

Sharpening the Tools of the ESG Investor

Why ESG Factors Are Important, How Investors Use ESG Data, and What Policies Promote (or Impede) Effective ESG Investing?

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Introduction: Sustainable Investing Is Going Mainstream

More and more investors around the world are putting their money in sustainable investments. In the United States, mutual funds focused on sustainable investing attracted more than \$20 billion in assets in 2019, more than 4 times the flows in 2018.¹ In Europe, investor interest in sustainable funds has been even higher over the past half-decade, with more than EUR 35 billion in new net assets each year since 2016.² In 2019, fund flows reached a new record for European-domiciled funds of EUR 120 billion, according to Morningstar data.

Investors from all demographic groups report interest in incorporating sustainability into their investment choices. Morningstar's behavioral research team finds that all generations and genders are interested in sustainable investing, although as has been found with other research, women and millennials were slightly more interested.³ Furthermore, Morningstar researchers found that 72% of the U.S. adult population expressed at least moderate interest in sustainable investing.⁴ A more-traditional survey commissioned by Morgan Stanley similarly found high levels of interest in the U.S. for sustainable investing.⁵ In the United Kingdom, researchers found that about 80% of investors would be more likely to invest if there were a guarantee they were avoiding unethical companies or that their money could create a positive impact.⁶

Public interest in sustainability (as well as new regulatory mandates in Europe) creates a rare opportunity for financial advisors and asset managers to engage ordinary people in investing for their futures, and in so doing, enhance the reputation of the asset management and financial advice industry. To take advantage of this opportunity, financial advisors need both the tools to evaluate whether a client's portfolio is aligned with their sustainability preferences, and the skills to evaluate these preferences. Further, asset managers need to develop products that meet a range of investors' needs and clearly define the target market for each product, based on investors' sustainability goals. Just as asset managers develop products that are financially suitable for different investors with varying capacities, knowledge, and time horizons, they also need to be clear about an investment's suitability for investors with varied sustainability goals. Some investors may prefer to focus primarily on climate change, others on social issues and governance, and still others may want to avoid controversial industries.

1 Hale, J. 2020. "Sustainable Fund Flows in 2019 Smash Previous Records." Morningstar. Jan. 10, 2020. <https://www.morningstar.com/articles/961765/sustainable-fund-flows-in-2019-smash-previous-records>.

2 Bioy, H., Stuart, E., & Boyadzhiev, D. 2020. "European Sustainable Funds Landscape." Morningstar. August 2019. <https://www.morningstar.com/en-uk/lp/sustainable-funds-landscape>

3 These researchers asked respondents to choose between investments with lower returns and higher levels of sustainability.

4 Wendel, S., & Lamas, S. 2020. "Who Cares About ESG Investing?" Morningstar. May 3, 2019. <https://www.morningstar.com/articles/926921/who-cares-about-esg-investing>

5 Morgan Stanley Institute for Sustainable Investing. 2019. "Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice." https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf

6 Boring Money Insights. 2019. "ESG Investing: The Retail Appetite." September 2019.

Morningstar's long-term investment philosophy embraces the use of environmental, social, and governance (or ESG) factors, as these factors can materially affect a company's future financial performance. To do this, our analysts need a view on the sustainability of its business, which determines the likelihood that the firm will continue to generate or expand cash flows. A company's long-term profitability and growth are consistent with a business model that leads to community well-being, engaged employees, and shared values with customers. Thus, a robust analysis of ESG factors is a critical part of this kind of analysis. A company's long-term profitability is at risk if it faces ESG risks that it cannot manage effectively. Conversely, a company with limited ESG risks should be better able to maintain or improve its profitability.

Put another way, long-term investing is increasingly about considering the social costs of businesses. Companies that create negative externalities such as carbon emissions or a poorly paid workforce that relies on public benefits might face risks such as new regulation, poor labor relations, or customer boycotts. In particular, corporations that contribute disproportionately to climate change as a part of their business model will face increasing pressure from regulators to change their practices. (Companies that do not create these kinds of negative externalities, but are at risk because of them, also need to manage their ESG risk to be sustainable in the long term.) Even investors that are focused on shorter time frames need to manage immediate ESG risks such as worker health and safety, product safety and recalls, or business ethics, which, if unmanaged or not addressed, could damage a company's profits or even cause it to go bankrupt. Of course, companies with high ESG risks may be attractively priced even after taking ESG risks into account. Companies with poor ESG track records can also make rapid adjustments to manage those risks. Regulators also increasingly require asset managers to disclose how they consider ESG risks and long-term sustainability in their investment products, particularly in Europe.

In this paper, which is meant to help financial advisors, asset managers, and ordinary investors understand our perspective on sustainable investing and ESG factors, we examine **1.** why ESG factors are important for investing and to whom; **2.** how investors use ESG data, and its limitations; and **3.** what policymakers are doing to promote or impede ESG investing.

Key Takeaways

- ▶ Investors increasingly wish to consider the environmental and social impacts of their investments, while achieving competitive returns.
- ▶ Whether they are “avoiders,” eschewing investment in certain businesses, or “amplifiers,” seeking out positively influential companies, investors want to have the option—as they increasingly do around the world—to incorporate ESG preferences into their investing approach.
- ▶ Regardless of investors’ preferences, financial professionals have a responsibility to manage ESG risk, just as they would manage any other investment risk.
- ▶ Asset managers are increasingly using their roles as stewards to push the companies in which they invest to address ESG risks and adopt more sustainable practices.
- ▶ There are many established ESG measures to help investors pursue different approaches to investing sustainably, but there is room for further improvements as the quality and comparability of the data—from issuers and asset managers—continues to create challenges for investors.
- ▶ Worldwide, policymakers can improve ESG investing by collaborating and working with expert groups to standardize key data, terminology, and disclosures.
- ▶ American regulators can remove specific barriers that are slowing the growth of sustainable investing in the U.S. compared to in Europe by clarifying that retirement-plan sponsors should consider ESG factors when selecting investments.

Investors Want the Option to Incorporate Their ESG Preferences; Financial Professionals Have a Responsibility to Manage ESG Risks

All investments have impacts on the environment and society, and investors increasingly want to know about these impacts and what they mean for their investments. First, investors want to know how these impacts align with their values. Second, investors increasingly want to consider long-term ESG risks such as climate change when they make long-term investments. However, investors do not fall into exclusive camps of being focused on either values or risk. Rather, many investors care about both aspects to varying degrees simultaneously. For their part, asset managers are increasingly incorporating ESG risk factors into their process, but many are going further and developing sustainable or impact strategies. They are also taking their responsibilities as stewards more seriously by pushing companies to manage their ESG risks and consider the impact of their operations on the environment or society.

Investors Consider Environmental and Social Impact, While Seeking Competitive Returns

Investors are interested in sustainability, but of course, they also still strive to realize competitive returns. A growing body of evidence suggests that using sustainable investments generally has not reduced risk-adjusted returns to date. In a recent study, Morningstar researchers found that investors that focus on companies with positive ESG attributes generally do not sacrifice returns, although there may be a small ESG premium in the U.S.⁷ A U.S. Government Accountability Office meta-analysis found that 88% of studies of the relationship between ESG factors and financial performance found that using ESG information does not reduce financial returns.⁸ In short, picking investments that score better on ESG metrics at the margin or as a tie-breaker could be a reasonable strategy for investors who want their investments to reflect their values.

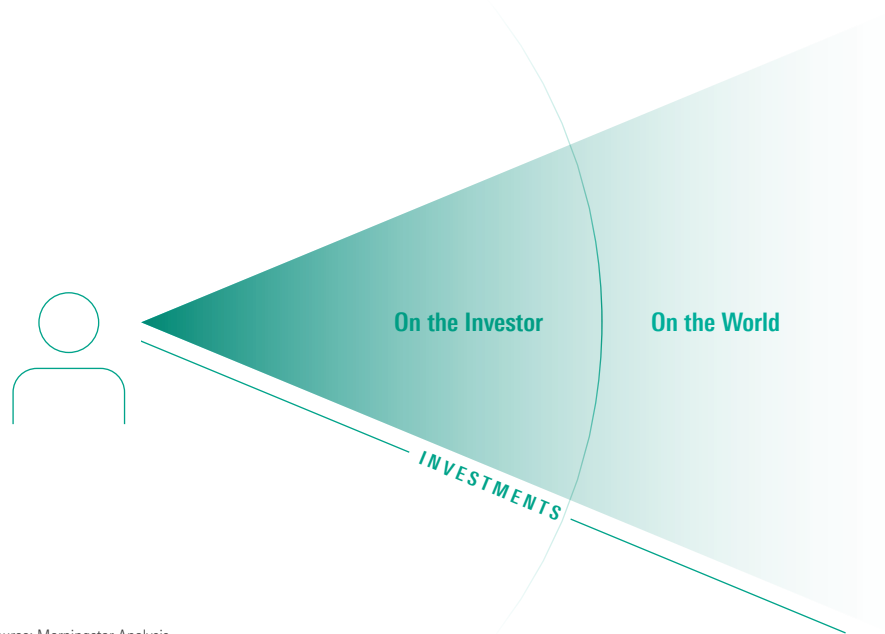
⁷ Sargis, M. “Do Sustainable Stock Portfolios Lead to Lower Returns?” Morningstar. Feb. 20, 2019.

<https://direct.morningstar.com/research/doc/967980/Do-Sustainable-Stock-Portfolios-Lead-to-Lower>Returns->

⁸ United States Government Accountability Office. 2018. Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would be Helpful. May 22, 2018. <https://www.gao.gov/assets/700/691930.pdf>

Impact

How People Invest Impacts Their Finances and The World Around Them



Source: Morningstar Analysis.

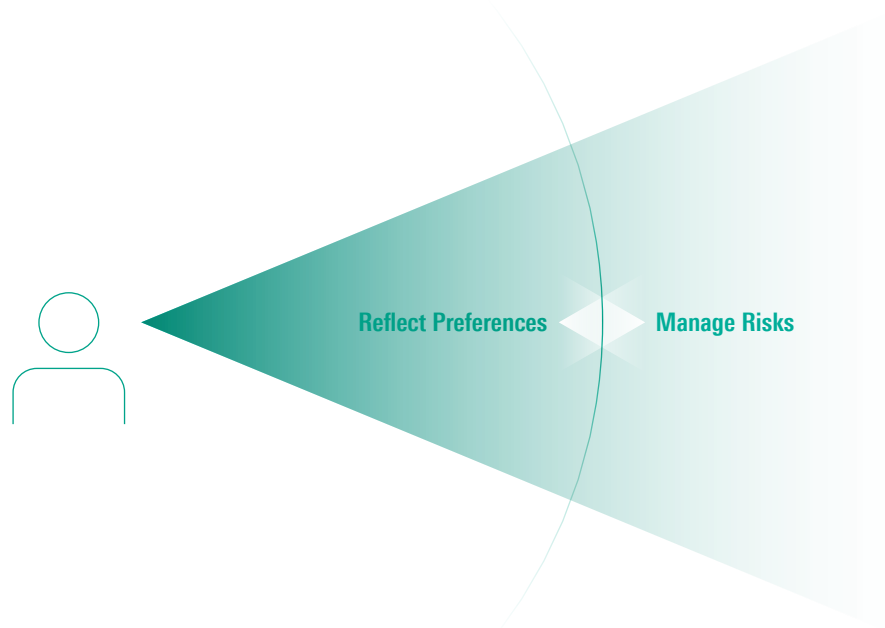
Although studies find that an ESG focus has not reduced returns in the past, there is no guarantee that this relationship will continue in the future. Advisors have a responsibility to communicate this potential risk, as they would any risk. For example, as more and more investors look for companies that perform well on ESG metrics, they might increasingly pay a premium to invest in them, reducing future returns. A strict adherence to ESG criteria can also lead to large sector, market-cap, and geographical deviations from the market. At a minimum, investors weighting toward ESG preferences are making an active bet (whether they realize it or not) that the market has not fully priced in these factors, which may or may not pan out. For their part, sustainable investment managers typically seek to achieve competitive returns compared with other investments. However, they also typically acknowledge that constraining investments to a particular sustainable focus limits the types of investment available and could result in a focus on industries that underperform the market.

Investors with nonfinancial objectives fall into two categories: avoiders and amplifiers. However, these are not mutually exclusive concepts and investors can pursue both approaches at the same time.

Avoiders eschew investments in companies or industries that engage in controversial business activities or produce negative environmental or social impacts as a cost of business. For example, avoiders might purchase funds that screen out issuers using animal testing, selling controversial weapons, or mining coal. These avoiders may, of course, also be deciding on financial grounds that companies involved in certain controversial activities are not well-positioned for the future.

Perspective

Investors Vary in Their ESG Preferences but They All Must Consider ESG Risk



Source: Morningstar Analysis.

Amplifiers seek out investments in companies or sectors that create a positive environmental or social benefit. For example, amplifiers might look for companies focused on getting better access to medicine; helping people adapt to climate change; or developing new technologies to reduce carbon emissions such as electric vehicles, clean power technology, or green building products. Since these investments could help address the medium- and long-term challenges of adapting to a warming world, investors could have high returns expectations for these investments, or be motivated by a combination of financial and nonfinancial objectives.

Evaluating Long-Term Risks, Including ESG Risks, Is Fundamental to Investing

Values aside, ESG factors are key risks to corporate sustainability, and these risks are as important as any other risk that companies face. Just as businesses cannot ignore material risks from new competitors or changing technology, companies cannot ignore material risks that climate change—or government regulation to curb it—might affect their production capacity. They cannot ignore the risks that their employee health and safety practices might lead to a dearth of workers willing to work for them if labor markets tighten, or the risk that their management team is not properly incentivized to focus on long-term results. Considering these risks cannot be a check-the-box exercise. Different companies have different material ESG risks, and different industries have varying exposure to different types of ESG risks. But the long-term profitability of any investment can be undermined by unmanaged ESG risks.

Because ESG risks are relevant for long-term investing they should be considered as part of security analysis. Failing to do so can lead to an overestimation of a security's fair value. For their part, financial advisors need to ensure investors understand ESG risks just as they explain the way interest-

rate risk, default risk, currency risk, stock market risk, or sector-concentration risk (to name a few) could affect their investments.

Investors also need to understand the ESG characteristics of their portfolio because they add additional insights into the portfolio's possible risks and returns.⁹ In addition to finding that ESG factors are not associated with lower returns, we have also found that investments' low levels of ESG risk may be a distinct investment factor, largely uncorrelated with other investment factors such as company size or volatility.¹⁰ This means that investors can understand the risk in their portfolio in part based on the ESG characteristics of the securities they hold and use that to forecast their portfolio's risk in the future.

Asset Managers Increasingly Focus on Stewardship

Finally, asset managers are increasingly using their roles as stewards to move the companies in which they invest to address ESG risks.¹¹ One important way that asset managers act as good stewards of their clients' capital when they vote on shareholder resolutions or when they engage directly with companies they own, by meeting with company management to address ESG-related issues or to otherwise influence how these companies run. These direct engagements include private communications, and they may involve collaborations with other investors to gain more leverage over a company.¹²

One public way that asset managers act as stewards is through their proxy votes on behalf of their investors on shareholder resolutions. Shareholder resolutions facilitate a dialogue between investors and corporate management, and are used to suggest changes in corporate practice or disclosures; signal shareholder concerns; or create momentum for regulatory initiatives protecting investors.

These shareholder resolutions often address ESG issues, by requesting more disclosure on carbon emissions, gender pay discrepancies, or board diversity, for example. Morningstar research on asset manager proxy voting support for ESG-related shareholder resolutions shows that it has increased considerably over the past five years. Across all fund families Morningstar evaluated, average support for ESG shareholder resolutions increased to 46% in 2019, up from 27% in 2015.¹³ Morningstar also found that larger asset managers have lagged smaller asset managers in voting for ESG resolutions. That may in part be because larger asset managers have more ways to directly engage companies in which they invest, but it also appears to be changing. For example, in his 2020 letter to investors, Larry Fink, the CEO of the largest asset manager in world, BlackRock, wrote: "Investment stewardship is an essential component of our fiduciary responsibility. This is particularly important for our index holdings on behalf of clients, in which we are essentially permanent shareholders. We have a responsibility to engage with companies to understand if they are adequately disclosing and managing sustainability-related risks, and to hold them to account through proxy voting if they are not."¹⁴

⁹ Wang, P. & Sargis, M. "Better Minus Worse: Evaluating ESG Effects on Risk and Returns." Morningstar. Feb. 20, 2019. <https://direct.morningstar.com/research/doc/963558/link>

¹⁰ Ibid.

¹¹ Cook, J. "How Fund Families Support ESG-Related Shareholder Proposals." Morningstar. Feb. 13, 2020. <https://www.morningstar.com/insights/2020/02/12/proxy-votes>

¹² For more on engagement practices, see Cook, J. 2020. "Asset Manager Reporting on Climate-Risk Engagements: What It Tells Us About a Firm's Approach to Stewardship." April 17, 2020. <https://direct.morningstar.com/research/doc/978205/link>

¹³ Ibid.

¹⁴ See the letter here <https://www.blackrock.com/corporate/investor-relations/blackrock-client-letter>.

Other larger asset managers such as State Street and Vanguard have also expressed commitment to using their leverage in the proxy voting process, to compel companies to take ESG issues more seriously.¹⁵ Its importance was emphasized in the 2019 legislative updates to the EU Shareholder Rights Directive, which now requires asset managers to publicly disclose their engagement policy, and provide annual updates on its implementation and how material votes were cast.

A Wide Variety of ESG Metrics Guide Sustainable Investing Today, but There Are Opportunities to Further Improve Quality and Comparability of Data

Using data to ascertain whether an investment aligns with an investor's values and how much ESG risk is intrinsic to the investment is challenging with the best data. In this section, we discuss how, despite major progress in the past few years driven by investor demands and early regulatory efforts, the current state of ESG disclosures can still be improved to further empower investors. Simply put, ESG disclosures from issuers are all too often inconsistent and noncomparable, and material information is not always available. (These disclosures should not be conflated with the ESG ratings that end-investors often see from sustainability rating shops, which are based on a variety of sources and methods.)

The lack of consistent data is not the only reason that different analysts hold different points of view on the degree to which an investment is sustainable. That divergence of views is a feature, rather than a bug, of ESG investing. If every investor agreed on which companies faced what ESG risks, these risks would be fully priced into the securities that these companies issue. Just as portfolio managers hold diverse views on capital market assumptions, company valuations, and growth prospects, different sustainability raters and analysts have different ESG views. These differences make sense, just as it makes sense for different investment analysts to use the same financial information to value equities differently. However, to the extent that sustainability assessments vary owing to inconsistently available information, and to varying methodologies for estimating or extrapolating missing data by ESG analysts, it worsens ESG analysis for all investors. Analysts are also often forced to turn to other inconsistently available sources of information, such as surveys or controversies that garner news coverage. This absence of consistent data is also a burden on issuers, as they must respond to multiple enquiries from different analysts for more-detailed or consistent information.

Another reason that we see variability in sustainability ratings, even when there is high-quality ESG data, is that sustainability must be measured holistically, by considering a variety of ESG factors. A useful and comprehensive sustainability score for an investment should take a multidimensional approach and should include quantitative retrospective measures and evaluation of forward-looking plans. For asset managers, any evaluation of the sustainability of their strategy could also include their stewardship and engagement policies as an additional dimension. There are hundreds of measures to address the financial performance of an investment, and the same is true for sustainability performance. The difference is that many potential sustainability measures will not be material or useful for companies for which certain ESG factors are not relevant for their business.

¹⁵ See Vanguard's policy here: <https://about.vanguard.com/investment-stewardship/principles-policies/>
See State Street's here <https://www.ssga.com/us/en/individual/etfs/about-us/asset-stewardship>.

Gaps in Corporate Issuer Data Persist

Over the past half-decade, standard-setting organizations have produced volumes of recommended ESG indicators, disclosures, and metrics. These organizations and standards include approaches that are more focused on impact, such as the Global Reporting Initiative and the U.N. Guiding Principles Reporting Framework, as well as efforts that are more focused on financial materiality, such as the Sustainability Accounting Standards Board, and the Task Force on Climate-related Financial Disclosures. Unlike the SASB and the TCFD, the GRI focuses on nonfinancial materiality to a variety of community stakeholders, rather than financial materiality to shareholders. These kinds of disclosures are particularly important for investors who wish to invest in sustainable technology or business practices, or avoid investing in businesses that create negative externalities.

Despite these standards, investors still lack complete and consistent ESG data. Fewer than 30% of stock issuers around the globe disclose ESG factors in a comprehensive and consistent fashion.¹⁶ The public markets, despite their limitations, at least have some ESG data. More than 50% of new capital is being raised in the private markets in the U.S., which are exempt from most disclosures.¹⁷ These private issuances have minimal ESG disclosures at best. Indeed, only two out of 45 questions in a recent European consultation about standardized disclosure asked about applicability to non-listed companies. This lack of data is particularly problematic because some exempt investments, such as private equity funds, have begun to attract policymakers' interest for poor labor practices and possible price gouging.¹⁸ As more investors gain exposure to private firms, it will be increasingly important to consider the role of ESG data for nonpublic companies.

For their part, public companies produce voluminous sustainability reports, but they often pick and choose indicators from a variety of standard-setting organizations. These reports may not contain information that is material given the firm's business context, and do not help investors meaningfully understand a company's ESG risks while impeding comparisons between companies. Many of these reports read more like marketing documents than clear discussions of material ESG risk, or areas of investment in green technologies, leading to some cynicism on the part of asset managers and financial advisors about sustainable investing in general. Environmental, social, and governance disclosures need to focus on critical, material issues that are relevant to a company's business strategy and products.

In the fixed-income market, the available disclosures are inconsistent and incomplete to an even greater degree. For example, sometimes a bond's ESG rating is based on the ESG risk the issuer faces. Sometimes the ESG rating is based on the bond's use of proceeds—whether they are used to fund greener activities. A lack of consistency has made it difficult for investors interested in green bonds, arguably the most important way investors could achieve positive impact with their investments. The reason is that if investors eschew bond issuances that do not meet their sustainability standards, it will raise the cost of borrowing for those companies, perhaps forcing them to adjust their business

¹⁶ This data is from <https://www.globalreporting.org/Pages/default.aspx>, which lists 11,802 organizations (excluding governments, nonprofits, academia) that have published GRI reports. Assuming 44,000 companies on listed exchanges, less than 30% report ESG data.

¹⁷ United States Securities and Exchange Commission. 2020. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets. May 4, 2020. <https://www.sec.gov/rules/proposed/2020/33-10763.pdf>.

¹⁸ Warren, E. 2019. End Wall Street's Stranglehold On Our Economy. July 18, 2019. <https://medium.com/@teamwarren/end-wall-streets-stranglehold-on-our-economy-70cf038bac76>

approach to be more sustainable. Tentative steps have been taken to improve the situation, with the International Capital Market Association's green bond principles and the drafting of an EU Green Bond Standard, but ultimately, green bonds need to be comparable regardless of where they are issued.¹⁹

In short, investors do not lack ESG data from issuers (at least in the public markets), but they often lack the right data, which addresses material ESG risks and helps investors assess a business's environmental and social impact on the world. Too much ESG information, including data defined by standard-setting organizations, is backward-looking. This information largely tells investors about current operational efficiency but does not provide much insight as to where a company may be headed on the sustainability issues it faces. Nor do many disclosures help investors understand the metrics that companies use to measure their success in meeting the U.N.-defined Sustainable Development Goals, or SDGs. For example, an automobile manufacturer might disclose the emissions it has created to produce vehicles and might even discuss ways it plans to reduce that number in the future. But investors also need to understand the efficiency of the fleet; how it will adapt its business model, such as by making electric cars as governments around the world push for a lower-carbon economy; and even the carbon emissions produced in its supply chain.

Alongside more forward-looking disclosures, investors lack standardized, comparable retrospective ESG metrics. Of course, these metrics should only be disclosed when they are material to a company's products and business. These ESG factors tend to be sector-specific and can have a material impact on cash flow and valuation. Assessing them should be part of investment analysts' evaluation. For example, investors would benefit from a standardized disclosure of carbon-intensity that normalized carbon emissions to production output (rather than revenue) for all relevant industries such as electric power producers. There are also many industry-specific metrics outside of disclosures around climate change that could help investors. For example, standardized worker health and safety disclosures for apparel manufacturers and their supply-chain contractors, or the amount of plastic packaging in a consumer sector company's product, would be useful to investment analysts.

We also believe there are many ESG issues that are sector-agnostic but still essential to assess. For example, human capital is important for any company whose primary asset is a workforce that cannot be easily replaced, such as in "knowledge industries" like pharmaceuticals. Even for companies that do not require a skilled workforce, turnover measures can indicate how well the company could attract talent in tighter labor markets. Similarly, lax business ethics can mean management engages in slipshod practices that might invite regulators to fine or otherwise sanction a business, destroying the company's value for shareholders. As with all ESG disclosures, despite the glossy sustainability reports many corporations publish, there is a dearth of useful and comparable disclosures on these sector-agnostic topics.

¹⁹ https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-green-bond-standard-usability-guide_en.pdf

Moving beyond ESG-risk measures, investors focused on impact need relevant disclosures on how a company's activities align with the U.N. SDGs, such as sustainable water management, reducing poverty, reducing food insecurity, and, of course, adapting to or mitigating climate change. (The U.N. has defined 17 broad SDGs in total.) The lack of consistent, quantitative data on how companies are creating a positive impact, rather than merely mitigating their negative impact, remains a challenge for investors looking to direct capital to the SDGs. Specifically, while many companies disclose generally how some of their activities align with various goals, they rarely provide concrete data on how much revenue or capital investment is aligned with these goals, although the EU Taxonomy will gradually start to impose these kind of obligations on large companies in 2022. Instead of vague disclosures, investors need companies to disclose quantitative data on the more than 160 metrics related to the SDGs that the U.N. has developed.

Asset Managers Use "Sustainable" or "ESG" to Describe a Variety of Investment Strategies

There are now 311 sustainable open-end and exchange-traded funds in the U.S., along with more than 2,500 in Europe, as asset managers respond to investors' demand for investments that align with their sustainability preferences and values, according to Morningstar data. However, "sustainable" funds use the term to describe a wide variety of strategies. Our sustainable funds framework includes three subgroups of funds: ESG Focus funds; impact/thematic funds; and sustainable sector funds. ESG Focus funds use ESG criteria as a key part of their security selection and portfolio construction process. Impact/thematic funds seek to make a measurable impact with investments on specific thematic areas like climate change, gender diversity, and community development. Sustainable sector funds are nondiversified funds investing in mostly environmental-services industries and renewable energy.

In addition to funds committed to sustainability, many otherwise conventional funds now include some consideration of ESG issues within their investment process.²⁰ ESG Consideration funds invest across a variety of asset classes and implement their goals in numerous ways. These funds are also becoming increasingly common as more asset managers incorporate ESG factors in their analysis: In two years the number of ESG Consideration funds in the U.S. grew over tenfold, from fewer than 50 at the end of 2017 to over 500 as of December 2019.²¹ In Europe, integrating ESG factors at the research, securities selection, and/or portfolio level has become the norm.

Finally, mutual fund asset managers inconsistently disclose ESG information about their holdings. Third parties can analyze a fund's holdings to present an impartial estimate of the degree to which a fund is sustainable or meets various ESG measures. However, such an approach may not align with the definition the asset manager uses to define an ESG holding or how their strategy reflects an ESG approach. This sustainability data is valuable for investors, and asset managers should present sustainability information in a way that helps lay investors understand a fund's sustainability objectives.

²⁰ Hale, J. 2020. "The Number of Funds Considering ESG Explodes in 2019." Morningstar. March 30, 2020. <https://www.morningstar.com/articles/973432/the-number-of-funds-considering-esg-explodes-in-2019>.

²¹ Ibid.

To some extent, this is a problem caused by inconsistent disclosures from issuers. For example, companies inconsistently disclose their direct and indirect carbon emissions, as well as the carbon emissions in the value chain, so asset managers often end up double-counting carbon emissions. To understand why, consider an asset manager that discloses the carbon footprint for a portfolio with equities issued by a company that reveals the carbon it produces (called scope 1 emissions), and also the carbon that its energy suppliers produce (scope 2 emission). This company is also part of the supply chain for a second company, which also discloses the emissions of the first company as part of its supply chain (scope 3 emissions.) The asset manager has now double-counted the emissions of the first company. In an ideal world, every issuer would disclose their scope 1 and scope 2 emissions, eliminating the need to worry about double-counting, but since disclosure practices vary, double-counting is a major issue at the portfolio level because it can overestimate exposure to carbon risks.

Policymakers Can Improve ESG Investing by Standardizing Key Data, Terminology, and Disclosures as well as Removing Arcane Regulatory Barriers

Policymakers need to be cautious about stifling innovation, but they also need to help investors by standardizing ESG disclosures to make them more comparable, material, and useful. Regulators need to embrace third-party standard-setting organizations' metrics for reporting ESG indicators, with an emphasis on material and forward-looking disclosures. Just as regulators have deputized standard-setting organizations, such as the Financial Accounting Standards Board, for determining the financial information issuers must disclose, organizations such as SASB should play a vital role in future ESG disclosure.

Already, standards set by GRI and TCFD are referenced in dozens of proposed or finalized regulations around the world and in multiple stock exchanges' listing requirements. However, as they embrace these standards, regulators need to use their influence to ensure they are better targeted and more useful than they are today. In short, plenty of useful metrics have been developed—regulators need to embrace standard-setting organizations into legally required disclosures as they have done for financial reporting, but they need to harmonize these disclosures as they do so and push issuers to focus on material ESG disclosures. Additionally, some archaic policies in the U.S. have made retirement-plan administrators skittish about offering ESG investments, and these barriers must be lifted.

Regulators Can Push Corporate Issuers to Improve Their ESG Disclosures

At the issuer level, as investors increasingly consider ESG factors, regulators must help the market coalesce around a standard set of ESG disclosures. Investors do not just need more ESG data—they need material, comparable, and timely ESG data that helps them make decisions about their investments. While the efforts from standard-setting organizations have led investors to appreciate the importance of ESG disclosures, it also means there is ESG disclosure overload. As regulators start to require a standard set of disclosures, they must require principles-based disclosures that provide flexibility so that issuers (and asset managers) disclose all material issues, rather than take a cookie-cutter or check-the-box approach. They should also seek to gradually extend reporting requirements from the largest firms, to substantially all companies. There are unique challenges for disclosures from issuers to investors and asset managers, and from asset managers to investors for the ESG characteristics of pooled investments such as mutual funds, ETFs, or collective investment trusts.

Disclosure

Aligning ESG Reporting Across Issuers Will Make It Easier for Investors to Compare Them



Source: Morningstar Analysis.

Regulators need to nudge markets toward a more standard set of sector-specific disclosures on their environmental impact, starting with climate change. These frameworks should be standardized across issuers, when they are material, and must include forward-looking disclosures, backward-looking metrics, a discussion of risk management, and climate scenario analysis. A vast majority of companies in most sectors face risks from climate change, and many will also potentially see opportunities.

Organizations and regulators are increasingly incorporating the TCFD recommendations into their disclosure requirements. The TCFD requirements are comprehensive, and balance forward-looking disclosures with backward looking metrics, and we support their increasing incorporation into reporting requirements. For example, in the U.K. the government set an expectation in its Green Finance Strategy²² that all listed issuers and large asset owners would be disclosing in accordance with TCFD recommendations by 2022. At the EU level, the commission is targeting more standardization of issuers' nonfinancial reporting, where its existing nonbinding guidelines²³ already integrate TCFD recommendations. Nonetheless, climate change disclosures are not enough: Regulators around the world should start requiring disclosures from issuers on other environmental impacts such as wastewater management.

Further, investors need more indicators about the positive impacts companies make if they want to direct capital toward solving sustainable-development challenges. In the EU, regulators have begun

22 U.K. Treasury and Department for Business, Energy & Industrial Strategy. 2019. Green Finance Strategy. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf

23 U.K. Treasury and Department for Business, Energy & Industrial Strategy. 2019. Green Finance Strategy. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf

to build a taxonomy designed to identify company activities that contribute to mitigating climate change or adapting to it without hurting other environmental objectives. There are plans to expand this taxonomy to cover other SDGs such as protecting water and marine resources, and mitigating other kinds of air pollution. These efforts should lead to a wealth of new information for investors to consider. However, the sustainable taxonomy's full value will depend heavily on how well it is presented and explained by companies and financial products. This is an area that regulators are highly focused on as they draft and publish the detailed implementing standards in 2020. It is an area that Morningstar is monitoring closely and will be engaging in with the regulators during their consultation phases.

Regulators also need to focus on baseline ESG disclosure requirements for critical indicators across industrial sectors. To name a few examples, we believe every business should disclose workforce turnover, workforce cost, and workforce safety. Regulators should also require all businesses to disclose key information on board diversity that is standardized and comparable as well as demographic data of the workforce. In terms of governance, companies should disclose their policies on bribery and corruption, whistle-blowing, and their codes of ethics. Again, there is positive momentum around the world. The EU is deep into defining these requirements as part of the sustainable action plan and has required some level of ESG disclosure since 2018. In China, the China Securities Regulatory Commission will require all listed companies and bond issuers to disclose ESG risks associated with their operations.²⁴

These standardized ESG disclosures must look like other kinds of financial disclosures, and regulators must mandate that ESG data is temporally aligned with financial disclosures and machine-readable in a standard format with a standard taxonomy where appropriate. If ESG disclosures cover different time periods than financial disclosures, then investors cannot easily connect these ESG disclosures to financial results, nor can they act on them in concert as they evaluate the fair value of a security. As financial disclosures increasingly move to machine-readable (typically extensible business reporting language) disclosures, ESG data must as well. Transparency in capital markets is critical so that investors compare investments to each other. Machine-readable disclosures for key ESG metrics will make it easier for investors to find opportunities, greatly increasing processing time for these disclosures so that they are widely available and reduce human error as the market processes new filings. These machine-readable disclosures will be particularly critical for smaller issuers where there are fewer human analysts analyzing non-machine-readable disclosures.

Regulators Can Help Build Confidence That Sustainable Funds Do What Investors Expect

Regulation should require asset managers to provide clear, consistent descriptions in prospectuses on funds' approaches to considering or incorporating ESG factors in their analysis and through their stewardship activities. The clearest fund-level disclosures describe screens for controversial business activities.²⁵ The massive growth in funds that consider ESG factors is not surprising given investor interest and the importance of taking ESG risk into account in security selection. The challenge is that simply adding a line to a prospectus that "ESG is considered" does not convey the extent to which

²⁴ See news release here: http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201911/t20191129_366686.htm

²⁵ Hale, J. 2020. "The Number of Funds Considering ESG Explodes in 2019." Morningstar. March 30, 2020. <https://www.morningstar.com/articles/973432/the-number-of-funds-considering-esg-explodes-in-2019>

the manager acts on ESG factors. In fact, nearly 60% of these consideration funds in the U.S. fail to earn a High Morningstar Sustainability Rating.

Investors need clear and consistent disclosures that make it easy to understand what a portfolio manager is doing when it considers ESG factors, and that these considerations may not make it more sustainable. Passing references to ESG do not necessarily mean a fund is committed to sustainable investing practices. For example, one of the largest funds with an ESG consideration statement notes that “Factors considered may include analysis of an issuer’s earnings, cash flows, competitive position, and management ability. [The fund] may also consider environmental, social, and governance (ESG) factors in its fundamental investment analysis.”

While this disclosure signals to investors that ESG factors are important and the fund is not blind to them, it does not clarify the extent to which the manager incorporates these ESG factors in its capital-allocation process, nor which ones they are most likely to consider. Ultimately, Morningstar believes investors need to be shown the limitations of these consideration funds (for example, using our globe ratings), while being able to see what differentiates an ESG consideration fund from funds that more fully integrate ESG into their process.

Similarly, investors need more disclosure for funds on the extent to which they integrate different ESG factors. Investors interested in amplifying the effect of their investments also need consistent disclosures that explain how a fund does so and how it evaluates success. For example, in a recent analysis, Morningstar found that funds that market themselves as climate funds often have exposure to companies deriving revenue from fossil fuels.²⁶ Such exposure may be appropriate given a fund’s strategy, but it’s important that investors understand what they are getting from their investment.

Given these needs and the current state of disclosures, we believe that regulators should require that funds with “sustainability” in their names should be able to demonstrate “intentionality”—that is, that their process is carefully designed to consider a variety of ESG indicators to arrive at a sustainable investment mix. Regulators should require funds that include “sustainability” or “ESG” in their names to evaluate all aspects of ESG, both qualitatively and quantitatively. For example, in Hong Kong, the Securities and Futures Commission requires green or ESG funds to substantiate that they invest primarily in sustainable securities. The EU is currently considering whether to pursue a union-wide “ecolabel.” Certifying a sustainable or green fund could help investors know they are getting what they pay for, instilling confidence in sustainable funds, in addition to new sustainability disclosures that every fund will need to provide. Given the existing regulatory efforts to require asset managers to disclose their process incorporating ESG into their fund’s security selections, we do not think that an ecolabel requirement is warranted. However, ecolabels can help investors as long as their assessment methodologies are transparent and audited, fees for labels are reasonable, and they require quantitative reporting of positive as well as negative impacts.

²⁶ Bioy, H. 2020. “Investing in Times of Climate Change.” Morningstar. April 21, 2020. <https://www.morningstar.co.uk/uk/news/201578/investing-in-times-of-climate-change.aspx>

Additional Barriers That Need to Be Removed in Order to Mainstream ESG into Investing

As we have referenced, there are many actions of varying ambition and at different stages of development aiming to eliminate obstacles to sustainable investing. In sharp contrast to much of the rest of the world, including Europe and Asia, U.S. policy creates specific challenges for ESG investing but these are not being addressed. U.S. policymakers should remove these barriers, given the importance of using ESG data for investors. These barriers include confusion over the role of ESG in workplace retirement plans, attacks on shareholder rights, and weak regulatory guidance on ESG disclosure generally, and climate-change disclosure specifically.

Most retirement savings are accumulated in workplace defined-contribution plans, such as those governed by section 401(k) of the tax code.²⁷ Congress did not contemplate ESG or socially responsible investments in 1974, when it passed a sweeping law that regulated workplace retirement-plan investments, and it has not updated this important legislation to promote ESG investing.

When Congress reformed retirement savings through the Employee Retirement Income Security Act of 1974, policymakers focused on ensuring that everyday people's money was kept out of objectives that were unrelated to helping participants attain a secure retirement, so they placed restrictions on "economically targeted investments." ERISA's restrictions (rather awkwardly) have been applied to contemporary investments that may provide social or environmental benefits, leaving plan administrators reticent to include investments that highlight the use of ESG factors. This set of rules was never meant to be an ESG policy for retirement plans. Certainly, other jurisdictions believe that ESG investments are compatible with the goals of saving for retirement. However, to the extent that the current law and the Department of Labor interpret sustainable investing under the existing law's treatment of economically targeted investments, it has blunted the availability of ESG strategies in retirement plans.

This barrier is particularly problematic in retirement plans, because most investors saving for retirement are long-term investors trying to address a need that may be decades in the future. Since the long-term risks they face include ESG risks, particularly climate change, the lack of strategies that emphasize ESG metrics could reduce their ability to invest successfully for these goals.

The U.S.'s fiduciary barrier to using ESG factors for investment selection also stands in sharp contrast to the rest of the world. The EU now requires asset managers to integrate ESG factors into their overall investment process or explain why they do not do so. In Japan, the Financial Services Agency is revising its code of conduct to require institutional investors to focus on ESG factors as they consider investments and engage with companies in which they invest.²⁸

Additionally, the U.S. lags the EU and other markets in requiring publicly traded companies to disclose clear, comparable ESG metrics. In the U.S., despite some 2010 guidance from the SEC, investors generally find climate change disclosures incomplete, noncomparable, and lacking in key metrics or

²⁷ Copeland, C. 2018. "EBRI IRA Database: IRA Balances, Contributions, Rollovers, Withdrawals, and Asset Allocation, 2016 Update." Employee Benefits Research Institute. Aug. 13, 2018. https://www.ebri.org/docs/default-source/ebri-issue-brief/ebri_ib_456_iras-13aug18.pdf?sfvrsn=6a58352f_2

²⁸ Financial Services Agency. 2020. "Principles for Responsible Institutional Investors." March 24, 2020. <https://www.fsa.go.jp/en/refer/councils/stewardship/20200324/01.pdf>

forward-looking analysis.²⁹ Two bills—the ESG Disclosure Simplification Act of 2019 and the Climate Risk Disclosure Act of 2019—would require to the SEC to make more specific rules around metrics and disclosures for climate change issues and ESG issues more broadly.

These bills would address the challenges investors face in finding useful and comparable ESG disclosures when studying U.S. securities. The Climate Risk Disclosure Act would fill major gaps in U.S. companies' disclosures by requiring the SEC to define the key climate metrics that different sectors would need to disclose, and require companies to disclose their assumptions and methodologies for forward-looking warming analysis for their businesses. It would both codify in law the requirement to make these disclosures and go further than the SEC's 2010 guidance. The ESG Disclosure Simplification Act would require companies to disclose more robust, useful, and comparable ESG information. Both acts would incorporate and build on the work of outside experts and standard-setting organizations, while allowing the SEC to ultimately set rules to better align these ESG disclosures.

Finally, in the area in which the U.S. has long led Europe and other regions with a robust shareholder resolutions system, a recent proposal would make it much harder for shareholders to influence corporate management to disclose more ESG data. Shareholders' participation in the proxy process via shareholder-resolution filing has resulted in important enhancements to corporate disclosures on ESG matters. Even when these resolutions do not pass, they signal to management that investors want to see these kinds of disclosures.

Even so, the SEC has proposed a rule that would make this process much more restrictive. It proposes, among other things, raising the submission and resubmission voting thresholds that qualify shareholder resolutions for the ballot.³⁰ This would increase the thresholds of votes cast to 5% if previously voted on once in the past five years (up from 3%); 15% if previously voted on twice in the past five years (up from 6%); and 25% if previously voted on three times or more during the past five years (up from 10%). In all these cases, the most recent vote must have taken place within the past three years.

We believe the proposed rule will stifle investors' voices, making it harder for them to signal which kinds of ESG disclosures they view as important. Investors are continually learning about how various risks, including those that become the subject of shareholder resolutions, affect their investment portfolios. Shareholders often need time to learn and educate their peers about risks. The 2019 proxy season demonstrated that shareholders now are more concerned about climate risk, along with human rights risks and corporate political activity that presents reputational risk. It is not necessary, nor is it in the interest of investors, for the SEC to further limit how often and under what circumstances investors can bring shareholder resolutions.

Further, shareholder resolutions spark dialogue and facilitate change through engagement as well as voting. Sometimes a proposal is withdrawn because of engagement and dialogue sparked by that

29 See for example commentary by the US SIF: The Forum for Sustainable and Responsible Investment, The Interfaith Center on Corporate Responsibility, and Ceres, available here: https://www.ussif.org/files/Public_Policy/Comment_Letters/Business%20Case%20for%2014a-8.pdf.

30 U.S. SEC. 2019. Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8. Dec. 4, 2019. <https://www.govinfo.gov/content/pkg/FR-2019-12-04/pdf/2019-24476.pdf>

proposal, as was the case with climate-change proposals during this past proxy season. Shareholder resolutions also prompt institutional investors, such as asset managers, to engage with companies on high-profile issues. Just as the large asset managers are showing a renewed commitment to stewardship, reducing shareholders' voices would be a step in the wrong direction to mainstream ESG investing.

Conclusion and Summary of Policy Recommendations

As this analysis illustrates, there is a mismatch between investors' needs for clear, comparable, and material ESG data and the current state of ESG disclosures. Investors need this data because they increasingly want to evaluate the ESG risk and its impact in their portfolios. The data these investors need can be standardized although their motivations may be highly varied. Whether they are avoiders, eschewing investment in certain businesses, or amplifiers, seeking out positively influential companies, we believe that investors should have the right to incorporate ESG preferences into their investing approach. Similarly, financial professionals need to be able to meet investors' needs and financial professionals have a responsibility to manage ESG risk, just as they would manage any other investment risk.

Worldwide, policymakers can improve ESG investing by collaborating and working with expert groups to standardize key data, terminology, and disclosures. In recent years, financial regulators across the world have begun to focus on ESG, with the EU in the vanguard. As they take the next steps in mainstreaming ESG disclosures to help investors, regulators should integrate the following principles. The U.S. lags much of the rest of the world, and American regulators can remove specific barriers that are slowing the growth of ESG investing in the U.S. compared with Europe. ■■

Principles for Regulators Across the Globe

1. Regulators should embrace standard-setting organizations' existing metrics and require issuers to disclose these metrics when they are material to a company's business or to their broader stakeholders.
2. Regulators should coordinate with each other so that investors in different jurisdictions have access to comparable ESG metrics.
3. Regulators should ensure that the ESG disclosures are temporally aligned with financial disclosures.
4. For pooled investments, regulators should set a minimum standard so that investors know whether a fund considers ESG factors at all as part of its investment process and if a fund considers ESG criteria, sustainability assessments, or impact assessments as central to its investment approach.

Additional Regulatory Barriers U.S. Regulators Can Lift

1. Congress and the Department of Labor should clarify that retirement plans can incorporate ESG factors into the selection of investments available to their participants
2. Congress should require the kinds of ESG disclosures for issuers that other jurisdictions have begun requiring, and the SEC should implement this requirement following the principles above.
3. The U.S. should not backslide by weakening its world-class proxy voting system.

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