HIGH MEADOWS INSTITUTE

Sustainability in Capital Markets

A Survey of Current Progress and Practices

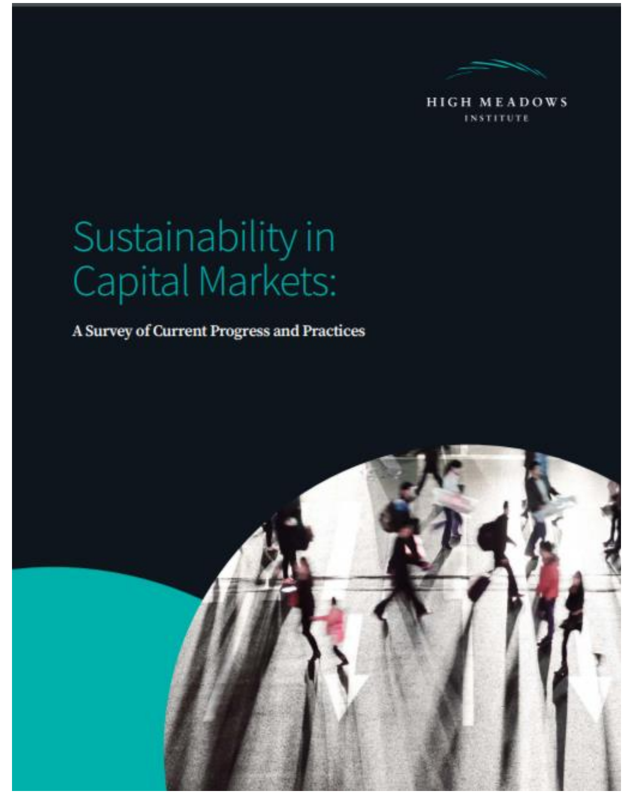
kks advisors
reshaping markets

Introduction

HIGH MEADOWS
INSTITUTE

- A landscape analysis of the mainstream capital market ecosystem and the views and practices of its key stakeholders around the issue of long-term value creation and ESG

- A refresh of the original report published in 2015, with a new capital market stakeholder group added for analysis (Index Providers)



Some feedback on the report:

George Serafeim • 1st
Professor, Harvard Business School
4d

This new report provides the best landscape of how capital markets are evolving to integrate ESG issues. From asset managers and owners, to investment consultants, credit rating agencies and stock exchanges. Must read for anyone interested in sustainable investing High Meadows Institute KKS Advisors #esg

Overview of report

Introduction
Section I: Key Drivers of Change

This section of the report explores some of the key drivers of change between 2015 and 2019.

- Changing Demographics
- Multi-stakeholder and Industry ESG-related Initiatives
- Global ESG Regulatory Changes
- Advances in Technology and Data Science
- ESG Counter-trends

Section II: Capital Market Stakeholders

The second section of the report focuses on eight different capital market stakeholders in turn (e.g. asset managers, stock exchanges etc.), exploring the key changes that have occurred since 2015, what is driving the change and what the barriers there are to further progress.

Introduction – Some key findings

HIGH MEADOWS INSTITUTE

- Interest in ESG has gone mainstream since the 2015 survey, with ESG investment products flooding the market in every investment category
- ESG is increasingly being seen as a viable way to increase alpha and manage risk
- The corporate engagement practices of the world's largest institutional investors around ESG issues material to long term performance has increased significantly
- Investors are now looking for qualitative data on how ESG is being integrated into strategy in addition to quantitative data on ESG performance.
- Market intermediaries from credit rating agencies to consultants and stock exchanges are building ESG into the platform and valuation models.
- There is still work to be done to obtain a consistent definition of ESG and determine how to report on performance
- Growing the necessary human capital infrastructure to support ESG integration is an increasing challenge

What are the driving forces for the rise of ESG?

HIGH MEADOWS INSTITUTE

Summary

1

Changing demographics

- Increase in millennial and women investors with greater interest in sustainable investing
- Digitization to meet the needs of the changing demographics

2

Global ESG Regulatory Changes and Key Initiatives 2015 - 2018

- A proliferation of regulation globally
- Sustainable Development Goals
- Paris Agreement

3

Advances in technology and data science

- Increase in ESG 'quant houses'
- Growing burden on companies and distrust in some data providers

What are some of the barriers to further ESG integration?

HIGH MEADOWS INSTITUTE

Summary

1

Lack of standardization

- No standardized way for companies to report on or communicate ESG data
- Early movers are integrating SEC filings with SASB metrics

2

Changes in shareholder rights

- Proposed Financial CHOICE Act will limit small investors from filing shareholder proposals on ESG issues and exerting influence

3

Corporate lobbying on climate policy

- Some organizations are lobbying against climate change policy, despite setting targets to reduce emissions
- Corporate membership of trade associations is also being questioned

Driving forces

Changing demographics

HIGH MEADOWS INSTITUTE

Summary

- 78% of individuals said that sustainable investing has become more important to them in the past 5 years and 86% of millennials had expressed an interest in sustainable investing compared to an overall average of 73% (Schroders, 2017).
- 92% of millennials surveyed by Nuveen agreed that having a positive societal impact was more important to them than doing well financially.
- The full effects of millennial expectations for investment are yet to be fully realized in the market but it is estimated than in the next 10 years, $12 trillion of assets will pass from the baby boomers (51-69 year olds) to millennials.
- A shift in global assets to women is also expected to be driving the increased interest in socially responsible investment. Morgan Stanley found that 84% of women were interested in SRI, compared to 67% of men.
- The marketing of financial products needs to respond to the changing demographic of investors, e.g. products that embrace digitisation and more female-centred marketing of products.

Multi-stakeholder and industry ESG-related initiatives

Summary

- Significant increase in public policy initiatives focused on responsible investment in the last 5 years (50% of total number of policy instruments ever created were post-2013 according to the PRI).
- High profile regulations introduced include a package of Sustainable Finance measures launched by the European Union's High-Level Expert Group on Sustainable Finance and the Guidelines on Establishing a Green Financial System launched in China.
- Sustainable Development Goals were launched in 2016 and are starting to be adopted by some investors as a framework for monitoring impact or a capital allocation guide. Some investors, e.g. Mirova, have launched SDG-focused funds.

Advances in technology and data science

HIGH MEADOWS INSTITUTE

Summary

- Technological advances in data science and the development of sophisticated algorithms have helped investors partly overcome the lack of completeness in ESG data by ‘smart scraping’ company reports for material ESG information
- More advanced technology has also helped to expand the list of metrics for some ESG issues as data can be gathered from unconventional sources, e.g. using satellite data to track climate indicators.
- Despite this progress, concerns are growing about the validity of some data and a lack of transparency about how ESG data is being used in rating methodologies.

TRUVALUE LABS

TruValue Labs, a new data provider, leverages the supervised learning form of AI to filter through over 75,000 sources from newspapers, watchdog organisations, specialist publications and NGOs to analyse and interpret massive amounts of unstructured ESG data.

Counter-forces

Lack of a standardized framework for disclosure of ESG issues

HIGH MEADOWS INSTITUTE

Summary

- There has been growing pressure on the SEC, in its role as a market regulator, to provide a standardized framework for disclosure of ESG performance.
- Some companies have already started to seek out more robust ways to disclose information on ESG issues that are financially material by using SASB metrics in their SEC filings or aligning their sustainability report with SASB.

Lack of a standardized framework for disclosure of ESG issues

HIGH MEADOWS INSTITUTE

MSCI ESG Research	Sustainalytics	Vigeo Eiris	DowJones Sustainability Index
Thomson Reuters	Institutional Shareholder Services (ISS) Oekom	RepRisk	Bloomberg ESG Data Service
	TruValue Labs	Corporate Knights Global 100	

- A lack of a standardized framework for organizations to disclose ESG information essentially creates a market inefficiency as financially material ESG issues might not be taken into account during valuation.
- The process of reporting organization-level data for different data providers is placing a significant burden on companies

Changes in shareholder rights and push-back on activism

HIGH MEADOWS INSTITUTE

Summary

- Shareholder proposals are an important mechanism for investors to engage with companies on ESG issues, with more than 2/3 of shareholder proposals concerning social or environmental issues in 2017. Popular topics include climate change, lobbying and gender diversity.
- The current mechanism is being challenged by the proposed bill, the Financial CHOICE Act, that will stop small investors (owning less than 1% of the company's stock) from being able to file resolutions.
- Multiple NGOs and investor coalitions are arguing to protect shareholder rights (see below)

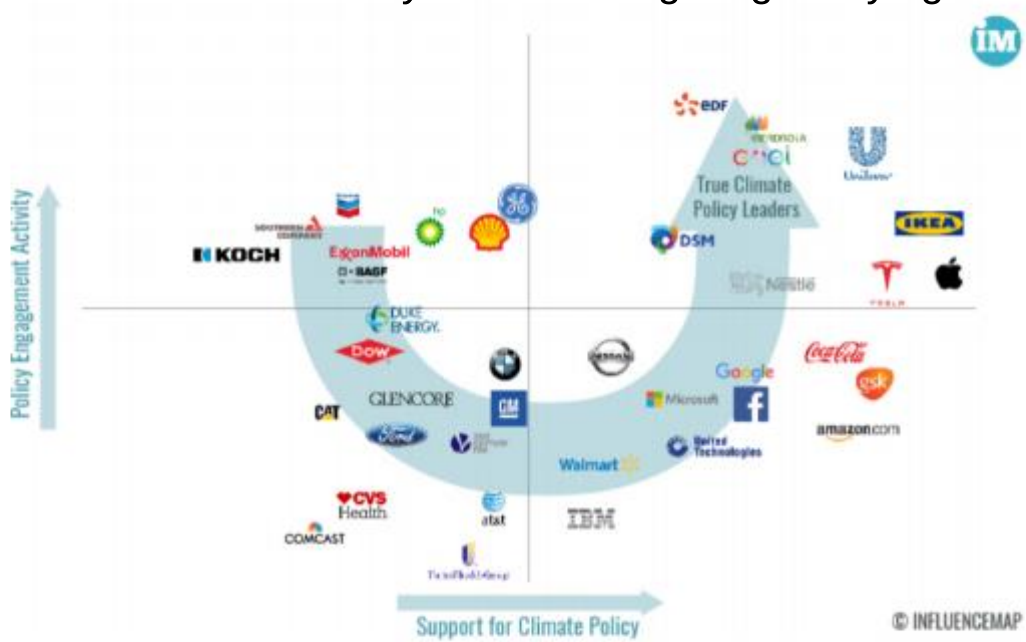
Excerpt from a letter to the White House from the PRI, US SIF, ICCR, Ceres and CII arguing to protect shareholder rights

"Our members are long-term shareholders who can attest to the fact that for over 45 years the shareholder proposal process has served as a cost-effective way for corporate management and boards of directors to gain a better understanding of shareholder priorities and concerns and to benefit from those insights on critical and emerging risks and opportunities. The process has proven to be valuable to numerous companies and has given shareholders an important voice."

Corporate lobbying on climate policy

Summary

- Recent research has highlighted the significant negative impacts of corporate lobbying on climate policy, with a growing number of investors demanding more information on the role companies are playing. See a research extract from Influence Map below.
- In 2017, the Swedish National Pension Fund AP7 divested from Exxon Mobil based on their obstruction of climate change risk.
- Corporates can also impact climate change policy through their membership in trade associations who can lobby on their behalf. A coalition of investors representing $32 trillion in AUM has been established with a key focus on targeting lobbying disclosure.



Capital market actors – key highlights

Asset Owners and Asset Managers

HIGH MEADOWS INSTITUTE

Highlights from research

- Significant body of evidence that good corporate performance on ESG issues is value-enhancing – 13% increase between 2017-18 in the number of investors that believed ESG-integrated portfolios would perform better than those that had not integrated ESG.
- 12% increase in the number of the top 25 Asset Owners assigning oversight of long-term investing to the CEO, CIO or Investment Committee and 8% increase in the top 25 asset managers assigning the same responsibility.
- Principles for Responsible Investment (PRI) remains the most popular responsible investment initiative among top 25 asset owners and top 25 asset managers, CDP is 2^{nd} most popular
- Asset Managers have grown their ESG stewardship teams significantly between 2015 and 2017 – BlackRock team has grown by 65% and Vanguard's by 110%.
- Increase in amount of asset managers building bespoke ESG integration models

Asset Owners and Asset Managers

HIGH MEADOWS INSTITUTE

Highlights from research

> "Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends – from slow wage growth to rising automation to climate change – affect your potential for growth… To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."[3]
>
> *Larry Fink, CEO, BlackRock, 2018 Letter to CEOs*

Incentive systems for long-term investing	2015	2018
Assign oversight of long-term investing to the board or trustees	8/25	**10/25**
Assign oversight of long-term investing to the CEO, CIO or investment committee	7/25	**10/25**
Assign implementation of long-term investing to CEO/CIO/investment committee	3/25	**5/25**

Table 1. Asset owner incentive systems for long-term investing

Incentive systems for long-term investing	2015	2018
Assign oversight of long-term investing to board or trustees	9/25	**18/25**
Assign oversight of long-term investing to the CEO, CIO or investment committee	19/25	**21/25**
Assign implementation of long-term investing to CEO/CIO/investment committee	5/25	**10/25**

Table 3. Asset manager incentive systems for long-term investing

Investment Consulting Firms

Highlights from research

- 30% increase, since 2015, in the top 10 investment consulting firms publicly outlining how they incorporate ESG factors into their research.
- Increase in regulation affecting investment consultants since 2015 – Competition and Markets Authority and Financial Conduct Authority in the UK in particular and European Commission through MiFID II that requires investment consultants to ask clients about their ESG preferences

MERCER

In 2017, Mercer was voted the best investment consulting firm for sustainable and responsible investment by the Independent Research in Responsible Investment (IRRI) survey. They have developed an assessment framework to determine how well ESG issues are incorporated across 1) idea generation, 2) portfolio construction 3) active ownership and 4) business management.

Stock Exchanges

Highlights from research

- 10% increase in the percentage of stock exchanges offering sustainability-related indices since 2015 (now 9 out of the top 10, based on market capitalization)
- All the top 10 stock exchanges have now signed up to the Sustainable Stock Exchange Initiative, a 50% increase since 2015
- However, there has been a 20% decrease in stock exchanges requiring sustainability reporting as a listing rule

ESG reporting was introduced as a voluntary recommendation for all listed issuers on the Hong Kong Stock Exchange (HKEX) in 2013. In 2016 the ESG reporting guide was expanded and general disclosures were upgraded to a 'comply or explain' status. In 2017, Environmental KPIs also gained 'comply or explain' status.

Key data points demonstrating stock exchanges' commitments to sustainable investing	2015	2018
Percentage of top 10 stock exchanges offering sustainability-related indices	80%	**90%**
Percent that have signed the Sustainable Stock Exchange (SSE) Initiative Commitment Letter	50%	**100%**
Percent that require comprehensive sustainability as a listing rule	40%	**20%**
Offer sustainability guidance or training for investors	40%	**60%**
Offer sustainability guidance or training for companies	70%	**60%**

Table 6. Stock exchange commitments to sustainability

Credit Rating Agencies

HIGH MEADOWS INSTITUTE

Highlights from research

- Significant progress by CRAs in 2018 to integrate ESG data into ratings decisions with both Fitch Ratings and S&P Global integrating it into their products, in response to Principles of Responsible Initiatives and others
- Growth of ESG teams, e.g. acquisition by S&P Global of ESG data experts Trucost

FitchRatings

ESG Relevance Scores were launched by Fitch Ratings in 2019 and fill a market gap by disclosing how an ESG issue directly affects a company's credit rating. They transparently display the relevance and materiality of individually identified ESG elements into the rating decision.

ESG measurement and reporting bodies

Highlights from research

- Significant growth in 3rd party data and ESG rating providers (600 products globally according to WBCSD, 2018), see examples below
- The process of reporting organization-level data for different data providers is placing a significant burden on companies
- Increased use of big data and machine learning to find unique ESG signals
- Some early adopters are using SASB standards in their sustainability reporting, e.g. JetBlue, NRG, Host Hotels & Resorts; JetBlue was the first publicly traded company to incorporate the SASB metrics in its financial disclosures

Examples of data providers

Regulators and industry accounting boards

Highlights from research

- There has been mounting pressure on industry accounting boards and regulatory bodies to integrate ESG into their standards
- Proponents of greater integration of ESG into the Securities Exchange Commission's (SEC) filings argue that mandated ESG reporting would overcome the current challenges around incomplete and inconsistent data that is disclosed voluntarily by companies
- The Industry Accounting Standards Board (IASB) has also been under pressure to include ESG information in its standards, but argues that integrating ESG would lead to a loss in their focus and identity

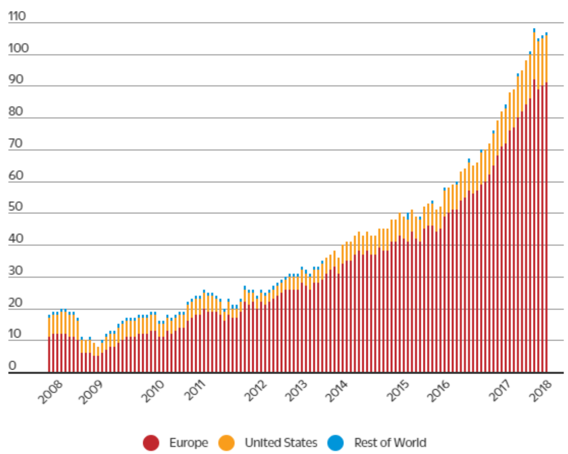
In October 2018, a group of investors, government officials and NGOs, representing over $5 trillion in assets under management petitioned the SEC to develop a framework that would require public companies to disclose ESG information material to their operations.

Index providers and exchange-traded funds

Highlights from research

- Given the significant growth in passive investment, an analysis of this set of capital market actors was included in the 2018 analysis for the first time (see graph below)
- ESG-focused indices are gaining popularity with investors seeking cost-effective solutions to sustainable investing
- Questions have arisen about where the responsibility lies in improving ESG practices of organizations within an index
- Exchange-traded funds (ETFs) have grown significantly in the last three years, with 214 ESG-related ETFs launched in 2017 and 77 between January-June 2018 alone

CHART 1 - PASSIVE SUSTAINABLE FUND ASSET GROWTH (US$ BILLION)



What next?

- Continued growth of ESG investment products and services
- Increasing investor demand for data on ESG quantitative and qualitative data directly from companies rather than data provider intermediaries
- An increased focus on ESG materiality and the role of ESG in risk management and opportunity identification.
- A move beyond ESG factor analysis to an integrated systems perspective on environment and social issues using frameworks such as the Taskforce on Climate disclosure (TCFD), Sustainable Development Goals (SDGs)
- Continued push for standardized comparable data standards for non financial reporting using frameworks like Sustainable Accounting Standards Board (SASB)
- Possible ESG intermediary rating and ranking agencies as the big three mainstream credit rating agencies fully integrate ESG into their rating platforms