Cerulli Associates

10 × 10

10 of the world's leading institutional investors | 10 of the world's leading asset managers

Part Two

Climate Change Investing

Commissioned by:

Russell Investments

November 2021

In 3Q 2021, Russell Investments held its annual Partner Innovation Lab, a roundtable event where large asset owners from various geographies brainstorm their greatest concerns and areas of interest. Russell Investments asked Cerulli Associates to interview participating organizations, as well as some of Russell Investments' asset management partners, to extract individual perspectives on topics discussed at the event. In aggregating insights, Cerulli sought to compare asset owner and manager views on key topics, as well as leverage data and insights from its existing suite of research on the institutional asset management space. Interviews were conducted from mid-July to mid-August and spanned a series of topics:

1 Diversity & Inclusion

2 Climate Change Investing

The second installation of this series covers research dedicated to asset owner and manager progress towards incorporating climate considerations into their investment processes.

3 Seeking Future Returns

Participating Firms

10 Asset Owners: Organization	10 Asset Managers: Organization
The Boeing Company	Brevan Howard
Fujitsu Global	Hamilton Lane
Mazda Motor Corporation	Oaktree Capital Management
Microsoft	RBC Global Asset Management /BlueBay Asset Management
Mitsubishi Electric	Western Asset Management Company
Nestlé	BlackRock
Roche	J.P. Morgan Asset Management
Unilever	Morgan Stanley
The New York Presbyterian Hospital	Putnam Investments
Robert Wood Johnson Foundation	Wellington Management
Thomas Jefferson University	

Summary

According to asset managers, there is no greater force on their ability to impact climate change than client demand. In other words, asset owners are in a significant position when it comes to impacting climate change investing.

Some of the worlds' largest asset owners and managers shared insights on their approaches to climate change investing. The group of participants includes many successful thought leaders, something that Cerulli and Russell Investments believe will shed light on some of the innovative strategies employed. Cerulli found that asset owners exhibited varying levels of adoption, while asset managers had more universally established climate investing as an initiative. Many asset managers have built proprietary research platforms in efforts to service multiple clients with different climate objectives. Discrepancies in levels of adoption from asset owners generally correlated with institution type: While most nonprofits have taken measures to incorporate climate metrics in their investment processes, fewer corporate retirement plans employed measures.

KEY POINTS

- Compared to asset managers, asset owners were more varied in their adoption of climate metrics in their investment processes. Several managers have built out proprietary research initiatives, leveraging their size and resources to provide more insights into climate initiatives. Among asset owners, nonprofits have generally made greater strides on the climate front. Corporate plan sponsors cite various barriers preventing them from moving ahead with climate investing, including the DOL's guidance on pecuniary factors. Cerulli's survey of asset managers finds that while at least two-thirds of managers expect high demand from non-profits in the next few years, less than one third expect high demand from corporate DB plans or Taft-Hartley plans.

- Investment portfolios are used to help with organization-wide climate goals. Several asset owners have sought to offset their carbon footprints via their investment portfolios, investing in technologies like carbon recapture. Some have set up separate portfolios to do this. Asset managers have sought to provide these types of investment options for their clients, as well as investing their own corporate funds into various technologies.

- Internal values are the predominant force driving assets owners towards climate-investing programs. While asset managers cite internal values and belief in the merits of climate investing as drivers to adopting capabilities, participants in this study stressed the importance of client demand in their initial decisions to adopt capabilities. Several managers cite demand from European clients, specifically, being the catalyst for their adoption of climate investing capabilities.

- Climate-change investing depends on strategic partners. Integrating a climate investing approach is seldom done in isolation – asset owners tend to partner with asset managers or intermediaries (consultants, OCIOs) when taking their first steps into a broader approach. Asset managers generally begin by responding to ad hoc client requests, and a full-fledged process often involves partnering with a third-party data provider or specialist.

- Asset managers are increasingly devoting resources to ESG, either by establishing ESG specialists or heads of ESG. Similar to comments on D&I (covered in Part One of this series), asset managers tell Cerulli that devoting resources is necessary to fully embrace the initiative.

- Data continues to be a key challenge. Both asset owners and managers struggle with sourcing, aggregating, and interpreting data from the increasing universe of climate data providers. 10X10 participants frequently cited the tendency of different data sources to lead to varying implications on climate impact. Further amplifying barriers to garner clean insights, reporting standards vary drastically between regions and investments (*i.e.,* public vs. private).

Climate Change Investing

Compared to asset managers, asset owners were more varied in their adoption of climate metrics in their investment processes – for one, there were several asset owners in this research that do not incorporate climate change considerations at all. There are multiple reasons for this (cited later in this section), but it paints a stark contrast from asset managers, which had all tackled climate change in some form. As the asset management industry is increasingly competitive and firms are constantly searching for a competitive edge over passive, managers have devoted significant resources toward combating the climate crisis.

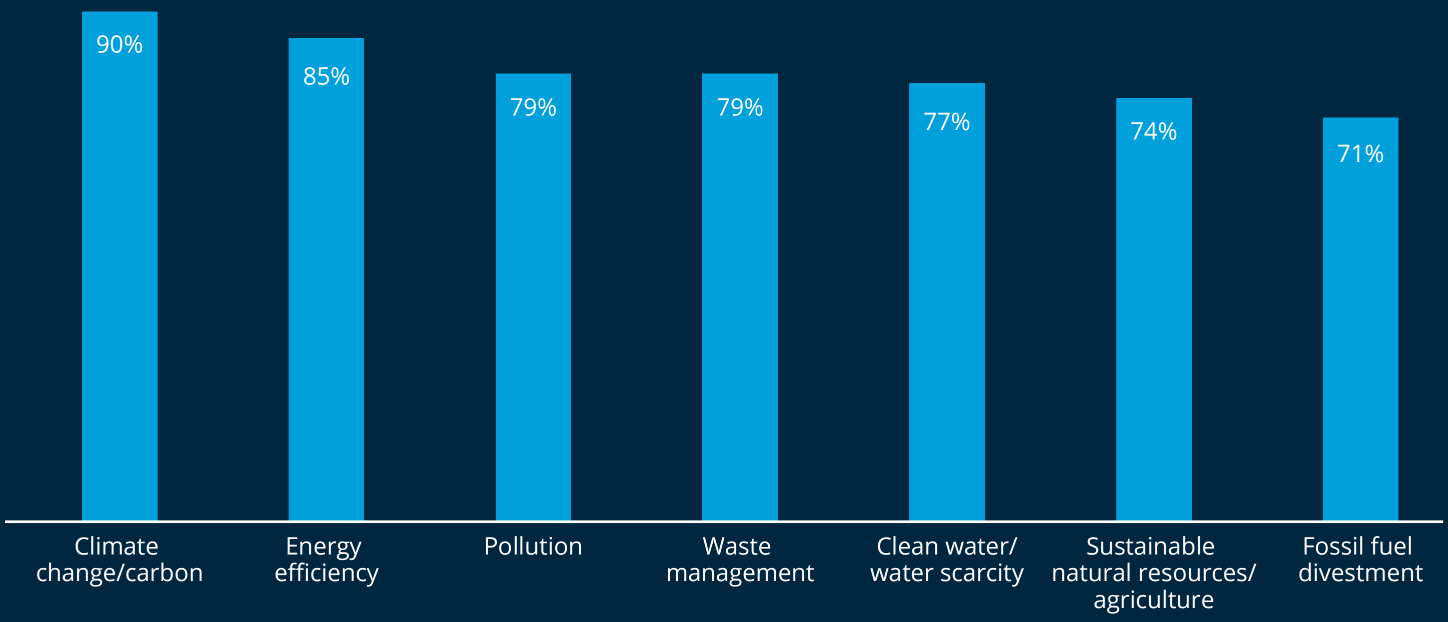
Almost all managers with whom Cerulli spoke reported having proprietary research efforts on climate investing. These efforts are often housed with a dedicated team. One manager told Cerulli that it makes a large effort incorporating climate metrics into its capital market assumptions. Specifically, this manager's factor team, charged with developing capital market assumptions, partners with its sustainability team to set expectations. Other managers talked about their focus on researching transition and physical risks, often looking at various scenarios and their implications for portfolios.

> “Transition risk – we are looking at policy from a regulatory perspective [as well as] the technological disruption like clean energy and electric vehicles. We are trying to understand how well the companies are prepared for that transition. Our fundamental factor team put out a piece on how clients were putting in carbon limits and the degree of difficulty to achieve various outcomes, like income.”
>
> *– asset manager*

> “We partnered with the sustainability team to set our expectations. We consulted with them, and a number of investment teams are consulting with them to see how they can leverage their sustainability data and analytics into their investment process. It's not yet mainstream; [but it is] mainstream in that when you talk about the investment outlook you can't not talk about sustainability. I still think when it comes to having your ear to the ground and knowing where the pulse is – and the accounting standards that are changing, and the regulatory standards – having that in-house expertise is important.”
>
> *– asset manager*

Asset Managers

Top Environmental Themes Incorporated into ESG Integration Process, 2021



Source: Cerulli Associates

Asset managers have greater influence on companies, while asset-owner clients have influence on asset managers. Many participants talked about driving positive environmental outcomes via influencing the companies in which they invest. Asset managers tend to have the upper hand with influence (compared to asset owners) because they are closer to the investments and they are often allocating larger positions on behalf of multiple investors. One manager tells Cerulli that communicating its values to companies is one of the ways it seeks to influence. Specifically, this manager writes letters to CEOs, emphasizing its goals and citing the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD) as initiatives that it monitors and supports. Asset owners tend to influence the companies in which they invest through their asset manager partners by making sure that the manager is proxy voting in a way that aligns with the asset owner's values.

> Our engagements are about asking meaningful questions, and how to improve it. We often own a sizeable portion of our investments so we can influence things in that way."
>
> *– asset manager*

> We go through equity holdings, large holdings, and we write letters to the CEOs – thoughtful specific letters. We try to avoid narrow prescriptive things, but we want to emphasize that the SASB and TFCD are important principles, and we encourage them to do it."
>
> *– asset manager*

> [We are] engaging with investment managers to make sure that you are taking proxy and voting into consideration. Are they a) voting our shares, with respect to socially conscious initiatives? and b) are they engaging with the companies?"
>
> *– asset owner*

An emerging goal for many organizations involves offsetting carbon footprints either solely within the investment portfolio or across a retirement plan sponsor's scope of business activities. Several asset owners with whom Cerulli spoke had explicit targets of reaching net-zero carbon emissions over certain time horizons. Investment offices can seek to offset other investments or their corporate plan sponsor's carbon footprint by investing in technologies that reduce carbon footprints. An asset owner told Cerulli that it launched a climate innovation fund that invests in climate-focused technologies such as carbon recapture. Another asset owner told Cerulli that, in addition to generating most of its energy from a nuclear site, it invested in a windfarm in order to become carbon-neutral.

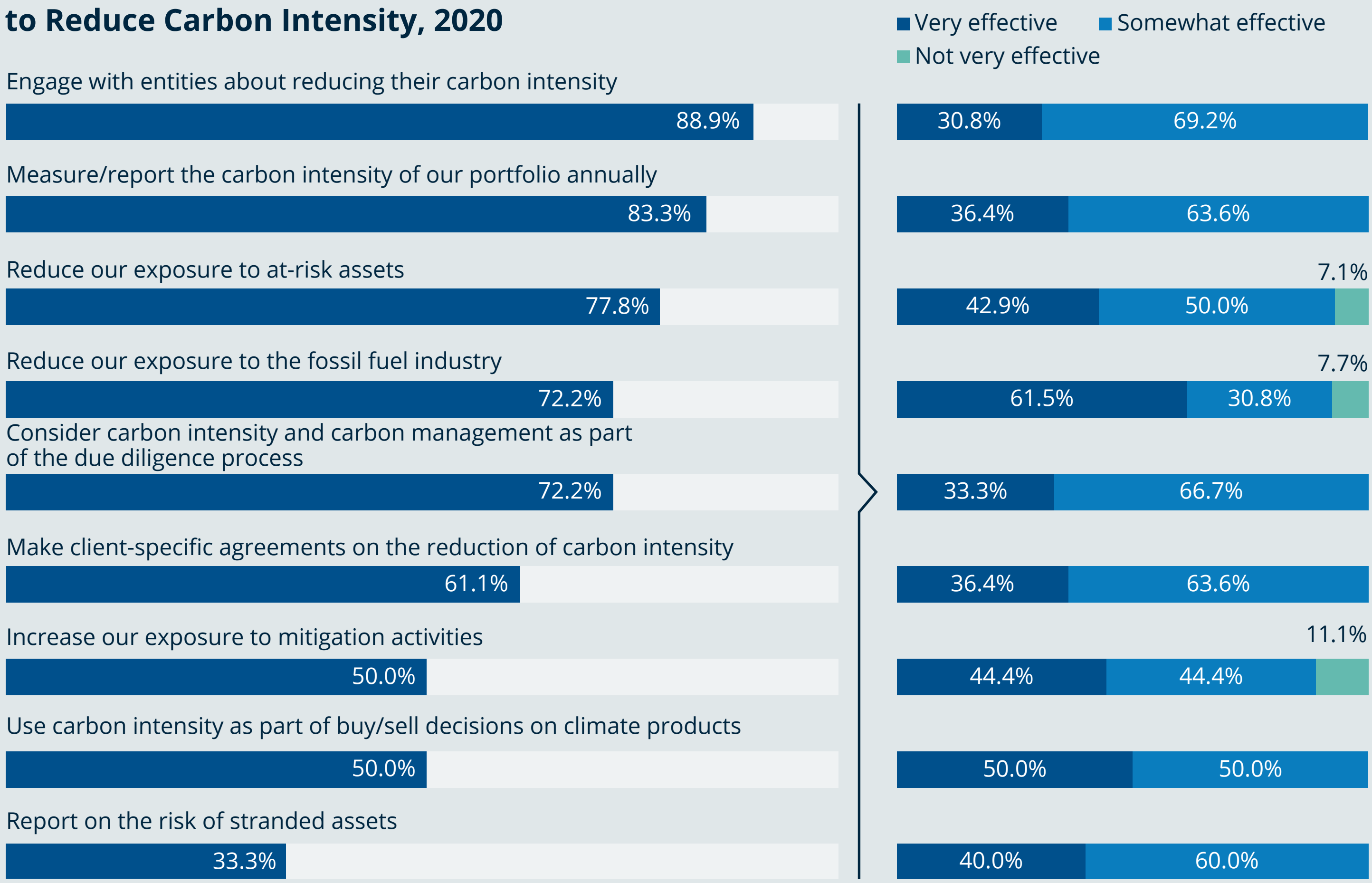
> You can do the research, MSCI, Sustainalytics, and invest in accordance to that. You can do your own research. We've taken it a step further. We purchased a foresting company and create carbon credits for our asset management firm as a whole, or there may be clients interested in investing in the foresting industry to capture carbon credits."
>
> *– asset manager*

> If we focus on carbon, making sure that we understand the inherit risks we are taking. The risks that we are facing in terms of transition, but also in terms of opportunities. On the liquid part of the market spectrum, we are trying to move that to an allocation that is consistent with a net-zero landscape in order to mitigate risk."
>
> *– asset owner*

> Customers using [corporate sponsor product] are using electricity, and where does that electricity come from? We are trying to enter energy supplier agreements for data centers, etc. Are there new technologies that can reduce the carbon footprint, like carbon recapture? We created a $1 billion climate innovation fund where we are investing in new climate-focused technologies."
>
> *– asset owner*

European Asset Managers: Approaches Taken to Reduce Carbon Intensity, 2020

Effectiveness of Approach



Source: Cerulli Associates

Climate Focus Catalysts

Institutional clients drive climate focus through asset manager partners

10X10 participants report several catalysts or driving forces behind their adoption of climate considerations in their investment processes, including internal values, external demand, and regional beliefs. One asset manager told Cerulli that the rise of ESG, including environmentally sustainable investing, is a result of the world re-thinking the way it looks at companies. The traditional view is that the goal of corporations is to make money for shareholders, and profits ultimately stand in for the welfare of society. This manager claims that people increasingly believe that corporations have responsibilities beyond making money.

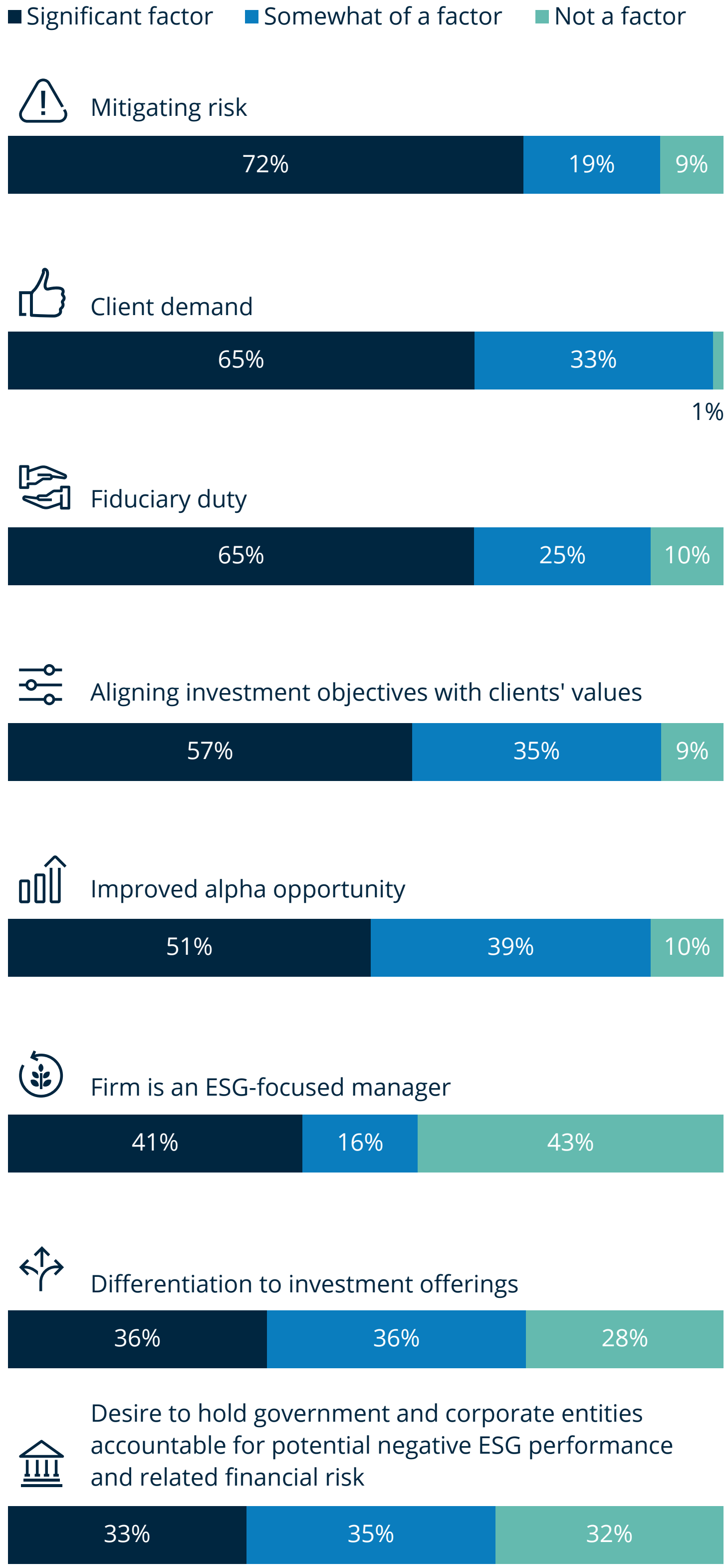
While internal values may have played a small role, asset managers told Cerulli that their adoption of sustainable investing capabilities is primarily driven by external client demand. Managers generally believe that clients bear the ultimate responsibility in adopting a climate change investing lens. While asset managers take their own measures, internally, to combat climate change, most have clients that do not consider ESG metrics at all and, as fiduciaries, they must invest in a way that is commensurate to their clients' objectives. Data collected from Cerulli's 2020 Environmental, Social, and Governance report shows that managers' belief in merits of ESG factors was the most commonly-cited significant factor driving their decision to start using ESG criteria in their investment analysis. While there could be a genuine difference between the views of survey participants and 10X10 participants, views portrayed via research calls often differ from survey results, as conversations are more directed and participants have a tendency to speak more candidly.

> Here, I think the clients have more responsibility [for our adoption of ESG]. They were more proactive, as opposed to DE&I. Especially European clients."
>
> *– asset manager*

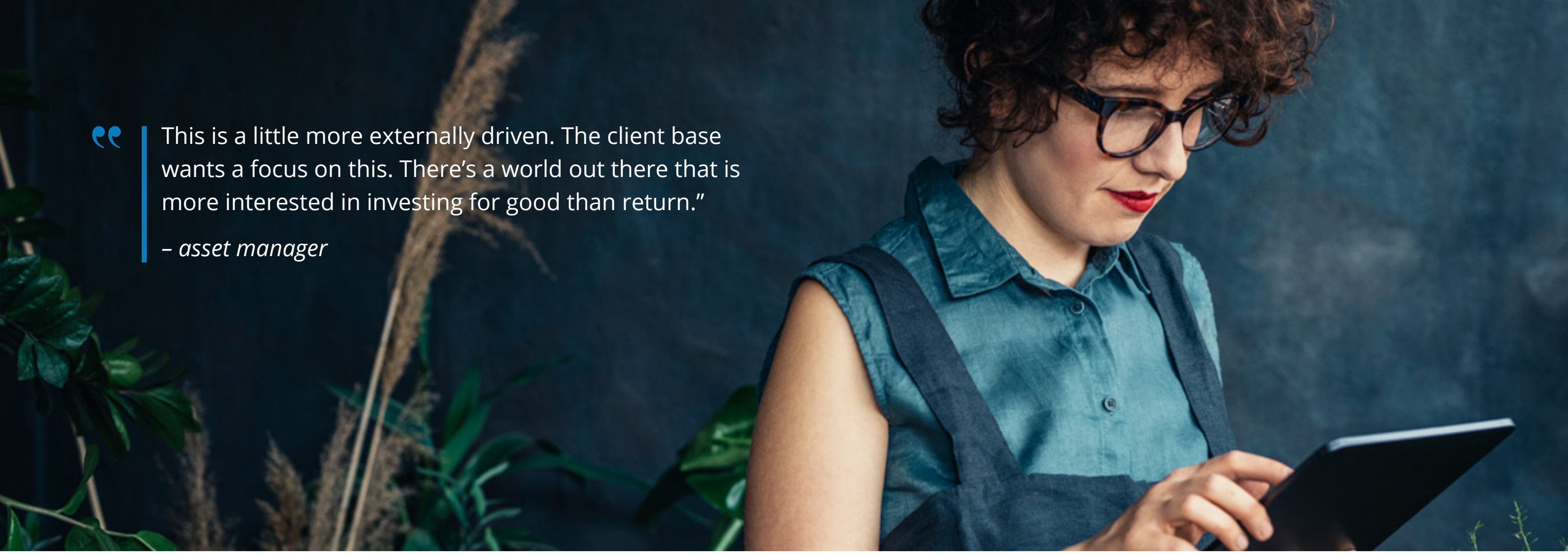
> We are a global bank; the government decides what's legal and what is not, so we have to offer all of those options and it's guided by the clients."
>
> *– asset manager*

Asset Managers

Factors Driving Decision to Start Using ESG Criteria in Investment Analysis, 2021



Source: Cerulli Associates



> This is a little more externally driven. The client base wants a focus on this. There's a world out there that is more interested in investing for good than return."
>
> *– asset manager*

Client demand is a powerful driver. Most managers have put significant effort into tackling climate change investing simply because it's needed to compete in today's marketplace. While there are several asset owners that do not have a climate change focus in their investment programs, every single manager with whom Cerulli spoke has made progress one way or another. Many of them global, they made efforts to adopt capabilities to compete in Europe, following client demand in that region. Managers benefit from serving the needs of multiple clients and they often evolve with their clients' thinking. In addition to shaping the way they do research, the demand for climate impact has also guided product development efforts.

> Elements such as sustainability, carbon transition, becomes incredibly important to our end-investors. They want the impact to be in line with the performance. It's a space that is continuing to develop very rapidly."
>
> *– asset manager*

> It's not just research, but also product development and making sure the products we have on the platform are meeting the demands of our clients."
>
> *– asset manager*

> We build portfolios tailored to our clients' desire. The first move was SRI – we managed money for entities that have SRI restrictions and have had for many decades... In the last ten years, but more relevant in the last four years, we have been engaging with clients and discussing ideas of environmental investing, especially around carbon footprints. Clients want portfolios with lower carbon footprints against the benchmark."
>
> *– asset manager*

> It all comes down to guidelines. We have 1,000 core bond clients, and there's probably 50 different sets of guidelines; they all want something different. You can offer all of those choices. You can have a traditional unconstrained product, or you can come in with your own guidelines with your own exclusions."
>
> *– asset manager*

> You've already seen it evolve. Three years ago, it was something that you sort of considered. Now it's something you consider, and I don't think that you will be able to do an investment mandate without climate change involved in some way. I think now it is part of every investment decision and it will continue to become more important."
>
> *– asset manager*

> For a number of years, it seemed like it was a subject that was at the side of people's desk; not mainstream by any means. Come 2016-2017, we heard much more from asset owners that this was core, especially around the environmental aspect and reducing carbon, though not exclusively."
>
> *– asset manager*

> Clients want it; they want to see that you have a process. Some want it integrated into your process, some want you to have a bias, [and] some want it to be exclusionary. Some want to exclude any bad carbon footprint."
>
> *– asset manager*

Internal values are the key driving force behind asset owners' adoption of environmental metric considerations. Sometimes these internal values emerge from the investment office itself, and other times they trickle in from other parts of the organizations (*i.e.,* a broader initiative of a plan sponsor organization). In addition to internal values being a driver, some asset owners are beginning to adopt a climate focus simply because they project that climate change investing is inevitable – it's the future. A Japanese pension reports that it has taken steps to tackle this initiative in an attempt to follow the lead of U.S. investors.

> ESG will be an important issue. It will become common to think about ESG factors for mutual funds in the future. Success in ESG products depends on whether the resolution of social problems using ESG will lead to firms' business expansion."
>
> *– asset owner*

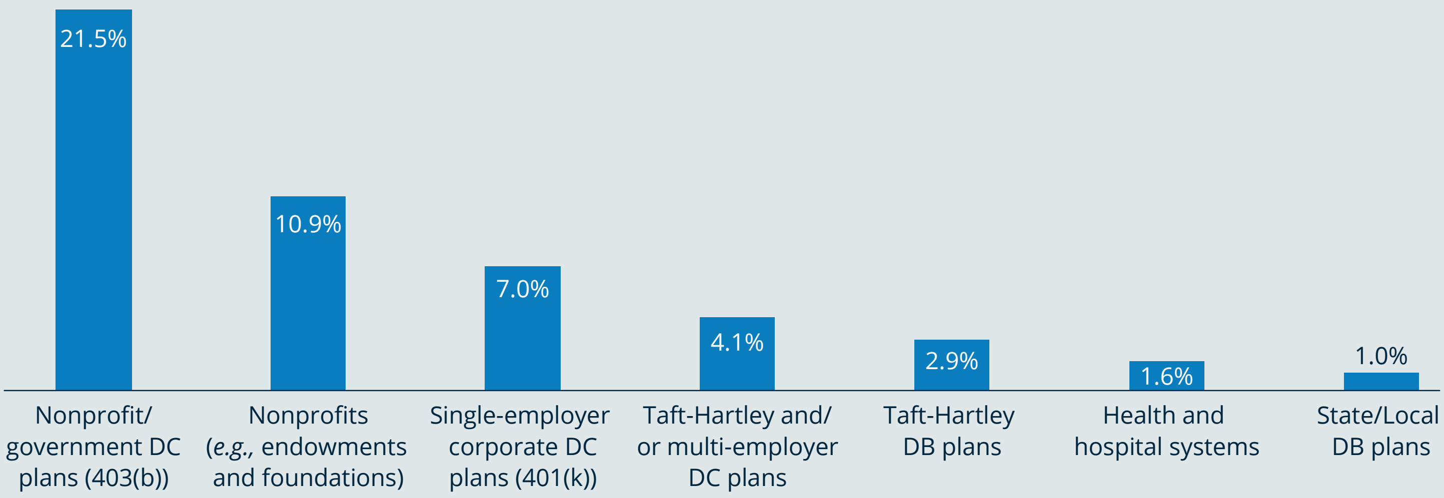
> We have had little time to do research yet, as we are so busy making other changes to our investment style over the past five years. We want to do as the U.S. and European pension plans, endowment funds, and university funds do, and are changing ourselves accordingly."
>
> *– asset owner*

Other Stakeholders

Asset owners and their managers are not the only stakeholders driving the push toward investing to combat climate change. Through its ESG research and confirmed by participants in this study, Cerulli has found that institutions' end-beneficiaries are often a driving force behind adoption. One corporate plan sponsor mentioned that it relies on nonprofits (endowments and foundations) for thought leadership on ESG broadly, as those institution types are generally further along in implementing ESG practices. The participant mentioned that nonprofits' constituents (or end-beneficiaries) are often more vocal and demanding on this front. Corporations' end-beneficiaries (plan participants) are often less vocal. Cerulli attributes this to plan participants being more heterogenous (*e.g.*, spectrum of ages, with older participants being less focused on impact and more focused on retirement security) and corporations in general being primarily driven by generating profits. In the case of nonprofits, donors and foundations from which non-profits seek grants are often advocates for climate-oriented sustainable investing. Furthermore, these institutions often have missions that align with sustainable outcomes, so incorporating these principles into their portfolios is more seamless from a governance perspective.

> On the university side, they have constituents that are very vocal. Corporates don't have the same. I would say, on the 401(k), we will get participants requesting ESG funds and evaluating whether it can be available. On the ESG side, it's a legal challenge for us. I can't say with certainty that once guidance comes out, we will come out with something. But we are evaluating it."
>
> *– asset owner*

Investment Consultants
Clients With a Dedicated Allocation to ESG Investments, 2020



Source: Cerulli Associates | Analyst Note: No participants indicated that their corporate defined benefit or state/local defined contribution clients have a dedicated allocation to ESG.

Stakeholder impact can be seen even more broadly. Asset managers have increasingly seen pressure from the general population, most often via advocacy groups. Retirement plan investment committees could see pressure from their corporate sponsors' clients, although this is less common. Most of the time the client pressure is limited to the sponsor's operations rather than its retirement investment portfolio. In explaining their adoption of ESG strategies and capabilities, many asset managers point to regional differences factoring into their efforts. Specifically, managers with a presence in Europe report demand from European clients driving their initial adoption of ESG capabilities. Managers often tell Cerulli that Europe is ahead of the U.S. in the overall sustainable investing trend, and the influence of regulators in these regions further amplifies their rate of adoption.

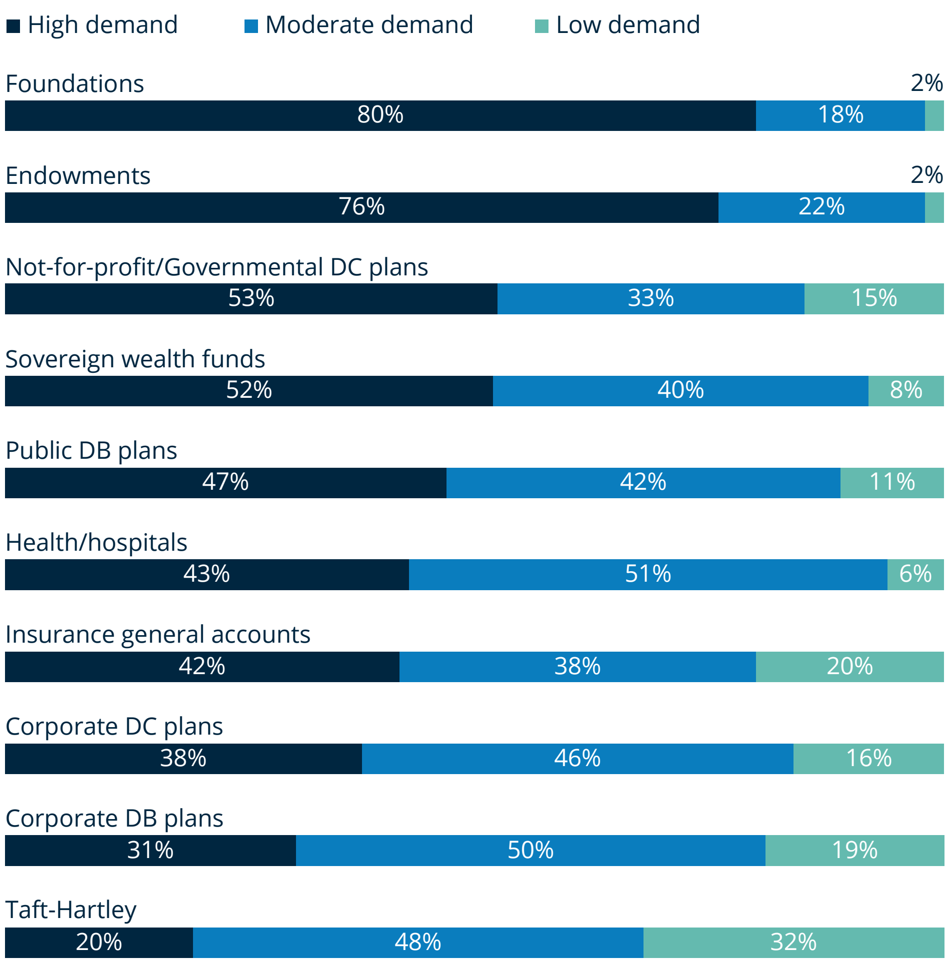
> My perception is that the U.S. market is where the European market was five or ten years ago. There are pockets within the U.S. where ESG has been embraced more readily. That mirrors some of the conversations we had five or ten years ago...[That] doesn't mean it will take that long to catch up. But it requires a change in the mindset of investment professionals... A theme like ESG is giving European managers a chance to compete in the U.S. market."
>
> – *asset manager*

> This is an area where interest from the client is very instrumental in increasing our focus, especially European clients. They are more demanding than U.S. clients."
>
> – *asset manager*

> We saw that first being relevant in Europe, then Asia, and now the U.S.... [It] started in Europe a decade ago. Once investors start valuing that, regulation follows. In Europe you are seeing regulation coming on the mutual fund side. All of that has been implemented in the last twelve months. It's becoming more relevant."
>
> – *asset manager*

> Here [in the United States] it hasn't been as advanced because of the Trump DOL and the pecuniary requirements. The U.K. has a requirement that plans incorporate ESG, but also say how they are doing that and communicating that to the shareholders (SRD II). The actual regulatory bodies in Europe and the U.K. have mandated that pensions take this into account – U.K., EU, Swiss regulations on reporting. [Investors in those countries have] more freedom to incorporate these principles into the portfolios."
>
> – *asset manager*

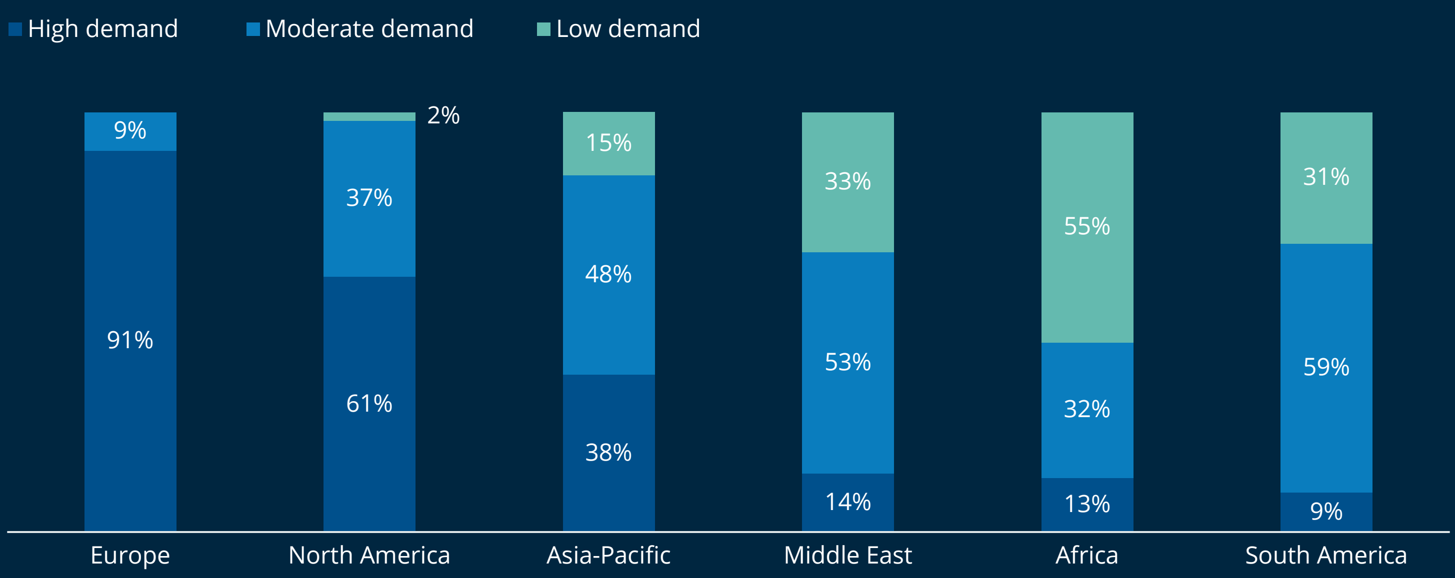
Asset Managers: Institutional Demand for ESG Strategies in the Next Two to Three Years, 2021



Source: Cerulli Associates

Asset Managers

Demand for ESG Strategies in the Next Two to Three Years by Region, 2020



Source: Cerulli Associates

Incorporating Climate Metrics

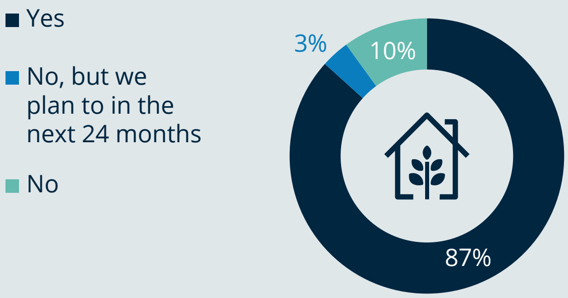
Adopting a climate investing lens or ESG more broadly is a complex process that takes time. No matter where they are in terms of progress toward incorporating these initiatives, asset owners and managers anticipate their approaches evolving in the future.

Asset owners partner with investment consultants, asset managers, and third-party data providers to provide guidance on climate-friendly investment strategies and potential frameworks to analyze their own portfolios. There are significant challenges when it comes to gathering, interpreting, and acting upon data in the climate realm. As such, partnering with external organizations that have experience or specialize in the space is extremely valuable for asset owners considering the initiative. Many participants in this study said that taking on climate investing is not simply an exercise of overlaying an investment process with insights found from a handful of sources. A manager painted an illustration of this when explaining his view on green bonds. Specifically, this manager explained that the "green bond" categorization was generally flawed and shallow. His firm believed that green bonds only had merit when their issuance actually impacted the end-issuer's behavior. Hence, by investing in green bonds asset owners are checking an ESG box, but in many cases, they are not actually creating an impact. Asset owners can rely on their managers to guide them toward research and point out nuances like this.

> We went out to all 401(k) managers and asked how they are integrating climate focus into their investment approach."
>
> *– asset owner*

> Real impact comes from engagement. We want to deliver results that are consistent with the ESG goals we are looking to attain."
>
> *– asset manager*

OCIOs with Resources Dedicated to ESG Incorporation, 2020



OCIOs' ESG Support Offerings, 2020

Source: Cerulli Associates | Analyst Note: Other responses include "enhanced level of dialogue on trends in ESG" and developing a "suite of internally managed solutions."

Reliance on Strategic Partners

Asset owners often rely on their intermediaries to provide guidance. One explained that its investment consultants are charged with helping them implement ESG considerations and opportunities. Another explained that it collaborates with its consultant on developing sustainable equity options for its DC plan and creating the right management structure. Several told Cerulli that consultants play a pivotal role collecting and consolidating data. Data from Cerulli's 2020 Outsourced Chief Investment Officer report shows that almost all (93%) OCIOs support incorporating ESG into clients' investment plans, further confirming 10X10 participants description of intermediaries playing an important role.

> It's really important to have a relationship with your investment consultant because [there is] a lot of the reporting you need to rely on them for. We have reached out to a specific company in Europe, not the U.S., that is feeding back data to us and they specialize in ESG data reporting"
>
> *– asset owner*

Both asset owners and managers partner with third-party data and research providers to learn about their own impact and build climate investing programs. An asset manager described a partnership it had established with a climate change think tank to create investor tools that uncover climate risks. It described one of these as a geospatial risk assessment tool that enabled portfolio managers to look across assets and assess the risks from changes in the climate.

Another third party that asset owners rely on is their peers. People can make lateral career moves, from institution to institution, and bring their insights with them, or asset owners can simply call upon each other. An asset owner tells Cerulli that its peers are very forthcoming when it comes to initiatives like ESG or D&I.

> "When it comes to diversity or ESG, you aren't looking for investment secrets. Just given the mission of those questions, you want to be helpful and there's a lot of sharing that goes on."
>
> *– asset owner*

Unlike most initiatives, integrating climate metrics in investment processes generally does not start with setting goals beyond integration itself. It tends to start off as more of a directional initiative, where asset owners build out capabilities ad hoc. As they make progress, they further define their goals. In other words, these investors don't wake up one day and say, "I want to have a net-zero carbon portfolio" before having taken some measures prior. Included in the challenges they face, asset owners and managers struggle to define their approaches as they seek to tackle the issue more comprehensively.

> We will try to figure it out over time. We will walk before we run and step into naturally. We don't have the asset base of some other organizations who have done this."
>
> *– asset owner*

> We were doing active ownership, exclusions, etc. But it wasn't coming together as a strategic whole. We have decided that climate change is the predominant factor that we are facing...we've committed to net zero by 2050 as a company. We will make that earlier if we can. I don't know if people know, if anyone knows, what net zero will look like. But I think you will have to have significant investments in technologies like carbon capture to reach that goal."
>
> *– asset owner*

Dedicated ESG Resources

Rather than integrating a new investing framework across all positions/responsibilities, most asset managers have built functions or assigned dedicated resources to addressing climate investing. Several managers have hired heads of ESG to assist in developing frameworks and ultimately integrating ESG policies broadly. Some asset owners report hiring heads of ESG as well, although this is a bit rarer as the investment offices tend to be limited in size. After initial adoption, the head of ESG and/or teams of ESG specialists collaborate with other investment professionals, educating them and providing independent analyses. They are often charged with leading their firm's proprietary climate research efforts as well. As best practices are constantly evolving, these specialists are also charged with leading their firms in the right direction on this front and innovating as necessary. Notably, no 10X10 participants reported having specialists dedicated to climate-oriented sustainable investing but rather wrapped these responsibilities into ESG specialists or heads of ESG. In some cases, heads of ESG were also responsible for promoting their firms' D&I efforts.

> We wanted a better way to progress towards a sustainable portfolio so we hired a Head of ESG, and she got us over the hump in terms of ESG integration policy."
>
> *– asset owner*

> The head of ESG – when we created it five years ago, it was pivotal to us in organizing our thinking and structuring how we would think about that risk across the desks consistently."
>
> *– asset manager*

> I think they (heads of sustainability and diversity) are essential. It depends on what you want to do – do you want to approach it as an amateur? Our do you want to deliver expertise on these topics?"
>
> *– asset manager*

> You do need to allocate resources to solely focus on this. It's not clear where the alpha insights are when it comes from the ESG data from ratings providers. It's important to have a team that's focused on developing proprietary research capabilities."
>
> *– asset manager*

> We have a generalist format [no asset class specialists]...ESG was a special case. We really needed to have a specialist in that role... My ESG person basically put up a grid that is now the standard approach. Before, everyone had their own opinion on it, so there was some initial pushback. I think it's important to have that sort of expertise."
>
> *– asset owner*

Climate Data and Barriers to Adoption

Throughout this research, many participants described challenges with data on climate metrics. With a flurry of third parties making efforts to track climate data, there is no shortage of sources. There is, however, a shortage of comprehensive and complete datasets, and existing sources often rely on different metrics. Several asset owners and managers tell Cerulli that using different sources often results in different outcomes.

> Not all of these data providers come up with the same answer for the same issues."
>
> – *asset owner*

> One analogy that I draw is looking at factors. When we started looking at factors the data was pretty messy, but now it is very streamlined. One of the ways ESG is improving is the number of disclosures that are being required. We've gravitated towards a preferred provider on carbon data, but we are constantly evaluating our data sources."
>
> – *asset manager*

> On the investment side, how do we assess this? Data is the most important thing...The data itself is not comparable across different sources. It's a challenge and you have to come at it from different sides. My caveat is that it's a moving target and we are focusing on data gathering as our first step. Once we have the data, how do we use it? The metrics we are trying to gather are greenhouse gas emission, carbon footprint, water use, [and] hazardous waste. Are you exposed to water stressed areas, supply chain risks, etc.?"
>
> – *asset manager*

> We use a third party to measure carbon footprint, things like that. That will be the friction point – what are you measuring? Did you eliminate this amount of carbon, or provide food for this number of people?"
>
> – *asset manager*

> Another reason we aren't being super aggressive about ESG is that you get different conclusions from different sources. Like Tesla – you get a great rating about them because of EVs [electronic vehicles], but they use lithium batteries so another source will say they are horrible."
>
> – *asset owner*

Industry participants struggle to find consistent data across the universe of companies. The lack of reporting disclosures is particularly challenging for investors looking to build a framework for U.S. holdings. While companies in Europe are required to report more disclosures on the climate front, many asset owners and managers look to gather data beyond what is required. As asset owners and managers continue to streamline their processes, they are likely asking U.S. companies for the same metrics that European companies are required to disclose, providing an avenue through which there could ultimately be some standardization.

> One of the things they [the SEC] wanted to do was disclose certain statistics as part of their disclosure. I thought that was a slippery slope. But now I'm more supportive of it; I think there needs to be more consistency and standardization around reporting."
>
> – *asset owner*

One manager tells Cerulli that it first built a framework for addressing the issue in Europe and is using that framework as a template to extend to other regions, namely the U.S. This approach makes sense for anyone who projects that U.S. regulation or client preferences will follow Europe's. Notably, European countries have taken steps toward requiring certain disclosures so asset owners and managers servicing the region have had to incorporate that data gathering and maintenance process. As organizations seek to create global frameworks, they are likely to extend their gathering laterally, across non-European countries.

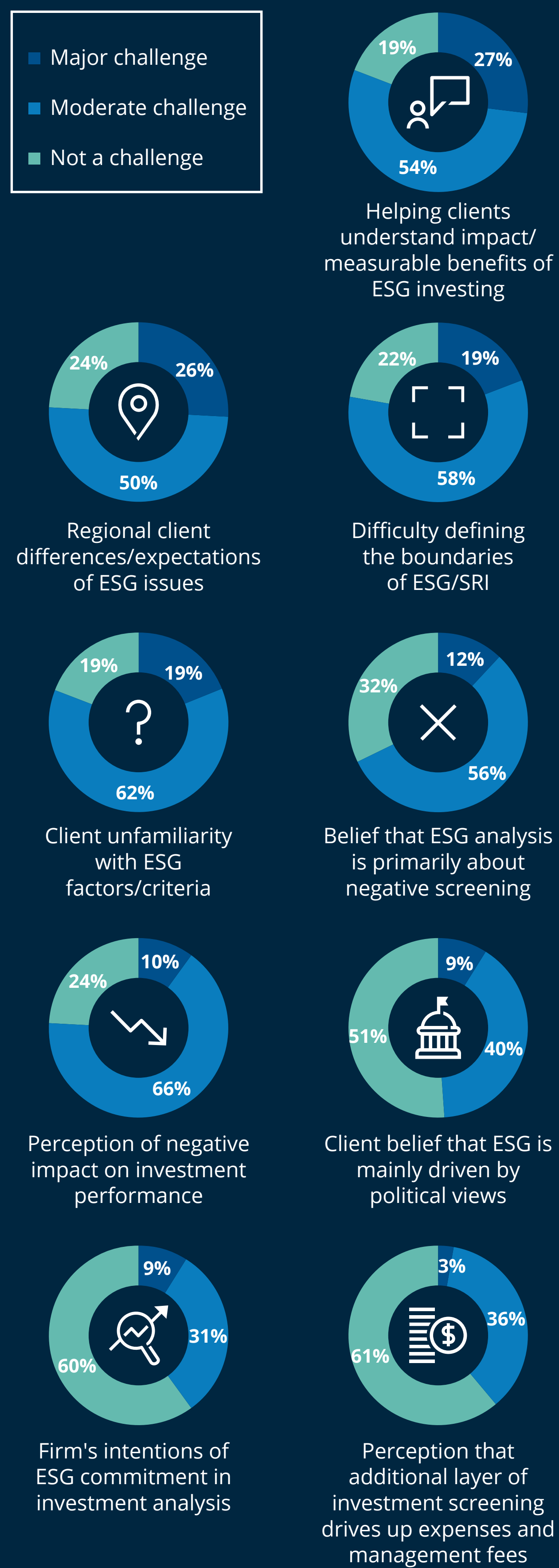
> There's a lot that needs to evolve from a data-gathering side. [It's] one of the first caveats that you get caught up in, [and it's] hard to measure in certain asset classes. The U.S. is probably behind in development of infrastructure relative to Europe. You have to have a broad approach, so we spend a lot of time on the legal and compliance side so that we are complying with European guidelines and that those processes can be utilized in other territories. That's a challenge and a moving target."
>
> – *asset manager*

> I think there will be consolidation. It's like credit ratings; you really only have two or three people doing the credit ratings. The ratings tend to be very similar. Do you ultimately need all of these credit agencies at the end of the day? As companies track this data, they might evolve over time and consolidate."
>
> – *asset owner*

> I think it will start with the regulatory change. [The] Biden admin has sent smoke signals that they will open this and companies won't have to strictly rely on a pecuniary objective. That will force companies report it better and we will have to better monitor it. I see the regulatory as the key impetus."
>
> – *asset owner*

> [In] my own mental map, I think ESG is trickier than DEI...We have a good sense of the problems in DEI. But when it comes to ESG, we don't know what the metrics are. For example, one thing that troubles me is that people say Exxon is not compatible with our IPS but will invest in Amazon. But Amazon is one of the biggest polluters of any company. It's not obvious to me that you are making any difference by switching your dollar from Exxon to Amazon."
>
> – *asset manager*

Asset Managers:
Challenges to Increasing Client Receptivity of ESG Issues, 2021



Source: Cerulli Associates

The challenge of appropriating the correct data is rooted in another challenge: defining climate change investing or even ESG. Simply put, a large barrier to incorporating climate considerations is the fact that it's overwhelming and difficult to measure – an information overload. In developing a comprehensive framework, asset owners and managers must make several judgements throughout, making it a highly subjective process. A manager highlights this in his explanation of comparing different alternatives in energy consumption (e.g., fossil fuels vs. lithium). He describes this as an issue rooted in the shortfall of pricing; there are various negative climate externalities and there is no established pricing mechanism to compare them.

> What's the definition of ESG? You might get ten answers from ten people. Tesla – one vendor has them top quartile and [another] one had them bottom quartile. So where does that shake out?"
>
> *– asset owner*

> Winners and losers are based on thinking through what that data means rather than just relying on the data out there."
>
> *– asset manager*

> On this point, there's a big market failure. The market failure: pollution is a negative externality that is unpriced. We haven't priced that well, and it won't change any time soon because the carbon tax is incredibly unpopular. You can't get anyone to vote for it. Both DEI and ESG share the basic problems, which is when you have markets with these broad negative externalities, you end up have very deep market inefficiencies. It's an impossible matrix to navigate. There's nothing to say that guns are worse than tobacco or so on. The other thing we can't control is China or the developing world. Until you get the Chinese on board, they are still building coal fired power plants. The most destructive force is the developing world led by China. The externality is global in nature."
>
> *– asset manager*

> I would say ESG is happening faster than the focus on diversity. The other thing that makes it different is diversity is easy to measure. [For] ESG, the biggest hurdle is 'what are you measuring?'"
>
> *– asset manager*

Barriers to Adoption

Likely due to the fact that the research participant sample was slightly skewed toward U.S. corporate plan sponsors, the most oft-cited barrier to implementation is regulatory hurdles, specifically rules surrounding pecuniary factors. Plan sponsors say that they have not integrated climate considerations because they fear going against Department of Labor (DOL) guidance. One plan sponsor, quoted earlier, mentioned that it expects the new administration will be more receptive to climate considerations but until new guidance is put forth, it will refrain from making any drastic changes.

> ESG was on our project list last year, in terms of developing a policy or implement specialized investment options, but until we knew where the regulations were going, we couldn't justify focusing on it."
>
> *– asset owner*

> On the 401(k) side, we haven't made ESG-focused strategies available to the participants. We are still sorting through that, and we haven't gotten the guidance on that yet. We are still waiting to see."
>
> *– asset owner*

> We aren't quite there on the U.S. side. We had some DOL ruling that prohibited anything outside of pecuniary factors. It's hard for us to say that we are going to go ahead and include those factors formally in the decision-making process. We've been doing a lot of research on the topic and finding ways to include ESG in the IPS. We've been making sure we have a strong understanding from all of our investment managers in how ESG is involved in their investment process...In terms of climate change, we haven't gotten to that level of detail at all."
>
> *– asset owner*

> As a corporate, we are doing quite a lot. From our DC plan, it comes up because of ERISA and the regulatory risk. Economic factors need to be the driver, so we've taken a more conservative approach within ERISA-type plans... We are doing those investments where we don't have the regulatory risk. We've pledged to be carbon negative. We are looking at supplier relations. We are looking at scope 2 and scope 3 emissions and those are included in our pledge."
>
> *– asset owner*

> If they [new DOL rules] offer a safe harbor, we could offer [climate options] in the core lineup... We've had a working group that's focused on this and trying to get an ESG option in the core lineup. One comment they made was that "I don't care if returns are lower, as long as the investments align with our views." But would that person sign off on an agreement not to sue down the road?"
>
> *– asset owner*

One corporate plan sponsor told Cerulli that it tracks ESG factors in its portfolio while managing to keep its analysis strictly pecuniary, surrounding its core belief that companies that do not meet certain ESG criteria would struggle maintaining value.

> We are excluding controversial weapons, producers of thermal coal, which is the worst pollutant product out there, and companies that are failing the UN Global Compact. From those three things, we believe that those companies will struggle for results in the future. We have core beliefs around that as a company, but also from a pecuniary perspective we believe that those companies will struggle with results... [We have] no explicit targets like Net Zero. We are trying to keep it strictly pecuniary and that's really what we are tracking to."
>
> *– asset owner*

Among firms that have not taken steps, one of the primary reasons was that they did not want to exclude potential investment opportunities from their selection processes. An asset owner tells Cerulli that energy sectors that contribute to global warming are often necessary and that it did not wish to exclude entire sectors from its investable universe. Another asset owner tells Cerulli that its plan participants are generally not interested in restricting their investment options for the sake of climate initiatives. Finally, there was an interesting observation on investment time horizons. Namely, a corporate pension tells Cerulli that by having a shorter time horizon than its public pension peers, the potential universe of climate-friendly investments from which it could choose is smaller.

> We have not restricted ourselves. Energy is becoming a smaller portion of the portfolio. There is an energy sector, and there are sectors that are contributing to global warming, but we believe they are necessary as well. We want them to operate by industry best standards. But we aren't going to restrict an entire sector."
>
> – *asset owner*

> The companies we invest in using active management are likely to include sustainable approaches. Therefore, we do not think [we need] to have a special focus on sustainable investments, but we are keeping a close watch on it to diversify management and see alpha. We are asking consultants to look for ESG products, including foreign ones, for future consideration. We have just started to examine this."
>
> – *asset owner*

> We have different views compared to public pensions. While public pensions are considering a 100-year period for assets to be managed, we think our company will not survive for such a long time. [Our] time scope is different and therefore, the products that public pensions are using now are not necessarily good for us."
>
> – *asset owner*

Another factor preventing a fully integrated climate stance is the uncertainty in how to look at passively managed assets. An asset owner that allocated a large portion of its asset to passively managed strategies tells Cerulli that exclusions are one of the only tools it can use for those assets.

> There's a lot of ways you can look at indexes. A lot of our assets are passive, so exclusions are really one of the only tools we have in this area. While we have a mature framework, it's not aggressive."
>
> – *asset owner*

Cerulli Research and Consulting

For nearly 30 years, Cerulli has provided global asset and wealth management firms with unmatched, actionable insights.

Headquartered in Boston with offices in London and Singapore, Cerulli Associates is a global research and consulting firm that provides financial institutions with guidance in strategic positioning and new business development. Our analysts blend industry knowledge, original research, and data analysis to bring perspective to current market conditions and forecasts for future developments.

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