CHANGE FINANCE

2021

ESG Asset Allocation Trends Report

The mission of Change Finance is to accelerate the adoption of sustainable and responsible investing so that capital markets promote the business practices and innovation necessary to address our most pressing social and environmental challenges. To meet this goal, it is essential for investors and financial advisors to fully understand the rapidly evolving portfolio management practices related to environmental, social, and governance (ESG) data integration. This report surveys some of the latest trends pertaining to the relative performance of ESG funds, fees, thematic products, and preferences for shareholder advocacy. These findings do not represent asset allocation recommendations. They are intended to provide insights into a wide array of portfolio management approaches so that investors may test assumptions, substantiate conclusions, and consider new ideas.

The Sample

This report is based on more than 100 proprietary **Portfolio Impact Analyses** conducted by Change Finance between July 2019 and December 2020. Our Portfolio Impact Analyses utilize data from the non-profit, As You Sow, to reveal portfolio-level risk from factors such as fossil fuel-related investments, carbon footprints, gender equality scores, and deforestation impacts. The analyses do not provide information on fixed income allocations and exclusively consider investments in mutual funds and exchange traded funds (ETFs). For this report, the team at Change Finance specifically focused on those asset allocations with comprehensive ESG integration and examined all investment products from such asset allocations. This produced a sample of 55 ESG-focused mutuals funds and ETFs provided by 27 asset managers. These represent the investment products most commonly used by those investors and advisors in Change Finance's network.

Most analyses of macro fund flow data are influenced by large institutional investors and turnkey asset management programs. In contrast, this report provides insights into those practices employed by independent leaders in the ESG investment community.

ESG Focused

55 Funds & ETFs
27 Asset Managers

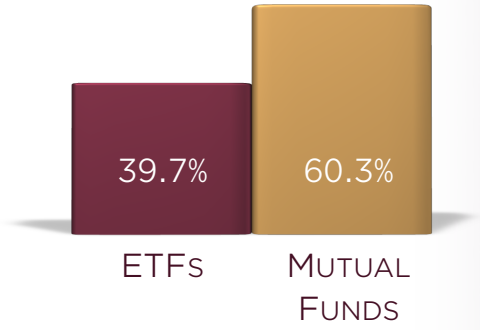
100+ Portfolio Impact Analyses

The Results

Mutual Funds v ETFs

Despite the rapid proliferation and growth of ESG-focused ETFs in recent years, mutual funds made up the majority of the investment products within the sample. Investors showed a preference for those asset managers with a singular focus and long history of sustainable and responsible investing.

Sampled Products

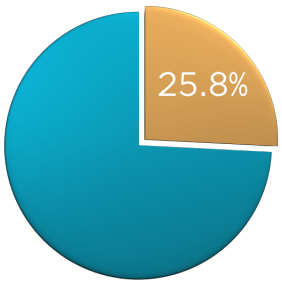


By Asset Class	Ave Weighted Exp Ratio
Large Cap Blend	0.44%
Large Cap Growth	0.76%
Large Cap Value	0.30%
Small / Mid Cap	0.71%
Developed International	0.55%
Emerging Markets	0.79%
Global	0.87%

Expenses

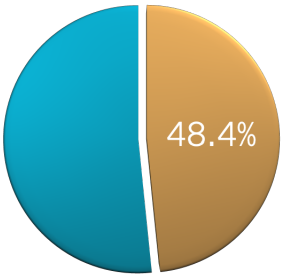
Despite ETFs making up a minority of the sampled investment funds, they contributed meaningfully to fee compression. The weighted average expense ratio of all sampled asset allocations was **0.56%**.

Ave Mutual Fund Expense Ratio	0.78%
Ave ETF Expense Ratio	0.35%



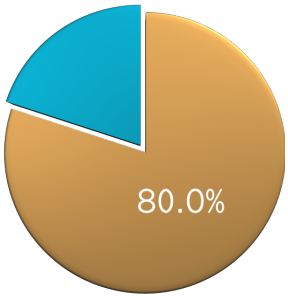
Global v International & Emerging Markets

A minority of the sampled portfolios incorporated products with global investment mandates. Investors expressed a preference for specific allocations to domestic, developed international, and emerging markets.



Blend v Growth & Value

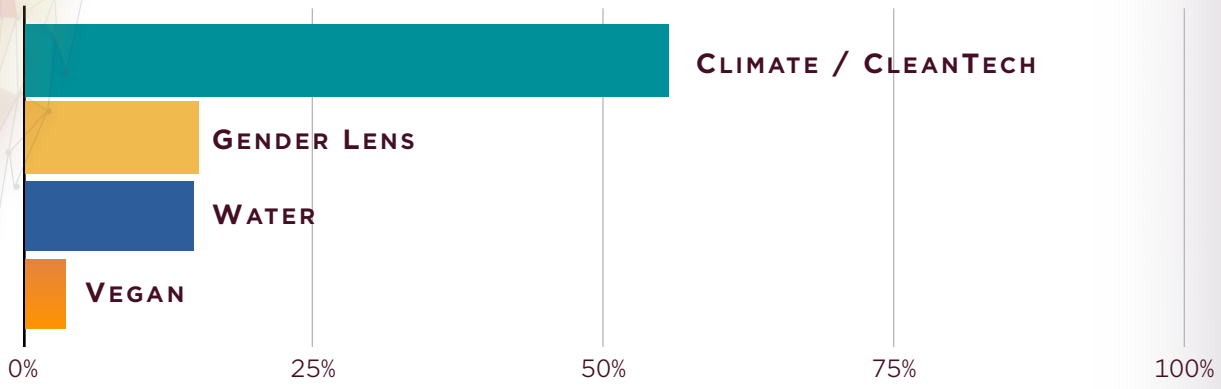
Approximately half the sampled portfolios favored the use of blend products over distinct allocations to growth and value portfolios in the domestic large cap arena. Sparse availability of style-specific products with ESG mandates is a likely cause for this finding.



Thematic Allocations

The vast majority of allocations included an ESG-oriented thematic element. Climate and cleantech-focused products were most popular, followed by gender lens, water, and vegan-oriented funds.

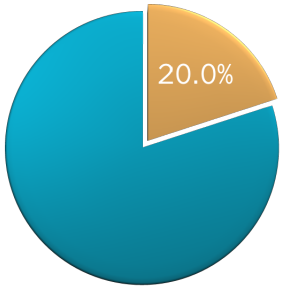
Thematic Trends



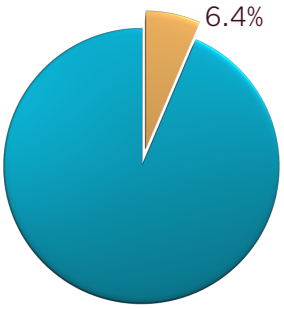
Fossil Fuel Exposure

Investments funds that exclude those companies that own, extract, process, or burn fossil fuels for electricity generation remain relatively rare. Therefore, the construction of comprehensive fossil fuel free asset allocations is challenging. Very few of the sampled portfolios met this standard; however, a reasonable number of fossil free funds across various asset classes are available and allow for the provision of fossil free asset allocations. Offering such solutions to investors continues to present advisory firms with an opportunity to differentiate themselves in the marketplace.

100% Fossil Fuel Free



Sampled Funds/ETFs



Sampled Asset Allocations

Shareholder Advocacy

The sampled portfolios demonstrated a preference for ESG funds provided by asset managers that align ESG integration and investment stewardship. The 27 asset managers from the sample exhibited a wide array of investment stewardship policies and practices. To separate those asset managers that demonstrate leadership in advocacy, the team at Change Finance conducted a qualitative analysis focused on dedication and transparency related to advocacy initiatives. **63%** of the sampled managers demonstrate leadership by this definition. Those managers with a singular focus and long history of sustainable and responsible investing comprise most of the leading organizations, but we are encouraged to see all of the sampled asset managers pursuing some degree of investment stewardship that improves the environmental and social impact of portfolio holdings.

Relative Returns

% of Sampled ESG Products That Outperformed Peer Group Benchmark

	Mutual Funds	ETFs	Total
1 Year	78.3%	80.0%	79.1%
3 Year	72.7%	87.5%	78.9%

We examined the 43 ESG funds and ETFs falling into core asset classes and compared trailing one and three-year performance to the traditional benchmark most appropriate for that asset class. The vast majority of the sampled ESG products outperformed their benchmarks over both periods, with ETFs exhibiting a slightly higher rate of success relative to mutual funds over the three-year time period.

Further examination reveals that the sampled investment products exhibited strong performance in all asset classes except for small/mid cap. Unfortunately, smaller cap ESG offerings have struggled to produce the same relative performance as their large cap, international, and emerging markets peers.

% of Sampled ESG Products That Outperformed Peer Group Benchmark

	1 Year			3 Year		
	Mutual Funds	ETFs	Total	Mutual Funds	ETFs	Total
Large Cap Blend	100.0%	77.8%	86.7%	66.7%	71.4%	69.2%
Large Cap Growth	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Large Cap Value	100.0%%	0.0%	50.0%	100.0%	100.0%	100.0%
Small/Mid Cap	0.0%	50.0%	16.7%	0.25%	100.0%	40.0%
Developed Intl	83.3%%	100.0%	90.0%	83.3%	100.0%	88.9%
Emerging Markets	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Global	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Conclusion

These findings are consistent with Change Finance's research on the behavioral drivers of sustainable and responsible investing. That research finds that individuals pursue investment portfolios with ESG or socially responsible integration (SRI) for three primary reasons: *Altruism*, seeking to make a positive impact on the world; *Autonomy*, seeking the reflection of specific personal values in investment portfolios; and *Performance*, a belief that ESG/SRI integration will serve to mitigate risk and enhance returns. The relative one and three-year returns of the funds from the sample have likely satiated *Performance* seeking investors, while those driven by *Altruism* have achieved at least some degree of the positive impact they demand through shareholder advocacy. Finally, those investors motivated by *Autonomy* have seen their personal values reflected in their portfolios through the various thematic elements present in most of the sampled ESG asset allocations. Ultimately, investors are being successfully engaged on all three behavioral drivers, implying a high degree of satisfaction with their investments. It is a small wonder that demand for ESG-focused investment management is surging.

DISCLOSURE

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The information within this report was researched by Change Finance, PBC with the tools available to the Firm from Change Finance Portfolio Impact Analyses, As You Sow, and Morningstar.

Various indexes were chosen that are generally recognized as indicators or representation of the stock market in general. Indices are typically not available for direct investment, are unmanaged and do not include fees or expenses. Some indices may also not reflect reinvestment of dividends.