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# Sustainability and Capital Markets—Are We There Yet?

by Chris Pinney, High Meadows Institute, Sophie Lawrence and Stephanie Lau, KKS Advisors

In the three years since our 2015 survey on the state of ESG integration in capital markets, interest and engagement with ESG in capital markets can truly be said to have gone "mainstream." ESG investment products flood the market in almost every investment category, from ETFs to fixed income and alternatives. ESG assets under management now total $30 trillion, up from $23 trillion in 2016, and are projected to grow to $35 trillion by 2020.*

Several factors have driven the transition to ESG integration. First is the increase in millennial and women investors. A second major contributor is the growing realization, by asset owners and managers alike, that ESG is a viable way to increase alpha and manage risk across their portfolios. Third, there has been a proliferation of multi-stakeholder initiatives established with the aim of accelerating solutions. Finally, technology has also been a driving force for ESG integration, most notably in the sense that advances in data science have gone some way to deal with the paucity of ESG information and data collection fatigue. Advanced technology has also helped investors expand the breadth of information they can access. Together these forces are shaping not only the way investors use ESG in their approach to asset valuation and selection, but also how they use ESG issues to engage companies in a strategic dialogue.

While the last three years have seen significant progress in ESG integration, substantial challenges remain before we will be able to say that ESG is a fully integrated part of the U.S. capital market system. The primary challenge continues to be the lack of a normative and widely accepted definition of ESG and standards for companies when measuring and reporting on ESG performance. A second challenge is the lack of understanding of and appreciation for ESG at the corporate governance level. Third is the size of the talent pool needed to support full ESG integration, which is also formidable since it requires a combination of skills provided by few universities or colleges, including interdisciplinary knowledge and strategic policy experience along with deep investment expertise and the emotional intelligence skills to communicate with diverse corporate stakeholders. Finally, at least in the U.S., the organized pushback against ESG integration and shareholder activism around ESG by corporate and political interests remains a significant challenge.

But if challenges persist, there is no question that the move to full ESG integration in capital markets is well underway and has considerable momentum. The question for most capital market participants is no longer why ESG, but rather defining what it means specifically for their business and how to integrate ESG in ways that will improve returns and create value for their clients.

## Client Interest and the Changing Demographics of Investors

Since our 2015 survey, we have seen continued growth in client interest in ESG and, in particular, an increase in the interest of millennial and female investors. A 2017 survey noted that 86% of millennial investors expressed an interest in sustainable investing, as compared to 73% of investors overall. And 70% of such investors have backed their expressions of interest with increased investments in sustainable funds.[1] Similarly, women have shown greater interest in

*https://www.pionline.com/article/20190213/INTERACTIVE/190219949/esg-interest-driving-data-spending-higher.

1 https://www.schroders.com/en/sysglobalassets/digital/insights/2017/pdf/global-investor-study-2017/schroders_report_sustainable-investing_final.pdf.

sustainable investing than men (84% versus 67%),[2] which is a good sign for ESG since recent figures show that women control 40% of global wealth and 51% of U.S. personal wealth[3]—and that, in the next decade, some $12 trillion worth of assets is expected to pass from baby boomers (today's 51-69-year olds) to millennials.[4] These demographic shifts in wealth management are driving uptake in sustainable investing.

On the institutional side, we also see a marked increase in interest in ESG by the largest asset owners. And along with such interest has come a sharp increase in mandates for investment managers that include consideration of ESG. Such a development is likely to be important since, as the PRI has reported finding, some asset owners have made commitments to sustainability that have yet to be implemented in their investment mandates.[5]

## ESG as a Driver of Alpha (or "Doing Well by Doing Good")

In the past few years, there has been a shift in the perception of ESG; capital market players understand that it is more than a marketing tool or a basis for a set of niche products. Asset owners and managers now view ESG as a viable way to increase alpha and manage risk across their portfolios. In 2017, the *Financial Times* stated that "the outperformance of ESG strategies is beyond doubt."[6] And across the industry perceptions are changing rapidly: between 2017 and 2018 there was a 13% increase in the number of capital market stakeholders who said they believe that ESG-integrated portfolios are likely to perform better than non-ESG-integrated portfolios.

As one example of ESG's effectiveness in generating alpha, in December 2017, Citywire analyzed the performance of MSCI ESG and non-ESG indices in emerging and developed equity markets. While picking ESG over non-ESG indices had little impact in world equities, in emerging markets such as Brazil and India, investing in an ESG index was found to have led to an increase in returns of 74.49% over the past 10 years, as compared to only 18.3% for the regular emerging markets index over the same period.[7]

## Technology

Advances in data science and the development of sophisticated algorithms have played a significant role in improving the collection and analysis of ESG data, thereby overcoming the current paucity of ESG information. For example, AI and machine learning techniques have helped in "smart-scraping" company reports for material ESG information at a level of efficiency, both in accuracy and speed, that human efforts cannot match.[8] In the past, extensive surveys were required to transfer information between investors and companies, which led to investor analyst bias, survey fatigue for company sustainability teams, significant time lags, and masses of unaudited and inconsistent data on ESG issues in the market.

The question for most capital market participants is no longer why ESG, but rather defining what it means specifically for their business and how to integrate ESG in ways that will improve returns and create value for their clients.

Advanced technology has also helped investors to expand the breadth of information they can access on ESG issues. One example is the integration of high frequency data from unconventional sources to expand the list of metrics for a given ESG issue, such as the use of satellite data to track climate indicators that can then be integrated into supply chain analysis.[9] Boutique data and service providers also offer sustainable quant-based products and sophisticated algorithm-based analysis. For example, TruValue Labs, a new data provider, leverages the supervised learning form of AI to filter through over 75,000 sources from newspapers, watchdog organizations, specialist publications, and NGOs to analyze and interpret unstructured ESG data.[10]

## Regulation

Regulations around the world, especially in Europe, are starting to promote and enforce the consideration of ESG

2 https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf.

3 https://www.credit-suisse.com/corporate/en/articles/news-and-expertise/global-wealth-report-2018-women-hold-40-percent-of-global-wealth-201810.html.

4 https://www.ft.com/content/59f6562a-786d-11e8-af48-190d103e32a4

5 https://www.unpri.org/download?ac=1398.

6 https://www.ft.com/content/9254dfd2-8e4e-11e7-a352-e46f43c5825d.

7 https://citywireselector.com/news/chart-of-the-week-esg-vs-non-esg-indices/a1076798.

8 Smart-scraping refers to any scraping algorithm that learns from itself and updates periodically, similarly to the human learning processes.

9 https://www.brighttalk.com/webcast/14001/218341/can-fintech-and-ai-solve-the-esg-data-puzzle.

10 https://www.ipe.com/investment/strategically-speaking/strategically-speaking-deutsche-asset-management/dws-group/10023449.article .

factors throughout the capital markets system. In France, the energy transition law introduced in 2016 has strengthened mandatory carbon disclosure requirements for listed companies and introduced carbon reporting for institutional investors, defined as asset owners and investment managers. In the U.K., a 2018 green finance inquiry by the House of Commons' Environmental Audit Committee (EAC) demonstrated that some of the U.K.'s largest pension schemes have poor understanding of climate risk. This led to the Department for Work and Pensions announcing new rules in September 2018 mandating pension schemes with more than 100 members to start disclosing the ESG risks of their investments in October 2019.

The European Commission also introduced "The Markets in Financial Instruments Directive" (MiFID II) in January 2018 to further protect investors and bring greater transparency to all asset classes. And in May 2018, the commission announced they would be including sustainability considerations in the MiFID II suitability requirements to ensure that investment consultants ask their clients about their ESG preferences and provide the most suitable products or advice. Most recently, in March 2019, the EU ruled that money managers, insurance companies, pension funds, and investment advisers must integrate ESG factors into their portfolios, while disclosing in a consistent way how they invest and how this impacts the environment. This was part of a package of measures announced by the "High-Level Expert Group on Sustainable Finance."[11] These rules aim to eliminate greenwashing and ensure regulatory neutrality, and so drive robust ESG integration across the sector.

## Multi-Stakeholder Initiatives

There has been a significant increase in multi-stakeholder public policy initiatives focused on responsible investment in the last five years. In a 2016 report, the PRI found that over half of the 300 policy instruments that encourage investors to consider long-term value drivers had been created since 2013. [12] Examples include the 2° Investing and Science Based Targets Initiatives and the 2015 Paris Agreement—the first legally binding international climate deal.[13] In the past few years, the Task Force on Climate-related Financial Disclosures, which now has more than 500 supporters including 457 companies, has gained traction. And in September 2018, the World Benchmarking Alliance was launched to support businesses in measuring progress against the SDGs and designing incentives to deliver against the goals while overcoming the existing challenges associated with using the SDGs as a framework for the private sector.[14] Regional groups are also forming to tackle geography specific challenges; in 2016, for example, the Institutional Investors Group on Climate Change (IIGCC) re-launched the Asia Investor Group on Climate Change (AIGCC)[15] to raise awareness of Asia-specific climate change risks and opportunities among asset owners and financial institutions.[16,17]

## Investment Stewardship and Engagement with Companies

In the last three years, we have seen a rapid increase in the investment stewardship activity and engagement with companies by the so-called passive players like BlackRock and Vanguard but also by active managers as well. The influence of the "big three"—BlackRock, Vanguard, and State Street—is not negligible; when their holdings are added together they are the largest shareholder in 40% of all publicly listed companies in the U.S.[18] Despite concerns about a perceived misalignment of incentives—specifically, that an ownership "oligopoly" of passive investors could inhibit the efficacy of their engagement to benefit corporate performance—research finds that it is precisely the long-term nature of these strategies and the size of their stock holdings that provide passive investors with incentives to engage proactively with corporations and create a persistent dialogue to enhance corporate governance standards. As Bill McNabb, the former CEO of Vanguard, explained these incentives,

> *We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits. That is precisely why we care so much about good governance.*

## ESG Integration in Market Intermediaries

Since 2015, there has been a marked increase by stock exchanges and credit rating agencies (CRA) in integrating and promoting ESG. During this period, there has been a

11 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#hleg.

12 https://www.unpri.org/download?ac=325.

13 https://ec.europa.eu/clima/policies/international/negotiations/paris_en.

14 https://www.worldbenchmarkingalliance.org/wp-content/uploads/2018/09/WBA-Press-release-24-Sep.pdf.

15 http://www.iigcc.org/events/event/launch-of-the-asia-investor-group-on-climate-change-at-pri-in-person.

16 http://www.aigcc.net/who-are-we/.

17 http://www.aigcc.net/wp-content/uploads/2018/10/AIGCC-Member-List-Sheet1-1.pdf.

18 ttps://www.businessinsider.com/american-corporation-big-three-firms-2017-5?r=US&IR=T.

10% increase in the percentage of stock exchanges offering sustainability-related indices. The Sustainable Stock Exchange Initiative has also gained traction and succeeded in signing up the top 10 largest stock exchanges globally, a 50% increase since 2015.[19] Spurred on by the PRI's CRA initiative, credit rating agencies have made significant progress in integrating ESG data into their product offering, including Fitch Ratings' ESG Relevance Scores that display the relevance and materiality of ESG in a rating decision.[20]

### Remaining Challenges

Despite the preceding driving forces, several key challenges remain before we are likely to see full integration of ESG in capital markets (and hopefully the disappearance of the term as social and environmental considerations become the norm, simply part of mainstream investment management).

### Defining ESG and Reporting Standards

There continues to be no generally accepted definition of ESG and standardized way for companies to report on material ESG performance. This is further complicated by the lack of consensus between the major ESG rating and ranking agencies, which often provide widely different rankings for the same companies and are using different and often non-transparent methodologies to account for significant data gaps.[21] In addition, ESG ratings systems are criticized for failing to factor in issues such as transparency, lack of impact assessment, and stewardship.[22] Recently, the mining company Barrick wrote a public letter to MSCI to express frustration with their ESG report. Barrick's efforts demonstrate two things: first, companies do understand the importance of ESG ratings for their overall company valuation; second, as ESG continues to go mainstream, the pressure to demonstrate credibility, perhaps through greater transparency, will grow.[23] Overall, companies and investors are increasingly challenging ratings agencies over their opaque methodologies and seemingly hypocritical calls for more data disclosure. For their part, regulators in most jurisdictions have failed to require or set standards for ESG disclosure, although some, including the UK, are beginning to provide non-mandatory "guidance."

### Corporate Governance

A central challenge to full ESG integration remains the failure of corporate boards to understand and process ESG integration. In a 2018 survey of U.S. corporate directors, 74% said "no" to a question asking whether they felt disclosure on sustainability matters are important to understanding a company's business and helping investors make informed investment and voting decisions. A useful illustration of the challenge that this lack of understanding presents can be seen in the response by companies to increased shareholder activism on ESG issues, which accounted for almost half of 2018's shareholder proxies. An analysis by George Serafeim and others showed that, in 2016, companies were responding with equal thoroughness to ESG-related proxies, regardless of whether they were financially material or not. Not surprisingly, the study demonstrated that companies that responded to issues that were not material to the company's primary ESG impacts were associated with subsequent declines in firm valuation relative to their peers, while actions on proposals on material ESG issues were associated with subsequent increases in firm valuation.[24]

Finally, studies have shown that while most large companies state that they oversee sustainability at the board level, only a minority have formal mandates and demonstrate board-management engagement on sustainability. Ultimately this needs to change since it is those companies that can demonstrate stronger board governance systems that are more likely to have established ESG commitments.[25]

### ESG and Human Capital

Another challenge is that the rapid mainstreaming of ESG integration has outpaced the supply of finance professionals with the skills required for new sustainability-focused roles. Over the past three years, large institutional investors have grown their stewardship teams, with Vanguard more than doubling its team. However, behind this growth there is a "talent war" taking place as competition for individuals familiar with the complexity of ESG issues is rising.[26] This competition for talent is particularly noticeable among top asset managers, and while there is no shortage of applicants, there are few that hold all the skills that such jobs demand.[27,28] Lately, family offices have also been making a push to attract impact-oriented investors and have lured young talent seek-

19 Sustainability in Capital Markets: A survey of current progress and practices (2019).

20 Sustainability in Capital Markets: A survey of current progress and practices (2019).

21 https://cbey.yale.edu/sites/default/files/Responsible%20Investing%20-%20Guide%20to%20ESG%20Data%20Providers%20and%20Relevant%20Trends.pdf.

22 https://portfolio-adviser.com/fund-selectors-in-the-dark-on-esg-criteria/.

23 Environmental Finance, 2018.

24 Serafeim, 2016. Shareholder Activism on Sustainability Issues. Source: https://corpgov.law.harvard.edu/2016/07/25/shareholder-activism-on-sustainability-issues/.

25 https://static1.squarespace.com/static/5143211de4b038607dd318cb/t/5afc5e271ae6cf3092ecd7ed/1526488627169/Systems+Rule_Final.pdf.

26 https://www.ft.com/content/0695124e-6eec-11e8-852d-d8b934ff5ffa.

27 https://esgclarity.com/esg-talent-war-continues-as-calvert-grabs-analysts/.

28 https://www.ft.com/content/0695124e-6eec-11e8-852d-d8b934ff5ffa.

ing more responsibility away from institutional investors.[29] While the talent war extends beyond capital markets, a representative for Goldman Sachs believes that, in the long run, this development could be beneficial to the sector as family offices will provide a source of trained impact and ESG professionals in the future.

One effect of the talent war could be an increase in salary raises for specialists, which is atypical in the current climate where large pay rises are increasingly uncommon. Specifically, employees who are skilled in ESG issues or who are specialists in data or artificial intelligence (AI) could see big increases in demand for their services and in compensation.[30] It will be crucial for AI and data specialists to be compensated at rates comparable to those on offer from global tech companies.[31]

There continues to be no generally accepted definition of ESG and standardized way for companies to report on material ESG performance. This is further complicated by the lack of consensus between the major ESG rating and ranking agencies.

What is promising is that sustainability-focused programs are in demand among students. In the past five years, Stanford Graduate School of Business has experienced such a surge of interest in impact investing that it has developed two new related programs.[32] So-called "Green MBAs" are also becoming more popular. Of established college programs, the Princeton Review ranks the University of Vermont, Cornell, and Yale as the top three "Green MBAs" that prepare students for a career working in the sustainability field.[33] There is also demand for mainstream MBAs to incorporate responsible and sustainable business practices into their curriculums.

On the negative side, the United Nations Global Compact, funded by Aviva, published research this past year demonstrating that current business school rankings do not encourage MBA programs to incorporate training on how business leaders can contribute to a sustainable economy.[34] Steve Waygood, the Chief Responsible Investment Officer at Aviva Investors, has argued that MBA rankings should reward programs offering courses on responsible capitalism to help ensure that employers attract the right talent and that applicants are drawn to MBA programs that teach about the wider impact of business on environment and society.[35] Initiatives such as the "Ideas Worth Teaching Awards" from the Aspen Institute also encourage programs to teach courses on just and sustainable capitalism. Previous winners include the "Reimagining Capitalism" course at Harvard Business School, which now attracts 300 students a year—a big increase from the 28 students that enrolled when the course was first offered in 2012.[36,37]

In the absence of candidates with the broad range of skills required to work on ESG issues, investors must be prepared to invest in the professional development of existing investment managers, data scientists, and marketing staff now being assigned ESG-related responsibilities. They must also consider new hires who may not have the requisite financial background but have a strong background in ESG issues and stakeholder engagement. At the same time, experienced hires with backgrounds in mainstream finance are also increasingly moving into ESG in search of more meaningful work.[38] Finally, the issue of scarcity of ESG talent comes has a geographical dimension; while there is a relatively larger pool of ESG specialists in Europe, it is even more challenging to find individuals with specialist knowledge on the ground in Asia.[39]

### Corporate Lobbying Against ESG

A final challenge, especially in the U.S., is the emergence of organized resistance to ESG integration and shareholder activism around ESG, which is being fueled by corporate and political interests. Organizations such as the Chamber of Commerce and the Mainstream Investors Coalition argue that ESG is distracting companies and investment managers from their duty to maximize shareholder returns. Writing about the Mainstream Investors coalition, which is supported in part by the American Manufactures Association, *New York Times* columnist Andrew Ross Sorkin noted while the claim of this group is that attention to ESG factors is distracting investment managers from a focus on maximizing returns for their "Main Street" clients, their real objective appears to be to limit the

29 https://www.ft.com/content/88cadf34-a07c-11e8-b196-da9d6c239ca8.
30 https://www.ft.com/content/f47642a8-1b35-11e9-b93e-f4351a53f1c3.
31 https://www.ft.com/content/f47642a8-1b35-11e9-b93e-f4351a53f1c3.
32 https://www.ft.com/content/88cadf34-a07c-11e8-b196-da9d6c239ca8.
33 https://www.princetonreview.com/business-school-rankings?rankings=best-green-mba.
34 https://www.unglobalcompact.org/docs/publications/Business-School-Rankings_2019.pdf.
35 https://www.ft.com/content/f47642a8-1b35-11e9-b93e-f4351a53f1c3.
36 https://www.aspeninstitute.org/blog-posts/repurposing-management-education-to-serve-society/.
37 https://www.aspeninstitute.org/blog-posts/reimagining-capitalism/.
38 https://citywireselector.com/news/inside-the-arms-race-for-top-esg-talent-a-ceo-s-story/a1166105.
39 https://www.ft.com/content/9b6ef052-c0a3-11e8-84cd-9e601db069b8.

role of pension funds and large investment managers in focusing on ESG issues in their engagement with companies.[40] Recent research has also highlighted the significant negative impacts of corporate lobbying on climate policy.[41] Investors interested in a company's impact on climate change have traditionally looked at greenhouse gas emissions as metrics of performance. However, a growing number of investors, including the Swedish National Pension Fund, AP7, are now demanding information on whether companies are at the same time contributing to campaigns against climate policy.[42]

## Conclusion

Looking forward, we expect to see client interest in ESG continue to grow rapidly from both retail investors and asset owners. In response, we will see continued progress in integrating ESG factors across as capital markets and increased focus by investment managers on ESG as a value driver for long-term performance. Direct communication between investors and companies on ESG issues will accelerate as large investors increasingly look for direct sources of data on ESG and move past the plethora of intermediaries and rating agencies that now crowd the ESG data space. This in turn may help drive more coordination among intermediaries around the development of a baseline industry framework for defining and reporting on ESG. Investing for systemic impact using frameworks such as the Sustainable Development Goals or the TCFD is also likely to be an increased focus of attention as pressures mount around issues from climate change to income inequality. The PRI, for example, has said it will require its members to report against the recommendations of the TCFD by 2020.

While we are unlikely to see regulators in the U.S. play a role, the European Union may become more active in ESG reporting requirements. In February 2019, the EU gave the green light to a low-carbon benchmarking regulation, marking the first legislative agreement under the EU Action Plan on sustainable finance—and there are more ESG-related requirements expected, including guidance designed to improve corporate disclosure of climate-related information. Finally, as investors focus on ESG as a value driver and risk management tool, we can expect to see accelerating engagement of investors with companies at the governance level as large institutional investors look for assurance that boards are considering material ESG factors in their oversight of corporate strategy and longer-term plans.

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40 https://www.nytimes.com/2018/07/24/business/dealbook/main-street-investors-coalition.html.

41 https://iopscience.iop.org/article/10.1088/1748-9326/aa815f/pdf .

42 https://www.responsible-investor.com/home/article/agm_season_2019_need_to_know_topics_part_1_lobbying/.

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