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Evolving ESG Evaluations:
Considerations and Changing Expectations

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Amidst ongoing global uncertainty, institutional investors continue to seek investments that shelter their capital from risks while also generating strong returns. Even before the global crisis caused by the COVID-19 pandemic exposed the importance of public health policies to investments, there were reasons to think about environmental, social and governance (ESG) issues when making investment decisions.

Market participants and stakeholders continue to witness rapid change in the way markets assess, measure and respond to nonfinancial factors ranging from governance concerns, public health and climate change, in turn driving ongoing focus on investing through an ESG lens.

ESG INTEGRATION

In Canada, investors are increasingly looking at how ESG metrics can inform the oversight of assets. Investors are on the lookout to achieve financial returns while also incorporating and mitigating ESG risk, generating long-term value, and creating positive impacts on society. Demand is growing for investors to take ESG factors into account, thanks in part to interest among end investors, pension plan members and other stakeholders to align investment decisions with their values. Regulatory evolution is also a factor – from global influence such as the UN Principles for Responsible Investing, or local demands such as a requirement for Ontario-registered pension plans to disclose whether they consider ESG factors in their investment processes, and if so, how those factors are considered.

There is a rapidly growing business case behind considering ESG in investment decisions and the investment community is mobilized around it - currently, there are $2.1 trillion in responsible investment assets under management (AUM) in Canada with a 41.6 per cent growth over a two-year period. This represents 50.6 per cent of all Canadian AUM. Canadian investors have become more particular about how they deploy their capital and seek to deliver returns with ESG factors as a key consideration.

CLIMATE CHANGE CONSIDERATIONS

Institutional investors are increasingly integrating climate considerations into investment decisions to increase low carbon investments and screen out companies with high emissions and fossil fuel reserves.

Even before the global crisis caused by the COVID-19 pandemic exposed the importance of public health policies to investments, there were reasons to think about environmental, social and governance (ESG) issues when making investment decisions.

Whether these decisions are built in a values-based framework (e.g. where organizational stakeholders or policies direct investment away from carbon-intensive industries), or they are rooted in a value-based framework (e.g. seeking to reduce exposure to oil and gas as part of an investment thesis, or even exploiting differentials in relative carbon efficiency within a segment as part of a **"green beta" strategy)**, forward-looking analysis of potential sources of risk and return can inform the strategic asset allocation decision-making process by calculating how exposed the institution's investments are to changes in global temperatures.

IMPACT INVESTING REDEFINING THE ROLE OF CAPITAL

For some, the philosophy behind ESG investing is anchored in a belief that healthy markets require stronger economies and stable societies. For these institutions and investors, investing has to be about 'doing well' while also 'doing good'. This may be particularly relevant in values-driven organizations, for example faith-based organizations or mission-driven foundations who nonetheless seek to generate return for their members or underlying investors to support the long-term goals of the organization, as well as the increasing array of responsible investment funds that are seeing growing popularity - particularly among millennial investors. Across the spectrum, investors are demanding transparency on ESG issues and looking for additional investment options that may lead to positive ESG outcomes. Some investors are pursuing impact investing as a way to drive innovation in alternative technologies that may reduce the environmental impact of more traditional solutions. As millennials continue to accumulate wealth, financial services firms may see opportunities to shift strategies and create values-based investment options and products.

MATERIAL ESG FACTORS DRIVING POSITIVE FINANCIAL RETURNS

Some institutional investors have embraced the idea of "materiality" to determine which ESG concerns are relevant to particular investments. For many years, investors have been concerned that ESG investing requires compromises on investment return objectives. In fact, there is **evidence** to suggest that a focus on ESG investing does not require a reduction in investment return expectations.

A growing array of data reinforces the strength of ESG strategies during the COVID-19 market crisis supporting what many have been saying for years: ESG is not only good for the world, it's good for returns. According to Morningstar, global sustainable funds recorded U.S $45.6 billion of inflows over the first quarter of 2020 during a period where a net $384.7 billion was withdrawn from the overall fund space.

Going forward, we continue to monitor anticipated growing investor appetite for ESG as well as the ongoing innovation as investment managers launch new responsible investment products to capture the growing demand. There are also a variety of drivers such as the incorporation of climate risk into investment strategies, financial opportunity, and making an impact.

EUROPEAN INITIATIVES LEAD THE WAY FOR ESG REGULATORY MOVEMENTS

Globally, policymakers and regulators are playing a significant role in shaping sustainable investment practices. Europe has taken the lead in being a market mover for sustainable finance by creating a number of policies including both disclosure and taxonomy regulations. Recently, the European Union (EU) announced their proposal for a significant financial recovery program worth $750 billion euros to finance their recovery from the economic collapse related to COVID-19. In its proposals, the European Commission laid out their vision for their post-pandemic recovery funds, indicating that they intend on harnessing the full potential of the EU budget. Among other initiatives, EU policymakers also stated their intent to incorporate a number of 'green objectives' that would be tied to the various strategies – designed to help the EU achieve its goal of becoming carbon neutral by 2050.

The focus is on supporting the recovery of their economy while also investing in their future. This includes a number of climate-friendly expenditures designed to drive a 'green recovery' rather than support investment into activities or businesses that increase or intensify carbon emissions. Similarly, the ECB (European Central Bank) announced earlier in May its guide on climate-related and environmental risks, inviting comments from the industry specifically around how they expect banks to prudently manage climate-related and environmental risks within their disclosures and frameworks.

One of the core challenges around ESG investing and data is the disparity in approaches between various market and regulatory regimes. For example, in the United States, the U.S. Department of Labor (DoL) on June 23, 2020 announced a proposed rule[1] intended to provide clear regulatory guideposts for plan fiduciaries related to ESG. Specifically, the DoL noted that regulated (ERISA) US plans should be managed with unwavering focus on providing retirement security rather than with the incorporation of non-financial factors. The proposal acknowledges that ESG factors can be pecuniary factors, but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.

SOLVING ESG CHALLENGES: VALUABLE DATA, SIMPLIFIED SOLUTIONS

Today's complex market challenges include the growing need for both greater consistency in, and increased access to, the best practices of ESG investment. Among these best practices is the need for customization to reflect individual preferences, standards to support the ESG investment process, and demonstrability of ESG representation in sustainable investments. Asset managers, asset owners, insurance companies and other institutional investors can expect demands for greater transparency around ESG investing in their portfolios from internal and external stakeholders.

Across the spectrum, investors are demanding transparency on ESG issues and looking for additional investment options that may lead to positive ESG outcomes.

Institutional investors also continue to seek solutions that enable them to manage, monitor and analyze ESG factors across their portfolios, with easy access to simplified but comprehensive information about how a portfolio is scoring against key ESG and sustainability metrics.

1. U.S. DEPARTMENT OF LABOR PROPOSES NEW INVESTMENT DUTIES RULE https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623-0

In response to this growing demand, our global enterprise continues to develop tools to support ESG investor analysis, along with building out the necessary data set. We understand that many institutional investors need solutions that incorporate their ESG preferences and leverage data as an asset. We also recognize that ESG means different things to different investors based on their underlying stakeholders, organizational values and policies, and indeed their jurisdiction (e.g. the growing divergence in regulatory approaches to ESG consideration between the US and EU).

As we continue to monitor investors' rapidly evolving attitudes and explorations of ESG, we see its influence on a macro level and how it is driving change not only in the way organizations go about their business, but also in the way it defines itself and thinks about its own role in the world. While this paradigm shift works its way through our industry, these trends will be the defining challenge not just for the current generation but for generations to come.

For more information

Contact your Relationship Executive or Relationship Manager or visit www.cibcmellon.com.

We invite clients to consider a few questions within their own organizations, among their stakeholders and in collaboration with their CIBC Mellon relationship manager:

1. How do you see the role of ESG factors in your investment or risk management processes?
2. How has the pandemic changed your organization's or your stakeholders' views on ESG?
3. What is your organization's view on the future of ESG?
4. For multi-jurisdictional plans with operations across market regions with differing approaches to ESG, how will the plan navigate those complexities?
5. How does ESG figure into the organization's future investment, performance, compliance and reporting requirements? What are the implications for the organization's investment information data strategy?

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