Future First℠ Insights

Retail ESG Products Show Substantial Growth from a Small Base

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Consider Everything

Investors have been steadily flocking to environmental, social and governance (ESG) assets since the first quarter of 2020, as a global pandemic and increasing evidence of climate have put these issues in the spotlight. Despite the sharp market downdraft of the early months of the pandemic, sustainable investments have maintained their decade-long growth trajectory, especially as financial assets have regained some equilibrium over the past year: Assets under management (AUM) for ESG themes among national broker-dealers rose from 1.0% market share in Q3 2019 to 1.6% market share in Q2 2021, with market share up each quarter.

By looking at activity across three investment vehicles – exchange-traded funds (ETFs), mutual funds and separately managed accounts (SMAs), we can examine in more detail what's driving this growth and anticipate what investors can expect going forward.

Our perspective encompasses about $4 trillion held through ETFs, mutual funds, and SMAs. From that commanding view, we have broken down salient themes applicable to ESG strategies since early 2020.[1]

[1] BNY Mellon Growth Dynamics as of June 30, 2021. The aggregate data used in this analysis is based on Mutual Fund, ETF and SMA asset and sales data reported to BNYM Growth Dynamics under a data sponsor agreement, representing more than 900 broker-dealers and RIAs. The data set represents sales through a financial advisor, and excludes institutional and retirement plan sales. For this analysis, ESG assets are designated as follows. Mutual funds and ETFs have been placed in the ESG category and considered "Self-Identified" ESG based on Morningstar data; if the prospectus or other regulatory filing mentions a focus on sustainability, impact, or environmental, social, and governance (ESG) factors SMAs are included in the analysis by inferring an ESG designation from the product name and whether it carries any ESG connotation.

Setting the Stage: Small but Mighty

At this point, ESG products still make up only a tiny fraction of the overall asset universe and they do not yet make up 2% of any of the vehicles. In a 2020 OECD publication, *ESG Investing: Practices, Progress and Challenges*, the authors draw attention to the still-modest size of the ESG investment world. They write, "The size of the ESG investable shows market penetration of ESG scoring is still low based on number of companies, but is much higher when measuring it by market capitalisation, which better represents the investable universe."[2]

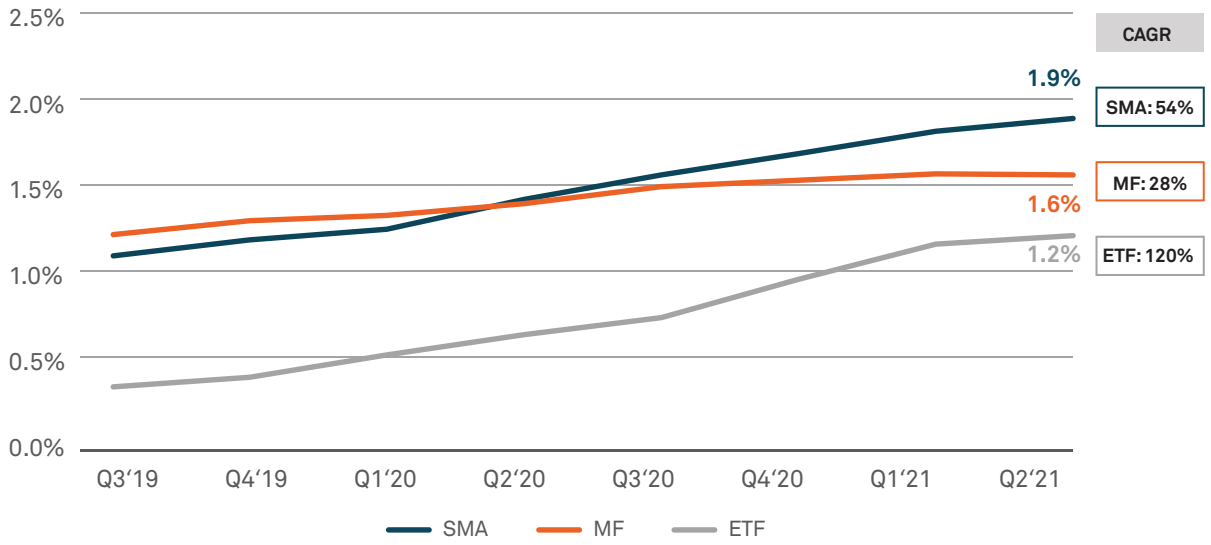
But from this limited base, ESG investments are showing substantial growth. In the period from Q3 2019 to Q2 2021, SMAs achieved the highest penetration for sustainable investments, at 1.9%. ESG mutual funds, at 1.6%, matched overall market share and represent the highest asset base across the three wrappers, with $20 billion in assets. Finally, ETFs saw the strongest surge in ESG penetration, rising from a small base of 0.4% to 1.2%.

Taken together, the three wrappers comprise a 51% CAGR. While mutual funds still represent the largest ESG asset base, both SMAs and ETFs are closing some of the gap by increasing at a faster rate of growth. Compared to mutual funds' larger asset base of $20 billion, we find $14 billion in SMAs and $13 billion in ETFs. But consider the discrepancy between the wrappers' compound annual growth rates: although mutual funds have achieved a 28% CAGR, SMAs have plowed ahead at 54% CAGR, while ETFs have left both in the dust with a 120% CAGR.

[2] OECD (Organisation for Economic Cooperation and Development). Boffo, R. and Patalono, R. (2020), ESG Investing: Practices, Progress and Challenges, OECD Paris. www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf

It is also interesting to note that mutual funds hover close to the average for AUM growth across the group, indicating their relative maturity, while SMAs are near the average for CAGR, indicating their core position in the growth of packaged products.

ESG Share % of Assets by Investment Vehicle– National Broker Dealers



What's Driving ESG Growth

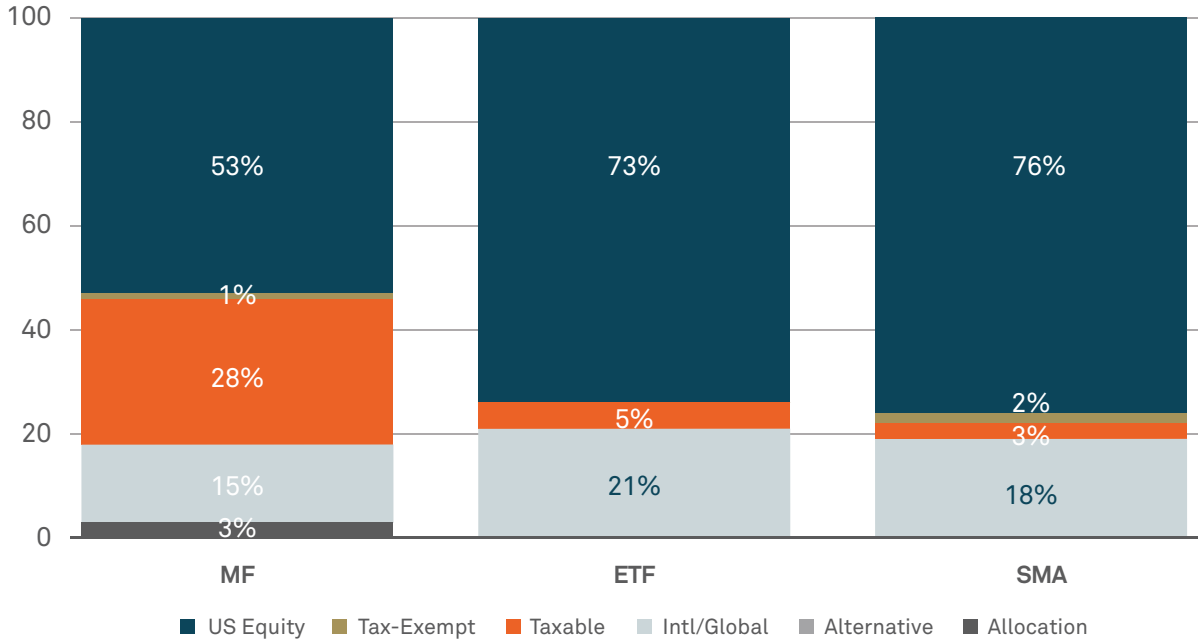
When drilling down into product types and asset classes, the overarching message is that U.S. equities have provided the tailwind behind the surge in ESG growth for all three wrappers. Their impact is most visible in ETFs (73% of ESG assets) and SMAs (76%). The OECD speculates that large cap U.S. companies, which represents the largest portion of U.S. equities, are followed more by analysts and investors and that they have ample resources to invest in disclosing information concerning their ESG scores compared to smaller cap companies.[2]

International/global equity ETFs are playing a significant role as well, witnessing a 21% ESG penetration rate. Although U.S. and international/global equities account for the majority of ETF and SMA holdings, mutual funds appear weighted to include more taxable fixed income positions, reaching a 28% share. Moreover, while U.S. equities have grown 8% in mutual funds since January 2020, taxable fixed income has diminished by 10% over the same period.

The top three asset managers across all three vehicles display a notable convergence, concentrated at 49% of net sales and 33% of AUM in ESG assets. Ultra-large asset managers, such as BlackRock, demonstrate their influence with top-heavy growth, with 64% of ESG ETF net sales and 59% of AUM.

We also found mutual funds and ETFs share a common appeal in Rep-as-Portfolio Manager (RPM) programs (also known as advisor-directed platforms). These platforms were early to adopt ESG strategies and have remained popular, representing net sales of 36% into ETFs and 44% into mutual funds since early 2020. However, over the second quarter of 2021, all three wrapper categories experienced a contraction in flows, comprising a fall-off in commission-based, fee-based and RPM sources.

Percentage of ESG Assets by Product Type and Asset Class



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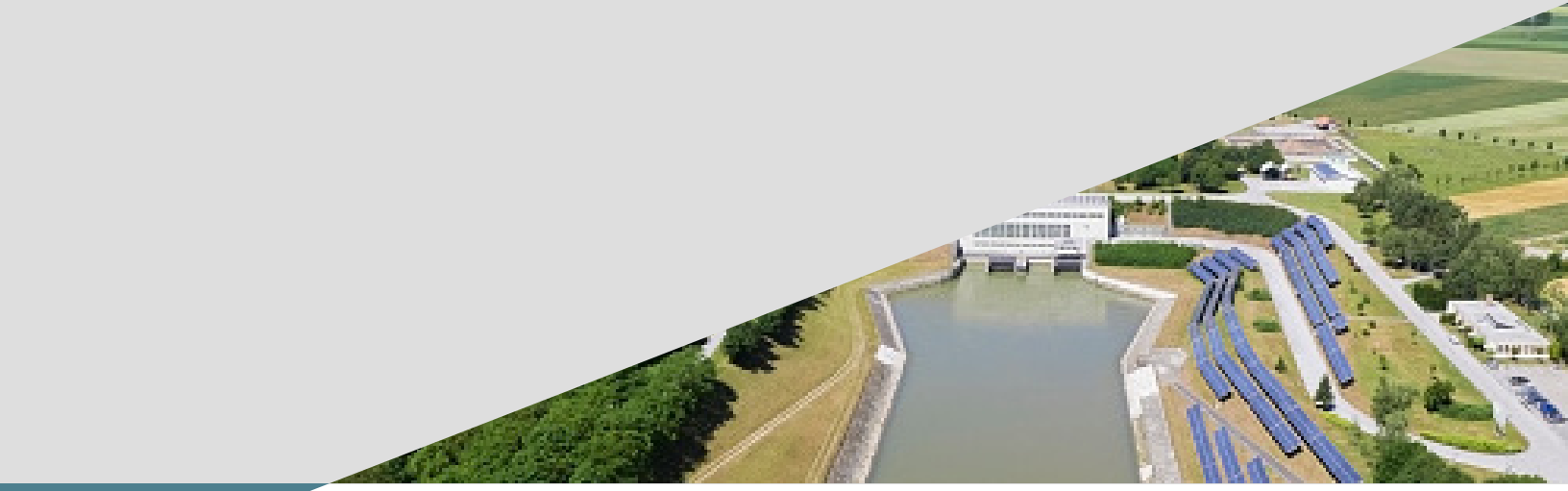


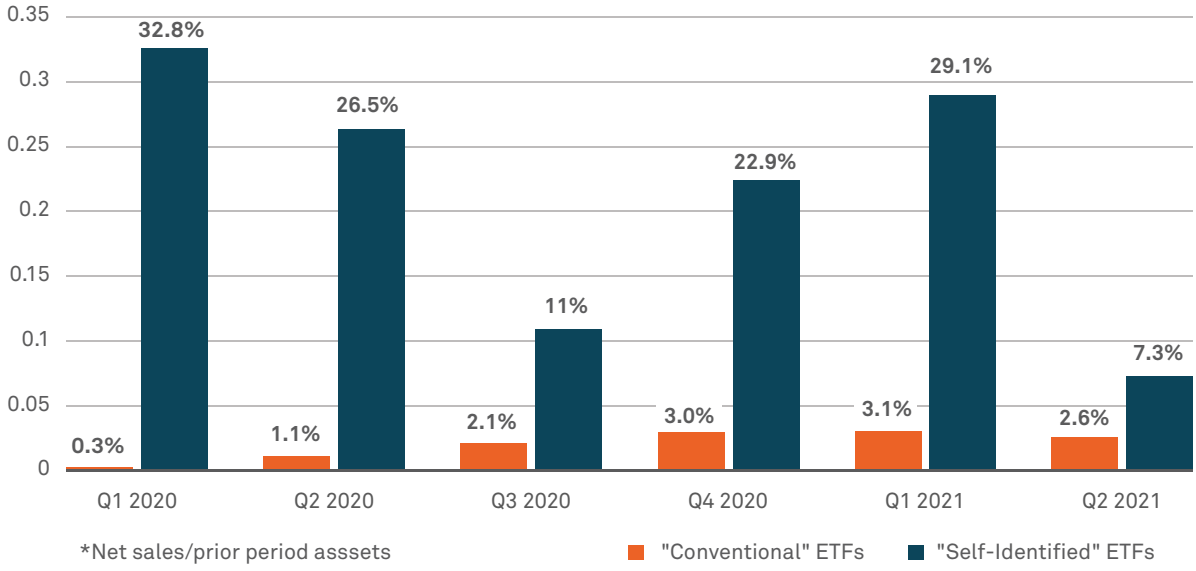
ETFs Seeing Rapid Growth from a Small Base

ESG assets retained in ETFs have continued to mount over the past two years and are now on course to reach 1.2% in market share of overall ETF holdings and 8% of net sales. Market share is now higher by 0.6% since the first quarter of 2020. It is noteworthy that these assets have added to their market share each quarter over the period.

That growth can largely be chalked up to heavy inflows. Inflows over the first six months of 2021 exceeded the total of those during every other six-month period since Q1 2020. Although flows did lose some steam during the second quarter of 2021, the robust growth rates of these assets position ESG to overtake the massive inflows of 2020. Compared with conventional ETFs, these funds are exhibiting more powerful sales growth.

Net Sales Growth Rates*

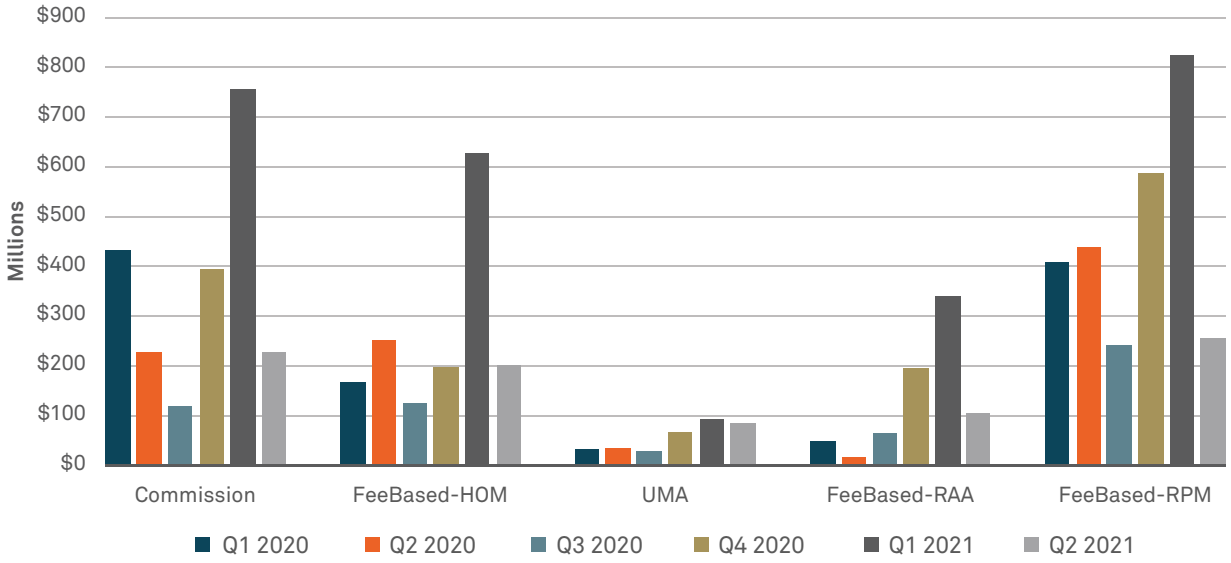
Conventional vs. Self-Identified ESG ETFs



U.S. equities have been the engine behind the growth in ETF ESG holdings since Q1 of 2020, as with mutual funds and SMAs. The asset class accounts for 70% of net sales and 73% of AUM. Most other accumulation has derived from international/global equities, which comprised 21% of net sales and of AUM. Lastly, taxable fixed income contributed 8% of net sales, and 5% of ESG assets, having witnessed a market share increase of 3%.

Across broker-dealer programs, ESG net flows have been mainly positive. The only exception to that upward trend occurred during the winter pullback during the second quarter of 2021. While all types of programs have boosted inflows, RPM programs led the pack, making up 36% of inflows, and commission-based program inflows reached 28% ESG ETF Net Sales.

ESG ETF Net Sales by Program Type



Indexed strategies have proved winners in ESG over the past 18 months, with index ETFs still driving net sales, representing 91% of inflows. Smart beta and active ETFs trailed behind, contributing 9% and less than 1%, respectively. Since the second quarter of 2021, net sales have contracted in Index, Active, and Smart Beta territories. However, with respect to market share, the Index category, which comprised 92% of ETF assets, lost 5% of market share, while Smart Beta, representing 7% of ETF assets, gained a 5% share.

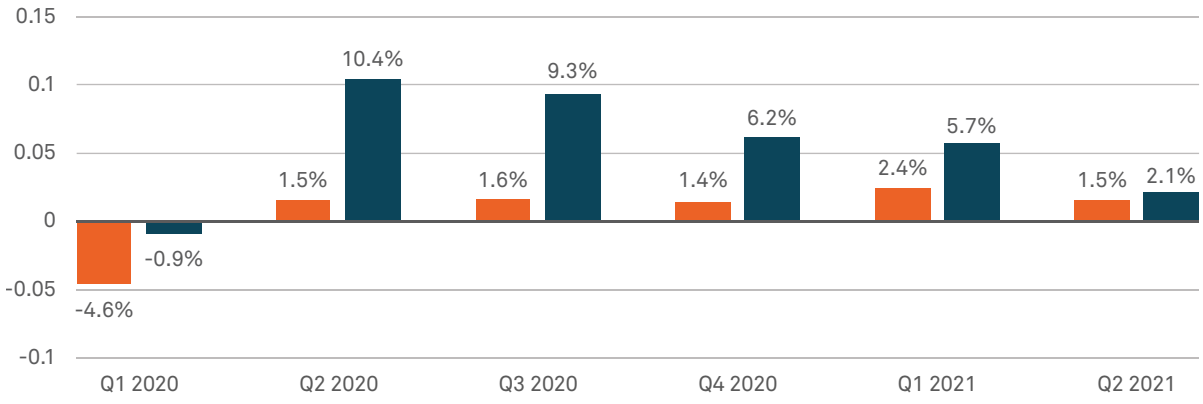
U.S. equities again echo their popularity in ESG ETFs with their dominance in the top 10 funds, encompassing 77% of net sales and 63% of AUM. Again, assets were concentrated among a handful of asset managers. Five asset managers attracted 95% of net sales and assets in ESG. In the first half of 2021, net sales headed downhill, while market share rose, with comparable growth across RIA, independent, and bank channels. Our data on these channels outside the national broker-dealer universe reveals the bulk of assets in U.S. equities (66%), ahead of international/global equities (27%).

Mature, But Steady Growth in Mutual Funds

Sustainable mutual funds are one of the most rapidly growing segments within the mutual fund industry. Extrapolating from sales performance figures during the first half of 2021, investors and their advisors are projecting solid inflows for the second half of 2021 for ESG funds. Looking back 18 months, ESG mutual funds enjoyed relatively stronger net sales than their conventional counterparts, at least relative to their respective AUM. Net sales growth rates have in fact given back some ground, from a 10.4% high in Q2 of 2020, to 2.1% a year later. That contraction has been due in part to the overall retreat in the second quarter of 2021.

Net Sales Growth Rates*

Conventional vs. Self-Identified ESG Mutual Funds

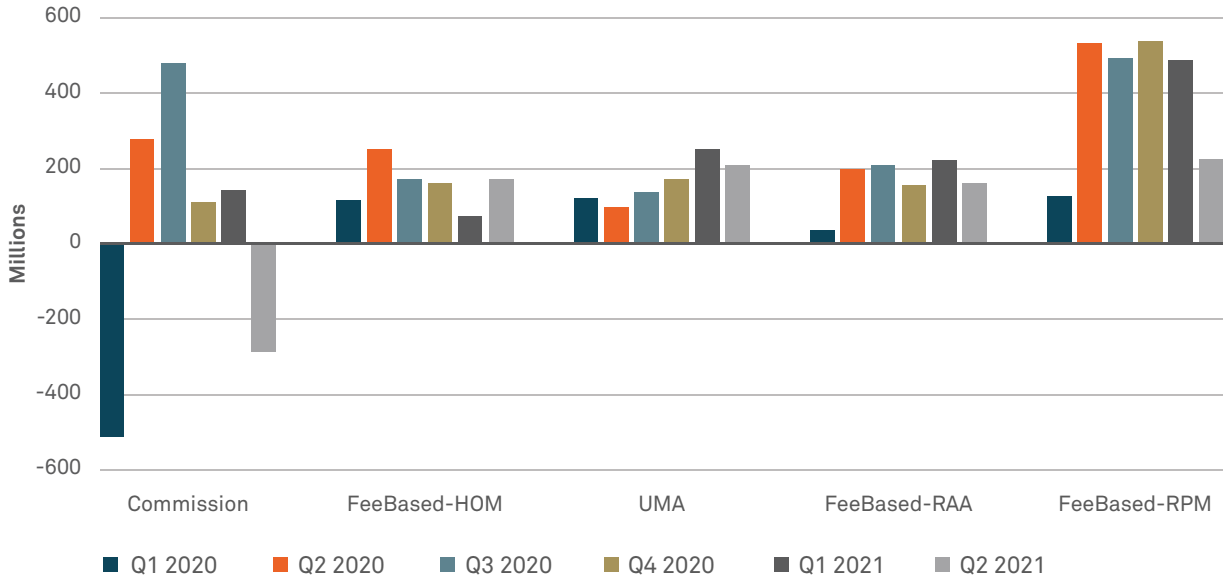


*Net sales/prior period asssets

"Conventional" Mutual Funds ■ "Self-Identified" Mutual Funds

In mutual funds, akin to the other wrappers, the consistent appeal of U.S. equities is reflected in ESG net sales results, to the tune of 47%. It is telling to compare those inflows to the opposite trend in non-ESG mutual funds, which suffered aggregate outflows over the same period. ESG assets increased under fee-based and RPM programs, in contrast to commission programs where outflows gained the upper hand.

ESG Mutual Fund Net Sales by Program Type



The leading 10 ESG funds again indicate concentration, weighing in at 63% of net sales and 30% of ESG AUM. These funds are divided between U.S. equity and taxable fixed income. Independent broker-dealers saw net sales growth flows in Q2 surpass those of Q1, with ESG funds accounting for 7% of net sales and persistently increasing market share. RIAs, by comparison, experienced a different dynamic. Net sales in ESG funds decreased to 6.7% although market share increased to 1.7%. RIA, independent and bank channels manifest one marked distinction, however. Our data indicate that 66% of mutual fund ESG assets represent U.S. equity, versus national broker-dealers, who apportion assets between U.S. equity at 53% and taxable fixed income at 28%.

Early Indications from SMAs

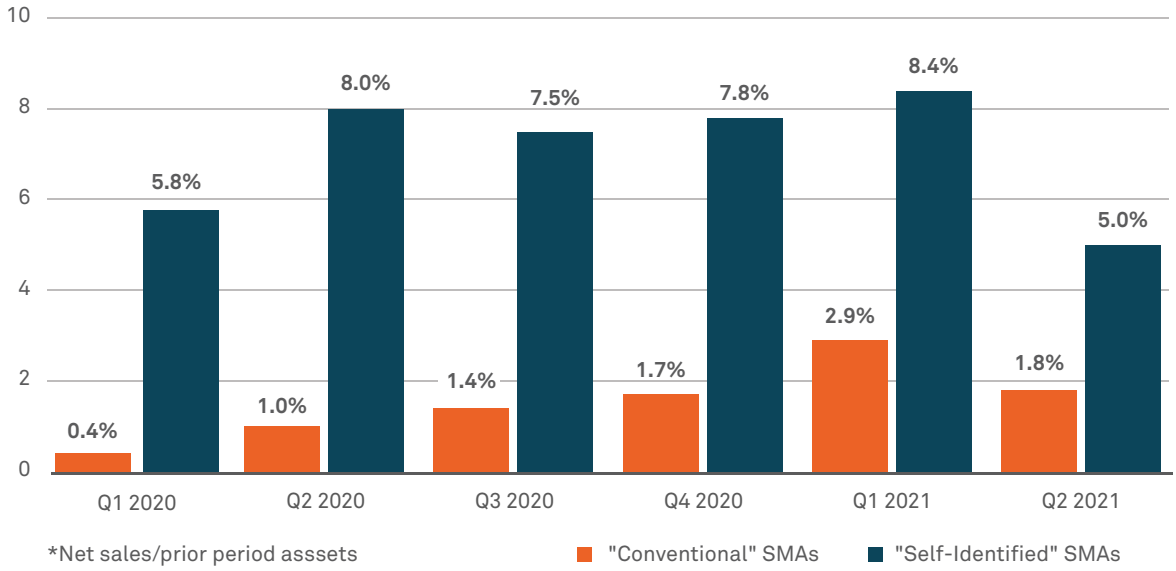
Separately managed accounts differ from mutual funds in their structure. The latter are pools of securities jointly owned by investors. SMA holders, by contrast, directly own the securities within a portfolio, which allows for more control, personalization and customization. With their potential for a tailored selection, SMAs are gaining popularity as vehicles for ESG strategies. The ability to shape and fine-tune SMAs to reflect investor preferences likely enhances their suitability for customized sustainable portfolios. They also tend to appeal more to higher net worth investors, given their higher required asset minimums.

ESG strategies have been a part of the SMA space with stable growth since Q1 of 2020, as market share and inflows have increased each quarter, barring a modest downtick in Q2 of 2021. Despite enjoying stronger growth rates than their conventional counterparts, ESG AUM in SMAs are still modest. Moreover, inside the small universe of SMA assets, ESG-related positions accounted for only 1.9% of assets and 6% of net sales over the past 18 months. Yet their ascent may be in its early stages. Market share has been growing each quarter, and is now ahead by 0.6% since Q1 of 2020.

Net sales growth has also been sound, compared to that of conventional SMAs. ESG SMAs grew from a rate of 5.8% in Q1 of 2020 to a level as high as 8.4% a year later, before dipping to 5.0% in the second quarter of 2021.

Net Sales Growth Rates*

Conventional vs Self-Identified ESG SMAs



Similar to ETFs and mutual funds, ESG SMAs have been clearly concentrated in U.S. equities, which are still propelling net sales. That asset class has driven 68% of net sales over the past 18 months and constituted a 76% share of ESG assets. SMAs also include a comparable proportion of international/global equities, comprising 21% of net sales and an 18% market share over the same period. The municipal-fixed income share in the space has also grown, climbing 1.2%, to arrive at a 1.7% share.

At national broker-dealers, the top 10 SMA ESG strategies resulted in 71% of net sales and 50% of AUM. Investment styles, while tending toward large cap, have likewise covered growth, value, and international, altogether adding up to 80% of net sales and 85% of ESG AUM. Large cap growth has particularly shone as a force driving 29% of net sales.

Just five asset managers have produced 86% of all net sales and hold 74% of ESG assets for SMAs, but Franklin Templeton towers above that group. Although the firm represents only 24% of net sales, it constitutes 42% of ESG SMAs.

Conclusion: Prevailing Trends and Product Appeal

A side-by-side comparison of the three major investment wrappers sheds light on some prevailing trends in the ESG sector. A primary theme of stable growth features in all three vehicles. In every case—with the exception of a down blip in Q2 of 2021 for each wrapper—sales and assets under management have been consistently climbing. Those steady increases are all the more significant, given how the larger investment climate was punctuated by volatility in the wake of the pandemic crisis. In Q1 of 2020, ESG mutual funds remained positive, whereas conventional mutual funds saw significant outflows, especially in Rep-as-PM programs. Only mutual funds experienced a brief dip in their ESG share of assets during the second quarter of 2021.

A clear pattern forms across the wrappers: those with greater AUMs have less dramatic growth rates, as is typical when assets grow from a smaller base. That relationship is discernible across the board, from the mutual fund side, with its more substantial AUM, to the much smaller world of SMAs, which are sprinting ahead at a relatively impressive rate. At every pace of growth, however, activity within the wrappers is revealing signs of a healthy investor appetite for ESG with solid underlying momentum.

Several observations transpire from an overview of the investment flows in the sustainability sector. First, U.S. equities have been the mighty tailwind driving sales in each of the categories, followed by international/global equities. Another distinction is a preference for large caps. A further characteristic, apparent across all the wrappers, is the heavy concentration of activity among a limited number of large asset managers.

A broad survey of the structure and current dynamics of the sustainability investment market suggests that further expansion is likely in store. With self-identified ESG products, sales and AUM alike have been headed higher, with so far little sign of flagging appetite. As the ESG market continues to grow, there is still ample room for improved transparency and investor education. According to the conclusions of the OECD analysis referenced earlier, “greater transparency is needed to understand what drives scores, how they compare, and the extent to which they seek to explicitly align with financial materiality.” As the industry works towards addressing transparency needs, this positive direction should likely place ESG-related products on the radar as a source of sales and AUM growth.

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