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Rapid Insights: Emerging ESG Trends for Asset Owners

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So, I'm going to give an update on three top trends in environmental, social, and governance, or ESG investing that our asset owner clients continue to focus on. First, is climate change. The second, evolving landscape of ESG data. And third, diversity, equity, and inclusion.

So, top on the list is climate change. This remains the top environmental issue that investors are seeking to address. And pension funds, in particular, are getting pressured from regulators to consider and disclose climate risk. At this stage, there's generally broad acceptance from investors that climate change is a material risk to global and financial investments, and the timing of this is what matters. The clock is ticking as regions around the world are making progress towards their carbon reduction commitments, so transition risk is imminent. And the physical risks, fires, floods, droughts, and heatwaves also seem to be on the rise.

So, unpacking this a little bit, the focus on pensions makes sense. Pension funds are tasked with the stewardship of long-dated liability-driven investment portfolios. These often have 30 and 50-year investment horizons. So, understandably, being aware of and managing for risks of these long-dated investment structures is really important to the financial security of their participants, and losses could be significant if left unchecked.

So, globally, regulators are responding, and some are instituting measures to require consideration of climate and the incorporation of climate risk. And there have been some really interesting developments.

So, the latest component of the European Commission's Sustainable Finance Action Plan went live in the spring, and under this regulation, pension funds will publish information on the consideration of adverse sustainability impacts of their investments.

In the UK, they've decided to enforce mandatory reporting aligned with the recommendations of the Task Force on Climate-Related Financial Disclosures, or the TCFD. The largest UK pension schemes will be required to report first, with smaller pension funds to follow.

And in the US, we're starting to see the shift that we anticipated with this new administration. The Biden Administration signaled earlier this year that it wants the Department of Labor to encourage ERISA (The Employee Retirement Income Security Act) plans to consider the economic impact of climate change in their plan offerings, which is a sharp pivot from the rule introduced by the previous administration. Recently, they introduced a new rule, which encourages the incorporation of financially material ESG factors in investment offerings, and this is likely to be the first major ESG regulatory statement from the Biden Administration.

And the second theme I talked about was data. Asset owners remain frustrated about the lack of widely available ESG data and information, and their concerns are that the quality is suspect, that it's not publicly and systematically disclosed by companies, ratings are incomparable, asset coverage can be spotty. And for some asset classes, it's just not available in the market. And then there's the challenge of that once you have it, effectively, efficiently, and systematically integrating it into an investment strategy can also be a challenge.

But for all of the challenges, it doesn't seem to deflect interest. Many asset owners are still considering sustainable investing a priority. In a recent Morgan Stanley Sustainable Institute survey, nearly eight in 10 agreed

that sustainable investing is a risk mitigation strategy. And in that same survey, asset owners already practicing sustainable investing identified clear benefits to reputation and stakeholder engagement. But in spite of this interest, ESG data issues continue to be at the core of investor challenges.

For example, our own asset owner survey reflected concerns related to ESG integration, specifically it noted the lack of quality ESG related data available to accurately inform investment decisions was considered the greatest hindrance to full ESG integration.

But in spite of this, asset owners continue to push for progress, particularly in asset class coverage. They're making their preferences known to their investment managers, and they're really proving to be a driving force to improve data overall for alternative investments. Actively pushing investment providers to incorporate criteria and information into private assets, we're hearing that from both our investment manager and our asset owner clients.

So, if you consider these stats from our survey, 62% of respondents seek disclosure on ESG issues from the private investment entities in which they invest. And 67% of respondents said they are likely to implement or continue implementing ESG integration in the next three to five years. We think we'll see some changes to come in this area.

And then the last theme we're hearing a lot about is diversity, equity, and inclusion. This is an interesting one, because it's always been part of the sociopolitical issue investing. But there's been a recent push from asset owners to hold organizations and entities accountable, which has resulted in a much more metrics-driven disclosure requirement, as well as impact metrics to improve progress in the area.

So, rather than just a cursory review of board composition in a stat, to ensure diversity on boards, the ask is for companies and entities to report on their diversity initiatives and then to report on outcomes to ensure that there are changes happening across the organization at all levels. And it's not just portfolio companies that are being assessed, some of our foundations and endowments clients have begun to gather their own diversity, equity, and inclusion data on their investment managers, and particularly their alts managers. So, this is a theme that continues to develop.

ESG research providers have begun to respond and we've seen some new providers begin to surface around these themes. So, there should be significant improvement in relevant and financially material data and metrics available in the near term.

So, given these top trends, we've been focused on solutions to help asset owner clients navigate the evolution of investing with services both from our regulatory reporting team, as well as specific data and analytics tools. We're here to help, so please reach to your relationship manager if you have interest in learning more.

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