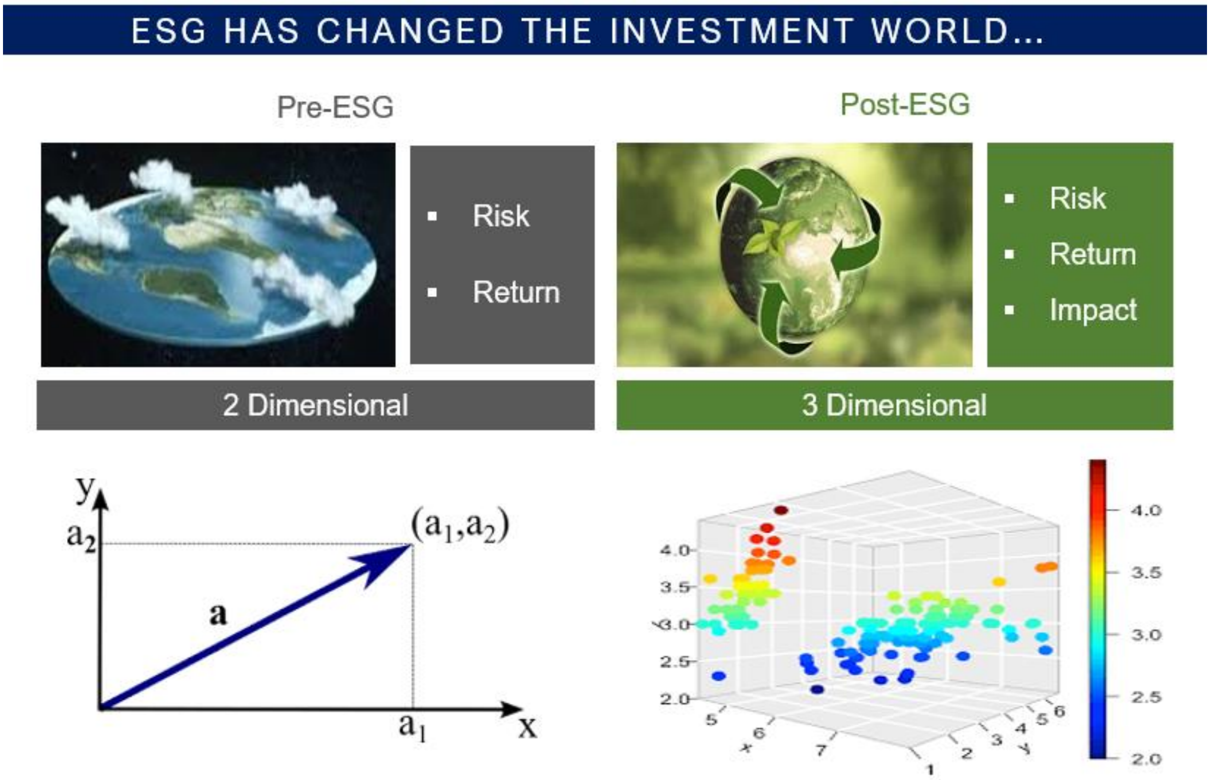
FrostConsulting

Solving the “ESG Gap”:
Managing Greenwashing Regulatory/Commercial Risks

The explosion of ESG is the most pivotal restructuring of the investment process since the development of modern portfolio theory, securities analysis and the development of the predominant contemporary view of how corporate managements are supposed to deliver “shareholder value”.

Many new pioneering processes are in various stages of evolution to address ESG requirements. These include the proliferation of ESG/climate databases (140 and counting), the development of complex ESG taxonomies, evolving hybrid accounting structures, the burgeoning of overlapping ESG organizations and standard-setters, political prioritization, increasing regulation and even the integration of ESG criteria into corporate executive compensation structures.

Why has ESG spawned a vast new industry of solutions? Because it has added an additional dimension to the measurement of investment returns – one that is extremely challenging to model by conventional means.



To be credible and competitive, ESG fund products must articulate their investment/ESG objectives and the process by which they are achieved. Yet, even in the face of this massive change, most managers have not altered their research valuation/budget processes, which were designed for the previous environment. This is a particular issue for the thousands of conventional funds which have “re-branded” into ESG products.

Given the impact of ESG on the investment process, it is not surprising that research valuation/budgeting solutions designed for a 2-dimensional world by definition will not work in a 3-dimensional context.

INVESTMENT PROCESSES HAVE BEEN TRANSFORMED BY ESG …..

…..but what about manager research budgeting/valuation process?

2 Dimensional World

Level: Firm-Wide

Process: Counting Documents/ Interactions from I Banks

Objective: Make Inv. Banks Happy

Q: How does this demonstrate ESG integration?

A: It doesn't. It's completely irrelevant.

The counting of interactions or documents provides <u>zero basis for establishing the value of an ESG database to an Impact Fund</u> (for example).

True ESG integration requires a completely new approach:

3 Dimensional World

Level: Fund-Level

Process: Portfolios value research/ ESG inputs based on fund's objectives.

Objective: Prove ESG integration to clients and regulators. Embrace transparency.

Increasing the challenge for managers from an investment process/style perspective, the ESG world is rapidly evolving to eclipse the complexity of the traditional 2-dimensional investment calculus.

Style Box for Traditional Fundamental Equity:

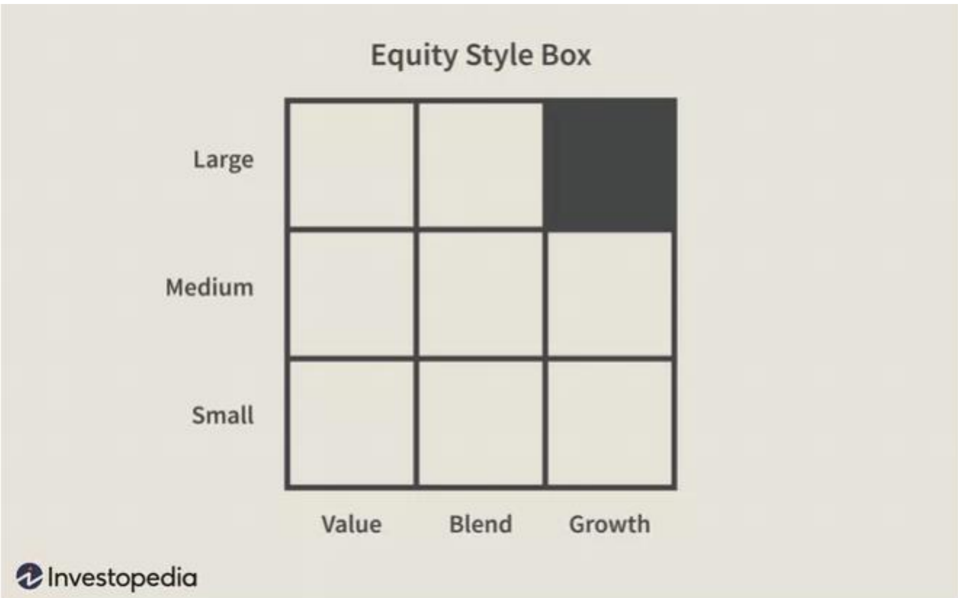
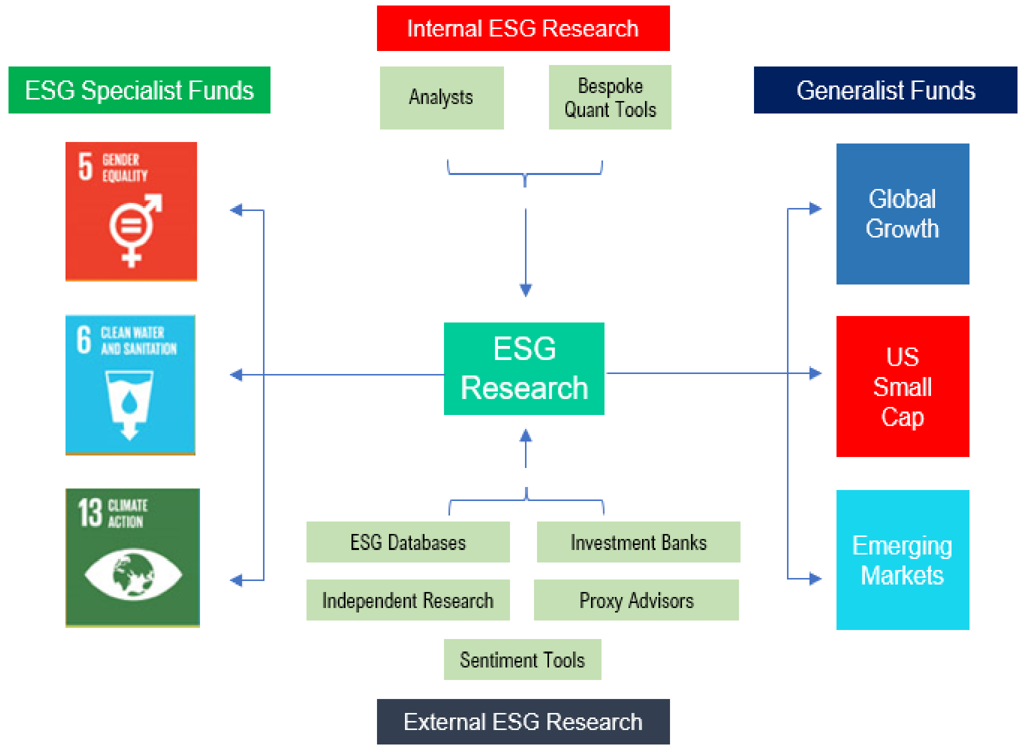


Image by Julie Bang © Investopedia 2019

A fairly generic set of investment research products/services can address this style matrix in a well-established format, with the majority of the output coming from fewer than 20 large investment banks.

In the ESG landscape a more complex, less homogenous set of inputs and providers, including ESG databases, specialist data (climate etc.), thematic research and proxy advisors, are required to service a wide variety of funds with very different objectives.

ESG INPUTS: SOURCES AND APPLICATION



Within the ESG category itself, increasing complexity will require the differentiated application of ESG and fundamental inputs. It seems unlikely that the following types of ESG funds would use identical inputs.

Source: Global Impact Investing Network

Given the diversity of these fund objectives, clearly no one singular ESG data score can describe how any given company would be assessed against all of these objectives. Although all the categories above are classed as "ESG" funds, the investment processes of these vehicles will be far more varied that those of fundamental equity funds, style differences notwithstanding.

The managers of each strategy should be able to clearly articulate the security selection and portfolio construction process and well as the external information inputs that inform the strategy. (This is particularly important in the US under 28 (e) as asset owners are paying for those external inputs.)

It should be a concern to fund investors and consultants (let alone regulators) if the manager is unclear as to what inputs are required to execute the ESG strategy.

However, it is quite likely that these diverse ESG funds may use some of the same inputs, but to varying degrees depending upon their specific mandates. This inter-relationship has also been captured by the Global Impact Investing Network, a portion of which is displayed below:

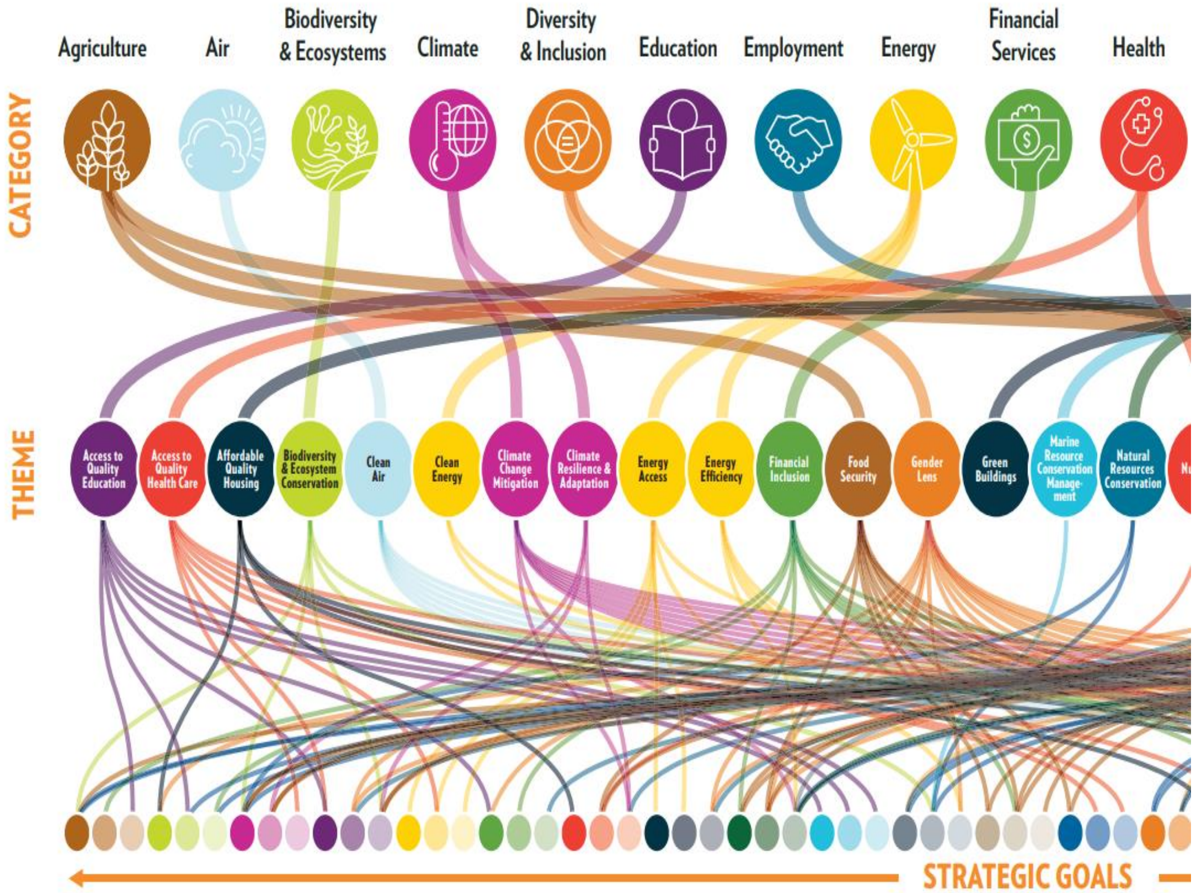


Figure 2: Interconnectedness of IRIS+ Impact Categories and Themes as of May 2021

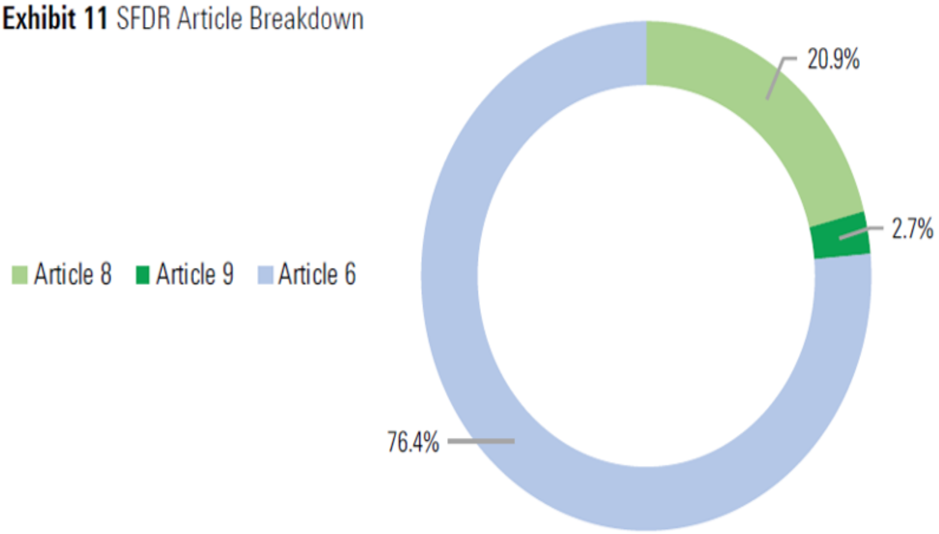
In an environment in which managers are under greater pressure from regulators and clients to prove that funds are following the articulated strategy and are "adequately resourced" how will managers demonstrate this?

The growth of ESG, is, by definition, creating greater asset owner/regulator scrutiny at the fund level. Obviously all funds are not ESG funds and ESG funds themselves vary considerably in terms of their objectives.

Regulators in the EU, the UK and the US are all emphasizing fund-level ESG attribution to avoid Greenwashing or fund descriptions that may be misleading to investors.

Even in the EU, under SFDR, Article 6, 8 & 9 funds are likely to use ESG inputs to varying degrees.

Exhibit 11 SFDR Article Breakdown



Source: Morningstar Direct. Data as of 27 April 2021.

The vast majority of EU funds will use limited ESG inputs but will still be obligated to demonstrate their integration into the investment process.

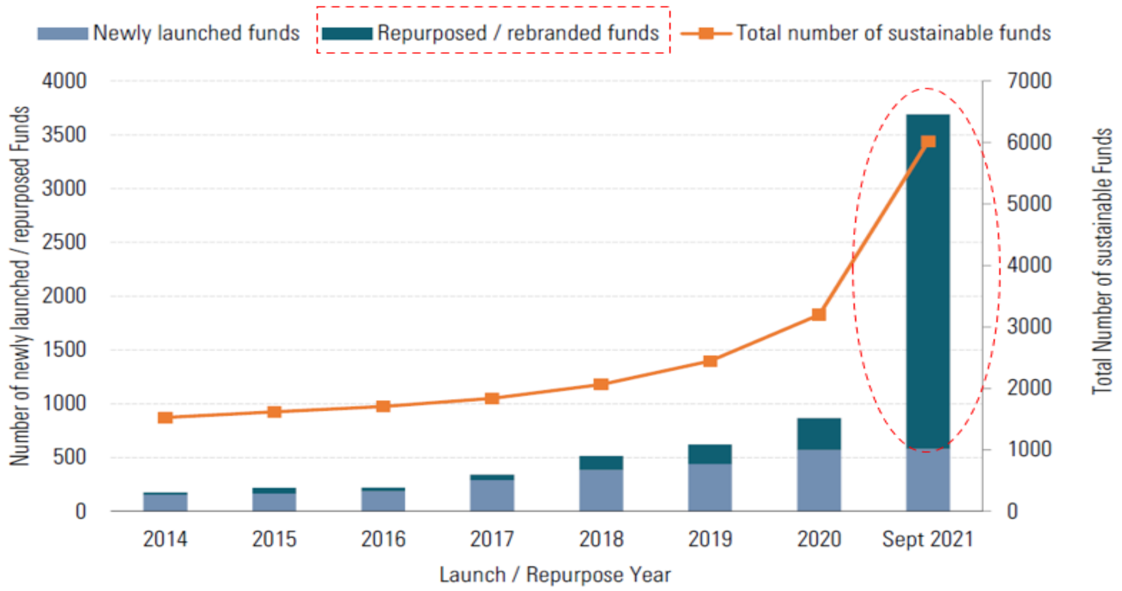
Article 6 funds are only required to consider ESG risks as part of the normal portfolio risk process, rather than having specific ESG objectives, and are therefore likely to use fewer ESG inputs versus Article 8 or 9 funds for which ESG outcomes is central to the investment strategy.

ESG/Fundamental Fund Matrix

Fund Type	ESG Approach	ESG Intensity	Fund Objective
Conventional Fundamental	None	Zero	Risk-Adjusted Return (Financial Only)
ESG “Aware” (Article 6)	Risk Overlay	Moderate	ESG Risk-Adjusted Return
ESG Speciality (Articles 8 & 9)	Organic/ Holistic	High	ESG/Impact Lead

Much of the growth of ESG funds, particularly in Europe, has come from “re-branding” funds as ESG offerings. In fact, the vast majority of today’s ESG products began life as conventional fundamental funds. The chart below from Morningstar indicates the sheer scale of this very rapid transition.

Exhibit 12.a Newly Launched and Repurposed Funds

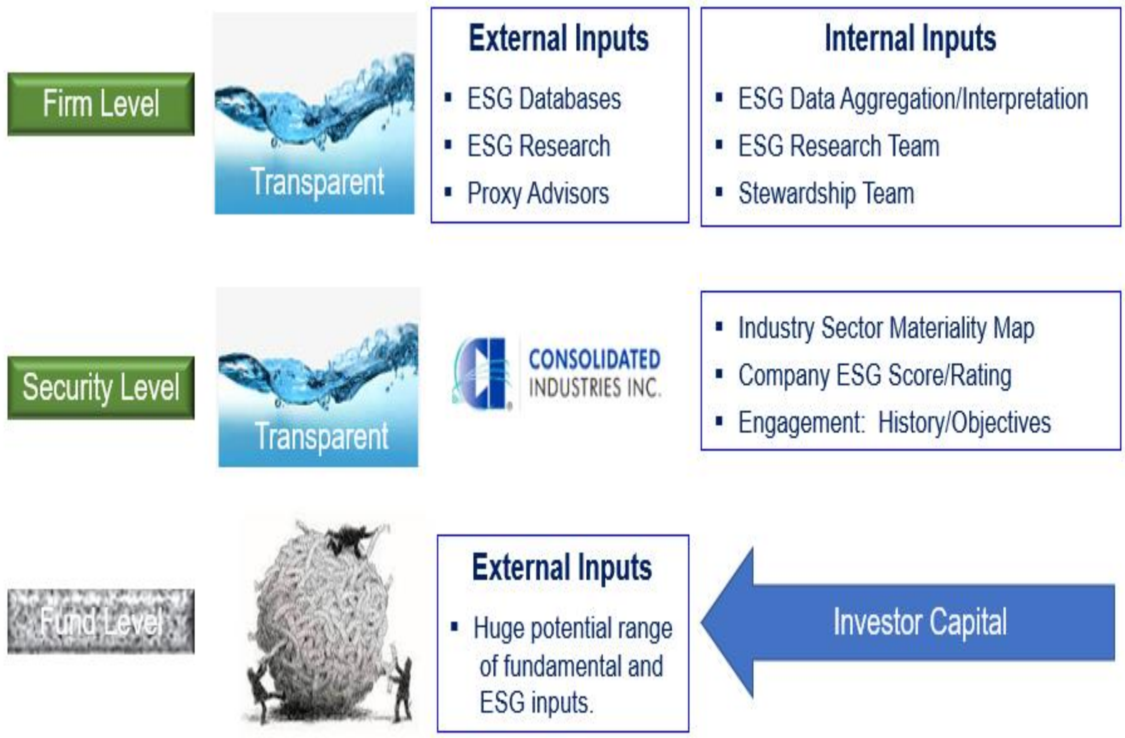


Source: Morningstar Direct, Morningstar Research. Data as of September 2021.

Do the ~5,000 newly re-branded “ESG” funds use an identical research valuation/budgeting process designed for the 2-dimensional world used by their predecessors? If so, how much have they really changed? These funds likely have the greatest burden of proof related to potential Greenwashing.

All of this should lead to greater scrutiny at the ESG fund level. Yet ironically, this is where even the most advanced ESG managers frequently struggle to allocate ESG inputs.

While there is increasing clarity of ESG inputs at the firm and security levels, input allocation at the fund level remains opaque.



This is a significant concern because investors do not invest in the asset manager as a whole, or in individual securities - but at the fund level.

Greenwashing Regulatory Risks

The longer that asset managers allow ESG and fundamental research valuation/budgeting processes to remain in separate silos, the greater the risk that the manager may be accused of overstating the degree of ESG integration at the fund level.

This is precisely the complaint that the SEC and the US Department of Justice are investigating related to a large European asset manager. The impact of the investigation has been material. The share price of the manager dropped 15% on the announcement last August wiping € 1.5 billion from its market cap. The stock has not recovered subsequently.

But, the risks go beyond regulation. The mere suggestion of Greenwashing can be very damaging to carefully and expensively constructed ESG franchises. Despite the immense investment many managers have made in their ESG products, many have neglected to construct the “last mile” of transparently allocating ESG inputs at the fund level which will certainly be subject to increasing scrutiny. This is a completely avoidable risk.

ESG funds need both ESG and fundamental research inputs. It’s not possible to run a portfolio based on climate data alone. Managers that can demonstrate the transparent allocation of ESG and fundamental inputs at the fund level will have more competitive and sustainable products.

The responsibility lies with senior management. ESG departments have their own priorities and may not have the enterprise-wide remit to make these decisions.

Managers should ensure that their ESG fund business models are resilient and sustainable as their ESG funds claim to be.