ASSET MANAGEMENT SOLUTIONS

March 2021

ESG: Transforming asset management and fund distribution

Broadridge Data and Analytics

Ready for Next

This paper represents an update of a version originally published in September 2020. In the short time since then, the expansion of ESG has accelerated even further, calling for a refreshed perspective with data through the end of the year.

Growing much faster than predicted, environmental, social, and governance (ESG) investing has emerged as a leading driver of change in the asset management industry. It is influencing all segments of the value chain, from investment analysis to product distribution, fund selection, manager due diligence, and financial advice. Additionally, it holds important implications for risk mitigation, asset pricing, and shareholder returns.

Asset managers, particularly active houses, have a unique opportunity to harness ESG, sustainability, and impact considerations to position their business propositions around active ownership and stewardship.

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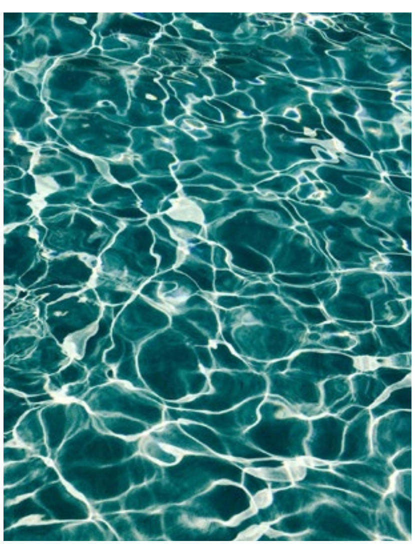
DRIVERS OF CHANGE

Extraordinary demand from institutional and retail clients has supported the rapid growth of responsible, sustainable, and impact investment funds. Global assets in dedicated ESG mutual funds and exchange-traded funds (ETFs) surpassed $2 trillion by year-end 2020, more than twice the amount of five years ago. The US market has witnessed the fastest growth, with assets rising to $275 billion. Additional large sums are managed through private vehicles and separate accounts adopting ESG in the investment process or through shareholder engagement.

Asset managers are continuing to expand their capabilities in ESG investing in response to the demand underpinned by multiple catalysts. Key drivers include rising client demand, risk management considerations, opportunities to improve shareholder value, and responding to long-term forces such as demographics and climate change.

The influence of ESG can be seen across the asset management value chain. It is transforming investment analysis, risk management, product development, distribution, and fund marketing and sales. At the same time, it has heavily influenced financial advisory and wealth management, fund selection, and manager due diligence processes. In response, asset management companies are implementing best practices and adapting their systems, processes, and teams to gain a competitive advantage. Firms are also deploying technology to harness ESG insights from big data.

Although ESG has been more widely embraced in Europe, it is on the verge of rapid expansion in the US, the biggest fund management market in the world. This White Paper provides a global perspective with a deeper look at the US market using our proprietary datasets.



RISING DEMAND AND SUPPLY

Investment activity in ESG mutual funds and ETFs has grown at a remarkable pace with net flows more than doubling to $371 billion worldwide in 2020. Perhaps even more striking was the fact that ESG strategies accounted for one-half of global long-term fund net flows excluding money market vehicles. Although volumes remain greatest in Europe and international cross-border markets, activity is growing much faster in North America.

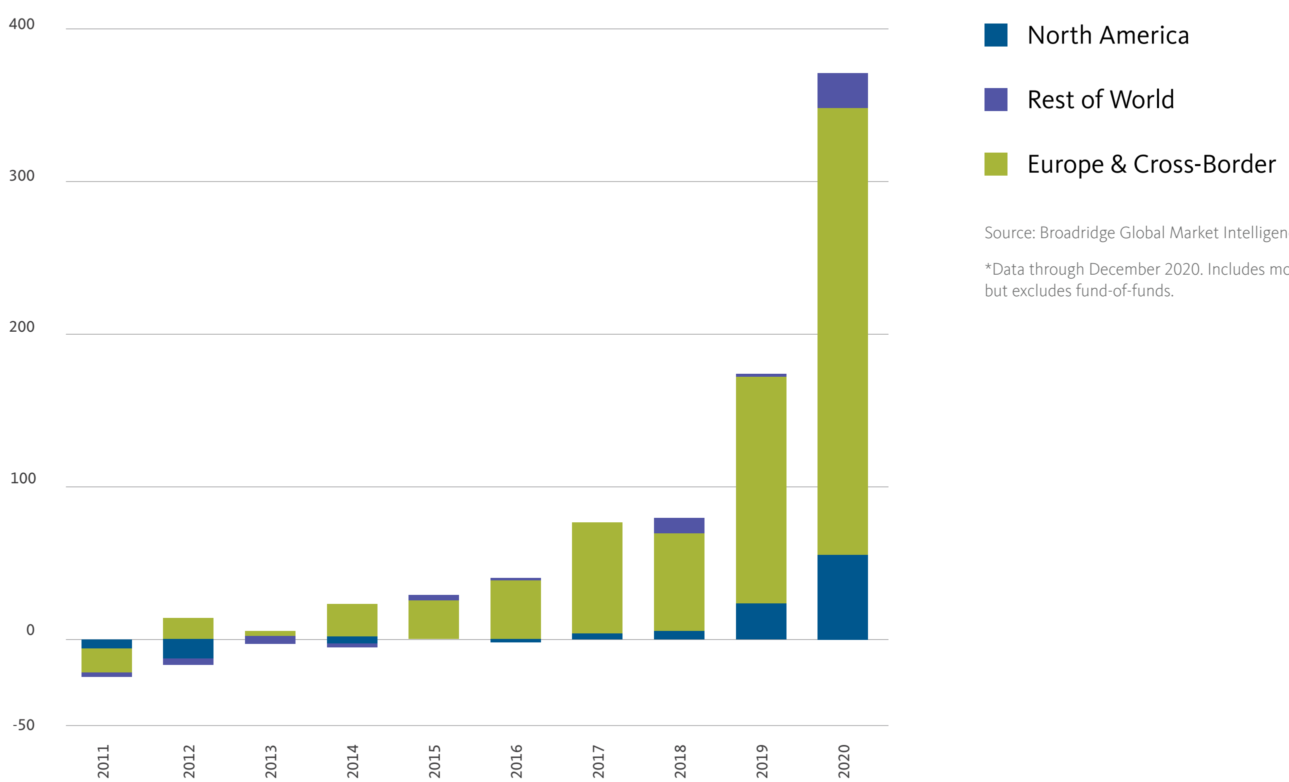
INNOVATION ACROSS ASSET CLASSES

Managers are finding gains across asset classes as they develop responsible investment products beyond traditional equities. Fixed income has been a focus recently, but multi-asset, money market, and liquid alternative options have also emerged to give investors a much broader palette to construct their portfolios. While implementing ESG has been challenging in certain asset classes, access to new data sources and methodologies have facilitated product development.

BUILDING BLOCKS FOR DIVERSIFIED SOLUTIONS

The increased range of ESG building blocks enables advisors to construct more diversified responsible investment portfolios. It gives broker-dealer and advisory firms greater latitude to develop model portfolios, helping advisors to more easily deliver solutions to their clients. Similarly, it allows digital advice and robo-advisors to strengthen their platforms. With deeper multi-asset capabilities, managers can build sustainable, long-term target-date and target-risk solutions for retirement investors. All these developments will help open up ESG investing to a more extensive client base.

ESG fund net flows by region ($ bn)



Source: Broadridge Global Market Intelligence Funds.

*Data through December 2020. Includes money market but excludes fund-of-funds.

EVOLVING FRAMEWORKS AND FUND STRATEGIES

Asset owners and managers are pursuing an increasingly diverse range of approaches, combining elements of both responsible asset selection and responsible ownership. Asset selection entails various forms of screening, along with the systematic integration of ESG factors in investment analysis and decision-making. Responsible ownership encompasses voting, engagement with issuers, and activism.

Individual funds often combine several of these activities yet are classified under one of a few core responsible investment types. As outlined below, these range from exclusionary screening to systematic ESG integration and engagement, best-in-class and positive screening, thematic strategies including sustainable funds, and impact investments.

Responsible investment fund approaches

RI – Embedded	**Exclusions**	The broad strategies apply additional exclusions to the portfolio, over and above the standard screens on controversial weapons, such as cluster munitions and landmines. Exclusions of certain sectors, companies or practices based on ESG criteria, for example, Conventional Weapons, Tobacco, Nuclear, or the Norms-Based Screening (NBS) approach.
	Integration/ Engagement	This category includes strategies that systematically integrate ESG into investment decision-making processes and/or employ proactive voting/engagement strategies.
RI – Screened	**Best-in-class & Positive screening**	These strategies pick those companies that have the best ESG score in a particular sector, including best-in-universe and best-in-sector. Also includes weighting allocations to companies with better ESG scores (tilts).
	Impact Investing	These strategies explicitly target generating a positive impact on sustainable developments, alongside financial return, and includes green- and social-bond strategies. This predominantly applies to private equity and other illiquid products.
	Sustainability/ thematic investment	This category includes a variety of thematic-focused strategies, including renewable energy, sustainable transport, buildings sector, water/waste management, etc. Also includes single-theme and multi-thematic funds, and strategies with a low carbon footprint as an explicit target.

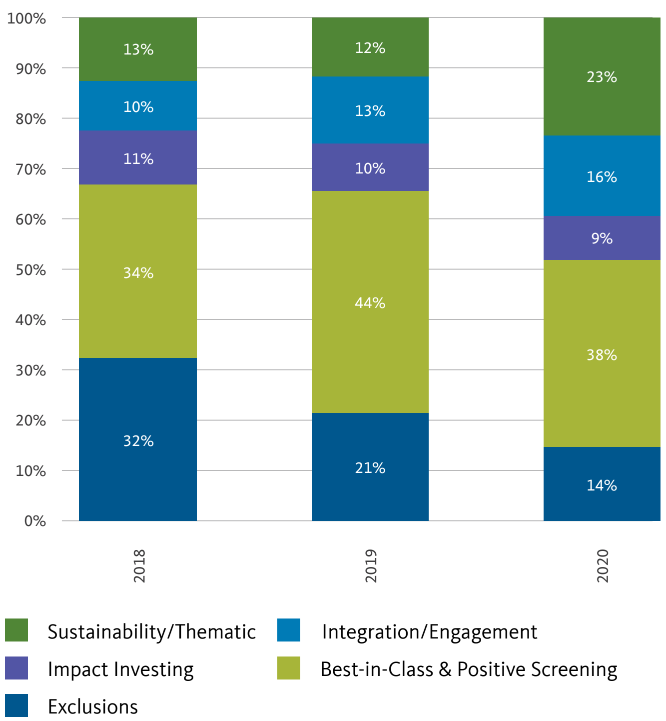
Source: Broadridge Data and Analytics.

SHIFTING CLIENT PREFERENCES

During the past decade, the center of gravity has shifted away from values-based, exclusionary approaches embodied by the first wave of 'socially responsible investing' and ethical funds. Attention now focuses on the systematic integration of financially material ESG risks and opportunities, combined with active shareholder engagement. The needle is also pointing towards thematic, sustainability-related, and impact investments that seek positive outcomes alongside competitive financial results.

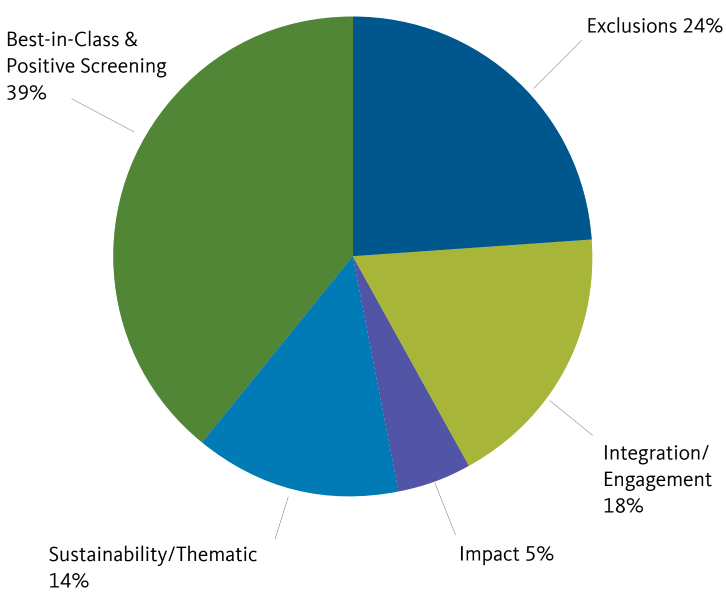
Best-in-class positive screening approaches still capture the largest proportion of investor commitments, but the share of flows going to sustainable, thematic, and systematic integration strategies has expanded. Funds that solely employ exclusionary screens attracted only 14% of flows, a dramatic decline in their share of wallet. As investors favor outcome-oriented strategies such as sustainable and impact funds, asset managers will need to demonstrate how real-world ESG outcomes are being delivered and benchmarked.

ESG funds by type worldwide, net flows (%)



Source: Broadridge Global Market Intelligence Funds. Excludes Money Market.

ESG funds by type worldwide, AUM (%)



Source: Broadridge Global Market Intelligence Funds.

INFLECTION POINT FOR THE US MARKET

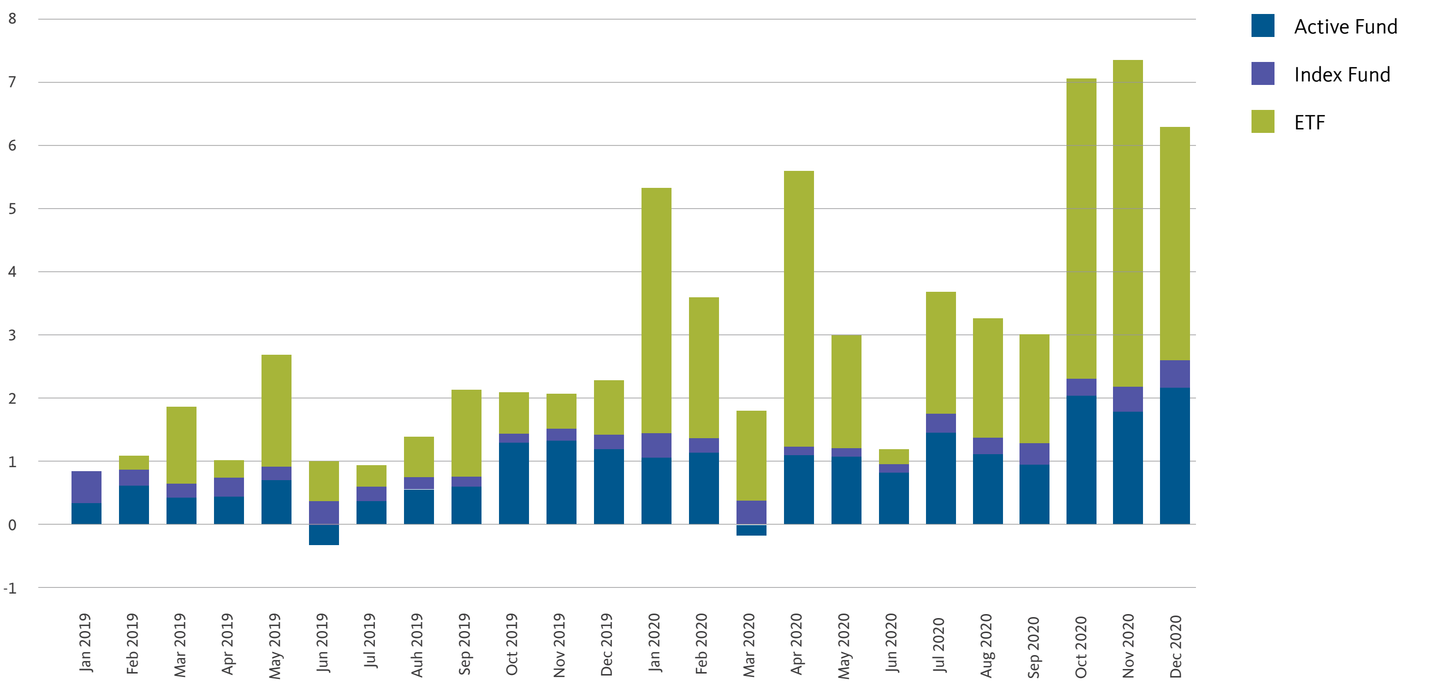
GROWTH AND RESILIENCE

Investors in the US are quickly warming to ESG. Net flows to long-term responsible funds more than doubled in 2020 to $51 billion after quadrupling in the preceding year. Recent gains have been driven mainly by a surge in ETF purchases, although active funds still set new records in each quarter. Together, net flows into active and passive ESG strategies grew despite the financial and economic shocks of the Covid-19 pandemic and surged towards the end of the year.

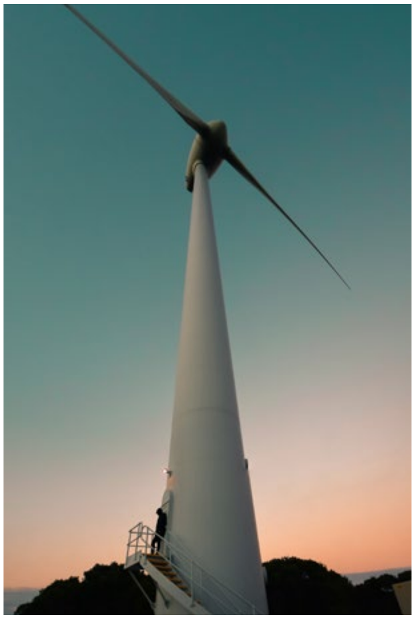
INSTITUTIONAL OPPORTUNITY

The growth of ESG in mutual funds and ETFs has been propelled by both retail and institutional demand. Additionally, about 10% of assets correspond to funds sub-advised by third party managers. Demand from institutional investors is also supporting the expansion of ESG in separate accounts, commingled funds, collective investment trusts, and alternative vehicles. Broadridge's Global Market Intelligence datasets suggests at least $384 billion of professionally managed institutional assets as of September 2020.

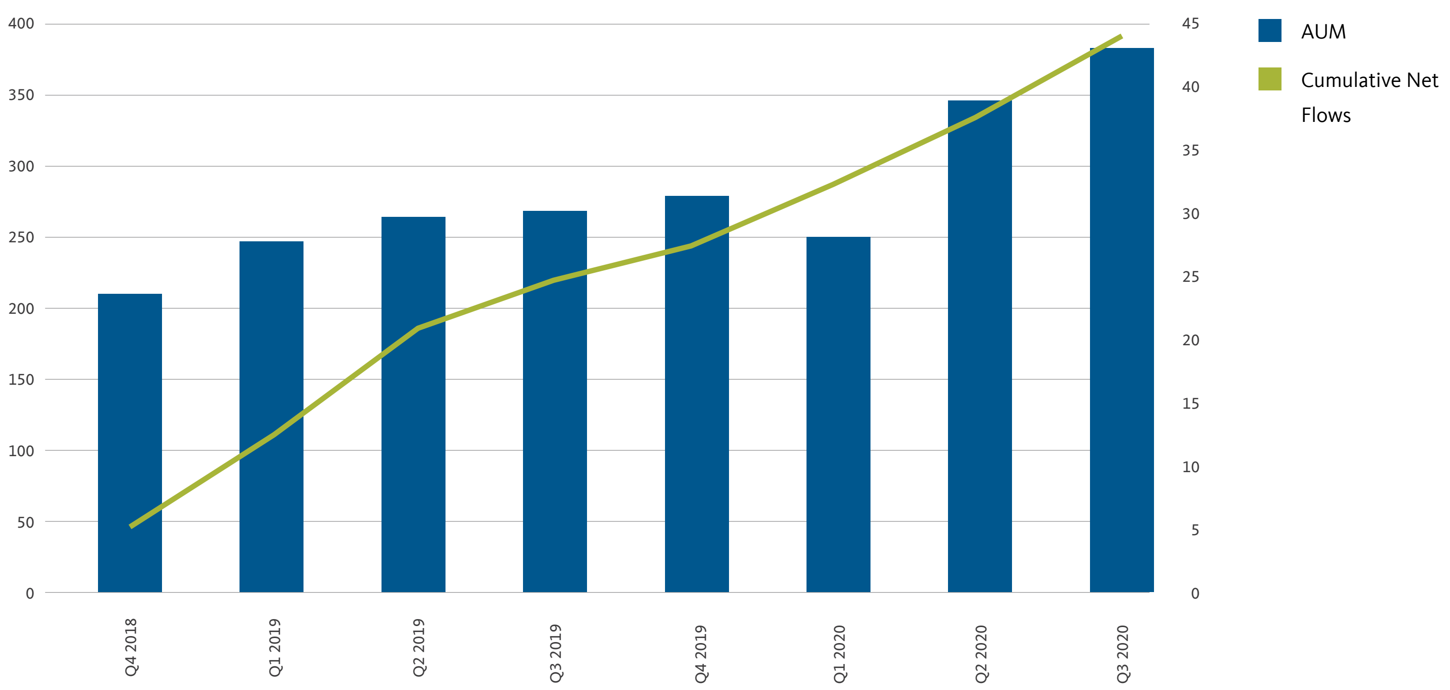
ESG fund net flows in the US ($ bn)



Source: Broadridge Global Market Intelligence Funds. Excludes money market and fund-of-funds.



Institutional ESG AUM and cumulative net flows Q4'18-Q3'20 ($ bn)



Source: Broadridge Global Market Intelligence.

ACTIVE MANAGERS IN THE DRIVING SEAT

HOME FOR ACTIVE EQUITY

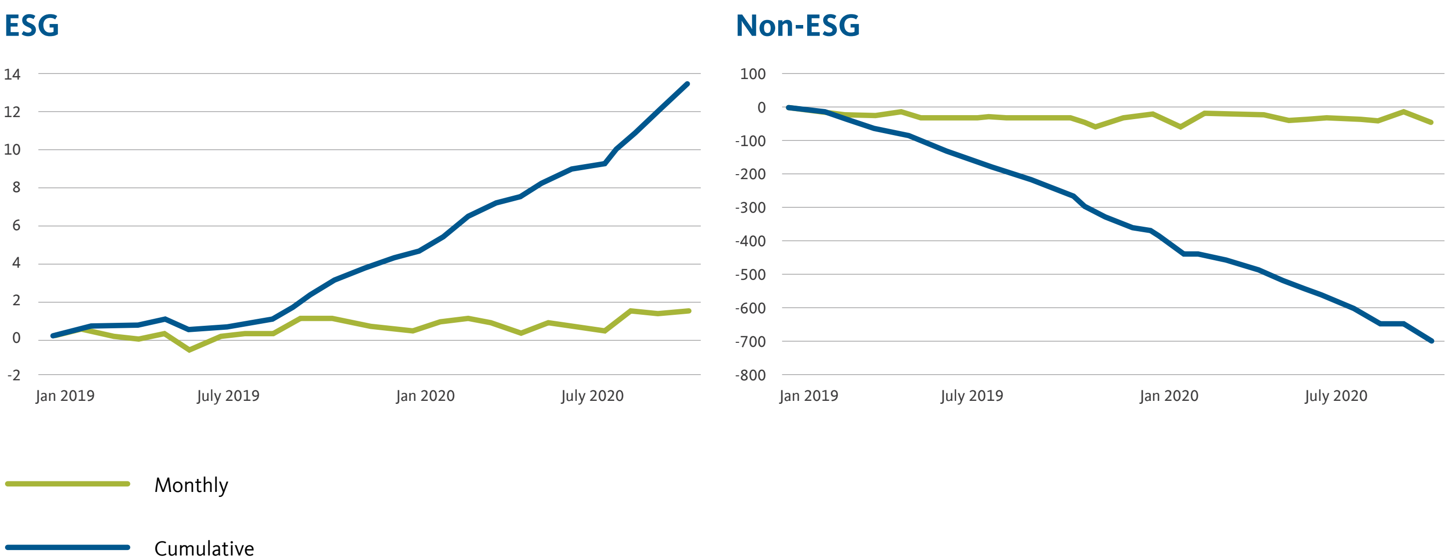
Currently, active strategies account for the majority of ESG fund assets, representing 81% of the segment in Europe and 64% in the US. These numbers will decline over time as passive strategies gain. Active funds in the US attracted 50% of ESG net flows during 2019, but their share dropped to 31% in 2020.

Despite the rising popularity of index funds and ETFs, ESG represents one of the most attractive segments for active fund managers. Flows into active ESG equity funds continue to build steadily, in contrast to persistent net redemptions from non-ESG peers. To maintain their edge in this segment, active managers can highlight their agility in proactively managing risks, leveraging active ownership, pursuing dynamic high-conviction strategies, and delivering sustainable outcomes.

ACCOUNTING FOR COSTS

For both active and index managers, the costs of ESG may rise in tandem with investor expectations for robust, state-of-the-art implementation. Such costs relate to data acquisition, expanded research, growing analyst teams and product specialists, wholesaler retraining, impact measurement, reporting and shareholder servicing, technology infrastructure upgrades, and corporate engagement. For active funds, costs may represent a smaller portion of total expenses than for index funds that compete fiercely on lower fees.

Active equity funds in the US: Net flows ($ bn)



Source: Broadridge Global Market Intelligence Funds.

BUILDING BRANDS AROUND ACTIVE OWNERSHIP

NEW VALUE PROPOSITIONS

The advent of ESG creates a unique opportunity for investment firms to redefine their value propositions and update traditional active management into a more compelling form of ownership. Until recently, most firms were conservative shareholders with relatively passive approaches to proxy voting and engagement. A more forceful engagement strategy can not only improve shareholder returns but also support a stronger brand image as a force for good.

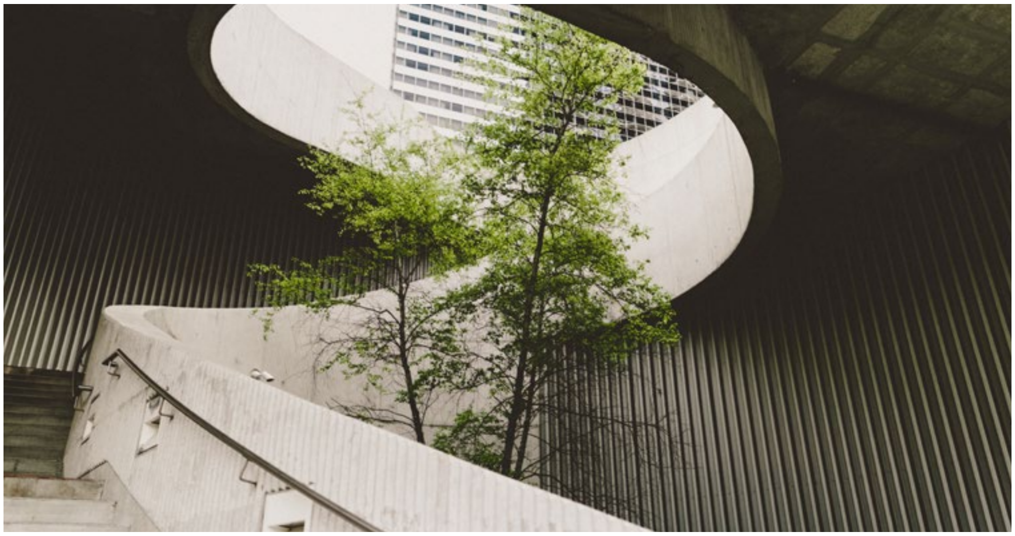
ALIGNING WITH OUTCOMES

Many aspects of ESG investing lend themselves to active approaches. These include the management of non-transparent risks, the ability to reduce or eliminate holdings, and identifying forward-looking opportunities when outcomes cannot be detected easily with current and historical data.

Active strategies also align closely with the increasing focus on outcomes through intentional impact investments and sustainability-themed solutions. These include funds dedicated to climate change, social impact, or investing through the lens of the United Nations' Sustainable Development Goals. Delivering such outcomes, along with measuring and communicating impact, requires more effort from asset managers but serves as an important differentiator between the leading firms.

ACTIVE AND PASSIVE APPLICATIONS OF DATA

Quantitative and index ESG strategies continue to grow in sophistication and can play an essential role in a portfolio. Yet the low correlations between ESG metrics from different providers remains a challenge for constructing rules-based approaches. Also, quantitative information alone has limits when assessing potential ESG improvements that may reward shareholders. Passive managers have also at times been perceived as less engaged shareholders, although most of them are now strengthening their corporate governance activities.



SUPPORTING FINANCIAL ADVISORS

By helping financial advisors in meeting the responsible investment needs of their clients, asset managers can drive faster adoption. In the US, seven out of ten financial advisors use ESG funds, and their usage is expected to increase in the coming years. Advisors serving high net worth clients are even more likely to increase their ESG commitments. While the majority of advisors across all channels use ESG, significant potential remains as only 11% of their clients have assets in such products. Wirehouse broker-dealers may play a key role since a higher proportion of them indicate inclusion of ESG options on their platform and promotion by the home office.

Advisor use of ESG expected to rise

% Use ESG Mutual Funds and/or ETFS

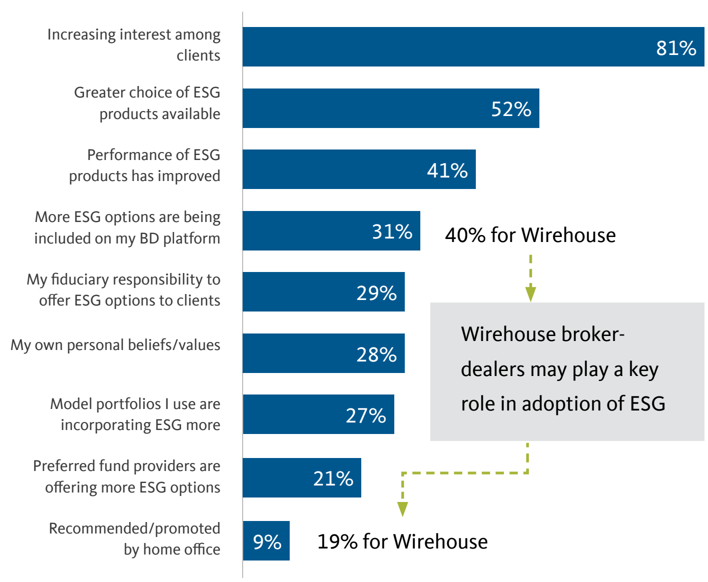
Today	Expected in 2 years
71%	84%

% of Mutual Fund/ETF Assets in ESG
(mean; includes zero)

Today	Expected in 2 years
6%	13%

Source Broadridge, The Impact of 2020 on Advice – and Advisers.

Advisors with higher AUM and younger advisors are more likely to use ESG funds



Source: Broadridge, Needs and Strategies of Financial Advisors – 2021

ROLE OF MODEL PORTFOLIOS

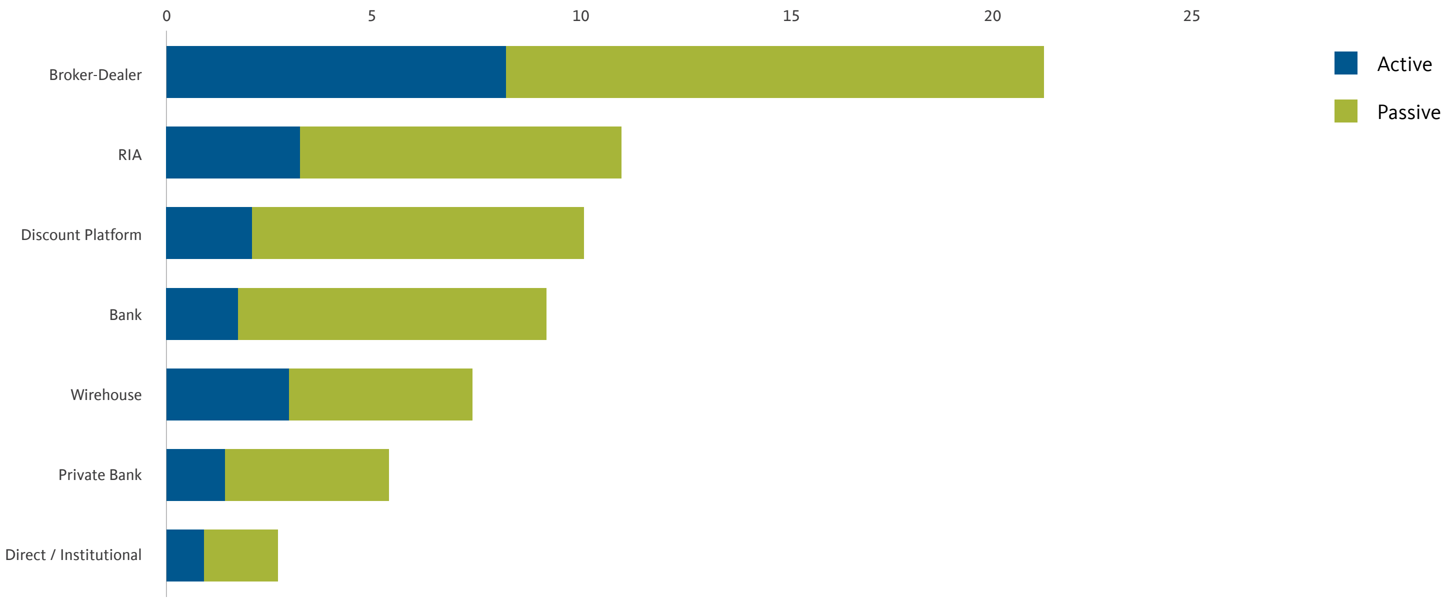
Broker-dealer, registered investment advisor (RIA), and wirehouse channels accounted for more than half of ESG fund flows in 2020. These intermediary channels are especially important for active managers, and managers can play a crucial role in empowering advisors to deliver responsible investment solutions more effectively.

To facilitate greater use, addressing the frequent misalignment of expectations between investors, advisors, and product providers is essential. Gaps in knowledge and understanding of ESG often drive such misalignments. Responsible investment has become complicated and confusing, and advisors need help to advance their learning curve. They also need better tools and content to communicate with clients. Educational programs, greater transparency, and clarity from asset managers about investment processes and outcomes will help.

Upgrading model portfolios to incorporate additional ESG risk and allocation considerations will act as a catalyst for growth. Models are increasingly relied upon in retail intermediary channels through broker-dealer managed accounts, digital advice and robo-advisor solutions, and emerging model marketplaces via fund company and third-party strategists. At least $4.5 trillion in assets reside in model portfolios, with 55% of that invested through mutual funds and 45% via ETFs.

Model portfolios enable advisors to build scalable businesses and to focus more attention on clients. Models implemented through Unified Managed Accounts that integrate separately managed accounts, funds, and ETFs can also offer flexibility for customization to each client's unique ESG preferences.

ESG flows by channel in the US, 2019-2020 ($ bn)



Source: Broadridge Global Market Intelligence – Americas. Excludes trust, retirement, and other intermediary.

COMPETING FOR TRUST AND THE NEXT GENERATION OF CLIENTS

The ESG and responsible investing market is now intensely competitive with a growing number of providers. Large global organizations with extensive distribution footprints and significant resources have prioritized sustainability as an integral part of their corporate strategies.

Many firms, however, remain dependent on Europe for new business. Few have yet succeeded in scaling their capabilities globally. Among the top ten firms ranked by their flows into ESG funds in 2020, seven of them sourced 99%-100% of their business from Europe. As demand for responsible investment ramps up in the US, opportunities will open for both local and international providers.

Sub-advisory relationships to access specialist ESG capabilities may also become more common. Only about 10% of responsible fund assets in the US is outsourced to non-affiliated external managers. Over time, we can expect competition, costs, complexity and scale to encourage a larger number of firms to seek out sub-advisory partners across the spectrum of sustainable investments.

Top managers of ESG funds by net flows, 2020

		ESG Net Flows			ESG % of
Rank	Group Name	$bn	% Active	% Europe	Total Flows
1	BlackRock	65.6	14%	64%	32%
2	UBS AG	14.9	44%	100%	>100%*
3	Intesa SanPaolo Group	10.6	100%	100%	>100%*
4	Amundi	10.4	23%	100%	>100%*
5	Crédit Suisse Group	10.0	52%	100%	70%
6	Nordea AB	9.2	100%	100%	86%
9	Pictet	8.3	100%	99%	53%
8	BNP Paribas	8.1	65%	100%	>100%*
7	DWS	7.6	22%	88%	>100%*
10	Mizuho Financial Group	7.3	>100%	0%	>100%*

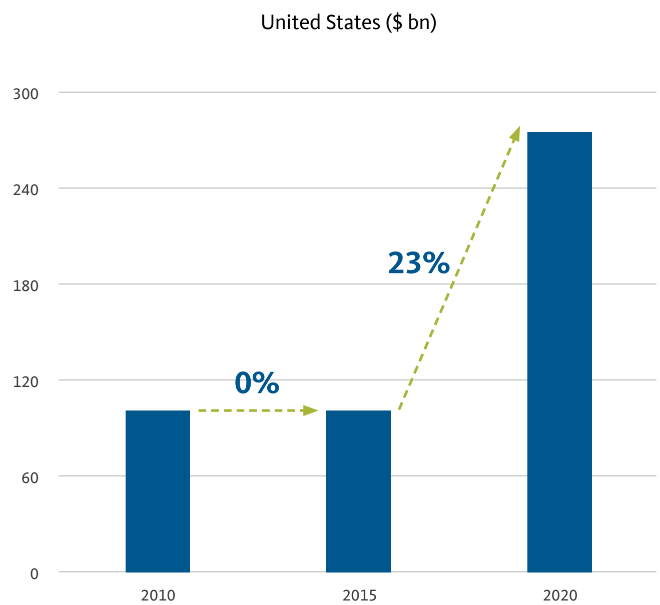
Source: Broadridge Global Market Intelligence Funds. Excludes money market and fund-of-funds.
Europe includes international cross-border. >100%* denotes net outflows from the company's full fund range.

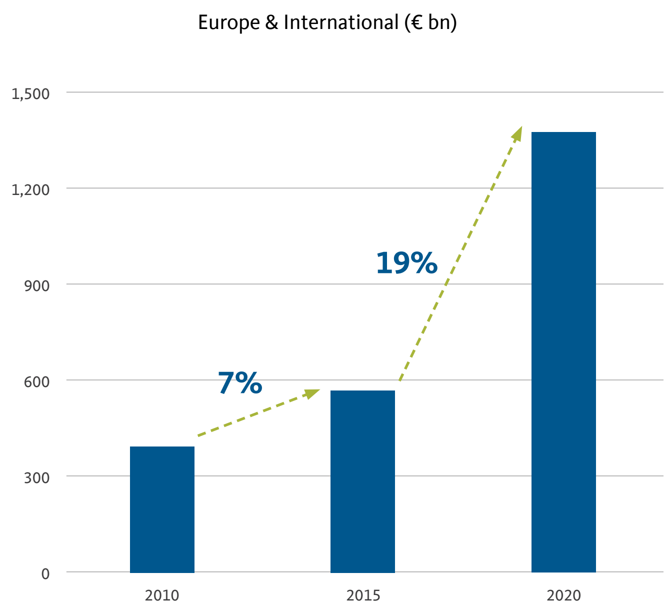
BROADENING THE CLIENT BASE

During the past decade, ESG has become an important force in the asset management industry. Assets have expanded dramatically with compound annual growth rates (CAGRs) of 23% in the US and 19% in Europe and international cross-border markets in the past five years. These rates are much higher than in the preceding half-decade, and roughly 2-3 times greater than for non-ESG products.

As ESG moves into the mainstream, asset managers have a chance to engage with a broader client base - especially with younger investors - and to facilitate committed, longer-term savings. Also, successful integration into the investment process may contribute to better management of risks and improved shareholder returns – a potential source of alpha. The fund industry can also play a more vital role as allocators of financial capital for sustainable growth.

ESG fund AUM and CAGR





Source: Broadridge Global Market Intelligence Funds. Includes money market but excludes fund-of-funds. International represents cross-border funds, primarily UCITS.

UNLOCKING THE AMERICAS

SURPASSING $600 BILLION NEXT YEAR

Europe has established a long lead in ESG investing and will likely maintain a higher volume of business for the foreseeable future. However, recent gains in the United States have been remarkable. If current growth rates persist, assets in the US will exceed $600 billion by the end of next year. As a result, asset management companies from around the world – and particularly from Europe – will find more attractive opportunities in the Americas.

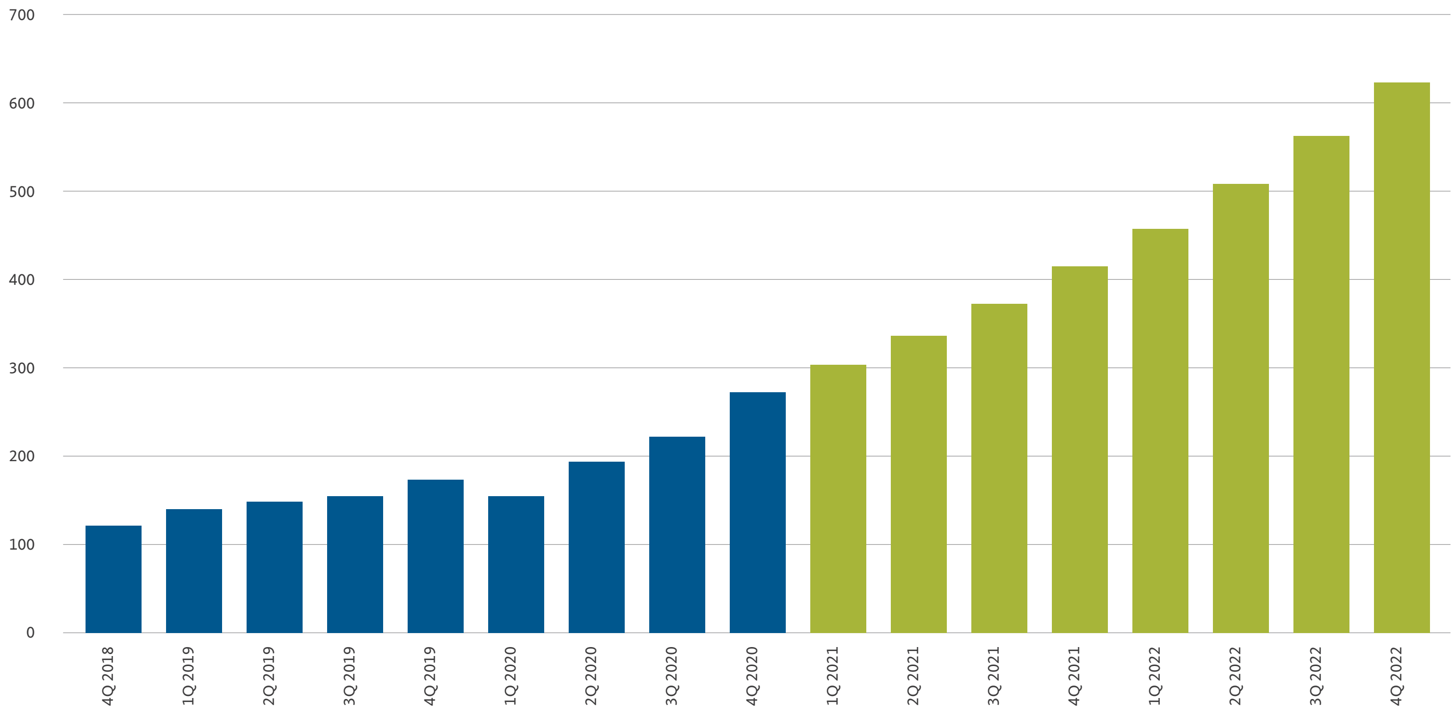
The most successful approaches will align with broader distribution trends in the US market. These include the widening divergence between active and passive funds, the rising importance of asset allocation programs and model portfolios, the ongoing shift to fee-for-advice solutions, channel developments including the expansion of registered investment advisors, emphasis on lower cost and higher quality, and the growth of digital platforms.

NEW REGULATORY DIRECTIONS

Changes in the White House suggests different regulatory and policy attitudes on ESG investments as well as shareholder engagement and proxy voting. The Department of Labor's final rule on Financial Factors in Selecting Plan Investments could be revisited, and the Securities and Exchange Commission may explore enhanced ESG and climate risk disclosure requirements. Government policy on climate change, renewable energy and green infrastructure could also create opportunities for asset managers in sustainable investment.

Across the Atlantic, regulation will consume significant resources from asset managers in Europe. In particular, the Sustainable Finance Disclosure Regulation (SFDR) requires firms to differentiate between 'light green' and 'dark green' strategies, and to disclose the adverse sustainability impacts of their investments. Some of this thinking may travel to the US and other regions in time.

ESG fund AUM forecast for the US ($ bn)



Source: Broadridge Global Market Intelligence Funds. Includes money market but excludes fund-of-funds.
Forecast assumes growth rate since 2018 persists until 2022.

LOOKING FORWARD

While ESG holds promise for asset managers, the next stage of growth will require substantial commitments by firms to adapt their systems, processes and teams. The proliferation of data has opened many possibilities. At the same time, it has also created challenges in extracting relevant insights for investment decisions and shareholder engagement. The industry is trying to develop more useful metrics, key performance indicators, standards and benchmarks grounded in financial materiality.

As firms pursue their business strategy in this space, they will consider the benefits of outsourcing key inputs and functions such as ESG data acquisition, technology and analytics. And potentially even investment management through sub-advisory routes. Costs will remain an essential factor in this equation.

How asset managers support financial advisors in meeting the responsible investment needs of clients will be critical. Upgrading advisory toolkits, especially model portfolios which increasingly guide allocation decisions, could facilitate adoption. Retraining wholesalers and product specialists to clearly articulate a company's ESG array will also be essential.

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POINT OF VIEW: SPECIAL

A Focus on ESG

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