THIRD ECONOMY

Setting the Narrative on ESG

The six most important lines from the 2022 State Street and BlackRock Annual Letters

By Chad Spitler, founder and CEO, Third Economy

Institutional investment giants BlackRock and State Street recently released their annual letters for 2022. BlackRock focused its letter on "the power of capitalism," while State Street centered its letter on the theme of "embracing transition as an opportunity."

These letters offer enormous insight into the key trends shaping the industry. They also signal how investment managers and corporations need to position themselves to take advantage of prevailing trends.

One thing is certain: ESG investing shows no signs of slowing. In fact, new investment innovations and automated portfolios will only accelerate flows toward ESG.

Below I highlight the most important lines from the two letters and offer a bit of context to explain what it could mean for you in 2022 and beyond.

#1 "*Stakeholder capitalism … is not 'woke.'*" (BlackRock)

Like years past, both asset managers again insist that ESG investing is principally about profit and durable long-term returns. For example, BlackRock writes, "We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients."

For these managers, environmental and social concerns are not part of a moral or political mission. Rather, they believe that only companies ready to capitalize on the winds of change will deliver investor value in the long run.

State Street emphasizes board diversity. For them, leadership and workforce diversity matters because it strengthens corporate culture and workplace engagement and satisfaction. It also helps businesses understand and respond to consumer trends and behaviors in a multiracial, multiethnic marketplace.

Bottom line: ESG is about making money. For more on this, see my recent presentation to NACD.

#2 *"The ultimate destination for companies … is net-zero emissions."* (State Street)

Since Amazon widely publicized the Net-Zero Climate Pledge, there's been significant momentum behind the push toward net-zero emissions by 2040. Today, the pledge has garnered 200+ signatories, many in the Fortune 500. And, according to State Street, 2,000+ additional public companies have made the commitment to net-zero outside of the pledge.

For both BlackRock and State Street, embracing net-zero (and other ESG goals) is critical for long-term risk mitigation. For example, businesses face physical risk to real assets from climate instability, flooding, fires, and more. There's also reputational risk stemming from conscientious consumerism and investor activism. And, of course, there's regulatory risk related to carbon taxes and other international climate policies.

As BlackRock writes, "Climate risk is investment risk."

#3 *"The next 1,000 unicorns won't be search engines or social media companies, they'll be sustainable, scalable innovators."* (BlackRock)

Importantly, climate change is not only about risk. There's also tremendous profit open to businesses ready to take advantage of this unfolding opportunity. Leading asset managers want to see a serious commitment to net-zero now because they believe it will inevitably spur innovation and new products, services, and markets.

As BlackRock writes, "Every company and every industry will be transformed by the transition to a net-zero world. The question is, will you lead, or will you be led?"

Corporations need to signal their readiness today by systematically measuring and mitigating carbon output. That's why Third Economy is innovating ESG analytics with our VIA[3] framework. We're committed to making it easier than ever for corporations and investors to implement an informed, data-driven ESG program.

#4 *"The tectonic shift towards sustainable investing is still accelerating."* (BlackRock)

Innovation in the asset management space continues to bring new flows into ESG investing. According to this article from Bloomberg News, "ESG assets may hit $53 trillion by 2025, a third of global AUM."

Obviously, this presents incredible opportunity for asset managers prepared to create new products, indexes, and portfolios. Innovation in the deployment of analytics will be especially critical in helping asset managers grab market share from industry leaders.

These new index products, however, spell potential risk for corporations. Many ESG and low-carbon funds now automate portfolio management based on predefined metrics. Corporations that can't reliably and transparently measure and benchmark progress toward net-zero might be automatically excluded from key ESG funds.

State Street's letter sends a subtle warning to that effect, saying that among the 2,000 public companies that have committed to net-zero, "few have provided a clear roadmap to achieve these goals."

#5 *"We are prepared to vote against the chair of the board's Nominating Committee or the board leader should a company fail to meet these expectations."* (State Street)

Large index managers have several ways to wield influence. Their investment stewardship teams can speak softly (through engagement) and carry a big stick (by voting). Both BlackRock and State Street tend to prefer direct engagement over voting power. However, both asset managers can and will vote against management when they believe it is necessary.

That's why it's important for corporations to stay alert to these modes of influence. As BlackRock writes, "Access to capital is not a right. It is a privilege. And the duty to attract that capital in a responsible and sustainable way lies with you [corporations]." [

The message is clear: If you want to attract capital, you better find ways to step up ESG performance.

#6 "*We are committed to a future where every investor — even individual investors — can have the option to participate in the proxy voting process if they choose."* (BlackRock)

BlackRock announced that they're giving select institutional clients proxy voting options. This will involve $2 trillion in investments tied to index-tracking assets, roughly 40% of BlackRock indexed AUM.

Similar "pass-through voting" initiatives have been a topic of conversation for several years. Advocates for shareholder democracy want to give end investors the ability to vote on the underlying shares. But there are significant logistical and legal hurdles that stand in the way.

BlackRock's move nevertheless represents a big shift for the industry. It signals a play to shore up their competitive advantage by further differentiating their offering.

Other asset managers will be under pressure to follow suit, which could spell trouble for corporations. I mentioned above that BlackRock and State Street tend to prefer direct engagement. But this doesn't mean their clients share the same philosophy. Soon we may see their more activist clients start to wield greater voting influence.

To avoid shareholder activism, it will be more important than ever to integrate these ESG trends into corporate strategy.

Toward a more sustainable economy

Corporations and asset managers are at a crossroads. Today, industry giants continue to set the agenda and terms. But there is opportunity to respond and set your own standard.

We work every day to empower institutional and corporate clients with the tools, analytics, and insights they need to realize durable financial success. Together we're building a more sustainable economy — a Third Economy.

Ready to take the next step?
Contact us