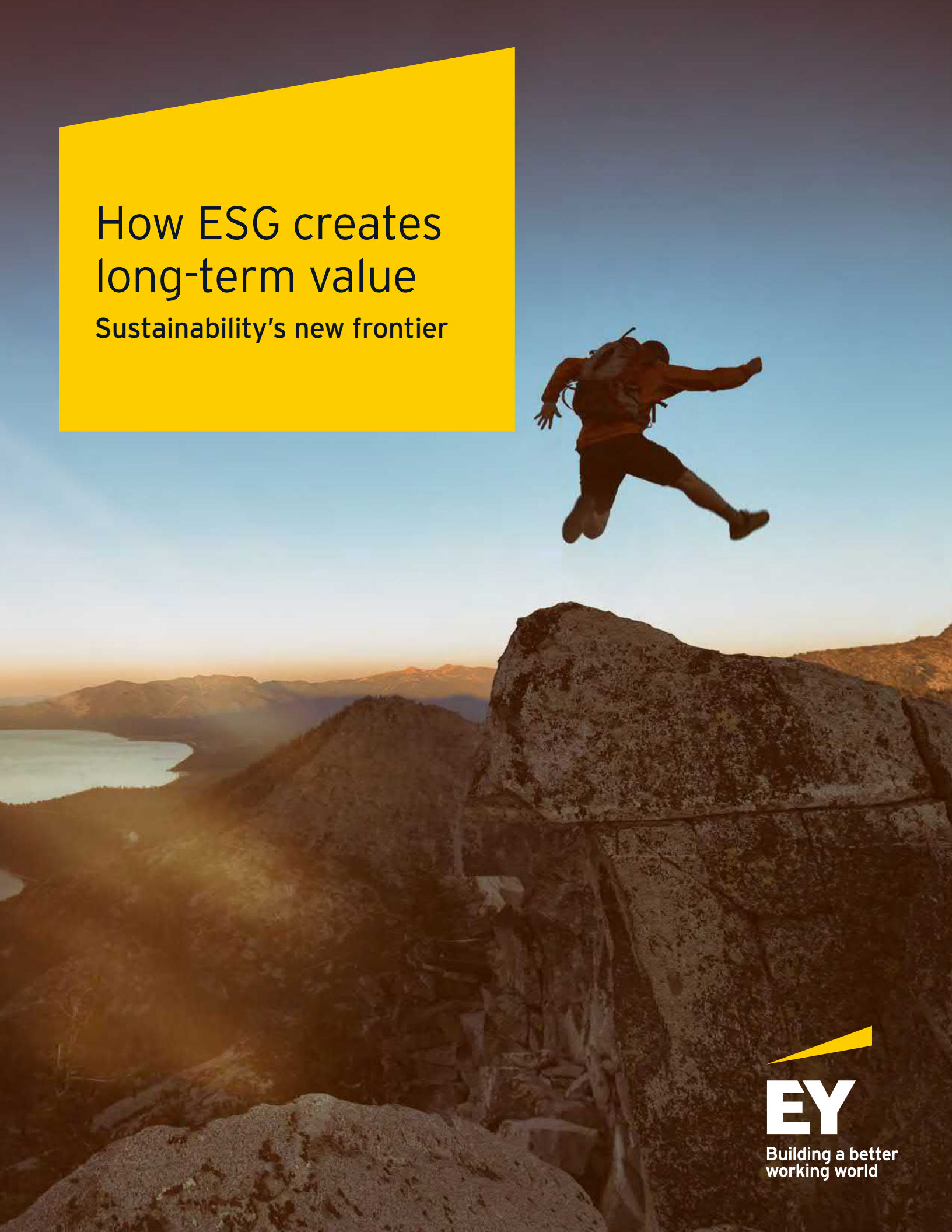
How ESG creates long-term value

Sustainability's new frontier



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Building a better working world

When it comes to environmental, social and governance (ESG) programs, the investment landscape has changed. Once relegated to lengthy, standalone sustainability reports that often failed to attract much attention, ESG has become a top priority on investors' agendas.

What is ESG?

Environmental, social and governance is the term used to identify matters that may traditionally be associated with sustainability or corporate responsibility, but that are deemed to have a material financial impact on an organization's short- and long-term value. These matters can vary based on industry and geography, on the nature and scale of the organization's operations and supply chain, on its business strategy and values, and on its investor base.

In Canada, investments that consider ESG are now valued at well over $2 trillion in assets under management across all major investment classes.[1]
In a 2018 Responsible Investment Association (RIA) study, Canadian investors reported that the two main ESG considerations they look for are fiduciary duty and risk management.[2] This underscores the fact that ESG has moved beyond basic corporate responsibility and into the domain of financial performance and enterprise risk.

So how can boards and executives meet this new investor demand for ESG information in a way that drives value for the organization? There are three things that companies should know to help answer this question.

ESG reduces risk and drives value creation

Research shows consistently that ESG and corporate performance are linked.

It's been well known for many years that companies with good governance practices demonstrate stronger corporate performance. But more recent studies are consistently proving that performance across all three pillars of ESG drives investment returns. A 2015 metastudy of more than 200 sources by Oxford University and Arabesque Partners noted that "80% of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance."[3]

Geography matters when it comes to investors' views on the drivers of this link. According to a report from RBC, most Canadian investors tend to think of ESG as a risk mitigation activity (68%) as opposed to a source of alpha (21%), while most European investors believe both to be the case.[4] Regardless of the driver, global investors are clearly well aware of the potential link between ESG and financial performance.

[1] "2018 Canadian Responsible Investment Trends Report," *Responsible Investment Association website,* https://www.riacanada.ca/content/uploads/2018/10/2018-RI-Trends-Report-FINAL-WEB-1.pdf, October 2018.

[2] "2018 Canadian Responsible Investment Trends Report," *Responsible Investment Association website,* https://www.riacanada.ca/content/uploads/2018/10/2018-RI-Trends-Report-FINAL-WEB-1.pdf, October 2018

[3] "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance," *Arabesque Partners website,* https://www.arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf, March 2015.

[4] "The future of ECG integration," *RBC Global Asset Management website,* https://www.rbcgam.com/en/ca/article/the-future-of-esg-integration/detail, 15 January 2019.

ESG has become an enabler of access to capital

Given this evidence that ESG drives performance, investors are embedding it into their investment decision-making process.

Recent EY research shows that investors are incorporating ESG into investment decisions at unprecedented levels – 97% of global investors did so in 2018, compared to 78% in 2017.[5] These findings are consistently supported by independent studies such as those performed by RBC[6] and HSBC.[7]

In extreme cases, poor ESG performance or disclosure can lead to exposure reduction, or even complete divestment. But for most companies, the greater risk lies in missing out on access to new and often more reliable sources of capital, for example:

Institutional investors	A strong ESG management story and performance record can attract the attention of investors with a longer-term outlook, particularly pension funds. Canada's pension funds account for 65% of all national investment that considers ESG[8] and they have a strong voice in the international demand for enhanced ESG disclosure.
Passive investors	Faced with the rise of exchange traded funds (ETF) and passive investment strategies, some companies assume that these investors pay less attention to ESG. But that's not necessarily the case. Morningstar has launched a sustainability rating for more than 20,000 managed products and indices targeted to passive investors and has made these ratings available on its standard quote page.[9] As millennial investors become an increasingly important segment of the retail investment market, their interest in values-based investing (another way to consider ESG integration) will enhance pressure for transparency on ESG, even at the fund level. Finally, given passive investors are by nature long-term investors, ESG integration becomes a more important component of managing risk under a passive strategy.
Impact investors	While impact investing – investing in companies that have objectives to improve specific environmental or social outcomes – remains a niche industry in Canada at just $15 billion, this can be a new source of capital for companies in the right industries.[10]

[5] "Does your nonfinancial reporting tell your value creation story?," *EY website,* https://www.ey.com/en_gl/assurance/does-nonfinancial-reporting-tell-value-creation-story, 29 November 2018.

[6] "Charting a Sustainable Advantage: 2018 Responsible Investing Survey," *RBC Global Asset Management website,* https://www.rbcgam.com/documents/en/other/esg-executive-summary.pdf, October 2018.

[7] "Sustainable Financing and Investing Survey 2019: Markets alert to the environment and society," *HSBC website,* https://www.societygbm.hsbc.com/insights/sustainable-financing/sustainable-financing-and-investing-survey-2019, 24 September 2019.

[8] "2018 Canadian Responsible Investment Trends Report," *Responsible Investment Association website,* riacanada.ca/content/uploads/2018/10/2018-RI-Trends-Report-FINAL-WEB-1.pdf, October 2018.

[9] "Morningstar Sustainability Rating: Methodology," *Morningstar website,* http://www.morningstar.com/content/dam/marketing/shared/Company/Trends/Sustainability/Detail/Documents/Morningstar-Sustainability-Rating-Methodology-0916.pdf, 31 October 2018.

[10] "2018 Canadian Responsible Investment Trends Report," Responsible Investment Association website, http://www.riacanada.ca/content/uploads/2018/10/2018-RI-Trends-Report-FINAL-WEB-1.pdf, October 2018

Lack of risk-based ESG management and disclosure can lead to undervaluation

To feed their investment models, investors demand ESG data that is high quality, risk-focused and comparable across companies and sectors, but such information is not readily available in the average corporate disclosure today.

EY's 2019 survey of global institutional investors on ESG showed that 56% of investors don't believe ESG disclosures are adequate[11] – a figure that has improved little since 2017 when 60% of investors felt the same.[12]

Information that companies do make available is too often focused on what's being done as opposed to why, and doesn't sufficiently address how ESG outcomes link to corporate performance. Investors seek ESG disclosures that identify the environmental and social factors that are important to the company in achieving its strategic objectives and also set targets related to these factors that will be relevant over the medium and long term.

In the same way that companies need to disclose their financial disclosures "warts and all," strong ESG disclosures should likewise divulge the bad along with the good on material topics, as well as the company's plans to address any shortcomings.

When a company fails to provide quality, investor-focused ESG disclosures to the market, investors often turn to third party ratings or generalized internal models. Big names such as Bloomberg, ISS, Moody's, MSCI and S&P have now joined boutiques like Sustainalytics in publishing company-specific ESG ratings. Such ratings, though, are perceived to be inconsistent[13] and can suffer in quality due to the lack of accounting standards for ESG data and the fact that ESG reporting remains voluntary in most jurisdictions. When you leave it to third parties to infer ESG performance from indirect sources, you're losing a valuable opportunity to tell your own story.

[11] "Does your nonfinancial reporting tell your value creation story?," *EY website,* https://www.ey.com/en_gl/assurance/does-nonfinancial-reporting-tell-value-creation-story, 29 November 2018.

[12] "ESG information: why investors aren't getting what they want," *EY website,* https://www.ey.com/en_gl/assurance/esg-information--why-investors-aren-t-getting-what-they-want, 1 May 2017.

[13] "Ratings That Don't Rate: The Subjective World Of ESG Ratings Agencies," Timothy M. Doyle, *American Council for Capital Formation website,* http://www.accfcorpgov.org/wp-content/uploads/2018/07/ACCF_RatingsESGReport.pdf, July 2018.

Spotlight on climate change

Climate change is one of the highest-priority risks for investors today because of the financial stability risks it could bring.

Investors and issuers alike are relying on new investor-led guidance — including the Taskforce on Climate-related Financial Disclosures (TCFD) — to better assess, manage and disclose climate change risks to companies and portfolios. Many boards and companies today are therefore focusing their ESG efforts on their assessment of and response to climate change risk, either as one of several top risks or as a singular entry point into the ESG domain.

How organizations should respond

Our experience shows that companies that are proactive on ESG have a clear market advantage. Even early adopters that may have produced sustainability reports for many years need to be actively transitioning their strategy and disclosures to the new era of ESG.

There are tools that can help. Traditional sustainability materiality assessments used to identify a company's top ESG issues can be adopted to an investor-focused, risk-based exercise.

Internal controls stalwart the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has collaborated with the World Business Council for Sustainable Development to release extensive guidance on how ESG can be incorporated into enterprise risk management practices. Investor-focused disclosure frameworks such as those developed by the Sustainable Accounting Standards Board and the TCFD can help adapt disclosures to better respond to investors' needs.

The most important thing to remember is that this is a journey. Whether you're revamping your existing strategies or entering the ESG conversation for the first time, investors understand that change can't come all at once. In the early stages, laying out your vision of how ESG impacts your business, supported by a multi-year strategy and roadmap, can do as much to change perspectives as robust metrics and targets can do over time. Other important steps include the integration of ESG into the corporate risk register, and the publication of investor-focused disclosures.

What hasn't changed is that boards and executives have a fiduciary duty to consider how their organizations are identifying and managing ESG-related risks and what story the market is getting about their performance. Failing to take meaningful action at this point can mean leaving money on the table.

Contact us

To find out how EY's Climate Change and Sustainability Services practice can help you define your ESG strategy, assess your material ESG risks, embed ESG management into your organization and enhance your ESG disclosures, connect with one of our leaders to help map out an approach suited to your particular field of play.

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2. Robert G. Eccles, Ioannis Ioannou, and George Serafeim, "The Impact of Corporate Sustainability on Organizational Processes and Performance," Harvard Business School website, http://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf, 25 November 2011.
3. "Climate change threatens 'both the economy and the financial system,' says Bank of Canada," Canadian Broadcasting Corporation website, http://www.cbc.ca/news/politics/climate-change-bank-of-canada-financial-system-review-1.5137625, 16 May 2019.
4. "Why sustainable investing matters," EY website, https://www.ey.com/en_us/financial-services/why-sustainable-investing-matters, 19 June 2018

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