Morgan Stanley

Sustainable Signals

Asset Owners Embrace Sustainability

Executive Summary

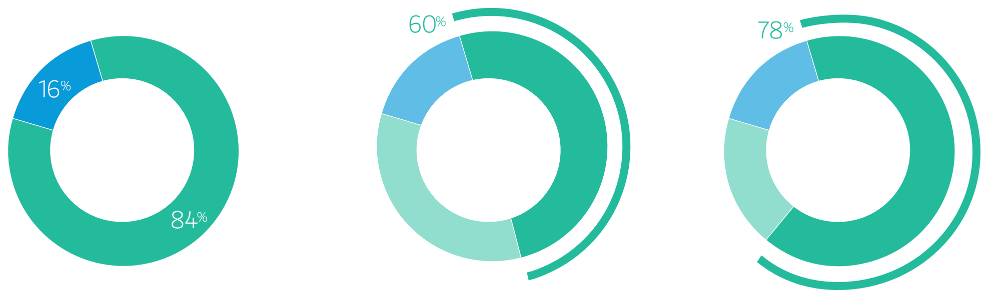
Sustainable investing has gone from a niche investment idea to attracting enough capital to start having an impact on global challenges at a meaningful scale. Globally, more than $22.8 trillion are invested sustainably, representing more than $1 in every $4 under professional management.[1] The intensity of recent growth has been driven by a fundamental shift in how investors and asset owners view environmental, social and governance (ESG) factors.

In this paper, we discuss the results of a recent survey conducted by the Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management. It reveals that among institutional asset owners, sustainable investing is increasingly pursued for its potential to manage risk and drive returns.

The survey polled 118 public and corporate pensions, endowments, foundations, sovereign wealth entities, insurance companies and other large asset owners worldwide and gathered insights about trends, motivations, challenges and implementation approaches in sustainable investing. By rounding out the sustainable investing landscape with the views of asset owners, this work builds on our previous Sustainable Signals studies focused on individual investors and asset managers.

Key Insights: Momentum and Shifting Perspectives

FIGURE 1
Three signs of momentum among asset owners



84% are pursuing or considering pursuing ESG integration in their investment process.

60% of those began doing so in the last four years.

And **78%** seek to align with the U.N. Sustainable Development Goals.

This material is developed by Morgan Stanley Investment Management and the Morgan Stanley Institute for Sustainable Investing.

Momentum: Sustainable Investing Has Arrived

Across asset classes, sustainable investing seems to have reached a tipping point. We find that sustainable investing has entered the mainstream and has overcome past inertia that may have associated the inclusion of ESG criteria with discounted returns.

We find that 84% of the asset owners surveyed are at least "actively considering" integrating ESG criteria into their investment process, with nearly half already integrating it across all their investment decisions. While respondents see public equities and real assets as the sectors with the most attractive sustainable investing opportunities, the interest in sustainable investing holds across asset classes, including fixed income and private equity. Only hedge funds were viewed as attractive by fewer than half of respondents.

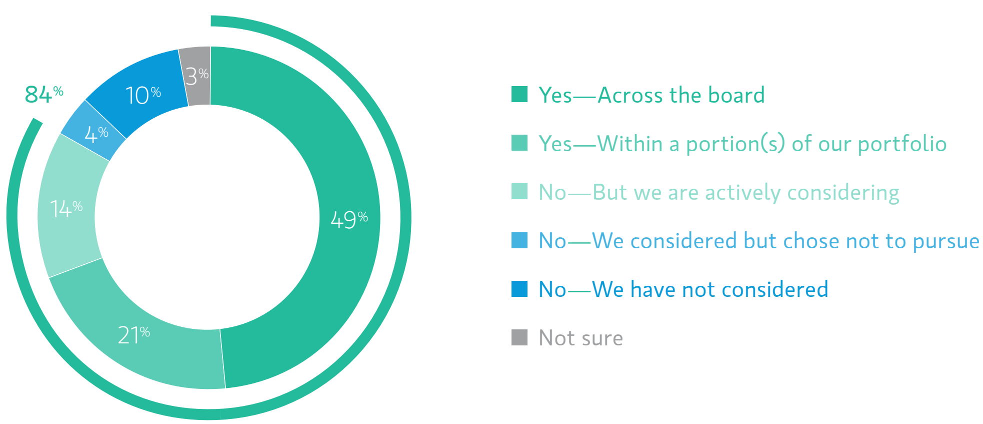
Compared to the investment universe as a whole, more than one quarter of the world's professionally managed assets—roughly $22.9 trillion—now have some sort of sustainable investing mandate, with about $8.7 trillion of that in the United States, $12 trillion in Europe and the rest shared by other regions.[2] The steady climb we have seen for two decades has accelerated over the past few years; sustainable investing assets are growing at a compound annual growth rate of 11.9%.[3] According to our survey, 60% of asset owners integrating ESG into their investment process have only begun doing so within the last four years and 37% within the last two.

Still, there is significant room to grow. The responses of asset owners to our survey reveal a gap between interest and implementation. While more than one-quarter of professionally managed assets now have a sustainability mandate,[4] more than three-quarters of institutional asset owners feel they have a responsibility to address sustainability through their investments. Among our respondents, 77% agree they have this responsibility, with 44% agreeing strongly.

Most Asset Owners Have at Least Considered ESG Integration

FIGURE 2

Does your organization seek to integrate sustainable investing or environmental, social and/or governance (ESG) criteria into the investment process, including selection of third-party investment managers? (n = 118)

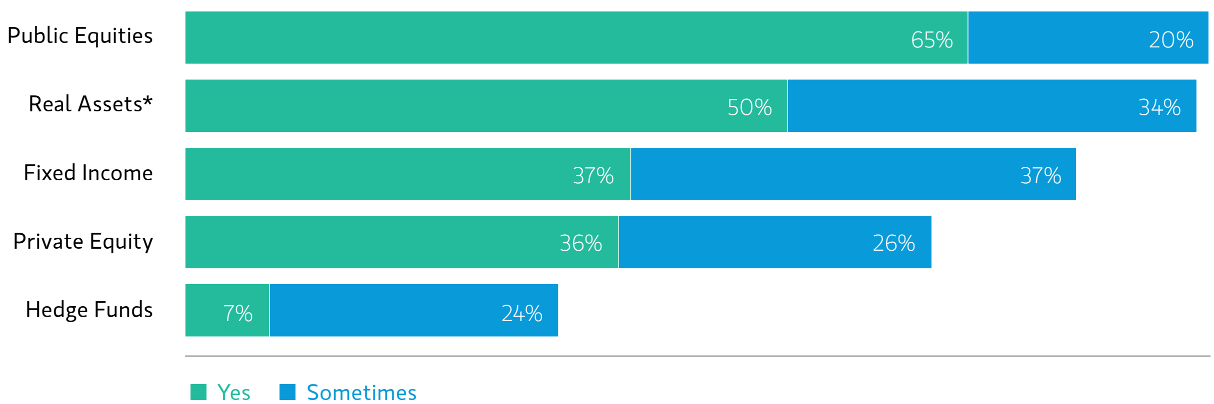


In this survey, we defined sustainable investing as the practice of making investments in companies or funds that aim to achieve market-rate financial returns while considering positive social and/or environmental impact. Environmental, social and governance (ESG) refers to the range of factors that are considered by sustainable investors.

Opportunities Exist Across All Asset Classes

FIGURE 3

In your experience, in which sectors has your organization been able to find quality sustainable investing strategies/managers? (n = 74)

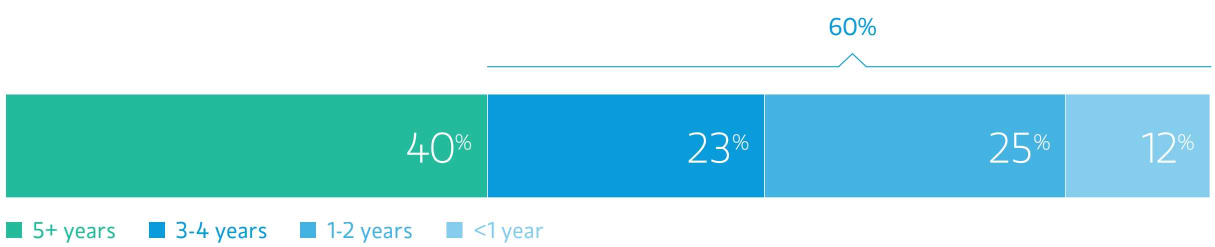


* Including Real Estate

Most Asset Owners Have Been Integrating ESG for Less Than Four Years

FIGURE 4

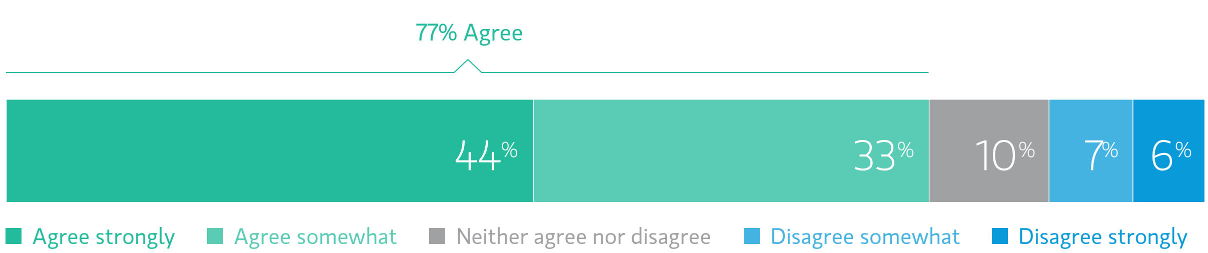
How long has sustainable investing or ESG criteria been integrated into your investment process? (n = 83)



Asset Owners Feel They Have a Responsibility to Address Sustainability

FIGURE 5

To what extent do you agree or disagree with the following statement: "Asset owners have a responsibility to address global sustainability issues through their investments" (n = 116)



Motivations and Challenges: Investing First

We believe the recent momentum in sustainable investing is the result of a convergence of several trends, but the relative importance of risk management and return potential among asset owners' top motivations is an important signal of sophistication and changing perceptions of sustainable investing.

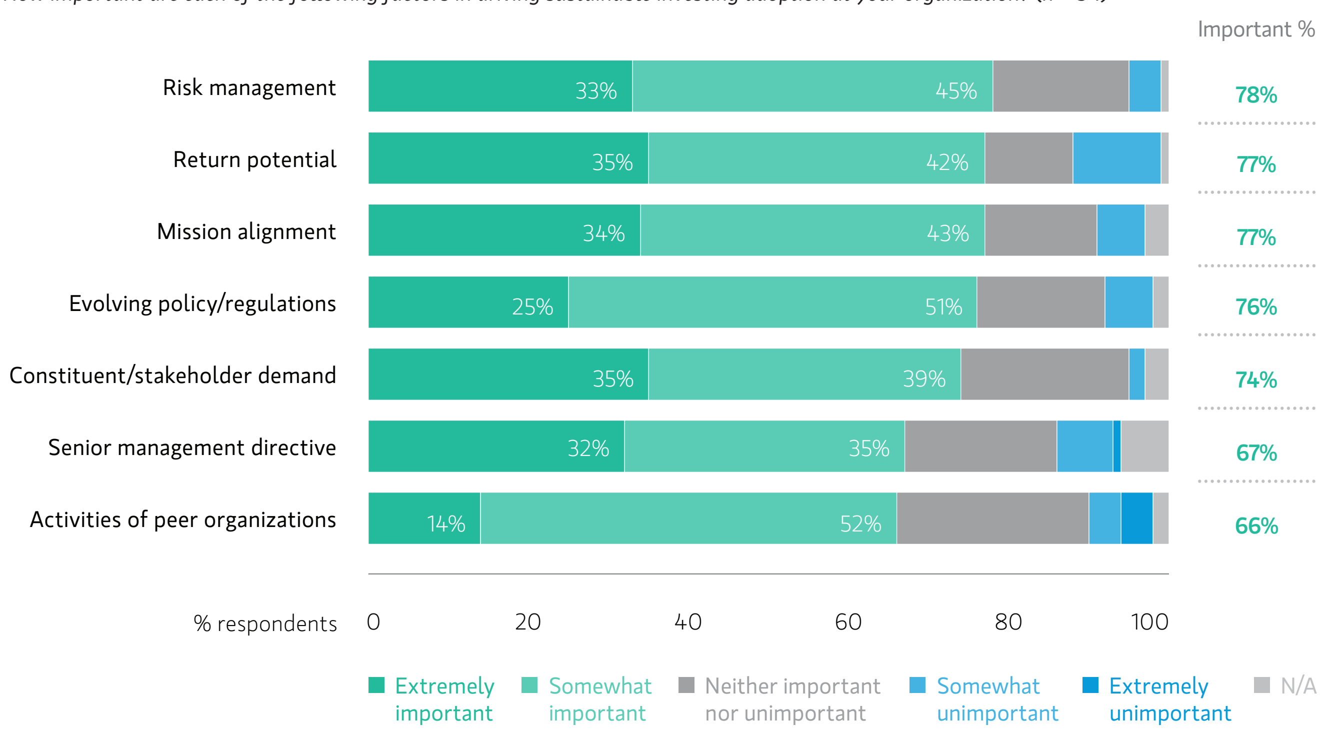
Motivated by Risk and Returns
Sustainable investing has enabled investors to think more systematically about risks of unexpected, costly issues arising from ESG factors that can hurt long-run returns.[5] Incorporating these criteria as a value-added part of the investment process provides an element of downside protection; fully 78% of respondents listed risk management as an important factor driving their adoption of sustainable investing.

Indicating a sense of optimism about sustainable investing, 77% of respondents also focused on generating returns. The benefits of sustainable investing may accrue through positive corporate reputation, reduced operating costs, new market opportunities or ethical management practices. Moreover, consumer trends point toward greater returns for sustainable companies. Nearly nine in 10 (87%) U.S. consumers say they will purchase a product because of a company's stance on an issue they care about, and 78% say they want companies to address important social issues.[6] Among millennials, this is even more pronounced. Our 2017 survey of individual investors found that millennials are more than twice as likely as other generations to purchase products from companies they view as sustainable.[7]

Risk and Returns Lead as Drivers of Sustainable Investing

FIGURE 6

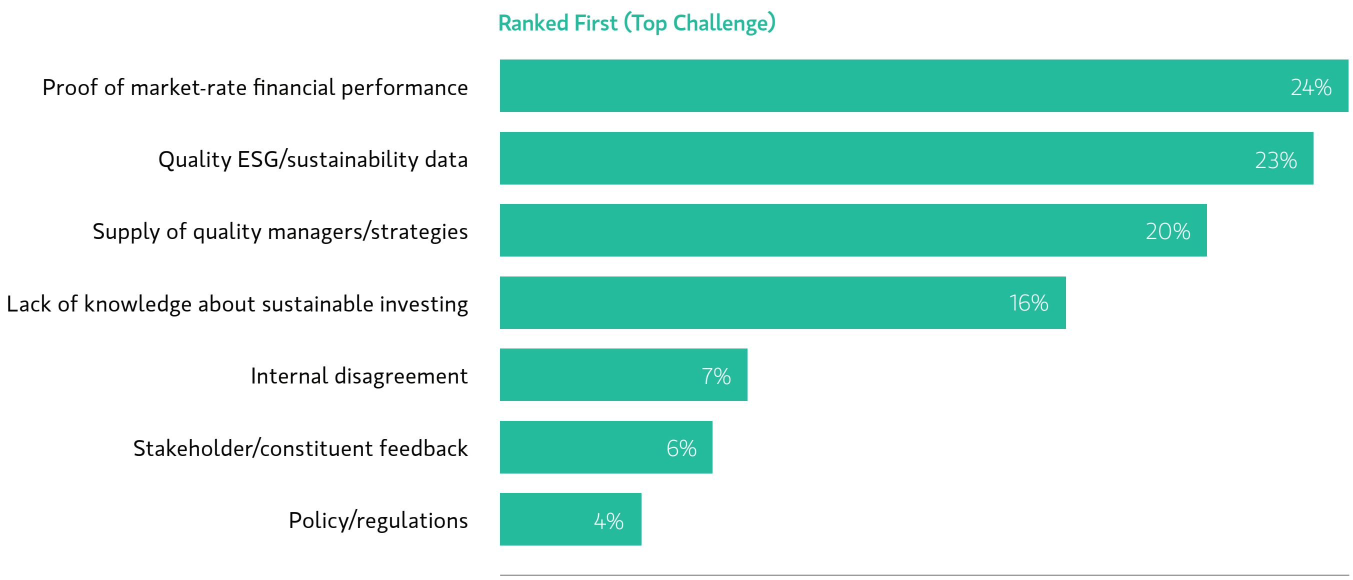
How important are each of the following factors in driving sustainable investing adoption at your organization? (n = 94)



Proof of Performance Remains a Top Challenge for Sustainable Investing

FIGURE 7

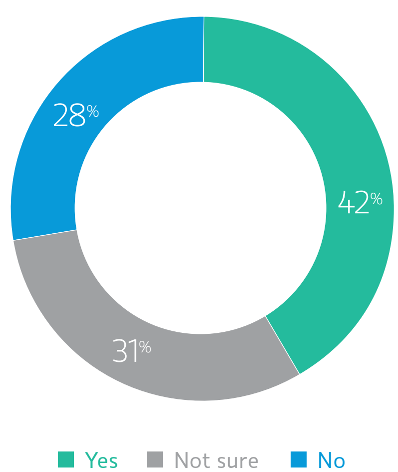
Which of the following represent or have represented the biggest challenges to adoption of sustainable investing at your organization? (n = 87)



Fewer Than Half Feel They Have Adequate Tools to Assess Sustainable Investments

FIGURE 8

Does your organization have adequate tools to assess the alignment of its investments with its sustainable investing goals? (n = 75)



Mission alignment rounded out the top three drivers of sustainable investing adoption (77%). In an era of big data and transparency, mission-aligned asset owners are better able to understand and tailor what they own—whether in the form of equity, bonds, real estate or any other asset class—in a way that genuinely reflects their mission statements.

Proof in the Performance

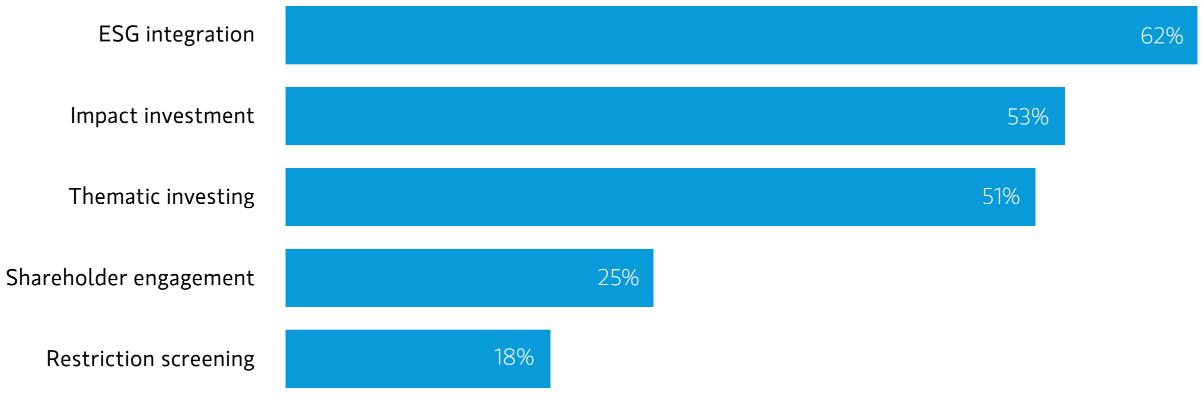
The presence of risk and return among the primary drivers for institutional asset owners is interesting in light of our individual investor survey which showed that a majority (57%) continued to believe that investing sustainably requires a financial trade-off.[8] While this perception may have grown out of early views of ESG as a negative screen that narrows the investment universe, it appears that large institutional asset owners may be replacing this view with a more sophisticated recognition that ESG factors provide unique insights into long-term risks and opportunities that might not be captured by traditional financial factors.[9] The belief in a trade-off appears to be fading.

Nevertheless, proof of market-rate financial performance remains a challenge to be addressed by the market. Twenty-four percent of survey respondents listed this as their top challenge to adopting sustainable investing.

Asset Owners Want to Learn More About Sustainable Investing Approaches

FIGURE 9

Which of the following topics, if any, would you like to learn more about? (n = 107)



The Need for Tools

Increased adoption of sustainable investing practices ultimately depends on being able to identify clear benefits for investors. As with any investment process, it is important to have meaningful data and the right tools. Among the top challenges cited by asset owners are the availability of quality sustainability data (23%) and lack of knowledge about sustainable investing (16%). When the top three-ranked challenges are aggregated, the availability of quality ESG data stands out, with 68% listing it as one of their biggest challenges. Three out of the top four challenges address some form of informational inadequacy—evidence, data and knowledge.

When asked specifically about tools used to inform sustainable investing strategies, only 42% of respondents indicated that they felt they had access to adequate tools to assess the alignment of investments with sustainability goals. Among them, they rely most heavily on in-house research (75%) to support those investments, with third-party specialty research following close behind (73%). In short, those respondents who are satisfied by the information available to them have either built the capabilities themselves or turned to specialists over mainstream investment information.

On the other hand, those not satisfied with ESG tools felt that reliable third-party data would be most helpful for assessing alignment of investments with sustainability goals, with 67% looking for mainstream third-party data providers; 57% looking for specialist third-party research; and 57% looking for third-party ratings, rankings and indexes. Only 35% felt that developing in-house research would be most helpful for their organizations.

The lack of reliable data is a real challenge for asset owners but within that challenge lies opportunity for asset managers and third-party data providers. With better tools, information and training, interest in sustainable investing is poised for continued growth. In fact, although 16% of investors described a lack of knowledge as their biggest challenge to adopting ESG by and large, they expressed interest in learning more about sustainable investing approaches. Eighty-four percent of survey respondents want to learn more about at least one approach to sustainable investing.

Implementation: Sustainable Investing in Action

The increased integration of sustainability and ESG criteria into the overall investment process among global asset owners has been accompanied by an increase in the sophistication of approaches. Over 80% of institutions integrating sustainability criteria rely on request for proposal (RFP) processes and Investment Policy Statements to ensure alignment and commitment to sustainability objectives. But there is no single "right way" to engage in sustainable investing.

Accordingly, asset owners employ a full spectrum of approaches. As they become more sophisticated about sustainable investing, asset owners are using multiple approaches and overlapping strategies to design solutions that meet their specific objectives and constraints.

ESG Integration

ESG integration—proactively considering ESG criteria alongside financial analysis—emerged as the most common approach, with nearly all asset owners who are engaged in sustainable investing using it at least opportunistically as part of their mix of approaches. More than half are required to do so by their Investment Policy Statement. This is in line with the role of risk and return as important drivers of the move toward sustainable investing, since integration tends to be focused on identifying long-term risks and capturing opportunities arising from sustainability trends. While ESG integration is practiced quite widely by the asset owners we surveyed, they still expressed a strong desire to learn more (62%).

Restriction Screening

Restriction screening, employed by 85% of respondents, intentionally avoids investments generating revenue from objectionable activities, sectors or geographies. Such strategies can provide downside protection and risk-mitigation benefits depending on the nature of the screen. If restriction screens lead to avoiding company-specific risk, they can play a positive role in maximizing risk-adjusted returns. However, the leading screens in our survey—for things like firearms, tobacco and pornography—seemed to be more tailored toward values-alignment goals.

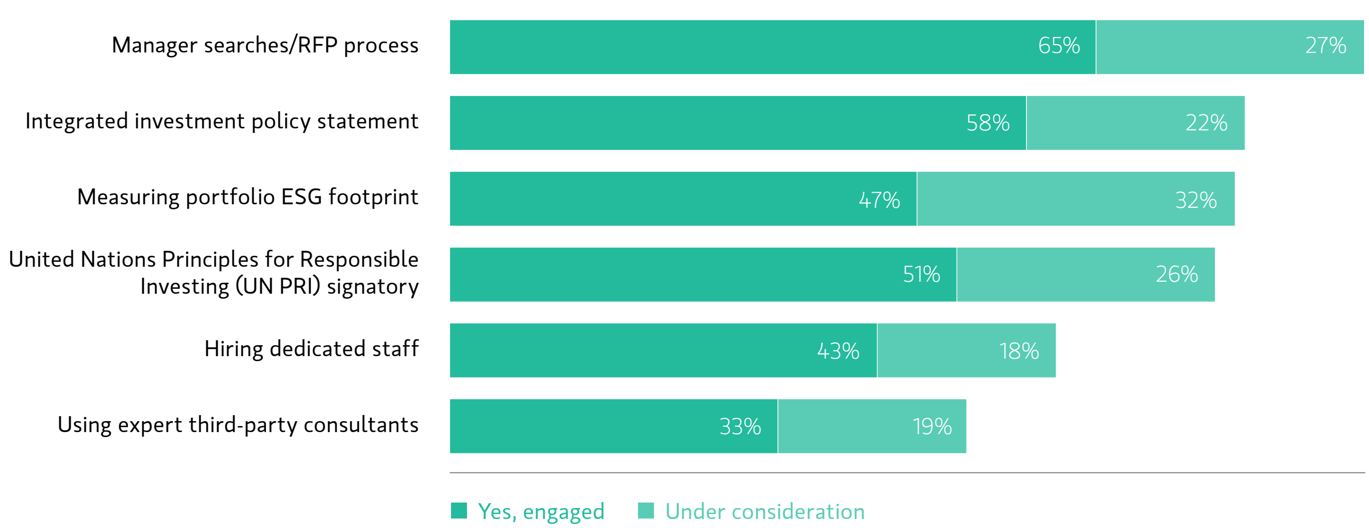
Thematic Investing

Thematic investment strategies, used by 81% of respondents, focus on themes and sectors dedicated to specific ESG issues. The more material the issue is to the valuation of each company, the more impactful the approach is likely to be on financial returns. The top thematic investments in our survey were those addressing climate change adaptation and mitigation, with 44% of respondents already seeking to address

Most Asset Owners Consider Sustainability in RFPs and Investment Policy Statements

FIGURE 10

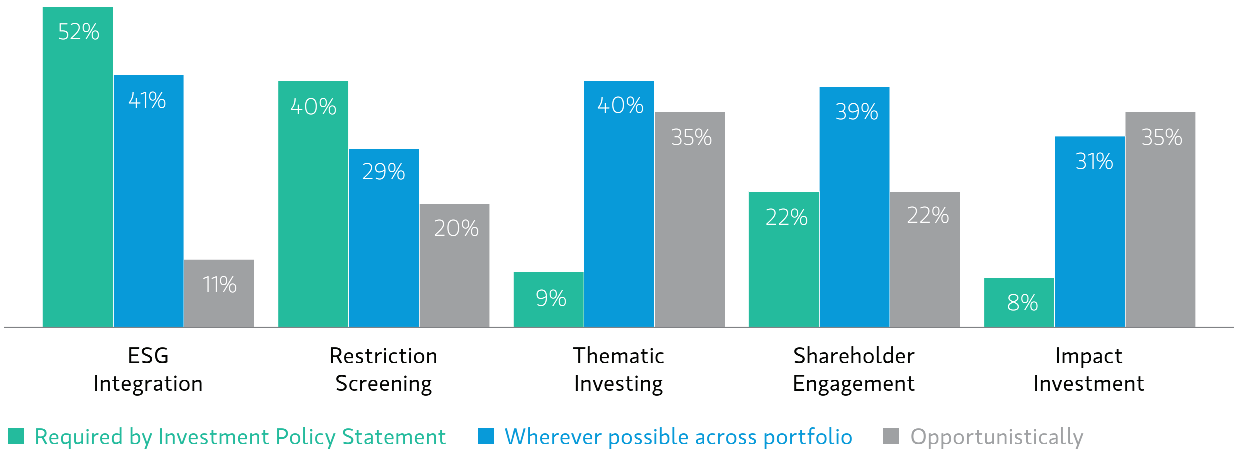
What activities has your organization engaged in or considered related to sustainable investing? (n = 98)



Asset Owners Employ Multiple Approaches to Sustainable Investing

FIGURE 11

Which of the following approaches to sustainable investing does your organization currently employ? (n = 79)



it or considering doing so. This may in part reflect the size of the asset owners we surveyed, given that large institutional investors tend to have highly diversified portfolios that are exposed to not only ESG risks from individual companies but also disruptions that span the entire economy, such as those likely to be caused by climate change and a transition to low-carbon energy sources.

Shareholder Engagement

Direct shareholder engagement on ESG issues, an approach used by 80% of respondents, gives investors additional opportunities to reduce risk and drive change in the direction they want, even within companies that may start off with poor ESG performance, but can potentially improve over time.[10]

To get the full benefit of these implementation approaches, particularly in light of the challenges identified by asset owners in accessing adequate tools and data, manager selection matters. Whereas restriction screens can be achieved with a passive portfolio, approaches like direct engagement may require a manager that is active, able to engage company management and takes a structured approach to sustainable investing.

The Most Common Exclusionary Screens Focus on Values Alignment

FIGURE 12

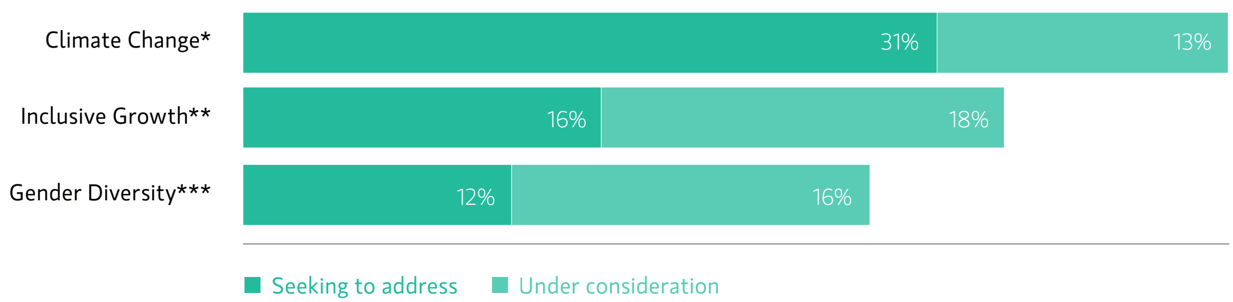
When employing Exclusionary/Negative/Values-Based Screening, which of the following screens does your organization seek to apply? (n = 63)

* Note: Only 21% of respondents seek to apply a screen for Fossil Fuels broadly

Climate Change Is a Leading Investment Theme

FIGURE 13

Do your organization's thematic investments seek to address any of the following sustainability issues? (n = 118)



* Climate Change: Investment seeking to adapt to and mitigate the effects of a changing climate and/or enable transition to lower carbon economy

** Inclusive Growth: Investments seeking to deliver economic growth and employment opportunities capable of lifting people out of poverty and promoting human rights

*** Gender Diversity: Investments that consider a commitment to gender diversity and/or that promote gender equality through their products or services

Impact Investment

Impact investing, the practice of allocating investments to enterprises or funds structured to deliver specific social or environmental impacts, was used by 72% of respondents, and was least likely to be required in investment policy statements (8%). The opportunistic nature of impact investing approaches is perhaps unsurprising given the bespoke nature of such strategies and potentially more limited availability of investment products. Nevertheless, more than half of all respondents (53%) expressed an interest in learning more about impact investing practices.

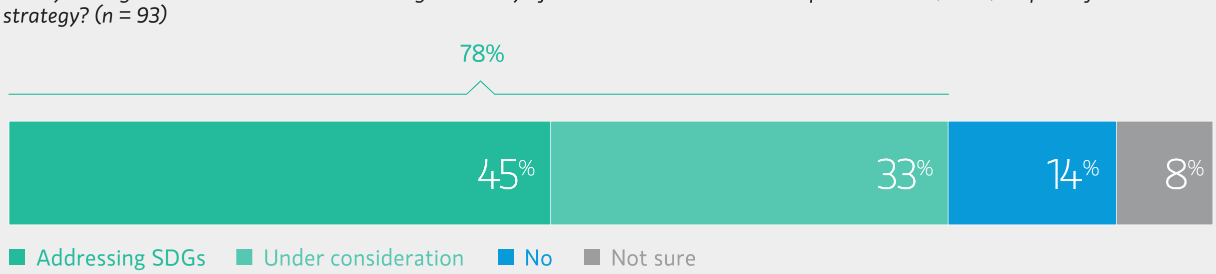
A New Framework for Sustainability

The United Nations Sustainable Development Goals (SDGs) are increasingly gaining traction as an organizing framework for many global asset owners, particularly those looking for a thematic investment approach. The SDGs are a set of 17 global goals focused on sustainable-development themes ranging from poverty, equality, education, climate change, infrastructure, land and water, and production/consumption, with a target date of 2030. Among asset owners in our survey, 78% of institutions integrating or considering sustainable investing are also at least considering an alignment with the SDGs as part of their investment strategy. Within the context of thematic investing, the SDGs are both a framework for thinking about and pursuing impact.

The Sustainable Development Goals Are Gaining Traction with Asset Owners

FIGURE 14

Does your organization seek to address or align with any of the U.N. Sustainable Development Goals (SDGs) as part of its investment strategy? (n = 93)



A Call to Asset Managers

A strong majority of asset owners surveyed believe third-party managers have an opportunity to support sustainable investing through a variety of mechanisms—providing reporting on ESG performance (78%), providing education about ESG investment approaches (73%) and writing investment policy statements incorporating ESG criteria (64%). And 43% of asset owners integrating or considering sustainability/ESG criteria can envision a time when allocations will be limited to managers with a formal approach to sustainable investing. Most (75%) anticipate this shift happening within the next two years.

While the accelerating interest in sustainable investing presents a clear business opportunity for managers, only half of the asset owners we surveyed are satisfied with the response of third-party investment managers to ESG and sustainable investing. At the same time, 50% identify the supply of quality managers as a "top three" challenge. This low level of satisfaction among asset owners should serve as a call to action.

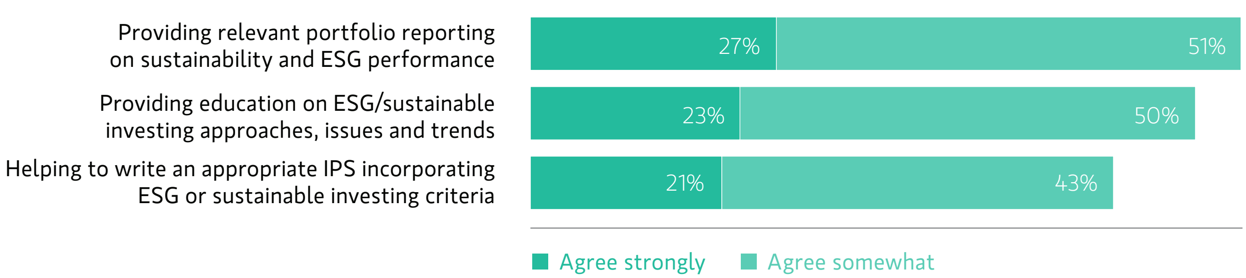
Sustainable investing has benefited from an increase in investor sophistication, with implementation approaches that span the full spectrum from restriction screens to specific proactive engagement. But the rapid entry of new asset managers attracted to this product opportunity may not have kept up with the needs of asset owners. In a previous survey of asset managers, we found that among those not currently engaged in sustainable investing, a majority said they planned to implement such approaches in the next 12 months.[12] This wave of new entrants lacking experience can potentially create a wide disparity in quality, and may explain some of the lower reported satisfaction. In our view, this further underscores the need that asset owners identified for better tools, information and education on sustainable investing.

Given the new momentum in sustainable investing and the resulting growth of product opportunities, it is more important than ever for investors to seek out managers with a clear and well-documented approach to sustainable investing. Asset owners evaluate managers based on firm-level and product-level policies, along with communication and reputation. Beyond offering investment products and helping with reporting, education and implementation, active third-party investment managers have an opportunity to help customize and align portfolios with owners' unique objectives.

Asset Owners Are Looking to Third-Party Managers for Information and Advice

FIGURE 15

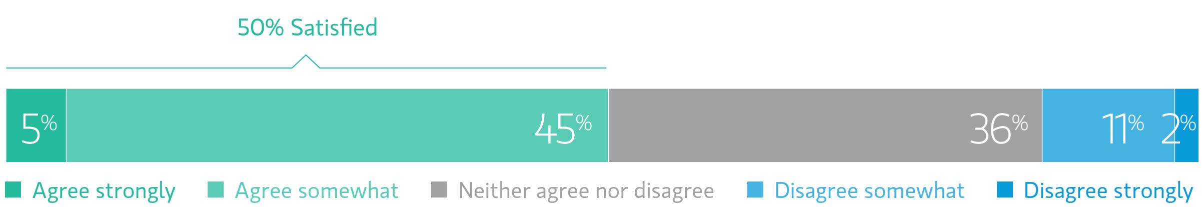
To what extent do you agree or disagree with the following statements: "Third-Party Investment Managers can play a role in helping my organization by …" (n = 116)



There is Room for Third-Party Managers to Improve

FIGURE 16

To what extent do you agree or disagree with the following statement: "My organization is satisfied with the response of Third-Party Investment Managers to ESG and sustainable investing" (n = 116)



Conclusion: Acceleration and Adoption

Our survey of asset owners brought to light a meaningful market shift, shedding light on the drivers of recent momentum in sustainable investing. Not only do more than three-quarters of asset owners now agree that they have a responsibility to address global sustainability through their investments, but they also list risk and return as driving forces behind their adoption of sustainability.

The perception of a trade-off between good ESG practices and financial performance is being replaced by an understanding of how environmental, social and governance issues can contribute to higher potential returns and mitigate risk. Fueled by a convergence of long-term performance considerations with trends like mission alignment, regulations and stakeholder demand, interest in sustainable investing has both accelerated and evolved.

As asset owners continue to integrate sustainable investing into their overall investment process, and third-party managers improve the tools for measuring both impact and performance, we expect many more opportunities to open up for those managers who are able to build the products, relationships and trust that can help investors generate strong risk-adjusted returns while having a positive impact on the world.

Survey Methodology

This paper is based on an online survey about sustainable investing conducted by Greenwald & Associates on behalf of the Morgan Stanley Institute for Sustainable Investing and Morgan Stanley Investment Management. Survey responses were collected from November 3, 2017, to December 19, 2017. Conducted in English and Mandarin Chinese, the survey was completed by 118 large global institutions, including public and private pension funds, endowments, financial institutions, insurance companies, sovereign wealth funds and other large asset owners. Of those who completed the survey, 60% had total assets of over $10 billion. The most common job functions of the individuals who answered the survey on behalf of their organization were portfolio managers, chief investment officers and sustainability officers. Survey results have been weighted to adjust for differential response rates by region. The margin of error at the 90% confidence level for the global sample is +/-7.3%.

	GLOBAL	NORTH AMERICA	EUROPE	ASIA/PACIFIC
Number of Completes	118	20	67	31

Notes

[1] "2016 Global Sustainable Investment Review," Global Sustainable Investment Alliance, 2017

[2] "2016 Global Sustainable Investment Review," Global Sustainable Investment Alliance, 2017

[3] "2016 Global Sustainable Investment Review," Global Sustainable Investment Alliance, 2017

[4] "2016 Global Sustainable Investment Review," Global Sustainable Investment Alliance, 2017

[5] "ESG Risks and the Cross-Section of Stock Returns," Gloßner, Simon, 2017

[6] "2017 Cone Communications CSR Study," Cone Communications, 2017

[7] "Sustainable Signals: New Data from the Individual Investor," Morgan Stanley Institute for Sustainable Investing, August 2017

[8] "Sustainable Signals: New Data from the Individual Investor," Morgan Stanley Institute for Sustainable Investing, August 2017

[9] "Foundations of ESG Investing: Part 1: How ESG Affects Equity Valuation, Risk and Performance," MSCI, 2017

[10] "ESG Shareholder Engagement and Downside Risk," Hoepner, Andreas, Ioannis Oikonomou, Zacharias Sautner, Laura Starks and Xiaoyan Zhou, February, 2018

[11] "Sustainable Signals: The Asset Manager Perspective," Morgan Stanley Institute for Sustainable Investing, November 2016

Disclosures

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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.

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