BY WIM WEIJGERTZE
AND RYAN ALLISON

A flourishing relationship between asset manager and asset owner: aligning sustainable investment solutions with institutional investor needs

The last year has seen a particularly meteoric rise in the popularity of sustainable investing, with institutional investors increasingly seeking to identify attractive investment opportunities which meet their risk and return objectives as well as achieve strong ESG (environmental, social and governance) performance.

Asset managers have consequently expanded their offerings to align solutions with client needs. Q3 2020 data released by Morningstar[1] indicates that global inflows into sustainable funds were up 14% to $80.5bn, while sustainable product development hit an all-time high with 166 new offerings (including 38 in countries outside of Europe and the U.S.). Asset managers also continued to repurpose and rebrand conventional products into sustainable funds, with 32 of such funds in Europe.

This growth is driven by several key factors which we explore further in this article: societal expectations, regulatory demands, and the search for yield.

Drs. W. Weijgertze AAG (left) is senior manager at Ernst & Young Actuarissen B.V. and R. Allison FIA is manager at EY Actuarial Services UK.

This article was written in an individual capacity.

DRIVERS OF CHANGE: THE RISE IN POPULARITY OF SUSTAINABLE INVESTING

A shift is underway within the corporate world, with organizations moving away from a shareholder primacy mentality to one of striving to create genuine long-term value for a range of stakeholders. It is arguably no longer acceptable for an organization to simply create returns for shareholders, but rather generate value in a sustainable way for its customers, employees and broader society.

And while societal expectations of a "good corporate citizen" continue to evolve, there are significant regulatory demands in this space for financial services to comply with. The EU Sustainable Finance Action Plan is far-reaching in nature and places a significant burden on firms, with the Sustainable Finance Disclosure Regulation (SFDR), going live in March 2021, significantly increasing disclosure of sustainability risks at a portfolio level.

This will have a material impact on asset managers and institutional investors in Europe who have been frontrunners in ESG investing to date. Expectations to invest in socially responsible products have on the one hand stemmed from sustainable investing principles incorporated in various European countries, and on the other hand emerged as a result of institutional investor's individual stakeholder demands (Figure 1).

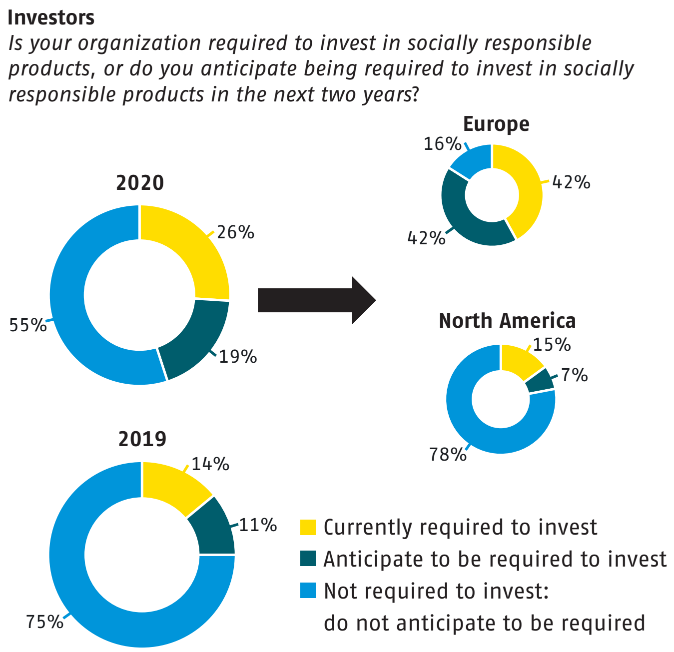

Figure 1
Source: EY 2020 Global Alternative Fund Survey

In the Netherlands this is further emphasized by the covenant signed at the end of 2018 by more than 200 organizations (several of which are pension funds), which states that those organizations will cooperate to invest more sustainably.

Furthermore, a group of 50 banks, pension funds, insurers and asset managers signed the "Climate Agreement" in July 2019. By signing this they are obliged to report on the climate-related impact of their investments starting from 2020 and have agreed to have action plans in place by 2022 to reduce their CO_2 emissions.

Another driver in the increase in allocation to ESG funds is return. A common school of thought is that there is at least a non-negative correlation between integrating ESG factors and financial performance, with academic literature and market commentators reinforcing this sentiment. Recent analysis from Fidelity International[2], for example, identified that stocks with an ESG rating of 'A' (based on its proprietary ESG rating system) consistently outperformed the MSCI AC World Index throughout 2020.

This however is only one side of the coin; it can be argued that ESG "outperformance" is somewhat warped in 2020 due to ESG funds typically being overweight in the technology sector, and underweight in carbon intensive sectors such as oil and gas and transportation. These sectors have been disproportionately affected during the unprecedented Covid-19 era, and so may act as a skew on the performance outlook of such funds.

Regardless of your sentiment on the ESG outperformance debate, it is clear that institutional investors continue to have an insatiable appetite for less liquid asset classes which offer a yield pick-up over longer durations. Such investments include renewable energy assets, infrastructure loans and social housing, and typically achieve attractive returns as well as being intrinsically of ESG value by their very nature and characteristic (Figure 2).

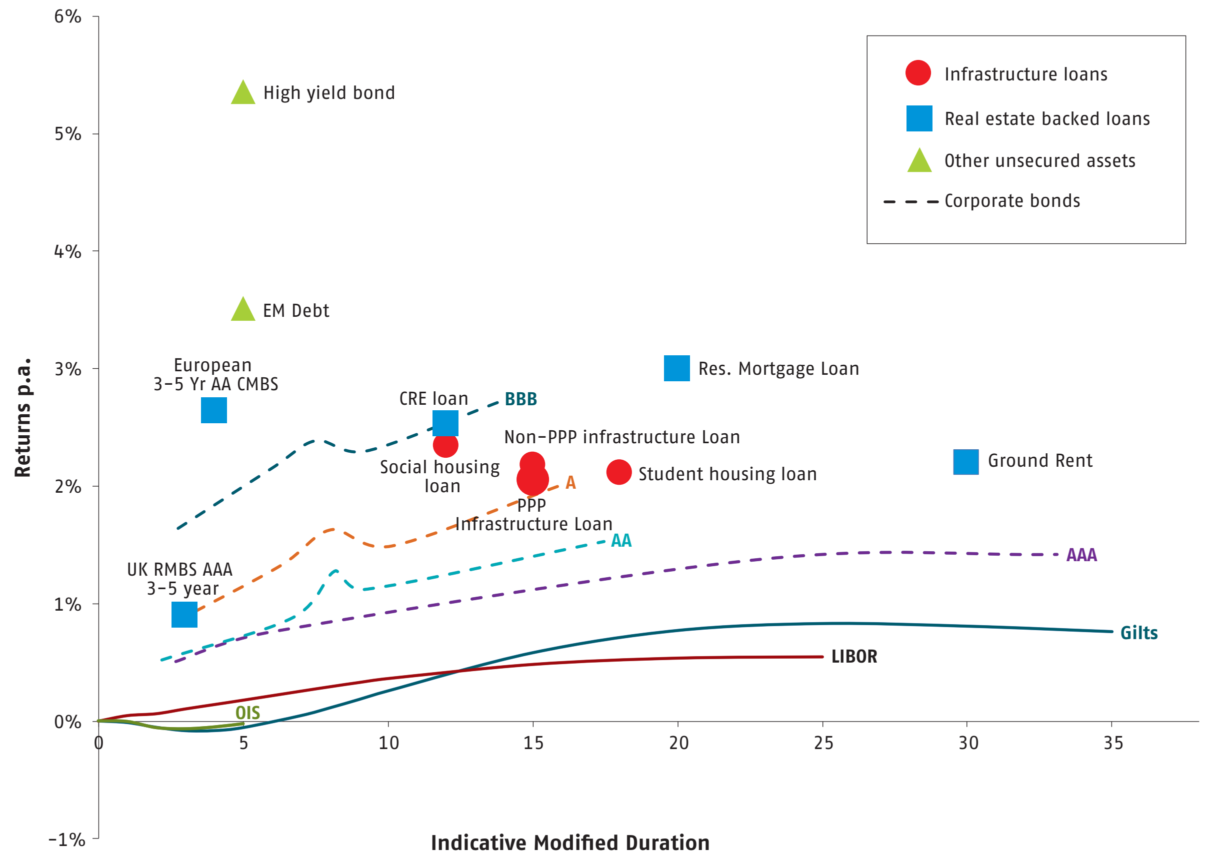

Figure 2
Source: EY Analysis, based on initial analysis performed by the Institute and Faculty of Actuaries (September 2020)

CHANGING GEAR: AN ACCELERATION OF ACTIVITIES AMIDST GROWING DEMAND

Amidst this backdrop, institutional investors and asset managers are increasingly developing their climate risk and ESG strategies and setting longer term ambitious objectives. Excluding certain carbon intensive and/or controversial sectors from the investment portfolio, such as coal, oil sands and Arctic drilling, is increasingly common place as a bare minimum.

Many of the more sophisticated firms in this space are taking steps to embed ESG factors into the investment decision making process, with clear hurdles, triggers and thresholds which demonstrate ESG is front and center of investment decisions rather than a disconnected "bolt on" to the process.

We have observed a broad maturity range in the market with respect to the integration of ESG factors. Some institutional investors expect asset managers to integrate ESG factors across core asset classes only, with high level monitoring of integration via a questionnaire process. Leading firms are requiring asset managers to integrate ESG factors across all asset classes, with an intrusive outcomes-based monitoring programme.

Given the clear increase in demand for sustainable investment products there is an obvious follow-up question: is there sufficient breadth and depth of sustainable (alternative) investment offerings to meet investor needs?

EY's recently released 2020 Global Alternative Fund Survey explored this very topic. Interviews were conducted with a total of 110 hedge funds (representing over $1.8tn in AUM), 127 private equity firms ($2.7tn in AUM) and 73 institutional investors ($1.4tn in AUM). The survey found that:

- 49% of investors are currently investing in ESG products, which is almost double the number of investors including ESG products in their portfolios in 2019.

- Investors are placing a significant emphasis on managers' ESG policies when deciding whether to invest with a manager. Nearly all investors (88%) ask managers how ESG is incorporated into their investment decision making.

- Although sustainable investing is top of mind for investors, the proportion of investors desiring exposure to ESG products well outpaces the number of alternative managers that offer them. In fact, only 1 in 5 managers surveyed offer ESG products, and a little less than half of managers have been unable to systematically include ESG risk factors into their investment process.

- Investors were asked whether there are enough ESG offerings across a range of asset classes to meet their needs in the next two to three years. The "yes" response rate varies significantly by asset class (Figure 3).

Do you feel there are enough ESG offerings in each of these asset classes to meet your needs in the next two to three years?

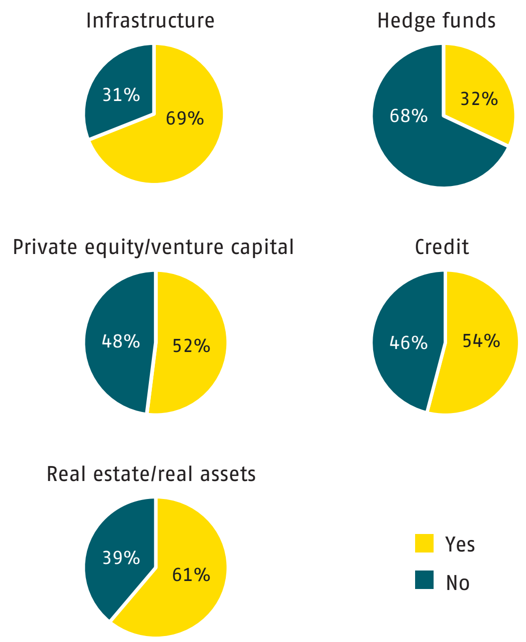

Figure 3

WHAT DOES THIS MEAN FOR ACTUARIES?

Actuaries can play an important role in helping to bridge the gap between asset manager and asset owner, for example helping to assess and evaluate ESG products to ensure solutions are aligned with client needs. Another important bridging role is the taxonomy used across financial services. Whilst the EU Taxonomy might go some way to standardizing the language used, helping asset managers and asset owners alike to speak the same language to connect ESG product supply and demand will be critical.

It's important to not lose sight of the fact that climate risk is "just another risk". Actuaries can play a much broader role in helping investors to better understand, monitor, mitigate and manage this risk. A better understanding of the risk will naturally lead to investors being able to more clearly articulate what they want, and for asset managers to design products that meet those demands. ■

1 – Global ESG Flows | Morningstar

2 – ESG-rated stocks and bonds outperform in 2020: Fidelity research (internationalinvestment.net)