5 Drivers of ESG Growth in Alternative Investments

ESG growth in alternative investments is accelerating. For both investors and fund managers, Environmental, Social, and Governance factors are becoming more and more important to their investment strategies.

According to Preqin, 40% of the $14T AUM in alternatives is managed by ESG-committed firms and continues to increase. ESG investing has been around for a while but has suddenly begun to hit the mainstream. What's behind the renewed interest in the alternative investments industry?

Following are 5 drivers of ESG that have pushed investors and fund managers towards a new investing reality.

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Source: Preqin, Rise of ESG

1 Regulation

With many US state and local pension funds mandated to make ESG considerations part of their investment portfolio, the focus on sustainable investment has sharpened. Even greater government intervention is anticipated in some markets. In Europe, the European Commission's Sustainable Finance Action Plan is intended to help direct capital toward sustainable activities and prevent greenwashing, which is the portrayal of an organization as environmentally friendly for marketing purposes only. Its cornerstones, the EU Taxonomy and Sustainable Finance Disclosure Regulation (SFDR), went into effect in March 2021 and will subject investment firms and asset managers to transparency with regards to sustainability risks.

The $226.4 billion New York State Common Retirement Fund will reduce its investments in energy companies in an effort to attain a net-zero carbon emissions target by 2040.

The $5 billion The Rockefeller Foundation has said it will divest from fossil fuels.[1]

On March 10, 2021 the EU SFDR Regulation went into effect. Certain financial market participants are now required to make mandatory environmental, social, and governance (ESG) disclosures.[2]

Sources:

[1] Pensions & Investments, Investors push alternative managers closer on ESG

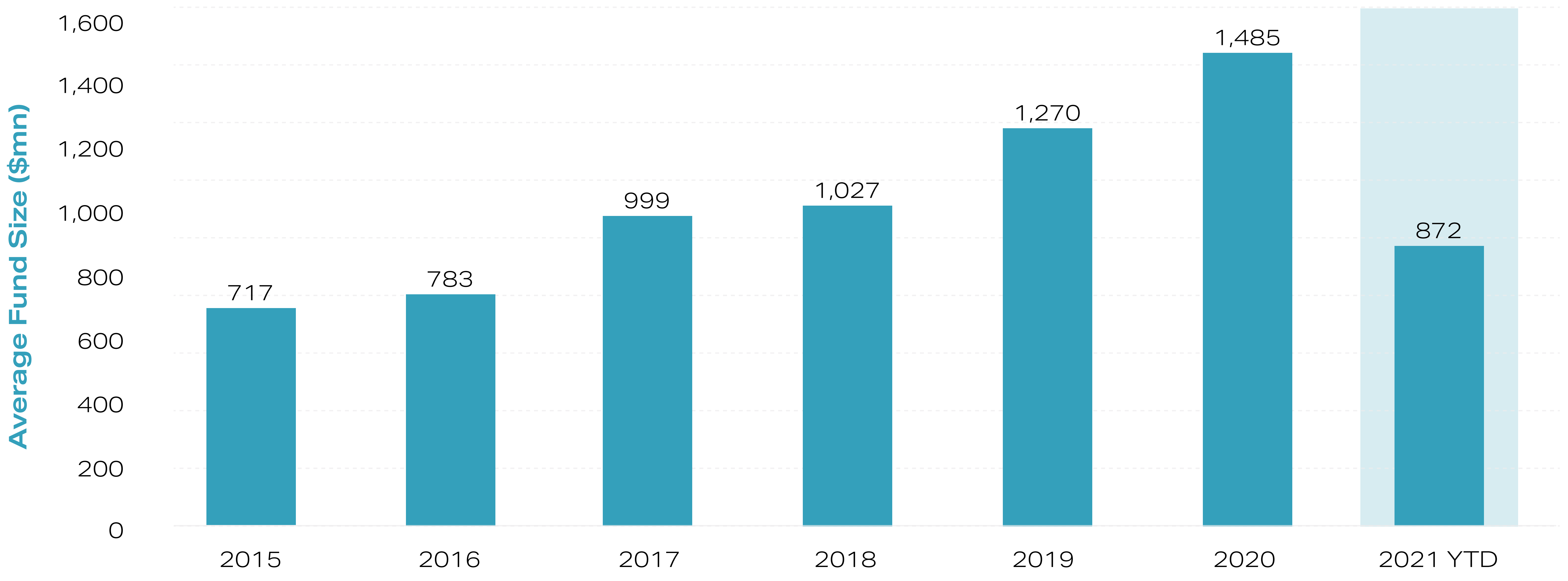
[2] The National Law Review, The EU Sustainable Finance Disclosure Regulation Enters into Force

2

LP demand for substainable investing

Investment trends are changing – LPs are diversifying their portfolios with an eye towards responsible investing, with 80% of investors intending to have an ESG plan in place by 2023. What's more, as LPs have become more aware of ESG risks and opportunities, they have begun to look to GPs to not only control for risk in their PE portfolios, but to effectively integrate ESG principles into their investments.

Average Size of ESG-Committed Private Capital Funds Closed, 2015 – 2021 YTD



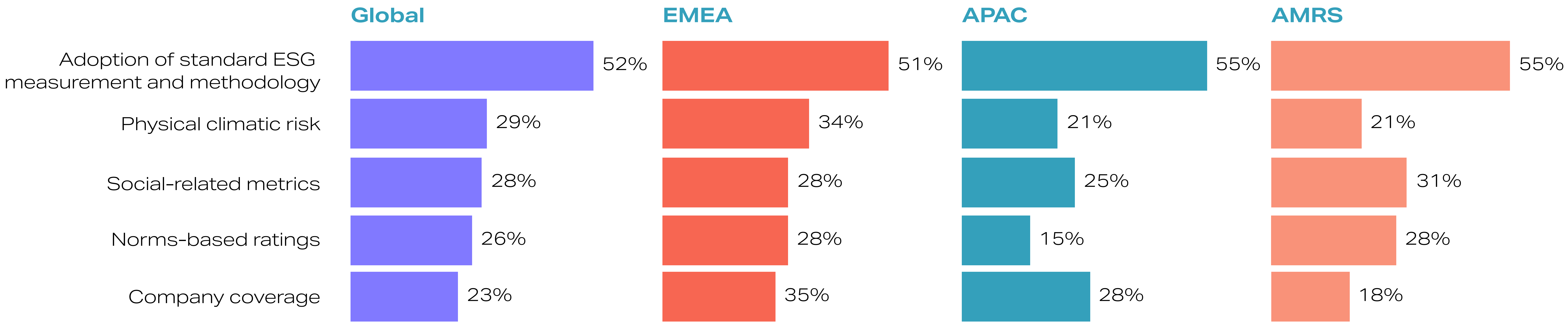
Source: Preqin Pro. Data as of April 2021

Source: Preqin, Rise of ESG

3 Improved ability to measure ESG KPIs

As the demand for sustainable investment increases, the successful adoption of ESG principles will require better data transparency and the ability to trust the data. The lack of a standardized methodology to effectively measure the impact of ESG investment in a portfolio has been a challenge for both GPs and LPs. In response to this, alternative investment technology providers have been updating their offerings to measure ESG KPIs and provide reporting capabilities that correspond with stakeholder needs.

The Need for Standardization: Which 3 ESG factors need the most development?



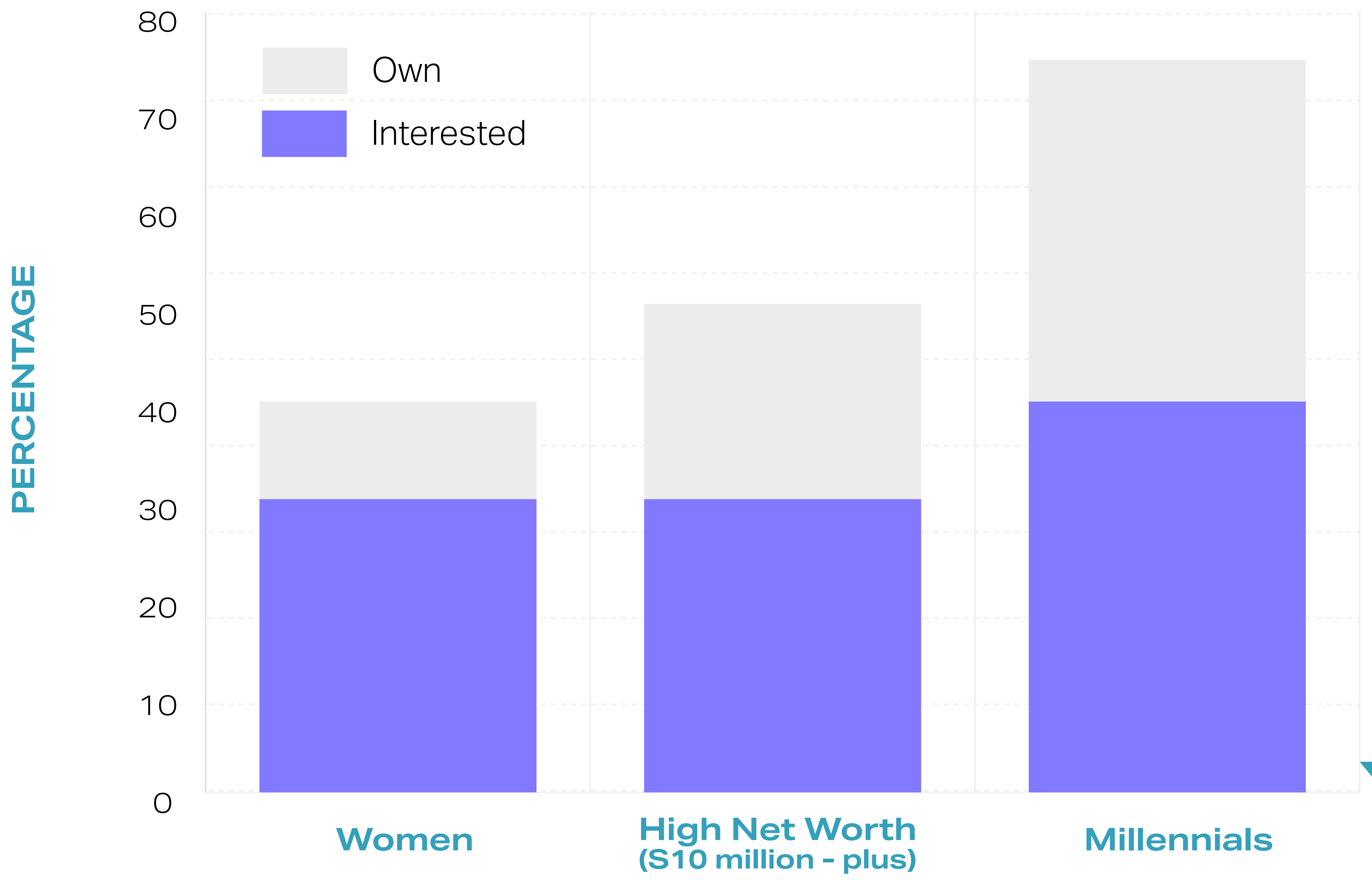
Respondents selected up to three responses.
BlackRock Global Client Sustainable Investing Survey, July-September 2020.

Source: BlackRock, 2020 Global Sustainable Investing Survey

4 A change in global focus

Global challenges increase risks for investors – while many thought ESG investment would fall by the wayside during the pandemic, the market turmoil caused by COVID-19 led businesses to re-evaluate their strategies. A new generation of investors is also turning their focus to ESG – in Europe, environmental issues are emphasized, while the U.S. has focused on social aspects. In Asia as well, target allocations to ESG strategies have seen a large increase over the past few years.

"New investments in ESG funds could total an estimated $20 trillion in the next two decades. Women, high-net worth individuals, and millennials are taking the lead."



Source: Bank of America Merrill Lynch, ESG Matters – US. "10 reasons you should care about environmental, social and governance (ESG) investing"

5

Competitive advantage

Due to the active fundraising market in alternative investments, the competition for deals is fierce, and offering ESG options is another way to distinguish oneself from other asset managers. What's more, asset managers who embrace sustainable investing are able to avoid fines associated with the implementation of mandatory regulations, better manage risk, and avoid possible reputational damage that can result from not implementing ESG practices. For these reasons, ESG adoption looks set to continue on an upward trajectory for the foreseeable future.

Stock Price Performance One Year Following ESG Risk Event

ESG RISK EVENT	DATE	1 YEAR (%)
Energy accounting scandal	8/14/01	-99.6
Telecommunications accounting scandal	3/11/02	-98.6
Upper Big Branch Mine explosion	4/5/10	-52.7
Deepwater Horizon oil spill	4/20/10	-28.2
Automobile airbag recall	1/21/14	-53.5
Pharmaceutical accounting scandal	8/5/15	-91.5
Automobile emissions scandal	9/20/15	-26.4
Average loss to shareholders after 1 year		**-64.4**

Source: Morgan Stanley. ESG and the Sustainability of Competitive Advantage.

Want to know more?

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