Reshaping sustainable investing

Four forces that we believe will accelerate sustainable index adoption and drive $1 trillion in new assets this decade
We believe four forces will help grow assets in global exchange traded funds (ETFs) and index mutual funds by roughly $1 trillion by 2030.

1. Recognition that sustainability influences risk and return

2. Better data leading to better indexes

3. Access to ESG at a fraction of the cost through indexation

4. Sustainable choices for every portfolio
Into the mainstream

Sustainable investing used to cater to niche investors and was often considered expensive, values-focused and indifferent to performance.

Indexation is helping to upend these perceptions by delivering choice, value and access to all investors. First-generation sustainable indexing strategies were available only to large institutional investors but today ETFs and index mutual funds allow all investors to target environmental, social and governance (ESG) risks and opportunities that are often missed in traditional financial analysis.

We believe many investors are poised to rotate out of traditional funds and into sustainable ones, and that advances in ESG research and indexing will enable ETFs and index mutual funds to play a pivotal role in the transition.

Indexed assets as a proportion of the $1.4 trillion market for sustainable funds more than doubled to 16% in 2019 from 7% in 2015. There is much more headroom for growth: Index penetration in mature fund markets, such as U.S. - domiciled equities, is 49%.

Last year marked an inflection point for the adoption of global sustainable ETFs and index funds. Flows tripled in 2019 to a record $55 billion, raising global assets in sustainable ETFs and index funds to $220 billion. Inflows have persisted into sustainable index ETFs in early 2020 in the face of pandemic-related market turmoil, underscoring persistent and growing investor demand for sustainable strategies.

Inflows into global sustainable ETFs totaled $14.8 billion in the first quarter of 2020 even as the entire fund industry experienced heavy outflows.

We believe the growth of sustainable indexing is only getting started. This paper discusses the four forces most likely to propel the adoption of sustainable ETFs and index funds and boost assets roughly six-fold to $1.2 trillion by the end of this decade.

1 BlackRock analysis of Morningstar data, as of March 2020. 2 Morningstar, data as of 31 December 2019. 3 BlackRock analysis of Morningstar data, as of March 2020. 4 BlackRock analysis of Bloomberg data, as of 1 April 2020. 5 BlackRock projection, April 2020, based on Morningstar data, as of March 2020.
The path to $1.2 trillion


Subject to change. The figures are for illustrative purposes only and there is no guarantee the projections will come to pass.
We believe more investors are recognizing that sustainability-related considerations such as climate change matter to long-term returns.

Evidence that ESG criteria influence portfolio outcomes has touched off a paradigm shift in investor thinking, one that is displacing conventional notions about sustainable investing. Looking ahead, we believe the search for enhanced returns will drive an enduring investor reallocation into sustainable strategies and out of traditional ones. Trillions of dollars could move into sustainable investments in the coming decades.

Investor preferences are changing globally and our analysis suggests that a swell of demand for sustainability will have profound implications for expected returns of numerous assets over the long term. BlackRock predicts that assets linked to high sustainability characteristics will become more attractive than those that are linked to lower sustainability characteristics. ESG-focused analysis will increasingly shed light on market risks and opportunities. For example, BlackRock analysis shows that extreme weather may threaten local economies and pose credit risks to state and local issuers of U.S. municipal bonds, and that electric utilities may be vulnerable to climate-related shocks including hurricanes and wildfires. Asset prices across equities, fixed income and real estate do not yet reflect such risks.

Track records of early sustainable indexes show comparable and sometimes superior returns versus their traditional market-weighted index counterparts. Take the MSCI KLD 400 Social Index, which selects U.S. companies with high ESG ratings and excludes companies engaging in controversial industries and severe controversies. This benchmark delivered a 6.85% return over the past five years, one full percentage point more on an annualized basis than the MSCI USA IMI Index. Additionally, certain ESG index strategies may potentially help investors manage market downturns since they tend to emphasize stable businesses. Sustainable indexes are generally comprised of companies with higher profitability and lower levels of leverage than the broader market. This is because companies with solid balance sheets may be better positioned to focus on mitigating ethical issues and introducing sustainable practices than their less-profitable peers.

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Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results. Index performance does not represent actual iShares Fund performance. For actual fund performance, please visit www.ishares.com or www.blackrock.com.
2 Better data leading to better indexes

The distinction between “sustainable” and “ESG”

Sustainable investing combines traditional investment approaches with environmental, social and governance (ESG) insights to pursue competitive risk-adjusted returns over the long term. We view “sustainable investing” as the umbrella category of investment strategies and “ESG” as the data and metrics that inform sustainable investment solutions.

Capturing ESG insights through indexes used to be challenging because information about corporate sustainability practices was scattered and hard to find. Change is underway. In the future, more and increasingly standardized ESG data will help support the growth of sustainable indexing.

The information that feeds into sustainable indexes is getting better for two key reasons. First, companies are increasingly disclosing ESG metrics to help measure and communicate their efforts at managing risk and creating value through sustainability. Second, companies are disclosing information in a manner that makes it more readily comparable for investors.

More companies are reporting ESG information

<table>
<thead>
<tr>
<th>Year</th>
<th>Reporters</th>
<th>Non-reporters</th>
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<tbody>
<tr>
<td>2011</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>2018</td>
<td>14%</td>
<td>86%</td>
</tr>
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Source: Governance & Accountability Institute, 2019, based on companies within the S&P 500.

Quality data is important because until recently its absence impeded the development of sustainable indexing and overall adoption of sustainable investing. Investors say that, while ESG data-related concerns including conflicting ratings and gaps in coverage remain barriers, the data is rapidly getting better.
Companies are divulging more information about their sustainability practices and have a greater incentive to improve their corporate behaviors. This is due in part to demands from investors, governments and the public that companies provide stakeholders with a clearer picture of how they are addressing sustainability-related business risks such as climate change. For example, the proportion of S&P 500 companies that published a sustainability or corporate responsibility report rose to 86% in 2018, the most recent year for which data is available, from 20% in 2011.12 Worldwide, more than 90% of the largest global companies by revenue report ESG information, up from almost none two decades ago.13

Greater disclosure means more comprehensive coverage by the ESG ratings firms, data aggregators and specialized data providers. MSCI has expanded the number of ESG ratings it provides to companies by about 60%, to 7,610, since 2018.14 Regulations will accelerate corporate ESG-related disclosures. Starting in 2018, the EU’s Non-Financial Reporting Directive required large companies to include non-financial statements in their annual reports related to environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, and diversity on company boards.15 Approaches vary by country and region but share similar objectives. The China Securities Regulatory Commission introduced requirements that will mandate all listed companies and bond issuers to disclose ESG risks by 2020.16 In the U.S., the Securities and Exchange Commission does not mandate ESG disclosure, although SEC commissioners have publicly discussed ESG standards and climate-related disclosure.

In parallel with regulatory initiatives, frameworks have emerged to help companies decide what ESG information to disclose and how to do it. Two frameworks stand out for helping standardize sustainable finance. The Sustainability Accounting Standards Board (SASB) framework recommends sustainability disclosures based on the most material considerations by industry; materiality criteria help investors identify and assess the most useful information for making financial decisions. Separately, the Task Force on Climate-related Financial Disclosures (TCFD) initiative recommends voluntary, climate-related financial disclosures for use by companies across industries that consider the physical, liability and transition risks associated with climate change. Almost 800 public and private companies have announced support for guidelines issued by the TCFD, and more companies are gearing up to provide them.17

More and better standardized ESG data have two key positive impacts: driving better ESG indexes and improving measurability for companies to change their sustainable behaviors.

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A few decades ago, investors could either pick securities themselves or pay a high price for actively managed mutual funds, many of which had inconsistent track records. Enter ETFs and index funds, which lowered the cost of access for all investors while providing transparency and precision.

We believe indexing will do for sustainable investing what it did for investing in stocks and bonds.

Until recently, sustainable investment strategies were available only through higher-fee actively managed funds, or highly customized mandates that required in-house ESG specialisation. Sustainable indexes are helping drive down the total costs of investing sustainably while broadening the variety of available exposures. Globally, the average actively managed sustainable equity mutual fund has a total cost of 1.15 percentage points per year on an asset-weighted basis. That is more than five times higher than the 0.22 percentage point total cost for the average iShares sustainable equity ETF.¹⁸ As with traditional indexing, lower fees give investors a better chance of tracking or potentially beating a benchmark, when possible.

Investors are transitioning money into sustainable investments and we believe they will increasingly do so in the most cost-effective way possible—through sustainable ETFs and index funds.

**Active sustainable equity mutual funds are five times more expensive than iShares sustainable ETFs**

<table>
<thead>
<tr>
<th>115 bps</th>
<th>4x</th>
<th>28 bps</th>
<th>5x</th>
<th>22 bps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actively managed sustainable equity mutual funds</td>
<td>All sustainable equity ETFs</td>
<td>iShares sustainable equity ETFs</td>
<td></td>
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</tbody>
</table>

For illustrative purposes only. Bps = basis points. A basis point is one hundredth of one percent. Subject to change. All chart data is global and calculated on an asset-weighted basis. Sources: BlackRock, Bloomberg (ETFs); Morningstar (mutual funds) as of 31 March 2020. Mutual fund data calculated based on oldest share class. 28% of active sustainable equity funds do not report an expense ratio in prospectuses or KIID documents.

¹⁸ BlackRock, Bloomberg (ETFs); Morningstar (mutual funds) as of 31 March 2020.
Sustainable choices for every portfolio

Investing sustainably for all but the largest investors used to be a one-size-fits-all proposition because there were a limited number of sustainable investment strategies. It was either invest in an actively managed equity fund—with a strategy that may not align with an investor’s overarching investment goals—or nothing. Creating an entire portfolio out of sustainable funds was all but impossible.

Sustainable index strategies simplified and expanded the options available to all investors and every portfolio. Since indexes can now give investors convenient and efficient access to numerous sustainable equity and bond approaches, these building-block exposures will pave the way for advances in portfolio construction. We believe investors will increasingly use sustainable index strategies in traditional portfolios as well as in portfolios that focus on sustainability.

Today sustainable indexes allow investors across the globe to screen out certain sectors or companies in which they do not want to invest. Or they allow investors to improve ESG scores at the fund and portfolio level while optimizing the ability to track traditional benchmarks. Indexes can provide access to emerging asset classes, for instance, “green bonds,” which fund specific sustainable projects or selected sustainable themes such as clean energy. And they can give investors access to companies with the highest ESG ratings, with potentially more deviation from traditional benchmarks.

There are thousands of sustainable indexes and the number of equity and fixed income ESG indexes globally grew 14% in 2019.19 In 2009, there were 35 sustainable ETFs that track indexes globally; fast-forward a decade, there are more than 300.20

The methodologies that guide sustainable ETFs and index funds are inherently transparent, which helps investors build portfolios with consistent sustainable outcomes. They also make it possible for investors to clearly articulate their objectives to stakeholders. A local pension fund seeking to avoid companies with exposure to civilian firearms; a large insurer committed to reducing the carbon footprint of its investment portfolio but has little leeway to deviate from returns of the broad stock and bond markets; and a retiree aiming to help fund clean power sources in a convenient way—each can use sustainable strategies both as positions at the heart of portfolios or as satellite holdings. And since many sustainable strategies are built from the industry’s most popular broad benchmarks, many investors can take a sustainable approach without fundamentally changing their asset allocation strategies.

19 Index Industry Association, Global Index Survey 2019.
20 BlackRock, Bloomberg, as of January 2020.
How BlackRock thinks about building sustainable portfolios

We believe sustainability is now a key component of portfolio construction.

Investors can use sustainable index products as benchmark replacements, as model building blocks and as unique satellite exposures.

**Five ways to align client goals with sustainable strategies**

- **Screened**
  Clients looking to exclude securities based on non-sustainable business involvements

- **ESG optimized**
  Clients investing to pursue similar returns to a particular benchmark and gain exposure to securities with high ESG scores.

- **ESG best-in-class**
  Clients seeking to achieve concentrated ESG holdings by investing in top ESG companies

- **Thematic**
  Clients pursuing specific sustainable themes based on how companies operate

- **Impact**
  Clients investing for a measurable sustainable outcome alongside financial returns

Source: BlackRock, as of 31 March 2020.
BlackRock’s commitment to sustainable investing

Investors want choice and BlackRock is a leader when it comes to giving investors access to sustainable investment strategies. While investors have expressed interest in sustainability for years, until recently they lacked efficient, transparent, low-cost and easy-to-use investment options. Now iShares sustainable index strategies provide investors with choices to build sustainability into nearly every portfolio.

Earlier this year, BlackRock Chief Executive Officer Larry Fink’s letter to CEOs and the firm’s letter to clients outlined our vision for making sustainability the new standard for investing. This includes offering investors more choices through index strategies. Over the past two years, we have more than tripled the number of iShares sustainable investment products to 100, which is the largest global lineup of any firm. And we plan to launch at least 40 new sustainable ETFs and index funds in 2020 alone.

We are working with index providers to expand and improve the universe of sustainable indexes, including engagement with them about providing sustainable versions of flagship indexes. Funds that seek to track sustainable versions of widely recognized benchmarks will make it easier to build sustainability into every portfolio.

At the same time, BlackRock is offering sustainable versions of our model investment portfolios, which consist mostly of iShares ETFs. More broadly, we are committed to using sustainable funds as the standard building blocks for all of our investor solutions whenever possible.

Finally, BlackRock is committed to helping advance the standardization of corporate ESG disclosures and the data that feeds into ESG indexes. We have called on the companies that we invest in, as a fiduciary on behalf of our clients, to publish disclosure in line with SASB guidelines by the end of 2020. And we have asked them to disclose climate-related risks in line with TCFD’s recommendations, including plans for operating under a scenario where the Paris Agreement’s goal of limiting global warming to less than two degrees is realized. As more companies adhere to these frameworks, we believe ESG data and sustainable indexes will be even more robust.
Carefully consider the Funds’ investment objectives, risk factors, and charges and expenses before investing. This and other information can be found in the Funds’ prospectuses or, if available, the summary prospectuses which may be obtained by visiting www.ishares.com or www.blackrock.com. Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal.

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A fund’s environmental, social and governance (“ESG”) investment strategy limits the types and number of investment opportunities available to the fund and, as a result, the fund may underperform other funds that do not have an ESG focus. A fund’s ESG investment strategy may result in the fund investing in securities or industry sectors that underperform the market as a whole or underperform other funds screened for ESG standards.

A fund’s green bond investment strategy limits the types and number of investment opportunities available to the fund and, as a result, the fund may underperform other funds that do not have a green bond focus. A fund’s green bond investment strategy may result in the fund investing in securities or industry sectors that underperform the market as a whole or underperform other funds with a green bond focus. In addition, projects funded by green bonds may not result in direct environmental benefits.

International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. These risks often are heightened for investments in emerging/developing markets and in concentrations of single countries.

Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments.

Buying and selling shares of ETFs may result in brokerage commissions.

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