incorporated into the investment process; as well as the ability to track questions that are asked in company engagements and provide proxy voting statistics.

Although there is an argument that imposing disclosure rules to companies would increase the compliance and financial burden put on them, the counter argument is that without some sort of uniformity among countries, finding sustainable investing information that could have a material impact on performance is near impossible. Either the information is hidden on a fund’s website or there is little uniformity year on year, making it difficult to make necessary comparisons. For instance, an insurance company could report the number of deaths in one year and the number of accidents the following year making any comparison a meaningless statistic.

Regulating ESG; Europe leading the way

The European Union has been at the vanguard of the global adoption of ESG standards (see Exhibit 23) and is expanding its agenda to foster sustainable growth in ESG as well as introduce a taxonomy of terms to limit the potential for greenwashing. In May 2018, the European Commission (EC) adopted a package of four legislative initiatives including a proposal to create an EU taxonomy on what should be considered environmentally sustainable economic activities, which is seen as the first step to channel investments into sustainable activities. In September 2018 EU ambassadors greenlighted the Council’s position on a proposal to create this taxonomy. Six environmental objectives have been identified which have to be met in order for economic activities to qualify as environmentally sustainable;

1) climate change mitigation;
2) climate change adaptation;
3) sustainable use and protection of water and marine resources;
4) transition to a circular economy, including waste prevention and recycling;
5) pollution prevention and control; and
6) protection and restoration of biodiversity and ecosystems.

This is a new approach by the regulators in positively incentivising asset managers to move to sustainable investment, alongside stricter risk management controls regarding sustainable investing and amendments to the Financial Reporting regulations as per recommendations from the TCFD. The regulation is aimed addressing two challenges including reducing any potential mis-selling. “Getting involved in the industry debate is very important to influence regulatory policy. Then, that the policies are actually applied and that people are not using terms to describe something which actually is not there – impact investing is a prime example. Getting involved in proxy voting and engaging with management to ensure greenwashing isn’t taking place is also important. Are the sustainable investing products actually doing what they are saying they are doing – there are important implications here for potential mis-selling.”

Head of Global ESG Investment Research, Global Asset Manager

We have various frameworks being established, and the Investment Association in the UK is looking to establish a framework for UK investments. I think it is quite difficult to create a global framework because – as we have discussed -there are a number of regional differences in how people view RI and ESG, the starting point of the RI, and the PRI’s version of what RI is. You then have the various things which define impact investing.”

Head of Global ESG Investment Research, UK Asset Manager

“One of the big industry problems is the whole risk of greenwashing. So, recently there was a review of UMRCI which has 120 mangers and I think 80 of those are going to be knocked off the registration list because they are saying they are doing things in relation to ESG – but the reality is that they are not.”

Head of ESG, US Asset Manager

6) protection and restoration of biodiversity and ecosystems.

20

34. www.cpd.net
In France, Article 173 of the Energy Transition and Green Growth Law came into force on 1st January 2016 and requires asset managers and investors to provide information on their management of climate-related risks, and the integration of ESG factors into their investment policy. Article 173 also extends corporates’ obligations by strengthening the requirements for transparency on the risks and opportunities related to climate change and the measures taken to implement a low-carbon strategy.

**APAC - the pressure is on**

In APAC, Japanese business leaders are increasingly pushing for a wider adoption of SDG principles, spear-headed by the Government Pension Investment Fund (GPIF). With approximately Y139 trillion invested according to ESG principles, GPIF is a global leader in greater responsible investment and adoption of ESG spear-heading a 307% rise in sustainable assets in Japan over a two-year period. Together with the University of Tokyo, the GPIF is planning to issue strong guidelines to the corporate and investment world on how asset management firms can better incorporate ESG into the investment process.

The Hong Kong Stock Exchange is also set to demand greater disclosure of ESG-related risks for listed companies through a new initiative where asset managers have a new product labelled ESG or Green. However, the strongest pressure in the region is coming from Australia. The Australian Securities & Investments Commission (ASIC) has highlighted its priorities as encouraging strong and effective corporate governance and disclosure to mitigate climate change risk, in the same manner as compliance risks, cyber security or digital disruption.

**Exhibit 23: ESG regulation worldwide**

Source: Liquidnet Market Structure Outreach June – September 2019

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37.  https://www.ft.com/content/026ee8f2-b2de-11e9-8cb2-799a3a8cf37b
US – regulatory stagnation

In contrast, the inclusion of ESG standards in the investment process in the US has been slower compared to the rest of the world. This is reinforced by the lack of regulatory support from the SEC, which to date has done little to foster greater adoption among market participants. One Trump-appointed commissioner even instead warned of a potential ESG “witch hunt”39. In addition, the US Congress has rejected a provision to introduce European-style reporting standards on ESG information and climate change risks aiming to provide investors with a better understanding of where risks in their portfolios lie40. The Trump administration has taken a number of highly publicised decisions asserting its opposition to climate change actions such as pulling the US out of the Paris Agreement (COP 20), reducing funding at the Environment Protection Agency (EPA) as well as favouring oil and coal at the expense of clean energy41.

One area where the US looks set to address is proxy voting where the SEC appear concerned that proxy advisers may be aligning recommendations with political perspectives of unions and state pension funds, rather than end investors. The SEC have now issued guidance to clarify how an investment adviser’s fiduciary duty relates to an adviser’s proxy voting on behalf of clients. Proxy advisers will have to have to disclose the basis for their recommendation, which should include linking this to shareholder value. This argument potentially could expose differences in approach between the US and Europe. While the EU support delivering value to the end investor, this should not preclude looking at the wider societal benefits that greater investment in sustainable finance and ESG can deliver.

Industry Solutions

Thirty-five percent of respondents in our market structure outreach thought an industry-wide agreement would be hard to achieve globally given regional differences in how ESG and RI are defined (see Exhibit 24). Similarly, imposing specific reporting rules could limit the number of metrics used because information could be seen in different ways. Those respondents sceptical of the feasibility of a global regulator effort would prefer a regional definition matching local cultural as well as regulatory requirements. However, 61% of respondents believe industry standards should be developed and are of the opinion that the industry would benefit if there was greater clarity about what is required from them and from the companies in which they invest specifically, when looking at the definition of ESG and disclosure requirements (see Exhibit 25).

Exhibits 24 and 25: To what degree do you think ESG analysis requires broad industry-wide norms/frameworks/standards? / With Codified Rules of Disclosure?

Source: Liquidnet Market Structure Outreach June – September 2019

40 https://www.ft.com/content/0dd92570-a47b-11e9-974c-ad1c6ab5e6d1
In the interim, most respondents we spoke to are managing risk internally through a hotchpotch of different means. Some are using third-party ESG data specialists in an attempt to verify their investment decisions and demonstrate adherence (see Exhibit 26). However, the ability to correctly label a strategy in a standardised manner is recognised as the most effective means of demonstrating adherence and different regulatory approaches are exacerbating this issue.

Exhibits 26 & 27: How do you manage the risk of Green or Social Washing? To what degree do you find each of the following industry tools/bodies helpful?

Source: Liquidnet market structure outreach, June - September 2019

Although there is an argument that imposing disclosure rules to companies would increase the compliance and financial burden put on them, the counter argument is that without some sort of uniformity among countries, finding ESG information that could have a material impact on performance is near impossible. Either this is hidden on a firm’s website or there is little uniformity year on year, making it difficult to make necessary comparisons.

The UN Principles of Responsible Investing has also played an important role in attempting to provide a global framework for asset managers to understand the investment implications of sustainable investing and how to include these factors into their decision-making (see exhibit 27). Similarly, a number of industry bodies such as the SASB and the Global Reporting Initiative (GRI) have established a set of frameworks on codified disclosure rules for businesses to inspire from. The SASB Materiality Map, identifies a range of issues that are likely to have a financial impact on the performance of a company. Yet, one of the limits of such a framework is that it remains focused on public corporate listings only and fails to encompass the full spectrum of investments such as ETFs, multi-assets portfolios and real estate. Most of the effort has been focused on corporate debt and equities, but as the make-up of investments continues to shift with investors looking at greater asset diversification, any framework will have to adapt to the new order to ensure adherence to ESG standards across a variety of investment strategies and asset classes.

“SASB has been really useful for us in terms of pointing our analysts in the right direction. There again we are not telling the analysts SASB says this, therefore, it is so. What we are saying is that there is a group that has put a lot of time and a lot of rigour into determining this materiality map. In fact, the feedback that we have gotten from our analysts is that it is very useful. Not everything is relevant for every company of course, we know that. But having that as a tool has been really useful. PRI is more useful in terms of the firm or people at my level thinking about the ESG across the firm. PRI is helpful for us particularly to identify holes in what we are doing and then correct them.”

ESG officer, Global Asset Manager

“We are spending a lot of time on ensuring a strong infrastructure – how we integrate ESG factors into the investment process and how we can demonstrate that integration to clients. Sometimes the best examples are when ESG issues mean you don’t buy something – why not? What is the process?”

ESG Analyst, Global Asset Manager
Creating the Right Culture

Training and education on ESG issues
As firms understand the challenges unfolding in front of them, internal training of staff is essential across organisations, including sales and trading as well as investment teams. Education is still perceived as one of the main barriers to broader ESG and sustainable investing adoption for 77% of participants (see Exhibits 28 and 29). It is a slow process and some respondents have already faced pushback internally from staff who have failed to comprehend the strategic shift now underway. However, while cultural change cannot be achieved overnight, the economic argument for doing so is growing – most mandates now include a requirement for ESG or SRI in some form. From morning meetings to periodic training sessions, companies are looking for staff to understand what ESG and responsible investing means for their organisation and why it matters to the success of an organisation in the longer term.

Exhibits 28 and 29: To what extent have sales and investor teams have received training on ESG?/What do you see as the main barriers to broader ESG adoption and integration?

Investment strategies perceived as successful a few years ago could struggle today to perform if not adapted to respond to investors’ demands and the scarcity of natural resources. Recent analysis produced by BP at the end of 2018[^42] highlighted that at the current production rate, oil reserves will only last for another fifty years. BP and Total now allocate capital aligned with a sustainable world and have increased investments in renewables such as the solar sector via Lightsource BP[^43] and SunPower[^44] respectively. The rising social stigma in the Nordic region regarding taking flights for social purposes, so-called “flight-shame”, alongside wider industry concerns in relation to low-cost airlines cutting valuable safety precautions are likely to have negative ramifications for an already struggling European airline industry. As companies need to take future environmental risks into account, so will the asset managers who chose to invest in those companies – and managing this process will become increasingly complex to monitor and control.

[^43]: https://www.bp.com/energytransition/
Getting the C-suite on board

One important step in addressing these challenges is for asset managers to be able to create the right culture internally. As the industry works its way through yet another seismic shift as it adjusts to the sustainable revolution, a top-down approach needs to be adopted for the change to be successful. This means that strategic responsibility to integrate ESG analysis throughout the firm now lies with the C-suite.

Today, only 36% of respondents in our market structure outreach highlighted that their CEOs and/or CIOs are leading the effort firm-wide (see Exhibit 30), indicating that more change will need to come in the future as firms continue to transition ESG integration fully into the investment process. The C-suite has an essential role to play in defining the direction of travel of an investment firm and positioning its strategy in the market, which then will be adapted by each investment team based on their own mandate. Most of the respondents highlighted the importance for the ESG team to collaborate with the PMs and analysts. For some firms, the ESG analyst sits within the investment team, while for others a separate sustainability team was created, but in both instances, they are fully integrated in the evaluation of investments or divestments. ESG teams working in silos seems counterproductive for many; instead, as the function continues to evolve, forming a true partnership with the investment teams will help identify new opportunities based on the team’s needs. Two fully integrated fund managers could make very different investment decisions while being provided with the same metrics; it is the rationale behind the decisions in relation to the mandates that now needs to be understood.

"Our CEO has already made a strong statement that he is fully supporting ESG. On the website, there is a really good paragraph talking about how we divided our three different ESG approaches. Actually, that is by our global CIO and the global office. It is really high up.”

Head of ESG & Sustainability, UK Asset Manager

“Market forces will sort out who is really delivering ESG because people who are not paying attention to extra financial issues, who are only looking at the balance sheet, won’t perform as well. One thing that is interesting which is not necessarily investment-related but plays out in the investment space is that millennials as a generation have been pretty good at communicating their beliefs and desires to boomers. And boomers are starting to buy in.”

Head of ESG, Global Asset Manager

“I would say responsibility for ESG sits with the CEO and CIO. They are both part of a responsible investing company committee where we have representation from different areas, for instance, sales, compliance, ESG team, but the CIO and CEO are primarily responsible for the strategic decisions. And the policies are approved by the board of course.”

ESG analyst, EU Asset Manager
Conclusion

In a world of shrinking resources, with a growing and ageing global population alongside rising inequality, as well as increased purchasing power within the investment process, a perfect storm is being created. Responsible investing is moving rapidly from the exclusion of “sin stocks” to a broader investment strategy based on the future sustainability of company business models, and asset managers can no longer ignore this shift in client demand, nor how they will need to adapt and automate their investment processes to adjust for this change.

From Occupy Wall Street to the Guilet Juanes, Generation Y and Millennials are redefining what is perceived as valuable and decentralising the corporate power structure as social media fuels a more disruptive approach to the global economy. Climate change is pushing these issues up the corporate agenda as those whose business models are perceived as damaging to the planet are being shunned by end investors and the asset managers who service them alike. Bond markets are also becoming increasingly affected as countries and regions struggle to cope with climate change. The impact on a 30-year government bond in a country beset by drought, floods or hurricanes as homes and businesses are destroyed not only limits the ability for governments to raise taxes on declining corporate earnings, but also halts normal capital markets activity such as the ability for companies to raise debt or issue shares.

The far-reaching industry changes will not only impact the research and investment process but will have significant implications for how investment decisions are executed, and the brokerage services required for doing so. Traditional research based on annual reports and cash flows will be replaced with alternative datasets covering a vast array of non-financial information on climate change and biodiversity, to social statistics such as child labour, human rights and diversity statistics as well as board quality and cybersecurity capabilities. Some firms will choose greater stewardship of poorly performing organisations, others will exclude those who fall short of the mark. Any concentration of investable instruments not only necessitates greater alternative data sources to understand a company’s profile but also to alert traders to any potential liquidity issues well in advance. Traditional pricing of risk will likely be impacted as holding inventory in a stock that is deemed non-sustainable in the long-term will only increase the cost of capital as the risk profile deteriorates. Data will need to become much more targeted and personalised to individual asset managers to remain relevant; reading through the noise to establish what is of value and what is not.

While asset management firms currently focus on winning mandates, it will be through automating the investment process that will enable firms to not only win, but keep mandates by delivering measurable outcomes – both in terms of implementing investment strategies but also being able to demonstrate adherence to those strategies. Due to the lack of standardisation within ESG and RI, the interpretation of how ESG and RI factors should be incorporated varies and where the subjectivity of the individual portfolio manager and the investment strategy comes into play. For example, depending on the firm or fund, certain managers will exclude all weapons manufacturers, others only those that have negative environmental impact such as cluster ammunitions; some firms chose to maintain energy holdings but only for those who invest in R&D or green renewable energy. The lack of standardization in ESG ratings and disclosure rules means asset managers rely on proprietary rating systems by gathering data from multiple different sources. But as interpretations of what ESG is can diverge greatly even within firms, as well as between countries and regions, benchmarking sustainable investment funds is not only challenging but confusing for investors. If the industry fails to self-regulate we can anticipate far greater regulatory constraints.

Despite these challenges, the rise in sustainable investing also offers a huge opportunity for active managers. Passive investing can no longer equal passive ownership. All portfolio managers have a fiduciary duty towards their end investors, and the need to engage with companies’ management to address future sustainability concerns will require a different approach to investment, potentially restoring end investor confidence in Capital Markets in the process. Those firms with high ratings on material sustainability issues significantly outperform those with poor ratings; ESG no longer represents a noble way to underperform, but instead offers rational business sense.

The mark of any successful evolution is the ability to adapt and change. As a revolution of sustainability unfolds within an ever-increasing competitive asset management industry, only those who are able to automate their investment process quickly and efficiently will have the best chance of survival. While the speed and depth of ESG and SI adoption will vary from firm to firm, region to region, those who ignore its importance will be left behind in its wake – affecting both the asset managers and the companies they invest in alike.
Appendices

Appendix 1: ESG solution providers

**BNP Paribas Securities** [https://securities.bnpparibas.com](https://securities.bnpparibas.com)
BNP Paribas Securities is a multi-asset serving securities solution provider. In addition, they pride themselves in committing their business activities to a long-term sustainability focus.

**Clear Macro** [https://www.clearmacro.com/](https://www.clearmacro.com/)
ClearMacro provides institutional investors with a front-office software/service solution that processes rapidly changing data and information into live investment signals. It makes decision-making easier, helps improve portfolio returns, expands the user’s investment coverage, and increases the transparency of their decision-making.

**Sensefolio** [https://sensefolio.com/](https://sensefolio.com/)
Sensefolio is a data and rating provider for over 20,000 companies, assessing their ESG involvement with the help of Machine Learning and Neuro Linguistic Programming techniques.

**Sustainalytics** [https://www.sustainalytics.com/](https://www.sustainalytics.com/)
Sustainalytics is a global leader in ESG and sustainable finance solutions. For over 25 years, the firm has been at the forefront of developing high-quality, innovative ESG solutions that integrate the latest in smart technology. Sustainalytics works with hundreds of the world’s leading pension funds and asset managers, enabling them to incorporate ESG insights into their policies, decision-making and engagement practices.

**TruValue Labs** [https://www.truvaluelabs.com/](https://www.truvaluelabs.com/)
TruValue Labs specialises in combining artificial intelligence and alternative data in order to provide a better informed, data-driven decision basis for companies focusing on ESG investing.

Appendix 2: 17 UN Sustainable Development Goals (SDGs)

Appendix 3: Non-financial reporting frameworks

<table>
<thead>
<tr>
<th>Framework</th>
<th>Type</th>
<th>Description</th>
<th>Usage</th>
<th>Content and issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>TCFD Recommendations</td>
<td>Recommendations</td>
<td>Encourages better acknowledgement of climate-related risks and opportunities by companies and financials</td>
<td>+800 institutions</td>
<td>Governance/strategy/risks/targets and indicators</td>
</tr>
<tr>
<td>CDSB Principles</td>
<td>Principles</td>
<td>Reference principles for measuring impact on financial performance, based on international systems (TCFD, IASB, IFRS, etc..)</td>
<td>Approx. 400 companies</td>
<td>Impacts: environment and climate, capital and corporate activities (governance, strategy, future performance)</td>
</tr>
<tr>
<td>ONU Global Compact</td>
<td>Principles</td>
<td>10 principles to encourage companies to adopt socially responsible practices approx. 9000 companies</td>
<td>Approx. 9000 companies</td>
<td>Human rights/international labour standards/environment/corruption</td>
</tr>
<tr>
<td>GRI Framework (Indicators)</td>
<td>Based on international standards with obligations and recommendations</td>
<td>38% FTSE 100; 90% CAC 40</td>
<td>Dimensions: environment, share capital, human capital, innovation, governance</td>
<td></td>
</tr>
<tr>
<td>SASB Framework (Indicators)</td>
<td>Focused on financial issues to provide information about risks and opportunities</td>
<td>50 companies from the SASB alliance</td>
<td>Four subject-based questionnaires (climate change, water, forests, supply chain) plus sector-specific questions</td>
<td></td>
</tr>
<tr>
<td>CDP Database</td>
<td>Database</td>
<td>Run by investors, focused on voluntary questionnaire to collect data</td>
<td>+7000 companies, +535 investors, +600 cities</td>
<td>ESG criteria for supply chains</td>
</tr>
<tr>
<td>EcoVadis Database</td>
<td>Database</td>
<td>Collaborative platform for assessing sustainable development performance of suppliers (companies)</td>
<td>At request from clients</td>
<td>12 modules, both general and by asset class</td>
</tr>
<tr>
<td>UN PRI Database</td>
<td>Database</td>
<td>Aimed at investors, frameworks of environmental, social and governance indicators</td>
<td>Investor signatories of the PRI</td>
<td></td>
</tr>
</tbody>
</table>

Source: adapted from work by EcoAct, 2019 and the report “guaranteeing the relevance and quality of corporate non-financial reporting”, De Cambourg

[45](https://www.un.org/development/desa/disabilities/envision2030.html)
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Rebecca is considered to be one of Europe’s leading industry voices on market structure, regulatory reform, and financial services technology. She has authored a plethora of qualitative research reports and commentary covering the impact of market regulation on all asset classes, changing market structure and developments in dark pools, HFT, and surveillance. She joined Liquidnet in July 2016 to use her 20 years’ experience to collaborate and deliver research and insights for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community’s EMEA Regulatory Subcommittee, dedicated to addressing real business and regulatory issues impacting multi-asset trading in global markets. She has held prior roles at TABB Group, Incisus Partners, the British Embassy in Bahrain, Credit Suisse, Goldman Sachs International, and Bankers Trust International.

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