Marketing communication

ESG Global Study: Chapter 2

ESG Product Insights, October 2022

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01 Executive summary

Executive summary

Funds with exposure to a broader range of ESG themes hold increasing appeal for investors seeking more innovative ESG solutions with a real-world impact. However, global investors are struggling to find products offering the full spectrum of themes across the waterfront of ESG. Nearly half say ESG funds provide only limited exposure by overly focusing on environmental issues.

Investors looking to access a broad range of ESG themes are therefore tasked with buying several single-thematic or narrowly focused funds. This underscores the need for all-in-one, fully diversified solutions that target a wide array of sustainable goals through one vehicle. More than four in 10 investors say there is a need for multi-thematic ESG funds.

Funds tapping into a broad range of ESG themes allow investors to view sustainability through the widest lens. But they also provide targeted exposure to those harder-to-reach goals, including ending poverty and hunger, which are more difficult to translate into specific investment strategies. These vehicles therefore plug important gaps in the market by accessing themes that are overlooked by, or beyond the scope of, traditional single-theme ESG funds.

As well as helping investors fine-tune their ESG strategies, multi-thematic funds could also boost ESG uptake. Nearly four in 10 investors think a lack of product innovation is acting as a brake on ESG adoption. The coming to market of more sophisticated solutions offering overarching exposure to multiple themes could thus accelerate ESG take-up.

There is also appetite for more innovative ESG funds that steer away from a quality and growth bias – a style that has suffered amid the recent market rotation to value. This reflects a need for all-weather ESG funds that can adapt to changing market conditions and better withstand volatility.

While investors report equities and bonds remain the most popular ESG asset classes, they have upped their usage of emerging markets and private markets. These sectors are well-suited to diversified funds tapping into a blend of different sustainable goals. Tackling the challenges facing emerging markets and fostering the growth and development of their economies are key to addressing some of the world's biggest challenges. Meanwhile, the private-markets sector has the ability to channel funds into the infrastructure supporting the growth of these emerging-market economies.

As was the case last year, ESG investors have a strong bias toward active strategies. This shows how investors realize ESG is a complex area of investment that might not easily be distilled down to a single score or rating.

Moreover, there is a growing acceptance within the investment community that the transition toward a sustainable future cannot be achieved solely by backing companies that are ESG leaders today to the exclusion of transitioning companies looking to improve their ESG credentials.

In summary, ESG investors are seeking actively managed, diversified and dynamic solutions providing exposure to multiple themes and a variety of transitioning companies. Such an approach has the potential to maximise both long-term financial and sustainable returns.

02 Methodology/ Sample breakdown

Methodology

This Capital Group ESG Global Study was commissioned for a second year to gather the views of 1,130 global investors via an extensive online survey conducted by CoreData Research between February and March 2022.

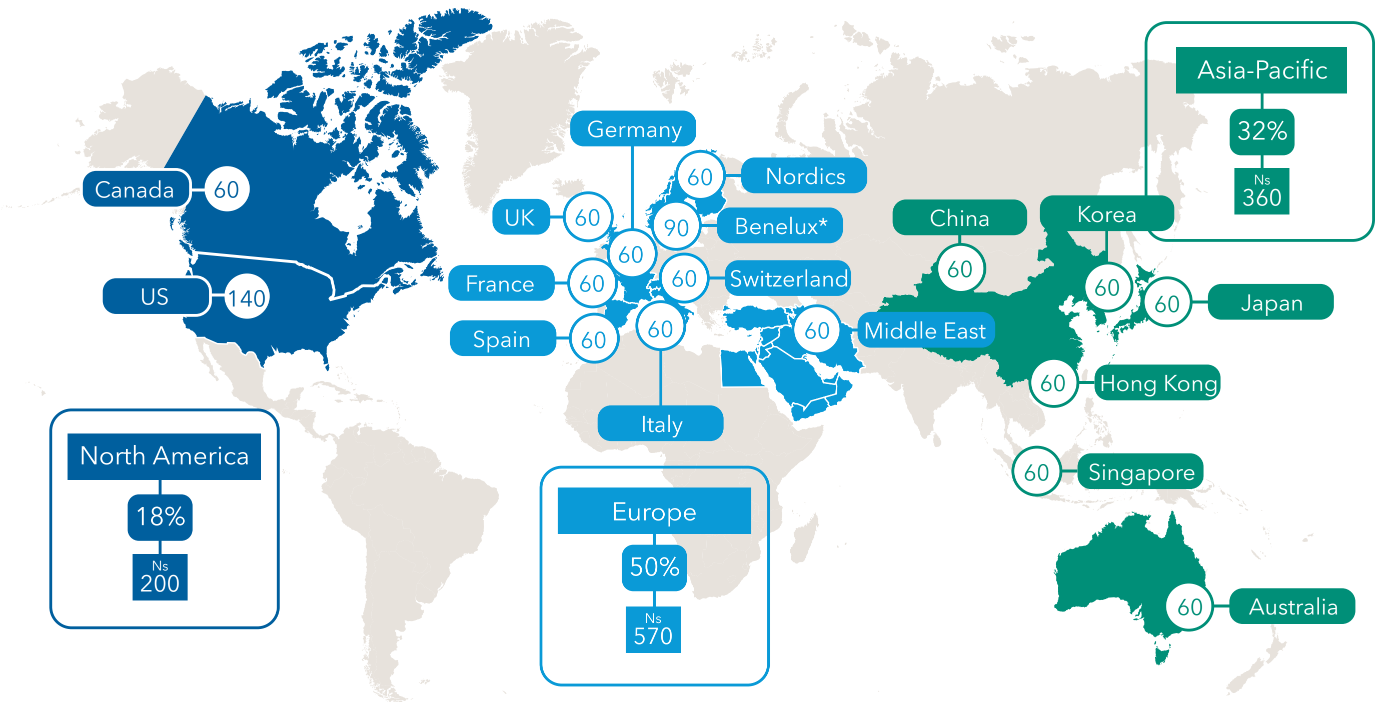
The sample includes 565 global institutional investors (pension funds, family offices, insurance companies, sovereign wealth funds, endowments, foundations, defined contribution funds) and 565 global wholesale investors (funds of funds, discretionary fund managers, private banks, wirehouse broker-dealers, registered investment advisors, independent advisory, investment division of insurance companies).

Investors were based in 19 countries and regions from Europe (50%), Asia-Pacific (32%) and North America (18%). The sample also includes ESG users/adopters (89%) and ESG non-users/non-adopters (11%).

Sample breakdown

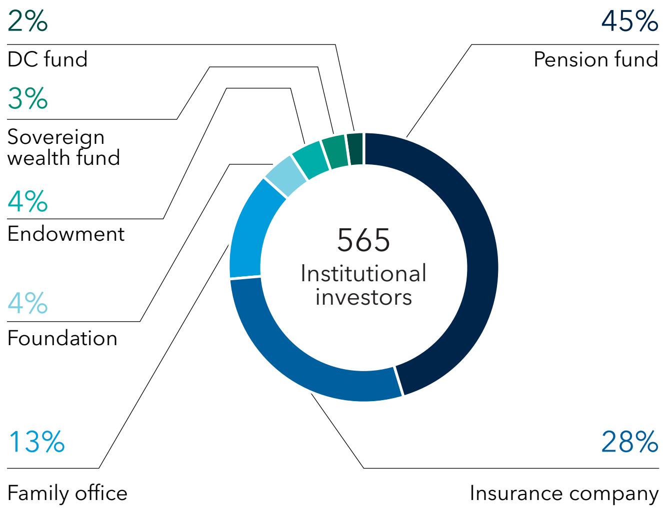
1,130 Global investors

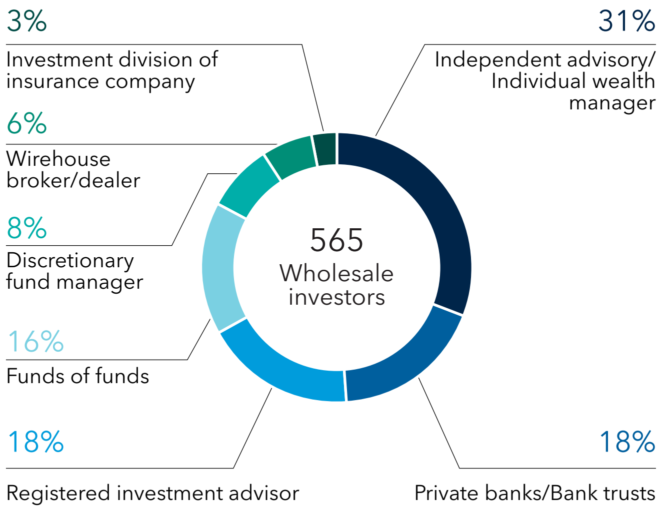
19 Countries and regions

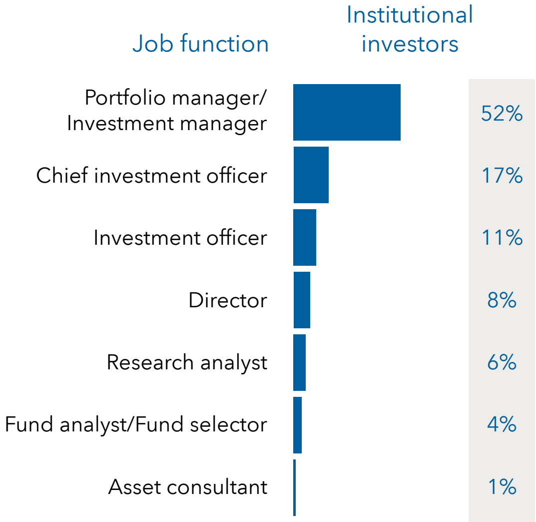


*Belgium, the Netherlands and Luxembourg

Sample breakdown







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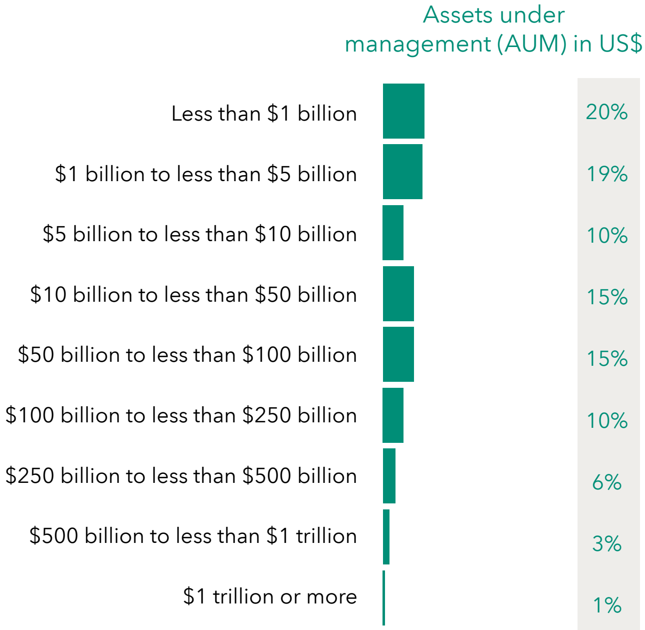

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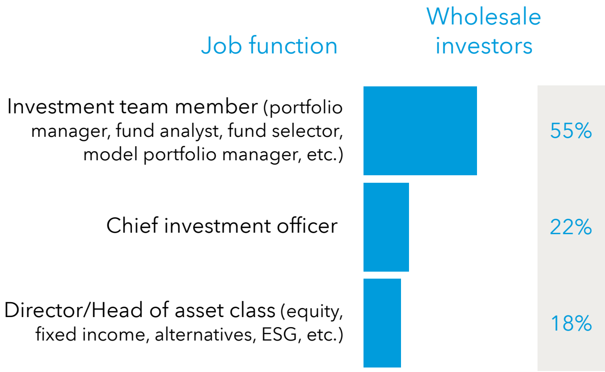

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03 Background

Background

Our study

Our survey covers so much detail that we decided to produce two separate chapters this year. Chapter 1, which we released earlier in 2022, primarily focused on the key drivers and challenges influencing ESG adoption. Chapter 2, which we are releasing now, focuses on ESG product insights, including attitudes to sustainable investing.

Measuring impact

One of the enduring challenges of ESG investing is measuring impact. This has taken on added importance amid the rising interest in impact investing, which aims to provide positive and measurable social and environmental benefits in addition to a financial return.

While investors can measure financial results against a benchmark, such as an index, the task of measuring environmental and social impact presents a more difficult undertaking.

The United Nations Sustainable Development Goals (SDGs), launched in 2015, offer one method of measuring or benchmarking impact. The SDGs aim to provide a "blueprint to achieve a better and more sustainable future for all" through a framework of 17 goals and 169 targets to be met by 2030.

The goals can provide a useful common framework for investors and companies to measure impact and track progress.

But the SDGs are not perfect. They have limitations that investors need to both recognize and navigate. For example, they do not explicitly measure ESG risks, and the LGBTQ+ community is not overtly referenced anywhere in the SDGs. Furthermore, the current goals target 2030 and will likely evolve over time, so they do not necessarily provide a future-proof framework.

Despite their shortcomings, the SDGs encompass a diverse spectrum of themes spanning the economic, social and environmental spheres – including climate change, hunger, poverty and inequality. Investing in funds spanning a variety of SDGs is a way of gaining exposure to multiple ESG themes.

Taking a broader, multi-thematic approach can help build well-balanced portfolios that are diversified across sectors, which mitigates some of the volatility common in single-themed funds.

Gauging investor attitudes toward the use of SDGs can help inform debate around the benefits of a broad multi-thematic approach versus a narrower or single-themed approach.

04 Product preferences

Product preferences

Demand for multi-thematic funds

Investors have a strong appetite for funds that provide exposure to multiple themes. However, this study highlights a gap between investor demand and the availability of such offerings.

"I think, at the moment, the focus is fairly narrow and mainly around environmental and climatic-type issues," says the CIO of an Australian wealth management firm.

Almost half of global investors think there are not enough funds aligned to the SDGs (46%). In addition, respondents say the funds that are available are too narrowly focused and provide only limited alignment to the 17 goals. Just under half (47%) of global investors agree that funds currently targeting the SDGs overly focus on environmental issues. This increases to 51% of Asia-Pacific investors.

"I think, at the moment, the focus is fairly narrow and mainly around environmental and climatic-type issues," says the chief investment officer (CIO) of an Australian wealth management firm. "The focus on climate change, CO_2 and fossil fuels is very topical, but it tends to sweep away some of the other issues which are still relevant to ESG investing."

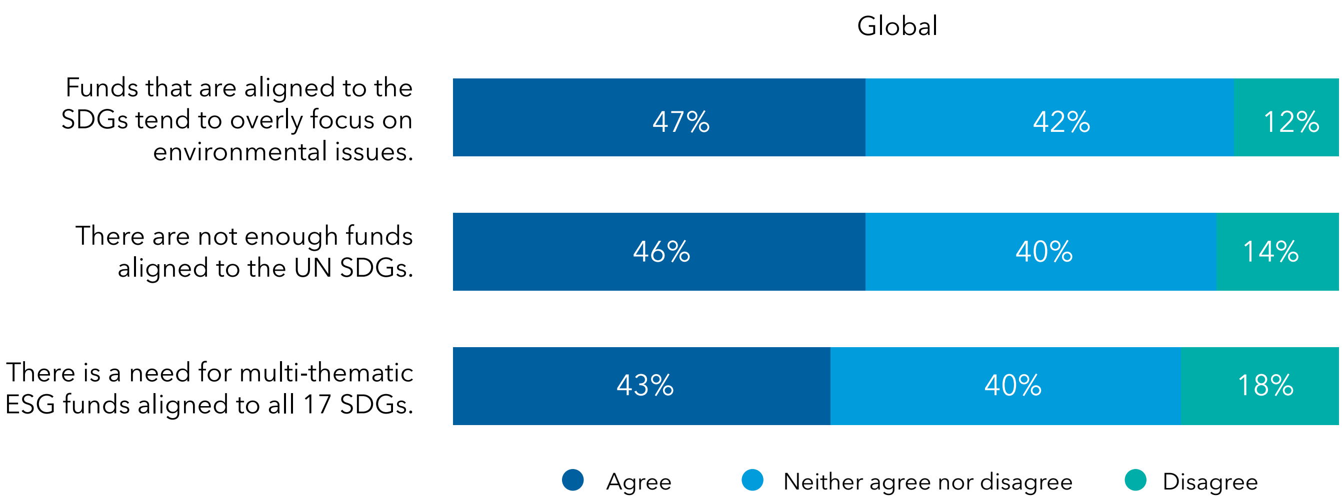
A portfolio manager at a Canadian insurance company comments on the difficulties of gaining exposure to a variety of different SDGs:

"We are investing in affordable and clean-energy companies, but this is only one of the goals of the UN SDGs. So we are not discovering the full aspect of it. It's just really difficult to cover all aspects."

Accessing exposure to multiple goals

Investors looking to tap into the full spectrum of ESG themes simultaneously therefore may face the arduous task of buying several single-thematic or narrowly focused funds. This underscores the need for all-in-one, fully diversified solutions that allow investors to target multiple goals through one fund. Indeed, more than four in 10 global investors (43%) point to the need for multi-thematic ESG funds. And half (50%) say the ability to offer the full spectrum of SDG themes is an important consideration when selecting funds.

Exposure to a multitude of interlinked ESG themes can help investors make tangible real-world change on a widespread scale. This is because taking action on one theme can positively impact other causes. Climate change, for instance, is related to the food system, migration, poverty and economic growth. Investing in a broad range of themes amplifies the multiplier effect, triggering a set of sustainable chain reactions and positive feedback loops throughout the ESG ecosystem.



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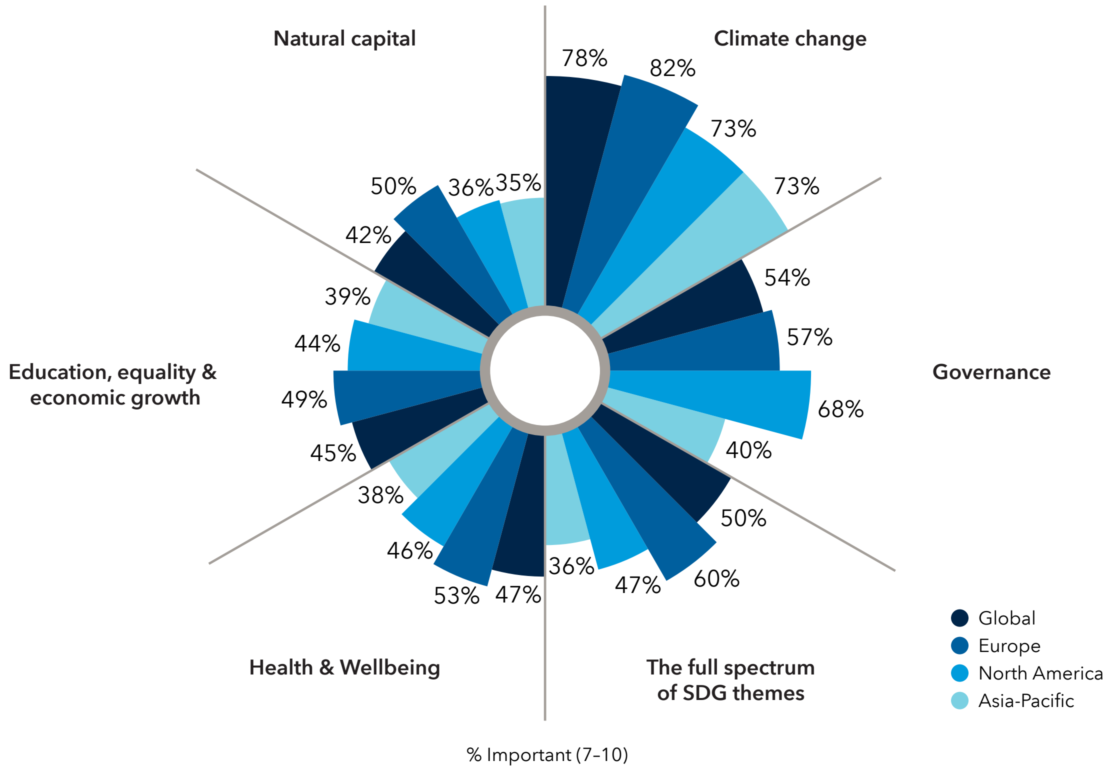


When thinking about the UN SDGs, how important do you consider the following when selecting funds? (Rate on a scale of 0–10.)

Targeting harder-to-reach goals

As well as broad-based coverage, funds that are aligned to a wide range of sustainable themes offer exposure to harder-to-access goals, including ending poverty and hunger and promoting peaceful and inclusive societies. Translating these social themes into specific investment strategies and monitoring their progress can be difficult and complex undertakings that require asset managers with broad and deep research capabilities. Funds targeting multiple sustainable themes are therefore more than an amalgamation of themes from the wider ESG ecosystem. They provide targeted alignment to themes that are overlooked by, or beyond the scope of, more traditional thematic funds.

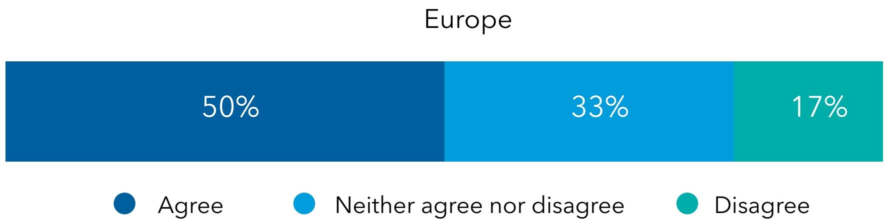
An evolution of ESG

"The SDGs are an evolution of ESG," says a portfolio manager at a Canadian insurance company.

A higher percentage of investors in Europe, where the ESG market is more mature, say there is a need for multi-thematic funds aligned to the 17 SDGs (50%). In addition, more Europeans flag the importance of vehicles offering the full spectrum of SDG themes in the fund-selection process (60%). This indicates that, as investors become more familiar with ESG and refine their strategies, they will increasingly desire products accessing and promoting a more complete set of SDG goals.

"The SDGs are an evolution of ESG – so it will start with ESG and ultimately evolve into SDG investing," comments a portfolio manager at a Canadian insurance company.

There is a need for multi-thematic ESG funds aligned to all 17 SDGs.



Appetite for SDG-aligned funds is thus part of a wider progression in ESG implementation. We saw in Chapter 1 how thematic investing and impact investing are the second and third most popular implementation strategies respectively this year – replacing positive screening and negative screening. Investors are therefore advancing their ESG approach as they move away from basic screening methods toward more targeted thematic strategies.

Boosting ESG adoption

While multi-thematic strategies can help investors fine-tune their ESG approach, they could also encourage non-adopters to enter the ESG space. Almost four in 10 (39%) global investors think a lack of product innovation is holding back greater adoption of ESG. The coming to market of more sophisticated funds providing exposure to multiple SDGs could thus accelerate ESG adoption.

"These funds would encourage greater take-up of ESG investing because of better ease of access," says the CIO of an Australian wealth manager. "They overcome the difficulty of actually putting together a properly constructed portfolio which covers the broad range of ESG criteria."

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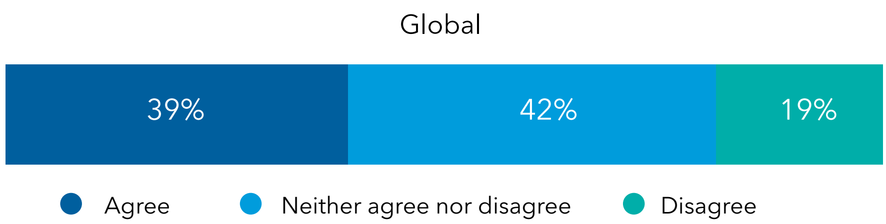
A lack of product innovation is holding back greater adoption of ESG.



Regulatory readiness

"We have big regulation issues in Germany and the European Union, and therefore I think the SDGs will play a much more important role," says a senior portfolio manager at a German wealth management firm.

As well as helping investors implement a more holistic and targeted approach, strategies that reference a comprehensive framework like the UN SDGs could help financial professionals offer products that match client preferences. This will aid compliance with regulations such as Europe's Markets in Financial Instruments Directive II (MiFID II), which requires distributors to ask clients about their sustainability preferences to determine product suitability.

A senior portfolio manager at a German wealth management firm speaks of the difficulties created by the emergence of European rules, including the Sustainable Finance Disclosure Regulation (SFDR), taxonomy and MiFID II.

"We have big regulation issues in Germany and the European Union, and therefore I think the SDGs will play a much more important role," he says.

Cementing credibility

"It helps their credentials if they're being seen by investors to have coverage across the breadth of different issues rather than being too isolated into the topic of the day," says the CIO of an Australian wealth management firm.

Investment products that are aligned to a variety of ESG themes also bring benefits to asset managers looking to authenticate and validate their sustainability offerings and win the trust of investors.

"It helps their credentials if they're being seen by investors to have coverage across the breadth of different issues rather than being too isolated into the topic of the day," says the CIO of an Australian wealth management firm. "So I think it demonstrates greater knowledge, greater credibility, and therefore garners better investor confidence."

05 Routes into ESG

Routes into ESG

ESG across asset classes

Investors have clear preferences in terms of the investment vehicles and asset classes used to access ESG.

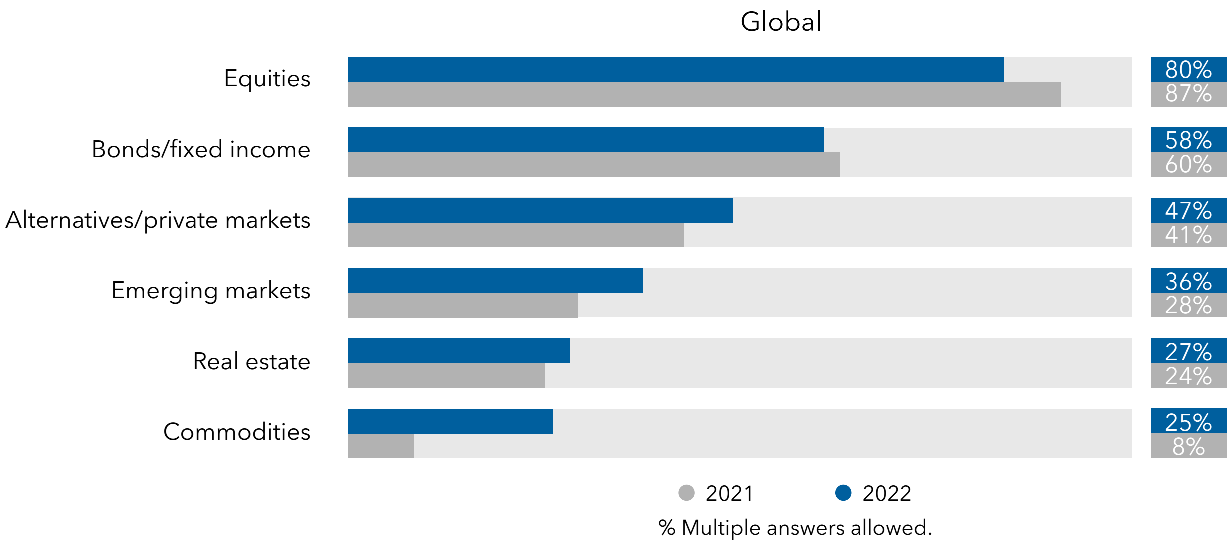
"Our product preferences have altered in terms of [how] we are now looking more at private markets and real estate as a hedge against inflation," says a portfolio manager at a UK pension fund.

Equities (80%) and bonds (58%) remain the most popular asset classes to gain exposure to ESG among global investors. But interestingly, investors have upped their usage of alternatives and private markets from last year (47% vs. 41%) as well as emerging markets (36% vs. 28%) and commodities (25% vs. 8%).

For investors explicitly seeking impact funds, tackling the challenges facing emerging markets – including hunger, poverty and disease – and fostering the growth and development of their economies are key steps to achieving the SDGs. And commodities are important growth drivers for many emerging-market countries. Meanwhile, the private-markets sector has a unique ability to channel funds into the infrastructure supporting the growth of these emerging-market economies.

A portfolio manager at a UK wealth manager says there needs to be more impact funds holding private assets. "I think it's easier to do impact funds in private markets, but most ESG funds don't have impact as one of their specific mandates."

Private markets also appeal to ESG investors looking for inflation protection amid sharply rising prices. "Our product preferences have altered in terms of [how] we are now looking more at private markets and real estate as a hedge against inflation," says a portfolio manager at a UK pension fund.

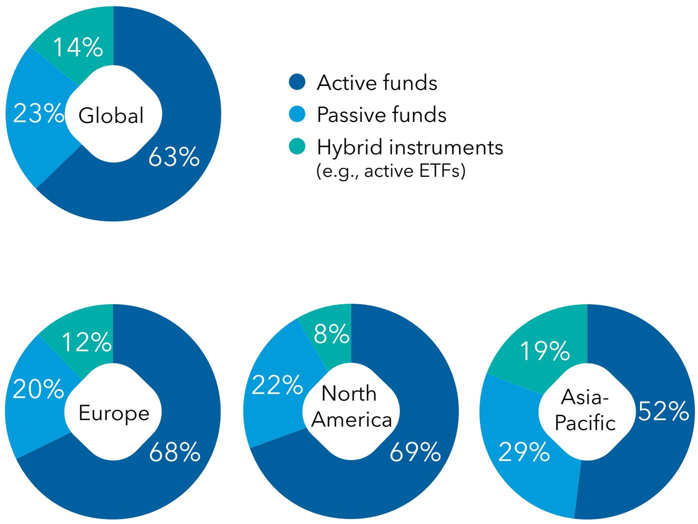


Which asset classes and sectors do you use to gain exposure to ESG?

Active strategies

ESG investors have a strong bias toward active strategies, as was the case last year. Nearly two-thirds (63%) of global investors say their preferred approach when integrating ESG is to use active funds. Active funds are most popular among North American (69%) and European (68%) investors.

This demonstrates how investors think active managers are uniquely placed to capitalize on and manage ESG opportunities and risks. This requires research-intensive resources beyond the reach of passive managers.



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What is your preferred approach to integrating ESG?

Value strategies

"What we have been doing over the past few months is looking for ESG funds with more of a value tilt, which are really hard to find if you're looking for gaps in the market," says a portfolio manager at a UK wealth management company.

There is also appetite for more innovative ESG funds that steer away from a quality and growth bias – a style that has suffered amid the inflation-fueled rotation to value strategies.

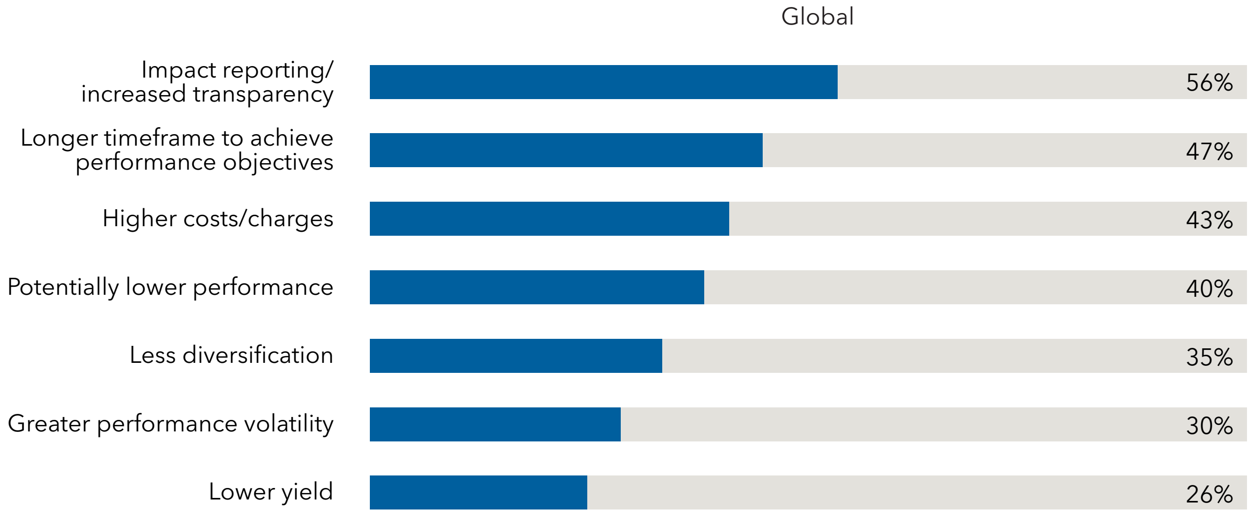
"What we have been doing over the past few months is looking for ESG funds with more of a value tilt, which are really hard to find if you're looking for gaps in the market," says a portfolio manager at a UK wealth management company. "If we're going to see higher inflation for a longer period of time, I think it's more and more important that there are ESG products out there that cater to a value style and a higher inflationary environment."

06 ESG fund differentiators

ESG fund differentiators

The characteristics that investors associate with ESG funds shed important light on industry perceptions of ESG. This can help tailor products in line with investor needs and expectations and overcome some of the perceived challenges of ESG investing.

Global investors point to impact reporting and increased transparency (56%), longer timeframes to achieve performance objectives (47%) and higher costs (43%) as the core elements differentiating ESG funds. This is followed by potentially lower performance (40%), less diversification (35%) and greater volatility (30%). We shall now look at these distinguishing features and see how they relate to ESG investing.



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What do you expect to be different when investing in an ESG fund? (Select all that apply.)

A deeper level of transparency

Investors identify impact reporting and increased transparency as the most defining feature of ESG funds. This factor will likely become more important as regulators increasingly clamp down on asset managers not living up to their sustainable claims. The transparency factor will also prove decisive in addressing greenwashing concerns.

Greater transparency and consistency in ESG fund reporting and data availability remain the biggest factor encouraging global investors to increase their ESG focus (42%). In addition, nearly four in 10 (38%) say more clarity in ESG product strategies and definitions would prompt them to raise their ESG commitment.

Which of the following factors would encourage your organization to increase its ESG focus? (Select up to three answers.)

Cost complexities

"There can be additional costs involved in ESG, which I think is perfectly fine," says a UK pension fund portfolio manager.

About four in 10 global investors cite higher costs or charges as a differentiating factor of ESG funds. But while some investors may associate ESG funds with higher costs, this is not necessarily acting as an investment barrier. Only a fifth (21%) of global respondents say lower costs would encourage them to enhance their ESG focus. This suggests investors are largely looking beyond fees because they recognize the deeper level of research and analysis needed to construct robust ESG funds.

"There can be additional costs involved in ESG, which I think is perfectly fine," says a UK pension fund portfolio manager. "That's something we should accept as part of the process because it's a relatively new market and we need that specialist knowledge, and we need to know that we're on the right track."

Performance perceptions

Four in 10 investors say they associate ESG funds with potentially lower performance. But as we saw in Chapter 1, far fewer investors this year flag performance concerns as an ESG adoption barrier (35% vs. 49% in 2021).

Furthermore, investors appear to recognise that returns for ESG funds will play out over longer periods of time as they tap into generational structural shifts, like the energy transition. Longer timeframes are the second-most distinguishing feature of ESG funds, according to investors.

Taming volatility

Meanwhile, three in 10 global investors say greater performance volatility is a hallmark of ESG funds. Some narrowly focused ESG funds may be more susceptible to volatility, as they are less diversified. Indeed, more than a third of investors point to less diversification as a characteristic of ESG funds.

Investing in vehicles providing broad exposure to the SDGs could help deliver smoother and more consistent returns. This is due to a more diversified range of sustainable priorities being targeted.

And on the performance front, there may be additional rewards on offer from investing in companies able to improve their sustainable credentials. Investing in these transitioners is the focus of the next section of this report.

07 The sustainable transition

The sustainable transition

Role of transitioners

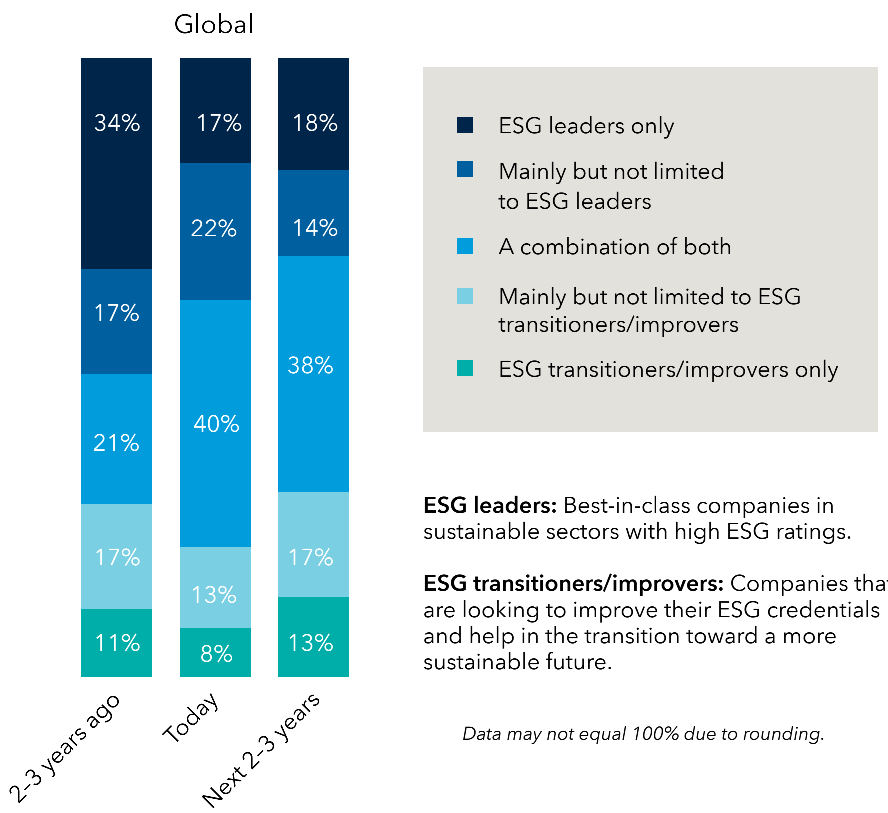
There is a growing acceptance within the investment community that the transition toward a sustainable future cannot be achieved solely by backing companies that are ESG leaders today.

"I think there's a place for both – those companies that are already ESG friendly and those that clearly have a mandate to become more ESG friendly," says a portfolio manager at a U.S. RIA.

Investors recognize the need to invest in transitioners (companies that are looking to transition their business models to be more sustainable) and are set to adjust portfolios accordingly. Four in 10 (40%) global investors currently favor a combination of ESG leaders and transitioners. However, the proportion expecting to focus on ESG transitioners either mainly or exclusively is expected to jump from 21% today to 30% over the next two to three years.

Investors in Europe are set to have the highest focus on transitioners going forward, increasing allocations from 20% today to 34% over the next two to three years. And while North American investors currently have the lowest allocation to transitioners, they plan to more than double their exposure over the next few years (11% today to 26%).

A portfolio manager at a U.S. Registered Investment Advisor (RIA) says leaders and transitioners play complementary roles in portfolios. "I think there's a place for both – those companies that are already ESG friendly and those that clearly have a mandate to become more ESG friendly."



ESG leaders: Best-in-class companies in sustainable sectors with high ESG ratings.

ESG transitioners/improvers: Companies that are looking to improve their ESG credentials and help in the transition toward a more sustainable future.

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Which of the following types of companies (ESG leaders vs. ESG transitioners) do you mainly focus on when allocating to ESG today? How does this compare to two to three years ago and how do you expect it to change over the next two to three years?

The green revolution

"You need transitioners to be part of the whole process of improving and going in the right direction, so I think you cannot deliver on the SDGs without them," says a portfolio manager at a German private bank.

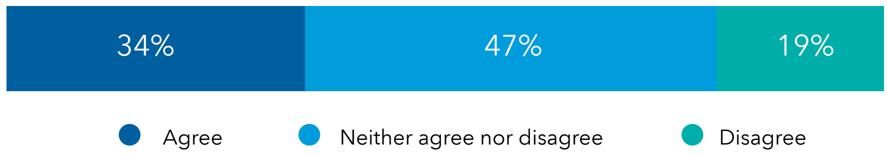
A third of global investors (34%) agree that asset managers investing solely with ESG leaders at the expense of transitioners are doing more harm than good. Fewer than one in five (19%) disagree that a sole focus on leaders is detrimental.

Interviewees also think the ability of asset managers to engage with and allocate capital toward transitioners will help realize the SDGs.

"You need transitioners to be part of the whole process of improving and going in the right direction, so I think you cannot deliver on the SDGs without them," says a portfolio manager at a German private bank.

Global

Asset managers that solely invest with ESG leaders at the expense of transitioners are doing more harm than good.



Financial returns

"Companies in transition have much greater scope for making financial returns along the journey to being ESG leaders," says a portfolio manager at a UK wealth management firm.

Critically, some investors believe that there will be alpha (above-market returns) from companies improving their ESG performance.

"If a company is already screening wonderfully on every ESG metric, it probably trades on a premium rating to the market and the scope for upside ESG returns are quite limited," says a portfolio manager at a UK wealth management firm. "But companies in transition have much greater scope for making financial returns along the journey to being ESG leaders."

Driving innovation

“You want to avoid having a too narrow, undiversified ESG portfolio,” says the CIO of an Australian wealth manager. “So the more companies you get transitioning up to best in class the better you can develop a robust, well-diversified and risk-managed investment offering.”

Portfolios including ESG leaders and transitioners will also benefit from greater diversification by holding companies in different sectors and at different stages of growth. As we saw earlier, more than a third of global investors think ESG funds are less diversified. But constructing portfolios with both ESG leaders and transitioners can help overcome these diversification concerns.

The CIO of an Australian wealth manager thinks transitioners give investors a wider and more diverse range of opportunities: “You want to avoid having a too narrow, undiversified ESG portfolio. So the more companies you get transitioning up to best in class the better you can develop a robust, well-diversified and risk-managed investment offering.”

The influence of climate

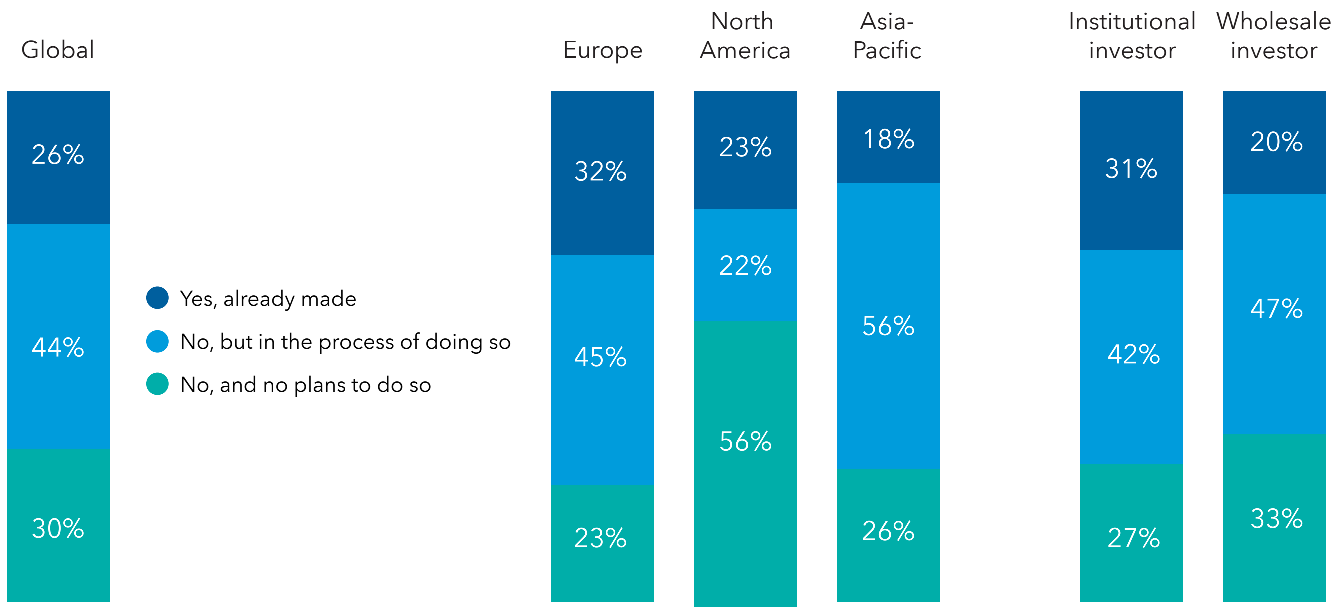
“We’re fully committed to net-zero carbon emissions, and that’s what we as a company are intent on achieving for 2050,” says a UK pension fund portfolio manager.

We saw in Chapter 1 how climate change concerns are very much at the forefront of investor minds.

Seven in 10 global investors say their organization is committed to achieving net-zero greenhouse gas emissions by 2050. While 26% have already made a public commitment to hit net zero by 2050, nearly half (44%) are in the process of doing so.

Net-zero commitments are particularly prevalent in Europe – nearly a third (32%) have made a public commitment to achieve the 2050 goal. Support for net zero is further evident in the finding that fewer than three in 10 (29%) investors think “net zero” is meaningless in investment terms.

“We’re fully committed to net-zero carbon emissions, and that’s what we as a company are intent on achieving for 2050,” says a UK pension fund portfolio manager.



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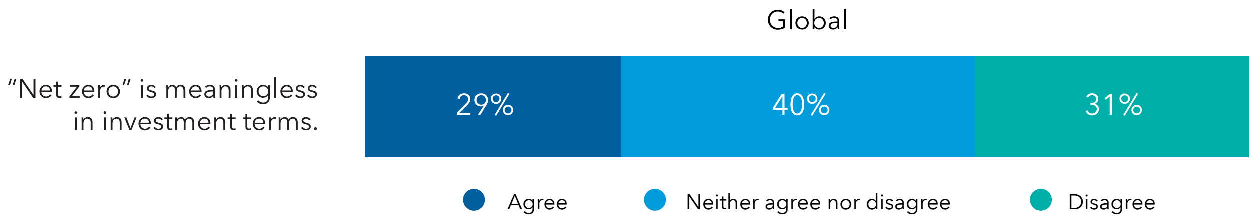
Has your organization made a public commitment to achieving net-zero greenhouse gas emissions by 2050?



Conclusion

Our study shows investors want to support a broad range of ESG themes through their investment actions. This is part of a more sophisticated and holistic approach to ESG, as investors evolve beyond negative screening and divestment. In particular, ESG investors seek actively managed, diversified and dynamic solutions providing exposure to multiple themes and a variety of transitioning companies. Such an approach has the potential to maximize both long-term financial and sustainable returns.

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