Investment Institute

Working Paper 153 | **February 2024**

Institutional investors' approaches to responsible investing: insights from an investors' survey and academic research

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

Trust must be earned

Amundi
ASSET MANAGEMENT

Institutional investors' approaches to responsible investing: insights from an investors' survey and academic research

Marie BRIÈRE
Amundi Investment Institute, Paris Dauphine University, Université Libre de Bruxelles
marie.briere@amundi.com

Timothée JAULIN
ESG Business Development & Advocacy
timothee.jaulin@amundi.com

Caroline LE MEAUX
ESG Research, Engagement & Voting
caroline.lemeaux@amundi.com

Murad NURIYEV
Amundi Investment Institute
murad.nuriyev@amundi.com

Eric TAZÉ-BERNARD
Amundi Investment Institute
eric.taze-bernard-ext@amundi.com

Abstract

In this paper, we aim to understand institutional investors' approach to responsible investing, which has become an important consideration in many investors' portfolio management decisions. We conduct in-depth qualitative interviews with more than twenty institutional investors – mostly consisting of pension plans and central banks –, and complement our insights with relevant findings from academic literature. First, we show that there is a broad diversity in investors' responsible investment preferences that can be attributed to cultural factors. Regulation also plays a significant role in influencing investors' attitudes, with Europe leading the way in sustainability regulation. Second, for most investors, long-term financial return and sustainability go together and responsible investing is often a key element of risk management. Third, regarding implementation, we observe a rising interest in sustainability themes, and an awareness from large investors that transition-focused strategies are key in reaching Net zero objectives. Active ownership is also a key feature of institutions' responsible investment policy and a large majority of investors favor engagement to influence corporate behavior, whose success needs to hinge on a well-formalized process. Divestment strategies are seen as a last-resort instrument, that often stem from beliefs and stakeholder pressure rather than financial considerations. Finally, while ESG data remains a challenge, many investors feel the need to strengthen their resources in the area. These may be organized around a decentralized approach so that responsible investing can better irrigate the whole institution.

Keywords: Institutional Investors, Sustainability Regulation, Responsible Investments Performance, Sustainable Allocation, Active Ownership, Divestment

Acknowledgement

The authors would like to warmly thank the interviewees for accepting to contribute to our survey, as well as our Amundi colleagues for their support, and in particular: T. Bangstad, A. Chor Joyce, L. Ben Lazrak, V. Beullens, T. Bishop, P. Boots, O. Brouwers, A. de Bazin, F. Ciceri, F. Deixonne, T. Deneke, D. di Napoli, J. Elbaz, T. Godovits, K. Franceries, E. Laugel, M. Lee, S. Lee, G. Lozano, E. Martin, U. Mehofer, C. Miller, T. Pietri, T. Roncalli, S. Santarsiero, C. Samano, V. Savcenko, T. Tixier.

About the authors

Marie BRIÈRE

Marie Brière, PhD, is the Head of the Investor Intelligence and Academic Partnership at Amundi Investment Institute. She is a senior associate researcher with the Centre Emile Bernheim, Solvay Business School, Université Libre de Bruxelles. Marie conducts research on portfolio choice, with a recent focus on sustainable finance, household finance and pensions, advising the strategic decisions of institutional investors and the design of investment solutions for retail clients. She is the Chairman of Inquire Europe, a member of the expert group advising the ESMA Standing Committee on Financial Innovation and a member of several scientific councils, such as the European Capital Market Institute of CEPS and the European Savings Observatory. Marie started her working career as a quantitative researcher on the proprietary trading desk of BNP Paribas. She joined Crédit Lyonnais Asset Management in 2002 as a fixed income strategist, and then became the Head of Fixed Income, FX and Volatility Strategy at Credit Agricole Asset Management. As an Affiliate Professor, she has been teaching at Paris Dauphine University for more than ten years. Her scientific articles have been published in academic journals and her work has been featured in several news outlets including the Financial Times and the Wall Street Journal. She received the Markowitz award for her article with Zvi Bodie on “Sovereign Wealth and Risk Management: A Framework for Optimal Asset Allocation of Sovereign Wealth”, published in the Journal of Investment Management. Marie holds a PhD in Economics from Université Paris X and graduated from ENSAE.

Timothée JAULIN

Timothée Jaulin oversees ESG Development & Advocacy for Amundi Asset Management since 2020. He joined Amundi in 2012 as a Research Associate, and then contributed to the setting-up and development of the Institutional Investment Solutions team before being in charge of the coverage of supranational entities globally.In both capacities, he has been closely involved in the development of some of Amundi most innovative investment solutions including Amundi climate finance offer. Timothée was notably involved in the launch of flagship green finance public-private partnerships such as the Portfolio Decarbonization Coalition with the United Nations Environment Program, green bond development programs with the International Finance Corporation and the European Investment Bank and the Asian Infrastructure Investment Bank’s Climate Change Investment Framework. Prior to working in Amundi Paris headquarters, Timothée worked for Amundi in London and New York and for the French Treasury in Washington D.C. Timothée is a graduate from the Ecole Normale Supérieure Paris-Saclay and holds degrees in Philosophy and Sociology as well as a Master in Theoretical and Applied Economics from the Paris School of Economics.

Caroline LE MEAUX

Caroline LE MEAUX joined Amundi in 2019 and is responsible for ESG Research, Engagement and Voting team within the ESG Business Line. She was previously head of the long-term investment department at the pension division of Caisse des Dépôts et Consignations (CDC) which is the fiduciary manager of several French pension funds, in charge of the SRI strategy, ESG and climate policy. Before that, she was director of investment at FRR Fonds de Réserves des Retraites from 2011 to 2014. She was formerly fund manager at BNPPAM, managing Small and Mid-Caps European equities and has been head of quantitative analysis for European equities. Caroline Le Meaux began her career at Paribas Asset Management. She is a CFA (Chartered Financial Analyst) and is a graduate of Paris IX Dauphine University.

Murad NURIYEV

Murad Nuriyev is a research analyst at Amundi Investment Institute. He is working on sustainable finance, with a special focus on climate innovation. Before joining Amundi, he worked as an external auditor at KPMG Azerbaijan. Murad is a first-year PhD candidate at Toulouse 1 Capitole University under a CIFRE agreement with Amundi. He holds a Master of Science in Finance from Toulouse School of Management.

Eric TAZÉ-BERNARD

Eric Tazé-Bernard is a Senior Advisor at Amundi Investment Institute. In particular, he is in charge of knowledge transfer activities for Amundi's institutional clients and of communicating institutional approaches to asset allocation through insight papers. He also participates in institutional advisory activities in coordination with Amundi OCIO Solutions, where he brings his experience in governance. He joined Amundi in 2008 as Head of Long-Only Multi-Management. He then became Chief Allocation Advisor between 2013 and 2022 and was a Director of Amundi between 2016 and 2021. Before that, he was CIO of INVESCO France from 2002 to 2008, with a special focus on the multi-management business, after having been CIO of Multi-management at BNP Paribas Asset Management from 1999 to 2001. He was Director of Research, Strategy and Asset Allocation at Indosuez Asset Management and then CAAM from 1993 to 1998, and Deputy Head of Economic and Financial Research of Banque Indosuez from 1987 to 1993. He began his career as an economic consultant in the Caisse des Dépôts Group between 1983 and 1987.

Introduction

As the environmental and social effects of climate change are occurring at an unprecedented rate, with a potential to trigger massive economic and financial disruptions globally**, investors have a significant role to play to contribute to climate change mitigation objectives and support the transition to a low-carbon economy**[1] **and sustainable development**. However as this is a relatively new topic, a number of institutional investors are still wondering how to define their approach to responsible investing and are raising many questions. How to integrate responsible investing in investment objectives? What specific targets can be set? How to organize its governance? What strategies can be implemented?...

The ambition of this paper is to provide insights based on qualitative interviews we conducted with more than twenty institutions across continents, cross-linked with research findings from academic research. These insights are organized around the following topics:

- What are the key factors that drive the definition of investors' responsible investment policy?
- How to position responsible investing within the traditional return/risk framework?
- What is the role of regulation, particularly regarding strategies to reach a Net zero economy in the next decades?
- As active ownership is one of investors' preferred ways to implement a responsible investment policy, what form does it take and how to evaluate its efficiency?
- What is the impact of divestment, particularly in the fossil fuels industries?
- How to improve ESG data availability and quality, which clearly remains a major challenge for many investors?

Before providing our answers to these questions, we need to clarify a few delicate vocabulary issues. While ESG refers to the environmental, social and governance factors that a number of investors analyze and integrate in their investment policy, we will tend in this analysis to focus on the concept of responsible investing, which is a broader and more qualitative notion that also covers institutions' engagement and voting policy[2]. We will also refer to investors' approach to sustainability which, beyond pure investment matters, refers to their philosophy and to the principles that guide their governance. As mentioned by a large investor, responsible investing is applied to investee companies, and more generally to investment portfolios, whereas Corporate Social Responsibility (CSR) relates to the way the institution is managed. Sustainability encompasses both. These terms are not always used homogeneously throughout the paper as we have been faithful to the wordings used in the research papers and investors' communications on which we have based our work.

[1] Article 2.1c of Paris Agreement: Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.
https://unfccc.int/files/meetings/paris_nov_2015/application/pdf/paris_agreement_english_.pdf

[2] See PRI 'Introductory Guides to Responsible Investment" for additional information

Chapter 1: A wide diversity in approaches to responsible investing

1- Diversity of approaches to responsible investing: the impact of geography

There is a wide variation between investors in terms of degree of integration of responsible investing and more specifically ESG considerations. **Geography is a key factor of differentiation**, and as stressed in Box 1 summarizing academic literature on cross-country differences in responsible investing, **the degree of social norms in a country influences local investors' focus.**

These social norms tend to be reflected in final investors' demand. Individual investors in Europe have a relatively high sensitivity to sustainability, and this is particularly the case in Nordic countries or the Netherlands. Dutch pension fund ABP, which uses surveys to explore beneficiaries' preferences, estimated in 2021 that 59% of surveyed participants were in favor of sustainable investments, as long as financial returns are not negatively affected to a large extent[3]. More precisely, about 70% of individuals who believe that sustainable investments will generate lower returns still prefer them, and this proportion falls below 50% only for those who expect "much lower" returns from these investments. British reputation for pragmatism may be illustrated by the fact that, according to UK pension fund Nest, "people need to understand the benefits of responsible investments for them personally, alongside any broader social or environmental benefits".

The situation is more heterogeneous in the US, where views on the definition and applicability of responsible investing diverge. While some investors see "ESG analysis and potential investing as one more tool in meeting our fiduciary responsibility to our retirees and our taxpayers"[4], others would consider that incorporating ESG considerations is in contradiction with their fiduciary responsibility. Core to the dispersion is the spectrum of responsible investing approaches, which have often been generically categorized under the ESG umbrella. While there can be explicit exclusionary or impact investing approaches, with the objective to generate positive outcomes, the majority of US institutional investors that see the value of integrating responsible investment factors understand that the rapidly changing ecosystem, particularly the environment, can have long-term implications on their portfolios. Therefore, if climate mitigation, where feasible, does not get addressed, there could be bottom-line impacts on companies within their portfolios.

Regulation, which will be discussed in greater depth in the next chapter, plays an important role in whether there is broader adoption or the opposite. At the federal level, the SEC is proposing a law that would require climate-related disclosures. However, since a final decision is not affirmed, there has been a lower incentive in the market to implement. Over the last couple of years, regulation at the State level has taken the rein. For example, California has passed a state-level mandate for companies to provide climate-related disclosures and legislation prohibiting its state pension funds from investing or reinvesting in thermal coal companies. Meanwhile, several states, including the State of Texas, have blacklisted financial institutions who, according to its comptroller, are allegedly "boycotting" oil and gas from managing assets for the State pension funds. The politically driven debate on ESG has created a backdrop of noise which has presented a challenge for responsible investing to directionally move forward in the US. A recent ShareAction report shows that in 2023, only 3% of the 257 environmental and social shareholder resolutions presented to Annual General Meetings (AGM) they assessed received majority

[3] This is mentioned in Bauer R. § Smeets P. (2021). Eliciting pension beneficiaries' sustainability preferences: why and how?, PRC Working paper

[4] Massachusetts Pension Reserves Investment Management Board

support, down from 14% in 2022 and 21% in 2021. The downward trend in support for resolutions has been driven by large US asset managers who voted for just 25% of resolutions in 2023[5], against 88% for European asset managers. This decline in support for social and environmental resolutions allowed companies such as Chevron or Valero to avoid setting emissions reductions targets aligned to the Paris agreement. Similarly, a resolution to create trade unions at Amazon was rejected, helped by these financial actors' votes. This dichotomy could result from **different asset managers' views on the materiality of climate issues, but also different expectations fromfinal investors on climate**, as well as the strengthening of European regulation on ESG reporting, which can contribute to raising awareness within investors on these matters.

The contrast within North America is also quite strong between US and Canadian investors, as the latter do not feel that the US "anti-ESG" trend has crossed the border. This is due to a Canadian culture that has historically put a stronger emphasis on social issues, as well as to the wide recognition of the Canadian pension fund system, which shows a strong awareness of broad issues. As an illustration, a Canadian pension fund states that "as a global corporate citizen, we embrace our responsibility to use our capital and influence to drive Paris-aligned decarbonization across our investment portfolio".

2- Content of responsible investing policies: cultural factors at play

Cultural factors also influence the content of institutions' responsible investing policies. In line with academic research underlining that European companies are much more likely to consider the environment as a stakeholder, the E pillar tends to be dominant within these companies' ESG approach, whereas US investors tend to put a stronger focus on social considerations, and in particular on the "Diversity and inclusion" theme, as reported by the recently-published Amundi-Create publication[6]. Within its responsible investment policy, a US pension fund has identified Diversity and inclusion, Human rights and Human capital management as key factors. This is the case in Canada as well, where a major Canadian pension plan has defined diversity, human rights and indigenous people's rights as its core themes, along with climate and in line with the priorities set by the Canadian government. Likewise, another Canadian pension fund supported a proposal for third-party racial audits at two large Canadian banks in 2022.

Social issues are less often cited in Europe as, according to a European institution, "they are more difficult to handle" and a few investors consider that it is rather up to governments to articulate social policy. Social issues, including labor rights, can also be perceived as particularly sensitive when analyzing companies operating in emerging markets with low social standards. Nevertheless, for a large French institution, firms' social policy is an important element to integrate in the evaluation of the quality of a company's governance.

The Environment is a widely shared preoccupation for European investors. Many of them have defined a net zero objective by 2050, with intermediate targets in a number of cases, whereas this is less frequent in the US where an interviewee reports that many investors that have set a net zero objective are now at pains to define how to reach it.

Meanwhile, **investors in all continents have long considered governance as a key element in their analysis of companies.** In our survey, we observed a widely-shared focus on board

[5] And even 12.5% in the case of the four largest US asset managers

[6] Amundi/ Create report (November 2023). The next state of ESG evolution in the pension landscape.

diversity – this is all the more important for Australia's NGS Super as about 70% of participants in its plan are female –. Management remuneration and shareholders rights are other frequently cited components of investors' governance analysis.

3- Impact of stakeholders' characteristics

Beyond geography, other factors may impact investors' attitude to sustainability, and one of them is the nature of investors' stakeholders and in particular the structure of pension plans' membership. For Austrian investor APK, it is in line with its stakeholders' expectations, as many participants are university representatives. Likewise, sustainability moves by Californian Teachers CalSTRS pension fund or by Australia's NGS Super have been partly driven by their members who in both cases belong to the teaching community.

This also translates into specific emphasis of responsible investment policy. Denmark's pension fund Pensam, which is owned by Danish third largest trade union, carries many values that are at the basis of Danish welfare society, such as attention to climate, labor rights and fair taxation, the latter being specifically mentioned as a focus of several Nordic investors. Likewise, Holland's PGGM who manages assets of the pension fund for Dutch healthcare workers (PFZW), "wants to make a greater contribution to climate and health" while Nest pays a lot of attention to the living wage theme, which strongly resonates with members, many of whom are low-paid workers.

Age also may play a role as, according to several investors, as is the case of Nest or of a Canadian pension fund, the younger generations are particularly sensitive to environmental and social issues, and this represents a source of influence for financial institutions. As seen above in the case of NGS Super, the structure of membership by gender also has an influence on the definition of institutions' responsible investment policy.

In conclusion, there is a broad diversity of investors' preferences and approaches to responsible investing, which can be attributed to cultural factors that are themselves intertwined with the sustainability preferences of the principals, as well as the length of investment horizon and the role of regulation. However, causality between these may be hard to establish.

Box 1 *Cross-country differences in responsible investing*

Academic researchers have shown a considerable impact of country factors such as the legal and cultural landscape on Environmental, Social and Governance (ESG) characteristics. This also leads to a lot of heterogeneity in terms of responsible investing across different regions and countries. This heterogeneity is evidenced by the much larger relative size of the responsible investing industry in Europe than in the U.S. (Starks, 2023).

Impact on firm behavior

These regional differences are observed in the ESG policies of companies, as well. Across the three pillars, European countries come out at the top in terms of average firm ESG score (Starks, 2023). Graham (2022) confirm that European executives are twice more likely to consider the environment as a stakeholder.

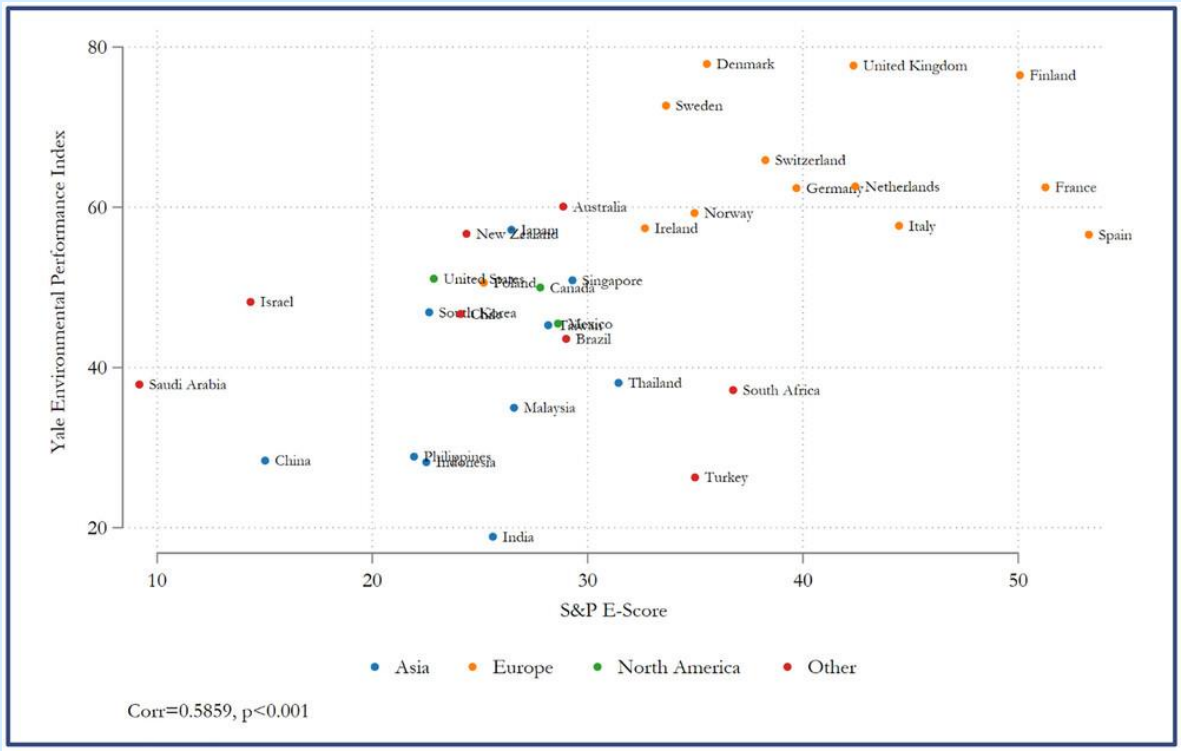
Interesting details of the cross-country heterogeneity in corporate social responsibility are found in Cai et al., 2016. First, the level of economic development is significantly associated with median ESG score in the country. However, economic development is not the sole driver. Social norms and institutions are also important. For example, ESG scores are higher in countries with strong civil and political rights. Country-level factors may even be more important in explaining ESG performance than company-level characteristics. Ioannou & Serafeim (2012) find similar results by emphasizing the role of country-level institutions such as the political or educational system.

A country's law of origin is also a strong predictor of its companies' CSR performance (Liang & Renneboog, 2017). Companies in common law countries receive lower CSR ratings, on average. This may be because civil law is more likely to adopt a "stakeholder view" of business. Similarly, ESG data providers from common law countries are more interested in the financial impact of ESG on shareholders, compared to those from civil law countries (Commonwealth Climate and Law Initiative, 2021).

Impact on investors' preferences

Cultural and country-level factors may also influence investor preferences for responsible investing. A country's culture and institutional environment have been shown to influence institutional investors' horizon and engagement style in that country (Döring et al. 2021). This relationship also holds for responsible investing. Institutional investors from countries where there are high social and environmental norms, affect E & S performance of firms more positively (Dyck et al., 2019). Norm-constrained investment institutions such as pension funds and universities avoid holding "sin stocks" – stocks of alcohol, tobacco, and gaming producers – due to social norms (Hong & Kacperczyk, 2009).

Countries' government policies are related to companies' actions



This figure shows the 2022 Yale Environmental Performance Index per country plotted against the average S&P Global environmental scores for companies in the country.
Source: Starks, 2023

In conclusion, many academic papers have established the significant role of country and cultural factors in driving corporate social responsibility and ESG investment preferences. These insights are nicely summarized by the above graph provided in Starks (2023). However, this correlation does not mean causation, since both variables may affect each other. We cannot establish either to which extent regulatory pressures versus cultural norms determine the ESG decisions of firms and investors' responsible investment practices. Finally, increased globalization may cause these differences to converge in the future and reduce the role of country-level factors (Cai et al., 2016).

KEY MESSAGES

- There is a wide diversity of investors' approaches to responsible investing.
- Geography is a key factor of differentiation in both the importance given to and the content of responsible investment policies.
- While European investors tend to give priority to environmental issues, social issues – diversity and inclusion in particular – tend to be dominant in the US.
- This is due to differences in regulations but also to social norms, cultural factors and sustainability preferences of the end-beneficiaries.
- Other factors are related to the nature and structure of investors' stakeholders – by professional background, gender, age…).

RECOMMENDATIONS

- Define your own philosophy and approach to ESG, based on your cultural environment as well as the values, beliefs, characteristics of your institution, and in particular the sustainability preferences of your principals.
- Your responsible investment objectives should also be adapted to the specificities of your stakeholders and beneficiaries. Surveys can be useful to better understand your stakeholders' expectations.

Chapter 2: The role of sustainability regulation

Beyond pressure from final investors and social norms, sustainability approaches may be encouraged by regulation, which investors recognize as a major driver to catalyze improved ESG disclosures and increased integration of sustainability considerations in investment strategies. As an example, the recent US Inflation Reduction Act (IRA) legislation is cited by some investors as a game-changing measure to help develop climate-related investments. The SEC is also proposing regulation that would require companies' annual reports to include data on their direct emissions and those generated by the products they purchase - Scope 1 and 2 emissions, respectively, while Scope 3 emissions would only be disclosed if they were deemed "material" or part of the climate objectives of the companies concerned -. However, a final decision has yet to be deliberated. In Europe, the regulatory landscape related to sustainable finance has considerably expanded in the recent years, with in particular the European Shareholders Directive, the Sustainable Finance Disclosure Regulation (SFDR), the Taxonomy Regulation, the Corporate Sustainability Reporting Directive (CSRD) and the Markets in Financial Instruments (MIFID2) update regarding sustainability preferences. A description of these regulations can be found in an Amundi ESG Thema publication[7]. As mentioned in the following Box 2 on the survey of academic literature, **Europe's leading role in regulation is recognized by investors in other continents**, for instance in Asia, reflecting a form of "Brussels effect[8]" whereby "market participants tend to respond through imitation in their global business when the EU creates incentives to adjust to its stringent standards". As the regulatory framework continues to be enriched, with important pieces expected in different areas such as deforestation, human rights or the request through the CS3D (Corporate Sustainability Due Diligence Directive) for large companies to undertake due diligence on their own activities and those of their suppliers, this will likely have impact on companies' business models, which investors need to analyze.

Regulation has also been a key driver of the integration of sustainability by Japanese investors. In 2020, the Japanese Ministry of Health, Labour and Welfare and three other ministries revised the Basic Policy of Reserves, including asking public pension funds to "consider promoting ESG investment from the viewpoint of securing long-term returns for the interest of beneficiaries". Following this requirement, the largest domestic pension fund GPIF revised its investment policy accordingly.

Responsible investment issues start to be integrated by emerging market investors as well, but the process usually remains at an early stage and regulatory pressure is generally not a strong driver. As an example, while ASEAN countries have defined their own sustainable finance taxonomy with an initial focus on environmental objectives, this looks quite pragmatic and less constraining than the EU taxonomy as it has to take into account the heterogeneity between member countries. Taking another example, the Mexican pension fund sector is now submitted to a regulation requiring these investors to integrate ESG in their investment approach, but local institutions regret that other actors such as insurance or public companies are not submitted to similar constraints.

However, for some, regulation is going too far and is becoming too complex. In California, where the law already prohibits state pension funds from making new investments or renewing existing investments in thermal coal companies, a Senate bill is being discussed that would forbid any investment in fossil fuels by 2030 by state investors. According to some, such a measure would be too extreme, inefficient in terms of portfolio management and probably not the best

[7] https://research-center.amundi.com/article/esg-thema-11-eu-sustainable-finance-action-plan-state-play
[8] See https://www.mdpi.com/1911-8074/15/7/291

approach to mitigate climate change, notwithstanding the fact that the planned legislation leaves areas of uncertainties regarding the scope of its implementation.

In Europe as well, some investors report a form of regulatory fatigue, mentioning that sustainability regulation already contains a lot of rules which they see as sometimes redundant or contradictory[9]. Such complexity may be enhanced by the fact that in some cases national legislations or standard-setting bodies introduce additional elements to the EU framework, reflecting local specificities. As an illustration, the strong sensitivity to nuclear energy that prevails in Austria has led the Austrian Ecolabel for Sustainable Financial Products to forbid any investments in enterprises that are related to the production of or the trade with nuclear energy and armaments.

In Canada, divergences between different provinces have prevented the federal government to act, and regulation there tends to be decided at provincial level. For instance, Manitoba province has passed The Trustee Act, which is voluntary in nature and allows local pension funds to consider ESG factors if they are otherwise consistent with prudential standards. One can also cite the Ontario Pension Benefits Act and Ontario Regulation, which requires disclosure of whether environmental, social and governance factors are incorporated into the plan's investment policies and procedures.

One can argue that the relationship between sustainability regulation and investors' approach goes both ways, as local institutions also impact the design of regulation to a certain degree. According to some investor surveys, this is particularly the case in the US where investors have apparently shown to be more prone to taking a greater role on regulatory consultations on responsible investing than in Europe. Moreover, investors sometimes take the lead over governments. This is the case in Canada where some pension plans have worked on their own taxonomy in the absence of a federal one.

In the UK, Nest states that it has been implementing climate reporting before the enactment of the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations. In Luxembourg, according to a European institution, the Parliament is very active on sustainability issues but has yet refrained to engage in a specific legislation applying to financial investors as it observes that major local institutions are acting spontaneously. More generally, large investors who consider themselves as leaders in responsible investing have not seen regulation as a constraint, at least up to recently, and some in emerging countries even expect their government to take more decisive regulatory action, for instance regarding the implementation of a carbon trading market.

In summary, **while sustainability regulations may be partly achieving their objectives and responsible investment stands to gain from increased disclosure requirements, there is still room for improvement.**

Box 2 A Review of Academic Literature on Regulation

A myriad of recent academic studies have investigated the impact of new regulatory developments in EU on responsible investing. ***Becker et al. (2022) provide causal evidence that regulation improves ESG performance.*** *Compared to similar ESG focused US funds, European funds classified as sustainable (Article 9) increased their ESG scores after the regulation on Sustainable Finance Disclosure Regulation (SFDR) came into effect.*

[9] See in particular https://www.agefi.fr/asset-management/analyses/linvestissement-responsable-an-ii

Aside from the European markets, some studies also investigate the regulatory landscape for Green Finance in China. Zhang et al. (2021) argue that compared to the developed economies, government policies shape investment decisions more decisively in developing countries. ESG investing in Chinese stock markets became profitable post 2016, when an ESG legislation was passed, providing specific guidelines. Studies on low carbon pilot programs launched by National Development and Reform Commission show that they have led to increased ESG performance (Shen et al., 2023).

***However, some market participants may not necessarily welcome green regulations that mandate disclosures**. Investors expect firms to make optimal decisions when it comes to ESG disclosures and performance, thus any regulation mandating ESG-related disclosures would be seen as an additional cost for firms (Grewal et al., 2019). Empirically, events related to EU directives on ESG have on average led to negative market reaction. Firms with higher than median ESG scores, however, have actually enjoyed positive stock returns due to these regulatory events (Grewal et al., 2019).*

*Another widely discussed subject in this area is the European Taxonomy, which required financial and non-financial firms to report on their sustainable activities based on a set of technical screening criteria. Redondo Alamillos & de Mariz (2022) argue that **EU regulation on ESG can not only have a direct impact on firms in Europe, but also spillover effects around the world through what is called a "Brussels effect"**, as EU regulations have historically often affected businesses globally. Furthermore, the current proposed regulations on ESG involve firms outside the EU, and the EU is actively shaping the international discourse on ESG through international bodies such as the Task Force on Climate Related Financial Disclosures (TCFD).*

***The main potential benefit of increased regulations is to address the issue of market fragmentation in ESG investing** (Chan et al., 2022). In 2016, the G20 stated that one of the main barriers for growing the green finance market was the lack of common and exact definitions for "what is considered green finance[10]". The lack of convergence for companies' ESG ratings among different data providers is reported by scientific studies and is a persistent issue regarding the data quality of ESG (Chatterji et al., 2016). A more recent study shows that revenue alignment with the Taxonomy is correlated with the company's environmental scores, but there is still room for harmonization (Dumrose et al., 2022).*

*EU Taxonomy was also created to redirect capital towards environmentally sustainable activities. **Investors can even be ahead of the regulation and align their portfolios before it takes effect**. For example, between 2005 and 2018 firms with higher Taxonomy-aligned revenues paid on average lower interest rates on bank loans (Sautner et al., 2022). Similar capital reallocation is also reported in equity markets, as green revenue alignment commands a stock market premium from 2017 to 2020 (Bassen et al., 2022).*

*To sum it up, studies that evaluate the current regulatory development in the EU and around the world find some evidence suggesting that **these regulations may be partly achieving what they set out to do: improve ESG disclosures, harmonize the responsible investment market and support its growth.** However, there is still room for development, as greenwashing, among many issues, remains a source of attention. Even though the regulations may not be welcomed by all market participants, responsible investing stands to gain from increased disclosure requirements.*

[10] The lack of convergence for companies' ESG ratings among different data providers is reported by scientific studies and is a persistent issue regarding ESG data quality (Chatterji et al., 2016). A more recent study shows that revenue alignment with the Taxonomy is correlated with the company's environmental scores, but there is still room for harmonization (Dumrose et al., 2022).

KEY MESSAGES

- Regulation has a major influence in the definition of responsible investment policies, although some investors act ahead of it.
- Regulation influences investors' competitive environment, and Europe is seen as a global leader in sustainable finance regulation, while the North American regulatory landscape remains highly fragmented.
- Regulation has been useful, particularly in improving sustainability-related disclosures, but a number of investors now perceive it as being too heavy and complex.

RECOMMENDATIONS

- Try to anticipate the consequences of regulation on your institution and on investee companies, in terms of potential impact on costs and performance.
- Discuss with supervisory authorities the design of your regulatory environment, through advocacy.
- Resources should be devoted to regulatory development monitoring, analysis and implementation of regulatory standards.

Chapter 3: How do institutional investors perceive the impact of responsible investment on return and risk? Do they see a potential trade-off between these objectives?

Another key issue is related to **investors' beliefs regarding the relationship between responsible investing and investment performance**. Box 3 proposes a review of academic literature on the topic. This generally shows that **responsible investing has at a minimum a neutral impact on investment performance**. Green investments have even tended to outperform the market in recent years[11], even though studies admit that this trend may be related to large investors' flows into ESG and should not be extrapolated. For some investors we interviewed, "there is no evidence that ESG will improve returns".

Most of the institutions that we interviewed stress that **their fiduciary duty to their stakeholders is to generate return, and that return is their priority.** For instance, Pensam's strong sensitivity to sustainability issues does not lead it to compromise on returns. However, investors usually add, as stated in a large pension fund's annual report, that "consideration of material ESG factors aids the institution reach its goal of generating superior risk-adjusted returns for its clients in the long term". The view that **responsible investing is favorable to performance in the long term** is a consistent theme. As mentioned by Canada's CPP in its 2022 Sustainable Investing Report[12], "…we believe organizations that effectively anticipate and manage dynamic and emerging material business risks and opportunities, including climate change, are more likely to make better-informed decisions, and endure and create value over the long term. This is why we consider and integrate these sustainability-related risks and opportunities into our investment analysis across the investment life cycle and across asset classes, where such considerations are material". They mention as well that "Maximizing the long-term value of a business today is no longer about financial excellence… it requires boards and executives to anticipate and manage a highly dynamic environment". Hence, according to this line of thought, **there is no trade-off between responsible investing and investment performance** as these go along with each other in the long term. Likewise, one of Sweden AP2's ten investment beliefs is that "sustainability pays off"[13].

A large European investor in the public sector even expresses an official preference for sustainability over investment performance, as a result of its Board structure and general objectives, even though it does not see this as an issue as it believes that both go hand in hand in the long term. For this type of investor anyway, objectives are not purely financial and are often complemented with non-financial ones. A Canadian pension plan, as a government-affiliated entity, claims in particular that its fiduciary duty goes beyond future pensioners and applies to the whole society, with the objective to "create a better Canada".

Turning to the specific case of central banks, while some are cautious as they fear that responsible investments may affect their return potential, others, particularly in Europe, believe otherwise. As an example, the National Bank of Belgium has recognized sustainability as a fourth objective of its strategic asset allocation policy, along with safety, liquidity and return, for its non-monetary policy portfolios. This institution underlines that "in the long term good quality businesses with lower risks should result into better returns".

[11] See Box 3 for references

[12] Several references in the article are based on institutions' sustainability reports and official communication, in addition to the information we gathered from qualitative interviews

[13] https://ap2.se/en/asset-management/

In many cases, responsible investing is also seen as a key element in investors' risk management approach. Climate risk in particular is increasingly integrated within institutions' general risk framework, which many see as holistic, including both financial and non-financial risk sources. Another of AP2's ten beliefs is that "climate change is a systemic risk". For the Future Fund of Australia[14], "the integration of ESG factors enables investors and companies to better understand the full spectrum of future risks and opportunities to which assets are exposed. Sound management of ESG factors also contributes more broadly to the development of more efficient and sustainable capital markets**".** Likewise, weak corporate governance is associated with an increased risk of negative events, as illustrated by the "Dieselgate" at Volkswagen in 2015, justifying investors' focus on governance indicators to enhance their portfolio's return/risk profile. More generally, investors often see sustainability-related issues as business-critical, and complementary rather than orthogonal to financial considerations. Integrating these issues in their analysis will certainly help investors understand if and how corporates will be able to adapt to the physical and economic conditions they will face in the future.

Now, even if investors are convinced that integrating sustainability will not affect their long-term performance, they may face periods of short-term underperformance that will help test the strength of their convictions. As an illustration, with the war in Ukraine, 2022 was a year of outperformance for the energy sector. However, responsible investment strategies tend to underweight this sector, which in aggregate triggered lower performance.

Large institutions are also particularly sensitive to reputational risk and are well aware that corporate reputation can be improved through the integration of sustainability[15]. As stated by Australia's Future Fund, "our reputation is one of our most valuable assets, resting on our sovereign status and enhanced through time by our conduct and results[16]…". Likewise, in its above-mentioned report, CPP declares[17] that "Underinvesting in climate change-related transition strategies can erode a company's value and result in decreased customer trust and loyalty or inability to attract talent. In the worst case, the company could even lose its license to operate".

Beyond purely financial motives - the quest for higher returns, possibly through mitigating the costs of climate change, or lower risks -, **investors report broader, non-financial motives for integrating climate risks into investment decisions**. For these, the most frequently cited elements by respondents are the protection of the investor's reputation, before moral/ethical considerations and legal obligations/ fiduciary duty. **Pressure may also come from individual investors**. According to the Australian UniSuper pension fund as quoted in the 2021 BNP Paribas ESG Global Survey[18], "much of the drive has come from our members", echoing Benabou and Tirole's "delegated philanthropy concept". As mentioned by Brière et al.[19], "when shareholders are also citizens, consumers, workers and taxpayers, absent perfectly competitive and complete markets, they care about corporate policies' impact on their welfare, over and above the cash they receive from the firm". Interestingly, some Singaporean institutions have reported that the promise of an increased talent pool was also a factor in accelerating ESG integration, as talented

[14] 2021-22 Future Fund Annual Report

[15] As shown in Boubaker S.i, Liu Z.§ Zhan Y (2022). Customer relationships, corporate social responsibility, and stock price reaction: Lessons from China during health crisis times, Finance Research Letters 47: 102699

[16] 2021-22 Future Fund Annual Report

[17] CPP 2022 Sustainable Investing Report

[18] BNP Paribas, The ESG Global Survey (2021). The path to ESG: No Turning Back for Asset Owners and Managers

[19] Brière M., Pouget S., Schmalz M. § Ureche-Rangau L. (2022), Delegated Philanthropy in Mutual Fund Votes on Climate Change Externalities.

individuals, especially in the younger generations, expect their employer to embrace strong sustainability values.

In conclusion, investors' motivations for incorporating responsible investing, and in particular climate risks into their decision framework, can be financial, non-financial or a combination of both.

Box 3 ESG, Risk and Return in Academic Literature

A comprehensive starting point to understand the academic consensus on ESG financial performance link is provided by Friede et al. (2015), who aggregate evidence from over 2,000 empirical studies. Their meta-analysis, a statistical tool for summarizing results of scientific studies, reveals that approximately 90% of empirical studies conducted until 2015 show a non-negative relationship between ESG and corporate financial performance. ***This historical perspective suggests, at a minimum, a neutral impact of ESG investments on returns.***

Recent research by Savio et al. (2023) adds to the discussion, highlighting the positive influence of robust ESG practices on stock prices during the COVID-19 crisis. ESG investments seem to have served as a protective 'safe haven' during turbulent market conditions. In the U.S., sustainability was one of the strongest predictors of fund performance between February 20 and April 30, 2020 (Pástor & Vorsatz, 2020), i.e. during the peak of the Covid crisis. Things were different however at the start of war in Ukraine, as sustainability funds, less exposed to fossil fuel companies suffered lower returns and attracted lower flows from investors (Chen at al., 2022).

Economists have identified several mechanisms through which ESG orientation can enhance firm value, potentially increasing shareholder wealth*. Pure economic motivations can lead firms to adopt a corporate social responsibility strategy, responding to preferences from both the demand (consumers) and supply (labor) sides (Kitzmueller and Shimshack, 2012). These preferences can also translate into government policy through democratic action, making CSR a return enhancing or risk management strategy.*

For example, Gompers et al. (2003) document higher returns of well-governed companies, while Fornell et al. (2006, 2016) find that firms with high customer satisfaction outperform. A portfolio of the "100 Best Companies to Work For in America" from Forbes earned a positive four-factor alpha of 3.5% between 1984 and 2009 (Edmans, 2011). According to human relations theory, employee satisfaction, often categorized under the social pillar of ESG, can enhance firm performance by increasing motivation and retention. A study on Swedish companies finds that workers in sustainable firms earn lower wages plausibly due to employee preferences for sustainability (Krueger et al., 2023).

However, the issue of reverse causality is inherent in studies attempting to establish how ESG can benefit financial performance*. Studies focusing on the long-run performance of ESG firms cannot determine whether the positive correlation is due to profitable firms being more likely to engage in corporate responsibility or corporate social responsibility contributing to firms' financial success (Krueger, 2015).*

Recently, a rich debate arose with the publication of 2 influential papers examining the link between carbon emissions and stock returns. Bolton and Kacperczyk (2021) find that US companies with high level of carbon emissions have high realized stock returns and explain this result by the fact that firms with higher emissions are facing higher transition risk. Thus investors request a higher cost of capital. On the contrary, Aswani, Raghunandan, and Rajgopal (2023) show that this carbon premium becomes insignificant when considering carbon intensities (emissions

scaled by sales), or disclosed vs estimated emissions. In practice, higher realized returns may reflect either higher unexpected returns (mispricing) or higher risk. Atilgan et al. (2023) recently show that companies with higher emissions enjoy superior earnings surprises and earnings announcement returns, suggesting that the historical carbon premium reflects some form of mispricing.

Furthermore, the historical outperformance does not guarantee future returns. *This issue is discussed in Pástor et al. (2021), who show that environmentally green portfolios outperformed brown portfolios between 2012 and 2020. In theory, since some investors prefer holding green assets due to non-pecuniary reasons and push the prices up, green assets should have lower expected returns. Nevertheless, green assets may yield higher realized returns if unexpected shifts in investor preferences occur, for example, as a result of an environmental disaster. Recent empirical evidence supports this theory. Shifts in a climate attention factor constructed on news explain most of the green stock outperformance (Pastor et al.,2021). Furthermore, green sentiment (i.e. preferences for green assets unrelated to climate fundamental information, and measured using abnormal flows into green ETFs) leads to a positive stock performance of firms with high environmental score (Brière and Ramelli, 2022).*

In conclusion, while there is consensus regarding the potential of responsible investment strategies to deliver long-term value and mitigate downside risk, most studies lack causal evidence and cannot predict future outcomes*.*

KEY MESSAGES

- Return generation remains investors' main priority.
- There is a widely held view among surveyed investors that sustainability is favorable to performance in the long term. Research emphasizes that green investments have tended to outperform the market in recent years, but recognize that this trend has at least partly been related to large investors' flows into ESG and should not necessarily be extrapolated.
- Responsible investing is also seen as a key element in institutions' risk management framework.
- Many investors are also particularly sensitive to reputational risk, which sustainability helps mitigate.

RECOMMENDATIONS

- Investors should formalize their investment beliefs on risk, return and sustainability.
- As some investors may consider that their mission goes beyond pure financial objectives, they should have a clear understanding of their stakeholders' preferences and constraints.
- The impact of climate scenarios on physical and transition risks should be integrated in investors' holistic risk management framework.

Chapter 4: Various approaches to responsible investing

From exclusion to ESG integration

For a number of investors, the responsible investing journey started with an exclusion policy. Our survey shows that this remains a secondary component of their responsible investment policy, which in many cases covers coal and sometimes more generally carbon-intensive assets. According to a Robeco report[20], 20% of surveyed investors' portfolios will be divested in the next 5 years from these assets, illustrating that the process is gradual. According to Dutch investor Rabobank, cited in this report, "we always choose a proper balance between the societal need for oil and gas and the energy transition we are in. We are not automatically excluding oil and gas companies, but we engage actively with them". Interestingly, while the proportion of investors that "invest in oil and gas companies, despite their carbon emissions, as long as they provide good returns" is the highest in North America at 29%, only half of these expect to continue to do so in the next two years, showing that even there, investors' attitudes are changing.

Still in the Netherlands, **PGGM implements several product-based exclusions**, regarding controversial weapons, tobacco, arctic drilling and tar sands and in 2022, the revenue thresholds for the production of coal and tar sand oil have been made more stringent to 5% and 1% respectively. Unlike some of its peers that have decided to completely move out of fossil fuels due to their client pressure, PGGM still holds some of these companies "if they have a credible strategic plan to operate in line with the Paris Agreement and the 1.5 degree scenario". In Australia, NGS Super has a particular restriction on any holdings of companies that generate more than 30% of their revenues from the distribution, power generation or extraction of thermal coal or which are in the oil and gas production and exploration sector, although some positions may be kept on excluded securities for some of its clients where there is a clear transition plan.

Top-down vs bottom-up

According to our observations, investors essentially apply a bottom-up approach when integrating responsible investing in their portfolios, i.e. constructing ESG-tilted portfolios at individual asset class level, rather than integrating it at their Strategic Asset Allocation level (SAA), using standard indices for major asset classes when setting their SAA.

Despite this, investors such as CalSTRS acknowledge that climate change is going to have significant impacts on economic variables and on asset returns, although this has not led them to alter their expected return goal. Climate-related issues are also sometimes included by investors at a broad level, for instance to generate climate scenarios, often based on those provided by the Network for Greening the Financial System (NGFS), to estimate physical and transition impacts on companies' profits. Australia's NGS Super also conducts climate physical and transitional scenario analysis, to obtain a deeper understanding of individual asset valuation and value destruction under the various climate scenarios.

ESG integration may nevertheless lead to certain geographical tilts resulting from bottom-up selection. For instance, Pensam accepts an underweight position on emerging markets as companies in these markets tend to have lower ESG ratings and higher climate risk. Likewise, its allocation to US High Yield debt is relatively low as a number of companies in this market have a higher carbon emissions profile.

ESG integration also quite frequently leads to certain sector tilts, and in particular an underweight on energy or an overweight on technology. However, according to a major investor, one should be aware of the interconnection between Environmental, Social and Governance criteria, citing electric vehicles producers that can have a better carbon emissions profile, although counteracted when taking into account their

[20] Robeco, 2022 Global Climate Survey, March 2022

impact on the exploitation of natural resources or the quality of their governance. Investors can then decide to correct undue sector tilts, for instance by adding maximum sector deviation constraints to the use of Climate Change benchmarks for their global equity portfolio.

Selecting benchmarks and managers

Investors generally set as an objective that their portfolio's carbon footprint be better than that of their benchmark, but the majority of them do not move to **ESG-specific benchmarks for their portfolio as a result**. One reason put forward by Caisse des Dépôts is that it considers that index providers' methodologies are highly debatable. The first step for using these **specialized benchmarks generally applies to investors' passive portfolio.** As an example, CalSTRS has shifted 20% of its equity allocation to a low emissions index. VBV also reports using Paris-Aligned benchmarks for its passive equity mandates and intends to increasingly use them for its equity and corporate debt investments. Interestingly, VBV applies stricter criteria than those used by the index provider, by imposing a 10% yearly decarbonization path compared with 7% for the index.

Most institutional investors also integrate ESG considerations in their manager selection process, and the recently-published Amundi-Create report[21] notes that external manager selection criteria have become far more stringent on these issues. As an illustration, together with other Danish pension funds, Pensam has contributed to the definition of a detailed questionnaire that is addressed to private equity managers. Another European institution started as early as 2013 to include sustainability-related questions in its RFP questionnaires, and since 2017 it is mandatory for its tendering asset managers to integrate a sustainability approach into their active management strategies, with a 20% weight given to these considerations in its manager selection process.

Moreover, NGS Super focuses its selection of managers on those with a robust methodology, and strongly engages with them to follow its own recommendations on specific issues.

The rise of sustainability-themed investing

As a good illustration of the shift to ESG integration, PGGM will move from exclusions to positive selection. Together with other institutional investors in the Asset Owners Platform, it has developed a Taxonomy to standardize the assessment of companies' contribution to the SDGs, and has set a goal of a 20% share of AUM for "Sustainable Development Investments" (SDIs) that contribute to one or more SDG according to this Taxonomy. Many investors also set a target for the share of "green" investments in their portfolio.

In order to define what is green, a Canadian pension fund has developed its Green Assets Taxonomy which it uses to quantify its greenhouse gas (GHG) exposure and track GHG changes over time by company and by portfolio. This Taxonomy distinguishes three categories of assets: green assets, or investments in low carbon activities that lead to positive environmental impacts; transition assets, or investments that have committed to make a substantial contribution to a low carbon transition; and carbon-intensive assets.

Investors can then define a specific "green" bucket target that receives different denominations. Following its goal to be a net zero investor by 2050, Denmark's Pensam has set a 15% target for the weight of "green" assets in its portfolio, along with a 55% CO_2 reduction in 2025 compared with 2019. This bucket can include the following strategies:

[21] Amundi/ Create report (November 2023, The next state of ESG evolution in the pension landscape

- Equities – that continue to be the primary asset class to deploy responsible investing considerations -: thematic strategies are generally focused on alternative sources of energy, hydrogen, water or socially-oriented strategies (education, working conditions…).
- Fixed income: strategies include green bonds that finance projects with environmental and climate benefits, such as wind farms, solar or hydropower infrastructure, smart grids, green buildings, clean transportation etc., as well as social bonds. As an illustration, a US pension fund recently created an "Investment opportunity" sleeve within its fixed income portfolio that will invest in energy transition through a customized mandate delegated to an external manager. For central banks that essentially invest in high quality bonds, investment in green or sustainability bonds usually remains marginal as they fear it could have a negative impact on their portfolio return or liquidity, on which they are not ready to compromise. Latin American Reserve Fund FLAR reports that it started to apply NBIM's exclusion policy to its high-quality credit portfolio and found out that it had a limited impact.

As there is also an increasing sensitivity to responsible investing in alternative assets, infrastructure and private equity can be appropriate asset classes to invest in green and social themes. Some investors actually claim that in private markets they can leverage their direct access to companies to monitor and engage directly with boards and management on climate-related risks and opportunities. Several surveyed investors also use side letters explaining their exclusion policy that has to be followed by their private asset manager. For Pensam, side letters are possible to accommodate specific requirements in cases where Pensam represents a significant weight in the manager's assets. And regarding real estate, a European institution aims at maximizing energy performance when renovation work is conducted within its direct portfolio.

In the case of sovereign funds, such thematic strategies may reflect priorities set by the government. As an illustration, Malaysian sovereign fund Khazanah has committed to dedicate MYR6bn over 5 years to direct investments across six themes (including quality health and education for all, decent work and social mobility, food and energy security, building climate resilience) corresponding to key challenges facing the country[22].

Some investors accept that certain investments in their portfolio will remain carbon-positive in the foreseeable future and try to **identify carbon offsetters to compensate for these**, based on research they conduct on carbon-negative assets. Examples of carbon-offsetting and low-emission investments considered by NGS Super are carbon capture and storage, credits from projects in forest conservation or windfarm projects, or investments in batteries.

In summary, our observations confirm the results of the above-mentioned 2022 Robeco Global Climate Survey. **This report mentioned the adoption of thematic investing as one of its key findings**, with 70% of investors then implementing it as a high or core priority, within a building block meant to invest in projects or corporates that develop technologies and solutions contributing to the energy transition. However, it remains to be seen whether, as feared by Pensam for instance, the valuation of these green strategies has not been over-inflated due to an imbalance between strong investor demand and a still narrow market. For Pensam, which prefers to stay away from these thematic strategies, this is the case, while a Canadian pension plan considers there are currently lots of opportunities there, including climate impact and social impact solutions, to help it build a climate sleeve in its portfolio.

[22] https://www.khazanah.com.my/who-we-are/about-us/

Moreover, while an increasing number of investors allocate to sustainability-themed and impact strategies as a way of greening their portfolio, some of them stress that **transition-focused strategies are key to reaching net zero objectives**, and that a mere rebalancing of their portfolio is not the most efficient approach[23]. NGS Super in particular "is not taking the easy route consisting in getting rid of high-carbon emitters to decarbonize its portfolio as it wants to maintain portfolio diversification", whereas "merely divesting high emissions companies would bring immense volatility and tracking error to investment returns and not reduce the Fund's carbon emissions to zero".
In order for these transition strategies to be successful, engagement is key.

How to make engagement successful?

Beyond ESG integration in investors' process and investment in thematic buckets, **engagement is a key pillar of responsible investment strategies**, as investors see it as in line with good governance practice as well as part of their fiduciary duty. While Box 4 summarizes the main conclusions of academic research on the topic, some investors provide interesting descriptions of their engagement approach.

The first step consists in setting clear objectives. CalSTRS in particular has set four priorities for its engagement policy:

- Achieving measurable outcomes through influencing corporate and market accountability
- Supporting effective corporate boards
- Transitioning to a low-carbon economy
- Addressing firearm safety and responsibility

These issues are defined after consideration of three factors:

- The issue must be relevant to the long-term performance of our portfolio
- We must have the capacity to influence a meaningful change
- We must be able to deliver measurable outcomes

Taking another example, a Canadian pension fund has adopted a global engagement policy, addressing holistic topics such as indigenous rights, labor practice and shareholders rights. More specifically on climate, its focus is on alignment of reporting practices to the TCFD framework, verification of emissions data and integration of climate objectives in managers' remuneration. Its criteria for engagement include probability of success or influence as well as reputational risk. Because of its focus on fair taxation, Pensam also cites its pressure on certain US companies to obtain more tax transparency from them, or to pay the right amount of tax in some of their countries of operations.

Investors must then define the target companies for engagement, as scarce engagement resources need to be used efficiently. As mentioned in Box 4, research has shown that "targets with more reputational concerns and a higher capacity to change see a higher success rate". For instance, NGS Super, which announced in 2021 its ambitious goal to transition its portfolio to neutrality by 2030, conducts it with "companies with high emissions that have a sound and realistic business plan to transition to a low-carbon economy within a timeframe deemed

[23] As confirmed by Atta-Darkua et al. in Decarbonizing Institutional Investor Portfolios: Helping to Green the Planet or Just Greening Your Portfolio?, 2022

acceptable to the Fund". It exercises pressure on companies it holds to improve their client reporting, but due to limited resources, it has to primarily focus on Australian companies.

A third element is the engagement process. Engagements most often start with discussions between management and shareholders and then potentially escalate depending on how the initial discussions are received. In addition to traditional forms of engagement such as in-person or virtual meetings, investors may conduct advocacy-related engagements, raising key issues with various levels of government, regulatory bodies or industry associations. For CalSTRS as well, "beyond engagement at single company level, it might be more efficient to push industry standards".

Engagement is an area where coordinated action is an advantage, as according to Pensam, which may conduct some of its engagement together with other Danish pension funds, "institutions can be stronger as a group". Research shows nevertheless that having a leader in an engagement coalition increases its success rate. Investors may also rely on their external managers to conduct engagement for them, most often sharing their priorities with these managers. However, whereas one European institution requires its external managers to be involved in engagement, it leaves it up to them to define their engagement approach and aims to benefit from the diversification effect linked to the diversity in these managers' approach to sustainability.

Last but not least, **a strong focus should be put on engagement monitoring**, in order to regularly evaluate actions taken by companies in the engagement process, based on precise KPIs. Such monitoring is also advised when investors use external managers. As an illustration, VBV, which conducts engagement policy through its external managers, integrates ESG criteria in its manager selection process and uses a checklist to review which concrete engagement measures have been set by these managers during the assessment period.

Statistics on the number of companies engaged by a given investor are scarce. Engagement can be conducted in different ways: direct, but also collaborative engagement and policy advocacy, or delegated to external advisers; engagement can also be thematic rather than at company level. In its integrated report[24], PGGM mentions having engaged 154 companies in 2021 and achieved 15 results, while CalSTRS states it "engaged hundreds of companies over several years on the board diversity theme".

Now is engagement successful? While academic studies highlight a generally positive impact of engagement, **actual observations are more mixed** regarding its effectiveness in fostering change and progress on ESG policies in investee companies[25]". Moreover, if portfolio firms did not respond to an engagement or showed resistance, then investors usually gave up and did not take further actions. One possible explanation of this apparent contradiction is that, as seen above, **engagement must be based on a well-formalized process and produces results over time. Investors must therefore devote significant resources to engagement, and show patience and perseverance**. In these conditions, it can certainly be effective

Voting policies

As shown in Box 4, **there is a positive link between active ownership on responsible investing issues and firm performance**, and this is encouraging for a potential role of investors in improving the sustainability performance of the firms in their portfolio. **Many investors do actually use voting policy to try and influence corporate behavior,** or according to an interviewee, **"to encourage ambition"**. For a Canadian pension fund, "the election of directors is

[25] This is mentioned in the already-cited Robeco survey

an important channel for expressing dissatisfaction when they believe a company has not taken steps to understand, assess and mitigate climate risks". Investors may vote against the reelection of board members if climate strategy is not sufficiently addressed, or if they consider that key governance criteria, such as board independence or diversity, are not met. In Krueger's survey, about a third of the respondents have submitted shareholder proposals on climate risk issues, and a similar fraction voted against management proposals because of climate concerns.

At a large investor like Caisse des Dépôts, the Sustainability team is in charge of voting policy, on the basis of a voting guide which is reviewed every year with the support of governance experts, and it participates to pre-AGM meetings with companies. As is the case with a large majority of institutional investors, they tend not to present resolutions themselves, but may frequently vote in favour of resolutions presented by other investors. PGGM also submits shareholder proposals, often with other investors, to spur a company into action, and escalate according to engagement guidelines. As an example, they decided to vote against the entire board of directors of a major US technology company due to the company's unwillingness to enter into a dialogue on anti-competitive behavior.

However not all investors are equipped to have their own voting policy, and a number of them rely on external proxy advisors, without necessarily applying all of their recommendations, or in some cases on their external managers. As reported by Nest, it is very important for investors to express their voting rationale to the companies when they decide to vote against certain resolutions, as a contribution to the necessary dialogue to maintain in an engagement process.

Some investors also show a high level of transparency in their voting policy. This is the case of Pensam which produces a report detailing its votes according to different criteria, such as country, company or type of resolution. NGS Super also publishes its interactive proxy voting history, which can be seen as a faithful reflection of its focus issues within ESG.

Voting is also an area where investors may gain influence by working together to submit resolutions to AGMs.

As a conclusion **it is likely that investors' focus on active ownership will further increase as they should be encouraged by studies showing, in the case of responsible investment issues, its positive link with firm performance.**

Box 4 ***Active Ownership***

According to a survey of 439 institutional investors, when dealing with climate risks, ***investors prefer engagement over divestment*** *(Krueger et al., 2020).* ***However, the effectiveness of engagement strategies in enhancing the sustainability of targeted firms is not well understood****, as data on private engagements are scarce and difficult to obtain, and engagement policy is never conceived as a randomized experiment. Some academic studies on ESG engagement focus on the impact of the engagement on financial performance of the targeted firms. According to Dimson et al., 2015, "universal owners" – institutional investors with diversified and long-term holdings – may have incentives to engage with firms on ESG issues, as their portfolios are more exposed to the negative externalities of corporate activities (e.g. environmental pollution). Using proprietary data provided by a large ESG-oriented institutional investor, they show that* ***successful engagements on ESG themes improve stock market and accounting performance.*** *Namely, an additional successful engagement on governance and climate change leads to an average abnormal cumulative return of +8.6% and +10.3% over one year, respectively. A more recent study on coordinated engagements of UN PRI investors confirm these results*

(Dimson et al., 2023). Investors also tend to engage on ESG issues that are financially material to the target firm (Bauer et al., 2022).

On the other hand, some studies look at the impact of engagement on environmental performance. Azar et al., 2021 show that ***engagements by the Big Three asset management companies in the U.S are followed by a reduction in carbon emission intensity****. Private engagements of a large Japanese passive asset manager on environmental issues lead to an increase in the FTSE environmental score of the target firm, compared to a similar firm that was not engaged (Becht et al., 2023). These results are not confirmed when using E scores from another data provider, which the authors attribute to differences in scoring methodologies.*

The success of an engagement depends on several factors. Targets with more reputational concerns and a higher capacity to change see a higher success rate *(Dimson et al.,2015). As for when an engagement is coordinated,* ***having a leader in the engagement coalition increases the success rate*** *by 22-25% (Dimson et al., 2023).*

A common issue with studies on engagement is that the treatment – the group of companies chosen to be engaged – is likely not exogenous. Asset managers may be strategically choosing whom to engage based on some unobserved characteristics, which makes establishing a causal relationship difficult.

Another type of strategy to influence firms in their sustainability behavior is proposing and voting in shareholder resolutions, which can be less costly and time-consuming than direct dialogue with firms. The recent rise of passive ownership may increase the role of voting as a way of influencing firms on ESG issues, but can also lead to less hands-on engagement (Bekjarowski & Briere, 2017). ***The empirical evidence on the voting behavior of institutional investors on ESG resolutions is mixed.*** *For example, US mutual funds identified as sustainable by Morningstar are significantly more likely to vote in favor of ESG resolutions than conventional funds (Dikolli et al., 2022). Similarly, fund families with a higher percentage of responsible funds are more likely to support shareholder resolutions on climate (Brière et al., 2022). . However, after joining UN PRI, the signatories only slightly change their voting behavior on social issues, while no meaningful change is observed in environmental or governance votes (Kim & Yoon, 2020).*

In conclusion, while some studies do show that investors engage firms successfully on ESG issues, a causal link needs to be better identified. Academic findings on voting are also mixed. *However, the positive link between active ownership on ESG issues and firm performance is encouraging for a potential role of investors in improving the sustainability performance of the firms in their portfolio.*

KEY MESSAGES

- Many Investors have started their responsible investing journey with exclusion strategies that now tend to be largely based on international norms (for instance linked to cluster bombs, coal…). Meanwhile, there is an increasing focus on ESG integration.
- Investors' ESG approach remains essentially bottom-up, while some are starting to integrate ESG and in particular climate scenarios in capital market assumptions used in their strategic asset allocation.
- There has been a rise of sustainability-themed and impact strategies and of the share of green assets in portfolios across all major asset classes.
- Engagement is a key pillar of many institutions' responsible investment approach, and investors tend to believe that it has a generally positive impact on performance. While large investors do direct engagement, some also conduct collective engagement, while others rely on their external managers.
- Engagement is particularly important to the success of transition-focused strategies.

RECOMMENDATIONS

- Evaluate whether the size of green assets opportunities available in the market is sufficient for your needs.
- Integrating climate-economic scenarios and transitioning strategies must be a key component to reach your net zero objective.
- Your engagement policy must be well formalized in terms of process, priorities and monitoring.
- Within private assets, the use of side letters can be a good way to have external managers integrate investors' constraints.

Chapter 5: Engagement vs Divestment strategies

When engagement and voting are not successful, **divestment may be considered, but all surveyed investors mention it as a last-resort instrument** that they are reluctant to use. As an illustration, only 17% of investors surveyed by Krueger indicated that they divested when dissatisfied with portfolio firms' responses.

There are a few explanations for this. **Investors probably consider that divestment would reduce their influence to improve sustainability and in particular climate policies within invested companies. Divestment can also generate significant opportunity costs to investors** who divest fossil fuel companies, such as reduced diversification, but also ongoing transaction and compliance costs. A Canadian pension fund provides a good illustration of this attitude when stating that "we prefer to leverage influence as investors to spur constructive dialogue on ESG best practices rather than divest and unnecessarily reduce the investment universe". Investors may also consider that divesting will not be in their interest if they sell their stake at heavily discounted prices, letting investors with much less focus on responsible investing considerations benefit from a cheap buying opportunity. Moreover, as seen in the previous chapter, beyond divestment, **investors can engage and use their shareholder rights to convince management to change course** in the direction of non-fossil fuel resources or they can invest in renewable and more sustainable energy technologies.

However, a minority of investors still resort to divestment, and according to Brière[26], "funds with shorter horizons and smaller ownership stakes are more likely to vote with their feet" adding that "the threat of exit must be credible, and it must be seen as a source of new negative information in order to affect market prices".

The issue of divestment is particularly acute regarding fossil fuel companies and as shown in Box 5, academic literature is not fully conclusive on it, depending in particular on whether passive investors are integrated in researchers' models and on the degree of correlation between brown and green stocks (i.e. whether investors can find close green proxies for the brown stocks they divest). A paper also argues that investing in a brown firm that takes a corrective action to reduce its externalities can incentivize it to improve its environmental performance, all the more so as, according to another paper, "firms in brown industries are usually active in producing green patents"[27]. As stated in the recently-published Amundi-Create report, "energy companies can be both part of the problem and part of the solution"[28].

Divestment campaigns have secured most of their success in the non-profit sector: endowments, charities and universities and colleges, in some cases in response to student protests. The specific attitude of US university endowments is well illustrated by the Brandeis University discussion, which concluded, "The majority of the Committee advocates that Brandeis strongly considers divesting its holdings in fossil fuel firms. Student consensus and robust faculty concern suggests that continued investment in fossil fuels presents a fundamental tension with Brandeis' proud tradition of social justice"[29]. **In Europe as well, investors are under pressure from NGOs, the press and the public to divest their holdings in oil and gas companies**, and some may be inclined to yield. According to PGGM, oil and gas are not immoral, but the sector must be brought into line with the Paris agreement. On the other hand of the spectrum, institutional investors may consider that fossil fuel divesting conflicts with their fiduciary duty, although a study[30] argues that this is not the case, as "This avoids the risk of stranded assets, which could threaten pensions in the future". For Australian pension fund NGS Super indeed, "any asset deemed to become stranded will be flagged for assessment and potential divestment". The institution has already divested from certain oil and gas companies.

[26] Marie Brière, Shareholder Activism: Why should investors care? Amundi Discussion Paper, DP-30-2018
[27] See details in Box 5
[28] Amundi/ Create report (November 2023), The next state of ESG evolution in the pension landscape
[29] Brandeis University's Exploratory Committee on Fossil Fuel Divestment, Final Report and Recommendations, April 2015
[30] Plantiga A. § Scholtens B. (2020), The financial impact of fossil fuel divestment

Box 5 Divestment

The merits and limitations of divestment strategies are extensively debated by academic researchers. While some researchers question the price impact of divestment on brown firms' stock, due to the existence of arbitrageurs in equity markets, others argue that exclusion, even if successful in pushing brown stock prices down, may not be effective in reducing emissions. However, several empirical and theoretical studies push back against this idea and show how boycotting certain stocks is likely to work.

Berk & Van Binsbergen, 2021 argue that ***the impact of divestures on the cost of capital of dirty firms would be too minimal to make a difference in investment decisions****. The increase in the cost of capital, when a proportion of investors divest away from dirty firms, can be approximated by:*

$$Market\ Premium \times \left(\frac{ESG\ Investor\ Wealth}{Rest\ of\ Investor\ Wealth}\right) \times f \times (1-\rho^2)$$

Divestment works when there are many investors willing to divest, and when the correlation (ρ) between the stocks of dirty firms (f) and clean firms is not high. A calibration based on the current data on US mutual fund holdings shows ***a very negligible impact of divestment strategies on brown stock prices. The limited power of divestment stems from the large correlation between dirty and clean stocks.*** *Since dirty stocks are close substitutes to clean stocks, traditional investors do not demand a high premium for holding dirty stocks. In an unrealistic scenario, where ESG investors would make up at least 84 % of all investors and are willing to use exit, the cost of capital of brown firms would rise by merely 1% (100 basis points).*

Cheng et al., 2023 use a similar equilibrium framework, yet reach a different conclusion. The main divergence arises due to the existence of passive investors *in Cheng et al., 2023. In other words, passive investors cannot absorb all brown assets sold by green investors and have less price sensitive demands, since they usually do not diverge too much from the market portfolio. This additional assumption makes brown and green stocks not perfectly substitutable, and increases the price impact of a divestment campaign.*

Empirically, Berk & Van Binsbergen, 2021 show that being included or excluded from a sustainable index (FTSE USA 4 Good) does not lead to a significant stock price reaction. Similar results are found in a couple of studies with an international sample (Hawn et al., 2018, Durand et al., 2019). On the other hand, Noh et al., 2020 find that due to price pressure from its investors, an average firm could expect its valuation to increase by 0.63 % if it improves its environmental score by 0.1 standard deviation. In addition, survey data shows that there has been an average of -2.6 percentage points difference in the perceived cost of capital between the greenest and brownest companies, and this difference also translates into a decrease in discount rates used by green firms (Gormsen et al., 2023).

On the other side of the coin, ***blanket exclusion strategies that divest away from all brown firms may not provide these firms with any incentives to do better*** *(Edmans et al., 2022). Namely, by agreeing to invest in a brown firm that takes a corrective effort to reduce its externalities,* ***the socially responsible investor can incentivize brown firms to improve their environmental performance****. This corrective action could be, for example, developing green energy for a fossil fuel energy company. If such efforts are very effective at reducing emissions, investing in brown firms may be more "socially responsible." However, the tradeoff of such a strategy is that it allows brown firms to easily access capital, allowing them to grow and increase their emissions. Empirically, some tests demonstrate that,* ***when brown firms face financial constraints (e.g. decrease in profitability), their emission intensity increases*** *(Hartzmark &*

Shue, 2023). However, the impact on absolute emissions may be more interesting from a social utility maximization perspective.

A possible reason as to why firms in brown industries such as energy or fossil fuel firms may be in a position to benefit from such incentives is ***that they are usually active in producing green patents*** *(Cohen et al., 2020). Empirical evidence shows that responsible investors tend to shun such companies (Atta-Darkua et al., 2022). On the other hand, these green patents produced by the brown energy sector may not be fundamental or even effective in reducing emissions (Bolton et al., 2022).*

KEY MESSAGES

- Divestment is the least frequently used component of investors' approach to shareholder stewardship.
- This is due in particular to the will to leverage influence as investors to spur a constructive dialogue on responsible investing issues.
- Results from academic studies are mixed regarding the efficiency of divesting from "brown" industries and securities. While the impact on divested firms' cost of capital is debated, divesting may lead to reduced portfolio diversification and prevent investors from incentivizing "brown" firms to improve their environmental performance.
- Divestment campaigns are most popular in the non-profit sector. Pressure from NGOs and the public may lead some investors to divest from "brown" companies, at least partly for reputational risk management purposes.

RECOMMENDATIONS

- Investors should clearly formalize the role of divesting within their stewardship approach and set of responsible investment policies, and communicate their expectations transparently as a way to incentivize companies within escalation procedures.

Chapter 6: Sustainability governance and resources: data remain a key challenge

ESG data is an issue that many investors still see as a challenge, while, as described in Box 6, academic literature reports **considerable divergence in ESG data, which arises from their inherent subjectivity and the lack of consensus on their definition**. As an illustration, the above-mentioned Amundi-Create report deplores "the absence of credible audited data on ESG risks and opportunities" as an obstacle to further progress in responsible investing. Data quality and consistency issues are particularly acute within the S pillar, which investors see as the most difficult to analyze and integrate, due in particular to lack of standardization. To take an obvious example, labour rights are not directly comparable between most developed and certain emerging countries.

Beyond measurement, there is a debate about **whether to apply the same criteria uniformly across markets or to adapt them**, and in particular when analyzing assets in developed or emerging markets. As an illustration, the minimum percentage of female directors criteria set by CPP in its analysis of companies applies only to developed countries – although it has just recently added South Africa in its scope –. A large European financial institution also admits that it cannot apply the same criteria in its responsible investment analysis to small and mid-size companies compared with large capitalizations. Moreover, as mentioned by Prudential Corp Asia, "We want to lead on net zero, but we also want to be aligned with the countries we operate in[31]". This illustrates that investors sometimes focus on momentum rather than on actual levels for ESG indicators, and will look for ESG improvers in their investment strategy.

While most data providers focus on equity and bond markets, **data issues are particularly acute in private markets** due to the nature of these asset classes and the lighter regulatory framework they are subject to for their reporting. However, they often represent a significant share of pension or sovereign investors' assets and play an important role in their responsible portfolio. As an illustration, ABP mentions in its annual Sustainability report that the largest share of its SDIs is in real estate, in support of SDG 11 (Sustainable Cities and Communities), explaining that real estate qualifies as SDI if it receives four of a maximum of five stars in the annual sustainability survey of the Global Real Estate Sustainability Benchmark (GRESB). According to a Canadian pension plan, in order to make informed decisions**, "it is decision-useful data that is the issue, rather than data as such** and the gap is more on private than on public assets data". In private equity, they used MSCI data as proxies for the measurement of their portfolio carbon footprint, but had to make adjustments due to problems of classification of companies.

Investors relying on systematic quantitative rating tools are rare. Austria's APK has designed its proprietary rating methodology called APK Sigma that helps evaluate whether an investment's ESG features are positive or negative, and uses ESG scores produced through this methodology in its selection process, while most other investors underline that quantitative indicators in the area are debatable. A South-Asian pension fund has also developed its ESG scoring methodology, based on a combination of data published by external providers, which it applies to its domestic investments. In reaction to the perceived limitations of ratings provided by consultants, Dutch pension fund ABP has built its own classification methodology, with different criteria set for different sectors. Its climate dashboard includes 20 indicators, such as global demand for fossil fuels and investments in renewable energy, and provides an indication on the extent to which the world is on track to reach the Paris objective.

[31] Cited from Robeco, 2022 Global Climate Survey 2

For a US pension fund, "aggregate ESG scores are meaningless and one should rather focus on individual issues within each of the ESG pillars". Within real estate, one investor mentions for instance that targets can be much more easily met when investing in new office real estate than on their portfolio of old residential housing.

Beyond data, a number of investors are developing climate scenarios to support their climate risk analysis framework and/or to estimate the impact of climate on different types of securities in their portfolios, while sometimes acknowledging the imperfections of climate risk indicators provided by major external consultants.

In conclusion, ESG data remains a key challenge, **in terms of quality, consistency and availability for all asset classes, and investors must rely on multiple data sources, metrics and technology**. This makes the measurement of their progress towards their climate targets uncertain and their compliance with reporting requirements sometimes difficult. In order to cope with this challenge, investors will need to develop their own capacity to analyze and aggregate data, and to put pressure on companies as well as on their asset managers to develop their own set of data. This will require significant resources, justifying the brief analysis of investors' sustainability governance that now follows.

Centralized or decentralized sustainability set-up

While the main features of investors' sustainability policy are typically defined at the highest level of the institution, such as the board, sometimes supported by a committee of experts[32], **the organization of internal sustainability resources varies**.

When a Sustainability department has been set up, it is typically in charge of conducting institution-wide responsible investment initiatives, such as setting carbon targets, taking a position on certain sectors… as well as participating in external managers' due diligence process and coordinating engagement activities. Its Head generally reports to the CIO, as an illustration that the key challenge lies in marrying the two cultures, and less frequently directly to the CEO. A survey[33] showed that CIOs are responsible for implementing climate risks at 36% of respondents and CEOs at 23%, but as it was conducted prior to 2019, results may have changed since then. The Head of Sustainability of a Canadian pension plan has a dual reporting line, to the Chief Investment Officer but also to the Chief Risk Officer, as a testimony of the importance of these issues in the institution's risk management framework and monitoring tools. According to him, **there should not be conflicts between sustainability and investment professionals, as long as they communicate appropriately and listen to each other.** This ongoing internal communication is facilitated by the existence in many organizations of a Sustainability committee that, taking the example of Singapore sovereign fund GIC, "… is tasked to implement GIC's sustainability framework, support and promote sound stewardship, monitor and respond to emerging trends and issues. Across GIC, the investment committees are ensuring compliance and integration of sustainability considerations in our investment process[34]…"

In a decentralized model, sustainability issues, such as regulation, integration of responsible investing, climate scenarios, carbon measurement, etc., are discussed in a transversal way through regular meetings gathering representatives of different departments (Investment, Risk, Systems, Legal…), and dedicated sustainability resources are minimal. This is

[32] For instance, at French institution Caisse des Dépôts, the Finance and Sustainability department, which is in charge of defining principles for the whole group on all ESG-related topics (such as coal policy), relies on a Stakeholders committee gathering experts to provide views on strategic choices. This structure provides an interesting illustration of the perceived integration between financial and non-financial issues

[33] See above-mentioned paper by Krueger et al.

[34] https://www.gic.com.sg/thinkspace/emerging-markets/sustainability-an-enterprise-journey/

the case at a Mexican pension fund, where the person in charge of the whole corporate sustainability process coordinates a pluri-disciplinary working group gathering asset allocation, portfolio management and quantitative specialists.

The institution's size has an obvious impact on the internal set up, as only large institutions can afford to dedicate sizeable internal resources to sustainability. A recent survey of Chinese financial institutions on their ESG practices[35] underlined that the majority of Chinese respondents had a team of 1 to 5 persons dedicated to ESG, which is a sign of emerging interest but clearly too limited to conduct in-depth analysis on investee companies. However even large institutions may favor a decentralized set up. As an illustration, PGGM will re-organize its Responsible investment team for more effective ESG integration by other departments, according to its 3D investment strategy (balancing risk, return and impact objectives).

In order to cope with resource limitation, we observe that **institutions tend to specialize in certain areas**. For instance, a large French institution focuses its engagement policy on European companies that represent the essential part of its equity allocation, and not on US companies of which it owns only a very small share of capital and where its action would not be efficient.

Resources can also be shared between institutions, and this is a frequently observed approach regarding engagement policy. Most investors are actually part of various investor coalitions, and we see more and more asset owners collaborating to build a consensus on how the UN SDGs can translate into practical and implementable investment KPIs.

Box 6 ***ESG Data Divergence: Understanding the Complex Landscape***

Issues with ESG data have been identified and discussed widely in the academic literature. Krueger (2015) emphasizes two primary issues with measuring corporate social responsibility. ***First, CSR activities are difficult to quantify due to their inherently qualitative nature. Second, devising a unified metric to gauge the effects on various stakeholders of a company proves elusive, given the divergent needs and motivations of these stakeholders.*** *For example, if a corporate action benefits the community, but harms employees, averaging the social impact across these two dimensions becomes meaningless.*

One of the first comprehensive quantitative studies supports these arguments. Social scores from six major rating agencies (KLD, Asset4, Calvert, FTSE4Good, DJSI, and Innovest) display low pairwise correlations among them (Chatterji et al., 2016). The analysis suggests that ***data providers diverge not only on the definition of social responsibility but also on their measurement methodology.***

Berg et al. (2022) categorize this divergence into three distinct types: scope divergence, measurement divergence, and weight divergence. Scope divergence arises when ratings hinge on different attributes, e.g., one provider may include lobbying efforts while another does not. Measurement divergence materializes when the same attribute is assessed using different indicators, such as evaluating labor practices based on high turnover or work-related accidents. Lastly, weight divergence stems from disparities in the weight assigned to various attributes. Their research highlights that measurement divergence is the dominant factor contributing to rating discrepancies, accounting for 56% of the overall divergence. Scope divergence accounts for 38%, while weight divergence, the easiest to solve, only explains 6% of the total variance. This underscores that ***addressing measurement differences in ESG ratings may involve reconciling data generation processes underlying them.***

[35] China SIF, 2022 ESG Survey Report for Asset Owners

Christensen et al. (2022) argue that contrary to conventional wisdom, more disclosure by companies results in increased disagreement among ESG data providers due to the subjectivity of ESG information. In the absence of a disclosure, data providers tend to use rules of thumb and imputation methods to fill in the data. For example, if a company does not report on an issue that is widely reported on by its industry peers, the firm often automatically gets a zero score. In contrast, when a company reports its ESG performance, providers must make subjective judgments, amplifying divergence. ***These findings align with sociological theories predicting pluralistic evaluations in emerging fields.*** *The authors supplement their findings with causal evidence. When a given firm is forced to disclose ESG performance due to requirements at the country or stock market level, disagreements about the firm's ESG scores are likely to increase.*

Nevertheless, not all ESG data discrepancies can be attributed to subjectivity, since studies report such divergence even for carbon data. *While data providers generally agree on Scope 1 emissions (direct emissions), correlation declines for Scope 2 emissions (indirect emissions from electricity and heating consumption) and is very low for Scope 3 emissions (upstream and downstream emissions in a product's lifecycle), which are hardest to estimate (Busch et al., 2022).*

Studies also explore the repercussions of ESG data divergence. Bancel et al. (2023) find that ESG disagreement on a firm corresponds to a stock market premium, primarily driven by discrepancies in environmental ratings. This reflects the role of uncertainty in influencing financial outcomes.

In summary, ***academics mostly agree on the existence of divergence in ESG data. This divergence fundamentally arises from the inherent subjectivity of ESG data and the lack of consensus on the definition of ESG.*** *Disagreements in ESG data, as Joubrel and Maksimovich (2023) argue, should not necessarily be seen as an impediment but rather can be an opportunity for different data providers to offer distinct value propositions. Leveraging on different data providers, thus, can be a valuable strategy for investors. The subjectivity inherent in ESG data also implies that* ***such divergence is likely to persist****, despite efforts to standardize and harmonize it. Developments in alternative data analysis (e.g. textual and satellite data) and Artificial Intelligence can provide a remedy and improve data quality (Brière et al., 2022).*

KEY MESSAGES

- ESG data remains a challenge, in terms of quality, consistency and availability for certain asset classes (such as private assets).
- There is a debate amongst investors on whether ESG criteria should be applied uniformly across geographies.
- Alternative data may significantly improve data quality in responsible investment.
- Investors' use of systematic quantitative ESG scorings is rare, and academic research shows substantial discrepancies between different rating providers. As a result, investors tend to rather use these ratings as indicative of certain risks.
- While the governance of internal sustainability varies across investors, a number of them insist on the need to organize transversality and make sure the ESG focus is widely shared within the institution.

RECOMMENDATIONS

- Investors need to:
  - develop their own capacity to analyze and aggregate data,
  - engage companies to improve their ESG reporting,
  - understand data providers' approach to incorporating decision-useful data in their analysis.
- The increased sophistication of ESG requires expanding resources, in terms of data selection and management, staffing, reporting…
- Organize transversality in order for responsible investing to be a widely shared preoccupation within your institution.

References:

Chapter 1:

Anderson, C. W., Fedenia, M., Hirschey, M., & Skiba, H. (2011). Cultural influences on home bias and international diversification by institutional investors. *Journal of Banking & Finance*, *35*(4), 916–934. https://doi.org/10.1016/j.jbankfin.2010.09.006

Bose, S., Burns, N., Minnick, K., & Shams, S. (2022). *Climate-Linked Compensation, Societal Values, and Climate Change Impact: International Evidence* (SSRN Scholarly Paper 4260409). https://papers.ssrn.com/abstract=4260409

Cai, Y., Pan, C. H., & Statman, M. (2016). Why do countries matter so much in corporate social performance? *Journal of Corporate Finance*, *41*, 591–609. https://doi.org/10.1016/j.jcorpfin.2016.09.004

Commonwealth Climate and Law Initiative, C. G. I. (2021). *Primer on Climate Change: Directors' Duties and Disclosure Obligations*.

Döring, S., Drobetz, W., El Ghoul, S., Guedhami, O., & Schröder, H. (2021). Cross-country determinants of institutional investors' investment horizons. *Finance Research Letters*, *39*, 101641. https://doi.org/10.1016/j.frl.2020.101641

Dyck, A., Lins, K. V., Roth, L., & Wagner, H. F. (2019). Do institutional investors drive corporate social responsibility? International evidence. *Journal of Financial Economics*, *131*(3), 693–714.

Graham, J. R. (2022). Presidential Address: Corporate Finance and Reality. *The Journal of Finance*, *77*(4), 1975–2049. https://doi.org/10.1111/jofi.13161

Hong, H., & Kacperczyk, M. (2009). The price of sin: The effects of social norms on markets. *Journal of Financial Economics*, *93*(1), 15–36. https://doi.org/10.1016/j.jfineco.2008.09.001

Ioannou, I., & Serafeim, G. (2012). What drives corporate social performance? The role of nation-level institutions. *Journal of International Business Studies*, *43*(9), 834–864. https://doi.org/10.1057/jibs.2012.26

Liang, H., & Renneboog, L. (2017). On the Foundations of Corporate Social Responsibility. *The Journal of Finance*, *72*(2), 853–910. https://doi.org/10.1111/jofi.12487

Shin, J., Moon, J. J., & Kang, J. (2023). Where does ESG pay? The role of national culture in moderating the relationship between ESG performance and financial performance. *International Business Review*, *32*(3), 102071. https://doi.org/10.1016/j.ibusrev.2022.102071

Starks, L. T. (2023). Presidential Address: Sustainable Finance and ESG Issues—Value versus Values. *The Journal of Finance*, *78*(4), 1837–1872. https://doi.org/10.1111/jofi.13255

Chapter 2:

Bassen, A., Kordsachia, O., Lopatta, K., & Tan, W. (2022). *Revenue Alignment with the EU Taxonomy Regulation* (SSRN Scholarly Paper 4100617). https://doi.org/10.2139/ssrn.4100617

Becker, M. G., Martin, F., & Walter, A. (2022). The power of ESG transparency: The effect of the new SFDR sustainability labels on mutual funds and individual investors. *Finance Research Letters*, *47*, 102708. https://doi.org/10.1016/j.frl.2022.102708

Chan, K. J. D., Cheung, B., & Mok, L. W. (2022). *Market Fragmentation or Market Failure? A Dilemma of Harmonizing Green Finance Taxonomy Designs* (SSRN Scholarly Paper 4188304). https://doi.org/10.2139/ssrn.4188304

Chatterji, A. K., Durand, R., Levine, D. I., & Touboul, S. (2016). Do ratings of firms converge? Implications for managers, investors and strategy researchers. *Strategic Management Journal*, *37*(8), 1597–1614.

Cremasco, C., & Boni, L. (2022). Is the European Union (EU) Sustainable Finance Disclosure Regulation (SFDR) effective in shaping sustainability objectives? An analysis of investment funds' behaviour. *Journal of Sustainable Finance & Investment*, *0*(0), 1–19. https://doi.org/10.1080/20430795.2022.2124838

Dumrose, M., Rink, S., & Eckert, J. (2022). Disaggregating confusion? The EU Taxonomy and its relation to ESG rating. *Finance Research Letters*, *48*, 102928. https://doi.org/10.1016/j.frl.2022.102928

Grewal, J., Riedl, E. J., & Serafeim, G. (2019). Market Reaction to Mandatory Nonfinancial Disclosure. *Management Science*, *65*(7), 3061–3084. https://doi.org/10.1287/mnsc.2018.3099

Redondo Alamillos, R., & de Mariz, F. (2022). How Can European Regulation on ESG Impact Business Globally? *Journal of Risk and Financial Management*, *15*(7), Article 7. https://doi.org/10.3390/jrfm15070291

Sautner, Z., Yu, J., Zhong, R., & Zhou, X. (2022). The EU taxonomy and the syndicated loan market. *Available at SSRN 4058961*.

Shen, H., Lin, H., Han, W., & Wu, H. (2023). ESG in China: A review of practice and research, and future research avenues. *China Journal of Accounting Research*, 100325. https://doi.org/10.1016/j.cjar.2023.100325

Zhang, X., Zhao, X., & Qu, L. (2021). Do green policies catalyze green investment? Evidence from ESG investing developments in China. *Economics Letters*, *207*, 110028. https://doi.org/10.1016/j.econlet.2021.110028

Chapter 3

Aswani, J., Raghunandan, A. & Rajgopal, S., 2024. Are carbon emissions associated with stock returns?. *Review of Finance*, *28*(1), pp.75-106.

Atilgan, Y., Demirtas, K.O., Edmans, A. and Gunaydin, A.D. (2023). Does the Carbon Premium Reflect Risk or Mispricing? *Available at SSRN*.

Bolton, P. & Kacperczyk M. (2021). Do Investors Care About Carbon Risk? *Journal of Financial Economics* 142, 517–549.

Chen, L., Chen Y., & Zhang C. (2022). "Sustainable Investing During the War in Ukraine." *Available at SSRN*

Edmans, A. (2011). Does the stock market fully value intangibles? Employee satisfaction and equity prices. *Journal of Financial Economics*, *101*(3), 621–640. https://doi.org/10.1016/j.jfineco.2011.03.021

Fornell, C., Mithas, S., Morgeson F.V., & Krishnan M.S. (2006). Customer Satisfaction and Stock Prices: High Returns, Low Risk. *Journal of Marketing* 70, 3–14.

Fornell, C., Morgeson F.V., & Hult G.T.M. (2016). Stock Returns on Customer Satisfaction Do Beat the Market: Gauging the Effect of a Marketing Intangible. *Journal of Marketing* 80, 92–107.

Friede, G., Busch, T., & Bassen, A. (2015). ESG and financial performance: Aggregated evidence from more than 2000 empirical studies. *Journal of Sustainable Finance & Investment*, *5*(4), 210–233. https://doi.org/10.1080/20430795.2015.1118917

Giglio, S., Maggiori, M., Stroebel, J., Tan, Z., Utkus, S., & Xu, X. (2023). *Four facts about ESG beliefs and investor portfolios*. National Bureau of Economic Research. https://www.nber.org/papers/w31114

Gompers, P., Ishii J., & Metrick A. (2003). Corporate Governance and Equity Prices. *Quarterly Journal of Economics* 118, 107–156.

Kitzmueller, M., & Shimshack, J. (2012). Economic Perspectives on Corporate Social Responsibility. *Journal of Economic Literature*, *50*(1), 51–84. https://doi.org/10.1257/jel.50.1.51

Krueger, P. (2015). Corporate goodness and shareholder wealth. *Journal of Financial Economics*, *115*(2), 304–329.

Krueger, P., Metzger, D., & Wu, J. (2023). *The Sustainability Wage Gap* (SSRN Scholarly Paper 3672492). https://doi.org/10.2139/ssrn.3672492

Krueger, P., Sautner, Z., & Starks, L. T. (2020). The importance of climate risks for institutional investors. *The Review of Financial Studies*, *33*(3), 1067–1111.

Pastor, L., Stambaugh, R. F., & Taylor, L. A. (2021). *Dissecting green returns*. National Bureau of Economic Research.

Pástor, L., & Vorsatz, M. B. (2020). Mutual fund performance and flows during the COVID-19 crisis. *The Review of Asset Pricing Studies*, *10*(4), 791–833.

Savio, R., D'Andrassi, E., & Ventimiglia, F. (2023). A Systematic Literature Review on ESG during the COVID-19 Pandemic. *Sustainability*, *15*(3), Article 3. https://doi.org/10.3390/su15032020

Starks, L. T. (2023). Presidential Address: Sustainable Finance and ESG Issues—Value versus Values. *The Journal of Finance*, *78*(4), 1837–1872. https://doi.org/10.1111/jofi.13255

Chapter 4

Azar, J., Duro, M., Kadach, I., & Ormazabal, G. (2021). The big three and corporate carbon emissions around the world. *Journal of Financial Economics*, *142*(2), 674–696.

Bauer, R., Derwall, J., & Tissen, C. (2022). *Private Shareholder Engagements on Material ESG Issues*.

Becht, M., Franks, J. R., Miyajima, H., & Suzuki, K. (Icko). (2023). Does Paying Passive Managers to Engage Improve ESG Performance? *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.4506415

Dimson, E., Karakaş, O., & Li, X. (2015). Active ownership. *The Review of Financial Studies*, *28*(12), 3225–3268.

Dimson, E., Karakaş, O., & Li, X. (2023). *Coordinated Engagements* (SSRN Scholarly Paper 3209072). https://doi.org/10.2139/ssrn.3209072

Krueger, P., Sautner, Z., & Starks, L. T. (2020). The importance of climate risks for institutional investors. *The Review of Financial Studies*, *33*(3), 1067–1111.

Chapter 5

Atta-Darkua, V., Glossner, S., Krueger, P., & Matos, P. (2022). *Decarbonizing Institutional Investor Portfolios* (SSRN Scholarly Paper 4212568). https://doi.org/10.2139/ssrn.4212568

Berk, J., & Van Binsbergen, J. H. (2021). *The impact of impact investing*.

Bolton, P., Kacperczyk, M. T., & Wiedemann, M. (2022). The CO2 Question: Technical Progress and the Climate Crisis. *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.4212567

Cheng, G., Jondeau, E., Mojon, B., & Vayanos, D. (2023). The impact of green investors on stock prices. *BIS Working Papers*.

Cohen, L., Gurun, U. G., & Nguyen, Q. H. (2020). *The ESG-innovation disconnect: Evidence from green patenting*. National Bureau of Economic Research.

Durand, R., Paugam, L., & Stolowy, H. (2019). Do investors actually value sustainability indices? Replication, development, and new evidence on CSR visibility. *Strategic Management Journal*, *40*(9), 1471–1490. https://doi.org/10.1002/smj.3035

Edmans, A., Levit, D., & Schneemeier, J. (2022). *Socially Responsible Divestment* (SSRN Scholarly Paper 4093518). https://doi.org/10.2139/ssrn.4093518

Gormsen, N. J., Huber, K., & Oh, S. (2023). *Climate Capitalists* (SSRN Scholarly Paper 4366445). https://doi.org/10.2139/ssrn.4366445

Hartzmark, S. M., & Shue, K. (2023). Counterproductive Sustainable Investing: The Impact Elasticity of Brown and Green Firms. *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.4359282

Hawn, O., Chatterji, A. K., & Mitchell, W. (2018). Do investors actually value sustainability? New evidence from investor reactions to the Dow Jones Sustainability Index (DJSI). *Strategic Management Journal*, *39*(4), 949–976. https://doi.org/10.1002/smj.2752

Noh, D., Oh, S., & Song, J. (2020). *Unpacking the Demand for Sustainable Equity Investing* (SSRN Scholarly Paper 3639693). https://doi.org/10.2139/ssrn.3639693

Chapter 6

Amel-Zadeh, A., & Serafeim, G. (2018). Why and How Investors Use ESG Information: Evidence from a Global Survey. *Financial Analysts Journal*, *74*(3), 87–103. https://doi.org/10.2469/faj.v74.n3.2

Bancel, F., Glavas, D., & Karolyi, G. A. (2023). *Do ESG Factors Influence Firm Valuation? Evidence from the Field* (SSRN Scholarly Paper 4365196). https://doi.org/10.2139/ssrn.4365196

Berg, F., Koelbel, J. F., Pavlova, A., & Rigobon, R. (2022a). *ESG confusion and stock returns: Tackling the problem of noise*. National Bureau of Economic Research.

Berg, F., Koelbel, J. F., & Rigobon, R. (2022b). Aggregate confusion: The divergence of ESG ratings. *Review of Finance*, *26*(6), 1315–1344.

Busch, T., Johnson, M., & Pioch, T. (2022). Corporate carbon performance data: Quo vadis? *Journal of Industrial Ecology*, *26*(1), 350–363. https://doi.org/10.1111/jiec.13008

Chatterji, A. K., Durand, R., Levine, D. I., & Touboul, S. (2016). Do ratings of firms converge? Implications for managers, investors and strategy researchers. *Strategic Management Journal*, *37*(8), 1597–1614.

Christensen, D. M., Serafeim, G., & Sikochi, A. (2022). Why is corporate virtue in the eye of the beholder? The case of ESG ratings. *The Accounting Review*, *97*(1), 147–175.

Commonwealth Climate and Law Initiative, C. G. I. (2021). *Primer on Climate Change: Directors' Duties and Disclosure Obligations*.

Dumrose, M., Rink, S., & Eckert, J. (2022). Disaggregating confusion? The EU Taxonomy and its relation to ESG rating. *Finance Research Letters*, *48*, 102928. https://doi.org/10.1016/j.frl.2022.102928

Joubrel, M., & Maksimovich, E. (2023). ESG Data and Scores. In D. Glavas (Ed.), *Valuation and Sustainability* (pp. 67–98). Springer International Publishing. https://doi.org/10.1007/978-3-031-30533-7_3

Kotsantonis, S., & Serafeim, G. (2019). Four Things No One Will Tell You About ESG Data. *Journal of Applied Corporate Finance*, *31*(2), 50–58. https://doi.org/10.1111/jacf.12346

Krueger, P. (2015). Corporate goodness and shareholder wealth. *Journal of Financial Economics*, *115*(2), 304–329.

Chief Editor

Monica DEFEND
Head of Amundi Investment Institute

Editors

Marie BRIÈRE
Head of Investors' Intelligence & Academic Partnership

Thierry RONCALLI
Head of Quant Portfolio Strategy

Amundi ASSET MANAGEMENT | Investment Institute

Working Paper
February 2024

Important Information

This document is solely for informational purposes.

This document does not constitute an offer to sell, a solicitation of an offer to buy, or a recommendation of any security or any other product or service. Any securities, products, or services referenced may not be registered for sale with the relevant authority in your jurisdiction and may not be regulated or supervised by any governmental or similar authority in your jurisdiction.

Any information contained in this document may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices.

Furthermore, nothing in this document is intended to provide tax, legal, or investment advice.

Unless otherwise stated, all information contained in this document is from Amundi Asset Management SAS. Diversification does not guarantee a profit or protect against a loss. This document is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The views expressed regarding market and economic trends are those of the author and not necessarily Amundi Asset Management SAS and are subject to change at any time based on market and other conditions, and there can be no assurance that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, a security recommendation, or as an indication of trading for any Amundi product. Investment involves risks, including market, political, liquidity and currency risks.

Furthermore, in no event shall any person involved in the production of this document have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages.

Date of first use: 08 February 2024.

Document issued by Amundi Asset Management, "société par actions simplifiée"- SAS with a capital of €1,143,615,555 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 91-93 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

Photo credit: iStock by Getty Images - monsitj