

The evolution of ESG investing

From popular rise to strategic growth

Executive summary

This report surveys a dozen Canadian asset managers with over \$2.8t (or ~80% of Canadian assets under management (AUM)), to highlight the state of environmental, social and governance (ESG) integration into the investment space.

The report focuses on four key strategic ESG topics:



ESG STRATEGY AND PRODUCT OFFERING

/ page 4



RISK MANAGEMENT

/ page 9



OPERATING MODEL

/ page 15



DATA AND REPORTING

/ page 17

Key findings indicate a significant shift in asset managers' approach to ESG integration, with the proportion of asset managers offering a comprehensive ESG product offering across the spectrum of capital doubling compared to the previous year's survey. Building thematic and impact-driven approaches, which have demonstrated resilience to market outflows were clearly a growing focus.

The level of client sophistication and commitment has impacted the requirements for asset managers, with large institutional investors leading the way in seeking and demanding ESG integration. Many large institutional investors have evolved their investment beliefs to reflect the view that ESG integration will lead to better long-term returns, and this is beginning to trickle down to smaller institutional investors who want more transparency on their holdings' footprint.

While the divide between institutional and retail remains with respect to the level of understanding and adoption, we observed strong AUM growth among those with a robust ESG offering from a retail perspective, despite the remaining advisory gap as advisors struggle with how to proactively engage in ESG dialogue with clients.

This report serves as a valuable resource for investors and asset managers looking to better understand the current state of ESG integration in the investment space, and to identify potential areas for growth and improvement.

Introduction

The first Canadian Asset Manager ESG Survey revealed a growing interest in ESG integration, driven largely by institutional investors demanding a more modern version of ESG investing from their asset managers, going beyond the traditional exclusionary approach, and high-net-worth clients demanding the expansion of ESG propositions to include outcome-based products, and some even hinting at philanthropic products.

We perceived varying levels of maturity in ESG integration, with most respondents' immediate concern being around the integration of ESG risk management across their product offering. In our first report, the respondents' expectations of what the future held for ESG investing beyond the immediate focus on integration was the rise of outcome-based products. Not surprisingly, we found this to be a primary focus in this second issue of our survey.

Over the past year, the level of ESG integration into the investment decision-making process has evolved more quickly than ever before, with asset managers not only integrating it from a risk management perspective, but also from a long-term value perspective. In addition, clients' requests on this front continued to evolve both from the institutional and retail perspectives.





ESG STRATEGY AND PRODUCT OFFERING

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The evolution of the ESG spectrum of capital

Asset managers continue to deepen their ESG proposition, with 50% indicating they offer solutions across all ESG proposition approaches.



Note: Year-over-year comparisons consider only asset manager respondents that participated in both the 2021 and 2022 surveys.

The evolution of the ESG spectrum of capital (cont'd)

Half (50%) of respondents provide an offering across the ESG spectrum of capital, effectively doubling last year's responses, when only 25% of all respondents (10% when considering the same respondents) indicated they had the same depth of offering. While notable shifts to more thematic and impact-driven options year over year were common across respondents, this trend was more widely observed among large bank-owned and independent asset managers (\$100b+) with a strong retail presence.

% OF ASSET MANAGERS (<\$100B) OFFERING SOLUTIONS WITHIN AN ESG PROPOSITION APPROACH

ESG proposition approach	2021	2022
Impact driven	25%	50%
Thematic	25%	50%
Sustainable	25%	75%
Responsible	100%	100%
Traditional	100%	100%

% OF ASSET MANAGERS (>\$100B) OFFERING SOLUTIONS WITHIN AN ESG PROPOSITION APPROACH

ESG proposition approach	2021	2022
Impact driven	0%	40%
Thematic	10%	90%
Sustainable	50%	100%
Responsible	100%	100%
Traditional	100%	100%

An additional 17% of respondents are actively pursuing the addition of impact solutions within the next 12 months, taking the proportion of asset managers fully integrated across the spectrum of capital to 67% of respondents.

Some (17%) asset managers continue to take a wait-and-see approach before deepening their offering.

Those who have not expanded their offering since our last survey reported a change in leadership's tone surrounding ESG. This is leading them to explore how to evolve their product offering, most notably in the thematic space, and as such are currently researching opportunities for new thematic options.

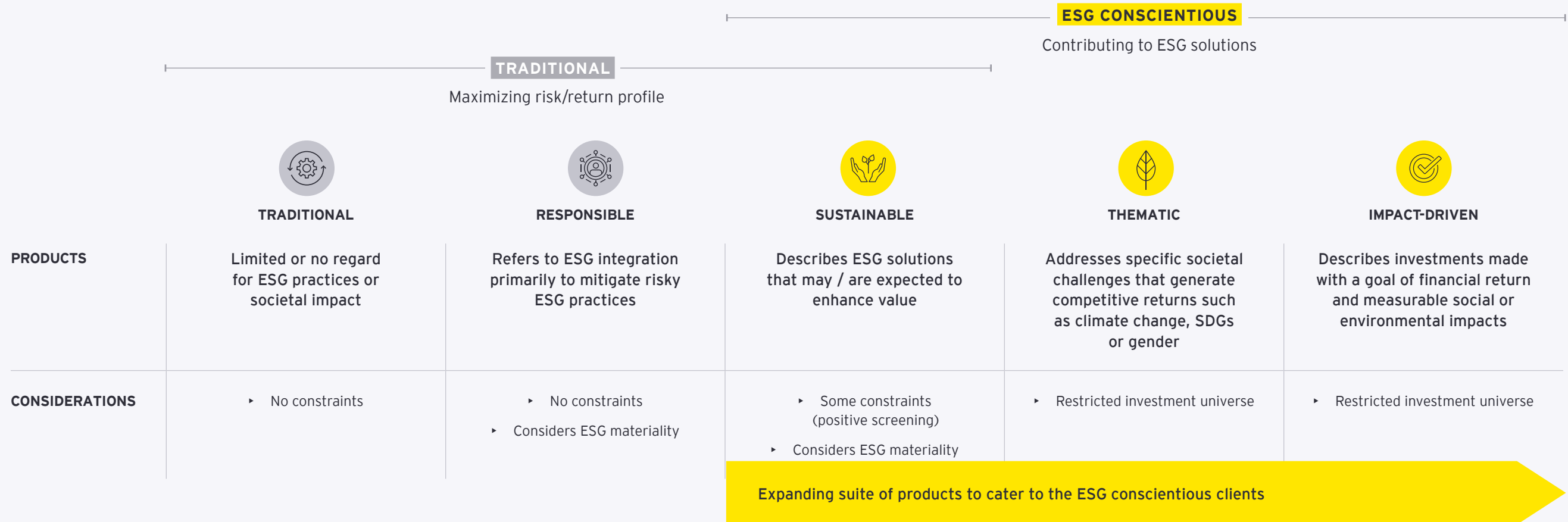
Over 90% of the respondents are using ESG as both a risk-mitigation strategy and a value-creation opportunity. This shows a significant development in the maturity level of ESG integration in the investment process relative to last year's survey, where fewer than half were viewing ESG with that lens.

Note: Year-over-year comparisons consider only asset manager respondents that participated in both the 2021 and 2022 surveys.



Spotlight: Evolving the product offering

Implementing an ESG strategy is not about restricting the product offering, but rather expanding it to cater to evolving client needs. Surprisingly, some asset managers appeared paralyzed on ESG due to 'fiduciary responsibility' while for others it was simply a question of a clear and varied client offering across the spectrum of capital.



New product trends: thematic/impact funds lead the way

When it comes to the development of new ESG products, respondents largely stated that current and future new product growth was aimed towards thematic and impact-driven approaches, with specific interest in products addressing decarbonization.

This demonstrates an evolution from last year’s survey, when the focus for most asset managers was on the development of sustainable products. Interest in thematic and impact-driven approaches aligns with a recent report indicating that 2021 saw 23 new thematic fund launches, whereas only 30 thematic funds were launched between 2016 and 2020.¹

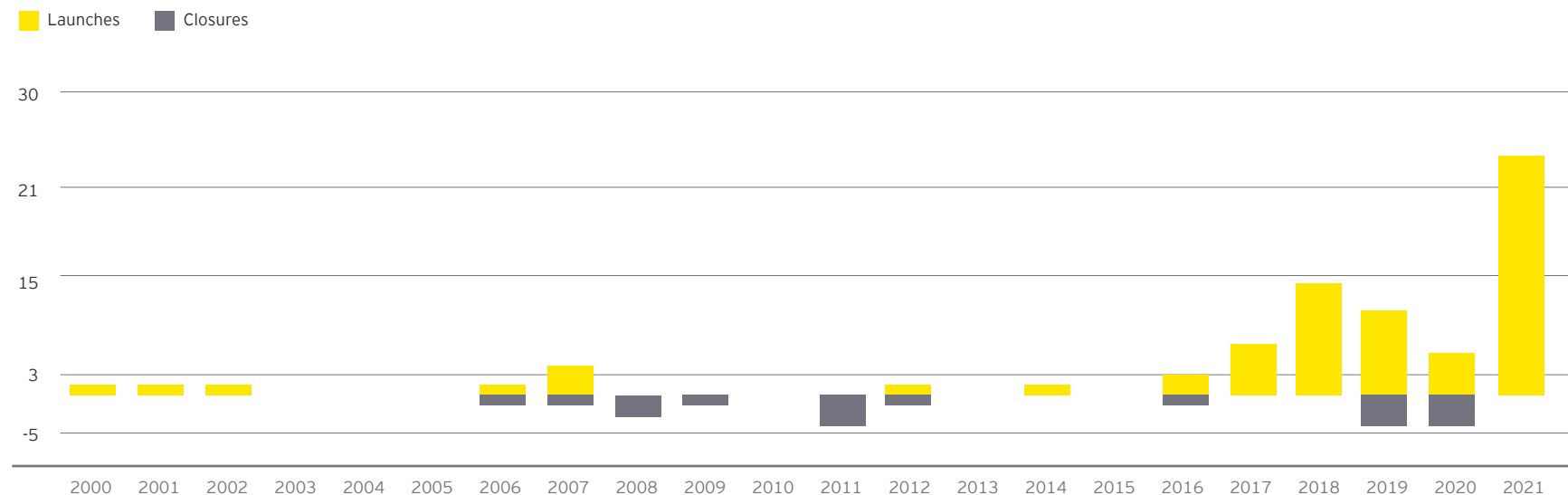
How respondents approach the expansion of their ESG product roster sometimes varies from their traditional approach to product development, with some respondents using external subadvisors with an established track record and investment processes.

Many discussed considering entering private markets as an effective way to develop impact investing products. With the expectation of future product releases, some firms have voiced concerns over the potential for “impact washing.”

The growth and increased interest towards ESG-themed funds peaked during the pandemic, as we’ve seen these particular products display strong performance.

As current geopolitical events have brought about headwinds for ESG funds, it will be interesting to see how this will impact investor appetite for these funds in the future. In fact, the flow of funds slowed significantly after a booming 2022- Q1, as reported by Morningstar.²

CANADIAN THEMATIC LAUNCHES BY YEAR



¹ Morningstar Global Thematic Funds Landscape 2022, Morningstar Manager Research, March 2022.

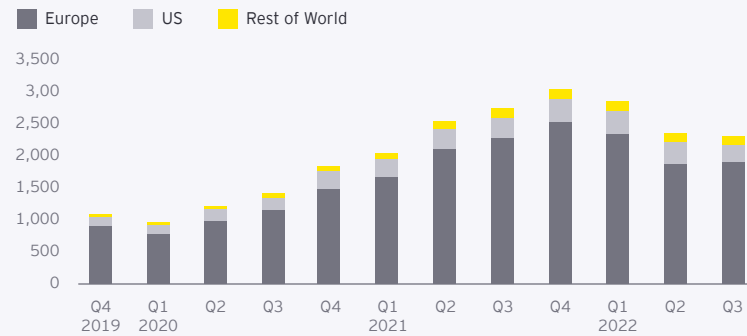
² Ibid.

Spotlight: Sustainable fund market resilience

The growth of total AUM in sustainable funds has been exponential in recent years and has demonstrated resilience to market volatility.

ESG funds have seen a significant growth in AUMs over the last few years...

QUARTERLY GLOBAL SUSTAINABLE FUND ASSETS (USD BILLION)



Source: Morningstar Direct, Manager Research. Data as of September 2022.

Broader market:

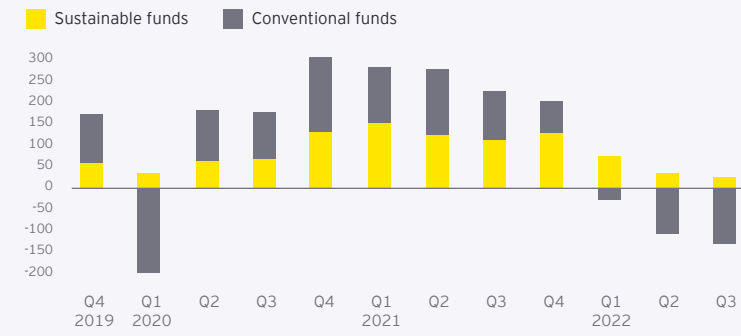
↓ 7.5%

Global Sustainable Funds:

↓ 1.6%

... and have proven resilient to market performance as reflected by the flow of funds...

SUSTAINABLE FUND FLOWS COMPARED WITH CONVENTIONAL FUND FLOWS (USD BILLION (ERUOPE))

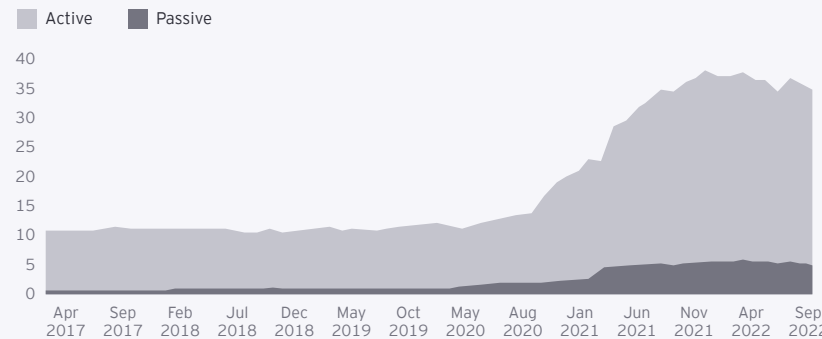


Source: Morningstar Direct, Manager Research. Data as of September 2022. Sustainable fund flow data for Q1 and Q2 was retreated using the new framework for eases of comparison. Under the old framework, flows in Q1 and Q2 were USD 71.7 billion and USD 30.7 billion, respectively.

European sustainable funds added \$22.5B USD of net new money in Q3 2022

...this was also reflected in the Canadian market

CANADIAN SUSTAINABLE FUND ASSETS, ACTIVE VS. PASSIVE (EXCLUDES FUNDS OF FUNDS; CAD, BILLIONS)

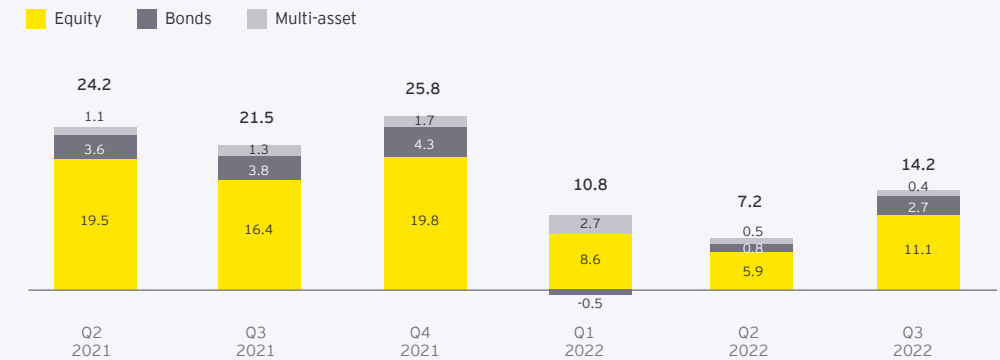


Source: Morningstar Direct, Manager Research. Data as of September 2022. Excludes funds of funds.

However, to a lesser extent for passive funds

... with impact funds faring better than funds that promote E or S characteristics

NET FLOWS OF SFDR ARTICLE 9 (IN EUR BN)





Investor demand vs. adoption

While interest in ESG continues to grow among all investors, the divide between institutional and retail remains wide, particularly with respect to the level of client understanding, due diligence and adoption.

Institutional investors are not only integrating ESG into their investment decision-making process from a risk management perspective, they are also leveraging it to create long-term value and support transition financing in an effort that also enables them to achieve their net-zero goals.

Asset managers indicate that it's rare an institutional manager search would not speak to ESG considerations and integration into investment processes. The same is not necessarily true of retail investors, who are often left to initiate conversations around making their money matter and contributing to a better world.

Despite growth in retail client interest, confusion as to the meaning of ESG investing still abounds. Much of this is related to an ongoing advisory gap as advisors struggle with articulating the value proposition of ESG and its alignment to clients' investment beliefs. In fact, in some cases, respondents have noted the advisory gap has contributed to lower-than-anticipated flows; one stated, "This gap needs to be bridged to avoid a stagnation in growth." It is our opinion that what makes this discussion difficult is that it is much more about a comprehensive portfolio discussion than a product sell.

For those who have worked diligently to close that gap, they have been able to enjoy a significant flow of funds, capturing a greater proportion of the last few years' AUM growth in sustainable funds their sustainable fund assets by over 3,000% over a two year period.



RISK MANAGEMENT

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Managing operating and financed emissions

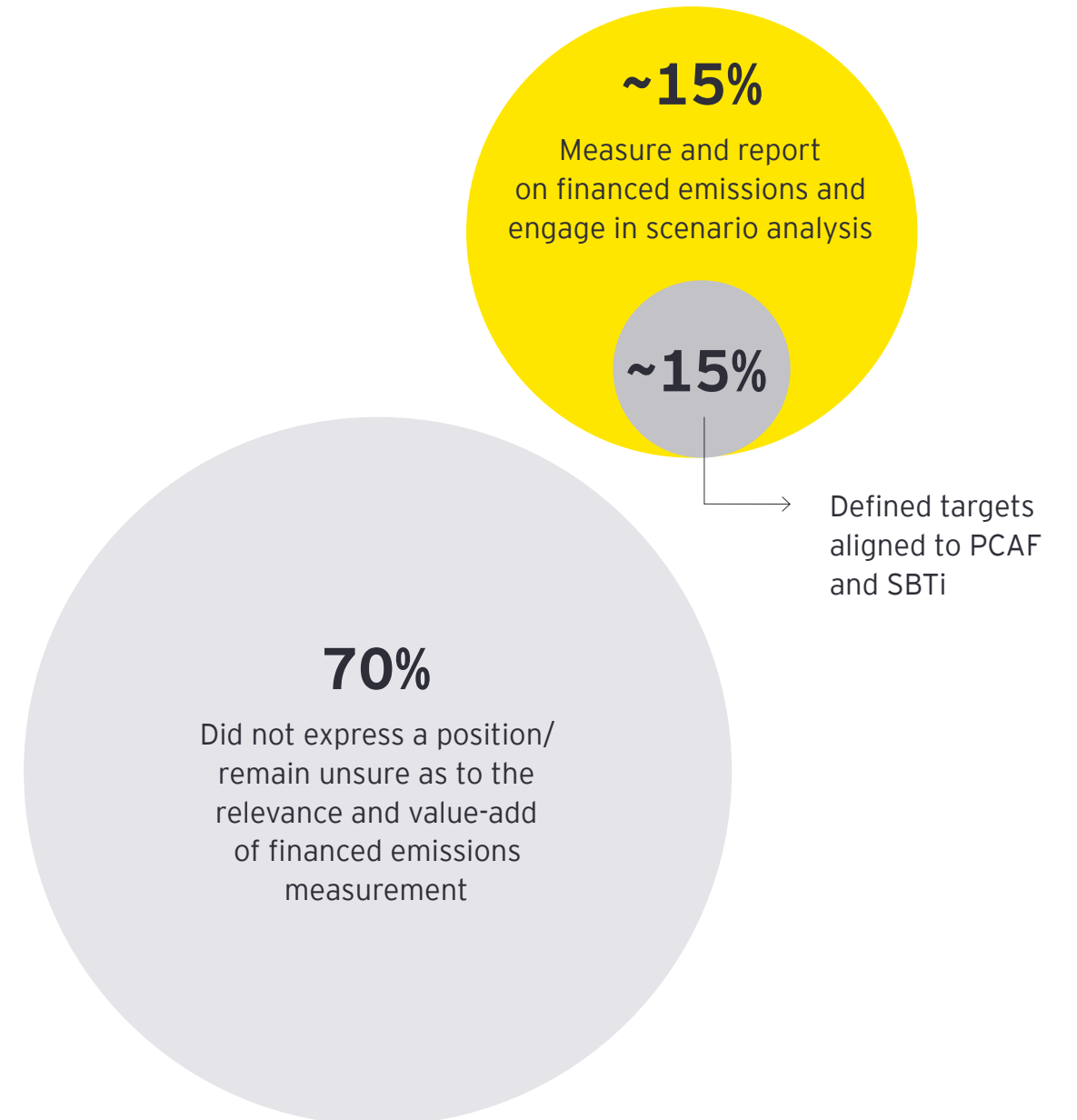
A current priority for most asset managers is improving the oversight of their emissions. The current intent for most is not to actively manage, but rather gain an understanding of, where they stand and their evolution over time.

From an operating emissions perspective:

- ▶ 40% of respondents told us they have defined targets and are collecting and monitoring data to manage their operating emissions.
- ▶ Publicly traded asset managers are further incentivized by public ESG scores to act on their emissions.

Meanwhile from a financed emissions perspective:

- ▶ ~30% of the asset managers are measuring and reporting on their financed emissions. They also reported that they are using scenario analysis to assess the potential business implications of climate-related risks and opportunities for the portfolio companies and to understand how the investee organization is positioning itself in light of these risks and opportunities.
- ▶ Only two of respondents mention having defined targets measured against the Partnership for Carbon Accounting Financials (PCAF) and aligned to the Science Based Targets initiative (SBTi).





Net-zero commitments

For asset managers who have made net-zero commitments, the development of this strategy and associated targets is a natural next step, as it is a requirement of the Net Zero Pledge.

Those who have started on this journey are working on developing a sector-based climate transition and decarbonization approach to help them meet their climate goals and set sector-specific targets.

Overall, 30% of asset managers in our survey have signed up to the Net Zero Asset Manager Initiative (NZAM). Those who have not attribute their restraint to multiple reasons, including:

- ▶ The impact of net-zero asset managers on their fiduciary duty towards clients
- ▶ No intention to evolve their operating model to support the appropriate and required disclosure on emissions, as their clients did not appear preoccupied by the subject³

However, one asset manager argued that by not being a signatory, others are also limiting themselves by not taking a seat at the table, effectively relegating their power of influence to the industry by excluding themselves from the discussion.

Most asset managers are also defining a governance structure around ESG risks, particularly climate risk, with one mentioning defining a global climate change committee that will look like a risk committee but will focus on addressing climate change risks and addressing TCFD recommendations.

³ Since the interviews, Canada has announced that its financial regulator OSFI will require federally regulated financial institutions (banks, insurance companies and federally incorporated or registered trust and loan companies) to publish climate disclosures aligned with the TCFD framework beginning in 2024, stating that it will use a “phased-in” approach for the requirements.



OPERATING MODEL

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ESG implications on the operating model



Asset managers have largely been following clients' lead to determine the product offering and breadth as it relates to ESG.

- ▶ Those who have seen a large uptick in client interest and selection preference typically develop a broader offering and a robust integration within the investment process.
- ▶ Respondents whose clientele have not indicated a strong preference are generally waiting to see where the trend falls in the next few years.

Integrating ESG into the business largely falls under two categories:

- ▶ Creating a dedicated team to support investment teams
- ▶ Integrating ESG processes into existing channels through the formalization of ESG training, processes and procedures

Out of the 12 respondents, 4 indicated it would be the CIO's responsibility to make or approve ESG policies.

Independent of whether or not they have signed the NZAM, asset managers are looking at how the ESG trend will materialize within and beyond their book of business while keeping a close eye on the regulatory space to inform on the potential need to evolve their policies and procedures.



DATA AND REPORTING

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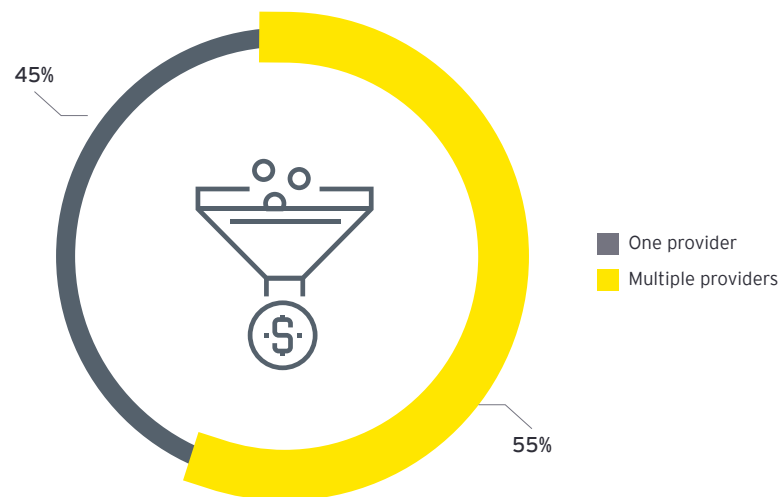


The data challenge

Asset managers continue to face data integration and data management issues. ESG data service providers are fragmented across the market, and as such firms must often rely on multiple data vendors to satisfy the variety of outputs they are targeting.

All survey respondents use at least one service provider for data, while over half (55%) mentioned using multiple providers.

NUMBER OF SERVICE PROVIDERS



The most common sources for ESG analysis and ratings were Sustainalytics and MSCI, coupled with Bloomberg.

In addition, scoring methodology and data definitions continue to be viewed as opaque, as service providers use proprietary methodologies to inform their scoring processes, which asset managers felt they had limited visibility on. As such, most asset managers develop their own scoring methodologies in-house, leveraging third-party scores and data.

Other pain points included:

- ▶ No clear reporting and data definition standards, resulting in a lot of noise and confusion as to where time and effort should be focused.
- ▶ Lagging carbon tracking data, particularly for private markets, which increases the complexity of emissions tracking and management.

When it comes to reporting, organizations are largely using TCFD, SASB, GRI and UN SDGs as foundational frameworks for their reporting processes.

The Canadian Government announced TCFD-aligned disclosure requirements and governance expectations for federally regulated financial institutions. These are expected to come into effect by 2024.

As regulation continues to evolve, Canadian asset managers can expect similar regulations and should proactively prepare for similar regulatory action.

Conclusion

Client demand has been core to the evolution of the asset management industry, and it's no different when it comes to ESG. Acting on ESG is no longer optional for asset managers who wish to preserve and acquire AUMs. ESG has transcended the "fad" stage and become a real business model imperative driven by client demand.

The proportion of asset managers offering a comprehensive ESG product offering across the spectrum of capital has doubled in the last year, with an increasing focus on building thematic and impact-driven approaches. In fact, as impact products experienced resilience to market outflows in the second half of 2022, more and more global asset managers have stated they want to venture into private markets to capture this resilience from a flow of fund perspective, while simultaneously benefiting from the opportunities the climate transition brings about and providing clients with new options in private markets.

Questions asset managers were asking two years ago about possible misalignment between fiduciary duty and ESG have been replaced with a mindset of evolving their offerings and giving their clients the option to choose, leaving it up to them to decide. This probably explains why the industry has remained shy when it comes to commitments to net-zero initiatives such as the NZAM.

This lack of commitment is also reflected in the engagement process. While we've seen some of the most advanced global asset managers who have signed up to NZAM advance their engagement practices to foster impact, most Canadian asset managers have yet to evolve their engagement practices to focus on impact from the ESG perspective.

However, the asset managers we interviewed expressed increased commitments with respect to their own operational footprints and set targets to that effect. Of the asset managers surveyed, 40% have defined emissions targets and are collecting data and monitoring their operating emissions. They have also dedicated significant efforts to ensure readiness for upcoming regulatory reporting requirements. In fact, the more advanced asset managers are beginning to inquire about auditing services for ESG reporting, not only to avoid allegations of greenwashing but also to present a robust positioning.

The level of client sophistication and commitment has impacted the requirements for asset managers. Large institutional investors have evolved their investment beliefs to reflect the view that ESG integration will lead to better long-term returns. This has started to trickle down to smaller institutional investors, who want more transparency on the footprint of their holdings.

We can expect that this trickle-down effect will also impact ultra-high-net-worth clients, as they are being approached with more comprehensive offerings. In fact, in 2020 UBS was the first financial institution to make sustainable investments their preferred solution for private clients.⁴ Surprisingly, no formal or holistic solution-based offerings have been made available to clients, including for the OCIO model, potentially providing an opportunity for some asset managers to distinguish themselves in the marketplace.

⁴ "UBS mobilizes private wealth towards sustainable finance at APAC Sustainable Finance Conference 2021," UBS Global, July 16, 2021.

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