LOST IN TRANSLATION: HOW TO NAVIGATE TOP INVESTOR ESG PRIORITIES

Authors:
Meagan Tenety, Lead ESG Advisor, Nasdaq ESG Advisory
Steve Vargas, Lead ESG Advisor, Nasdaq ESG Advisory

Executive Summary

Nasdaq's vision of reimagining markets to realize the potential of tomorrow also places us at the nexus between the issuer community and the investor community. That nexus allows us to observe emerging trends from both sides of the market. One emerging trend that few can miss is the rising influence of Environmental, Social and Governance (ESG). One of the key observable ESG trends for both issuers and investors alike is the confusion in the market on which ESG topics are most relevant. More specifically, there is a disconnect between which ESG topics investors want to hear from issuers and how issuers translate those investor topics into ESG disclosures relevant to their respective businesses models.
In conversations with our thousands of corporate issuer clients, we hear that while many issuers understand the importance of ESG, the issuer community is facing difficulty incorporating the feedback of the disparate stakeholders into their corporate strategy and risk management practices.

To help provide clarity for issuers on the current and emerging ESG priorities from the investor stakeholder, we set out to gather input from the Top 100 ESG asset managers[1]. Each year top long-term investors outline their ESG engagement priorities for either the previous year or the year ahead in the form of annual stewardship reports and UN PRI Transparency Reports. These two sources were selected for analysis due to the annual nature of the reports and the insights into the application of ESG from an investor perspective. We analyzed these reports to identify the common and key ESG engagement topics. The common ESG priorities were broken out into Environmental (E), Social (S) and Governance (G). Within each ESG pillar, we analyzed ESG investor trends based on an investor's investment style, equity assets under management (EAUM) and geographic region.

Three key takeaways from our analysis:

1. Incorporate top ESG priorities from top global investors into corporate strategy planning and disclosure efforts.
2. Create an ESG dialogue with your top investors. Be aware of your investor base as composition can drive variance
3. You are not alone, everyone is facing difficulty in moving landscape.

1 The Top 100 asset managers based on UN PRI Signatory status and assets under management ensuring that these firms had a stated public commitment to ESG and significant assets under management. Stewardship reports covered pre & post COVID & BLM movement (2019 & 2020).

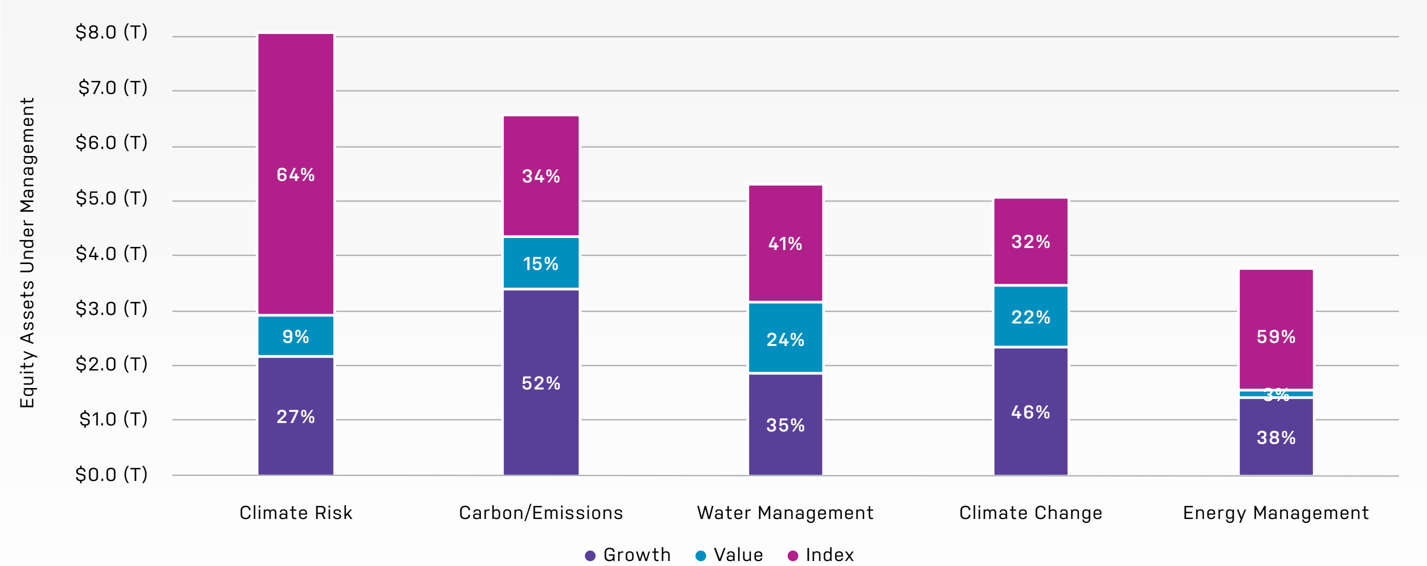
Top 100 ESG Asset Manager Universe

The top 100 ESG asset manager universe we observed oversees $16 trillion in equity assets under management (EAUM), represents all global geographic regions and covers major growth, value and passive (index) styles. Interestingly we found a high variance in topic categorization from stewardship and UN PRI Transparency reports. The sheer volume of topics poses challenges to corporate issuers attempting to synthesize what ESG topics are most relevant or influential. After normalizing the data, we narrowed down the asset managers interests to over 100 ESG topics. This influential stakeholder is increasingly engaging with issuers around ESG topics and management should be prepared for shareholder proposals and increasing pressure from all directions including asset owners, portfolio managers, analysts and Boards.

Investors Environmental Priorities

Over the last decade, investors have recognized that climate change will have an enormous impact on their long-term investment returns. There have been many calls to action from groups such as the United Nations Principles for Responsible Investing (UNPRI) to the Climate 100+ in an attempt to rally around common climate change themes. Many issuers have tried to respond to this call to action but there are disparate approaches to climate change, its risks and mitigation. Each year, as the landscape evolves, top long-term investors outline their engagement priorities for the prior year and year ahead as a **call to action** for issuers on the topic of climate change. When analyzing the stewardship and UN PRI Transparency reports from the Top 100 ESG asset managers, we found that five key environmental topics stood out for investors (figure 1).

Figure 1: Investors' Top Five Environmental Topics

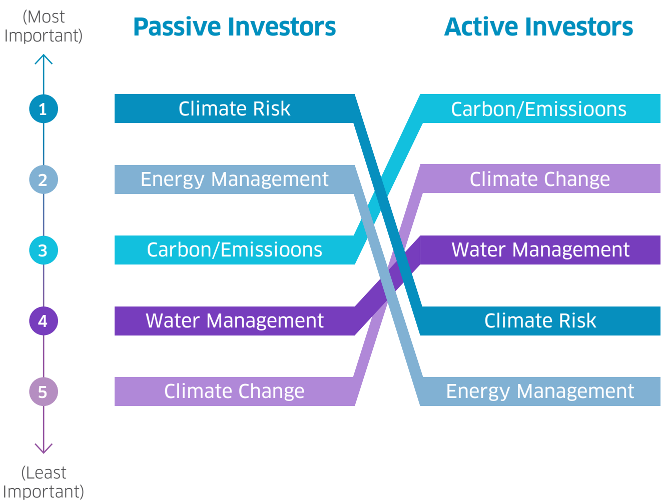


Source: Nasdaq, Asset Manager Stewardship Reports, UN PRI Transparency Reports

It is important to note that investors see a difference between the term climate change and climate risk. This subtle difference is very important for issuers to understand as they assess their ESG profile. Climate change is the manner in which business operations contributes to climate change. Climate risk, on the other hand, is the risk that climate change poses on an issuer's unique business model. This can be anything from exposure to coastal areas or flood zones for insurance companies or disruptive technologies that will change business models in the energy sector or transportation. Each company and business model has unique exposure to climate risk and the onus is on the issuer to understand this risk and create strategies to mitigate it.

Interestingly, our research identified notable differences in how active and passive investors prioritize environmental topics (figure 2). Passive investors placed a high emphasis on climate risk calling companies to evaluate their business risks posed by climate change. Active investors focused on carbon emissions and water management, essentially asking issuers to disclose related metrics.

Figure 2: Passive & Active Investors Environmental Views Vary



Key takeaway for issuers:

The difference between passive and active investor environmental priorities highlights the different types of influence that active and passive investors have on issuers. Passive investors are looking for companies to incorporate the long-term effects of climate risk to their business while active investors want to evaluate how companies are managing their effects on climate change. This year's investor ESG engagement priorities reveal that investors will engage with issuers to push them to seriously consider the risks of climate change and to integrate the mitigation of those risks into overall business strategy. Disclosure on key material 'E' topics, in particular around carbon emissions, water management and energy management may be fundamental in ESG transparency.

ENVIRONMENTAL CASE STUDY...CLIMATE RISK ENGAGEMENT IN ACTION

AXA Investment Managers: 2019 Active Ownership and Stewardship Report "Resolving climate change will be the dominant challenge of the coming years. As investors, we will also need to tackle the complex – and at times severely damaging – relationships that companies can have with the environment and biodiversity. At the heart of this is our ambition to achieve a clear 'win-win' of improving risk-adjusted returns at the same time as contributing to broader societal and environmental objectives as defined in the United Nations Sustainable Development Goals (UN SDGs). Our key climate engagement objectives are shaped by the Taskforce for Climate related Financial Disclosures (TCFD) framework, the de facto reporting framework on this issue. Alongside establishing public support for the TCFD, our recommendations included urging companies to:

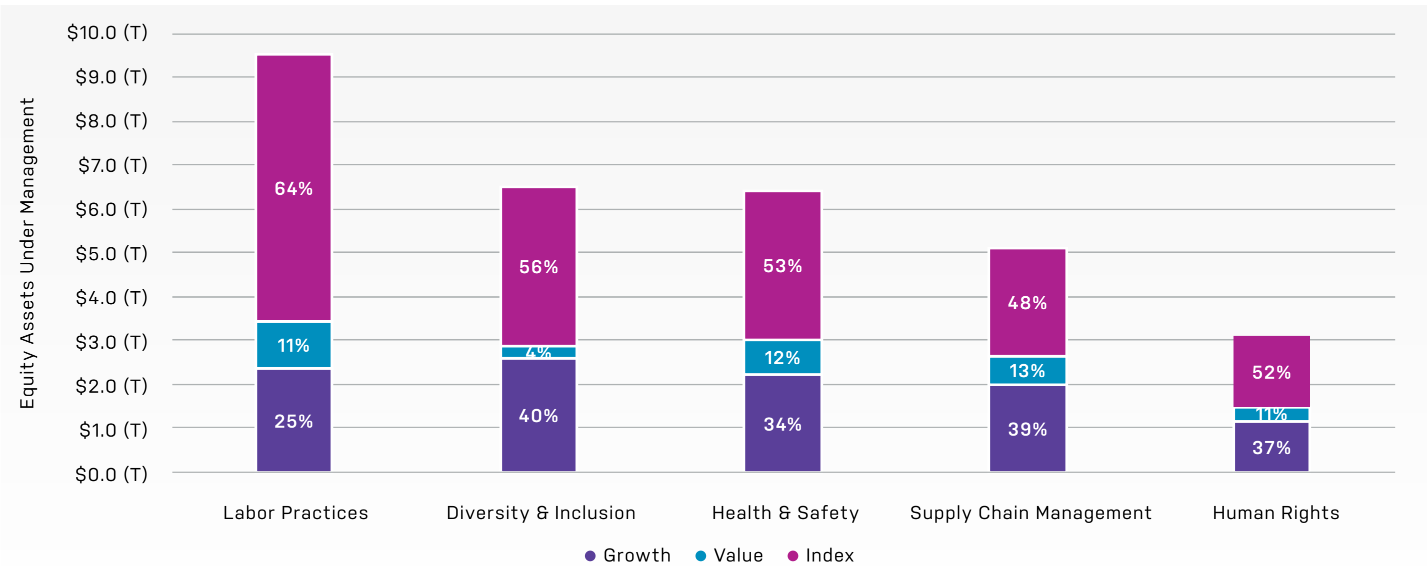
- Commit to short-, mid- and long-term carbon emissions reduction targets that are based on climate science. There should be a clear explanation of corresponding capital expenditure plans
- Perform scenario analysis using a scenario where global warming is limited to the Paris Agreement goal of well below 2˚C
- Align executive remuneration with climate change objectives.

We are an integral part of Climate Action 100+, a major collaborative engagement initiative consisting of a large group of institutional investors and the 100 most carbon-intensive listed companies in the world. We led the group's engagement with numerous companies in the oil and gas, mining and utilities sectors. Dialogue focused on conducting climate scenario planning, ensuring lobbying practices are aligned with climate goals and establishing clear coal exit roll-out plans."

Investors Social Priorities

Social importance is growing as the economy continues to transition from asset heavy business models to businesses that require a highly skilled workforce. Recent events like the Black Lives Matter movement and the impact of COVID-19have brought social topics to the forefront of every stakeholders mind. The capital markets are no exception. In recognition of the growing influence that social matters play within the capital markets, when analyzing the stewardship reports from the Top 100 ESG asset managers we found that five key social topics stood out for investors (figure 3).

Figure 3: Investors' Top Five Social Topics[2]

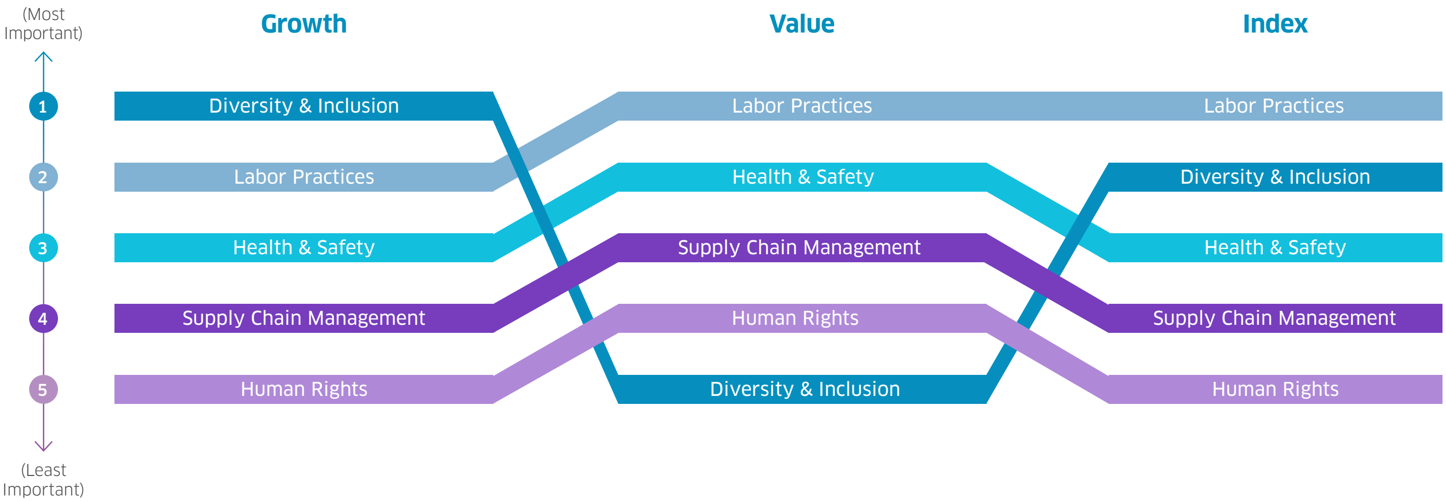


Source: Nasdaq, Asset Manager Stewardship Reports, UN PRI Transparency Reports

When evaluating the composition of investors, there were notable differences in how growth, value and index investors prioritize social topics (figure 4). Growth investors place higher importance on diversity & inclusion and supply chain management issues. Value investor interest in diversity & inclusion related matters was noticeably lower but supply chain management and health & safety remained integral to their engagement priorities perhaps reflective of the mature or asset heavy business models characteristic of their portfolio company holdings. Passive investor priorities for all five topics were equally represented, but labor practices was the most important social engagement topic.

2 We acknowledge categorization remains subjective but in an attempt to standardize common engagement topics amongst a diverse investor universe we grouped labor topics into themes addressing work culture, wages, worker rights, freedom of expression and grievance mechanisms. Diversity & inclusion topics were grouped into themes addressing workforce diversity, gender diversity, women & minority empowerment and disability hiring. Health & Safety topics were grouped into themes addressing working conditions, employee heath and workplace safety. Supply chain management topics were grouped into themes addressing supply chain labor standards, sustainability, risk and transparency. Human rights topics were grouped into themes addressing social risks and community impact.

Figure 4: Growth, Value & Index Investors Have Differing Social Priorities



Key takeaway for issuers:

As issuers and investors rely on each other for capital and value creation, we see an opportunity for issuers to isolate key social topics based on materiality to their respective business models and the composition of their respective investor base or prospective investor base. While labor practices are key for all issuers irrespective of style, for growth-oriented companies engaging with growth investors we see diversity & inclusion as key components in meaningful dialogue. For value-oriented companies engaging with value investors we see supply chain management and health & safety as key components for meaningful dialogue.

SOCIAL CASE STUDY...GENDER DIVERSITY ENGAGEMENT IN ACTION

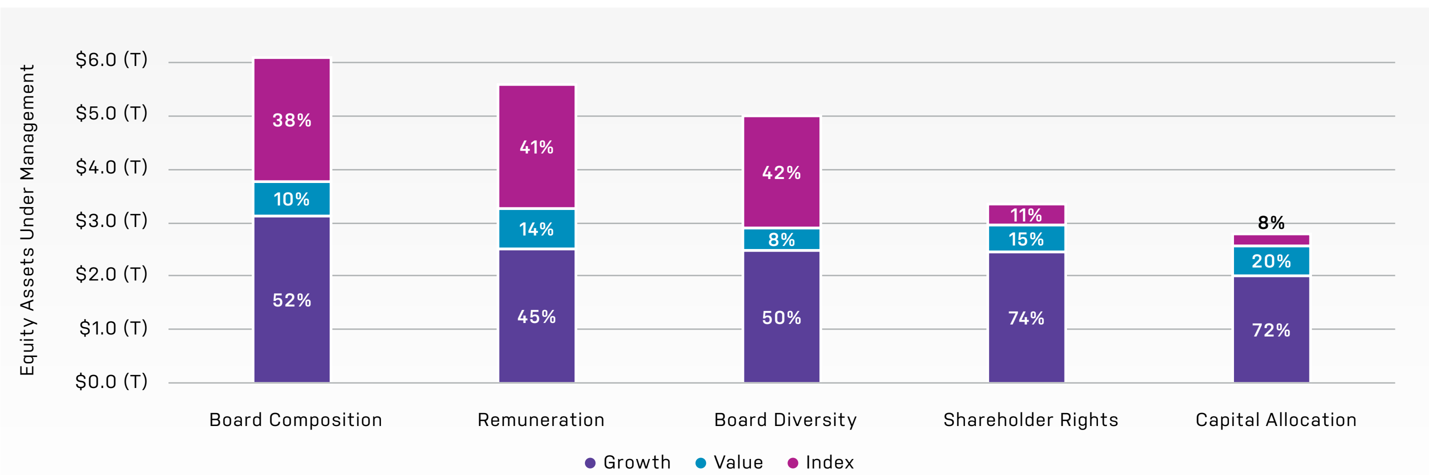
ClearBridge 2020 Impact Report.: Creating Gender Parity Through Ownership and Engagement "ClearBridge is working to further improve gender parity in the workplace through both active ownership of leaders in gender diversity and through engagement with companies we own on specific gender-related topics. For example, while finance has been slow to embrace gender parity in investment roles, ClearBridge holding Bank of America has made notable strides in addressing gender diversity representation and support, as well as the gender pay gap. ClearBridge engaged with management recently on the topic of gender diversity and other sustainability matters. In this discussion, management addressed the company's commitment to diversity and inclusion of its workforce, including that 51% of global employees and 42% of global management are female. Bank of America explained that it is focused on driving sustainable "Responsible Growth" by enacting policies and practices to support its diverse workforce, such as investing in their Women Leadership Council for senior executives and employee networks for women at all levels to support recruitment, development, networking and culture."

Investor Governance Priorities

In the world of ESG, 'G' may be the most understood by corporate issuers and asset managers as there has long been mandatory disclosure and established dialogue on these matters. However, governance topics continue to evolve, as risk management changes. One major trend has been the notable increase in board oversight of ESG matters including the establishment of ESG focused committees. While governance has been integral to meaningful dialogue between issuers and investors, by analyzing the stewardship and UN PRI Transparency reports from the Top 100 ESG asset managers, we found that five key governance topics stood out for investors (figure 5).

Upon further analyzing the composition of investors interested in these governance topics, we observed growth investors appeared to detail governance interests far more frequently than value and index investors. This was most apparent on the issues of shareholder rights and capital allocation where growth investors represented 74% and 72% of EAUM, respectively. Value investors also placed high importance on shareholder rights and capital allocation but at lower levels relative to growth investors. Index investors placed higher priority in board diversity and remuneration but at lower levels relative to growth investors (figure 5).

Figure 5: Investors' Top Five Governance Topics By Investor Style[3]



Source: Nasdaq, Asset Manager Stewardship Reports, UN PRI Transparency Reports

3 We acknowledge categorization remains subjective but in an attempt to standardize common engagement topics amongst a diverse investor universe we grouped board composition topics into themes addressing board independence, quality, structure and oversight. Remuneration topics were grouped into themes addressing executive compensation, management incentive structures, CEO pay ratio, compensation structure & oversight and performance metrics. Board diversity topics were grouped into themes addressing board balance and board diversity. Shareholder rights topics were grouped into themes addressing proxy access, voting rights and minority shareholder interests. Capital allocation topics were grouped into themes addressing capital policy, capital efficiency, dividend policy, dilution and M&A.

Key takeaway for issuers:

Shareholder rights and capital allocation remain to be at the core of active ESG investor's interests. For board composition related matters we see equal importance placed by both active and passive investors. Similarly, board diversity related matters also sees equal importance placed by both active and passive investors. As fund flows continue to shift toward passive, active investors will likely have to justify higher management fees and with that comes the heightened expectation for dialogue around these topics, especially around capital allocation due to its impact on growth fund mandates. Additionally, it is becoming increasingly important across both passive and active managers that companies' board composition reflects a diversity of gender, race and ethnicity as well as skills and expertise. Growth investors have shown more engagement around governance related matters relative to environmental or social matters. We interpret this as an opportunity for Boards and management teams to solidify communication and establish oversight, with diverse perspectives over these five prioritized governance topics.

GOVERNANCE CASE STUDY...BOARD DIVERSITY ENGAGEMENT IN ACTION

PSP Investments 2020 Responsible Investment Report. Public board composition and diversity "Our priority: Maintain our engagement and proxy voting activities to ensure that public boards have the requisite skills, expertise and independence to exercise effective leadership and oversight.

- Supported more than 30 engagements on the topic of gender diversity at board and executive levels through the Canadian Coalition for Good Governance and the 30% Club in Canada, and witnessed positive outcomes in close to 50% of these dialogues.
- Exercised our voting rights to hold members of board nominating committees accountable for implementing credible policies or targets to increase diversity.

View to the future

While the Canadian Securities Administrators' report on women on boards and in executive positions found that about one-half of a sample of 641 issuers listed on the TSX have adopted policies related to the representation of women on their boards, the percentage of board seats occupied by women in Canada remained disproportionately low – at 17% in 2019. An emphasis on gender diversity is likely to continue in the future; however, it will be as part of a broader focus on diversity in all forms at both the board and executive levels, as a way of fostering diverse views and more informed decisions, and driving value creation.".

Conclusion

Within Nasdaq's ESG Advisory practice, we spend our days studying and analyzing the interactions between issuers and asset managers, centered around ESG. Analyzing the Top 100 ESG asset managers' stewardship reports revealed some surprising results, even for those of us that live the ESG landscape daily. Our analysis suggests there are three key E, S and G considerations for issuers.

Key Investor E, S & G Priorities

1. Environmental engagement priorities reveal that investors will engage with issuers to seriously consider the risks of climate change and to integrate the mitigation of those risks into overall business strategy. Disclosure on key material 'E' topics, in particular around carbon emissions, water management and energy management will be helpful in ESG transparency.
2. Social engagement priorities are highly dependent on the investor's investment style. However, issuers should be prepared to discuss their efforts around diversity & inclusion and supply chain management. While it's important to acknowledge the investor stewardship and UN PRI Transparency reports analyzed encompass both 2019 and part of 2020 when the impacts of COVID-19 and the BLM movement materialized, our findings showed that diversity & inclusion and supply chain management were already in the top five social engagement topics amongst our Top 100 ESG asset managers' universe. We believe these two topics will continue to accelerate in importance in the future.
3. Governance as a priority was clearly called out most frequently by growth investors, specifically on shareholder rights and capital allocation topics. We interpret this as an opportunity for Boards and management teams to solidify communication and establish oversight, with diverse perspectives over these five prioritized governance topics. Maintaining a dialogue with investors across such a diverse set of engagement themes may stretch an issuer's time and resources. In consideration of these time constraints, we see efficiency gains by grouping and categorizing shareholder bases by topic for effective outreach.

Closing Thoughts

What are the implications of our research on issuers? The first is to study the aforementioned ESG topics and begin the process of incorporating these perspectives into your strategy, planning and ultimately your ESG disclosure. Second, it is encouraged that issuers have an understanding of the engagement priorities of their top shareholders. Last, while every company has a unique story to tell, one common theme we observe in the market is that every issuer deals with the same market confusion and is looking for a strategy to manage their ESG story. To build this narrative, we suggest that issuers identify and manage the material topics, track relevant supporting metrics, and position themselves to address emerging ESG risks and opportunities. With the benefit of strong synergies between improved ESG governance, disclosure, and performance, companies can meet the rising performance and disclosure bar, while becoming a better managed company, and create sustainable value.

We also encourage issuers and investors to think deeply about disclosure and engagement. Issuers disclose on ESG topics to satisfy their stakeholders (investors, employees, NGO's etc.). Investors use their stewardship reports, first to guide their asset owners on their values and how they are stewarding their assets, and second as a means to communicate their ESG priorities to issuers. As an issuer, we suggest you do your research and establish a meaningful dialogue with investors on these ESG topics. Issuers in particular need to understand where they stand on these critical issues. If a topic is critical this year, it will likely be critical in the years to come. Engagement on these critical ESG topics will most likely not go away and will likely increase over time. Collective actions like the Climate Action 100+ show that asset managers are increasing the visibility and power of influence on critical ESG topics. Boards and management teams should be prepared for these engagements.

How Nasdaq's ESG Advisory Practice Can Help

The ESG priorities identified in our research can help corporate issuers understand where the top 100 global ESG asset managers focus their time and effort. Nasdaq ESG Advisory helps corporate issuers translate the ESG priorities of their unique shareholder base and other stakeholders such as rating agencies and framework providers. Nasdaq ESG Advisory offers flexible solutions for companies at different points on their ESG journey.

About the Authors

Meagan Tenety is a Lead Analyst on Nasdaq's ESG advisory services team which advises corporate issuers on all ESG issues including disclosure, ratings agencies, frameworks (SASB, GRI, TCFD, UN SDG's) and ESG investor engagement. Meagan advises healthcare, consumer and financial issuers on ESG ratings agency and disclosure evaluations to guidance on ESG investor outreach, planning and intelligence. Meagan received her MBA from the University of Notre Dame where she was the President of the Net Impact Club, a national organization aimed at re-imagining capitalism for a sustainable future. Prior to her studies she worked as a Development Manager at Fair Trade USA where she focused developing relationships with mission-driven philanthropists who wanted to transform and invest in labor and environmental issues agricultural supply chains around the world.

Steve Vargas is a Lead Analyst on Nasdaq's ESG advisory services team which advises corporate issuers on all ESG issues including disclosure, ratings agencies, frameworks (SASB, GRI, TCFD, UN SDG's) and ESG investor engagement. Steve advises technology, financial, energy, industrial and material issuers on ESG ratings agency and disclosure evaluations to guidance on ESG investor outreach, planning and intelligence. Prior to Nasdaq, Steve spent time in financial data consulting with stints at Thomson Reuters' Global Business Consulting practice and at Bloomberg in their data analytics division. Steve holds the SASB FSA credential and completed coursework from the GRI.

Nasdaq