A Blueprint for Leading in Sustainable Investing

April 2021
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Boston Consulting Group partners with leaders in business and society to tackle their most important challenges and capture their greatest opportunities. BCG was the pioneer in business strategy when it was founded in 1963. Today, we work closely with clients to embrace a transformational approach aimed at benefiting all stakeholders—empowering organizations to grow, build sustainable competitive advantage, and drive positive societal impact.

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A Blueprint for Leading in Sustainable Investing

Most asset managers recognize that sustainable investing is the new standard. But it's one thing to know and another one to deliver. And it's the delivery that's proving challenging. Too many asset managers continue to approach environmental, social, and governance (ESG) issues in piecemeal fashion, resulting in equally piecemeal processes that make it harder for firms to acquire the depth of insights needed to differentiate their offerings and provide credible proof of true ESG value.

From our recent survey of more than 50 asset managers with a combined $20 trillion in assets under management (AuM), and from our work in the sector, we see the full spectrum of ESG maturity. Some firms have truly integrated sustainability into their DNA, while others are struggling. Only about one-quarter of those surveyed said they manage 20% or more of their assets using fully integrated ESG. The lack of ESG integration is now hitting the bottom line: one-third of US asset managers reported that they lost or were at risk of losing over 20% of their institutional mandates because of their inadequate ESG capabilities. Asset managers that fail to improve their offerings and capabilities risk being left behind by their customers.

Sustainable investing is worth getting right. The leaders today enjoy a competitive advantage that we think will be durable. Their ability to incorporate material ESG information, apply differentiated proprietary data, and create a purposeful culture that attracts and retains top talent will establish a brand identity that will appeal to discerning, high-value clients and make it much harder for slower-moving peers to gain inroads.

The good news is that there is a blueprint for sustainable investing leadership. We have deeply studied how to make sustainable investing work within an asset manager context and have helped many firms put these insights into practice over the past several years. The basic framework is common sense. It's holistic because sustainable investing is by its nature an end-to-end process from idea generation through reporting. Each part must be integrated so that it works and is credible in the eyes of regulators and customers.

Strategy—a Purposeful Edge

A few years ago, an asset manager could have a conversation about whether to lead or fast follow. Not anymore. Today, clients and regulators are setting the pace. The real question now is whether a firm is able to keep up, given the growing spread between leaders and laggards. Top firms are going all in, some in very public ways, to realign their business model as sustainable investors. The models have many differences, but these leading firms all see sustainable investing as their future and believe that anchoring their sustainable investing strategy to their corporate purpose gives them a big advantage.

Sustainable investing isn't a sideshow and it's certainly not going away—it's now simply how business is done.

Investing is a deeply people-centric business. Investment strategies, at their core, are simply ideas that come from talented people thinking about the world in novel ways. As a consequence, the ability to attract, develop, and retain the best talent is also a competitive requirement. Today's workforce, especially younger generations, seeks purpose. Sustainable investing is a gift in that regard. The smartest firms have seen this and are enjoying the edge of being purposeful. Others should take note and follow quickly because being the last over the line won't be a good look.

ESG Integration—the Real Deal or an Imposter

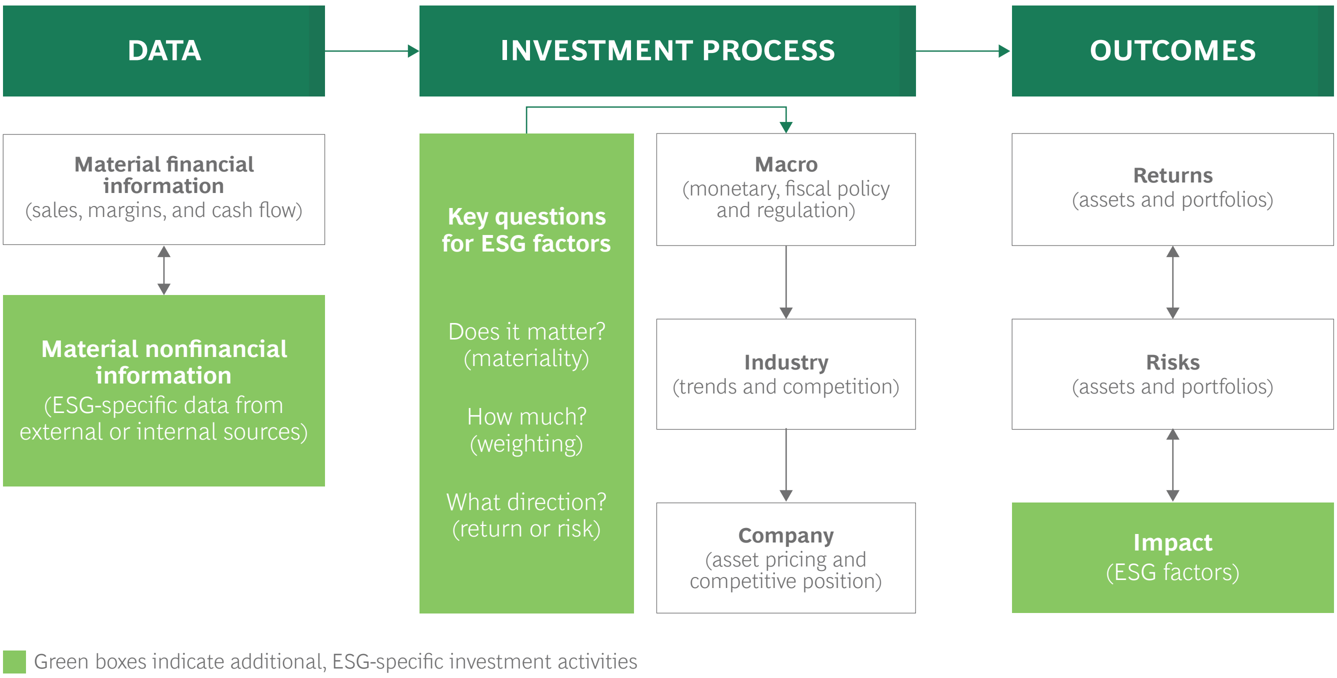
Understandably, there is a lot of confusion about how to integrate material ESG information into the heart of the investment process. Translating data such as ESG scores into meaningful cash flow impacts is new thinking for many, and the links are not widely established. For long-duration assets, such as ports, roads, and other infrastructure that are exposed directly to climate risk, firms are accustomed to taking environmental factors into consideration in their analysis. But some other assets, like technology stocks, are new territory, and the impact of ESG information will vary widely.

As a result, we see many firms purporting to integrate ESG information when, in reality, they're doing so at a superficial level, driven by compliance demands more than client needs. Companies that continue on this path are setting themselves up for failure. They will miss out on the information value of material ESG data and will be left behind as clients and regulators quickly sort out those firms that can truly integrate ESG end to end from those that cannot—that is to say, the authentic players from the pretenders.

To truly integrate, investors need to recognize ESG information for what it is—a highly imperfect, potentially very meaningful source of new data that sits alongside traditional investment criteria. Like any other data source, such as credit scores, ESG data should not be taken at face value. Asset managers should do their homework and triangulate multiple sources of internal and external information to raise their confidence and sort meaningful information from noise.

Then investors need to answer three basic questions: How material is the ESG factor? What weight should we give it? And will the impact improve returns or add risk? (See the exhibit.) Each investor needs to answer these questions for themselves, weighing all the available information, both ESG and traditional.

A Framework for ESG Integration



Source: BCG analysis.

Note: ESG = environmental, social, and governance.

Authentic ESG integration will enable investors to explain logically how upstream decisions link through to all investment outcomes. Imposters will struggle to explain how they arrived at their decisions and will face both regulatory and client exposure.

ESG Data—Pain and Opportunity

In our recent survey, asset managers cited data quality as the top challenge they face when trying to integrate ESG into their investment process. The quality issues are well known and include inconsistent methodologies, a lack of longitudinal data, and other gaps. Pristine near-real-time data is a relatively new asset in the world of investing. Two decades ago, an investor had to thumb through dense, heavily footnoted annual reports and compute a firm's income statement using a calculator. It may feel like we are at a similarly early stage with ESG data. And although that's frustrating, it's a natural state that will improve as standards and norms form.

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Analytics will drive that progression. Because ESG data is unstructured and almost limitless in quantity, it is ideal for machine learning and advanced analytics. Some asset managers with superior analytics capabilities have already begun to innovate. One firm, for example, built an in-house scoring model that now covers 6,000 companies. Another created a framework that measures climate change impacts. And a third developed an ESG engine that consolidates data from multiple vendors and provides an analysis of 10,000 companies.

Investment Products—Proliferation to Personalization

ESG products have ballooned in recent years, leading to confusion and skepticism about labeling and performance. For example, some ESG funds tout their strong returns but don't make clear that the real drivers are sector characteristics, such as a heavy weighting toward technology companies that have seen above-average rates of growth, and not ESG practices alone. We believe that performance distinctions are a misnomer and that labeling and transparency will improve in the near term with regulation and customer scrutiny. Longer term, bright lines between ESG and non-ESG products are likely to fade as sustainable investing practices become the norm for all offerings and are integrated into the underlying investment engine.

One area where leading asset managers will be able to carve out differentiation is in portfolio construction. Over the next few years, the ability to create a truly personalized portfolio that reflects how a client thinks about sustainable investing will transform the ESG product landscape. Institutions, advisors, and individual investors will increasingly be able to express their views on what they want to own. This type of customization would normally require an expensive and complex separately managed account (SMA) structure. But direct indexing and fractional ownership have broken down that barrier. Asset managers can now build deeply personalized portfolios involving small sums and do so at scale.

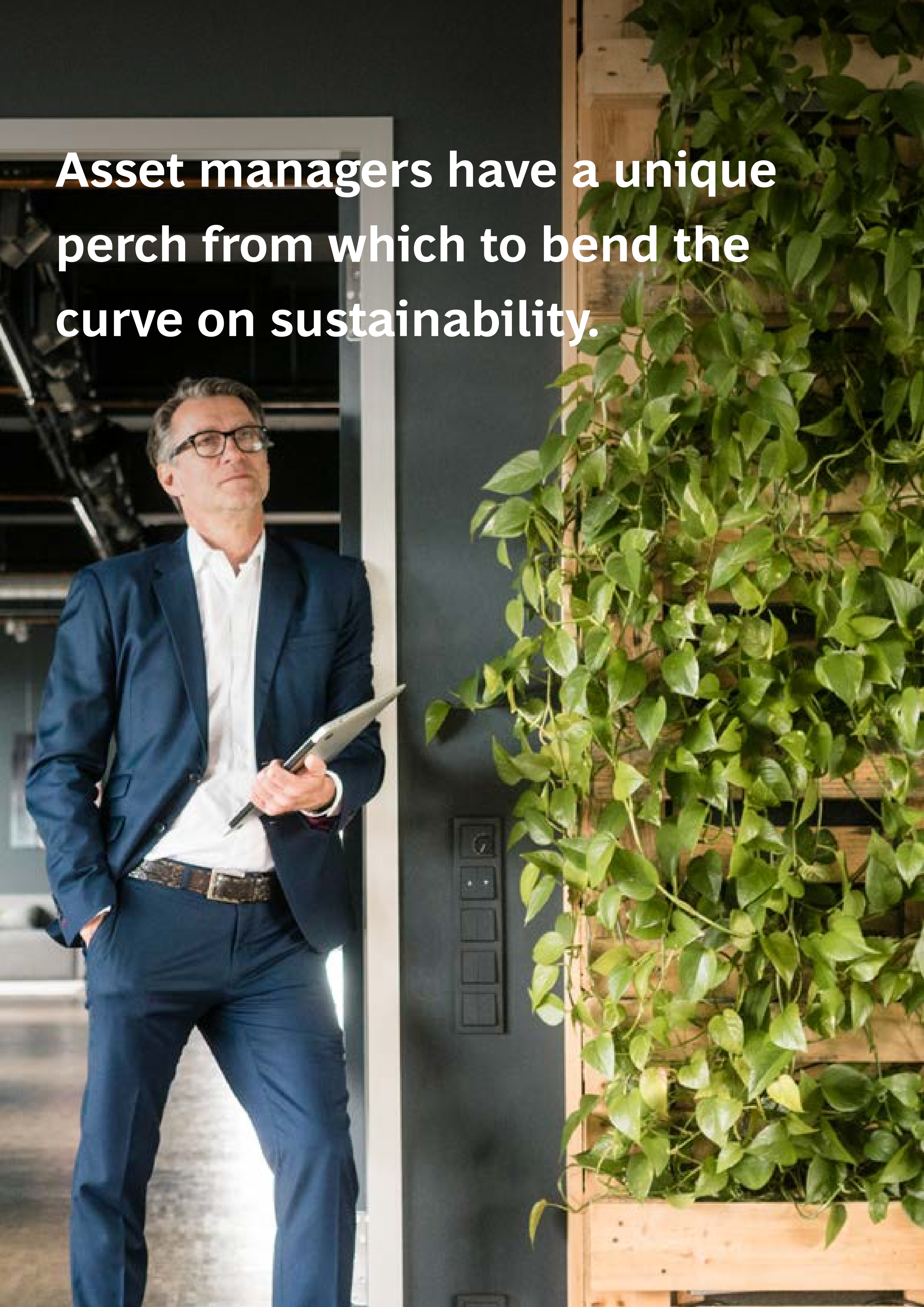
Reporting—Scale and Standardization

Sometimes, looking in the mirror can be uncomfortable, which is how many of our clients feel about their ESG reporting. Until relatively recently, firms didn't need to worry about ESG reporting at scale. Some did it because that was their culture from the beginning. Most did not because, well, it didn't matter. Now, it matters a lot. Clients and regulators want to see "the proof in the pudding."

It's early days for reporting, and firms are being admirably resourceful, using visuals such as climate thermometers and custom scoring methodologies to offer a basis of comparison. Such measures will create some advantage when communicating with customers in the short run. But in the end, once standards are made clear, we expect the hype around reporting to fizzle. And then clients will, as they should, focus on the machine that created the outcomes. Firms would be wise to keep their eyes on the long-term prize and start building (or buying) the capabilities they will need.

In Europe, the standards for doing so are rising fast. Asset managers operating in Europe must comply with the EU's Sustainable Finance Disclosure Regulation (SFDR), which requires firms to harmonize their ESG reporting and upgrade their disclosures on the sustainability risks and impacts of their investments. By 2022, SFDR compliance will have further stipulations. Asset managers may be required to calculate dozens of quantitative ESG indicators at the portfolio and product levels, such as aggregate carbon emissions, average gender pay gap, and the number of human rights incidents. That's a tall order for most firms today and one that will necessitate managing large amounts of highly detailed and traceable information on each of their investee companies.

Asset managers have a unique perch from which to bend the curve on sustainability.



Also, by 2022, managers will need to align their ESG products with the new "EU taxonomy"—a unified classification system for green economic activities under the EU's sustainable finance regulations. Conforming with the taxonomy will require firms to have even more data than for the SFDR and follow changes to the taxonomy as it evolves. Non-EU funds may also encounter stepped-up scrutiny. Those with an EU presence or ESG-minded investors may face pressure to upgrade their reporting and harmonization.

Engagement and Voting—Productive and Proactive

Asset managers have a unique perch from which to bend the curve on sustainability: through engagement, they can help bring about ESG changes in their investee companies.

Private capital investors, with their longer hold periods and control positions, are particularly well suited to drive change—for example, by mandating board diversity, linking lines of capital to sustainability metrics, or crafting an ESG strategy to transform "dirty" businesses into clean ones. Beyond being the right thing to do, it makes great financial sense, given that buyers are increasingly paying a premium for assets that have undergone a sustainability transformation.

Public-market investors have two challenges. First, even the largest asset management stakes are only a small fraction of a company's equity. Second, engagement is the latest sustainable investing buzzword; hence, the current race to engage. Many investee companies are experiencing a proliferation of low-value interactions with asset managers. High-quality campaigns exist, but it's not practical for most asset managers to prepare these for every name in their portfolios. Instead, a better route is collective action—advocating for shared sustainable investing principles across the industry.

Firms must also be more thoughtful about their voting record. We expect a company's voting record will soon be available like a calorie count on a food label. Asset managers need to anticipate such a shift and start taking appropriate action now.

Go to Market—Authenticity and Trust

The last mile in sustainable investing is distribution: the marketing and selling of investment products to individuals, advisors, and institutions. Today, between unclear product labeling and a lack of training for sales people, the messages leaking into the marketplace can be quite confusing. By one measure, fully two-thirds of global equity AuM is "sustainable," a claim that few would deem credible. We believe firms that are authentic and transparent about their investment process and products will be rewarded with customer loyalty.

Effective training will be key to building and retaining strong customer relationships. In asset management, most sales are still done person to person. It can take months, and even years, to build rapport and trust before money changes hands. Given the long-term nature of these relationships, getting ESG messages right is all the more critical. Leading firms are investing heavily in training and development to ensure that their messaging is accurate and compelling.

Talking about your ESG commitment matters but only if fund managers believe that commitment is genuine. A senior sovereign wealth fund manager tells us, "Asset managers like to parade their ESG leaders in front of us. But with all due respect to those individuals, the people we want to hear from are the portfolio managers. We like to go onto the shop floor and ask them how they're running ESG in practice." A pension fund manager says, "If a portfolio manager can't give me a documented example of why the portfolio looks different because of ESG integration, then it's clear they're not doing it." On one hand, it's troubling if you are one of these asset managers who can't pass the authenticity test. On the other hand, the motivation of capital outflows could be a tide that stimulates more forward thinking, raising more boats than it moors.

There is no doubt that sustainable investing is a messy, confusing, and exciting topic for asset managers, one with the potential to shake up the industry and create new sources of competitive advantage. Scale will continue to matter, performance will always matter, and so will fees. But now, sustainability will matter as well. At root, the best investors have a deep desire to understand how the world works—economies, markets, and people. It's all connected, and it always has been, but now we have a name for it.

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