The 2021 ESG Roundtable

Pandemic Boosted ESG Momentum

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Even prior to the pandemic, attention on ESG (environmental, social, and governance) factors was gathering momentum, says Priti Shokeen, Head of ESG Research and Engagement at TD Asset Management.

In the *Benefits and Pensions Monitor* Roundtable discussion on ESG, with Aaron White, Vice-president, Sustainable Investments, at CIBC Asset Management, Inc., and Jenn-Hui Tan, Global Head of Stewardship and Sustainable Investing, at Fidelity International, Shokeen said the inflection point was around 2018 where "we essentially saw ESG factors contributing to portfolio performance compared to the benchmarks." The pandemic just supported some of the underlying pieces that economic growth needs to happen holistically in conjunction with our living environment and in conjunction with our communities in a fair and equitable way.

White said we were seeing a combination of the existing significant and growing trend of ESG adoption leading into the pandemic, combined with the unfolding scenario of how exactly non-financial risk can meaningfully impact risk adjusted performance of portfolios. "We had a front row seat to really see the varying degrees of impact at both the sector and the individual company level and how quality management teams were able to navigate the crisis," he said. This really changed the way a lot of investors think about ESG considerations and how material their impact can be.

Tan attributes the growing interest to the theme of corporate resilience. "What we have seen in the pandemic is the importance of that resilience, whether it's in terms of your supply chain and how robust it is or whether it's in terms of your employee welfare, how well they're being looked after."

Why does climate seem to attract all the interest?

Tan: It is the existential crisis of our generation and, from a historical perspective, it's one that we have created in a remarkably short space of time. If you look at the buildup in the emissions curve, almost half of the carbon emissions have been emitted since the 1980s. While emissions growth has slowed over the last few years, they have rebounded post-pandemic and we are far from a peak. That's probably why climate does, and rightly should, get a lot of the attention.

Shokeen: The most critical challenge is climate change. It is a systemic issue and it's already affecting companies and their results. It's not something on the horizon, it's happening now and we're seeing companies adapting their business strategies and diversifying away from the current business models that are deemed risky from a climate change perspective.

The transition is already happening in the economy. The inflationary aspect of climate change continues to be a challenge for investors as well as companies because their operational costs are going up.

White: It's also the pressing nature of the issue. If you follow the UN's Intergovernmental Panel on Climate Change and its results,

it's very clear that, based on its climate scenarios, we need to steer towards the most aggressive mitigation scenario. Ultimately, that means immediate and pressing action by all global stakeholders. That's one of the main reasons why I believe it continues to garner the most attention.

What are the ESG issues that institutional investors face today?

White: For institutional investors, the primary challenge is data availability and accuracy. This has certainly improved significantly over the last several years, particularly from larger global issuers that have the resources available to them to provide robust sustainability reporting. However, when we work down the capitalization spectrum or look into more emerging markets, data access and accuracy becomes probably the most challenging aspect of evaluating the ESG risks of a company.

We're also facing rapidly evolving regulatory environments in which regional standards and taxonomies differ. This creates a significant challenge related to effectively solutioning for our clients and then developing and anticipating the various reporting needs for our strategies in order to fulfill the needs of each of our regional investors.

Tan: As a firm, we have focused this year on three specific stewardship priorities in response to the pandemic. The first is our challenge to build back greener: how are we valuing our natural ecosystem and particularly how the loss of biodiversity is posing a systemic risk for investors and society. Our view is that biodiversity loss is as much of an existential risk as climate change. Indeed, the two are inextricably linked.

The second is around how we build back stronger: the pandemic's disproportionate impact on our most vulnerable, yet essential, workers has both revealed and exacerbated societal inequalities. We have put pressure on our investee companies to take greater accountability for their employees, communities, and their supply chains, voted against boards which paid executive bonuses where they also accepted government support, and promoted initiatives to narrow the gender pay gap.

The third is around the issue of digital ethics and inclusion. Increasingly, access to modern society requires access to digital tools – for needs such as job searches or even vaccine appointments – and these tools have enabled many of us to continue working or studying from the safety of our homes. But half of the world doesn't have access to the internet and divides persist between emerging and developed countries and urban and rural areas.

At the same time, the increased use of digital channels is going to be permanent and there needs to be much greater focus on the implications – topics such as privacy, cybersecurity, online welfare, misinformation, and ethical AI design. We have sought to understand how our ICT companies are addressing and evolving their approach to these issues.

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Shokeen: We need ESG information which is consistent and more standardized. We utilize ESG information to ensure we're capturing financial as well as some of the non-financial factors that play a critical role in delivering on our investment objectives. In our minds, intentionality matters the most and being transparent about that intentionality is important. Unless there's a specific process and objective built into the construction of those portfolios, they are not labelled ESG.

Who has to take the lead in coming up with a consistent global ESG standard?

Tan: Everyone talks about ESG's growth – at first slowly, but now very rapidly.

When we have these discussions, we tend to assume that a lot of the infrastructure to take on these global challenges already exists. However, often it has not actually been built yet. Every day there are new codes, coalitions, organizations, campaigns, pledges, etcetera. All of these things are bubbling from the bottom up.

What is terrific about this kind of explosion of initiatives and ideas is that different firms can and should prioritize the different things that they choose to focus on in ways that are relevant to their organization.

That being said, what is key is the spirit of collaboration and open dialogue between different stakeholders, including policy-makers, NGOs, standard setters, asset owners, and companies. We need a consensus to emerge in terms of what are the right things to measure and how we should be measuring them. Things are never going to be perfect – look how long we have been working at financial reporting standards – but we all know we need to make progress now.

White: There are some positives and some negatives in creating a more merged global understanding.

We are very much in the infancy stage of this explosion of growth. This area has been around for four decades, but only in the last three years has it really moved to the forefront of discussion within our industry. So we now have a lot of extremely capable people all around the world starting to focus a significant amount of resources and attention on it.

However, one of the biggest barriers to building out ESG capabilities in any firm today is finding talent with the necessary expertise. It's virtually impossible.

Shokeen: IFRS is working on producing a global standard and that's a very welcome move.

We do need consistent metrics and reporting, especially corporate reporting that's following a standard and is assured to some degree, but it's complex because in ESG, it's a mix of soft metrics as well as quantitative metrics. Employee engagement or human capital indicators, for example, are captured in soft metrics, whereas carbon emissions is quantitative.

With IFRS, we expect a good quality global standard for ESG, something we all can benefit from.

How do institutional investors manage community values, alongside their traditional fiduciary duties?

White: If we think about this from the per-

spective of an institutional investor, I have never seen the level of pressure coming from stakeholders as I have in the last 18 months. There has been an explosion of interactions between stakeholders who are continuing to mount pressure for more values aligned with their communities and the broader stakeholders of their organizations. So we spend a lot of time working with clients and prospects on how to best implement those non-financial objectives into their investment policies and guidelines, ultimately working towards strategies that can continue to accomplish their financial objectives.

This is a trend that's not going away.

Tan: A lot of what we're talking about goes to the core of our fiduciary duty.

One of the things that we always need to remember as asset managers is that it's not our capital, it belongs to our clients and our duty is to manage that capital in a way that meets their long-term financial objectives. We integrate ESG because we believe that this is consistent with that fiduciary duty. And indeed, it is now increasingly a necessary part of executing that fiduciary duty.

But ESG is not a mandate to go and take other people's capital and stake out positions on things that are not relevant to their long-term positions. It's a mandate to use it in pursuit of our clients' objectives.

Shokeen: Client driven ESG mandates are always welcome as they integrate the client's community values with their financial objectives. So those are specific to clients and it is part of the investment management apparatus to cater to those requirements. At a firm level, we integrate ESG in our investment analysis and some of those factors may affect valuations. We also engage with companies on a regular basis and it's not just to ask them about their financial metrics. We have focused ESG engagements that are valuable tools in our toolkit to fulfill our fiduciary responsibility. This provides us with a window of opportunity to do more due diligence that can affect the value of our investment. Engaging with ESG actually helps us understand the company and do better due diligence. Secondly, it gives us an opportunity to set out expectations as an investor, which helps our investing companies do a better job, be better prepared, and have more resiliency to mitigate and better manage their ESG risks and their opportunities.

Engagement in our mind is a superior tool to ensure that we're being mindful of our responsibility. And this is especially true for real assets as we have direct influence and higher expectations of ESG performance for those assets.

Is there a right way to integrate ESG considerations into the investment decision-making process?

Tan: The way we choose to integrate ESG is twofold. We want to build it into our investment research process. We want our fundamental analysts to be analyzing companies on their sustainability characteristics, as well as their fundamental characteristics. In order to comprehensively understand the risks and opportunities of our investments, we must comprehensively understand their management of sustainability characteristics. Therefore, we don't think that this is an activity that should be done by a siloed sustainable investing team. For that reason, at Fidelity we've placed the obligation to create ESG research and ratings on our team of 180 investment analysts, leveraging their sector knowledge and relationships with companies to gain unique insights into companies' practices

WE TRACK OUR CLIENT MEETING TOPICS AND THE ONE THING THAT STANDS OUT IS THE RISE IN INTEREST IN SUSTAINABILITY. IT HAS BECOME THE MOST DISCUSSED TOPIC IN OUR CLIENT MEETINGS. THE INTEREST IS GLOBAL - Tan

The second is through engagement. We do a lot of company meetings, on average 16,000 meetings every year across the world. We use these meetings to do more than just extract information. We also extract insights and engage with companies as well as promote the kinds of sustainable behaviours that we think are going to create long-term shareholder value.

Shokeen: ESG performance and financial performance in the long run are generally considered to be aligned. One way to make sure the process is aligned to the investment objective is to ensure that the data that goes into that particular process is solid and fit for purpose. Getting those ingredients right –input, output, and reporting – is the roadmap to success for the ESG integration.

White: ESG integration has to be done authentically. We often hear of investment managers who say they've been doing ESG for the past 30 years, but they only focus on very specific governance factors within their existing fundamental framework. To my mind, that is not authentic. They're not truly trying to understand the non-financial factors that drive material financial performance and integrate those risks into their financial considerations.

Where does client demand fit into all of this?

White: Client demand is accelerating, as is the number of meetings that have focused exclusively on ESG over the last 18 to 24 months. Previously, many of our clients and prospects weren't focused on engaging on ESG issues at all.

We're at the forefront of an explosion of what I call 'creative solutioning' related to responsible investing, data integrity, and accessibility. This is continuing to increase and creating more options available to us as asset managers to deliver unique and custom solutions for our clients that are outcome-focused.

Tan: We track our client meeting topics and the one thing that stands out is the rise in interest in sustainability. It has become the most discussed topic in our client meetings. The interest is global – it has now penetrated all of the markets in which we do business and is at the forefront of people's minds.

It's not just the number of our clients that are interested in sustainability that is growing; but their sophistication in discussing and understanding the topic is rapidly developing which, in turn, increases expectations.

Shokeen: Clients now have, especially in the institutional space, established investment rationales and policies for ESG. Clients are also seeking more transparency on ESG at the portfolio level and are interested in how

ESG works at the portfolio level for their investment objectives.

How do you apply ESG in evaluating investments from high-income and low-income countries?

Shokeen: We have seen some parts of the world getting dinged on ESG. There are companies from specific countries that we will see on a regular basis being rated on the lower end, compared to some of the other industry players.

How we approach it is more of a balance between our global view versus regional accommodations. For example, at TDAM, we focus a ton on racial diversity in Canada and the U.S. We think that social inequalities can create imbalances within financial markets and affect economies in negative ways. If taken care of, they could actually produce positive growth for our economies.

But in Japan, given the demographics, we would focus a lot more on gender diversity. Our expectations on ESG are reflective of the local composition or demographics or the market that the company is operating in.

Another example would be national targets on GHG emissions. China, for example, has committed to net-zero by 2060, not by 2050, given their economic development needs. Marrying their economic objectives with ESG objectives is critical for those economies to ensure a just transition.

Tan: Sometimes there is a tendency to view ESG as a top down driven process. Clearly elements of that are true – climate change is a global crisis.

But, to genuinely integrate ESG and particularly to promote it with the companies in which we invest, we need to understand and apply ESG in the context of their local market and the objectives of their regulators and their policy. For us, this means interpreting ESG from the bottom up, recognizing that there are going to be differences in materiality factors between different industries, different geographies, and different business models. This is why we have a global team spread out across seven markets, five of those in Asia. We are not going to get a solution to any global ESG issue without that solution going through, or originating from, Asia.

White: There are also considerations across the capitalization spectrum. So our expectations for a micro-cap company versus a large multinational company in terms of resources and their ability to integrate ESG considerations into their structure is extremely varied. We often have the opportunity to work with smaller capitalization companies along their sustainability journey as larger shareholders of those organizations. We spend a lot of time within our small cap team working with those organizations in order to improve disclosures and to understand what we believe is material and where we can have the most impact in terms of our engagements.

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What sort of challenges do you think the industry faces over the next 10 to 15 years as firms declare net-zero commitments?

White: There are a lot of challenges across net-zero commitments. We've seen corporations make commitments without measurable interim targets that are achievable. That's the biggest factor to consider when evaluating the authenticity of the commitments. We want to see science-based targets that are integrated into the company's net-zero objectives. We want to see interim targets that are achievable. We also want to see buy-in across the organization from senior executives. And we want to see interim targets that are tied to executive compensation.

Shokeen: For us, it's ensuring we're on top of how these commitments are being met, but also how they affect business strategy and models for these companies. For example, in oil and gas, we're seeing investors offloading a lot of their assets which are linked to fossil fuel extraction and development.

The speed of this transition to mitigate physical impacts of climate change and related financial implications is really at the heart of our fiduciary responsibility and that is where it's going to be challenging creativity and innovation – that push and pull factor on meeting the climate commitments, while also maintaining profitability in some of the highest risk sectors. It's also a window of opportunity – electrification is offering strong demand for the semi-conductor industry from electric vehicle manufacturers and other sectors. Those are pockets of opportunity for those companies that get it right while being consistent with reducing carbon emissions across their value chains.

Tan: The reality is that you can't just assess whether or not they've made a plan, you must assess the credibility of that plan. Interim targets provide some comfort that a company can be held accountable to achieving its long-term commitments.

However, it is critical to understand how commitments are being operationalized. This includes, allocating capital to be consistent with achieving net-zero, how companies are organizing their governance structures to ensure proper oversight and accountability, and how their climate lobbying effort aligns with what they say are their ambitions.

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