Semi-Annual ESG Sentiment Study of Canadian Institutional Investors

July 27th, 2022

Sailing in rough waters and battening down the hatches

In June 2022, Millani conducted its Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, with 37 asset owners and managers representing over CA $5 trillion. This report takes a deep dive into the key trends identified by these investors.

The key observations are as follows:

- Financial markets were shocked by the conflict in Ukraine and its aftermath in commodities markets and the global food supply chain.
- Another surprise was the speed at which inflation raised its head, fuelled by the conflict, Covid-related supply chain issues and the pent-up demand.
- Despite this volatility, 97% of interviewees indicated they have not changed their ESG integration approach, although many did increase their focus on engagement.
- Although global sustainable fund flows decreased by 36% (Q4/21 - Q1/22), they still held better than broader global market fund flows which slumped by 73% over the same period. The Canadian market was the outlier as sustainable fund flows increased by 13%.[1]
- The Ukrainian conflict has refocused investors on the issue of energy security and has led some to requestion total divestment from fossil fuels and defense-oriented corporations, with more openness towards transition financing.
- Investment industry regulators increased their scrutiny of ESG disclosures and labelling in early 2022 which was considered welcomed progress by respondents. In a market that has become increasingly politicized and polarized, a shift towards more robust assessments is expected to increase overall credibility for ESG and responsible investing.
- Investors believe Canada is at the forefront of ESG and can become a global leader. Canada has the opportunity to aim high with its regulations, leveraging the success and strong global reputation of its pension plans. Additionally, by focusing on further developing strong relations with its Indigenous communities, it is also uniquely positioned to ensure their voices be heard and shared on the global stage.

1. Morningstar, Global Sustainable Fund Flows: Q1 2022 in Review, May 2022.

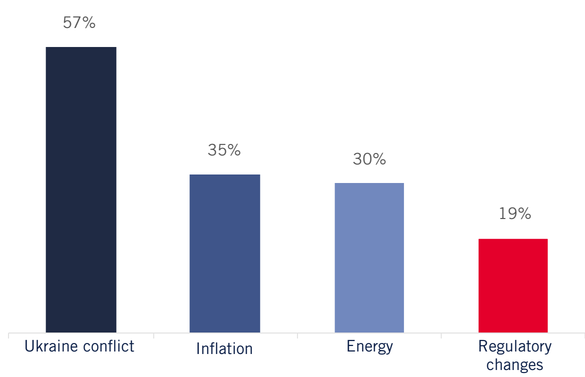
Millani

The 2022 surprises… that were not

The study began with understanding investors' biggest surprises since the beginning of 2022. An overwhelming majority of responses centered around the underestimation of the impact the conflict in Ukraine has had on capital markets, inflation, global supply chains, most notably on energy security and food supply chains. Economic sanctions and the removal of Russia from SWIFT, a global messaging service that connects financial systems, impeded the flow of goods which in turn fueled dramatic cost increases and food shortages.

Many investors acknowledged their concerns about global food supply given that Ukraine ranks amongst the largest exporters of grain, barley, corn and wheat[2]. In addition, many highlighted a renewed focus on energy security, leading to internal discussions regarding investment strategies. For instance, given current global economic sanctions, many investors are having ongoing discussions around whether to divest from fossil fuel and/or defence companies or to focus on transition financing by leveraging strategies investing in the transition a lower carbon economy.

Figure 1
What was your biggest surprise in the market since the beginning of 2022?



Numbers do not add up due to multiple responses.

Source: Millani, 2022

Inflation

Most respondents talked about the unexpected speed, breadth and entrenchment of inflation, highlighting that the Ukrainian crisis and China's zero-Covid policy contributed to the tightening of global supply chains.

Most anticipate further interest rate hikes by central banks to combat inflationary impacts, with varying views on the possibility of a recession. Following the completion of our study, the Bank of Canada icreased its key interest rate by 100 basis points on July 13, 2022, bringing the central bank's policy rate to 2.50%.

Given the market's correction, one of the largest preoccupations was where to find a safe haven in a shifting market. With the FTSE Canada Universe Bond Index and the S&P/TSX Composite down 12.3% and 11.1% respectively (to June 30, 2022), most investors have not significantly changed their asset mix. Minor rebalancing occurred with some investors reporting tactical moves to limit exposure to Russia, emerging markets and growth stocks, while others tried to shelter their funds from the downfall of conventional bonds by shifting to higher yielding, low duration bonds. However, the majority of respondents underscored that any diversification of assets into private, public, and real assets had started before the market correction.

Energy and the transition to net zero

In this survey, 30% of investors cited surprises related to energy, such as the sudden need to diversify energy sources (both type and origin), the challenges faced by the energy transition and the skyrocketing price of oil. Throughout our studies in 2021, Millani had observed a shifting sentiment by Canadian investors towards transition financing rather than developing an overarching divestment strategy. This sentiment continued in this survey, and expanded to the resource, defense, and nuclear industries. Macroeconomic conditions, the importance of the resource sectors to the Canadian economy (as of June 30, 2022, energy and materials sectors represent 18.4% and 11.6% of the S&P/TSX Composite Index) and the performance of the S&P/TSX Capped Energy index which is up 38.9% (to June 30, 2022), are factors that are solidifying this shift in sentiment towards transition financing. It was also expressed that those taking positions in Canadian issuers expect strong ESG performance and net-zero ambitions to be part of business strategies.

Respondents clearly indicated a desire for issuers to provide net-zero and interim targets, climate-related data (including Scope 1 to 3 emissions reporting), transition plans and Task Force for Climate-related Financial Disclosure (TCFD) reports. The desire for targets is being heard by issuers. In May 2022, the Institute for Sustainable Finance (ISF) published a report indicating that the number of TSX-listed issuers who have emissions reduction targets has doubled, from 60 to 120 (or 52%) in one year. The rate of firms with interim targets has also increased, from 18.3% to 49.2%[3] over the same period.

A consistent message from investors however, is the expectation that these climate targets connect to executive compensation.

2. IHS Markit, Ukraine agriculture exports – what is at stake in the light of invasion?, March 2022.
3. Institute for Sustainable Finance, An Update on Canadian Corporate Performance on GHG Emissions, Disclosures and Target Setting, May 2022.

In this case, the ISF report shows that only 14% of companies with stated targets had compensation tied directly to GHG reduction targets in 2020 versus 25% in 2019, a notable decline.

Our own study on the disclosure trends of TSX-listed issuers will be published in September 2022, where additional details on this topic will be provided.

Regulatory changes have investors on guard

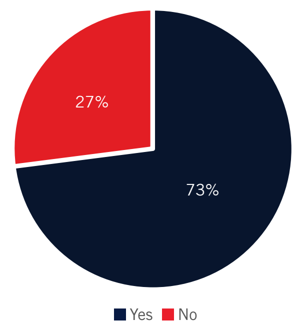
The majority of investors noted that they were taken aback by the speed at which regulators have engaged on both fund labelling and climate change. The raid by German regulators of DWS, the asset management unit of Deutsche Bank AG, in May 2022, took all by surprise. This has been accompanied by the US Securities and Exchange Commission's (SEC) proposal for ESG labelling and their investigations of firms like Goldman Sachs and the USD$1.5M settlement with Bank of New York Mellon. Furthermore, on July 4, 2022, the UK Financial Conduct Authority (FCA) announced that it postponed the publication of its revised regulations until later this summer as it wants to align with other global regulators such as the SEC. This is leading many investors to look inward to validate and verify the alignment of their marketing and communications with investment practices.

> ***"Regulators sanctioning investors and searching out offices was the big surprise. They have shown signs that they would do this through notes, guidelines, special alerts, but they had never sanctioned anyone before. Lesson is: if you say it, back it up, disclose. They look at RFP's blogs, public websites, ... everything is fair game. It sifts out the industry, which is a good thing."***
> - Asset Manager

Investors also expressed their surprise at how quickly the SEC moved on developing its proposal for climate-related disclosures. The respondents are very supportive of these recommendations and believe that the proposal should provide strong direction for issuers, even though scepticism remains as to whether all of the recommendations will be approved. The majority of respondents also indicated their desire to see the Canadian Securities Administrators (CSA), which began a market consultation in October 2021 on its proposed climate-related disclosure requirements, to challenge themselves to meet similar levels of disclosures as proposed by the SEC.

We validated investors own commitments by investigating their public support for climate reporting, as well as their own climate disclosures, and found that 73% of respondents have indicated public support for the TCFD.

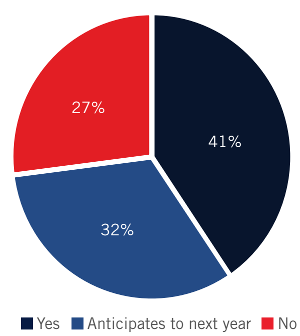
Figure 2
Has your organization indicated support for TCFD publicly?



Source: Millani, 2022

In addition, 73% of respondents had already produced a TCFD report, or anticipate producing one in the next year.

Figure 3
Has your organization produced a TCFD report?



Source: Millani, 2022

Changes in reporting practices and disclosure

Asset Owners and Managers disclosures

Clients' expectations and requests are driving investors' disclosures as well. Of the investors interviewed, 84% shared that they are experiencing increased demand for more qualitative and quantitative reporting from their clients and stakeholders.

"We have seen more demand from clients, which is driving increased transparency, depth, nuance and level of details. We see requests to discuss specific details on a company-by-company basis, as opposed to disclosures at the portfolio level."
- Asset Manager

Investors are now facing similar experiences to issuers on reporting - an increasing number of questionnaires without standardized questions. This is requiring additional resources and is becoming particularly challenging for smaller firms, fuelling the shared call for standardization in reporting. This standardization request may begin to be resolved with the International Sustainability Standards Board (ISSB) consultation process underway for two new standards: one for the disclosure of sustainability-related financial information and the other for climate-related disclosures.

Impact investing is gaining momentum

An interesting development in this mid-year study is the degree to which impact investing is gaining momentum. Impact investing was once considered a separate asset class for which investors would be willing to give up returns for social impact. That definition is quickly changing in financial markets, as the UN Principles of Responsible Investing has added a requirement in 2020 to disclose on sustainable outcomes to its reporting framework. This has investors looking for outcomes and not just outputs.

"Does impact reporting fit into the fiduciary duty of investment managers? This is one of the challenges that we're going to see. You'll have a whole group saying yes, and it will create debate and polarization. Pension plans will face a similar challenge if they pursue outcomes that are not aligned with the fiduciary duty of their sponsor."
- Asset Manager

This is leading to important questions with regards to best practices for the measurement of impact, and how to report on such impact, as well as a much debate about the fiduciary duty of pension funds and its connection to impact. Although this discussion is in its early stages, most agree that issuers will feel investors' growing desire for details on measurement of impact associated with the UN Sustainable Development Goals (UN SDGs).

Issuers Disclosures

Of course, demand on investors for more detailed ESG reporting means that those same requests will trickle down to issuers as well.

The good news is that investors are seeing improvements, notably on relevant metrics and key performance indicators (KPIs). Respondents cited the moves made by regulators as the cause for this stronger quality and quantity of reporting and data.

"Reporting from issuers is increasing in terms of quality and quantity. More companies are coming out with TCFD reports, dedicated ESG reports, and the robustness of these reports is getting better."
- Asset Owner

That said, investors are still pushing for more robustness in disclosures. For example, they would like more information and data around climate such that they can make their own assessments and implement the information into their own proprietary models.

"Issuers are trying to disclose quantitative information but they're hiding behind GHG and CO_2 emissions data, which are nice-to-see disclosures. However, we would like to also see things like electricity use, oil and natural gas consumed, etc., so that we can validate these GHG numbers."
- Asset Manager

These requests are no longer only coming from the public markets. The diversification of institutional asset mix into real assets mentioned earlier, means that private equity and real estate investors are also feeling pressured to demonstrate their integration of ESG into their risk management tools. This, in turn, is creating a rising demand for ESG disclosures by private companies as well.

"Investors who are purchasing private placements are insisting on ESG elements. For private debt, the purchaser of the security is asking for a covenant that will relate to the issuer's achievements of certain ESG targets. To be able to monitor those [targets], the disclosure requirements will need to go up."
- Asset Manager

Some investors raised the point that Canadian issuers were not participating as much as European issuers in collaborative projects. The Science Based Targets initiative (SBTi), which seeks to promote best practice in emissions reductions and net-zero targets in line with climate science, and the Workforce Disclosure Initiative (WDI), which was designed to help companies improve the standard of reporting on workforce metrics, were noted as two important projects that were not seeing as much traction in Canada.

"We have supported certain best practices such as the Workforce Disclosure Initiative (WDI), which helps address modern slavery and forced labor. We don't see as many issuers participate in these initiatives in Canada as there are in Europe, yet the WDI is to human capital management what the Carbon Disclosure Project is to climate."

- Asset Manager

Investor engagement

One point that was made very clear is that with limited available data and shifting macroeconomic conditions, investors are focusing on engagement. Asset owners are asking more questions and expecting stronger levels of engagement from asset managers. They are also asking for evidence of engagement with portfolio investees, as well as a description of outcomes, across all asset classes. Expectations on reporting are progressing as well. Basic information, such as number of engagements, is no longer considered adequate disclosure. Investors are requesting to see contextualized and timebound outcomes.

"We're pretty consistent. We're getting more savvy ourselves, asking for the right data and metrics, and focusing on tangible outcomes. Every time there is a new ESG report, we want to see actions happening, we are moving away from just disclosures."

- Asset Manager

Many investors indicated that they have, or will, become signatories to the collaborative engagement efforts of Climate Engagement Canada (CEC) whose aim is to engage with the highest GHG emitters across sectors of the Canadian economy, with a view to having net-zero transition-focused outcomes over time. As issuers, if you don't already have an investor engagement strategy, the time has come to put one into place. The pace and expectations of investors to move beyond targets and to see tangible outcomes is steadily rising.

Proxy season

Investor stewardship has two key elements: engagement with issuers and using the collective power and voice of shareholders through proxy voting. As noted by one investor, the proxy season in 2022 was uncharacteristically dynamic.

"Many shareholder proposals reacted quickly to events in the market. For example, in the aftermath of the Roe v. Wade Supreme Court ruling, we saw proposals asking for disclosure on how employees can access healthcare facilities. Last year, shareholder proposals were not as reactive to ongoing events."

- Asset Manager

In all, the 2022 proxy season saw 924 ESG-related shareholders proposals at annual meetings of companies in the Russell 3000 index, compared to 837 and 754 in 2021 and 2020 respectively.[4]

The increase in the number of ESG proposals could at least partly be due to the SEC allowing more environmental and social proposals to go to vote after overturning a policy enacted under the previous administration, which made it easier for companies to exclude such resolutions from ballots.

One key topic that was top of mind this proxy season was gender equity on Boards of Directors, with 24% of respondents having set targets. Some have even been using their voting power to vote against nominees if organizations did not meeting their gender diversity targets.

"Where we were looking for 30% of Board Directors to be women, now we're looking at 40%. It facilitates gender balance. We shifted requirements for ethnic representation on the Board in certain regions as well. Previously, we were looking for one person who was from a different background but in certain markets, we are now looking for two."

- Asset Manager

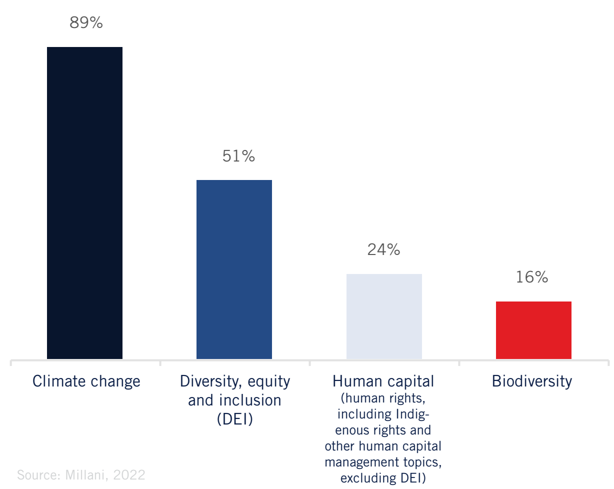
However, it should be noted that the investor focus on Diversity Equity and Inclusion (DEI) is also moving beyond gender to representatives of various professional backgrounds and ethnicities, as well as representatives of the markets the organization serves.

4. BenefitsPro, Record high of 924 ESG shareholder proposals in 2022, but support is 'muted', June 2022.

Top ESG topics

With the growing importance of DEI, climate change remaining a preoccupation and the macroeconomic conditions creating market turmoil, Millani wanted to confirm if there had been shifts in the top ESG topics for investors.

Figure 4
Most popular ESG focus topics for respondents



Similar to last year, climate change was mentioned by 89% of investors as a priority falling within their top three. In fact, 68% of respondents mentioned it as their number one priority. This was followed by 75% of respondents choosing DEI, or another human capital management-related topic like human rights (including Indigenous rights), talent retention or compensation as a top-three priority. Biodiversity was also cited as an up-and-coming topic, which is highly related to climate change but challenging to integrate.

As investors are themselves dealing with reporting challenges connected to climate change, the general consensus is that they would like to see issuers move beyond pledges, towards interim targets. More importantly, they would like to see concrete action plans to meet those targets. This is, and will remain, an important part of investor engagement, and issuers should anticipate seeing this become a mainstream expectation across the broad market, not just for the higher emitting sectors.

"We need to turn words into action. If you've made the commitment to net-zero, do it. If you have emission reduction targets by 2030, do it. I want to see a broader range of commitments from investors, not just 2030 reduction targets. Start small, reward funds with good solutions."
- Asset Owner

Human capital management

When it comes to human capital management, we observed a lack of clarity in investor expectations of issuers, since many are grappling with understanding what should be considered strong disclosures for this topic themselves. Given a lack of standardization, firms are developing their own questionnaires.

"We see the more companies disclose, the more they seem to be better with human capital management overall. We'd like to see self-identification. We sent an ESG questionnaire, and we expanded our scope of questioning to include social issues, Indigenous relations policy, workplace safety, and health and diversity issues beyond gender metrics."
- Asset Manager

Most importantly, investors would like issuers to go beyond accumulating data and setting DEI targets to providing information and context around internal processes and policies that have been put into place to attain those targets.

"The most important part is the process: How do you read and interpret a score? We used to own a company with 50% women on staff. For this company, it was their process that led to those statistics. We wanted to understand the process behind the data."
- Asset Manager

When asked what type of information they would like to see, investor responses varied from gender representation on Boards and in the workforce, the ratio of executive pay to average employee pay, turnover, Indigenous policies, and other commentary related to the organization's culture. Investors are currently being patient with issuers, recognizing the difficulty in delivering the data, but express a desire for more and better articulation of insights related to these topics. They would like to see an added focus on disclosing progress over time.

"Human capital management targets are coming, it's the natural next step after disclosing once the data gathering process is mature enough. The lack of data means it's hard to set targets. Start small and build on it, we want to see progression."
- Asset Owner

Canada's Leadership in ESG

Our study found that investors believe ESG is here to stay. With shifting macroeconomic and market conditions, and a rise in the demand for Canadian natural resources, Canada therefore seems to be in a strong position to lead in the ESG arena.

Mega-sized pension plans

Many investors pointed to the size and number of our Canadian pension funds - often referred to as the "Maple Eight" pension funds - as a symbol of Canadian leadership in ESG. These pension funds are highly respected and even emulated on the world stage. Many investors suggested that we use the knowledge and best practice of these funds in terms of ESG integration and extend them to the broader market.

"Europe has done a great job including ESG and reporting on ESG, but Canada, with its own large plans and its great reputation, is already a leader in ESG. Where the government can harvest that is by taking the practices that are already in place, formalize them and extend them to the broader market. We can learn from the practicalities put in place by the leaders in the market and use that as a great framework to make it more formal for the average pension plan."

- Asset Manager

Another strong recognition by investors was the unique role that Indigenous peoples of Canada have in the 'Just Transition'[5]. In our September 2021 paper, The Value in Indigenous Relations, we cited that approximately 180 producing mines and more than 2,500 exploration properties are located within 200 km of Indigenous communities in Canada, many on traditional lands. Canada can be a model to the world in how to move towards reconciliation, collaboration and partnership with Indigenous peoples in creating and developing transition projects that are economically sound for all parties involved.

"Our clients want more screening and involvement regarding Indigenous communities, and in assessing whether investments have a positive or negative impact on communities."

- Asset Manager

As well, investors identified that with the development of standards for reporting on sustainability-related issues, such as the development of the ISSB standards, the collective voice, knowledge and experience of Canada's Indigenous peoples are needed. It was clearly communicated that we are at an important time in the development of standards that may well be entrenched in disclosures for market participants. It was noted that Canada has a unique opportunity to promote inclusivity and lend its voice to these discussions at a global level.

Respondents also loudly voiced their desire for Canadian regulators to be bold and aim for uniformity in regulations with other jurisdictions, across our own country, as well as in alignment with other regions around the globe. This is in reference to both the efforts of the ISSB as well as with climate related reporting.

"Policy makers and regulators need to be bold and must stress the importance of being bold. We must learn from the European Union (EU) and produce strong principled-based guidelines, while not being overly prescriptive. However, we must not be too lax and aim for good disclosure outcomes that showcase best practices and get it right."

- Asset Manager

5. The Government of Canada sees a 'Just Transition' as a process involving:
   - preparing the workforce to fully participate in the low-carbon economy while minimizing the impacts of labour market transitions;
   - identifying and supporting inclusive economic opportunities for workers in their communities; and
   - putting workers and their communities front and centre in discussions that affect their livelihoods.

Source: Government of Canada, Just Transition, 2021.

Challenges to ESG

Education

ESG education was identified as a focus area for Canada. Many investors acknowledged the adoption and understanding of ESG has advanced substantially in some areas of financial markets, however, there remains many segments of the overall Canadian economy and its financial systems that require support.

"There should be more education on ESG and responsible investing at university, and on financial literacy in high school."
- Asset Manager

Given the current market turmoil and the lack of clarity on definitions, especially in the retail market, there is a need for education of the general market on the variations of responsible investing approaches. Regulators, standards setters, and industry associations like the RIA (Responsible Investment Association) and the CFA (Chartered Financial Analysts) Institute each have roles to play to counter the presumed pushback on ESG that may be occurring given the lack of understanding of what ESG is and its role in investment strategies.

The introduction of ESG labelling may clear out some of the confusion, but in the meantime, there appears to be a polarization around the topic of ESG, especially in the US market. While this narrative should be monitored, investors already integrating ESG into their processes readily acknowledge that ESG is a fundamental part of their investment strategies and that there is no desire to stop integrating it into decision-making.

Presumed pushback

What lie ahead for ESG integration? Market participants indicated that the focus on fund labelling, and therefore the risk for potential greenwashing, has created what many feel is a presumed pushback. When asked about the challenges of the future however, the clarity of fund labelling was a welcomed idea given the clarity that labelling can provide, and was deemed necessary for the industry to advance.

As has been the historic nature of ESG-related investors, the focus on the long-term was reiterated. Although the perception is that ESG may have gotten pushed to the sidelines by macroeconomic conditions as of late, respondents indicated that ESG is not an investment style. Rather, it was cited as being an approach to fundamental investment analysis – and for those who have truly embraced it, there is no turning back.

"ESG is not an investment style, not an alternative to growth, value, etc. It is part of sound investment management practices. I will not do ESG because I will get lower/higher returns. It's not a returns' discussion, it's more about having a long-term view on returns."
- Asset Manager

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Contributors

Thank you to our contributors who took the time to provide their insights on key ESG trends. Our contributors represent 37 institutional investors, some of which are listed below.

ACM · ADDENDA CAPITAL · AGF · AlphaFixe Capital
BeeQuest · BMO Global Asset Management · Connor, Clark & Lunn Financial Group · Canada Post / Postes Canada
CDPQ · CIBC Asset Management · CI Global Asset Management · Clear Skies Gestion de placements / Investment Management
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About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 15 years, Millani has become the partner of choice for institutional investors. By providing advisory services on developing ESG communications, engagement and disclosure strategies and integrating material ESG issues into their investment strategies and decision-making processes, we help our clients reduce risks, increase returns, and create value. Millani is also leveraging this expertise and its experience in ESG consulting to help reporting issuers improve their ESG disclosure to financial stakeholders and optimize their market value.

For more information, contact us at: info@millani.ca or visit our website: www.millani.ca