

September 2020

# ESG: Transforming asset management and fund distribution

Broadridge Data and Analytics



Ready for Next



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 \$1.3 trillion in June 2020, more than twice the amount of five years ago. The US market has witnessed the fastest growth, with assets rising to \$185 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 \$173 billion worldwide in 2019. The expansion continued in 2020, with average monthly flows in the first half running 35% higher than the previous year. Although volumes remain greatest in Europe and international cross-border markets, activity is growing much faster in North America.

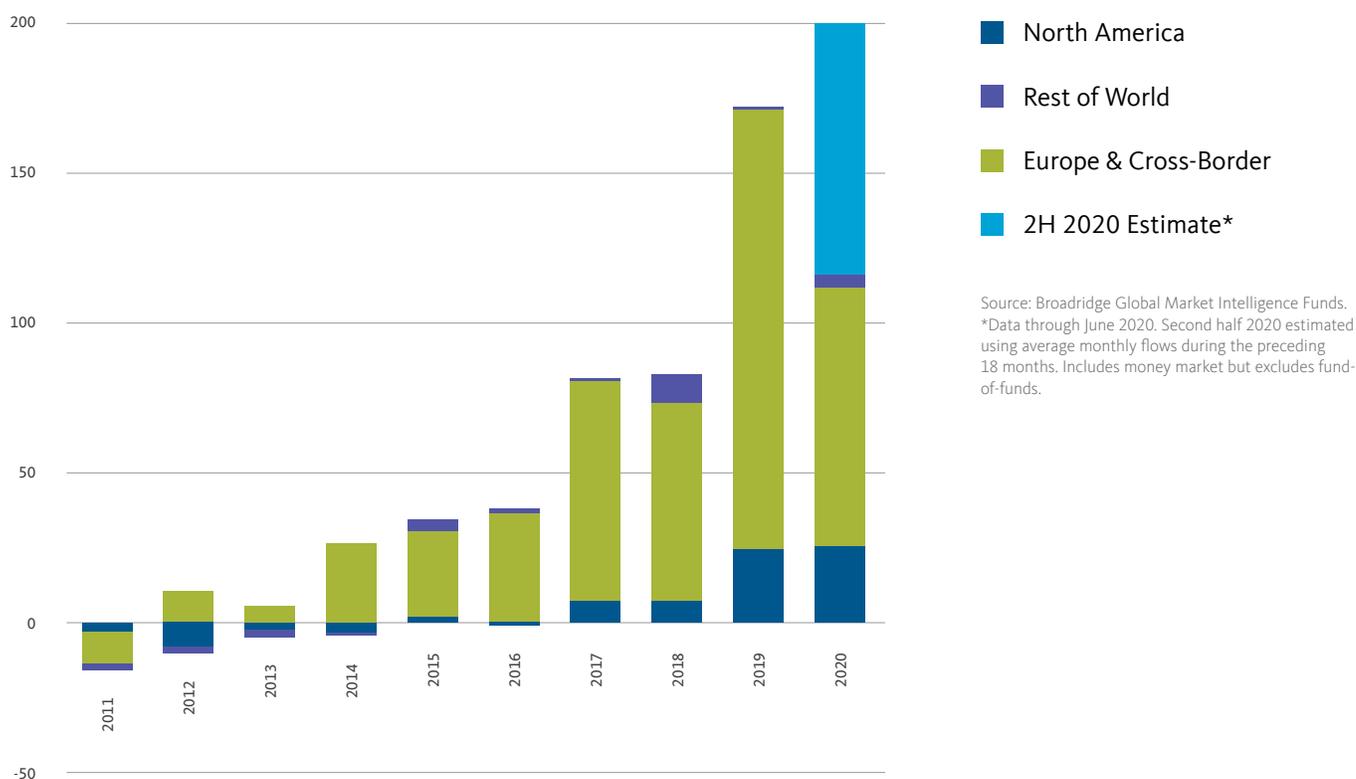
### INNOVATION ACROSS ASSET CLASSES

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)



## 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

<b>RI – Embedded</b>	<b>Exclusions</b>	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.
	<b>Integration/Engagement</b>	This category includes strategies that systematically integrate ESG into investment decision-making processes and/or employ proactive voting/engagement strategies.

<b>RI – Screened</b>	<b>Best-in-class &amp; Positive screening</b>	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).
	<b>Impact Investing</b>	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.
	<b>Sustainability/thematic investment</b>	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.

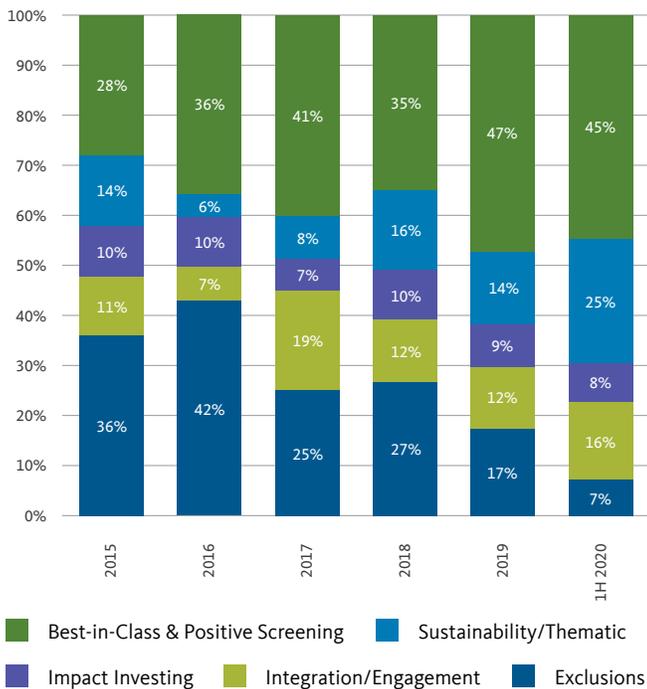
Source: Broadridge Data and Analytics.

### 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.

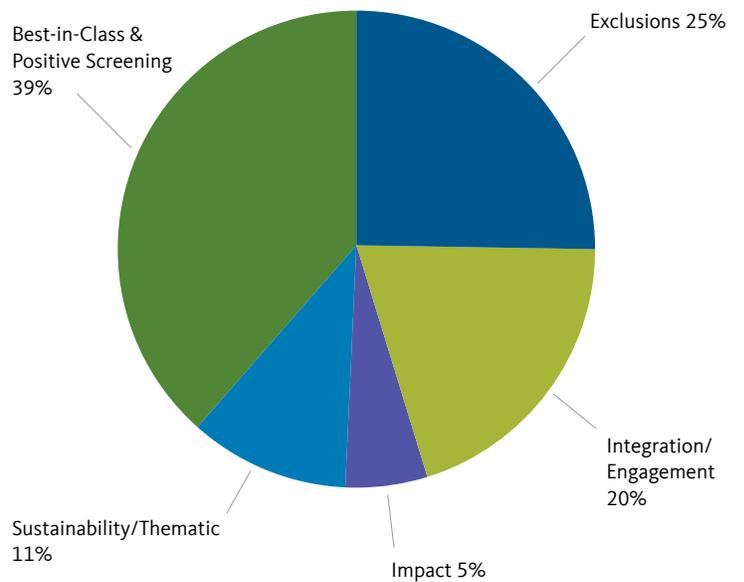
Best-in-class, sustainable/thematic, and impact investments together absorbed 77% of total ESG fund flows in the first half of 2020. Systematic ESG integration strategies also increased their share, but funds that solely employ exclusionary screens captured only 7% of flows, a dramatic decline in their 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.

ESG funds by type worldwide, AUM (%)



Source: Broadridge Global Market Intelligence Funds.

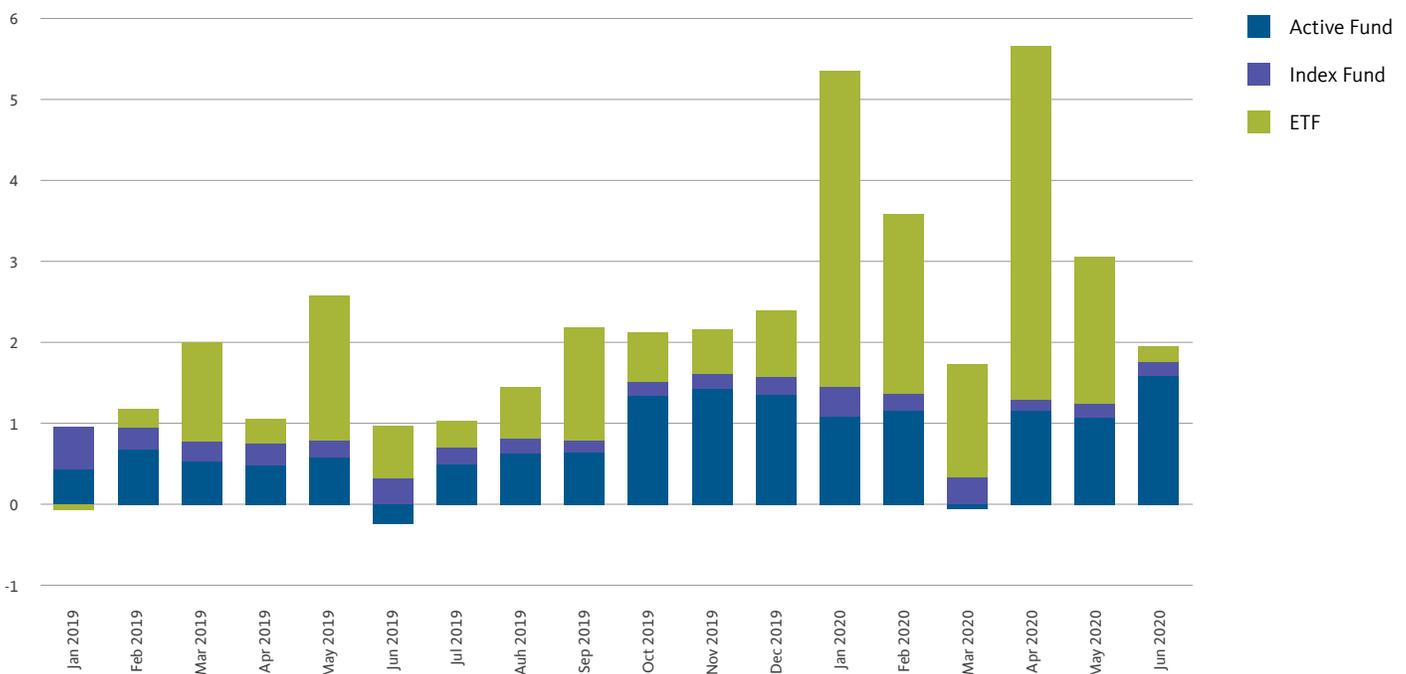
# INFLECTION POINT FOR THE US MARKET

## GROWTH AND RESILIENCE

Investors in the US are quickly warming to ESG. Net flows to long-term responsible funds quadrupled in 2019 to \$20 billion, and then accelerated further during the first half of 2020 to reach \$21 billion. Recent gains have been driven mainly by a surge in ETF purchases, although active funds set a record for net flows in June. Together, active and passive ESG strategies set a record in the first quarter that was matched in the second, despite the financial and economic shocks of the Covid-19 pandemic.

Broadridge's Global Market Intelligence datasets suggest that both retail and institutional demand propelled the market with roughly one-third of mutual fund and ETF assets sourced from retail clients, and their share has been growing. Two-thirds of assets represent institutional channels. Additionally, 11% of assets correspond to sub-advised funds via third-party managers.

## ESG fund net flows in the US (\$ bn)

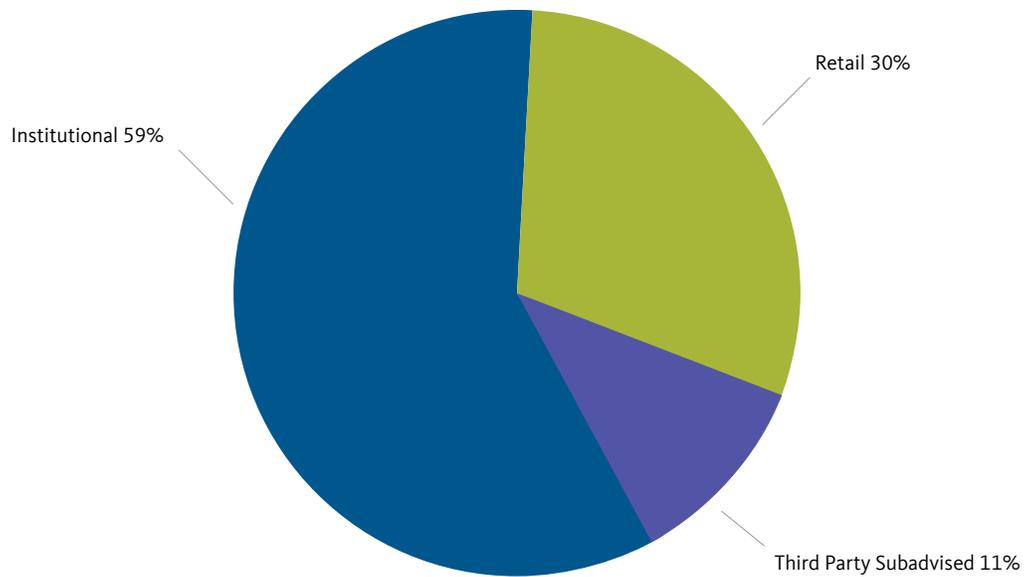


Source: Broadridge Global Market Intelligence Funds. Excludes money market and fund-of-funds.



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### Estimated ESG fund AUM in the US by type (%)



Source: Broadridge Global Market Intelligence Funds. Excludes money market and fund-of-funds. Includes only mutual funds and ETFs; does not include separate accounts or commingled institutional funds. Sub-advisory includes both retail and institutional. Estimates based on March 2020 data.

# ACTIVE MANAGERS IN THE DRIVING SEAT

## HOME FOR ACTIVE EQUITY

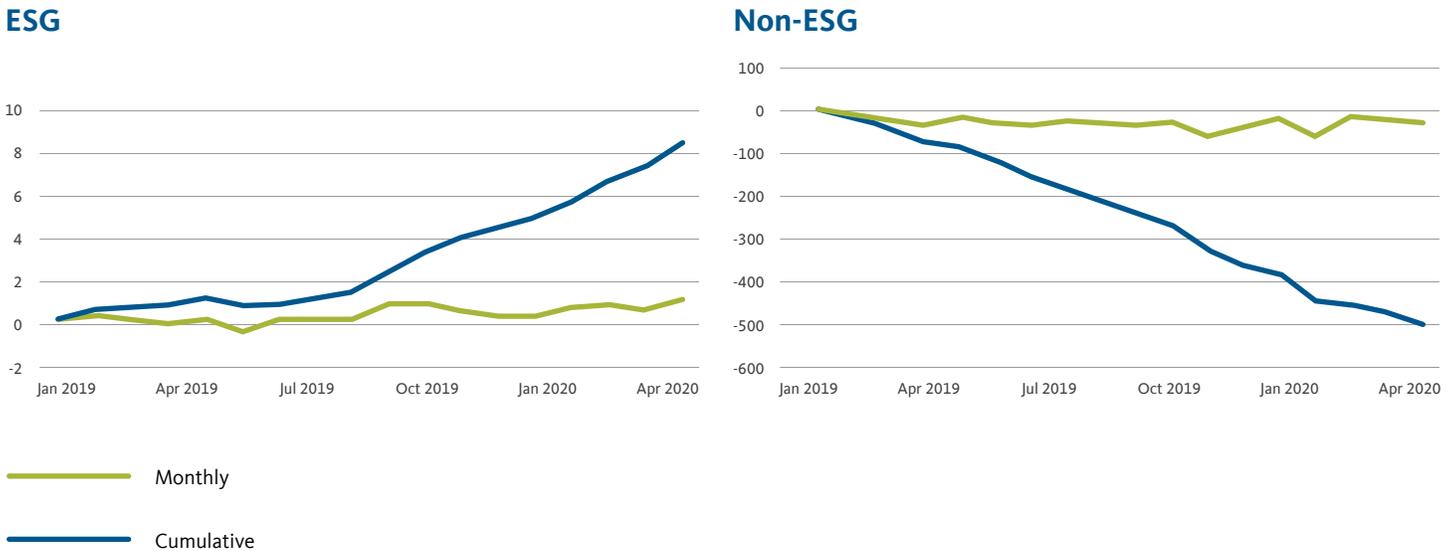
Currently, active strategies account for the majority of ESG fund assets, representing 81% of the segment in Europe and 68% in the US. These numbers will decline over time as passive strategies gain. Last year in the US, active funds attracted 52% of ESG net flows, but their share dropped to 35% during the first half of 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.

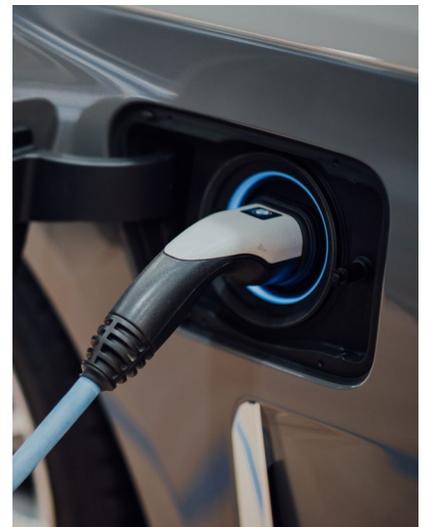
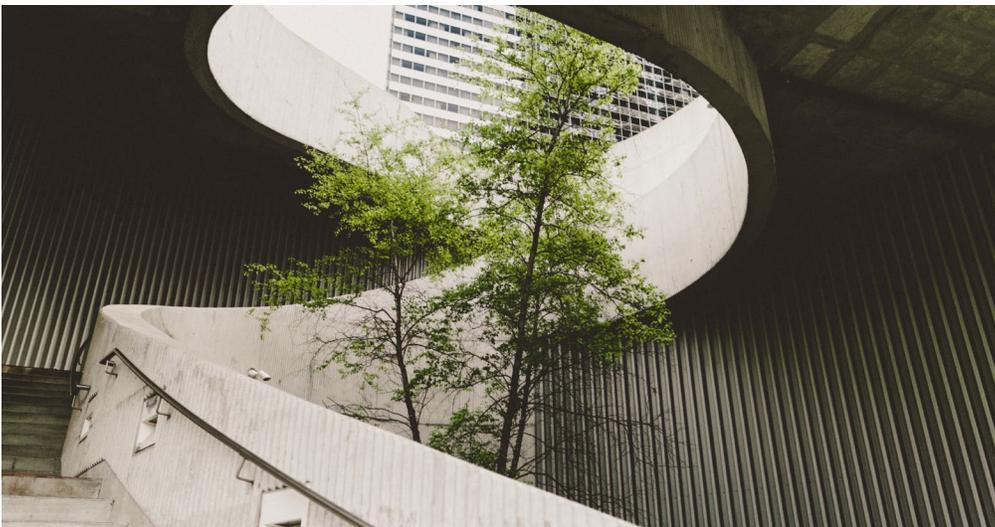
### ALIGNING WITH OUTCOMES

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

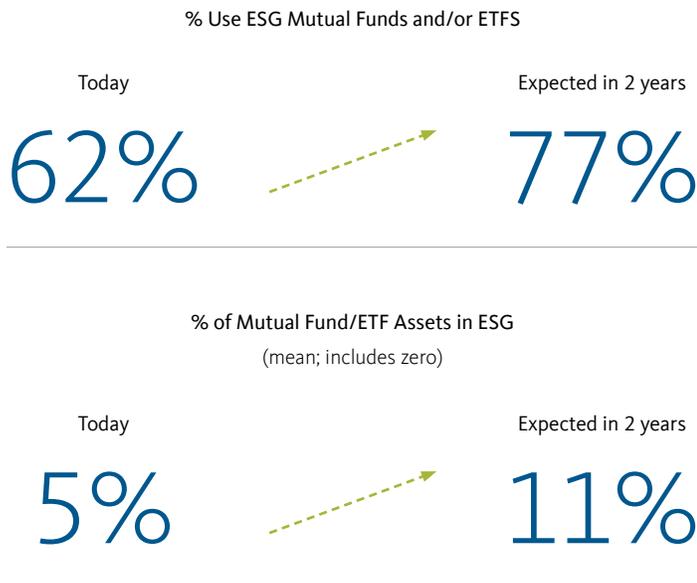
Quantitative and index ESG strategies continue to grow in sophistication and can play an essential role in a portfolio. Yet the low correlations between ESG metrics from different providers remains a challenge for constructing rules-based approaches. Also, quantitative information alone has limits when 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 accelerate ESG adoption. In the US, six 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. Among advisors for whom more than half of their clients have over \$1 million in net worth, 62% plan to increase ESG commitments, compared with 49% among advisors for whom less than half their client base exceeds \$1 million in net worth.

### Advisor use of ESG expected to rise



Source: Broadridge Portfolio Construction Trends Survey - 2019.

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

	Use ESG MFs/ ETFs Today	Expect to Use ESG MFs/ETFs in 2 Years
\$10M - <\$100M AUM	53%	72% (+19%)
\$100M+ AUM	68%	80% (+12%)
Age <35	69%	83% (+14%)
Age 35-54	63%	76% (+13%)
Age 55+	56%	74% (+18%)

Source: Broadridge Portfolio Construction Trends Survey - 2019.

## ROLE OF MODEL PORTFOLIOS

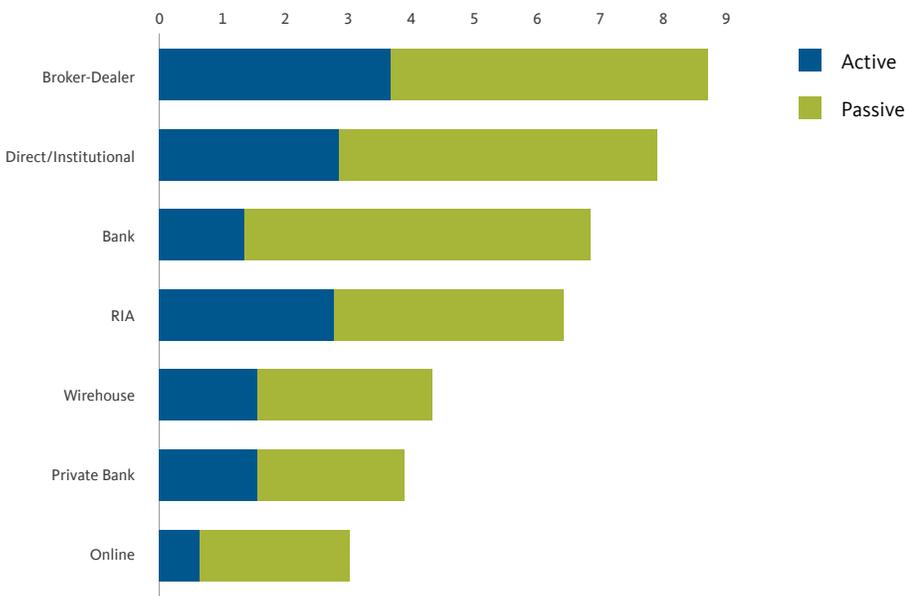
Broker-dealer, registered investment advisor (RIA), and wirehouse channels account for nearly half of ESG fund flows since the beginning of 2019. These intermediary channels are especially important for active managers, and managers can play a crucial role in empowering advisors to deliver responsible 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 \$3 trillion in assets reside in model portfolios, with 53% of that invested through active mutual funds and 43% 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-June 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 since the start of 2019, eight of them sourced 98%-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. Just 11% 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, 2019-June 2020

Rank	Group Name	ESG Net Flows			ESG % of
		\$bn	% Active	% Europe	Total Flows
1	BlackRock	42.1	7%	63%	22%
2	UBS AG	15.0	46%	99%	>100%
3	Amundi	12.1	61%	98%	>100%*
4	BNP Paribas	10.5	66%	100%	>100%*
5	Nordea AB	8.6	100%	100%	>100%
6	Intesa SanPaolo Group	8.0	100%	100%	>100%*
9	Crédit Suisse Group	6.8	27%	100%	19%
8	KBC Bank and Insurance Holding Company	6.7	100%	100%	>100%
7	Northern Trust Corporation	6.7	3%	93%	>100%*
10	Volksbanken Raiffeisenbanken	6.2	99%	100%	69%

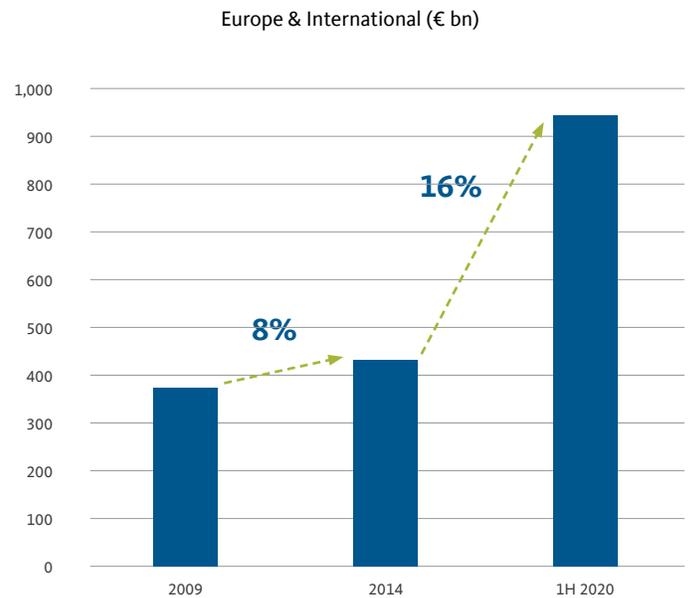
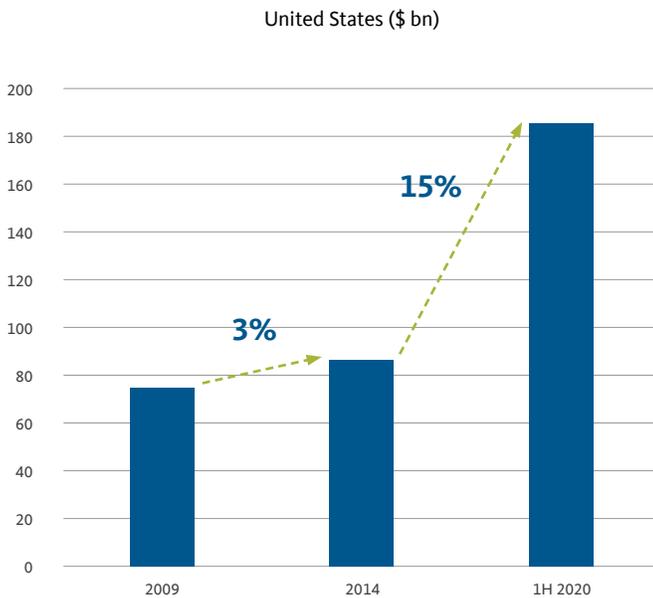
Source: Broadridge Global Market Intelligence Funds. Excludes money market and fund-of-funds. Europe includes international cross-border. >100%\* denotes net outflows from the company's full fund range.

### 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 15% in the US and 16% 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 \$300 BILLION NEXT YEAR

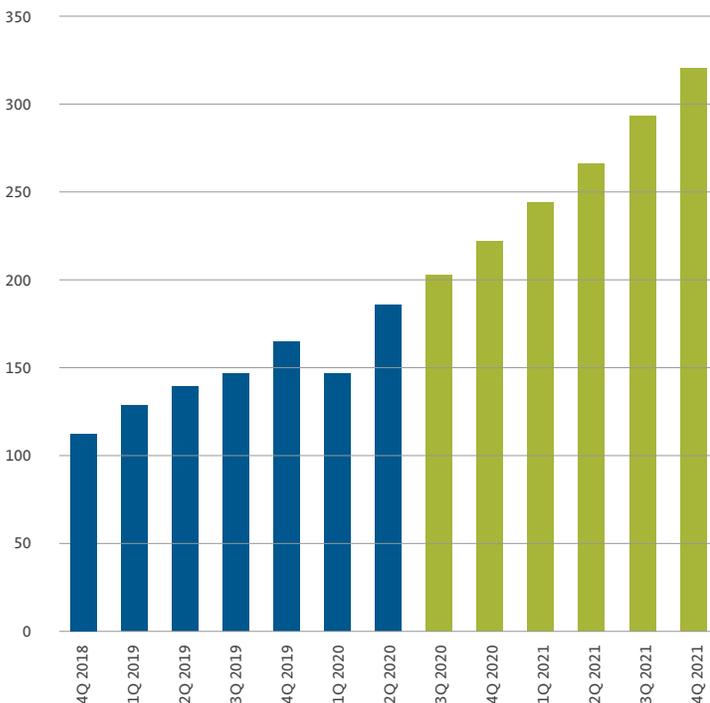
Europe has established a long lead in ESG investing and will likely maintain a higher volume of business for the foreseeable future. However, recent gains in the United States have been remarkable. If current growth rates persist, assets in the US will exceed \$300 billion by the end of next year. As 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.

## PROPOSED RULES WILL HAVE MIXED EFFECTS

The US Department of Labor's efforts to set guideposts for ESG usage in retirement plans by prioritizing financial returns will dampen progress in the near term. However, this will also lead managers and plan sponsors to work harder in demonstrating the risk management and performance benefits of responsible investment. The resulting evidence over time will likely strengthen the case for ESG as consistent with fiduciary duty.

## 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 2021.



## 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.

**Explore the full suite of ESG resources on our Distribution Insight Platform.**

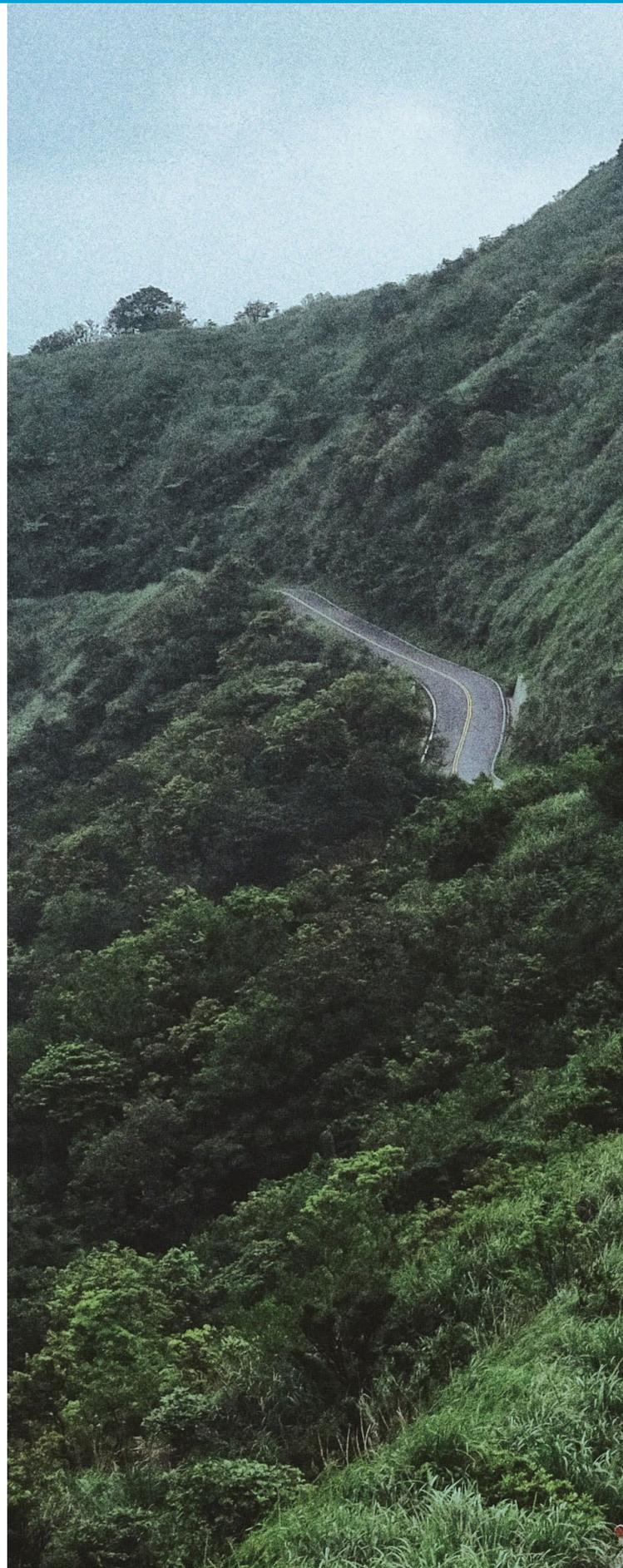
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Please contact Thomas Marsh via email [thomas.marsh@broadridge.com](mailto:thomas.marsh@broadridge.com)





POINT OF VIEW: SPECIAL

# A Focus on ESG

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