Insights
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Five ESG Investing Trends to Watch in 2020

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There are a number of signs that over this past year, ESG investing is going mainstream. Investors have grown more sophisticated in understanding the challenges of ESG data, new regulation in Europe is propelling investors to seriously pursue climate-aware investing and interest in ESG analytics and total-portfolio risks is at an all-time high.

All of this is resulting in growing demand for talent — particularly senior leaders — with the unique skills and experience to further integrate ESG across financial firms. Evidence of these trends is captured in *Into the Mainstream*, a research report we published in October 2019 that surveys more than 300 global institutional investors on their attitudes towards ESG investing.

Looking forward, we expect 2020 to be a year where critical ESG infrastructure is built, leading to the further maturing of the ESG market. Here are five ESG trends to watch for in the year ahead:

- SASB will emerge as the leading global ESG disclosure framework.
- ESG will be seen as a fiduciary responsibility.
- ESG strategies will become more complex.
- Investors will need to own their approach to exclusionary screening.
- ESG will become a mainstream boardroom issue.

1

The Sustainability Accounting Standards Board (SASB) will emerge as the leading global ESG disclosure framework.

With ESG data under scrutiny, investors are beginning to focus on the quality of the ESG data they use. Central to that understanding of quality is that ESG data should be financially material, consistently reported by companies, and comparable across peer firms.

In just the first twelve months since the SASB standards were launched, there has been a significant uptake in the number of investors and companies that see SASB as a framework that can improve the quality of companies' ESG reporting. As of Q3 2019, there was a 150% increase in the number of companies reporting against SASB compared to the previous year. While absolute numbers of SASB reporting companies are relatively low at just above 100, we expect SASB to emerge as the preferred standard for investor-relevant sustainability disclosure in 2020 for three reasons:

1 First, unlike existing sustainability reporting frameworks, SASB focuses on metrics that are financially material to investors, establishing a baseline standard of expectations for disclosure, and offering clear guidance to companies.

2 Second, the tools provided by SASB are accessible and easy for users to understand, thereby facilitating implementation.

3 Finally, SASB's standards can play a valuable role in investors' implementation of their TCFD commitments, as a framework for climate metrics reporting. The ongoing work between SASB and TCFD will support further adoption of SASB.

2

Consideration of ESG will be seen as a fiduciary responsibility.

To be considered as a part of fiduciary responsibility, an issue — and the data that describes it — needs to be seen as relevant to investment outcomes. Because the roots of ESG investing go back to socially responsible investing (SRI), a values-based framework, investors often debate if ESG is part of fiduciary responsibility.

But with the codification of the SASB standards, investors are converging around the idea that quality ESG data is based on financially material issues: for example, the selling practices of a pharmaceutical company or the data privacy management practices of a software company. There is growing awareness within investment organizations – backed both by academic evidence and growing ESG teams — that such issues matter to long-term company performance.

Alongside this awareness is the increasing availability of SASB-aligned data such as R-Factor™. Investors now have the ability to quantify and compare companies' operational performance on the ESG risks and opportunities that matter most to their industry.

Collectively, both greater awareness and access to data are moving investors towards the view that considering ESG issues in the investment process is part of honoring one's fiduciary duty.

3

ESG strategies will become more complex.

Investors have typically set a single ESG objective alongside the financial objectives they wish to address in the investment process: for example, reducing exposure to a particular sector or increasing exposure to companies with high ESG scores. Often in index strategies this was implemented via exclusionary screening. But as a sign of the ESG market maturing, we are increasingly seeing the adoption of more complex ESG strategies. Investors are beginning to set multiple ESG objectives within their portfolios: for example, fully eliminating exposure to certain sectors while minimizing exposure to underperforming companies and also setting broad emissions reduction targets across the portfolio.

This complexity has implications for both portfolio construction and product development.

In incorporating ESG into index portfolios, most institutional investors still seek market-rate returns. In order to address growing complexity and still achieve these returns, investors will need to get comfortable with more nuanced, and potentially more algorithmic-oriented, ways of building portfolios.

The increased incorporation of ESG into index portfolio construction will further mainstream ESG investing within active strategies. This along with the evolving understanding of fiduciary responsibility means that active managers who do not incorporate ESG into their company due diligence and investment processes will need to explain why they don't see ESG as a portfolio risk or investment opportunity.

Investable products, too, will respond to investors' evolving ESG goals. We expect to see the methodologies of existing product suites being updated to reflect multiple ESG objectives, and a growth in new investable solutions to meet the variety of more complex demands emerging in the market.

4

Investors will need to own their approach to exclusionary screening.

Exclusionary screening, the oldest and most common form of ESG investing, emerged decades ago as a straightforward process: a client would typically give a list of restricted securities to their asset manager, who would implement the restrictions. As exclusions became more widely used — both to express values and as a risk mitigation tool — clients have come to rely on third party ESG data providers for "screens" of the topics they wish to exclude.

With greater awareness of challenges in ESG data, investors are now beginning to question the data and methodology powering their exclusionary lists. We are seeing a growing number of questions about how different screens are constructed by different providers as well as the low correlation of names screened by different providers for the same topic. As with broad ESG ratings, the choice of a data provider's methodology and which companies are included in their overall universe can have direct and differentiated impacts on a portfolio.

Because of these differences and the increased scrutiny of all ESG investment products by both regulators and activists, in 2020, we expect it to become increasingly untenable for investors to fully outsource their exclusionary screening methodologies and keep their involvement at arm's length. As oversight of this area tightens, we expect to see more asset managers taking greater ownership of their exclusionary processes.

5

ESG will become a mainstream boardroom issue, resulting in better infrastructure and ESG disclosure by companies.

In 2020, we expect ESG to top the agenda in the boardroom, as directors respond not just to their investors, but to the broader debate about shareholder primacy. This was crystalized in the US by the 2019 Business Roundtable's updated Statement on the Purpose of a Corporation, expressing that a company's purpose is to promote 'an economy that serves all' and that their constituencies include customers, employees, suppliers, communities, and shareholders.

SASB's work makes clear that these constituencies are often aligned: how a company treats its employees or its surrounding community can have a direct impact on shareholder returns over the long term. But it will be up to boards to articulate these alignments at the specific company level.

In order for boards to effectively oversee this broader set of issues, companies will need to build up the internal infrastructure needed to effectively manage and disclose them. We expect to see companies collecting new types of data, building new reporting mechanisms, and focusing on their performance against these financially material issues.

Additional Resources

Implications of these five trends for investors, as well as thoughts on the future of a changing ESG space, can also be found in *Into the Mainstream*.

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