

The rise of ESG investing

Insights from Canadian asset managers
into the environmental, social and
governance (ESG) strategies in the
investment management industry



Executive summary

2020 was nothing short of a watershed year. Amid what was already a year of change across all industries, the COVID-19 pandemic served as a further accelerator of transformation. This was the case in capital markets with investments on an environmental, social and governance (ESG) basis, fuelled by some of these highlights of the year:



Record flow of ESG funds

2019 saw a record inflow into ESG-branded mutual funds, capturing 4x the level experienced in 2018, which was a record year itself. Not to be undone, 2020 came in at 2x the 2019 level of ESG fund inflows.



Governments driving ESG investments

Governments globally started to invest massively in sustainable and innovative infrastructure – from clean airplanes to affordable housing.



The World Economic Forum (WEF)

Global leaders brought to light the “tectonic shift in capital markets,” investments taking place and a program that referred to ESG buzzwords such as “... sustainable, resilient economic systems,” “...responsible industry transformation...” and “enhancing stewardship...” programs.

Regulators accelerating change

UK and Japan stewardship codes adopted in 2020 have redefined stewardship for asset owners: “The responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.”

CEOs committing to change

The World Economic Forum’s International Business Council (WEF-IBC) – a group of 120 global CEOs – has proposed a set of common metrics for measuring important ESG metrics, with the goal of driving global standards convergence to provide asset managers and investors with better data for investment decision-making.

Given the growing spotlight on ESG factors and long-term value creation, EY conducted a survey of Canadian asset managers to better understand what their clients were asking them, how they are approaching ESG now and beyond, and how they are evolving their operating model as a result.

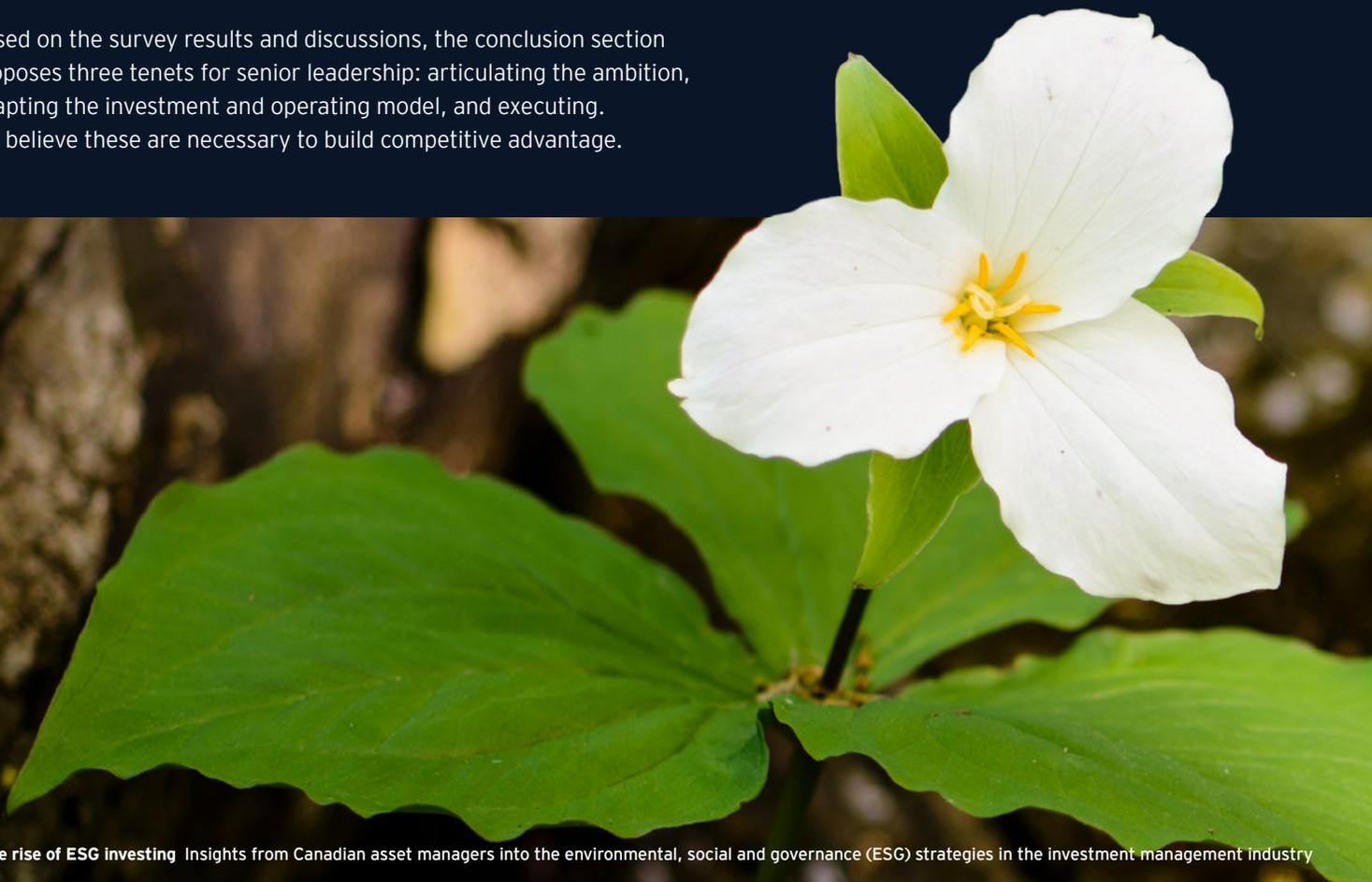
The survey results confirm the current diversity of strategy and value propositions, as well as the strong drivers of adoption and evolution.

Key findings

Our key findings include:

- ▶ Most asset managers have been reactive to the market.
- ▶ The integration of ESG into investment decision-making is taking place at two levels:
 - ▶ Across all products - only 50% indicated being fully integrated
 - ▶ From the point of view of the sophistication and robustness of integration
- ▶ The majority of respondents anticipate developing more outcome-based products in the future, but their immediate focus is on integration.
- ▶ Institutional clients continue to drive the demand for modern ESG investing – that is, not using the traditional exclusionary approach – while ultra-high-net-worth clients are demanding the expansion of ESG propositions to include outcome-based products, and some are even hinting at philanthropic products.
- ▶ Discussions on future perspectives and challenges reinforced the fundamental need for quality and standardization of data and taxonomies.

Based on the survey results and discussions, the conclusion section proposes three tenets for senior leadership: articulating the ambition, adapting the investment and operating model, and executing. We believe these are necessary to build competitive advantage.



Introduction

2020 was an impressive year for ESG investments. As century-defining social, political and economic issues emerged, such as recent social justice movements, climate change protests and the global pandemic, investors' attention to sustainable investments increased significantly.

For this survey, we interviewed large Canadian and Global asset managers to gain visibility on the current state of ESG integration into their investment approaches and offerings. We interviewed the key contributors responsible for ESG strategies with their respective organizations. Our aim was to ascertain the progress their firms are making, what role clients are playing in driving demand, understand current industry trends and drivers, and the future of sustainable investing. We interviewed participants from 20 firms, with collective assets under management of over \$2.5 trillion.

We structured the interviews around the following key areas:

- 1. Strategy and product offering:** What is the ESG strategy and how is the offer being developed to support it?

- 2. Market drivers and client perspectives:** How do the needs vary by type of client?

- 3. Investment process and organizational design:** How are firms integrating ESG into their investment processes and how do they structure to support it?

- 4. ESG reporting:** How is the industry addressing reporting?

- 5. Future perspectives and challenges:** What are the industry's views on the future of ESG and challenges in moving forward?

In conclusion, based on the views expressed and data collected, we propose key insights to help guide organizations in their next phase of ESG integration.

1. Strategy and product offering

ESG integration is a key business goal

ESG integration is a strategic priority for investment houses where it's been culturally and operationally embedded for several years, as well as those who are rapidly upskilling. But despite the unanimous agreement on the importance of ESG, the extent to which firms have integrated ESG into their strategy and product offerings varies greatly.

The majority of our respondents view ESG as a key tenet of corporate culture and investment beliefs. While some respondents are focused on branding products as ESG, others are more focused on ESG integration and less on labelling. When we asked respondents whether their organizations saw ESG as a product or a corporate belief:

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The majority of respondents (14) answered that they view ESG as a corporate belief, ensuring, at least, a minimum level of ESG integration across all of their assets under management.

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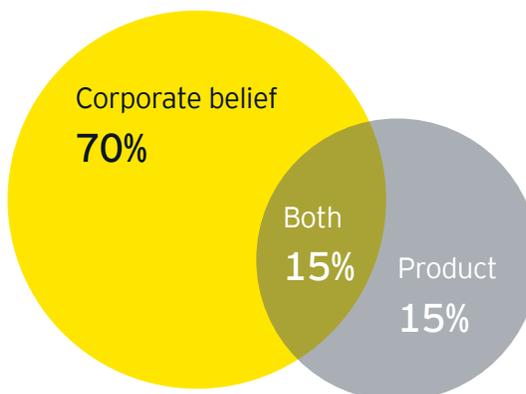
Fewer respondents (3) answered that ESG is currently a tool or product used to respond to client demand.

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The remaining respondents (3) said they see ESG as both a product and a corporate belief.

The extent to which asset managers have embedded ESG into their products and investment processes varies across a wide spectrum. Ten respondents report themselves to now be fully integrated across all portfolio managers and investments, with an additional eight respondents reporting to be somewhat integrated. Only two respondents indicated that they are in the early phases of integration, with a clear ambition to improve ESG integration in the upcoming years. A common priority across respondents was the importance of ensuring portfolio managers are equipped with the appropriate tools, knowledge and data to support them while leaving the investment making to their discretion.

Is ESG a product, corporate belief or both?



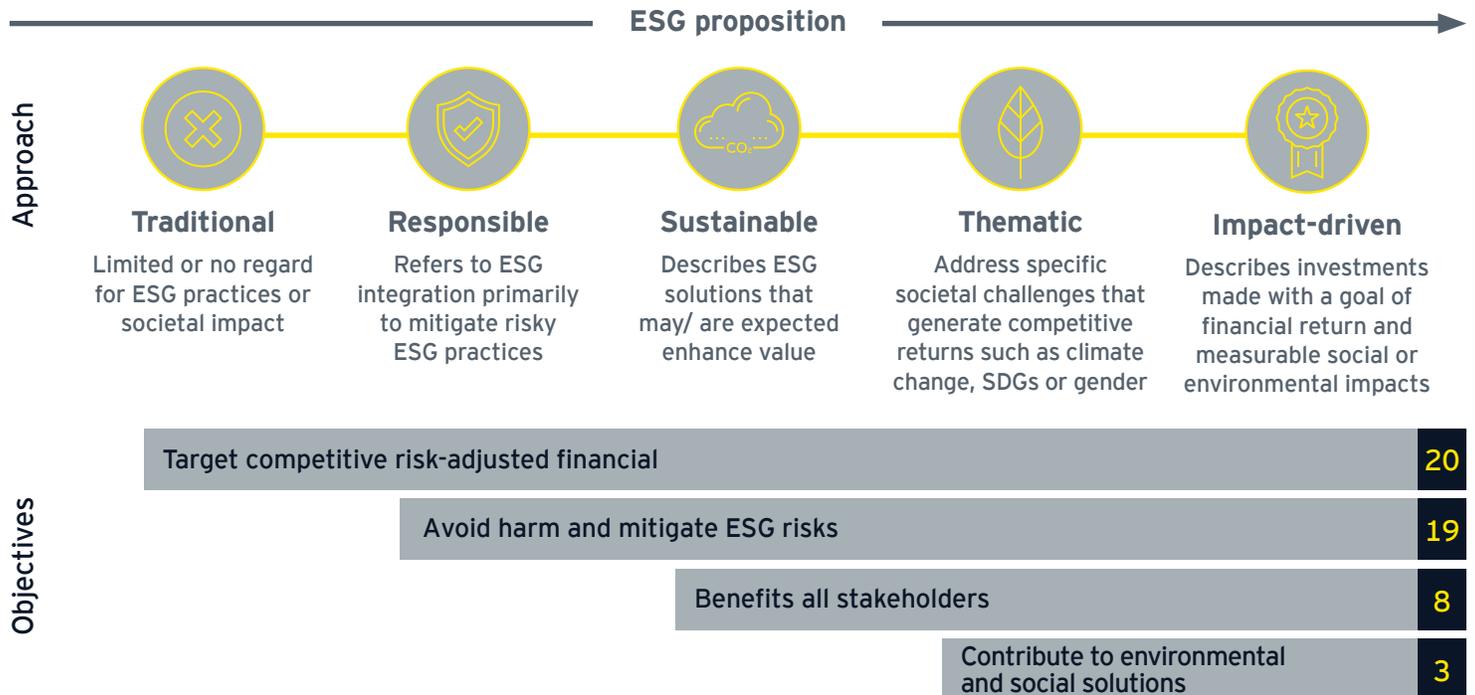
The spectrum of capital

To better understand respondents' approach to responsible investing, we asked where they would place their offerings on the spectrum of capital. Most identified their organizations as fitting in the responsible and/or sustainable investment propositions. A select few stated that they have already started developing capabilities in impact-driven investing. In most cases, the respondents identified with multiple propositions. Some also mentioned that their goal is to provide their clients a full service offering across the entire spectrum rather than limit to one.



The goal is not to go all the way to the right of the spectrum, it's to be able to have an offering across the entire spectrum.

- Head of ESG, Global Asset Manager



■ = Number of respondents currently identifying with the objective

Avoiding harm and mitigating ESG risk

All but one of the 20 asset managers indicated they offered responsible investing solutions, and for 11 of those, that was as far along the spectrum as their offer went. Most of them indicated an intent to move further along the spectrum once all their current products include ESG considerations as part of the investment process. For the others, they did not see the benefit of moving further along the spectrum (although they weren't averse to it) and as such were applying a "wait and see" approach.

Benefiting all stakeholders

Of the asset managers interviewed, 40% offer solutions that benefit all stakeholders. In particular, the "sustainable" solutions are animated by the belief that true value creation over the long-term will be driven by sustainable practices. In fact, products characterized by long holding periods are prone to sustainable investment practices. As one respondent put it, *"We are a high-conviction investor and when we get into a stock we hold it in the portfolio for an average of eight years and... we have been integrating ESG in our analysis both from a return and risk perspective as well as from an engagement perspective for years now. We just didn't label it as ESG."*

Contributing to environmental and social solutions

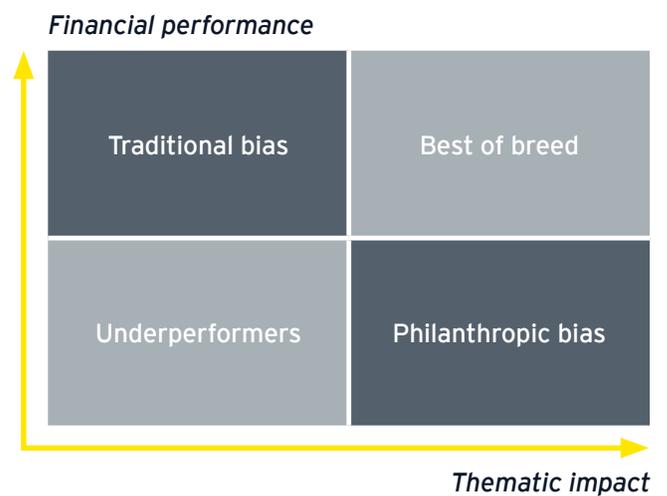
Only 3 of the 20 respondents fit into the "contributing to environmental and social solution" proposition, where various themes are being pursued with a particular focus on the UN Sustainable Development Goals (SDGs). These themes include low carbon, climate change and environment, women in leadership and diversity in the workforce.

Focusing on the most mature end of the spectrum, only 2 of the 20 respondents surveyed mentioned they have an impact investment offering today. In addition to financial objectives, these strategies have goals around achieving and reporting on positive societal impact, in relation to themes such as climate change or the UN Sustainable Development Goals. As with ESG more broadly, there are challenges around the measurement of impact with no single, agreed-upon methodology. Although we expect that as impact funds rise, the traditional top-quartile and bottom-quartile investment manager benchmarking approach will emerge on a two-dimensional basis (Illustration A).

We attribute the low number of impact-driven solutions, and the fact that few respondents indicated a growing interest in moving towards more impact-driven investing, to three key factors:

- ▶ Impact-driven investing requires, as part of the investment thesis, the ability to engage effectively with the investee companies.
- ▶ It is difficult to define ESG outcome-based investment mandates that are relevant across time and will resonate with a mass audience to ensure commercial sense, and are not unduly restrictive for asset managers to implement.
- ▶ Impact investing represents the next frontier as ESG integration with current products is the immediate priority.

Illustration A



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People only doing ESG from a defensive perspective will be left behind.

- President, Global Asset Manager

2. Market drivers and client perspectives

We wanted to understand the driving forces of the strategic focus on ESG – whether it is driven by fundamental investment beliefs, client demand or other factors.

Respondents clearly indicated that the largest market driver of ESG integration has been client demand. This section will explore the different client types driving the demand and the growing interest for responsible investing.

Institutional investors

ESG demand is largely driven by institutional investors, whose understanding and appetite for sustainable investing has been a driving force in the development of solutions. Institutional investors are increasingly requiring asset managers to be signatories of the UN Principles for Responsible Investment (UN PRI). They are also demanding more visibility on the actions being taken to support ESG integration in the investment process, in addition to looking for greater support from their asset managers in terms of education, idea sharing and thought leadership.

Institutional investors: pensions funds, university foundations and endowments

Among Institutional Investors, pension funds and endowments are the strongest drivers of the demand for sustainable investment. Pension funds are considering ESG from a perspective of better performance over the long term, which aligns well with the longer-term liabilities they must support. In fact, there is growing consensus that long-term value creation and ESG considerations in the investment process are intrinsically linked, which likely explains why long-duration liability actors such as pension funds are strong drivers of demand.

Sensitivity to ESG is even more acute for entities that are more public in nature, such as universities. They are demanding increased visibility on their portfolios' impact from an ESG perspective.

Foundations and endowments are also keen on ensuring a high level of alignment with their organizational beliefs and values. They were among the first to request screened products in the 1990s.

Institutional investors: insurers

Insurers are an interesting subsegment. None of the asset managers we interviewed indicated that change or demand was emanating from their insurance company clients. However, when it comes to management of the general account, most felt strongly about the importance of ESG integration in their investment practices. In fact, some of the insurers we spoke with are extremely sophisticated and have a robust internal process to assess the ESG integration maturity of subadvisors. However, this isn't true for all. Across all our interviewees, insurers were among both the least and our most sophisticated participants.

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Institutional clients are by far the most demanding in terms of ESG.

- President, Global Asset Manager



Retail and high-net-worth¹ clients

On the retail side, the landscape is more fragmented. Some asset managers are waiting for client demand to drive the development of dedicated ESG funds. Others are planning to brand themselves as fully ESG integrated and are working on expanding their offering to improve the breadth of available impact-driven products.

Asset managers serving high-net-worth clients – particularly those serving the second generation of these clients – notice that these clients are interested in investing their money for purposes beyond financial return. According to respondents, high-net-worth clients often have philanthropic-view tendencies when it comes to their investments. In the past, this translated into ESG integration into their portfolios mainly through exclusionary mandates such as ex-fossil fuels and carbon emission reduction mandates. However, a new concept is emerging among the new generation of high-net-worth clients: the purpose of wealth. These clients are asking themselves: How will my money create a better future for my children and grandchildren? Will my legacy be simply about money or a future with a quality of life at least as good as the one I've enjoyed?

As we begin to experience the largest wealth transfer in history, the need for relevant ESG solutions is expected to grow. Respondents mentioned that high-net-worth clients are the ones initiating the discussion and are seeking tangible impact from their investments. They prefer to invest in opportunities that will move the dial for the better rather than invest in already best of breed, effectively seeking to play a role in moving companies closer to their own values.

We expect that the frequency of these discussions will be further accelerated by the strong performance of some ESG funds over the last few years (illustration B). Additionally, the pandemic has shone a light for retail investors on ESG investing, thereby increasing the demand for sustainable investing, something the UK has already begun to experience (illustration C).

¹ For the purpose of this report, we define high net worth as \$20m+.



Illustration B

**Cumulative index performance – gross returns (USD)
(Sep 2007 - Feb 2021)**



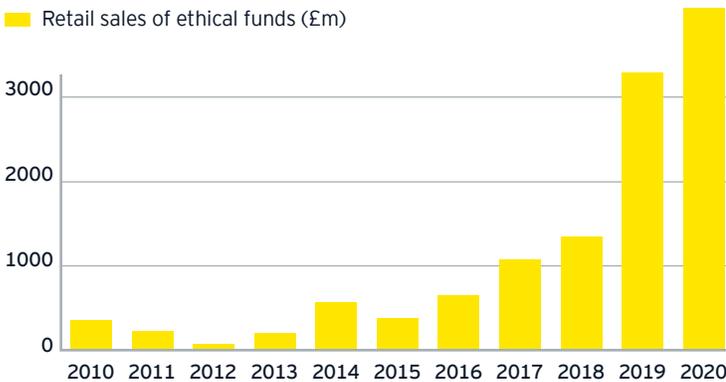
Source: <https://www.msci.com/documents/10199/9a760a3b-4dc0-4059-b33e-fe67eae92460>

Annual performance (%)

Year	MSCI ACWI ESG Leaders	MSCI ACWI
2020	16.58	16.82
2019	27.89	27.30
2018	-8.11	-8.93
2017	23.77	24.62
2016	8.50	8.48
2015	-1.72	-1.84
2014	5.40	4.71
2013	25.13	23.44
2012	15.87	16.80
2011	-5.77	-6.86
2010	13.26	13.21
2009	35.88	35.41
2008	-39.81	-41.85

Illustration C

Ethical funds have become increasingly more popular



Source: <https://www.ftadviser.com/investments/2020/10/20/top-10-esg-funds-named-amid-record-year-for-inflows/>

The advisor knowledge gap

While most respondents agree that retail clients – especially high-net-worth clients – are showing growing interest, all agree that one of the challenges of engaging in an ESG discussion is the lack of advisor knowledge. Respondents indicated that advisors were not ready to have conversations on ESG investing, even when their clients were. An Oxford risk study of the North American market indicated that only a quarter of advisors are comfortable engaging in responsible investing discussions with their clients.

Asset and wealth managers acknowledge that they don't have formal ESG education programs and presentations to support advisors. However, various efforts are underway to remedy this, with some asset managers having started taking steps towards educating and supporting their advisors. They are creating material, articles and thought leadership for their sales channels. One asset manager even launched an ESG profiling tool to support advisors in identifying their clients' ESG needs.



The evolution of ESG through time

Many of our interviewees mentioned that the early phase of ESG integration – that is, the exclusionary approach of the 1990s – limited the approach to ESG and anchored it to their personal beliefs. Today, integration of ESG into investment practices is about improving decision-making with a more holistic risk-return perspective, spanning multiple time horizons. As one asset manager focused on value funds told us, “We have been doing ESG for years! We just didn’t call it ESG. When your average holding period in an entity is eight years, you would be foolish not to analyze these [ESG] factors and engage accordingly.”

In fact, although some asset managers were reacting to client demand, others saw ESG in investing as a natural evolution of capitalism.

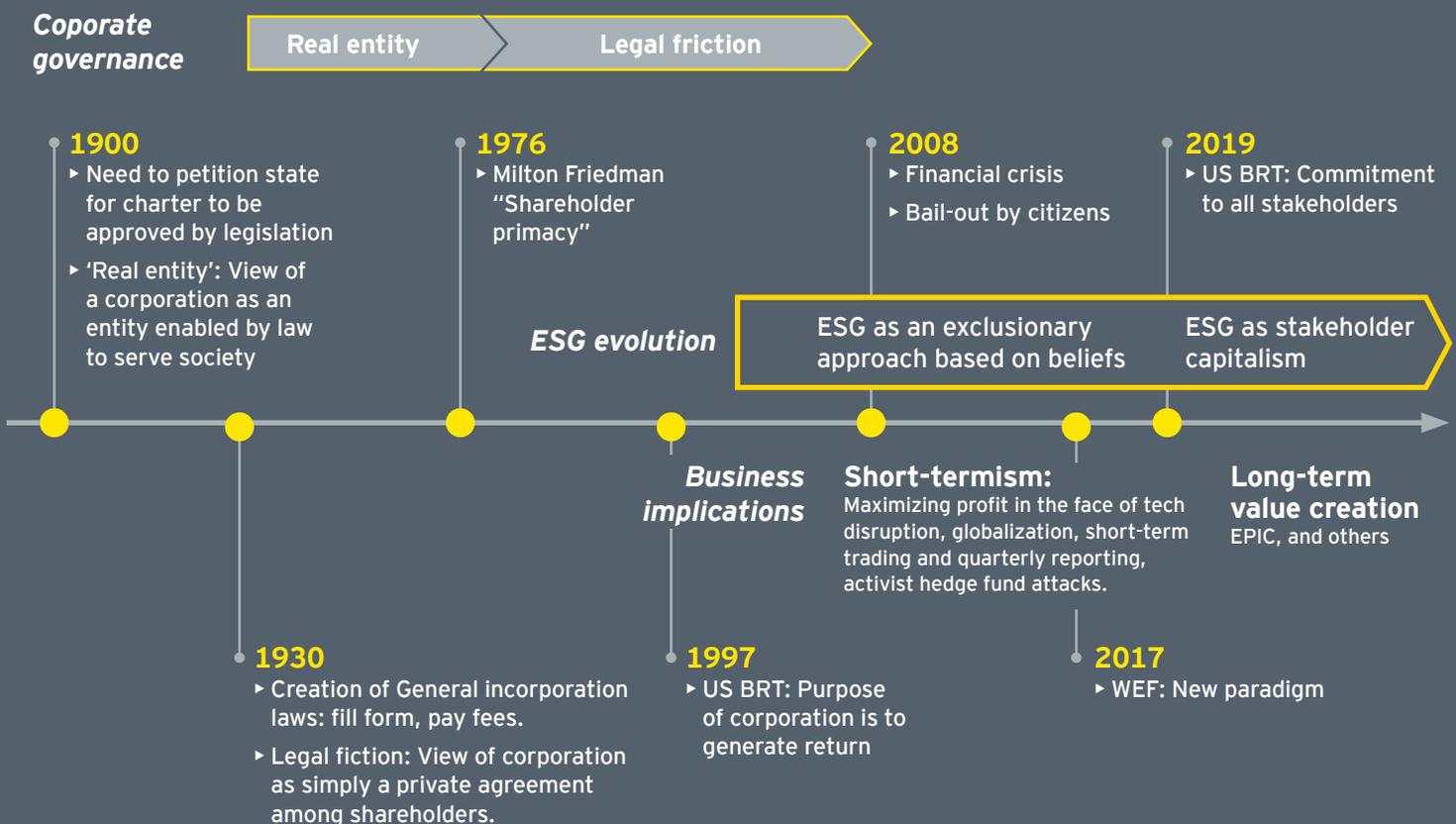
As the following timeline illustrates, there were key historical steppingstones leading to ESG as we know it today:

- ▶ In the early 1900s, a company was perceived as a real entity: enabled by law to serve society.
- ▶ Around the 1930s, general incorporation laws were created, accelerating the ability to create a company (vs. having to petition the state). This gave rise to the view

that a company was a legal fiction, a private agreement among shareholders, hence beginning a disconnect between the corporation and society.

- ▶ This disconnect was accelerated by Nobel prize winner Milton Friedman’s advocacy of shareholder primacy.
- ▶ The next few decades would see themes of major change, such as maximizing profits in the face of tech disruption, globalization, short-term trading and quarterly reporting, and activist hedge fund attacks, together leading to short-termism.
- ▶ In the eyes of many, the 2008 financial crisis was a culmination of this short-termism, which led to a society bailout. For many this shed a new light on the premise of shareholder primacy.

It does not seem that there is any intention to return to the paternalistic approach associated with the real entity concept. But ESG appears to be the natural evolution of a capitalism no longer solely focused on shareholders but on all stakeholders, where capital will be allocated less on the potential for short-term results and more on the ability to create sustainable long-term value.



3. Investment process and organizational design

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A lot of the time the portfolio managers don't think of what they're doing as ESG — it's been part of their stock analysis for a long time.

- Manager, Stewardship & Engagement, Global Asset Manager

Levels of ESG integration

A majority of survey respondents have been integrating ESG into some or all of their investment processes for years now.

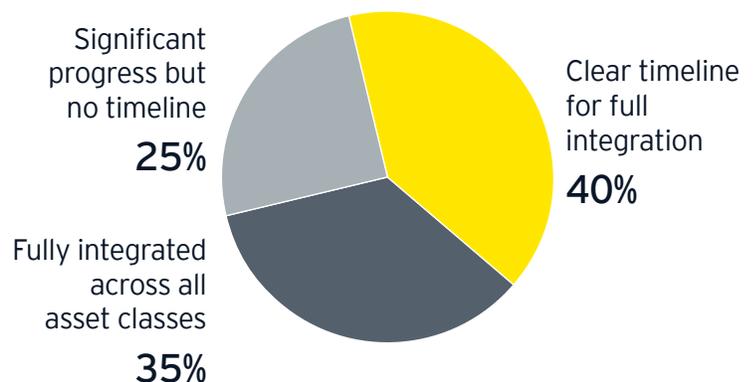
Of the 20 firms that took part in the survey:

7 identify themselves as fully integrated across all asset classes.

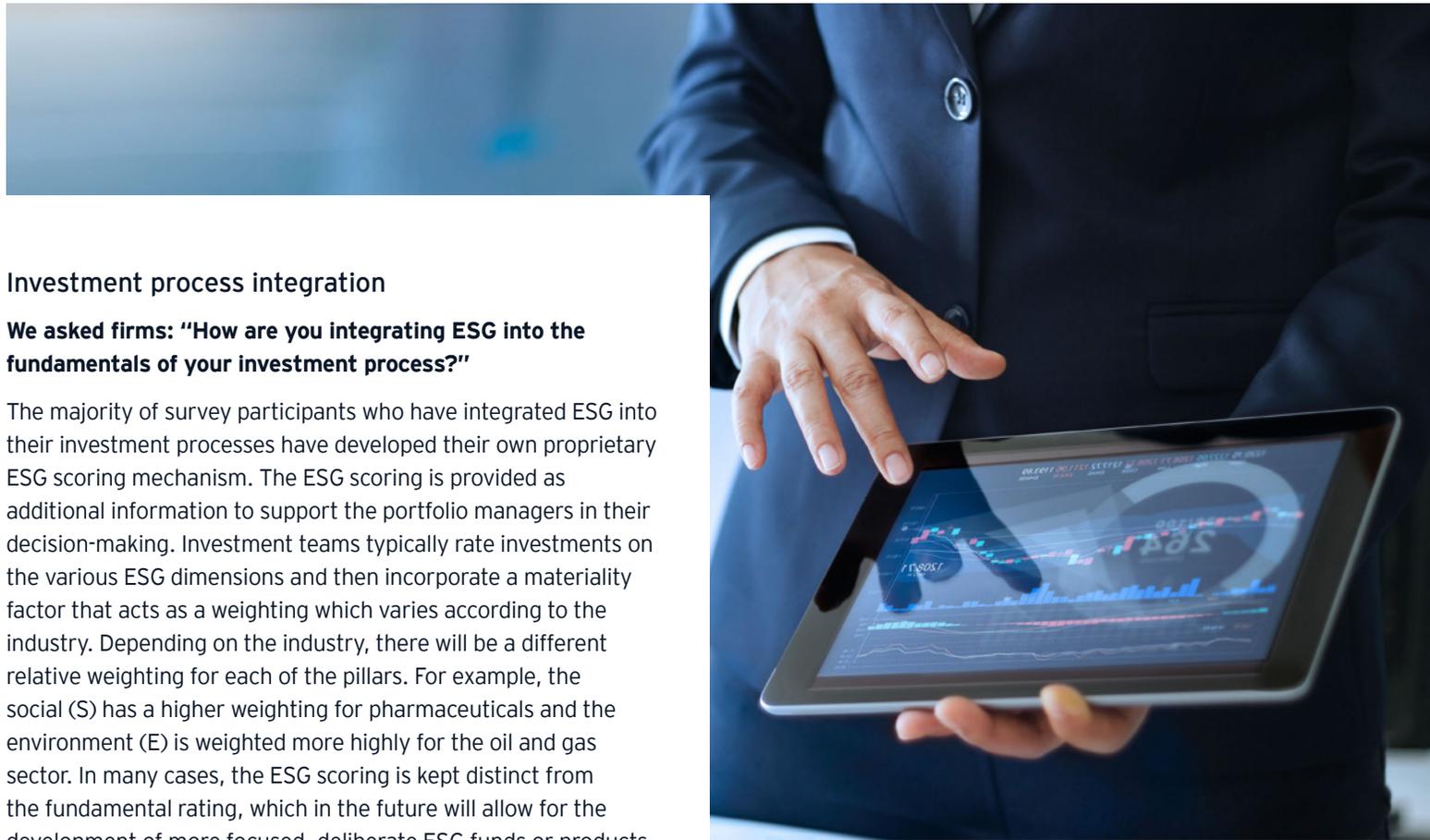
8 reported they are close to achieving full integration or have clear timelines for achieving it, ranging between one and three years.

5 stated they are making significant progress but did not share specific timelines.

Managers' assessment of ESG integration



A few respondents noted that they have been leveraging ESG concepts for decades now. It's part of their DNA, but only recently did they start to better articulate how ESG is integrated in response to client demands. Interestingly, many also pointed out that the nature of the Canadian market (i.e., higher exposure to natural resources such as oil and gas) has driven many investment managers to consider ESG-related risks (e.g., climate-related risks) for many years. This is particularly the case for those with a long-term investment horizon.



Investment process integration

We asked firms: "How are you integrating ESG into the fundamentals of your investment process?"

The majority of survey participants who have integrated ESG into their investment processes have developed their own proprietary ESG scoring mechanism. The ESG scoring is provided as additional information to support the portfolio managers in their decision-making. Investment teams typically rate investments on the various ESG dimensions and then incorporate a materiality factor that acts as a weighting which varies according to the industry. Depending on the industry, there will be a different relative weighting for each of the pillars. For example, the social (S) has a higher weighting for pharmaceuticals and the environment (E) is weighted more highly for the oil and gas sector. In many cases, the ESG scoring is kept distinct from the fundamental rating, which in the future will allow for the development of more focused, deliberate ESG funds or products (e.g. the scoring being used to tilt the portfolios).

All respondents mentioned that they subscribe to at least one external data provider to support their ESG scoring. The most common sources were Sustainalytics and MSCI. Most respondents integrate the data from these providers to feed directly into their investment platforms. This data is typically used as a basis and then further enriched by the analysts' own research to support the fund's proprietary ESG scoring mechanisms. A few respondents indicated that they have started to use alternative data sources that rely on AI techniques to enrich their views and further support their ESG assessments, with some hoping to gain a competitive edge.

All respondents were of the opinion that independent of the ESG rating, the related investment decisions must ultimately remain the prerogative of the portfolio managers and their investment team. The portfolio managers must exercise their own discretion to assess the relevance of the ESG insights in light of various portfolio factors, such as length of holding period or total portfolio exposure to the ESG factors. However, to incentivize ESG integration by the portfolio managers, many organizations incorporate it into the investment teams' annual review, where it may play a role in determining compensation.

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We subscribe to MSCI and Sustainalytics and use that information to think about ESG issues. But ultimately we do our own scoring because, depending on the data source, you can often get totally different results.

- President, Global Asset Manager

Organizational design

While asset managers are using similar approaches to integrate ESG into their investment processes (e.g., use of distinct ESG ratings), respondents clearly indicated they are using different organizational designs to operationalize their integration.

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We have a team dedicated to ESG integration and sustainability that is about 15 people across the global firm — 10 people are dedicated to public markets, of whom 3 are in Canada.

- Head of ESG, Global Asset Manager

Champions, dedicated teams and integrated approaches

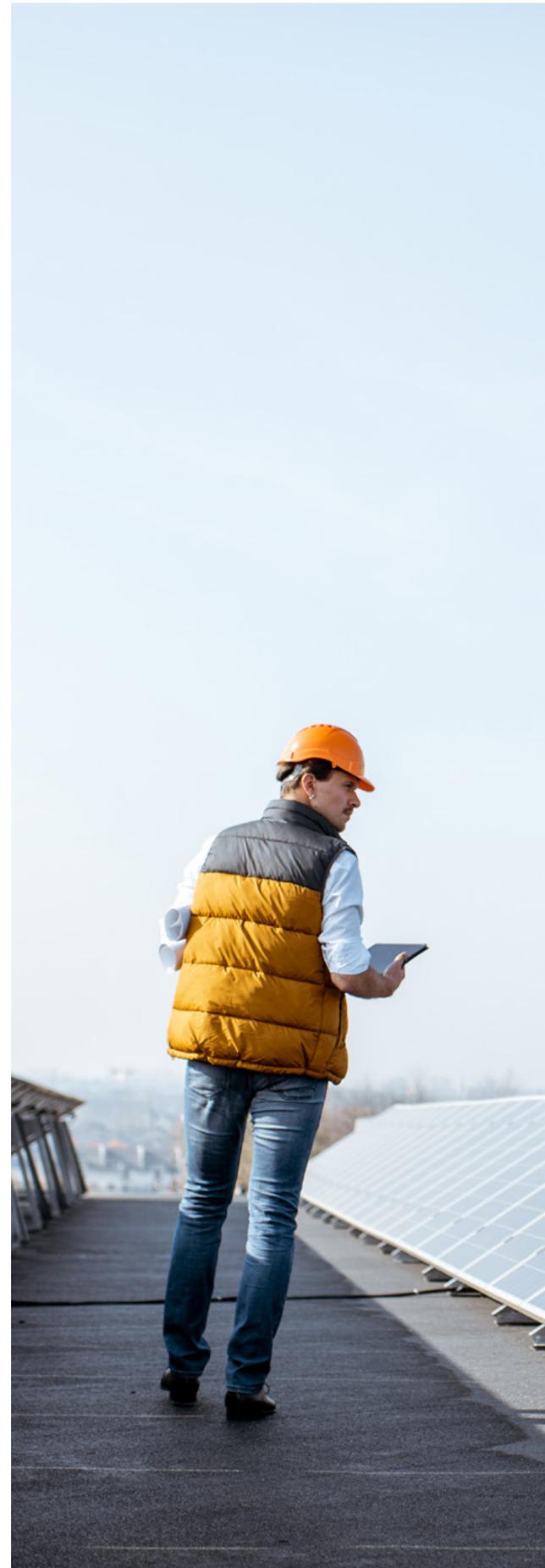
The majority (60%) of asset managers indicated they have a dedicated ESG team in their organization, whose role is to support the investment teams and portfolio managers in their ESG integration. Those who don't have an ESG team are either working towards developing one or leveraging a champion model allowing them to support, manage and monitor ESG integration from within the investment team.

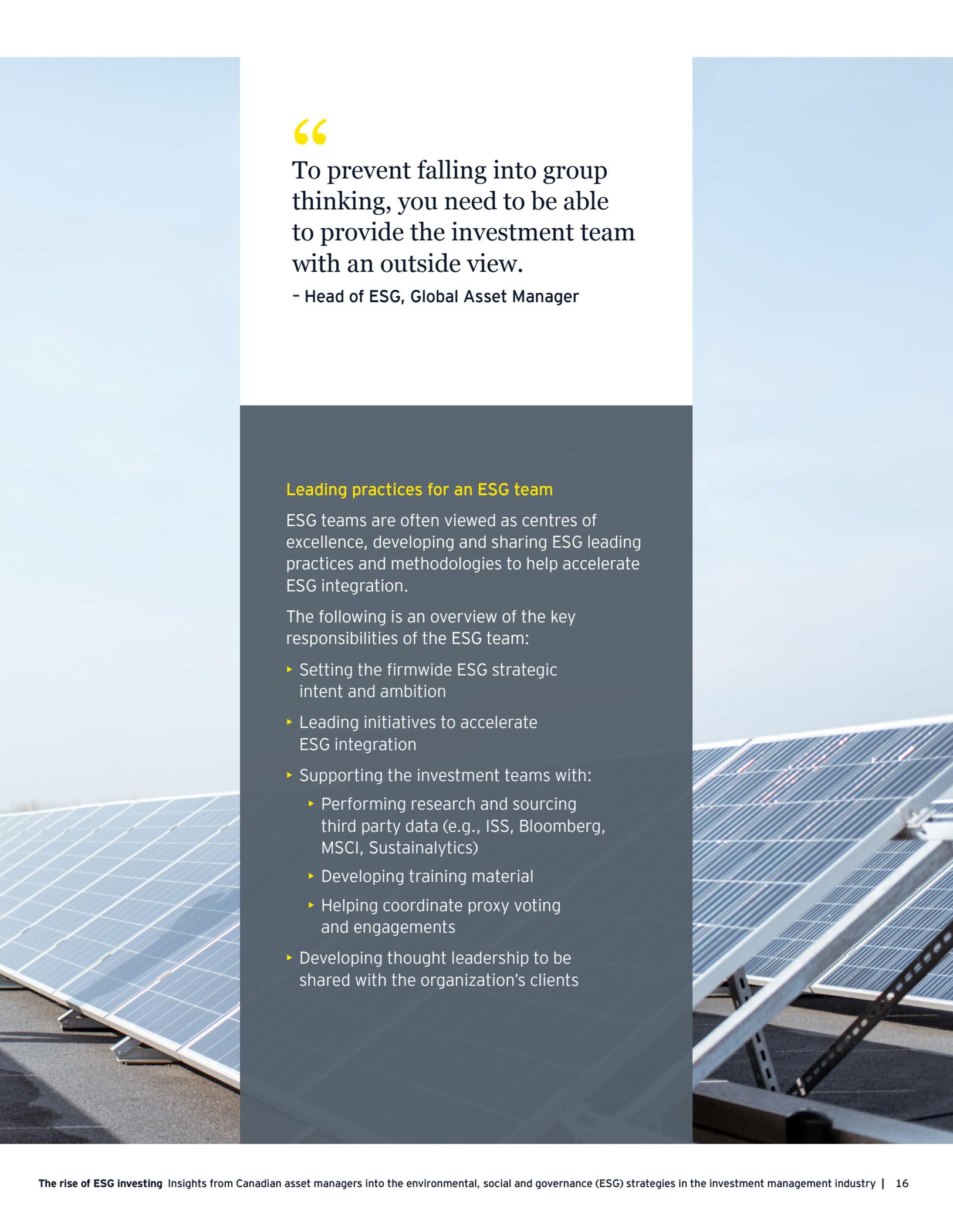
Very few organizations use a hybrid model, where there is a central ESG-dedicated team as well as “reference analysts” in the investment teams. The dedicated ESG team governs standards and practices across the firm, including points of view on macro trends. The reference analysts act as primary points of contact on ESG issues in their investment team. The reference analysts liaise with the ESG team, bringing about leading practices to be disseminated across the organization while being trained on macro trends and their potential portfolio implications.

The typical dedicated ESG team

In the majority of instances where a dedicated ESG team exists, the team is centralized as a corporate function, not an investment function. The team's key mission is to set firmwide ESG policies and support the investment functions by providing specific ESG-related research and relevant data. They effectively act as a consulting body to the investment function. However, the extent to which the investment teams make use of their full capabilities varies.

These ESG-dedicated teams are continuing to grow in popularity, with several respondents mentioning that they are actively recruiting.





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To prevent falling into group thinking, you need to be able to provide the investment team with an outside view.

- Head of ESG, Global Asset Manager

Leading practices for an ESG team

ESG teams are often viewed as centres of excellence, developing and sharing ESG leading practices and methodologies to help accelerate ESG integration.

The following is an overview of the key responsibilities of the ESG team:

- ▶ Setting the firmwide ESG strategic intent and ambition
- ▶ Leading initiatives to accelerate ESG integration
- ▶ Supporting the investment teams with:
 - ▶ Performing research and sourcing third party data (e.g., ISS, Bloomberg, MSCI, Sustainalytics)
 - ▶ Developing training material
 - ▶ Helping coordinate proxy voting and engagements
- ▶ Developing thought leadership to be shared with the organization's clients

An alternative approach to a centralized team

Some asset managers embed ESG without a dedicated centralized ESG function. In many cases, these organizations are smaller, with a more focused offering. These asset managers shared with us a few examples of how they are integrating ESG:



A dedicated ESG committee made up of senior executives – such as the CEO, all the CIOs, head of product, head of management research, head of distribution – takes responsibility for the firm's overall ESG strategy.



A senior investment professional from each investment team acts as an ESG ambassador who works with the centralized committee to ensure processes are integrated properly.



The CIO and director of investment research take responsibility for ensuring that ESG data and the proper tools are available to the investment teams, but it is the teams' responsibility to integrate ESG into their investment decisions.

Proxy voting and engagement

Proxy voting and engagements were also identified as critical to ESG integration, with many asset managers expected to use these as an additional dimension to improve ESG integration.

For the majority of asset managers, proxy voting and engagement is left to the portfolio managers. The ESG teams are typically involved, but mainly in a consultative manner at the portfolio managers' request. However, some organizations have indicated their desire to increase the implication of the ESG teams on both engagement and proxy voting, with the aim of improving cohesion and coordination.

Sub-advisory

The more advanced asset managers use proprietary ESG evaluations to rate their sub-advisors both during the selection process and annually. They have also built internal capabilities that allow them to repatriate the proxy voting internally and engage directly with the underlying portfolio companies.

Most respondents leave the proxy voting and engagement up to the sub-advisor but do a certain level of monitoring, such as reviewing the voting rationale and shareholder resolutions and ensuring the proxies are properly voted and aligned with the organization's values. Though they ensure that sub-advisors are signatories to the UN Principles for Responsible Investment, they don't pay much attention to their scores, which may reflect a lower level of sophistication for some, while for others it is likely because they have their own internal assessment of the sub-advisors when it comes to ESG integration in the investment process.



Mature practices for ESG integration

Throughout the various discussions we had with the asset managers, it became clear that some were more mature in their ESG integration journey than others. Although there are different maturity levels (each potentially essential to the evolution of the organization), we've identified practices that we believe characterize the most ESG-mature organizations.

Structure and approach	ESG team	Dedicated ESG team within investments and outside investments (hub and spokes): ESG team as a value creation partner – seamless integration.
	Investment process (bottom-up)	Investment analysts have a major role in ESG and act as first point of reference.
	Investment process (top-down)	ESG team provides macro-view of ESG trends and potential portfolio implications.
	Portfolio construction	Total ESG scoring of portfolio is actively monitored and adapted to the different strategies.
	Engagement and voting	Working group ensures coherence and firm positioning on ESG basis.
Operating model	Data sourcing	Multi-sourced + proprietary scorings.
	Reporting	Separate ESG reporting.
	Incentives	Formulaic, based on proprietary rating.
ESG KPI	UN Principles for Responsible Investing rating	Top scores on all products.
	Portfolio integration level	Applies to 100% of portfolio.

4. ESG reporting



Reporting requirements are getting more and more demanding. The challenge today is creating a methodology that will allow us to measure the SDG impacts associated with the companies in which we are investing.

- Client Portfolio Manager,
Canadian Asset Manager

With increased demand for greater transparency driven by both institutional and retail high-net-worth clients, ESG reporting is increasingly top of mind for all asset managers. How they report on these metrics, however, differs across the respondents. Some are more advanced while others are still in the development phase.

For this survey, we asked asset managers how they were reporting against ESG and whether they were members of the United Nations Principles for Responsible Investment.

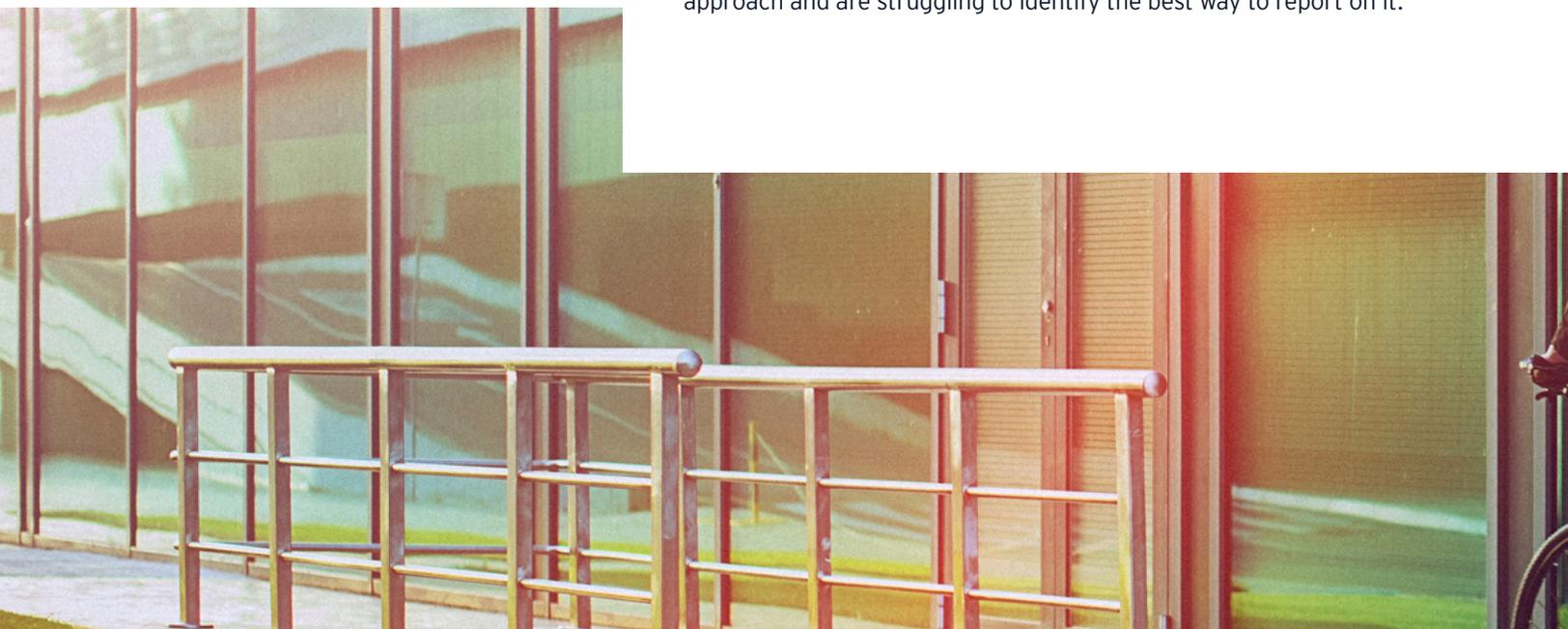
Widespread and developing ESG reporting

All but two respondents report on their ESG efforts in some form. About half of them include an ESG section in their annual report, while the other half publish separate ESG reports. Some organizations do both. ESG-specific reports include aspects such as ESG thesis, highlights of new names introduced and names exited, and emerging themes. This is often supplemented with thought leadership and white papers.

As demand for transparency increases, asset managers are increasingly providing their clients with customized ESG reports. They are also increasingly publishing their engagement efforts and proxy voting. This includes summaries of particularly productive investor company engagements. Some are also reporting on the progress towards ESG integration, presenting an overview of specific ESG initiatives, with illustrative case studies.

Asset managers also report on the ESG positions of their portfolio, including metrics such as carbon footprint (e.g., carbon intensity, top 5 emitters). Many, however, pointed to the challenges of reporting on specific metrics, particularly given the lack of consistency among data providers.

Moreover, as asset managers consider moving into impact investing, many have indicated the unique reporting challenges that come with this approach and are struggling to identify the best way to report on it.



Universal United Nations Principles of Responsible Investing membership

All asset managers surveyed are signatories to the United Nations Principles of Responsible Investing. The majority have been signatories for a number of years, with only a few having joined within the last year or so.

We asked survey respondents about the level of resource commitment required to support reporting under the principles. Most agreed that the reporting process is quite consuming in terms of both time and resource commitment. They mentioned that they allocate the equivalent of at least one FTE to complete the reporting required, with most requiring between two and five FTEs for several weeks. The process differs by size of the asset manager and the number of product offerings, as it is more onerous for those with a greater number of products.

The respondents attribute the lengthiness of the process to several factors, including the process of engaging with different stakeholders in the organization and ensuring the accuracy of the information being reported. Although many pointed out that there is slightly more leniency in the first year of a firm's reporting, it seems reporting guidelines are becoming more stringent.

Many respondents indicated that they make their rating public, while others will only release it upon request. The majority of respondents expect this information to become a table stake requirement in the industry. However, some pointed to the danger of relying solely on this assessment to evaluate the organization's ESG integration. Many believe that the assessment should be complemented by investors' own due diligence.

Beyond reporting

Although reporting and communication are often perceived as necessary evils, some are actually using these efforts to create value for their organization.



Enhance brand image and credibility

- ▶ Publish thought leadership and white papers
- ▶ Publish an ESG-dedicated annual report that covers, among others:
 - Firm vision going forward
 - New ESG initiatives and actions supporting ESG integration
 - Impact and outcomes
 - Proxy voting and engagements



Improve integration performance

- ▶ Understand the drivers of UN Principles of Responsible Investing scores
- ▶ Adapt internal integration processes
- ▶ Reinforce marketing's ESG storyline



Drive efficiencies

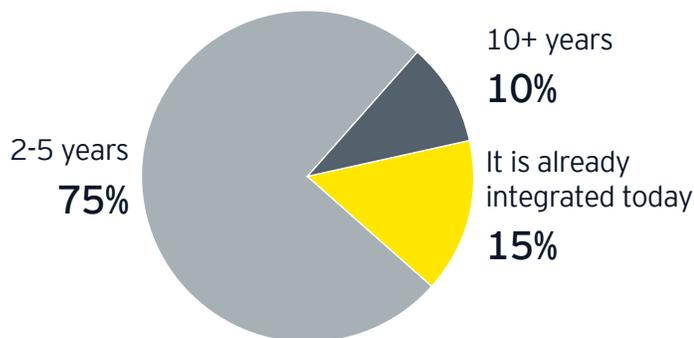
- ▶ Design future-proof client reporting
- ▶ Develop systems that facilitate necessary data capture



5. Future perspectives and challenges

We asked respondents how long they thought it would take for ESG to become fully integrated into the investment process of Canadian asset managers. The majority of respondents (15) expect that it will take another 2 to 5 years. Three said it was already fully integrated today, while the remaining two respondents are estimating another 10 years.

How long until ESG is fully integrated into the investment process?



None of the asset managers we spoke with saw ESG products either returning to or remaining on the margins, as investor demand and regulations are expected to continue to drive growth.

We also asked respondents whether they believe ESG performance will become as important as financial performance, and if they saw a future where investors would be willing to give up some returns in exchange for a societal/ESG impact. The majority don't expect clients will be willing to sacrifice return in exchange for impact. Some indicated that institutional investors' fiduciary responsibility precludes them from accepting lower returns. On the other hand, there is a consensus that retail investors are more likely to view impact on the same level as financial performance, especially younger investors and high-net-worth clients, and in particular second+ generation wealth inheritors.

“

Demand has been accelerating, and in the future there will definitely be a group of clients that takes into consideration impact as much as performance.

- Client Portfolio Manager,
Canadian Asset Manager

Key challenges - data, taxonomies and talent

More than half of the survey respondents mentioned data, or the lack thereof, as being the biggest challenge of ESG integration. Some respondents shared with us that the data tends to be limited for some asset classes and may lack granularity in some areas. One respondent also said that depending on the data source, the ESG scores could differ materially. As such, they felt that the data from third-party providers could not be taken as-is and needs to be adapted to ensure it is serving its intended purpose.

ESG disclosure from companies is also a challenge. Since it is not fully standardized, there are gaps in the information, making it challenging for portfolio managers to analyze. The standardization of data is viewed as a prerequisite to further support ESG integration. Many mentioned that the SASB disclosure standards are expected to contribute significantly to this standardization.

The second-most mentioned challenge was the lack of standard taxonomies that organize and combine pertinent elements of ESG data from different sources and how they relate to derive scoring. ESG means different things to different stakeholders and there is, for the time being, no formal standard or consensus on what the proper set of definitions should be. This lack of standardization makes it difficult to measure and compare ESG impact across asset managers and against benchmarks. Having said this, many recognize that the industry is evolving rapidly and expect that some standardization will emerge sooner rather than later.

Another challenge is the continuously expanding reporting requirements, which makes it hard for less-equipped asset managers to keep up. The growing pressure for reporting transparency from clients is also adding to this challenge.

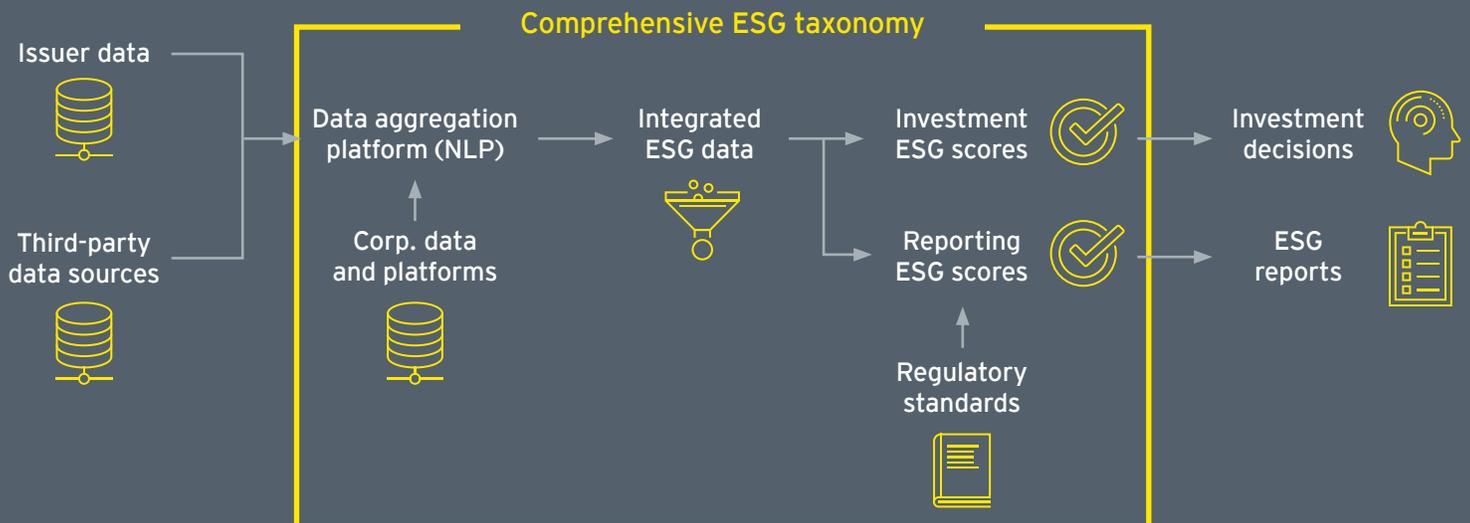
Another emerging challenge is talent. According to some respondents, there is a limited pool of available talent in Canada with ESG and technical investment expertise. This could hinder adoption and integration of ESG in the investment process.

The evolution of ESG taxonomies and data

There are various dimensions of difficulty in working with ESG data. For one, the ESG data available is often limited and proprietary to specific providers, with visible discrepancies in scoring results among major sources. Additionally, several ESG factors and UN Principles of Responsible Investing goals require some level of qualitative assessments to which thresholds and arbitration must be applied. A comprehensive overall assessment will need to be composed of a combination of both quantitative and qualitative data, weighted based on investment objectives.

The data and scoring currently in use mostly relies on quantitative metrics, whereas the UN principles and other sustainability frameworks require integration of large amounts of unstructured information. Natural Language Processing and other machine learning solutions, based on vendor proprietary taxonomies and scoring, are emerging.

Finally, ESG data sources, taxonomies and scoring used to inform asset evaluation, ment process will be different from those used for formal and regulatory reporting. As the former focuses on forward-looking opportunity identification, the latter is anchored on point-in-time reporting. Below is a high-level illustration of the ESG data landscape.





Conclusion

As illustrated by our survey, ESG is clearly a key strategic consideration for asset managers across Canada – both for those that have been using it for years and those that are just ramping up.

While the integration of ESG into the investment process is becoming imperative for asset managers' survival, approaches to this integration vary across organizations with different propositions, strategies and methods. Today, asset managers in Canada are going about it in a variety of ways, including building ESG-dedicated teams in their organizations, developing proprietary ESG scoring mechanisms and taxonomies, introducing ESG-themed alpha generation, partnering on sourcing and integration of data into their systems, and developing dedicated ESG reporting.

However, the integration of ESG still faces several challenges, including the lack of consistent data and clear reporting standards.² In addition, reporting requirements continue to become more stringent and the demand for greater transparency from clients continues to grow and expand to capture impact, making it harder for less-equipped managers to keep up.

Far more than a fad, ESG represents a fundamental change in investment, and we are still in the early stages of understanding its full impact on capital markets. We believe that the client demand for ESG will continue unabated and that asset managers that are able to jump ahead with appropriate offerings and capabilities will gain a considerable competitive advantage.

² We see an effort from the industry to create generally accepted standards, such as the WEF-IBC initiative.

In our view, those that will be able to gain an early competitive advantage will have senior leadership aligned to the following three tenets:



1. Articulate the ambition

Asset managers need to define and align around a compelling ESG ambition for the organization, effectively ensuring that they:

- ▶ Take a proactive stance vs. reacting to the market
- ▶ Filter out the noise to focus on real change imperatives
- ▶ Define indicators on which clear management action is enacted once triggered



2. Adapt the investment and operating model

Translating the ambition into the necessary evolution to the investment and operating model will be a cornerstone of quickly creating a competitive advantage. Are major changes to the organizational model, investment processes, data and analysis, and reporting necessary? In what order and to what time horizon? What about talent and comp models? Answering such questions early to form coherent evolution of the investment and operating model will enable efficient execution compared to a piecemeal approach and will prove to be more cost effective and impactful in the long term.



3. Ensure C-Suite-owned execution

Developing a shared vision and roadmap that drives transparency towards the ambition will be critical. For many, working towards the ambition represents a transformational journey that require trade-offs and reprioritization in a dynamic environment, and thus demands senior leadership ownership and accountability.



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