



ESG Is Not GIPS: Your ESG Philosophy Must Be Part of Your DNA

IN THIS ARTICLE

Integrating ESG factors into investments is top-of-mind for the investment industry today. We explore how asset managers and OCIOs can win and retain business by effectively navigating rapidly-changing investor demands and regulatory rules around these issues.

Author

Amanda Tepper

CEO

Chestnut Advisory Group is a boutique growth strategy consultant dedicated to asset managers and OCIOs. We provide custom growth advisory for product, distribution, M&A and brand strategies. Chestnut is a woman-owned, practitioner-led firm.

Even though there is no agreement today around ESG definitions, standards, and measurements, asset managers' wide-ranging ESG efforts are nonetheless driving capital flows. Over 40% of asset manager respondents to our survey report their ESG efforts are having a high impact on their asset flows.

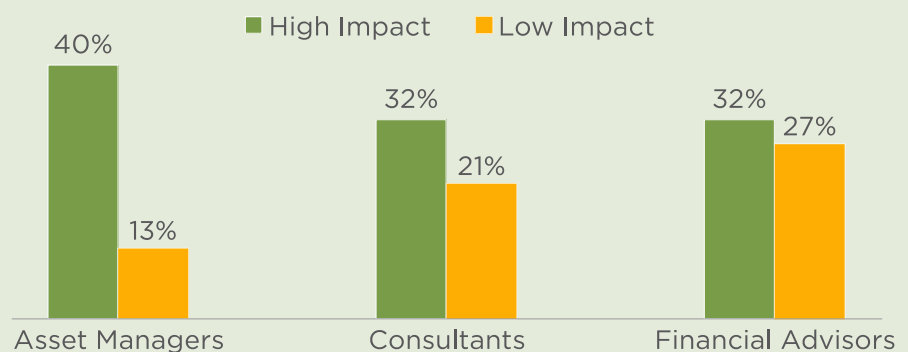
ESG disclosure standards are evolving and, just as with GIPS, we anticipate most managers will eventually comply with them. Mere compliance with evolving ESG standards, however, will not suffice to differentiate a manager from its peers.

Active investment managers who want to win long-term need an ESG philosophy and approach that is an authentic part of their DNA. The ESG philosophy must be as fundamental as investment style (i.e. Value or Growth).

Passive investment managers must also create a thoughtful and coherent ESG philosophy as more asset owners include this as an issue in their due diligence and selection of index providers. Thoughtful proxy voting and engagement policies will become a more important determinant of passive managers' success over time.

The Importance of Asset Managers' ESG & DEI Efforts on Asset Flows

By Respondent Type



Source: Chestnut Advisory Group

ESG Is Not GIPS¹: Your ESG Philosophy Must Be Part of Your DNA

In our strategic growth engagements with asset managers and OCIOs, the topic of how our clients can authentically integrate ESG considerations into their investment process has taken on greater and greater importance. We explore how asset managers and OCIOs can win and retain business by effectively navigating rapidly-changing investor demands and regulatory rules around these issues.

Note: this article does not address the many other open ESG investing topics, such as data sources, alpha impact, impact investing and sustainable investing. We will address DEI (i.e. diversity, equity and inclusion) issues facing asset managers in a subsequent article.

This article is part of our Future of Investments research project, incorporating responses from over 450 investment professionals in four key cohorts: asset managers, institutional investors, RIAs and investment consultants.

ESG Investment Integration Today: More Heat than Light

There is widespread agreement today that integrating ESG factors is important to a sound investing process. Beyond that, however, each asset manager is left to its own devices to figure out how to address ESG in a way that will meet its target investors' needs and help its business grow profitably, while remaining true to its investment philosophy. Any widely-accepted ESG investment integration standards remain nascent today.

While we anticipate these standards will continue to evolve for the next five to ten years, investors and managers are not waiting for the ESG dust to settle. Instead, a great deal of investor, consultant and manager activity today is focused on developing commonly-accepted standards for describing how managers integrate ESG considerations into their investment processes and how they should report on these efforts. Some managers are investing heavily to incorporate

ESG into their investment approach, and investor capital is already flowing as a result of these efforts and the communications around them.

According to a recent study, there is very little discernible difference between the main ESG indices today and the broad market indices.² Given that managers' ESG efforts are occurring in a noisy environment with few agreed-upon standards, this may not be surprising.

ESG Efforts Are Driving Flows

Despite continuing confusion over what ESG integration actually is, 40% of asset managers and one-third of consultants and financial advisors in our recent survey believe that asset managers' ESG and DEI efforts are having a high impact on asset flows (see the chart on the cover page). In 2021 over \$649 billion flowed into ESG-focused funds.³

Is ESG In the Eye of the Beholder?

Our survey results reflect the wide range of understanding and implementation of ESG approaches. As we show in the following chart, almost half of asset manager respondents told us

¹ Throughout this article we use the term 'ESG' as shorthand for the environmental, social and governance criteria for any company's business that investors can use to help make decisions around investments tied to that business and to building investment portfolios overall. In addition, our use of the term 'GIPS' refers to Global Investment Performance Standards, a set of voluntary standards created by the CFA Institute and used by investment managers to ensure the full disclosure and fair representation of their investment performance.

² Source: Research Associates - <https://www.institutionalinvestor.com/article/b1wnwgxd3clgjh/Research-Affiliates-Says-ESG-Isn-t-an-Investment-Strategy-And-That-s-a-Good-Thing>

³ Source: Russell Investments

ESG Is Not GIPS: Your ESG Philosophy Must Be Part of Your DNA

they believe their firms currently exemplify ESG best practices, a self-assessment many investment consultants may disagree with.



82% of US-based asset managers and 95% of non-US managers now say they have integrated ESG factors into their investment processes across asset classes.⁴ Two-thirds of asset manager respondents in our survey say they have a good understanding of what the investment marketplace views as a strong ESG investment policy. Again, investors and consultants may beg to differ. We think this perception gap is mainly due to lack of consensus around a clear definition and measurement of what ESG investment best practices actually are today.

Investors Want Help Approaching and Understanding ESG

In our survey, fully one-third of institutional investors using an OCIO cited the availability of ESG advisory services as a “top two” factor driving their OCIO hiring decision. In another recent survey, only 17% of institutional investors who have incorporated ESG factors into their investment process also have

We think this perception gap is mainly due to lack of consensus around what ESG investment best practices actually are today.

a specific ESG asset allocation separate from their main portfolio.⁵ This tells us that even those institutional investors who are ESG aware rely primarily on their existing asset managers to address ESG issues within their current mandates.

Perception of Greenwashing Is Easy Given No Agreed-Upon ESG Standards

It is not surprising that there are significant degrees of skepticism and concern about asset manager “greenwashing”: In a recent poll, 69% of investment professionals said they believe many asset management products use ESG as a marketing gimmick but don’t actually deliver on their stated objectives.⁶ This speaks to a lack of trust where ESG claims are concerned.

ESG Is Not GIPS

We believe the widespread perception of greenwashing results from confusing the following two separate issues around ESG:

1. Investment industry ESG definitions and reporting standards
2. Each manager’s core ESG philosophy

Before GIPS, Performance Could Not Always Be Trusted Either

When GIPS was first introduced, many investment managers complained about the extra work and costs involved in complying. GIPS was seen as a tax on the system. The need for audits was resented by many.

Today, GIPS compliance is simply part of the normal course of business. It is table stakes for any asset manager, and the widespread adoption

⁴ Source: Russell Investments, 2021 Annual ESG Manager Survey

⁵ Source: Callan, 2021 ESG Survey

⁶ FundFire poll, March 2021

of GIPS across the industry has improved trust in managers' performance reporting, and hence in the managers themselves.

ESG “Definitions and Reporting Standards” Are Coming

In November 2021, the CFA Institute released its Global ESG Disclosure Standards for Investment Products, after two rounds of consultation and comment.

These Standards provide a detailed list of recommended disclosures at the product level.

However, the Standards are voluntary, and only apply to products that utilize an “ESG approach” - a term that “includes but is not limited to approaches that are often referred to as ESG integration, exclusion, screening, best-in-class, thematic, sustainability themed investing, impact investing, and stewardship.”⁷

Private Markets Seek to Establish Relevant ESG Standards

Asset managers committed to ESG investing manage 36% of total global private market assets today.⁸ Some private asset classes have very specific ESG issues to contend with. For example, detailed asset-by-asset environmental analysis is necessary in real estate and infrastructure. Consequently, ESG analysis has been taking place in the real assets space for some time. GRESB has been providing ESG assessment and benchmarking for managers of real estate since 2009 and started doing so more recently for infrastructure managers as well.

In addition, the ESG Data Convergence Project, led by the Carlyle Group and CalPERS, is working to create a standardized set of ESG metrics at the portfolio company level for private equity reporting. The intent is to aggregate data from private equity GPs into a new benchmark to provide more comparable portfolio ESG information for LPs.

⁷ CFA Institute, *Global ESG Disclosure Standards for Investment Products - Frequently Asked Questions (FAQs)*

There will be no ‘right’ or ‘wrong’ ESG philosophy for asset managers

The CFA Institute's Global ESG Disclosure Standards for Investment Products and the requirements of the UN-supported Principles for Responsible Investment (PRI) are two big steps towards generally accepted standards for ESG reporting across the investment industry. Indeed, signing on to the PRI is already table stakes: As of February 2, 2022, 3,565 investment managers were PRI signatories.⁹

Whether it is the above-mentioned developing ESG standards or some others yet to come, we are sure that eventually most managers will

comply with a broadly accepted set of standard ESG definitions and reporting rules, just as they do with GIPS.

But ESG Is Not GIPS!

Unlike GIPS, integrating ESG factors into an investment process goes right to the heart of each asset manager's investment philosophy and process. An investment manager never had to explain why and how it implemented GIPS, and was never asked what it meant by GIPS. Conversely, investment managers also never asked investors to tell them which type of GIPS compliance they wanted. With ESG integration, simply checking the ultimately-standardized boxes will not be enough.

Managers Need to Define What ESG Is For Their Firm - and Mean It

For a manager to be credible around ESG it will need to articulate its own ESG philosophy. **There will be no ‘right’ or ‘wrong’ ESG philosophy.** Over time, we expect manager ESG philosophies will run the gamut from ‘we are complying with all rules and otherwise are implementing our legacy investment philosophy’ to ‘our investment philosophy centers around driving impact in the world toward our stated ESG goals’ to everything in between.

⁸ Source: Prequin

⁹ Source: UNPRI

A successful manager ESG philosophy will be as deeply-rooted and considered as the firm's investment philosophy, and as much a part of its DNA as being a Value or a Growth manager. For a manager to win and keep investors' trust it needs to explain where it stands on ESG, how its ESG philosophy is implemented as part of the firm's investment process, and why its ESG philosophy matters to its clients.

A Glossy ESG Book Alone Doesn't Cut It

We have heard many managers lamenting that their expensive ESG communications do not seem to be resonating with investors. We suspect the primary reason for this is the lack of the two items noted above: an authentic ESG philosophy, and a compelling explanation of why investors will benefit from having that philosophy expressed in their portfolios over time.

We have seen many examples of expensive, glossy publications by managers describing their ESG approaches. Many of these publications are far too long for all but the most dedicated investor or consultant to read in depth. To the extent the fabulous 60-page book seems out of character for the manager, it will actually reduce, not enhance, investor trust.

Similarly, parachuting in a highly-paid ESG professional from another firm, naming them Global Head of Sustainable Investing, and having them report directly to the CEO can come across as window dressing without any accompanying authentic firm-wide ESG philosophy. There's a risk that whatever ESG initiatives those firms undertake may appear transplanted from outside the organization rather than a natural outgrowth of the firm's true beliefs, and hence not credible.

Winning asset managers will help investors understand the importance of the manager's ESG approach for them.

Conclusion: Best ESG Integration Practices for Asset Manager Growth

Chestnut's clients know that there are three critical questions all successful asset managers have addressed (we call these the Golden Circle of Asset Management):

- What do your target investors want?
- How can your firm deliver?
- Why you?

Each of these questions can be considered through the lens of ESG.

Thoroughly Understand Your Target Investors' Needs

This understanding presupposes knowing who your target investors are! Not all investors have the same views on ESG. As an extreme example, a recent article noted that contrary to the trend of large institutional investors seeking to reduce their carbon intensity, two U.S. "red states" have moved to punish managers that back away from oil and gas investments.¹⁰

Educate Investors on ESG

Most investors don't know what they should be doing to address ESG factors in their portfolios. In our latest survey, 63% of institutional investor respondents told us they are 'just getting started' when it comes to ESG. We believe it is managers' job to educate investors on how each manager is integrating ESG factors into their investment process, along with the benefits and costs of that approach. Over time we expect managers who are viewed as among the smartest on ESG issues will gain an edge over their competitors with investors who value their ESG expertise.

¹⁰ FundFire, *Managers Face Growing Resistance to Climate Policies from Red States*, January 21, 2022

ESG Is Not GIPS:

Your ESG Philosophy Must Be Part of Your DNA

Help Investors Understand How Your ESG Philosophy Can Benefit Them

Grounded in their deeply-held convictions about ESG, and informed by their thorough understanding of their clients, winning asset managers will help investors understand the importance of the manager's ESG approach for them. In the "what, how, why" scheme, this is the all-important "why" part. As Chestnut clients know well, if you can successfully address an investor's "why", you can win their trust and their business.

Ensure Your ESG Philosophy Is Authentic to Your Firm's DNA

An investment consultant survey respondent told us, "We have no time for a manager who says they can give our clients whatever they want where ESG is concerned. We want to know what the manager truly thinks about ESG and how their view is reflected in their decision-making."

Make Your ESG Philosophy Part of Your Value Proposition

There can only be one cheapest manager and one largest manager; all other managers have to think more deeply about their value proposition. As we noted earlier, the same is true around ESG: those managers that are authentic will have thought very deeply about their beliefs and how they fit within their investment philosophy.

Invest in Your ESG Efforts to Be Credible

Building new investment processes and training investment teams on ESG integration requires a substantial ongoing investment. There is a "War for ESG Talent" in North America and globally as managers race to gain credible traction on ESG. As we noted before, this does not have to mean expending large sums on 50+ page glossy reports on ESG that most investors and advisors don't have the time or patience to read. Short, focused communications developed with the target clients in mind are much more impactful.

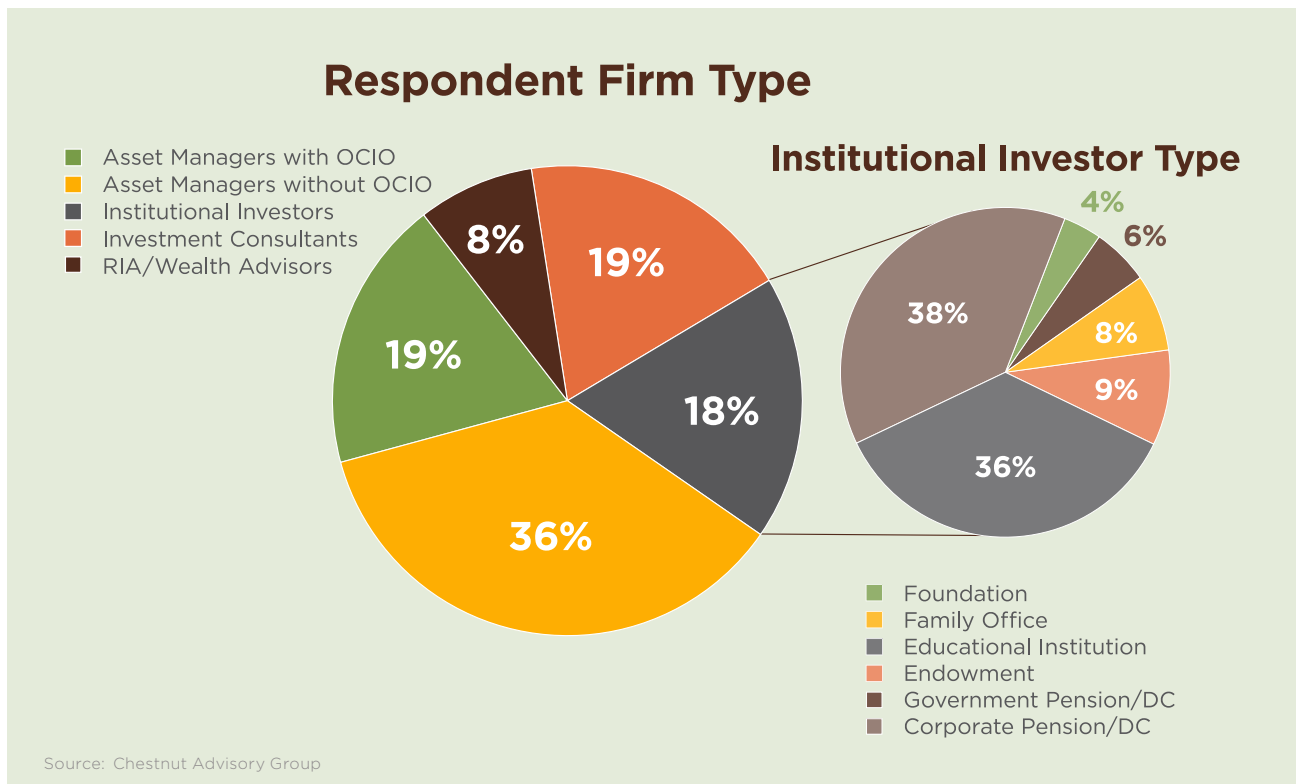
And of course it's necessary to meet the table stakes: join the PRI, complete the eVestment DEI questions, follow the CFA Institute's Disclosure Standards, and so on.

OCIOs Can Go Further

OCIOs are asset managers too so all of the points above apply to them as well. In addition: offering expert ESG advisory services can help to build assets. In our recent survey, fully one-third of institutional investor respondents utilizing an OCIO cited the availability of ESG advisory services as one of the top two factors driving their OCIO hiring decision.

Research Methodology

As the investment industry faces unprecedented challenges, Chestnut Advisory Group and *Pensions & Investments* partnered to conduct comprehensive research into the issues impacting the future of the investment industry, your organization, and your career. Over 450 professionals from across the industry participated in our study.



Acknowledgements

This article is part of our Future of Investments research project, conducted in partnership with *Pensions & Investments*.



About the Author



Amanda Tepper

CEO

atepper@chestnutadvisory.com

Over the past nine years Amanda has helped Chestnut's clients navigate the rapidly changing industry landscape by creating and implementing custom strategic growth roadmaps. Her areas of expertise include distribution, brand and M&A strategy. Amanda brings over 25 years of industry experience to Chestnut's clients. Prior to founding Chestnut, Amanda served as Global Director of AllianceBernstein's senior portfolio management team. Previously, Amanda developed deep experience in sell-side equity research as Associate Director of Equity Research at Bank of America and as an Institutional-Investor All-America Team- ranked equity analyst at JPMorgan.

Chestnut would like to thank David Eisenberg, OCIO Leader at Buck, for his invaluable contributions to this article.



All content and material contained in this document is protected by United States copyright law and is the exclusive property of Chestnut Advisory Group, LLC and may not be reproduced, distributed, transmitted, displayed, published or broadcast without its prior written permission. © 2021 Chestnut Advisory Group, LLC. Chestnut's logo is a registered trademark of Chestnut Advisory Group, LLC.