Volatile Transitions
NAVIGATING ESG IN 2021

Annual Global Outlook

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Key Takeaways

- The forecast recession and “long ascent” of global economic recovery after COVID-19 will require a strong commitment and decisive action from financial markets.

- While the global economic downturn has been a time of significant stress for all investors, the willingness of international governments to couple stimulus programs with sustainability objectives offers a clear opportunity for responsible investors to play a leading role in the recovery.

- Regulatory pressure will be a key driver for responsible investment practices in 2021, with significant initiatives in the European Union coming into force, and governments in Asia making strong commitments to Net Zero targets.

- While the term ESG is broadly accepted in responsible investment markets, the range of issues that responsible investors are called upon to consider daily continues to expand. The topics covered in this paper are framed in three broad conceptual groupings: Planetary Boundaries, Inclusion and Stewardship.

- ISS ESG has identified 10 of the key global trends that we believe responsible investors will be focusing on through 2021, both in terms of impacts on portfolio risk/returns, and in terms of time spent managing policies and stakeholder relationships.

- This year we have also prepared a regionally-focused paper for each of the Americas, EMEA, Asia and Australia/New Zealand, highlighting risks about which the local teams in each region are speaking with their own networks.
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Overview

As the world seeks to reconcile the impacts of the first, second and subsequent waves of COVID-19, investors and market participants usher in 2021 with equal measures of optimism and consternation. While working with uncertainty has been a modus operandi of the industry since its inception, 2020 tested the resolve of even the most seasoned Environmental, Social and Governance (ESG) investor: the oft-prophesied Black Swan event collided with already intensifying ecological, economic and socio-political pressures, paralyzing companies, cities and democracies across the world. In this climate, the role of the responsible investor emerges with renewed purpose.

The International Monetary Fund has outlined a “long and difficult ascent” for the global recovery, predicting the most severe recession since the Great Depression. While the recovery is projected to be “disproportionate and uneven,” the financial market is expected to play a pivotal role. For responsible investors, that role entails both damage control and an altered scope of investment opportunity concerned with restoring stability.

As nations attempt to recover their economies, implementing policies to shield their borders and industries against further systemic disruptions, the need emerges for investor vigilance across industries employing vulnerable communities or operating in regions with weak employee protections.

Simultaneously, knee-jerk and protectionist reactions from governments and regulatory bodies threaten to jeopardize the significant gains of the last two decades of ESG activism and policy reform, particularly in the areas of climate change and ecological management. Compounded by civil and geopolitical tensions cultivated in the aftermath of pandemic restrictions, the investment landscape of 2021 is characterized on the one hand by fragility, and on the other by the urgent need for decisive and committed action.

For asset owners and asset managers, such action includes the capacity to:

- engage in support of labor, human rights, and health and safety protections of employees in global supply chains;
- advocate against premature withdrawals from or reversal of climate change policies on global, regional and national levels;
- bolster the potential of a green recovery in ailing economies; and
- utilize active ownership strategies that hold companies to account for decisions that disrupt or exploit already volatile and biased economic and social structures.

Responsible investors ... have an unprecedented opportunity to call other market players to the table. The downturn initiated by COVID-19 has brought to light the potential for ESG-savvy investments to buoy economic markets in times of crisis...

Responsible investors also have an unprecedented opportunity to call other market players to the table. The downturn initiated by COVID-19 has brought to light the potential for ESG-savvy investments to buoy economic markets in times of crisis, with ESG funds overall outperforming the S&P500 in 2020. Proof that
investors globally were taking note, the U.K.’s Investment Association reported that responsible investments in 2020 enjoyed an almost four-fold increase from 2019.

Such trends are supported by the findings of the 2020 ISS Asset Owner’s Stewardship Survey, which identified an increasing focus of asset owners on stewardship activities that work to hold companies accountable for ESG risks – particularly in those sectors weakened by COVID-19. Furthermore, the ISS ESG Asset Manager’s survey conducted in Q3 of 2020 found that 62.5% of the asset managers surveyed reported an increased focus on social issues due to the pandemic, with 44% expecting future ESG ratings to increase the value attributed to issues such as workplace safety, treatment of employees, diversity and inclusion, and supply chain labor dynamics. Overall, more than a third (37.5%) of asset managers reported plans to hire more ESG-related staff to manage the expected increase in workload.

Regional Developments

Regional trends in ESG risks emerge as a confluence of several macro trends endured through 2020. Stoppages in the manufacturing of consumer staples and consumer discretionary goods exacerbated labor and human rights, modern slavery and occupational health and safety in key supplier countries. The global surge in demand for health care and personal protective equipment highlighted frictions in wealth disparity and social inequality on the one hand, and weaknesses in waste disposal processes and plastic pollution risks on the other. As these risks unfolded alongside increasing rates of climate change and refugee migration, civil society in several regions grew increasingly unstable, bringing concerns around governance, accountability, and the urgency for climate change action into sharp focus.

Americas

Following the widespread Black Lives Matter protests that gripped the country and ripped across global headlines, the election of Joe Biden in the U.S. has been seen as an encouraging sign of progress towards the restoration of economic and social stability in the United States. Biden’s hallmark $1.7 trillion plan to fuel a “green recovery” from COVID-19 suggests enhanced potential for the nation to achieve the goals of the Paris Agreement. Other ESG-related by the Trump presidency are also expected to be revised.

Meanwhile in the region’s south, the Amazon rainforest fires and enhanced measures to protect biodiversity in Brazil remain high on the ESG radar. The Bolsonaro government faces a threat of divestment by major European investors — including divestment from government bonds — if ESG risks facing the Amazon rainforest regarding deforestation, mining and beef production are not addressed.

Such actions are consistent with a greater demand for ESG-aligned investments across the Latin American region, where demand for ESG-investment has tended to outstrip supply. Encouraging developments include Mexico’s issuance of the country’s first ESG-themed ETF, which drew over $450 million within two months of issue, as well as the new entry of two of the country’s largest pension funds to PRI membership. Where this momentum can stimulate genuine action, the Latin American region is considered to have strong gains to observe from implementing a “green recovery” from COVID-19, with Chile already leading the way in the development of significant renewable energy capacity.
In our regional ESG Themes and Trends 2021 paper for the Americas, we drill down into four key ESG topics:

- Topic 1: ESG’s Hidden Asset — All That Cash
- Topic 2: Climate Change — The Other Global Pandemic
- Topic 3: Biodiversity Developments in 2021
- Topic 4: Diversity & Inclusion — One Step Forward, Two Steps... Forward

**Asia**

ESG developments in the Asia Pacific region have largely been characterized by a surge in green finance and increased regulatory commitments regarding ESG issues. Some notable developments include commitments by the Japanese government to become carbon neutral by 2050 and bolster $2 trillion in green business and investment, and the Indian Government’s introduction of a landmark Stewardship Code outlining six principles that include the mandatory requirement to monitor and engage with investee companies on ESG risks. China will also implement mandatory environmental reporting by companies in 2021 – delayed from 2020 due to the pandemic, while the Hong Kong Stock Exchange implemented mandatory ESG disclosure rules regarding board disclosure, climate change and ESG reporting.

Despite these significant moves by several governments within the region, the short- to medium-term impacts of COVID-19 on supply chain production across several countries in the region have highlighted concerns regarding employee welfare. An ILO policy brief released in June 2020 found that employees in Asia and the Pacific represented those at highest risk of losing their job. While the ILO urges large-scale support for enterprises and enterprise workers, ISS ESG research has highlighted emerging risks of violation and abuse of modern slavery regulations, coupled with weak enforcement, across the region.

Increased attention flowing to the “S” aspect of ESG as a result of the COVID-19 pandemic is also likely to lead to scrutiny of the traditionally low levels of diversity observed within Asian companies. International and regional investors are likely to be taking a more proactive approach in their engagement strategies in the coming year.

These and other issues are examined in more detail in our dedicated Asian edition of the ESG Themes and Trends 2021 research series. Specific topics covered include:

- Topic 1: The Shift Towards a Mandatory Climate Risk Disclosure Regime in Asia – Will There Be a Resulting ESG Data Boom?
- Topic 2: China – Climate and the Five-Year Plan
- Topic 4: Japan – Diversity Beyond the Boardroom

**Australia & New Zealand**

Investors in Australia and New Zealand continue to lead in their integration of ESG, with the Responsible Investment Association Australasia reporting responsibly managed assets under management growing by 17% year on year, and now representing 37% of total managed assets.
Incidents like the destruction of the 46,000-year-old Juukan Gorge caves in Western Australia by mining giant Rio Tinto have raised investor doubts about the practices of the important resources industry, however.

The region has also made headlines for Australia’s lagging legislative action on climate change and emissions reductions, which are seen as particularly tone deaf given the widespread acknowledgement that the devastation of the 2019 bushfires was worsened due to climate change. Nevertheless, members of the Australian Sustainable Finance Initiative have forged ahead with a series of ambitious recommendations that seek to align financial market practices with the targets of the Paris Agreement and other global initiatives.

As noted above, some of the largest Asian markets for Australian resources are committing to Net Zero targets – given national policy support for the export of fossil fuel-intensive commodities, how well prepared is the Australian economy for some of these key markets drying up?

The New Zealand Government, following its Zero Carbon Act of 2019, declared a climate emergency in December 2020, and has proceeded with strategies that aim to achieve climate neutrality by 2050. Most notably, in September 2020 the New Zealand Government mandated climate-related financial disclosures for all publicly listed companies, large insurers, banks and investment managers – a move that demarcated the island nation as the first jurisdiction in the world to require compulsory climate change reporting.

The local ISS ESG research team has prepared a regionally focused ESG Themes and Trends 2021 paper. Topics covered in this analysis include:

- Topic 1: Bang! And the Reputation Is Gone – Indigenous Inclusion in the “Never Again” Era
- Topic 2: Portfolio Disclosure – This Time for Sure!
- Topic 3: Water Stress – Still a Big Deal in 2021
- Topic 4: Buy Now, Pay Later – Investor Dilemmas Around Consumer Credit

Europe, Middle East & Africa

In the European Union, the EU Green Deal has put forward plans to cut a further 55% of emissions by 2030, with an aim to achieve climate neutrality by 2050, and further measures expected to be announced in June 2021. Several pieces of sustainable finance legislation are being fine-tuned or are coming into force. The EU Taxonomy Regulation for example, is intended to ensure that designated environmentally sustainable economic activities genuinely contribute to climate change mitigation and adaptation and thus to the transition to a low-carbon economy.

In the Middle East, issuance of green and sustainable bonds increased by 50% during 2020 correlating with increasing legislative actions in the region aimed towards a green recovery. The 2019 INVESCO Global Sovereign Asset Management survey also found almost 60% of 139 sovereign investors and central bank reserve managers in the region reported incorporation of a top-down ESG strategy – an encouraging sign for a region often lagging in performance against traditional ESG benchmarks.
With an eye firmly focused on the “S” of ESG, the African Development Bank won accolades after its issuance of a $3 billion “Fight COVID-19” bond, which aims at remedying the social impacts of the pandemic. Social bonds and green bonds are a key means through which a “green recovery” is anticipated for African nations, as evidenced by ongoing growth in the issuance of sustainable bonds and social bonds since 2019. Companies and investors working in African countries will also be increasingly impacted by the changes to the Equator Principles which came into effect July 2020 and dictate greater alignment with the UN Guiding Principles on Business and Human Rights, the Recommendations of the Task Force on Climate-related Financial Disclosures, and adherence to the International Finance Corporation’s standards regarding Free, Prior and Informed Consent.

ISS ESG’s team in EMEA has pulled together their top three ESG Themes and Trends for 2021. The topics covered are:

- Topic 1: The EU Sustainable Finance Disclosure Regulation
- Topic 2: Mandatory EU Human Rights Due Diligence – A Game Changer for the European Market
- Topic 3: Biodiversity – A Major Linchpin for Investors in 2021

Summary

The issues and developments highlighted above are but small parts of the increasingly complex and diverse global ESG landscape that greets investors in 2021. With the impacts of the pandemic still looming over most economies in the world, responsible investors face a balancing act of maintaining momentum on climate change action, while becoming instrumental actors in the recovery and redevelopment of localized economies.

In the process, a sea of “red flag” issues across labor and human rights; biodiversity and resource scarcity; wealth disparity and income inequality; and governance and accountability, demand immediate attention and investor mobilization.

Fortunately, ESG investors are now seen to be ahead of the pack, and in prime position to utilize their reputations to garner greater mainstream buy-in towards sustainable business practice. As such, 2021 offers responsible investors an opportunity to truly live up to their potential, aiding in the delivery of a socially and environmentally sustainable global recovery.
Themes

ISS ESG has compiled the following overview of global and regional ESG themes and trends that have emerged on our radar as the key issues to focus on this year. Using ISS ESG data, analyst commentary, and comprehensive qualitative research from the ISS ESG global database, this paper acts as a year-long resource for investors seeking to navigate the potentialities of diverse global and regional ESG issues and their impacts across various investment markets.

As complex and interrelated ESG risks continue to unfold globally in 2021, how can investors integrate material issues while sustaining the momentum of their ESG-balanced portfolios? How can Universal Owners navigate the shifting margins of risk unfolding disproportionately across global and regional supply chains? What tools are available to enhance the quality of existing issues-based investment analyses?

With due consideration to the changing discourse of ESG investment, the 2021 ESG themes and trends report covers topics under three interrelated areas that speak to the shifting parameters of traditional ESG risks.

Planetary Boundaries

Planetary Boundaries refers to the host of risks that arise from the degradation of ecological systems including the impacts of climate change, biodiversity loss, ecological collapse and resource depletion. This theme builds from the traditional “E” in ESG and integrates the considerations of the Nine Planetary Boundaries put forward in 2009 by Johan Rockström (Stockholm Resilience Centre) and Will Steffen (Australian National University). Risks include those related to climate change, ocean acidification and water consumption/depletion, land degradation and deforestation, food and agricultural systems, ecological collapse, air pollution and atmospheric impacts.

Stewardship

The theme of Stewardship, a key focus for Universal Owners, refers to the suite of interconnected risks related to corporate governance and market integrity. Extending the traditional “G” in ESG, the theme of Stewardship seeks to encompass the increasingly complex and multi-faceted manifestations of governance risks emerging at the intersection of civil, corporate, digital and political spheres – risks including data privacy and technological regulation, cyber risk, advocacy and corporate lobbying, corruption and accountability. Responding to the growing consensus regarding climate change risk as an economic as well as environmental issue, the theme of Stewardship also includes activities regarding climate change regulation, governance, measurement and reporting, nationally and globally.
Inclusion

The theme of Inclusion aims to expand on the “S” of ESG to better address the host of systemic issues that cause or relate to: wealth and resource disparity; risks to labor and human rights; cultural and racial prejudice; discrimination related to particular demographics and populations, such as gender and age-based discrimination; and issues that impact the democratic participation of individuals and communities in their civil duties and rights. The term “Inclusion” captures the causes and symptoms of systemic inequity in its various forms, both where they show up directly in the corporate or socio-political landscape and where they emerge as the result of larger economic structures.

The ten topics considered in this paper can be roughly grouped under the following headings:

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<td>Examining the Economic Model</td>
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<td>Biodiversity/Deforestation</td>
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We hope that the following topics assist ISS ESG’s clients and stakeholders to successfully navigate their ESG journey through 2021!
Topic 1: Not Even a Pandemic Can Slow Action on Climate Change

Maximilian Horster, Head of Climate Solutions, ISS ESG

Despite last year’s unexpected COVID-19 turmoil, it is remarkable that our expectations for the climate change policy area in early 2020 still unfolded largely as predicted. COVID-19 did little to diminish climate change as a focus topic for investors, and in many ways it has even accelerated action. And it should: 2020, despite having been a (typically colder) La Niña year, came out again as one of the hottest years on record.

In essence, COVID-19 and climate change have a lot in common. First, in both cases, science tells us what is coming and what needs to be done, and it is on us to embrace the inconvenient truth. Second, while we don’t see the immediate outcome of taking (or not taking) action to address either COVID-19 or climate change, both have a direct and measurable impact on the future. Third, both are global challenges that can’t be solved domestically, but require a huge multilateral effort.

The latter point might entail positive news for addressing climate change. While it was always understood that global action was required, there was little conviction that the world could manage to act in concert. COVID-19 has taught us that this might actually be possible, if the magnitude of the danger is widely accepted.

When reviewing global COVID-19 stimulus packages, it becomes clear that many countries tried to use the opportunity presented by 2020 to combine their desire to avoid an economic collapse with their vision for a low-carbon future (for more information see recent ISS ESG research papers “Economic Recovery and the Potential for Green Public Finance Amid COVID-19” and “Should COVID-19 Bailouts Include ESG Performance Metrics?: An Australian Case Study”). As a case in point, the French government rescued Air France, and one of the conditions applied was for the company to stop unnecessary domestic flights where highspeed trains can transport travelers as quickly but with lower emissions.

At the beginning of 2021, a climate awareness landslide may accelerate a transition from a 4°C world to a 1.5°C world, despite the need for massive changes to whole industries, individual companies and societies. With the new U.S. President Joseph Biden having
rejoined the Paris Agreement on his first day in office, the world can expect stronger climate action from one of its most powerful countries and largest economies, promoting climate transparency and “Net Zero” initiatives around the world.

The remaining question for 2021 will be whether or not the U.S. will go from being a follower to a leader on climate – ideally in friendly competition with China, which was the first large economy in the world to announce a climate neutral target. The former Obama and Biden special envoy for international energy, Amos Hochstein, said at the ISS 2020 Stewardship Week that he could imagine a Biden presidency leading the world to a “Paris 2.0” agreement, given the original agreement dates from 2015.

For investors, these observations result in three major takeaways for 2021:

1) The focus on climate change in the real economy will accelerate and create winners and losers on two levels:
   a) Physical Risks: Assets that will and won’t be affected by the physical effects of climate change such as floods, droughts, storms or wildfires.
   b) Transition Risks: Assets that will or won’t be able to transition in line with the international push for a low-carbon economy.

In consequence, investors will get literate on differentiating between climate winners and losers in order to protect their assets and potentially even gain additional returns through the envisioned economic transformation.

2) Investors will find themselves focusing ever more strongly on their own role in financing climate change (or its reversal). This will play out especially in two areas:
a) Regulation: Regulators around the world are calling on investors to create more transparency around their investments’ climate risks. The EU Taxonomy or the PRI’s TCFD-aligned mandatory reporting are just two examples. ISS ESG counts close to 60 regulatory and self-regulatory investor-gearied climate transparency initiatives globally.

b) Self-commitment: In light of regulatory and civil society expectations, a lot of investors globally will keep joining initiatives that highlight self-commitment. This includes “Net Zero” pledges to create climate-neutral portfolios by 2050, as well as collective engagement initiatives such as Climate Action 100+, and there is no shortage of collective methodology developments under groups such as the Partnership for Carbon Accounting Financials (PCAF) or the Science Based Targets initiative.

Figure 3: A global diversified large- & mid-cap portfolio (Solactive GBS Global Markets Large- and Mid-Cap Index, solid lines) is geared towards 3°C of warming by 2050, in line with the CPS (Current Policies Scenario) of the International Energy Agency. An ESG version of the same portfolio manages to stay in a budget for 1.8°C of warming (Solactive ISS Prime Rated ESG Global Markets Large- and Mid-Cap Index, dotted lines). Source: ISS ESG Climate Impact Report.

3) The investor climate focus will keep progressing from reporting to acting. After years of climate transparency practice, investors and their stakeholders are starting to manage the climate risk and impact of their investments.
This results in two trends for the year ahead:

- The investor’s climate toolbox: 2021 will see a wide variety of new investment products. Pushed by the EU guideline on “Paris-aligned” and “Transition” Benchmarks, there will be both tracking strategies as well as actively managed portfolios across listed equities and corporate bonds. The topic of climate voting – using shareholder rights to make climate expectations heard in the board room – will accelerate through collective climate engagement initiatives and individual climate champions that aim to strengthen their engagement efforts. Further, the focus will widen into other asset classes – ISS ESG clients in the Private Equity, Real Asset, Sovereign Bond and Loan Book will be particularly focused on this topic. If the first few weeks of January 2021 are any indication, green bond issuances will most likely set new records this year.

- Impact versus risk: With more investors moving their assets following climate considerations, the old debate of impact versus risk gets fueled again. It is now widely understood that a climate-titled equity index can reduce climate risks but generates less real-world impact than if it’s combined with engagement and voting practices. Yet, the disconnect between regulator expectations (impact and real economy change) and their asks (portfolio transparency and risk management) prevails, and might eventually surface this year.

Across all asset classes, 2021 will leave very few unexplored regions on the global professional investor map where climate change won’t play a role in some form or shape. While this might create some challenges and significant shifts for financial market participant thinking and operations, the investment sector’s actions on climate change can be inspired by the global initiatives that will be undertaken through 2021 to combat and hopefully eradicate COVID-19.
Topic 2: Clickbait Has a Whole New Meaning

Duncan Paterson, Global Head of ESG Thought Leadership Program, ISS ESG

While 2020’s troubles led many to contemplate the onset of 2021 with optimism, the events that took place in the U.S. Capitol on January 6 provide a sobering reminder that some of the core problems from last year will not go away as easily as the turning of a page in the calendar.

The online world promised so much in its early days – deepening social connections across the globe, improved information sharing and education, and a new and more productive form of commerce that would allow for the frictionless trading of goods, services and information.

While many of these promises have been fulfilled, they come with a price, one of which society is becoming increasingly aware. The algorithms that underly social media platforms have combined with the allure of anonymity to create an online environment that is characterized by partisanship and conflict, ironically more so than IRL (in real life). Electronic transactions come with a cost in terms of privacy, and when a company’s online security systems fail, the costs can be catastrophic.

Regulators around the world are losing patience with the slow progress that the industry is taking in managing these risks on its own, and we are seeing a number of emerging policy responses. Responsible investors would do well to heed these signs, and work to ensure that the social license to operate of large tech firms are managed in such a way as to ensure the sustainability both of the businesses in question and the communities that they serve.

Cyber concerns are less well recognized as a systemic risk, but as more of the economy moves online, we can expect greater attention to be paid to this area. As recent high-
profile attacks demonstrate, determined bad actors have the capacity to penetrate even the most heavily guarded systems. Investors have until recently not had the ability to integrate awareness of cyber security into their ESG risk management systems, but this is changing thanks to the development of ISS ESG’s new Cyber Risk Score.

**Whose Content Is It Anyway?**

Internet firms have for many years been navigating a tricky conceptual tightrope. On the one hand they insist that they are not responsible for the content that is uploaded to their platforms, that they are in effect a *tabula rasa* upon which their users write their own thoughts and opinions, and as such internet firms should not be held responsible for this content. On the other hand, they acknowledge their responsibility to police certain and specific types of content and have a demonstrated their ability to do so very effectively.

The question lies of course in where one draws the line on what constitutes objectionable content, and what does not. Initially this decision was relatively straightforward – things that were clearly illegal or immoral were out, so the platforms were cleansed of child pornography, drugs, extreme violence and so on. Even adult content was removed, although this turned out to be more complicated than expected – who recalls the disputes about images of breastfeeding mothers, or fine art nudes? This challenge is of course made more difficult when the content that is being assessed comes with a political flavor.

As social media platforms have become more ubiquitous, serious concerns have arisen about their potential to harm social cohesion. This is due to two unfortunate characteristics of social media, often operating in tandem and reinforced by the platform’s algorithms – opinion siloing and the spread of disinformation.

Over the last few years, questions have been raised over the influence that social media has played in terms of swaying significant public votes. While certainly not the first, the 2016 Brexit referendum was an early high-profile example of social media platforms being used to distribute disinformation in an effort to influence the outcome of a major election – it is estimated that 150,000 fake Twitter accounts were deployed in order to disrupt the process of the vote. U.S. authorities have concluded that social media platforms were one of the theaters of electronic warfare utilized by foreign entities seeking to interfere with the 2016 presidential elections. The 2017 French elections saw over 30,000 fake Facebook accounts deleted by the firm in an effort to combat a serious disinformation campaign.

The COVID-19 pandemic has served to crystalize many of the concerns regarding social media companies’ role in distributing disinformation. In a March 2020 statement, the head of the World Health Organization (WHO) noted:

> “We’re not just fighting an epidemic; we’re fighting an infodemic,” said Tedros Adhanom Ghebreyesus, Director-General of the World Health Organization, at a gathering of foreign policy and security experts in Munich, Germany, in mid-February, referring to fake news that “spreads faster and more easily than this virus.”

Academics and think tanks globally are identifying how institutions’ abilities to manage the pandemic are negatively impacted by social media disinformation. Such
disinformation ranges from out-and-out false information to the artificial inflation of messaging around specific policy objectives.

Concerns on this issue are heightened by the increased time and commitment that consumers have devoted to their electronic devices during periods of COVID-19 lockdown. Analysis from ISS ESG’s Corporate Rating team found that during 2020 the increased demand for tech heightened risks around issues like privacy and data security.

ISS ESG research identifies companies that collect user-generated content, and assesses the quality of the systems they have in place to manage risk in this area. The results are not encouraging.

**Figure 5: Responsible Oversight of User-Generated Content and User Conduct, Source: ISS ESG data.**

The analysis is based on a selection of 166 companies from different sectors such as media and entertainment (e.g., Activision Blizzard), transportation (e.g., Uber) and internet services (e.g., Facebook) that all offer users the opportunity to actively participate on online platforms in one way or another. The chart shows that the majority of companies do not take any action at all (46%) or have only taken initial steps (41%) when it comes to the responsible oversight of user-generated content and user conduct.

Looking at the most prominent players from the social media space, including Silicon Valley giants such as Facebook and Alphabet as well as prominent examples from China such as Tencent and Weibo, some interesting observations can be made.

**Figure 6: Managing User Content and Conduct, Source: ISS ESG data**
These results suggest that companies recognize their responsibility when it comes to the content on their websites (user guidelines, Good Performance = 4), but are less prepared to effectively manage content, and even less inclined to publicly share how they are dealing with breaches of their guidelines (transparency, Poor Performance = 1).

Social media platforms have managed to weather a number of serious crises in recent years, but the real-world harms of disinformation demonstrated through 2020's COVID-19 pandemic have tested the patience of policymakers, and the invasion of the U.S. Capitol building on January 6 will provide ample fodder for those looking to tighten regulation on the sector.

Managing Portfolio Cyber Risks

Companies managing risks associated with user-generated content are at least dealing with actors utilizing the platforms as they were designed. Cyber risks are quite different in nature, arising from malicious attempts to breach internet security systems.

Steps that companies can take to ensure application security include relevant guidelines for developers; use of technical safeguards such as encryption and firewalls for product and service provision; and implementation of a secure development lifecycle including threat modelling, security code reviews, vulnerability management, and penetration testing. Analysis shows that most companies handling user data have at least some systems in place, but when we look for comprehensive coverage in the form of a Certified Information Security Management System, the numbers drop dramatically.

Figure 7: The Vast Majority of Companies Take Action to Address Information Security – But Comprehensiveness Varies, Source: ISS ESG data

The consequences of a failure in managing cyber risks can be dramatic – the Managing Director of the ISS Cyber division recently described real-life outcome scenarios from a serious breach:

- Unprotected workstations at a chemical manufacturer in Germany are used to launch a successful phishing attach against a small health care provider in the U.S. resulting in a $2.3 million payment in response to the ransomware event. The chemical manufacturer did not consider cybersecurity investments as contributing to their core business activity.
A manufacturer of a commonly used IT platform failed to secure their systems correctly, resulting in over a thousand clients being compromised through their platform. Each client had to bear its own investigation, remediation and incident response costs. The IT platform manufacturer had an expansive insurance policy that covered their own business income losses.

A large consumer credit organization fails to correctly configure/manage consumer credit records, resulting in 100 million consumers needing to devote time and energy in protecting themselves. Fees and fines totaling $1 billion were paid as estimated costs, but were only a fraction of the true cost of the combined costs experienced by 100 million consumers.

Investors in such companies are likely to find their value impacted by reputation damage, regulatory penalties and management distraction.

With the rise of ransomware and global cyberattacks, the ISS Cyber Score can support asset managers with assessing and minimizing significant reputational damages and long-term financial losses associated with data breaches.

What Does the Near Future Hold for Investment in Tech?

Responsible investors have long grappled with the contradictions presented by the social media space. 2021 is likely to see a number of regulatory initiatives impact on the sector, including anti-trust actions in the U.S., media revenue sharing arrangements in Australia and the recently announced Digital Services Act package in the European Union.

Perhaps the most striking example of enthusiasm for regulation in this space came in a recent presentation to the World Economic Forum by Ursula von der Leyden, the President of the European Commission (from 14:33 onwards). In it she notes the dangers to society posed by unregulated social media platforms and the growing risk of cyberattacks as digitization permeates our society, and she welcomes the new U.S. President Joe Biden’s openness to action on sustainability-related matters, something on which ISS ESG has also written.

ISS ESG clients are able to use Corporate Ratings data to drill down into the performance of companies managing user-generated content and identify those best placed to deal with a changing regulatory environment. While portfolio screening and position re-weighting is always an option, the scale of the problems that can arise when public discourse is distorted by disinformation means that more creative approaches will also be considered. Asset owners might consider taking more direct action in support of the liberal democratic systems and institutions that underpin their ability to invest for the longer term, by engaging directly with companies, voting their shares (in the face of challenges arising from shareholder structures), and also looking further afield to engage with other stakeholders such as mainstream political parties.

As the growing risks associated with cyberattacks become apparent to investors, ISS ESG clients will be able to access the new Cyber Risk Score to identify and mitigate cyber risk
exposure present within their investments in order to ensure long-term viability and cyber resiliency.

In 2020 the world’s eyes were opened to the downsides of an unregulated digital society – political disruption, inability to effectively manage a pandemic, and high-profile cybersecurity breaches. In 2021 investors should be prepared to deal with the consequences of this new awareness.
The COVID-19 pandemic is not only a short-term economic risk factor. It is also set to entrench inequality in an unprecedented manner. While finance is often said to have exacerbated the trend towards rising inequality, it has definitely done little to brace itself for the long-term consequences of this phenomenon. However, sustainable finance has the opportunity to form a cornerstone of inclusive growth in a renewed “stakeholder capitalism” model, particularly if the learnings from climate change research about harnessing the correct metrics are applied to socially focused investment policies.

Rising Inequality

The COVID-19 pandemic risks causing social inequality to soar within rich nations. As real wages have stagnated vis-à-vis capital income, economic inequalities have risen constantly over the past five decades. And just when an economic upturn was able to disguise some of the growing disparities in income and wealth distribution, the COVID-19 pandemic has hit the economically vulnerable the hardest.

The pandemic is likely to continue casting a shadow over the vulnerable even when the worst health consequences have passed and the broader economy is headed back to recovery. IMF Economists have found that a pandemic is followed by rising economic inequalities.

Measures of inequality go up after a pandemic, and the incomes of those with low levels of education tend to decline disproportionately, given they tend to bear the brunt of job losses. Even now, when frontline workers like postal deliverers or checkout clerks seem more indispensable than ever, their bargaining power diminishes through the greater competition they face from laid off staff elsewhere. They also run the risk of becoming victims of further
company-side automatization, e.g., as self-checkout lines in supermarkets become more accepted.

While to date the employment of skilled workers has been fairly resilient given their ability to work from home and run errands online during lockdowns, employees with basic education lose out in the long term. With government support in many rich nations scheduled to fade in 2021, a more inclusive growth trajectory looks way out of sight, despite its prominence in SDG #10.

**How to Tackle Inequality as an Investor**

Many economists argue that inequality hampers growth through reduced consumption; concentration of power and increased rent-seeking; and increasing financial and societal instability. The latter connection was starkly revealed in 2020 in the global #BlackLivesMatter movement and in 2021 through the U.S Capitol invasion. Investors are not yet prepared for the risk inequality bears.

![Rising inequality - ensuing social tensions?](image)

*Figure 8: Average Topic Scores “Inequality” and "Non-Discrimination", ISS ESG Country Rating, OECD countries, Source: ISS ESG Data*

Compiled using data from the ISS ESG Country Rating service, the above graph illustrates the association between a declining score at a national level for inequality and for non-discrimination policies. Over the last five years, as measures of inequality have declined, so have national-level measures of non-discrimination, for countries within the OECD.

While the world has seen some natural convergence across countries, domestic inequality is going relatively unaddressed by institutional investors. One reason for this might be the lack of an agreed “global norm” serving as a generally accepted target, comparable to the 2°C target from the Paris Agreement in the arena of climate change.

However, corporates – and hence investors – can positively influence social cohesion on many levels. What’s necessary for this to materialize are meaningful and widely accepted metrics to capture these opportunities. The push for this comes not only from non-
governmental actors but increasingly from business itself, as exemplified by Measuring Stakeholder Capitalism, the whitepaper jointly authored by the World Economic Forum and International Business Council.

The first crucial element is to focus on labor relations more specifically. While core labor rights such as collective bargaining and safe working conditions should be adequately ensured at a minimum, these only indirectly support a more equitable society. More transparency is necessary with regard to pay and benefits, as well as with regard to the exploitation of non-regular labor. For instance, corporates could readily disclose information on their overall wage levels versus an established benchmark, e.g., national poverty lines. ESG disclosures should also emphasize wage growth vis-à-vis growth in revenue and profits.

The second element would be a national examination of fair taxation and responsible public policy efforts. Responsible tax policies have gained prominence in recent years, based on a mixture of raised public scrutiny and regulation. However, new data suggests that tax avoidance and evasion harm many economies throughout the world, especially in the poorer parts. Moreover, responsible treatment of society doesn’t stop at the taxman. Corporates are often involved in public affairs and lobbying. Keeping a closer eye on the ratio of spending to influence public policy versus non-influencing payments (i.e., taxes) would broaden the picture of a company’s societal responsibility.

Thirdly, and more traditionally in the governance domain, executive pay packages should be evaluated not only against corporate financial performance, but also assessed against socially acceptable levels and towards keeping employee motivation in check. This element is discussed in greater detail in Topic 10 below. CEO pay ratios have not only risen sharply, especially vis-à-vis general wage growth, they are also varying enormously across corporations. While U.S., U.K. and Indian companies are required to disclose median CEO pay ratios, data for the rest of the world remains patchy. And while disclosure is high in countries with respective legislative requirements, the reporting is not always of an adequate quality.

Dividend policies are also often neglected as potential levers in the context of promoting the “S” in ESG. While dividends extract value from an enterprise, from a sustainable finance perspective they are rarely measured against wage growth or even capital.
expenditure. Clean and economically accurate capital expenditure data is key to such long-term reasoning.

**Sustainable Finance as an Enabler for Inclusive Growth**

Sustainable finance is widely seen as a key enabler for green growth. It can develop into the same role for inclusive growth. While regulation will eventually also stretch further into the social dimension (it is expected that the EU’s subgroup on social taxonomy will deliver its first report in 2021), developing further metrics and requiring greater transparency efforts in this regard can also help reduce portfolio risks. And while sustainable finance apparently doesn’t come **as a free lunch either**, there are opportunities for investors as more equitable growth also entails an expansion of the economy as a whole.

Many issuers and investors have begun to harness the potential of social financing, as social bonds have seen an **impressive growth of 778% in 2020** as well as considerable innovation, as in the examples of Mexico’s inaugural SDG Impact Bond or the increasing amount of general purpose sustainability-linked obligations which also encompass social targets.

Sustainable finance came to life on the eve of the financial crisis, when finance faced accusations of being self-serving and having lost touch with the real economy. More than ten years in the sector is able to successfully link complex “real world” risks such as **climate change** and incorporate them effectively into financial instruments – reconnecting financial markets to the real economy.

In 2021 sustainable finance can seize the opportunity to mature also on the social dimension, paving the way for more inclusive global growth, a key element in a renewed “stakeholder capitalism.”
Topic 4: Sustainable Finance Regulation

Lydia Sandner, Associate Vice President, ESG Ratings and Regulatory Affairs, ISS ESG

The last few years have marked a rapid growth in the finance sector’s appreciation of the importance of sustainable finance. While this has been reflected initially in market initiatives and voluntary standards, more recently mandatory regulation on the national, regional and international levels has emerged, and it is anticipated that this will be a major issue for global investors through 2021.

This development has been strongest and is currently most advanced in the European Union, with several pieces of legislation already adopted. However, New Zealand, Canada and Australia are following suit with roadmaps including recommendations for regulatory actions and initiatives. In Asia, sustainable finance initiatives are also advancing in countries such as China, Japan, Malaysia and Singapore. Meanwhile, in the U.S., new rules at the SEC and the Department of Labor have been perceived as discouraging responsible investment practices, rather than promoting them. There are encouraging signs that this will change with the Biden administration, however.

The below map illustrates the progress of sustainable finance regulatory initiatives around the world, with darker colors indicating more developed regulations.

Figure 10: ISS ESG Sustainable Finance Regulation Heatmap
Objectives of regulation generally include:

- Adequate management of ESG risks in investment and financing decisions;
- Prevention of greenwashing: transparency and clarity for customers regarding sustainable investment products; and
- Redirecting capital flows to support sustainable development and the low-carbon economy.

As a result, hot topics in regulation at the moment include sustainable investment taxonomies (with numerous countries developing such taxonomies) and ESG risk integration in investment decision-making.

A strong focus on climate risks is maintained but is often extended to further environmental risks (especially biodiversity for example, but also water and the circular economy) or a whole range of environmental, social and governance topics.

It is important to point out that both risks and impacts are being addressed. Often described as “double materiality,” this refers to financially material ESG risks for the company on the one hand and impacts from company activities on society and the environment on the other hand.

At a supervisory level, climate risk is increasingly integrated into stress tests, where financial market participants are required to demonstrate their resilience and risk management. Moreover, disclosure with regard to the management of climate risks, aligned with the TCFD recommendations, is set to become mandatory in some jurisdictions.

In 2021, we are likely to see more regulatory initiatives developing or coming into force:

- In the EU, the Sustainable Finance Disclosure Regulation (SFDR) will come into force. The SFDR and its implications for investors is discussed in detail in the EMEA edition of this year’s ESG Themes and Trends report. Moreover, requirements under the EU Taxonomy Regulation will be further specified and come into force from the end of December. ISS has recently launched a specific taxonomy solution to assist investors to deal with the requirements of this new regulatory package. In addition, a revised Non-Financial Reporting Directive will be proposed by the European Commission, and the Renewed Sustainable Finance Strategy, the continuation of the EU Action Plan, will be published with proposals for further sustainable finance initiatives.

- The Australian and New Zealand markets continue their march toward sustainable finance. We should see further regulatory initiatives in New Zealand based on the recommendations of its sustainable finance roadmap, on top of mandatory TCFD disclosure obligations. In Australia, initiatives proposed in the roadmap of the Australian Sustainable Finance Initiative will likely be industry-driven, but nevertheless ambitious.

- Asia has not traditionally been a leader in sustainable finance, but regional markets are likely to catch up. In Japan, both industry and government are committed to promoting sustainable finance, while the Chinese government plans to work on climate investment and financing policies and standards, and lead international cooperation in this area. In Hong Kong, a Green and Sustainable Finance Cross-Agency Steering Group was set up by the financial regulator to coordinate the management of environmental risks and accelerate the growth of sustainable finance in Hong Kong.
More information on sustainable finance regulation in Asia can be found in Topic 1 of the regional edition of the ESG Themes and Trends 2021 paper.

- As for North America, the U.S. is expected to rejoin the Paris Agreement in 2021. Moreover, the Federal Reserve intends to join the Network for Greening the Financial System, a global network of central banks, and is expected to move forward with relevant commitments. President Biden has also committed to set a Net Zero emissions target and achieve 100% clean energy by 2035. In addition, the EU has proposed a comprehensive transatlantic green agenda in partnership with the U.S. for mid-2021. Among the proposals is a global regulatory framework on sustainable finance, and transatlantic cooperation on the design of such a framework.

For financial institutions offering products in relevant jurisdictions such as the EU, this means that they need to look at their products to make sure that they are aligned with regulation. This involves getting data on ESG risks and impacts for the assets in their products, developing an approach to considering these risks and impacts in the investment process, and preparing respective disclosures. In addition, for specialized ESG products, there needs to be clear descriptions of the ESG criteria and sustainable investment approaches applied, including, where applicable, a reference to and use of taxonomies.

With its broad approach of covering both sustainability risk and opportunities while applying double materiality, ISS ESG is well positioned to assist clients address regulatory requirements. For specific EU regulations such as the Taxonomy Regulation and the Benchmark Regulation, we have already developed specific product solutions. In addition, our ESG ratings data, climate solutions, Sector-Based Screening and Norm-Based Research enable the identification and management of ESG risks and adverse impacts. Moreover, the Climate Impact Report, which includes a specific TCFD section, helps investors address the increasing climate-related requirements in many global regulatory frameworks.

Over the next few years, a number of the major global sustainable finance regulatory initiatives begin to take effect. Investors will need to be well informed on which are relevant to their operations, and prepare to deal with increased governance and transparency requirements.
The sharper focus on racial equality that began last spring in the U.S. has permeated the globe, potentially affecting investors in every region and elevating the debate around social and racial injustice and inequalities globally.

Many institutions have shown solidarity and participated in the conversation around diversity. However, this has also raised potential investor concern about actions that seek to increase social capital rather than represent commitments to deeper change. Accordingly, ISS ESG’s board and executive diversity data is highly relevant to the many institutions now working to incorporate these factors into their investment processes.

The State of Diversity in Corporate America

ISS ESG estimates that in the United States, under-represented ethnic groups make up 40% of the population but only 12.5% of board directors – up from 10% in 2015. Nine out of 10 director positions with the most influence over the direction of the company and the board are white. Black directors made up just 4% of the total (up from 3% in 2015) and Black women make up just 1.5% of the 20,000+ directors. Women made up 21% of directors in 2019, up from 13% in 2015.

Across the 3,000 largest U.S. corporations, 29% of companies now have two or more ethnically diverse directors – seven percentage points up from 2016. 66% of those boards now have two or more women – 27 percentage points up from 2016. Despite this slight increase, 84% of these companies have no ethnically or racially diverse senior executives among their top five, down only 1.4 percentage points from 2016.

ISS ESG research suggests that only 4% of large U.S. companies are able to demonstrate at least half of the 12 qualities of a diverse board (these include aspects such as 3+ diverse directors, 2+ diverse women, 3+ ethnic groups represented, diverse board chair or CEO, diversity incentives in executive compensation, among others).
Why Representation of Diverse Individuals Matters

Organizations with brief and superficial responses to calls for greater diversity and inclusion can face reputational damage as well as operational and legal risks. Governments are increasingly legislating to require companies to conduct salary gap audits and reveal salary disparities between women and men, as seen recently in Spain, following the steps of other European countries like the U.K., France and Sweden. Furthermore, new listing rules related to disclosure and transparency are now a reality, and organizations may be penalized for not fulfilling minimum requirements. In early December 2020, Nasdaq filed a proposal with the U.S. Securities and Exchange Commission to require all listed companies to have at least one board member who identifies as female and at least one board member who identifies as LGBTQ or as a member of an underrepresented group.

Until recently, measuring the impact of diversity has been elusive due to insufficient disclosure. ISS ESG understands the client need for highly accurate and timely data that is actionable. Our recently expanded data sets include the racial and ethnic characteristics of senior leaders at more than 6,000 U.S. corporations, including more than 33,000 directors and 6,800 named executive officers. Furthermore, in 2020 ISS launched the ISS ESG U.S. Diversity Index, the first index to integrate both ethnic and gender representation for Directors and Named Executive Officers. An analysis of data underlying the Index found a significant increase over recent years, with 300 companies meeting the minimum requirements as of November 2020 compared with only 147 three years ago. As shown below, this index, incorporating large-, mid-, and small-cap companies, has outperformed both the S&P 500 and the Russell 1000 since inception.

![Graph showing outperformance of ISS ESG U.S. Diversity Index vs Broad U.S. Benchmarks](image)

*Figure 11: Outperformance of ISS ESG U.S. Diversity Index vs Broad U.S. Benchmarks, Source: ISS ESG, ISSDIVUT index total return since inception on Nov 1, 2017.*

Integrating diversity and inclusion in investment portfolios can have a significant impact on financial performance. Companies with greater gender diversity exhibit better market performance and higher financial quality than those companies that do not prioritize
gender diversity. This has been shown in a recent ISS ESG study based on the Solactive GBS U.S. All Cap Index, which contains about 2,000 U.S. companies. Based on data spanning 2016 to 2020, we assessed the cumulative returns of companies with different gender-related performances. Four portfolios were created based on the ISS ESG Corporate Rating score for gender diversity, which ranges from very good diversity to lacking or insufficient diversity. This factor provides a rated entity with a numeric grade from 1 (D-) to 4 (A+), based on the level of female representation in management and in the executive management team. As can be seen in the figure below, the A+B portfolio consistently and clearly outperforms the C and D portfolios while also beating the overall index.

![Figure 12: Cumulative Total Return by Gender Score, Source: ISS ESG](image)

When looking at board composition, ISS Governance Director Data found that boards with at least two women outperform the Russell 3000 returns over three-, four-, and five-year periods, while male-dominated boards underperform over the same periods. Over a holding period of four years, the spread between the two groups is greater than 1% annually.

Similarly, board compositions with ethnically diverse directors (defined as three or more directors that belong to a minority ethnicity) outperformed boards without such individuals. Over four- and five-year holding periods, the less diverse boards underperformed the Russell 3000 by about 0.25%. Most dramatically, investors with holdings concentrated in companies without ethnic diversity would have lost out on 1.3% average additional returns annually over a four-year period, compared to investing in a basket of companies with strong ethnic diversity board signals.
What Should Be Considered Beyond Representation?

Business must acknowledge that efforts should not stop at the appointment of diverse people to key leadership roles. Although the recent debate has focused on gender and/or ethnic diversity, a holistic understanding of diversity and inclusion is required.

The conversation should evolve from “diversity,” which equals representation, to “inclusion,” which goes beyond. Relevant questions include:

- Does the company’s overall workforce reflect its social makeup?
- Does the company have policies in place prohibiting discrimination and harassment, and adequate channels to raise concerns?
- Does the company conduct and act on pay gap analysis?
- Does the company provide equitable opportunities to all employees in recruitment and selection, training, development and promotion?

Despite more than half of global companies rated by ISS ESG having a policy on non-discrimination covering the different requirements in varying degrees of detail (prohibition of discrimination on different grounds, non-discrimination principles covering all relevant aspects of employment and a prohibition of harassment and abusive behavior), data also show that only a small share of these companies have implemented significant measures to promote equal opportunities and diversity. Measures demonstrating that a company follows a strategic approach include:

- having a clear assignment of responsibilities (e.g., appointing a Diversity and Inclusion Officer);
- developing strategic targets,
- implementing action plans and programs focused on inclusion;
- offering training opportunities for both HR and staff in general (including awareness raising);
- setting up anonymous and confidential grievance procedures; and
- conducting audits and evaluations (e.g., supervision of recruitment or promotion procedures, pay gap analysis, etc.).
Only around 14% of companies with a policy on non-discrimination (covering the requirements in varying degrees of detail) have implemented from four to six of these measures and only 1% have implemented all six measures.

Diversity-related data needs to be looked at with a critical eye, and the challenges of data collection for some organizations will continue to be complex. However, the implications for investors and organizations are clear – companies exhibiting greater diversity and inclusion are potentially rewarding portfolio holdings. In 2021 we expect to see an increased research focus on this topic, particularly as companies move beyond simple measures of diversity and look to demonstrate true inclusion.
Topic 6: ESG’s Assets Might Just Be Its Biggest Asset

Anthony Campagna, Director of Research Integrated Financial & Impact, ISS ESG

2020 represented a banner year for ESG investing globally in many ways. One feature that might be the easiest to measure is the growth in assets under management (AUM). Funds and ETFs specifically denoted as “ESG” reached record levels of AUM in 2020, and 2021 is poised to break those records.

Through our communication with clients, prospects, industry peers, and academics, ISS ESG continues to measure a clear shift in investor sentiment in favor of ESG, and integrating it is a critical part of their investment process. Institutions have for decades looked at ESG components, but ESG investing has increased in prevalence over the last 5-10 years, beginning in Europe and now moving more global. That rise has been driven in part by increased regulatory changes, a more progressive view globally on social and environmental factors, as well as a focus on stewardship and governance at the corporate level.

But what has really been key is the determination of asset owners (institutional and retail) to drive change – these people are the capital providers which have spurred demand for ESG investment options. This demand has allowed (and, in a way, forced) asset managers/mutual fund houses/ETF providers to offer ESG strategies and focus on the E & S & G impacts on investments globally. These trends help support the long-term viability of ESG offerings and will continue to support their growth as well.

One key driver of the AUM growth in ESG has been an alignment with global policy and regulatory advancements. The Principles for Responsible Investment (PRI) has been key, with signatories expected to commit to being aligned with their six core principles. As of March 2020, there were 3,038 signatories (2,701 investors and 337 service providers) and the figure below highlights the level of growth we have seen since 2006.
One of the other key factors is performance. 2020 marked a very strong year for ESG fund and ETF performance, with many of the largest ESG-themed ETF’s and Mutual Funds outperforming their respective benchmarks throughout 2020. Continued strong performance of highly-rated ESG firms has helped performance, but alongside that notion of a “few good apples” our team published a white paper outlining the link between ESG and financial Quality (as measured by EVA Margin) in early 2020 and observed those results to hold throughout 2020 as well. The figure below highlights this relationship, with the most favorably rated ESG firms having the highest level of EVA Margin (higher is more favorable).

![Figure 15: Higher ESG Performance Related to Higher EVA Margin, Source: ISS ESG Corporate Rating data and ISS EVA (Investor Express).](image)

Notes: Data is for 12/31/2018. EVA Margin is the trimmed average (20% outliers excluded) and ESG Performance is the average. EVA Margin equals [(ROIC – cost of capital) * invested capital] / sales. Alternatively, EVA Margin is (NOPAT – capital charge) / sales and (sales – operating costs – capital costs) / sales. ESG Performance can range from 0 to 100 based on ISS's proprietary model. 1-5 are quintiles for sorts on ESG Performance.

Lastly, regulation has continued to have a heavy influence in the growth of ESG’s popularity and growth in AUM. In 2020 alone the global regulatory bodies proposed and passed groundbreaking regulation on ESG disclosure rules, climate change initiatives and alignment, diversity and inclusion targets, social equality, and corporate governance practices. These moves from regulatory bodies continue to highlight the need for diverse ESG offerings in the market, and drive investor demand directly toward these products.
Building off the progress made in 2020, 2021 is shaping up to be a material year for ESG investing as well. The Biden administration in the United States, representing the largest economy in the world (measured by GDP), can realign its administration’s position with those of other nations in the world through policy change and action. The changes that the new administration plans to bring to the U.S., coupled with other G7 member nations, will only help build on the importance of ESG and continue to attract assets from institutional and retail investors alike.

The retail space is a particularly interesting one when it relates to ESG, as the generational wealth transfer that is projected to happen over the next decade could fuel even more demand for ESG-related products. A study that was published by Wealth-X titled “A Generational Shift: Family Wealth Transfer Report 2019” estimated that by 2030 approximately $15.4 trillion of wealth will be transferred from individuals to their family members. This wealth transfer to the younger generation, who align more with ESG ideals and practices, is likely to support a continued boom in ESG AUM going forward.

The growth in AUM for ESG investments has one other positive outcome as we highlighted in other sections of this paper: the more investors care about ESG the more the C-suite will care about ESG and vice versa. The growth in the AUM of ESG only works to strengthen the messaging to management teams of the overall importance of ESG alignment at the corporate level.

The rise in AUM in ESG investing is not without risks and challenges, and while it has been very strong over the last decade and has accelerated recently, the challenges ahead persist. As ESG attracts more assets, it will be a natural progression for the importance of high quality, actionable, and independent analysis of ESG to grow. ISS ESG has positioned itself as an industry leader in all things ESG and beyond. Accessing quality data and analysis will help investors navigate the increasingly crowded waters of ESG investing confidently and consistently, and also hopefully to wield their influence with more confidence through 2021.
Topic 7: Biodiversity – Once It’s Gone, It’s Gone!

Dennis Tung, Environment Analyst, Norm-Based Research, ISS ESG

Why Does Biodiversity Matter?

Around the world, threats to biodiversity are increasing, ranging from habitat loss caused by deforestation in the Amazon, to the 2019-2020 bushfires that killed billions of animals and insects in Australia. Within the next few decades, about 1 million species will face the threat of extinction, pushing the world closer to a point of no return, a tipping point called the Planetary Boundary for biodiversity loss. Beyond nature’s inherent value, biodiversity loss represents a tangible material risk to companies and their investors because most businesses directly or indirectly depend on ecosystem services underpinned by biodiversity. According to the World Economic Forum (WEF), more than half of the world’s gross domestic product is moderately or highly dependent on nature and its services. Furthermore, in its Global Risks Report 2020, the WEF ranked biodiversity loss in the top five global risks in terms of likelihood and impact.

Many industries continue to rely upon or are complicit in deforestation and the destruction of natural habitats. As a result, wild animals are forced to find new habitats, potentially in areas with higher human populations. This increases the risk of zoonotic
transmission, the passing of viruses from insects or animals to humans. The COVID-19 pandemic clearly demonstrated the consequences of society’s failure to properly conserve and protect biodiversity. SARS-CoV-2, the virus that causes COVID-19, is a zoonotic disease. The persistent encroachment of human populations onto previously natural habitats increases the risk of zoonotic transmission and the likelihood of another global pandemic infecting millions of people and crippling our economies.

How Are Investors Impacted?

According to the Global Futures report from the World Wide Fund for Nature, the failure to protect nature and its ecosystem services, including biodiversity, would result in a total cumulative loss of nearly $10 trillion from the global economy by 2050. At the portfolio level, the United Nations Principles for Responsible Investment has outlined how biodiversity loss is already impacting businesses as a result of transition and physical, litigation, regulatory and systemic risks which can affect investment value in the short, medium, and long term. A recent survey showed that close to 80% of asset owners and managers are very concerned about biodiversity loss, but feel they lack the data to appropriately act on it.

ISS ESG’s Norm-Based Research service has identified 192 publicly held issuers involved in a controversy where biodiversity loss or deforestation are the main issue, and 30% of them have been assessed as severe or very severe. 22% of the issuers with severe or very severe biodiversity or deforestation controversies are in the Food Products industry, reflecting its exposure to biodiversity and deforestation risks.

Biodiversity or Deforestation Controversies: Industry Distribution

- Food Products: 33%
- Automobiles: 22%
- Oil, Gas & Consumable Fuels: 12%
- Trading Companies & Distributors: 9%
- Metals & Mining: 7%
- Industrial Conglomerates: 7%
- Chemicals: 5%
- Other: 5%

Figure 16: Industries with Biodiversity Controversies, Source: ISS ESG Norm-Based Research Data.

By combining such incident-based data with other sources such as sustainability ratings and SDG-alignment assessments, investors are increasingly able to practice what they preach on the topic of biodiversity.
Stakeholder Scrutiny and Concerns

Demands from stakeholders for companies and investors to protect biodiversity have also steadily increased over the past few years, as have allegations against companies that have failed to do so. In 2020, several reports linked financial institutions to biodiversity loss, most notably Portfolio Earth’s Bankrolling Extinction Report, which described how the world’s largest banks have invested more than $2.6 trillion in sectors seen as the primary drivers of biodiversity destruction. As these reports become more common, investors should expect increased scrutiny on their biodiversity impacts. In the near future, some analysts predict that biodiversity will become another focus of shareholder proposals.

What are Governments and International Bodies Doing in 2021?

In May 2021, the UN Convention on Biological Diversity (CBD) will hold a Conference of the Parties (COP15) to adopt a post-2020 global biodiversity framework, seeking to galvanize international action towards achieving its 2050 vision of “Living in Harmony with Nature.” As the CBD is the preeminent international legal instrument for the conservation of biodiversity, the conference will define measurable targets that will drive not only improved corporate disclosure but also collaboration among stakeholders to identify and prevent adverse impacts. The outcome of the conference could result in significant changes for governments, corporations, and investors in the coming decades, as the CBD concluded that “business as usual” needs to stop after the world failed to fully achieve any of the CBD’s 2020 Aichi biodiversity targets.

An early mover, the European Union has designated the protection and restoration of biodiversity and ecosystems as one of six environmental objectives established in its Sustainable Finance Taxonomy. Adopted by the EU in July 2020, the legislation requires financial market participants to demonstrate how their activities contribute to and do not harm a set of environmental objectives and social safeguards. Disclosures on biodiversity will be required by the end of 2022, so investors should assess their impacts on biodiversity as soon as possible.

Key Investor Initiatives

Planned for release in 2022, the Task Force on Nature-related Financial Disclosures (TNFD) is a UN-backed initiative that aims to enable financial institutions to better understand their risks, dependencies, and impacts on nature. When complete, it could be a major step towards collaboration among financial institutions to positively affect nature, steering finance towards outcomes in alignment with the UN Paris Climate Agreement, the CBD Post-2020 Biodiversity Targets, and the UN Sustainable Development Goals. ISS ESG is a member of the TNFD’s Informal Working Group and will remain vigilant regarding developments, including the announcement of the Task Force’s scope, plan, and team after the CBD’s COP15 this Spring.
Currently, What Steps Can Investors Take to Manage These Risks?

ISS ESG has a range of solutions that investors can leverage to assess companies’ management of biodiversity loss and deforestation risks. Norm-Based Research (NBR) can help investors identify companies that are not aligned with international norms and guiding principles on environmental topics, and also associated issues such as human rights. ISS ESG’s Corporate Rating assesses companies’ sustainability performance based on industry-specific ESG criteria with a sector-based and materiality focused solution.

Forward-looking indicators are also important, with ISS ESG’s Sustainable Development Goal Impact Rating conducting a holistic assessment of a company’s impact on the UN SDGs, including SDG 15: Life on Land. ISS ESG’s Pooled Engagement service helps investors to exercise active ownership.

Biodiversity will be a key topic for responsible investors in 2021. By utilizing the right tools, there should be no hindrance to building this topic into portfolio management practices, both at a policy and implementation level. It is essential that the finance sector steps up to the plate on this critical topic – because unlike some other ESG topic areas, once biodiversity is gone – it’s gone.
Topic 8: Human Capital Management

Georg Präauer, Labor Rights Analyst, Norm-Based Research, ISS ESG

What is Human Capital and Why has it Recently Gained Momentum?

One of the key areas when analyzing the “S” of ESG is a company’s management of its human capital, which encompasses factors such as workers’ well-being, terms and conditions of employment, training, and health and safety. Companies have a direct impact on their own employees, but also an indirect impact on their subcontracted workforce and supply chains. Proper management of human capital can not only increase productivity, profitability and innovation, but also improve employer branding and resilience in times of crisis. In a world of rapid technological change, it is seen as imperative for companies to remain competitive.

Structures for sound human capital management are set out in global responsible business conduct standards such as the UN Global Compact and OECD Guidelines for Multinational Enterprises, and founded on the International Labour Organization’s (ILO) conventions, many of which have been in place since the first half of the 20th Century. Over the years further global commitments have been developed, for example under the UN Sustainable Development Goals (SDGs) or the World Bank’s Human Capital Project (HCP), a global effort to accelerate more and better investments in people for greater equity and economic growth.

The COVID-19 crisis has shed new light on the social side of ESG, although this has not always been in a positive sense. The sharp drop in activity in certain sectors has had a significant impact on companies and communities, reminding investors of the importance of the topic of human capital. The pandemic has been a stress test for companies’ human capital management, and in some instances an accelerator to pre-existing trends.
What are the Key Trends Concerning Human Capital?

The pandemic has highlighted health and safety and job protection issues in industries with pre-existing poor labor standards. A particularly poignant example is the meat processing industry, which has been facing a high degree of scrutiny for failing to protect workers during the pandemic, with many meat factories turning out to be hotspots for the spread of the virus. ISS ESG has noted that companies in the meat industry have traditionally performed poorly on working conditions, often relying on a vulnerable workforce in low-paid work with weak health and safety management systems. This left many companies in the sector ill-prepared for protecting workers during the pandemic, with a number of high-profile controversies highlighting high infection rates and fatalities in the industry’s plants.

Another example is the gig industry for ride-hailing and deliveries, where stakeholders have for many years criticized companies for denying drivers’ basic rights and employment protections by not employing them directly. This industry has seen an influx of workers who may have lost their jobs as a result of the pandemic as it has low barriers to entry, but the oversupply of drivers has further increased the pressure on wages or fees per gig, and stakeholders have noted worsening trends of precarious work.

In the apparel sector the pandemic exposed weaknesses in global supply chain structures, with global brands either cancelling orders or in some cases not paying for orders already in production. The Business & Human Rights Resource Centre has estimated that around $16 billion orders have been left unpaid worldwide by retailers, impacting millions of workers furthest down the supply chain, predominantly women. These workers already risked low wages, dangerous and unsafe working conditions, and very few or no social protections before the pandemic. The NGO Clean Clothes Campaign estimates that 60 million vulnerable garment workers around the world have lost up to $5.8 billion of unpaid wages just in the period between March and May 2020.

Even prior to the pandemic, the #MeToo movement exposed companies which did not have adequate protections in place to protect employees from sexual harassment and that complaints were often not handled properly. The Black Lives Matter movement has also led to companies being challenged on their management of diversity and inclusion. Stakeholders are holding companies to account on their “social license to operate,” demanding greater alignment between management and boards and broader society.

ISS ESG’s research results show that human capital is a challenge across a large part of the economy. Norm-Based Research notes that of all identified controversies for publicly held entities in the “S” area assessed as severe or very severe, some 28% relate to human capital (defined as working conditions, workplace health and safety, workplace discrimination – including gender pay discrimination – and union rights).
Human capital controversies affect companies across a variety of sectors, though some in particular stand out. The top five sectors facing such controversies are Industrials, Consumer Discretionary, Consumer Staples, Communication Services and Materials, jointly representing nearly 85% of all human capital controversies assessed as severe or very severe.

**Figure 17: Human Capital Controversies, Source: ISS ESG Norm-Based Research Data.**

**How Can Investors Address the Increased Focus on Human Capital?**

Stakeholders globally have responded to the negative pandemic-related developments for human capital by advocating for better labor standards. For instance, under the umbrella of the [Interfaith Center on Corporate Responsibility](https://www.ifi.org/), investors gathered to pressure meat processing companies to enhance worker protection.

More broadly, there are also initiatives at the international policy level which can guide investors in their efforts to consider human capital. In June 2019, the [ILO member states adopted the Declaration for the Future of Work](https://www.ilo.org/declaration/declarationforfutureofwork2019/lang--en/index.htm) in response to transformative changes that were ongoing even before the pandemic – such as technological innovations, demographic shifts, climate change and globalization.

Among the recommendations, the ILO’s Future of work commission calls for a “human-centred agenda for the future of work that strengthens the social contract by placing people and the work they do at the centre of economic and social policy and business practice.” It also reaffirms the social justice mandate the ILO was given 100 years ago, and the critical role of social dialogue and international labor standards. The commission identifies possible ways to achieve this and highlights lifelong learning for all, supporting
people through transitions, a transformative agenda for gender equality and strengthening social protection.

ISS ESG has a range of solutions that investors can leverage to assess companies’ management of human capital and associated topics. Norm-Based Research can help investors identify companies which are not aligned with international norms and guiding principles on labor rights, and also associated issues such as payment of taxes. The ISS ESG Corporate Rating allows for a portfolio-level assessment of companies’ sustainability performance, including metrics related to human capital issues, with a sector-based and materiality focused solution.

In a report published in 2020, ISS ESG noted that the COVID-19 pandemic was proving to be a tenacious stress test for companies’ stated labor policies, and an unfortunate accelerant to pre-existing trends towards precarious work. On the positive side, ISS ESG data found an uptick in corporate commitments to minimize the impacts of the pandemic. Investors may deem it beneficial to reinforce this message, and encourage portfolio companies to act on human capital commitments as needed.
How to Feed a Growing Population Sustainably: Status Quo of the Food & Beverages Industry

The global population is projected to reach nearly 10 billion by 2050. Meeting the growing food demand by merely expanding our current agricultural production system will have serious environmental consequences, including contributing to and being affected by climate change; land degradation; declining soil health and biodiversity; water overuse; and pollution. Intensive livestock and feed crop farming takes a particular toll – accounting for 14.5% of all anthropogenic greenhouse gas emissions alone – and surging meat demand in emerging markets intensifies the issue. Furthermore, one-third of food is lost or wasted.

ISS ESG Corporate Rating data shows that the majority of the industry is currently failing to ensure sustainable agricultural practices along its value chain and to reduce food waste in the supply chain, its own operations and on an end-consumer level. While 23% of Food and Beverages companies perform at a medium level or better when it comes to soil and biodiversity management in agricultural production, only 14% score comparably when it comes to climate impacts of agricultural production (Scale D- to D+ = poor / C- to C+ = medium).
Shifting to more sustainable agricultural practices and reducing waste alone is not sufficient: A change in dietary behaviors will also be a key determinant of society’s ability to feed the planet’s growing population within planetary boundaries. If this was not enough already, we are also midst a global obesity epidemic - while hunger is still on the rise, more deaths annually can be attributed to the long-term effects of diet-related non-communicable diseases.

ISS ESG’s Sustainable Development Goals (SDG) Solutions Assessment demonstrates that only a minority of product portfolios in the Food & Beverages Industry can be considered as net contributors to the fight against malnutrition and hunger, and the promotion of sustainable agricultural practices; both essential to deliver SDG #2. It is evident that there is still a long road ahead.
Ringing in the Decade of Transformations in the Global Food System

In September 2021, the UN Food Systems summit takes place. This is a critical milestone in deciding on bold action to transform our global food system by 2030 and deliver on all the relevant Sustainable Development Goals. Industry, governments, and investors will face significant expectations that they lead the way in this area.

From a regulatory perspective, there are several developments that will potentially impact the industry. The EU taxonomy for sustainable activities, for example, recognizes agriculture as one of the sectors which are of particular relevance for the transition to a low-carbon economy and sets standards for what can be considered “environmentally sustainable.” Similarly, the major social and environmental consequences of livestock production, and particularly factory farming (see ISS ESG’s overview on the true cost of factory farming), have led to discussions on regulating the sector. Some countries are even debating a meat tax comparable to pre-existing sugar taxes. Companies that are prepared will be ahead of regulation here and will also be able to amplify and profit from another trend: a perceptible shift in consumer behavior.

Consumer behavior has the potential to be the true driving force of change. The overall demand for animal protein may still be increasing, especially in emerging economies, but the link between zoonotic diseases and meat consumption as well as animal welfare concerns have alerted consumers globally. With consumers now more than ever rethinking how and what they eat, and vegetarian, vegan and flexitarian diets on the rise, the demand for alternative proteins and environmentally friendly food is increasing.

A study by IBM shows sustainability is high on global consumers’ purchasing agendas in 2020. For 77% of them, sustainable and/or environmentally responsible brands are at least moderately important, and 73% are willing to pay more for brands that use organic ingredients.

Food & Beverages companies’ use of raw materials / products from certified organic farming

![Graph showing the percentage of food and beverages companies using raw materials/products from certified organic farming.](image)

Figure 20: Source: ISS ESG Corporate Rating universe data for the industry Food & Beverages (n=303)

While demand for sustainable products is increasing, supply remains quite low. The share of raw materials and products certified to an organic standard in the Food & Beverages industry, for example, is negligible, as ISS ESG Corporate data shows.
The emerging trend is thus providing ample growth opportunities in the food market, driving disruptions, and spurring innovation. Developments include lab-grown meat, diverse plant-based products, regenerative agricultural practices, novel production technologies, and new approaches to protein production such as indoor fish factories.

The Role of the Far-Sighted Investor – Risks and Opportunities

The food and agriculture sector accounted for approximately 10% of global GDP in 2018. Most investors are therefore likely to have at least some exposure to the industry. In addition, livestock production represents about 40% of the global agricultural sectors’ value.

This is also reflected in ISS ESG data showing that 36% of Food & Beverages companies are involved in the sourcing and production of red-meat products. More than 50% of these companies are estimated to generate 10% and more of their net sales from red meat-based products. Given our growing population, the intensification of the climate crisis, and regulatory transformation efforts, the food industry must become more sustainable to keep up and stay in business. Continuing with business-as-usual – conventional agricultural practices and expansion of production – will affect investors’ portfolio returns if not adequately managed through:

a. **Direct financial risks**: Revenue losses due to risks of intensive farming such as supply disruptions and harvest losses, and lacking climate-resilience. The more natural resources essential for agricultural production – land, soil, water – are exploited, the more agricultural land will become a stranded asset. It is time to shift the investment focus on regenerative practices which are also profitable. Better soil also improves land’s capacity to sequestrate carbon. The sector has the potential to mitigate its own enemy – climate change.

b. **Reputational risks**: Allegations and problematic practices such as labor scandals, deforestation, biodiversity destruction or factory farming have long been associated with the Food & Beverages Industry. ISS ESG data illustrates that 30% of companies in the Food & Beverages Industry are involved in controversies with a high prevalence in the area of environmental protection and labor rights. Investor pressure – particularly with regard to deforestation and the Brazilian meat industry – has increased through 2020. ISS Governance services related to proxy voting, stewardship, and engagement can be utilised by investors wishing to use their influence to drive change.
**Business Ethics** includes cases on corruption, anti-competition, accounting fraud, and tax avoidance.

*Figure 21: Exposure to ESG Controversies, Source: ISS ESG Corporate Rating universe data for the industry Food & Beverages (n=303), as of January 1, 2021.*

c. **Market risks:** Companies with high exposure to animal protein are undergoing disruption. Laggards may not be able to keep up – the U.S.’s largest milk producer [filed for bankruptcy in early 2020](#). Investor initiatives such as [FAIRR](#) have identified critical sustainability challenges for the animal protein sector through their research, and put increasing pressure on meat companies to adapt practices and diversify their product portfolios.

d. **Regulatory risks:** A [meat tax](#) or changes in agriculture/livestock production regulation bear higher cost for conventional producers and may impact revenue streams.

2021 brings opportunities for investors to take action in supporting the transformation of the global food system. ISS ESG’s product offerings – ranging from Norm-Based Research and Sector-Based Screening to ESG Corporate Ratings, SDG Assessments Solution and Pooled Engagement Services – provide investors with the necessary tools to assess, monitor and influence risks and opportunities related to the Food and Beverages industry, as the edge of the planetary boundary moves ever closer.
Topic 10: The Rise and Rise of E&S Incentives

_Casey Lea, Executive Director of Research Integrated Financial & Impact, ISS ESG_

Incentive compensation programs provide a rare window into the strategic priorities the board emphasizes for management. Investors are increasingly demanding environmental and social (E&S) metrics be included in these priorities.

Historically, the purpose of executive incentive programs was to align CEO pay with shareholder value. Financial performance is implied within the pay-for-performance construct. As a result, the dominant metrics used to drive CEO pay are earnings or stock price related. E&S incentives were often seen as an afterthought or a mechanism to supplement executive pay when financial performance lagged.

Today, E&S incentives have become a critical issue for compensation committees around the world, and adoption has more than doubled since 2018. This rapid increase in adoption means investors must be mindful of not just who is adopting these incentives, but also what type of metrics are being used, how important they are in driving executive pay, and the performance period on which they are measured.

% of Companies With at Least One E&S Incentive

Figure 22: Company E&S Incentives, Source: ISS ESG, Universe: United States, Canada, EMEA, AUS/NZL.

Who and Where?

It is critical to understand which companies are most likely to adopt E&S incentives when prioritizing engagement with portfolio companies. The two key drivers of adoption are geography and sector. While the U.S. may have the most companies adopting E&S incentives, the highest adoption rates are in Europe where sustainable investment is more mature. Sectors with the highest physical risk are the most likely to adopt E&S incentives. Just behind Europe is Australia and Canada, a byproduct of the substantial concentration of Energy and Materials companies in those markets.

The figure below highlights just how popular E&S incentive metrics have become, but also how much more room for growth in adoption there is in major markets globally. Notably
under 8% of all firms in the U.S. have E&S incentive metrics included in their compensation package targets.

% of Companies With at Least One E&S Incentive by Country

Figure 23: Where are E&S incentives most often used? Source: ISS data.

The ISS ESG research team analyzes ESG issues based on up to 100 rating criteria, most of them sector specific. The indicators are constantly reviewed and developed to align with the latest scientific findings, technological developments, regulatory changes and social debates. Analysts gather information through media and other public sources, conduct interviews with stakeholders, and collect information on company policies and practices. Extensive company and stakeholder dialogue, coupled with strict verification, ensures objective and in-depth research. When the E&S incentive results are overlaid with those ISS ESG performance scores, it becomes clear that Energy ranks the lowest (least favorable), but somewhat surprisingly Utilities rank near the highest (most favorable). We can infer that the Utilities sector has put in place the highest number of E&S metrics, helping to improve its overall scores through time. The Energy sector has begun this transition as well, but has a very high hurdle to overcome in the future.

% of Companies With at Least One E&S Incentive by Industry (GICS 2)

Figure 24: Industries using E&S incentives, ISS data.
What Types of Metrics?

While safety remains the most common sustainability incentive, investors’ increased focus on sustainability and widespread protests over racial inequality have led companies to consider other metrics as well. Diversity and staff relations/training are the emerging metrics.

**Figure 26: What E&S metrics are being used**

Source: ISS data.
Weight and Duration

Three of the most important considerations when evaluating the “strength” of E&S metric inclusion are weight (or the percentage of the incentive plan), duration (how long do they have to achieve the goal) and structure (how performance will impact compensation).

- **Weight** is a strong proxy for how much time the board wants the CEO focused on the E&S targets. If the metrics are simply add-on or non-material, they can be pushed aside without a material impact on compensation. But if they are material a management teams’ ability to ignore them will directly impact their compensation. Incentives dictate behavior.

- **Duration** is important to determine if the company takes a short- or long-term approach to sustainability. Analyzing the time horizon that metrics are measured against can highlight the view and approach that management may take. Metrics only focused on the short term may align management teams to ignore potential longer-term consequences (under investing in the future), while only long-term goals could eliminate any sense of urgency to improve on the status quo. A healthy balance of long, medium, and short-term alignment can provide a balanced approach to improving a firm’s E&S scores and impact sustainably.

- **Structure** is also critical for the optics of E&S metrics. E&S metrics often align with tangible measures of “acceptable” failures (i.e., safety incidents, staff health and safety) where anything below 100% implies that some loss/injury/accident is acceptable. For example, for a metric like safety, it may be more appropriate to reduce compensation when accident rates hit a certain threshold versus a measure of employee retention where higher levels may warrant additional pay.

Investors may want to balance these considerations with the overall complexity of the incentive plans when assessing the efficacy of E&S inclusion.

What Gets Measured Gets Done

As the E&S metrics continue to become more popular, benchmarking will also become stronger, allowing management teams to be compared and judged on progress. We view the increase in inclusion as very favorable as it continues to bring E&S issues to the forefront of management teams’ day to day operations and in doing so should continue to improve ESG scores globally. The inclusion of E&S metrics in remuneration practices is a key lever being pulled by several investor initiatives globally, and we can expect this to be an issue that responsible investors will want to be on top of in 2021.
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