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Market Structure

ESG: The top 10 things traders need to know

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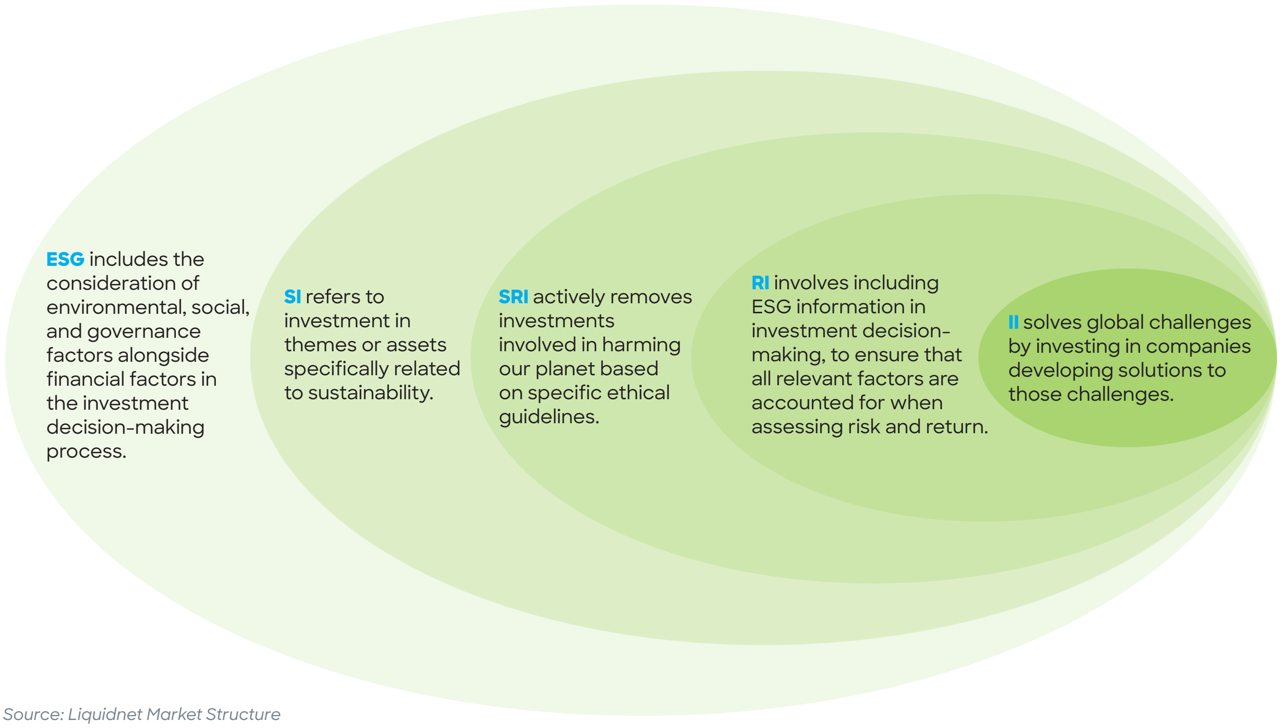
ESG (Environmental, Social, and Governance) is rapidly becoming the key topic of 2019. News that the European Commission has now formally incorporated new legislation on sustainability disclosures[1] will only speed up adoption of ESG factors within the investment process. Asset managers will not only be required to integrate and disclose sustainability risks within their portfolios but will also be required to disclose any adverse sustainability impacts on fund returns and also the climate for the first time. While asset managers will need to adjust portfolios to incorporate this new legislation—what will this mean for traders?

Earlier this year we wrote about the key issues that would impact the future of the Asset Management industry—which included data, technology and ESG[2]. Having attended four conferences in as many weeks Oslo Bors, FIX Nordics, EPFR ClearMacro and European Sustainable Investment Summit, it is clear that the ESG and Sustainable Finance is gathering critical momentum in Europe—and the speed at which this is developing requires all of us in the industry to sit up and take notice. Some may be further along the path of enlightenment than others, but the incorporation of ESG and Sustainable Investment strategies into mainstream asset management is creating challenges and opportunities for all. During the summer, we spoke to 32 individuals comprising of Heads of ESG, RI, Stewardship and CIOs at firms representing $8.2 trillion assets under management as well as ESG data providers to understand how these challenges are being addressed and where the greatest opportunities are unfolding as the sustainability revolution redefines the asset management industry. Here's what we have learnt:

1. What is ESG?

Due to the lack of standardisation in terminology, ESG means very different things to different firms and investors. Historically a fund would simply be labelled as ESG or Socially Responsible Investing (SRI) but now there are multiple interpretations and regional differences as to what is ESG or SRI. This may change with the introduction of the EU Commission's taxonomy[3] designed to improve disclosure requirements on how institutional investors integrate ESG factors in their risk processes, including the creation of benchmarks which will help investors compare the carbon footprint of their investments. This could be extended further by including amendments to MiFID II to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients.



Source: Liquidnet Market Structure

1: *https://data.consilium.europa.eu/doc/document/PE-87-2019-INIT/en/pdf*
2: *https://bit.ly/2m0MCQK, http://bit.ly/2oCG10b*
3: *https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en*

2. Why is ESG moving mainstream?

To meet client demand. It appears that every European asset manager you speak to has either set up, is in the process of setting up an ESG fund or is looking to incorporate an ESG overlay across all funds and all asset classes to meet rapidly growing client demand. According to one panellist at the European Sustainable Investment Summit[4], every mandate includes an ESG questionnaire—some now as extensive as operational questionnaires and even US asset managers, perhaps traditionally not as seen as supportive of ESG as their European peers—are sitting up and taking notice. Performance is no longer the only consideration in ensuring retention of investment mandates.

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.

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http://bit.ly/2oCG10b

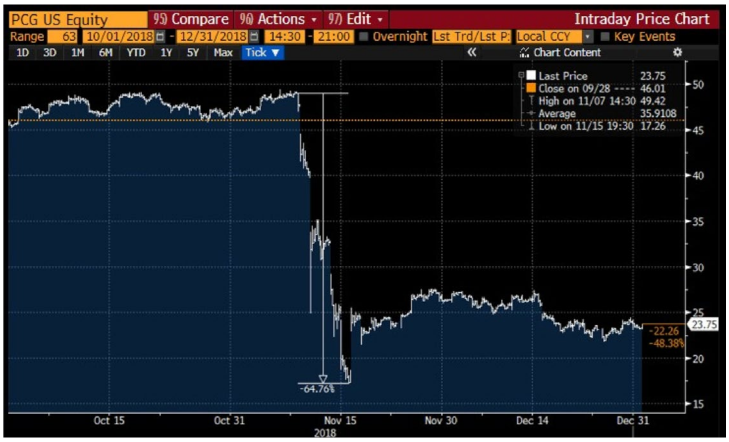
3. Why is liquidity an issue for ESG and sustainable investments?

Performance is only delivered once the investment strategy has been executed. As ESG moves mainstream and certain sectors and assets fall out of favour, PMs may have long-term investment horizons but they still need access to information that could negatively impact a holding ahead of any PR disaster before their peers. Recent examples such as the impact of the Californian Wildfires on PG&E, or Dieselgate on Volkswagen offer clear evidence of the impact of poor governance and the direct correlation on stock performance (*see Exhibit 1*).

“Two thirds of the mandates now have an ESG component. We have to embrace ESG to survive.”

Senior ESG analyst, Global Asset Manager

Exhibit 1: PG&E stock performance – October 2018 – December 2018



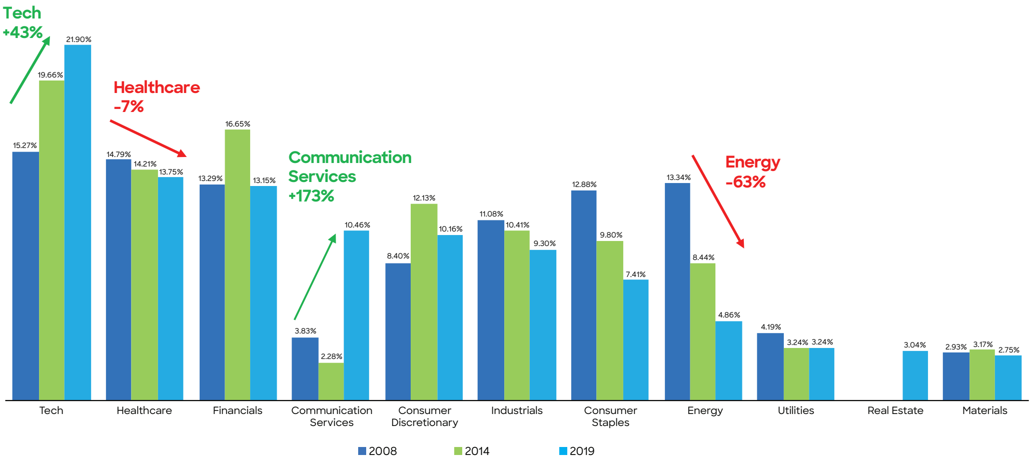
Source: Bloomberg

”Because we include ESG metrics, we knew about the Nissan issue way before the rest of the market. Now you have to look beyond the initial factors to understand whether you need to get rid of a position before it impacts your portfolio.”

Head of ESG, Global Asset Manager based in APAC

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&P 500; they now represent just 4%, a decline of 63% in little more than a decade *(Exhibit 2)*; and current trading strategies need to adjust and evolve as a result.

Exhibit 2: Change over the last decade in S&P 500 sector weights



4: *https://finance.knect365.com/european-sustainable-investment-summit/agenda/1*

Maintaining investments in poor performing stocks 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—"assets that turn out to be worth less than expected[5]"—will represent $20 trillion globally by 2050[6]. 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. Selling into a falling market can be a significant challenge but the extent of the consequences can be severe. The UK-based Woodford group of funds were heavily invested in illiquid assets which not only led to poor fund performance but the suspension of fund redemptions, which eventually led to closure of the fund itself and Neil Woodford losing not only his PM star status but his career.

4. What will the shift to sustainability mean?

Rather than focus on the exclusion of sin stocks, an increasingly broader set of criteria is being incorporated into investment strategies based on one or more of the 17 UN Social Developmental Goals (SDG). SDG is becoming a critical framework to provide measurable outcomes—either as a starting point or as a sanity check for a particular investment strategy. Not all of the 17 SDGs, nor the 169 underlying indicators, can be viewed in the same light, but all can provide a useful best case scenario. This raises some interesting questions such as should a fund invest in US Treasury bonds for example if they object to the US Death Penalty under SDG: 16 Peace and Justice challenging the traditional concept of value.

"If you are an ESG fund and have invested in a company where a scandal breaks, you will also be judged on the fact that you react in a timely manner. Performance is very important but the change in the rating or the loss of an ESG rating is just as important and this means you need to follow any news that comes out."
Head of ESG, Global Asset Manager based in EU

Source: https://www.un.org/sustainabledevelopment/news/communications-material/

5. Why will ESG and sustainable investments require the incorporation of more diverse datasets?

This not only extrapolates the amount of data to be incorporated into an initial investment decision but also to monitor and track the suitability of a particular holding within a portfolio. From MSCI, to SustainAnalytics, Arabesque, TrueValue Labs, or ClearMacro, the new alt data providers offer different services which provides an additional overlay, but ultimately it remains company engagement along with propriety qualitative and quantitative analysis which will continue to provide "the edge", differentiating those who have expertise in this investment strategy versus those looking to follow the herd. This requires technology to be able to read through the growing wall of data and hone in on extracting information of value.

5: *https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/avoiding-the-storm-climate-change-and-the-financial-system-speech-by-sarah-breeden.pdf*
6: *http://ieefa.org/wp-content/uploads/2019/07/Inaction-BlackRocks-Biggest-Risk-During-the-Energy-Transition_August-2019.pdf*

6. Why will access to research have to change?

The current investment process is often manual and prone to error. Rising regulatory and end investor focus is demanding greater oversight as to how investment decisions are made and demonstrative rationale for the decision which will lead to a digitalisation of the investment process. This requires a greater and broader intake of data to back up an investment decision as well as understand the optimal moment to enter or exit the strategy. This is changing what research is consumed ahead of an investment strategy as well as the manner in which it is consumed and how the information is used internally. Half of the respondents in the recent outreach are already looking further afield than traditional research providers and company engagement, incorporating specialist data providers and building proprietary means of analysing new unstructured data sources; 41% are incorporating new public sources of data such as NGO and voluntary company reports.

Aggregating these new sources of data to build an enhanced overview of a company, weighted against The Sustainability Accounting Standards Board (SASB) materiality map or incorporating the UN SDGs, also changes how a company is valued leading to more predictive future evaluations alongside the more traditional retrospective analysis.

With the increased focus of operating in a global 24/7 economy, this investment analysis also has to be tracked and monitored to ensure that any individual investment strategy remains within the guidelines to avoid any risk of greenwashing.

62%

of firms see the incorporation of ESG and RI data as increasingly important to their overall investment process.

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7. What is Greenwashing and why does it matter?

Historically a fund would simply be labelled as ESG or SRI but now evidence is required to demonstrate that a fund is adhering to the ethical standards it claims. The risks associated with green or social washing are not only becoming more prevalent, but also more complex. Investment firms are under increasing pressure to demonstrate just how they are adhering to sustainable investing principles, how research is accessed, what data is used and how this is incorporated into the investment process. In the UK, asset managers also now have a new Stewardship Code from the Financial Reporting Council[7] which reflects the growing demand for more sustainable investments. Committing to this code requires signatories to submit to annual reports to The Financial Reporting Council (FRC) detailing the steps firms have taken to ensure the assets they invest in meet relevant criteria and what checks were taken including auditors.

Last year, in Europe alone, 300 ESG funds were launched which had apparent examples of greenwashing, according to Morningstar[8]. Sixty-one percent of respondents in the market structure outreach 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.

8. How many firms are choosing to educate their staff in relation to ESG?

From the companies asset managers are choosing to invest in and their board members, to the end investors they are acting on behalf of, as well as policy makers and regulators– the education process as to what ESG is today and what it will mean for the industry going forward is essential. Investments for insurance purposes will have different requirements than those from an asset management perspective which sustainability will play a greater role in ESG integration across multiple funds and products.

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.

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http://bit.ly/2oCG10b

7: https://www.frc.org.uk/investors/uk-stewardship-code
8: https://fundselectorasia.com/as-esg-products-grow-greenwashing-follows/

9. How will Fixed Income be impacted by ESG?

Cumulative issuance in green bonds now stands at the $1T mark[9]. The boom is being driven by corporations and governments looking to raise funds to meet carbon emission commitments and meet the Paris Agreement on climate change. The largest market participants are sovereign borrowers, such as France which has issued around $4B in green bonds this year. But increasingly corporates are looking to invest in carbon neutral incentives leading to new types of green bond such as a $1.5B "sustainability" issue from Enel, the Italian energy company[10].

$1 trillion

With the growing demand for green assets, there is a growing challenge in secondary market trading: many green bond buyers hold to maturity meaning buyers often have to pay a scarcity premium ranging from 1-5bps vs. non-green bonds. This is in tandem with a wider liquidity squeeze where a quarter of the $15T fixed income market is trading on negative yields and the average liquidity shortfall across bond funds has increased by about a third over the past two years[11]. Concerns among regulators that bond funds may struggle to meet repayments have been exacerbated by institutional fund challenges such as Neil Woodford, H2O, and GAM and are leading to changing trading behaviours in an increasingly electronic market to uncover liquidity[12].

10. What will ESG mean for passive funds?

The overarching question is how passive management can incorporate ESG strategies when tracking an index. Some argue that poorly rated ESG companies can just be excluded from the index under ESG screening rules-based criteria, such as excluding fossil fuels, but then the question is whether this is really passive or in fact Active, or smart Beta. Others argue that by merely tracking there is no active engagement, therefore tracking the best performing ESG companies remains a passive strategy. Regardless—active or passive—there is potential more inherent systemic risk as tracker funds crowd into a smaller number of assets, particularly if this continues to alter the make-up of indices.

ESG can no longer be considered an investment "fad". It is the means by which asset managers are holding companies to account, scrutinising their P&L to a far greater extent to understand how firms are making money and whether that business model is sustainable in a future carbon neutral world. Put simply, is the investment in a particular company on the right or the wrong side of the UN SDGs on the UN Principles for Responsible Investing. This isn't about hugging trees, it is about identifying the economic success stories of the future. Whether that is the automotive company that is investing in the latest active safety technology (SDG 3.4) or a technology company that offers the largest database of academic research at free or low cost to developing nations (SDG 4.3 and 4.4), or companies investing in electric charging infrastructure to make cities more efficient (SDG 9, 11, or 13). Extinction Rebellion may recently have pounded the City Streets in London to demand action on climate change, but this is not just about climate change, this is investing in the next industrial revolution, which is why every active asset manager is looking to embrace ESG. However, new regulatory focus on disclosures will accentuate the challenges in ensuring asset managers make the right investments. To ensure successful execution of these investments, traders will need to focus on incorporating new data sources and analytics as the squeeze on liquidity becomes exacerbated in the move to a more sustainable capital markets Eco structure.

Read more here.

9, 10: *https://www.ft.com/content/f9baa3b8-f51d-11e9-b018-3ef8794b17c6*
11: *https://www.cnbc.com/2019/08/07/bizarro-bonds-negative-yielding-debt-in-the-world-balloons-to-15-trillion.html*
12: *Bond Liquidity - Survival of the Fittest (September 2019)*

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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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