ESG Sentiment Study of Canadian Institutional Investors

February 15th, 2021 By: Milla Craig & Charlotte Lombardi

In April 2020, Millani conducted a sentiment study with Canada's largest institutional investors (representing $2.3 trillion[1] of assets under management) to understand how they thought ESG integration (environmental, social and governance) might change as a result of the COVID-19 pandemic. We shared the results of the study in May 2020.

As a follow-up, during the period of December 14th to December 22nd, 2020, we interviewed a sample of the same investors to gather their views on what surprises they had witnessed in 2020, and to understand the key ESG trends that they envision for 2021.

1. Approximate amount calculated from public sources

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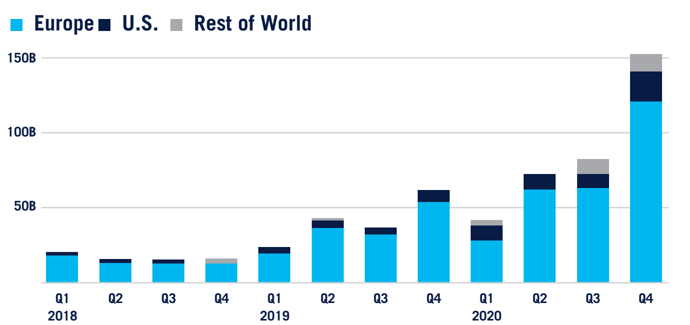
ESG has evolved

When Millani interviewed investors in April 2020, the majority (74%) felt that the global COVID-19 pandemic would have a positive impact on ESG. This perspective remained with investors in December 2020. In fact, we discovered that most were surprised at the degree to which market sentiment had advanced around ESG issues in the previous 9 months, and at the overall speed of the market's decline and recovery. Global sustainable funds once again broke records in 2020 and attracted more than $150 billion in fund flows.[2]

Figure 1

Sustainable fund flows surge past $150 bilion

Flows into sustainable fund flows over time, in billions of U.S. dollars

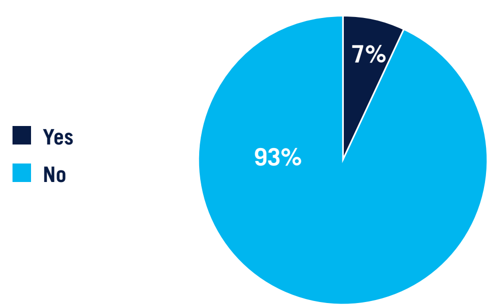


Source: Morningstar, 2021

"These issues have been discussed for years. It [ESG integration] paid off so much in so little time. You couldn't have adjusted for this…The surprise was both how quick it paid off and how fast markets recovered." Asset Owner

Figure 2

Is this what you anticipated 9 months ago?



Source: Millani, 2020

Investors expressed that rather than "pushing" ESG products and strategies, they are now at the "pull" stage and reacting to market demand. In response, investors are moving to build in-house expertise and suggested that for smaller firms, it may be challenging to keep up with the pace of change without dedicated resources.

"What is a challenge for smaller investors is the speed of change. If we don't keep track with market pace, we will find ourselves way behind." Asset Owner

Pressure is coming from all angles

Over the year, advancements in ESG were also witnessed in regulation and disclosure, all contributing to increased scrutiny of investors, from a range of stakeholders. There has been greater interest from the public on social issues, and what the financial system's influence might be. Asset owners are increasing their level of ESG integration due diligence of their external asset managers, and the PRI (United Nations Principles of Responsible Investment), to whom more than 3,000 investor signatories report, has broadened the scope of their framework. Signatories must now report on the "real-world outcomes" from investments and provide details on climate-related information.[3]

Taxonomies and fund labels are starting to dictate what is and what is not considered "ESG" or "sustainable". The EU Sustainable Finance Disclosure Regulation (SFDR) will require that asset managers disclose how they are integrating ESG into their funds. This has implications for Canadian asset managers who sell products in Europe, as they will be under the same scrutiny as European fund companies. Even without this regulation in Canada, it is likely that the Canadian investor community will move to align to these regulations for competitive reasons.

"We have EU funds that must comply with SFDR. It's not just about integrating ESG, we must promote it and show what you have done to support commitments. We are starting to receive questions from European-based clients that have mandates in Canada – they know what is happening in Europe and are wondering how it will impact Canada." Asset Manager

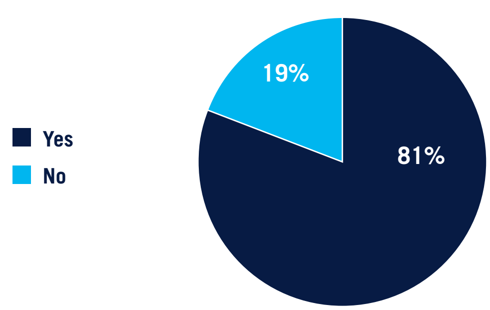
2. Howcroft, Elizabeth, Jessop, Simon, "Sustainable fund assets hit record $1.7 trln in 2020: Morningstar", Reuters, January 28, 2021
3. McElhaney, Alicia, "UN PRI Revamps Reporting Rules to Focus on 'Real-World' Outcomes", Institutional Investor, June 17, 2020

Climate change is still the priority

In April 2020, 87% of investors surveyed felt climate change would remain a priority. In December 2020, the issue remained top of mind for investors, with 81% saying climate change would be in their top three engagement priorities for 2021. 56% claimed it was their **number one priority**. The Taskforce on Climate-related Financial Disclosures (TCFD) remains the framework of reference for climate change disclosure for investors and issuers alike, with a particular focus on scenario analysis as a key transition tool.

"There was very high momentum around TCFD in Fall 2019 and I think [attention] will come back on the "E" generally. The US rejoining the Paris Agreement – that will create big momentum around climate change." Asset Manager

Figure 3
Do you expect to see climate change on the list of top three ESG issues for 2021?



Source: Millani, 2020

To note, investor sentiment was that for Canada the issue isn't just about climate change, but how Canada can **transition** to a lower-carbon economy. This was noted as being key for both investors and issuers.

"This transition [to a lower-carbon economy] is a real issue, and Canadian issuers need to understand, they need to drive this issue. We are where we are. We didn't plan on this happening but now we need to plan to change direction." Asset Manager

Social issues were thrust into the spotlight in 2020

Diversity and Inclusion (D&I) was highlighted by 75% of respondents as a key engagement issue in 2021 and with broader diversity disclosure requirements from the Canada Business Corporation Act (CBCA), investors in Canada will increasingly have access to data relating to the representation of women, visible minorities, First Nations and those with disabilities, at both the board of director and senior management levels.

"Diversity & Inclusion is in all of our engagements right now." Asset Manager

"Diversity – I think it's getting more and more important. What we now see are companies that have never cared about this, starting to build diversity committees and have diversity communications. Minorities have been put on these committees but we know the culture of some of those firms has nothing to do with diversity. It is sad that some aren't doing it for the right reason. The good thing is that I think D&I is now here to stay." Asset Manager

Many of the participants noted that investment managers acknowledge the materiality of D&I and the tangible connection it has to value creation. It was pointed out by some that the real benefits lie in pushing for inclusivity in their own operations, as well as in their portfolios.

"For asset managers, it's not about scandals but about having diversity in-house. Inclusivity is our main risk. Diversity is getting a place at the table, but inclusion is getting a voice at the table. It's not just about getting more women or minorities in our industry; it's about giving those currently in the industry, a voice". Asset Manager

Regulation in diversity and inclusion is also getting tighter and is leading investors to taking a more proactive approach to this topic. In August 2020, the Securities and Exchange Commission (SEC) amended disclosure requirements for human capital resources.

Issuers are now required to provide a description of human capital resource management rather than simply disclosing data on the number of employees. These disclosures may include metrics on initiatives relating to diversity, culture, health and safety, skills development, and workforce stability.[4]

"In all of our engagements since March, one topic is always corporate culture, mobilization of employees, and mental health. How do you track, measure, and monitor? What new initiatives have been put in place to be proactive in terms of human capital management?" Asset Owner

Other social issues that were highlighted was labor relations and employee health and wellness. Given that throughout the year, many investment professionals were themselves dealing with work from home issues and balancing work and family life, there was a sentiment of heightened sensitivity towards these issues.

"We know it's OK to ask these questions about mental health. We are more sensitive to these issues now than ever. Sometimes, we have to feel it, in order to understand it's importance." Asset Owner

Issuers should also expect increased scrutiny on their supply chains, as pressure grows from both the public and from financial stakeholders on ensuring that people are treated fairly, and products sourced responsibly.

"People are really asking how companies are treating people in the supply chain and ethical sourcing is becoming more important." Asset Manager

A disconnect between market performance and the real world

Since the downturn in global capital markets in April, there has been a remarkable recovery. The S&P/TSX Composite Index and the S&P 500 closed at record highs in 2020,[5, 6] and the Dow Jones had recovered to February 2020 levels by November 2020. However, many investors were concerned with the disconnect between the capital markets and the real economy and with a rising level of income inequality that could have long-term impacts on economic growth.

"The market is doing so well, but it illustrates a bigger divide between have and have-nots." Asset Owner

"As we've seen with the pandemic, the rich experienced it better than others." Asset Manager

Issuers should expect increased scrutiny and engagement related to social issues during the 2021 proxy season. Investors are keenly aware of corporate actions taken during 2020 and noted that they will have a sharp focus on executive compensation: *Does it align with decisions made throughout the first wave of the pandemic? Did the company cut dividends or did the executive agree to cuts in compensation as they managed layoffs? Does the overall compensation align to the commitments and engagements that have been undertaken with investors?*

4. Goforth, Alan, "SEC human capital disclosure rules: What businesses need to know", Benefits Pro, January 26, 2021
5. Annual development of the S&P/TSX Composite index from 2005 to 2020, Statista, January 6, 2021
6. Pound, Jesse, "Here are the top performing stocks in the S&P 500 for 2020", CNBC, December 31, 2020

Is mandatory ESG disclosure around the corner?

As demand for ESG-related information grows, each year Millani researches the ESG disclosures of Canada's S&P/TSX Composite Index constituents. As of December 31, 2020, we found that 71% had released a 2019 report relating to ESG issues, be it a Sustainability, Corporate Social Responsibility, or ESG report. However, we continued to hear that the type of information being reported often does not align with investors needs: credible, consistent, and comparable decision-useful information.

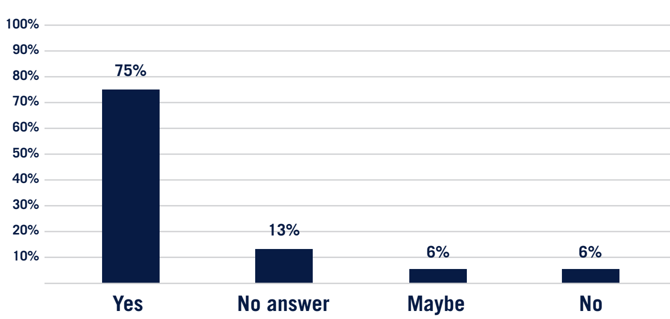
In September 2020, the International Financial Reporting Standards Foundation (IFRS) released a consultation paper, welcoming comments on the market's desire for global sustainability standards. The investors interviewed were pleasantly surprised by the IFRS's move, communicating that they supported the efforts to develop an internationally recognised standard.

With this type of standardization, many of the barriers towards achieving mandatory disclosures of ESG related data would be reduced. However, there was some reservation from investors as to the risk of losing the nuances in this type of information, highlighting the need to provide context on ESG issues.

Of our respondents, 75% believe that mandatory disclosures will come in. The broader question remained: "When?". Few anticipated that it would be required in 2021, but felt that we would see movements in the year. Many cited the first ever joint statement by eight of Canada's largest pension funds[7], calling for issuers to disclose better ESG information aligned to the TCFD and the Sustainability Accounting Standards Board (SASB) frameworks. **We discovered that 100% of our participants agreed with this proposal.**

Figure 4

Do you think mandatory ESG disclosure will come in?



Source: Millani, 2020

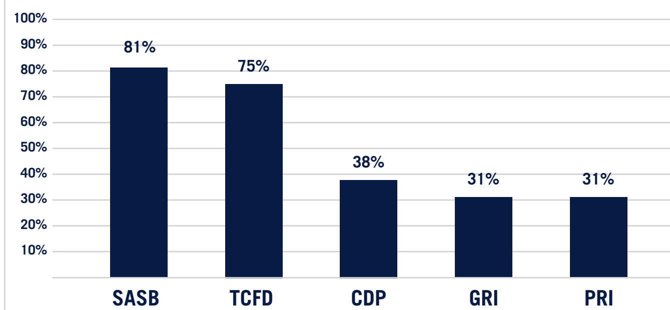
We asked which frameworks the interviewees use in their assessment processes, or alternatively, report to. 81% named SASB, and 75% are looking to or already aligning their own reporting to the TCFD. Other frameworks, such as the CDP (Carbon Disclosure Project) were mentioned as a source for climate-related information, and the GRI (Global Reporting Initiative) for broader reporting needs.

"SASB and TCFD are our North Stars"
Asset Manager

The PRI has already made it mandatory for its signatories to report to the TCFD as of 2021. This will continue to drive investors' needs for quality data so they can fully integrate these issues into their investment analysis.

Figure 5

Which reporting standards or frameworks do you use?



Source: Millani, 2020

The new PRI reporting framework is raising questions

Late in 2020, the PRI published its updated reporting structure for signatories. We discovered that the new framework has left some investors with some serious questions as to how "real-world outcomes" fit within their fiduciary duty, indicating that they integrate ESG issues in an effort to generate the best financial returns for their clients, over any other reason. Investors communicated that they would continue to report to the PRI but felt the initiative had perhaps moved beyond its original scope and might meet some resistance in the market.

7. Kolivaskis, Leo, "Canada's Top Eight Pension Funds Unite on ESG Disclosure", Pension Pulse, November 25, 2020

Key takeaways

2020 is the year that ESG went mainstream.

Climate change remains a priority but for Canada, and Canadian investors, the transition to a lower-carbon economy is a necessity. Issuers should expect demands for quality climate disclosure and for details on short, medium and long-term climate strategies.

Diversity and Inclusion pushed its way into investors' top priorities and is expected to remain a hot topic throughout 2021.

Social issues will be top of mind, in particular employee health & wellness and responsible supply chains.

Mandatory ESG disclosures is anticipated. There is demand for consistent, comparable and decision-useful data. Issuers' ability to provide this data will be the differentiator in their access and cost of capital.

About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 13 years, Millani has become the partner of choice for institutional investors. By providing advisory services on 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

Some of our participants

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