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U.S. ESG in 2023: A Snapshot

Assets, political pressure, regulation

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Views

About the Author



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Michele is a director of the Institutional practice and leads research for annual reports and strategic consulting engagements. She specializes in environmental, social, and governance investing and outsourced CIO research.

Prior to joining Cerulli Associates, Michele worked at Cambridge Associates as an Associate Director in the Client Relationship Management Group. Additionally, she worked at Manulife Asset Management in the Institutional Investment Sales & Services Group, and held roles in Product Management and Client Relationship Management. She began her career as an analyst in the Investment Policy & Research Group at John Hancock.

Education

- University of Massachusetts at Amherst
Bachelor of Business Administration
- Boston College
Master of Science in Finance

Honors and Awards

- CFA® charterholder and member of the CFA Society Boston

Areas of Expertise

- Environmental, social, and governance investing
- The outsourced CIO industry
- Investment consultants
- Alternative investments

Key Points

- Cerulli projects that U.S. ESG-focused mutual fund and ETF assets will surpass \$1 trillion by the end of 2025.
- A full three-quarters (75%) of asset managers cite that clients' belief that ESG is mainly driven by political views is at least a moderate challenge to increasing client receptivity of ESG issues, up from 49% in 2021.
- While a majority (87%) of managers polled tell Cerulli they are currently mentioning their use of ESG information in prospectuses and other documents, market sizing and analysis suggests that these percentages are much lower.



ESG assets

As of June 30, 2022, total U.S. publicly traded ESG consideration product assets tracked by Cerulli, a category that encompasses traditional products that consider ESG criteria, stood at \$9.1 trillion, up from \$7.3 trillion a year earlier.

U.S. publicly traded ESG-focused product assets ended 2021 with a record \$1.2 trillion but slipped to \$950.4 billion as of June 30, 2022. Both equity and fixed-income markets have been impacted by economic and policy uncertainty, causing volatility and pressuring investment returns in 2022. Cerulli projects that U.S. ESG-focused mutual fund and ETF assets will surpass \$1 trillion by the end of 2025. ETFs will experience the strongest growth rate, climbing to \$564.7 billion by year-end 2027.

However, assets do not tell the whole story in the United States. A full three-quarters (75%) of asset managers cite that clients' belief that ESG is mainly driven by political views is at least a moderate challenge to increasing client receptivity of ESG issues, up from 49% in 2021. Helping clients understand impact/measurable benefits of ESG (87%) and the perception that an additional layer of investment analysis drives up expenses and management fees (86%) are also identified by asset managers as at least moderate challenges to increasing client receptivity of ESG issues. Additionally, difficulty defining the boundaries of ESG was also cited as a challenge by half (51%) of managers polled.

Political pressure

The U.S. political environment has become increasingly polarized, as the two sides of the aisle have disparate views on timely environmental and social-related issues, in particular climate change, when it comes to investment portfolios. Of late, environmental, social, and governance (ESG) and sustainable investing has been met with backlash by politicians at both the congressional and state level. Some politicians view these practices as ideologically driven or partisan in nature. For example, several states including Texas, Florida, West Virginia, Louisiana, and Oklahoma have either proposed or implemented policies to penalize pension plans, asset managers, and banks that are addressing the risks of climate change.

To alleviate skepticism from investors caused by recent political backlash, Cerulli asserts that asset managers need to discuss the merits of ESG and sustainable investing with their clients and reinforce how and why they are using relevant ESG data to drive long-term economic value. Educating clients on how ignoring ESG risks, such as climate risk, is likely to harm long-term returns will help show clients that ESG is not about politics, it's about managing investment risks and returns.

Asset Managers: Challenges to Increasing Client Receptivity of ESG Issues, 2022

■ Major challenge ■ Moderate challenge ■ Not a challenge

Belief that ESG analysis is primarily about negative screening



Difficulty defining the boundaries of ESG/SRI



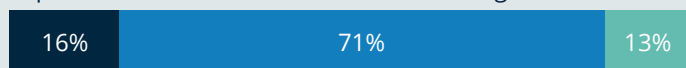
Client unfamiliarity with ESG factors/criteria



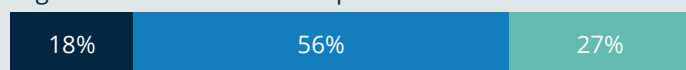
Firm's intentions of ESG commitment in investment analysis



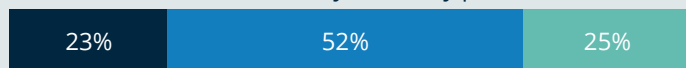
Helping clients understand impact/measurable benefits of ESG investing



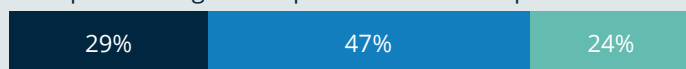
Regional client differences/expectations of ESG issues



Client belief that ESG is mainly driven by political views



Perception of negative impact on investment performance



Perception that additional layer of investment screening drives up expenses and management fees



Source: Cerulli Associates

On the other hand, some states are requiring fiduciaries to divest holdings in fossil fuel. Public pension funds and investment managers are often feeling the heat from moving too slowly on divesting fossil fuel assets, coupled with pressure from radical divestment campaigns. Unfortunately, the responsibility of navigating the complexities of these demands falls on asset managers and pension plan fiduciaries, as these asks do not typically consider the challenges of managing the assets.

The asset allocation, composition, and liquidity of each portfolio is unique. One-size-fits-all divestment timelines imposed by lawmakers and other activists are not always easy for pension trustees and investment managers to comply with and are restrictive in ways that don't make sense. Cerulli advises that pension trustees and investment staff work closely with their investment consultants, outsourced CIOs, and asset managers to develop a reasonable blueprint and timeline for divestment plans that allows pension trustees to maintain their fiduciary duty and act in the best interest of plan participants.

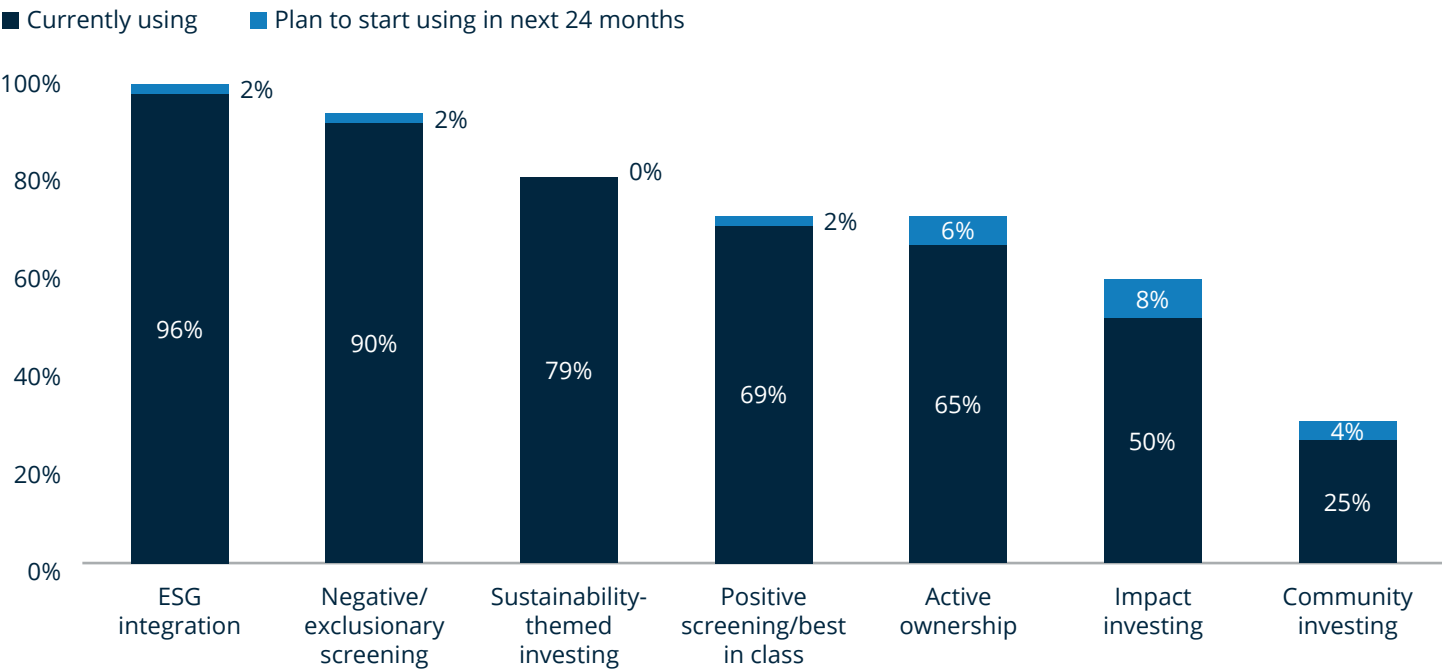
Managers' approaches to ESG

In the near term, recent pressures faced by investors have not impacted asset managers' responsible investing plans, with nearly all survey participants saying that they use material ESG information when evaluating underlying investment portfolio companies to identify risks and opportunities. Product development and active ownership activities also remain strong. Unavoidably, managers have noticed an uptick in the number of clients that perceive that ESG is politically motivated, given the recent anti-ESG rhetoric.

Nearly all survey participants have (96%) or plan to have (2%) an ESG Integration approach and are using material ESG information when evaluating underlying investment portfolio companies to identify risks and opportunities. Asset managers are also offering and developing a range of responsible investment strategies: negative screening (90%), sustainability-related thematic investing (79%), positive screening (69%), impact investing (50%), and community investing (25%).

Consistent with last year's survey results, risk mitigation is cited as the top reason why asset managers are incorporating ESG information into investment analysis and decision-making, with 76% of participants citing this as a significant reason. Aligning investment objectives with clients' values (68%), client demand (66%), and fiduciary duty (62%) are also cited as top factors for asset managers using ESG information in investment analysis.

Asset Managers: Methods for Considering ESG Issues, 2022



Source: Cerulli Associates

Recent regulation

Nearly half (48%) of asset managers cite insufficient data from third-party providers on ESG criteria and more than one-third (36%) identify limited/selective disclosure of ESG issues from companies as major internal challenges to incorporating ESG criteria into investment decision-making.

The U.S. took positive steps to address regulation in 2022, with the Securities and Exchange Commission (SEC) issuing a number of proposed rules addressing ESG disclosure. To provide investors with more transparency and standardization around ESG strategies, the SEC proposed the “Enhanced Disclosure by Certain Investment Advisers and Investment Companies about ESG investment practices” rule. The rule would require funds to disclose more about how they use ESG considerations and data. While a step in the right direction, asset manager feedback gathered during the comment period show that many managers believe that the SEC needs to narrow the focus of the proposed ESG disclosures.

A growing percentage of asset managers are disclosing their consideration of ESG information in prospectuses and other formal fund documents for ESG consideration funds. While a majority (87%) of managers polled tell Cerulli they are currently mentioning their use of ESG information in prospectuses and other documents, market sizing and analysis suggests that these percentages are much lower (as shown in ESG consideration assets, which total \$9.1 trillion as of 2Q 2022). If the SEC finalizes its proposed regulation asking for more transparency around ESG strategies including products that don't have a specific sustainable or ESG-focus, asset managers should prepare for additional scrutiny from the SEC if these proposed disclosure requirements get approved.

Additionally, to address potential “greenwashing,” the SEC has also proposed an amendment to modernize the Investment Company Act “Names Rule.” Lastly, the SEC issued a proposed rule that would require U.S. publicly traded companies to disclose emissions data and provide transparency into how their businesses are assessing, measuring, and managing climate change risk. Asset managers widely view this proposal positively.

Asset Managers: Internal Challenges to Incorporating ESG, 2022

■ Major challenge ■ Moderate challenge ■ Not a challenge

Insufficient data from third-party providers on ESG criteria



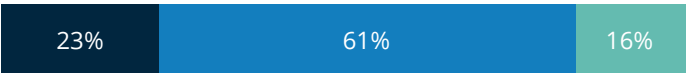
Limited/selective disclosure of ESG issues from companies



Subjectivity of ESG factors in investment analysis



Credibility of ESG factors/criteria



Integration of ESG criteria into quantitative/risk models



Firm's technology and infrastructure not able to accommodate ESG data



Source: Cerulli Associates | Analyst Note: One participant cited small and micro-cap stock coverage as a major challenge, given the lack of ESG data for these underlying companies.





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Cerulli Research and Consulting

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