Millani's 2021 MarketTrends

February 23, 2021

2020 brought about unprecedented challenges and disruptions for all. The impacts of the COVID-19 pandemic (and other major global movements) put the spotlight on a variety of economic, environmental, social and governance issues, which societies continue to navigate through.

The world of sustainable finance also witnessed major developments, accelerating responsible investing into the mainstream.

As trusted advisors to investors, corporate issuers and capital market participants, Millani offers a unique perspective on the rapidly evolving field of ESG integration and sustainable finance.

Read Millani's insights on the most significant ESG integration trends for 2021 and beyond.

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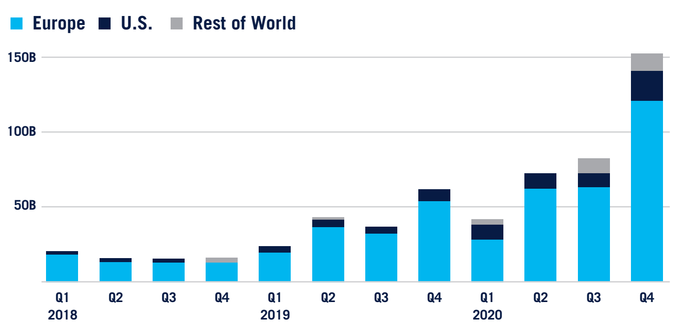
2020 in review

2020 was a year that put ESG (environmental, social and governance) integration to the test as the COVID-19 pandemic introduced significant volatility into the market. Looking back on the year, it could be said that ESG passed the test. **In fact, it aced it**. Global sustainable funds broke records in 2020 and attracted more than US$150 billion in fund flows globally.[1]

Figure 1

Sustainable fund flows surge past $150 bilion

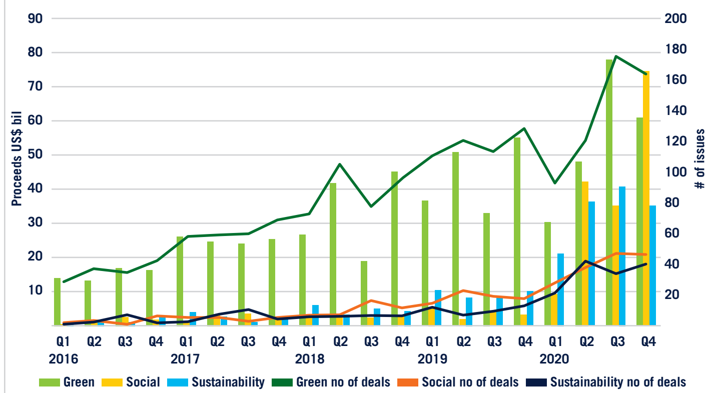
Flows into sustainable fund flows over time, in billions of U.S. dollars



Source: Morningstar, 2021

Figure 2

Global ESG quarterly volumes by type



Source: Forbes, 2020

ESG momentum rose in other asset classes

Flows into sustainable fixed income products also experienced considerable growth, with social bonds leading the way. In Q4 2020, approximately US$70 billion were funneled to pandemic healthcare and relief programs (See Figure 2).[2]

It was also a particularly impressive year in the passive market. ESG ETFs saw a growth of 223% over the year, achieving a new record of US$189 billion in AUM.[3]

Private equity is acknowledging the value of ESG, with 88% of private equity fund managers in North America, Asia and Europe planning to ramp up their ESG performance measurements of their portfolio companies.[4] The availability of consistent and objective data was identified as their biggest hurdle.

A shift towards a sustainable finance system

Although the COVID-19 pandemic brought many uncertainties, it served as a catalyst for ESG. The materiality of E, S and G issues increased as the pandemic resulted in a dramatic reassessment of risk models, together with increased social and economic disparities. Over the year, significant moves from regulators, governments, investors, corporate issuers, and civil society suggested a desire and a growing appetite for a more sustainable financial system.

A complex system of change is being introduced and Millani has identified the most important trends to consider as 2021 progresses.

Millani's MarketTrends for 2021

Clarity around fiduciary duty will lead to further ESG integration

The stellar performance of ESG and sustainable funds over 2020 has prompted investors to consider the degree to which they are meeting their fiduciary duty. This rings particularly true if they were not integrating ESG into their investment process before 2020.

Revisions to UK regulations in 2019 clarified that consideration of ESG factors is a component of prudent investment decision making and is therefore required by pension trustees.[5] In Canada, the Federal Government's November 2020 Economic Statement made a commitment of $7.3 million towards the creation of the Sustainable Finance Action Council,[6] which will work towards improving climate disclosures for issuers and developing standards for the identification of sustainable investments. Most significantly, the Council will implement the recommendations of Canada's Expert Panel on Sustainable Finance, **one of which is to clarify the scope of fiduciary duty in the context of climate change**.[7]

1. Howcroft, Elizabeth & Jessop, Simon, "Sustainable fund assets hit record $1.7 trln in 2020: Morningstar, Reuters, January 28, 2021
2. Global ESG Quarterly Volumes, Refinitiv, December 2020
3. "ESG and active ETFs witnessed unprecedented inflows in 2020", Nasdaq, January 11, 2021
4. Baskar, Chitra, "New study reveals rise of ESG among private equity GPs yet obstacles remain", Intertrust Group, June 22, 2020
5. "Fiduciary duty in the 21st century", UN PRI, October 2020
6. "Fall Economic Statement has dollars for climate action", Clean Energy Canada, November 30, 2020
7. Final report of the Expert Panel on Sustainable Finance, Government of Canada, 2019

In June 2020, the US Department of Labour proposed revisions to a previous amendment that stated ESG factors could be integrated into pension plans. The revision meant that investors could not integrate ESG factors into their investment process unless they could provide evidence of financial returns, signifying a step backwards for ESG integration in the US. The Biden Administration has since placed this ruling under review and there are growing expectations that it will be reversed, which could reinvigorate growth in the US market. However, this reversal may take as long as 18 months.[8]

Litigation around fiduciary duty relating to climate change and diversity is on the rise. As of 1 July 2020, at least 1,550 climate change cases had been filed in 38 countries.[9] In 2020, lawsuits were filed against three large technology companies (Facebook, Oracle and Qualcomm) alleging that the companies' statements about their commitment to end discrimination and support diversity and inclusion were false.[10] This trend signals that appropriately addressing ESG factors is becoming increasingly important in meeting one's fiduciary duty.

Increased scrutiny of fiduciary duty is also being felt by investors. The EU Sustainable Finance Disclosure Regulation (SFDR) will require that asset managers with European funds disclose how they are integrating ESG in their funds. Fund 'labels' are being launched across jurisdictions, which aim to reduce greenwashing, and Morningstar has started to publicly assess and rate the level of ESG integration by asset managers.[11]

Pressure is being put on investors from all angles for greater disclosure and transparency. Meeting these fiduciary commitments will require quality information, so issuers should expect more pressure to provide this additional data.

Mandatory ESG disclosure is around the corner

The management of ESG issues has historically been disclosed on a voluntary basis. With increased regulation regarding ESG integration and the explosion of ESG and sustainability-related reporting frameworks in recent years, there have been calls from both the investor and issuer side to implement a global standard for ESG disclosure. Following framework harmonization efforts from "The Big Five" ESG reporting frameworks,[12] and the IFRS (International Financial Reporting Standards Foundation) moving forward in their consultation on standardized ESG reporting,[13] it is increasingly likely that ESG disclosure will become mandatory in coming years.

Millani's annual research into the ESG disclosures of the S&P/TSX Composite Index constituents[14] shows that 71% of companies published a 2019 report dedicated to ESG issues. However, the quality and credibility of information, and the reporting frameworks used vary widely, highlighting the need for standardization in ESG disclosure.

Figure 3
Millani's ESG Sentiment Study of Institutional Investors

Mandatory climate-related disclosure is already being introduced, with focus on alignment to the Task Force on Climate-related Financial Disclosures (TCFD) recommendations. In September 2020, New Zealand became the first country to require mandatory TCFD-aligned climate-related disclosure for financial institutions and listed companies by 2023.[15] In November 2020, the UK announced its intention to make TCFD-aligned disclosures mandatory across the UK economy by 2025, with a significant portion of mandatory requirements needing to be in place by 2023.[16] In the US, a new Senior Policy Advisor for Climate and ESG has been announced[17], and in Canada, the Sustainable Finance Action Council is mandated to implement the Expert Panel on Sustainable Finance's recommendations, which include making TCFD reporting mandatory. Ontario's Capital Markets Modernization Task Force's final recommendations include making the TCFD mandatory over a timeline aligned with the Expert Panel's recommendations.[18]

8. Braham, Lewis, "Biden Administration will reverse the Department of Labor's ruling on ESG funds, analysts say", Barron's, January 31, 2021
9. "Global Climate Litigation Report: 2020 Status Review", UNEP, January 26, 2021
10. Moorcraft, Bethan, "ESG challenges growing more important for boards of directors", Insurance Business, January 5, 2021
11. "The Morningstar Commitment Level", Morningstar, November 17, 2020
12. Carbon Disclosure Project (CDP), Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB)
13. "Consultation paper on Sustainability Reporting", IFRS Foundation, September 2020
14. "Millani's Annual ESG Disclosure Study: A year in review", Millani, January 2021
15. "New Zealand becomes world's first country to introduce mandatory TCFD disclosure", Responsible Investor, September 15, 2020
16. "UK joint regulator and government TCFD Taskforce: Interim Report and Roadmap", HM treasury, November 9, 2020
17. "Satyam Khanna named Senior Policy Advisor for climate and ESG", U.S Securities and Exchange Commission, February 1, 2021
18. "Final Report", Capital Markets Modernization Taskforce, January 2021

Given the regulatory changes that took place around the world in 2020, and the recent political changes in the US, one can only expect that mandatory ESG disclosure is around the corner. The question is, are issuers ready for this? The first step of a strong ESG disclosure strategy is going through the process of identifying material ESG issues. Most large companies already have ESG reporting and processes in place. This may not be the case for many small- and medium-size companies. Regulatory changes could be significant for these companies, particularly if access to capital – capital for an economic recovery – is tied to ESG disclosure.

Find your role in the transition, or get left behind

Climate change remains a priority, even as the economic and social impacts of the COVID-19 pandemic continue. Investors continue to engage heavily on the topic. The RIA's 2020 Canadian RI Trends Report found that for investors, climate change is the number one engagement issue and that the TCFD is the most widely used ESG framework.[19] Millani's *ESG Sentiment Study of Canadian Institutional Investors* produced similar results, finding that 81% of interviewed investors put climate change among their top three engagement priorities for 2021. 51% named it as their number one priority[20] (see full research details at www.millani.ca).

51% of interviewed investors named climate change as their number one priority.

Investors are engaging both directly with issuers and via collaborative engagement initiatives, such as Climate Action 100+, the Net Zero Asset Managers Initiative and the Net-Zero Asset Owners Alliance, increasingly placing pressure on issuers to disclose climate strategies and set carbon reduction pathways and targets.

For issuers and investors alike, it will be vital to establish the role that could be played in a transition to a lower-carbon economy, and more specifically for Canada, in a "just" transition. It is acknowledged by investors that transitioning will be an iterative and challenging process for issuers. Climate stress-testing and scenario analysis are tools that may help assess the strategic implications of climate change on businesses or portfolios.

National financial institutions have begun their own assessments of this kind. Banque de France and Bank of England are stress testing against climate-related risks to understand the level of risk exposure of their financial systems,[21] while the Bank of Canada and Office of the Superintendent of Financial Institutions (OSFI) announced they will work with financial stakeholders to assess the Canadian financial system's exposure to risks arising from the transition to a lower-carbon economy.[22]

Those who forego these types of exercises may miss out on potential risk mitigation and financing opportunities. The CSA Group (Canadian Standards Association) is currently developing Canada's "Transition Finance Taxonomy", based on the recommendations of the Expert Panel on Sustainable Finance's Final Report. This framework will provide clarification to companies seeking capital for transition-oriented activities, to investors seeking assurance that investments support the transition, and to other financial institutions on how to enable the transition.[23]

Products that are likely to appear in the taxonomy, such as sustainability-linked loans and bonds, are increasingly being made available to issuers that are communicating their role in the transition to a lower-carbon economy. Taking the time to assess, strategize and disclose on this topic may be vital to accessing new forms of capital.

The "S" finally has a seat at the table

In previous years, the "S" in ESG was the most challenging to value. As we live through the COVID-19 pandemic, social issues remain in the spotlight. Income inequality has been highlighted, as the impacts of the pandemic continue to unproportionally affect lower-income individuals. The World Economic Forum highlights "livelihood crisis" as one of the top issues for 2021.[24] Underlying issues like income and racial inequality have been driven deeper by COVID-19, and without controls in place, could lead to political and geo-political instability, creating market volatility. Governments may face the challenge of balancing two major issues: social inequality and climate change. As Canada is a resource-based economy, with many jobs tied to the resource sector, the need to consider a "just" transition is crucial.

The market has acknowledged the value in diversity & inclusion (D&I) and is taking action. The NASDAQ exchange filed a proposal with the U.S. Securities and Exchange Commission (SEC) to adopt

19. "2020 Canadian RI Trends Report", Responsible Investment Association, November 2020
20. "ESG Sentiment Study of Canadian Institutional Investors", Millani, February 2021
21. "France to stress test banks, insurers' climate risks next year", Reuters, November 29, 2019
22. "Bank of Canada and OSFI launch pilot project on climate risk scenarios", OFSI, November 16, 2020
23. "Defining Transition Finance in Canada", CSA Group February 21, 2020
24. "Global Risks Report 2021", World Economic Forum, January 2021

new listing rules related to board diversity and disclosure, which would require all companies listed on the NASDAQ to publicly disclose consistent, transparent diversity statistics regarding their board of directors.[25]

Similarly, ISS (Institutional Shareholder Services) will expect all issuers on the S&P/TSX Composite Index to have at least 30% of its board comprised of women, or a written gender diversity policy that includes a commitment to achieve at least 30% female board representation. For companies without this commitment, ISS will recommend withholding votes for the Chair of the Nominating Committee.[26]

More recently, the "I" in D&I has been getting attention. Diversio, a platform that measures, tracks, and improves diversity & inclusion, perceives inclusion to be a competitive advantage. "Inclusion is essentially a catalyst to diversity. You need inclusion to retain your diverse staff and attract more diversity. Only then can you leverage the benefits of diversity".[27]

What's next?

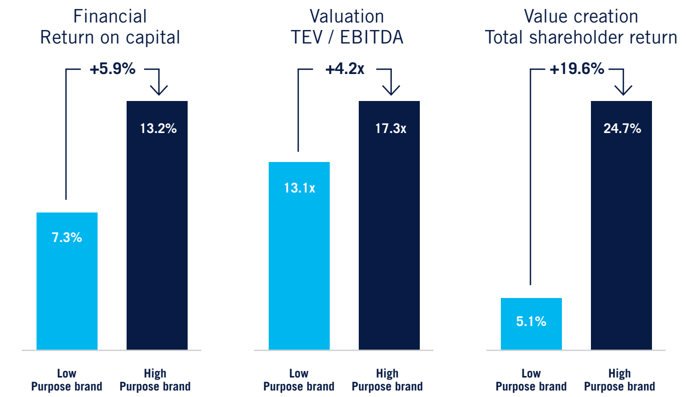
Every year, Millani leverages its market knowledge and expertise to identify the issues that are rising in importance in the ESG space. This year, these insights were complemented with views from some of Canada's institutional investors (see www.millani.ca for detailed results from Millani's *ESG Sentiment Study of Institutional Investors*).

Purpose

The pandemic and the subsequent impacts and shocks to societal life in 2020 led to companies considering what their role, or purpose, in society is. Fortuna Advisors analysed the impact of corporate purpose on company performance, based on consumer perceptions of corporate purpose, for 13 different purpose attributes (e.g., innovation, inclusivity, personal connection). The results show that companies with "High-Purpose" outperformed "Low-Purpose" companies on financial measures such as return on capital, valuation multiples and EBITDA valuation. "High-Purpose brands demonstrate a nearly 20 percentage point advantage in annualized total shareholder returns over Low-Purpose brands". What's more, the gap between "High-Purpose" and "Low-Purpose" companies widened during the COVID-19 pandemic.[28]

Figure 4

The Return on Purpose



Source: Fortuna Advisors, 2020

"High-Purpose" brands outperformed on common measures of financial performance, market valuation and shareholder value creation.

Biodiversity

The 2021 World Economic Forum's annual Global Risks Report assessed biodiversity loss as #5 for risk likelihood and #4 for risk impact, clearly signalling the significance of the issue[29]. In Millani's *ESG Sentiment Study of Canadian Institutional Investors*, it was found that 50% of investors thought that biodiversity could be an issue for 2021 but they are struggling to assess how to value and implement this topic into their investment analysis.

50% of interviewed investors thought that biodiversity could be an issue for 2021.

Investors communicated that the biggest challenge around biodiversity is the complexity of the issue and lack of data. There are several global initiatives underway to advance this issue. Most notably is the Task Force on Nature-related Disclosures (TFND) which is mobilising to provide a framework for "corporates and financial institutions to assess, manage and report on their dependencies and impacts on nature".[30]

25. "Nasdaq to Advance Diversity through New Proposed Listing Requirements", Nasdaq, December 1, 2020
26. Ramchandani, Rima, Johnson, Glen & Teneva, Paulina, "ISS releases new diversity proxy guidelines", Torys LLP, November 17, 2020
27. Diversio, 2021
28. Fortuna Advisors, "The Return on Purpose: Before and During a Crisis" SSRN, October 2020
29. McLennan, SK Group, Zurich Insurance, The Global Risks Report: 16th Edition, World Economic Forum, January 2021
30. www.TNFD.info

Water

Water scarcity and water stress are also coming into the spotlight globally. Reactions from interviewed investors on this issue were mixed, with 31% naming it as a high priority topic. Investors are aware of the issue, but other topics tend to move into the priority seat for engagement.

31% of interviewed investors named water as a high priority topic.

Millani's *Annual ESG Disclosure Study: A Canadian Perspective*[31] found that 51% of Canadian S&P/TSX Composite Index companies already report on water. It could be that investors are getting enough information on this topic to suit their needs. Issuers should continue to disclose on this issue if it is financially material to their business. Companies that take a proactive approach to water risk management will be able to mitigate for potential exposures, resulting in more resilient earnings and better valuations in the long-term.

Hydrogen

Given Canada's exposure to the resource sector, there has been much talk about hydrogen as a potential solution for the country to reduce its GHG emissions. In December 2020, Canada issued its Hydrogen Strategy[32] and positions the development of lower-carbon hydrogen as a strategic priority. From investors however, there were mixed views. Some see it as playing a viable role in the transition to a lower-carbon economy, while others view this development more skeptically.

Implications

2020 was a proven stress test for ESG. Regulations around ESG have progressed all over the world, and multiple commitments have been made from investors and issuers alike.

This has all set the stage for 2021. There is greater clarity around fiduciary duty and ESG, which is leading to a new age of scrutiny for investors. Mandatory ESG disclosure is around the corner, and is already being rolled out for climate-related disclosure. Companies and investors alike need to understand the impacts of climate change and the transition to a lower-carbon economy on their business, to ensure they remain relevant and resilient. In parallel, social issues are now considered material, and are now top of mind for financial stakeholders.

Call to action

Start now! ESG has been a "carrot" space for some time, but the "stick" is coming.

ESG issues are business issues and they can have significant implications on your strategy and business model. Investors will expect that management teams and boards can demonstrate awareness and can focus on questions like:

- Is your business still **relevant** within the transition to a lower-carbon economy?
- Are you exposed to the **right sectors**?
- Are you, and how will you, be **resilient**?

You need to tell your whole story, not just the climate story.

About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 13 years, Millani has become the partner of choice for institutional investors. By providing advisory services on integrating material ESG issues into their investment strategies and decision-making processes, we help our clients reduce risks, increase returns, and create value. Millani is also leveraging this expertise and its experience in ESG consulting to help reporting issuers improve their ESG disclosure to financial stakeholders and optimize their market value.

For more information, contact us at: info@millani.ca or visit our website: www.millani.ca

31. "Millani's Annual ESG Disclosure Study: A Canadian Perspective", Millani, September 8th, 2020
32. "Hydrogen Strategy for Canada, A Call to Action", Government of Canada, December 2020