diffusetap
Virtual Event Series

Data First ESG Investment Management

Guest Speaker:

Emily Chew

Global Head of Sustainability
for Investment Management
Morgan Stanley

Hosts:

Kenny Estes
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DiffuseTap: Data First ESG Investment Management

Last time on DiffuseTap, **Emily Chew, Global Head of Sustainability for Investment Management at Morgan Stanley**, talked about what sustainable investment really means, how funds and companies will be affected by the imminent global enforcement of ESG, and why you might want to take the "sustainable fund manager" bandwagon seriously.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas) … straight from your armchair like a boss.

Meet the Speaker

EMILY CHEW is an experienced leader out to drive sustainability forward in the investment management field. She has led sustainable investing and ESG integration efforts in some of the world's most recognized investment and finance companies like MSCI Inc. and Manulife Investment Management. Emily is Global Head of Sustainability for Investment Management at Morgan Stanley, where she leads sustainable investing business strategy for the investment management business unit. LinkedIn: @chewemily

About Diffuse®

We are an alternative fund platform offering differentiated investment products. From digital assets to VC funds and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds.

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KENNY ESTES: Without further ado, today's speaker is Emily Chew. Emily, would you mind introducing yourself a little bit?

EMILY CHEW: Sure. Thanks, Kenny. It's wonderful to be on this call with all of you, and wonderful to see you all. So many people are turning on their cameras, so thanks for that. It's a nice change not to be speaking to a bunch of black squares.

My name is Emily Chew. I am originally from Australia and currently based in New York. My professional title is global head of sustainability for Investment Management at Morgan Stanley. Morgan Stanley is a very large wall street investment bank that's historically known for its investment banking division. But in the last 10 years, Morgan Stanley has really gone through a transformation, and we now have three very large divisions.

There's Investment banking. Then there's also wealth management, which has really grown since the global financial crisis under the leadership of our CEO James Gorman. And now, investment management has just gone through a transformative acquisition, so we've grown really large. That acquisition was just closed a month ago, so we're all in the midst of adjusting and reforming the business.

My role is to lead our sustainable investing business strategy for the investment management business unit. I'm not involved in the wealth and banking side, so I won't address any of that today. Morgan Stanley investment management's AUM (assets under management) is now over 1.4 trillion. We invest across the global capital markets in all geographies, in all major asset classes. About 480 billion of our AUM is in fixed income, and around 360 billion is in listed equities, and we also have a fairly sizable footprint in real assets, infrastructure, private credit, private equity, and then fund of funds in the private credit, private equity, and in the hedge fund space. We have a meaningful exposure and interaction with alternatives.

Leading and defining our sustainable investing business strategy includes setting up policy, providing definitions and frameworks, identifying data sources, and creating training programs on how to use the data that's going to support our investment management staff. It also includes supporting the launch of label schemes for ESG (environmental, social, and governance) and sustainable funds, and building out a whole regulatory monitoring practice, because this space is very much influenced by regulation at this point. Regulation has really ramped up in the last couple of years.

So, it's really a little bit of everything. I get pulled in a lot of directions, which keeps me on my toes.

If there's any particular topics or questions that pique your interest about sustainability and ESG, environmental, social, and governance, feel free to ask. I imagine many of you have had some interaction with this topic, which is why you've probably come to this conversation today. Let me know, and I'll try to address them as I see them come through.

KENNY: That's great. And actually, it's a good segue, because the way we do this is as a fireside chat. My senior partner, in basically every way, is Ayla Kremb. We'll tag-team a few questions that Ayla already chucked in the chat there, and if anyone in the audience has more, we can pick yours up as well.

AYLA: I love that people are already starting to bombard the chat, so that's exciting. The first one is, when we had our prep call, we talked about what a "sustainable investment" really means in public and private markets, and you touched on the normalization of ESG integration. I think that's an interesting bit to touch on. Do you maybe want to start there?

EMILY: Yeah. I think this is an important topic to start with. It came up in my small group chat just now. People are using these terms like green or sustainable, but they're just slapping the label on to a company, or a fund, and it doesn't really mean anything. Is that a problem? Yes, it absolutely is a problem.

First of all, particularly in the investment management space, things have been really evolving for a few decades now. But it really kicked off in 2006 with the establishment of the UN principles for responsible investment, or the UN PRI, which put in place six principles that investment managers and asset owners were to sign up to support the idea that ESG factors are relevant for how we invest. It's a commitment to incorporate that into the investment process, and I think that really codified the idea that ESG factors are material and should be incorporated into your process. So, at that point, we as an industry began to think about sustainable investing as a field of practice, where there is a process element, and then distinct from that, there are outcomes.

What has been mainstreamed in the last 14 or so years is this idea that environmental, social, and governance factors are real, they're relevant, they're trackable, they're observable. There's more data available now more than ever before, and that behooves us as investment managers to look at these factors, and to incorporate them into our process. That's because there may be information there that gives us a more accurate forward-looking view of the company, that company's exposures to risks, and their leveraging of relevant opportunities, more than financial statements do.

Financial statements are basically a backward-looking view of what just happened, and the day that they're released, they immediately become historical. Whereas ESG factors or considerations can give us a better understanding of the fuller picture of the environmental and social resources that a company is relying on, which are not currently materialized in the balance sheet or in the income statement.

That's the whole spirit of ESG integration, and that's really what's been mainstreamed. What we see coming at us from all of our largest asset allocators, from all of the major and even the minor investment consultants such as organizations like Morningstar, is extensive due diligence into our processes and the rigor of our processes pertaining to ESG integration.

They're asking questions like, is the integration process systematic, transparent, measurable? Are the processes enshrined around a policy and a governance structure? How do we incorporate consideration of environmental, social, and governance factors into everything we do? Now, obviously, in the public markets space, that's going to be different to private markets, because the investment processes are different. But in the public markets space, it's very much arm's length. Starting with desk-based research, all the way to conversations with management teams, there is that kind of agency relationship between you as an allocator of capital, and a company management team. You are looking for their disclosure in their public reporting, that is being fed through to Bloomberg and other data services so that you can do that at scale in large spreadsheets and in a quantitative manner.

With that data, you're looking at things like the various material factors that could affect this company. That's going to be very different if you're looking at, say, a healthcare services company, versus a fashion retailer. The kinds of issues that you're going to focus on, and where they're going to impact intangible value, revenue, growth, potential liabilities, and provisioning for those liabilities, will be different depending on the industry that that company operates in.

It gets complex quickly. You can tell because we're talking about a huge universe of issues that includes everything from water stress, community protest, labor efficiency, labor retention, carbon emissions, climate change — just this huge gamut of issues. And then, you're looking at that in an almost matrix fashion of materiality to different industries.

Obviously, if you're an airline, your direct carbon emissions is very material, because that's quantifiable and associated with a budget, and it's a very direct cost on your bottom line. But if you're an insurance company, not so much. What is going to be relevant to an insurance company is potentially your exposure to physical climate risk on the physical assets that you're underwriting. And if you get those calculations wrong, you could be up for billions of dollars in unforeseen payouts, if you haven't modeled that appropriately.

That is the practice of ESG integration, and that's what I'd say is being mainstreamed. People walk around the industry saying it's just good investing, because it is. It's essentially expanding the view of traditional asset management — from financial metrics recorded in the income statement balance sheet, to a broader set of “non-financial metrics,” as people call them. I prefer to think of them as “pre-financial metrics,” because there's stuff in there that could be relevant, but you're not going to know if it's relevant unless you look at it, so you should look at it.

Another analogy that I like to use is that your financial statements are like your rearview mirror, and your ESG metrics are like your sideview mirror. They're both a reflection of the same reality from different angles, and you need both to be a responsible driver. You need to know what's going on. What's most important depends on where you are on the road, and what's happening around you.

It's also worth noting that the amount of due diligence that's done by investment management clients on ESG integration processes is huge and is growing. It takes us many, many hours of answering many, many due diligence questions. And those of you who are fund managers, I would imagine you would also be starting to see this feeding through. Some of the due diligence might have been done on you, particularly by some of the larger public pension funds, or larger asset allocators.

Some of the resources you can find to help you navigate this space will be on the UN PRI website. There are some really helpful technical guides for limited partners on what questions to ask GPS, so you can do a reverse inquiry there as a GP reading it. Figure out what it is that you need to get prepared to answer.

And then, I would say that where the greenwashing concern comes in is when people start to say, “Well, I'm doing all this work, considering and researching and integrating and talking to companies about it. I'm an ESG investor, or I'm an ESG fund.” I think where that gets confusing for people is when you put a label on your product and say, “I'm a Green Fund,” or “I'm a sustainable fund,” that connotes certain asset allocation decisions, and a leaning into intentional outcomes around your investing, as distinct from a mere process of consideration of ESG factors. It means that people are going to expect to see “green” companies in your portfolio. They're not going to expect to see just P&G, which is not popularly identified as a green company.

You can do an ESG analysis of P&G, and you can say, “Oh, P&G has a potentially incredible deforestation footprint. I want to see that they're doing due diligence on all their suppliers, around timber, and around palm oil, and I want to see them signing up to various commitments and monitoring all of that.” However, that in and of itself doesn't really make it a sustainable company, because that's not really built into their DNA. What we're seeing now come out of the EU regulators are much more top-down definitions of what a sustainable company is. They're actually trying to codify that through a project called the EU taxonomy project.

And the taxonomy is going to essentially define what is a “sustainable” business activity. For example, this is renewable energy generation, or this is plastics recycling. Here are a bunch of other activities, which are not necessarily unsustainable, but they're not sustainable. And so, when this gets codified over the course of the next 12 to 18 months, I think what we will expect to see is a fund that is labeled “sustainable” will need to be reporting on what proportion of their assets under management, or their NAV, is allocated to “sustainable” activities or to “sustainable” assets. It's getting to the point where it has to be classified in order to cut through some of that greenwashing.

KENNY: I have a question for you, and Sohail and Tony both had questions related to this. You were talking about standards, and the issue with standards is usually enforceability. Who's actually going to pay attention to it? What does that initiative look like in our universe? Is this like a bank-led consortium where they're all voluntarily agreeing to these types of things? Where's the teeth in all this?

EMILY: That’s a great question, Kenny. I think that one of the challenges of the space that we're in, or that I'm in, is that all of this has been monetized before any definitions were actually agreed upon by anyone, and all that has been built to date is based on voluntary standards or commitments with many conceptual gaps. There's BlackRock out there raising billions of dollars in their ESG index products, and you've got various asset managers launching these funds, but there is no definition that the CFA Institute, the IOSCO or any regulator has agreed to.

What we're starting to see just now, in the last six months, are moves by the IFRS, and the International Accounting Standards Board. We're also starting to see moves by the EU regulators to actually bring some definitions and baseline definitions as to what is a sustainable activity, what is a sustainable fund, and when can you use those labels. It’s not yet clear how this all gets enforced. First of all, we need to have the actual regulations, then the technical standards, which will then presumably define the enforcement capabilities of regional or domestic regulators.

What we're starting to see from regulators is inquiries. Someone already raised the SEC note that came out just at the end of last week, and we're seeing a lot of signaling from them that with the change of the administration in the U.S., the SEC is concerned about greenwashing more so than previously. They are conducting examinations of managers that have held themselves out to be ESG managers or sustainable fund managers with sustainable products. There are 20-, 30-page examination letters going out right now to those managers, where they need to provide evidence of the research, the definitions they're using, the auditing that they do around these definitions, and the evidence of impact on performance. The SEC is in information-gathering mode right now.

On the 10th of March, the EU just went live with a new regulation, which is an attempt to classify funds according to how ambitious the sustainability lean-in is in the fund process. The disclosure standards apply to any fund product that is managed in, sold in, or marketed to Europe. There's lots of problems with the EU regulation and personally, I found it to be unfortunately much vaguer than it could have been. But the point is that it's an attempt to codify, and we do expect that the EU will be enforcing the disclosure standards used under that regulation at some point. I think it will take more than 12 months for European regulators to actually put enforcement powers behind it, because the whole industry is still trying to sort itself out right now under this new regulatory standard.

In summary, Kenny, I would say that the enforcement has been lacking, which is why there's been a proliferation of greenwashing. But all the signals from all the regulators are imminent. We've also had the Japanese Financial Services Agency get triggered recently to ask questions and to start to look into this. So, we expect that they will be coming out with some form of guidance or standard in the next year or two as well.

AYLA: One of the questions that came up was around social investments, which is a very nebulous term. How do you measure the social impact either within a fund or within investments specifically? Could you maybe cite some data sources that would define a social investment?

EMILY: Yeah, sure. With a social investment, people say, “oh, G is clear, everyone agrees with G” – the governance side. And that's because the actual metrics that you consider to be indicators of strong or weak governance at a company have been supported by industry consensus for the last 20 to 30 years, with an extensive body of quantitative research based on these metrics. And people then say, well, environmental metrics are very conceptually clear measurable, so they're clear and can be material. But “social” is unclear and is not material.

I don't think that social metrics are not material, I just think it's much harder to quantify. Environmental is much easier to quantify, because we're talking about a physical reality. And there are agreed standards for measuring water intensity, and carbon intensity has the Greenhouse Gas Protocol, and you can measure hectare loss around forests, right? For social metrics, again, it heavily depends on the industry that you're talking about. But it's generally going to be some combination of customer metrics, employee or labor metrics, and some other metrics potentially around community engagement, and a broader set of society social stakeholders.

In the customer space, relevant metrics are going to be things like customer satisfaction, recall ratios, product safety complaints, percentage of customers which are underserved, or which were considered to be low income groups. In the employee space, it's going to be things like diversity among your employee base, your management team, your board; employee retention and turnover, average tenure, and employee satisfaction scores. All of these metrics will tend to be the ones that you'll look at.

Another helpful starting point could be the Sustainable Accounting Standards Board guidelines, which, over 10 years ago, started the process of trying to codify the potentially financially material ESG factors industry by industry through extensive consultation with industry and investor representatives. What we see now are more and more companies trying to align their ESG reporting with the Sustainable Accounting Standards Board, as well as with some other reporting frameworks that are out there.

What we see from the IFRS is that they are putting together a working group of five other voluntary ESG reporting standard groups, and they plan to establish the minimum reporting standard for sustainability/ESG metrics — this would be an industry breakthrough for creating global consistency, and interoperability of terms and definitions across markets. We've had country-level requirements usually implemented by securities commissions or listing exchanges. In China, Hong Kong, and Singapore, for example, they have a certain minimum standard of ESG metrics that you need to disclose once you get to a certain size of company. But we've never had a global standard so far. Now, we're on the cusp of having that conversation.

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Corporate Director, CME Group

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