Sustainable Investing Growth – We've Made It!....or Have We?

(Part 1 of 2)

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INTRODUCTION

Regardless of how it may be quantified, it seems that sustainable investing is reaching a critical juncture. Assets in mutual funds and exchange-traded funds (ETFs) in the United States sourced to sustainable investing reached $1.6 trillion[1] at the end of 2019 while a broader accounting of investment products based on data, as of early 2018, points to an even higher $12.0 trillion[2] in assets sourced to sustainable investing strategies. Just last month, the Chairman and CEO of the largest asset management firm in the world wrote in an annual letter to clients about the importance of sustainability and climate change to investment outcomes and the need to integrate sustainability more deeply into its investment and risk management processes.[3] This action, on the part of BlackRock, Inc. with its global scale and reach that now manages $7.4 trillion in assets is expected to further accelerate the triple-digit growth in sustainable fund assets observed in 2019.

In this, the first of two papers, we examine the most recent growth trends in sustainable investing focusing on more frequent and up-to-date data from the mutual fund and ETF Sector. In the second paper, we identify concerns and challenges associated with this reported growth and offer for consideration some initial recommended action plans.

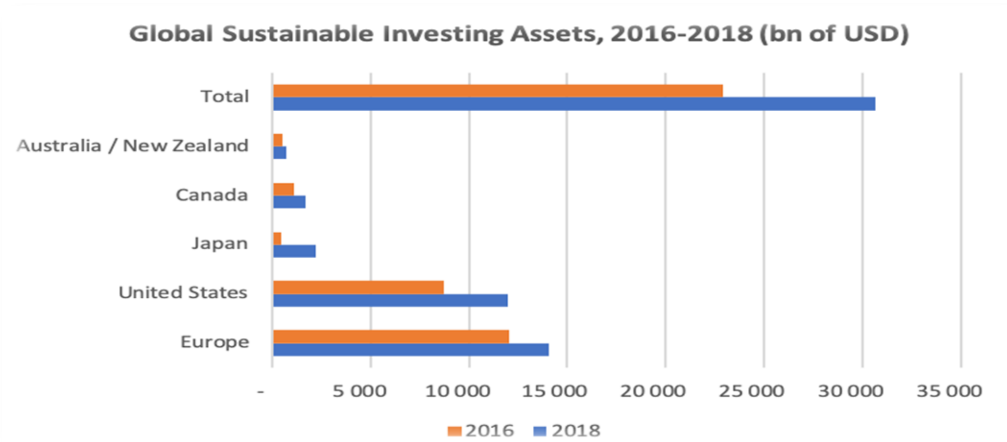
GROWTH

Asset growth in the sustainable investment space has been unmistakable, validated by numerous reports and yardsticks. In particular, two widely acknowledged periodic reports, released most recently in 2018 by The Global Sustainable Investment Alliance (GSIA) and US SIF Foundation (US

[1] Research and analysis conducted by Sustainable Research and Analysis LLC., using data sourced to STEELE Mutual Fund Expert, Morningstar.
[2] Report on US Sustainable, Responsible and Impact Investing Trends 2018, US SIF Foundation, October 31, 2018.
[3] Laurence D Fink, BlackRock, Inc. Chairman and CEO annual letter to BlackRock clients, January 14, 2020.

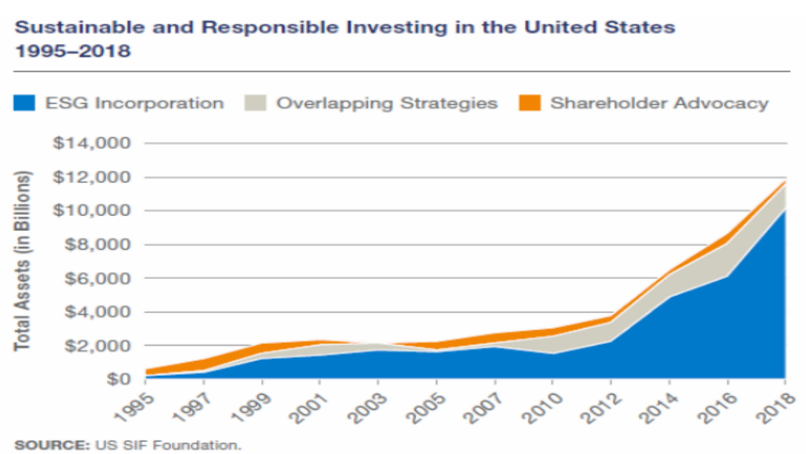
SIF) have tracked and reported on the growth trajectory of assets sourced to sustainable investing strategies.

The GSIA's 2018 biennial Global Sustainable Investment Review reported that global sustainable investment assets reached $30.7 trillion at the start of 2018, led by Europe, Canada, the United States, Japan and Australia/New Zealand.



According to this GSIA report, sustainable investing assets in these five major markets grew by thirty-four percent (34%) over the two-year period ending January 1, 2018.[4]

The US SIF Foundation's 2018 biennial Report on Sustainable, Responsible and Impact Investing Trends focused on one country, the United States. In this comprehensive survey, it is reported that the total United States domiciled assets under management using Socially Responsible Investing (SRI) strategies grew from $8.7 trillion at the start of 2016 to $12.0 trillion at the start of 2018. This two-year growth rate of thirty-eight percent (38%) is consistent with the global growth rate reported by GSIA.[5]



[4] Global Sustainable Investment Review 2018, GSIA, March 28, 2018.
[5] Report on US Sustainable, Responsible and Impact Investing Trends 2018, US SIF Foundation, October 31, 2018.

Methodological considerations aside, the reported sustainable investment growth numbers, influenced materially by the uptake of ESG integration that has increasingly been incorporated into active investing strategies, are impressive. This is especially so given the fact US SIF reported one out of every four dollars invested professionally in the United States is being sourced to a sustainable investing approach or strategy.

In order to better understand the drivers of this reported US growth, we directed our attention to an important sub-set of the sustainable investing universe, namely US-based sustainable mutual funds and ETFs.

ANALYSIS

While GSIA and US SIF cover a broader universe of institutional and retail assets, we explore this question with more recent data through the prism of US mutual funds and ETFs that are self-described as sustainable funds. These are funds that by prospectus language identify themselves as sustainable by means of explicit language set out in their prospectus or Statement of Additional Information (SAI) or, in the case of thematic investment funds, the nature of their investments, such as alternative energy, low carbon or gender diversity, to mention just a few. These funds, which represent a sub-set of the mutual fund industry's $25.7 trillion[6] in assets under management at the end of 2019, reached $1.6 trillion or 6.3% of industry assets as of December 31, 2019.

To isolate this universe of funds, we rely on Morningstar's data covering open-end funds and exchange-traded funds tagged as Socially Responsible funds. To further validate this selection, an independent review was conducted of each fund's prospectus and SAI to identify and verify its sustainable investing strategy. For purposes of this analysis, funds have been qualified based on a set of six overarching but not mutually exclusive sustainable investing approaches.

The six overarching sustainable investing approaches are:

1. **Values-based Investing –** a strategy based on the guiding principle of investments that are based on a set of beliefs that contain a view toward achieving a positive societal outcome. Typically, this approach is executed via negative screening, divestiture or divestment.
2. **Negative Screening Strategies -** involve the exclusions of companies or certain sectors from portfolios based on specific ethical, religious, social or environmental guidelines. Traditional examples of exclusionary strategies cover the avoidance of any investments in companies that are fully or partially engaged in gambling, sex related activities, the production of alcohol, tobacco, firearms, fossil fuels or even atomic energy. These exclusionary categories have been extended, in recent years, to incorporate serious labor-

[6] Mutual funds and ETF data per the ICI.org as of December 31, 2019.

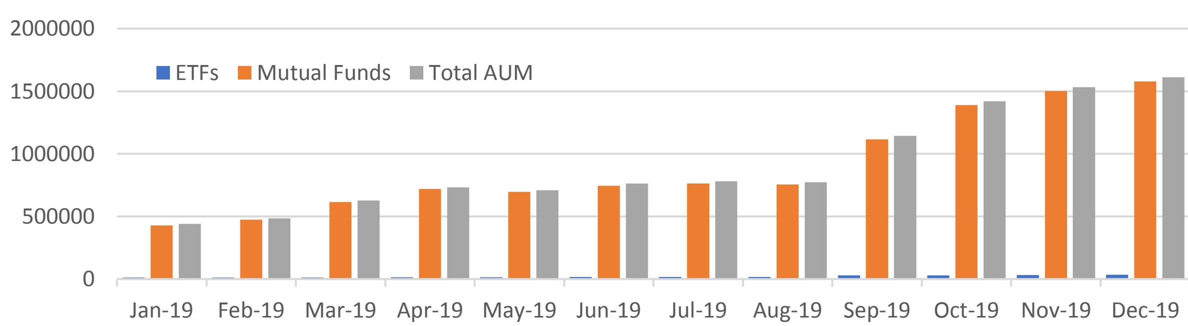
related actions or penalties, compulsory or child labor, human rights violations and genocide.

3. **Impact Investing –** a relatively small but growing slice of the sustainable investing segment, impact investments are investments directed to companies, organizations, and funds with the intention to achieve measurable social and environmental impacts alongside a financial return. The direct capital in this strategy addresses challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, affordable and accessible basic services, including housing, healthcare, and education.
4. **Thematic Investing –** an investment approach with a focus on a particular idea or unifying concept. Clean energy, clean tech and gender diversity are a few of the leading sustainable investing fund themes. Investing in green bonds or low carbon emitting stocks, bonds and funds also fall into the thematic investing category.
5. **ESG Integration -** the investment strategy by which environmental, social and governance factors and risks are systematically analyzed and, when deemed relevant and material to an entity's long-term performance, influence the buy, hold and sell decision of a security. For these reasons, ESG integration is referred to as a value-based investing approach.
6. **Shareholder Advocacy/Proxy Voting -** leverages the power of stock ownership in publicly listed companies using action-oriented approaches that rely on influencing corporate behavior through direct corporate engagement, filing shareholder proposals and proxy voting.

These definitions and labels of sustainable investing are important not only for selecting assets into the sustainable investing universe, but also to help both professional and nonprofessional investors navigate through their sustainable investment decisions.

If the fund's sustainable strategy could not be verified, the fund was excluded from consideration. At the end of 2019, the universe of sustainable mutual funds and ETFs we identified consisted of 977 funds comprising of 3,460 funds/share classes.

Chart 1: Growth of Sustainable U.S. Mutual Funds and ETFs: 1/2019 – 12/2019



Data sources: Research and analysis conducted by Sustainable Research and Analysis LLC using data sourced to STEELE Mutual Fund Expert, Morningstar.

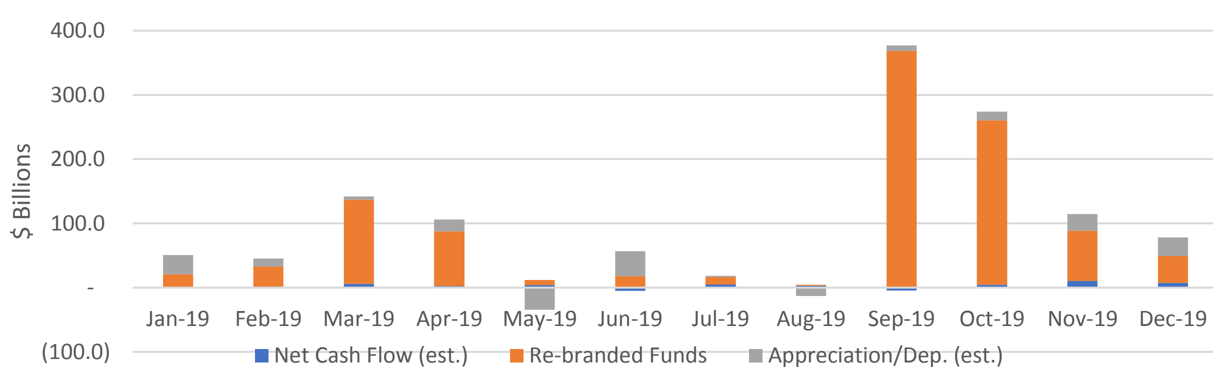
This subset of assets relative to the total amount of assets identified by the US SIF indicates significant expansion continued in 2019. In fact, assets under management in this subset of sustainable mutual funds and ETFs expanded by a whopping three hundred thirteen percent (313%). Focusing on this subset also reveals significant increases in i) the number of money management firms offering sustainable fund products, ii) the number and type of fund offerings and importantly, iii) a shift in the dominant form of sustainable investing strategies from negative screening (exclusions) to ESG integration approaches.

SOURCE OF 2019 GROWTH IN FUND ASSETS

During 2019, the total assets of mutual funds and ETFs[7] associated with sustainable investing approaches expanded from $0.4 trillion to $1.6 trillion, or $1.2 trillion, over the twelve-month interval, or an increase of three hundred thirteen percent (313%). This was the largest ever year-over-year increase for sustainable funds and it may arguably represent an inflection point for the segment as well as the broader funds industry.

At the same time, further analysis of the data shows that three factors contributed to the $1.2 trillion growth in assets. These are fund re-brandings, market appreciation and net cash flows.

Chart 2: Growth Components of U.S. Mutual Funds and ETFs: 1/2019 – 12/2019



Notes of Explanation: Total net assets data sources: STEELE Mutual Fund Expert, Morningstar data. Estimates of growth attributable to market movement and net cash flows based on an analysis conducted by Sustainable Research and Analysis LLC. Estimated cash flows include flows into/out of sustainable money market mutual funds.

Based on our analysis, fund re-brandings represent the most significant contributor to the 2019 increase in sustainable investment fund assets in the United States. The term fund re-branding refers to the formal adoption of a sustainable investing strategy or approach by an existing mutual fund or ETF in the form of an amendment to the fund's offering document (i.e. prospectus). This activity involved 47 separate firms and 460 funds or 2083 funds/share classes

[7] Also includes a small number of exchange-traded notes (ETNs).

that added $1.05 trillion in assets, or 86% of the increase recorded in 2019.[8] Market appreciation, including all fund types, added an estimated $135 billion in assets while net cash inflows, including money market funds, added an estimated $33.9 billion, accounting for almost 3% of the total increase in 2019.

The dramatic expansion of sustainable investing assets and, in the process, growth in the number of firms offering sustainable funds and the number and type of funds offered, pose some new industry concerns and challenges for investment managers, regulators, investors as well as financial intermediaries. For example, key concerns and challenges include: (1) The increasingly common misunderstanding between values-based investing that reflect social or ethical investing considerations and ESG integration pursuant to which relevant and material risks and opportunities are taken into account in the process of evaluating securities. In part, this arises due to a lack of commonly accepted sustainable investing definitions that, in turn, sows some confusion about the relevance and application of fiduciary responsibility rules. (2) The proper classification of funds that pursue varying sustainable investing strategies, and (3) Financial and non-financial reporting and disclosure practices.

In the meantime, existing and new investors as well as investment advisors face the burden of having to step up their analysis to understand the newly adopted funds' approaches and their impact on the overall investment strategy of re-branded funds.

CONCLUSION

Based on our analysis of the mutual fund and ETF offerings in the United States, the sustainable investing segment continued to expand and experienced significant growth in 2019. As this paper has revealed, fund-re-brandings has been the single most important contributor to the growth recorded by mutual funds and ETFs in 2019.

Our second paper in this series, will explore some of the reasons behind the rise of fund re-brandings, the emerging industry challenges and concerns for investment managers, regulators, investors as well as financial intermediaries, and offer for consideration some initial recommended action plans.

[8] Based on total net assets as of month-end during which re-brandings occurred.

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Michael Cosack is a principal at ImpactWise and brings more than twenty years of business leadership experience, including the qualitative and quantitative analytical skills needed to implement programs and people in a meaningful, measurable and impactful way. Michael has spent most of his professional career advising the trustees on the investment and fiduciary responsibilities regarding their institutional funds. As an entrepreneur, he has built several organizations, including one of the largest independent investment consulting firms in the Greater Philadelphia region. His role at ImpactWise is to help institutional money managers, consultants and trustees explore, create and implement innovative impact investment strategies and solutions.

Michael holds an undergraduate degree in business from The College of New Jersey, achieved multiple certifications in both the business and nonprofit industries and is an active member of the CFA Society.

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Henry Shilling, Director of Research, Sustainable Research and Analysis LLC, a NYC-based independent provider of research focused on sustainable investing for the benefit of institutional investors. In addition, the firm provides consulting, training and education services targeted to institutional investors as well as financial intermediaries.

Previously with Moody's Investors, Henry in more recent years initiated and coordinated Moody's efforts to expand disclosure and add transparency in research, ratings and analysis to the reflection of environmental, social and governance (ESG) risks. He also led the firm's effort to launch and implement a methodology for assessing green bonds world-wide.

Henry is the author of The International Guide to Securities Market Indices which was published in 1996 by International Publishing Corp., Chicago, Illinois. He is a contributor to Money Market Funds in the EU and the US, published in 2014 by Oxford University Press.

He earned a B.A. in economics from Lehman College, City University of New York.