Morgan Stanley

Bloomberg®

INSTITUTE FOR SUSTAINABLE INVESTING

Sustainable Signals:

Growth and Opportunity in Asset Management

Executive Summary

Sustainable investing has gone mainstream in the United States. A new survey reveals that asset managers now view sustainable investing as a strategic business imperative. Asset managers surveyed foresee a rosy outlook for both client demand and competitive returns, and will continue to build their sustainable investing capabilities and product portfolios in the coming years.

This survey by the Morgan Stanley Institute for Sustainable Investing and Bloomberg highlights the growth, direction and future outlook of sustainable investing among U.S. asset managers. It builds on a survey and interview series first conducted in 2016.

In our 2018 survey …

Key Insights

Our findings revealed four central themes:

1

Sustainable Investing Goes Mainstream

The rapid growth of sustainable investing has continued apace since our first survey of U.S. asset managers in 2016. Respondents overwhelmingly agree that sustainable investing is no longer a fad, with 89% saying it is here to stay and 63% saying they expect adoption to grow in the next five years. Three in four U.S. asset managers say their firms now offer sustainable investing strategies, up from 65% in 2016.

89%

say sustainable investing is here to stay.

2

A Financial Case for Sustainable Investing

As sustainable investing matures, most asset managers surveyed are putting financial considerations at the forefront of their sustainable investing strategies (79%). Looking ahead, 82% think strong ESG practices can lead to higher profitability and that companies with such practices may be better long-term investments. Almost two thirds (62%) believe it's possible to maximize financial returns while investing sustainably. Among those practicing sustainable investing, increased investment stability and high client satisfaction were the top drivers of success.

82%

think strong ESG practices can lead to higher profitability.

3

Product Types Proliferate, Expanding Investor Choice

As more firms embrace sustainable investing strategies, they are offering more ESG-tailored investment vehicles and expanding investor choice. Sixty-two percent of respondents' firms offer mutual funds that integrate sustainability or ESG considerations, followed by alternatives (55%), exchange traded funds (51%) and separately managed accounts (45%). Sixty-three percent employ more than one sustainable investing strategy across shareholder engagement, restriction screening, ESG integration, thematic investing and impact investing.

63%

employ more than one sustainable investing strategy.

4

Expertise, Better Data and Impact Reporting Support Customization and Drive Future Success

The industry is betting on continued growth, and 68% of survey respondents expect to see the most growth from customized products. In preparing for enhanced client sophistication and demand, nearly all (89%) respondents report their firms will devote more resources to sustainable investing in the next two years.

Better data is also critical to future growth. Seventy percent of respondents felt that the industry lacks standard metrics to measure nonfinancial performance of sustainable investments, hindering their ability to quantify impact. Yet more firms will need to measure and report the ESG impact of their portfolios amid rising investor demand for such information.

68%

expect to see high growth in customized solutions.

Methodology

The Morgan Stanley Institute for Sustainable Investing and Bloomberg L.P. partnered to support this second edition of a biannual analysis of trends in sustainable investing among asset managers. This work builds on the 2016 report *Sustainable Signals: The Asset Manager Perspective*. Analysis included:

SURVEY: A quantitative survey, conducted by market research firm Edelman Intelligence, of 300 respondents at U.S. asset management firms that each manage at least $50 million in client assets. Respondents included employees from a range of professional roles, including C-Suite, senior executives, portfolio managers and analysts. The survey was conducted online from March 12–30, 2018.

Quotas were set on certain response criteria to ensure a sample composition comparable to 2016. These included: firm's primary clients, headquarters geography, type of firm, total assets of firm, asset classes managed and respondent's job function.

INTERVIEWS: In-depth phone interviews were conducted with employees at 10 asset management firms active in sustainable investing, primarily in the public markets. Interviewee firms were selected because they have a historical track record of offering sustainable investment products, are new entrants to the sustainable investing field or have a noteworthy approach to sustainable investing. They included both specialists and adopters, as defined in the survey. Interviews were conducted by the Initiative for Responsible Investment (IRI) at the Harvard Kennedy School between May 7 and June 15, 2018.

DEFINITIONS: In the survey and interviews, sustainable investing was defined as the practice of making investments in companies or funds that aim to achieve market-rate financial returns alongside positive social and/or environmental impact.

Throughout this brief, "survey" or "respondents" refers to the group that responded to the quantitative survey. "Interviewees" or "subjects" refers to the group that participated in phone interviews.

Sustainable Investing Goes Mainstream

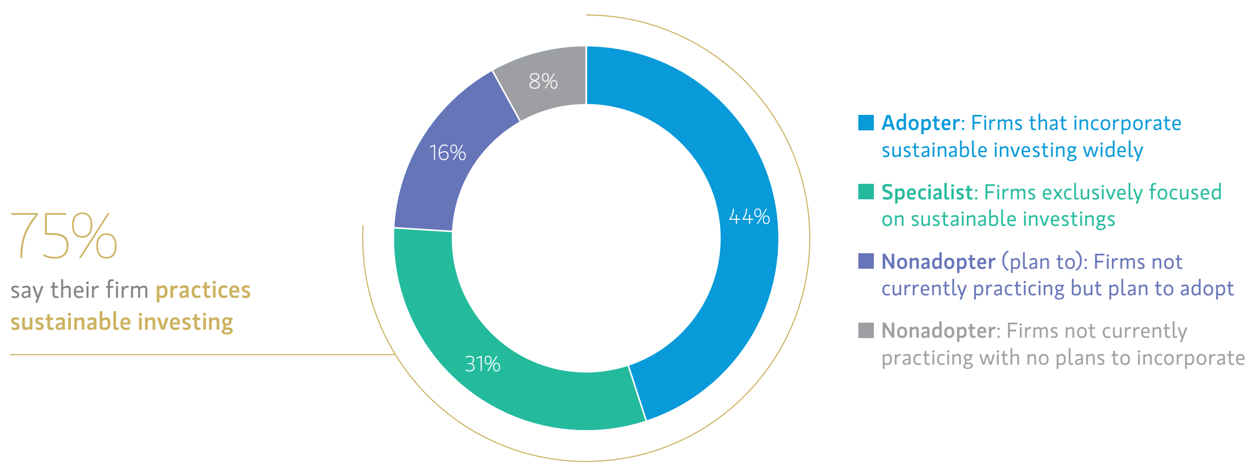
With $12 trillion, or one quarter, of U.S. assets under professional management now considering sustainability principles,[1] sustainable investing is no longer practiced in a silo by boutique investors and specialist firms. The industry has matured to the point where environmental, social and governance (ESG) factors are being widely incorporated into investment processes across the spectrum of investors. Three in four survey respondents (75%) report that their firms have adopted sustainable investing, up from 65% in 2016.

Firms with sustainable investing strategies reflect a mix of specialists that focus exclusively on sustainable investing (31%) and more mainstream players that have adopted investing across their practices (44%). This mainstreaming trend is also far from peaking. Two-thirds of respondents that don't currently practice sustainable investing said their firms actively plan to incorporate such strategies in the future.

Most Respondents Have Adopted Sustainable Investing

FIGURE 1

Which of the following best describes your firm when it comes to sustainable investing? (n = 300)



Respondents with sustainable investing practices employ a broad spectrum of sustainable investing approaches, including thematic investing (51%), ESG integration (46%), impact investing (45%), shareholder engagement (43%) and restriction screening (29%). In the two years since our first survey and interview cohort, the field appears to be coming into its own, with specialists (those exclusively focused on sustainable investing) and adopters (those incorporating sustainable investing widely) each finding a foothold. For the specialists, depth of knowledge and engagement with investors have driven growth and success, while for the adopters scale and impact are the key drivers. In both our survey and interviews, asset managers across the board appeared committed for the long haul, with a focus on building skills and tools to strengthen meaningful and credible approaches to sustainable investing.

Almost nine in 10 (89%) respondents believe sustainable investing is here to stay and 63% expect adoption to grow in the next five years. Even interviewees from firms that are recent entrants to the field described their work as a commitment to sustainable investing rather than an exploration of whether it was worth pursuing.

89%

of respondents believe sustainable investing is here to stay.

Sustainable Investing Approaches Defined

In this survey, sustainable investing approaches were defined as follows:

RESTRICTION SCREENING

Exclusionary, negative or v alues-based screening of investments.

ESG INTEGRATION

Proactively considering ESG criteria alongside financial analysis.

THEMATIC INVESTING

Pursuing strategies that address sustainability trends such as clean energy, water, agriculture or community.

IMPACT INVESTING

Seeking to make investments that intentionally generate measurable positive social and/or environmental outcomes.

SHAREHOLDER ENGAGEMENT

Direct company engagement or activist approaches.

A Financial Case for Sustainable Investing

As sustainable investing matures and develops a proven track record, the industry is embracing the approach as a strategic business-building opportunity. Our survey confirms that the widespread adoption and expected growth of sustainable investing is driven by the belief that sustainable investments are good investments. Asset managers surveyed overwhelmingly agree (82%) that strong corporate ESG practices can potentially lead to higher company profitability and that companies with such practices may be better long-term investments.

Moreover, while three-quarters of those polled (76%) believe that a perception remains among some investors that sustainable investing requires a financial tradeoff, they themselves do not agree. Instead, 87% of respondents believe it is possible to achieve financial returns alongside social or environmental impact. And 62% go even further, agreeing that it is possible to *maximize* returns while investing sustainably.

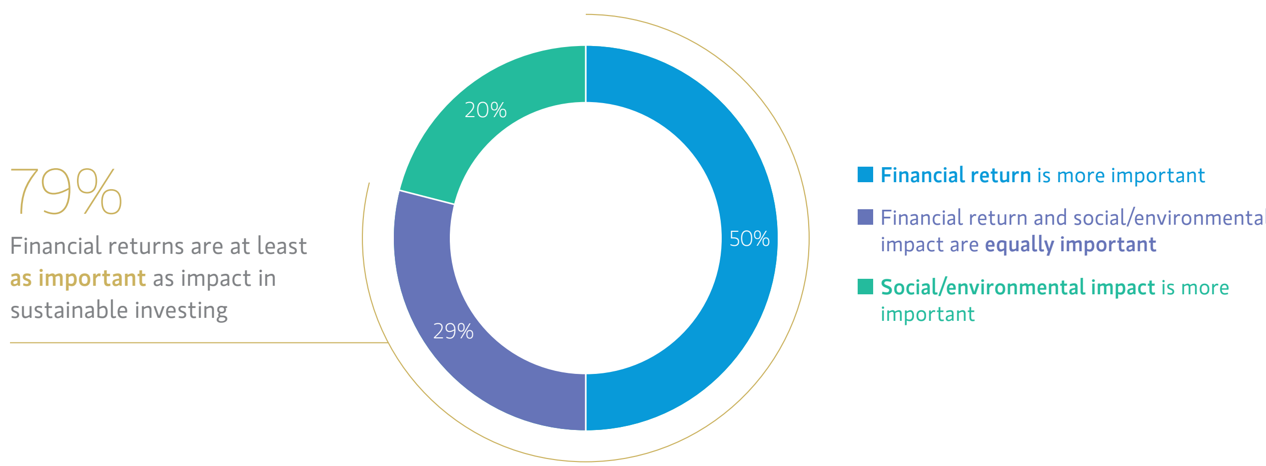
While environmental, social and governance impacts continue to be key motivators of sustainable investing, financial and business drivers are just as important. When asked to prioritize financial returns or social and environmental impact in investment decisions, 79% of survey respondents said that financial returns were at least as important as impact.

Our survey and interviews point to client demand as an initial catalyst for the adoption of sustainable investing by U.S. asset managers. Indeed, as Figure 3 shows, capturing new assets under management and investor expectations are among the top three reasons for firms and managers to develop sustainable investing strategies, alongside the potential for high growth.

Financial Returns as Important as Impact

FIGURE 2

In sustainable investing, how much of a priority is financial return, and how much is social/environmental impact? (n = 300)

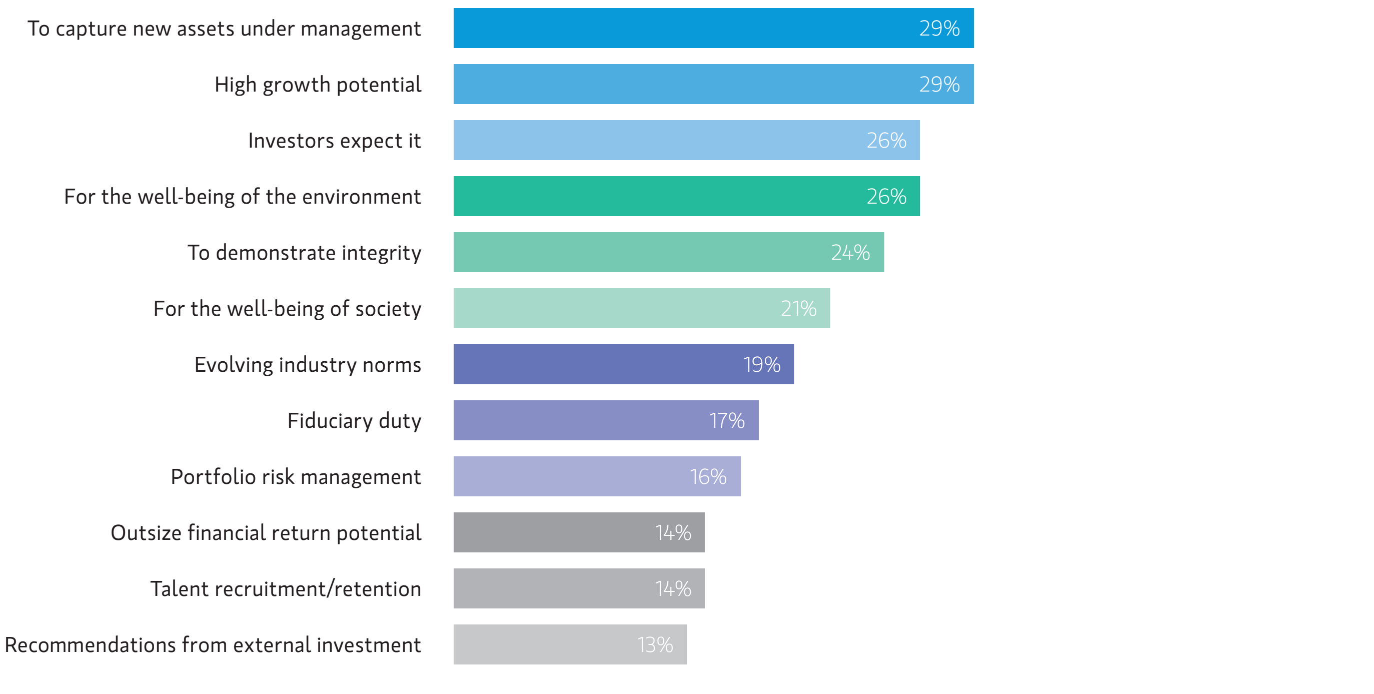


However, client demand-driven motivations for sustainable investing give way to a strong financial case as asset managers' strategies evolve. When asked what underlies their ongoing success with sustainable investing, financial outcomes outweighed growth in assets under management as well as impact. Increased investment stability ranked as a key driver of success at 51%, followed by client satisfaction (50%), product popularity (44%) and high financial returns (41%). In interviews, asset managers emphasized a surge in client inquiries about, and requests for, both sustainable investing products and sustainable investment performance data. They described such client input as a reinforcing mechanism for mainstreaming sustainable investing within their firms, supporting strategic engagement and expanded capacity.

Adoption Driven by Opportunity

FIGURE 3

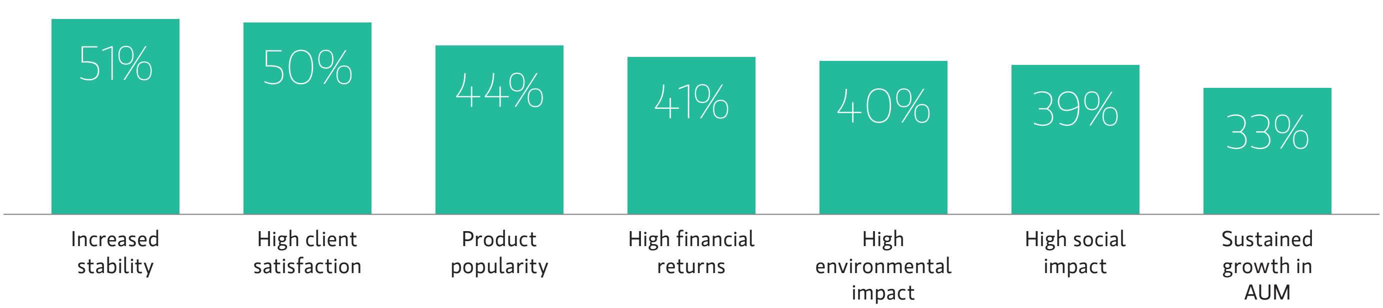
There are many reasons why firms adopt sustainable investing practices. What do you believe are the primary reasons firms adopt sustainable investing practices? (n = 300)



Drivers of Sustainable Investing Success

FIGURE 4

You mentioned that your firm has had high success in using certain sustainable investment strategies. Why do you say so? (n = 195)



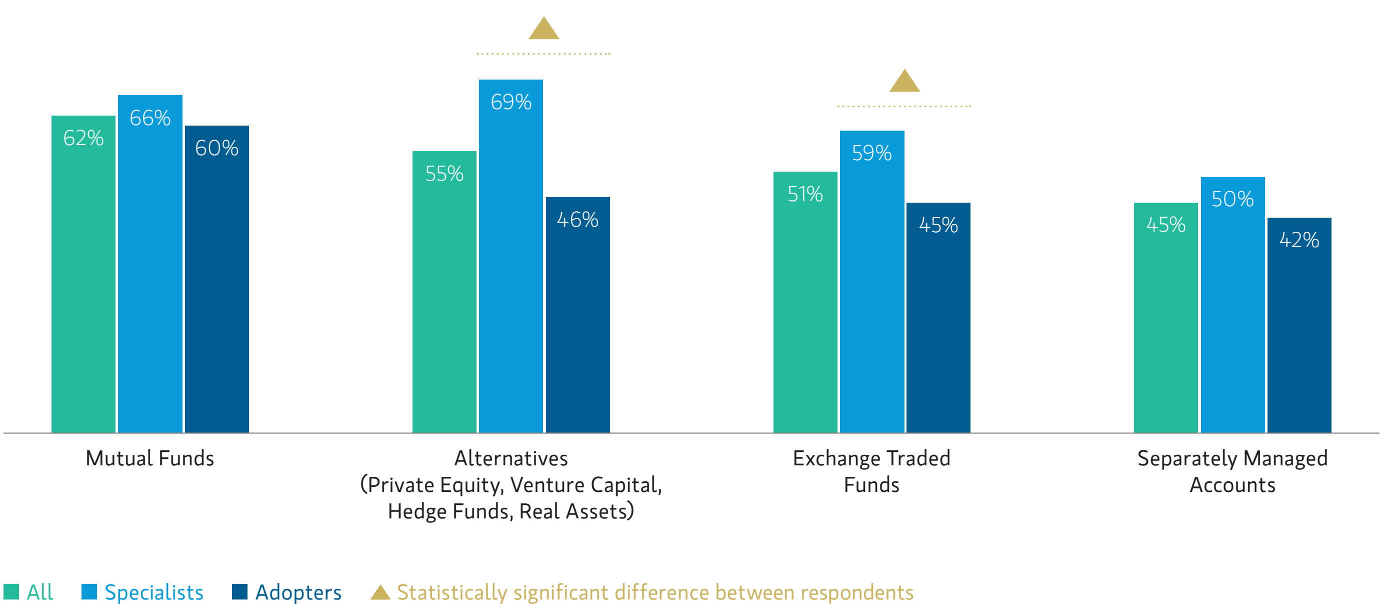
Product Types Proliferate, Expanding Investor Choice

As more firms embrace sustainable investing strategies, they are expanding ESG-tailored investment vehicles and investor choice. The asset managers surveyed offer sustainable investing opportunities for investors across product types and asset classes. Sixty-two percent of respondents' firms offer mutual funds that integrate sustainability or ESG considerations, followed by alternatives (55%), exchange traded funds (ETFs) (51%) and separately managed accounts (SMAs) (45%). Specialist firms are significantly more likely to offer sustainable investing products in alternatives and ETFs than others.

Sustainable Investing Products Offered

FIGURE 5

What kinds of sustainable investing products does your firm offer? (n = 224)



Asset management firms also offer investors a wide range of approaches to sustainable investing, with no single strategy dominating the field (Figure 6). Sixty-three percent report that their firms employ more than one sustainable investing strategy. Thematic investing products, ESG integration and impact investing products are the most popular options, followed by active engagement with portfolio companies and restriction screening tailored to clients' values. Our interviews revealed some crossover between categories. In particular, thematic and impact investing products driven by a specific lens such as Catholic values or gender diversity often include screens to exclude certain industries or types of companies.

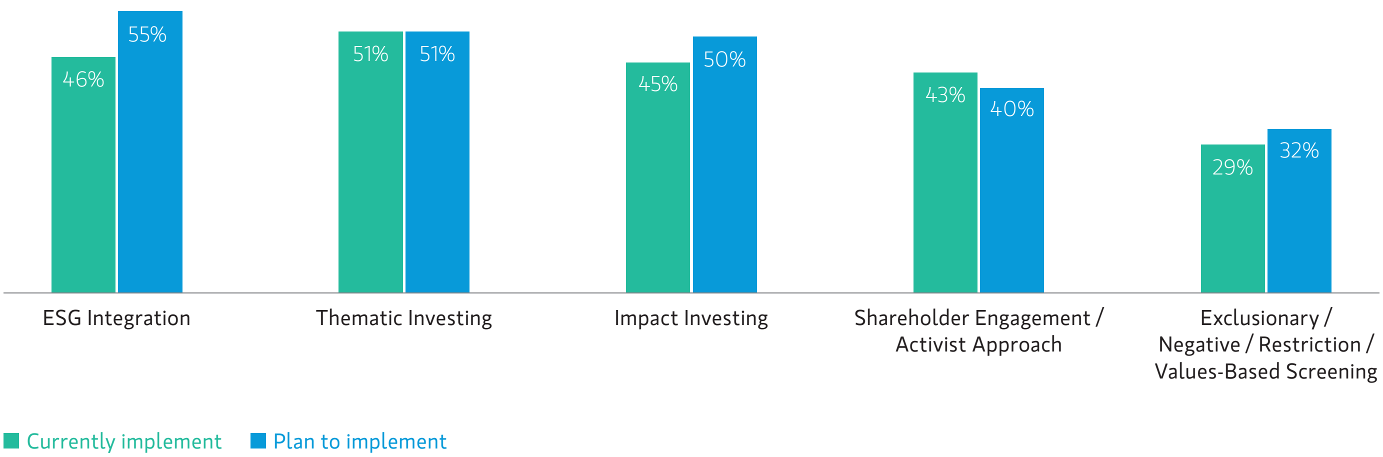
Compared with mainstream adopters, specialist firms were significantly more likely to utilize ESG integration, shareholder engagement and restriction screening strategies, perhaps reflecting a general application of ESG principles across all practices. A few interviewees described investor activism, with links to social or environmental movements, as a potential area for specialists to develop capacity as the field grows.

Interviewees also highlighted the UN Sustainable Development Goals (SDGs) as the kind of broad global initiative that will shape thematic product development. Firms have launched a number of SDG-focused bonds, ETFs and mutual funds since 2015. Among institutional asset owners that practice sustainable investing, 78% report that they are seeking to address or align with the SDGs, or actively considering doing so.[2]

Current and Future Strategies

FIGURE 6

Which of the following approaches or activities around sustainable investing does your firm currently implement? (n = 224)
Which of the following approaches/activities does your firm plan on implementing over the next 12 months? (n = 254)



A Seat at the Table: ESG in Shareholder Engagement

As sustainable investing strategies evolve, the voice of shareholders on ESG issues cannot be ignored. Forty-three percent of asset managers surveyed say their firms now practice shareholder engagement as an approach to sustainable investing. In a separate recent survey of global asset owners by Morgan Stanley, 39% reported that they practice shareholder engagement wherever possible across their portfolios and 22% said doing so is required by their investment policy statements.[3]

The 2018 US SIF Report on Sustainable, Responsible and Impact Investing Trends found that asset owners and managers with more than $10.1 trillion in assets reported active engagement with portfolio companies on ESG issues between 2016 and 2018. In addition, institutional investors and money managers controlling $1.76 trillion in assets filed shareholder resolutions on ESG topics.

In 2018, the Harvard Law School identified 430 ESG proposals filed across the Russell 3000. Notably, social and environmental topics comprised more than two thirds of them, led by political contributions (16%) and climate change (15%).[4]

While enhanced data availability and client demand are driving growth in ESG integration, thematic investing and impact investing, shareholder engagement remains an important resource in the investor's toolkit, giving investors a seat at the table.

No One-Size-Fits-All Approach to ESG Integration

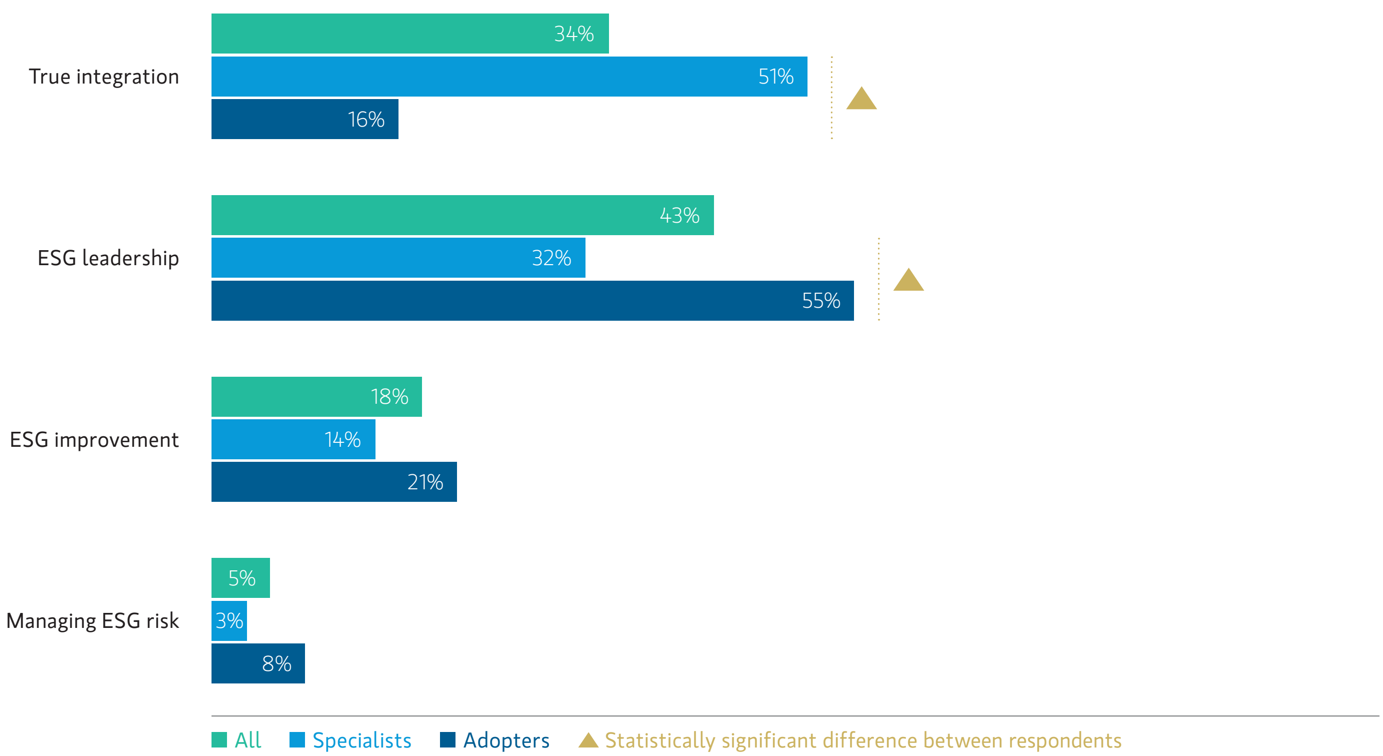
As asset managers have become more sophisticated about sustainable investing, ESG integration—the most commonly used strategy—has evolved in several directions. Instead of adopting a one-size-fits-all approach, asset management firms incorporate varied strategies across different investment portfolios. In our survey, the most common approach to ESG integration was ESG leadership (43%), defined as investing in companies with superior ESG characteristics and/or performance. The second most popular option was true integration (34%), in which ESG analysis is embedded into the broad investment decision process. True integration was much more common among specialists than adopters, while for ESG leadership the reverse was true. Interviewees across all firms highlighted ESG leadership as a prominent focus of client inquiries and product requests. Those at specialist firms described the emergence of true integration as driven by a fundamental belief in the field's long-term profitability.

ESG integration was a consistent and dominant theme in the conversation about the evolution of sustainable investing toward mainstream practice, and where the field will go next. Many firms emphasized the importance of adopting a credible approach, backed by both internally generated and third-party research data. In particular, interviewees cited enhanced internal systems and better data tracking and reporting mechanisms as focuses of internal discussions on sustainable investing strategy.

Approaches to ESG Integration

FIGURE 7

Which of the following approaches to ESG integration most closely describes your firm's approach to sustainable investing? (n, specialist = 52; n, adopter = 52)



Approaches to ESG integration were defined as:
True Integration: integrating ESG analysis into the investment decision process
ESG Leadership: investing in companies with superior ESG characteristics and/or performance
ESG Improvement: investing in companies where improvements in ESG characteristics and/or performance can drive value
Managing ESG Risk: using ESG analysis as a way to limit exposure to risks

Expertise, Better Data and Reporting Support Customization and Drive Future Success

As barriers to sustainable investing continue to fade, sustainable investing will continue to grow. In our view, the field's evolution will be shaped by increasingly sophisticated investors that demand products with demonstrated impact outcomes. To meet this need, asset management firms are building their skills and capabilities in order to deliver customized products to their clients. Better data is also critical to future growth, both to develop credible, standard metrics to measure the nonfinancial performance of sustainable investments and to provide investors with the impact information they seek.

As they look ahead, two-thirds (68%) of the asset managers we polled anticipate that more growth in sustainable investing will come from customized products and portfolios than from standardized products. They see client demand for such products rising as investors become increasingly sophisticated and targeted in their approach. In addition, given the variety of sustainable investing definitions that currently face investors, firms may see customizable solutions as an area of growth to better tailor products to client interests and demands.

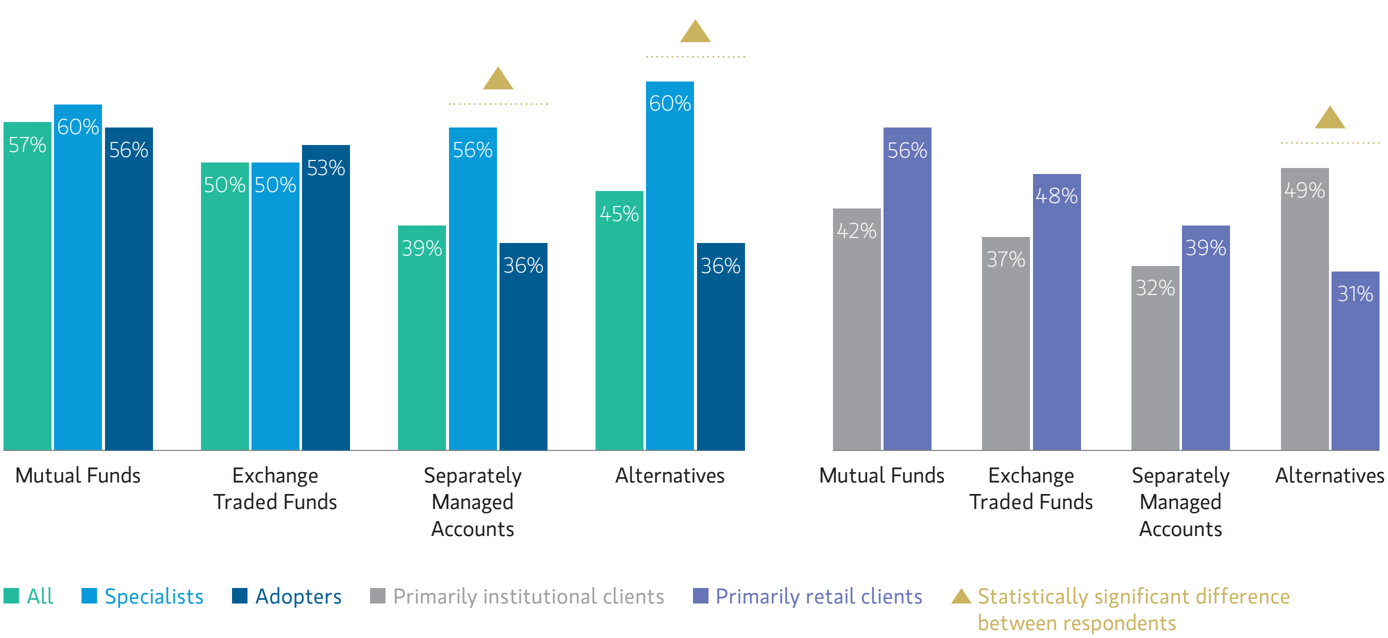
This shift toward customized products will most likely be led by specialist firms and those that serve mainly institutional clients. Asked about new products, survey respondents at specialist firms were significantly more likely to consider separately managed accounts and alternatives than mainstream firms. Asset managers serving primarily institutional clients were significantly more likely to consider offering sustainable products in alternatives than those with retail clients.

In order to meet an increasingly sophisticated client base with the custom products they seek, firms will need expert capabilities, better data and the ability to demonstrate impact.

Customization May Drive New Product Introductions

FIGURE 8

What kinds of products is your firm considering offering in the future? (n = 300)



Boosting Expert Capabilities

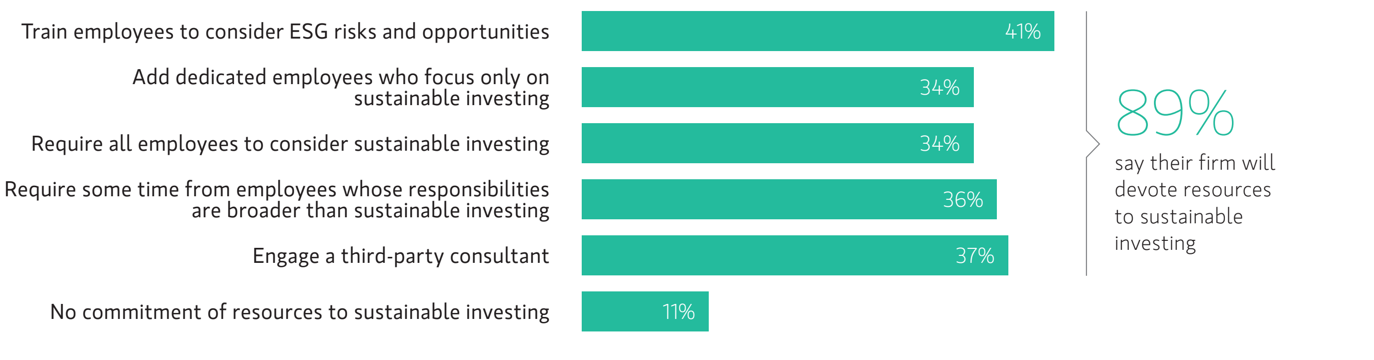
The industry is betting on continued growth, with nearly all asset managers polled (89%) reporting that their firms will devote more resources to sustainable investing in the next one to two years, and much of this will come from in-house skills and capacity. Common strategies for expanding resources include employee training (41%), more dedicated time from generalists (36%) and specialist hires (34%). A third of respondents (34%) plan to require all employees to consider sustainable investing in their portfolio decision making. Outside experts will also help firms keep pace with expected growth in demand (37%).

Interviewees expressed confidence that their firms were on course to respond to the field's rapid evolution. Many emphasized that they were investing human capital in order to scale their existing practices, rather than shifting their fundamental approaches to sustainable investing.

Firms Invest in Human Capital

FIGURE 9

In the next 1–2 years, what additional resources do you expect your firm will devote to sustainable investing? (n = 300)



Defining and Measuring Impact

As clients place ever more sophisticated demands on asset managers, the ability to define, measure and track non-financial impact is paramount. Yet, asset managers continue to identify a lack of clear definitions, data and research regarding sustainable investing and its impact as key challenges in developing and promoting products.

In our survey:

7 in 10

respondents agreed that there is no standard industry definition for sustainable investing, up from 65% in 2016.

70%

agreed that there are no standard industry metrics in place to measure the nonfinancial performance of sustainable investments.

66%

warned that there is not enough credible data and research to make sustainable investing decisions or to prove that it offers a good financial opportunity.

The number of ESG data providers, ratings and rankings has ballooned in recent years, but the proliferation of data has not necessarily resulted in better, more trustworthy information. To date, no provider has emerged as a clear leader, and in some cases different providers offer conflicting insights. A large body of work has demonstrated low correlations between ESG raters and rankers.[5] For example, researchers that compared

ESG scores for the S&P Global 1200 from two leading providers found a relatively weak correlation, at 0.32.[6]

Given this unsatisfactory situation, interviewees revealed that they often do not rely on any one source. Instead, their firms use the underlying data from multiple third-party providers to conduct their own analyses and inform their sustainable investment approaches.

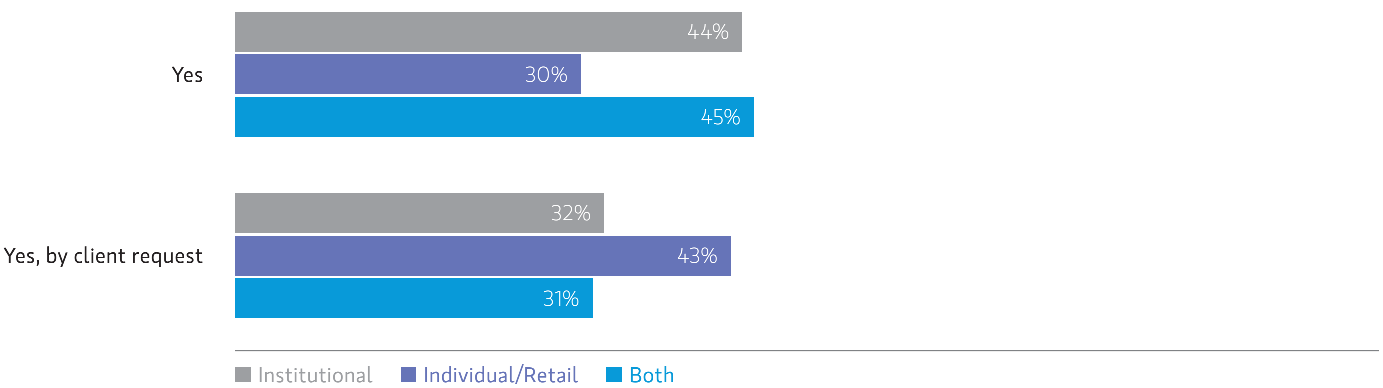
Client Impact Reporting

Given the growth of interest in sustainable investing among individual and institutional investors alike, client demand for impact reporting is unlikely to wane. Interviewees across asset management types report more frequent and sophisticated questions about impact outcomes and data. And while these clients remain in the minority for nonspecialist firms, they are seen as a motivated, and quickly growing, segment. In a recent survey of asset owners, the Morgan Stanley Institute for Sustainable Investing found that nearly four in five (78%) said that managers could better serve investors by providing relevant portfolio reporting on sustainability performance.[7] Yet, fewer than half (40%) of asset managers surveyed for this publication provide such data on a routine basis, while another 35% will do so only by client request. In our view, asset managers should therefore view impact measurement and reporting as a key opportunity for differentiation and growth.

Fewer Than Half Provide Impact Metrics Alongside Financial Performance

FIGURE 10

Does your firm provide clients with performance metrics about social/environmental impact alongside financial performance? (n, both = 138; n, institutional = 62; n, individual/retail = 101)



Conclusion

With more than one quarter of professionally managed assets in the United States now invested according to ESG principles,[8] asset managers overwhelmingly view sustainable investing as a business-building opportunity. They see sustainability as a permanent feature of the U.S. investment landscape and recognize that clients—both retail and institutional investors—are demanding an increasingly sophisticated range of investment approaches and impact outcomes.

The asset managers we surveyed and interviewed see sustainable investing as a viable strategy for achieving financial returns alongside impact. They understand that the rapidly growing field presents opportunities to capture new assets under management and tap into investment growth.

In order to capture these opportunities, they recognize a need for standardized data that is comparable across companies and over time. Such data will both support greater integration of ESG factors into investment strategies and enable firms to better report on impact to clients who are looking for customized solutions to align their investments with their values.

However, the current lack of quality data is not limiting firms' willingness to dedicate new resources and enhanced capabilities to sustainable investing. Nearly all asset managers surveyed expect their firms to channel more resources into sustainable investing, and see dedicated talent as a potential driver of differentiation and business success.

Overall, the future is bright for sustainable investing. As client sophistication across ESG topics continues to grow, the industry would benefit from putting their support and resources behind several key developments including:

1. **Standardization of ESG definitions and metrics.** There remains significant confusion around definitions of sustainable investing and approaches to measuring social and environmental impact. While existing efforts such as the Sustainability Accounting Standards Board (SASB) guidance continue to gain traction, no single set of metrics has fully addressed the need for comparable, high-quality ESG data. Industry engagement in efforts to create a common language of sustainability and impact remains paramount to overcoming this challenge.
2. **Training and development for ESG leaders.** With most asset management firms looking to expand resources dedicated to sustainable investing, a talent war could be looming. Asset managers can view this as an opportunity to build their own careers, while firms should think proactively about how best to build talent from within and develop career paths to retain ESG expertise.
3. **Proof of performance for sustainable investments.** While asset managers themselves no longer view sustainability and financial returns as a tradeoff, they believe this view still hampers the growth of client interest and demand. Clear and compelling research that counters this view may accelerate growth of sustainable assets under management.

Notes

1 US SIF, "Report on US Sustainable, Responsible and Impact Investing Trends 2018," 2018.

2 Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management, "Sustainable Signals: Asset Owners Embrace Sustainability," 2018.

3 Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management, "Sustainable Signals: Asset Owners Embrace Sustainability," 2018.

4 Harvard Law School Forum on Corporate Governance and Financial Regulation, "An Overview of U.S. Shareholder Proposal Filings," 2018.

5 TrueValue Labs, "ESG Ratings and Rankings: All Over the Map. What Does it Mean?" 2017. (https://www.truvaluelabs.com/wp-content/uploads/2017/12/ESG-Ratings-and-Rankings-All-Over-the-Map.pdf; accessed January 17, 2019).

6 Ross Kerber and Michael Flaherty, Reuters, "Investing With 'Green' Ratings? It's a Gray Area," June 26, 2017. (https://www.reuters.com/article/us-climate-ratings-analysis-idUSKBN19H0DM).

7 "Sustainable Signals: Asset Owners Embrace Sustainability," Morgan Stanley Institute for Sustainable Investing, 2018. (https://www.morganstanley.com/assets/pdfs/sustainable-signals-asset-owners-2018-survey.pdf; accessed July 16, 2018).

8 US SIF, "Report on U.S. Sustainable, Responsible and Impact Investing Trends 2018," 2018.

Acknowledgements

The Morgan Stanley Institute for Sustainable Investing and Bloomberg L.P. would like to thank the Initiative for Responsible Investment at the Hauser Institute for Civil Society at the Harvard Kennedy School and Edelman Intelligence for their contributions to this work.

Disclosures

This material was published on February 19, 2019 and has been prepared for informational purposes only and is not a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. This material was not prepared by the Morgan Stanley Research Department and is not a Research Report as defined under FINRA regulations. This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Morgan Stanley Smith Barney LLC and Morgan Stanley & Co. LLC (collectively, "Morgan Stanley"), Members SIPC, recommend that recipients should determine, in consultation with their own investment, legal, tax, regulatory and accounting advisors, the economic risks and merits, as well as the legal, tax, regulatory and accounting characteristics and consequences, of the transaction. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

This material contains forward-looking statements and there can be no guarantee that they will come to pass. Information contained herein is based on data from multiple sources and Morgan Stanley makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley. References to third parties contained herein should not be considered a solicitation on behalf of or an endorsement of those entities by Morgan Stanley.

Morgan Stanley, its affiliates and Morgan Stanley Financial Advisors do not provide tax, accounting or legal advice. Individuals should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving legal matters.

The returns on a portfolio consisting primarily of Environmental, Social and Governance ("ESG") aware investments may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria.

For more information about the Morgan Stanley Institute for Sustainable Investing, visit **morganstanley.com/sustainableinvesting.**

CRC 2415532 02/2019