

ESG Conspiracy of Silence



The Sustainability of Sustainability:

How and Why Asset Owners/Asset Managers Should Work Together



HOW DO ASSET MANAGERS USE EXTERNAL INFORMATION?

Regulatory
Context



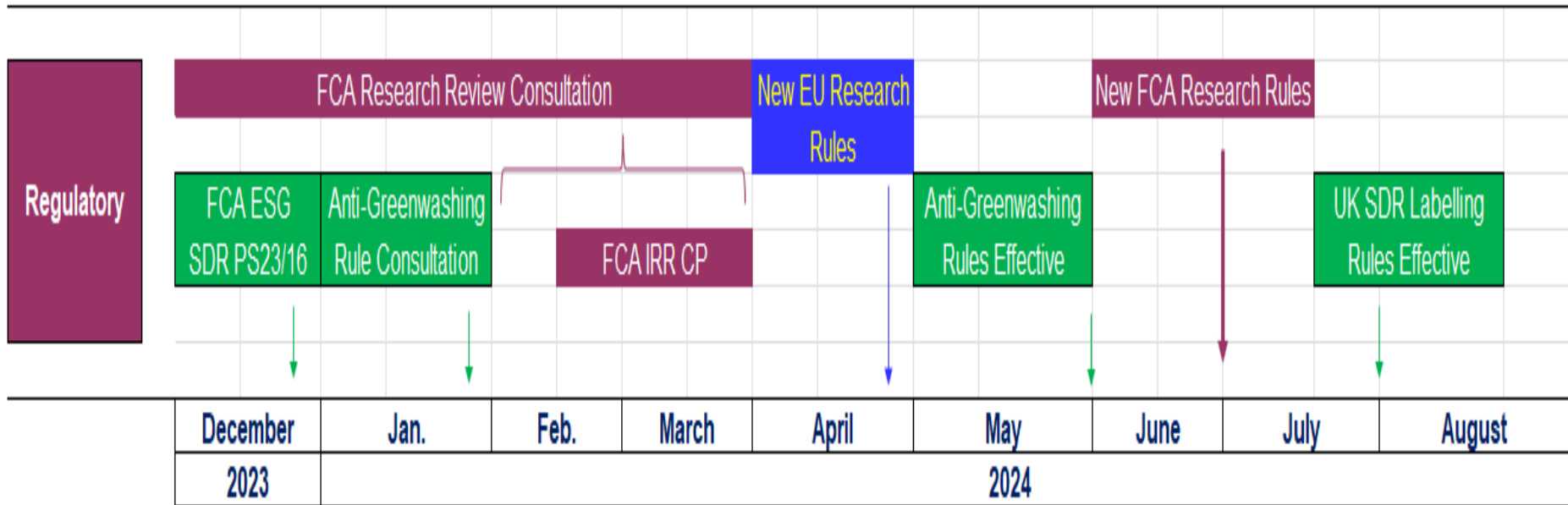
Critical for stock
selection/
portfolio
construction.



Critical to analyze
ESG risks and
opportunities.

- External information (fundamental research and ESG inputs) are critical intelligence, but a huge expense for asset managers.
- It is their second biggest expense, right behind staff compensation.
- Until MiFID II (Jan 2018), asset owners paid these charges based on “research commissions” deducted from fund returns.
- Post MiFID II, most UK/EU asset managers funded this via their very volatile P&Ls, which changed the international competitive landscape and represents an existential threat to ESG objectives.

IMMINENT UK REGULATION OFFERS RISKS AND OPPORTUNITIES



THE FUTURE IS NOW!

MIFID II RESEARCH EVOLUTION

EUROPE

1. European asset owners/regulators request manager research transparency.

2. European Managers:



3. Result: (Research Rules)



4. UK/EU Managers Initial MiFID II Position: (1H 2017)

Most large UK/EU managers state they intend to continue to use client money for research despite the additional administrative burden.

USA

5. Select US Managers Respond:

In 2H 2017, 3 US managers

- BlackRock
- JP Morgan
- T. Rowe Price

Say they'll pay for research from P&L
(for UK/EU clients only: ~ 5% of AUM !!).

6. Mass UK/EU Move to P&L

95%
of
AUM



SUSTAINABILITY COMPLICATED BY REGULATORY INTERACTION



- Dramatically changed the way asset managers buy and consume external research (and ESG) inputs that are critical for the investment decision making process.
- Most UK managers decided to fund these inputs from their P&Ls own starting in 2018, with profound implications. Before MiFID II, these inputs were financed by asset owners.



- When MiFID II was being formulated (2013–2017) ESG products/priorities at this scale (and cost), were not remotely on the horizon.
- Regulators did not create MiFID II with ESG in mind.

Why is Funding Research/ESG/Stewardship from Asset Manager P&L So Important?

Pension Fund



- Research/ESG costs for Pension Funds are extremely small
- Usually a handful of basis points versus LT equity returns ~ 700 Bps

Cost
Asymmetry

Asset Manager



- External research/ESG costs for fund managers are extremely high
- Usually the largest cost after the #1 cost - staff compensation

CAUTION

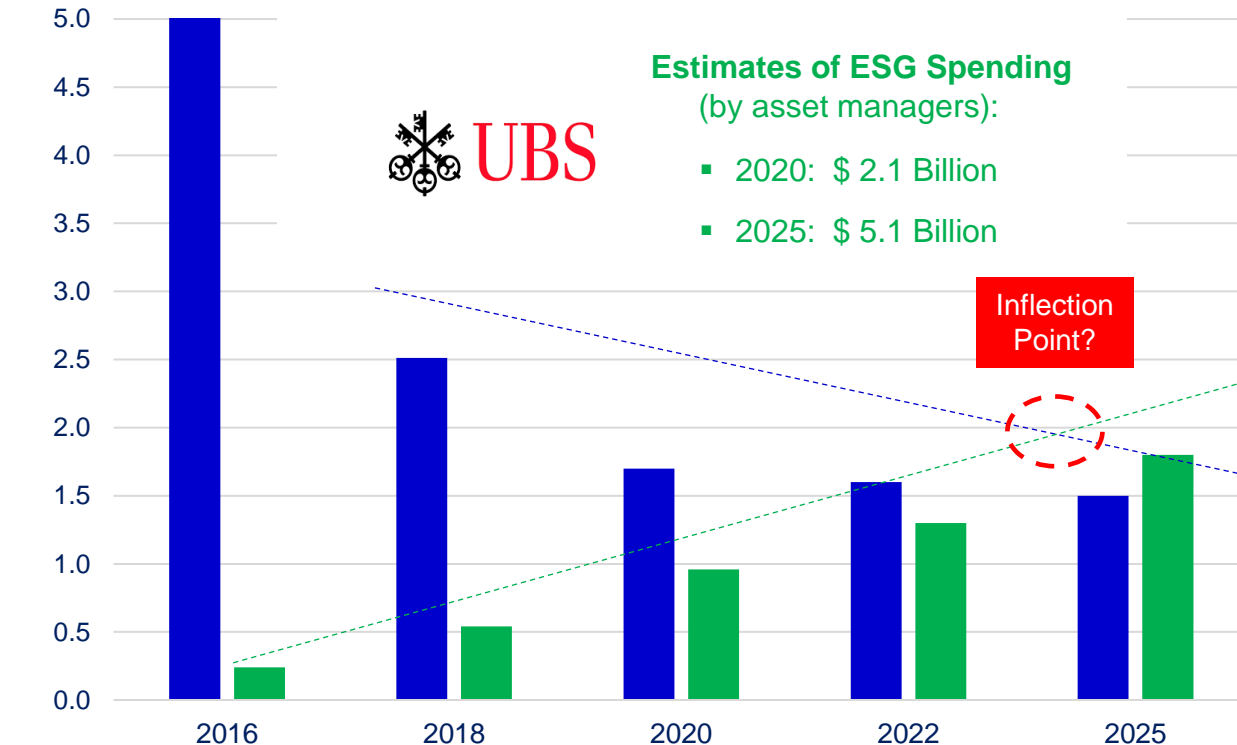
P&L funded research/ESG makes access to these vital inputs a function of manager profitability. This is determined by the level and direction of markets - which dictates their assets under management (AUM).

RESEARCH VS. ESG SPENDING: EUROPE



is an existential threat to long-term European ESG objectives.

\$ Billions ■ UK/EU Manager Fundamental Research Spending* ■ European Manager ESG Spending**



- Regulatory/Client requirements for manager ESG spending may cannibalize fundamental research spending, with negative impacts on investors.
- This is not sustainable unless European managers become non-profit social enterprises
- This assumes no Bear Market.



BEAR MARKET IMPACT ON ESG/RESEARCH BUDGETS – COVID TEST CASE



Bear Market

25% Equity decline in 2 weeks.

What would happen now in a 2008 magnitude event? (S&P 500 – 58%)

Most UK managers would lose money – and be unable to fund research or ESG initiatives.

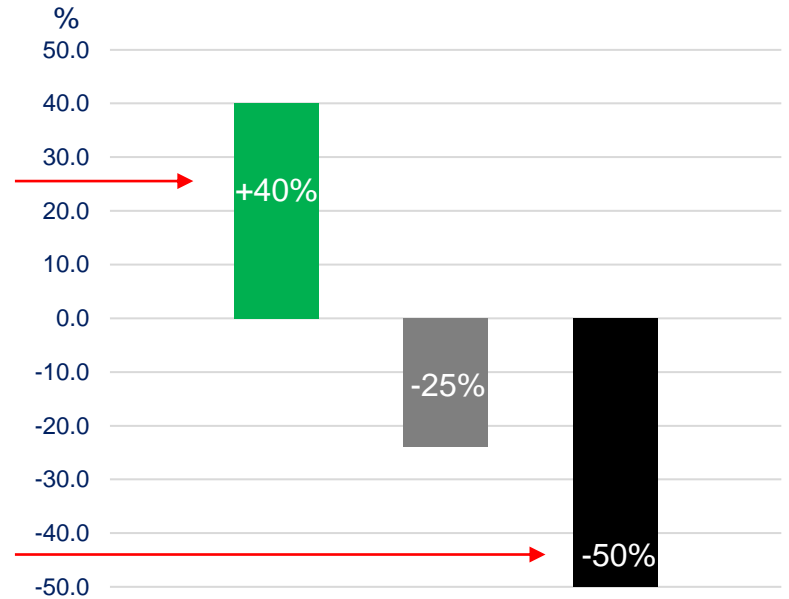
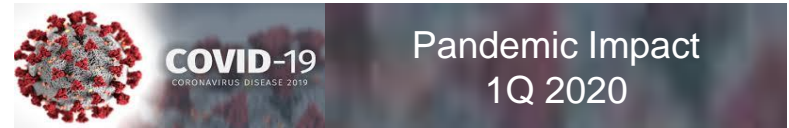
US and European research budgets are both “pro-cyclical” – but in opposite directions.



Research Budget Leverage Factor:
Equity Trading Volumes



Manager Pre-Tax Profits



The lower markets (AUM) go, the less research P&L managers can access. ESG Implications?

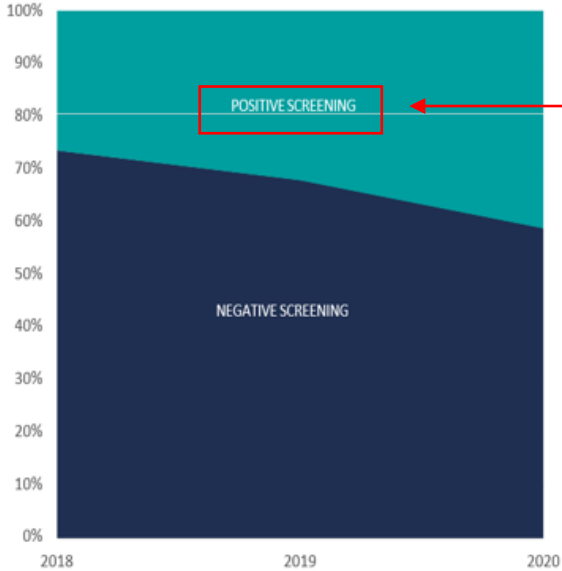
European Managers

RISING MANAGER ESG COSTS: ACCELERATING

Evolving ESG Processes

ESG Criteria Investors are Screening in 2020

Rising Interest in Inclusionary Screens



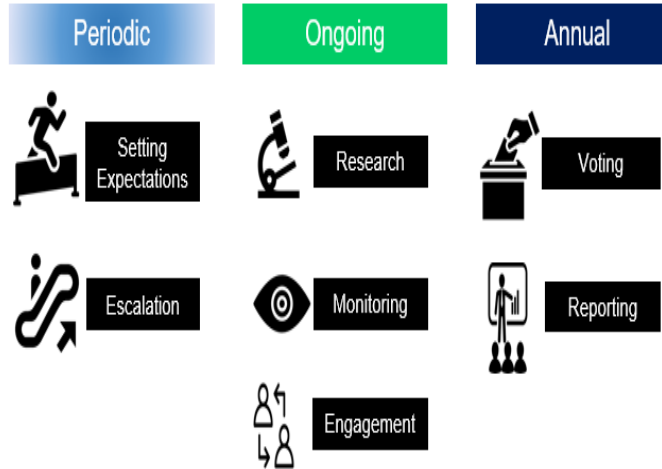
More research intensive

Source: eVestment Advantage, through Q3 2020
* Frost Consulting Estimate

Increasing Engagement



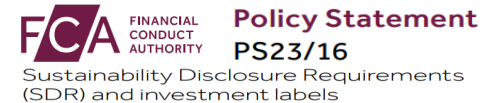
Rising Stewardship Expectations from Asset Owners/Consultants.



Major resource commitment for asset managers.

Some UK manager's Stewardship teams are 30% of the size of their global investment team.

Expanding Regulation



Expanding reporting/
disclosure obligations

RISING MANAGER ESG COSTS: ACCELERATING

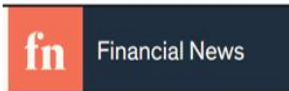
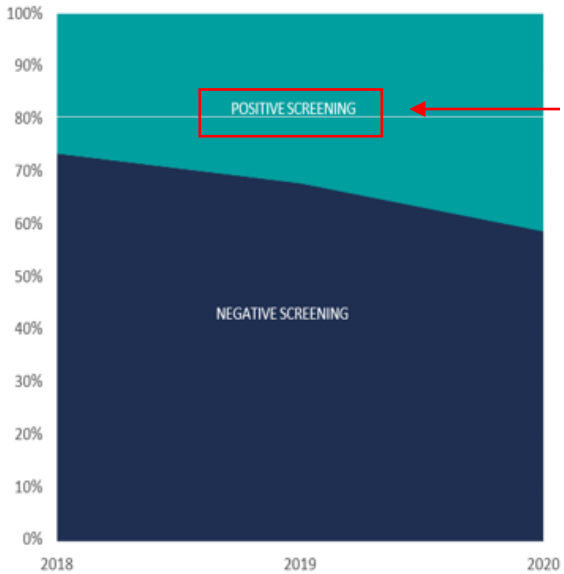
Evolving ESG Processes

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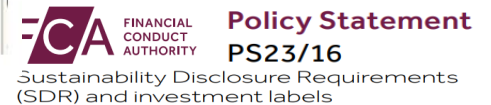
ESG >

ESG fund losses near 40% for worst performers in mixed 2023

Green strategies saw record outflows in a tough year for some ESG investors

By Kristen McGachey [Follow](#)

Wednesday, 3 January 2024 at 13:33



With AUM down 25%, most UK asset manager ESG franchises will lose money.*

* Frost Consulting Estimate

SHIFTING TO A 3-DIMENSIONAL RETURN FRAMEWORK IS COMPLEX

Asset managers are unsurprisingly struggling with ESG integration.

Fundamental World



ESG World



Dimensions

2: Risk/Return

3: Risk/Return/Impact

Timeframes

Quarters

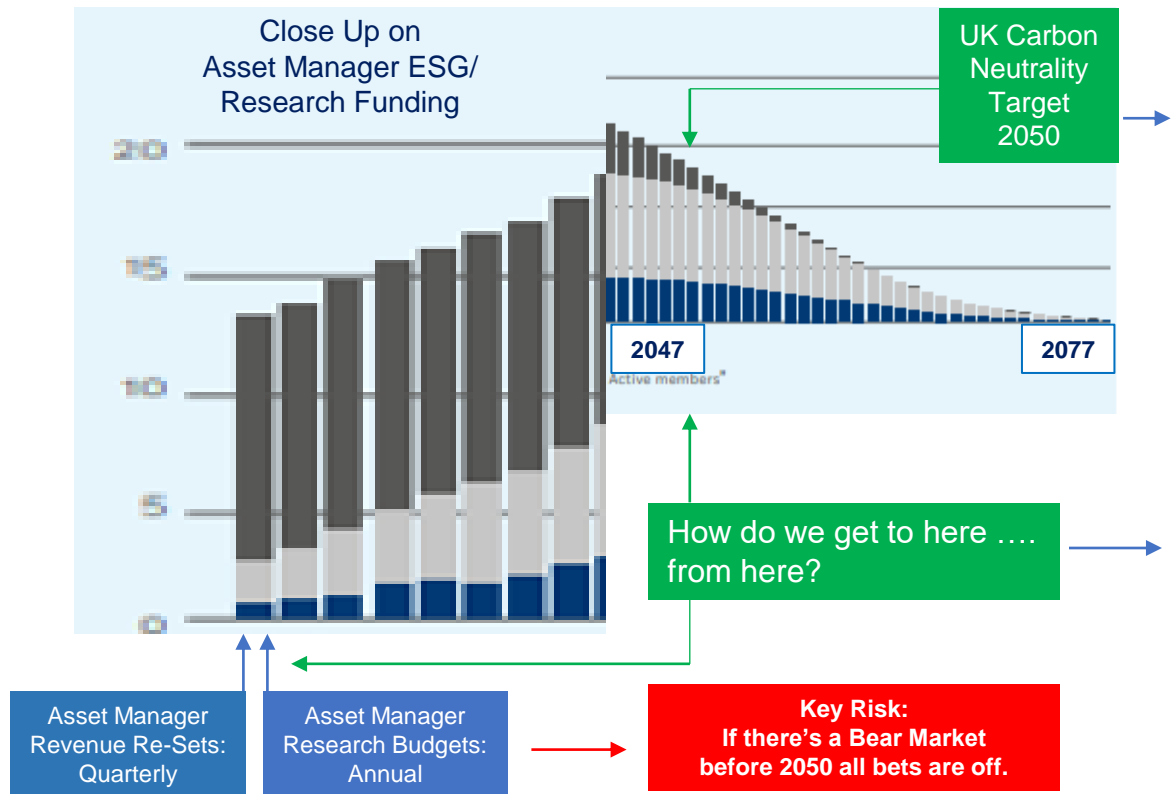
Decades

Further Challenges/Considerations:

- UK/EU Asset Owners have delegated much of their ESG/Stewardship activity to external asset managers – who are largely financing this increasing expense via their P&Ls (in Europe).
- The interaction of global regulations governing asset managers becomes an important variable in achieving long-term ESG objectives - and ensuring the sustainability of manager ESG franchises.
- Financial market cycles also play a critical role given the European ESG funding mechanism.
- New solutions are needed. Managers adopting an “ESG-Native” architecture in collaboration with asset owners can solve these challenges.

ESG FUNDING: DURATION MISMATCH

Pension Funds – Long-Tailed Liabilities



- UK/EU Pension Funds have outsourced increasingly expensive ESG/Stewardship programs to their external managers.....
- **Who must fund this from their P&L!!**

There is an enormous funding duration mismatch between long-term ESG objectives and the current asset manager research/ESG funding mechanism.

Unless UK/EU Pension Funds are willing to take advantage of their very long duration and low research costs to support this process, these efforts will fail, unless:

1. Governments fund this entirely, or
2. Asset managers elect to become not-for-profit social enterprises.

Post-MiFID II, UK/EU Pension Funds are often unwilling to incur additional costs on behalf of managers – including ESG. UK/European governments/regulators now understand that MiFID II research rules are an existential threat to ESG objectives.

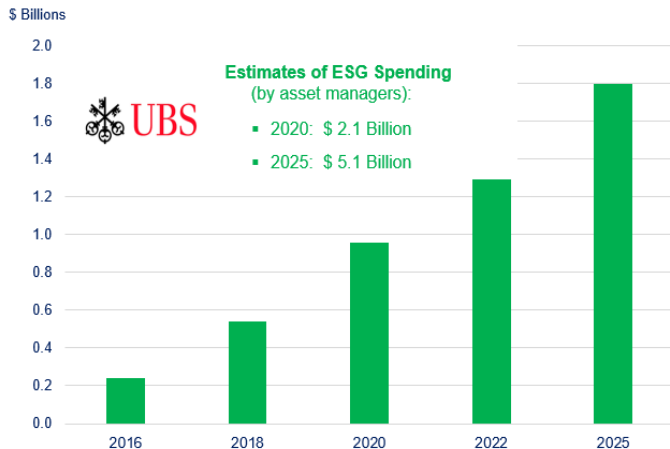
20:20 HINDSIGHT: MIFID II, ESG AND BEAR MARKETS

Post-MiFID Mass UK/EU Manager Move to P&L



Significant Research Budget Cuts

Rapidly Increasing Manager ESG Spending



Bear Market



Difficult Fund Performance

Key Long-Term Question:

Which research/ESG funding system is in the best interests of Asset Owners?

??

UK/European P&L Asset Managers



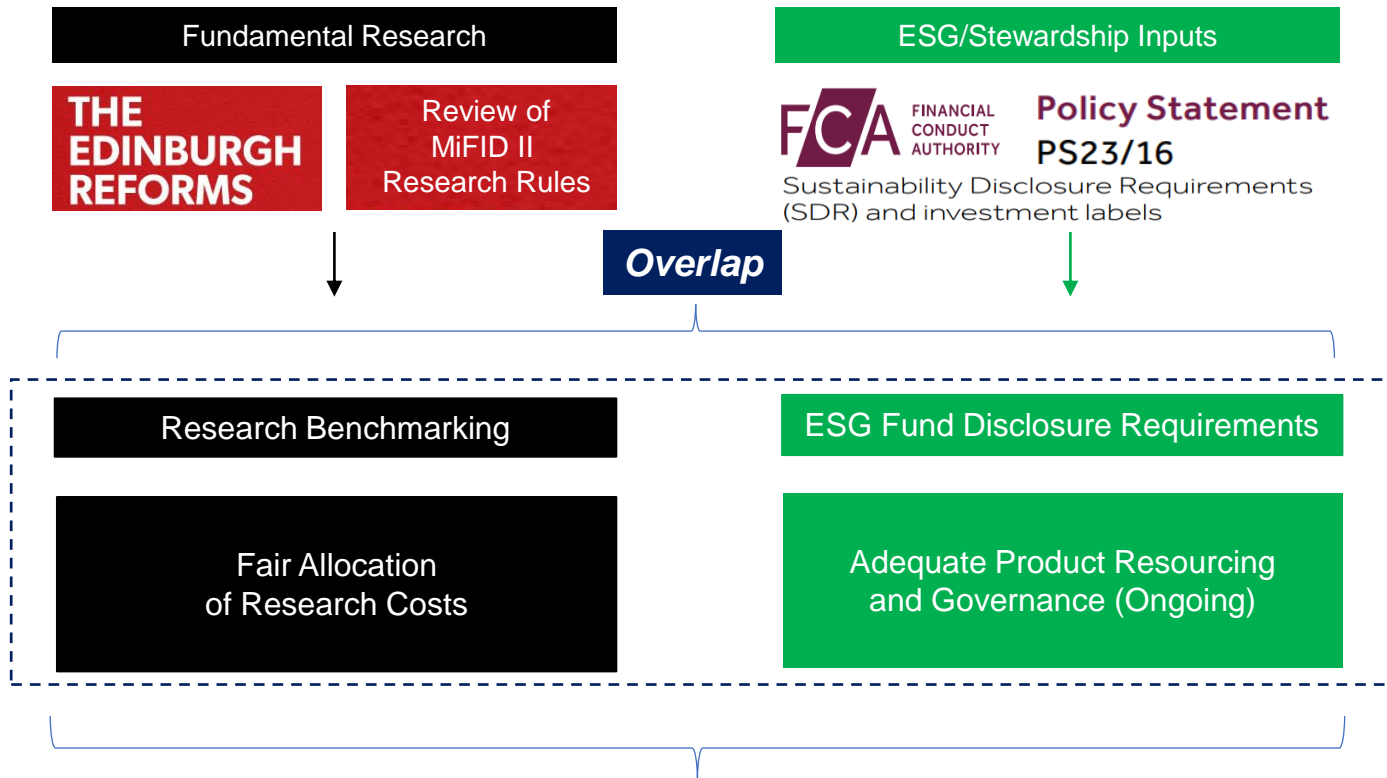
UK/EU Governments/Regulators to the Rescue?

THE EDINBURGH REFORMS
MiFID II Research Review

EU Listing Act

Triumph of Experience over Hope?

PARALLEL EVOLUTION: INTEGRATION INEVITABLE



Fund-Level
Valuation/
Attribution

Solution:



OVERSTATING FUND-LEVEL ESG INTEGRATION: SEC - PAYING ATTENTION?

DWS rocked by \$1trillion SEC greenwashing probe

SEC fines BNY Mellon over ESG in first case of its kind

Deutsche Bank Replaces DWS's Woehrmann After Greenwash Raid

Goldman Sachs to pay \$4mn penalty over ESG fund claims

New US Regulation Needed? Nope.

- Investment Advisor Act of 1940
- Investment Company Act of 1940

ESG: the next mis-selling scandal?

US/UK Class Actions???

The SEC didn't care on MiFID II.....



... but the Gensler SEC does care on ESG.

Expensive manager ESG franchises are at risk if they can't demonstrate fund-level ESG integration.

REGULATORY/CLIENT “GREENWASHING” ALERT



Building trust in the funds market...

Some firms are making *misleading* or *exaggerated* claims that don't stand up to closer scrutiny...

FCA Thematic Review of ESG Funds



To assess Compliance with Dear Chair Letter



AFM Letter/July 2021

- Scrutiny of ESG claims in fund launches
- ESG funds must be “adequately resourced”
- Ongoing Supervision - All ESG funds must meet new standard

Will take enforcement action

INVESTMENT
WEEK

Professional Adviser

Only 1% of intermediaries
'completely trust' funds'
ESG claims

REGULATORY/CLIENT "GREENWASHING" ALERT



Sustainability Disclosure Requirements (SDR) and investment labels



New Fund Labelling/Disclosure Requirements

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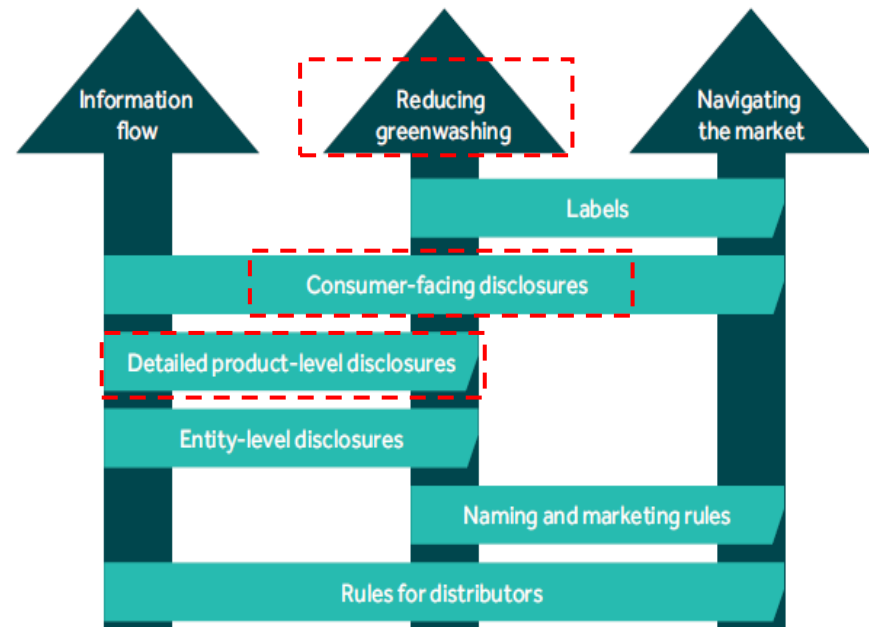
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Will take enforcement action



SPECIFIC PROVISIONS

- (7) in relation to the *manager's* governance and resources, ensure that:
- (a) there are appropriate resources, governance and organisational arrangements in place, commensurate with enabling the sustainability product to achieve its *sustainability objective*;
 - (b) there is adequate knowledge and understanding of the assets in which the sustainability product is invested; and

Product-
Level
Detail
Not Firm-
Level

What are the specific ESG inputs used in the fund/product?

ARE ALL “ESG” FUNDS THE SAME?

No two manager’s ESG processes are identical.

ESG inputs will have differing values to each strategy.

ESG External Inputs

ESG Company Rating Data/ Databases

- MSCI
- Sustainalytics
- Refinitiv

Climate Data/ Analysis

- S&P Tru Cost
- Carbon Tracker
- Moody’s ESG

ESG Sentiment Data

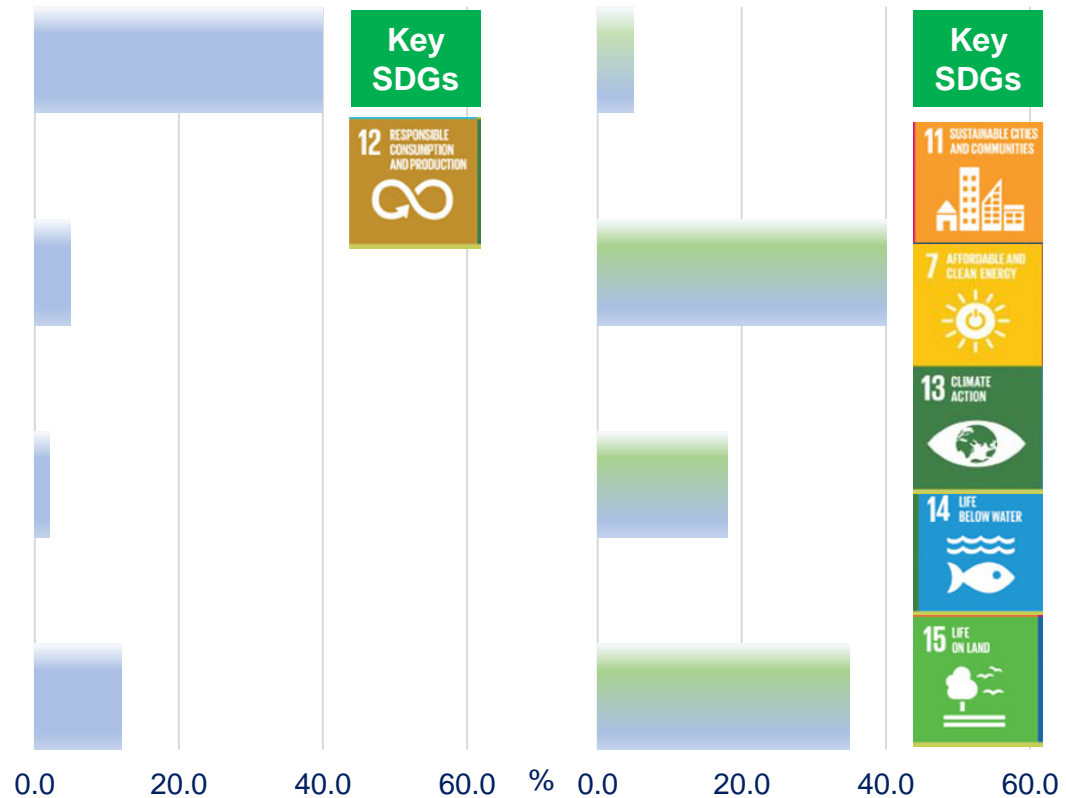
- RepRisk
- TruValue Labs
- Causality Link

Engagement/ Stewardship Services

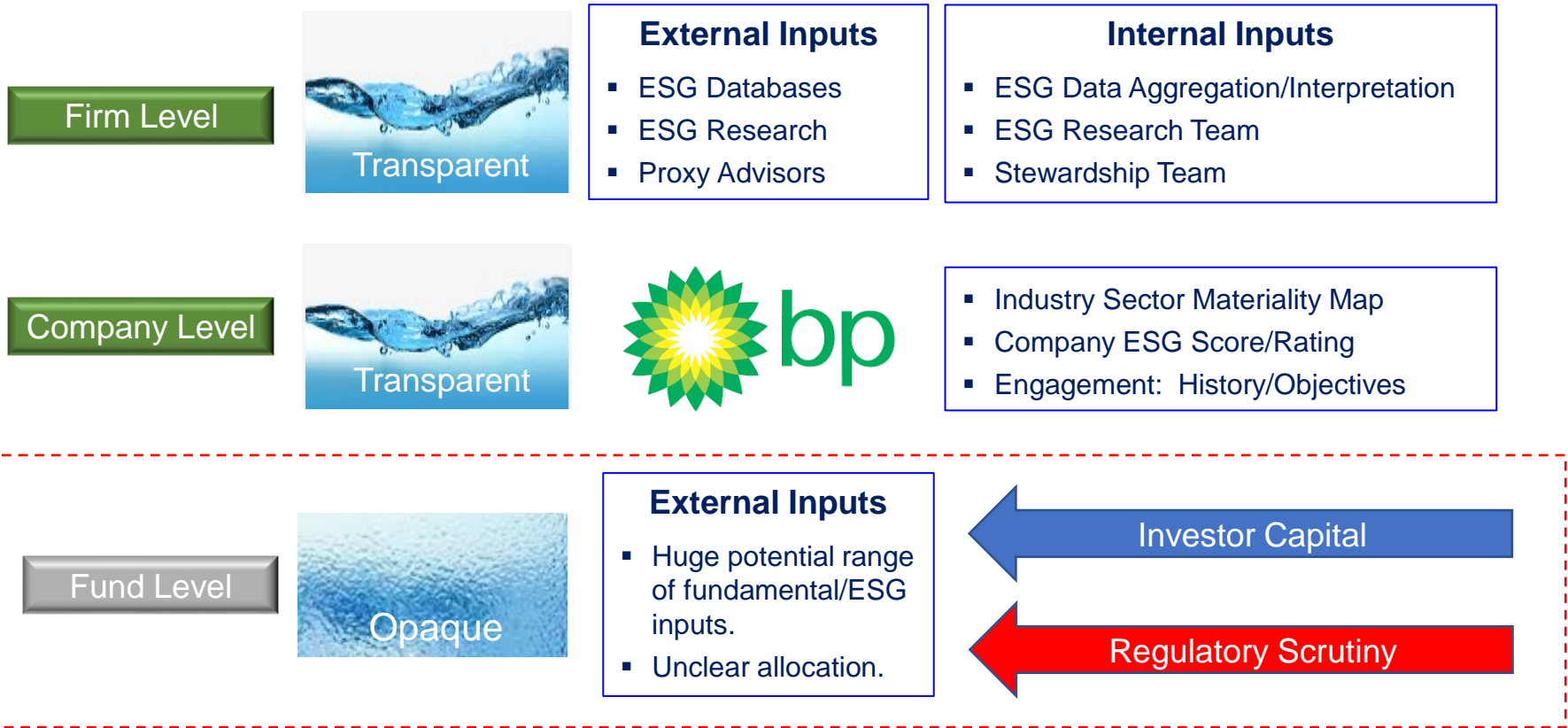
- ISS
- Glass Lewis
- Egan-Jones

Article 6 – Global Growth

Article 9 – Climate Change



FUND-LEVEL ATTRIBUTION: MANAGERS MUST ADDRESS THE “LAST MILE”



This has lead to significant regulatory scrutiny of ESG funds.....
that demands greater transparency at the fund level.

SPECIFIC PROVISIONS

4.2.20 R A *manager* must ensure that the general and specific criteria with respect to using a *sustainability label* are met on an ongoing basis, in particular:

- (1) The *manager* must ensure that:
- (d) the *manager* continues to maintain appropriate governance and resources in accordance with the requirements under *ESG 4.2.9R(7)*; and
- (e) the *manager* continues to maintain an appropriate investor stewardship strategy and apply that strategy and its resources in accordance with the requirements under *ESG 4.2.9R(8)*; and

Product-
Level
Resources

How can managers fund this on a continual basis for the next 30 years?

No explanation from the FCA as to how this will be measured and/or enforced.

ESG OBJECTIVES: A LONG WAY TO GO



UK Carbon Neutrality Target 2050

Sources: Capital Group, RIMES, Standard & Poor's. As of 12/31/18. Bear markets are peak-to-trough price declines of 20% or more in the S&P 500. Bull markets are all other periods. Returns shown on a logarithmic scale.

HOW TO EMBED SUSTAINABILITY

The inevitable question for European Asset Managers from Asset Owners/Consultants:

Can you guarantee to maintain the current level of external fundamental, ESG (research/data) and stewardship spending required by our mandate - until our ESG objectives are achieved?

Possible Asset Manager Answers:

- a) We will make a good faith effort, but cannot contractually guarantee that we will maintain these spending levels in all market conditions.
- b) We are prepared to lose a theoretically unlimited amount of money on this mandate in order to support your ESG objectives, regardless of the circumstances.
- c) We are happy to offer a transparent, benchmarked, fund-level (mutually agreed) ESG budget to support this mandate in return for your willingness to fund it – thus insulating the process from market volatility.



SEC Investor Advisory Committee

Which is the most sustainable approach?

NEW UK FUNDAMENTAL RESEARCH RULES



HM Treasury

**THE
EDINBURGH
REFORMS**

Review of
MiFID II
Research Rules



2. Allow additional optionality for paying for investment research.

- Managers have the option to charge asset owners for research (and ESG) without their consent.

Where managers charge clients for research/ESG, they must:

- Allocate research costs fairly between clients (fund-level accounting).
- Inform clients of the method of payment.
- Inform clients of their research policies and how they benchmark research spending.

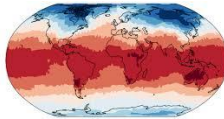
New UK Research Rules by June 30, 2024

Most asset managers have not allocated research/ESG inputs at the fund level. But it's possible!

MAPPING FUND-LEVEL ESG/STEWARDSHIP INPUT ATTRIBUTION

Will allow asset owners to contribute to ESG funding.

ESG/Fundamental Inputs



Climate Data



ESG Databases



ESG Research



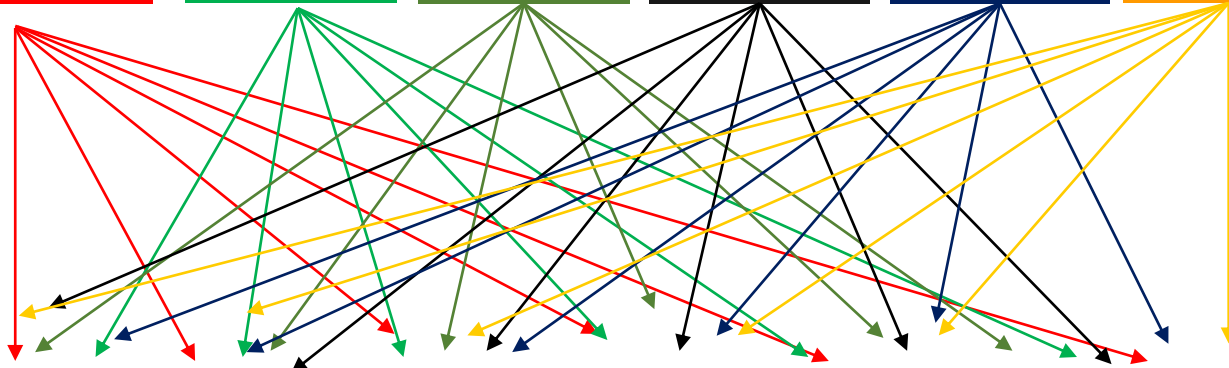
Stewardship/Proxy



Equity Research



Sentiment Data



ESG: Integrated

Not Bolted On!
Reduces SEC
ESG Reg. Risk

- Environmental Markets
- Global Opportunities
- Sustainable Food
- Climate Fund
- US Small Cap
- Asian Environmental
- Sustainable Infrastructure

FrostRB

ESG Research
Valuation/Integration
Frameworks



ACME

Asset Management

CURRENT MARKET/REGULATORY RISKS



ESG Conspiracy of Silence

Asset Managers:

- Won't admit that ESG costs are a concern - for competitive reasons.
- Don't want to draw attention to the fact that they may have to cut ESG/ Stewardship budgets if their profitability declines.

Asset Owners:

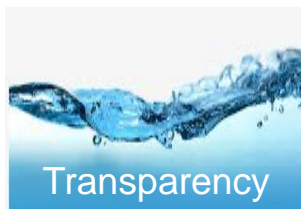
- Refuse to consider *anything* that might add to their costs.

Yet, ESG/Stewardship Funding Risks Are Accelerating Rapidly.

When the industry can't find solutions on its own, regulators must take a leadership role – *before it's too late!*

- Is sustainable manager ESG/Stewardship funding a desirable outcome? A) YES B) NO

The Answer?



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