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How best to measure asset managers' credentials when it comes to ESG

A transparent approach is required particularly when it comes to measuring ESG AuM, assessing proxy voting track record and understanding ESG datasets

Overview

If one were to name key industry-wide buzzwords in asset management over the past few years, 'ESG' would easily be at or close to the top of the list. In the United States, new money inflows into ESG mutual funds and exchange-traded-funds hit a record high of US$20 billion last year, almost quadruple the number in 2018[1]; in Europe, new inflows of €120 billion into European ESG funds has increased the total assets in European sustainable funds to €668 billion in 2019, 56% higher than that in 2018[2].

The evidence so far this year has been that this trend has continued with ESG funds and indices outperforming their parent benchmarks and ESG ETF equity flows proving to be considerably more resilient that their non-ESG ETF equity counterparts[3].

When it comes to public policy, regulators and supervisors are also playing a more forceful role in pushing the ESG agenda. For example, European Central Bank President Lagarde has emphasised that the ongoing review of the ECB's monetary policy strategy creates an opportunity to reflect on how to address sustainability considerations within the central bank's monetary policy framework[4].

In addition, the increasing interest among asset owners when it comes to ESG has also been driving investments in this area. In fact as of 2019, 96% of UN PRI signatory asset owners' asset under management (AuM) have been covered with missions, strategies or investment policies in responsible investments[5].

In what has become a more active regulatory ESG environment, and to cater to the booming demand from asset owners, asset managers have entered a new battlefield, competing on areas from ESG product offering to dedicated green campaigns. In a world where rankings have become one of the most important factors driving decision-making, from choosing a restaurant to applying to university, it is unsurprising to witness how asset managers are now trying to top one another in ESG metrics, such as green AuM, proxy voting and press coverage.

However, league tables in ESG capabilities are not as straightforward as one might imagine. Addressed in a previous DWS white paper *Slaying ESG Dragons*[6], data inconsistency has long been a difficult problem in this universe. In this paper, we reveal three major data pitfalls to watch for when assessing firms' credentials in respect of ESG KPIs.

We focus on discerning ESG capabilities from a myriad of data metrics at a firm level, rather than at a fund level. According to the Responsible Investment Framework, introduced by the Investment Association UK, firm-level components comprise ESG integration, stewardship and exclusions, usually interconnected and used in combination[7]. Our analysis concentrates on ESG integration and stewardship components, since exclusion involves more subjective, value-based judgements. We hope shedding light on the various approaches deployed will help to deliver more transparency is this muddy space.

FIGURE 1. REPORTED ASSET MANAGERS RANKINGS IN ESG/SRI AUM (€ BN) BY TOTAL EXTERNAL CLIENT (YE 2018)

Ranking	Total	Negative Screening/Exclusion	Impact Investing
1	Legal & General Investment Management 993.7	Ares Management 111.9	Swisscanto Invest by Zürcher Kantonalbank 48.0
2	BlackRock 414.5	NN Investment Partners 103.3	Merian Global Investors 6.5
3	PIMCO 278.7	Robeco 90.9	Aquila Capital 4.4
4	Dodge & Cox 249.6	Northern Trust Asset Management 70.2	Putnam Investments 4.3
5	BNP Paribas Asset Management 222.0	Union Investment 41.4	Sycomore Asset Management 2.9
6	UBS Asset Management 193.4	Kempen Capital Management 34.2	Impax Asset Management 2.9
7	Neuberger Berman 158.3	Heitman 33.8	Northern Trust Asset Management 2.0
8	State Street Global Advisors 157.0	Union Bancaire Privee, UBP SA 25.4	Muzinich & Co 1.9
9	Legg Mason 154.2	Eurizon Asset Management 24.3	SCOR Investment Partners 1.7
10	Amundi Asset Management 150.8	Comgest 24.2	Candriam Investors Group 1.3

Source: IPE (June 2019). IPE ESG/SRI Survey

Green AuM: ESG integration counted or not?

Let's first consider ESG AuM, which can differ for the same company depending on the agency reporting the statistics. We have chosen IPE's approach to ESG AuM reporting across the market place. Its approach benefits from covering more categories, as well as a wider range of individual asset managers. In its 2019 survey, illustrated in Figure 1, Investment & Pensions Europe (IPE) reported the 2018 total ESG / SRI AuM for more than 150 asset managers globally. It also assigned dedicated AuM rankings according to the different ESG strategies deployed, for example, negative screening, best-in-class, thematic and impact investing[8]. While the latest data only references 2018 data, as we await an update to their analysis, we believe it provides a good snapshot of the marketplace when it comes to ESG AuM.

Confusingly, what appears to be substantial total ESG/SRI AuM for most managers (second column in Figure 1), is not matched by correspondingly large ESG / SRI AuM assigned to dedicated ESG strategies, represented in columns three and four of Figure 1. The inconsistency is explained by what asset managers are doing behind the scenes when it comes to ESG integration.

ESG integration, as defined by the Principles for Responsible Investment, is the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions[9]. In ESG integration, ESG quality factors do not overrule financial factors and any financially immaterial ESG factors do not affect investment decisions[10]. Compared to the above-mentioned specific ESG strategies, such as negative screening or impact investing, ESG integration only acts as a starting point and can sometimes use techniques that are difficult to verify.

This is why at DWS, it is important to have our ESG AuM put into the scope of the third party assurance by our statutory auditor. At DWS, ESG integration is strictly-defined and underpinned by our ESG Integration Policy across the Active investment platform. This requires that all investment specialists in equity and fixed income include ESG aspects into earnings estimates, valuation models and investment recommendations in a detailed manner.

DWS also only labels strategies as ESG integration when the following criteria are met: first, the strategy is actively managed and second we have coverage of ESG data (the overall SynRating[i]) of more than 90% of the portfolio. As of 31 December 2019, €413.6 billion of AuM has been identified in ESG integration for 1,573 actively managed strategies.

As for dedicated ESG strategies, DWS has selected dedicated ESG AuM as one of its Sustainability Key Performance Indicators. This, as well as the other KPIs, will be tracked and monitored quarterly from 2020 onwards. Our objective is to measure and manage progress in a transparent and consistent fashion. With a continuously increasing number of dedicated ESG strategies, DWS reported €69.7 billion of dedicated ESG and sustainable AuM at the end of last year, which includes €16.5 billion of real estate investments in certified green-labelled buildings and €862 million of infrastructure investments in renewable assets. Combining integrated and dedicated ESG strategies translates into ESG AuM equivalent to 68% of total AuM, illustrated in Figure 2.

FIGURE 2. DWS ESG/SRI AUM (AS OF 31 DEC 2019)

	Assets (€ bn)	Percentage
ESG Integration Strategies*	451.0	59%
Dedicated ESG Strategies**	69.7	9%
Total ESG AuM	**520.7**	**68%**
Total AuM	**767.4**	**100%**

* € 451 billion includes € 27 billion in Direct Real Estate and € 10 billion in Infrastructure, on top of the € 413.6 billion in Active & Liquid Real Assets. ** Real estate and infrastructure consist of € 16.5 billion and € 0.86 billion respectively Source: DWS Investment GmbH (March 2020). DWS Sustainability Report 2019.

Proxy votes against management: it is all about the denominator

Signalling the 'rebellious' gene within an asset manager, proxy votes against management is widely-used as an essential criterion in corporate governance, to quantify the level of scrutiny and the will to drive change. However, a deeper examination into various corporate governance reports shows that asset managers have been employing a number of different calculations around this metric. A simplified and hypothetical example for asset manager X is illustrated in Figure 3.

FIGURE 3. ASSET MANAGER X PROXY VOTING METRICS

# of votes against	# of companies voted	# of meetings voted	# of resolutions voted
1,500	1,500	2,000	10,000
Proxy votes against management	***100%***	***75%***	***15%***

Source: DWS Investment GmbH (May 2020)
For illustrative purposes only

As shown, this "rebellious" measure can range from 15% to 75%, or even 100%, by applying smaller denominators such as the number of meetings held or companies voted, instead of number of resolution items, provided that there are usually multiple resolutions raised in one shareholders' meeting and one company can have more than one shareholders' meeting per year[11]. It might seem cynical to regard such calculations as intentionally misleading, nevertheless, it is fair to say such examples perfectly demonstrate how primary school maths can shape reader perception.

In its annual Proxy Voting and Engagement Report, DWS calculates and discloses the more conservative metric - proxy votes against management divided by number of resolutions / items voted. For DWS funds in Europe and Japan, 21% were voted with an "Against" / "Withhold" out of all the voted resolutions / items. If another denominator (# of meetings voted) is used, the figure would be 72%, indicating 1,477 meetings out of 2,045 meetings were voted with at least an "Against" / "Withhold"[12].

Figure 4 serves as another example. When evaluating asset managers' support for ESG resolutions, Morningstar has adopted the average number of resolutions voted across the five-year period from 2015 and 2019, as the assessment measure of managers' proxy voting behaviour[13]. We expect this will become an even more important metric particularly for those managers close to the bottom of the Figure 4 league table.

[i] SynRating is the overall ESG score given by the proprietary DWS ESG Engine, which is outlined on page 4

FIGURE 4. THE 10 MOST SUPPORTIVE AND LEAST SUPPORTIVE ASSET MANAGERS FOR ESG-SHAREHOLDER PROPOSALS (2015 – 2019)

Fund Group	# of Resolutions Voted	Support (%)
Top 10 - Most Supportive		
DWS	998	87%
Allianz Global Investors	794	78%
Blackstone	360	73%
TIAA (Nuveen)	977	67%
AQR	882	67%
AllianceBernstein	942	65%
PIMCO	646	65%
Guggenheim	929	65%
Wells Fargo	1003	64%
Mainstay (incl. IndexIQ)	976	63%
Bottom 10 - Least Supportive		
Federated	970	8%
Hartford (Wellington)	795	7%
JP Morgan	1002	6%
Amundi (Pioneer Funds)	554	6%
American Funds Capital Group	737	4%
Vanguard	1033	4%
BlackRock (Incl. iShares)	1033	3%
Lord Abbett	706	3%
Voya	1027	3%
DFA (Dimensional)	1004	1%

Source: Morningstar (February 2020)

ESG data sources: scope of inclusion not consistent

Asset managers also boast about the wide ESG dataset and information they consume as testimony to the rigour with which they integrate ESG. This has been used as evidence that an increasing number of asset managers are building up an in-house ESG methodology and scoring system for corporate and sovereign issuers. This is happening at a time when professional ESG data providers are growing in both size and significance highlighted by the fervent level of merger and acquisition activity in the sector, such as ISS-Oekom[14].

We have also seen traditional data providers join this trend either by developing ESG data sets in-house or by acquisitions of other dedicated ESG data providers. S&P Dow Jones Indices acquired over 98% stake in Trucost, a carbon and risk analysis provider, in 2016. More recently, S&P Global acquired SAM (RobecoSAM ESG rating business) from Robeco in January 2020[15]. Fitch launched an integrated scoring system, ESG Relevance Scores, to substantiate how ESG factors influence credit rating actions in 2019[16]. Morningstar announced it would acquire the remaining approximate 60% of Sustainalytics in April 2020, after owning a close to 40% stake, which it had acquired in 2017[17].

All this M&A activity adds additional difficulty when it comes to disclosing the number of ESG data providers used by asset managers. For example, is it necessary to discern Oekom from ISS? Therefore, when asset managers disclose third-party ESG data providers in their PRI annual Transparency Report or Sustainability Report, the scope is not entirely consistent. Some only identify dedicated external ESG providers, such as Sustainalytics, MSCI or Trucost, while some others include existing financial data sources which provide additional ESG information, such as the three traditional credit agencies and Bloomberg. Thus the number of external ESG data providers presents only a limited level of evidence on the data capabilities one asset manager possesses.

At DWS, our proprietary ESG Engine collects data from five dedicated ESG data vendors, including ISS (Ethix and Oekom), MSCI, Morningstar (including Sustainalytics), S&P TruCost and Arabesque S-Ray, a high-tech ESG data provider, of which DWS bought a minor stake in 2019 to leverage its machine learning capabilities and has recently been integrated onto our platform. The ESG Engine covers 13,000 issuers and helps DWS professionals systematically integrate ESG factors into the investment process. This structured database is embedded within our portfolio management tool and is available for all liquid asset classes[18].

Behind quantitative measures: more qualitative aspects need to be considered

In addition to the three quantitative metrics mentioned above, a number of other metrics are also being closely watched by asset owners and investment consultants – ESG AuM growth, inflows and number of ESG products among others. We believe only by incorporating the qualitative contexts can one really make sensible judgements on asset managers' ESG capabilities.

For instance, due to limited availability of clean data around ESG and historically fluid categorisation, greater AuM growth and inflows can be achieved by ESG fund re-classification[19]. Similarly a larger number of ESG-related products does not testify for better approaches, underlying assets nor investment processes. Indeed when it comes to ESG fund classification more levels of scrutiny are required. Thankfully, the EU Action Plan on Sustainable Finance is a good example of increased oversight and regulation in this area.

To push this to the next step, robust ESG approaches, funds, assets and processes should be equipped with good ESG reporting. However, companies are faced with another layer of complexity, given the myriad of different reporting frameworks developed globally, ranging from the PRI, GRI, SASB, CDP to TCFD, all of which are aiming to provide guidance on measuring, assessing and reporting ESG initiatives, risks and opportunities.

In spite of the efforts underway which are trying to address concerns on reporting incoherence, such as the collaborative Better Alignment Project, the existing standards and frameworks are still individually important with distinct aims, fulfilling information needs of various audiences and serving different purposes[20]. Unsurprisingly this can be another challenging area for both asset managers and asset owners.

Not surprisingly asset managers are increasingly being ranked according to these various metrics to assess their ESG credentials. In a recent Credit Suisse equity research recommendation, DWS is acknowledged by its ESG-branded assets, flows and performance and is CS's top pick along with Amundi[21]. In its 2020 Sustainable Investments awards, Environmental Finance has recently announced DWS winning the award for the Best Sustainability Reporting by an Asset Manager[22].

Conclusion

Our aim in this paper is to show some of the metrics and their associated pitfalls in assessing ESG KPIs among asset managers. For example, classifying ESG AuM according to ESG integration rather than sustainable investment objective can inflate ESG AuM significantly. Or when assessing the performance of asset managers by proxy voting, votes against management in percentage terms can be artificially increased if a smaller denominator, such as number of companies voted, is applied. Lastly, asset managers often reveal the number of ESG data providers as an indication of their ESG commitment. However, this may not lead to more or superior data or even deeper ESG integration.

More rigorous questions therefore need to be asked on specific ESG strategies, on engagement activities with investee companies and on data coverage and analysis methodologies. And more qualitative factors need to be taken into account when evaluating ESG credentials in a broader context.

Since becoming a newly listed company in 2018, DWS has recently published its second annual Sustainability Report. In this report, we have developed our own set of Sustainability KPIs to track and measure our own progress when it comes to ESG. These include dedicated ESG AuM, proxy voting by number of meetings attended, number of corporate engagements and gender diversity among others[23].

We believe with greater transparency and third party auditing we will not only help to stamp out greenwashing, but, improve the trust and integrity of the rapidly growing ESG marketplace. Indeed, faced with inconsistencies in quantifying methodology, scope of disclosure, use of metrics and so on, industry bodies, regulators, asset managers and asset owners need to continue their collaboration in establishing a dependable framework for ESG KPIs. Behind the noisy self-promotion stage, more due diligence, comprehensive disclosure and joint efforts are necessary to make this change happen.

The Authors

Wan Huang
Investment Specialist
wan.huang@dws.com

Michael Lewis
Head of ESG Thematic Research
michael.lewis@dws.com

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Important information