Semi-Annual ESG Sentiment Study of Canadian Institutional Investors

February 12, 2024

Key observations

In December 2023, Millani conducted its Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, with 32 asset owners and managers representing approximately CA $4.5 trillion of assets under management.

Key observations include:

- **An upswell of impact-oriented products expected in 2024.**
  This was the major surprise in this study: 43% of asset managers interviewed plan to launch impact products in 2024.
- **Asset managers: be clear and precise on fund labels.**
  In the past, we witnessed claims of greenwashing with ESG products. To avoid impact washing, language aligning with the fund strategy will be crucial.
- **Asset owners: grasp the nuances between sustainability outcomes and impact.**
  With the anticipated launch of impact funds in the market, asset owners are advised to understand the nuances between ESG integration, investing for sustainability outcomes and impact, while strengthening their investment processes and increasing oversight in external manager in due diligence.
- **Biodiversity is expanding the focus from “climate” as a topic, towards “environment”.**
  Biodiversity, a growing topic of focus amongst respondents, is clearly aligning beside climate as the top two issues for investors. The conversation is expanding from a focus on “climate change” and broadening to “environment” as a topic area.
- **Issuers: accessing this shifting capital requires double materiality assessments.**
  The growing interest in investing for sustainability outcomes and impact, added to the backdrop of evolving European legislations, means that issuers wanting access to this shifting capital will need to conduct double materiality assessments to identify both the sustainability-related risks and opportunities on their business (financial materiality) as well the impacts of their business operations on people and the environment (impact materiality).
- **Still no taxonomy in Canada – investors are disappointed.**
  Of this study’s respondents, 63% expressed that the federal government has not moved fast enough in the development of a Canadian taxonomy, leading to disappointment and a sense that Canada is losing its competitive position.

2024 – The year impact goes mainstream in Canada

As leaders in the ESG arena in Canada for more than 15 years, we are seeing many parallels between how the ESG market developed and what is occurring in the impact space.

It has been a market assumption that to do impact investing, one needs to give up financial returns. Given the leadership of several fund companies, that assumption is being disproven and Millani's latest study shows an anticipated upswell of new impact-oriented products in the market in 2024.

History always has lessons, and the market would do well to learn from them. There are nuances between ESG integration, investing for sustainability outcomes and impact investing. Knowing the differences and using accurate language to describe those strategies can help the investment community correct the missteps of "greenwashing" and the backlash that the ESG movement has experienced. *Impact has arrived in our markets. Are you ready?*

Anticipating a year of instability

As we held interviews for this eighth edition of our Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, we noticed a strong recognition by participants that market preoccupations have shifted. Our interviews with 32 investors, representing approximately CA $4.5 trillion of assets under management, were conducted throughout the month of December 2023. In parallel we saw both the Bank of Canada and the U.S. Federal Reserve provide stability to the market, indicating that interest rates were likely to top out. This led to numerous commentaries that a steady decline in interest rates is already in market anticipations and that, should interest rates and inflation not decline, there may be some important market reactions.

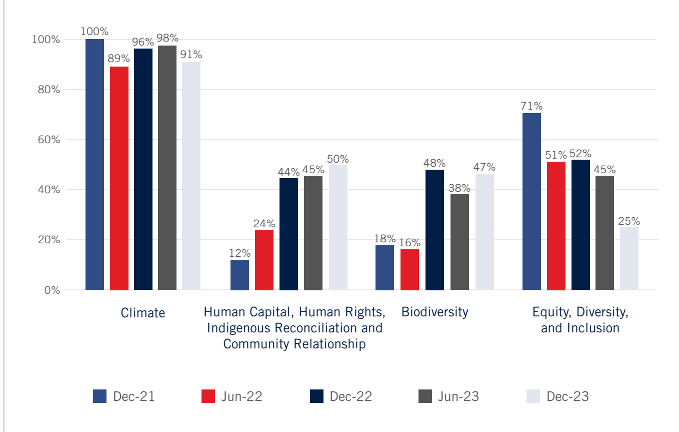
In addition, the risk of current and potential further geopolitical issues is top of mind for many investors. In particular, there is a rising concern related to social and political divides, with investors mentioning political instability in Ukraine and the Middle East, as well as elections in Europe and the United States, as worrisome. This reaction aligns with the January 2024 World Economic Forum survey of risk managers, who have also identified misinformation and disinformation as the most severe risk anticipated over the next two years[1].

Clearly the market is expecting a year of instability.

Top ESG topics

For consistency purposes, we always ask which top three ESG topics are preoccupying the institutional investor participants. There were some interesting observations in this study.

Figure 1
Most frequently mentioned ESG focus areas



Climate gets more granular, while focus further shifts away from EDI

The first relates to climate. Rather than being the only E-related topic in ESG, we are seeing a widening of the conversation from "climate change" to "environmental issues". Although climate change remains the top issue by far, being cited by 91% of investors as a top three ESG issue, there is a change in the dialogue. In previous studies, investors were focusing on developing their models and methodologies, and defining expectations. This has quickly evolved to disclosures and actions on climate, now considered an expectation in the market, similar to what we have witnessed with other ESG topics like EDI (equity, diversity and inclusion) and cybersecurity. Investors are looking for more granularity in disclosures related to climate and are highlighting their expectations – no longer desires – for transition plans, targets, risk analysis and demonstration of how organizations will adapt and mitigate the effects of climate change. As the materiality of these topics becomes understood by the market, the expectation grows that those seeking capital must address it and report on it.

The upward momentum observed over the last two years for Human Capital, Human Rights, Indigenous Reconciliation and Community Relationship continues at the expense of EDI which decreased in popularity. EDI was mentioned half as often as the broader Human Capital category.

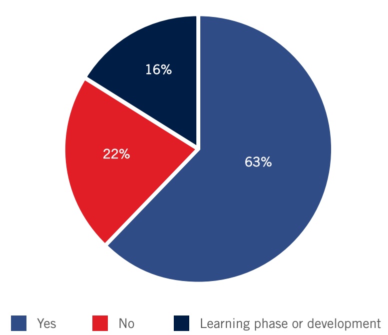
1. CNN Business, *The people paid to spot risks see high chance of 'global catastrophe' within 10 years - annual survey by the World Economic Forum*, January 10, 2024.

A rising focus on biodiversity

Closely behind in third place is Biodiversity cited by 47% of respondents as a top three ESG issue. The discussion is reminiscent of the narrative that we have seen in past studies related to climate. There is a strong acknowledgement by participants that biodiversity is different than climate, yet highly connected to the climate conversation, which explains the broadening of this conversation to "environmental issues".

Investors are in the learning stage on this topic, and by the responses received, many are not yet able to pinpoint exactly what they need beyond disclosure. One thing is clear: investors need issuers to determine the materiality of biodiversity and nature-related issues specific to their business.

Figure 2
Are you integrating any nature-related considerations into investment decision-making processes?



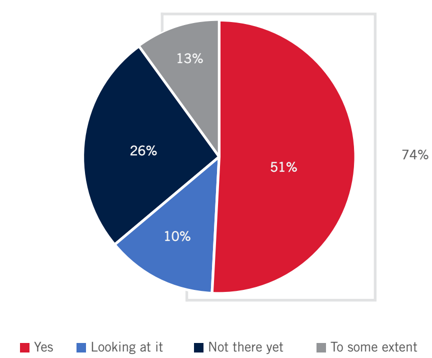
When asked about expectations for issuer disclosures, many acknowledged the newly published Taskforce for Nature-related Financial Disclosures (TNFD) framework as a potential tool for issuers' disclosures. However, given the early stages of their own understanding of the implications of these topics, the expectation is that issuers should demonstrate an understanding of biodiversity's materiality (whether it is related to land, water, forest, species or otherwise) and begin to speak to potential exposures, start value chain assessments and gather data on their positive and negative impacts. It is anticipated that there will be more focus and growing disclosure expectations on this topic. For those issuers who are already aware of their impacts, there are currently strong advantages to demonstrating and engaging on this topic.

"Now that the TNFD has introduced a framework, we want to see companies show that they know where they are exposed to biodiversity risk. We want to see that they are able to talk about how biodiversity risks are relevant to their business models." *– Asset Manager*

Now that ESG integration is the standard, bring on sustainability outcomes

As the debate over the use of the term ESG continues, we are witnessing an evolution. There is a growing expectation that integrating E, S and G factors into investment processes is but one step. Increasingly asset owners want to see reporting on measured outcomes of their investments. This is a broadening of the scope of responsible investing.

Figure 3
Has your organization started to embrace 'sustainability outcomes'?



Source: Millani, August 2023 ESG Investor Sentiment Study, August 23, 2023.

From our December 2022 to June 2023 studies, we observed a substantial increase in the number of participants moving towards sustainability outcomes, from one participant to 51% of participants indicating that they had begun to embrace it. Since then, the percentage of respondents indicating they are, or are looking at, embracing sustainability outcomes remained stable at 63% in December 2023 vs. 61% in June 2023. Some noted that the UN Principles for Responsible Investment (PRI) planted the seed with a voluntary module in their framework and as such, there are growing expectations that reporting on sustainability outcomes will become mandatory over time. We also heard from asset managers that **"We are not at all surprised. It is our clients that are asking for it [sustainability outcomes]. This is the next stage for ESG."** (Asset Manager)

As noted by one asset manager: **"We primarily embrace sustainability outcomes through stewardship. As a signatory of the FRC [Financial Reporting Council] stewardship code, we have focused on reporting stewardship activities and outcomes. We want to show what we are achieving with stewardship and show milestones."** (Asset Manager)

This is becoming the most important discussion relating to sustainability outcomes: How does one execute and who can claim the outcome? **"So, you engage with companies, so what? The natural thing to ask is what is the outcome? And contribution is important – is it your victory or is it a shared victory?"** (Asset Manager)

One asset owner cautioned that: **"Measuring is an important question [...] methodologies need to be clear. Please be precise and prove your claims [...] It is much better to say that you are producing a certain amount of green power, instead of saying 'We displaced so many emissions'."** (Asset Owner)

Given the growing oversight of greenwashing claims by regulators, investors are responding by creating processes to accurately track and report on outcomes. **"We are building our own tools to measure sustainability outcomes. We are also starting to track our outcomes when it comes to our engagement [...] the ability to have vendors that provide accurate data is vital for us."** (Asset Manager)

This leads to the question: Is investing for sustainability outcomes the same as impact investing? This is where nuances and words matter. As noted by one asset owner: **"I'm not sure "outcomes" is the correct word, there is no intent in that [...] The notion of intent is key. We talk about "positive externalities," not "impact investing". We have nothing against impact, but we are a pension fund, and we need to be careful with the language we use – especially as impact is still closely associated with charity."** (Asset Owner)

The surprise: impact investing is here!

And yet, our study indicates that 43% of asset managers plan to launch impact products in 2024. We have witnessed some of the misleading marketing claims relating to ESG or sustainability funds. The market must learn not to make the same mistakes as we evolve from ESG integration to sustainability outcomes and impact.

In 2023, the Global Sustainable Investment Alliance (GSIA), the CFA Institute and the UN PRI, issued a new resource that aims to bring greater understanding and consistency to terminology used in responsible investment. According to their definition, impact investing is "investing with the intention to generate positive, measurable social and/or environmental impact, alongside a financial return." Going further still, the definition notes that "allocating capital to investees that have a net positive impact is not impact investing, unless there is a credible expectation that the investor will play a contributory or catalytic role in generating an improvement over the status quo."

This underlines the differences between investing for sustainability outcomes and impact investing. There are four elements to consider for impact investing: intentionality, measurability, additionality, and financial performance. When it comes to sustainability outcomes, often intentionality and/or additionality are not present.

Figure 4
Sustainability Outcomes versus Impact

	Sustainability Outcomes	***Impact***
Financial Performance	✔	✔
Measurability	✔ How operations contribute to global objectives, positive or negative	✔ How operations intentionally create positive impact
Intentionality		✔ The impact must be intentional
Additionality		✔ The contribution must enable a net positive impact

We asked participants what is holding back impact investing in Canada. A clear response was education relating to perceptions. The hurdle mentioned most frequently is the perception that one needs to give up financial returns, which may go against fiduciary duty.

As noted by one asset manager: **"It is just about proving to everyone that this approach [impact investing] can generate enough financial returns so that asset owners feel like they are meeting their fiduciary duty ... we probably just need time to get asset allocators comfortable with the approach."** And many managers feel that the hard part of proving returns is already behind us with one specifically mentioning, **"of all of our funds, our impact fund is the best performer in the past 5 years."** (Asset Manager)

We've lived this before with ESG. The need to prove out that integrating ESG issues into investment processes doesn't hurt returns and are within one's fiduciary duty. However, many market conditions have changed, which now provide for financial returns and impact. Educating and limiting "impact washing" will be key.

"There is still too much greenwashing [impact washing] in the industry. We need LPs [asset owners] to be skeptical and do good research and due diligence, to hold asset managers to the test, and flush out organizations who use the word impact [and don't meet its proper definition]." *– Asset Manager*

Given the number of firms suggesting they will launch impact products this year, both those asset managers and their clients would do well to ensure that they are clear on definitions, language used and marketing practices. Regulators have updated their oversight of ESG products, and missteps for investors could have reputational and financial implications.

To get to impact, issuer double materiality assessments are key

With this growing demand for sustainability or impact products, investors clearly expressed that they need issuers to provide information and disclosures. Millani's seventh annual ESG disclosure study of S&P/TSX Composite Index constituents released on October 11th, 2023 showed that 19%[2] of materiality assessments undertaken by the constituents are currently applying a double materiality approach – providing information related to their financially material risks and opportunities, as well as their positive and negative impacts on society and the environment.

In our December interviews, 31% of investors indicated they have noticed this trend, up from 19% in June 2023. And when asked if a double materiality approach is useful for investment decision making, they acknowledged that this approach allows for a more holistic picture, unlocking risks and opportunities that would be overlooked through a financial materiality lens only and that negative impacts become risks over time. **"Today's externalities are tomorrow's risks and the day after's losses."** (Asset Owner) Many noted that the double materiality approach is important for the creation of impact products, for their assessment of the positive or negative impacts of the entities that they invest in.

In January 2023, the Sustainable Finance Disclosure Regulation (SFDR) came into effect, where financial market participants and advisors are now required to publish a Principal Adverse Impact (PAI) statement. The PAI relates to any impact of investment decisions or advice that results in a negative effect on ESG issues such as environmental, social or employee concerns, respect for human rights, anti-corruption, or anti-bribery matters.

"With SFDR, [double materiality] is very important. In our universe, we look at the mandatory PAIs for SFDR, and we try to look at the voluntary PAIs. The covered universe is not great, some of them have coverage as low as 2%. It is challenging, in the sense that when you have that low of a number, we must start on our own to fill out what those numbers are. We need the companies to disclose their impacts, or we have to make estimates." *– Asset Manager*

"Double materiality is very important for us to be able to assess the company's impacts on society and the impacts on its financials as well. It does open and unlock some risks and opportunities that we would not have seen through a financial materiality lens only. So, because we have to do this with SFDR, it makes us go the extra mile and allows us to get the full picture, and it is part of our due diligence. The growth of double materiality will help to have more and better sustainable investing funds." *– Asset Manager*

"The growth in double materiality will be closely aligned with the growth in sustainable investing solutions that meet [SFDR] article 9, and this is a big risk for Canadian issuers … because when we build our portfolios and they [issuers] don't disclose on double materiality, they lose access to capital. The earlier they do double materiality, the more likely they are to get into one of our sustainable investing solutions." *– Asset Manager*

In addition, participants also noted for them to fully embrace this evolving market development, they require a high enough threshold of issuer participation in double materiality disclosure in order to get comparability.

The European regulation, the Corporate Sustainability Reporting Directive (CSRD), will drive these disclosures in 2024. The first reporting cycle for the CSRD, which is expected to cover the 2024 financial year with reports scheduled to be published as soon as January 1, 2025, will require issuers to disclose using this double materiality approach. Although the *Wall Street Journal*[3] suggests that as many as 1,300 Canadian companies will need to report, the competitiveness for capital will drive issuers not required to comply to embrace this materiality approach as their competitors do.

Our experience is that leading issuers have already understood this market dynamic and are actively working to determine the added value of double materiality assessments. We anticipate this movement will breathe new life into issuer disclosures and that comparability will follow shortly. Not to be forgotten, and as noted by one investor, with societies changing expectations, issuers should also remember that **"investors are only one stakeholder, and that issuers have other stakeholders that appreciate and expect such disclosures from companies."** (Asset Manager)

One should also take into consideration that as many of these funds are deployed, given the nature and need to measure these impacts over the longer term, the turnover in these funds is anticipated to be lower. As such, those who embrace the double materiality approach may have a first mover's advantage and be more attractive to long-term investors.

2. An update to *Millani's October 2023 ESG Disclosure Study* was conducted to account for reports published between August 31 and December 31, 2023, which revised the percentage of double materiality assessments undertaken by S&P/TSX composite index constituents to 17%.
3. Wall Street Journal, *At Least 10,000 Foreign Companies to Be Hit by EU Sustainability Rules*, April 5, 2023.

Impact may still be in a nascent stage, but that is shifting quickly – perhaps quicker than many in this market anticipate. There are some warning signs to be aware of, including **"the need for better understanding and education efforts on the part of the industry. There is a lot of confusion between true impact funds and sustainability outcome funds."** (Asset Manager)

As well, as it develops there are variations in views on where impact and financial returns can be found. As noted, **"You can't do impact on a big cap market. Most impact still is in the private market space. In the publicly traded space, you can only have impact in liquid, small cap markets. Other than that, it is mostly sustainability outcomes as opposed to impact."** (Asset Manager)

And as one manager noted **"[We are not planning to launch an impact fund] because I don't think you can have an impact in public markets. I don't think you can have additionality. We only have one product, but it doesn't mean that we will not measure our impact, we will just not label it impact."** (Asset Manager)

There are a variety of views on this point and much discussion to be had, and we expect that as the market develops, this debate will continue but, given the enthusiasm we have witnessed in this study, we believe impact investing is here to stay.

Will a Canadian climate taxonomy support this market development?

Many of the impact-oriented funds anticipated in 2024 are aligning with climate-related investments. With the UN PRI having increased its focus on signatories' public policy engagements, we note that 57% of respondents indicated they or their firm engage on public policy issues.

Efforts for a green and climate investment taxonomy in Canada is where many have focused their efforts. One pension plan noted that **"to look at outcomes and impact, I think a taxonomy would be very helpful."** (Asset Owner) Our previous studies have indicated that Canadian investors are hungry to invest in climate transition-oriented investments, so we gauged their reaction to the Canadian federal government's 2023 Fall Budget announcement that "the Department of Finance will work with Environment and Climate Change Canada and Natural Resources Canada to [...] develop a taxonomy that is aligned with reaching net zero by 2050."

Of those who responded, 25% indicated that it's a positive move, however 63% indicated that they felt that Canada was losing its competitive position and that this announcement was late in coming. In general, there was an overall sentiment of frustration at delays in moving forward with a taxonomy and a high degree of skepticism that this announcement was more about delaying efforts than advancing to meet the market's needs.

"In terms of the announcement, we would like it to be quicker. We will be patient, but we are a bit frustrated with the amount of time it is taking. The longer it takes, the more Canada will be penalized, and so will our investments." *– Asset Manager*

"We can't fall behind the rest the world. We don't know, as investors, where to invest the capital in line with the country's objective." *– Asset Manager*

"It is disappointing to see the lack of oversight of our federal government on Sustainable Finance. There is no leadership on that front, and there is reluctance to engage on this important topic while the rest of the world is pushing [forward]. We have no way out for our Canadian companies [except to follow] the US and EU requirements." *– Asset Owner*

As disappointed as investors are, it is not stopping them from moving forward with investments. Of the participants, 69% indicated that they were already investing in new technologies, either with direct investments (12%) or indirect investments as issuers in their portfolios invest in such technologies (50%). Capital appears to be sitting on the sidelines with strong desires to invest in the Canadian economy and to support fund managers who are making efforts to flow capital to Canadian entities. The message is clear: a taxonomy, whether from the federal government, or not, will unlock that capital.

Conclusion

Markets are moving towards impact.

Having been in the ESG arena for more than 15 years, we have lived through the phases of its evolution. We see many parallels as impact begins to gain ground.

The ability to have competitive market performance, and impact, through investments, while meeting one's fiduciary duty, is possible. This understanding is about to create a new dynamic in capital markets.

Given the number of firms who anticipate launching impact funds in 2024, one should keep in mind that regulatory oversight of "greenwashing" and "impact washing" will be present in this phase of the market's development in ways it wasn't in the earlier development of ESG. Asset owners and asset managers would be best to ensure that they have solid due diligence and monitoring processes, use appropriate language, and create appropriate strategies for their investments and products.

Given the growing focus on sustainability outcomes and impacts, issuers would benefit from getting ahead of this trend and embracing the double materiality approach. Regulations are moving in this direction and those who seek capital for growth would be well advised to seriously consider a double materiality assessment for reporting and disclosures in 2024 and beyond.

The market is evolving from ESG integration to impact of investments. Those who prepare well will be positioned to gain early competitive advantages.

Contributors

Thank you to our contributors who took the time to provide their insights on key ESG trends. Our contributors represent 32 of Canada's largest institutional investors, some of which are listed below.

About Millani

Millani provides responsible investing and corporate sustainability advisory services, including ESG integration and impact, to both investors and companies.

For the past 15 years, Millani has become the partner of choice for institutional investors and corporations alike. By providing advisory services on integrating material ESG issues into investment strategies and decision-making processes, Millani helps reduce risks, increase returns and create value. Millani also regularly develops leading thought leadership on investor and disclosure trends. The firm leverages this expertise and experience to help corporations, both public and private, create strategies, engage with stakeholders and strengthen their disclosures, supporting the organizations in their access to capital and optimization of market value.

Millani's success is founded on a bespoke, client-centric approach that focuses on material issues, practical implementation, and independent advice. Our extensive capital market experience and unparalleled expertise in ESG, and its connection to value creation, position Millani at the nexus between investors and companies—making us unique in the Canadian market.

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