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ASSET MANAGEMENT

Impact Investing Digest

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What We're Reading

- **[Bucking the Trend, Flows Into ESG Funds Set Another Record in 2018]**

  Morningstar / by Jon Hale / January 24, 2019

  Despite significant market headwinds, U.S.-domiciled open-end and exchange-traded funds that practice sustainable investing attracted nearly $5.5 billion in net flows last year. That marks the third straight year of record annual net flows to sustainable funds and stands in stark contrast with the overall U.S. fund universe, which netted its lowest calendar-year flows since 2008. Stock market returns in 2018 were the worst since 2008, and bond market returns the worst since 2013, yet both ESG equity and bond funds garnered positive net flows. ESG bond funds set a record for annual net flows. Last year's showing continues a six-year string of significantly higher annual net flows for ESG funds in the U.S. In the four years after the financial crisis, 2009-12, annual net flows averaged a paltry $136 million. From 2013-18, average annual net flows were more than 30 times higher, at $4.4 billion, and for just the past three years, annual net flows have averaged $5.2 billion.

- **[Norway Deals a Blow to an Oil Industry That's Quickly Losing Friends]**

  Bloomberg / by Kelly Gilblom / March 8, 2019

  The decision of the world's largest sovereign wealth fund to reduce holdings in oil stocks wasn't as far-reaching as the industry feared, but dealt a symbolic blow to fossil fuels that will reverberate for energy companies and their investors. While the divestment by Norway's $1 trillion fund doesn't include Big Oil, instead rooting out $7.5 billion of companies that focus purely on exploration and extraction, the impact of the announcement rippled through the sector. Shares of all oil companies initially plunged on the news, suggesting the move sets the industry up for greater disruption. Life is changing for oil companies. Ten years ago, they accounted for about 15% of the S&P 500 index. Today, they make up just 5%, having been mostly displaced by technology giants such as Facebook Inc. and Apple Inc. Consumer choices are set to drift farther from the hydrocarbons of the 20th century, with renewables potentially meeting about a quarter of demand by 2040, according to oil major BP Plc. It's no surprise, then, that investors are increasingly questioning the wisdom of betting on oil and gas. In the longer term, a dearth of capital will push up the cost of borrowing to explore for oil and gas, with those costs likely passed on to consumers, according to Georgi Slavov, head of research at energy broker Marex Spectron. That makes renewables comparatively cheaper, further pushing fossil fuels out of the market. While Shell, BP and other oil majors were spared in Norway's decision, they may yet be earmarked for divestment in the future. For those oil companies moving to diversify, there's light at the end of the tunnel. In its statement, Norway said some of the biggest investments in renewables now come from Big Oil. "While the fund was initially built on revenue from oil and gas, the Ministry of Finance understands that the future belongs to those who transition away from fossil fuels," said Mark Campanale, founding director of energy researcher Carbon Tracker. "Now is the time for smart investors around the world to follow their lead and make decisions driven by the reality of the energy transition."

- **[Large fund firms' support for combating climate change is all talk, as proxy voting record shows bottom performance]**

  CNBC / by Eric Rosenbaum / March 18, 2019

  Vanguard Group and BlackRock have been more vocal in recent years on the subject of corporate responsibility. Before he died, Vanguard Group founder Jack Bogle said one of the biggest issues the index fund would face in the future is its societal influence. He meant the need to vote proxies on complex issues such as sustainability at annual meetings held by every publicly traded company and on behalf of so many individual fund shareholders. As two of the world's largest asset-management companies, with more than $11 trillion invested on behalf of fund shareholders, they also are among the largest shareholders of stocks in the world. In 2017 both companies voted to require ExxonMobil to produce a report on climate change, a watershed moment showing what can occur when index funds punch their weight in proxy voting. Yet shareholder advocates say there have not been nearly enough of those ExxonMobil vote moments. A data analysis released by Ceres shows that when BlackRock and Vanguard are measured on their up-or-down votes on climate change resolutions at stockholder annual meetings, they have among the worst voting records in the fund industry. Among 48 large fund companies that Ceres included in its review of up-or-down votes on climate-related shareholder proposals, Vanguard finished 42nd (voting for climate proposals 12% of the time), and BlackRock finished 43rd (voting in favor of these resolutions 10% of the time). T. Rowe Price Group, Putnam Investments and Dimensional Fund Advisors were all below BlackRock and Vanguard. The fund companies can't argue with the data, but they do argue with placing all the importance on proxy votes. A Vanguard spokeswoman said that its Investment Stewardship team views voting proxies as one piece of a broader engagement strategy that also includes discussion with company boards and management and advocating on behalf of all shareholders. But here's the problem: Disclosure of a proxy vote is black and white; disclosure of ongoing engagement is not. Shareholder advocates say these lists may be long in the number of companies engaged, but fund shareholders don't know who specifically was engaged at the companies and what policy changes were offered as a result of the fund companies' efforts.

- **[The Firm Behind 'Fearless Girl' Has a Dubious Record of Backing Gender Diversity as a Shareholder]**

  Fortune / by Emma Hinchliffe / April 1, 2019

  As the firm behind New York's Fearless Girl statue, State Street Corporation has gotten an estimated $13 million in free publicity and even seen success pushing companies to add women to their boards of directors. But as a shareholder, the firm's fund specifically devoted to gender diversity has often opposed initiatives in favor of that mission. New research from Morningstar shows that on eight out of 10 shareholder resolutions related to gender diversity that State Street's Gender Diversity Index ETF, known as SHE, faced between July 2015 and June 2018, it either voted no or abstained. State Street says that shareholder resolutions "[do] not tell the whole story" of how it approaches this issue. But Madison Sargis, who completed the research at Morningstar, studied the votes of three funds devoted to gender and diversity lens investing. State Street's SHE was the only one that often voted against these kinds of proposals. Gender lens investing funds Pax Ellevate Global Women's Leadership Fund and Glenmede's Women in Leadership Portfolio both voted in favor of all gender and diversity resolutions they faced—23 for Pax and 14 for Glenmede. State Street's SHE invests in companies with women in senior leadership positions. The fund voted against an annual report on the gender pay gap at Aetna; against a gender pay equity disclosure at American Express; and against a report on gender pay equity at Mastercard. At TJX Companies, SHE voted against a resolution on diversity among senior executives playing a role in CEO compensation, against including diversity as a CEO performance metric, and against a report on gender, racial, and ethnicity compensation disparities. State Street has drawn criticism before for issues seemingly in conflict with its Fearless Girl campaign, which launched two years ago. The firm paid $5 million in late 2017 to settle with more than 300 female employees who said they'd been paid less than their male colleagues after a Department of Labor audit uncovered gender-based discrepancies in compensation.

- **[The S&P 500 Gets an ESG Makeover — but It May Not Go Far Enough]**

  Barron's / by Leslie P. Norton / April 11, 2019

  S&P Dow Jones introduced a sustainable version of the S&P 500 index this week. The new index will target 75% of the traditional S&P 500's market capitalization at the industry level. It will exclude tobacco companies, some weapons companies, and companies that score low relative to the United Nations Global Compact principles for responsible businesses. To screen out companies, S&P will use ESG data providers Sustainalytics, Arabesque and RobecoSAM. Some longtime ESG investors are less than impressed with the news. Even an updated S&P 500 is still, well, the S&P 500—which still has all kinds of improvements to make in terms of ESG. Leslie Samuelrich, president of Green Century Funds, says "it's not so hard to drop the worst 25% of the S&P 500." She compared the new index—and any ETFs based on it—to "the lightest version of some ESG product. If you're looking to check a box, that's what this is. If you're trying to have value alignment or value impact, this is just one in a long line of 'lite' ESG products."

Research / Reports

Sustainable Signals: Growth and Opportunity in Asset Management */ Morgan Stanley and Bloomberg / February 2019*

This survey polled 300 respondents at US asset management firms with at least $50 million in client assets and gathered insights about the growth, direction and future outlook of sustainable investing among asset managers. Key findings:

- *Sustainable Investing Goes Mainstream:* 75% of US asset managers say their firms now offer sustainable investing strategies, up from 65% in 2016. Asset managers overwhelmingly agree that sustainable investing is no longer a fad, with 89% saying it is here to stay and 63% expecting it to continue to grow in the next five years.
- *A Financial Case for Sustainable Investing:* As sustainable investing matures, asset managers are putting financial considerations at the forefront of their sustainable investment strategies. 82% think strong ESG practices can lead to higher profitability and that companies with such practices may be better long-term investments. Almost two thirds of asset managers (62%) believe that it's possible to maximize financial returns while investing sustainably.
- *Product Types Proliferate, Expanding Investor Choice:* As more firms embrace sustainable investing strategies, they are offering more ESG-tailored investment vehicles and expanding investor choice. Many employ a full spectrum of sustainable investing approaches, with 63% employing more than one strategy across shareholder engagement, restriction screening, ESG integration, thematic investing and impact investing.
- *Expertise, Better Data and Impact Reporting Will Support Customization and Drive Future Success:* Nearly all (89%) respondents report their firms will devote more resources to sustainable investing in the next two years. Common strategies for developing in-house skills and capacity include employee training (41%), dedicating more employee time (36%) and specialist hires (34%). Seven in 10 asset managers agree that the industry lacks standard metrics to measure nonfinancial performance of sustainable investments. The field is wide open for better data and the development of impact measurement tools.

Moving Toward Gender Balance in Private Equity and Venture Capital */ IFC / March 2019*

This report draws on data from more than 700 funds and 500 portfolio companies; survey results from over 500 fund managers and institutional investors; interviews with more than 50 investors and gender diversity experts; and case studies. Key findings:

- About 65% of Limited Partners view gender diversity of a firm's investment team as important when committing capital to funds. However, General Partners report that less than 30% of their Limited Partners view gender diversity as an important consideration when making investment decisions.
- Only 15% of senior investment teams are gender balanced (defined as leadership teams with at least 30% of men and women) and nearly 70% are all male.
- Gender balanced funds realized excess net internal rate of return of 1.7 percentage points greater than male- or female-dominated funds when controlling for vintage, geography, and strategy. This difference in performance is about 20% of the median net IRR in emerging markets.
- The lack of gender balance is likely reinforced by insufficient diversity goal setting and exclusive recruiting practices. Less than 10% of General Partners have strategies or targets for improving the promotion rate for female employees.
- 7% of private equity/venture capital is invested in female-led businesses. Female-led business receive only 65% of the funding received by male-led business.
- About 20% of portfolio companies have gender balanced senior leadership teams, while nearly 70% are all male.
- Gender balanced leadership teams are correlated with approximately 25% greater increases in valuation than unbalanced teams.
- Portfolio company imbalance appears related to GP imbalance. Female partners invested in almost twice as many female-led businesses as male partners.

Sizing the Impact Investing Market */ The Global Impact Investing Network / April 2019*

This report provides an in-depth analysis of the current size and composition of the impact investing market. Over 1,340 organizations currently manage $502 billion in impact investing assets worldwide. This research underscores the diversity of the market, capturing data from many types of investors including asset managers, foundations, banks, development finance institutions, family offices, pension funds, insurance companies, and others.

Global Sustainable Investment Review 2018 */ Global Sustainable Investment Alliance / April 2019*

This report collates results from market studies of regional sustainable investment forums from Europe, the United States, Japan, Canada, and Australia and New Zealand. This report also includes data on the African sustainable investing market and on Latin America from the Principles for Responsible Investment. Highlights:

- At the start of 2018, global sustainable investment assets reached $30.7 trillion, a 34% increase from 2016.
- Sustainable investment commands a sizable share of professionally managed assets in each region, ranging from 18% in Japan to 63% in Australia and New Zealand.
- Europe accounts for the largest pool of sustainable investment assets with $14.1 trillion in assets under management, followed by the US with $12.0 trillion.
- Negative/exclusionary screening remains the most prevalent sustainable investment approach globally, affecting $19.8 trillion in assets, followed by ESG integration, applied to $17.5 trillion in assets.

Getting Physical – Scenario Analysis for Assessing Climate-Related Risks */ BlackRock Investment Institute / April 2019*

The report uses new tools and data to articulate the potential impact on different US asset classes, marking an important next step as investors increasingly recognize the importance of integrating climate-related risk factors in the investment process. Key findings:

Municipal Bonds

- Extreme weather events pose growing risks for the creditworthiness of state and local issuers in the $3.8 trillion US muni bond market. A rising share of muni bond issuance over time will likely come from regions facing economic losses from climate change and events linked to it.
- Within a decade, more than 15% of the current S&P National Municipal Bond Index (by market value) would comprise metropolitan statistical areas (MSAs) suffering likely average annualized climate-related economic losses of up to 0.5% to 1% of GDP.
- Looking out to 2080, an estimated 58% of US metro areas will likely see GDP losses of up to 1% or more, with less than 1% set to enjoy gains of similar magnitude.
- The New York City region faces annual losses equivalent to roughly 1% of GDP by late century. Florida will be affected the most, with Naples, Panama City and Key West seeing likely annual GDP losses of up to 15% or more, mostly driven by coastal storms. Miami's current annual GDP losses are already more than 1% and projected to grow to an annualized 4.5% of GDP by the end of the century.

Commercial Real Estate and CMBS

- Hurricane-force winds and flooding are key risks to commercial real estate. The median risk of a building that backs a CMBS bond being hit by a Category 4 or 5 hurricane today has risen by 137% since 1980. BlackRock is projecting a 275% increase in the risk of category 5 hurricanes between now and 2050.
- More than 80% of properties tied to CMBS loans affected by recent hurricanes in Houston and Miami are outside official flood zones — meaning they may lack insurance coverage. This makes it critical to analyze climate-related risks on a local level.
- New York City is facing rising sea levels of up to three feet by the end of century exposing more than $70 billion of property to potential losses.

Utilities

- Aging infrastructure leaves the US electric utility sector exposed to climate shocks such as hurricanes and wildfires. The risks are currently underpriced.
- Investors in utility stocks are quick to sell out of these names following an extreme weather event, with stocks down 1.5% on average over the ensuing 40 days.
- However, these stocks recover quickly while the true economic losses are still being calculated, suggesting that investors are focused on headline risk rather than assessing utilities' vulnerability to climate-related weather events.
- BlackRock has generated a climate-risk exposure score for every US utility based on a plant-by-plant assessment of physical risk, and finds that the most climate-resilient utilities tend to trade at a slight premium to peers. This gap may become more pronounced over time as weather events turn more extreme and frequent.