Does your nonfinancial reporting tell your value creation story?

The better the question. The better the answer. The better the world works.
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Foreword

On behalf of EY, it is my pleasure to introduce this fourth edition of EY research on investor perspectives of environmental, social and governance (ESG) or nonfinancial reporting and the role it plays in decision-making.

This year’s study of institutional investors globally reveals notable consensus that ESG information is critical to investor decision-making. As you’ll read in the pages ahead, investors around the world have come to expect broader, more useful reporting of material nonfinancial performance information. After years of sporadic, often promotional reporting of nonfinancial information, issuers have risen to the challenge of meeting investors’ demands for high-quality nonfinancial information disclosures. Their first step in doing so is to better understand the material topics for an organization or an industry; that is, determining which topics, measured with which metrics, will yield the most useful view of the risks and opportunities that drive the long-term value of their companies. Investors in this year’s study affirm that, while companies have improved their ability to discern what is and what is not material to valuation, both issuers and investors look forward to consensus on how to report and value performance on these material topics. Such consensus is likely to require intelligent collaboration between government, industry groups and investors in the years ahead.

We at EY are grateful for the candid responses from more than 260 institutional investors who participated in this year’s research effort and their thoughtful remarks.

There is a lot at stake here. For EY, this research provides insight into how we can play our part in meeting our purpose of building a better working world. How so? Well, by contributing to practices that lead not only to greater transparency and better constructs for long-term value, but also to fostering a sense that stewardship of the planet’s environment, resources and people will be central to how well business and our world works in the future.

Mathew Nelson
EY Global Leader
Climate Change and Sustainability Services
Key findings

Over the last 10 years, investors have come to place greater emphasis on ESG factors when evaluating companies in which to invest, and ESG has now become integral to the investment decision-making process. Companies should issue “a holistic collection of material disclosures that provide investors with insights they need to understand the future of a business and the quality of corporate management’s handling of the opportunities and challenges ahead,” says Jonathan Bailey, Head of ESG Investing at Neuberger Berman (US$299 billion under management).
An increasing reliance on ESG

In a dramatic increase from the 2017 EY survey, nearly all investors who responded to the survey (97%) say they conduct an evaluation of target companies’ nonfinancial disclosures; leaving just 3% of respondents now saying they conduct little or no review. The proportion of investors’ clients that are asking about ESG and expecting it to be integrated into mandates is also increasing. Furthermore, ESG information plays an increasingly important role in the investment decision-making process, and nearly all respondents (96%) say that such information has played a pivotal role. In interviews, investors stressed the importance that sustainability disclosures play in appropriate market valuation. Listed entities, therefore, should focus on ensuring nonfinancial information has the same level of scrutiny as financial information.

A demand for broader and more consistent data

Investors are requesting broader and higher-quality nonfinancial data from public companies, and seeking consistent, investment-grade information to support their decision-making. “It’s not particularly helpful if companies are disclosing different types of information and using different metrics,” says Glenn Booraem, Principal and Investment Stewardship Officer, Vanguard (US$5 trillion under management). “The real value for us is consistency on a cross-industry and long-term basis.” The most useful ESG reports come from companies that understand the notion of materiality and can identify which nonfinancial factors are most important to their industry and business model. Also often missing are measures of accountability. Getting the alignment that investors seek is a challenge for both listed entities and regulators.

Disclosure has improved, but remains uneven

It is clear from responses that corporate disclosures are improving. Investors responded that, while they believe most companies are disclosing the ESG risks that could affect their current business models, the disclosure is unbalanced: governance risk leads reporting, with social and then environmental risks being less well reported. Investors say that most companies are able to assess the materiality of governance factors but, in interviews, investors say there is a long way to go for companies to fully understand what is material, what is relevant and how best to report it, beyond governance. Investors report that, governance aspects aside, the main ESG factors in investment decision-making are related to supply chain, human rights and climate change risks.

More concern over physical risk of climate change

Investors who responded to the survey say they are currently more concerned about disclosures in relation to the physical implications of climate change risk than the transitional risk tied to adapting to new regulations, practices and processes. However, in interviews, investors say they pay close attention to both aspects, depending on the type of investment under consideration.

Wanted: investment-grade accounting standards

Investor demand for prescriptive nonfinancial accounting standards is rising: 59% of investors who responded say that accounting standards for nonfinancial information would be very beneficial, a dramatic uptick of 26 percentage points over our last survey. Respondents also say that ESG data must be standardized to create a useful basis of comparison, to establish benchmarks and to mark trends.

Collaboration critical to closing information gap

Investors who responded to the survey say that national regulators are best suited (70%) to lead efforts to close the gap between investors’ need for nonfinancial information and the information actually provided by issuers. In addition, investors interviewed for this report are looking for intelligent collaboration among themselves, regulators and organizations such as trade groups and non-governmental organization (NGOs) to establish appropriate and effective reporting standards.

In summary, these findings reflect a more sophisticated understanding by investors of the link between performance and ESG factors. This means organizations should seek to build a coherent and strategic story on how they are seeking to grow intangible value to support their conversations with investors and prepare for future regulatory development.

Establishing a structured materiality process is the starting point to understanding and measuring impact. With this, organizations can begin to measure and report ESG outcomes (via appropriate measurement indicators and proxies for nonfinancial information), and subsequently long-term value.
Investors increasingly rely on ESG or nonfinancial information
An increasing reliance on ESG

After several years of growing evidence of the impact of commerce on climate change, scandals tied to poor corporate governance and a new appreciation for the social impact of business, institutional investors are increasingly likely to use nonfinancial performance information as an essential component in investment decision-making. Nearly all investors who responded to this survey (97%) say they conduct either an informal evaluation (65%) or a structured, methodical evaluation (32%) of a target company’s nonfinancial disclosures. Only 3% say they conduct little or no review (see figure 1). This represents a dramatic rise of nearly 20 percentage points in the use of ESG information since our last survey. In the 2017 EY report, 78% of investors who responded said they conducted either an informal evaluation of a target company’s nonfinancial disclosures (51%) or a structured, methodical evaluation of nonfinancial disclosures (27%). A full 22% said they conducted little or no review; in 2015, 48% of survey respondents held this view.

Figure 1: Most investors conduct an informal review of ESG and many conduct a structured review; very few ignore ESG
Investors’ method for evaluating nonfinancial and ESG disclosures

- We conduct little or no review of nonfinancial disclosures (3%).
- We usually evaluate nonfinancial disclosures informally (65%).
- We usually conduct a structured, methodical evaluation of nonfinancial disclosures (32%).
Versatile application of ESG factors

ESG information plays an increasingly important role in the investment decision-making process, and respondents believe that ESG factors can help mitigate downside risk. Nearly all respondents (96%) say that such information has occasionally (62%) or frequently (34%) played a pivotal role in decision-making. Only 4% say such information is seldom or never part of the decision-making process (see figure 2). Again, this increased use of ESG information is a dramatic rise from the 2017 EY survey, where 68% of investors who responded said they used ESG information frequently or occasionally and 32% said they seldom or never use it.

In interviews, investors stressed the importance of sustainability disclosures in appropriate market valuation. “We’re not interested in the disclosure for disclosure’s sake. What’s most important is to ensure the market has adequate access to information so that it can set appropriate value, and we see more and more advocacy from a broader range of investment managers who are driven by this long-term perspective,” says Glenn Booraem, Principal and Investment Stewardship Officer at Vanguard.

Investors say they are more likely to consider nonfinancial information occasionally or frequently when adjusting valuation for risk (70%), examining industry dynamics and regulation (63%), and when reviewing investment results (61%). “ESG disclosure creates a significant degree of alignment with the long-term value orientation of each portfolio company, and ESG oversight and its framework are foundational to long-term value creation for our end investors,” says Booraem.

Investors believe that ESG factors can provide downside risk protection – 89% of respondents say that ESG information is somewhat more valuable (80%) or much more valuable (9%) in investment decision-making in a market downturn.

“ESG oversight and its framework are one foundational pillar of the long-term value creation for our end investors.”

Glenn Booraem
Vanguard

Figure 2: Investors see ESG information as valuable in a market downturn

In the last 12 months, how frequently has a company’s nonfinancial performance played a pivotal role in your investment decision-making?

- Frequently: 34%
- Occasionally: 62%
- Seldom: 3%
- Never: 1%

In the event of a market downturn or correction, do you think ESG and nonfinancial information will become:

- Much more valuable: 80%
- Somewhat more valuable: 9%
- Somewhat less valuable: 1%
- Much less valuable: 2%
- Don’t know: 8%
Increasing reliance on integrated and annual reports

Investors are relying increasingly on ESG disclosures from the target companies themselves, and their use of corporate social responsibility (CSR) or sustainability reports, equity research from broker-dealers, press coverage and other external sources is decreasing or unchanged. Nearly all responders (94%) reported that integrated reports are very useful (88%) or essential (6%) sources of nonfinancial information. The same percentage reported that annual reports are very useful (82%) or essential (12%) sources of nonfinancial information (see figure 3). In the 2017 EY survey, only 57% reported that integrated reports were very useful or essential, and 63% reported the same about corporate annual reports.

However, with more investors requesting broader and higher-quality nonfinancial data from target companies, they tend to find it lacking. “Effective ESG reporting is less about marketing and glossy pictures and metrics that may not be relevant to the core business model of a company,” says one of the executives interviewed for this report. The hallmarks of good reporting combine metrics and quantitative measures in the context of their long-term strategies. He explains that the most useful ESG reports come from companies that understand the notion of materiality and can identify which nonfinancial factors are most important to its business model.

Figure 3: Integrated reports and annual reports emerge as preferred sources of ESG information

How useful do you find the following sources of nonfinancial information when making an investment decision?

<table>
<thead>
<tr>
<th>Source of Information</th>
<th>Essential</th>
<th>Very useful</th>
<th>Somewhat useful</th>
<th>Not very useful</th>
</tr>
</thead>
<tbody>
<tr>
<td>Integrated report</td>
<td>6%</td>
<td>89%</td>
<td>4%</td>
<td>1%</td>
</tr>
<tr>
<td>Annual report</td>
<td>12%</td>
<td>82%</td>
<td>5%</td>
<td>1%</td>
</tr>
<tr>
<td>CSR or sustainability report</td>
<td>2%</td>
<td>51%</td>
<td>43%</td>
<td>4%</td>
</tr>
<tr>
<td>Equity research and advice prepared by broker-dealers</td>
<td>2%</td>
<td>50%</td>
<td>45%</td>
<td>3%</td>
</tr>
<tr>
<td>Press coverage and business commentary</td>
<td>2%</td>
<td>42%</td>
<td>51%</td>
<td>5%</td>
</tr>
<tr>
<td>ESG ratings or assessments from investment data providers</td>
<td>3%</td>
<td>34%</td>
<td>56%</td>
<td>7%</td>
</tr>
<tr>
<td>Sustainability Accounting Standards Board indicators</td>
<td>4%</td>
<td>27%</td>
<td>66%</td>
<td>3%</td>
</tr>
<tr>
<td>Social media channels</td>
<td>4%</td>
<td>25%</td>
<td>64%</td>
<td>7%</td>
</tr>
<tr>
<td>Corporate website</td>
<td>6%</td>
<td>15%</td>
<td>73%</td>
<td>6%</td>
</tr>
<tr>
<td>Sustainability or CSR index rankings produced by a third party</td>
<td>2%</td>
<td>12%</td>
<td>81%</td>
<td>5%</td>
</tr>
</tbody>
</table>

Nearly all investors who responded said integrated and annual reports are essential or very useful sources of nonfinancial information.
“It’s not particularly helpful if companies are disclosing different types of information and using different metrics,” says Booraem. “The real value for us is consistency on a cross-industry and long-term basis.” More than half of respondents (56%) say that a company’s nonfinancial disclosures are either not available or inadequate for meaningful comparison with those of other companies. Here lies the merit of having common frameworks in place, say investors interviewed for this report, several of whom point to the Sustainability Accounting Standards Board (SASB) framework and other industry-wide standards. “First and foremost, we evaluate whether a company is reporting in general alignment with one of these frameworks, or in general alignment with their peers,” says Booraem.

Investors report that the quality and relevance of nonfinancial data that companies provide can vary significantly by company, industry and region. “At a high level, it’s important that the information we see from companies is comparable. Comparability is important both across companies at a point in time and across the market over time,” says Marc Lindsay, Senior Strategist at Vanguard. Such comparability makes it possible to assess the relative performance of companies within an industry and to identify leaders and laggards on a sector-by-sector basis. Common metrics and reporting criteria, says Lindsay, allow him to observe long-term trends and evaluate the progress of a board and a management team in responding to market feedback and their oversight of significant risks.

“Comparability is important both across companies at a point in time and across the market over time.”

Marc Lindsay
Vanguard
Investors say that there is a lot of disclosure about formal governance documents, policies and practices that are in place, but what’s missing are measures of accountability — information on how nonfinancial metrics are established and managed on a short-, medium- and long-term basis. “We get a lot of data around practices, but we’d like to see more details on their effectiveness,” says one executive. “But there often aren’t any measures that allow us to assess the quality of how an ESG process is actually managed in any detail.” For example, a company may be taking actions to reduce its carbon intensity and emissions. “That’s great. Very helpful and good to know, but it would also be helpful to have a breakdown and data around their internal benchmarks and the progress being made against them in different business segments, regions and facilities,” he says.

Investors also seek more forward-looking information and closer connections between ESG activities and business. “It’s one thing for a company to report its ESG achievements over the past 6 months, 12 months, or 3 to 5 years, but we’d like to see what that will look like 20 or 30 years in the future,” says a vice president at a large asset manager. Company reporting by its nature is backward-looking, and claims of environmental or social achievements are often reported without strategic context. As one investor put it, “… companies tout their ESG performance even when there had never been a clear commitment to improve in the first place. And, of course, there are many cases when a commitment is made and quietly forgotten in the years that follow.”

In the ESG data that’s available in the market, there’s a clear tendency for companies to disclose their activity-based data. “Companies often list the ways they are contributing to a given ESG issue, reducing carbon emissions, for example, but the outputs don’t really get reported,” says Urs Bitterling, Senior Manager Corporate Responsibility and ESG at Allianz. “Maybe they started a program or trained a number of workers, but there is no follow-up and no way to measure progress or final results.”

Investors look to companies to identify the environmental and social factors that are important to helping them achieve a long-term strategic objective and to set the targets that will be relevant over that time horizon. “It is helpful for us to understand how management incorporates material ESG considerations into the broader strategic and capital allocation decisions that they are making,” says Jennifer Signori, Senior Vice President and Principal at Neuberger Berman.

Investors look to companies to identify the environmental and social factors that are important to helping them achieve long-term goals and set targets.
Issuers are getting better at assessing materiality, but there is a long way to go.
Companies disclosure of ESG risks is improving – especially governance

ESG disclosure is improving dramatically. Investors surveyed report that most companies disclose the ESG risks that could affect their current business models. “We are on a journey,” says Marc Lindsay at Vanguard. “We’re seeing different markets that seem to be integrating these factors into their strategies as well as providing more robust disclosure, and it also depends on which ESG factors are at play.”

He cites, for example, European companies providing more disclosure of their approach to climate risk and notes that, while many companies in the US and elsewhere do a good job, there is a long way to go.

Some investors say that information about corporate governance, such as a board’s capacity and capability, the structure of executive compensation, transparency of accounting practices and capital allocation techniques, tends to be more complete because of accounting or exchange-listing requirements in place in many countries. “While we still think there are gaps on the material issues like performance targets, or more nuanced understandings of board capacity, the output of board annual reviews, training programs and so on, we get more of the governance data than we do of the environmental and social data that’s material,” says one asset management executive.

The reporting quality of governance data can vary among companies as well, often by region. “Regarding governance, versus environmental and social, the distinction may not be as much on disclosure as it is the underlying standards within a market,” says Booraem at Vanguard. Generally, governance norms in the US, continental Europe and Australia are more mature, and disclosure is more objective than for sustainability issues. “On the other end of the spectrum, the governance maturity of markets like Japan, China and other Asia-Pacific countries are not as far along. So whether there’s disclosure about board independence and board refreshment topics in Japan or not is less relevant because their standard of board independence is so low, for example, relative to other developed markets,” says Booraem. Governance reporting could also be more of an execution issue, he explains, versus the environmental and social categories that are more focused on disclosure.

There can be large discrepancies between the quality of reporting in the environmental and social categories. Environmental metrics around carbon emissions tend to be a bit more straightforward, and third-party data sources can reasonably estimate what those would be for a company’s operations. “For example, scope 1 and scope 2 carbon emissions are disclosed fairly widely, and we tend to get reasonably good disclosures on things like water, but data on the softer, more practice-type measures, like responsible marketing practices and gender pay equity, will often be less well disclosed,” says one asset management executive. “There are process-type metrics on environmental and social factors, whether it’s employee turnover, injury rates, water or carbon emissions that we tend to get, but there are a lot of other environmental and social metrics that are more uneven.”

One such soft factor is the management of human capital. A company may monitor and track the social metrics of human capital management for internal use. Employee turnover numbers may be public if it is a labor-intensive business that recognizes, through a dialogue with investors, that such data is important to disclose. “However, things like employee survey results and issues around employee satisfaction or engagement are social metrics that perhaps a company measures, but does not widely share,” says Lindsay.
Most issuers report materiality of ESG issues adequately

Investors say that most companies are able to assess the materiality of governance factors, with 87% reporting that most (78%) or nearly all (9%) of the companies they follow assess ESG materiality adequately (figure 4). Investors rate companies’ assessment of governance materiality best (8.28 on a scale of 1 to 10), followed by social (7.72) and environmental (6.19), as shown in figure 5. However, while governance factors may be reported most thoroughly, it can be difficult to value and measure. “In general, governance is harder to quantify. It’s the hardest one to translate into financial terms,” says an asset manager with more than US$70 billion under management. The effects of environmental and social liabilities are easier to value. “For the social side of things, we can always try to find lawsuits we can avoid, but with governance, the effects are harder to pin down,” she says.

In interviews, however, investors say that the concept of materiality, at least in its application to sustainability and ESG factors, is still not fully understood by some companies. “Reporting varies widely, which is somewhat ironic, given that it’s a focus in traditional financial accounting,” says Booraem. “More often than not, we find a disconnect between individuals in companies’ dedicated sustainability teams who understand the concept of materiality and advocate internally for its use and those in investor relations or the CFO’s office who don’t understand the concept and are still operating in a CSR mindset.” Investors also stress that there is a long way to go in terms of understanding and reporting materiality. “A large European manufacturer included a governance disclosure in a report, but it was buried in the text,” says a European asset management executive. “It was there, but easy to miss, hidden on something like page 124 in the second paragraph, sentence three – a note about a governance issue. There was a complete failure to disclose material information.”

**Figure 4: Investors say that most of the companies they cover adequately assess the materiality of ESG factors**

What proportion of the companies you follow adequately determine what environmental, social and governance issues and topics are truly material to their ability to create value in the long term?

- Few of the companies I follow (25% or less) assess ESG materiality adequately.
- Many of the companies I follow (25%-50%) assess ESG materiality adequately.
- Most of the companies I follow (50%-75%) assess ESG materiality adequately.
- Nearly all the companies I follow (75% or more) assess ESG materiality adequately.

**Figure 5: Companies assess materiality of governance issues best**

On a scale of 1 to 10, how well do the companies you follow assess the materiality of the three components of ESG?

- Governance factors: 82% 15% 3%
- Social factors: 64% 33% 3%
- Environmental factors: 11% 86% 3%
Does your nonfinancial reporting tell your value creation story?

The variance in terms of quality reporting and disclosure is still quite wide. “I’ve seen the entire spectrum,” says Carmela Mondino, Associate at Partners Group. “We have companies where ESG factors are directly or explicitly embedded into their business models, and those companies are great at assessing materiality.” For example, she explains that many food companies know that health and safety, mostly food safety, is important, and they are serious about protecting their supply chain because it is material to the business. “In these cases, reporting and disclosure is great.”

Another subgroup of companies that are good at assessing the materiality of ESG factors are those that were owned by private equity funds in the past. “Those companies have the systems in place to track these things,” says Mondino. And she points out that some companies have underdeveloped approaches or have not prioritized these practices. “These are the biggest challenges. When we engage with these companies, it’s our job to explain to them what we are looking for. We need to make sure that we connect the dots, because the connection between these factors and their businesses is not always easy for them to see,” she says.

The concept of what’s material and how well it’s reported varies significantly by sector and by market. “There are different standards of disclosure,” says Kim Farrant, Manager Corporate Responsibility at VicSuper (US$14 billion under management). “The disclosure of many Australian companies slightly lags their European counterparts, but it’s more advanced than similar Asian listed companies.” By sector, better materiality disclosures have been driven by competition. “It becomes a point of differentiation,” she says, but ESG issues vary by sector. “Overall, there is currently more focus on the environment, but social issues are beginning to get more attention in relevant sectors.”

Compliance and risk management are motivators

Overwhelmingly, investors report that they believe regulatory compliance (90%), followed by risk management (87%), most motivates companies to report details on nonfinancial and ESG activities. Strategy for long-term value (78%) and competitive pressure (70%) were deemed to be other compelling reasons (figure 6). Only 44% of investors cited investor demand as a reason for companies to report this data. In the 2017 EY survey, a company’s reputation (74%) were seen as whereas, this time, only 40% cited reputation.

Figure 6: Compliance and risk management drive issuers to report ESG performance: PR and marketing have become less compelling reasons

Which of the following items most strongly motivate companies to report details on their nonfinancial and ESG activities?

<table>
<thead>
<tr>
<th>Motivation</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comply with regulatory requirements</td>
<td>90%</td>
</tr>
<tr>
<td>Demonstrate management of risk</td>
<td>87%</td>
</tr>
<tr>
<td>Explain their strategy to generate shareholder value over the long term</td>
<td>78%</td>
</tr>
<tr>
<td>Respond to competitive pressure</td>
<td>70%</td>
</tr>
<tr>
<td>Meet investor demand for disclosures</td>
<td>44%</td>
</tr>
<tr>
<td>Build corporate reputation with customers</td>
<td>40%</td>
</tr>
<tr>
<td>Demonstrate cost savings, operating improvement or return on ESG investments</td>
<td>17%</td>
</tr>
</tbody>
</table>
Does your nonfinancial reporting tell your value creation story?

Key ESG factors

Investors in this year’s study report that the main ESG factors in investment decision-making have to do with risks related to governance, supply chain, human rights and climate change (see figure 7). The risk or history of poor governance practices would cause 63% to rule out an investment immediately. Similarly, supply chain risks tied to ESG (52%), risk or history of poor human rights practices (49%), and risk from climate change (48%) are also triggers to avoid an investment. In the 2017 EY survey, investors reported that they would rule out an investment immediately based on governance (38%), human rights (32%), and ability to verify ESG data and claims (20%), and supply chain (15%). Climate change was the lowest-scoring factor, at only 8%.

Four factors emerge as the most important in decision-making
Does your nonfinancial reporting tell your value creation story?

Figure 7: Governance, supply chain, human rights and climate change are the main ESG factors in investment decision-making

How would the following disclosures about a prospective investment affect your investment decision?

<table>
<thead>
<tr>
<th>Disclosures</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk or history of poor governance practices</td>
<td>63%</td>
<td>38%</td>
</tr>
<tr>
<td>Risk or history of poor human rights practices</td>
<td>49%</td>
<td>32%</td>
</tr>
<tr>
<td>Risk from climate change</td>
<td>48%</td>
<td>8%</td>
</tr>
<tr>
<td>Risk from resource scarcity (e.g., water)</td>
<td>22%</td>
<td>12%</td>
</tr>
<tr>
<td>Risk or history of poor environmental performance</td>
<td>17%</td>
<td>15%</td>
</tr>
<tr>
<td>Limited verification of ESG-related data and claims</td>
<td>17%</td>
<td>20%</td>
</tr>
<tr>
<td>Absence of a direct link between ESG initiatives and business strategy</td>
<td>10%</td>
<td>12%</td>
</tr>
</tbody>
</table>

1. Rule out immediately
2. Reconsider
3. No change

Transition risk versus physical risk in climate change

Investors continue to tell us that climate change is consistently one of the most material issues identified by reporters. However, in this survey they told us they are more concerned about the physical implications of climate change risk than the transitional risks, such as those tied to adapting to new regulations, practices and processes. Seventy percent say that, over the next two years, they will pay a fair amount or a great deal of time and attention to physical risk (see figure 8). Forty-eight percent say the same of transition risk.

In interviews, investors’ perspectives on climate change risk are more balanced and nuanced than the data might suggest. “We pay attention to both kinds of risk. Depending on the sector, we’re looking for companies to provide appropriate disclosure, as well as boards and senior management teams to exercise oversight around both to the extent that each is a material risk to the business,” says Marc Lindsay at Vanguard.

Both types of risk are important, and which might take precedence depends on the investment strategy and the time horizon. “An investment-grade bond that has a four-year duration has a very different view of physical risk than a 30-year bond,” says Jonathan Bailey at Neuberger Berman. “Historically, there is probably more focus on transition risk, because of the regulatory shocks that can happen on a short-term basis.” But there are many examples where physical risk has caused disruption to supply chains, companies and municipalities directly. “Those will only increase. We consider both in a robust way and we encourage companies to provide clarity around the steps they are taking to manage both types of risk.”

Figure 8: Investors are more concerned with actual negative outcomes of climate change rather than the inconvenience and cost of compliance and transition

Over the next two years, how much time and attention will you devote to evaluating transition risk and physical risk tied to climate change in your asset allocation and selection decisions?

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical risk</td>
<td>69%</td>
<td>24%</td>
</tr>
<tr>
<td>Transition risk</td>
<td>47%</td>
<td>44%</td>
</tr>
</tbody>
</table>

1. A great deal of time and attention (5)
2. 4
3. 3
4. 2
5. Little time and attention (1)
Investors report investment objectives drive the use of positive or negative screening and portfolio tilts based on ESG factors

ESG factors can be used as both positive and negative screens for potential investments, and respondents provided keen insights on the effect of doing so in the creation and performance of a balanced portfolio.
Negative and positive screening

Investors who responded to the survey say that negative screening yields excess return (85%) and lowers risk (67%) versus a benchmark or target. What was also surprising was that investors also said positive screening lowers risk (79%) and achieves important nonfinancial objectives of a portfolio (73%), as shown in figure 9.

Investors also support portfolio tilts based on ESG

Respondents say that underweighting for negative ESG attributes lowers risk (67%) and yields excess return (68%) versus a benchmark or target, while overweighting for positive ESG attributes achieves important nonfinancial objectives of a portfolio (72%) and lowers risk versus a benchmark or target (69%).

In interviews, investors report using screening and tilting strategies, applied singly and in combination, and in varying degrees, to achieve particular investment objectives. “We do a bit of everything. In our general portfolio, we have a negative screen, so we don’t invest in things that are harmful to the environment or society, like weapons for example.” says Carmela Mondino at Partners Group. On the positive side, she says they look for investments that have a positive impact, such as renewables, education and health care. “We engage with everything in between,” she says, adding that companies can manage ESG responsibly independently of the industry in which they operate.

Investors express a preference for being responsible as opposed to being ethical. “Our responsible investment approach focuses on ESG integration, active ownership and investing in sustainable outcomes. Company engagement provides the ongoing ability to positively influence our investments, so divestment – outside of tobacco – is not the focus of our approach,” says Kim Farrant at VicSuper. “However, we offer our members the option to exclude investments in fossil fuels, weapons, nuclear power, tobacco, alcohol, gambling and companies that don’t adhere to UN conventions.”

ESG plays a role in indexed products as well. “The majority of our products that are index-based that don’t have ESG screens in them, so we own whatever the universe is relative to that benchmark. However, we incorporate ESG perspectives into our engagement and voting at the individual portfolio companies owned by each of those funds,” says Glenn Booraem at Vanguard. “There are a limited number of index products for which the index provider applies a negative screen on ESG criteria, and a relatively small subset of products that use negative screening,” he adds.

“The way that we apply ESG is relevant and specific to a particular asset class and investment style, but our view is that ESG practices are a part of good, long-term investing and we do track, as part of our integration process, some strategies where it’s possible to disentangle the contribution that ESG is making,” says Jennifer Signori at Neuberger Berman. In others, she says, it is so embedded in the process that it’s hard to disentangle.

ESG-specific instruments

Investors say that ESG-specific instruments, such as green bonds, can lower risk versus a benchmark or target (72%), achieve nonfinancial objectives of a portfolio (71%) and provide excess return versus a benchmark or target (69%). Some investors like these types of investments on their own merits, such as the risk associated with underlying assets. “We often buy green bonds because they’re simply good bonds,” says a European asset manager.

Figure 9: Negative screening yields return while positive screening lowers risk

Screening that excludes or includes assets based on ESG attributes is a sound strategy to deliver:

<table>
<thead>
<tr>
<th>Negative screening</th>
<th>Positive screening</th>
<th>Underweight for negative ESG attributes</th>
<th>Overweight for positive ESG attributes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess return versus a benchmark or target</td>
<td>85%</td>
<td>70%</td>
<td>67%</td>
</tr>
<tr>
<td>Lower risk versus a benchmark or target</td>
<td>67%</td>
<td>79%</td>
<td>68%</td>
</tr>
<tr>
<td>Important nonfinancial objectives of a portfolio</td>
<td>59%</td>
<td>73%</td>
<td>70%</td>
</tr>
</tbody>
</table>
Investors seek intelligent collaboration among governments, industry groups and other organizations to establish ESG reporting standards.
A call for standards

Investors express an urgent demand for prescriptive nonfinancial accounting standards. Fifty-nine percent said that prescriptive accounting standards for nonfinancial information would be very beneficial (see figure 10). This is a rise of 26 percentage points since the last survey. Furthermore, the relative demand for standards has overshadowed that for the next three ranked by importance: integrated reports that follow the International Integrated Reporting Council (IIRC) framework, company disclosures based on what management believes is most material to the company’s value creation strategy, and company-defined reports that integrate financial and nonfinancial information. Previously, investors viewed each element within a relatively narrow band of 14 percentage points, ranging from 40% for sector or industry-specific reporting criteria and KPIs to 26% for company-defined reports that integrate financial and nonfinancial information.

As a useful basis of comparison, to establish benchmarks and to mark trends, ESG data has to be standardized, and there is a move in that direction. “We try to standardize the data, and we try to take a systematic approach. That’s why we use the SASB standards to focus our ESG assessments,” says Carmela Mondino at Partners Group. Sometimes, those metrics are quite specific, so analyses are instead based on the underlying risk mitigation or value creation concept. In many cases, data just isn’t relevant or available. “We may not have access to the last three years of statistics on health and safety, for example, but we try to get the last year or two and see if there is a health and safety policy and systems in place to track progress,” says Mondino. External service providers can often fill in the data gaps and provide additional insight. “We’re not experts on each industry, and sometimes we have to adapt.”

Instead of looking at portfolio-wide materiality, we try to ascertain the material factors for each industry, and we focus on those that create value or mitigate risk,” she says.

Investors are shifting their focus toward forward-looking disclosures and measurement of long-term value creation.

Figure 10: Investors issue a call for prescriptive nonfinancial accounting standards

How beneficial would each of the following reports or disclosures be to your investment decision-making?

<table>
<thead>
<tr>
<th>Prescriptive accounting standards for nonfinancial information</th>
<th>Very beneficial</th>
<th>Somewhat beneficial</th>
<th>Not beneficial</th>
</tr>
</thead>
<tbody>
<tr>
<td>Integrated reports that follow the International Integrated Reporting Framework issued by the IIRC</td>
<td>59%</td>
<td>30%</td>
<td>11%</td>
</tr>
<tr>
<td>Company disclosures based on what management believes</td>
<td>12%</td>
<td>58%</td>
<td>30%</td>
</tr>
<tr>
<td>is most material to the company’s value creation strategy</td>
<td>11%</td>
<td>58%</td>
<td>31%</td>
</tr>
<tr>
<td>Company-defined reports that integrate financial and nonfinancial information</td>
<td>10%</td>
<td>71%</td>
<td>19%</td>
</tr>
<tr>
<td>Sector or industry-specific reporting criteria and KPIs</td>
<td>9%</td>
<td>82%</td>
<td>9%</td>
</tr>
<tr>
<td>Statements and metrics on expected future performance and links to nonfinancial risks</td>
<td>8%</td>
<td>77%</td>
<td>15%</td>
</tr>
<tr>
<td>Separate sustainability and financial reporting</td>
<td>8%</td>
<td>78%</td>
<td>14%</td>
</tr>
<tr>
<td>Climate-related disclosures in financial reports as recommended by the Task Force on Climate-related Financial Disclosures (TCFD)</td>
<td>5%</td>
<td>66%</td>
<td>29%</td>
</tr>
</tbody>
</table>
Quantifying risks can pose a challenge. “In general with ESG topics, once you define the material issues for each industry, it can be hard to translate them into financial terms,” says Mondino. “We’re used to balance sheets and income statements and things that we can aggregate and compare. It’s quantification that’s missing – there is no IFRS for sustainability, although the industry is trying.” There continue to be many attempts to approach these issues, but there is not a single standard that everyone is following, which makes it an often-complicated process. “It’s important to define a common standard, but also give it enough flexibility so that companies can report and really track the things that are material for them and relevant to their industries,” Mondino says.

Defining relevant, investment-grade standards is a formidable task, and, the widespread adoption will take time and consensus among investors. “We’re a big advocate of SASB because we think it provides a clear materiality-driven approach based on what investors want. It includes a useful set of disclosure topics, and we look forward to more companies choosing to use it as a basis for their disclosure, and we would welcome groups like the Financial Accounting Standards Board to continue to support SASB’s work,” says Jonathan Bailey at Neuberger Berman. Although FASB, SASB and other organizations are taking affirmative steps toward standardization, widespread adoption of uniform reporting is elusive. “I think these are still relatively early days on the journey toward standards,” says Glenn Booraem at Vanguard. “Yes, there are a handful of early adopters, particularly on sustainability matters but, so far, there is no critical mass of investors committed to consistent standards on many risks,” says Booraem.

While current standard setters such as SASB and the Global Reporting Initiative (GRI) have discrete approaches to assisting companies in determining what, and how, to report, investors are clearly shifting their focus toward forward-looking disclosures. For that, new approaches may be needed. “We recognized a while ago that there needs to be a framework for reporting on long-term value creation,” says Dr. Matthew Bell, EY Asia-Pacific Managing Partner, Climate Change and Sustainability Services. “The Coalition for Inclusive Capitalism and EY have brought together CEOs from more than 30 global companies, representing more than US$30 trillion of assets under management, to work on such a framework to measure long-term value creation. The project, called The Embankment Project for Inclusive Capitalism, seeks to better reflect the full value companies create through human, physical, financial and intellectual capital.”

**A call for state-led efforts**

Investors responded saying that national regulators are best suited (70%) to lead efforts to close the gap between investors’ demand for nonfinancial information and the information actually provided by issuers. Others that should play a role include international organizations and NGOs (60%), and investors and asset managers themselves (56%). Only 20% of respondents think issuers or private sector trade organizations should take the lead (see figure 11).

In interviews, investors are looking for intelligent collaboration among themselves, regulators and organizations such as trade groups and NGOs to help define what’s most material to a company’s long-term sustainable growth, and to communicate to a wider array of stakeholders. “There’s a big role for industry trade groups to play, and we see that in some sectors already,” says an asset management executive. One such example is the Fair Fashion Center in the US, which has worked with its members to determine and define material sustainability disclosures in collaboration with SASB, and to lead consensus among designers, manufacturers and retail fashion outlets. That approach is also being replicated in other sectors.

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**Figure 11: Investors look to national regulators to bring order and discipline to nonfinancial reporting**

Which of the following stakeholders are best suited to leading efforts to close the gap between investors’ need for nonfinancial information and the information actually provided by issuers?

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>National regulators</td>
<td>70%</td>
</tr>
<tr>
<td>International organizations and NGOs</td>
<td>60%</td>
</tr>
<tr>
<td>Investors and asset managers</td>
<td>56%</td>
</tr>
<tr>
<td>Issuers or private sector trade orgs</td>
<td>20%</td>
</tr>
</tbody>
</table>
“It works well when it’s a collaborative effort,” he says. Another way to mobilize the creation of standards is through issuers that want to take a leadership role and demonstrate that ESG disclosure is part of being a forward-looking company. “There are many that believe this to be relevant to their business model, and we hope it will lead to more,” says the asset manager.

“It’s hard to say which entities should define the standards. There are a lot of government attempts, especially in Europe, but except for SASB, I haven’t seen anything practical or definitive so far,” says Mondino. “The people who are talking about this are already using US GAAP (generally accepted accounting principles) and International Financial Reporting Standards (IFRS), and it would be easier if it came from them.” At the same time, she recommends they establish a collaborative relationship with SASB to bring credibility into measuring materiality. “I would create a hybrid of the accounting methodology on one hand and the sustainability knowledge and expertise on the other, and any legislation has to be specific to be actionable.”

Collaboration among nonprofit organizations and trade organizations has been critical in the progress so far. “Collaboration and streamlining can really solve for this broader challenge,” says Jennifer Signori at Neuberger Berman. “We are aware of conversations and collaborations under way among SASB and GRI, which is another standards body that has a broader definition of materiality to include more stakeholders.” She says there is an active recognition of the importance of mapping standards and clearly identifying the target user and use cases for each respective framework is important for investors, companies and other users of these standards to navigate and to mitigate the confusion that historically has been quite prevalent in this space. “Collaboration among SASB, GRI, Principles for Responsible Investment (PRI) and the Impact Management Project, another broader industry group, can help to tie together the existing tools and frameworks out there.”

Investors recognize the need for increasing collaboration. “It’s very important. Financial institutions need to demand better data, and regulators’ can help to streamline and codify it to make it standard and simple to use,” says Bitterling.

Investors are hopeful for a convergence. “One of the things that has driven our support of SASB is that it’s very specific at an industry level. It is not a one-size-fits-all approach across multiple sectors. To the extent that there are different material risk factors for energy companies than financial services companies, for example, it is important that the disclosure is tailored to information that is actually relevant and decision-useful for each individual company’s investors,” says Marc Lindsay at Vanguard. One of the dangers is multiple constituencies seeking to impose standards on parallel issues, and compliance with these standards becoming an ongoing tax on corporate resources. “Convergence is a beneficial outcome, to be sure. Every one of us who has a point of view on the variety of these approaches is drawn into these multiple efforts at the same time. We’d all be more efficient and productive, and we’d probably get to common solutions sooner, if there were some degree of convergence. The challenge is for all stakeholders to decide collectively where that should live,” says Lindsay.

“Are there are good reasons to believe that the process will continue to improve. We’re seeing some corporate leaders embrace SASB, and others are asking us what they should do and what they should focus on,” says Bailey. “We explain why we think SASB is helpful and, more often than not, they welcome clear direction from investors.” They put an explicit reference to SASB and the Task Force on Climate-related Financial Disclosures in their proxy voting guidelines, along with the expectation that board members be familiar with those frameworks and the potential material risks and opportunities for the businesses that they oversee as part of their duties. “We try to be reasonable and clear about what we want, companies value that guidance, and we’re seeing some move in that direction, which is great. Ultimately will there be regulatory support? I’d hope so, but there’s still a lot that can be done before we get to that stage.”

Investors don’t want standards to become too prescriptive. “An internationally consistent reporting framework would help drive consistency, but it should be sufficient to suit a range of industries and markets,” says Kim Farrant, Manager of Corporate Responsibility at VicSuper. “The International Integrated Reporting Framework strikes that balance. It provides an overarching framework whilst leaving guidance on detailed disclosures to industry and issue specific guidelines.”
Investors’ increasing demand for reporting on nonfinancial assets reflect a more sophisticated understanding by investors of the link between performance and ESG factors. This means that, alongside your financial reporting, there should be a coherent and strategic story on how you are seeking to grow intangible value to help your business to thrive. Having this framework and the data may help support your organization’s position to have conversations with investors and prepare for future regulatory development.
It is believed there are four main areas organizations should consider:

- Establishing a structured materiality analysis process
- Measuring and reporting social and environmental outcomes
- Measuring and reporting long-term value
- Reporting more comprehensively on all climate risks and engaging with stakeholders, including investors

1. Establishing a structured materiality analysis process

Understanding and measuring impact is not straightforward, but a structured materiality assessment process can support you in:

- Setting strategic objectives and establishing a corporate sustainability strategy
- Defining the issues that should be covered in ESG reporting and disclosures
- Designing KPIs to measure performance against expectations of the business and its stakeholders
- Aligning ESG risks with business risk management priorities to increase consistency and cohesiveness of sustainability risk management

The EY approach to materiality analysis is designed to be customizable to an organization’s specific objectives and context, while adhering to the requirements of the relevant reporting framework such as the SASB framework, GRI Standards or the <IR> Framework. It also provides a critical input to the setting of business strategy that will likely respond to the future view of value.

2. Measuring social and environmental outcomes

Once you have established where your material impact lies, you can begin to identify the appropriate measurement indicators and proxies for nonfinancial information and subsequently report them.

EY teams have built up a database of outcomes around value reporting to support an outcomes measurement framework. Methodologies have been established that give companies the tools to assess their outcomes and associated higher-level impact. These outcomes can then be mapped to the Sustainable Development Goals.

3. Measuring long-term value

With the appropriate method and metrics for your reporting, you can begin to identify the KPIs to answer specific performance questions and inform your corporate reporting. By putting risks and outcomes into financial proxies, you can begin to understand the total cost, value and return of your activities. Investors are influencing the need for transparent disclosures on a range of nonfinancial metrics to help them assess the risks and creation of long-term value, including new markets, products and services.

EY can support you in identifying relevant metrics and then measuring them to help you to provide a clear long-term value creation story in order to support the attractiveness of your organization to investors.

4. Reporting more comprehensively on all climate risks and engaging with stakeholders, including investors

The increase in demand for more nonfinancial information to indicate long-term value creation has also influenced regulatory developments such as the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

Only a few organizations are deploying forward-looking scenario analysis to address climate risks and support their strategic vision of how to protect and create value. Organizations should consider how to:

- Assess their exposure to climate-related risks
- Build forward-looking scenarios
- Disclose the information required by stakeholders
- Build futureproof strategies in countries of operation
- Take advantage of low-carbon market opportunities

EY can help develop and implement climate risk strategies, from helping identify risks and monitoring impacts, identifying climate-reporting requirements through to identifying and developing opportunities.

---

**Long-term value reporting**

<table>
<thead>
<tr>
<th>Materiality analysis</th>
<th>Value outcomes universe</th>
<th>Measurement and valuation techniques</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work with stakeholders to identify your biggest and most relevant areas of impact. Activate by linking to business strategy.</td>
<td>The outcomes measurement framework draws from a universe of social, environmental and economic inputs and outputs.</td>
<td>Robust, standards-based techniques are utilized for measuring and valuing outcomes, including primary valuation, modeling and econometric analysis.</td>
</tr>
</tbody>
</table>

Engage investors with value strategy and understand the opportunity.
In May 2018, EY commissioned Institutional Investor’s (II) Custom Research Lab to conduct its fourth survey of institutional investors to examine their views on the use of nonfinancial information in investment decision-making.

II and EY collaborated on writing the questionnaire, incorporating some repeated questions from prior years along with several thematic questions on topics of near-term interest. In total, II collected 260 responses from senior decision-makers at buy-side institutions around the world. In addition, II interviewed eight investors to capture contextual details.

Demographic highlights of the research program are below:

### What is your title?

<table>
<thead>
<tr>
<th>Title</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chief investment officer</td>
<td>18%</td>
</tr>
<tr>
<td>Chief operating officer</td>
<td>17%</td>
</tr>
<tr>
<td>Director of research</td>
<td>17%</td>
</tr>
<tr>
<td>Managing director</td>
<td>16%</td>
</tr>
<tr>
<td>Portfolio manager</td>
<td>16%</td>
</tr>
<tr>
<td>Equity analyst</td>
<td>16%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial services</td>
<td>68%</td>
</tr>
<tr>
<td>Business services</td>
<td>35%</td>
</tr>
<tr>
<td>Consumer products</td>
<td>30%</td>
</tr>
<tr>
<td>Real estate</td>
<td>24%</td>
</tr>
<tr>
<td>Energy</td>
<td>17%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>15%</td>
</tr>
<tr>
<td>Industrial</td>
<td>14%</td>
</tr>
<tr>
<td>Mining and metals</td>
<td>7%</td>
</tr>
<tr>
<td>All of the above</td>
<td>7%</td>
</tr>
</tbody>
</table>

### What type of institution do you work for?

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Third-party investment manager</td>
<td>17%</td>
</tr>
<tr>
<td>Family office</td>
<td>17%</td>
</tr>
<tr>
<td>Endowment</td>
<td>17%</td>
</tr>
<tr>
<td>Bank</td>
<td>16%</td>
</tr>
<tr>
<td>Private pension</td>
<td>7%</td>
</tr>
<tr>
<td>Insurance company</td>
<td>7%</td>
</tr>
<tr>
<td>Foundation</td>
<td>7%</td>
</tr>
<tr>
<td>Public pension</td>
<td>6%</td>
</tr>
<tr>
<td>Sovereign wealth fund</td>
<td>6%</td>
</tr>
</tbody>
</table>

### What are your institution’s assets under management?

<table>
<thead>
<tr>
<th>Asset Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than US$1 billion</td>
<td>20%</td>
</tr>
<tr>
<td>US$1 billion to US$5 billion</td>
<td>20%</td>
</tr>
<tr>
<td>US$5 billion to US$10 billion</td>
<td>20%</td>
</tr>
<tr>
<td>US$10 billion to US$50 billion</td>
<td>20%</td>
</tr>
<tr>
<td>US$50 billion or more</td>
<td>20%</td>
</tr>
</tbody>
</table>

### Where is your position located?

<table>
<thead>
<tr>
<th>Location</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>39%</td>
</tr>
<tr>
<td>EMEA</td>
<td>38%</td>
</tr>
<tr>
<td>Latin America</td>
<td>10%</td>
</tr>
<tr>
<td>North America</td>
<td>13%</td>
</tr>
</tbody>
</table>
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ED None.

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