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ESG and Diversity & Inclusion Strategies: A Look Ahead

These issues are increasingly important to the next generation of clients — and firms are taking notice.

In 2019, there were over 500 funds, with assets topping $321 billion, invested in accordance with ESG principles (environmental, social and governance criteria) in the U.S.[1] While this figure represents just a small portion of the $25.7 trillion invested in U.S. open-end mutual funds, ESG and other thematic funds are important to a key client segment: Millennials. Perhaps because of this fact, many firms anticipate adding exposure to these strategies to client portfolios in the near future.

The increased focus on ESG and other types of thematic funds raises important questions about which clients are most interested in ESG or diversity and inclusion themes, how advisors can incorporate these themes into a portfolio, and how advisors should evaluate their investment options. A recent survey by WealthManagement.com asked more than 250 advisors across all industry channels about their thoughts on ESG and diversity and inclusion themes. The results provide insight into how the industry is embracing thematic investing.

Key findings:

1. Who wants ESG? Younger investors are more likely than members of previous generations to say strategies built around ESG and diversity and inclusion principles are important.
2. Thematic strategies are on the rise. Advisors expect allocations to thematic strategies in general to increase slightly over the next two years, with allocations to ESG strategies experiencing a larger boost.
3. Thematic investing is a diversification tool. Advisors are most likely to use thematic strategies to diversify client portfolios or to target specific sector or asset classes.
4. Ratings and performance matter. Advisors rely on industry ratings when making up their minds about ESG funds, although performance still has a big influence on advisors' opinions of fund managers.
5. Due diligence standards differ across strategies. There is a larger focus on ESG due diligence when adding ESG managers, compared to adding managers with a focus on diversity and inclusion.

Who Wants ESG?

The looming $68 trillion wealth transfer from boomers to their heirs is one of the main arguments for why advisors need to better understand the next generations' values. As this survey finds, advisors may want to review their stance on ESG and diversity and inclusion strategies, as younger generation's have a much more positive view of these themes than their boomer counterparts.

In fact, advisors report that millennial and Gen Xer clients are more than twice as likely as boomer clients to believe that ESG is "very important" to an investment strategy. Meanwhile, women are more than three times as likely as male clients to say the same. A similar pattern plays out when considering the importance of diversity and inclusion strategies, albeit with a less pronounced difference.

As the makeup of advisors' client base skews increasingly toward younger generations, advisors would do well to pay attention to shifting views about ESG, diversity and inclusion, and other thematic investing strategies. Moreover, the fact that women are assuming control of an ever-larger share of private wealth underscores the importance of this shift in client preferences.

Opinions on Strategies Differ Among Clients Segments

	ESG strategies are "Very Important"	D&I Strategies are "Very Important"
Overall Client Base	14%	21%
Millennials	36%	29%
Women	26%	23%
Gen Xers	22%	22%
Boomers	10%	13%
Men	7%	10%

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Thematic Strategies Are On the Rise

The greater interest in thematic investing among the next generation of clients has already caught the notice of many advisors and firms. Three in four advisors invest client assets in thematic funds, primarily on a case-by-case basis — although 12% of advisors use thematic funds across their entire client base.

Advisors generally anticipate an increase in their allocations toward this type of investment strategy. The increase is substantial in relative terms — a 50% increase over the next two years — but not in absolute terms, as advisors are estimating allocations to increase from 10% to 15%. ESG strategies are set to experience a larger increase — from 11% in 2020 to 18% in two years — perhaps because ESG strategies enjoy wider recognition and have a longer track record than other thematic investment strategies.

In general, advisors are most likely to report using thematic funds in the portfolios of their millennial clients or younger investors, which aligns with the survey's findings around who wants ESG and diversity and inclusion themes. High net worth clients also use these investment strategies frequently, hinting at the potential benefits they have in terms of generating growth and performance in a portfolio.

Percent of Advisors Who Use Thematic Funds:

Millennials	57%
Young Adults/Accumulators	51%
HNW	41%
New Clients	37%
Retirees	29%
Accommodation Accounts	19%

Thematic Investing as a Diversification Tool

ESG and other thematic investing strategies have potential roles to play in portfolio design beyond simply aligning clients' investments with their values. Well over half of advisors report using thematic investing to add diversification. Given that ESG stocks tend to be less vulnerable to certain types of risk, they offer potential benefits from a diversification point of view. Advisors were also likely to use ESG and other thematic strategies for asset class-specific purposes, which makes sense as themed funds can help investors cut across sectors or more traditional groupings of stocks or bonds.

Nearly a third of advisors use thematic investing to generate alpha. This fact is noteworthy given the long-standing view that ESG investments generally underperform the market. However, recent analysis of 745 European-based ESG funds using data from Morningstar[2] shows that this long-held belief may not be true. It would seem at least a third of advisors surveyed have already embraced the performance potential of thematic funds.

Percent of Advisors Who Use Thematic Funds:

Diversification	57%
Sector or Asset Class-Specific Purposes	47%
Alpha Generation	30%
Differentiation From other Advisors	28%
Alongside Core/Broad-Based Funds	27%
Better Story to Tell to Engage Clients	23%
Follow a Wave of a Certain Trend or Sector	23%

Rating and Performance Matter

As ESG and other thematic strategies gain importance in the eyes of the next generation of clients, advisors will need to develop the strategies necessary to evaluate their investment options. The survey suggests that the Morningstar Sustainability rating is one of the top tools used by advisors to evaluate ESG strategies, with 22% of advisors saying it is a "very important" factor in their consideration.

Morningstar developed this tool to gauge the risks that environmental, social and governance factors may have on a particular investment strategy. A one-globe rating means a fund or company is vulnerable to potential ESG factors, while a five-globe rating means the fund represents a lower risk due to these influences. The Morningstar rating appears to be a useful surrogate for evaluating how deeply ESG factors are embedded in a company or fund manager's approach, as it outranks many of the other factors advisors could consider.

In addition, performance remains an important factor in advisors' evaluation process. For instance, when considering a fund manager's brand, nearly half (45%) of advisors say fund performance is critically important. The next most common answer is third-party ratings, which are deemed critically important by just 14% of advisors. Third-party ESG ratings, by contrast, are deemed critically important by just 10% of advisors — although 57% say they are at least somewhat important.

Advisors Opinion on Importance of the Following Factors When Selecting ESG Strategies

	"Very Important"
Morningstar Sustainability Rating	22%
The ESG Process Is Deeply Embedded as Part of the Overall Manager	14%
The Product Is Labeled ESG	10%
The ESG Process Is Deeply Embedded as Part of the Strategy	7%

Diligence Varies

Many firms are planning to increase the number of ESG criteria they use in the manager due diligence process. For instance, 50% of advisors say a fund manager's formal ESG/SRI policy is already part of their firm's due diligence process or will be in the next one to two years. Responses are similar for other factors, including whether a manager has a dedicated ESG/SRI team in place or whether ESG/SRI has been incorporated into portfolio and performance reviews. In fact, only about a third of firms do not plan to consider these kinds of criteria in their due diligence.

Advisors are much less likely to evaluate a manager's focus on diversity and inclusion, with just over a quarter (29%) considering this factor when selecting a strategy. In fact, nearly half (48%) of advisors say there's no value in asset managers weighing in publicly on diversity, equality, inclusion and community issues at all, while just 11% say this behavior has high value. The difference between the due diligence levels on these two themes may reflect the fact that ESG/SRI has been around a lot longer as a strategy than has diversity and inclusion. Advisors also say diversity and inclusion is slightly less important to younger clients than ESG.

Due Diligence Criteria for ESG/SRI Fund Managers

	Currently Included	Will Include in 1 to 2 Years
Manager Has a Formal ESG/SRI Policy	35%	15%
Manager Has a Dedicated ESG/SRI Team	31%	13%
Manager Has Incorporated ESG/SRI into Portfolio Manager Performance Reviews	29%	16%
Specific Examples of Manager's ESG/SRI Factor Incorporation into Investment Analysis	28%	0%
Manager's Participation in ESG/SRI Initiatives	28%	17%
Manager's Use of Third-Party ESG/SRI Data	23%	18%
Manager's ESG/SRI Active Engagement Policies and Practices (Including Proxy Voting)	23%	17%

1. ICI Fact Book 2020. https://www.ici.org/pubs/fact_books
2. "Majority of ESG funds outperform wider market over 10 years" June 13, 2020. (https://www.ft.com/content/733ee6ff-446e-4f8b-86b2-19ef42da3824)