

Resetting the agenda

How ESG is shaping our future.



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Opportunities for a better future

A foreword by UBS Asset Management



Suni Harford
President, UBS Asset
Management

Sustainable investing is at the very core of what we do and has been a key focus at UBS Asset Management for over two decades. It is integral to the way we invest, and we have continued to focus on developing innovative products and solutions to help our clients address some of the most pressing investment challenges we face as a world in transition.

At UBS we are committed to helping our clients who wish to mobilise capital towards the achievement of the 17 UN Sustainable Development Goals (SDGs). UBS has recently set out its ambitions for the future, with the publication of the Group's Net Zero statement, "Net Zero and Beyond". And, as a founding member of the newly launched Net Zero Asset Managers Initiative and the Net Zero Banking Alliance, we will partner with peers to identify the fastest and most effective route towards a net-zero global economy.

Focus has turned to the role of financial markets and investing in driving this transition. The consideration of environmental, social and governance (ESG) factors in investment decisions is being viewed less as a trade-off and more as an essential part of what is required to succeed in a sustainable world. To that end, we believe ESG considerations, with climate change among them, are being more widely recognised as a key investment parameter, creating opportunities for investors across asset classes.

Changing global attitudes can already be seen in the persistent and accelerating flow of capital into sustainable investment funds, particularly against the backdrop of the pandemic. Sustainability-focused, climate and impact funds experienced double-digit new net money growth in 2020, and we are seeing this continue into 2021.

Against this backdrop, we commissioned The Economist Intelligence Unit to survey 450 institutional investors across the world. Three-quarters of investors agreed that the pandemic has accelerated their interest in ESG, and, unsurprisingly, inflows into sustainable investments are expected to continue gathering pace in the next three to five years.

Almost three-quarters of survey respondents also agreed that those investments integrating ESG factors performed better financially than equivalent traditional investments in the three years prior to 2020.

Beyond climate change, the global pandemic has also reinforced the importance of the 'S'. Even though the climate debate has focused discussions on the 'E' in recent years, social factors now rank among the most significant issues for respondents globally - and there are no regional disparities. We expect continued focus on the social agenda.

We've also started to see a shift from a broader ESG approach to a focus on investing for measurable impacts and outcomes aligned with the SDGs. These offer a blueprint to achieve a better and more sustainable future for all and have enormous potential to further propel ESG flows, while at the same time addressing some of the most pressing challenges of climate change and wealth inequality.

While we see a great shift in mindset, the transparency conundrum remains. Even with the advent of the Sustainable Finance Disclosure Regulation in Europe, a lack of data consistency and transparency has proven a further stumbling block to widespread adoption of this new SDG approach to investing.

Investors and the capital markets are moving faster than the speed which regulators are able to reach to address the myriad challenges, and it is the former that will set the pace of progress in achieving real-world sustainability outcomes in the short term.

As industries and financial players alike commit to a range of sustainability goals, including the transition to net zero, whole business models will shift or disappear altogether. The change and opportunity this represents is extraordinary, and means that sustainable investing will be a key driver of performance for years to come.

I hope that you will find this an interesting and provocative read.

UBS Asset Management's commitment to sustainability

At UBS Asset Management, we believe that sustainable investing can result in better overall risk-adjusted outcomes for clients by primarily protecting against downside risks associated with ESG-related issues.

By identifying long-term investment opportunities, anticipating and managing financially material risks, engaging with the relevant third parties, and creating products and services that take into account ESG considerations, we believe that our investments will be more successful in the longer term, and will positively impact society and the environment.

We work towards this by integrating sustainability into our mainstream offerings, through new and innovative financial products that have a positive effect on the environment and society. We are also focused on providing compelling investment opportunities to help our clients with their transition to a low-carbon economy.

Acknowledgments

To understand the ongoing shift of environmental, governance and social factors from risk to opportunity within the investment space, and how this is impacting investment processes and strategies, The Economist Intelligence Unit (EIU) surveyed 450 institutional investors working in asset and wealth management firms, corporate pension funds, endowment funds, family offices, government agencies, hedge funds, insurance companies, pension funds, sovereign wealth funds and reinsurers in North America, Europe and Asia-Pacific.

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Resetting the agenda

Executive Summary

The Covid-19 pandemic has exposed a wealth of interconnections – between ecological and human wellbeing, between economic and environmental fragility, between social inequality and health outcomes, and more. The consequences of these connections are now filtering through, reshaping our society and economy.

In this setting, the need to integrate environmental, social and governance (ESG) factors when investing has become even more critical. Institutional investors must employ ESG not just to mitigate risks and identify opportunities, but to engage with companies to bring about the positive change needed to drive a sustainable economic recovery in the post-Covid world.

In order to understand how ESG could be both a new performance marker and a growth driver in this environment, as well as how institutional investors are using ESG to make investment decisions and to assess their own performance, The Economist Intelligence Unit (EIU), sponsored by UBS, conducted a survey of institutional investors globally.

The key findings of that survey include:

- Three-quarters of institutional investors globally agree that the coronavirus pandemic will accelerate the general interest in ESG and capital inflows into sustainable investments over the next three to five years.
- Nearly three-quarters (74%) agree that their company's investments that integrate ESG factors performed better financially than equivalent traditional investments in the three years prior to 2020.
- That clear impact held up in 2020, with similar numbers of respondents saying that their company's investments that integrate ESG factors performed better financially in 2020 than equivalent traditional investments.
- While over a quarter (28%) of institutional investors globally have used ESG factors in the investment process for at least 50% of their assets under management (AUM) in the past three years, next year almost a third (32%) will. This figure rises to 65% when considering respondents who plan on integrating ESG into at least 25% of their AUM for the next 12 months.
- During the three years prior to 2020, improved management of ESG-related risks has been the main driver of ESG investments, followed by diversification of investments and enhanced financial returns.
- Since the beginning of 2020, the drivers for further ESG integration are expected to have shifted in the light of the wide-ranging impacts of the Covid-19 pandemic. Enhanced returns are still a top-three driver, but mitigation of the recession induced by the Covid-19 recession, cited by 26% percent of respondents, jumps to the top of the list.
- The UN's Sustainable Development Goals (SDGs) have taken centre-stage in ESG investing. Fulfilment of the SDGs ranks second on the list of drivers for ESG integration post-2020, while 74% of respondents state that the SDGs are a main guiding framework when it comes to defining and measuring the positive impact of their investments.

- Of the top five themes selected for future investment, four are related to the environment – renewable energy and energy efficiency, climate change adaptation and mitigation, pollution prevention and control, and sustainable water and wastewater management. Cybersecurity and data privacy rank second on the list.
- Survey respondents most often use ESG factors with listed equities, fixed income, real-estate investment trusts and infrastructure. At least 30% of respondents use ESG factors in all asset classes including commodities, private debt and alternatives.
- While cost is likely to remain an impediment to greater integration of ESG into the investment processes, the other top two barriers cited – the lack of clarity around ESG standards, taxonomy and metrics; and lack of awareness and understanding of ESG and its role within the company – are weakening. Similarly, obstacles that would have rated more highly in the past, such as inadequate data, lack of regulatory guidance and lack of clear assessment around impact, are now concerns for less than a fifth of respondents.
- Seven in ten survey respondents agree that there are too many frameworks when it comes to measuring and reporting on impact and non-financial performance. However, there is growing satisfaction with the frameworks that respondents have selected. Eight in ten agree that the frameworks that they follow to measure and report on impact are fit for purpose, with North Americans more convinced of their usefulness than their counterparts in other regions.

“Three-quarters of institutional investors globally agree that the coronavirus pandemic will accelerate the general interest in ESG and capital inflows into sustainable investments.”

- The range of guidelines used by survey respondents shows the challenge that asset owners face in selecting frameworks to guide their investments processes. While ten out of the 12 standards are used by at least a quarter of respondents, even the most popular, the Sustainability Accounting Standards Board is used by just over a third (34%) of respondents.
- Environment-related benchmarks are considered the most important, but over half of survey respondents use social-related and governance-related benchmarks as well. Almost a quarter use undifferentiated ESG benchmarks.

Moving from risk to opportunity

For many investors, the events of 2020 crystalised the need for ESG. From the physical effects of climate change witnessed in wildfires in Australia and California, to the social inequalities highlighted by the Black Lives Matter movement, to the corporate governance failings that led to the collapse of Europe's pre-eminent fintech, Wirecard, to the myriad consequences of the Covid-19 pandemic across environmental, social and corporate governance issues, we believe the risks from and consequences of not considering ESG have never been so stark.

While the case for integrating ESG into the investment process has strengthened, the ultimate purpose of ESG is still contentious. In November 2020 the Norwegian Government Pension Fund claimed that the UN Principles for Responsible Investment (UN PRI) had gone beyond its remit with its proposed strategic plan for 2021 to 2024, which emphasised alignment of investment decisions with real-world outcomes – that is, having a positive impact on environmental and social conditions via investments.

But according to Fiona Reynolds, CEO of the UN PRI, "The mission of the PRI is to embed sustainability issues in the investment process, but also to think not just about what are the ESG risks, but [also] the real-world outcomes of the investment, of the portfolio. The PRI was launched in 2006 by asset owners who wanted to integrate sustainability issues into their investments and to be better stewards of the capital that they managed on behalf of much of the world's workforce. They took the view that they are not just responsible for managing people's money and giving them returns. Of course, you have to do that, but you also have to be responsible for thinking about the world into which people are going to retire."

As an organisation for responsible investment, the question of the UN PRI's remit was seen as a broader question of the purpose of ESG investing. As it has become more mainstream, a wider range of views have joined what was once a much more niche "ethical investing" community. In the past, investors may have had different priorities such as protecting the environment or supporting religious values, but the motivation for utilising ESG in their investments was the same – to do good. Now that numerous studies have proven the positive impact of ESG on financial performance and volatility, more investors are integrating ESG who see it not only as a tool for risk mitigation, but also increasingly as a revenue driver.

Chapter I.

Changing perceptions

The main mandate of long-term investors such as institutional asset owners is to maximise risk-adjusted returns. Joel Posters, head of Investment Stewardship & ESG at the Future Fund, Australia's sovereign wealth fund explains: "Our initial rationale for considering ESG factors was to manage the risk side of that equation, and to a certain extent, we still do."

Richard Manley, head of sustainable investments for CPP Investments, the Canadian Crown pension fund, takes a broader view of ESG as a tool for risk management and alpha generation. "One of the things that has evolved since we started doing ESG is a belief that consideration of what I call '21st-century business risks' would inform the investment process," he says. "I think we now have very clear evidence that integration of these risks – and opportunities – really does inform our investment process and outcomes, and actually makes us better investors."

He adds: "While we respect other organisations integrating ESG because of a belief in right or wrong, I don't think you need to take a moral and ethical position on ESG factors to believe it's right to integrate them into the investment process."

A new fiduciary standard?

As ESG has evolved, the argument that its use is inconsistent with the fiduciary mandate has been challenged. Now, utilising ESG is considered by many to be necessary in meeting that responsibility. The CFA Institute contends that "failing to consider long-term investment value drivers, which include environmental,

"We come at ESG as grounded in fiduciary duty."

Anne Simpson,
CalPERS

social and governance issues, in investment practice is a failure of fiduciary duty"¹.

"We come at ESG as grounded in fiduciary duty," says Anne Simpson, managing investment director, board governance and sustainability at CalPERS, the pension fund for California's public employees. "This isn't something that you bolt on, it has to be a fundamental platform for everything you're doing."

When you are a pension or sovereign wealth fund founded and mandated by government legislation like the Future Fund and CPP Investments, fiduciary duty includes reputational considerations. The same holds for the Guardians of New Zealand Superannuation (Guardians). Its head of responsible investment, Anne-Maree O'Connor, explains: "We were set up by an Act of Parliament, which sets out our mandate. Beyond managing the fund in a prudent manner and maximising returns, it requires us to protect New Zealand's reputation as a responsible member of the world community."

¹ www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx

For other investors, their integration of ESG had more ethical motivations. “As the second-largest asset owner in Thailand, and long-term investors, we can do more than bring a financial return for our pensioners,” says Srikanya Yathip, secretary general of the Government Pension Fund (GPF) Thailand. “Because we don’t have to be focused on short-term results, we can also do good for society. As investors, we have the most power because we have the money – if we don’t invest, business can’t get very far. We want to use that power for all stakeholders.”

This consideration of the wider needs of beneficiaries reflects a broader shift seen in the past year away from shareholder primacy. “I think one of the barriers to greater adoption of ESG is the mindset that ‘my job is to make profits, and this is the way that we’ve always done it,’” Ms Reynolds says. “But we’re starting to see a shift, to see [Milton] Friedman’s economic theory tossed aside and corporations saying, ‘our role is much broader, we have a whole of stakeholders’ view’. And I think the mindset of a lot of investors is changing too – they don’t expect a company to think just about profits at the expense of everything else.”

“The year 2020 was a kind of breakthrough for ESG for institutional and mainstream investors. It’s now what I call ESG 3.0, which brings in the concept of stakeholder capitalism,” says Torben Möger Pedersen, CEO of PensionDanmark. The fact that some of the major asset management firms are now taking into account stakeholder values is a big indicator that “stakeholder capitalism and

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PensionDanmark

impact investing have moved from some of the more obscure corners to the centre of the industry,” he says.

Mr Manley contends that Friedman has been misinterpreted or should be reinterpreted in the context of today’s investing environment. “If you go back and read his work, he didn’t say you should ransack the environment or abuse labour, he said to maximise return, taking into account the environment in which you operate,” he says. “There’s a long, growing list of companies that have either destroyed or failed to create shareholder value over the course of the last two decades, because they failed to embrace the reality of this new century. In some ways, the underlying objective behind maximising shareholder returns is still legitimate – as long as you embrace the reality of the fact you’re doing it in a different world.”

ESG or GES?

The confluence of maximising shareholder returns and utilising ESG in the investment process is seen most clearly for some in the “G”, governance. As Ms Yathip bluntly states, “G is the most important factor – if the management and the board are not strong, nothing else works.”

Mr Posters finds that governance factors can still be more clear-cut in their relevance for individual investment decisions. “While there are some structural improvements we’d like to see in the market from a corporate governance perspective, often, when we look at governance, we look at it on a deal-by-deal basis,” he says. “Whereas, climate and other more systemic issues are important on a deal-by-deal basis, but also as drivers and potential barriers for macro indicators like economic growth or inflation. Investors need to look at it that way as well.”

Mr Pedersen also believes that the “G” is the key to better overall ESG. “For many years, we have believed the most important of these three letters is the G because companies with a good governance and policy structure, in general, also have good policies on the major social areas. It’s hard to find companies good at E or S that aren’t also good at G,” he says. “But for the last few years, the focus on climate change has been very prominent and dominant for many reasons.”

The growing concern about climate change and its potential for major systemic impact has shifted many investors’ focuses to the “E”. “Global systemic issues like climate change have come to dominate because of the sheer enormity of that issue,” says Ms O’Connor.

Mr Posters agrees: “What we've seen within our own organisation, and more broadly among institutional investors, is that climate risk is often a key talking point.”

Environmental factors were cited as “very important” by 54% of respondents to a survey of 450 institutional investors across Europe, North America and Asia-Pacific conducted in November and December of 2020. Governance factors (53%) have a slight edge on social factors (50%). Small regional differences are seen – investors in Asia-Pacific ranked social issues (53%) higher than the other two regions, and those in North America ranked environmental (60%) and governance (61%) factors marginally higher than their counterparts in Europe and Asia-Pacific.

Growing integration of ESG

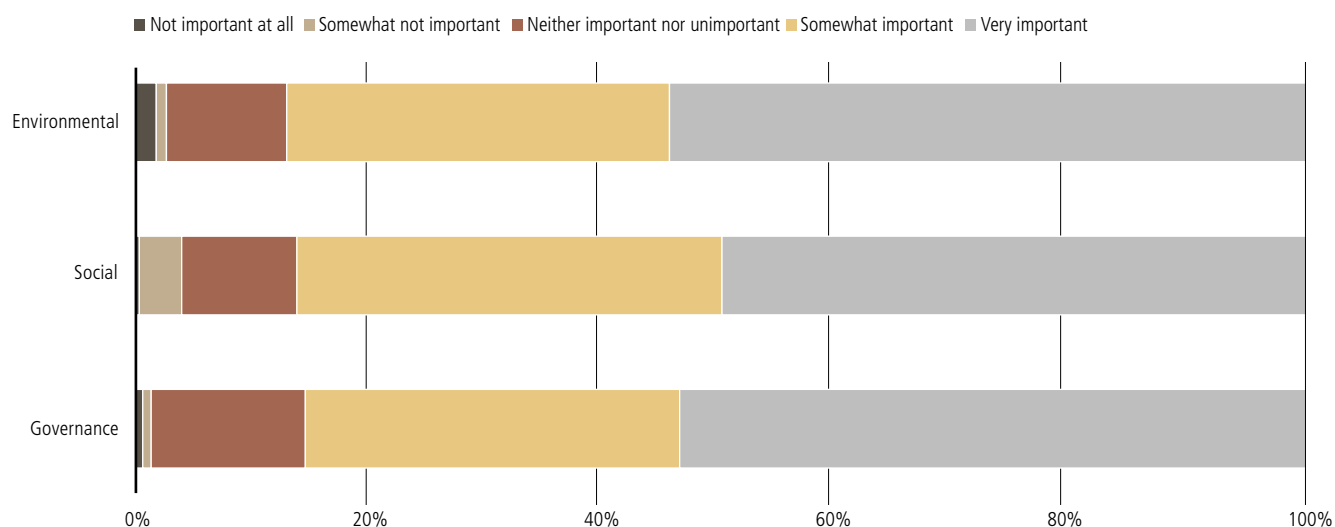
Whether because of Covid-19, climate change or other concerns, survey respondents plan to increase their integration of ESG factors in the investment process in the coming years. Whereas over a quarter (28%) globally have used ESG factors in the investment process for at least 50% of their assets under management (AUM) in

the past three years, next year almost a third (32%) will. This figure rises to 65% when considering respondents who are planning on integrating ESG into at least 25% of their AUM for the next 12 months.

“We're working to have ESG integration at all levels of our investments, covering most of the assets,” says Bruno Servant, CEO of Generali Insurance Asset Management. “We have an exclusion policy, which applies to €300bn in assets. Then we have the second level of ESG integration, and 80% of listed securities – corporate, sovereign bonds and equities and so on – are covered by this ESG analysis. The strategy and the ambition are to increase the coverage ratio of the ESG analysis and to integrate more non-financial consideration into investment decisions.”

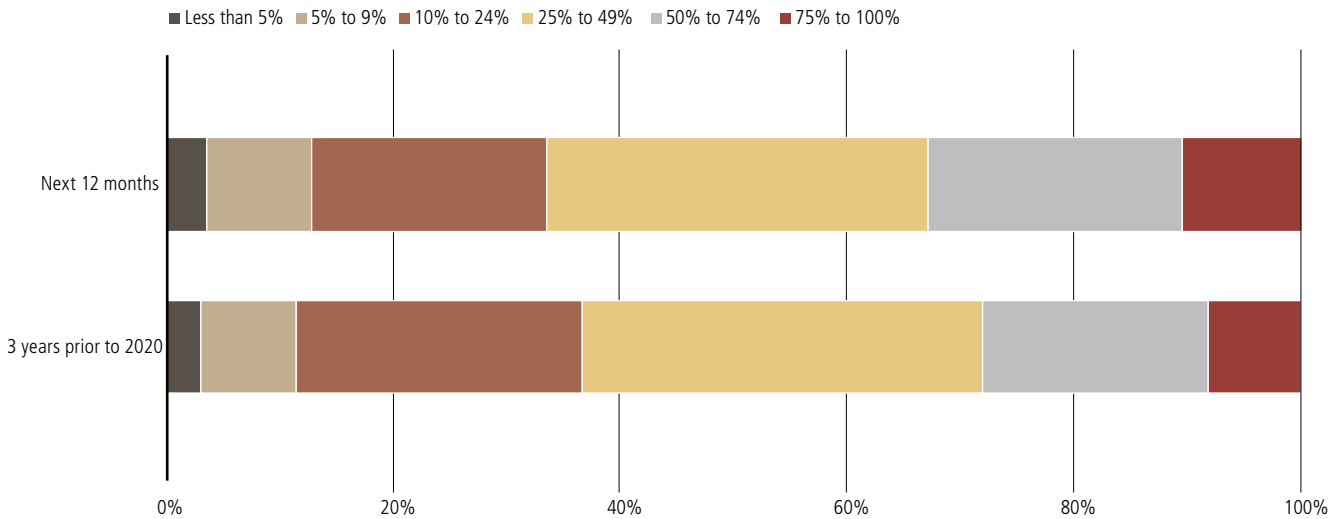
North American investors appear to be ahead of their counterparts in other regions, with 41% having at least 50% of their AUM currently integrating ESG criteria, compared with a quarter in Asia-Pacific and just 18% in Europe. However, the other regions plan to catch up – next year 30% of investors in Asia-Pacific and 26% in Europe plan to have at least half of their assets integrating ESG.

Chart 1. On a scale of 1 to 5 (where 1 is not important and 5 is very important), how would you rate the importance of environmental, social and governance factors in your investment decision process?



Source: EIU survey

Chart 2. What percentage of your firm's AUM have/will have ESG factors incorporated into their investment process?



Source: EIU survey

The insurance companies, government agencies, asset and wealth managers, and pension funds among the survey respondents are more likely to have at least 50% of AUM under ESG than endowments, family offices or hedge funds. Hedge funds, asset and wealth managers, pension funds, and family offices plan the largest amount of growth of assets integrating ESG in the next year.

“Hedge funds, asset and wealth managers, pension funds, and family offices plan the largest amount of growth of assets integrating ESG in the next year.”

Key highlights:

- Is ESG a fiduciary duty?
- Twenty-eight per cent of respondents globally have integrated ESG factors into the investment process for at least 50% of their AUM in the past three years; next year almost a third (32%) will.
- Environmental factors were cited as “very important” by 54% of respondents.
- The G in ESG, or the strength of boards and executive management, is also viewed as central. Moreover, governance factors (cited as “very important” by 53% of respondents) have a slight edge on social factors (50%).

Chapter II.

Drivers of ESG

The increasing coverage of assets under management by ESG criteria indicates a growing belief in the benefits of utilising ESG in the investment process – and growing evidence to back up that belief. According to survey respondents, for the past three years, improved management of ESG-related risks has been the main driver of ESG investments, followed by diversification of investments and enhanced financial returns.

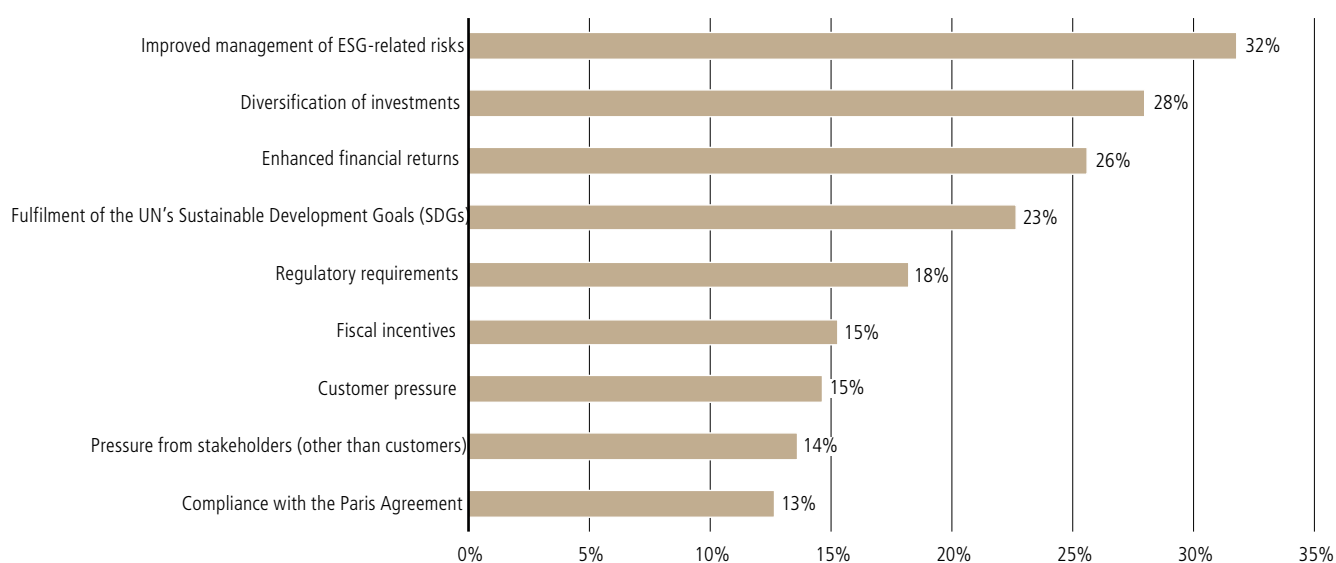
The benefits of ESG have been seen both by the companies using the criteria to improve their own operations and performance, and by investors funding them. Many studies have looked at how sustainable corporate practices can

affect investment returns, and a meta-study of about 200 of these investigations discovered conclusive evidence of ESG's positive effects. Almost nine in ten (88%) of the studies showed that solid ESG-compliant practices result in better operational performance of firms, and 80% showed that stock price performance of companies is positively influenced by good sustainability practices.²

Enhanced returns

Survey respondents have seen that evidence for themselves. Nearly three-quarters (74%) either agree or strongly agree that their company's investments that integrate ESG factors

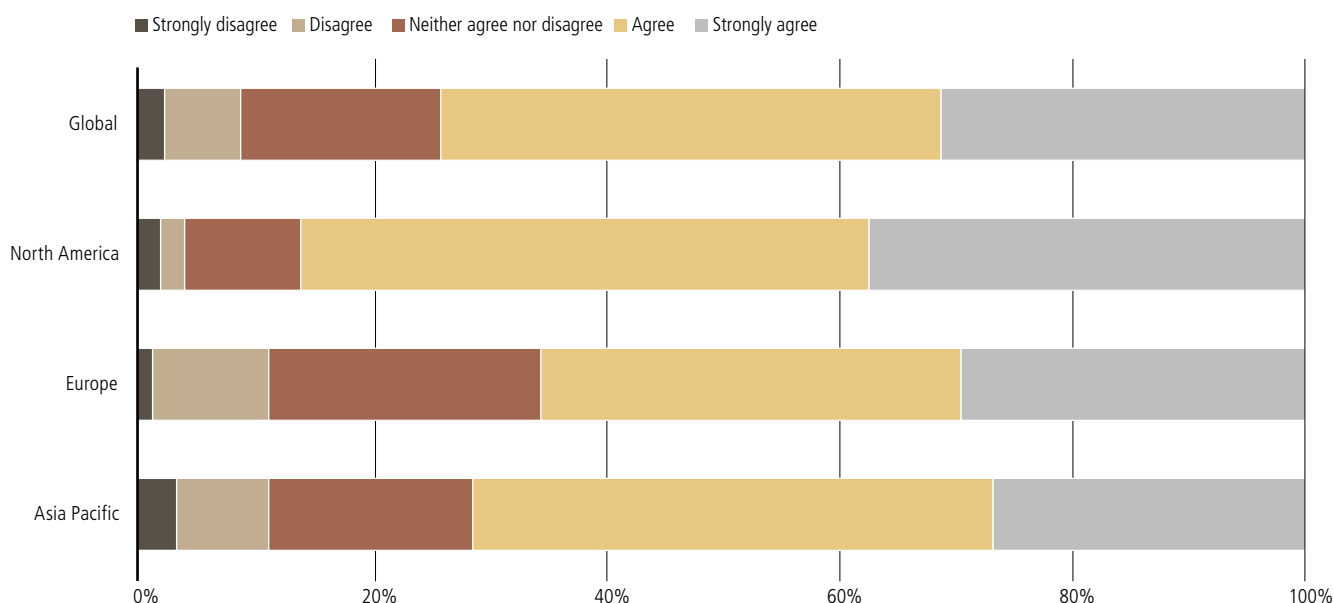
Chart 3. In the three years prior to 2020, what were the main drivers for your organisation's sustainable/ESG-integrated investments?



Source: EIU survey

² www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.aspx

Chart 4. My company's investments that integrate ESG factors have performed better financially than equivalent traditional investments in the three years prior to 2020



Source: EIU survey

performed better financially than equivalent traditional investments in the three years prior to 2020. North American respondents (86%) are even more likely to have seen the positive impact of ESG on their performance than their counterparts in Europe (65%) and Asia-Pacific (72%).

This clear impact held up in 2020, with similar numbers of respondents saying that their company's investments that integrate ESG factors performed better financially in 2020 than equivalent traditional investments. "2020 showed that sustainable companies or companies with strong records on ESG issues have performed superiorly to other companies," says Mr Pedersen of PensionDanmark. "We've seen a large inflow of funds for companies with a strong sustainability brand. Ten years ago, we would be talking about the trade-off between doing good and good performance, but this has changed."

Over the next year, the drivers for further ESG integration are expected to shift in the light of the wide-ranging impacts of the Covid-19 pandemic. Enhanced returns are still a top-three driver, but mitigation of the recession

induced by Covid-19, cited by 26% of respondents, jumps to the top of the list.

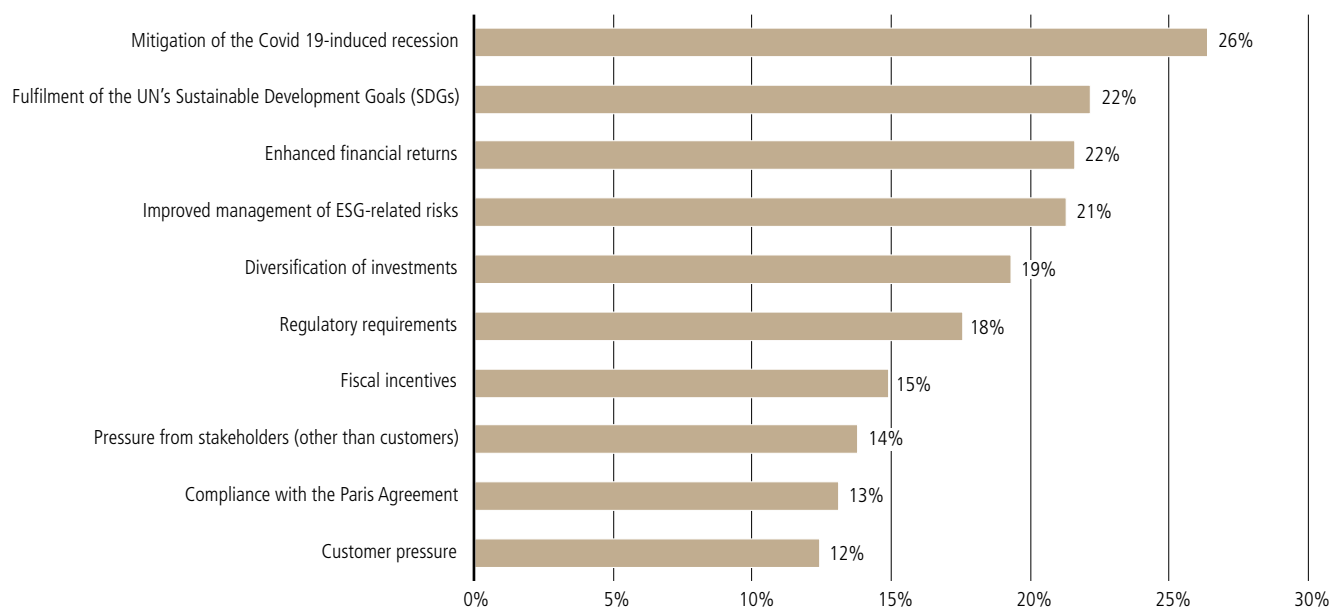
Fulfilment of the UN Sustainable Development Goals (SDGs; cited by 22%) also grows in importance to survey respondents in terms of the coming year's investments, moving from the fourth major driver to the second. However, European respondents (at 18%) are the least likely to see the SDGs as a driver. (See Chapter VI for more on how investors are utilising the SDGs in the investment process.)

The 17 SDGs are a part of the 2030 Agenda for Sustainable Development, adopted by all UN Member States in 2015. They acknowledge that ending poverty goes hand-in-hand with strategies to improve health and education, reduce inequality, and promote economic growth, while combating climate change and preserving oceans and forests.³

"The reality is that ESG factors are all inter-related," says Peter Webster, CEO of EIRIS Foundation and senior advisor, Vigeo Eiris. "For example, accelerating forward on the energy transition and winding down coal power projects

³ sdgs.un.org/goals

Chart 5. Over the next 12 months, what will be the main drivers for your organisation’s sustainable/ESG-integrated investments?



Source: EIU survey

has an impact on social factors such as employment. And deforestation activities are widely linked to social risks such as the rising prevalence of pandemics or rare diseases. In that respect, the interconnected framework of the Sustainable Development Goals provides the right prism through which to view ESG factors. They are not a menu to be selected from. All require targeted action, and they connect with one another. A pragmatic, holistic approach that balances the integration of E, S and G factors into decision-making processes is vital.”

The carrot and the stick

Other incentives for greater ESG adoption are a mixture of carrot and stick. For survey respondents, regulatory requirements have been slightly more influential than fiscal incentives over the past three years – particularly in Europe – and will continue to be so over the next year. However, interviewees see a growing role for fiscal incentives. “Pre-Covid, I worried about the sustainability of central-bank policies and the momentum of implementation of the climate agenda. Now fiscal policy will dominate over monetary policy,” says Mr Pedersen. “The ECB can’t raise rates – that

would be a disaster for some countries like Italy – but the Covid stimulus financed by euro bonds (a first) will have an impact. We’re moving to a new regime, similar to the late 1940s to 60s, where growth comes from expansive fiscal policy. The result will be a larger role for the state in the economy – it’s needed to steer it through the crisis.”

Fiscal incentives have been seen mostly in encouraging private investment in green infrastructure, and a wide range of financing mechanisms can be used for this purpose. Direct risk-sharing through co-investment, guarantees and insurances, and increasing rewards through premium prices or tax credits can help to scale up investments. Other, non-financial strategies can also help to reduce risk, such as fostering long-term policy stability, streamlining licensing processes or ensuring a local supply of expertise.⁴

Risk-sharing mechanisms and concessional loans or grants have been the most-used subsidies so far, and in recent blended energy projects financed with public support, the rate of subsidisation can exceed 50% of the project costs – largely eliminating the risk to private investors. But while

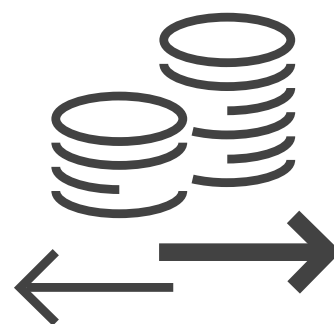
⁴ sustainabledevelopment.un.org/content/documents/2111Chapter%204-public%20support%20to%20private%20investment.pdf

this can help to encourage early investors or demonstrate developing green technologies, it is not sustainable in the longer term, as it cannot be used at the scale required. Mechanisms that focus on risk-mitigation (such as streamlined licensing processes and local supply of expertise) rather than risk-sharing (such as co-investment, guarantees and insurances) or risk-compensating (premium prices and tax credits, for example) may be better suited to encouraging private-sector finance in the future.⁵

Other tools are needed, particularly for developing countries, which face major challenges in mobilising private financing to implement the SDGs. Various instruments, such as green, blue and sustainability bonds, are helping to channel investment into SDG-aligned projects. However, the US\$966bn in foreign direct investment that those projects received in the 2015/16 financial year is just a fraction of the estimated US\$2.5trn annual SDG financing gap.⁶

Clearly, the incentive structure must be reinvented to mobilise private finance at the scale required. Suggestions from the G20 include actions in areas ranging from leveraging innovative financing vehicles, to economic modernisation and inclusive business tax reform, and streamlining credit-rating systems.⁷

Mr Servant agrees that governments must think more holistically in order to encourage private investment. "Regulation has a role to play, and public incentives, to encourage change," he says. "The point is not to just make companies pay more tax because they aren't doing things correctly, or taking measures that simply move the problem from one country or one region to another. The objective is to make global progress everywhere." Linda-Eling Lee, global head of research of MSCI's ESG research group, also emphasises the need for a more global approach. "The differences in regulatory development, both in terms of pace and emphasis, are of interest and possibly concern," she says. "It is harder and harder to navigate if there isn't a more globally consistent change."



US\$2.5trn
annual SDG financing gap

US\$966bn
FDI received by SDG-aligned projects in 2015/16 financial year

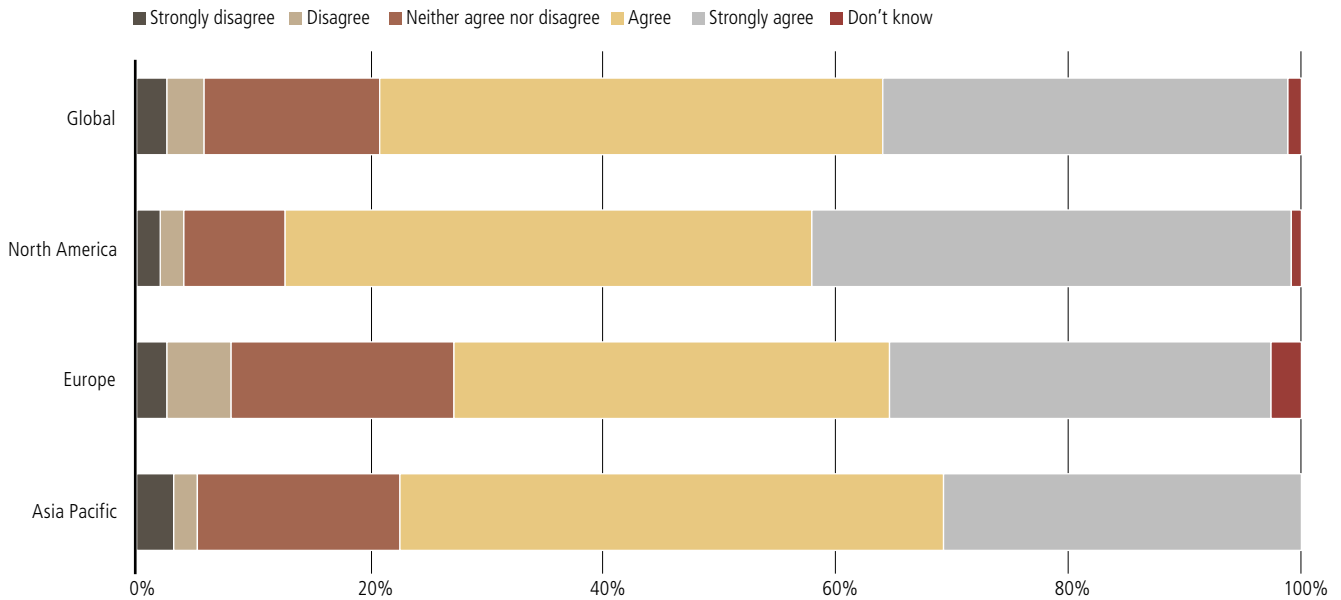


⁵ sustainabledevelopment.un.org/content/documents/2111Chapter%204-public%20support%20to%20private%20investment.pdf

⁶ www.g20-insights.org/policy_briefs/incentivizing-the-private-sector-to-support-the-united-nations-sustainable-development-goals/

⁷ www.g20-insights.org/policy_briefs/incentivizing-the-private-sector-to-support-the-united-nations-sustainable-development-goals/

Chart 6. Regulation should require asset owners to have at least one trustee/board director with ESG expertise



Source: EIU survey

Acknowledging stakeholder pressure

One suggestion that more than three-quarters of survey respondents agreed with is that regulation should require asset owners to have at least one trustee or board director with ESG expertise. The idea is especially popular among North American investors, garnering agreement from 86% of them. Making ESG expertise a necessity at board level would be one way for asset owners to demonstrate that they are taking their fiduciaries duty – the updated version that considers a range of stakeholders, not just shareholders – seriously. However, pressure from customers and other stakeholders is cited by survey respondents as a low priority compared with other drivers of ESG integration, both in terms of the past three years and in the coming year. Mr Pedersen thinks that this is short-sighted. “If you want to attract the most talented young staff, you need a convincing story about the purpose of your company. They will ask, ‘what are you doing good for the world?’ It is long gone that you can attract people only by the paycheque,” he says, adding that this is true for both

investors and corporates. “Many of the most interesting short-term and, especially, long-term investment opportunities are in the ‘sustainability agenda’. It’s because that’s what the consumer wants, the employees want – and that’s what the investors want.”

Key highlights:

- Nearly 74% either agree or strongly agree that investments that integrated ESG factors saw better performance than traditional investments in the three years prior to 2020.
- There is a growing role of fiscal incentives in encouraging private investment in green infrastructure.
- More than three-quarters of survey respondents agreed that regulation should require asset owners to have at least one trustee or board director with ESG expertise.

Chapter III.

ESG investment themes

Concerns around the sustainability agenda are reflected in the investment themes that survey respondents said that they are looking to invest in. Of the top five, four are related to the environment – renewable energy and energy efficiency, climate change adaptation and mitigation, pollution prevention and control, and sustainable water and wastewater management.

Cybersecurity and data privacy rank second on the list, given the potential that cyber-attack threats could lead to heavy financial losses and social instability. This is an issue that has been growing in prominence over the years, but has perhaps come to the forefront now as a consequence of the pandemic, which has led to a significant rise in the use of digital technologies and a mass move to home-working. Although cybersecurity is not an obvious ESG issue, ensuring that data and systems are secure is not just necessary for the smooth running of a business – it also protects the privacy of customers and employees, making it a social issue as well.

Whereas the pandemic has boosted interest in cybersecurity and data privacy, its effect is seen less in social issues such as access to healthcare, which ranked just 11th out of 14 investment themes surveyed. However, healthcare is a higher priority in North America, as are education and affordable housing.

Other investment preferences are seen in the different regions, with sustainable agriculture and food security more popular in North America (cited by 33% of respondents) and Asia-Pacific (29%) than in Europe

(21%). Pollution prevention and control is much more of a prevalent theme in North America (33%), and renewable energy and energy efficiency (42%) is a stronger preference in Asia-Pacific.

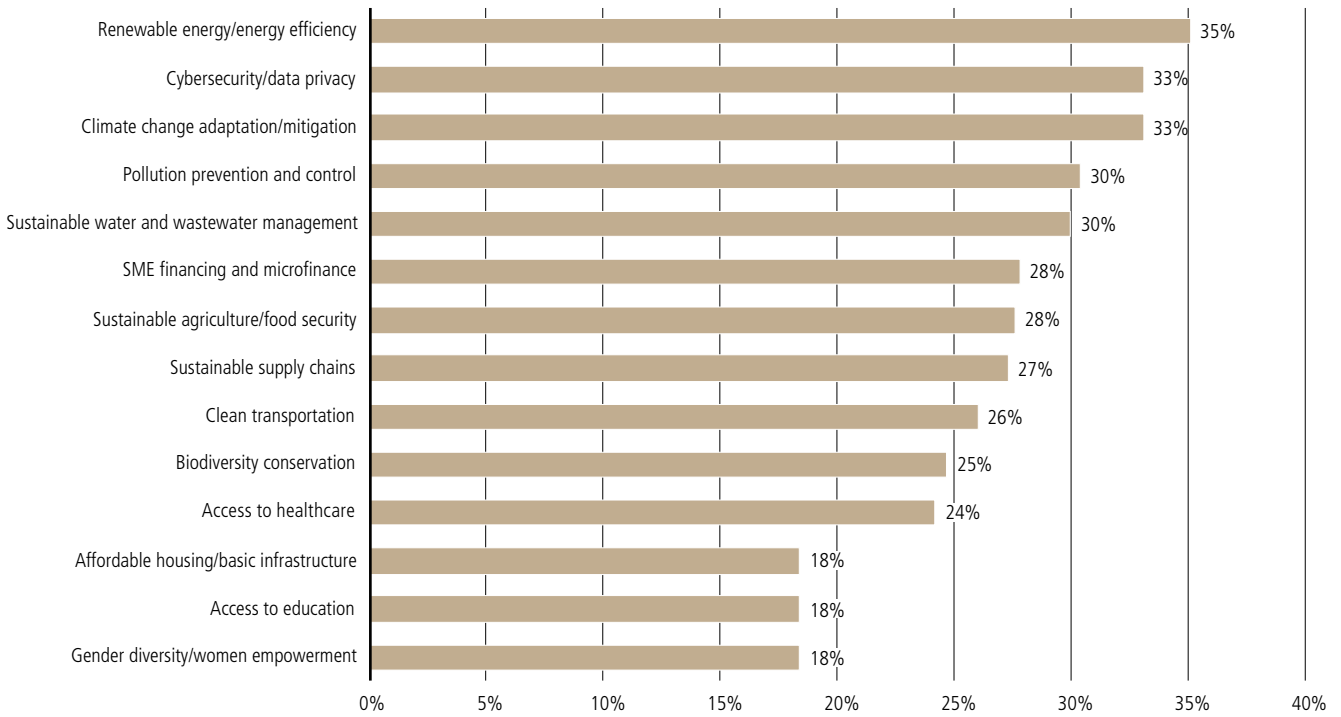
“Many investors struggle with social issues because they understand they are very important at a systemic level, but in terms of implementation – how you can allocate to those things – they become quite narrow quickly, like with access to healthcare assets,” says Ms Lee of MSCI. And for investors who mainly utilise ESG as a risk-management tool, these social themes may have less appeal, according to Mark Campanale, founder and executive chairman of Carbon Tracker Initiative, a think tank researching the impact of climate change on financial markets. “Access to healthcare is not a risk-mitigation question, so I can see asset owners not investing there,” he says.

Environment-related themes are getting a boost from government Covid-19 recovery plans that promise “green” recoveries. For example, the EU’s plan to emerge stronger from the coronavirus crisis, NextGenerationEU, will offer loans and grants of €672.5bn (US\$801.3bn) through the Recovery and Resilience Facility (RRF). The RRF is structured around six pillars: green transition; digital transformation; smart, sustainable and inclusive growth and jobs; social and territorial cohesion; health and resilience; and policies for the next generation, including education and skills.⁸

Analysis by the OECD finds that governments have so far concentrated their green measures in the energy

⁸ ec.europa.eu/commission/presscorner/detail/en/mex_21_204

Chart 7. Which of the following sustainability-related themes is your organisation looking to invest in?



Source: EIU survey

and surface-transport sectors. But it notes that other sectors – such as industry, agriculture, forestry and waste management – are equally important for a green and resilient recovery.⁹

Green recovery plans are inspiring asset owners to think about how their investments can support both economic revival and the transition to a low-carbon future. “As a response to the Covid crisis, and in line also with the EU recovery plan, we launched our own recovery plan, through our Fenice 190 initiative,” says Mr Servant of Generali. “It is a five-year, €3.5bn plan to fund a greener and more sustainable, resilient recovery in a wide range of sectors such as renewables and green mobility. This initiative is on top of the commitment taken since 2018 to increase our green and sustainable investments by €4.5bn by 2021.”

Renewable energy and energy efficiency

Renewable energy and energy efficiency is the most popular investment theme, according to survey

respondents, particularly in Asia-Pacific, where 42% of respondents said that they plan to invest in this area, compared with about a third in Europe and North America. The sector is in need of additional investment after slumping in 2020 owing to the Covid-19 pandemic. According to the International Energy Agency (IEA), total global investment in green energy was down by 20% compared with 2019, owing to side effects of the pandemic including lower demand for energy, lower prices and a rise in non-payment of bills. The IEA described the drop in investments as “staggering, in both its scale and swiftness, with serious potential implications for energy security and clean energy transitions.”¹⁰

Even before the pandemic, global investment in green energy was falling well short of that believed to be necessary to hit the Paris Agreement target of limiting global warming to well below 2 degrees Celsius, preferably to 1.5 degrees. Annual investment in renewables must at least double compared with current levels – from around

⁹ <http://www.oecd.org/coronavirus/en/themes/green-recovery>

¹⁰ www.iea.org/reports/world-energy-investment-2020

US\$310bn to more than US\$660bn, according to the International Renewable Energy Agency.¹¹

Not only is this investment needed, it has also proved profitable. Imperial College London and the IEA analysed stock-market data to determine the rate of return on energy investments over five and ten years (starting in January 2010 and ending in December 2019) and found that renewable energy consistently outperformed fossil fuel investments. In Germany and France, renewables investments yielded 178.2% over a five-year period, compared with -20.7% for fossil fuel investments; in the UK, renewables yielded 75.4%, compared with 8.8% for fossil fuels; and in the US, they yielded 200.3%, versus 97.2% for fossil fuels. Renewable energy stocks were also found to be less volatile, particularly during the turmoil caused by the pandemic, when oil and gas prices collapsed.¹²

So why does investment in renewables remain relatively low, despite apparently stellar returns? The Imperial College/IEA research points to the smaller market caps of renewables – less than a quarter of the average market cap for fossil fuels – and the fact that large asset managers and institutional investors require deep liquidity. “It is easier to allocate a meaningful percentage of their assets under management to renewables if the market is deep and liquid, but currently that is not the case,” the report states.¹³

The sector is expected to get a boost from green recovery plans, and from the change in administration in the US. The president, Joe Biden, has re-joined the Paris Climate Accord, and pledged to invest US\$2trn in clean energy and to fully decarbonise the power sector by 2035, in order to reach net-zero carbon emissions by 2050.¹⁴

Although this may expand investment opportunities, Mr Posters of the Future Fund worries that an over-abundance of capital might have an impact on returns. “We may have had return expectations a couple of years

ago for renewables markets that were quite robust: those have been compressed over time,” he says. “What that means is that it's become a lot more competitive.”

Climate change adaptation and mitigation

Adaptation and mitigation is the second greatest area in which investors see an opportunity for ESG investment, cited by a third of survey respondents globally. It drew the greatest level of attention from investors in Asia-Pacific, at 35%. This is unsurprising, given that this is a region expected to bear the brunt of climate change, and therefore at greatest risk from failing to address this issue.

Adaptation and mitigation are two core climate change strategies. Adaptation means the adjustment of natural or human systems in response to the impact of climate change, which moderates the harm this causes, or exploits opportunities that arise from it. Mitigation involves reducing greenhouse gas emissions at source, or through their removal with “sinks” – natural phenomena such as forests, vegetation or soils that can reabsorb CO₂. As greenhouse gas levels are rising at their fastest level in at least 650,000 years, such mitigation is essential.¹⁵

Investors in this space are not only financing existing adaptation and mitigation solutions, but also using their influence to encourage the companies that they invest in to develop strategies to manage the climate transition. Interestingly, despite how financially exposed such changes leaves them, only 24% of insurance companies saw opportunities here. Instead, hedge funds (44%), asset and wealth managers (40%), and corporate pension funds (37%) were those most likely to invest.

Despite much of Asia's greater exposure to the effects of climate change, the EIU's Climate Change Mitigation Opportunities Index identified the obstacles of low incomes and shallow pools of skilled labour in nascent markets, many of which are found in the region, acting as a drag on the development and implementation of high-technology mitigation solutions. However, the report found that, over

¹¹ www.forbes.com/sites/davidrvetter/2020/05/28/just-how-good-an-investment-is-renewable-energy-new-study-reveals-all/

¹² www.imperial.ac.uk/business-school/faculty-research/research-centres/centre-climate-finance-investment/research/energy-investing-exploring-risk-and-return-the-capital-markets/

¹³ www.imperial.ac.uk/business-school/faculty-research/research-centres/centre-climate-finance-investment/research/energy-investing-exploring-risk-and-return-the-capital-markets/

¹⁴ www2.deloitte.com/us/en/pages/energy-and-resources/articles/renewable-energy-outlook.html

¹⁵ unfccc.int/files/press/backgrounders/application/pdf/press_factsh_mitigation.pdf

the longer term, technical adoption and rising domestic skill levels should increasingly address these shortfalls.¹⁶

Relevant areas for adaptation include financing low-carbon transitions in industry, buildings and transport. Indeed, shifting construction from cement to more sustainable materials such as timber could also mean that buildings play a role as carbon sinks, so covering both adaptation and mitigation.¹⁷

Climate mitigation strategies focused on agriculture are coming increasingly to the fore. Given the importance of carbon sinks, both forestry and agricultural investments play an indispensable role in addressing this role. And here, especially, “institutional investment can lead to a more efficient use of the land,” as such investors “have a long-term interest in farming the land and investing in infrastructure to maximize cash flows”, write Ivo Knoepfel and David Imbert in a 2011 report, *The Responsible Investor’s Guide to Commodities*.¹⁸

All of which comes at a price: US\$20trn in capital expenditure on low-carbon energy supply and energy efficiency, to meet the Paris Agreement targets.¹⁹

According to the G20 Insights Platform, which offers policy proposals to the G20, “given the large scale of the investment required to decouple carbon emissions from economic growth, it will have to rely largely on mobilising private capital.” This offers huge opportunities to investors willing to take this on.

A range of institutions, including the UN Framework Convention on Climate Change, the Global Impact Investing Service and the IMF – which launched the first green bond and has been instrumental in the development of such instruments to finance mitigation projects – are involved in the marshalling of private capital.^{20,21}

Pollution prevention and control

Pollution prevention and control ranked fourth in terms of the areas that survey respondents were looking to invest in – it was selected by 30% overall, with a third of North American investors (33%) highlighting it. This was the same as the figure for endowments and government agencies, who led the field in prioritising this issue.

Pollution prevention is a catch-all term for addressing negative emissions: from the run-off from industrial processes, to the disposal of the ubiquitous plastic packaging that remains after use or consumption. It is increasingly moving up the value chain – from what is known as “end of pipe control”, where waste is disposed of at the end of production, to adopting sustainable processes that minimise any such waste from the outset, and which are implemented at every level.

Investing in this area is not simply about selecting a technology, business or sector with low externalities. While divesting from a particularly dirty industry may clean up an investor’s portfolio, someone, somewhere still owns the securities, and the company continues polluting. To a very large extent, it is about reducing pollution in existing “brown” industries. To this end, the advent of transition bonds has been a real boost.

Transition bonds help brown companies become more sustainable, for instance, by financing a transport company’s shift from diesel to electric vehicles. Such bonds are especially suitable for those not yet green enough to be able to issue green bonds. The greatest opportunity for these bonds is in improving energy and materials efficiency in heavy industries, such as cement, iron, steel and aluminium: in other words, precisely those industries that are the biggest polluters.

However, as with climate adaptation and mitigation, it is not just about investing, it is also about using institutional investors’ influence to encourage change, particularly where it is needed most with the biggest polluters.

¹⁶ www.morganstanley.com/content/dam/msdotcom/ideas/climate-change-mitigation-index/MorganStanley_EIU-ClimateChangeIndex_Report.pdf

¹⁷ www.nature.com/articles/s41893-019-0462-4

¹⁸ www.unglobalcompact.org/library/212

¹⁹ www.g20-insights.org/policy_briefs/investing-in-climate-change-mitigation-a-g20-action-plan-for-upscaling-private-sector-contributions-3/

²⁰ unfccc.int/topics/climate-finance/the-big-picture/introduction-to-climate-finance

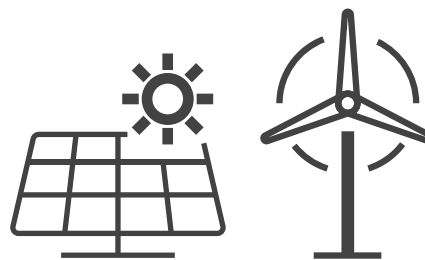
²¹ thegiin.org/climate-finance

The size of investment needed is enormous: the OECD estimates that US\$6.9trn a year is required by 2030 to meet climate and development objectives, with energy, transport, building and water infrastructure making up more than 60% of greenhouse gas emissions.²² It has been estimated that more than US\$90bn a year will be needed to address ocean pollution alone.²³ As yet, there have only been a handful of transition bond issuers, with sums totalling single-digit billions.²⁴

Data is the other area seeing a real change in dealing with pollutants. Getting a grasp of the environmental impacts of specific goods and services demands an understanding of the entire value chain. But this requires large amounts of data and, more often than not, data that the producers do not supply. However, emerging technology solutions allow investors to monitor companies' activities through various means such as satellite monitoring, where the extent of visible pollutants can be tracked from on high.

Another approach is data scraping: companies that are illegally dumping pollutants will not declare it in their accounts or shareholder reports. But communities on the receiving end of these will be, as will their employees. Information to this effect may appear on social media such as blogs or Twitter, or in local media reports, with a reach unlikely to stretch as far as the compliance officers of these polluting companies' investors. Technologies such as web scraping, primed for certain words or phrases, can sift through huge amounts of data and compile it in an intelligible form.

Some market participants, including the World Bank, are using artificial intelligence (AI) and big data to get a broad regional view of pollution's effects in a way that is beyond the scope of unaided human capacity. For example, levels of ocean pollution in one country may spike after the relaxing of environmental policies in another by such means as over-fertilisation generating toxic chemical runoff into the sea.²⁵



US\$20trn

in capital expenditure on low-carbon energy supply and energy efficiency is needed to meet the Paris Agreement targets¹⁹

Sustainable water and wastewater management

"Ensuring the availability and sustainable management of water and sanitation for all", the sixth of the UN SDGs, is increasingly being used by investors to frame ESG objectives. The UN estimates that 2.2bn people lack safely managed drinking water, and 4.2bn are without appropriate and safe sanitation – more than half of the world's population. This has a bearing on the global health inequalities exacerbated by Covid-19, with an estimated 3bn people lacking basic hand-washing facilities – one key way of limiting the pandemic's spread.²⁶

Overall, sustainable water and wastewater management (cited by 30% globally) is the fifth most popular investment theme for survey respondents. While prioritised most by European investors and least by those in Asia-Pacific, all regions are clustered quite tightly around 30%. Asset and wealth managers (35%) and endowment funds (33%) are those most likely to be looking to make commitments in this area.

When one looks at the growth of assets in water-orientated funds, it is easy to see why water supply and

²² www.oecd.org/environment/cc/climate-futures/policy-highlights-financing-climate-futures.pdf

²³ www.greenbiz.com/article/what-will-it-cost-save-earths-oceans#:~:text=At%20over%20%2490%20billion%2C%20that,kind%20in%20the%20first%20place

²⁴ www.theedgemarkets.com/article/intheknow-transition-bonds

²⁵ http://www.efunds.com.cn/en/pdf/Final_green_intelligence_eiu_e_fund.pdf

²⁶ sdgs.un.org/goals/goal6

management should be so popular with asset and wealth managers. According to Refinitiv, a provider of market data, in excess of US\$30bn was invested in water-themed mutual funds and exchange-traded funds in 2020 – more than double that of five years’ previously (US\$13.9bn), with the overwhelming majority of these being domiciled in European jurisdictions.

Investible ways of addressing issues around water supply and management fall into two broad areas: infrastructure investments, such as developing new water and sanitation pipelines or repairing existing ones, in order to improve usage efficiency; and the development and implementation of technologies that use and recycle water in a more efficient manner, such as through smart metering devices, desalination or rainwater harvesting systems. While such infrastructure themes can be accessed through both public and private markets, the latter are a particularly good option for asset owners attracted to impact investing as a strategy, as they grant greater control over the assets – and the sustainable water projects in which they are engaged.

Index providers also offer a growing number of ways for investors to access this theme through passive strategies: for example, MSCI’s Sustainable Water Index comprises “products, services and projects that attempt to resolve water scarcity and water quality issues, including minimising and monitoring current water use and demand increases, improving the quality of water supply, and improving the availability and reliability of water”.²⁷

People lacking²⁶:

safely managed drinking water

2.2bn 

appropriate and safe sanitation

4.2bn 

basic hand-washing facilities

3bn 

So, while passive investments comprise less than 10% of assets invested in water-themed funds (US\$2.8bn), growing product granularity could well see this increase.

The UN has estimated that in the US alone between US\$300bn and US\$1trn will be invested in clean water infrastructure by 2030 and, along with the Climate Bonds Initiative, has flagged these new so-called “blue bonds” as being a major source of finance raising for such infrastructure.²⁸

Cybersecurity and data privacy

A key risk linked to social factors such as employee and consumer protection, cybersecurity and data privacy was the second most popular investment theme in our survey, selected by a third of respondents (33%) overall. It is particularly of interest in Europe (38%), and less so in North America (28%).

As more companies move operations to the cloud and employees access business-critical systems and operations remotely, cybersecurity has taken centre stage and become a governance issue. At the same time, growing consumer awareness of data privacy issues, along with government action such as fines imposed on Google, Twitter and Whatsapp for infringing the EU’s General Data Protection Regulation, are increasing interest in solutions and companies that protect data privacy – and highlighting it as a social issue as well.

Covid-19 has inspired a record number of online scams targeting both consumers and businesses. By early April 2020, the World Health Organisation (WHO) had seen a fivefold increase in the number of cyber-attacks directed at its staff, as well as scams impersonating the WHO that targeted the public at large. Coronavirus was also referred to in more than 900,000 spam messages, 700 malware attacks and 48,000 malicious domains discovered in the first four months of 2020, according to Interpol.

The pandemic has also created a perfect storm for cyber breaches, in the form of the mass migration of employees to remote working and people increasingly relying on digital services. Global losses due to cybercrime in 2020 have been estimated at US\$945bn, almost double the monetary loss in 2018 of US\$500bn. As a result, global spending on cybersecurity exceeded US\$145bn in 2020

²⁷ www.msci.com/eqb/methodology/meth_docs/MSCI_Global_Environment_Index_May2018.pdf

²⁸ www.un.org/waterforlifedecade/waterandsustainabledevelopment2015/pdf/Justine_LeighBell_CaseBM.pdf and www.climatebonds.net/standard/water

and is expected to hit US\$400bn by 2026, according to Global Market Insights.^{29,30}

According to McKinsey, more than half of chief executives plan to increase their cybersecurity budgets in 2021, even where business revenues are under pressure. The cyberthreats that firms are most worried about are attacks on cloud services, 'disruptionware' targeted at critical business operations and ransomware. Therefore, much of the spending will be focused on areas such as network security, endpoint security, identity and access management, and messaging security.³¹

Just as investment is necessary to transition the economy to a low-carbon future, investment is needed to support the development of information societies around the globe. According to the World Economic Forum, a lack of effective cybersecurity has a potential knock-on effect on the Fourth Industrial Revolution by undermining stability and trust in digital technologies. Therefore, cybersecurity is essential to harness the potential of digital technologies to deliver outcomes that are beneficial to society.³²

Moreover, the importance of increasing access to information and communications technology (ICT) and the internet is enshrined in the SDGs (Goal 9.c) and it such access also seen as essential for the implementation and monitoring of the other SDGs.³³

Sustainable supply chains

Other themes are growing in importance as investors realise their potential impact, such as the need for sustainable supply chains. This theme encompasses a range of social and environmental issues, but its significance is seen most clearly in the fact that supply-chain CO2 emissions are on average 5.5 times as high as a corporation's direct emissions, meaning that reduction efforts that ignore supply chains are missing the bulk of the problem.³⁴ Unsurprisingly, the topic is seen as a higher priority among investors in Asia-Pacific (33%), home to much of the world's supply chains, than among those in North America (23%) or Europe (26%).

In New Zealand, the Guardians have been monitoring issues around human rights within supply chains, such as child labour and modern slavery. Ms O'Connor believes

that focus on the theme has increased as the tools to understand its myriad of elements have improved.

"Supply-chain issues are pretty complex and often require different mechanisms than being able to manage health and safety on a site where you might have more direct control. Or, if you utilise a lot of subcontractors, you don't know everything they do, but you still have responsibility around these," she says. "There are tools that have improved over time – like ISO standards for managing environment, health and safety, human rights – that companies and investors can draw on as auditing mechanisms."

These tools have a strong bearing on where asset owners invest. "What themes we invest in depend on the opportunities that we select, and the potential to measure impact," says Mr Servant.

"What themes we invest in depend on the opportunities that we select, and the potential to measure impact."

Bruno Servant,
Generali

Key highlights:

- Renewable energy and energy efficiency, climate change adaptation and mitigation, pollution prevention and control, and sustainable water and wastewater management are the top four investment themes that respondents said they are looking to invest in.
- Cybersecurity and data privacy rank second on the list, given the potential that threats could lead to heavy financial losses and social instability.
- Other themes, such as the need for sustainable supply chains, are growing in importance as investors realise their potential impact. The theme of sustainable supply chains encompasses a range of social and environmental issues.

²⁹ www.mcafee.com/enterprise/en-us/assets/reports/rp-hidden-costs-of-cybercrime.pdf

³⁰ www.gminsights.com/pressrelease/cyber-security-market

³¹ www.mckinsey.com/business-functions/risk/our-insights/covid-19-crisis-shifts-cybersecurity-priorities-and-budgets

³² www.weforum.org/agenda/2019/08/we-must-treat-cybersecurity-like-public-good/

³³ dig.watch/processes/sustainable-development-goals

³⁴ www.cdp.net/en/research/global-reports/changing-the-chain

Chapter IV.

Integrating ESG and the challenge of transparency

There are still obstacles for asset owners in terms of achieving greater integration of ESG into their investment processes, but some barriers are beginning to seem surmountable. While cost is likely to remain an impediment, the two other top barriers cited by survey respondents – the lack of clarity around ESG standards, taxonomy or metrics; and lack of awareness and understanding of ESG and its role within the company – are weakening. Similarly, obstacles that would have rated more highly in the past, such as inadequate data, lack of regulatory guidance and lack of clear assessment around impact, are now concerns for less than a fifth of respondents.

The regional differences of the survey results reflect the changing dynamics in each region. Asset owners in Asia-Pacific may have more recently integrated ESG, and therefore are still grappling with issues like lack of clarity around ESG standards, taxonomy or metrics. With many asset owners in Europe further along the journey, lack of awareness and understanding of ESG and its role within a specific company is less of an issue than in other regions, and instead cost is more of a concern.

Cost – or at least allocation of resources – is an issue, even at the largest asset owners. “As we increase our ESG coverage, it raises the question of the organisation of research and the resources we dedicate to do this work,” says Mr Servant.

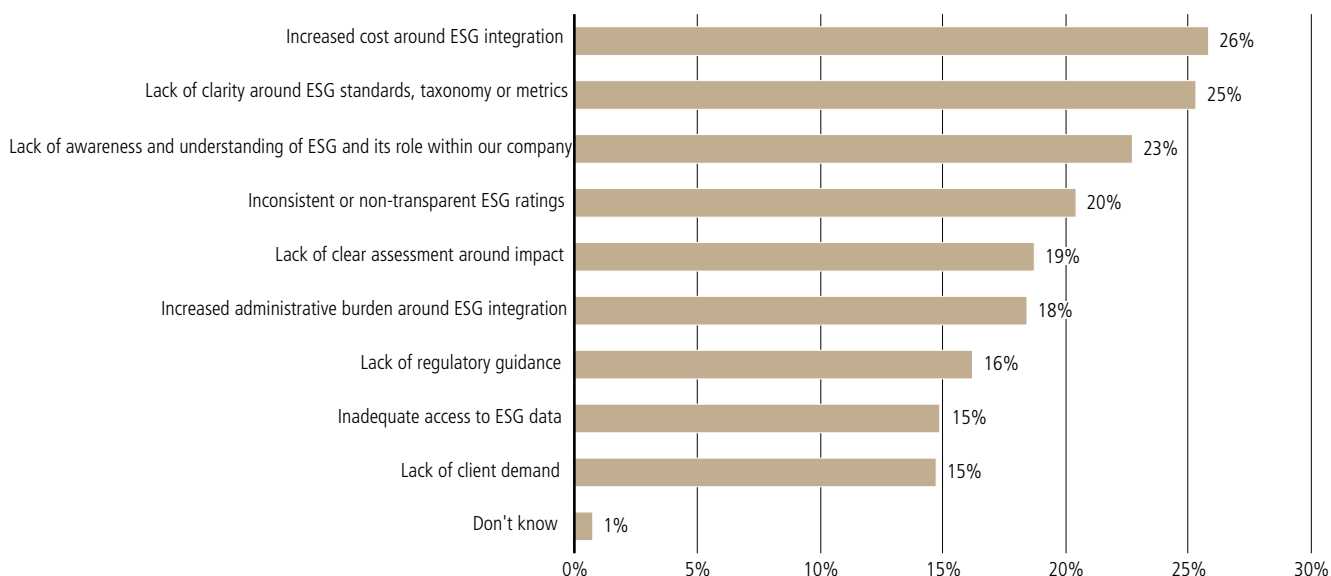
However, cost is not holding back an increase in sophistication in how asset owners are integrating internally and developing their own analysis and methodologies, as well as how they work with external managers.

Mr Servant explains the progression at Generali: “In 2010 we developed our own SRI analysis and scoring methodology. It was a general approach, mainly for our direct investments and listed securities. We then developed a positive ESG selection for the mutual funds through which we held European equities, because they were the core of our equity portfolio at the time. Now, integration goes further, covering most of our assets. In 2019 the group officially adopted a group sustainability policy with a charter of sustainability, which is managed and monitored at the highest level of the group.”

Working with external managers

More asset owners are setting consistent frameworks for both internal teams and external managers. “We’ve always taken a ‘whole of fund’ approach with our responsible investment strategy,” says Ms O’Connor. “So if it’s the internal team managing direct investments or the team that hires the fund managers to manage different types of asset classes, we follow the same responsible investment framework, but we have developed guidelines that are tailored to different asset classes.”

Chart 8. Which condition best describes the main obstacles to further ESG integration into investment decisions at your firm?



Source: EIU survey

Establishing a framework is just one part of the greater attention that asset owners are giving to ensuring that their external investment managers are not just talking the talk on ESG. “When selecting external fund managers, in the past we just cared about performance,” says Ms Yathip of GPF Thailand. “But now we use an ESG due-diligence questionnaire to understand how they integrate ESG factors in the investment process. We also introduced a questionnaire that goes to the companies invested in through the manager, and that data goes into our database.”

This is increasing the sophistication of asset managers’ approaches. “With asset owners, we are seeing more due diligence and monitoring of investment managers,” says Ms Reynolds. “They no longer just ask if they are members of the PRI, if they integrate sustainability, and then appoint them. They are much more sophisticated now, and that is moving managers. Because asset owners aren’t just asking for box-ticking on ESG but for evidence, investment managers are becoming more sophisticated in their approach.”

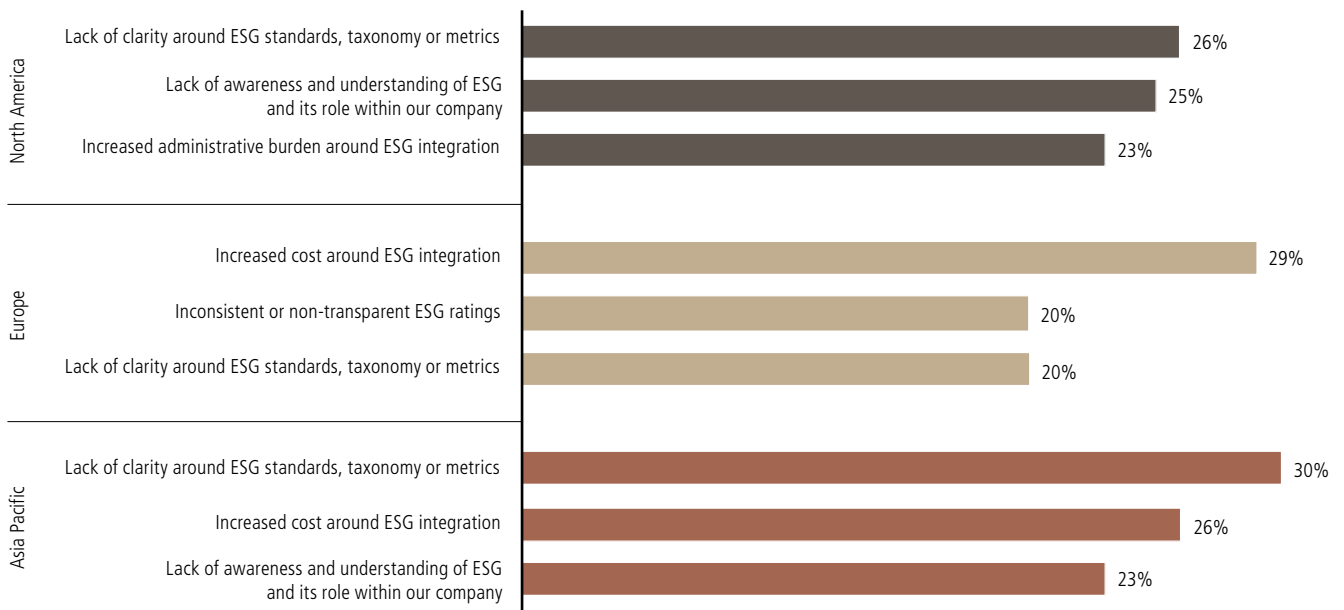
She adds: “I think in the beginning a lot of managers were reluctantly dragged into ESG because [they felt that] this is

the way that they have to operate, but now I think most see the benefits, see it as an imperative, and they take it seriously. We are seeing more of the sustainability people sitting alongside and working with the portfolio manager. There’s still a long way to go, but I think in the future we’re going to see far more chief sustainability officers in companies and in investment organisations who report to the CEO, talk to the board and play a key role within the organisation. I also hope that we will start to see, at the board level of corporations and investors, that they have people with sustainability backgrounds.”

One area where asset owners are paying much more attention to the actions of their external managers is engagement. “Asset owners want to see that the managers they give mandates to really understand ESG, and they want evidence of that – not just measuring the performance that they provide but [also] the stewardship,” says Ms Reynolds.

Ms Lee of MSCI agrees. “There are definitely asset owners that have always prioritised engagement, and they are doubling down on it – and demanding their external managers do so,” she says.

Chart 9. Top 3 obstacles to further ESG Integration by region



Source: EIU survey

Applying ESG across asset classes

The frameworks introduced by asset owners are increasingly important as they work to apply ESG across all asset classes in their portfolios, says Ms Lee. “The evolution for many asset owners started in the equity space and has extended across fixed income, particularly in Europe, and now they’ve gained traction into real estate and alternative assets,” she says. “They have been on a journey developing their ESG investment policy and now, rather than integrating asset class by asset class, there is a shift to taking a more top-down view, where they measure everything in the same way, to improve consistency and transparency across asset classes.”

CalPERs has made a concerted effort to apply ESG across asset classes in a strategic way. “We took the bold step five years ago of saying, ‘we’re going to have a sustainable investment strategy for the total portfolio, of all asset classes, with KPIs, timelines and a focus on results,’” says Ms Simpson. This has been driven from the top down by CalPERs investment beliefs, but also bottom up from its investment managers.

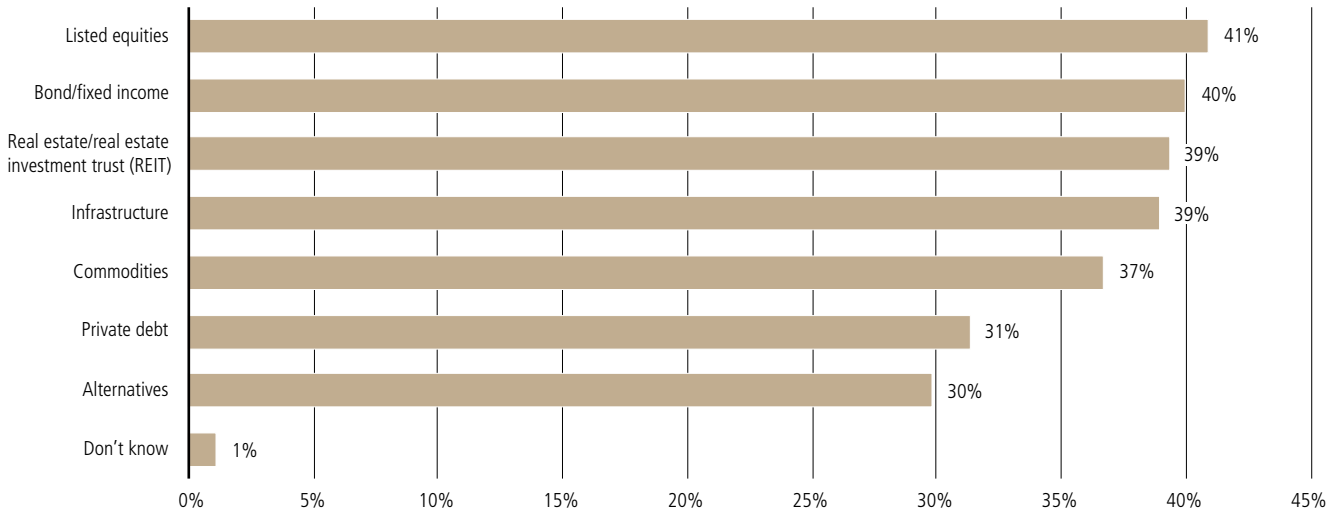
“We knew we needed to be strategic, so we commissioned a review, the Sustainable Investment

Research Initiative, with a team of academics who reviewed about 800 papers and held a symposium. Then we used that feedback to develop a set of ten investment beliefs. These have been absolutely critical to redefine what investment is for CalPERs,” she says. “However, each of our asset classes – private equity, real assets, fixed income, global equity, etc – has a set of sustainable investment practice guidelines, and this has been generated bottom up by our investment managers.”

Survey respondents most often use ESG factors with listed equities, fixed income, real-estate investment trusts (REITs) and infrastructure. At least 30% of respondents use ESG factors in all asset classes, including commodities, private debt and alternatives. Small regional disparities are seen. Respondents in North America are more likely than other regions to use ESG factors for REITs (44%) and private debt (35%), while those in Asia-Pacific are more likely to do the same for bond/fixed income (47%) and those in Europe for commodities (41%).

As equities typically were the first asset class to have ESG integrated into the investment process, asset owners are developing more sophisticated techniques to apply it across both active and passive investments.

Chart 10. Which asset classes does your organisation most commonly integrate with ESG factors during the investment decision process?



Source: EIU survey

“Most of our listed equities portfolio is now passively managed, or as factor portfolios, which makes ESG integration different than if it had an active approach,” says Mr Posters of the Future Fund. “We work with a number of managers that are quite sophisticated at integrating ESG considerations into these types of mandates, but it is still an evolving area of practice within the institutional investor community.”

The Guardians also takes a slightly different tactic for active and passive investments. “Our passive portfolio, which makes up quite a lot of our assets under management, includes over 6,000 companies, and we’re putting our strategy across these,” says Ms O’Connor. “With passive investment, companies enter the portfolio depending on how the benchmark index is tracked. It’s a bit different than what we do on the active side, where we need to focus on the worst cases, with our engagement and monitoring programme.”

Fundamental to the approach taken is the fact that asset owners are long-term investors. “Investing in equity capital with a pretty long duration holding period, we have a further reason to be really focused on ESG integration, because we own a bit of the capital structure where the value change can be quite considerable,” says Mr Manley. “If we were a high-frequency, quantitative trading house

owning securities for minutes, hours, days, the likelihood of an ESG event crystallising in that short holding period is relatively lower than it is where we own assets for potentially a decade.”

Their long-term nature also makes asset owners significant investors in private assets, so applying an ESG policy to those investments has been an area of development.

“Private asset classes will get the most attention from asset owners as they increase their ESG integration, because that’s where a lot of the opportunities are for climate-related investments.”

Linda-Eling Lee,
MSCI

“We have one approach to listed assets, especially listed equities, commodities and bonds, and another one for direct investments,” says Mr Pedersen of PensionDanmark.

For others there is more overlap. “When you take it down to the sector level in the equity-related strategies, the materiality matrix that we use is the same, but clearly the due-diligence processes are quite different when making a private equity investment,” says Mr Manley. “But the issues that we are probing, the engagement we are hoping to see from management teams is the same, independent of whether it’s a public or private company.”

The interviewees that we spoke to feel that ESG can actually be more important in this space than in listed assets, because of a stronger need for risk management and the responsibility of governance.

“We do reasonably little in listed corporate bonds, but we do a lot in private debt, distressed and emerging markets debt. The specific investment strategy dictates what we can do from an ESG perspective,” says Mr Posters. “When you’re looking at things like distressed debt, I would argue that ESG is more important there than in investment-grade corporate bonds. We do a lot more due diligence around those investments, especially if they’re chunky.”

He adds: “If you’re invested in private equity and you’re not managing governance, then you’re doing something wrong. With assets like infrastructure, we look at social licence to operate more so now than ever. For example, for airport assets, managing community issues like noise, traffic, pollution and complaints can all be important to maintain our long term ability to manage these assets successfully.”

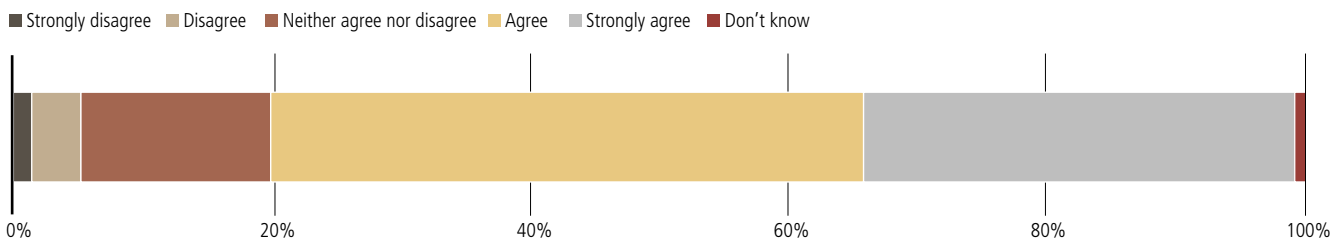
Ms O’Connor agrees. “With private assets, we have more governance responsibilities and more direct influence, although we always co-invest with others,” she says. “We will have due diligence going in, and my team will also be very involved in operational risk assessment – we’ll look at how those risks have been mitigated, whether they can be mitigated.”

Mr Pedersen sees a strong connection between ESG and performance in this space. “When it comes to real estate, there is a very strong correlation between a high ESG score, especially on climate impact, and the opportunities,” he says. “For example, there is more demand from tenants for sustainable, modern office buildings, and they are willing to pay higher rent than for a traditional office building without the sustainability features. The same goes for housing – it’s very clear that young families really give priority to either buying or renting housing with a high level of sustainability.”

Mr Pedersen also sees the potential to have greater impact with ESG in directly held assets like real estate and infrastructure. “We have a very advanced programme for getting our real-estate investments sustainability-certified, as we are a big real estate investor,” he says. “The same goes with our direct investments into renewable energy – infrastructure assets like offshore wind and solar parks, etcetera. These two areas, real estate and energy infrastructure, account for a little more than 20% of our portfolio.”

Ms Lee from MSCI expects that it will be private asset classes that get the most attention from asset owners over the next couple of years as they increase their ESG

Chart 11. The framework(s) we follow to measure and report on impact is/are fit for purpose



Source: EIU survey

integration, “because that’s where a lot of the opportunities are for climate-related investments. The view is that there will be this shift in transitioning the economy.”

Choosing the right guidelines

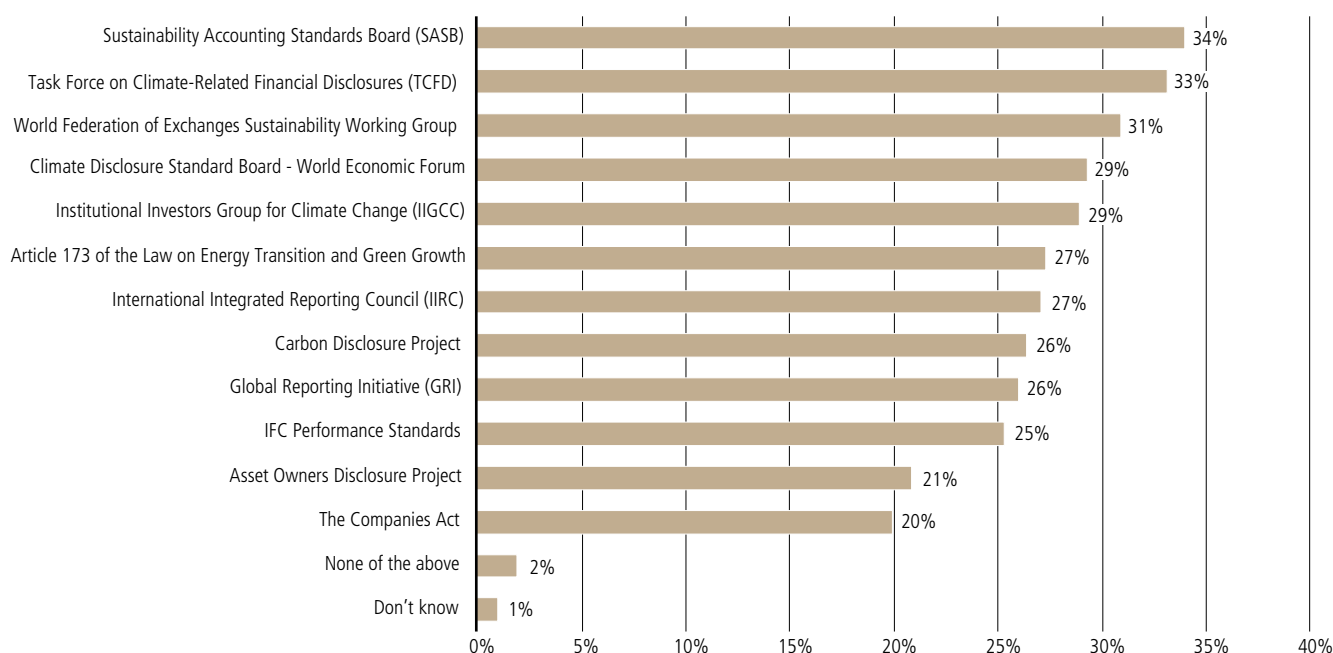
The wide range of frameworks and guidelines developed over the years by organisations with different priorities and areas of focus has long been a source of frustration for investors. Seven in ten survey respondents agree that there are too many frameworks when it comes to measuring and reporting on impact and non-financial performance. However, there is growing satisfaction among investors with the frameworks that they have selected. Eight in ten respondents agreed that the frameworks that they follow to measure and report on impact are fit for purpose, with North Americans more convinced of their usefulness than their counterparts in other regions.

The range of guidelines used by survey respondents shows the challenge that asset owners face in selecting frameworks to guide their investment processes. While

ten out of the 12 standards are used by at least a quarter of respondents, even the most popular, the Sustainability Accounting Standards Board (SASB) is used by only just over a third (34%) of respondents. SASB is used most in Asia-Pacific (47%), as is the International Integrated Reporting Council (35%). The World Federation of Exchanges Sustainability Working Group is used most in North America (36%). Article 173 of the Law on Energy Transition and Green Growth is used less in Europe (23%), as are the Global Reporting Initiative (21%), Institutional Investors Group for Climate Change (19%) and the Climate Disclosure Standard Board (25%).

The CFA Institute notes that the investment industry is coalescing around SASB, which identifies the subset of ESG issues most relevant to financial performance in each of 77 industries, and the Task Force on Climate-related Financial Disclosures (TCFD) standards for climate-related disclosures, which it believes are the most relevant and succinct climate-related disclosure standards for addressing the materiality of climate-related risks.³⁵

Chart 12. Which of the following recommendations/guidelines does your organisation follow, or plan to follow in the following 12 months, when measuring positive impact and reporting on non-financial performance?



Source: EIU survey

³⁵ www.cfainstitute.org/en/research/industry-research/climate-change-analysis

“The nice thing about SASB is that they place investment materiality at the core of their standards, and that’s the way we look at it as well,” says Mr Posters.

SASB’s emphasis on materiality and industry specific factors works for CPP Investments. “We need to really focus on sector-specific material business risks and opportunities, and the ESG elements for an industry that are integral to informing our investment decision-making,” says Mr Manley. “We are of the view that a framework that focuses on numeric performance rather than policy statements is the most value-adding reporting mechanism for broad ESG metrics that is available.”

However, Mr Campanale of Carbon Tracker Initiative sees flaws in an approach that focuses solely on financial materiality, when some investors want to integrate ESG to generate positive real-world outcomes, not just mitigate risk. “People are saying they’re interested in more and better data points to identify materiality and risk issues from ESG factors. But with SASB, if it’s not financially material, it doesn’t matter,” he says.

With its narrower focus on climate change and use of scenario analysis to link companies’ actions to real-world outcomes like global warming, TCFD is less contentious. “In terms of companies reporting how they have identified climate risk, quantified it, put in governance processes around it, integrated it into their strategy and where they have set targets around it, the TCFD framework is currently the best tool available for us and for corporates,” says Mr Manley.

Ms Lee agrees that the industry is coming closer to consensus. “There is sufficient momentum that there will be more consolidation on disclosure standards, as clearer winners in the standard setting industry will emerge,” she says. “This is already clear for climate change – the TCFD has set a framework that is well accepted across asset owners globally.”

Asset owners recognise the challenge corporates have in deciding which standards to report to and experience that frustration themselves as holders of significant stakes in companies. “If we look at private market holdings, especially where we have a large stake, we don’t want them to report to 20 different standards,” Mr Posters says. “Ideally, we want them to report to one standard so they can focus all their energy on that, get it right and then have time to do everything else that they need to do.”

But while consolidation in some spaces is useful, asset owners acknowledge that it can only go so far. “There

are so many frameworks, it’s a headache,” says Ms Yathip. “However, I used to think that one standard would be good but have realised that there can’t be one standard, as there may be different priorities in different countries, with different investors. There is no one size fits all.”

Mr Campanale agrees. “Things like a common standard around an environmental or climate policy statement – we can get to an agreement on that,” he says. “But fundamental things like the purpose of the firm, what they’re for, whose interests they serve – we’re never going to agree on that. I have a fundamental disagreement with this idea that you can create these types of standards.”

Participating in policy initiatives

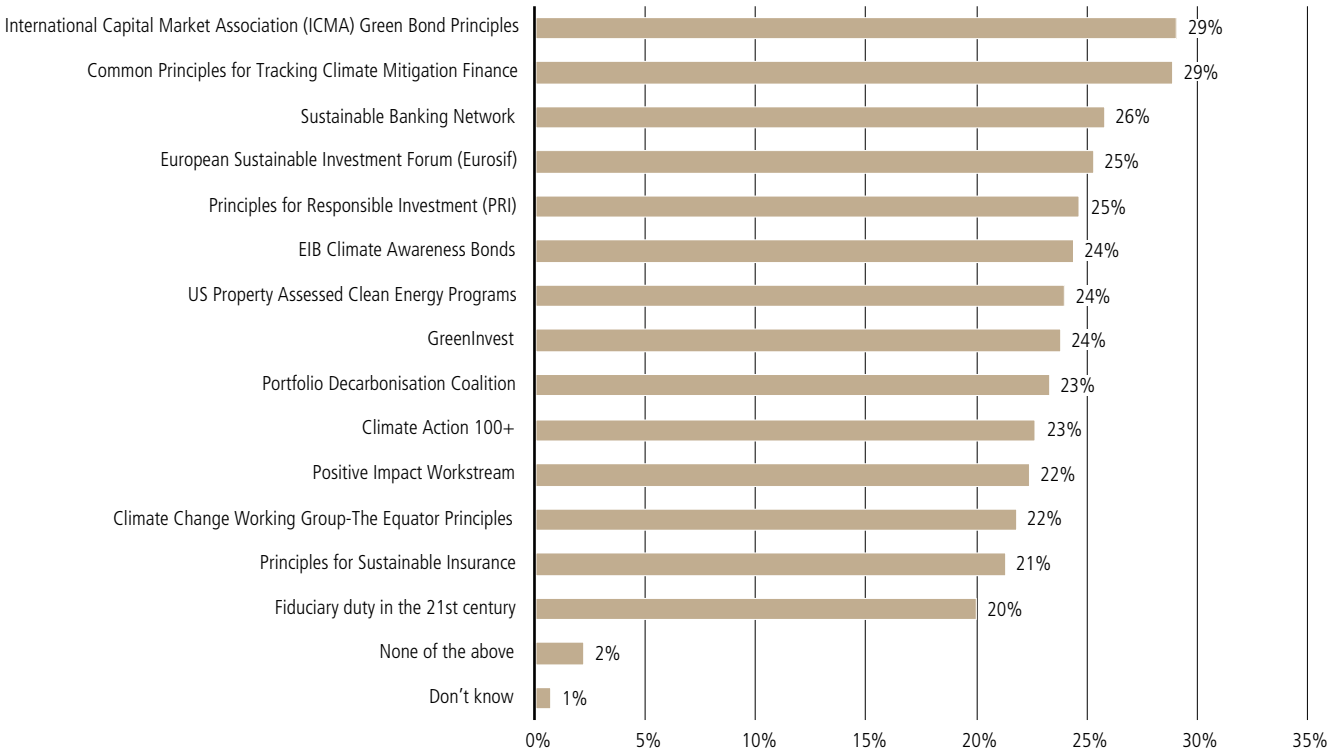
As with guidelines, there are a range of policy initiatives in which asset owners can choose to participate, resulting in few organisations capturing a majority of investors. Of the 14 initiatives included in the survey, none are used by a third or more of the respondents. Of the policy initiatives that respondents have participated in or plan to participate in within the next 12 months, International Capital Market Association Green Bond Principles, Common Principles for Tracking Climate Mitigation Finance, Sustainable Banking Network, European Sustainable Investment Forum and the UN PRI are used by at least a quarter of respondents.

Generali participates in a range of initiatives. “In 2007 we signed the Global Compact, which focuses on human rights mainly; in 2011, the UN PRI; in 2014, the Principles of Sustainable Insurance; in 2016, the Paris pledge for action; and in 2019, the Net Zero Asset Owners Alliance,” says Mr Servant.

“Ideally, we want companies to report to one standard so they can focus all their energy on that, get it right and then have time to do everything else that they need to do.”

Joel Posters,
Future Fund

Chart 13. Which of the following policy initiatives has your organisation participated in or is planning to participate in within the next 12 months?



Source: EIU survey

However, other asset owners prefer to stick with a smaller number of organisations. “When we started to be serious about responsible investing, we started off with two big organisations, the OECD and UN PRI,” says Ms Yathip. “They both worked with us to understand the frameworks and to give us an explanation of what it really is to be a responsible investor. Now we bring those two frameworks together in our investment framework.”

Interviewees told us that they appreciate established organisations that have created lasting principles and a forum for investors to share best practice. “When we started 15 years ago, there weren’t any international standards. The UN PRI was being developed, so we became one of a handful of founding members,” says Ms O’Connor. “Its six principles have been relatively enduring, and they have helped guide us over time in how we integrate ESG in our investment policy and engage with voting rights. It has also been helpful to share best practice with like-minded funds around the world, and it helps us communicate what we’re doing, so we’re being transparent.”

Longevity can be useful in terms of the resources that the organisation can provide. “One of the first collaborative

engagements we ever joined was [...] the Carbon Disclosure Project [in 2007], because we felt that climate change was a key issue,” says Ms O’Connor. “We really needed that carbon data. Having been part of that journey since 2007 means at least we’ve got a good chunk of carbon data to work with in the equity market, and we’ve got methodologies to apply in our private market.”

Key highlights:

- The main barriers to integration of ESG include cost; lack of clarity and ESG standards, taxonomy or metrics; and a lack of awareness and understanding of ESG.
- ESG frameworks are being introduced by asset owners as they work to apply ESG across all asset classes in their portfolios.
- ESG factors are most often used with listed equities, fixed income, real-estate investment trusts (REITs) and infrastructure.
- At least 30% of respondents integrate ESG factors in all asset classes, including commodities, private debt and alternatives.

Chapter V.

Leveraging data for impact

The variety of frameworks, guidelines and policy initiatives results in companies reporting in a variety of ways, making data hard to compare and not increasing transparency. “When it comes to data, there needs to be a great convergence,” says Ms Reynolds. “Investors are frustrated that they don’t get the data that they need, that is meaningful, comparable and that they can base their investment decisions on. Corporates say they are asked to report through all of these frameworks, and investors are still saying they haven’t got the data that they want. There is frustration on both ends. In some cases, investors won’t look at particular issues because of the lack of data. But I don’t think we can wait for perfect data – the perfect can be the enemy of the good.”

Convergence may come from a non-ESG source. The IFRS Foundation, the body that oversees the work of the International Accounting Standards Board in setting financial reporting requirements across more than 140 jurisdictions, has proposed the creation of a parallel Sustainability Standards Board. The goal is to integrate financial and sustainability reports to make it easier to understand the relationship between financial performance and sustainability performance.³⁶

“The same role that IFRS plays around financial data, there is a meaningful role for them to play around ESG data,” says Leon Saunders Calvert, head of sustainable investing at Refinitiv. “However, they need to figure out where they can do something genuinely new and valuable, versus where they should align to something that already exists and not throw yet another voice into the mix. My

impression so far is that they are looking at the role that they can play in a very considered way.”

Mr Manley is hopeful that this work will expedite more standard reporting and greater transparency. “If you’d asked me six months ago how long it would take to see the industry coalesce around a common approach, I would have said at least five years,” he says. “But some of the momentum we saw in the last quarter of last year, with regards to the largest frameworks committing to collaboration and discussion around the IFRS Foundation and its prospective future role, has really catalysed the desire of key stakeholders to accelerate the process of convergence.”

Diving into data

However, even more basic than the difficulty of comparing data is the lack of data, which has long been a drag on greater integration of ESG in the investment process. Ms Lee of MSCI explains the evolution of different types of ESG data: “Traditionally, there are four types of data. First, the disclosure that comes from issuers – that’s what most people focus on when they complain about the lack of comparability and gaps. It’s true that disclosure from companies is still quite limited and patchy, but it’s improving.

“The second type of ESG data is more media-driven data, which has really taken off over the last couple of years as we’ve had more help from AI and big data to be able to gather much more data, much more widely, in many more languages and far-flung places – there is hardly any place in the world that a company can undertake some type of an

³⁶ hbr.org/2020/12/the-future-of-esg-is-accounting

activity and not have it be detected in some way through this media and NGO data. However, the kind of data that you're capturing is more controversy-driven because it's news-driven, so the danger is that the quantity way outweighs the quality – a lot can be noise.

“The third type of data is alternative datasets, which are sources of ESG information other than the issuers’ disclosure. People are talking about things like satellite data, but many sources are government databases – they are a treasure trove. As our ability to find them and make them comparable and meaningful has increased, this is where a lot of major insights can come from. It’s particularly helpful where issuers do not disclose much, say in emerging markets. There is a lot of health and safety and labour-related data, for example.

“And finally, models and methodologies. People don't really think of them as data, but they are the critical underpinning of a lot of the ESG data and insights that investors use. We've always had to make estimation models for data, and they fill in the gaps.”

This is where data providers can differ significantly in their approach – how to fill in the gaps left by lack of disclosure. Mr Calvert believes that ESG data should require the same level of robustness as any other form of fundamental data about a company. “If a company didn’t report its revenues, you wouldn’t just guess based on an aggregate of other companies in the sector – that’s not an option. We need to treat ESG data similarly,” he says. “We think it's important to recognise that companies haven't disclosed certain data points, especially if those data points are supposed to be material to investors. Investors shouldn't be making allocation decisions based on us filling in the blanks. Other providers would say they're trying to be helpful and making the data more comprehensive, but our approach has been different.”

Asset owners need to ensure that they understand data providers’ methodologies, as differences can have a huge impact. “Getting data from outside, you need to select it, but also you need to prove the provider’s methodology and ensure it fits with your own methodology,” says Mr Servant. “When we started working on the climate numbers a few years ago, we found that the methodological impact aspect was very strong.”

Investors are dependent on external providers for much of their data – almost three-quarters of survey respondents (72%) said that they rely on third-party service providers for the analysis, measurement and reporting of impact

“You cannot completely rely on the public record, on a company’s website or annual report, to know if a company is doing good. That’s only maybe 50%. The rest we have to get from company engagement.”

Srikanya Yathip,
Government Pension Fund Thailand

for their investments. But they are increasingly combining it with internally generated data and using their own methodologies to tailor it to their needs.

“We buy raw data from vendors but when we take that into our database, we score it ourselves,” says Mr Manley. “One of the challenges is, if you are providing a broad-based data solution to a broad client base, there is an element of ‘as I don't know what everybody will specifically want, I will provide everything to everyone,’ and that gives me too much data rather than not enough.”

Mr Posters agrees. “We use quite a few ESG data providers,” he says. “The issue is none of them do everything we want perfectly. So that means that we have to reach out to multiple providers and closely examine the relevance of each data point, which is somewhat suboptimal”.

Asset owners are also increasingly using engagement to fill in the gaps. “The challenge is that you cannot completely rely on the public record, on a company’s website or annual report, to know if a company is doing good,” says Ms Yathip. “That’s only maybe 50%. The rest we have to get from company engagement.”

The amount of data available is increasing rapidly, both in terms of company disclosure and data providers’ coverage, helping to increase transparency. “We've increased the size of our global ESG database on companies by about a third in the last 18 months, and the investment in that growth increases going into 2021,” says Mr Calvert. “That’s partly

because we want to be more comprehensive, but also because the levels of disclosure are increasing.”

Disclosure is improving, but not all of the data is quantitative, which can influence the way in which investors use it. “Often, the frameworks use policy statements because they don't have comprehensive data sets for the numeric data,” says Mr Manley. “Seventy per cent of all the issued ESG data is policy statements – diversity, supply chain, etcetera – so only 30% of the data reported is numeric data. And within that 30%, 25 percentage points of that is actual data and five percentage points is targets. Then, unfortunately, for half of that data, only 20% of companies in a sector will typically report.”

He adds: “The fact that you have comprehensive health and safety policies is good, but what we want to see is that those policies have transmitted themselves into a robust culture of health and safety in the workplace, such that the company has a low incidence of lost-time incidents and hopefully zero fatalities. And, consequently, in our proprietary methodology, we would always place emphasis on the actual numeric performance and de-emphasise the disclosure of the policy.”

On the other hand, Mr Pedersen worries that giving such primacy to quantitatively measurable elements “might give a bias to the elements of the ESG agenda that are easier to calculate.”

Another issue is the lack of forward-looking data. “What we want to have is a forward-looking view on where the companies are going – what are their policies, what are their plans, what do they really want to act on,” says Mr Servant. “Because, as a buy and hold investor, we need to have this view. But this forward-looking data is not always available, so you have to make your own assessment.”

Ms Lee sees a role for modelling to fill this gap. “As investors become more sophisticated about data and the modelling component of it, there is a lot of potential,” she says. “For example, how can we model the forward trajectory of emissions? We have been collecting over many years companies’ emissions profiles and targets – so we can assess how credible future targets are, based on past performance, but also on things like capital expenditure plans that will impact their forward trajectories.”

Measuring the impact of the “E”, “S” and “G”

As data coverage and modelling improves, the ability to determine the effect of individual environmental, social

and governance issues on performance is also improving. For many interviewees, governance issues are the most clear-cut in their impact. “We view governance as an important source of alpha,” says Mr Manley. “Our internally published research has concluded that strong or high-performing boards is an area that does differentiate corporate performance.”

Ms Lee agrees. “The research we have done bears out that it is governance data – certainly over the last 13 years, for which we have very consistent data – that captures a company's ability to be more profitable and pay more dividends, while also experiencing fewer downside incidents and less systematic risk,” she says. “But the question is, will that be true going forward? Because there's probably a little less room for arbitrage these days.”

Environmental issues are capturing more attention at the moment, and Ms Lee believes that this is partly because the data is more quantitative in nature, something that investors are more comfortable with. This is helped by the fact that as datasets grow over time, the impact of the longer-term risks in the environmental space become more apparent. “For environmental issues, there are much more what we call erosion risks. They are an indication of a company's slight lack of competitiveness, that overtime accumulates into lower profitability and stock price value,” says Ms Lee.

Ms Lee believes that social issues may get less attention because of their dual nature. There are episodic incidents like labour strikes or litigation, but there are also erosion risks, such as labour management. “Because it has these mixed dimensions, it's been less well captured,” she says.

Mr Calvert believes the ease in quantifying “E” factors compared to “S” factors can be overstated. “There is a lot of focus on climate, and you can measure things like carbon emissions, so people feel it's robust compared to social factors,” he says. “But with other environmental factors, like biodiversity, it is a challenge to quantify impact.”

While social issues often get short shrift, both Refinitiv and PensionDanmark point to diversity and inclusion data as strong indicators. “From a pure investment perspective, companies with an advanced diversity and inclusion policy have demonstrated that they perform better,” says Mr Pedersen.

“One of the best correlations that academics and quants in the financial space have identified between an ESG data

point and long-term performance is actually diversity inclusion, which falls under the S,” says Mr Calvert. But he cautions that there will never be a silver bullet indicator for alpha. “It’s not clean-cut, it’s identifying which are the data points that enable you to best articulate your impact, to manage your risk and to generate alpha.”

“It comes down to which are deemed to be the material business risks or opportunities for the industry, and then which of those externalities is the hot topic today,” says Mr Manley. “If you look back over time, there was a moment in Nike’s history where the social factors were red-hot, as governance was with Volkswagen and the environment for BP.”

CalPERs is currently looking at human capital management, particularly issues of racial justice. “We want to develop a racial equity audit on our portfolio in the same way we’ve done carbon footprinting,” says Ms Simpson.

Utilising benchmarks

Benchmarks are increasingly used to help measure impact. “The use of ESG benchmarks is something that is clearly gaining momentum,” says Ms Lee. “They are tools readily available for equity and fixed income, to be able to align their investment in those two asset classes with their overall investment policies. It’s these other asset classes where there is more room for exploring how to integrate different components.”

Bloomberg (used by 42% of respondents globally) is the most used provider of ESG benchmarks across the

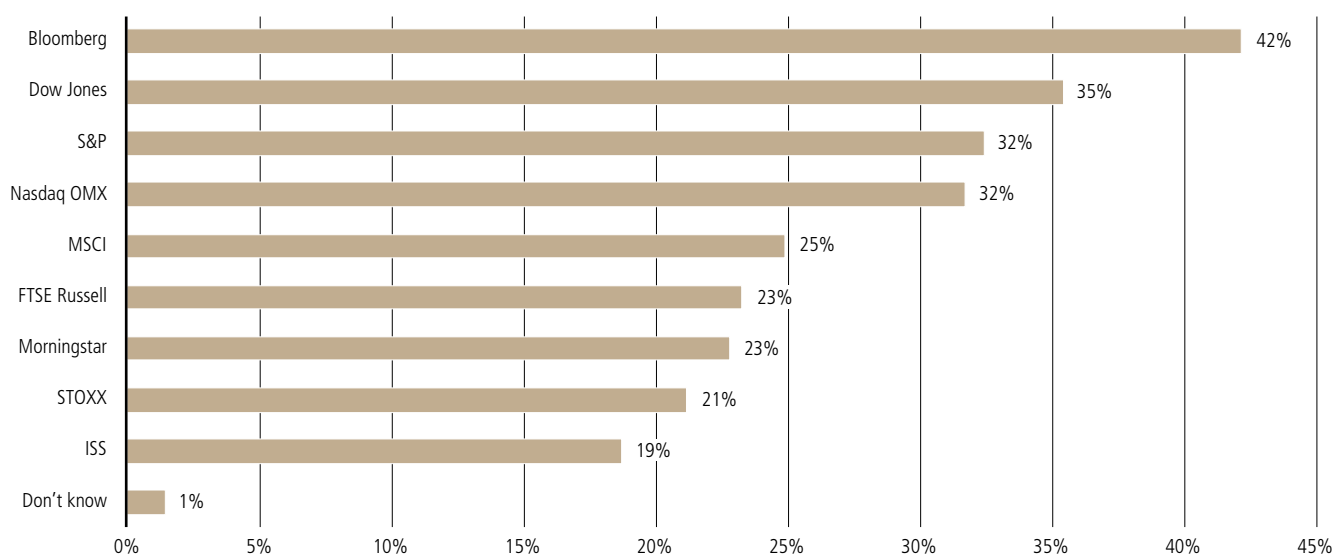
board, followed by S&P, Dow Jones, Nasdaq OMX and MSCI, all of which are used by at least a quarter of respondents. There is a relative preference for Dow Jones in North America (40%), for Nasdaq OMX in Europe (33%) and for MSCI in Asia-Pacific (29%).

Nearly eight in ten (79%) survey respondents either agreed or strongly agreed that ESG benchmarks are useful in supporting their organisations’ investment decisions, with those in North America (84%) finding them more useful than those in Europe or Asia (both at 76%).

Environment-related benchmarks are considered the most important, but over half of survey respondents use social-related and governance-related benchmarks as well. Almost a quarter use undifferentiated ESG benchmarks and just 2% do not use any benchmark. European respondents are the least likely to use factor-specific benchmarks, slightly preferring the undifferentiated types (25%). North Americans (at 3%) are more likely to say that they do not use ESG benchmarks at all in their investment process.

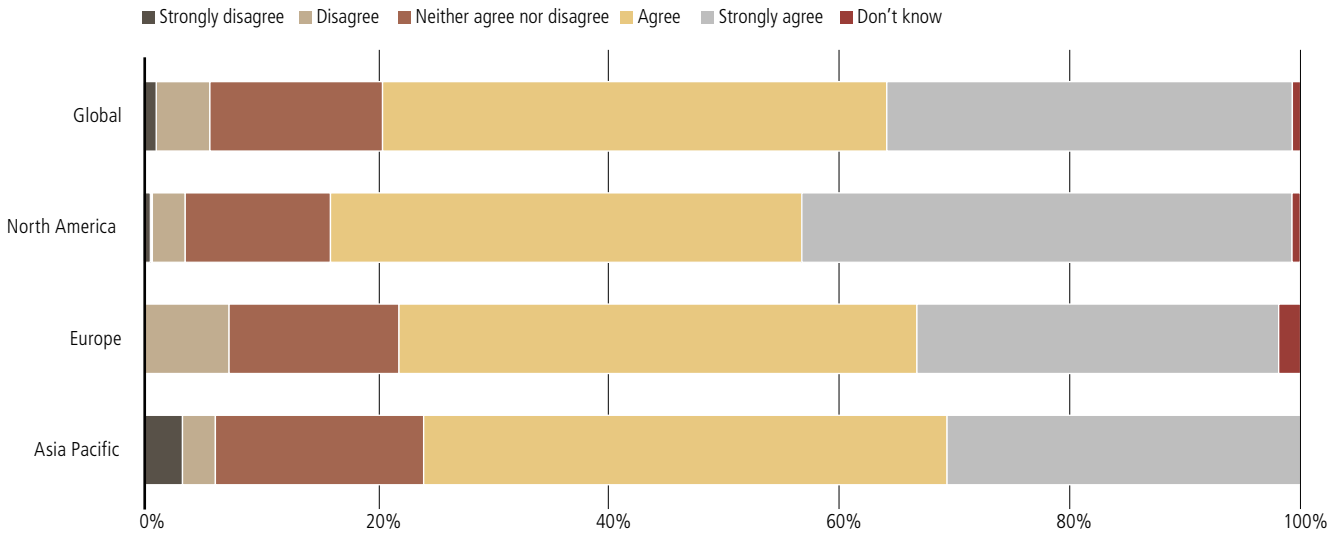
PensionDanmark started with environmental benchmarks. “We are pragmatic and try to develop baseline benchmarks which are as relevant as possible for each asset class. Of course, it’s an incredibly difficult thing to add up what’s the bottom line for the total portfolio, but we have been able to do that for CO2 emissions,” says Mr Pedersen. “On some of the other SDGs, it’s not that developed yet, but we are on a good path. We have chosen to use the UN SDGs as our benchmark for our value proposition.”

Chart 14. Which ESG benchmark provider(s) do you use in your investment process?



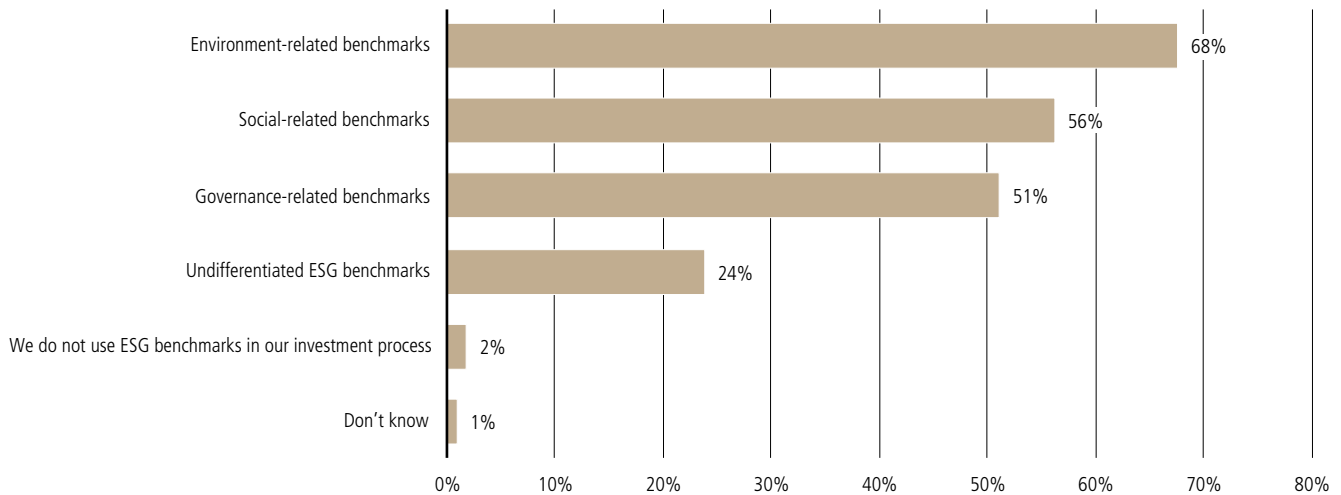
Source: EIU survey

Chart 15. ESG benchmarks are useful in supporting my organisation’s investment decisions



Source: EIU survey

Chart 16. When considering environmental, social and governance factors, do you use any of these ESG benchmarks for your investment decisions?



Source: EIU survey

Key highlights:

- The large number of frameworks in place makes comparing data challenging; greater convergence is required. The lack of data also impacts greater integration of ESG into the investment process.
- ESG data, which is by essence more media-driven, has been given a boost by the use of artificial intelligence and big data. Alternative datasets are sources of ESG information that draw from data other than the issuers’ disclosure.
- Models and methodologies are the critical underpinning of a lot of the ESG data and insights that investors use. Estimation models fill in the data gaps.

Chapter VI.

How will ESG shape the investment landscape?

The UN SDGs have become a benchmark for many asset owners. Three-quarters of survey respondents agreed that the UN SDGs are the main guiding framework when it comes to defining and measuring the positive impact of their organisations' investments. Those in North America (where 80% agreed) have been even more enthusiastic adopters.

"For me it is not sufficient to say that we have been in a dialogue with this long list of companies, we should also be able to demonstrate and report on what is actually the impact in real life of this dialogue on CO2 emissions, on progress on diversity, gender equality – on all the 17 SDGs," says Mr Pedersen.

The SDGs are giving investors clear goals for their impact assessment, which is helping to drive a boom in impact investing. "There is a big shift now to look at impact investment. It's always been here, but it's growing in terms of focus," says Ms O'Connor. "There had been a focus on the negatives of ESG risk and the impact on your returns, but now the conversation is shifting to 'What can you do about investing in solutions? What can you show us about your positive impact?'"

This is supporting greater levels of engagement between investors and the companies that they invest in, and also of co-operation between investors to drive change. "We wanted there to be a collective process for ESG investors – to do it together, with more momentum, rather

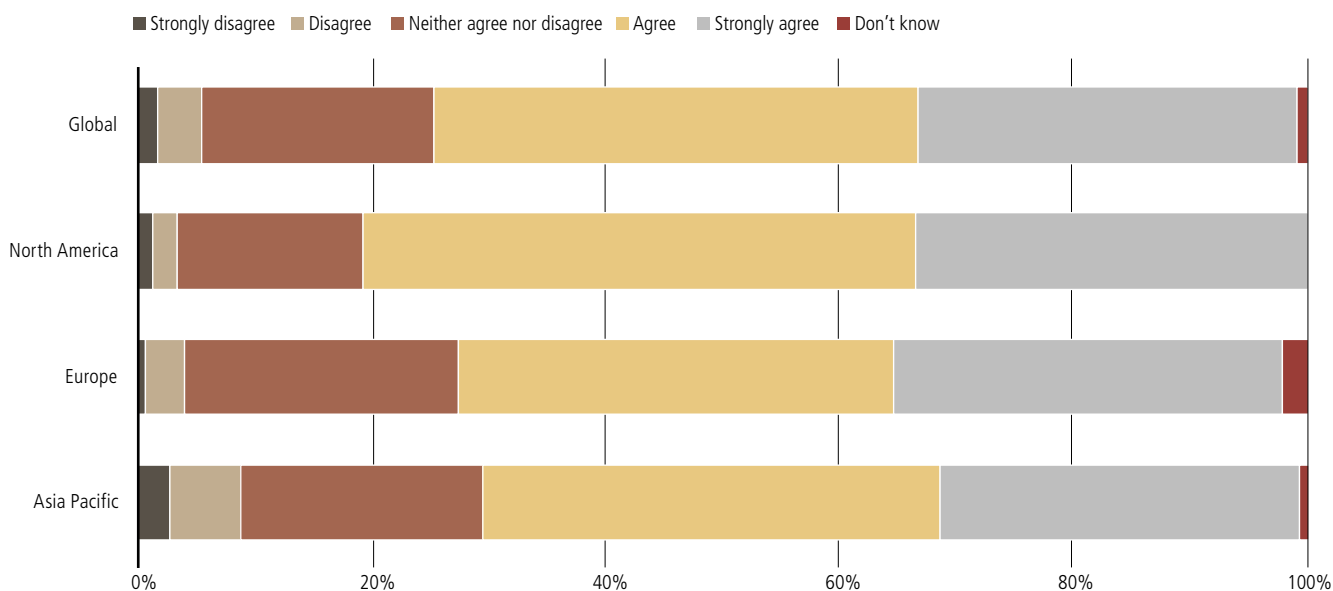
than just do it alone," says Ms Yathip of GPF Thailand. "So we started the Collaborative Engagement and Negative List Guidelines, an agreement to collective engagement with companies on ESG issues, to which 90% of Thai institutional investors have now signed up."

She explains: "When we see breaches of ESG issues, we have guidelines on how our group will engage with the company to resolve the issue, when we will stop further investments into a company and when we will divest if we do not see any action. Now, when something bad happens in the Thai market, we just need to call the company and, as they know we [the investors] will act together, they usually change their ways. We are also working to create a broader pension investor network across Asia-Pacific."

The Thai group also publicly announces the collaborative engagement and its result. Ms Yathip emphasises that this is about giving a boost to companies that improve and creating greater transparency that benefits other investors as well. "Our role isn't to be the 'police' but to be supporters of those companies that are doing good – it's positive encouragement," she says.

Investors have tended to rely on organisations like the UN PRI to act as conveners and to lead engagement, but Ms Yathip believes that asset owners need to take a more active approach. "I'd like to see more collaboration – not just talking, but creating a collective process," she says.

Chart 17. The UN's SDGs are the main guiding framework when it comes to defining and measuring the positive impact of my organisation's investments



Source: EIU survey

“The PRI is doing their best, but they are just a facilitator. Investors themselves need to take action and co-operate with each other.”

Investor coalitions are emerging – some like Ms Yathip’s group of Thai institutional investors, which look at a range of ESG issues, and others with a specific focus like the Net Zero Asset Owners Alliance of which PensionDanmark is a founding member. “In 2019 at the UN Climate Summit in New York, a number of large asset owners, including ourselves, established a new alliance called the Net Zero Asset Owners Alliance,” explains Mr Pedersen. “We started with 12 members, now we are 30 plus, and before we open COP 26 in Glasgow in November 2021, we will have passed 50 members, with US\$10trn in AUM. We have committed ourselves to change our portfolios to have net zero, or even negative, emissions. To reach this goal, we have promised to work together to engage with companies, especially the big emitters, to assist them in changing their business models.”

Climate Action 100+ is another investor-led initiative, with the goal of ensuring the world’s largest corporate greenhouse gas emitters take necessary action on climate change. “Climate Action 100+ is a good example of how you can scale if you co-ordinate with others, how you can overcome that tragedy of the commons. On their own, nobody has an incentive and economic incentive to solve systemic level problems,” says Ms Simpson of

CalPERS, a founding member. “We now have signatories with about US\$52trn AUM. This is now moving huge quantities of money, and that is having a really big impact on the regulatory and policy agenda.”

CalPERS also provides an example of how asset owners are going beyond their traditional remit to not just engage with companies to encourage change, but also giving them the tools to do so. “When we were in the early stages of talking to boards about diversity and inclusion, many of them said they didn't know where to find qualified women or people of colour,” says Ms Simpson. “We said, if the problem is that they don't know where to look, we can solve that. So we set up the Diverse Director DataSource – 3D for short – which has so far helped source over 1000 diverse candidates for boards of US companies.”

Driving decarbonisation and managing transition risks

The drive to net zero emissions is necessary to both limit global warming and to protect portfolios from climate transition risks. A recent analysis of insurers’ exposure to these risks by Europe’s insurance and pension supervisor, the European Investment and Occupational Pensions Authority (EIOPA), found that “losses on equity investments in the high-carbon sector can be high, reaching more than 25% on average”, based on disorderly transition scenarios. Losses were driven by investments

in fossil fuel extraction, especially oil and gas, and in the production of combustion engine cars.³⁷

EIOPA's research assessed €3.4trn (US\$4.1trn) in corporate bond and equity holdings of European insurers (including the UK) of which around €539bn (US\$641bn) is in "climate policy relevant sectors", such as coal mining, steel and cement production, vehicle production, or the power sector. It found that while corporate bond portfolios better managed the shock of a disorderly transition, losses were largely driven by the same sectors as equities, "reflecting the fact that profitability declines are likely to impact equity prices."³⁸

However, EIOPA also said that it was unable to assess certain sectors that may be affected by climate policy shocks, such as agriculture and real estate, due to data limitations, and physical risks were not considered in its analysis. The report warns that the physical impacts of climate change are "potentially substantial and can impact not only the asset side, but also the liability side and even business models," and more work is needed to understand these risks in depth.³⁹

The scenarios used by EIOPA involved delayed but abrupt policy action to move the economy towards alignment with the Paris agreement. However, policy changes – and their impacts – may come sooner than expected. In June 2021 the European Commission will release its proposal for a carbon border adjustment mechanism, as part of a wider package of laws aimed at reducing the EU's emissions by 55% below 1990 levels before the end of this decade. The EU is expected to impose a levy on non-EU competitors unless they commit to lowering their emissions, in order to avoid the risk of carbon leakage from companies relocating manufacturing to countries where pollution costs are lower.⁴⁰

As the EU tightens its climate goals, the price of CO₂ allowances on the EU carbon market are predicted to jump from around €30 per tonne of CO₂ today to around €40 per tonne by 2030 and above €230 per tonne by 2050, according to a study from the Association Française des Entreprises Privées (AFEP), a think tank working to promote

the competitiveness of French companies.⁴¹ The cement, steel and chemical industries are expected to be the worst hit because they are energy-intensive, exposed to international competition and cannot easily switch their manufacturing processes to low-carbon electricity.⁴²

Mr Campanale from the Carbon Tracker Initiative believes that asset owners and managers need to do more to integrate these predictions into their models. "The world's going to have to decarbonise 30-40% of global industry by market value over the next decade or two. We'll have to write down oil refineries, oil wells, coal mines, about a third of shipping; things like aviation fuel, transportation fuel and LNG. You then have the retirement obligations of cleaning up these worlds, which are not priced into stock valuations," he says. "You need to use higher discount rates for business sectors that you think are non-viable and build in the true cost of externalities as a shadow price. For example, building in a carbon price and the impact of early retirement of fixed assets into your model to come up with what these companies are actually worth."

For Mr Manley of CPP Investments, asset owners must take into account not just risks from the transition to a low-carbon economy, but novel business risks more broadly. "We're of the view that the companies that differentiate themselves over the next decade will be the ones that have a culture that has evolved to embrace the reality of 21st century business risks, where the board is providing oversight and counsel to the executive team to proactively identify the material risks and opportunities that are inherent in their business, integrating those considerations into the strategy and how it's operationalised, and communicating that with their stakeholders," he says. "Those companies that embrace that reality and execute that well are likely to both capture and create value, but importantly, insulate and preserve value as they proactively navigate the reality of the operating environment. Those that don't are risking their brand, their ability to hire, the ability to source capital, and potentially risking the long-term intrinsic value of the business."

³⁷ www.eiopa.europa.eu/content/sensitivity-analysis-of-climate-change-related-transition-risks-eiopa%E2%80%99s-first-assessment_en

³⁸ www.eiopa.europa.eu/content/sensitivity-analysis-of-climate-change-related-transition-risks-eiopa%E2%80%99s-first-assessment_en

³⁹ www.responsible-investor.com/articles/european-insurers-face-25-write-downs-on-high-carbon-equity-investments-under-disorderly-transition-says-regulator

⁴⁰ www.euractiv.com/section/energy-environment/news/eu-carbon-border-levy-shaping-up-as-notional-ets/

⁴¹ afep.com/en/publications-en/afep-position-on-a-possible-european-border-carbon-adjustment-mechanism/

⁴² www.euractiv.com/section/energy-environment/news/eu-carbon-border-levy-shaping-up-as-notional-ets/

Asset owners can encourage the companies that they invest in to better manage transition risks and to transparently communicate those strategies. “Investors want to see the company’s ability to deal with major risks, such as the disclosures of its assessment of physical and transitional risks brought about by climate change and the resulting strategic changes under the TCFD framework,” says Richard Sheng, head of group ESG strategy development for Ping An Group. “Currently, there is a need for more good information available in the market to support investors in evaluating whether a company has sufficient and scientific plans to realise the transformation of future business strategies and the management of future cash flow.”

The impact of Covid-19 and the growing importance of the “S”

Social issues, particularly human rights, is one area that is seeing greater investor attention in terms of materiality. A growing number of jurisdictions are introducing elements of the UN Guiding Principles on business and human rights (UNGPs) into domestic law. The UNGPs create a process – human rights due diligence (HRDD) – for companies to identify, prevent, mitigate and account for the human rights impacts and outcomes of their own activities and business relationships.⁴³

The HRDD has been used in countries like Australia and the UK to combat modern slavery, and in the Netherlands for child labour. The French “Duty of Vigilance” law goes further, requiring broader human rights and environmental due diligence of the largest French companies and foreign firms with a significant business presence in the country. In the first quarter of 2021 the European Commission will issue a legislative directive requiring HRDD for companies based within the EU or with sizeable operations in the region.⁴⁴

In October 2020 the UN PRI issued a report, *Why and How Investors Should Act on Human Rights*, which sets out expectations for investors based on global human rights standards and provides recommendations on the integration of human rights into the investment process.⁴⁵

“We’re not expecting miracles overnight,” says Ms Reynolds of the UN PRI. “We’re building a five-year

programme, and by the end we want to see human rights thought about like climate. It’s not just about the planet, it’s about the people as well – and we have to have that balance between people, planet and profit.”

She adds: “Covid has put a spotlight on social issues, or human rights issues like labour rights and supply chains, and I want to make sure that stays there after Covid-19.”

The Covid-19 pandemic has been a driver of increased attention on a number of social issues. “We’ve seen that the current Covid crisis has made social inequality much stronger, putting stress on social systems and creating more demand for public health,” says Mr Servant. “The reskilling and training that will be needed to help people find jobs are a very challenging target, because the jobs themselves are changing. It’s not simply relaunching the economy; it’s relaunching the economy in a more inclusive and more sustainable way.”

“Over the last year, with Covid and the racial justice movements, attention to social issues has really skyrocketed,” Ms Lee says. “But the question is how that interest translates into capturing the data needed to properly integrate them.”

Mr Calvert also sees a challenge in how to translate general attention to social issues into the investment process. “Covid-19 has demonstrated that significant humanitarian and social challenges are very difficult to divest away from or diversify away from,” he says. “That means you need to internalise and quantify externalities which were previously not part of your investment model practices.”

Key highlights:

- Three-quarters of survey respondents agreed that the SDGs are the main guiding framework when it comes to defining and measuring the positive impact of their organisations’ investments.
- Those in North America (where 80% agreed) have been even more enthusiastic adopters.
- The COVID-19 pandemic has put a spotlight on social factors, such as labour rights issues, and supply chains.

⁴³ www.responsible-investor.com/articles/fiona-reynolds-and-john-ruggie-what-institutional-investors-need-to-know-about-the-s-in-esg

⁴⁴ www.responsible-investor.com/articles/fiona-reynolds-and-john-ruggie-what-institutional-investors-need-to-know-about-the-s-in-esg

⁴⁵ www.unpri.org/human-rights-and-labour-standards/why-and-how-investors-should-act-on-human-rights/6636.article

Supporting a better future

A year after Covid-19 was declared a pandemic, its consequences are reshaping our world, and will continue to do so. In investment decision-making, the importance of utilising ESG factors has been reinforced by issues brought to the fore by the global health crisis. This effect will not be short term – three-quarters of survey respondents believe that the pandemic will continue to accelerate general interest in ESG and capital inflows into sustainable investments over the next three to five years.

Asset owners recognise the necessity and opportunity of further integrating ESG into the investment process, and are increasing their expertise in a range of areas: selecting the most relevant guidelines and initiatives, creating their own methodologies, setting consistent frameworks across asset classes for both internal teams and external managers, working with multiple data providers to get a comprehensive data set, using benchmarks to judge their performance, and actively engaging with the companies that they invest in to encourage the positive change needed to build the post-Covid economy.

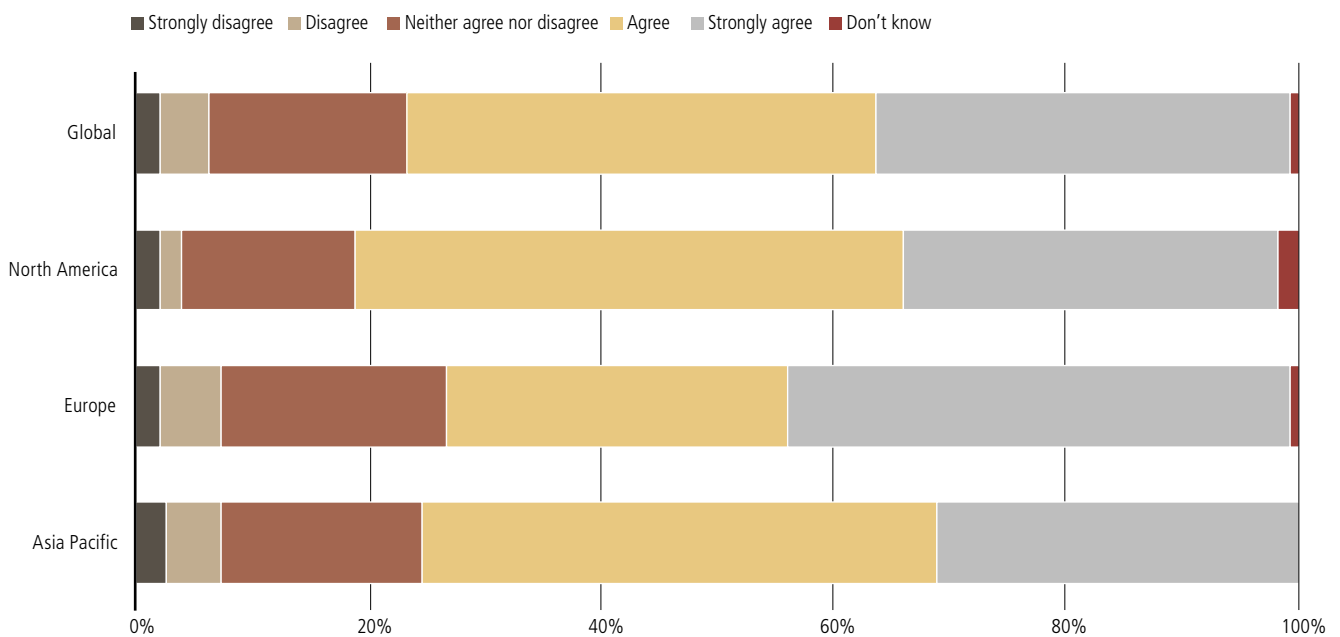
For Ms Reynolds, the Covid-19 pandemic has indeed been a proof point for ESG investing. “ESG is about looking at companies in a more holistic way – how do you think about what companies are going to be around and value them over the longer term – and with Covid-19 we really passed the test,” she says. “For those who were sceptical, who didn't get sustainability, I think for the first time they could see that if you want to have a healthy economy, and operate in a healthy economy, you have to have healthy people in a healthy planet – they underpin everything.”

“Covid has provided us with a brutal clarity over what are central requirements of global society. But it's also shown how much innovation there can be when capital is allocated and scaled up so quickly.”

Anne-Maree O'Connor,
Guardians of New Zealand Superannuation

There is a broad scientific consensus that climate change, biodiversity loss and deforestation are contributing drivers behind pandemics. For Mr Pedersen, the Covid-19 pandemic has not just raised awareness of the importance of social issues, but the connections between them and environmental issues. “Within environmental issues, there has been a dominance of climate change – and when the pandemic is over, it will be dominant again,” he adds. “But this will broaden to a focus on biodiversity as well.”

Chart 18. The coronavirus pandemic will accelerate the general interest in ESG and the capital inflow into sustainable investments over the next three to five years



Source: EIU survey

Ms O'Connor hopes that the pandemic and the response to it provide insight into how other global problems can be tackled. "I think Covid has actually provided us with a brutal clarity over what are central requirements of global society. It has made us see who are the essential workers, what are essential systems, and made us appreciate things like our ability to travel, to move," she says. "But it's also shown how much innovation there can be when capital is allocated and scaled up so quickly, such as with the Covid vaccine. I think it helps the whole world visualise, what does an emergency look like and how do you have to respond to that? It's shown how we can be really innovative with our capital, if you work together – the public and private sectors, and the other parts of society."

The silver lining of the pandemic is the opportunity that investors – and the rest of the world – have been given to reset. The test will be if we can both adapt and maintain the change after the crisis. As the findings of this research have highlighted, our ability to pass that test rests on two key principles: collaboration and innovation. By keeping both front and centre, we have a chance to accelerate the shift towards sustainable finance, supporting a better future in which people and the planet can flourish together.

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