conversation ▪ with Milla Craig

Milla Craig
President and CEO
of Millani, Inc.
Montréal, Québec

Concerns surrounding environmental, social and governance (ESG) investing appeared to arise overnight, but the idea of sustainable investment and the desire to seek sustainable returns for clients is nothing new, according to Milla Craig, founder and president of Millani, a Montréal ESG advisory firm that focuses on education, training and advisory services to both investors and companies. Millani has spent the last 15 years educating investors and businesses about strategic services that integrate ESG factors. In December 2022, Millani conducted its Semi-Annual ESG Sentiment Study of Canadian Institutional Investors *to determine whether the shifting environment had resulted in adjustments to their investment strategies. Craig discussed the results of the survey with editor Tim Hennessy.*

What are some common misconceptions about ESG investing, and why is it important for ESG to become better understood?

ESG investing has been often understood as an investment strategy focusing on exclusions and divestment. In reality, it is a mechanism that supports traditional financial analysis and provides investors the opportunity to develop a fulsome view of investments by better understanding the impacts of tangible and intangible factors on long-term performance. As such, the integration of ESG risks in financial analysis has existed for a long time, just not under the term "ESG." It has been used to evaluate future returns and risk, along with traditional financial indicators of performance.

ESG integration is sometimes used interchangeably with the umbrella term "responsible investing." However, ESG integration is, in fact, one of multiple responsible investing approaches. The most common approaches are:

- **ESG integration:** The most widely used form of responsible investing.[1] It explicitly considers ESG factors in the investment decision-making process with the goal of achieving higher risk-adjusted returns.
- **Socially responsible investment (SRI):** A strategy that includes or excludes investments based on the application of positive or negative screens, which come from a defined set of values.
- **Impact:** Aims to generate a positive and measurable social and/or environmental impact, along with financial returns. Not all impact strategies are the same: Some will seek to earn market returns while others may include a financial trade-off.

Ultimately, ESG integration is about value creation and achieving better risk-adjusted returns, unlike other responsible investing approaches that tend to be mainly values-based. This distinction, or lack thereof, may have contributed to market confusion and the recent backlash and politicization around the term "ESG."

Another popular misconception about ESG investing revolves around the notion that it is an approach that may lead to negative impacts on performance. However, there is growing empirical evidence that this is not the case.[2]

What are the benefits and disadvantages of using an ESG-focused investing strategy?

Every investor leveraging an ESG strategy will have a unique approach depending on the nature of their fund(s), the horizon of their investments, the regulatory framework(s) under which they operate and their stakeholders. That said, there are several advantages and disadvantages—or rather, challenges—to this approach that tend to be common to most investor profiles.

The advantages of ESG integration in investments can include having:

- A broader lens on the drivers of financial performance
- A longer term focus that counterbalances the short-term focus of traditional financial metrics
- The potential for better risk-adjusted return
- Potential positive outcomes for people and planet.

Conversely, some challenges can include the lack of:

- Additional resources to analyse ESG data (financial and human)
- Access to comparable, decision-useful data.

Investors and regulators have often scrutinized ESG-minded funds with the belief that performance is sacrificed for sustainability. How can plan sponsors/trustees evaluate whether ESG investment opportunities allow them to meet their fiduciary obligations to their beneficiaries?

When fiduciary obligations in Canada are discussed, the following legal concepts are often cited.

1. The Income Tax Regulations state that "the primary purpose of a pension plan is to provide periodic payments to individuals after retirement and until death in respect of their service as employees."
2. Canadian provincial pension standards legislations include a prudent person rule that applies to the investment of pension assets. The prudent person rule is typically captured in the care, skill and diligence required of a pension plan administrator (for example, in section 22 of the Ontario Pension Benefits Act).

Last year, the Canadian Association of Pension Supervisory Authorities (CAPSA) issued a draft guideline on ESG considerations in pension plan management.[3] It stated:

> "*Pension plan administrators . . . **should consider ESG characteristics that may have material relevance to the financial risk-return profile of the pension funds investments**.*"

Furthermore, the Association of Canadian Pension Management released a research paper on June 1, 2022 entitled *Fiduciary Considerations Relating to ESG Issues for Canadian Retirement Arrangements.*[4] It states:

> "*Pension plan administrators may consider ESG factors in investment decisions provided that any such investment is in the best financial interest of the beneficiaries and that their decision is rationally based on evidence after appropriate due diligence. **Such investments based on ESG factors would not be a breach of trust or a violation of the plan administrator's fiduciary duties**.*"

As can be seen, Canadian pension plans are currently on safe ground if they want to adopt an ESG integration policy. The key to aligning ESG with fiduciary duty is to focus on financially material ESG topics. There are various frameworks available to support investors in doing so.

For plans looking toward ESG-focused investments and trying to capitalize on the growing interest in sustainability, how is ESG integration a part of that? How are funds implementing ESG integration?

Fundamentally, ESG integration is about including environmental, social and governance considerations into existing investment processes. The first step to successfully achieve this is to define and implement a process supported by a responsible investment policy and a governance structure providing proper oversight. Finally, appropriate ESG-related disclosures can be developed to share ongoing efforts with stakeholders.

Plans come in all shapes and sizes, and integration is going to look different depending on a plan's size. Larger plans are often able to manage this approach internally. Smaller plans have traditionally delegated the responsibility of integrating ESG factors into their investment processes to their external asset managers. That said, we have recently seen a desire for sponsors to regain control and better oversight of their ESG integration process as, beyond the need for plans to meet their fiduciary duty, there has also been increasing market interest around ESG integration as well as shifting regulatory requirements.

What is biodiversity and why has it gained prominence as an ESG area of focus?

Biodiversity refers to the variety of all living organisms on Earth. *Natural capital* is the stock of renewable and non-renewable resources that combine to yield a flow of benefits to people. There is increasing recognition that much of the world's gross domestic product has origins in nature and that many essential goods and services are nature-based, such as pharmaceuticals, forestry, agriculture, tourism, textiles, food and beverage, etc. A few market movements have catalysed investor interest in biodiversity:

- **COP15:** The United Nations Biodiversity Conference (COP15) was held in Montréal in December 2022. Target 15 of the Kunming-Montréal Global Biodiversity Framework, the outcome of COP15, is directly related to the disclosure of biodiversity risk:
  in particular to ensure that large and transnational companies and financial institutions: (a) Regularly monitor, assess, and transparently ***disclose their risks, dependencies and impacts on biodiversity****, including with requirements for all large as well as transnational companies and financial institutions along their operations, supply and value chains and portfolios.”*[5]
- **TNFD:** Based on the widely used task force on climate-related financial disclosures (TCFD) recommendations, the task force on nature-related financial disclosures (TNFD) will enable companies and financial institutions to integrate nature considerations into investment decision-making processes. The final recommendations are expected to be published mid-2023.[6]

These market movements—along with the launch of a collaborative engagement initiative, Nature Action 100, and the inclusion of biodiversity questions in the sustainable finance disclosure regulation (SFDR) and the carbon disclosure project (CDP)—are expected to lead to further demand for biodiversity data from both corporate issuers and investors.

What are investors' top ESG focus areas and how have those concerns changed their investment strategies/behaviours?

Millani published its latest *Semi-Annual ESG Sentiment Study of Canadian Institutional Investors* in February 2023.[7] The study provides insights from interviews conducted during December 2022 with 27 asset owners and managers, representing over C$6.1 trillion in assets under management. Climate change consistently remains a top-of-mind topic for respondents. Investors are shifting their focus from board and management equity, diversity and inclusion to broader human capital management issues. In recent years, talent attraction and retention have been challenging for many businesses. In response, investors are now closely assessing topics like culture, training opportunities, employee engagement and well-being in their investment processes. Finally, biodiversity and human rights are both topics that have surfaced as rising priorities for the group.

Investors understand that these ESG topics are systemic issues and are looking to invest in the solutions needed to address them—not only in companies that are already successfully integrating ESG. Ultimately, investors are looking to enable a transition to good ESG practices, and it is often in the delta of supporting a shift from poor to strong ESG practices that there is value to create and capture.

Endnotes

1. Responsible Investment Association, *2022 Canadian Responsible Investment Trends Report.* riacanada.ca.
2. NYU Stern Center for Sustainable Business and Rockefeller Asset Management. www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/esg-and-financial-performance.
3. www.capsa-acor.org/Documents/View/1914.
4. www.acpm.com/getmedia/1b2c29d7-be93-400a-beaa-a2ab0081d58e/ACPM-ESG-White-Paper-June-1-2022.pdf.
5. Convention on Biological Diversity press release: Final text of Kunming-Montreal Global Biodiversity Frameworks available in all languages, Target 15, December 2022. www.cbd.int/article/cop15-final-text-kunming-montreal-gbf-221222.
6. Taskforce on Nature-related Financial Disclosures. www.tnfd.global.
7. Millani, *Semi-Annual ESG Sentiment Study of Canadian Institutional Investors,* February 2023.

pdf/523