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HOW INVESTMENT FIRMS NEED TO NAVIGATE THE ESG DATA LANDSCAPE

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CONTENTS

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INTRODUCTION

Financial reporting standards have created vast amounts of information that help investors make smarter decisions. Now, without global rules or the luxury of time, firms are rushing to incorporate disparate and sometimes contradictory sustainability data and metrics into their complex financial formulas.

After years of growing awareness, environmental, social, and governance (ESG) factors have transformed from an emerging interest to an urgent need.

When the United Nations unveiled its Principles for Responsible Investing in 2006, organizations representing more than US$2 trillion in assets agreed to join the effort.[1] Now the signatories have US$121 trillion in assets under management (AUM).[2] The performance of sustainable funds has also proved resilient, even in the midst of the brief global recession caused by the COVID-19 pandemic. While flows into traditional funds dropped by hundreds of billions of dollars in the spring of 2020, sustainable funds remained in positive territory, according to Morningstar.[3]

The question is no longer whether to factor ESG metrics into decision-making but instead how to integrate them fully into the investment process. However, these decisions will only be as good as the underlying data. Firms need to better understand which sustainability data leads to the insights that offer the greatest competitive edge.

455

Respondents

GOALS

To better understand how investment firms use ESG ratings and data to make decisions, and to determine how they can find better ways to evaluate this wealth of information

KEY SURVEY FINDINGS

The pace of ESG investing has accelerated greatly in recent years, with its share of global AUM projected to reach one-third by 2025.[4] ESG investments are an increasingly important part of portfolios, but the sustainability data ecosystem is far from mature. Infosys' global survey of investment and fund managers found that the types of data and ratings used make a difference in investment performance. But firms are often unsure about what data leads to the best results and even struggle to determine what outcomes ESG metrics should provide.

Let's take a close look at our **seven key survey findings:**

01 Internal ESG ratings generate better results

Companies that use data to create their own ESG ratings perform better than those that rely only on external ratings. Firms that combine internal and external ratings report the best performance — 6.9% above the S&P 500.

Our research also found that firms report the highest performance when they combine both data from ratings agencies and ESG data directly from companies.

02 Not all ESG data sources are equal

About 1 in 4 of the ESG ratings used by respondents had a statistically significant impact on investment performance. And the popularity of an ESG rating does not necessarily correlate with effectiveness.

03 Firms are complacent about ESG investing

More than 80% of investment and fund managers want to maintain their current ESG approach, neither increasing nor decreasing their focus on sustainability.

04 Investors are not convinced of ESG metrics' impact

More than 40% of respondents are neutral about whether their ESG metrics affect investment returns or people and planet. However, those who did report an impact say it affected only returns or people and planet — not both.

05 Altruism and profits go hand in hand

Investment managers who are more confident in their ESG metrics, including the effects on people and planet, are more likely to have above-average returns.

Respondents with the most confidence in their ratings' predictive ability have investment performance about 1 percentage point higher than those who are more neutral.

06 Risk or opportunity. Why not both?

Investment and fund managers say they use ESG metrics more often to measure risk. But they report that the primary benefit is generating higher returns.

07 Firms use ESG metrics to develop company relationships

Investment firms meet with their clients about ESG metrics and ratings for two main reasons: strengthening relationships and helping clients reach sustainability targets.

SURVEY METHODOLOGY

In October 2021, Infosys surveyed investment firms to better understand how they use ESG data and metrics to make decisions and to assess the benefits that result.

The survey also looked at the popularity of various ESG metrics and how they affect investment performance.

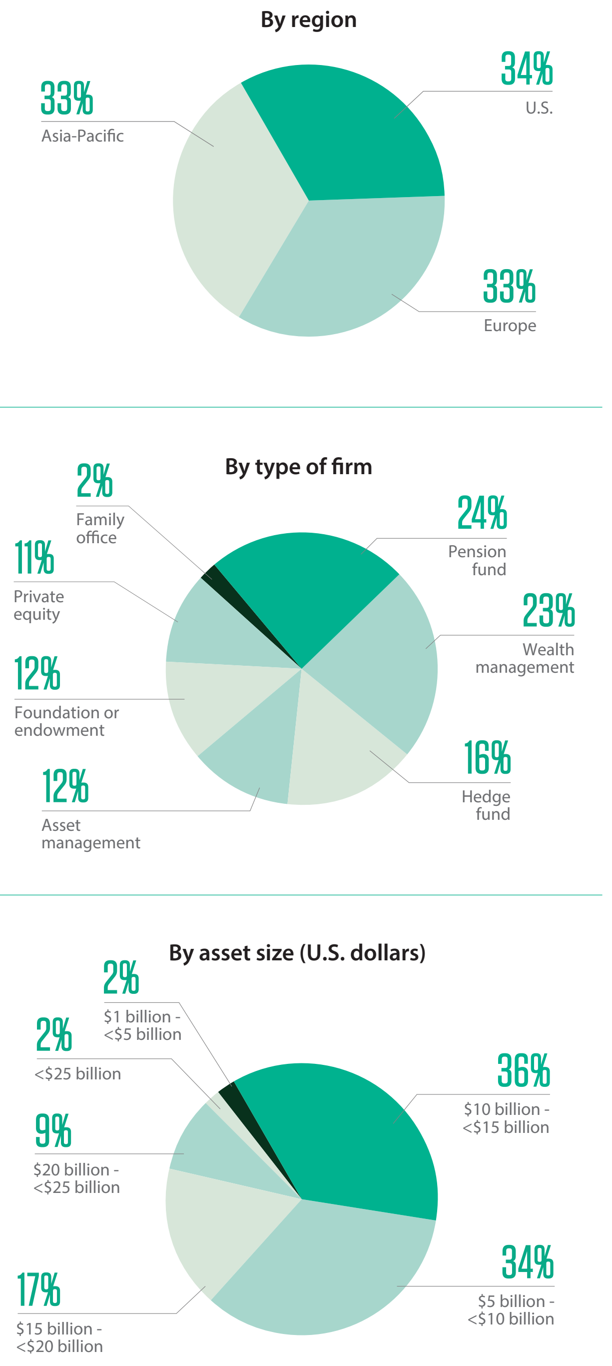
The data was collected from a global survey of 455 investment and fund managers. The respondents include those who oversee the investment process and those who make investment decisions.

The largest percentage are investment managers (62%), and the rest are fund managers (38%). Nearly half the people surveyed work at either a pension fund or a wealth management firm.

Each of the companies surveyed has assets of more than US$1 billion, and they are split equally among the U.S., Europe, and the Asia-Pacific region (see Figure 1).

The Infosys survey was designed to understand investment firms' ESG goals, identify the most commonly used data and metrics, and determine which ones lead to the best performance. The report also provides direction on how firms should evaluate their ESG data strategy.

Figure 1. Infosys surveyed 455 investment and fund managers



Source: Infosys Knowledge Institute

KEY FINDING 1

INTERNAL ESG RATINGS GENERATE BETTER RESULTS

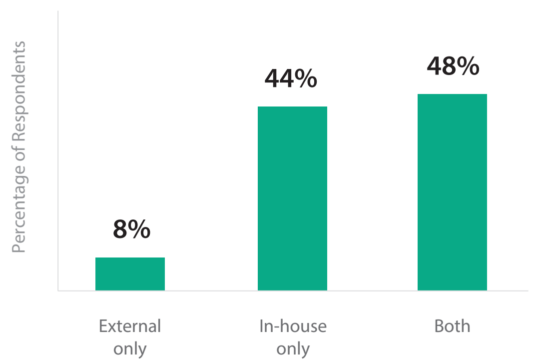
Investment firms are always seeking even the smallest edge — particularly when tiny fractions can equal millions or even billions of dollars.

It was inevitable that firms would utilize their deep knowledge of data analysis to develop their own internal ESG ratings.

Nearly all the investors in our survey say they either use internal ratings only (44%) or a combination of internal and external ratings (48%). (See Figure 2.) This specific data gathering and analysis led to better investment performance, although the ESG investments as a whole outpaced traditional investments.

Q. Do you use external ESG ratings agencies, ratings developed in-house, or both?

Figure 2. More than 9 out of 10 firms create their own internal ESG ratings

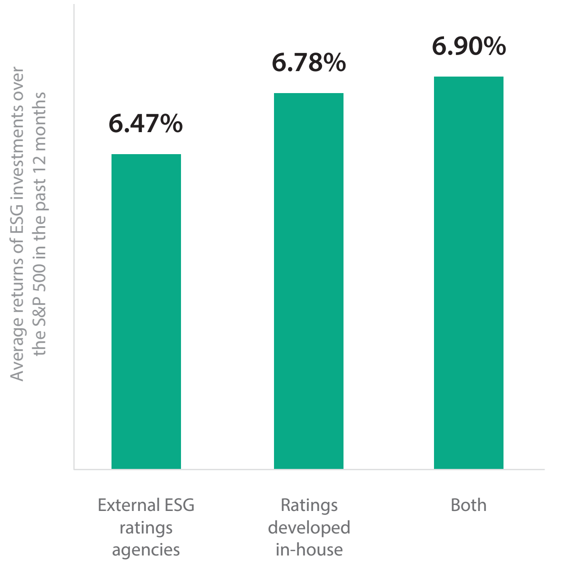


Source: Infosys Knowledge Institute

KEY FINDING 1

Investors that use internal ratings — either alone or in combination with external ratings — do better than firms that rely entirely on external ratings. Those investors have returns that were 6.47% higher than the S&P 500 (see Figure 3). That performance increased to 6.78% for those using only internal ratings and 6.90% above the baseline for firms using both internal and external.

Figure 3. The best-performing investment firms combine internal and external data



Source: Infosys Knowledge Institute

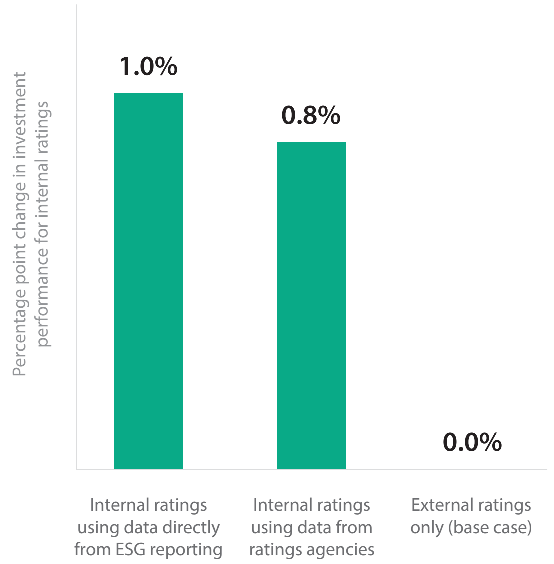
The survey results suggest that more than half of firms still have room to improve their investment performance — either by developing their own internal metrics or combining them with outside ratings.

Looking more closely at the survey results, our analysis found that firms can improve their performance further by deciding which data to gather.

On average, firms that use ESG reporting data directly from their target companies perform better (by 1 percentage point) than competitors that rely only on external ratings (see Figure 4). Firms that use data from ratings agencies — not just the ratings themselves — perform 0.8 percentage point better.

These data sources offer clear advantages, particularly when combined. However, we discovered that barely any firms (fewer than 3%) use both sources — company ESG reports and ratings agency data. Again, this offers another edge for investors; firms can use both these data sources and stack the benefits, leading to a potential 1.8 percentage point boost over those relying only on external ratings.

Figure 4. Firms can increase investment performance by gathering a wider variety of data



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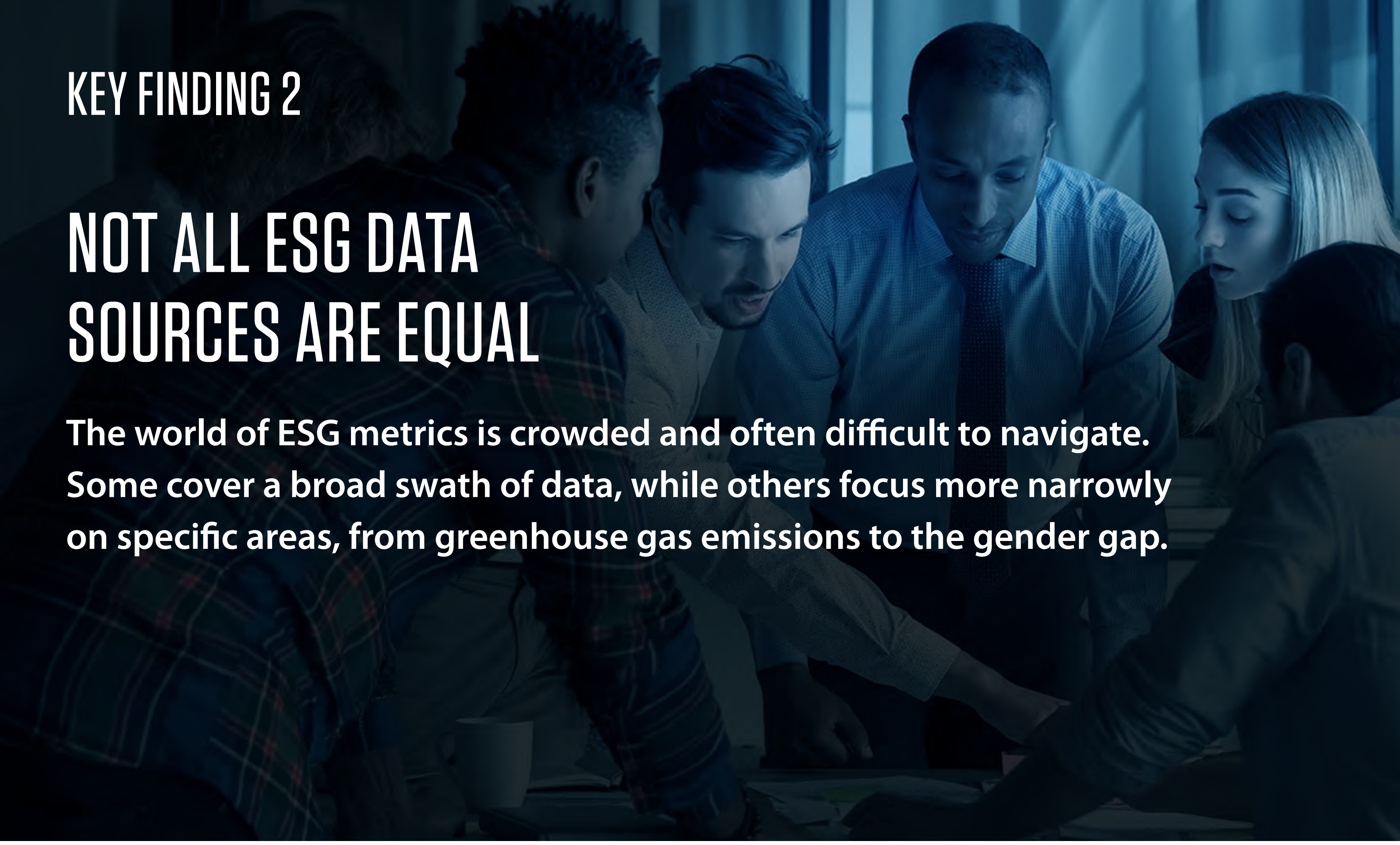


KEY FINDING 2

NOT ALL ESG DATA SOURCES ARE EQUAL

The world of ESG metrics is crowded and often difficult to navigate. Some cover a broad swath of data, while others focus more narrowly on specific areas, from greenhouse gas emissions to the gender gap.

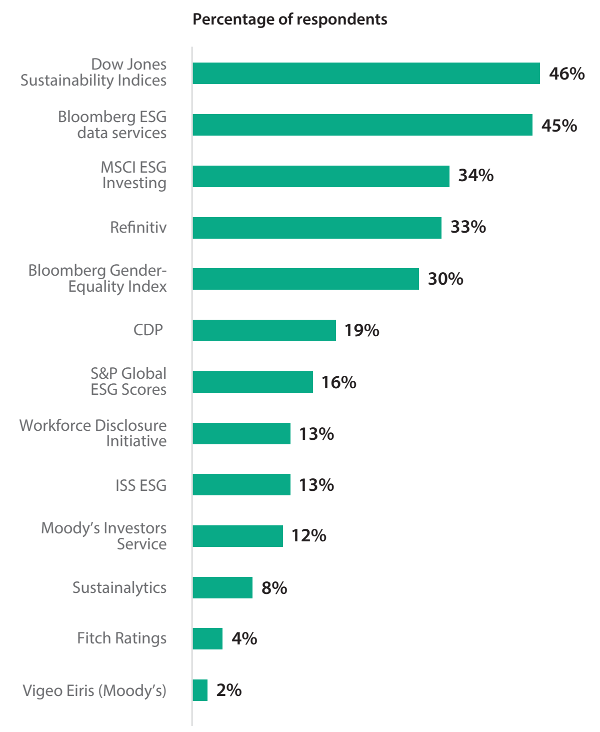
On average, these investors used about three different ratings agencies — or data from those agencies — to help untangle the complexity. Ultimately, the goal is to find investments that can weather long-term market changes such as stricter government regulations and shifting customer demands.

In our survey, we asked firms which ESG data sources they used most often. The Dow Jones Sustainability Indices and Bloomberg ESG data services stood out at the top of the list, with nearly half of investors (46% and 45%, respectively) using those two sources. (See Figure 5.) Three others — MSCI ESG Investing, Refinitiv, and Bloomberg Gender-Equality Index — were used by about one-third of the firms.

We also analyzed survey responses to determine how — or if — different sources affected investment performance (compared to the S&P 500), either positively or negatively. Few of these external sources stood out from the rest; only about 1 in 4 had a statistically significant impact on investment performance.

This analysis also found that popularity and effectiveness were not one and the same. Some of the most commonly used agencies had no effect on how well the firms' ESG investments performed. Meanwhile, use of one of the less-popular ratings agencies led to significantly better investment performance.

Figure 5. A handful of services dominate the ESG ratings market



Source: Infosys Knowledge Institute

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KEY FINDING 2

The mixed performances of these ratings, however, suggest that firms need to expend more effort to rate the ratings. Their robust data analytics capabilities and machine learning systems can help them better understand ESG data and ratings performance. Our research also offers insights into how the different combinations of ratings and data interact.

More research along these lines is needed to determine the factors that are likely to make ratings more predictive and understand how the results might change in different environments. There is no shortcut to finding the best ESG ratings.

"Investment professionals will need to carefully evaluate the different ESG ratings and data sources available to determine which factors best meet their clients' goals. Leaders in ESG will layer their own analysis and models onto available data to better understand ESG risks and opportunities."
Todd Roazen, Infosys Consulting

KEY FINDING 3

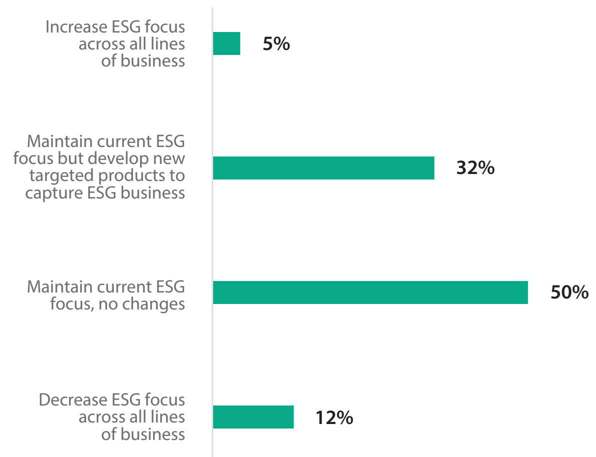
FIRMS ARE COMPLACENT ABOUT ESG INVESTING

This will be remembered as a critical era for ESG investment — the moment when outcomes outpaced expectations.

Moody's Investors Service calculated that inflows to ESG investments increased by 140% in 2020.[5] And even in a bull market, sustainability-focused investments beat the S&P 500. However, our survey uncovered signs of complacency among investment and fund managers. More than 80% of investors say they want to maintain their current ESG focus, although 32% are in favor of developing new targeted products to capture ESG business (see Figure 6).

A relatively small group (12%) wants to decrease their ESG focus across all lines of business. That's more than twice the percentage (5%) that want to increase ESG focus in all investment decisions. Even as growth is predicted to continue, these investors are satisfied with the status quo. Skepticism about some ESG investment or even fear of a backlash has grown stronger.[6]

Figure 6. A large majority of firms want to maintain their current ESG focus



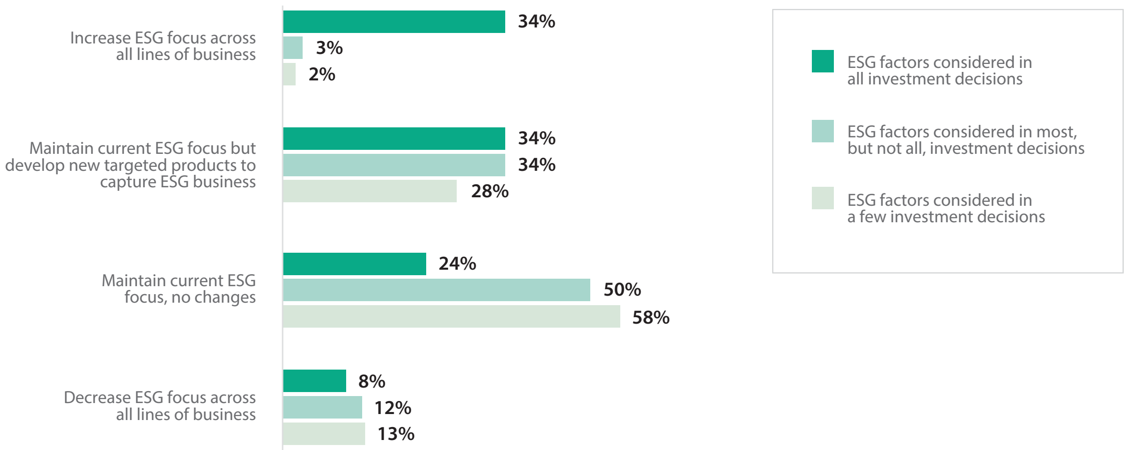
Source: Infosys Knowledge Institute

KEY FINDING 3

The survey results, however, show that investors who look to broaden their use of ESG metrics are already highly focused on sustainability. More than one-third of that group say they already consider ESG factors in all investment decisions (see Figure 7). Every firm is seeking to capture the growing ESG market.

But our survey shows a split between the largest group, which is interested in impact investing, and firms using standard ESG investing to make sustainability a core element of their investment strategies. This could be a differentiator for some firms if ESG investments continue their rapid growth and investors demand even higher levels of commitment to sustainability.

Figure 7. Firms that are the most focused on ESG investing are more likely to want to expand further



Source: Infosys Knowledge Institute

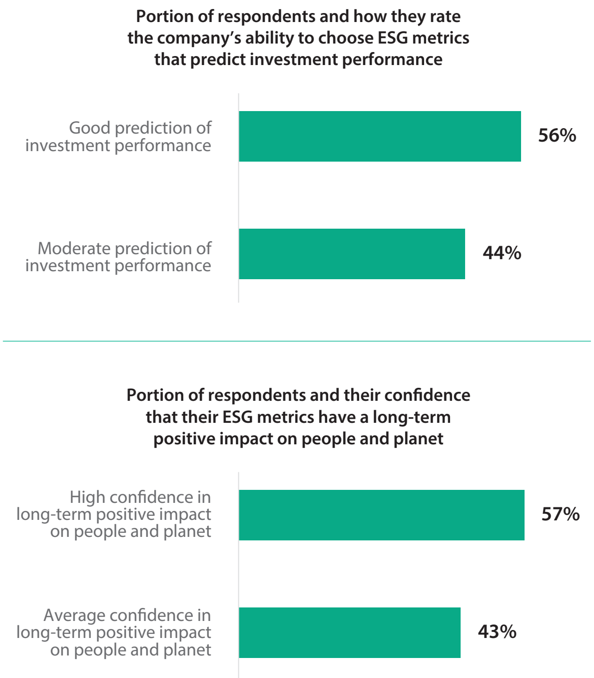
KEY FINDING 4

INVESTORS ARE NOT CONVINCED OF ESG METRICS' IMPACT

Investment firms are relying on their ESG metrics to steer them in a profitable and sustainable direction. But our survey found that many investors are skeptical that the metrics they use had a major impact.

Nearly half (44%) were neutral about whether their ESG metrics improved their investment returns, even for those whose sustainability-focused investments outperformed the market as a whole (see Figure 8). A similar proportion (43%) were neutral about whether their ESG metrics have a positive effect on people and planet. This suggests that many investment and fund managers either have limited confidence in their data or are not convinced about the value of their firm's growing ESG focus. This mirrors the attitudes of some critics who believe ESG investments are riding a wave of popularity rather than reflecting a commitment to change or a shift in how to value the bottom line.

Figure 8. A significant minority is unconvinced of their ESG metrics' impact



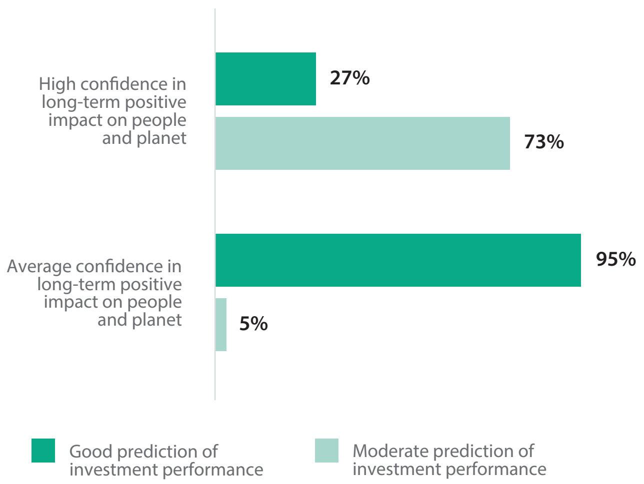
Source: Infosys Knowledge Institute

KEY FINDING 4

Despite this large group of skeptics, a majority of investment managers still believe that the ESG metrics they use help people and planet (57%) and predict investment performance (56%). Surprisingly, few of these bullish investors believe that their metrics accomplish both goals.

Among those most confident that their decisions help people and planet, only 27% also think that their metrics predict investment performance (see Figure 9). Conversely, among those most confident about the financial performance, only 5% say the metrics will significantly improve people and planet. These responses point to either a mistrust of the metrics' overall effectiveness or doubts that ESG can be everything to everyone — that investing can generate a positive environmental or social impact without sacrificing returns.

Figure 9. A significant number of investors are not convinced of their ESG metrics' impact



Source: Infosys Knowledge Institute

KEY FINDING 5

ALTRUISM AND PROFITS GO HAND IN HAND

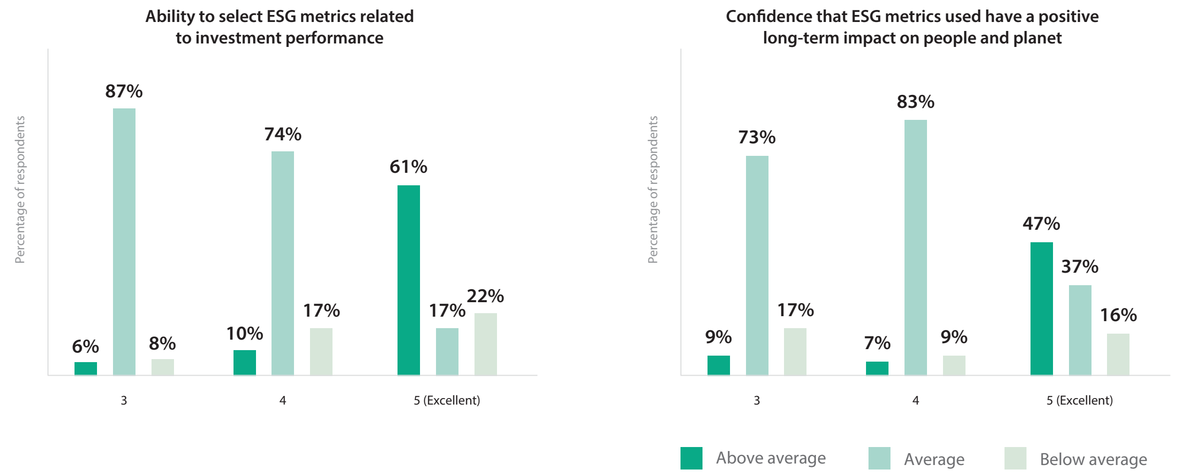
The often-haphazard world of ESG metrics frustrates many investors and leaves them wondering which ratings can be trusted. Investors, however, generally understand when those metrics are effective, according to our research into this tumultuous stretch.

Investors who are the most confident about their ESG metrics — both for societal and financial reasons — were also the most likely to report above-average investment performance in that 12-month period (see Figure 10). Those financial high performers are more certain that their sustainable investments have a long-term positive effect on people and planet. Among investors who were neutral (3 on a scale of 5) about their firm's ESG ratings, only 5.5% posted above-average returns. Of those who say their ESG ratings are excellent (5 on a scale of 5), 61% were above average.

We found a similar correlation for those who say their company's ESG metrics do an excellent job of predicting financial performance. In that group, 47% reported returns that were above average. Just 9% of the neutral respondents fell into that top category. When controlling for other factors, we found that the group most confident about predicting financial performance has returns that are 1 percentage point higher on average than those of the neutral investors.

The more you think your metrics matter, the higher your returns. And vice versa; the higher your returns, the more you think your metrics matter.

Figure 10. Confidence and outcomes go hand in hand



Source: Infosys Knowledge Institute

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KEY FINDING 6

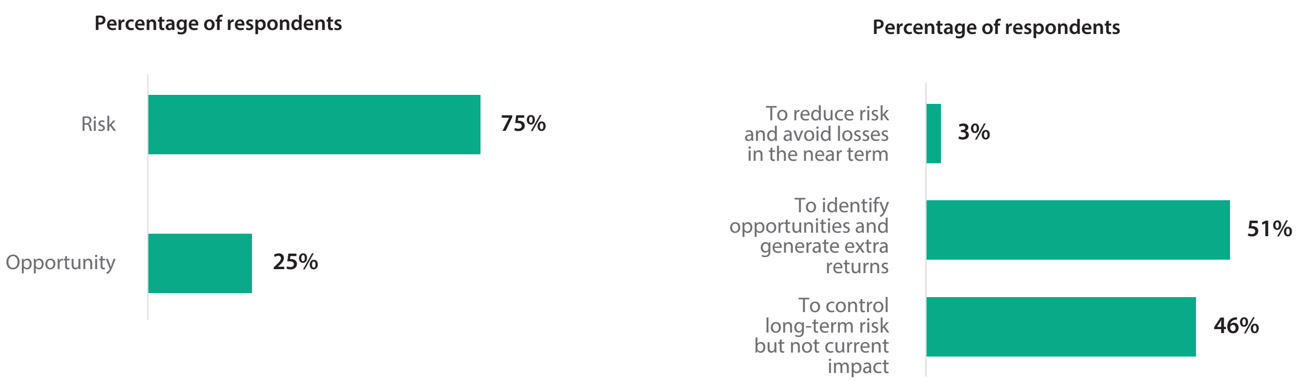
RISK OR OPPORTUNITY. WHY NOT BOTH?

The financial services industry has embraced ESG metrics, recognizing that these elements are critical to future success.

Q. **Do you view ESG metrics primarily as a tool for measuring risk or opportunity?**

Q. **What do you think are the primary benefits of using ESG factors for your investment?**

Figure 11. ESG strategy and benefits do not always align



Source: Infosys Knowledge Institute

In 2020, 85% of firms considered ESG factors in their investment decisions, according to Gartner.[7] Although ESG metrics are now a standard part of the investor's toolkit, firms are still trying to determine how best to use the data. We found that there is often a disconnect between the main reason that firms focus on sustainability and the benefits they receive.

In our survey, three-quarters of investment and fund managers use ESG metrics primarily to measure risk (see Figure 11). But a slight majority (51%) says the greatest benefit is identifying opportunities and producing higher returns.

KEY FINDING 6

This divide does not necessarily indicate a problem. Banks can use ESG metrics for these dual purposes; each set of benefits helps with a different timeline.

The mitigation of risk is a long-term effort — one that might not be apparent for years or perhaps decades. Few investors see significant benefits in near-term risk reduction. Still, investors are able to profit from the current ESG premium in the short term while insuring themselves against the future.

These staggered benefits will also allow investors to balance their concerns that ESG investments could be a bubble, a warning sounded by the Bank for Internal Settlements, among others.[8] Investment in ESG funds doubled to US$51.1 billion in 2020, according to Morningstar.[9] Still, if returns were to slip, the long-term benefits will remain for many of these investments.

Our survey also found a misalignment in how investors view ESG metrics — this time based on job functions. Eighty percent of respondents who oversee their organization's investment process say that measuring risk was their primary reason for using these metrics. Only 20% of those who make the investment decisions agree that risk is the driving factor. A majority (54%) of this group sees ESG metrics as an offensive tool that allows them to measure opportunities. Some of this difference is likely a function of roles and how far they are looking into the future.

KEY FINDING 7

FIRMS ARE USING ESG METRICS TO DEVELOP CLIENT RELATIONSHIPS

As ESG investments skyrocket, the importance of sustainability metrics has grown. But many firms have found additional benefits beyond the obvious.

More than one-third (36%) say the primary reason they contact companies about ESG ratings or metrics is to build or strengthen relationships. That was the most common answer, slightly ahead of reasons that are more directly related to sustainability. Investors say they typically engage with firms quarterly (50%) or annually (47%) about ESG ratings.

Nearly as many investment and fund managers (35%) say they engage with companies to help them meet their preferred ESG targets, such as the United Nations' Sustainable Development Goals (U.N. SDGs).

And about 10% say their goal is to help companies with their long-term risk and mitigation strategy. In this survey, investors say they consider ESG metrics mainly a tool for measuring risk.

Very few investors say they primarily engage with firms to reduce chances of greenwashing. However, this is a growing concern — and likely to increase — as ESG investing expands. Nearly 60% of investment professionals said that greenwashing is a major concern, according to the 2021 Schroders Institutional Investor Study.[10]

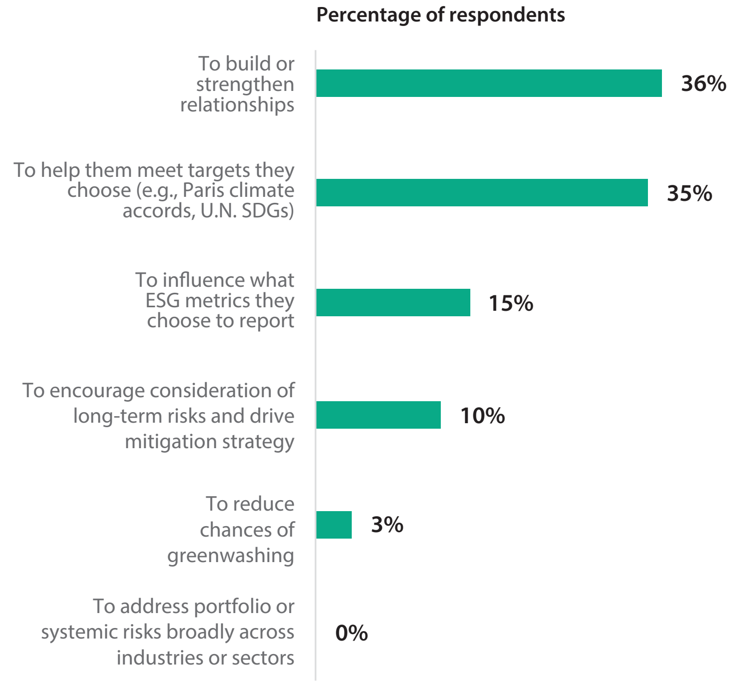
KEY FINDING 7

Our survey also found that for some investors, the main goal of client ESG meetings is to help that organization determine which metrics to report. Although not many (15%; see Figure 12) indicated this, it does highlight the confusion that is inherent in sustainability ratings. Companies frequently struggle to understand which data should be reported and which metrics are the most relevant to their industry. Currently, there is an effort to create greater ESG reporting standardization. These efforts include legislation, such as the European Union's Sustainable Finance Disclosure Regulation, which went into effect in 2020.[11] They also include organizations such as the International Financial Reporting Standards Foundation, which proposed the creation of a sustainability standards board that is similar to the International Accounting Standards Board.[12]

Q.

What is the primary reason you engage with companies about their ESG ratings or metrics?

Figure 12. Investors often use ESG discussions to strengthen client relationships



Source: Infosys Knowledge Institute

CONCLUSION

KEEPING UP WITH ESG'S PACE

The record-setting pace of ESG investments is both thrilling and intimidating for the financial services sector. Sustainability is certainly not a fad, and it is destined to push further into the mainstream. But for now, it is difficult to predict the pace and understand this rapidly evolving market.

Our survey found dissonance and confidence, skepticism and opportunity as firms navigate new metrics. Investment and fund managers are still trying to understand their vast collection of sustainability data and the benefits they can expect the data to offer. Is it defensive (risk management) or offensive (expanding market share)? Or both?

Investment firms are on the leading edge of data analysis, realizing how miniscule insights can pay off when billions of dollars are at stake. Even with that data-focused mindset, our research found knowledge gaps at these investment firms. They had decades to analyze and understand often-standardized financial data. Working from that common base, investors created their own proprietary formula for success. With ESG investing, that foundation is still being constructed with data that is not always standardized and is harder to sort and synthesize.

It is only a matter of time, however, before this innovative and analytic industry catches up. Based on our survey results, here are some suggestions for accelerating that pace and gaining a critical early advantage:

1 Firms need more data

At every turn, we found that expanding your data sources leads to better investment performance. That includes taking data from ratings agencies and ESG data directly from companies. When combined, the broadest amount of data provides the best results. There were not enough respondents that used alternative sources (e.g., news feeds, social media, satellite images) to draw conclusions about that. But it would not be surprising if even those data streams offered benefits.

2 Firms need better data — and better trust in that data

The investors who were the most confident about their ESG metrics reported the best results. However, we found a striking number of investors who were uncertain about the impact of the metrics they use and generally posted worse results. Firms are still trying to wrap their heads around the data and metrics, attempting to understand materiality to investment performance and materiality to broader sustainability. The most sophisticated analysis will make little difference if the data is not sound or relevant.

3 Embrace the possibilities

The Infosys survey was filled with diverse and sometimes contradictory answers. Firms can lean into the messiness and build on it to create a more agile strategy. Investors who seek one benefit (risk management) and get another (higher returns) can benefit from both. Or the unexpected benefits can lead investors to use discussions about ESG ratings as a chance to enhance company relationships.

INFOSYS VIEWPOINT

Jay Nair

Senior Vice President –
Industry Head, Infosys

ESG's role in investing is evolving rapidly but not always predictably.

Growth is certain, but that does not make it easier to determine the right strategy and predict the ebbs and flows.

Financial institutions must take ESG investments seriously but not fall into the FOMO (fear of missing out) trap. Often in those cases, investors follow perceived trends without understanding the fundamentals. However, with ESG investments, it is often difficult to get a handle on the basics. We are still in the early days of understanding how ESG metrics and data can most effectively predict investment performance and what the long-term demand curve will look like.

This is where technology will play a significant role — helping investment firms sort through vast stores of complex, often unstructured data. Machine learning can allow investors to find patterns where no patterns seem to exist in the mix of the quantitative and qualitative. This advantage will permit firms to increase investment performance and, at the same time, develop products more quickly. As a global company that became carbon neutral in 2020, we understand the power of data to fuel transformations of all kinds.

Still, technological expertise is only effective with the right planning, strategy, and mindset. Investment firms need to know what they want to get out of their ESG investments, from long-term risk mitigation to the development of new green assets to meet growing market demand. This self-reflection should be familiar to most organizations. Visualize the years of effort needed to digitally transform — still an ongoing process. For more than just software and hardware upgrades, companies had to wrestle with change management, talent needs, and the development of new business models.

With the current pace of ESG investments, firms do not have years to fine-tune their approach and decipher this new landscape. The risks are both global and individual. Sustainability is no longer a strategy but the key strategy.

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