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ESG Survives First Real Test In 2020

Headlines in 2020 have been stranger than fiction in many aspects as the globe, and its citizens, continue to adapt. Looking beyond the Coronavirus pandemic, which easily takes top spot in the list of oddities, this year still has a long list of notable events. The planet has been ravaged by environmental disasters such as vast wildfires, droughts, and hurricanes. At the same time, social unrest is elevated to levels not seen in many years. Environmental, Social, and Governance (ESG) issues have been at the forefront and it appears that the global investment community is considering these issues more closely too.

- Ownership of ESG assets among Canadian retail investors has grown across all age groups, however, the notable shift is the substantial increase among the youngest investors.
- While environmental and governance issues have long been a focus of investors, the results showed that the pandemic uncovered many social issues (the 'S' in ESG) that weren't being heavily considered prior. For example, how companies handled occupational health and safety or workers' rights has become of particular interest, which have proven to have sizeable impacts on brands.
- Data from Morningstar shows that, as of Q3/2020, there was almost US$1.3 trillion in sustainable funds outstanding globally. Noteworthy is that this figure was up nearly 20% from Q2, showing that investors gravitated toward sustainable companies and sectors out of the market crisis. Canadian sustainable funds remain a small piece of the pie at just over US$7 billion as of Q3, however this represents a massive 30% year-over-year increase.
- When raising debt during the pandemic, issuers largely remained committed to raising funds for green projects. This year through Q3, there has been US$161 billion in global green bond issuance; slightly less than the US$181 billion issued during the same period last year. In addition, there have been 158 issuers coming to market with their inaugural green bond this year, nearly identical to last year's cumulative Q3 figure.
- In November, the heads of the eight largest pension funds in Canada, who combined manage $1.6 trillion in assets, agreed on their ideal ESG frameworks that companies should use. In particular, they recommend companies should use SASB (Sustainability Accounting Standards Board) and TCFD (Task Force on Climate-related Financial Disclosures) frameworks when reporting on sustainability. This should undoubtedly help solidify the ESG landscape by encouraging companies to provide investors with more reliable and consistent data.

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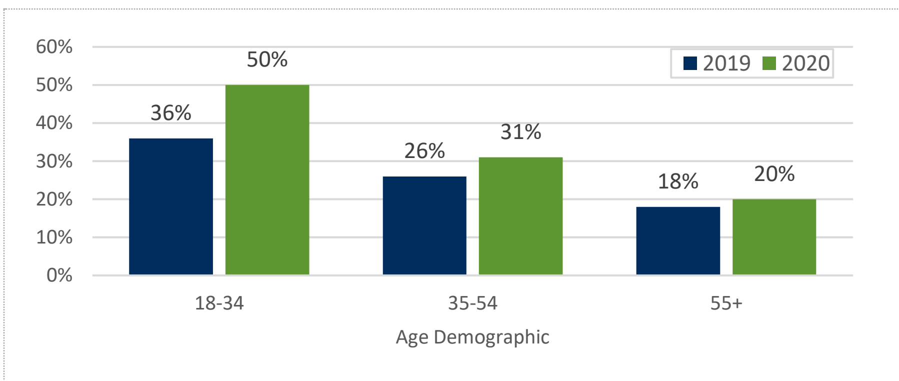
Headlines in 2020 have been stranger than fiction in many aspects as the globe, and its citizens, continue to adapt. Looking beyond the Coronavirus pandemic, which easily takes top spot in the list of oddities, this year still has a long list of notable events. The planet has been ravaged by environmental disasters such as vast wildfires, droughts, and hurricanes. At the same time, social unrest is elevated to levels not seen in many years. Environmental, Social, and Governance (ESG) issues have been at the forefront and it appears that the global investment community is considering these issues more closely too. ESG investing has gained enormous momentum during the past couple of years, with RIA Canada noting that responsible investing assets in Canada grew from $2.1 trillion in 2017 to a whopping $3.2 trillion at the end of 2019. However, many investors remain reluctant about the efficacy of considering ESG factors. As such, the market pullback in 2020 served as the first real test for ESG.

Research points to growth in ESG investing since the start of the pandemic rather than a contraction. While some investors put ESG on the backburner at the height of the market selloff, the recovery was swift. In this report we'll look at how the year 2020 has impacted the ESG and responsible investing landscape.

Broad Interest in ESG Continues to Grow

As an investment consideration, ESG has continued growing in popularity among all types of investors. Ownership of ESG assets among Canadian retail investors has grown across all age groups, however, the notable shift is the substantial increase among the youngest investors. Research from Bank of America shows that Generation Z (Gen Z), those born between 1996 and 2006, are extremely interested in investing responsibly. They surveyed consumers globally and found that 4 out of 5 Gen Zers factor ESG into their investing. This generation is on track to generate US$33 trillion in income by 2030 and is expected to surpass Millennials as the highest earners by 2031, which alone should signal that ESG investing is just in the early innings.

Ownership of ESG Investments Among Retail Investors



Source: RIA Canada

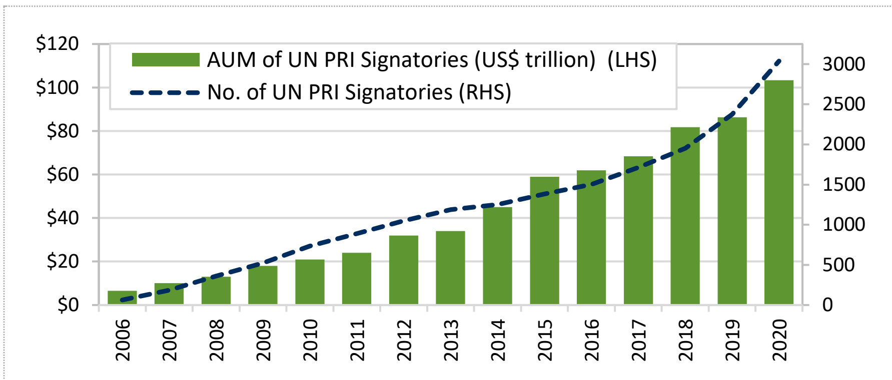
Evolving Focus on Key ESG Issues

The United Nations Principles for Responsible Investment (UN PRI) surveyed its 3000 signatories about how the crisis has impacted them in the short and long term, which includes many of the most prominent asset managers in the world. While environmental and governance issues have long been a focus of investors, the results showed that the pandemic uncovered many social issues (the 'S' in ESG) that weren't being heavily considered prior. For example, how companies handled occupational health and safety or workers' rights has become of particular interest, which have proven to have sizeable impacts on brand reputations. Similarly, RBC Global Asset Management's annual Responsible Investment survey found this year that 'Health & Safety' cracked the top five ESG themes investors are concerned about.

In the governance realm of ESG, board diversity has long been a key theme however civil rights protests in the US and across the globe have sparked greater interest into tackling diversity issues at the corporate level. In early December, NASDAQ filed a proposal with the SEC to encourage board diversity of all companies listed on its exchange. If approved, all NASDAQ-listed companies would have two years to have at least one diverse director, with certain companies being required to have at least two diverse directors within 4-5 years.

The 'E' in ESG remains a core component for most investors and many see an acceleration in the green transition toward more sustainable sources of energy. The recovery from the pandemic should provide nations the impetus to hasten action toward meeting the climate targets by encouraging structural changes in the energy sector (see the "Green Bonds Continue to Flourish" section for further discussion).

Institutional Investors Increasingly Commit to ESG



Source: UN PRI; As at April 2020

Investor Reaction During the Pandemic

In our May 22 *Market Perspectives,* we highlighted research from Morningstar that discussed how ESG funds performed in the first quarter of the year. The study revealed that relative to all funds (i.e. ESG and non-ESG funds) 35% of the 86 ESG-focused funds identified ranked in the top quartile and 73% ranked in the top two quartiles. Since Spring, there have been numerous studies conducted analyzing the performance of ESG investments on a more granular level.

For example, during the height of the market sell-off, we saw retail and institutional investors react differently in terms of their appetite for ESG investments. To gain insights into this topic, a study published by the Rotterdam School of Management and University of Florida analyzed weekly fund flows of US-domiciled mutual funds[1]. The study on the retail side shows investor preference for high sustainability funds weakened substantially during the sell-off. Meanwhile, high sustainability funds remained in demand among institutional investors during the same period.

We believe these findings make sense given our conversations with different types of investors. Despite ESG gaining traction among retail investors as a topic of interest, coupled with the fact that more asset managers keep launching ESG fund products, we've noticed that retail investors have yet to embed ESG into their investment process fully. On the other hand, institutional investors, including pension funds and endowments, have been early adopters of ESG. As long-term investors with vast resources, they can withstand market shocks easier than retail investors.

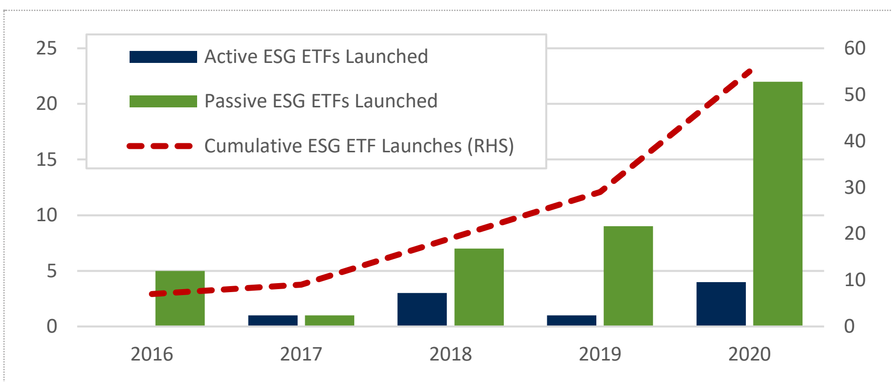
Trends in Managed Money Products

Many investors utilize mutual funds and ETFs to gain exposure to markets while having an ESG overlay. The trend had already seen huge momentum heading into 2020, with assets of ESG mutual funds growing 36% from 2017 to 2019 while overall Canadian mutual fund assets grew just over 10%, according to RIA Canada.

Data from Morningstar shows that, as of Q3/2020, there was almost US$1.3 trillion in sustainable funds outstanding globally. Noteworthy is that this figure was up nearly 20% from Q2, showing that investors gravitated toward sustainable companies and sectors out of the market crisis. Canadian sustainable funds remain a small piece of the pie at just over US$7 billion as of Q3, however this represents a massive 30% year-over-year increase. As such, despite being slow adopters of ESG, the trend among Canadians is clearly shifting.

And this trend can also be seen in the amount of ESG products launching. The Canadian marketplace saw 26 ESG ETF launches in 2020, a huge gap up from the launch of 10 ESG ETFs in both 2019 and 2018. The vast majority of ESG ETFs are passive mandates whereas most active ESG products tend to come in a mutual fund wrapper. There were many new entrants to the field, with TD Asset Management, Invesco and National Bank Investments all coming to market this year with their inaugural ESG ETF products. A key development was the launch of ESG ETFs by Robo-advisor Wealthsimple, which unlocked another avenue for how Canadian investors can access ESG investments. The firm's two socially responsible index ETFs have rapidly ascended to be among the largest ESG ETFs in Canada by AUM.

Canadian ESG ETF Listings Surge in 2020



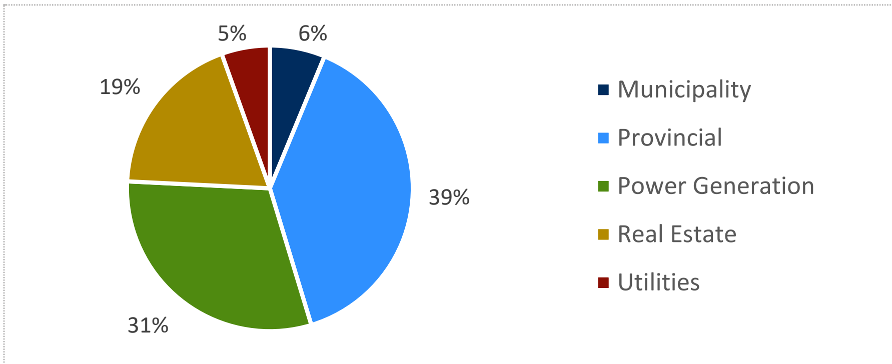
Source: Raymond James Ltd., Company Reports

Green Bonds Continue to Flourish

Though equity markets are often the focus when discussing ESG investing, the bond market has played a crucial role as well. There are many types of sustainable bonds, such as social bonds or transition bonds, but the most popular segment remains green bonds. Here, proceeds are earmarked for specific "green" purposes, including projects related to renewable energy, energy efficiency, or clean transportation.

When raising debt during the pandemic, issuers largely remained committed to raising funds for green projects. This year through Q3, there has been US$161 billion in global green bond issuance; slightly less than the US$181 billion issued during the same period last year. In addition, there have been 158 issuers coming to market with their inaugural green bond this year, nearly identical to last year's cumulative Q3 figure. Meanwhile, there has been over C$6 billion in green bonds issued by Canadian companies thus far in 2020, already surpassing the 2019 total and closing in on the record amount issued in 2018. What about the demand for green bonds? Green bonds were oversubscribed (more demand than the amount of product available) more than their non-green counterparts with similar terms and credit. Also, green bonds traded with tighter spreads after they were issued.

2020 Domestic Green Bond Issuance Led by Provinces (ON & QB)



Source: Raymond James Ltd., Company Reports

The use of green bonds by corporations and governments to raise money is expected to continue. One reason is the rising demand from institutional investors increasingly weaving them into their asset allocation frameworks. Furthermore, the OECD (Organisation for Economic Co-operation and Development) projects that US$6.9 trillion in infrastructure investment is needed annually in order for the global community to meet the 2050 Paris Climate Agreement goals. Related to this, many countries and regions are beginning to set targets exceeding what's expected. For example, China announced a 2060 target for becoming carbon neutral while the EU is committed to meeting that goal by 2050. In fact, the European Commission confirmed plans to issue EUR225 billion in green bonds in the coming years.

Looking Forward

2020 has proven to be a tumultuous year in many respects, but ESG investing should continue to thrive. Institutional investors have strengthened their use of ESG, which we believe should permeate to retail investors, many of whom remain reluctant to stick with incorporating ESG into their investment philosophy. Among all the progress in ESG, many challenges remain for broader adoption, such as a lack of consistent data reporting by companies or standardized frameworks for evaluating ESG. But the path forward remains bright. In November, the heads of the eight largest pension funds in Canada, who combined manage $1.6 trillion in assets, agreed on their ideal ESG frameworks that companies should use. In particular, they recommend companies should use SASB (Sustainability Accounting Standards Board) and TCFD (Task Force on Climate-related Financial Disclosures) frameworks when reporting on sustainability. This should undoubtedly help solidify the ESG landscape by encouraging companies to provide investors with more reliable and consistent data.

Citation:

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