WHITE PAPER

Making ESG Your DNA

How Wealth Managers Can Grow Through Sustainability

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White Paper

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How Wealth Managers Can Grow Through Sustainability

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FOREWORD

The wealth management industry is more than two centuries old. Yet for much of its existence it has stuck rigidly to its established playbook, leveraging the conservative values traditionally associated with private banking. Over the past few years, however, the ground has begun to shift, amid product innovation, digitization, and a fast-changing regulatory playing field. Attitudes are also changing, with a new generation of investors increasingly focused on environmental and social issues, as well as achieving investment returns.

In this tumultuous year, in which COVID-19 has dominated the global discourse, changes are accelerating. There is rising awareness that the status quo is unsustainable and that the environmental and climate challenges facing the planet cannot be separated from issues of fairness and social justice. Reflecting these values, investors are increasingly putting Environmental, Social, and Governance (ESG) priorities at the top of their agendas, and are demanding that wealth managers not only facilitate their requirements but demonstrate that they share the values they represent. This paper drills down into these dynamics, highlighting the key strategic levers that set sustainable investment leaders apart, and identifying the pivotal steps that wealth managers must take to turn ESG awareness into a defining element of the business.

We base our perspective on research that shows the extent to which ESG has become an investor priority, particularly for the next generation (Millennials and Gen Z). To serve this community, and enable the transition to a fully-fledged ESG operating model, we identify four key levers. A primary imperative is to establish a dedicated ESG strategy, and to be bold in doing so. The vision should support the second lever — a service model that incorporates ESG across multiple dimensions, starting with products and services, but extending into all aspects of the firm's activities. A key element of the model should be an ESG taxonomy that will support accurate labelling and govern how ESG is woven into client mandates. Wealth managers should also work with third parties to develop standards and reporting frameworks for investment impacts. In parallel, it makes sense to bolster the service model with data and analytics, which will enable systematization and ensure clients are kept well informed. The third lever is ESG talent, which will be critical in creating a standout ESG proposition. Finally, leaders should develop compelling communication strategies to ensure that internal and external stakeholders understand the transformation and buy-in.

Many of the insights in this paper are reflections of the observations of the ESG experts and wealth management decision makers we work with. This input, and compelling evidence of shifting client demands, presents a compelling case for accelerating engagement. As the world finds itself in uncertain times, the onus is now on wealth mangers to take a lead in creating a more positive narrative. Those that are successful have the highest chance of bringing new investors to the table and positioning the business to grow in the years ahead.

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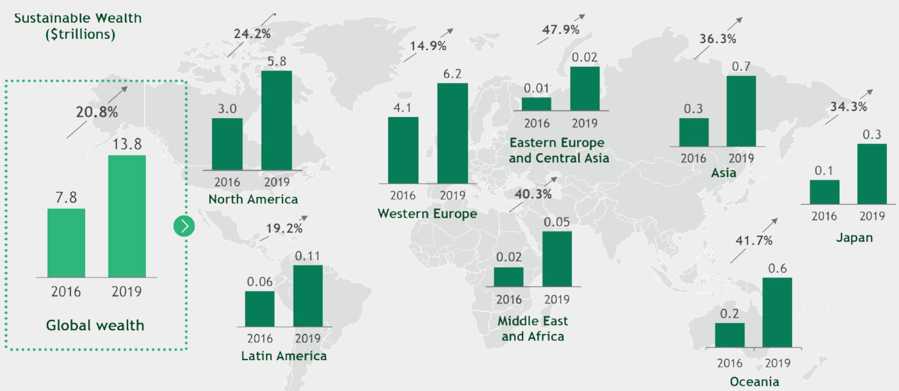
The Dangers of an ESG Deficit

Investors increasingly prioritize environmental, social, and governance (ESG) issues, reflecting growing appetite for strategies that reflect personal values and produce attractive financial returns. Wealth management firms have moved to reflect that shift in their products and marketing. However, few have made a decisive shift that incorporates ESG in every aspect of the business. In failing to do so, they risk underplaying one of the most powerful business differentiators of the decade.

Amid rising concern over climate change and the impacts of business on people and society, individual investments in sustainable assets have grown at a 20.8% annual rate over the past three years (CAGR), compared to 5.3% growth in traditional investments.[1] (See Exhibit 1).

EXHIBIT 1 | Private wealth held in sustainable assets is growing globally



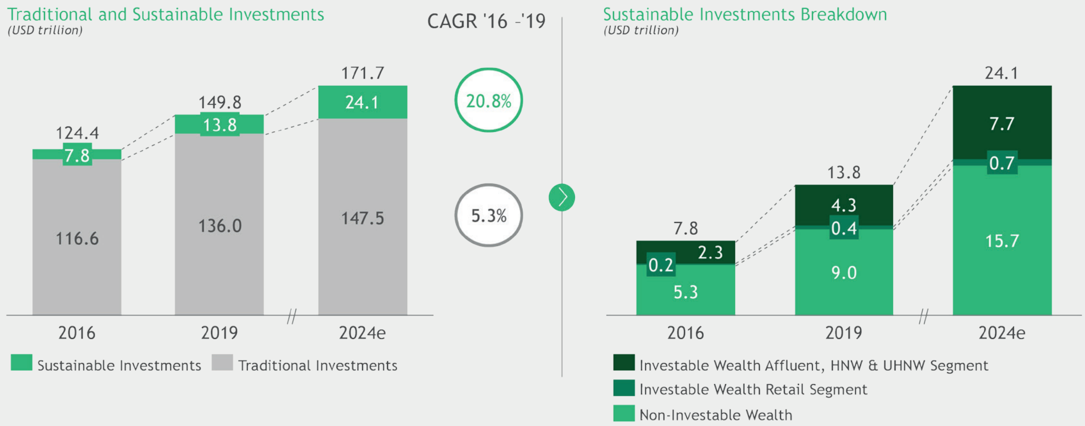
Note: Wealth in local currency was converted to US dollars at the 2019 year-end exchange rate across all time periods.
Source: BCG Global Wealth 2020 Market Sizing

Sustainable investments owned by private wealth investors reached around $13.8 trillion in 2019, and are expected to climb to around $24.1 trillion over the next five years.[2] This number is not the same as the size of the wealth management opportunity, because it includes wealth that is not addressable by wealth managers to date, and is tied up in assets including life insurance and pensions, unlisted shares, and other equity. Still, we expect the segment addressed by wealth managers to rise to $7.7 trillion by 2024, from its current $4.3 trillion. (See Exhibit 2).[3]

[1] Source: BCG Global Wealth 2020 Market Sizing
[2] Assuming continuous growth trends and based on a slow recovery scenario
[3] The estimate takes into account wealth held by affluent individuals and higher wealth segments (above $250,000) and only considers investable wealth; based on a slow recovery scenario

Exhibit 2 | Growth in sustainable investments is outpacing growth in traditional investments

SLOW RECOVERY SCENARIO
GDP decreases sharply in 2020, followed by slow recovery in 2021 and more stable growth from 2022 on



Note: Traditional and Sustainable Investments consist of Bonds, Listed Equity, Unlisted & Other Equity, Investment Funds, Life Insurance and Pensions held by private individuals; Cash & Deposits are not considered; CAGR = Compound Annual Growth Rate; 2024 figures assume continuous growth trends based on the slow recovery scenario; Retail segment includes adult individuals with personal wealth <$250k; Affluents, HNW & UHNW segments include adult individuals with personal wealth >$250k
Source: BCG Global Wealth 2020 Market Sizing

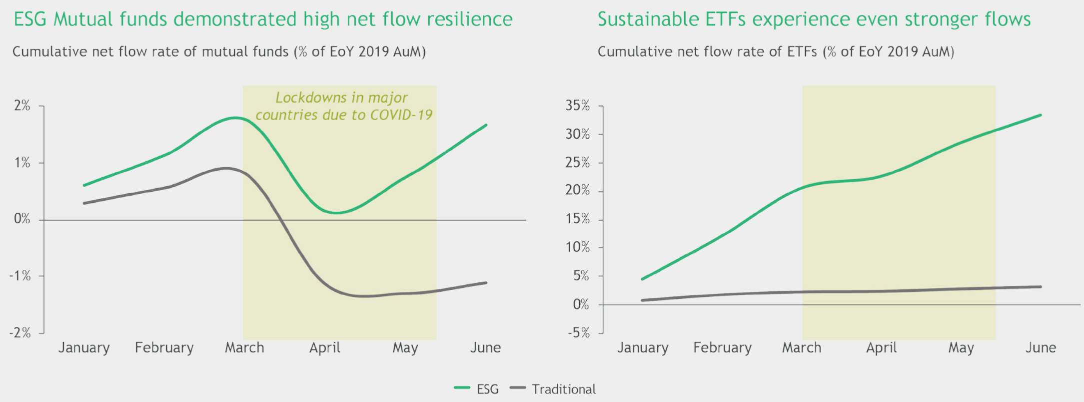
The imperative to ramp up ESG is reinforced by a shifting social landscape. As we continue to battle COVID-19, people are more aware than ever of the fragility of the world's socioeconomic systems, and the need to respect and safeguard human and natural assets. Given COVID's regressive impacts, there is increased focus on entrenched inequalities, and many wealth and asset managers are reporting rising demand for the "S" and "G" components of ESG. Investors increasingly expect companies to behave responsibly (e.g. limit their use of resources, reduce CO2 emissions) and make a positive contribution to their stakeholders and society (e.g. stand up for human rights and their own communities), and some 64% believe the crisis is a tipping point for ESG strategies.[4]

The changing mood is borne out by fund flows, which have been stronger into ESG funds than other fund categories since the start of 2020, including at the height of the COVID-19 crisis. (See Exhibit 3). The trend undermines the lingering suspicion that pro-ESG attitudes are a bull market phenomenon. Moreover, ESG strategies have outperformed during the crisis, based on MSCI data, and particularly at the height of the contagion in the early part of the year. The implication is that companies with higher ESG values are more resilient than their peers.

The accelerating demand for sustainable investing is more than a trend. Rather, it is a structural shift that highlights a change in attitudes – a change that is especially pervasive among the wealth creators of tomorrow. In that context, wealth managers must act now to ensure sustainability is at the heart of everything they do.

[4] Based on a Responsible Investor magazine survey of 300 people (April 2020)

EXHIBIT 3 | Strong consumer demand for ESG funds despite market sell-off



Note: ESG funds represent funds/ETFs that aim to reflect investors' moral and ethical values through investments that are screened for or based on issues including the environment, alcohol, gaming, tobacco, civil/human rights, religious views, etc. Traditional funds are any other funds which are not considered sustainable; Data as of June 30th, 2020; Money market funds are excluded
Source: Strategic Insight – Simfund; BCG analysis

ESG Benefits Wealth Managers and Their Clients

Wealth managers will realize clear and immediate benefits by offering a compelling ESG proposition, the most obvious being that such propositions attract inflows and create business value. In fact, banks with strong ESG performance overall benefit from valuation uplifts of as much as 3%, according to BCG's Total Societal Impact study.[5] There are also tangential impacts in terms of branding, employee engagement, and license to operate.

Given the many upsides, it is no surprise that many in the asset management industry are investing in their sustainability capabilities, often developing proprietary ESG data and analytics functions, expanding expert teams, and refining customizable investment processes across asset classes. Wealth managers are also on board, either through their asset management arms or via client-facing teams, research functions, technology tools, or the wider investment process. These efforts reflect a growing conviction that sustainable investing is a "must-have" and should be fully integrated into the operating model. Now the key is to execute on that ambition — top to bottom and front to back.

The impetus to prioritize sustainable investing is emphasized by the importance attached to the issue by younger cohorts. The NextGen segment (Millennials and Gen Z) is twice as likely to invest in companies targeting ESG factors than the general investor population. (See Exhibit 4). Moreover, NextGen's aggregate wealth will in the future be around five times what it is today, mainly driven by inheritance,[6] and already some 95% of the group expresses an interest in sustainable investing.[7] The next generation is also more eager to co-create than previous generations and is generally more committed to values around giving and sharing. Another supporting factor is that growth in women's wealth is outpacing that of men, amid rising levels of wage equality, more female leadership roles, and increasing female entrepreneurialism.

[5] Source: BCG Total Societal Impact: A New Lens for Strategy, October 2017
[6] Millennials Will Become Richest Generation In American History As Baby Boomers Transfer Over Their Wealth, Forbes, October 2019
[7] Morgan Stanley Survey Finds Investor Enthusiasm for Sustainable Investing at an All-Time High, Morgan Stanley, Sept 2019

Exhibit 4 | Next Gen will continue to drive sustainable investing demand

Note: Millennials defined as population born between 1981-1996
Source: Forbes "Millennials will become richest generation"; Morgan Stanley Institute for Sustainable Investing

This matters for sustainable investing because women favor thematic investing (including ESG) more than their male counterparts, according to BCG research.

Another tailwind emanates from the changing regulatory playing field. Since 2018, there have been over 170 ESG-related regulatory measures proposed globally — more than the previous six years combined.[8] The European Union is set to integrate sustainability risk into a range of directives, as well as the UCIT's investment framework. Companies and their auditors are also preparing to be scrutinized on how they report on climate change and ESG-related matters, in line with guidelines proposed by the Task Force on Climate-related Financial Disclosure, set up by the Financial Stability Board in 2015. By raising standards of reporting, it is likely regulators will facilitate flows of capital to sustainable businesses. The European Banking Authority, meanwhile, has published an action plan on sustainable finance and combating environmental risk.

Wealth Managers are Struggling to Capture the Opportunity

Most wealth managers have started to adjust internal organizational standards (including processes, systems and controls, and risk management) and customer-facing capabilities to cater to rising ESG demand. However, in a large number of cases, progress is being restrained by internal and external factors, the most powerful being that:

- There are few consistent definitions and too many ways to rate individual securities and third-party funds, leading to challenges in product categorization and constructing mandates for clients.

- Data quality is improving as the industry matures, but there is a long way to go.

[8] ESG regulations and their impact on advice, FT Adviser, May 2020.

- Investor values and expectations are heterogeneous, preventing firms from developing standardized playbooks.

- There is a lack of ESG talent and knowledge in the market, which means wealth managers are competing with each other for an insufficient pool of expertise.

- The ESG sales process tends to be less efficient than its mainstream counterpart, probably because it requires a more granulated understanding of client priorities and employs different measures of benefit. Sometimes the client is passionate about the issues involved and wants to talk about them for longer.

To get ahead of the competition, wealth managers must navigate these challenges and arrive at a practical roadmap and implementation plan. Maximizing impact is likely to be contingent on the ability to embed sustainability in the firm's DNA, based on strategic ambition cascaded into daily actions.

Getting There: Enhancing the ESG Operating Model

The opportunities offered by ESG are significant. However, amid rising competition, wealth managers are unlikely to reap the benefits without a step change in approach. That means constructing a dedicated framework, built on the foundations of strategic mission, technical expertise, and a willingness to put customers' priorities at the center of the process.

A common challenge in larger organizations is ensuring that the ESG focus in the wealth management business is matched by a similar level of commitment on an enterprise level. From an enterprise perspective, ESG must be aligned with the bigger picture, with decision makers focusing on three distinct areas of engagement, as BCG's work on Total Societal Impact shows. (See Exhibit 5).

Exhibit 5 | A holistic framework for ESG in Wealth Management

Source: BCG

There are three imperatives: a strategic vision and business case, backed by strong board and CEO leadership; supporting elements that include measurable goals, tracking capabilities, and stakeholder engagement; and a robust governance and organizational structure, with clear responsibilities and incentives.

In the wealth management context, the difference between offering a distinctive proposition and being one of the pack is likely to be calibrated to level of commitment. That means taking action in four key areas:

Establish an ESG strategy. As a first step, wealth managers should focus on creating a strategy for a comprehensive ESG value proposition, based on concrete growth targets and a roadmap to achieve them. Decision makers should be bold in setting growth projections and determining market positioning, but bear in mind that ESG targets should be realistic, measurable, and monitored on a regular basis. The business should have a clear idea of the proportion of sustainable assets it might reasonably expect to attract.

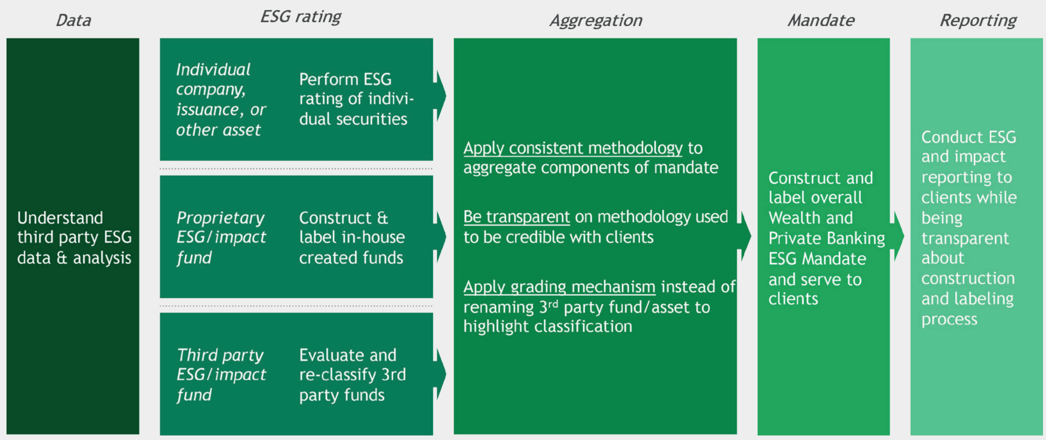
Build a viable ESG client service model. An ESG service model must cover multiple dimensions. (See Exhibit 5). It should comprise an expanded product and service offering, and incorporate ESG sensibilities through the advisory process, as well as in investment allocation, impact measurement, and client reporting. The wealth manager should be able to provide transparency on investment impacts, which may include decarbonization, governance changes, or benefits to social causes such as reducing gender or racial inequality. Ideally, wealth managers should provide clients with customized views of impacts, based on transparent and standardized reporting. They can also aggregate these into impact reports for their own purposes.

There is an imperative to invest in data and analytics that can create differentiation and generate value for clients in understanding, benchmarking, and reviewing their investments. Clients may ask how many women are on the board of a particular company, or about the carbon footprint of a particular corporate activity. There are tools on the market to help wealth managers respond to these questions, and leading players may also consider investing in their own capabilities, particularly where external data sources are not as reliable or consistent as they could be.

A key element of the client service model should be a clear and credible taxonomy, or set of rules that governs how ESG is woven into client mandates (See Exhibit 6). If necessary, firms should be willing to label third party funds based on their own criteria, as is increasingly common in the asset management space. In addition, wealth managers will require a methodology to classify the ESG performance of individual securities included in sustainable mandates. Mandates themselves should be clearly defined with respect to their sustainability credentials. These measures will help wealth owners understand the many terms and labels associated with ESG investing, and give them the confidence to identify products that meet their needs.

Wealth managers in the EU will likely keep an eye on the EU Taxonomy, currently in development, which will set out product-specific requirements for determining

EXHIBIT 6 | Workflow to create a taxonomy in wealth management



the sustainability of any product, the ESG objectives to which the products contribute, and the proportion of underlying investments that are taxonomy eligible.

Finally, the service model should incorporate standards for reporting and benchmarking, which wealth managers may wish to develop in collaboration with peers. Reporting standards should include consistent data fields and reporting languages, which will make it easier for companies to submit data to clients. In addition, there is work to be done to ensure companies report on factors that reflect wealth manager requirements.

Perfect your talent strategy. There is fierce competition for ESG talent, reflecting the need to set up new ESG service offerings, decisioning frameworks, assessment methodologies, and knowledge platforms. In addition, firms need to differentiate on expertise, commitment, and levels of service. To do so, a dedicated sustainability talent strategy is likely to be essential. Firms must identify the appropriate ESG expertise for their needs, while understanding that passionate and motivated people want to work where they make a difference. Initiatives should be backed with training across the firm, ensuring that teams are up to date on the latest developments and ideas. Role descriptions should be updated to include ESG knowledge.

Engage, excite, and communicate. Wealth managers should not underestimate the potential power of robust ESG communication frameworks for both internal and external audiences. This must go beyond lip service. Instead, decision makers must ensure the manager "walks the talk," for example, by becoming carbon neutral, using renewable energy, or promoting equality. These steps will help promote buy-in among employees and cement the brand's sustainability credentials. Externally, firms should report on metrics such as sustainable Assets Under Management (AuM), or achievements aligned with the UN Sustainable Development Goals, leveraging resources such as those provided by the Task Force on Climate-related Financial Disclosures. Decision makers should encourage employees to contribute ideas to communications initiatives.

Integrating ESG Across the Organization

Winning ESG propositions generally reflect pan-organizational buy-in and willingness to embrace radical transformation. From the board down, there is an imperative to live and breathe the values that ESG themes represent, and to ensure that these are reflected in decisions and processes. In advisory, for example, wealth managers should focus on ensuring that frameworks and methodologies are positioned to add value and reflect clients' priorities. Areas where ESG themes can be introduced and discussed include:

- Client profiling and setting of individual investment objectives
- Planning of the offering
- Presentation of the offering, including client-specific asset allocation and products
- Measurement and review of portfolio performance
- Portfolio rebalancing
- Reporting on the impact of investments and general client communication

There is a risk that ESG propositions do not live up to their billing, so wealth managers should be comprehensive in ensuring there are no potential liabilities contained in portfolios or marketing. Pitfalls to watch out for include invested companies not meeting ESG thresholds, products being misaligned with the taxonomy, and casual use of language that turns out to be inaccurate. The soaring popularity of ESG has created a bandwagon effect across business – leading to heightened awareness among consumers of the potential for "greenwashing". Wealth managers should be robust in ensuring they are not caught up in these kinds of criticisms and that the ESG proposition is squeaky clean.

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RISING DEMAND FOR sustainable investment presents wealth managers with a significant opportunity. For those set to accelerate their efforts, the current period, and its attendant pandemic-related sensitivities, is the ideal time to act. That means working to fully integrate sustainability across the organization (well beyond a narrow product lens), ramping up services to meet a diverse set of client needs, creating a taxonomy backed by expertise and analytical tools, and working in partnership with stakeholders to ensure more consistent standards around performance and reporting. These individually and collectively are significant challenges. However, given ESG's trajectory, they are also strategic imperatives that have the potential to create value and align wealth managers with the priorities of the next generation of investors.

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If you would like to discuss this report, please contact one of the authors.

Further reading

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An article by Boston Consulting Group, July 2020

The Pandemic Is Heightening Environmental Awareness
A slidedeck by Boston Consulting Group, July 2020

ESG Commitments Are Here to Stay
A commentary by Boston Consulting Group, June 2020

Global Wealth 2020: The Future of Wealth Management—A CEO Agenda
A report by Boston Consulting Group, June 2020

Climate Should Not Be the Virus's Next Victim
An article by Boston Consulting Group, May 2020

How Companies Can Turn ESG Risk Management into an Asset
An article by Boston Consulting Group, February 2020

Managing the Next Decade of Women's Wealth
A white paper by Boston Consulting Group, October 2019

How Asset Managers Can Seize the Lead in Sustainable Investing
An article by Boston Consulting Group, July 2019

Total Societal Impact: A New Lens for Strategy
A report by Boston Consulting Group, October 2017

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