PRIME SUSTAINABILITY SERIES

Terms, Fees & ESG

Why True Alignment Matters

ECONOMIC IDEAS ARE ALWAYS AND INTIMATELY A PRODUCT OF THEIR OWN TIME AND PLACE.

- John Kenneth Galbraith

When headlines regularly claim a line of sight of up to "**$50 trillion**" in assets invested in ESG or sustainable products – what are managers to think?[1]

That would size the universe as larger than *the market cap of all U.S. publicly traded companies*. Does every firm **really** fit in an "ESG/sustainable" strategy?

We will not challenge the size and scope of the current ESG and sustainable product market here – others have done so and land on an array of definitions, products and assets.

Rather, we acknowledge **the considerable hunger for products classified as an 'ESG' or 'sustainable' one and investigate what it means for this diverse array of products and potential alignment of terms, fees and structure between allocator and manager.**

We examine the range of what these vehicles 'cost' (and question what they *should* cost), look into their durations and time horizons, and offer insights on what robust alignment looks may look like on a go-forward basis.

- Could shorter duration of thematic vehicles pose challenges to these strategies?
- Does ESG/sustainable investing require greater costs for research or risk management?
- How do these realities differ between asset classes?
- How should asset owners be thinking about alignment for the **decade ahead**, rather than in the recent past?

DO ASSET OWNERS WANT WHAT THEY SAY THEY WANT

With trillions of dollars invested in ESG or sustainable products, it's hard to talk about the landscape as a monolith. A recent survey of allocators revealed current preferences for defined ESG products typically focus on a smaller group of themes and strategies:

Source: Jefferies Capital Intelligence

EVEN AT THE BROADEST LEVEL, ESG APPETITE IS HIGHLY IDIOSYNCRATIC

'Broad ESG/sustainability' searches. 'Carbon transition.' 'Diversity and Inclusion.' When we dig into the specifics of these searches, they are extremely diverse. **There is not "one" carbon transition strategy, as one example** – there are a seemingly infinite number of approaches – **and investing time horizons.**

One of the critical aspects of ESG/sustainable strategies, regardless of their specific focus, is that they are often **intended to play out over time or economic cycles, meaning they lend themselves to be better suited for vehicles with longer locked capital.**

Given the idiosyncratic nature of these strategies, what questions should **asset owners ask themselves and their managers when considering an investment?**

- ✓ What is the problem we are trying to solve? Performance? Broader thematic or ethical drivers? Diversification?
- ✓ What is the investment time horizon of the ESG/sustainable strategy? It is unlikely the target of 2050 of the Paris Accords would serve as an appropriate horizon for today's managers. But what are the expected ins and outs of these thematic strategies in the near to medium term?
- ✓ Do we have the ability to lock capital up longer than we initially thought?
- ✓ If so, where does this ESG/sustainable investment belong in our portfolios? Public markets? Private? A stand alone vertical?
- ✓ How do various asset classes affect duration of capital? Would an ESG CLO require longer locked capital than some equity strategies?
- ✓ Where do daily liquidity strategies fit into this landscape?
- ✓ How do we balance ESG/sustainable mandates with liquidity needs, and will this change in the next decade?

HOW MUCH DO ESG/SUSTAINABLE STRATEGIES 'COST?'

With estimates in the tens of trillions in assets – ESG/sustainable strategies could be generating billions in management fees.

However, what does **not** seem to be happening is the launch of 'premium' or more expensive ESG/sustainable products. Specifically in the alternative landscape, sustainable product fees are in line with broader trends for their asset classes.

Some argue these products *should* have higher fee structures, given the specific expertise needed to effectively run them.

A survey of more than 50 Equity ESG/sustainable strategies reveals **an average management and incentive fee structure in line with broader trends – with an average management fee of ~1.75% and incentive fee of 20%.**

Where fees diverge from this typically occurs because of locking up capital for longer, participating in a founder's share class or other early stage investment, or if the product is a co-investment or other single trade vehicle.

DOES DIVERSITY OF THEMATIC STRATEGIES IMPACT TERMS AND FEES

In a word: no.

Despite the fact that asset owners' mandates are extremely variable, there **does not seem to be price sensitivity around differences in mandates**. A carbon transition strategy does not typically have a different fee structure than one focused on human capital and diversity issues.

Where *are* the differences? Vehicles with different durations.

Over time, however, **we do expect some variation in the fees of some mature and highly specific ESG strategies** based on required expertise or expensive data efforts.

In the coming decade, we expect debates around ESG and sustainable investing will become much more specific and granular as to the strategies, processes and approaches that currently fall under this broad umbrella.

One driver of this may be regulation and increased reporting and transparency both on the part of companies themselves *and* the managers investing in them.

Europe's Sustainable Finance Disclosure Regulation (SFDR) went live in 2021, creating a new level of required transparency and accountability for in scope investors. Transparency and reporting is an important dimension of ESG discussions – but it can also be expensive. As there are different (and sometimes conflicting) frameworks, the current onus is on an individual company or manager to decide which, if any, to adhere to.

Down the line, as standardization increases, it is entirely possible that enhanced reporting requirements could add to the expense base, especially if it is an entirely new (but financially material) group of line items.

DURATION IS CURRENTLY A MUCH MORE DISCUSSED TOPIC THAN FEE STRUCTURE. ASSET OWNERS AND MANAGERS ARE LASER FOCUSED ON PROPER ALIGNMENT OF INVESTMENT STRATEGY AND TIME HORIZON.

THE MAJORITY OF HEDGED ESG STRATEGIES ARE IN LINE WITH BROADER FEE TRENDS FOR THEIR ASSET CLASSES.

WHAT HAPPENS NEXT

We are keeping an eye on the current fragmentation of regulations, frameworks, strategies and asset owner mandates, as standardization is increasingly becoming top of mind for managers, investors and policymakers.

We anticipate asset owners will start to get more specific as to where and how ESG/sustainable strategies fit in their portfolios. In a world where even "carbon transition strategy" could mean dozens of different things, we hear that greater specificity in understanding *what* asset owners want and *why* they want it would be very welcome.

Regional and geographic differences will also increasingly come into play – particularly vis-à-vis emerging market involvement in the carbon transition.

But among the most important action items is for asset owners and managers to precisely define the problem they are trying to solve. In doing so, they can more precisely align goals around performance, portfolio contribution and relationship to various benchmarks.

HOW JEFFERIES CAN HELP

Jefferies' ESG research and strategy group is a global and diverse set of resources for those managing or looking into investing into the rapidly evolving ESG and sustainable asset space.

Our experts deliver insights across the equities, fixed income and investment banking verticals, frequently collaborating to share information and create a cross-disciplinary offering to help clients achieve their ESG/sustainable goals in an efficient and effective manner.

ESG and sustainable investing is one of the fastest moving corners of the global economy. We expect new regulations to govern transparency and reporting in this space in the next few years – changes that will likely shape all of investing for the decades ahead.

As we quoted Galbraith at the outset – economic ideas are always a product of their time and place. This decade is likely to be dominated by the move to standardizing expectations and benchmarks for ESG and sustainable investing.

We look forward to helping you understand the shifting and maturing landscape as these drivers become more clear.

Shannon Murphy

Head of Strategic Content
Shannon.Murphy@jefferies.com
+1.212.336.1139

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[1] Bloomberg