



Is your ESG data unlocking long-term value?

Why nonfinancial information, data analytics
and better performance insight can be key to
enhancing the ESG premium

Sixth global institutional investor survey
November 2021



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The better the answer.
The better the world works.



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Foreword

The latest EY investor survey could not come at a more important time in the evolution of environmental, social and governance (ESG) principles. The COVID-19 pandemic has been a tipping point for ESG-driven approaches in both the investor and corporate communities, acting as a catalyst for even greater integration of ESG considerations into investment decision-making and corporate strategy. I am therefore pleased to introduce this sixth edition of EY research into investor perspectives on ESG performance, and the central role it plays in investors' decision-making and long-term investment management.

It seems ironic that, when the COVID-19 pandemic first took hold, commentators were initially concerned that it might undermine the momentum behind ESG. The concern was that companies would be forced to deprioritize sustainability principles because of pressure from the COVID-19 pandemic response and economic disruption. In fact, the research shows the opposite effect: ESG has actually been catalyzed by the COVID-19 pandemic and moved to center stage.

It is clear from this research that ESG principles have never been more important to both institutional investors and the corporate community. There are a number of possible reasons for this. First, the devastating impact of the COVID-19 pandemic on global economies has acted as a wake-up call, providing a glimpse into how climate risk could threaten our economic and social fabric and how ill-prepared many institutions are for major systemic risk. Second, the COVID-19 pandemic has also focused attention on social inequalities and workforce risks, placing increasing demand on companies to go beyond their regulatory obligations and take responsibility for driving social impact in areas such as inequality.

While I am pleased that ESG occupies center stage, the research also shows that there is still much for the investor and corporate communities to do to help ESG-driven approaches provide greater impact. In particular, there are continuing concerns about the transparency and quality of companies' ESG disclosures, particularly the materiality of the ESG aspects focused on. In fact, this concern is growing: 50% of investors surveyed said they are concerned about a lack of focus on material issues - an increase from 37% in 2020.

Addressing these issues and helping ESG-driven approaches provide a value premium will likely require two priorities to be tackled. First, that corporates provide investors with better-quality ESG data from companies, which in turn requires standard-setters and regulators to make concrete progress on establishing a clearer regulatory landscape for ESG reporting standards. Second, that both investors and corporates put in place a bold and forward-looking data analytics strategy. For corporates, this could be important in delivering trusted and financially material ESG reporting insight to help stakeholders better understand their long-term value strategy. For investors, this could be important to managing ESG risks and help to generate an ESG premium.

I would like to extend my thanks to the more than 320 institutional investors who participated in this year's research. As public opinion becomes ever more sensitive to ESG issues, our collective approach to ESG management and investment will be important in helping to rebuild in a post-COVID-19 pandemic world.



A handwritten signature in black ink, appearing to read 'Mathew Nelson'.

Mathew Nelson
EY Global Climate Change and Sustainability
Services (CCaSS) Leader

Executive summary

A turning point: the COVID-19 pandemic acts as a powerful ESG catalyst

While ESG-driven investment was a phenomenon whose time had already come, the COVID-19 pandemic has led to a rapid acceleration of broadscale adoption by investors. The research shows that, since the COVID-19 pandemic, 90% of investors surveyed attach greater importance to companies' ESG performance when it comes to their investment strategy and decision-making. But the research also found that slightly fewer than half (49%) have updated their ESG investment approaches. At the same time, the research shows that ESG risk has become an even more important part of investment decision-making and portfolio construction, with close to three-quarters (74%) saying that the COVID-19 pandemic has made them more likely to divest based on poor ESG performance. However, fewer than half (44%) of investors surveyed said that the events of the past 18 months have resulted in them updating their investment risk management strategies and processes. Finally, given the COVID-19 pandemic was a significant humanitarian crisis that brought social considerations to the fore, investors are putting a greater focus on the "S" element of ESG, as consumers mobilize on social issues.

The race to net-zero: climate change at the heart of investment decision-making

Investors are putting significant and increasing emphasis on their portfolios' exposure to climate change - both the physical climate risks and the risks from the inevitable transition toward a net zero global economy. For example, 77% of investors surveyed said that, over the next two years, they will devote considerable time and attention to evaluating physical risk implications when they make asset allocations and selection decisions (up from 73% who said the same in 2020). At the same time, 79% of investors surveyed said that, over the next two years, they will devote considerable time and attention to evaluating transition risk implications (up from 71% in 2020). However, the research found that fewer than half of investors (44%) have a highly mature approach when it comes to assessing performance from a climate risk perspective. The research also showed that corporate decarbonization is central to investors' investment decision-making, with 86% of respondents saying that investing in companies that have aggressive carbon-reduction initiatives is an important part of their strategy.

While the transition toward a net zero carbon economy presents significant material challenges, efforts by national governments to encourage the transition could also be an opportunity for investors. Over the last 12 months, 92% of investors surveyed said they had made an investment because they saw it benefiting from the green recovery. However, this opportunity could become a victim of its own success. With a potentially limited supply of suitable green investments achieving a high sustainability score from ratings providers, there is a risk of a market bubble: 76% of investors surveyed said the "shortage of supply in suitable green investments will lead to some investors overpaying for green assets, creating the risk of a market bubble."

The future of ESG investing: performance transparency and analysis capability

The research shows that investors surveyed have two priorities when it comes to making effective investment decisions based on ESG data. First, investors are seeking better-quality ESG data from companies and a clearer regulatory landscape. Companies' ESG performance disclosures are at the heart of investment decision-making: 78% of investors surveyed said they conduct a structured and methodical evaluation of ESG disclosures - when just three years ago, only 32% used this rigorous approach. However, despite the importance of ESG disclosures to investors, there are some concerns about their transparency and quality, particularly materiality. In fact, this concern is growing: 50% of investors surveyed said they are concerned about a lack of focus on material issues - an increase from 37% in 2020. Investors are clear that globally consistent standards are likely to be important to improving the quality and transparency of corporates' ESG reporting: 89% of investors surveyed said they would like to see reporting of ESG performance measures against a set of globally consistent standards become a mandatory requirement.

Second, investors should establish a forward-looking data analytics strategy to help incorporate high-quality ESG data into their investment decision-making process. Today, only a minority (45%) of investors surveyed have a highly mature approach when it comes to making use of advanced and intelligent investment analytics tools to assess ESG data and disclosures. However, the research shows the industry has significant ambition in this area: 75% of investors surveyed said they are looking to make significant investments in data management and sophisticated analysis tools.

What next?

To help ESG factors play a more important role in post-COVID-19 pandemic economic health and renewal, there are important actions for both the corporates issuing ESG reporting and the investors that then have to utilize that data.

Corporates should:

- ▶ better understand the climate risk disclosure element of ESG reporting
- ▶ make strategic use of the sustainability function to inject rigor into the process to determine the materiality of their ESG context
- ▶ engage with, and embed, the finance function to consider and align financial and value implications
- ▶ deepen engagement with investors, including understanding the new ESG disclosure requirements that can help differentiate a company from its competitors

Investors should:

- ▶ update their investment policies and frameworks for ESG investments while building an ESG-driven culture
- ▶ update approaches to climate risk so that they can better interpret and understand scenario analysis of the potential consequences of climate risks to target companies and sectors over the short, medium and long term
- ▶ put in place a bold and forward-looking data analytics strategy



A turning point: the COVID-19 pandemic acts as a powerful ESG catalyst

In under two years, the COVID-19 pandemic has had a significant impact on the global economy. The sharp shock in such a relatively short space of time has acted as a wake-up call for the world, showing the devastating consequences of major systemic risks. The parallels between the risks of a pandemic and issues such as climate change have highlighted how important ESG-informed investing can be.

Investors should update their approaches to capitalize on the increased importance of ESG

While ESG was already an important factor for many, the COVID-19 pandemic has led to a rapid evolution. Today, it is seen as central to how investors should make their decisions. The research found that:



For Daniel Wild, Global Head of ESG Strategy at Credit Suisse, the COVID-19 pandemic has acted as a reminder that the environmental pillar of ESG should not dominate the broad ESG debate. "I think the pandemic was very interesting from a sustainability perspective, because before COVID-19, and I have been in the field for quite some time now, ESG was almost the same as climate change," he says. "In around 2018-19, and I was not always happy about this, it had morphed into 'ESG equals climate change.' I think the pandemic has very clearly shown us that our economies and societies are more vulnerable than we would have thought, and in many different ways. While climate change is certainly an important issue, there are other things that are also critical, such as supply chain risks, social shortcomings, loyalty of workers and loyalty of clients. In that sense, I think the pandemic has helped bring our focus back to a broader understanding of ESG."

Establishing accountability for delivering on ESG promises

In addition to evaluating data and disclosures of companies about their ESG performance, investors are also actively looking to establish the authenticity and integrity of a company's approaches - helping to provide accountability for moving the organization from carefully crafted ESG statements to real action. For example, figure 1 shows that over half of investors surveyed now want to know whether important ESG business leaders - such as the chief sustainability officer - have enough power and influence at the very top of the table.

Figure 1: Investors take steps to establish credibility and authenticity of ESG performance

Question: Thinking about how you assess whether companies have established accountability for delivering against ESG goals, do you consider any of the following factors today?

Percentage of respondents who say they evaluate the following aspects



However, the accelerating importance of ESG factors in investment decision-making has not translated into universal action by investors to update ESG policies and frameworks as a result of the COVID-19 pandemic and other recent events. Investors were asked to think about the last 18 months - including the COVID-19 pandemic and issues such as social unrest over racial discrimination - and say whether they had taken action in a number of areas. Figure 2, which looks across the three industry segments in our research, shows that only about half of investors surveyed have updated their ESG investment approaches.

It is surprising to see that the attention ESG receives today does not appear to be matched by action when it comes to updating approaches. Matthew Bell, EY UK&I CCaSS Leader, believes this might reflect the inherent complexity and variation in today's ESG environment. "This hesitation could reflect the fact that investors are still navigating how to tackle what is seen as a complex issue," he explains. "There is huge variation in ESG policies, frameworks and assessment criteria across the industry, and there is still significant inconsistency around the disclosures that companies provide. However, even when faced with this lack of uniformity, there's still an urgent need to take the steps necessary to ensure processes are updated to match today's ESG realities."

Has the COVID-19 pandemic rebalanced the ESG world order?

Europe has traditionally been seen to lead the way in ESG investing, but this research suggests the COVID-19 pandemic could accelerate ESG's importance in the Americas and Asia-Pacific, and bring about a more consistent outlook across the areas. For example:

- ▶ Overall, 91% of investors surveyed in the Americas said that the importance that they give to corporates' ESG performance has become more important since the COVID-19 pandemic, including 41% of investors surveyed who classify it as "much more important." This 41% of investors surveyed exceeds the 28% of investors surveyed from EMEIA (primarily Europe, but also including the Middle East, India and Africa) who said it was now "much more important."
- ▶ The research also asked how investors are establishing accountability for delivering against ESG goals. In Asia-Pacific, 60% of investors surveyed said they evaluate whether organizational culture is aligned with ESG goals. This dropped to 44% of investors surveyed in EMEIA.

Figure 2: More should be done to update ESG investment approaches

Question: Thinking about the last 18 months - including the pandemic and issues such as social unrest over racial discrimination - have you taken any of the following steps in your approach to ESG investment strategy and decision-making?



The COVID-19 pandemic should be seen as an opportunity to identify gaps in the current risk management approach and areas of improvement.

Changing risk beliefs and behaviors, and the requirement to close the risk assessment gap

ESG risks have long been important in the investment industry. A study by Bank of America found that ESG failures resulted in a loss of over US\$500b in market value for a range of ESG-related events, from governance controversies to sexual harassment.¹ But the COVID-19 pandemic has still been a wake-up call when it comes to risk, with many organizations caught off-guard by it. For example, the COVID-19 pandemic revealed significant vulnerabilities in corporates' global supply chain networks, from sea freight shipping delays to shortages of critical parts in the automotive sector.²

The research shows that ESG risk is at the heart of investment decision-making and portfolio construction. The survey found that:

 74% of investors surveyed said they are more likely now to divest based on poor ESG performance than prior to the COVID-19 pandemic.

 86% of investors surveyed said they are more likely now to hold an investment based on its strong ESG performance than prior to the COVID-19 pandemic.

However, fewer than half of investors surveyed (44%) said that the events of the past 18 months - including the COVID-19 pandemic and issues such as social unrest over racial discrimination - have resulted in them updating their risk management strategies and processes. "This is a concerning gap between the volatility of today's risk environment and the will of the investment industry to update frameworks to take account of new ESG risk developments," says Mathew Nelson, EY Global CCaSS Leader. "For example, given wider use of virtual working, one area that needs increased attention is examining an investment target's

governance of its cyber-security. The COVID-19 pandemic should be seen as an opportunity to identify gaps in the current risk management approach and areas of improvement. It's important to take action and operationalize these changes to the risk environment."

For example, as discussed in *A changing risk agenda: rapid biodiversity loss represents a financial risk*³, biodiversity loss is an area that is evolving fast as a result of the COVID-19 pandemic, further demonstrating how the health of the planet can translate rapidly to a financial and operational and, in turn, investment risk.

44%

Fewer than half of investors surveyed (44%) said that the events of the past 18 months - including the COVID-19 pandemic and issues such as social unrest over racial discrimination - have resulted in them updating their risk management strategies and processes.

¹Flood, Chris. "ESG Controversies Wipe \$500BN off Value of US Companies.", Financial Times, 14 Dec. 2019, <https://www.ft.com/content/3f1d44d9-094f-4700-989f-616e27c89599>.

²Jones, Claire. "Pandemic Reveals Weak Links in Global Supply Chain.", Financial Times, 24 Mar. 2021, <https://www.ft.com/content/6458318f-deb8-48c4-8d79-d73acb3401e3>.

³Naik, Gautam. "Rapid biodiversity loss poses financial risk for business.", S&P Global Market Intelligence, 2 Feb. 2021, <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/rapid-biodiversity-loss-poses-financial-risk-for-business-new-report-finds-62432454>.

The COVID-19 pandemic was, and remains, a significant humanitarian crisis, and it has also brought social considerations to the forefront.

A changing risk agenda: rapid biodiversity loss represents a financial risk

Until the COVID-19 pandemic, biodiversity did not appear to receive the same attention as other ESG topics such as climate change or gender diversity. But today, the threat of biodiversity loss appears to be moving up the agenda. Close to half of investors surveyed (48%) said they now put more focus on biodiversity loss risks because of the link between natural capital erosion and the risk of zoonotic diseases, such as COVID-19. Furthermore, the World Economic Forum's Global Risks Report 2020 ranks biodiversity loss and ecosystem collapse as one of the top five threats humanity will face in the next 10 years.⁴

However, this is still an issue that has further to run, given increased attention from policy-makers and governments. In 2021, the UN Convention on Biological Diversity (CBD) released the first draft of a new global biodiversity framework intended "to guide actions worldwide through 2030, to preserve and protect nature and its essential services to people."⁵ Targets in the framework include eliminating plastic pollution, reducing pesticide use by two-thirds, halving the rate of invasive species introduction and eliminating US\$500b of harmful environmental government subsidies a year.

Social concerns take center stage: putting the "S" into ESG as consumers mobilize on social issues

The COVID-19 pandemic was, and remains, a significant humanitarian crisis, and it has also brought social considerations to the forefront. Many companies focused their attention on protecting their employees and helping their communities and vulnerable customers. At the same time, the COVID-19 pandemic coincided with a significant reassessment of the issue of social inequality, with a particular focus on race in a number of major markets, particularly North America and parts of Europe.

For Liza McDonald, Head of Responsible Investments at Aware Super - one of Australia's largest industry super funds - regulatory developments have also played a part in emphasizing social issues, alongside events such as protests over racial inequality, and controversies around "bullying" and company cultures.

"An important development is the introduction of the Modern Slavery Act here in Australia," she says. "That absolutely gave us the license, and the requirement really, to talk to companies about supply chains, supply chain management and how they were thinking about modern slavery in their supply chain."

"Our A\$150b portfolio is captured under the Act and requires us to ensure we're thinking about, identifying and assessing risks and ensuring we don't have modern slavery in our portfolio. That means we must engage with some managers on the issue, engage with companies on the issues, and really bring the supply chain and the workforce issues front and center. And while it's strict around the modern slavery definition, the Act supports us in talking about all human rights issues and workforce issues with companies as well."

"When we think about climate change, particularly here in Australia, we cannot ignore the social issues - for example, the impact to communities and the workforce. As an investor, we have a role to play when it comes to an equitable transition and we are focused on this when engaging with the companies we invest in."

Figure 3 (page 11) shows that investors surveyed put most of their focus on consumer sentiment when it comes to assessing a company against social criteria. For Christophe Schmeitzky, EY EMEIA CCaSS Leader, this finding reflects the importance of winning consumer trust and the increasing expectations that consumers have of brands today. "This finding could reflect the fact that consumer activism and protests are a powerful way for the public to show their dissatisfaction with companies when it comes to progress on social issues," he says. "For example, consumers have shown willingness to boycott companies that are perceived as lagging in diversity and inclusion or are dismissive of, or moving away from, climate change action. Today, consumers are increasingly willing to hold corporates to account."

⁴"Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy." World Economic Forum, <https://www.weforum.org/reports/nature-risk-rising-why-the-crisis-engulfing-nature-matters-for-business-and-the-economy>.

⁵"First Detailed Draft of the New Post-2020 Global Biodiversity Framework." Convention on Biological Diversity, <https://www.cbd.int/article/draft-1-global-biodiversity-framework>.

Figure 3: Investors are focused on consumers when it comes to social risks

Question: What are the two issues that are most important when you are evaluating a company’s performance or risk against social issues?

Top five social risk issues		
1	Consumer satisfaction	35%
2	Diversity and inclusion (D&I)	32%
3	Impact on local communities, such as job creation	28%
4	Workplace and public safety	27%
5	Labor standards and human rights across the value chain	25%

Note: respondents were only able to select two issues - the most important. The table features the top five risk issues only. Each percentage shows how many respondents selected an area as among their top two issues

While D&I, in second place, is an important consideration when assessing social performance, more could be done to focus on issues such as racial equity. The research found the events of the past 18 months have led to only 39% of investors surveyed putting “more focus on social justice and racial equity as a key sustainability performance issue.”

Moving forward, the challenge for the investment industry will likely be how to access and analyze the data required to link social impacts to financial performance. The lack of data could make it difficult to achieve a comprehensive inclusion of social factors in portfolio decision-making.

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Turning the D&I spotlight on the asset management industry

While major investors are focused on the social performance of public companies, the industry also has to consider its own position on issues such as D&I. Nancy Davis, Founder of US-based Quadratic Capital and Portfolio Manager for the IVOL and BNDD ETFs, points out that, in the US industry, minority- and women-owned (MWO) asset managers are under-represented. “The U.S. Government Accountability Office released a report that showed that women and people of color manage fewer than 1% of the US\$70t in US asset management,” she explains.⁶ “And that data is from 2018, so it’s probably a smaller percentage now because there’s been so much asset growth with all the fiscal stimulus and the rally in markets.”

For Nancy Davis, this means that ESG as an approach needs to extend to how institutional investors in the US, such as retirement plans and foundations, select their asset managers. “Why would you only focus on gender and diversity in public companies in terms of their boards and not be also focused on allocating to asset management firms that are actually owned and run by women and minorities as part of that ESG framework?”

⁶Clements, Michael. “Investment Management: Key Practices Could Provide More Options for Federal Entities and Opportunities for Minority- and Women-Owned Asset Managers.” GAO, U.S. Government Accountability Office, Sept. 2017, <https://www.gao.gov/products/gao-17-726>.



The race to net zero: climate change at the heart of investment decision-making

When the COVID-19 pandemic struck, there was some concern that it would put the brakes on investors' growing focus on climate change. With markets reeling from lockdown shocks, would investment managers back away from pre-COVID-19 pandemic climate change pledges?

In fact, the past 18 months have been a time of significant progress in the industry. For example, in July 2021, it was reported that a number of major investors had joined the Net Zero Asset Managers (NZAM) initiative.⁷ Although it was only launched in December 2020, these latest signatories mean US\$43t in assets, or almost half of the asset management sector globally in terms of total funds managed, are committed to a net zero emissions portfolio target.⁸

A renewed focus on climate risk: physical and transition

This progress could reflect the fact that the COVID-19 pandemic provided a stark and tangible example of the turbulence and volatility that are unleashed when we have to confront a systemic risk, be it a global pandemic or climate risk. Investors could see the economic fallout that might result if the world fails in its efforts to halt global warming. The urgency of this issue was given added impetus with the latest global warming analysis from the UN Intergovernmental Panel on Climate Change (IPCC). This report found that without "immediate, rapid and large-scale reductions" in emissions, curbing global warming to either 1.5°C or even 2°C above pre-industrial levels by 2100 would be "beyond reach."⁹

As a result of the increasing pressure to avoid possibly dangerous climate change, investors are putting a significant focus on their portfolios' exposure to climate risk. In March 2020, three pension funds - including Japan's US\$1.6t Government Pension Investment Fund and UK-based USS Investment Management - issued a joint statement on the problem of short-termism, including citing a forecast from Moody's Analytics that climate change alone had the potential to destroy about US\$69t in global economic wealth over the next 80 years.¹⁰

There are two forms of climate risk that are important to the industry: physical and transition risk.

1. Physical risk

This threat includes the potentially severe physical risk for companies around the world of climate change - either directly through the damage or loss of assets, or indirectly through its effects on supply chains. The research found that 77% of investors surveyed said that, over the next two years, they will devote considerable time and attention to evaluating physical

risk implications when they make asset allocation and selection decisions - an increase from 73% of investors surveyed in 2020.

2. Transition risk

At the same time, national governments are also taking action to mitigate the advance and impact of climate change. The governments of almost 200 countries signed the 2015 UN Paris Agreement that aims to limit global warming to "well below 2°C" above pre-industrial levels.¹¹ For example, the European Union (EU) has committed to decreasing greenhouse gas (GHG) emissions by 55% by 2030 relative to 1990, and to reach net zero levels by 2050. This transition to a low-carbon economy entails significant transition risk for companies around the world, and significant opportunity for companies that outcompete under such conditions. The EU's Fit for 55 package sets out a number of support mechanisms, and penalties, that will impact companies.¹² National governments may implement far-reaching regulations - such as a price on carbon - to reach their targets. The impact of transition risk on companies may range from direct and indirect costs to changing technologies and business models and stranded assets. Today, 79% of investors surveyed said that, over the next two years, they will devote considerable time and attention to evaluating transition risk implications when they make asset allocation and selection decisions - an increase from 71% of investors surveyed in 2020.

But, of course, understanding the impact of climate risk on portfolios is challenging. Institutional investors have vast experience and skills in assessing risks such as credit or liquidity, but assessing climate risk is a relatively new discipline. At the same time, assessing climate risk can be challenging: it is highly uncertain, sometimes difficult to quantify, and difficult to hedge against (because of the systemic and pervasive nature of climate risk).

The issue is complicated because there is still more to be done on the corporate side when it comes to climate risk. The 2021 EY Climate Risk Disclosure Barometer, which looks at more than 1,100 companies across sectors, found that not all are undertaking a climate scenario analysis, and those that do are not consistent in their approach. The research shows that only 41% of the organizations assessed had disclosed that they have conducted crucial scenario analysis to examine the likely scale and timings of particular risks and prepare for the worst-case outcomes. It also shows that only 15% of businesses reviewed feature climate change in their financial statements - suggesting they lack robust data or that they have not yet worked through the likely impact on the bottom line.¹³

⁷"Founding Network Partners and Signatories." *Net Zero Asset Managers Initiative*, July 2021, <https://www.netzeroassetmanagers.org/#>.

⁸Mooney, Attracta. "Investment Industry at 'Tipping Point' as \$43tn in Funds Commit to Net Zero." *Climate Capital*, Financial Times, 6 July 2021, <https://www.ft.com/content/e943869b-7afd-4eea-8e0c-6ba3991bc5e3>.

⁹Hodgson, Camilla. "Global Warming Will Hit 1.5C by 2040, Warns IPCC Report." *Climate Capital*, Financial Times, 9 Aug. 2021, <https://www.ft.com/content/9a11b08c-4fb3-49ec-8939-9d853745bfc6>.

¹⁰Lewis, Leo. "Pension Fund Giants Team up in Attack on 'Short-Termism'." *ESG Investing*, Financial Times, 4 Mar. 2020, <https://www.ft.com/content/2a58008a-5dae-11ea-8033-fa40a0d65a98>.

¹¹The Paris Agreement, United Nations Climate Change." *Unfccc.int*, Dec. 2015, <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>.

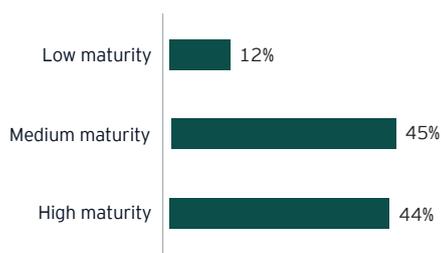
¹²"Commission Launches the Fit for 55% Package." *Interreg Europe*, 10 July 2021, https://www.interregeurope.eu/policylearning/news/12610/commission-launches-the-fit-for-55-package/?no_cache=1&chHash=a371af17736f1f2109030ee45e7dd6f2.

¹³If climate disclosures are improving, why isn't decarbonization accelerating?, EY, 2021.

Making climate risk central to portfolio construction and risk management can be difficult. To understand how robust and mature their approach is, respondents were asked to rank the maturity of their approach on a scale of 0 to 10, from “inadequate approach to assessing portfolio risk today” to “comprehensive view on how to assess performance from a climate risk perspective.” As figure 4 shows, fewer than half (44%) of investors surveyed have a highly mature approach.

Figure 4: Investors with a highly mature approach to assessing performance from a climate risk perspective in the minority

Question: When aligning your portfolio with climate commitments – such as the UN-convened Net-Zero Asset Owner Alliance – how mature is your approach today?



Note: numbers do not add to 100% because of rounding.

The gap between the importance of climate risk and the number of investors that have a sophisticated approach is also a concern. As with the lack of action around updating overall ESG risk factors, it could reflect the fact that the industry is struggling with what is a highly complex issue. For example, investors should identify and manage climate risks within the different sectors and geographies they invest in. A sophisticated approach to climate risk assessment likely requires that investors take into account the varying climate risk considerations for the different categories of investment. However, as the climate debate is likely to intensify over the coming years, urgent action is likely to be needed to build capability in the investment industry.

Decarbonization and the race to net zero

It has been over two decades since the Kyoto Protocol was adopted as a global climate deal, committing countries to climate action targets.¹⁴ Now, the race is on to get to net zero by reducing carbon emissions or decarbonization. As highlighted in the research, many institutional investors are signing up to significant and ambitious pledges to drive climate change action. As well as the Net Zero Asset

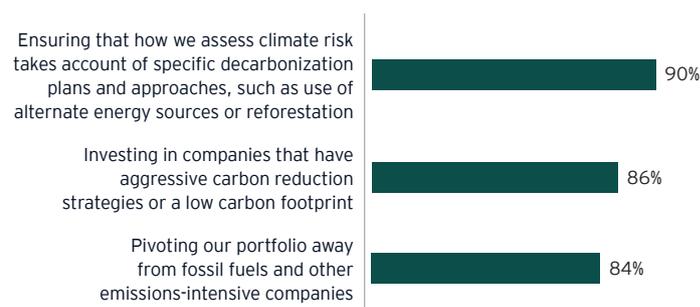
Managers initiative, the UN-convened Net-Zero Asset Owner Alliance includes a group of 43 of the world’s largest investors. The group has committed to reducing carbon emissions in its portfolio – worth US\$6.6t in assets under management (AUM) – to net zero by 2050.¹⁵

The research shows that decarbonization is also central to investors’ investment decision-making today (see figure 5).

Figure 5: Decarbonization is central to investors’ investment decision-making today

Question: Thinking about the role played by decarbonization strategy in your investment decision-making today, how important are the following factors?

Percentage of respondents who say the following tactics play an important role today in their investment decision-making



Making progress on net zero and decarbonization will likely require companies to produce a robust approach to scenario planning and investors to closely engage with organizations on their strategies:

- ▶ Companies should undertake robust scenario planning to help understand the potential implications of a range of climate outcomes and stress test the current risk management and strategy processes within their business. These should be completed for both physical and transition climate risk, and will form a core element of appropriate Task Force on Climate-related Financial Disclosures (TCFD) reporting.
- ▶ Companies should also consider how they will play a role in achieving net zero through their own decarbonization actions.
- ▶ Investors should engage with companies on the need to recast their organizational strategies to incorporate decarbonization and ESG factors. They should also determine a forward-looking view of decarbonization strategies. While it is important to understand a company’s historical carbon emissions, it could be more important that investors

¹⁴“What Is the Kyoto Protocol? United Nations Climate Change.” *Unfccc.int*, Jan. 2021, https://unfccc.int/kyoto_protocol.

¹⁵“Un-Convened Net-Zero Asset Owner Alliance – United Nations Environment – Finance Initiative.” UNEP FI, 30 Sept. 2021, <https://www.unepfi.org/net-zero-alliance/>.

understand the decarbonization strategies and plans of those companies going forward. This means understanding how different industries should decarbonize and what solutions they can draw on to reach their reduction goals. It could be a significant challenge because investors should have a strong grasp of each industry's pathway to decarbonization, founded on comprehensive quantitative data analysis.

A just transition

In a bid to achieve the deep climate mitigation efforts needed, unplanned or sudden intervention into emissions-intensive activities are likely to occur. In such circumstances, there is a risk that communities are left stranded by the transition.¹⁶ It is clear from the research that investors strongly believe the net zero transition should not lead to any potential injustice, and that it should create a healthier, more prosperous and equal society. The research also found that the vast majority of investors surveyed (97%) think it is important for investors to play a key part in helping with a "just transition"* for those emissions-intensive companies and the communities they support.

A recent report from the Investor Group on Climate Change, prepared by the EY organization, found that there is a growing recognition among institutional investors that these social considerations should form part of their broader response to the risks and opportunities inherent in the net zero transition.¹⁷ At the same time, global initiatives, mechanisms and strategies with a focus on a just transition are emerging and gaining momentum. These include the Just Transition Mechanism as part of the European Green Deal, the Climate Action 100+ Net-Zero Company Benchmark, Transition Bonds led by the Climate Bonds Initiative and emerging company just transition strategies.

*"Just transition" refers to ensuring that the burdens and benefits of addressing climate change are shared equally and that combating climate change is linked to tackling poverty, creating jobs, and addressing inequality and exclusion.

Green recovery programs are an opportunity for investors, but the threat of a market bubble is a significant concern

While the transition to a net zero carbon economy presents significant material challenges, efforts by national governments to encourage the transition could be an opportunity for investors. When the research was conducted in June and July 2021, investors were asked whether, over the course of the preceding 12 months, they had made an investment because they saw that target benefiting from the green recovery - 92% said they had.

They also see this transition continuing into the future, with 88% of investors surveyed saying it is likely that they will increasingly target green-focused investment opportunities following the COVID-19 pandemic, as they seek opportunities that are more resilient to global crises and able to deliver sustainable long-term value. For example, one area that has significant potential is nature-based sequestration (see page 16, "Investing in our ecosystem: nature-based solutions").

Credit Suisse's Daniel Wild points out that while government economic stimulus as part of the green recovery is important, so is setting the right policy and regulatory environment. "There is no doubt that it's a very positive signal, including to the market, if there is government support and subsidies for green infrastructure," he says. "While we want to see these opportunities, it cannot be in isolation. It's also necessary and helpful that governments and regulators do not just provide additional capital, but also set the right boundary conditions, which is perhaps even more important. For example, in the US, some thresholds for emission standards have been reactivated, which were put on hold by the previous administration. Another area is carbon pricing and the role it plays in ensuring funds flow in the right direction. In the long term these measures are even more important than the direct subsidies or direct investments in sustainability related infrastructures and activities."

While the research has shown that investors are increasingly focused on social issues, Quadratic Capital Management's Nancy Davis believes it is still important that the focus on green recovery does not consume so much attention that issues such as inequality are neglected. "An unfortunate side effect of the green recovery is that many people are very focused on the 'E' of ESG," she says. "But if you look at some of the biggest impacts of COVID-19, it's been on women. The pandemic has been a huge burden on mothers, for example. There's so much data about the number of women who've not been able to return to the workforce and the number of women who've been impacted by schools being closed around the world. I think this focus on the 'E' of ESG has meant that the 'S' and the 'G' issues have been put by the wayside. But, in my lifetime, there's never been a more important time to be focusing on those other aspects of ESG."

¹⁶Thomas, Nathalie. "Campaigners Push for 'Just Transition' for UK Oil Workers." *UK Business & Economy*, Financial Times, 23 Aug. 2021, <https://www.ft.com/content/84a48e79-bc69-4cab-97f1-9bcf8e1b408e>.
¹⁷"How Investors Can Support an Equitable Transition to Net Zero." *Empowering Communities*, Investor Group on Climate Change, July 2021, https://igcc.org.au/wp-content/uploads/2021/07/IGCC-Investors-role-in-an-Equitable-Transition-to-net-zero-emissions_FINAL-150720211-copy.pdf.

Investing in our ecosystem: nature-based solutions

Nature-based solutions to climate change, sometimes called “natural climate solutions,” involve conserving, restoring or better managing ecosystems to remove carbon dioxide (CO₂) from the atmosphere. Examples include allowing forests to regrow, restoring coastal wetlands and switching to restorative agricultural practices, such as cover crop rotation, that support healthy soils.¹⁸

According to the UN's inaugural *State of Finance for Nature report*, if the world is to meet its climate change biodiversity and land degradation targets, it needs to close a US\$4.1t financing gap in nature by 2050.¹⁹ To achieve this, investments in nature-based solutions would likely need to triple by 2030 and increase four-fold by 2050. This acceleration would equate to a cumulative total investment of up to US\$8.1t and a future annual investment of US\$536b. The report found that about US\$133b a year currently goes toward nature-based solutions; 86% of it is public funds and the remainder is made up of private capital.

As more companies emerge with compelling business models in this space, it is an area that is likely to receive growing investor attention.

However, this green recovery opportunity could become a victim of its own success. When ESG was previously more of a niche activity in the industry, there was less risk of a market bubble. Today, with the industry's interest in environmental issues surging, the result could be too much capital potentially chasing too few opportunities. The research shows that investment managers are concerned that demand is outstripping supply as the industry looks to invest in projects across areas such as renewable energy, electric vehicles and plant-based food:



77% of investors surveyed said that, with high demand for green investments, many investors will find limited investment options because of a relatively small number of equities meeting their environmental criteria.



76% of investors surveyed said that shortage of supply in suitable green investments will lead to some investors overpaying for green assets, creating the risk of a market bubble.

One important issue that appears to be driving concerns of a bubble is whether the sustainability or green claims of companies – either established players or innovative new players in green technologies – are in fact credible. A common concern, for example, is whether large and well-resourced companies can talk

up their sustainability credentials and, as a result, whether ESG-labeled investment products are associated with organizations that are in fact less sustainable. The scale of the issue is reflected in the fact that regulators are making moves to deal with this problem. For example, the EU's Sustainable Finance Disclosure Regulation (SFDR), which came into force on 10 March 2021, is designed to introduce more transparency and essentially categorize investment products into sustainable and non-sustainable.²⁰

At the same time, investors looking to get into emerging green technology companies should establish whether claims made about the potential of these technologies – and the potential for future revenues – stand up to rigorous examination. This can be important in helping to identify whether companies and projects they invest in will survive in the long term beyond the initial wave of enthusiasm. This in turn means having deeper insight beyond the stated claims and reporting of companies. Investor analysis should seek to understand whether an opportunity really is a sustainable and viable long term.

Aware Super's Liza McDonald, while recognizing that there is a risk from investors bidding heavily for particular renewable energy assets, believes that the threat of a market bubble is dampened by the fact that there is still huge scope to find innovative answers and technology solutions to the clean energy question. “We have been investing in renewables for some time now – it's been largely offshore for us, such as investments in Brazil in wind and solar,” she says.

“With our philosophy around benefiting our members in Australia, we are also looking at investing in the communities in which our members live, work and retire. This is about getting a return for them while also supporting their community. So how could we support and invest in renewables while generating jobs and sustainable living, to the extent of even looking at affordable housing as a strategy as well? It took a number of years to get comfortable with the investment and the long-term return aspect of investing in renewables in Australia. And any time an asset came up, it was heavily bid, particularly from institutional investors also wanting to invest.”

“So the challenge is finding where the opportunities are and the right investments. But looking not just at the actual renewable assets themselves, but looking at the technologies or the solutions that we might need to invest in. I don't think there will be a bubble in that because we haven't solved the problem. In terms of trying to work out how we can transition and where we might be able to create those technologies, I think there's a lot of capital that needs to flow into that area if we are to actually find the solutions.”

¹⁸“What Are Nature-Based Solutions?” *Fact Sheet: Nature-Based Solutions to Climate Change*, American University, Washington DC, 2021, <https://www.american.edu/sis/centers/carbon-removal/fact-sheet-nature-based-solutions-to-climate-change.cfm>.

¹⁹UNEP, WEF, ELD, Vivid Economics. “State of Finance for Nature.” *UNEP - UN Environment Programme*, May 2021, <https://www.unep.org/resources/state-finance-nature>.

²⁰Mooney, Attracta. “Greenwashing in Finance: Europe's Push to Police ESG Investing.” *ESG Investing*, Financial Times, 10 Mar. 2021, <https://www.ft.com/content/74888921-368d-42e1-91cd-c3c8ce64a05e>.

Decarbonizing the carbon-intensive or "greening the brown"

As institutional investors begin to align more with net zero, it is likely they will try to invest in low-carbon and net zero initiatives, such as the new technologies that get us to a decarbonized economy. However, it is important to remember that a huge amount of funding will likely be required to decarbonize many industry sectors. As a result, a significant amount of equity capital will likely need to flow to those organizations that are currently in the emissions-intensive sectors. According to the International Energy Agency's *Net Zero by 2050* report, this could require a near tripling of investment in energy markets - to nearly US\$6b. Companies demonstrating a clear strategy to capitalize on the net zero transition may pave the way for investors to allocate capital and avoid the growing reputational risks of supporting the emissions-intensive sectors.

Karine Hirn, Partner and Chief Sustainability Officer at East Capital - an active asset manager specializing in emerging and frontier markets - confirms the importance to green recovery of transitioning carbon-intensive organizations in emerging markets. "We believe much more in the importance of 'greening the brown' rather than just investing in the 'green', in terms of real-world impact," she says. "A focus on our active ownership agenda is about focusing on, for instance, Eastern European oil and gas companies. These are not really being pushed toward green by their own government because countries - such as Russia - are still a bit lacking in terms of ambition for a greener future. That's where shareholders such as ourselves have a huge responsibility to play - to push and 'nudge' these companies."

For East Capital, that means a focus on engagement rather than divestment. "You should never start with divestment," she explains. "Divestment would be the ultimate action if you really do not succeed with engagement. If you talk about divestment too early - at the same time as you're requesting very important changes and sometimes very difficult choices to be made by companies - then you are basically telling them, 'just wait a bit and we eventually won't be a shareholder anyway, so don't listen to us.' That's the old way. We are putting it the other way, essentially saying, 'You know what? We are going to stay with it. We are going to be a shareholder in your company for a long time, but we need these actions to be in place. If you do it successfully, there will be many more investors that want to invest in your company, so please listen to us.'"

Transition finance at Credit Suisse

For Credit Suisse's Daniel Wild, while investing in alternative energies and carbon reduction technologies is clearly important, it is also critical to transition the rest of the market. "We have made a very clear statement that we want to be a partner and a contributor to transition finance," he says. "That raises the question of how we define and measure transition to make it credible. If someone who is a climate transition laggard moves to the middle of the pack, or even to the front, maybe that can even have much bigger impact than, say, a green bond.

"We have defined a client energy transition framework, which we have rolled out internally and which classifies our clients into five segments, running from laggard to leader. This helps to adjust our client strategy along these lines in the sense that we engage with clients and try to be of help and a partner in transition. Only as a measure of last resort will we say goodbye to a client if we see there's no movement over a certain time period in terms of transition. We have already made some announcements in that direction: we do not provide new financing to clients if they have more than 25% revenue exposure to thermal coal, and we do not finance any new thermal coal activities. And we are not participating in financing conventional oil and gas production in the Arctic. In a sense, that's the 'dark end' of the spectrum, and the rest we're trying to move on a transition journey, while the criteria may become stricter over time with the advancement of a net zero oriented economy."

"Any action has to be credible and meaningful for us, and therefore we also subscribe to the Science Based Targets initiative. That compels us, which is a good thing, to be aligned to a net zero trajectory, not just with our own emissions but also with the financed emissions. Overall, this approach to transition finance offers our clients ways and opportunities to invest into these transition solutions."

US\$6b

According to the International Energy Agency's *Net Zero by 2050* report, a tripling of investment in energy markets totalling nearly US\$6b could be required to decarbonize many industry sectors.



The future of ESG investing: performance transparency and analysis capability

Both the companies issuing ESG performance data and the investors consuming that insight should build their capability in sophisticated data analytics.

While investors are putting ESG at the heart of their decision-making, they are only likely to realize its full potential when the industry receives better-quality ESG disclosures and data from companies, and when progress has been made by standard-setters and policy-makers around a clearer regulatory landscape governing these disclosures. At the same time, both the companies issuing ESG performance data and the investors consuming that insight should build their capability in sophisticated data analytics.

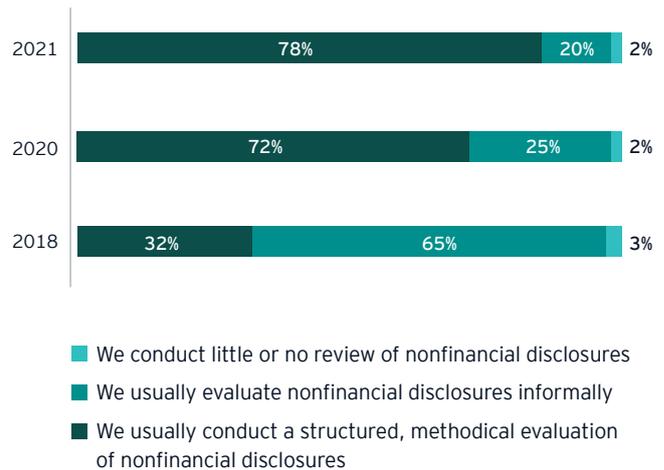
Priority one: better-quality ESG data from companies and a clearer regulatory landscape

Enhanced scrutiny of a company’s ESG claims and performance could prove critical if ESG investing is to realize its potential. This could be even more important given there is a degree of skepticism about some companies’ claims. As one manifestation of this, short sellers have even started to question some of the environmental claims of companies, along with scrutinizing accounting and financial issues.²¹

A company’s ESG performance disclosures are at the heart of investment decision-making. As figure 6 shows, the number of investors who conducted a structured and methodical evaluation of those disclosures has increased significantly over the past four years in which EY conducted this research. Today, it has hit 78% of investors surveyed, when just three years ago, only 32% used a rigorous approach.

Figure 6: Investors continue to raise their game when assessing companies using ESG information

Question: Which one of the below statements best describes how you and your investment team evaluate nonfinancial disclosures that relate to the environmental and social aspects of a company’s performance?



Note: 2020 numbers do not add to 100% because of rounding.

²¹Nauman, Billy. "Short-Sellers Step up Scrutiny of ESG Stocks." *On Wall Street*, Financial Times, 24 Oct. 2020, <https://www.ft.com/content/b8c91561-b44c-43cf-9810-7aeff9c377a8>.

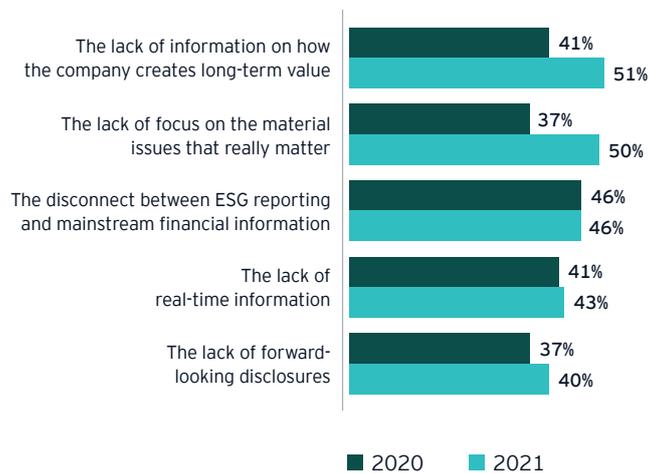
Lack of transparency into ESG performance

However, despite the importance of ESG performance reporting to the industry, there are some concerns about the transparency and quality of ESG disclosures. As figure 7 shows, the percentage of investors who are concerned about the usefulness of key aspects of companies' ESG disclosures is rising, with investors particularly concerned about the lack of insight into how companies create long-term value.

Figure 7: An increasing number of investors are concerned with the usefulness of key aspects of ESG disclosures

Question: Thinking generally about the ESG reporting you receive, what, if any, of the aspects below do you believe are challenges to its usefulness and effectiveness?

Percentage of respondents who think the following issues compromise the usefulness of ESG disclosures



As the data shows, there has been a significant swing toward two issues:

- ▶ Long-term value, which is the major source of dissatisfaction, at 51% - an increase from 41% in 2020
- ▶ Materiality, which is second in terms of investor concern, with 50% of investors surveyed saying they are concerned about a lack of focus on material issues - an increase from 37% in 2020

Velislava Ivanova, EY Americas Chief Sustainability Officer and EY Americas CCaSS Leader, believes these findings could show how the COVID-19 pandemic has had a significant effect on what investors want from companies' performance reporting. "With short-term performance and profitability significantly disrupted by the COVID-19 pandemic in sectors ranging from aviation to energy, investors want companies to demonstrate how their ESG strategy can drive long-term, sustainable value," she says. "At the same time, they want them to report on what is financially material. More financially relevant ESG reporting can help a corporate to deliver change and tell its story effectively, and also help investors to better understand a corporate's full value and the impact it is having."

For East Capital's Karine Hirn, effective disclosures on a company's specific performance are only part of the puzzle, as attention should also be given to providing ESG performance information and reporting across a company's ecosystem or extended value chain - showing how the company and its partners are driving sustainable development and protecting the planet. "Integrating those topics related to sustainable development calls not only on companies themselves, but also their wider value chain," she explains. "This is a major change: you have to speak about not only what you are doing as a company, but also how you are making sure that your suppliers, your clients and your partners are also behaving according to the standards and levels that you would expect of them."

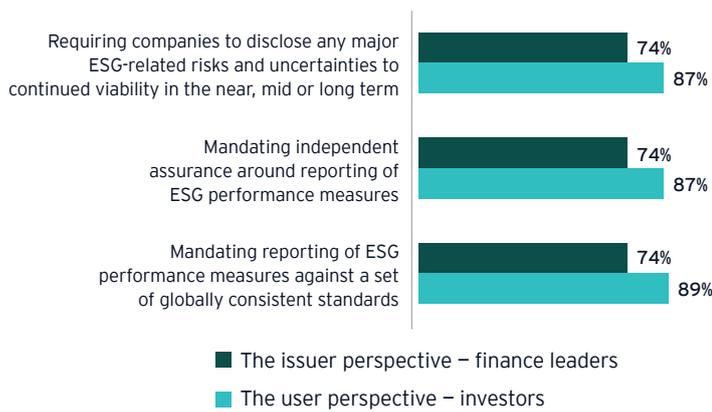
Globally consistent standards are key to transparency

Investors are very clear that globally consistent reporting standards could be an important part of improving ESG performance transparency. Without a clear and comprehensive corporate ESG reporting system, they could be left to navigate inconsistent data. In recent years, a number of large institutional investors have made their demands for uniform and consistent ESG disclosures more explicit and called for the adoption of standardized reporting frameworks. Research conducted by the EY organization has shown that the investor and corporate communities are broadly aligned on the importance of these issues. As well as this investor industry survey, the EY organization also sought the views of finance leaders at corporates worldwide. As figure 8 shows (page 21), both the issuers and users of ESG performance reporting believe it would be helpful if risk transparency, reporting and assurance of disclosures were actually mandated by policy.

Figure 8: Both investors and corporates are aligned on mandating key aspects of ESG performance transparency

Question: How helpful, if at all, would the following actions by policy-makers, regulators and standard-setters be in improving your ability to assess corporates' ESG performance?

Percentage of respondents who think the following actions by policy-makers, regulators and standard-setters would be helpful



Note: finance leader data taken from the 2021 EY Corporate Reporting Survey, drawing on over a 1,000 finance leaders worldwide. The question asked of finance leaders was: “How helpful, if at all, would the following actions by policy-makers, regulators and standard-setters be in improving your ability to produce high-quality and credible nonfinancial disclosures for stakeholders - such as investors - on your ESG performance and risks?”²²

Investors and corporates are aligned on mandating key aspects of ESG performance transparency.

Setting a direction of travel on ESG reporting standards

There has long been concern about what became known as the “alphabet soup” of ESG measurement and reporting standards, with the soup referring to the many acronyms that abounded, from GRI to Sustainability Accounting Standards Board (SASB) (now the Value Reporting Foundation together with the International Integrated Reporting Council (IIRC)), to TCFD.

However, the COVID-19 pandemic era - as well as COP26 meeting - has added an increased urgency to the search for common standards. Today, there is a degree of optimism that a solution is in sight, and there is a clear commitment to collaborate among the largest standard-setters. This could result in greater consistency - today, there is little consensus on what standards investors utilize. For example, when investors were asked to consider a list of standards and select the two they thought most valuable to them today, the picture was mixed: 56% of investors ranked the World Economic Forum International Business Council (WEF IBC)* approach among their top two, but 40% of investors favored the Value Reporting Foundation** approach.

One reason for the relatively high selection of the WEF IBC approach could be the related finding that investors are concerned that one of the major issues that affects the usefulness of companies' ESG performance reporting is the lack of information on long-term value creation. A focus on the long term is a key component of the WEF IBC approach, with the white paper that launched the framework stating that “To continue to thrive, companies need to build their resilience and enhance their license to operate, through greater commitment to long-term, sustainable value creation that embraces the wider demands of people and planet.”²³

*World Economic Forum International Business Council: the initiative from the WEF and the IBC - along with major accounting firms - to develop an approach to measuring and reporting on sustainable value creation.

** Value Reporting Foundation approach: the merged approaches of the IIRC and the SASB.

²²How can corporate reporting connect your business to its true value?, EY, 2021.

²³Measuring Stakeholder Capitalism Towards Common Metrics and Consistent Reporting of Sustainable Value Creation. World Economic Forum, Sept. 2020, https://www3.weforum.org/docs/WEF_IBC_Measuring_Stakeholder_Capitalism_Report_2020.pdf.

Technology and data innovation can be important to both the companies issuing ESG performance data and the investors consuming that insight.

Priority two: build data analytics capabilities to help produce trusted ESG performance reporting and incorporate that insight into the investment decision-making process

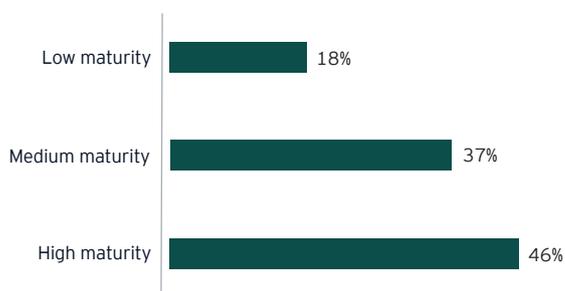
Building the data foundations through effective data management

To build a data edge - and drive data quality - investors need an approach to data management where they can process and channel relevant and high-quality data with flexibility, cost efficiency and effectiveness - with security and resilience - into the investment process. However, the research shows that fewer than half (46%) have a fully deployed and sophisticated approach to data management, with a central ESG data repository where data can be accessed simultaneously and in real time by many different applications (see figure 9).

Figure 9: More investors should seek to build a sophisticated approach and capability in ESG data management

Question: Thinking about your approach to analyzing and assessing ESG disclosures and data, to what extent have you implemented a central ESG data repository where data can be accessed simultaneously and in real time by many different applications?

Maturity of data management approach



Notes: rating based on a scale from 0-10, where 0 means "no data repository in place" and 10 means "data repository fully deployed and feeding multiple applications with real-time data." Numbers do not add to 100% because of rounding.

For Ben Taylor, EY CCaSS Global Strategy and Markets Leader, building data analytics capability is key in an environment where corporates are sharing more ESG disclosures as they look to deliver, measure and report on their ESG programs. "The amount of ESG data in circulation is an ever-expanding universe," he says. "This is because companies are increasing their ESG disclosures in response to stakeholders' demands for transparency and rating firms are incorporating new data points. Therefore, it has never been more important for investors to develop sophisticated in-house capabilities for gathering and managing quality data. At the same time, it is critical for corporates to develop data analytics capability to help produce trusted ESG reporting insight that tells their sustainability story and differentiates them from the competition."

Leveraging sophisticated data analytics to build ESG reporting transparency

Technology and data innovation can be important to both the companies issuing ESG performance data and the investors consuming that insight:

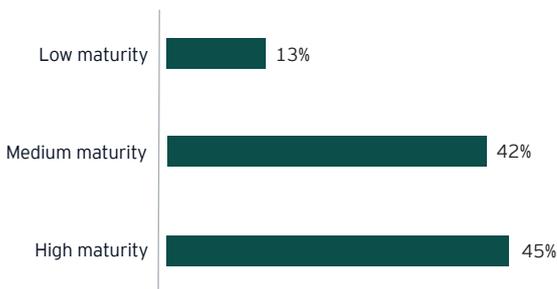
- ▶ As demand for deeper and more credible ESG performance data and insight grows, corporates should improve the way they collect, aggregate and take management responsibility for their own data. For larger companies, the collection of this data, using a consistent enterprise-wide taxonomy, can present a real challenge. And as the data is going to be used in formal dialogue with investors, its veracity becomes even more important. While many companies have strong taxonomies in place for financial information, including robust and documented underlying processes, together with the added assurance of multiple management signoffs, these processes are often more basic for ESG information.
- ▶ For investors, innovation in areas ranging from cloud computing to AI can help integrate ESG data into investment analysis. For example, AI can allow investors to uncover material data that may exist outside a company's formal ESG disclosures by scanning unstructured data to identify material ESG data, such as carbon emissions, which may not be in the sustainability report. The ability to use alternative data such as this can help identify risks and opportunities for ESG investments that other firms are blind to.

However, as figure 10 shows, just under half of investors surveyed (45%) have a highly mature approach when it comes to making use of advanced and intelligent investment analytics tools to assess ESG data and disclosures.

Figure 10: More to be done in adopting innovative new technologies such as AI in investment data analytics

Question: Thinking about your approach to analyzing and assessing ESG disclosures and data, to what extent have you made use of advanced and intelligent investment analytics tools - such as AI and machine learning -to assess ESG data and disclosures?

Maturity of data analytics approach



Note: rating based on a scale from 0-10, where 0 means “no use of advanced investment analytics tools” and 10 means “significant use of advanced investment analytics tools.”

While there is still more that needs to be done to build maturity, there is certainly appetite to do so. The research shows that 75% of investors surveyed will be looking to make significant investments in data management and sophisticated analysis tools. Banking & Capital markets, as a segment, is particularly bullish: 89% of investors surveyed said they will be looking to make significant investments, compared with 65% of investors surveyed in the Insurance segment.

Building an ESG data edge at Invesco: asymmetric information and artificial intelligence

For Glen Yelton, Head of ESG Client Strategies, North America & EMEA at Invesco, challenges with the quality and coverage of corporates’ ESG data disclosures are also an opportunity to seize a data edge for Invesco. “The fact is that the investment industry has an incomplete ESG dataset because we have inconsistent disclosures globally,” he says. “We have incomplete and inconsistent disclosures even within markets. For example, when I started in the ESG space back in 1999, fewer than 15% of the S&P 500 voluntarily disclosed ‘E’ or ‘S’ factors on their website or their public reporting. Last year, over 85% voluntarily disclosed ‘E’ or ‘S’ data. But while that is a massive growth in disclosures, it also means that almost 15% of the S&P 500 still don’t voluntarily disclose ‘E’ or ‘S’ data.

“That’s part of the conversation that we have with our investment teams whenever they’re looking at ESG integration into decision-making: the asymmetric access to information that exists. For good analysts, asymmetric information availability is where you find opportunity. For a lot of our teams that are doing ESG integration, part of the goal is to find that delineation and divergence between peer companies based on the disclosures and factors that are available.”

“We also have an internal proprietary tool called ESGintel. It integrates information from ESG data providers into an ESG value chain model, and provides an internal rating on all securities that we hold across Invesco globally. And that’s available as a resource that’s on everybody’s desk and everyone has access to it. The ESGintel platform will also be using natural language processing (NLP) to process transcripts of company meetings, which will allow us to begin highlighting ESG areas of interest for users.

“In parallel to that, for those asset classes that do not have readily available external information and external ratings, we build our own proprietary ratings models. We currently have 13 proprietary ratings models on ESG factors internally.

“Those systems are built by the analysts themselves. The global ESG team works in partnership with the investment analysts to build these out. We help them understand the models that you can use for evaluation, such as how to interpret ‘E,’ ‘S’ or ‘G’ data in context.”



4

What next?

To help ESG factors play an important role in post-COVID-19 pandemic economic health and renewal, there are a number of actions for both the corporates issuing ESG reporting and the investors that then have to utilize that information.

Issuer priorities: corporates

- 1. Better understand the climate risk disclosure element of ESG reporting.** Companies around the world are undoubtedly making progress on climate risk disclosure, spurred by growing demand from investors, regulators and the public. But there is growing pressure for them to do more. Companies should look carefully at the broad risks and opportunities that climate change presents to their business and their industries, undertaking robust climate risk scenario analysis. A number of steps are important to achieving this. First, help connect financial reporting with climate risks and embed it into existing risk frameworks, rather than treating climate as a separate issue. Second, start making climate risk disclosures now rather than waiting for global reporting standards to be introduced.
- 2. Make strategic use of both the sustainability and the finance functions to help inject rigor and materiality into ESG reporting.** The research has shown that investors care about the veracity and credibility of companies' ESG performance data, including whether it is material. Management teams and boards should establish the role of the finance function in ESG reporting. A clear role for the CFO and the finance team can bring value in a range of areas. First, helping to connect ESG reporting in a way that considers financial reporting. Second, bringing finance's understanding of data controls and processes to bear on ESG reporting, with the aim of moving ESG disclosures to "investment-grade" quality and credibility standards.
- 3. Deepen engagement with investors and understand how new ESG disclosure requirements could differentiate you from competitors.** The research has shown that investors view a company's ESG performance as pivotal in their investment decisions. As well as the existing ESG information that companies provide, issuers should understand what kind of new information investors are demanding, and how well prepared they are to access and disclose the relevant data. For example, today there is an increasing focus on the "S" of ESG, which offers an opportunity to build a unique narrative around people-related topics, from employee mental health to gender pay gaps.

User priorities: investors

- 1. Update investment policies and frameworks for ESG investments while building an ESG-driven culture.** As ESG factors become more important, investors should look to maintain appropriate investment policies and frameworks. This could mean reviewing current investment strategies for individual funds and portfolios and updating processes, systems and controls. But it could also require investors to help embed ESG into the culture and mindsets of their people - helping to align with their overall stance on ESG factors.
- 2. Update approaches to climate risk, including significant use of climate scenario analysis, allowing investors to understand the potential consequences of climate risks over the short, medium and long term.** While some companies might offer climate scenario analyses as part of their disclosures, building this capability within investors could help them to test how robust these issuer analyses are and add their own bespoke analysis to the information provided.
- 3. Put in place a bold and forward-looking data analytics strategy.** To build the data foundations, investors should identify and apply the relevant ESG factors to how they classify and assess their ESG data. By aligning robust data with advanced analytics tools, organizations can set out their forward-looking data analytics strategy and how it could help them to better manage ESG risks and generate an ESG premium. Designing a forward-looking data analytics strategy will likely require choices about the tools and platforms themselves, and also the implications for processes, legacy IT and talent.

About this research

In June and July 2021, the EY CCaSS team commissioned Longitude to conduct its sixth survey of institutional investors to examine their views on the use of nonfinancial information in investment decision-making.

Longitude and the EY CCaSS team collaborated on writing the questionnaire, incorporating some repeated questions from prior years along with a number of thematic questions on topics of near-term interest. In total, Longitude collected 324 responses from senior decision-makers at buy-side institutions around the world (demographic highlights of the research program are shown below).

The survey was supplemented by in-depth interviews with the following investment industry leaders, and the EY Global CCaSS team would like to thank everyone who contributed their insights and knowledge to this report:

- ▶ Nancy Davis, Founder, Quadratic Capital and Portfolio Manager for the IVOL and BNDD ETFs
- ▶ Karine Hirn, Partner and Chief Sustainability Officer, East Capital
- ▶ Liza McDonald, Head of Responsible Investments, Aware Super
- ▶ Daniel Wild, Global Head of ESG Strategy, Credit Suisse
- ▶ Glen Yelton, Head of ESG Client Strategies, North America & EMEA, Invesco

What is your title?



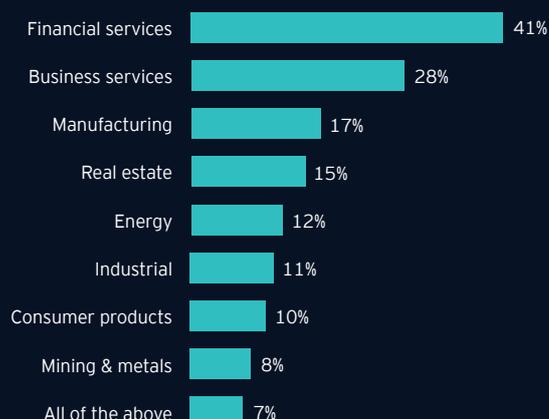
Note: numbers do not add to 100% because of rounding.

What type of institution do you work for?

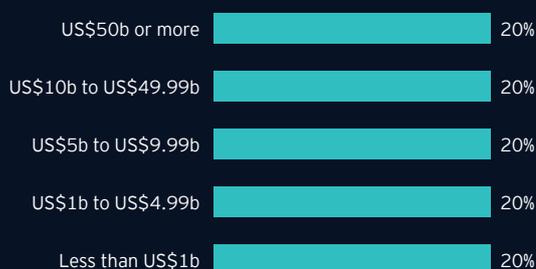


Note: numbers do not add to 100% because of rounding.

In which of the following sectors do you invest most heavily?



What are your institution's assets under management?



Where is your position located?



EY contacts



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