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Europe's Green Crossroad

Few human initiatives have received the near universal support enjoyed by ESG. But, the decisions made today will determine where the ultimate European ESG outcome lies on the spectrum between wishful naivete and practical possibility.

Key Points:

- The MiFID II research funding mechanism is an existential threat to European ESG objectives.
- There is an immense funding duration mismatch between long-term ESG goals and the current asset manager funding system.
- This exposes ESG outcomes to substantial market risk.
- Pension funds should be incentivized to use their extended duration and low research costs to underwrite long-term ESG objectives.
- Europe can make alterations to its regulatory architecture that meets these challenges.

If Europe wishes to make its global leadership position in Green finance sustainable, it must make changes in the existing financial regulatory architecture that do not support that outcome.

MiFID II poses an existential threat to these European ESG ambitions.

MiFID II allowed asset managers two methods to pay for investment research (including ESG inputs). 1. Continue client funding, (from the asset owner but with greater manager transparency), or 2. Pay for it themselves via their P&L.

For a variety of reasons, most managers chose option 2 – despite the risks to their profitability. The authors of MiFID II clearly misunderstood the huge research cost asymmetry between asset owners (who paid historically) and asset managers. The cost to Asset Owners was small – several Basis Points - versus average equity returns ~700 Bps. But, when research charges were transferred to the P&L of the asset manager it became their second largest cost, right behind staff compensation.

P&L managers cut fundamental research budgets (averaging 50-70%) to maintain profitability. This was before the advent of significant ESG expenses, and notably, during a period of rising multi-asset class financial markets.

Most importantly, from a forward-looking ESG perspective, P&L funding made the availability of research to asset managers (including ESG) a function of their profitability. The impact was illustrated recently in graphic fashion.

In 1Q 2020, markets collapsed ~25% in response to Covid. This instantaneously reduced European manager AUM/revenues by 25% resulting in European manager pre-tax profits falling ~50%.

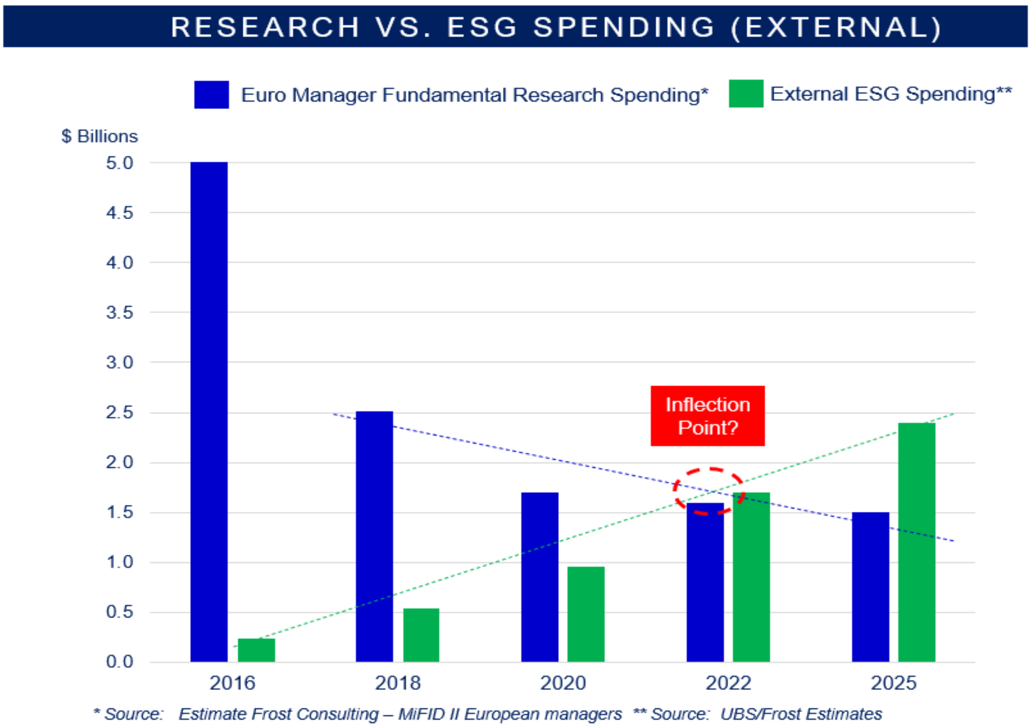
Had markets not recovered rapidly, P&L managers would have been forced to cut research budgets drastically – from already depressed levels. P&L is a treacherous funding mechanism when markets decline. The lower markets go, the less research P&L managers can access.

This is likely not in the best interest of asset owners. For pension funds, avoiding de minimus research charges of a handful of basis points (<10) makes little sense when the performance variance between funds that do well and those that do poorly is frequently measured in thousands of basis points.* (European regulators are beginning to realize this with the benefit of hindsight).

The MiFID II funding regime preceded the widespread adoption of ESG strategies. When MiFID II was being conceived, ESG at the current scale was not remotely visible on the horizon.

Flash forward to 2021: ESG AUM is growing rapidly, but so are ESG data, stewardship and regulation costs. UBS estimates managers spent $2 billion on ESG inputs in 2020 potentially growing to $5 billion by 2025.

European ESG spending may exceed fundamental research budgets before 2025. Both budgets now come from the same place – the manager's P&L. The two budgets may soon begin to cannibalize one another.



This is an issue because ESG funds require both types of research if they are to generate the required returns. It is difficult to run a portfolio with carbon data alone and no other fundamental inputs into likely factors affecting stock performance.

Now, both fundamental research budgets, and long-term European ESG objectives, are a function of short-term financial market direction – because they are tied to manager profitability.

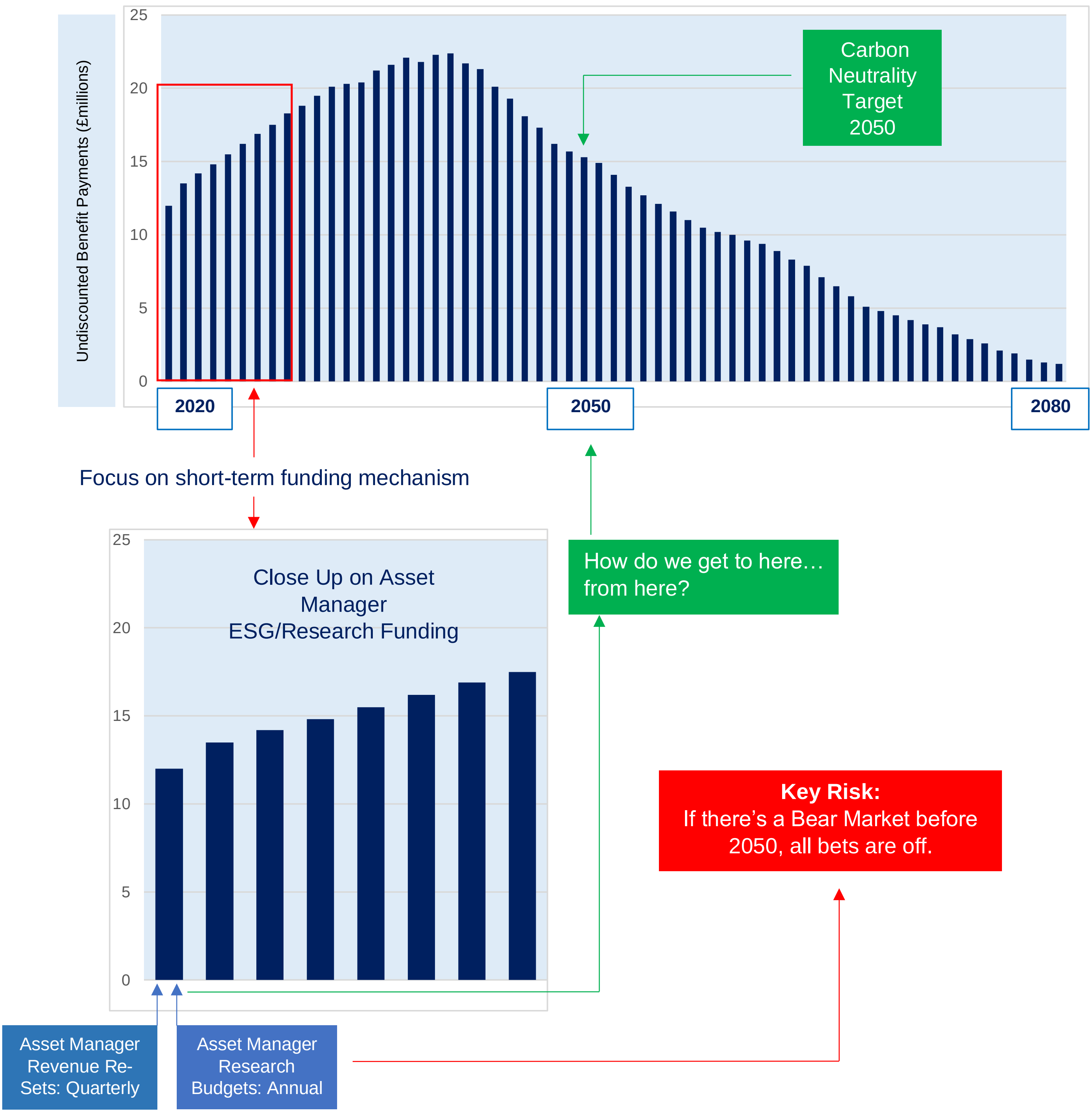
As long as there is an uninterrupted bull market between now and 2050, everything will be fine.

The Role of Pension Funds

Pension funds have long-term liability profiles that align well with the timeframes required for the achievement of ESG objectives. However, asset managers, measured quarterly, and with annual profit targets, operate in a much more constrained timeframe.

The result is an immense funding duration mismatch between long-term ESG targets (i.e. Carbon neutrality in 2050) and the current funding regime – (manager ESG budgets set annually based on revenue determined *quarterly* – 30 years in advance of the ESG target).

Pension Funds – Long-Tailed Liabilities

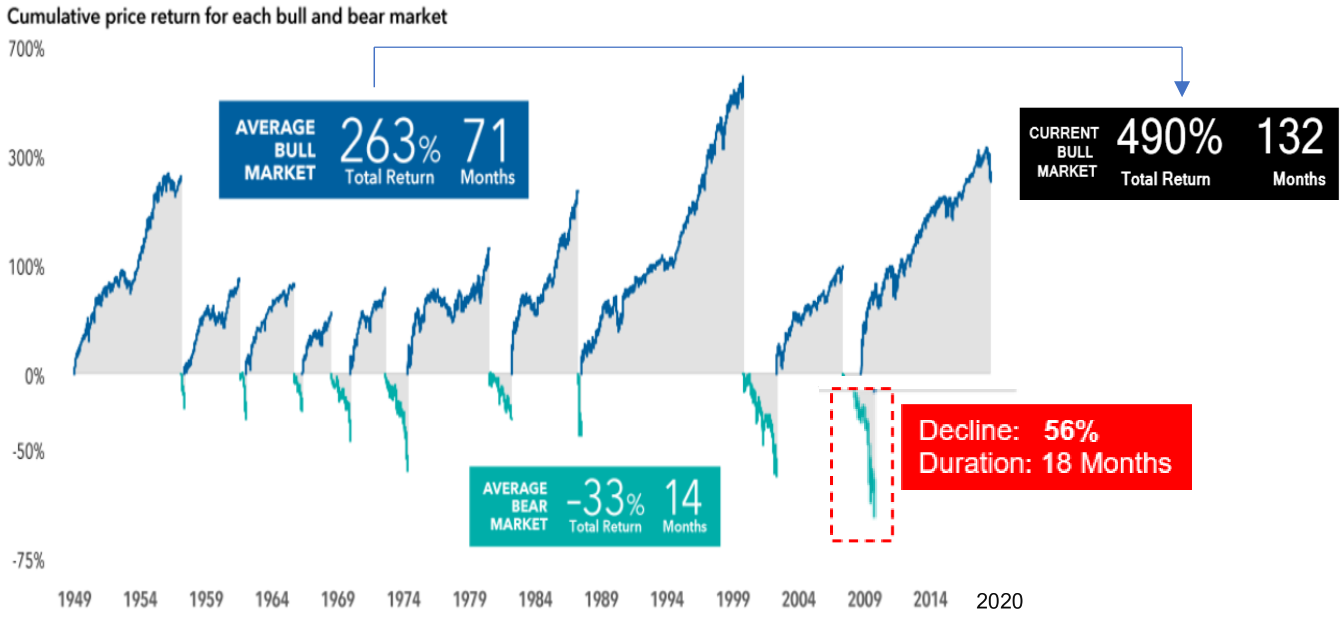


But, if market volatility is possible over the next 30 years, we must hedge this risk or sacrifice ESG objectives, long before they can possibly be realized, thereby squandering ESG momentum which has taken decades to marshal.

The following chart plots bull and bear markets in US equities since 1949. Historically, the liklihood of an uninterupted equity advance between now and 2050 seems low – particularly given the starting point.

EUROPEAN ESG OBJECTIVES: HELD HOSTAGE BY FINANCIAL MARKETS

Equity Returns: Long-term perspective



Sources: Capital Group, RIMES, Standard & Poor's. As of 12/31/18. Bear markets are peak-to-trough price declines of 20% or more in the S&P 500. Bull markets are all other periods. Returns shown on a logarithmic scale.

In addition, European asset managers are far less resilient now than they were in 2007. A 2008 magnitude market decline could eliminate manager profits (versus a decline of 40% in 2008)**. This could prove fatal for ESG objectives. No ESG budget could survive this unless asset managers became not for profit social enterprises.

One solution is to incentivize pension funds, whose liability profiles mirror long-term ESG timeframes, to use their unique characteristics to ensure sustainability. Pension fund liabilities stretch decades into the future: consequently, they have a vested interest in the sustainability of the ESG/research ecosystem.

Pension Funds should use their long duration and low research costs to finance transparent, benchmarked, fund-level asset manager ESG budgets, thereby insulating long-term ESG objectives from short-term market volatility, in a way that asset managers, measured quarterly, simply cannot. (This will be the ongoing methodology in the US).

The cost to the pension funds would be extremely small. The benefits to society could be extremely large. Many pension beneficiaries might willingly forgo a small portion of short-term return in exchange for longer-term ESG objectives to be sustained.

ESG might achieve what MiFID II couldn't: Manager research transparency in exchange for durable asset owner research/ESG funding.

Otherwise, European sustainability, good intentions notwithstanding, could prove to be anything but.

**Source: Frost Consulting/EvercoreISI - https://bit.ly/2MGIKTD*

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Frost Consulting Ltd.
15 St. Botolph Street
London, EC3A 7BB

www.frostconsulting.co.uk