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Top 10 ESG Trends for 2019

January 18, 2019

FOCUS/THEMES	INDUSTRIES/COMPANIES	COUNTRY/REGION
ESG Trends	Diverse	Global

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Responsible investment and strategies focusing on environmental, social, and governance ("ESG") risks are facing a very important year in 2019. The possibility of the first global economic slowdown since the dramatic rise of ESG investing will put all asset managers to the test, including those following ESG investment strategies. While several regulatory and investor-led initiatives affecting how companies deal with environmental and social issues are currently underway, a key question is whether such forces will maintain momentum despite potential economic and political headwinds.

In our predictions of ESG trends in 2019, our view is that the growth of ESG investing is independent of short-term economic or political trends, as by definition sustainability aims at mitigating long-term systematic and idiosyncratic risks. As such, our teams foresee a greater focus on stewardship and potential advancements in categorizing and measuring ESG risks and their impacts. Improved disclosure will play a key role in allowing investors to better analyze more accurate and more consistent ESG data. However, expert analysis and interpretation of data will also be crucial in allowing for effective integration of ESG signals in the investment approach. The main themes this year will continue to include existing key areas of focus, such as climate change, human capital management, and cybersecurity. However, additional topics, such as the growing scrutiny of unsustainable practices by consumers and the potential social risks associated with technology will also begin to surface more frequently. Below are our top 10 ESG investment trends for 2019.

ESG Investor Perspective

1. Active ownership strategies lead the sustainability discourse

We expect institutional investors globally to continue to intensify, strengthen and diversify active ownership strategies, as they continue to work with companies to manage sustainability risks and opportunities. Interest in sustainability-focused proxy voting policies and direct engagements – individual and collective – is growing in major markets, a trend supported by the PRI, a growing number of national Stewardship Codes, and the EU's Shareholder Rights Directive. The Task Force on Climate-related Disclosure's (TCFD) recommendations have pushed investors further towards climate-related active ownership.

Investor advocates, asset owners, and some investment managers will work with stakeholders to not only advocate for clarity and transparency, but to also promote ambitious social and environmental targets globally. As a result of these trends, in addition to increased activity in stewardship, we expect improved and more comprehensive disclosure by institutional investors on ESG issues.

2. Focusing on the impact of investments: more advanced measuring and reporting concepts

Impact investments are made with the intention to generate positive, measurable, real-world social and/or environmental impact alongside financial return. In 2019, mainstream investors will continue to increasingly factor impact goals into their investment decisions. Particularly the adoption of the UN Sustainable Development Goals (SDGs) has invigorated this development, as many investors embrace the SDGs as a useful framework for identifying impact areas, defining impact goals, and communicating on progress. Impact investing will further unfold, and other innovative concepts to support the SDGs will continue to emerge in the coming year. Notable examples include positive incentive loans, which link ESG performance to the pricing of a credit facility.

Both the impact investment landscape as well as the SDG investment landscape remain broad and fragmented. Their evolution in recent years has not put forth any standard methodologies for measuring and reporting on progress or impact. But many interesting initiatives aiming for more comparable and material global approaches are underway. One noteworthy example: Investors are looking at how their actions on climate change can positively impact the real economy. ISO 14097 is currently under development as a way to achieve this level of impact assessment.

3. ESG research and data quality to make the difference

ESG investing has finally and definitively gone mainstream. Many market participants see integration of ESG data as an indispensable add-on to traditional economic and financial information – and a key aspect of fiduciary duty. In 2019 and beyond, investors and asset managers will seek opportunities, manage risks, and contribute to sustainable development by harnessing the value proposed by ESG integration and sustainable finance.

However, the shift from a values-oriented niche to the mainstream capital markets and the resulting demand for entry-level ESG solutions also bears the risk of an increased offering and application of less robust ESG data and investment approaches.

Regulatory developments, such as the EU Sustainable Finance Initiative and its counterparts in Canada, Japan, and other countries, as well as accounting standardizations initiatives such as SASB, are expected to set some basic requirements and standards for certain areas of the sustainable investment market.

One of the action points of the EU Sustainable Finance Action Plan is to clarify the fiduciary duty of institutional investors and asset managers, requiring them to integrate ESG considerations in the investment decision-making process and to be transparent about their approach. Starting October 1, 2019, U.K. pension board trustees will be legally obliged to explain, in their statement of investment principles, how they take account of financially material considerations, including ESG factors.

In light of the growing complexity of environmental and social issues and dynamically changing risk scenarios, investors will require to access high quality ESG research and data to successfully comply with upcoming regulations and challenges.

ESG Trending Themes

4. Climate change: Sophistication is increasing

Climate change remains a dominating aspect in sustainable finance efforts. Examples of how climate change is gaining momentum in the investment field include the ever-growing green bond market, the EU taxonomy focus on climate change, and climate-related shareholder proposals garnering widespread media attention. As global leaders continue to focus on how to prevent catastrophic levels of global warming, sophistication is growing.

The car manufacturing industry is a case in point, as many carmakers are announcing a shift towards electric vehicles and other alternative-drive technologies. But even if alternative-drive vehicles are part of the solution, environmental impacts need to be carefully managed: hybrid vehicles still require

fossil fuels, batteries have potentially harmful social and environmental life-cycle impacts and energy sources used for electricity are not always clean.

In the December 2018 Climate Conference in Katowice, participants experienced the paradoxical tensions between strong public commitments and insufficient implementation. While large parts of the Paris rulebook were agreed upon, ambitious action from countries is more urgent than ever with global emissions hitting an all-time high in 2018. Likewise, in 2018, the UN PRI published the report "The inevitable policy response" highlighting the gap between actual emissions and policy ambitions to reduce them. Therefore, 2019 might be the year to see more forceful policy action. On proxy ballots, we expect another very busy year, with likely record numbers of U.S. shareholder proposal filings dealing with climate change.

5. Regulators supporting sustainable finance growth in the EU and beyond

The European Union will publish the first part of a regulator-driven taxonomy of environmentally sustainable activities in June 2019. This first part of the taxonomy will focus on the definition of climate change mitigation and adaptation activities. Economic activities need to demonstrate a positive contribution while ensuring that negative impacts on the environment and core labor rights are avoided. The taxonomy feeds into further work, including standards for low-carbon indexes and green bonds. Green finance initiatives around the world – among them those in Japan, Hong Kong and Canada – will closely monitor the EU's bid to set a new standard for sustainable finance.

The taxonomy is expected tocreate clarity in an area that has seen its fair share of debate in 2018, as the greenness of projects may often be put into question. For example, should green buildings for an airport qualify for a green bond issuance? Under which conditions can biofuels be considered sustainable given their potential adverse impact on availability of food crops?

It is not clear how strongly social aspects (e.g. human rights) will feature in the initiative and whether a taxonomy for socially sustainable economic activities will be developed further down the line, as suggested.

6. The impact of international politics on investments

2018 saw the re-imposition of U.S. sanctions on Iran, which do not only cover U.S. companies but also companies without any business ties to the United States. While the EU subsequently adopted measures to protect European companies from the effects of U.S. extra-territorial sanctions on Iran, many European companies still curtailed or ceased their ties with Iran to avoid the risk of being prosecuted by U.S. authorities. Together with the tariffs placed by the U.S. on Chinese and European steel and aluminum, and the retaliatory tariffs placed by both on a range of U.S. products, these sanctions are expected to have a continued chilling effect on business and investment in 2019. While the U.S. is currently negotiating separately with China and the EU with a view on reaching trade agreements, the outcome of these, as well as their longevity, remain unclear. Either way, these agreements will not provide relief of the extra-territorial sanctions-related measures imposed by the U.S. Looking into 2019, we expect businesses and investors to continue dealing with these and, possibly, additional restrictions and risks.

7. Digitalization and its associated impacts

The rapid digitalization of all aspects of business operations and social interactions is met with some fear of social disruption, but also expectations of creating new opportunities for accelerating sustainable economic growth. Digitalization has already affected the way we work, with the advent of phenomena such as the 'gig economy' and sectoral shifts towards e-commerce. In both these areas, ISS-ethix has noted an increased number of reports of poor working conditions, with 'gig' workers forced into precarious self-employment, and e-commerce relying on the development of mass-scale

distribution centers. Developments in AI and automation have also led to discussions around changes in labor demand and the ensuing needs for skills adaptation, as well as prospective effects on unemployment rates, migration and challenges in the provision of decent work. Investors will need to factor the balance of efficiencies driven by digitalization with the bigger socioeconomic changes. How will the digitalization and skills shift be sustained if associated job losses lead to social unrest or a drop in consumer demand?

In addition, as most industries rely on digital technology to support and often radically transform processes and operations, the protection of networks, systems and data, including personal data, has risen to a top strategic priority for businesses, and a key focus area for regulators globally. According to ISS-ethix data, during the past six months alone, more than 20 global companies across 10 industries were involved in severe global data security incidents resulting from ineffective cyber security management. Expectations on companies to acquire expertise and develop and disclose comprehensive cybersecurity risk assessments are fast increasing. On the data privacy front, European Union regulators are monitoring the implementation of the General Data Protection Regulation (GDPR) and challenging big tech firms in parliamentary hearings. Tech companies' ability and willingness to publicly and proactively disclose data security incidents and transparently communicate preventive measures and remediation efforts will be critical to address such concerns.

8. Managing risks in the workforce

The #metoo movement has made a significant impact globally, affecting the social and corporate spheres. 2018 saw companies and their respective boards realizing the reputational and operational risks of failing to react or address hostile environments. The discussion and ensuing review of conditions of work, prompted in part by regulation that was introduced to determine prospective discrepancies in the treatment of employees based on gender, is expected to take center stage in 2019. Investors have also joined the call to manage such risks at companies by focusing on conduct and respect in the workplace as a means to improve employee engagement and retention, which may have a positive long-term effect on productivity.

With many companies conducting their own reviews and introducing measures to rebalance these discrepancies, diversity and inclusion become critical in fostering an engaging environment. Such assessments normally include a broad definition of diversity, taking into account, gender, race, ethnicity, and cultural background. Some companies recognize that diversity may add significant value to helping them better serve their markets and client base.

9. Responsible consumption gains increasing stakeholder support

Public scrutiny is fast rising around a wide array of topics linked to irresponsible consumption. Examples range from the 13 million tons of plastic reportedly leaking into the oceans annually, to the depleting impact of "fast fashion," and the mountains of food waste generated in the face of the collective failure to eradicate hunger and the known severe environmental impacts. While the concept of the circular economy is not new, it has gained significant foothold beyond the expert debate and will be a central sustainability theme in 2019.

Pressure on companies to not only transform production processes but also their business models to maintain growth without depleting resources is increasing from investors on the back of consumer awareness and scrutiny. However, while voluntary action has raised standards among leaders, regulatory intervention at national and regional level in support of UN Sustainable Development Goal 12 on responsible consumption and production will be required to achieve real progress, as the 2021 EU ban on single-use plastics illustrates.

10. Biodiversity receiving more awareness; more aggressive targets may follow

In preparation for the 2020 Beijing conference that will define new targets under the 1993 Convention on Biological Diversity, mounting scientific evidence is made available about the impacts of climate change, overexploitation of species, monoculture, and land conversion on biodiversity. As public awareness of the critical state of biological diversity is rapidly increasing, both companies and investors are expected to extend improvements in corporate disclosure and in active environmental risk management, including climate change and the protection of the diversity of ecosystems.

Relevant themes include the protection of traditional knowledge of indigenous peoples, the tightening of certification requirements for sustainable palm oil under the Roundtable on Sustainable Palm Oil (RSPO), and, conversely, the expected further relaxation of restrictions on deforestation and mining in the Amazon following the appointment of a new environment minister in Brazil. We anticipate sustainable investment strategies by leading asset owners and asset managers, and multi-stakeholder initiatives, such as the Natural Capital Finance Alliance, to contribute to developing more aggressive post-2020 targets, aligned with the global agenda for sustainable development, and increase pressure on governments to significantly strengthen implementation mechanisms.

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